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The Economic Adjustment Programme

Cyprus
6th Review - Spring 2015

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European Commission

Directorate-General for Economic and Financial Affairs

The Economic Adjustment Programme

Cyprus, 6th Review – Spring 2015

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The text reflects developments until 15 May 2015

EXECUTIVE SUMMARY

Staff teams from the European Commission (EC) and the International Monetary Fund (IMF), in liaison with the European Central Bank (ECB), visited Nicosia from 27 January to 5 February 2015 and from 28 April to 8 May 2015 for the sixth review of Cyprus' economic adjustment programme, which is supported by financial assistance from the European Stability Mechanism (ESM) and the IMF. The objectives of Cyprus' programme are to restore financial sector stability, strengthen public finance sustainability, and adopt structural reforms so as to support sustainable and balanced long-run growth. Following the effective entry into force of the earlier adopted foreclosure law, including procedural rules for sale by auction of foreclosed properties, a staff level agreement was reached with the Cypriot authorities on policies that could serve as a basis for completion of the sixth review.

The economy is emerging out of recession. Following further moderation in the contraction of GDP in 2014, growth returned to positive territory in the first quarter of 2015. Short-term indicators suggest that this return to growth was driven by private consumption and exports, supported by lower energy prices and the euro depreciation. The labour market continues to show signs of stabilisation, while unemployment remains high. Growth is expected to settle at 0.2% this year, gradually regaining strength in 2016.

The fiscal target for 2014 has been overachieved by a wide margin, with a primary surplus of 2.6% of GDP in 2014, well above the programme requirement of a primary deficit of 1.3% of GDP. However, due to the one-off effect of the recapitalisation of the Coops, the headline deficit reached 8.8% of GDP. Taking into account the 2014 fiscal outcome and updated macroeconomic projections, the 2015 government primary balance target has been revised from a deficit of 1.6% of GDP to a surplus of 1.5% of GDP. The authorities will need to continue implementing their budget prudently in light of existing risks and, if required, take additional measures, in order to achieve a primary surplus of between 3% and 4% of GDP in the medium term, which would ensure that public debt is put on a sustainable downward path.

Reforms in the financial sector have progressed, but addressing the level of high non-performing loans remains the key priority. The deposit base has stabilised, banks' reliance on central bank funding has been further reduced. While the authorities continue to closely monitor the liquidity situation of the banking sector, all payment restrictions have been lifted in line with the government's roadmap without causing liquidity concerns. Banking sector exposure to Greece has been further reduced. Faced with still-rising non-performing loans (NPLs), banks and cooperatives have continued their loans restructuring actions, but efforts should be deployed to improve the sustainability of the restructurings offered to borrowers. The restructuring of the cooperative sector is progressing in line with the commitments, but challenges remain notably related to governance.

A comprehensive reform of corporate and personal insolvency laws has been adopted, which paved the way for the completion of the foreclosure framework. This legislation is an important instrument to help reducing the high level of NPLs, which is essential to restoring growth and job creation in Cyprus. The programme partners will support the authorities in implementing and monitoring the performance of the insolvency and foreclosure frameworks and make adjustments, if necessary. The authorities are also working on other measures to speed up the resolution of the NPLs, notably with regards to the sale of loans and to the transfer of issued title deeds.

Structural reforms have progressed, albeit at a slower pace, which calls for regaining momentum. The implementation of the National Health System (NHS) has been delayed to 2017, notably due to delays in finalizing the NHS bill and in initiating the procurement tender for the necessary IT infrastructure. In a first instance, priority will be given to implement reforms that strengthen the sustainability of the funding structure and the efficiency of public healthcare provision. Progress with regards to privatisation and corporate governance of state-owned enterprises has been uneven, notably due to protracted discussions with stakeholders and concerns whether key steps to prepare privatisation would gather a parliamentary majority. A firm commitment to the objectives of improving economic

efficiency, attracting investment and contributing to reducing public debt appears necessary in order to ensure timely implementation of the privatisation plan. The reform of the public administration has gained some traction, with a reform plan expected to be submitted after the ongoing consultation process with stakeholders. The revenue administration reform has overall progressed adequately, among others with the set-up of the integrated large taxpayer office, albeit with delays in some areas. A forceful implementation of the reform at operational level is now needed. The welfare reform is also progressing, with the processing of applications to the new Guaranteed Minimum Income scheme well under way and further reforms being prepared (notably on student and disability benefits and a single view of benefits). There continues to be a strong commitment by the Cypriot authorities to address the shortcomings identified by the OECD Global Forum, with updated statistics showing clear improvement. Also, the Anti-Money Laundering (AML) action plan continues to be steadily implemented by the authorities.

Regarding labour market reforms, a comprehensive methodology for monitoring and evaluation of ALMPs has been recently adopted and is being implemented, but the capacity of the public employment services to respond to their new tasks needs further strengthening. Finally, progress has also been made on reducing the title deed issuance backlog but further effort is needed, notably to streamline the issuance procedures.

The review is expected to be concluded with all necessary decisions by the Eurogroup, the ESM Board of Directors, and the Executive Board of the IMF to be taken by end-June. Its approval would pave the way for a cash disbursement of EUR 100m by the ESM, and about EUR 264m by the IMF.

1.	Introduction	7
2.	ECONOMIC DEVELOPMENTS AND OUTLOOK	9
2.1.	Macroeconomic Developments and Outlook	9
2.2.	Fiscal Developments and Outlook	14
2.3.	Financial Markets and Financial Sector Developments	18
3.	Programme Implementation	21
3.1.	Financial Sector	23
3.2.	Fiscal Policy	29
3.3.	Fiscal-Structural Reforms	30
3.4.	Structural Reforms	37
4.	Programme Financing and Debt Sustainability	41
5.	Risks to the programme	45
A1.	Compliance table	47
A2.	Macroeconomic projections	72
A3.	Financing Needs and Sources	77
A4.	Programme Documents	78
	Memorandum of Understanding on Specific Economic Policy Conditionality	78
	Cyprus: Letter of Intent	118
	Cyprus: Memorandum of Economic and Financial Policies	120
	Cyprus: Technical Memorandum of Understanding	129

LIST OF TABLES

2.1.	Main features of macroeconomic forecast	11
2.2.	Key macroeconomic and budgetary projections**	15
2.3.	Soundness indicators for the banking sector in Cyprus	19
3.1.	Summary assessment of compliance with policy conditionality for the sixth review (Q1 2015 - end April 2015)	22
3.2.	Fiscal accounts, projections for 2015-2016	30
A2.1.	Selected economic indicators	72
A2.2.	Use and supply of goods and services (volume)	73

A2.3. Use and supply of goods and services (value)	73
A2.4. Implicit deflators	74
A2.5. Labour market and costs	74
A2.6. External balance	74
A2.7. Fiscal accounts	75
A2.8. Debt developments	76
A3.1. Estimated financing need for the period 2014-2017	77

LIST OF GRAPHS

2.1. Real GDP and economic sentiment	9
2.2. Real gross value added and contributions to growth	9
2.3. Current account and net international investment position	11
2.4. Unemployment, employment and the labour force	13
2.5. HICP Inflation	13
2.6. Property sales	14
2.7. Borrowing from the Eurosystem	19
2.8. Deposit developments	20
2.9. Loan developments	20
2.10. Interest rates developments	20
3.1. Uninsured deposits at Bank of Cyprus: equity conversion and gradual release	26
4.1. Medium- and long-term debt amortisations	41

LIST OF BOXES

2.1. The treatment of ship-owners in ESA2010 and BPM6	10
2.2. Long-term unemployment in Cyprus	12
2.3. Cyprus export performance in goods markets	16
3.1. Banking sector downsizing in Cyprus: state of play	24
3.2. The Cypriot Insolvency Framework	27
3.3. CyTA's privatisation	33
3.4. Tax debt and its management in Cyprus	36
4.1. Debt sustainability assessment	42

1. INTRODUCTION

The report assesses compliance with the terms and conditions set out in the MoU, as updated following the fifth review mission. Following agreement between the Cypriot authorities and the programme partners, i.e. the European Commission (EC), the European Central Bank (ECB), and the International Monetary Fund (IMF), the updated MoU was signed on 9 December 2014 by Mr Pierre Moscovici, commissioner in charge of Economic and Financial affairs, Taxation and Customs.

The 3-year programme entails external financing by the ESM and the IMF of about EUR 10bn, for possible fiscal financing needs and support to the banking system. Around 90% of the programme envelope will be financed by the ESM, while the remainder will be financed by the IMF under an Extended Fund Facility.

A joint EC/ECB/IMF staff mission visited Nicosia from 27 January to 5 February 2015 and from 28 April to 8 May 2015 for the sixth quarterly review mission. It made significant progress towards reaching a staff-level agreement on the review. Following the effective entry into force of the earlier adopted foreclosure law including procedural rules for sale by auction, a staff level agreement was reached with the Cypriot authorities on policies that could serve as a basis for completion of the sixth review.

This report is based on information obtained during the sixth review mission, taking into account economic and policy developments until 15 May 2015.

The two prior actions in the updated MoU for the granting of the seventh disbursement were met. The two prior actions concerned the presentation to programme partners of two legal proposals, one that enables the sale of loans in line with international best practices and EU law, and another which ensures that issued title deeds are transferred to property buyers without delay, while safeguarding against abuse. Following the presentation to programme partners of the two legal proposals, the prior actions have been considered to be met.

A successful sixth programme review would unlock the disbursement of ESM's seventh tranche to cover financing needs arising until the end of the third quarter of 2015. In light of the government's comfortable cash position and limited financing needs, the seventh ESM disbursement in cash would amount to EUR 100m to cover deficit financing and redemption needs. The IMF would disburse about EUR 280m. After the disbursement by the ESM and the IMF, the government's cash balance is estimated to amount to around EUR 1bn at the end of Q2 2015.

The report is organised as follows. Section 2 examines recent macroeconomic, fiscal and financial developments. A detailed assessment of compliance of programme conditionality is reported in Section 3. Section 4 looks at programme financing and debt sustainability, while Section 5 discusses risks to the programme. Annex 1 contains a comprehensive monitoring table with an assessment of programme conditionality. Background tables are presented in Annexes 2 and 3. Programme documents are in Annex 4.

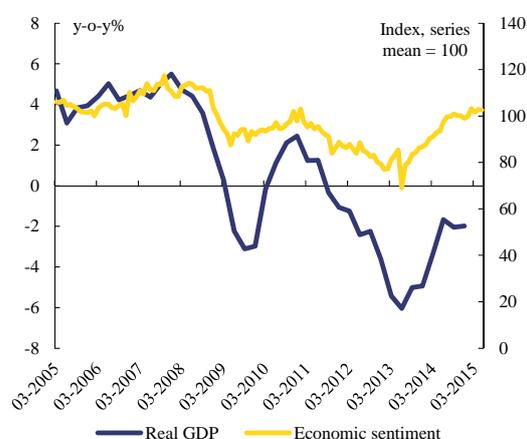
2. ECONOMIC DEVELOPMENTS AND OUTLOOK

2.1. MACROECONOMIC DEVELOPMENTS AND OUTLOOK

Real GDP fell by -2.3% for 2014 as a whole, i.e. significantly less than the -5.4% contraction recorded for 2013. The improvement was largely due to an increase in private consumption, which more than offset further decline in other domestic demand components. The increase in private consumption mainly reflected a base effect following its sharp contraction in 2013, but also the efforts of households to smooth consumption to mitigate some of the adverse impact of the recession. Real investment continued to show a significant drop, leading to a reduction of its share of real GDP from 27% in 2008 to 12% in 2014. Imports rose significantly, also reflecting a base effect, outweighing a nevertheless solid increase in exports. As a result the contribution of net exports to growth was negative in 2014.

Despite the easing recession, quarterly dynamics deteriorated in the second half of 2014. Quarterly national accounts data shows that the gradual moderation of GDP contraction observed since the second quarter of 2013 came to a halt in the second half of 2014, as growth settled at around -2.0% y-o-y (Graph 2.1), with the weakness mainly relating to domestic demand, particularly real investment.

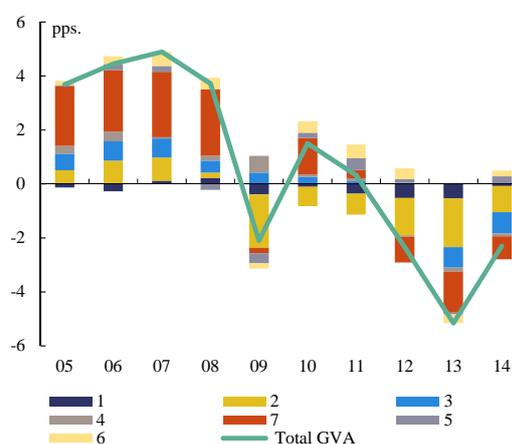
Graph 2.1: Real GDP and economic sentiment



Source: DG ECFIN and Eurostat

From a supply-side perspective, the economy was in 2014 supported by sectors relying on external demand such as professional business services and the tourism sector (Graph 2.2). While professional business services grew by about 3% in 2014, accommodation and food services expanded by 4% in real terms. On the opposite, real GVA in the construction sector declined by 23% in 2014, while bank deleveraging (see also Box 3.1) led to a 10% fall in real GVA in financial and insurance activities.

Graph 2.2: Real gross value added and contributions to growth



(1) Manufacturing (2) Construction (3) Financial and insurance activities (4) Public admin and defence (5) Accommodation and food services (6) Professional business services and (7) Others

Source: Cystat

The current account deficit widened to 5.1% of GDP in 2014, according to Balance of Payments (BoP) data⁽¹⁾ (compared to -3.1% in 2013) (Graph 2.3). While the trade and secondary income balances remained broadly stable in 2014, the primary income deficit widened by 1.4 percentage points (pps), mainly due to lower receipts of dividends from investments, particularly equity investments. Box 2.1 discusses how the new treatment of ship-owners, following the implementation of the new BPM6 standards, has affected BoP, national accounts and international investment position data.

(1) The current account balance shown in Table 2.1 is in National Account terms and suggests a smaller deficit than BoP data. The discrepancy arises due to methodological differences and revision schedules and is kept constant over the forecast horizon.

Box 2.1: The treatment of ship-owners in ESA2010 and BPM6

National accounts (NA), Balance of Payments (BoP), and International Investment Position data are now being published in accordance with ESA2010 and BPM6 standards. The implementation of ESA2010 led to a sizeable upward revision of the level of nominal GDP by around EUR 1.6bn, or 10% of GDP, in 2013 ⁽¹⁾ (Table 1). GDP growth rates remained broadly the same. BoP data was also affected, with a worsening of the current account deficit by EUR 242m (1.5% of GDP). The Net International Investment Position (NIIP) fell from EUR -14.1bn to EUR -28.4bn (from -78% to -157% of GDP).

One of the changes with the implementation of ESA2010 relates to the treatment of Special Purpose Entities (SPEs) and ship-owners ⁽²⁾. Reclassification of units according to the residency concept was clarified with the implementation of ESA2010 and has implications for the treatment of the SPEs and the ship-owning industry. Specifically, under the new treatment, a vessel registered in Cyprus is now treated as a Cypriot economic resident independently from the location of its activities. This was not necessarily the case under ESA95 unless the ship-owner was considered to have its main economic interest in Cyprus.

The new treatment of ship-owners has led to a larger fleet of vessels in Cyprus and changed the dynamics of exports of transportation services. BoP data now treats ship-owners in the same way as under ESA2010. In the BoP, exports of transportation services was revised up by EUR 1.1bn (6.1% of GDP) with the implementation of BPM6. ⁽³⁾ In the national accounts, the new treatment led to an upward revision of exports of services and gross value added of transportation services. The dynamics of gross value added of

transportation services also changed with the implementation of the new standards. However, due to other changes related to the implementation of ESA2010, GDP dynamics remained unchanged.

Table 1:
Selected national accounts and balance of payments indicators, 2013

(EUR m)	ESA95/BPM5	ESA2010/BPM6
<i>National Accounts, flow</i>		
Nominal gross domestic product	16,504	18,119
Private consumption	11,447	12,313
Public consumption	3,079	3,160
Gross fixed capital formation	1,729	2,196
Export	7,431	9,210
Import	7,182	8,760
<i>Balance of Payments, flow</i>		
Current account balance	-310	-552
Goods balance	-2,941	-2,893
Services balance	3,253	2,912
Primary income balance	-452	-227
Current transfer/secondary income balance	-171	-345
<i>International Investment Position, stock</i>		
Financial account, net	-14,138	-28,418
Direct investment, net	-9,340	-14,465
Portfolio investment, net	4,948	4,948
Financial deriv. and employee stock options	151	147
Other investment, net	-10,561	-19,714

Source: Centralbank of Cyprus and Eurostat

In addition, registration and deregistration activity of vessels in Cyprus will lead to more volatile dynamics for investment, and imports and exports of goods, but leaves GDP dynamics unchanged. Under the new treatment, the registration of a vessel in Cyprus will increase investment. This investment transaction is however offset by an increase in imports of goods. Likewise, when a vessel is deregistered in Cyprus, this will lead to a negative investment transaction, completely offset by higher exports of goods. Neither deregistration nor registration affect GDP.

The NIIP was significantly weakened by the new treatment of ship-owners. The capital intensive nature of the shipping industry has weighed significantly on the NIIP, as ship-owners have large financial liabilities, while their assets are mainly real and not financial. Since the NIIP shows the financial position, and does not include real assets, the inclusion of ship-owners, in line with the BPM6 standards, worsened significantly the NIIP from EUR -14.1bn to EUR -28.4bn, reflecting a drop of direct and other investment, net (Table 1).

⁽¹⁾ 2013 is the only year where both BPM5 and BPM6 data is available.

⁽²⁾ See box "The implementation of European Systems of Accounts 2010 for Cyprus", in EC (2014): "The Economic Adjustment Programme for Cyprus, Fifth Review – Summer 2014", Occasional Papers 209, December 2014, for a more general discussion of revisions related to the implementation of ESA2010.

⁽³⁾ The current account deteriorated by EUR 242m (1.5% of GDP), as the positive effect from shipping was offset by downward revisions due to the use of new statistical sources and methods related to the implementation of BPM6.

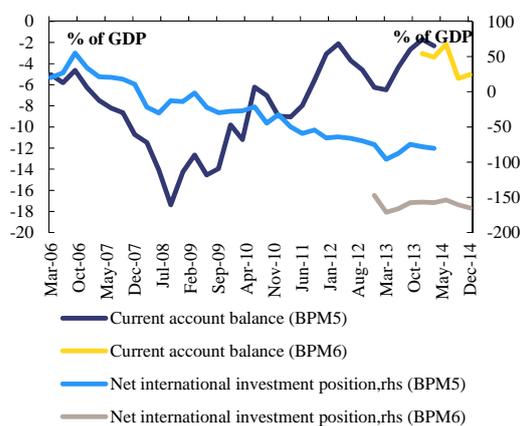
Table 2.1: Main features of macroeconomic forecast

	2014		2013	2014	Annual percentage change Sixth review forecast (April 2015)		Fifth review forecast (July 2014)	
	Curr. prices (EUR m)	% of GDP			2015	2016	2015	2016
GDP	17,506	100	-5.4	-2.3	0.2	1.4	0.4	1.6
Private consumption	12,185	69.6	-6.0	0.4	0.4	1.1	-0.2	1.5
Public consumption	2,751	15.7	-4.9	-8.7	-1.7	-0.8	-2.2	-3.2
Gross fixed capital formation	1,895	10.8	-17.1	-18.8	-0.9	3.6	1.3	3.9
Exports (goods and services)	9,704	55.4	-5.0	5.9	0.5	1.5	1.9	2.9
Imports (goods and services)	9,220	52.7	-13.6	8.1	-0.1	1.0	-0.1	1.3
GNI (GDP deflator)	16,631	95.0	6.7	-5.7	-4.3	1.3	1.3	3.1
Contribution to growth:	Domestic demand		-7.6	-3.8	-0.1	1.1	-0.4	0.9
	Inventories		-2.3	2.6	0.0	0.0	0.0	0.0
	Net exports		4.6	-0.9	0.3	0.3	0.9	0.8
Employment			-5.2	-1.9	0.0	1.2	0.4	1.5
Unemployment (1)			15.9	16.1	16.2	15.2	17.0	15.8
Compensation per employee			-6.0	-4.7	-0.3	1.1	0.4	1.5
Unit labour costs, whole economy			-6.1	-4.2	-0.6	0.9	0.4	1.4
Real unit labour costs			-4.7	-3.1	0.4	0.2	-0.6	-0.1
GDP deflator			-1.4	-1.2	-0.9	0.7	0.9	1.5
Harmonised index of consumer prices			0.4	-0.3	-0.8	0.9	0.9	1.3
Terms of trade			-0.7	2.2	0.5	-0.4	-0.3	0.0
Merchandise trade balance (2)			0.5	0.5	0.6	0.6	-16.4	-16.1
Current account balance (3)			-2.0	-4.0	-4.3	-4.4	0.2	0.6

(1) Eurostat definition, % of labour force (2) % of GDP, (3) National Accounts terms, % of GDP.

Source: Commission services

Graph 2.3: Current account and net international investment position



Source: Central Bank of Cyprus

The unemployment rate reached 16.1% in 2014, marginally higher than the 15.9% observed in 2013. After a slight improvement to 15.8% at the beginning of the year, unemployment has gradually increased during 2014 to reach 16.4% in the fourth quarter (Graph 2.4). Youth unemployment has declined from its peak of 39.6% at the beginning of 2014 to 33.7% at the

end of the year. While this positive development to some extent reflects enhanced active labour market policy measures, the latter have not succeeded in reversing the upward trend in long-term unemployment (see Box 2.2 for a discussion of unemployment and active labour market policies during the crisis). The decline in employment and compensation per employee eased to -1.9% and -4.7% in 2014, respectively. The decline in unit labour costs continued in 2014, easing to -4.2% compared to -6.1% in 2013.

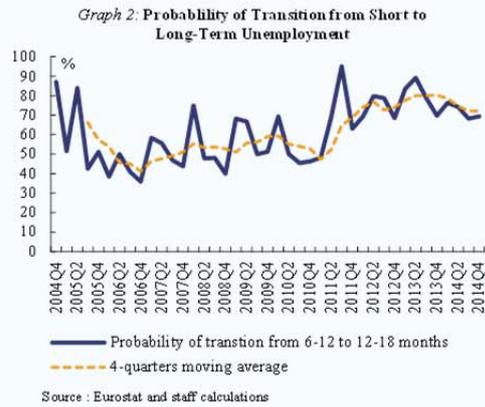
Box 2.2: Long-term unemployment in Cyprus

Short-term unemployment has declined from its 2013 peak, but the pool of long-term unemployed continues to increase significantly. Although the decline in short-term unemployment since 2014 is in line with a moderate increase in the vacancy rate (Graph 1), the pool of long-term unemployed (for more than 12 months) is not declining. In particular, the number of those with very long unemployment spells (above 24 months) continues to increase, reaching about 18,000 at the end of 2014. Increased unemployment duration can become a source of concern, as longer unemployment spells are generally associated with depreciation of skills and deterioration of employability, leading to labour market hysteresis effects (whereby a high number of job vacancies coexist with a high level of unemployment). This would prevent a decline in unemployment rates to pre-crisis levels even as the economy recovers.

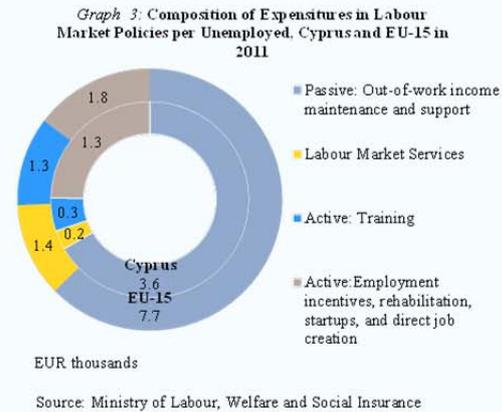


For those reaching the 6-month unemployment threshold, the probability of remaining unemployed in the longer term has stabilised at high levels, while exit from long-term unemployment remains limited. Graph 2 shows the transition probability from short to long-term unemployment, measured by the ratio between the number of job-seekers with unemployment spells between 12 and 18 months, to the number of job-seekers that had an unemployment duration of 6 to 12 months two quarters earlier. While between 2006 and 2011 about 50% of the unemployed with duration between 6 and 12 months were still unemployed six months later (having become long-term unemployed), this ratio has increased to about 75% since mid-2011. At the same time, the probability of exiting long-term unemployment continues to be very low: about 60% of those

unemployed between 12 and 18 months are still in unemployment 2 quarters later.



Active labour market policies can help address the problem of long-term unemployment, but their significance in Cyprus has been limited. Active labour market policies (ALMP) can help improve the employability of those willing to work, reduce discouragement, support inter-sectoral and geographic labour mobility, and curb an increase in structural unemployment.



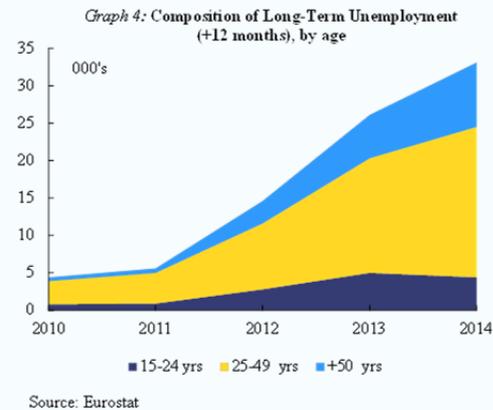
Comparable data for Cyprus and the EU-15, available up to 2011, reveals relatively limited expenditure per unemployed in Cyprus on training and labour market services (the latter being crucial to support ALMPs), while more focus has been put on passive measures and employment incentives, mostly subsidies. This should change, however, as the newly adopted Operational Programme for "Employment, Human Resources and Social Cohesion" for 2014-2020, with a budget totalling

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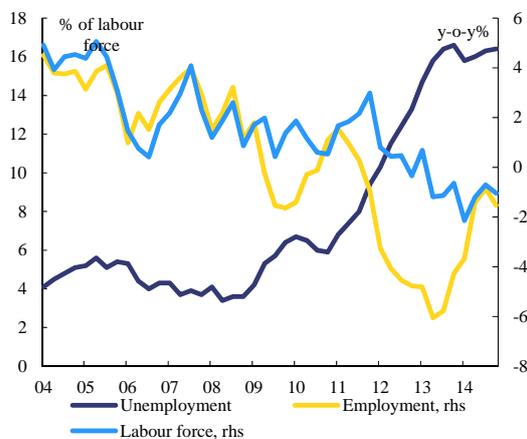
Box (continued)

EUR160m (about 1% of GDP), is being implemented.

The 2014 Cypriot ALMPs have put significant emphasis on the youth, but the young represent a relatively small and declining proportion of the long-term unemployed. Preliminary data for 2014 indicates that participants in all programs targeting youth having completed up to tertiary education represent about 64% of total participation. However, only around 13% of the long-term unemployed were below the age of 25 in 2014. This calls for an increased focus of ALMP in Cyprus on other age groups, and specifically on those more vulnerable to remaining in the long-term unemployment pool.



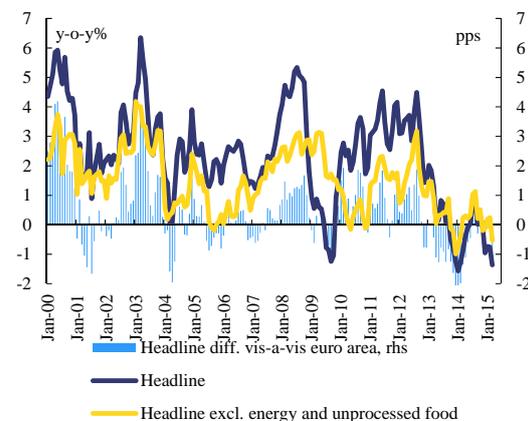
Graph 2.4: Unemployment, employment and the labour force



Source: Eurostat and Labour Force Survey

HICP inflation moved deeper into negative territory in Q1 2015, reflecting a gradual pass-through of the marked drop in oil prices towards the end of 2014. While the HICP inflation rate settled at -0.3% in 2014, compared to 0.4% registered in 2013, HICP inflation reached -1.4% y-o-y in March 2015. Core inflation, however, has been hovering around 0% in the first months of 2015, reflecting weak domestic cost pressure and sizeable economic slack.

Graph 2.5: HICP Inflation



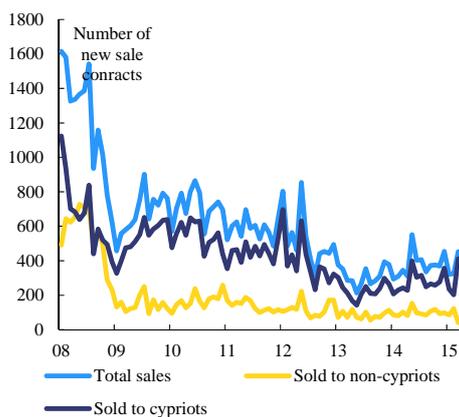
Source: Eurostat

The housing market continued its adjustment, with residential property prices down by -9.0% in 2014. This has brought the cumulative fall in prices since mid-2008 to around -30%. The fundamentals for housing demand remain weak. Labour income is still declining, credit for house purchases remains limited, with high lending rates. Moreover, public discussions on the foreclosure framework might have contributed to the weak activity in the housing market. Although the number of sold properties has rebounded somewhat in 2014 from low levels in 2013, current transactions remains at around 25% of the number observed at the beginning of 2008 (Graph 2.6).

According to the Bank Lending Survey, the weakness in demand for housing is likely to extend well into 2015.

Real GDP growth returned to positive territory in the first quarter of 2015. The Q1 GDP flash estimate indicates a GDP growth rate of 0.4% y-o-y (1.6% q-o-q). The expansion followed three and a half years of recession and was driven by positive growth in service sectors, with short-term indicators suggesting strong increases in the tourism and the retail trade sectors. Activity in construction and manufacturing, however, continued to contract, together with revenues from tourism, the latter suggesting that part of the good performance was due to price compression.

Graph 2.6: Property sales



Source: Department of Lands and Surveys

The positive developments of the first quarter pave the way for a modest recovery in 2015. The weakness in economic activity observed in the second half of 2014 seems to have withered away in the first quarter of 2015. Low energy prices are expected to underpin private consumption and export. Export growth turned out to be very high in 2014 reflecting new treatment of the ship-owners in ESA 2010 (see Box 2.1). The forecast for 2015 assumes a constant number of ship de-registrations compared to 2014, leading to a much lower export growth rate than in 2014. However, the underlying export growth momentum is improving, supported by the euro depreciation and should allow the economy to grow in real terms by 0.2% this year. With only modest growth in 2015, unemployment and employment are forecast to remain broadly

stable, while low energy prices will keep HICP inflation in negative territory.

The recovery will be consolidated in 2016. The gradual deleveraging of both households and corporates should remove impediments to a more balanced growth. At the same time, the insolvency and foreclosure frameworks should allow for more effective tools to deal with the high ratio of non-performing loans. This will help to gradually restore the health of the banking sector, loosen credit supply conditions and support a moderate pick-up in domestic demand. The ensuing growth momentum is expected to gradually ease unemployment. HICP inflation is forecast to turn positive in 2016, as energy prices rebound.

Risks to the GDP projection are broadly balanced. On the upside, low energy prices could support domestic demand more than currently envisaged. Also, the depreciation of the euro and stronger than expected tourist arrivals from other countries could mitigate the headwinds from the economic recession in Russia. On the downside, a failure to address high NPL ratios could lead to a more prolonged period of tight credit supply conditions, stalling the economic recovery. In addition, headwinds from Russia, may have larger than expected impact on the export performance in the short term (see Box 2.3 for an analysis of Cyprus' export performance).

2.2. FISCAL DEVELOPMENTS AND OUTLOOK

Excluding the one-off impact from the recapitalisation of the Cooperative Credit Institutions (Coops), 2014 budgetary developments were very positive. The primary balance for the general government for 2014 increased from a deficit of 1.8% of GDP in 2013 to a surplus of 2.6% of GDP in 2014. This corresponded to a headline deficit of 0.2% of GDP, compared to a headline deficit of 4.9% of GDP in 2013. The revenue ratio improved from 36.5% to 40.3% of GDP and the expenditure ratio improved from 41.4% to 40.5% of GDP. Prudent budget execution, additional permanent measures, as well as better revenues, on the back of more benign macroeconomic developments, have contributed to this result. In addition, total revenue benefitted from several one-offs and total expenditure from the deceleration of the public sector retirement

Table 2.2: Key macroeconomic and budgetary projections**

	2013	2014*	Sixth review forecast (April 2015)		Fifth review forecast (July 2014)	
			2015	2016	2015	2016
Real GDP (1)	-5.4	-2.3	0.2	1.4	0.4	1.6
Output gap (2)	-5.0	-5.4	-3.8	-1.7	-3.7	-1.2
General government balance (3)	-4.9	-0.2	-1.5	-0.1	-5.2	-2.2
Total revenue (3)	36.5	40.3	39.3	39.2	40.8	41.2
Total expenditure (3)	41.4	40.5	40.8	39.3	46.0	43.4
Primary balance (3)	-1.8	2.6	1.5	2.5	-1.6	1.2
Cyclical-adjusted balance (3)	-2.3	2.6	0.5	0.8	-3.6	-1.7
Structural balance (3)	-2.2	1.5	0.1	0.2	-3.6	-1.7
Gross debt	102.2	107.5	106.3	98.8	126.1	122.5

(1) % change (2) % of potential output (3) % of GDP

* Net of the one-off recapitalisation of the cooperative banking sector amounting to 8.6% of GDP in 2014.

** The figures of the fifth review are stated in ESA 95 while historical and sixth review figures are stated in ESA 2010. Although nominal fiscal figures are not significantly affected, the upward revision of nominal GDP by about 10% has affected the GDP ratios. Consequently, without the GDP revision the sixth review GDP ratios would have been higher due to the denominator effect.

Source: Commission services

wave. However, the recapitalisation of the Coops led to a one-off deficit increasing impact of 8.6% of GDP, leading to a headline deficit of 8.8% of GDP in 2014.

Data for the first quarter of the year show a similar fiscal performance as during the same period last year. The general government primary balance decreased only slightly to a surplus of 0.5% of GDP (in cumulative terms), while the headline balance remained the same, amounting to -0.1% of GDP. Underlying the result was a decrease in both total revenue and total expenditure of about 3% y-o-y.

The y-o-y fall of 3.1% in total revenue for Q1-2015 is partly explained by the somewhat protracted recession. The decrease was driven by a sharp decline in revenues from the levy applied on deemed dividends and interest income. The fee on deemed dividends declined as the 2012 profits, the relevant tax base for the 2015 collection, declined substantially compared to those of 2011. The reduction of the fee on interest income follows the decrease of both banks' deposits and interest rates. More temporary developments also affected revenues, such as a dividend from the ports authority, which has not yet been collected this year, and on the positive side an increase in VAT collections by about 10% y-o-y in 2014. The latter was driven by the hike in VAT rates during the

first quarter of 2014, which impacted positively on VAT collections only as of Q2-2014.

General government expenditure in Q1-2015 decreased by 3.3% y-o-y, net of the one-off banking recapitalisation. The major driver of this development was a large y-o-y decrease in social transfers, which was partly driven by lower expenditure on unemployment and redundancy benefits reflecting the extra cost of cleaning of the backlog in Q1-2014, as well as the stabilisation of the labour market. Further small decreases in expenditure were observed in interest expenditure and intermediate consumption.

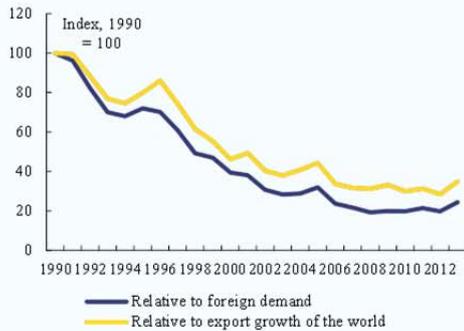
The debt-to-GDP ratio is expected to have peaked at around 108% of GDP in 2014. The debt-to-GDP ratio is projected to reach around 106% in 2015, and to gradually decline until 2020.

Box 2.3: Cyprus export performance in goods markets

Cyprus has lost significant export market shares in goods markets since 1990. Data on export of goods in current prices, denominated in US dollars, and extracted from the UN Comtrade database, shows that Cyprus export market shares in goods declined by 70% in the period from 1990-2008 when compared to world exports (Graph 1). Foreign demand for Cyprus, however, grew faster than world exports, and relative to foreign demand, Cyprus lost 80% of its market shares. Since then, both export markets shares indicators have stabilised, and small gains have been observed.

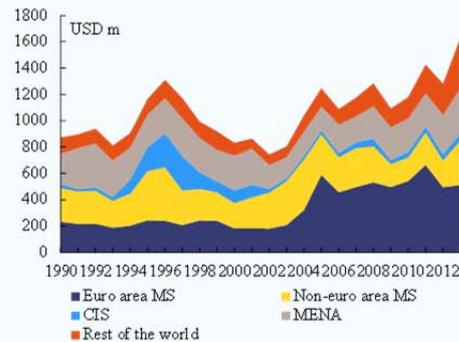
(2005)⁽¹⁾ shows that a large share of Cypriot exports was in the low-tech and more labour intensive category in the beginning of the 1990's (Graph 3). This share has since diminished and has been replaced by products of a higher technological content, particularly medium-tech such as pharmaceutical products. At around the years of EU accession, Cyprus exports of medium and high-tech products expanded significantly, suggesting that the EU accession allowed access to new technologies and markets.⁽²⁾

Graph 1: Export market shares



Source: UN Comtrade and own calculations.

Graph 2: Exports by trading partners



Source: UN Comtrade and own calculations

Geographical specialisation has helped to curb some of the declines in export market shares. Trade with EU Members increased significantly around the EU accession in 2004, and helped reverse the declining trend in exports of goods (Graph 2). However, export growth to EU Member States has been more muted in the years that followed EU accession. Since the outbreak of the global financial and economic crisis, exports to non-EU MS has increased, mitigating the weaker demand from the EU. Given that the loss in export market share are larger when comparing to foreign demand than to world export growth, suggests that Cyprus has a geographical specialisation in high growth countries. However, declining export market shares suggest that the favourable geographical specialisation was offset by other factors.

The improvement in technological content did not reverse the decline in export market shares. Despite the expansion in medium-tech products, growth in this product category was weaker than foreign demand growth. Export performance was even weaker for low-tech and high-tech products. This implies that Cyprus has lost market share on each of the product markets and suggests that the product composition of exports has contributed to the overall loss in export market shares.

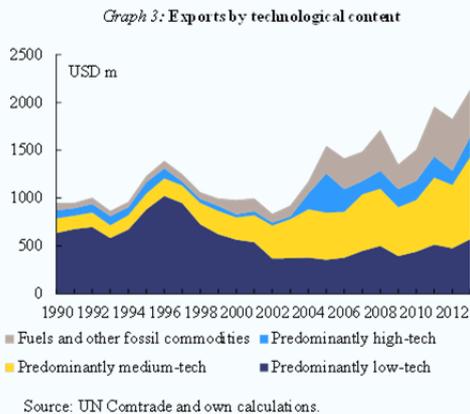
Cypriot export products have gradually climbed up the technological ladder since 1990. Using the product mapping suggested by the ECB

⁽¹⁾ ECB (2005): "Competitiveness and the export performance of the euro area" Occasional Paper Series no. 30 / June 2005.

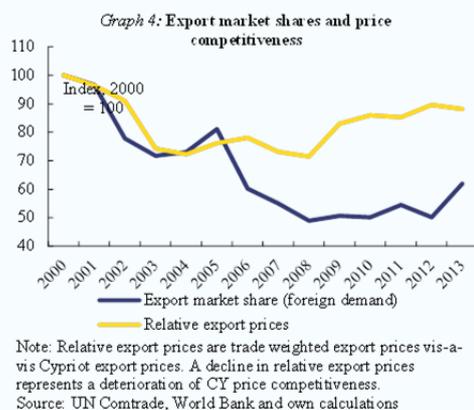
⁽²⁾ Cyprus has no oil production but exports large amount of fuels. This relates to the travel/shipping sector which consumes fuels in Cyprus and reflects re-export of imported fuels and oil products. For this reason, fuels and other fossil commodities have been excluded from the analysis in this box.

(Continued on the next page)

Box (continued)



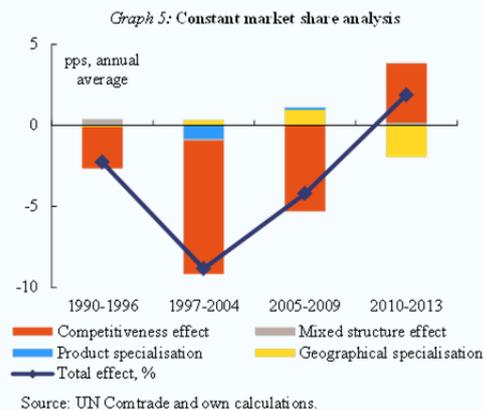
Until 2009 export market share declined together with price competitiveness. A deterioration of price competitiveness and relative export prices (i.e. a trade weighted index of export prices of Cyprus' trading partners) contributed to the loss of market shares from 2000-2008.⁽³⁾ Export price inflation has since been lower than that of its trading partners and some price competitiveness has been recovered, while small gains in market shares have been observed.



A Constant Market Shares Analysis (CMSA) shows that the loss in export market share mainly relates to deterioration of price competitiveness. Graph 5 shows the main results of a CMSA, which decomposes the export performance into competitiveness factors, product and geographical specialisation, and a mixed

⁽³⁾ Export prices are from the World Bank, and due to a low country coverage prior to 2000, only relative export prices from 2000 is shown.

structure effect.⁽⁴⁾ Although the method has some limitations, it largely confirms the findings of the descriptive analysis above, namely that: i) geographical specialisation has helped export performance around EU accession (Graphs 1 and 2), even though the gains in the period 1996-2009 were offset by losses in 1990-1996 and 2009-2013; ii) the product specialisation has hampered export performance (Graph 3), but this only explains a small part; iii) competitiveness is the main explanation for the poor export performance up until 2009. Since then and during the crisis Cyprus has gained price competitiveness (Graph 4), which in turn has supported the export performance.



A diversification to high-tech products would support the export performance of Cyprus. The CMSA showed that the export performance is closely linked to developments in price competitiveness, partly because of the high share of low and medium-tech. Competition in these markets has increased due to the globalisation and entry of new players, such as China, who has a comparative advantage on these markets. An upward movement on the technological ladder to high-tech products would move Cypriot export goods to markets with less price competition from new market players, more non-price competition, and higher demand, and ultimately support the export performance of Cyprus.

⁽⁴⁾ The interpretation of the mixed structure effect is not straightforward. In broad terms, it represents the interaction effect of the product and geographical effect. Due to its small size the focus will be on the other three components.

2.3. FINANCIAL MARKETS AND FINANCIAL SECTOR DEVELOPMENTS

The recovery of the financial sector is underway with stabilised liquidity and prospects for a return to profitability, though the sustainability of the trends remains to be proved. Deposits broadly stabilised at aggregate level, despite the full lifting of all remaining payment restrictions on 6 April 2015. The reliance on central bank funding was further reduced, thanks to asset disposals and capital increases.

However, despite progress in enhancing banks' operational capacity and policies to manage loans in arrears, both the amount and ratio of NPLs continued to rise to very high levels. The process is driven by the recessionary economic environment, still falling real estate prices and defaults by over-indebted borrowers and the ineffective foreclosure and solvency frameworks in place until recently, which undermined incentives to service debt. Resolute action to address this issue is necessary in order to preserve the progress achieved so far in terms of bank recapitalisation and stabilisation of deposits. In December 2014, NPLs on local operations of both banks and cooperative institutions reached 58% of credit facilities to non-financial corporations and 52.7% of loans to individual persons (Table 2.3) respectively 13.6 pps and 9.4 pps higher than in December 2013. Part of this increase is due to the adjustment of the definition of NPLs to the European Banking Authority's (EBA) non-performing exposure concept. Recent data up to February 2015 suggest a decline in NPLs of non-financial corporations, but NPLs of households continue to increase. The fact that NPLs to corporations are now representing more than half of banks' and coops' credit facilities is an indication of the misallocation of resources during the credit boom. The majority of household NPLs relate to mortgages, but non-performing consumer loans are also significant. The provisioning coverage of NPLs stands at about 35%, which is significantly lower than for average European banks. It reflects a high level of collateralisation of loans, but at the same time renders banks vulnerable to large drops in the market value of the collaterals and sensitive to changes in valuation policies.

Both banks and cooperative institutions appear to be ineffective in their loan restructuring actions, where more ambitious policy measures are needed. As of December 2014, restructured loans (performing and non-performing) accounted for about 28.6% of loans to non-financial corporations and 22.8% of loans to private individuals. From the former, about three quarters were reported as non-performing. About two thirds of the restructured individual facilities were performing. Comparing with numbers from December 2013, it appears that the same relative percentage of total loans was restructured, though a larger share is reported as non-performing. This would suggest that restructurings are not sufficiently efficient, and that they are not an effective tool for preventing loans from turning in arrears again. Thus, efforts should be deployed to improve the sustainability of the restructurings offered to borrowers.

After a protracted period of losses, financial institutions in Cyprus posted modest profits in the beginning of 2014, but eventually the year as a whole turned negative. After seven quarters of losses, due to the deterioration of asset quality, banks and coops returned to profitability in the first quarter of 2014. However, the net profit of only EUR 74mn by Q3 2014 appeared fragile and the loss in the last quarter led to an overall negative result for the year as a whole of EUR 464mn. Net interest income declined by 4% relative to 2013 and it should also be noted that a significant fraction of this income is booked on NPLs, which are not matched by actual cash flows. Income from net fees and commission is also subdued by some 8% relative to 2013. Thus, the containment of losses is primarily due to a successful compression of administrative expenses by about 20% and 40% in comparison to 2013 and 2011 respectively. This has also been translated in a significant reduction in the cost-to-income ratio (Table 2.3). Simultaneously, though still elevated and close to EUR 1.4bn in 2014, provisions for impaired assets were 60% lower than in 2013. Thus, the sustainability of the return to profitability is still pending on a significant improvement in assets' quality and permanently contained administrative expenses.

Table 2.3: Soundness indicators for the banking sector in Cyprus

	2012				2013				2014				
	(%)	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
NPLs, loans to legal entities		18.0	18.9	20.3	22.6	24.7	30.2	39.7	44.4	45.6	49.1	50.4	58.0
of which restructured							8.4	10.9	12.5	14.2	14.6	14.1	23.3
pm: performing restructured loans							15.1	13.7	12.2	11.2	10.2	10.0	5.3
NPLs, loans to private individuals		18	18.9	20.3	22.6	24.7	35.14	39.44	43.3	47.63	49.37	50.75	52.7
of which restructured							2.7	4.6	6.7	8.8	8.5	8.4	13.9
pm: performing restructured loans							11.9	12	10.4	11	10.3	9.1	8.9
Coverage rate					47.9				37.7		35.8	36.3	32.9
Cost-to-income ratio (Dec 2014)		-41.0	-49.7	-51.6	-55.6	-49.9	-52.4	-53.4	-53.4	-37.9	-37.0	-39.3	-40.4
Net interest margin (Dec 2014)		2.8	2.4	2.3	2.3	1.7	2.0	2.3	2.4	3.1	3.2	3.1	2.9
Core Tier 1 ratio		6.1	7.3	6.9	4.5	12.1	11.9	11.6	12.1	12.5	12.9	14.8	14.2
Return on assets		1.6	-1.9	-1.7	-3.4	-5.4	-3.4	-2.5	-4.3	0.1	0.3	0.1	-0.6

Note: Change in NPL definition in December 2014

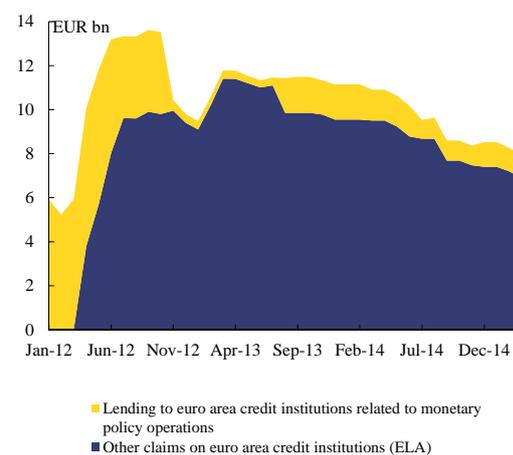
Source: Central Bank of Cyprus

The Core Equity Tier 1 (CET1) capital ratio of locally active banks and cooperative institutions stood at 14.2% in December 2014, representing a notable increase on a yearly basis. The CET1 ratio stood at 12.1% in December 2013. The improvement is due to banks' pre-emptive actions of increasing their capital position ahead of the publication of the ECB Comprehensive Assessment results.

Banks and coops reduced further their reliance on central bank funding, which went below EUR 8bn. On a yearly basis between March 2014 and March 2015, total reliance on central bank funding was reduced by almost EUR 3bn, i.e. 27% (Graph 2.7). In relative terms, the reduction concerns equally both the recourse to regular open market operations and other Eurosystem claims (Emergency Liquidity Assistance, ELA) funding. In nominal terms, however, it is to be noted that EUR 2.6bn of ELA was repaid within a year. The decline in central borrowing is almost exclusively due to the positive developments within Bank of Cyprus. However, the aggregate improvement in liquidity is linked to the capital increase and sales of assets that several banks undertook, while the positive developments in the deposit base played a lesser role.

Overall, deposits have stabilised since the last quarter of 2014 when the persistent outflows stopped. At system level, the deposit base started to stabilise as of October 2014, when the positive outcome of the ECB comprehensive assessment was announced. This also contributed to increasing banks' liquidity buffers.

Graph 2.7: Borrowing from the Eurosystem



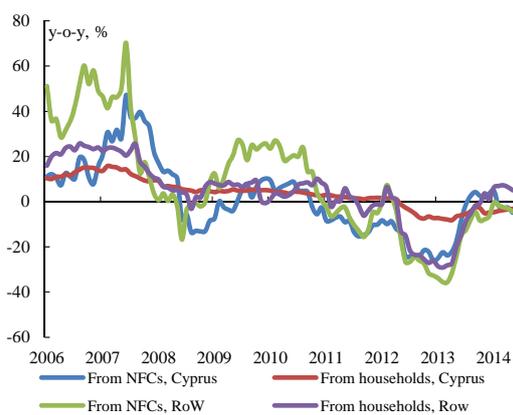
Source: Central Bank of Cyprus

The stabilisation of the aggregate figure is due exclusively to the deposits of non-resident households, which grew by about EUR 400mn in 2014. Other segments of depositors, however, continue to contract (Graph 2.8). In particular, both resident and non-resident non-financial corporations continue to reduce their deposits. In the first quarter of 2015, deposit inflows were recorded in all segments of the banking sector, with the exception of the Greek subsidiaries which were affected by the turmoil in Greece. It is also encouraging that the final removal of any remaining restrictive measure has not resulted in any noticeable movements of the deposit base. That said, the return of confidence is still fragile and needs to be confirmed in the future.

The financial downsizing in the economy continued as banks have reduced further their balance sheets.

Total assets in the banking sector declined to from EUR 77.6bn in December 2013 to EUR 75.6bn in December 2014, of which domestic institutions accounted for EUR 49bn or 280% of GDP. At the same time, the contraction of the stock of loans for both non-financial corporates and households has bottomed out since the end of 2013, but loan growth remains slightly negative (Graph 2.9) and overstated because of the capitalisation of interest arrears. The large increase of loans at the end of 2014 and early 2015 mainly stems from the purchase of foreign loans portfolios by subsidiaries of international banks, and to a smaller extent, from capitalisation of accrued interest, therefore having little impact on the Cypriot economy.

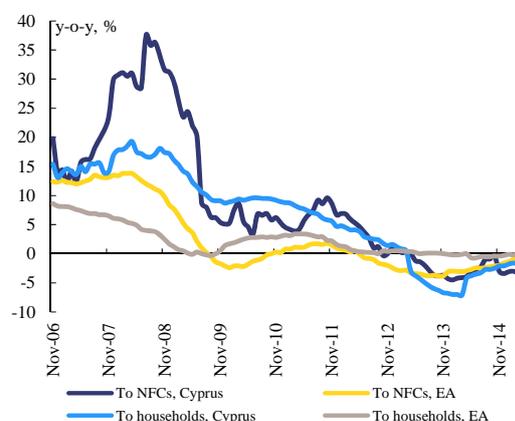
Graph 2.8: Deposit developments



Source: Central Bank of Cyprus

Regulatory action halted the rise in deposit interest rates. For the period between February 2014 and February 2015, interest rates on new loans for house purchases declined by about 13 basis points (bps), while the cost of new corporate loans was reduced by 10 bps (Graph 2.10).

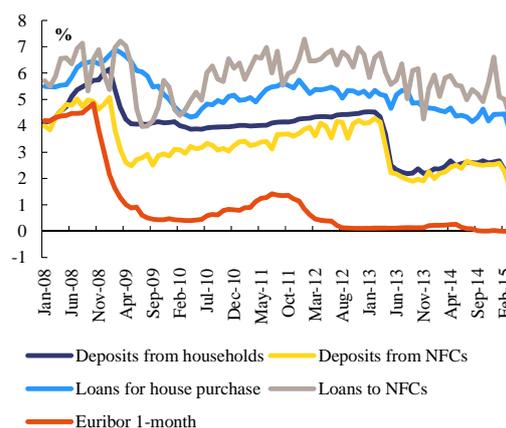
Graph 2.9: Loan developments



Source: Central Bank of Cyprus and European Central Bank

Following their sharp decline in mid-2013 as a result of a regulatory limit, deposit rates increased by about 60 bps during 2014, contributing to the reduction of deposit outflows. This put the banks' interest rate margins under increasing pressure. As a result, on 16 February 2015 the Central Bank further narrowed the maximum spread between Libor and the deposit interest rates that banks can offer from 300 to 200 basis points.

Graph 2.10: Interest rates developments



Source: Central Bank of Cyprus

3. PROGRAMME IMPLEMENTATION

The sixth review mission by staff of the European Commission (EC), European Central Bank (ECB) and International Monetary Fund (IMF) reached agreement with the Cypriot authorities on policies that could serve as a basis for completion of the sixth review.

The Cypriot authorities have made further progress in implementing the programme. Fiscal targets for 2014 have been exceeded by a wide margin, reflecting prudent budget execution. Reforms in the financial sector have progressed, but addressing the level of high NPLs remains the key priority. To that end, a comprehensive reform of corporate and personal insolvency laws has been adopted. The authorities have also taken steps toward implementing their ambitious structural reform agenda, albeit at a slower pace in some areas.

One of the objectives of the programme enshrined in the MoU is to minimise the impact of consolidation on vulnerable groups. To this end, reforms in the areas of pensions and social welfare have been undertaken, and the reform of health care system is under way. The social welfare reform was explicitly aimed at providing better protection of vulnerable groups with the introduction of a guaranteed minimum income (GMI) scheme and better targeting of benefits to ensure public support for those most in need, including the working poor. Cuts in public sector pensions have been largely progressive. Health care reforms aim at strengthening the sustainability of the funding structure and will contribute, together with the implementation of a National Health System, to more equal access to public health services for all parts of the population. The programme also comprises a range of actions with regard to activating the unemployed and combatting youth unemployment, as well as an explicit commitment to preserve the good implementation of structural and other EU funds and to target EU funds to those areas that have the most important economic and social impact. The support to the authorities' Action Plan for Growth is also of importance in order to recreate a sustainable growth pattern that can generate new opportunities and quality jobs.

Ambitious reforms of the tax revenue and public administration are envisaged in the

programme and aim at improving tax compliance, fighting tax evasion and making the public sector more effective in performing its tasks, including by making it easier to reallocate public sector resources to areas most affected by the economic crisis.

The design of fiscal consolidation measures aim at a more progressive tax system in several respects, by combining an increased taxation of capital (interest income, immovable property, bank levy) with a higher corporate tax rate. The VAT rate has also been increased. Where reductions in public sector emoluments have been necessary, they are predominantly progressive and target also certain benefits and privileges for senior officials. The objectives behind the necessary fiscal and fiscal-structural measures are clearly outlined in the introduction to these chapters of policy conditionality. Implementing the programme is instrumental to ensure that the disposable income of Cypriot households can start growing again over the medium-term and to secure sound public finances.

A summary assessment of compliance with programme conditionality is provided in Table 3.1, while the specific assessment on the implementation of individual elements of conditionality with deadlines for end-Q1 and end-April 2015 is found in Annex 1.

The authorities should re-establish the good track record in policy implementation which was observed until July 2014. There were some significant delays and partial compliance was observed in several areas, notably on some financial sector reforms, privatisation, tourism and revenue administration. The authorities should step up their efforts and continue to pursue their ambitious reform agenda and maintain its momentum. Continued full and timely policy implementation remains essential for the success of the programme, not least in order to ensure a lasting improvement in the financial sector and a sustainable growth pattern going forward.

Table 3.1: Summary assessment of compliance with policy conditionality for the sixth review (Q1 2015 - end April 2015)

	Status
Financial sector policy	<p>Partially compliant. Several deadlines were missed and actions non compliant, including again progress with the completion of the resolution of Laiki, the amendment to the Ombudsman Law, obtaining financial information and attachments to assets and income of delinquent borrowers and revoking the ban on the sale of loans, while admittedly its application is suspended. On the other hand, an important milestone related to the complete abolition of the capital controls was achieved as well as several requirements on continuous monitoring and reporting of banks and the Task Force on title deeds is delivering results. However, in the domain of NPLs management and the creation of a new foreclosure framework, partial compliance and often with delay is the verdict, e.g. with respect to the responsibility of guarantors when borrowers default, the organisation of auctions on foreclosed property and the review of the Civil Procedure Code for the smooth functioning of the new foreclosure law.</p> <p>On Anti-Money Laundering (AML) the Cypriot authorities are continuing the implementation of the Action Plan and overall progress has been steady in most areas, albeit with some delays. The CBC conducted 11 onsite inspections in 2014 and plans over 20 inspections in 2015. With some delay, the CBC has also increased the staff in its AML unit. The main actions which remain ongoing mostly relate to adequate staffing of the supervisory authorities in the non-financial sector, staff training programmes in all authorities, roll-out of the 2015 inspection plans and fine-tuning of the inspection tools.</p>
Fiscal policy	<p>Compliant. The 2014 primary balance target has been reached with a significant margin, excluding the one-off impact of the recapitalisation of the cooperative credit institutions. For 2015, the fiscal performance remains well on track. To reflect the positive developments, the primary balance target has been adjusted to a surplus of 1.5% of GDP. The risk of non-compliance with regard to the 2015 primary balance target appears low at this stage.</p>
Fiscal-structural measures	<p>Partially compliant. On health, non-compliance has been observed in several fields, namely the submission of the NHS bill, the submission of the hospital autonomy bill, the initiation of the IT tender, the adoption of contingency measures under NHS, and the fixing of pharmaceutical policies under NHS. On public financial management, an updated risk assessment report has been submitted to programme partners, whilst the guidelines for public investment projects have only been drafted, but have not been issued by the Ministry of Finance.</p> <p>The corporate governance law on state-owned enterprises (SOEs) has not yet been adopted by the HoR, which makes this section non-compliant. On privatisation, compliance is also partial, as all advisers for CyTA have been appointed, but the corporatisation law has not yet been adopted, partly due to ongoing consultations with trade unions. The study for EAC's unbundling is running late due to strong opposition from the trade unions. Preparation stages for Limassol Port's concession agreement have gained momentum. On revenue administration, compliance remains mixed. Satisfactory progress has been made in terms of management appointments and testing bank garnishment, but further work is required on compliance strategy and risk analysis and the related action plans by the headquarter units. In the area of international tax cooperation, adequate progress is observed regarding commitments taken to address the negative rating from OECD Global Forum. Non compliance on Immovable Property Tax reform, as most of the deadlines were missed. This poses risk to the IPT reform implementation. The new tax structure (required for implementation by early July 2015) and the draft legislations have not yet been presented to the programme partners.</p> <p>On public administration, compliance is partial, as the reform plan and related legislation on the horizontal review have not yet been submitted and adopted, respectively. On the first batch of vertical reviews, the Ministry of Interior has not yet submitted the action plan on local governments, while all others (Health, Education, Agriculture) were adopted between late 2014 and early 2015.</p>
Labour market	<p>Partially-compliant. COLA in the private sector has been suspended until end-2016 but there has been no agreement on the application of a 50% indexation system once COLA resumes. Little progress has been made on the enhancement of public employment services (PES), but with a budget now secured, reforms should gain speed in this area. Progress has been made in ensuring communication between PES, and benefit providing entities, but processes still need to be formalized. The National Action Plan for Youth Employment has been adopted and its implementation has started. The authorities have shared with programme partners a list of active labour market policies for 2014, and will continue to share updates.</p>
Goods and services market	<p>Partially compliant. On the regulated professions, all related laws have been duly amended, except for the engineers' profession, which will be closely monitored by the Commission in the framework of the ongoing Transparency Exercise at EU level. On housing market, although partly compliant, promising progress was observed. The authorities provided ideas on the streamlining of title issuances processes and for title deeds transfers. The relevant working group and task force have well been established working towards the goal of reducing the backlog and establishing sound future procedures. However, the majority of the proposals have not yet been enforced. On tourism, the bi-annual progress report was submitted and thematic groups were identified as part of the coordination plan. However, the regulatory framework and the consolidation of a national tourism strategy are now pending.</p> <p>On energy, the roll-out plan has been updated and the comprehensive outline for the regulatory regime and market outline has been provided to programme partners. The deadlines regarding the resource fund have not been met.</p>
Data reporting	Compliant

Source: Commission services

3.1. FINANCIAL SECTOR

3.1.1. Maintaining liquidity in the banking sector

The second and last phase of the Roadmap for the Gradual Relaxation of the Restrictive Measures was initiated at the beginning of December 2014 and concluded as of 6 April 2015. Based on the satisfactory outcome of the ECB Comprehensive Assessment and the stabilisation of the deposit base, the Cypriot authorities proceeded with the liberalisation of external capital controls. The decision to completely lift external capital controls as of 6 April 2015 was not unexpected, given the quick pace of the relaxations once the second phase of the road map was initiated. Except for the ban on freely crediting accounts abroad, the external controls on capital movements had de facto been lifted in mid-March when the very high transfer ceiling of EUR 1mn was introduced. Despite the sensitive international environment caused by the uncertain situations in Greece and Russia, warranting a more prudent and gradual approach, there has been no destabilisation of the liquidity of the banking system following the complete liberalisation of capital controls in Cyprus.

The Central Bank of Cyprus (CBC) continued to monitor closely the liquidity situation of the banking sector and stands ready to take appropriate measures to maintain sufficient liquidity in the system. Bank of Cyprus (BoC) and the Coops continued to submit their quarterly capital and funding plans to the CBC and to the programme partners. The government guarantees of EUR 2.9bn, granted at the start of the programme to facilitate the issuance of bank bonds in case of liquidity need, have not been called upon as the liquidity situation is normalising.

3.1.2. Monitoring the consequences of the Greek turmoil

Thanks to the sale of the Greek operations of the three main Cypriot domestic banks in March 2013, the exposure of the Cypriot banking sector to Greece has almost completely disappeared. As a consequence of the so-called "carve out", i.e. the sale of the Greek branches of Bank of Cyprus, Cyprus Popular Bank and Hellenic Bank, the Cypriot banking sector

achieved an immediate deleveraging of some 120 pps of GDP at the time. This was a significant step towards reducing the size of the domestic banking system to the target of the EU average (350% of GDP) set under the programme.

However, the four main Greek banks (National Bank of Greece, Piraeus Bank, Alpha Bank and Eurobank) still have subsidiaries in Cyprus. Although each subsidiary is small, the total of their deposits amount to EUR 7.6bn or 40% of GDP, therefore being systemically important for Cyprus. Since December 2014 the CBC in cooperation with the SSM is monitoring the situation closely and the Greek exposure of the four subsidiaries has been significantly reduced.

3.1.3. Regulation and supervision of banks and the cooperative credit institutions

The authorities have consolidated the progress achieved so far with the implementation of the new banking sector regulatory and supervisory framework. No new legal initiatives have been undertaken since the last review. At the same time, pending requirements, such as the use of the credit register for prudential supervisory purposes, remain important and will be assessed in the future. Thus, in the area of supervision and regulation *stricto sensu*, the authorities are fully complying with their commitments, notably with respect to the ongoing quarterly reports on banks' progress with their restructuring plans.

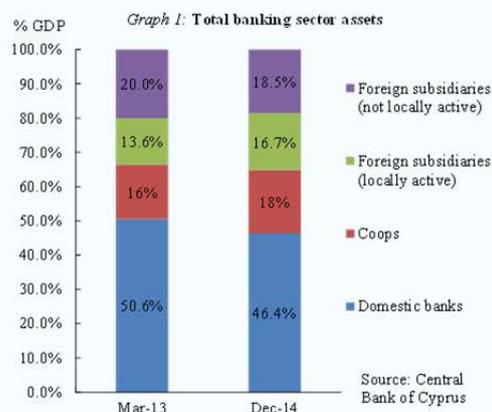
However, a number of delays and missed targets are to be reported in the area of the enhanced monitoring of corporate and household indebtedness. The revised arrears management directive was published a week after the end-March deadline, while the user-friendly guide on loan restructurings is still pending publication. Banks were instructed to start reporting on the targets for the various phases of the restructuring process by end-April, a month after the initial deadline. These loan restructuring targets will be further fine-tuned by the CBC and their first publication is expected for end-July. With respect to the external auditors' reports on banks' effectiveness in loan restructuring, two institutions missed the end-March deadline and requested a one-month extension.

Box 3.1: Banking sector downsizing in Cyprus: state of play

The financial assistance programme agreed by the Council and Cyprus in March 2013 had as primary objective the restoration of the viability of the financial sector. In this respect, the downsizing of the financial sector was seen as a prerequisite to addressing financial sector imbalances in Cyprus.

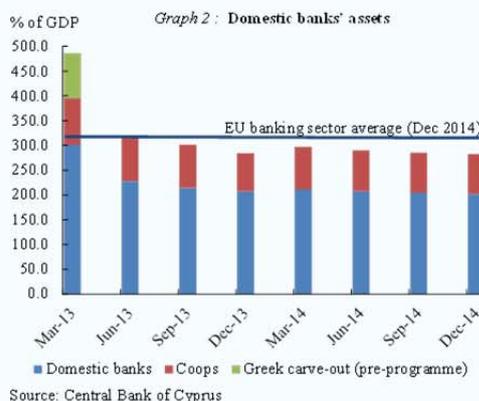
Starting during the boom years and continuing also during the crisis, the banking sector in Cyprus had grown rapidly to exceed the double of the average size of the Euro Area banking sector at the beginning of 2013. Therefore, the Cypriot authorities set as objective for the restructuring of the financial sector in Cyprus the reduction of the domestic banking sector to the EU average by 2018, estimated at 350% of GDP at the time. This box assesses the progress achieved towards this programme objective so far.

The downsizing target referred only to the domestic component of the banking sector. Indeed, the banking problems were mainly concentrated on domestic banks, which also owned sizeable overseas activities and were under the full supervision of the Central Bank of Cyprus. The domestic banks and cooperatives represented less than 65% of the total banking sector assets in Cyprus as of December 2014 (see chart 1). The rest of the banking sector includes other foreign bank subsidiaries which are locally active and foreign banks which are not active in the local market, with almost equal market shares.



The downsizing target was reached in December 2013. The size of the domestic banking sector was

rapidly brought in line with the EU average size of the banking sector (see graph 2). As a share of GDP, the total assets of the domestic banking sector shrunk from 396% of GDP in March 2013 (or 486% of GDP if the external assets sold in the Greek carve-out are included) to 284% of GDP in December 2013.



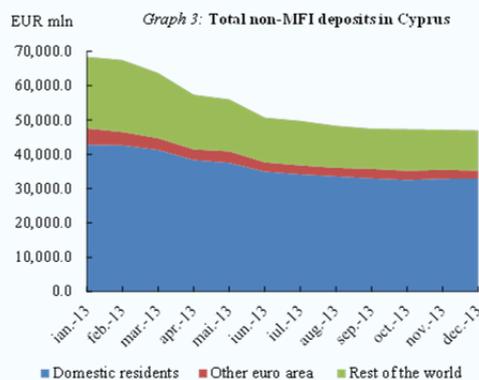
This downsizing was mainly due to the bail-in of creditors and the restructuring of the domestic banks, including the sale of external assets. From March to December 2013, the total assets of the domestic banking sector declined by more than EUR20bn or by about 28%, of which a EUR17bn drop for commercial banks (-31%) and a EUR3bn drop for the coops (-19%). The downsizing mainly reflects the the following factors. First, the Greek operations of the three main domestic banks were sold out to Piraeus bank in March 2013, before the start of the programme. This so-called "Greek carve-out" achieved a strong upfront downsizing effect of about EUR16.4bn or 90% of 2013 GDP. Second, the bail-in of liabilities in Bank of Cyprus and Laiki, which took place in April and July 2013 (see graph 3), contributed by about EUR9.4bn to the downsizing, or about 55% of 2013 GDP. The bail-in included EUR1.6bn of both subordinated and senior debt and EUR7.8bn of uninsured deposits. Third, the integration of Bank of Cyprus and Laiki bank achieved further downsizing as interbank positions cancelled.

The downsizing process has been slower in 2014 at around EUR2.5bn, resulting in a further slight decrease of the domestic banking sector size to about 283% of GDP, as nominal GDP also shrank

(Continued on the next page)

Box (continued)

by -3.4%. This slower pace of downsizing reflected lower sales of external assets by Bank of Cyprus. A more aggressive provisioning of non-performing loans in domestic banks could have led to a further reduction of net assets. In turn, a better management of arrears could have created resources for more new lending, benefitting the real economy. Nevertheless, the target set in the Programme was maintained in 2014 as the EU average banking sector stood at about 312% of GDP in December 2014. The slight overshooting of the target did not appear to have been detrimental to the economy as mainly assets in Greece and non-core activities were shed while a lack of credit demand from solvent borrowers did not allow banks to resume lending and support the economy.



Going forward, considerations about spurring new lending and growth in the real economy should move to the forefront. In this context, a more effective provisioning policy and arrears management could lead to a further restructuring of bank balance sheets in order to support economic growth.

The authorities missed compliance in two other work-streams. The draft law amending the law on the Financial Ombudsman, though submitted to the House of the Representatives on 23 January 2015, has not been approved yet. Similarly, the Banking Law has not been amended yet in order to allow for the sale of loans to third parties. The presentation to program partners of draft legislation to that aim has been made a prior action for the conclusion of this review.

3.1.4. Recapitalisation, resolution and restructuring

Bank of Cyprus

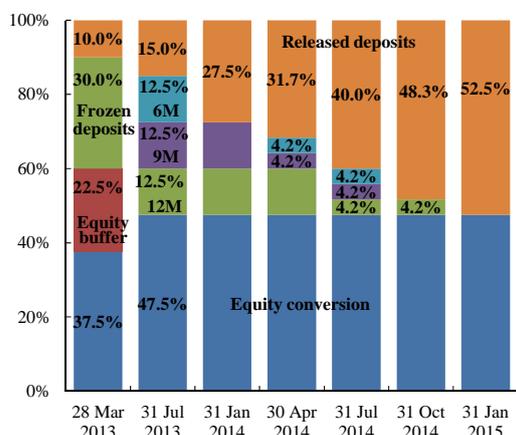
The Bank of Cyprus released the last tranche of frozen uninsured deposits on 31 January 2015. EUR 3.4bn of deposits, namely 40% of the original amount of uninsured deposits in March 2013 (EUR 8.4bn), had been blocked in July 2013 in three equal tranches of six, nine and twelve-month deposits, as a liquidity safeguard measure. While on 31 January 2014 the six-month deposits had been completely released, a gradual approach has been followed when the nine-month deposits

matured (Graph 3.1). At the expiry date of the twelve-month frozen deposits, the same prudent way forward has been pursued, and one third was released, with the remainder rolled over in three and six month deposits, each also for one third. Eventually, the last remaining tranche of EUR 350mn was released on the end of January 2015.

The deleveraging of Bank of Cyprus is progressing and is reducing risk from the Greek and Russian turmoil. Thanks to the sale of its Greek operations, BoC's exposure to Greece has almost disappeared. However, there are about 600 foreclosed Greek properties, with a book value of EUR 179mn ⁽²⁾ to be taken care of. On 31 December 2014, there was still EUR 120mn net on-balance sheet exposure and EUR 185mn off-balance sheet exposure.

⁽²⁾ See Audited Financial Results for the year ended 31 December 2014, Bank of Cyprus, page 8.

Graph 3.1: Uninsured deposits at Bank of Cyprus: equity conversion and gradual release



Source: Commission services

The sale of BoC's subsidiary in Ukraine has been finalised and the deleveraging of its subsidiary in Russia is progressing. The sale of the subsidiary in Ukraine was signed in March 2014 for EUR 200mn, and half of the payment was received immediately. The other half was received in March 2015. Thanks to deleveraging and increasing provisions, BoC's exposure to Russia has been significantly reduced. Total assets of the subsidiary in Russia fell from EUR 1.8bn in June 2013 to EUR 0.9bn at the end of 2014. On 31 December 2014, net exposure to Russia amounted to EUR 130mn, which was fully hedged to protect against the depreciation of the Rouble.

The Cooperative Credit Institutions

The restructuring of the cooperative sector is progressing in line with the commitments; only minor delays are to be reported. The first set of aggregate operational and financial indicators on progress with implementing the restructuring plan was published on 30 March 2015, and will be reported quarterly thereafter. Arrears management has been centralised and recruitment needs have been addressed. The efficiency of loan restructurings will be further improved, notably with the support of the technical assistance provided by the IMF. The relationship framework between the State and the sector has been updated. Two delays are to be reported. Even though the affiliation directive has been amended by the end-March deadline as agreed upon, its finalisation was

still pending at end-April 2015. The time-bound action plan on improving the efficiency of the Financial Control and Reporting was submitted with a one-week delay.

Despite these achievements, serious challenges remain. The Cooperative Central Bank (CCB) is still challenged in enforcing the Group policies in a more robust way, thus avoiding possible duplication of tasks with the regional managers at the level of individual Cooperative Credit Institutions (CCIs). Progress is also needed with respect to overcoming the continuous deterioration of the loan portfolios. Though deposit retention appears now less of an issue, the progress achieved so far must be preserved. Finally, though the cost-to-income target ratio has been achieved, the employment targets agreed with the European Commission (DG COMP) at the end of April 2015 suggest that some bottlenecks in cost compression might be appearing.

3.1.5. Legal framework for private debt restructuring

The Cypriot House of Representatives adopted on 18 April, 2015 a comprehensive reform framework, for corporate and personal insolvency. The box 3.2 details the key features of the new insolvency frameworks. A critical part of the new personal insolvency framework is the introduction of a *Personal Repayment Plan (PRP)*, which establishes a procedure whereby an insolvent debtor can, with the mandatory help of an insolvency practitioner, propose a restructuring plan which, where possible, should avoid the sale of the debtor's primary residence. In case of failure to agree a voluntary restructuring, a *compulsory element to the PRP* allows the debtor to apply to the court for the imposition, subject to certain criteria, of a restructuring plan on creditors. Further to these legislations, horizontal issues such as the establishment of an Insolvency Service, the development of reasonable living expenses guidelines and the regulation of insolvency practitioners have also been addressed by the reform framework.

Box 3.2: The Cypriot Insolvency Framework

The Cypriot insolvency framework has undergone a broad reform which encompasses the modernisation of both, the liquidation of companies and the bankruptcy of natural persons. The reform focused on facilitating the restructuring of debt by establishing a new examinership procedure for companies and by offering new instruments for the restructuring of debt for natural persons.

Regarding the corporate insolvency regime, the existing law on the winding-up of companies is updated to provide a swift liquidation procedure for insolvent companies which cannot be rescued. In addition to this liquidation procedure, a new corporate restructuring/rescue law (based closely on the Irish Examinership law) is established, which will facilitate the restructuring of viable companies with the help of an examiner (insolvency practitioner). The directors of the company would normally remain in control of the business.

The reform of the framework for personal insolvency consists of a modernisation of the existing bankruptcy law and the establishment of several tools for the restructuring of household debt.

The bankruptcy law, which essentially dates from 1914, is amended to permit automatic discharge of the bankrupt (natural person) after 3 years, in line with emerging EU best practice. The new procedure offers the possibility for a fresh start for over-indebted individuals, on the basis of full disclosure and surrender of assets and full cooperation. This discharge will also cover secured debt for the first time in order to permit a mortgage debtor to be released from a deficiency claim after loss or disposal of the property. The possibility of a debt discharge is an important development with regard to rehabilitation of entrepreneurs liable for the debt of a company.

In order to deleverage the high levels of private debt, two new insolvency tools were developed. The **Debt Relief Order** (which is based on similar UK and Irish models) offers the possibility of debt relief not exceeding euro 25.000 for debtors with virtually no assets and no income who are at risk of social exclusion.

The **Personal Repayment Plan**, (which mostly replicates the Personal Insolvency Arrangement of the Irish law) establishes a procedure pursuant to which, an insolvent debtor can, with the mandatory help of an insolvency practitioner, develop a restructuring plan which, where possible, should avoid the sale of the primary residence. The Plan, which could last up to 5-6 years, has to be approved by the creditors (35% veto right, of all creditors).

The authorities have also developed a **compulsory element to the Personal Repayment Plan** which – in case of failure to agree a voluntary restructuring – allows the debtor to apply to the court for the imposition, subject to certain criteria (the value of primary residence is up to €300,000, the total amount of debt is up to €350,000) of a restructuring plan on the creditors with the objective of avoiding bankruptcy and foreclosure. Creditors must at least get bankruptcy liquidation value.

The law establishing the **Cypriot Insolvency Service** will also regulate the eligibility criteria, training and licencing of insolvency practitioners who will operate the corporate and personal insolvency procedures.

The new laws will be accompanied by secondary legislation, yet to be finalised. A transitional scheme will bridge the period from the entry into force of the insolvency laws until the full introduction of a comprehensive licensing system.

However, some last minute amendments by the House of Representatives may reduce the effectiveness of the new insolvency framework. In particular, the amendment that allows courts to suspend the foreclosure on the primary residence of non-viable debtors without any obligation on the part of the debtor may delay resolution of NPLs in some cases. The impact of this

amendment will, to a large extent, depend on the courts' interpretation. The authorities will now implement and monitor on a continuous basis the performance of the insolvency framework and they have agreed to make adjustments, if necessary.

The legal framework establishing a new foreclosure procedure, which allows for

auctions/sales to be conducted without interference from government agencies, is now in force. The foreclosure law was adopted by the House of Representatives in September 2014 as a prior action for the granting of the sixth disbursement of financial assistance. However, the entry into force of the new Foreclosure Law was repeatedly suspended until April 2015. Following the adoption of the insolvency framework on 18 April, the Law is now in force. It became fully applicable when the accompanying regulation on the procedural rules for sale by auction was adopted on 14 May 2015.

As a further step to speed up the resolution of NPLs, the authorities are preparing draft legislation to ensure that property buyers, who have paid the purchase price in full, will have their title deeds transferred to them within 6 months after their issuance. The title deeds problem primarily affects a substantial number of buyers, who, despite having paid the full purchase price, have not received the title deed (full property right). The deed is still under the name of the seller (mostly developers), usually because there is an uncleared mortgage of the developer on the property. The mismatch between the legal owner of the property and its final buyer poses significant legal risks and impedes the resolution of NPLs. The draft legislation envisages putting obligations on all parties involved to ensure that the procedures releasing encumbrances and transferring the title deed can operate without delay and as automatically as possible. It should provide safeguards against abuse, inter-alia by introducing a mandatory escrow account to route all payments related to a property transaction, as well as adequate compensation for the parties involved, if available. The presentation to program partners of draft legislation to that aim has been made a prior action for the conclusion of this review.

3.1.6. Anti-Money Laundering

There has been steady progress on the implementation of most of the Anti-Money Laundering (AML) action plan by the Cypriot authorities, albeit with some delays. Main advances were made on the development and implementation of effective tools to strengthen the supervision of financial institutions, lawyers, accountants and administrative service providers

(ASPs). Progress has also been made in ensuring sufficient staffing of AML supervisory units.

The CBC has finalised its AML monitoring tools, but some fine-tuning is still needed. Fine-tuning of the onsite tool based on the results from the offsite tool was difficult since inspections had started before the offsite tool had been finalised. The results of the offsite tool have been taken into account when developing the 2015 inspections programme.

The CBC has made progress in ensuring that financial institutions have sound and effective AML/CFT systems. The CBC conducted onsite inspections of eleven banks in 2014 and submitted the related reports to its governor in April 2015. This notably concerns the local branch of FBME Bank Ltd., which was designated by the US authorities as a financial institution of primary money laundering concern. The Central Bank of Cyprus took over the management of the branch and the bank has been under resolution since July 2014. In order to protect the liquidity position of the bank and eventually avoid a call on the Cypriot Deposit Guarantee Scheme, the daily deposit withdrawal has been limited. It has been fixed at EUR 200 per day and per account since March. For all banks, the annual risk management reports for 2014 have now been submitted to their respective boards for approval and been provided to the CBC. The AML inspection plan for 2015 has been approved and foresees 24 missions in 2015, including some follow-up visits. By end-May 2015 the CBC AML manual is expected to include a procedure calling for prudential supervisors to inform the AML team in case of a change in the business model of the bank they are supervising.

The supervisory authorities of obliged entities in the non-financial sector are enhancing their risk-based supervision. Offsite risk-based tools have been completed, tested and implemented by the Cyprus Bar Association (CBA), Cyprus Securities and Exchange commission (CySEC) and the Institute of Certified Public Accountants of Cyprus (ICPAC). Risk profiles have been assigned to all firms and were used to determine onsite inspection priorities for 2015. The offsite tools will be improved based on the results of the onsite inspections.

The implementation of the onsite inspection tools by the supervisors of non-financial sector entities has started. By end-April 2015, the CBA had undertaken 30 visits based on the new risk-based supervisory programmes. Findings so far suggest increased awareness from lawyers, but application of the AML/CFT obligations can be improved. ICPAC is implementing its inspections programme, with support from a specialised services provider. No significant flaws have been detected, and petty issues are immediately highlighted for corrective action.

CySEC has developed and begun to implement its risk-based inspection tools. Its offsite tool has been completed and fine-tuned. All entities licensed as ASPs were assigned risk profiles, which were used to establish the onsite supervisory plan for 2015. The onsite tool has been designed and pilot onsite inspections will be finalised by Q2-2015.

Effective supervision requires all supervisory authorities to be adequately staffed and trained. The CBC has increased the staff of its AML unit by transferring experienced staff from another unit and hiring an additional person. External auditors have been contracted to help undertaking onsite visits. CYSEC, CBA and ICPAC have started to increase the resources dedicated to AML, through staff recruitment and the recourse to specialised service providers. All supervisory authorities have made use of training opportunities and started to develop training programs for 2015.

3.2. FISCAL POLICY

The 2015 primary balance target was revised upward significantly. The 2015 end-year primary balance target was revised from a deficit of 1.6% of GDP in the fifth review to a surplus of 1.5% of GDP.⁽³⁾ In addition, the fifth review forecast (July 2014) projected that measures of 0.3% of GDP were needed to reach the primary deficit target of

1.6% of GDP, while the updated projections do not foresee any measures for 2015.

The revision reflects the 2014 outcome, the updated macroeconomic forecast, as well as fiscal developments in the first quarter of the year.⁽⁴⁾ Compared to 2014, the general government balance is expected to worsen in 2015, when excluding the one-off effects from banking recapitalisation in 2014. This reflects the contraction of nominal GDP in 2015, impacting mostly on tax revenues, but also other factors beyond the government control, such as new location rules regarding VAT for e-commerce services, the loss of revenue linked to the national resolution fund and a decrease in dividend income from the CBC. On the expenditure side, the 2015 result is affected by expenditures related to the closure of Cyprus Airways and the introduction of the new Guaranteed Minimum Income scheme.

For 2016, in line with the broadly unchanged macroeconomic projections, the revision to the fiscal forecast is of a similar magnitude as the 2015 revision. Compared to the fifth review primary balance target of 1.2% of GDP including 1.9% of measures needed to reach this target, the primary balance is now forecast to reach 2.5% of GDP without any further measures.

The current forecast suggests the need for some further consolidation measures of lasting nature to achieve the primary surplus of 3.0% of GDP in 2017. However, there are obviously large uncertainties regarding the macroeconomic outlook and a continuously cautious implementation of fiscal policy in 2015-16 could improve outcomes compared to projections, thereby potentially reducing the need for further measures.

In line with the updated MoU, the fiscal target for 2018 and beyond has been revised slightly downward. Recognising the major fiscal consolidation achieved over the last years and the ensuing much better debt sustainability than envisaged at the onset of the programme, programme partners have agreed to a primary surplus for 2018 and beyond in the range of 3-4 %

⁽³⁾ Figures for the fifth review are stated in ESA 95. While the transition to ESA 2010 had only a limited impact on fiscal figures in nominal terms, the upward revision of nominal GDP by about 10% has affected the GDP ratios. Without the GDP revision the 2015 primary surplus in % of GDP would have been slightly higher. Therefore the ESA revision was not a driver behind the significant improvement of the primary balance projection compared to the fifth review.

⁽⁴⁾ The 2015 primary balance was already revised to a surplus of 0.2% of GDP in the European Commission's Winter Forecast 2015.

Table 3.2: **Fiscal accounts, projections for 2015-2016**

	million euros unless otherwise stated		Sixth review forecast (April 2015)		Fifth review forecast (July 2014)*	
	2013	2014	2015	2016	2015	2016
Total revenue	6,610	7,053	6,837	6,958	6,501	6,774
Taxes on production and imports	2,491	2,615	2,556	2,593	2,416	2,524
Current taxes on income and wealth	1,873	1,806	1,730	1,788	1,792	1,866
Social contributions	1,362	1,557	1,556	1,595	1,506	1,550
Sales and other current resources (1)	877	1,069	990	977	784	832
Capital transfers received	6	5	5	5	2	2
Total expenditure	7,501	8,596	7,090	6,978	7,326	7,134
Total current expenditure	6,877	6,567	6,503	6,409	6,786	6,622
of which						
Intermediate consumption	744	655	623	629	757	725
Compensation of employees	2,573	2,299	2,273	2,260	2,350	2,335
Social transfers	2,509	2,618	2,599	2,603	2,674	2,595
Interest (2)	563	498	517	458	568	561
Subsidies	95	80	80	81	90	91
Other current expenditure	392	417	411	377	347	316
Total capital expenditure (3)	624	571	588	569	540	511
General government balance	-891	-43	-253	-19	-826	-360
% GDP	-4.9	-0.2	-1.5	-0.1	-5.2	-2.2
General government primary balance	-327	455	264	439	-258	201
% GDP	-1.8	2.6	1.5	2.5	-1.6	1.2

* Figures for the Fifth review are stated in ESA 95. The transition to ESA 2010 has had a very limited impact on nominal fiscal figures.

(1) The 6th review projection includes expected dividends of EUR 133mn in 2015 and 114 in 2016, to be distributed by the CBC in line with the CBC's duties under the Treaties and the Statute.

(2) For 2013, this includes compensation of pension funds amounting to 1.7% of GDP.

(3) For 2013, this includes signing fees for gas exploration amounting to 1.0% of GDP, which are treated as negative capital expenditure (disposal of non-produced assets). Other capital expenditure in 2014 excludes the one-off impact of the recapitalisation of the cooperative credit institutions amounting to EUR 1.5bn (8.6% of GDP).

Source: Commission services

of GDP (down from the initial 4% of GDP). The exact target will be embedded in the medium term budgetary strategy for 2016-2018. As a technical assumption, the forecast assumes a fiscal target of 3.6% of GDP, which under the current forecast is expected to be achieved without additional measures. The analysis in chapter 4 shows that this revision in the primary balance requirement for 2018 and thereafter has limited impact on the debt path, which is expected to remain much lower than envisaged at the onset of the programme.

Fiscal risks remain significant. The risks concern notably the government's large exposure to contingent liabilities and potentially adverse macroeconomic developments in the outer programme years. The fiscal targets set would require the continuation of the authorities' commitment to prudent budget execution, despite possible political pressure for relaxation.

3.3. FISCAL-STRUCTURAL REFORMS

3.3.1. Healthcare System

The implementation of the National Health System (NHS) has been delayed to 2017. The initiation of the procurement tender for the IT infrastructure, which is a pre-condition for NHS going online, is now shifted towards end-May 2015, with the delivery of the IT infrastructure planned for early 2017. In addition, some necessary legislative changes are still under preparation. Specifically, while the NHS bill laying out the principles of the NHS has been put to public consultation end-2014, its submission to the House of Representatives is not expected before the authorities have reassessed the implementation schedule based on its decision on the final design of the NHS, most notably whether the system will be based on a single or multi-payer insurance system. This uncertainty regarding the final design of the NHS has impeded progress in

negotiations with stakeholders on the key fiscal parameters of the NHS, as the former would require clarity before firmly committing to financial obligations. As a consequence and under the best case scenario, NHS could be implemented fully in Q1-2017.

The authorities' commitment to a single insurer system, as agreed in the fifth review, has not been confirmed. While the government so far has continued to align with the original MoU commitment that NHS will be initially based on a single payer insurance system, the authorities have signalled that they envisage that it could be designed as a multi-payer insurance system. However, in the view of the programme partners, a multi-payer system could imply severe fiscal risks and is not considered a first-best choice for Cyprus. A related WHO study has recently confirmed these concerns, demonstrating that the pre-conditions for a multi-payer insurance system cannot realistically be met in Cyprus within the agreed deadlines, and that the multi-payer insurance system adds significant inefficiency and fiscal risks to a future NHS. Therefore the MoU in a first instance gives priority to a set of measures to strengthen the sustainability of the funding structure and the efficiency of public healthcare provision and makes clear that the final design of the NHS should ensure fiscal sustainability. A multiple insurance system can be implemented if and when the necessary preconditions for achieving fiscal sustainability as well as efficiency and affordability gains can be ensured.

Some progress has been observed regarding the preparation of the hospital autonomisation bill.

A draft bill has been subjected to public consultation and is envisaged to be put to legal vetting by Q2-2015. Under NHS, public health care providers may run deficits, potentially burdening public finances. Against this background, a timely adoption of this bill is key, as it prepares public hospitals and primary healthcare centres for competition with private healthcare providers under NHS.

Efforts in other areas for preparing the implementation of the NHS continue with mixed success. Compliance can be reported for the following items: i) A review of income thresholds for free public health care has been finalised; ii) Reports for collection of health-care contributions

and private co-payments by public health care providers have been submitted; iii) Work on clinical and prescription guidelines and health-technology assessment has continued; iv) Reviews of the basket of publicly reimbursed medical services are conducted periodically, and; v) public hospitals have completed the activity-based shadow budgeting. Also, the report on the reform of public primary health care centres has been submitted to programme partners, while a reform plan and policy decisions on how to reform these centres are still missing. Similarly, the authorities have prepared a report on contingency measures under NHS, which still needs to be translated into a legally binding document, so as to effectively strengthen the fiscal sustainability of the NHS. No progress on policies for pricing and reimbursement of pharmaceuticals has been made since the last mission, although policy options have been developed.

Implementation support from international experts is gaining ground. The Support Group for Cyprus has prepared together with the Ministry of Health and the World Health Organisation projects for supporting the implementation of NHS. The contract will be signed in the coming months. Support is envisaged in the areas of sustainable and equitable financing, hospital and specialist care reform, primary care, IT and e-health, consensus building and change management, health sector governance and pharmaceutical policies.

3.3.2. Public Financial Management and Budgetary Framework

Progress has been made with a view to managing the fiscal risk from government guarantees. Following the submission of the first risk assessment report to programme partners in Q3-2014, the authorities have received significant support through technical assistance (TA) from the IMF and the ESM to improve the management of government guarantees. With a view to streamlining procedures, and in line with the recommendations of this TA, the Minister of Finance has decided to shift the responsibility for the management of guarantees from the Public Debt Management Office (PDMO) to the Treasury. The next risk assessment report will be submitted to programme partners by Q2-2015. The report will take into account the newest available

data, but will, given the organisational changes and the tight timelines related, likely not yet incorporate methodological recommendations from technical assistance provided by the ESM. ⁽⁵⁾ The authorities have also progressed on establishing institutional arrangements for the management of existing and future guarantees.

Following the adoption of a medium-term debt management strategy (MTDS) by the Council of Ministers in December 2014, the PDMO continues to build up its strategies and skills to gain stable market access after the programme.

The adoption of the MTDS and the annual financing plan were important milestones in preparation for the debt management in the post-programme period. To further improve its operation, the PDMO sought further support through TA provided by the ESM, on the basis of which, by Q2-2015, an action plan will be prepared. The plan should lay out specific steps and detailed timelines, with a view to strengthening the organisational capacity of the PDMO.

The guidelines for public investment projects have been adjusted with the assistance of the World Bank and are expected to be adopted before the next review.

The purpose of these Guidelines is to complement the new Fiscal Responsibility and Budgetary System Law (FRBSL), by providing the rules and procedures and defining the roles and responsibilities of bodies involved in each of the project pre-selection, appraisal and selection stages. A manual elaborating methodology, criteria and templates to be used, will also be provided to ensure consistency and standardisation in the project pre-selection, evaluation and selection process.

3.3.3. Privatisation and State-Owned Enterprises

Since its creation in June 2014, the Privatisation Unit has appointed all relevant advisers for CyTA's (telecoms) privatisation and has made some progress on CyTA's corporatisation law, albeit discussions with trade unions are still ongoing. The law allowing for CyTA's conversion

into a Limited Liability Company, a key preparatory step for its privatisation, is currently subject to a consultation process with trade unions, mainly on personnel issues. Although the timeline remains challenging, the aim is for the law to be adopted by the Council of Ministers in June 2015 and by Parliament soon after the summer.

The concession agreement for Limassol Port's commercial activities is under preparation and its call for expression of interest is expected to be launched in June 2015.

In parallel to this, the Cyprus Ports Authority's enacting law, whereby the Cyprus Port Authority is transformed from being an operator to a regulator, has been prepared and should be adopted before the next review, after which the privatisation process is expected to accelerate.

The launching of the study on Electricity Authority of Cyprus (EAC)'s legal unbundling and ownership structure has been seriously delayed, due to strong opposition from the trade unions.

The aim of the study is to identify the best option for the unbundling of EAC's operations into different legal entities. The study will be conducted by an independent energy adviser, to be appointed by open tender. The trade unions have blocked the bidding process, as the study is regarded as a first step towards EAC's privatisation, and the study may not be finalised until November 2015, with an interim report expected two months earlier. The Council of Ministers will decide on EAC's form of effective and efficient unbundling in December 2015, in line with the principles of the Third Energy Package.

The State-Owned Enterprises (SOEs)' corporate governance law is currently under discussion at the Parliamentary Committee.

After a delay of more than 18 months, due to inconsistencies with the Fiscal Responsibility and Budget System Law (FRBSL), delays in the legal vetting, and objections voiced out by stakeholders through a public consultation process, the law should now be ready for adoption. This is an important law for the much needed governance reform in SOEs and for further mitigating existing fiscal risks.

⁽⁵⁾ The authorities assured that these recommendations would be taken on board at the latest in the Q3-2015 update of the report.

Box 3.3: CyTA's privatisation

Telecoms market structure

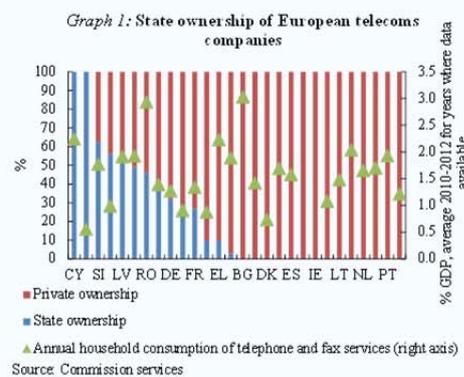
Privatisation of state-owned enterprises (SOEs) is a key component of the Cyprus programme. Cyprus's largest SOE is the Cyprus Telecommunications Authority (CyTA). A sale of CyTA would put Cyprus well on the way to achieving its target for privatisation proceeds.

Cyprus is one of the few Member States having a fully state-owned telecoms provider (Graph 1). Luxembourg is the only other EU Member State retaining a 100 per cent stake. European legislation ensures competition in telecoms markets regardless of ownership, including infrastructure competition. It also obliges Member States to ensure the provision of a universal service and allows them to secure other areas of public interest.

CyTA remains the main player in the Cypriot telecoms market. It is designated by the National Regulatory Authority as holding significant market power (SMP) in all markets that the Commission recommends national regulators to consider for ex-ante market regulation.¹ The market was opened to competition shortly before Cyprus's accession to the EU in 2004. The relatively short time since liberalisation, and the small size and low attractiveness of the Cypriot market helps explain CyTA's market positioning. Nevertheless, Cablenet and Primetel are both gaining market shares in the broadband and fixed voice service markets; and MTN has about 30 per cent of the mobile market. The authorities awarded a third mobile licence to the only bidder Primetel in early 2014, through auction.

While call volumes are high, internet access remains low, due to low digital skills, and high broadband prices, also due to the high cost of international connectivity. Only 65 per cent of households had internet access in 2013, compared to an EU average of 79 per

cent. High costs might explain this to some extent: broadband prices in Cyprus at purchasing power parity are the second highest in the EU,² and 39 per cent of households without internet said cost was the main barrier.³ Lack of digital skills is another reason: 28% of the population has never used the Internet and only 48% possess at least basic levels of digital skills.



Market readiness for privatisation and regulatory framework

Competition in the telecoms market is essential if the benefits of privatisation are to be maximised. A well designed regulatory framework that supports competition gives potential investors more certainty on the market's functioning, lowering the risk premium. This can support a higher sale price and more investment after the sale. European competition and sector regulation legislation aims to ensure that all Member States' telecoms markets are open to competition, whether the incumbent is publicly owned or not.

Cyprus's regulatory framework appears sufficiently robust to allow privatisation without delay. The framework is well structured and appears to comply with EU law. Cyprus has fully transposed the most recent EU

¹There is a new recommendation 2014/710, which has reduced the number of markets to five. In the termination markets (Markets 1 & 2), all network operators are considered to have SMP.

² http://digital-agenda-data.eu/datasets/digital_agenda_scoreboard_key_indicators/visualizations

³ Eurostat, table isoc_bde15b_h, series H_XACC

(Continued on the next page)

Box (continued)

Telecoms Framework¹, and there are no pending infringement proceedings against it in this area. Alternative operators have access to the different parts of CyTA's network at regulated prices.

Securing the public interest

Member States are able to designate one or more telecoms companies, privately or publicly owned, as universal service providers. This is done through an open process. These providers are then responsible for providing a minimum range of telecoms services specified in EU law. Most Member States have nominated such a provider, though Germany, Luxembourg and Sweden have not. They judge that the market alone provides a sufficient service.

¹ Revised EU Telecoms Framework 2009 (Better Regulation Directive 2009/140/CE and Citizen's Rights Directive 2009/136/CE)

CyTA could remain the designated universal provider after privatisation. CyTA can be compensated for any additional costs resulting from this designation through a proportionate levy on the rest of the sector or another compensation mechanism as appropriate.

National security is the sole responsibility of the Member State.² This has not hindered full privatisation of many European telecoms companies, though some governments have retained special rights through statutes or golden shares. Each case is considered on its own merits. The ongoing 'Cyprus problem' would be taken into account. Policies on interventions for national security and public policy reasons are reviewed when appropriate.

² TEU 4.2

Overall, a firm commitment to the objectives of the programme in the area of privatisation will be required in order to keep up momentum. Concerns are growing about the political support in Cyprus for the agreed policies in the area of privatisation. This relates both to the support for key steps that will increase economic efficiency and prepare privatisation, such as the legal unbundling of EAC, and in some instances to the end-goal of privatisation. It remains uncertain whether a parliamentary majority can be gathered to support these key steps, notwithstanding the fact that they are central elements of the programme. A firm commitment to the objectives of improving economic efficiency, attracting investment and contributing to reducing public debt appears necessary in order to ensure timely implementation of the privatisation plan.

3.3.4. Revenue Administration

The revenue administration reform has overall progressed adequately, albeit with delays in some areas. Since the fifth review mission, the integrated large taxpayer office has been set up, which is responsible for taxpayers accounting for about 40% of domestic tax revenue. Most top to middle management positions in the new tax

department have been filled and the organisational structures for the tax department have been approved. In addition, a debt management strategy and a debt collection action plan have been adopted and the process for bank garnishment has been set up and tested in practice. Further, a draft for the comprehensive compliance strategy has been submitted (with some delay) and the new tax procedure code is being drafted with support from technical assistance and in line with the agreed time schedule.

However, some delays have occurred, which slow down the reform process. There is still only one Assistant Tax Commissioner, even though it was originally foreseen to appoint two or three, and a new reform project manager has not been appointed either. Moreover, the authorities still seek for a solution for the integration of the grade structures, which were different in the two old departments. While the received draft for the comprehensive compliance strategy is broadly consistent with the approach recommended by technical assistance experts, it does not fully meet expectations in terms of its coverage and level of detail. Finally, the action plans that were supposed to be produced by the strategic headquarter units to prepare the operational implementation of the new

compliance strategy and integrated work along core functions of the department have not been submitted.

The reform is now at a juncture, where the implementation of the reforms at operational level needs to be reinforced. Currently, except for the large taxpayer office, the operational business still continues under its old work format, even if the formal integration has taken place. In order to reap the benefits of the reform, it is essential that the new function-based (instead of tax-based) work methods and the new approach to compliance management are implemented at the operational level and adequate human resources are allocated to this end.

3.3.5. Public Administration Reforms

The reform plan on the horizontal public administration is underway and is expected to be adopted by the Council of Ministers in late June 2015. Based on the findings of the horizontal review submitted in 2014, the Cypriot authorities are finalising a reform plan including a reform of the structure of public sector wages, the introduction of a new appraisal system and a new promotion system establishing a stronger link between merit and promotion, as well as measures to enhance further staff mobility. The authorities' reform proposals are currently subject to consultations with trade unions and opposition parties. The reform plan is expected to be submitted to programme partners before the next review.

Regarding the sectoral elements of the public administration reform, the first batch of the reform plan is almost completed, while the second batch is now underway. Only the Ministry of Interior has not come up with a concrete reform plan on local governments (Agriculture, Education and Health had their action plans adopted by the Council of Ministers between late 2014 and early 2015). Progress has been made on reforming and enabling the Department of Registrar of Companies (DRCOR): following third party reviews, the processes of the Companies Section of the Department are being improved with the help of external experts. The backlog of registration is being dealt with the DRCOR's existing staff. The legislation on the Companies Registrar still needs adoption by

Parliament. The functional review of the remaining ministries is now being followed by experts from the United Kingdom and Ireland. Reports on various ministries are expected to be ready before the summer.

3.3.6. Reform of the Welfare System

The welfare reform is progressing, with the processing of applications to the new Guaranteed Minimum Income (GMI) scheme well under way. After initial challenges, processing of the about 70,000 applications that were received has accelerated. In particular, the processing of the applications of households that were not eligible under the old public assistance scheme has been nearly completed. Furthermore, the authorities' update of the projected costs for the GMI shows that the additional costs for the new scheme (compared to the old public assistance scheme) is expected to be considerably lower than initially expected.

Further reforms are being prepared. The authorities have committed to prepare by end-June 2015 plans for complementary reforms aimed at the consolidation of student and disability benefits. Moreover, the authorities are working on establishing a single view on all benefits a given recipient receives. To this end, the three involved line ministries are starting to coordinate the building of compatible registries containing information on the beneficiaries' profiles and benefits they receive. Once constituted, this single view of benefits will allow the authorities to finalize an assessment report of the welfare reform, including possible refinements in administrative structures and benefits.

3.3.7. Other Fiscal-Structural Reforms

International tax cooperation

There continues to be a strong commitment by the Cypriot authorities to address the shortcomings identified by the OECD Global Forum. A supplementary review by the OECD Global Forum has been initiated, including an on-site visit in end-March 2015, and the authorities report that the reviewers have noted remarkable progress. A final decision on a new rating will be taken during the Global Forum annual meetings in fall 2015.

Box 3.4: Tax debt and its management in Cyprus

Tax debt in Cyprus is high in comparison to other EU countries. Cyprus has the third highest ratio of undisputed tax debt as a percentage of net revenue, about three times higher than the EU average. As of March 2015, the amount of immediately collectible debt stood at 4.3% of GDP (Table 1).

Table 1:

Tax debt as of 31 March 2015*	Total	Direct taxes	VAT
Sum (% of GDP)	11.4%	8.9%	2.5%
Not immediately collectible	7.1%	5.1%	2.0%
amounts under objection/appeal	2.9%	2.4%	0.5%
amounts not considered collectible for other reasons (bankruptcy, liquidation, lost contact, etc.)	4.1%	2.7%	1.4%
Immediately collectible	4.3%	3.8%	0.5%
amounts under measures	3.1%	2.8%	0.3%
amounts under no measure	1.2%	1.0%	0.2%

*figures include penalties and charges

A large fraction of total debt is considered non-collectible, either because the amounts are under objection, the taxpayer is bankrupt/under liquidation or because contact was lost. There exists currently no administrative procedure to write-off uncollectible tax debts, which has contributed to the accumulation of 7.1% of GDP in non-collectible debt as of March 2015.

Amounts to which the taxpayer has objected constitute about one quarter of total tax debt. Since an objection suspends the obligation to pay the disputed tax debt, collection enforcement actions cannot be applied. To bring down disputed tax debt, it is therefore important to on the one hand prevent disputes, for example by enhancing the use of self-assessments and improving the quality of administrative decisions, and on the other hand, shorten dispute resolution times.

Out of the immediately collectible tax debt, a sizeable fraction, mostly relating to companies, is not under any active management. In March 2015, this was the case for debt amounting to 1.2% of GDP (of which 1.0% of GDP in direct taxes and 0.2% of GDP in VAT), corresponding to about 30% of the immediately collectible debt. As of

September 2014, when the overall debt picture looked roughly the same, more than 70% of the amount under no active management was owed by companies and close to 60% was owed by a small population of taxpayers, namely less than 700 constituting only about 1% of cases.

The tax department has a range of options to address an existing collectible debt. At one end of the range it may take soft actions such as sending reminders, phoning the taxpayer, or offering an instalment plan. At the other end stand collection enforcement actions, which have recently been considerably strengthened and which include the seizing of assets and garnishment of bank accounts.

Table 2:

Breakdown of immediately collectible debt under no measure

	% of cases	% of debt
< 1,000	68%	5%
1,000 - 30,000	31%	37%
>30,000	1%	57%

When choosing the right tool to address an existing collectible debt, it is important to take account of the characteristics of the debt (e.g. its amount and age) and of the taxpayer, notably the taxpayer's compliance record. Taxpayers who are willing to comply but do not have the means to pay should be able to expect an accommodating administration using soft tools. In contrast, a taxpayer who has the means but is simply not willing to pay should expect swift use of enforcement tools such as seizing of assets, garnishment of bank accounts etc. Typically, tax administrations have sufficient information to be able to judge which type of taxpayer they are dealing with.

However, bringing down tax debt in a sustained fashion cannot be achieved by focussing only on the collection of existing tax debt. It is at least as important to prevent

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Box (continued)

that new debt is created. Any tax debt management strategy should therefore be rooted in an overall compliance improvement framework, setting incentives for taxpayers to comply with their basic obligations such as filing and payment. Such incentive setting should follow a carrot and stick approach, whereby complying with obligations is made as easy as possible for taxpayers while deliberate non-compliance is sanctioned.

The new approach to tax debt management that Cyprus intends to implement over the course of 2015 is consistent with the principles outlined above. It is integrated in a compliance improvement framework, which incentivises voluntary compliance, including by enhancing the fairness of the administration and showing flexibility to the economic context of Cyprus, while deterring deliberate evasion. In line with this approach, enforcement tools are applied proportionately, paying attention to the taxpayers' situation and willingness to comply.

Updated statistics on Cyprus' performance on information exchange with respect to direct taxes also suggest that improvements have been made. In parallel, the authorities have prepared amendments to address remaining concerns on the implementation of the related Directive 2011/16/EU on administrative cooperation in the field of taxation, which may allow closing the related Pilot that had been launched by DG TAXUD.

An enhanced access to databases of other public entities is expected to further facilitate the speedy processing of information requests. A continuous access to relevant databases is expected to be ready by end-2015 through the launch of the new government data warehouse. Compared to the initial deadline, this implies a substantial delay, but given that the data warehouse is a longer standing project with a larger scope, it is difficult to speed up the implementation.

The authorities have not yet performed any audits of paying agents with respect to their obligations under the so-called Savings Directive. Council Directive 2003/48/EC on taxation of savings income in the form of interest payments obliges paying agents (mostly financial institutions) to collect certain information about taxpayers and interest income paid. While audits on the compliance with these obligations have not taken place in 2014 as envisaged, the authorities

have included such audits in their audit plan for 2015 in order to make up for the delay.

Immovable property tax

Legislation must be approved imminently for the immovable property tax (IPT) reform to be implemented in 2015. Since the completion in November of the consultants' study on the reform, the necessary decisions on the structure of the new immovable property taxes (transaction and recurrent) have been pending. The appeals' period regarding the objections to last year General Valuations has been extended to the end of 2015, which led to a delay in the final design of the tax structure. In addition to a reform of the structure of IPT, the government also plans to consolidate the municipality tax with the IPT. With the aim to implement the reform in 2015, the authorities are expected to submit the relevant bills to the House of Representatives by Q2-2015. Further, to facilitate implementation and minimize objections to the reform, the authorities committed to develop a communication strategy on the new tax.

3.4. STRUCTURAL REFORMS

3.4.1. Labour Market

Tripartite negotiations to extend the reform of wage indexation to the private sector are still

on-going. While the suspension of wage indexation in the private sector has been extended to end-2016, there has been no agreement on the adoption of the reformed system agreed for the public sector. The private sector has accepted the lower frequency of indexation and the suspension of COLA during recessions, but no agreement has been reached on the change from full indexation to partial indexation (at 50% of inflation).

The National Action Plan for Youth Employment has been adopted. The data shows that the outreach of measures implemented in 2014 is limited, with disproportionate emphasis on the youth. To ensure consistency between measures targeting the youth and the overall program of active labour market policies (ALMPs), the authorities have agreed to produce a comprehensive note summarising the full list of all ALMPs (existing and envisaged) with the relevant intended aims, recipients and budgetary allocations. The adoption of the Operational Programme for "Employment, Human Resources and Social Cohesion" for 2014-2020 should now pave the way for more ambitious programmes, with a more balanced focus on various age groups and on containing the rise in long-term unemployment.

A comprehensive methodology for monitoring and evaluation of ALMPs has been recently adopted and is being implemented. A first report describing the implementation will be finalised for consultation with programme partners by Q4-2015.

The capacity of the public employment services (PES) to respond to their new tasks remains unsatisfactory in terms of staffing, organisation and procedures. To address the issue, a tender for the recruitment of additional staff will be launched by end-May 2015, with a view of having the new staff operational by Q3-2015. In parallel, reforms are envisaged in the short term to improve the effectiveness of the services. In addition, new procedures to ensure effective cooperation between the public employment services and entities providing social benefits have been introduced but not yet formalised.

3.4.2. Energy

The roll-out plan for the gas export infrastructure has been updated in due time,

but a further update will be needed, taking into account the latest developments. Whereas previous versions of the roll-out plan focused on an LNG plant, this solution seems to have now been put aside, at least for the short term, with a floating device with pipelines to Egypt and Cyprus a possible alternative. In view of this, the authorities committed to further update the roll-out plan when the development plan of the Aphrodite gas field will be received and to undertake a financial and budgetary impact analysis prior to any investment decision for the gas export infrastructure.

Regarding gas imports, the tender procedure on a 10-year supply contract is still on-going, and the period for assessing the bids has been extended until 31 July 2015. The tender implies gas imports for a duration of 7 years starting from 2016.

The Sovereign Wealth Fund (SWF) law is in the process of legal vetting. The authorities are committed to submit a complete set of legislation (comprising the SWF law as well as secondary FRBSL legislation defining inflow and outflow rules) to the House of Representatives by Q2-2015.

The final comprehensive outline of the market organisation and regulatory regime for the energy sector and gas exports has been provided to programme partners. This document, which specifies different options, should be the basis for a political decision on the preferred option, taking into account the timeline for the legal unbundling of the Electricity Authority of Cyprus (EAC).

3.4.3. Services Directive and Regulated Professions

The Cypriot authorities have amended all the necessary laws related to regulated professions, except for the engineers' profession. As Cyprus has to undergo the Transparency Exercise, which applies to all EU Member States and which implies providing specific information on specific professions, the elimination of unjustified requirements for the specific case of engineers remains subject to close monitoring and possible further actions by the Commission, so as to ensure compliance with EU law.

3.4.4. Housing Market and Immovable Property Regulation

Significant progress was made towards meeting MoU commitments on the issuance of title deeds. The backlog of title deeds outstanding for more than one year, which stems from slow administrative procedures in the land registry, was cut by half. Despite this progress, the initial target was not reached and was postponed to 2015. However, the definition of the backlog was broadened to include cases pending for six months or more.

The authorities have started reflecting on ways to streamline title deeds issuance processes, but more ambitious measures are needed. The relevant working group and task force have been established towards the goal of reducing the backlog and setting up sound future procedures. Some recommendations have already been made. However, many of the proposals have not yet been enforced. The authorities will prepare recommendations on comprehensive solutions to address the issuance hurdles and to streamline the relevant procedures by Q2-2015.

Limited progress was observed on the reduction of the courts backlog and efforts will now focus on measures aimed at ensuring the smooth and effective functioning of the revised foreclosure law and the new insolvency frameworks These will be a crucial follow-up steps to the newly adopted legislation. Obligations in that regards have therefore been shifted to the insolvency section of the MoU.

3.4.5. Tourism

Whilst there are indications in the bi-annual progress report that indicators such as tourism arrivals and tourism expenditure are kept at stable levels, more needs to be done in terms of strategy. As part of the Action Plan for Growth, led by the Presidency's Office, two fundamental areas are given priority: 1. an assessment of the current regulatory framework governing the tourism sector, which may help identify the impediments to competition in the tourism sector; 2. the preparation of a national tourism strategy that is still lacking, despite lengthy discussions. These two elements are fundamental intermediate steps to bring the tourism sector back on a balanced and sustainable growth path.

3.4.6. Growth strategy

A revised action plan for growth has been adopted by the Council of Ministers and progress has been made on main work streams. Various sectorial studies have been launched to improve the competitiveness and bottlenecks to growth, notably on tourism, education, research and innovation, and on strategic investment (i.e., with a significant impact on the country's economy, e.g. in terms of value, job creation). In parallel, the Cypriot authorities are working to simplify procedures in the areas of tourism, construction permits, migration, social insurance and on procedures for hiring highly skilled third country nationals. The various technical assistance projects related to the growth strategy are on track.

4. PROGRAMME FINANCING AND DEBT SUSTAINABILITY

Out of the EUR 10bn of external assistance agreed on 25 March 2013, EUR 6.1bn have already been disbursed by the ESM and the IMF. The ESM has disbursed EUR 5.7bn in six tranches, of which EUR 1.5bn for the recapitalisation of the cooperative banking sector in the form of ESM notes. The IMF has disbursed five tranches, totalling EUR 430m, the last 5th review by the IMF having not yet been concluded.

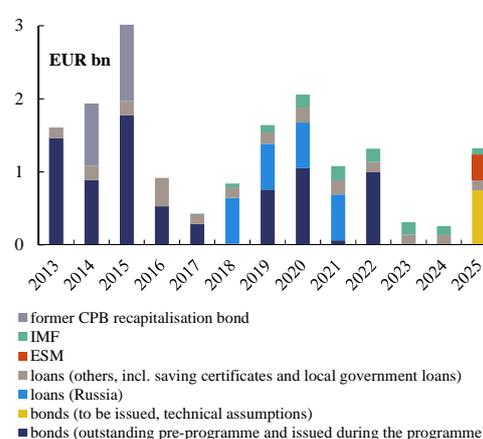
Total financing needs for the period Q2 2013-Q1 2015 proved to be below the initial projection. Total financing needs over the period Q2 2013-Q1 2015 amounted to EUR 5.1bn, of which EUR 1.5bn for financial sector recapitalisation, EUR 0.7bn for fiscal needs and EUR 2.8bn for medium- and long-term debt redemptions.⁽⁶⁾ The difference with the initial projections, mainly due to better-than-expected fiscal performance, has resulted in back-loaded ESM financing.

Yields on Cyprus' foreign-law bonds and T-Bills have further fallen to around 3.3% and 2.5%, respectively. Robust program performance, reflected in recent upgrades of Cyprus' rating or outlook by the three main credit rating agencies, positively affected Cyprus' bond yield (with the yield for 5-year-to-maturity bond at 3.3% and 3-month T-bill primary market yield at 2.5% in early May). The decrease in T-Bill yields was facilitated by the authorities having restarted regular T-bill auctions in February 2015. By the end of March 2015, the outstanding T-Bill stock stood at EUR 685m, lower than the EUR 970m at the inception of the programme. At the end of March 2015, six-year retail bonds, which Cyprus started to issue in June 2014, amounted to EUR 139m. Due to strong demand for those bonds, the authorities slightly reduced their average coupon (having a step up structure) to 3.9%.

Benefitting from a positive market sentiment, the Cyprus' authorities tapped markets again in 2015, in line with the recently adopted medium-term debt management strategy (MTDS).⁽⁷⁾

Following five-year bond issuance in June 2014, Cyprus issued on 28 April 2015 a seven-year Eurobond of EUR 1bn with a yield of 4%, significantly below the 4.85% yield of the five-year bond issued last year. The working assumption is that the proceeds will be used to redeem the CPB bond⁽⁸⁾, which matures in 2017. In parallel, the Cyprus' authorities continue developing the government securities market to prepare for public debt management in the post-programme period.

Graph 4.1: Medium- and long-term debt amortisations



(1) The above amortisation pattern assumes the repayment of the CPB recapitalisation bond in 2015 from the proceeds raised through market issuance. The working assumption is that also the domestic bonds maturing in 2019 will be redeemed early, financed by issuing a new bond at market conditions.

Source: European Commission.

Financing needs in the second and third quarter of 2015 are assessed to be limited. Based on the updated macro-fiscal projections, total financing needs for Q2 2015 are estimated to amount to some EUR 0.2bn, of which EUR 0.1bn for fiscal needs and EUR 0.1bn for debt redemptions. Over the third quarter, excluding the assumed redemption of the CPB bond, total debt redemptions are estimated to amount to around EUR 0.1bn, while an inflow of around EUR 0.1bn is expected to be generated from other proceeds.

⁽⁶⁾ For comparison purposes, this excludes EUR 850m, raised on the market in Q2 2014 and subsequently used to partly repay the CPB bond in Q3 2014.

⁽⁷⁾ Available at: <http://www.mof.gov.cy/mof/mof.nsf/All/082FF1F61BD32>

[B15C2257DB7003F3D6A/\\$file/Cyprus%20MTDS%202015-2019%20Final%20EN.pdf](https://ec.europa.eu/economy_finance/files/B15C2257DB7003F3D6A/$file/Cyprus%20MTDS%202015-2019%20Final%20EN.pdf).

⁽⁸⁾ In June 2012, the Cypriot government issued a EUR 1.89bn bond to provide Cyprus Popular Bank (CPB) with sufficient funds for re-capitalisation needs.

Box 4.1: Debt sustainability assessment

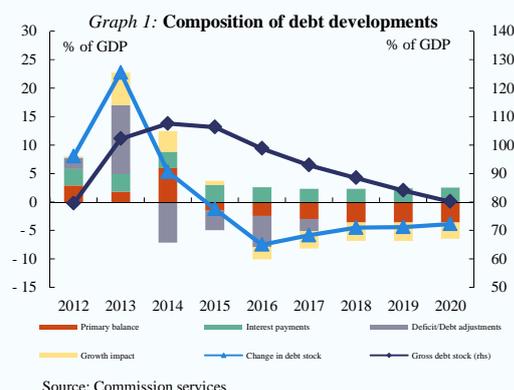
According to the updated projections, the debt-to-GDP peaked in 2014 and is projected to decline starting in 2015 from about 106% of GDP to about 80% of GDP in 2020. The debt to GDP ratio is therefore about 20 pp lower than projected in the fifth review. Various factors explain this development. First, the debt-to-GDP ratio has been significantly affected by the upward revision of nominal GDP by about 10% following the introduction of ESA2010. In addition, ESM financing has been lower than previously projected due to the good fiscal performance. Also, the comprehensive assessment did not give rise to financing needs in the financial sector and no further financial sector needs are projected to be covered by programme funds. This implies a lower debt ratio in 2014 and a lower projection for 2015. Finally, the total financing needs over the programme period appear at this stage to be lower than expected at the onset of the programme. This technical assumption does not prejudice a political decision on the usage of the programme financing buffer for alternative non-debt creating uses, which could include liability management operations.

The effect of updated macro-fiscal projections on the baseline debt projections is rather limited. Notably, the lowering of the primary surplus target from 4% to 3-4% of GDP for 2018 and beyond in line with the updated MoU is more than offset by better fiscal performance in 2015-2017.

The interest bill is expected to be lower than projected during the fifth review, mostly driven by reduced debt levels. The ESM interest rate is expected to be below previous assumptions for the period 2016-2020. After the programme horizon, the interest bill is projected to be influenced by higher market interest rates compared to those charged on ESM and IMF loans.

The loan-asset swap is assumed to be of a lower size. Due to a lower than envisaged valuation of the assets, the size of the loan-asset swap between the CBC and the Ministry of Finance has been revised

downwards to EUR 600mn and is now assumed to be finalised by Q4-2015.⁽¹⁾



The macroeconomic and fiscal performance continues to be an important risk for the evolution of the debt trajectory until 2020. A reduction (increase) in real GDP growth by one standard deviation over the programme period would result in a sharp upward (downward) revision of the debt trajectory. The impact of the shock is further intensified, if an additional effect of a lower (higher) real GDP growth on primary balance is assumed.⁽²⁾ The effects of an isolated fiscal shock to the primary balance of 1 pp over the programme horizon as well as higher (lower) short- and long-term market interest rates (by 2 pps, respectively) would be more limited. Assuming lower than currently envisaged proceeds from privatisation by about 2% of GDP in both 2016 and 2017 would lead to a corresponding upward revision of the debt trajectory in 2016-2020.

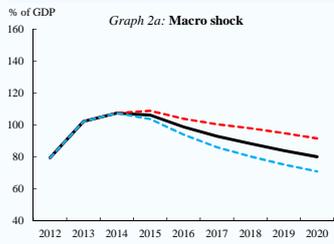
⁽¹⁾ The CBC debt swap is subject to a decision of the CBC board in full respect of the independence of the CBC, the treaty and the rules and procedures of the euro system.

⁽²⁾ The scenario is based on a semi-elasticity of the budget balance to changes in the output gap of 0.52. In doing so, it is assumed that potential GDP stays constant.

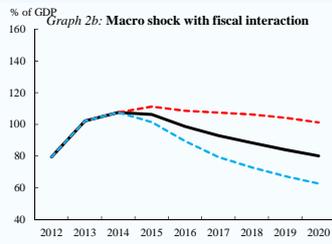
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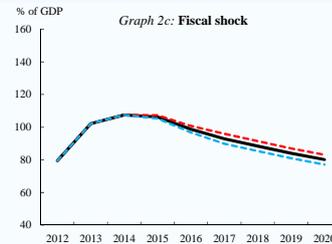
Programme scenario sensitivity analyses



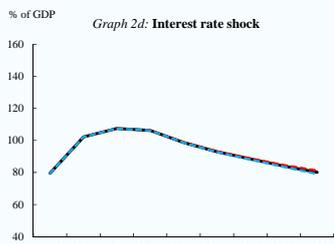
Scenario: reduction/increase in real GDP growth by one standard deviation (observed over the period 2008-2012), equivalent to a shock of 2.45% of GDP over the programme period.



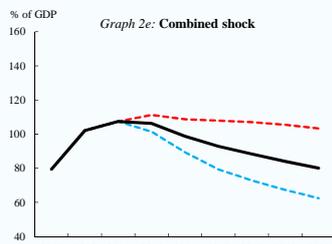
Scenario: additional impact of the change in real GDP growth on primary balance. Assumed semi-elasticity of the budget balance to changes in the output gap: 0.52.



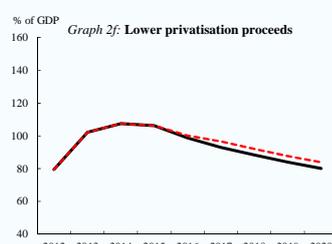
Scenario: annual deterioration/improvement of the primary balance by 1 pp over the programme horizon.



Scenario: 2 pps shock to short- and long-term market interest rates for new debt issuance and roll over.



Scenario: Combination of macro, fiscal and interest rate shocks.



Scenario: reduction in privatisation proceeds by around 2% of GDP.

Black line: baseline scenario; includes programme buffers which are not altered for the sensitivity analysis.

Blue line: positive shock.

Red line: negative shock.

A successful sixth programme review would unlock the disbursement of ESM's seventh tranche to finance fiscal needs arising until the end of the third quarter of 2015. In light of the government's comfortable cash position and limited financing needs, the sixth ESM disbursement in cash would amount to EUR 100m to cover deficit financing and redemption needs.

Due to lumping together disbursements of several reviews, the IMF would this time disburse about EUR 280m. After the disbursement by the ESM and the IMF and the assumed repayment of the CPB bond, the government's cash balance is estimated to amount to around EUR 1bn (at the end of Q2 2015).

5. RISKS TO THE PROGRAMME

Despite the determined implementation so far, continued full and timely policy implementation remains essential for the success of the programme. Overall and specific targets are conditioned by the following downside risks:

- A prolonged period of tight credit supply conditions and delays in the restructuring of the large and increasing stock of NPLs in the domestic banking system, which could lead to a slower than expected return of confidence in the banking sector and thereby potentially weigh on the economic recovery;
- A slower than expected return of confidence in the banking sector, following recapitalisation and restructuring;
- Further negative spillovers stemming from Russia and Greece, which could weigh on economic activity;
- A potentially weaker economic recovery, particularly in the medium term, related to slower than expected private sector balance sheet adjustment, further worsening of labour market conditions and steeper drop in real estate prices;
- Inability to reach the agreed primary surplus targets established in the programme, due to insufficient policy measures, implementation shortcomings or adverse macroeconomic and financial developments;
- Insufficient implementation of structural reforms, including in particular the implementation of the privatisation agenda, potentially leading to lower than expected privatisation proceeds; and
- Lack of success in regaining market access at a reasonable borrowing cost, once the programme comes to its conclusion.

ANNEX 1

Compliance table

Actions for the sixth review (completed by Q1 2015 and end-April 2015)	Assessment of compliance – Comments
1 FINANCIAL SECTOR REFORM	(Compliant, compliant with delay, partially compliant, non-compliant)
1.A. REGULATION AND SUPERVISION	
Maintaining liquidity in the banking sector	
<p>In December 2014, the Cypriot authorities started implementing the fourth stage of the roadmap for the gradual relaxation of restrictive measures which was published on 8 August 2013. The Cypriot authorities will ensure, in timely consultation with the EC, ECB, IMF and informing the ESM, that the gradual relaxation of the external restrictive measures, as envisaged in the public communication from 5 December 2014, is consistent with financial sector stability and preserves comfortable liquidity buffers.</p>	Compliant The capital controls were abolished on 6 April 2015.
<p>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. The additional government guarantees for the issuance of bank bonds of up to EUR 2.9 billion in nominal value could be used as collateral against liquidity, if necessary to safeguard financial stability, in line with State aid rules.</p>	Compliant Ongoing
<p>The CBC will continue to receive the updated condensed capital and funding plans of core banks on a quarterly basis, and within two months of the end of each quarter, and will transmit them to the ECB, the EC, the ESM and the IMF. The funding and capital plans should realistically reflect the anticipated deleveraging in the banking sector, the resolution of non-performing assets, and the reduction of borrowing from the central bank, with the objective to avoid asset fire sales and a credit crunch.</p>	Compliant Ongoing
Regulation and supervision for banks and cooperative credit institutions	
<p>BoC and the coops will continue to submit a quarterly report describing the progress with the implementation of the restructuring plans. The reports will contain the agreed set of key performance indicators, including selected operational and, where relevant, financial indicators.</p>	Compliant Ongoing
Monitoring of corporate and household indebtedness	

Measures will be taken to strengthen the management of non-performing loans and to deal with troubled borrowers, taking into account the developments and timelines in the SSM. A framework for targeted private-sector debt restructuring is being established.

· Banks will continue to report **quarterly** on restructuring progress and management of NPLs, using the agreed specific performance indicators and targets (e.g. number of loans restructured, cash collections, etc.). Furthermore, banks will continue to report monthly on early arrears (e.g. number and amount of past due loans within 1-90 days, type of actions taken, and number and amount of cured or uncured loans).

Compliant Ongoing

· After completion of the review of banks' arrears management policies and practices, revisions of the Arrears Management Directive and of the Code of Conduct will be finalised **by end-March**. Upon publication of the revised Arrears Management Directive and the Code of Conduct, the CBC will make available on its website a comprehensive and user-friendly guide on the practical application of the Directive and the Code.

Compliant with delay The Directive was published on 3 April 2015. The user friendly guide has been prepared and is pending publication.

· To ensure that banks offer sustainable restructuring solutions, the CBC will agree with banks on institution- and portfolio-specific targets to be set for the various phases of the restructuring process on a quarterly rolling basis and publish them on an aggregated basis **by end-March**. The aggregated performance of banks and coops against overall targets will be regularly published and for the first time by end-August.

Compliant with delay Banks were instructed to start reporting by end-April. The targets will be further fine-tuned by the CBC.

· Following the requirements introduced by the CBC in January, the banks and coops will submit regularly and for the first time **in March** the reports prepared by their external auditors on the effectiveness of their debt restructuring arrangements and strategies for the periods ending in December 2014, June 2015, December 2015, and June 2016. Relying on the finding of the reports, the CBC will assess the appropriateness of restructuring solutions and submit to the SSM the findings and recommendations on the banks' internal policies and processes regularly and for the first time **in May**.

Compliant with delay Most banks submitted their reports. The deadline for the remaining two reports was set at end-April.

· Legal amendments to the Law on the Financial Ombudsman were adopted by 10 July 2014. **By mid-March**, further legal amendments will be adopted in order to clarify that the responsibility for assessing compliance with the Arrears Management Directive is not transferred to the mediators but remains with the CBC.

Non-compliant The draft law with the amendments was submitted to the House of Representatives on 23 January 2015 and its adoption is pending.

· The Cypriot authorities, in view of financial stability considerations and on-going bank restructuring, commit not to introduce any new regulations which would interfere with the setting of bank lending rates. In particular no ceilings on bank lending rates would be introduced. **Compliant**

· **As a matter of priority**, the legality of the amendment to the Banking Law limiting the sale of loans to third parties will be assessed and, if necessary, will be further amended. **Non-compliant** The relevant section of the Banking Law will be amended together with the enactment of the new law on the sale of loans.

Increasing financial transparency

Based on the findings of the April 2013 audit undertaken by MONEYVAL and an independent auditor, the Cypriot authorities have progressed in enhancing the anti-money laundering (AML) framework in line with best practices and are committed 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).

Partially compliant - The CBC AML Manual does not yet reflect the obligation for prudential supervisors to inform the AML team of changes in the business model of the bank they are supervising (AML Action Plan item 1.2.1). CBC onsite inspection program of banks is ongoing (AML Action Plan items 1.3.2 and 2.2.2).

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

Partially compliant - The implementation of the governmental action plan to reform the Registrar is ongoing and appropriate resourcing (AML Action Plan item 4.2.2) has to be ensured, once the need is clear after finalizing the re-organisation and streamlining of the processes.

The supervisory competent authorities are reviewing 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). In carrying out its onsite supervisory program, the CBC will build on its follow-up work on the April 2013 audit regarding individual financial institutions. The Cypriot authorities will finalise the application of appropriate enforcement actions **by end-August** with regard to any breaches of compliance revealed by the April 2013 audit, and will take a final decision to apply sanctions if applicable. The final decision will be made public.

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.

To address concerns that Cypriot corporations and trusts might be misused, the Cypriot authorities have revised 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 related to money laundering and tax matters.

To ensure that adequate, accurate and current basic information on all types of legal persons registered in Cyprus could be obtained by the Registrar of Companies and be accessible by the public in a timely manner, the Cypriot authorities have committed to reform the Department of Registrar of Companies as foreseen in section 3.9.

The Cypriot authorities commit to maintain efforts to ensure that the widest possible exchange of information with other FIUs is achieved, either spontaneously or in response to requests. The Cypriot FIU has taken the initiative to provide the programme partners with a breakdown of requests made and received and spontaneous disseminations on a quarterly basis (within 14 days of the end of the quarter), starting with Q4 2013, and publish this information on the FIU website on an annual basis.

Partially compliant - All supervisory authorities have made important progress, completed some of the AML Action Plan items and work is ongoing in particular as regards the onsite inspections. The main actions which remain to be undertaken mostly relate to adequate staffing of the supervisory authorities in the non-financial sector, staff training, roll-out of the 2015 inspection plans and fine-tuning of the inspection tools. For details on timelines see the AML Action Plan (Annex 2 to the MoU) items 5.4.1, 5.4.2, 5.5.2, 5.5.4.2, 6.1.1, 6.2.2.3, 6.4.1, 6.5.1, 6.5.2 and 6.5.3.

Compliant - The programme partners reviewed a sample of the supervisory assessments and enforcement action by the supervisory authorities.

Compliant - The Trust and Company Services Providers Law has been adequately revised

Please refer to assessment of compliance as regards section 3.9.

Partially compliant - MOKAS provided to the programme partners the breakdown of requests made and received, including spontaneous disseminations, to and by foreign FIUs. However, the 2013 and 2014 annual reports have not been published on the MOKAS website yet.

To protect the integrity of the financial sector, the CBC took swift action to put the local branch of FBME Bank Ltd. under resolution following the measures taken by its correspondent banks after its designation by the US authorities as a financial institution of primary money laundering concern, initiated an investigation, and will take appropriate supervisory action based on the results.

Compliant - The CBC has undertaken an AML investigation and will take appropriate supervisory action based on the results.

1.B. RECAPITALISATION AND RESTRUCTURING

Restoring adequate capital buffers

The authorities adopted the transposition of CRD IV on 29 January 2015 and will fix the Common Equity Tier 1 ratio at 8% under Pillar 1 **by end-March**, in line with the harmonised benchmark applied under the baseline scenario of the ECB Comprehensive Assessment.

Partially compliant The required ratio has been set up at 7% so far. Work on the imposition of the systemic risk buffer has started already in order to lift the minimum up to 8%. Moreover, the CBC instructed banks to keep a minimum of 8% in 2014.

Management of legacy Laiki

The authorities will prepare, **by end-April**, a plan for completing the resolution of Laiki and will implement it without delay.

Partially compliant The Resolution Authority appointed the Investment Bank of Greece as investment adviser, which prepared an action plan for the foreign subsidiaries. A plan for the stake in BoC is still to be decided.

Restructuring of Bank of Cyprus

BoC has progressed with the implementation of the restructuring plan and has divested operations and stakes abroad ahead of schedule. Moreover, to strengthen confidence in the bank, the CBC agreed with BoC on the operational and financial indicators on progress with implementing the restructuring plan that will be communicated **quarterly** to the public, together with the financial accounts.

Compliant Ongoing

Restructuring and recapitalisation of cooperative credit institutions

- The Cooperative Group will ensure timely and complete implementation of the already agreed restructuring plan and take further measures to improve its operational capacity, notably in the following areas: i) arrears management, ii) Management Information System (MIS), iii) governance and iv) strengthening management capacity. As regards management of arrears, the Group will continue to ensure all relevant units have an appropriate level of skilled and professional staff, including by redeployment of existing resources and leveraging on external expert service-providers. [...] **By end-March**, the authorities will carry out a review of the sector's policies and operational capacity on debt resolution, also relying on technical assistance from the IMF. Based on this, they will address identified deficiencies in a timely manner.
- Compliant** Arrears management has been centralised. Recruitment needs have been addressed. The IMF provided technical assistance on arrears management.
- 1.16
- In order to equip senior management with adequate decision-making tools, the MIS will be improved. The overall IT infrastructure will be updated and fully integrated into the organisational structure of the Group, with the view of providing all the necessary data on a timely and accurate basis. The quality and validity of the existing data will be verified and monitored.
- Compliant** Ongoing
- 1.17
- To streamline execution of tasks, governance will be strengthened, avoiding parallel decision-making structures, also relying on technical assistance from the IMF. The CCB will ensure strict compliance of the individual CCIs with all its policies. To strengthen the governance of the CCB over the CCIs, the amendment of the affiliation directive will be finalised **by end-March**.
- Partially compliant** The amended directive has been prepared and is awaiting final adoption.
- 1.18
- To strengthen the implementation of the restructuring plan, the Group will continue to improve its management capacity and meet the employment targets. To provide exact and timely information to the executive management, an action plan on the necessary restructuring of departments will be prepared **by end-April**, based on the findings of the external consultant.
- Compliant** The employment targets have been modified with the agreement of DG COMP.
- 1.19
- The CCB received the report from the independent audit company on Financial Control and Reporting, including of Management Information Systems, and will submit, **by end-March**, a time-bound action plan to the SSM, informing the EC, ECB, IMF and ESM, to ensure that the identified deficiencies will be efficiently and timely addressed.
- Compliant with delay** A comprehensive action plan was sent to the CBC on 8 April.
- 1.20

- Compliance with the relationship framework between the State and the CCB will be reviewed **on a quarterly basis** by the monitoring trustee, who will also report any breaches of the framework to the EC. The authorities will inform the ECB, the
- 1.21 ESM, and the IMF of the conclusions of that report and the follow-up. To this end, the relationship framework will be amended by **end-April**. The effectiveness of the Management Unit of the Ministry of Finance will be reinforced with financial experts **by end-June**.
- Compliant** The amended version of the relationship framework was sent to Troika on 23 April.
- To strengthen confidence in the sector, the CBC agreed with the CCB and the Ministry of Finance Management unit on the
- 1.22 operational and financial indicators on progress with implementing the restructuring plan that will be communicated **quarterly** to the public.
- Compliant** The indicators were published on the website of the CBC on 30 March.

1.C. LEGAL FRAMEWORK FOR PRIVATE DEBT RESTRUCTURING

- All legal, administrative or other hurdles currently constraining the seizure and sale of loan collateral shall be removed so that the assets pledged as collateral can be recovered within a reasonable period deemed to be a maximum time-span of 1.5
- 1.23 years from the initiation of the relevant proceedings. In the case of primary residences, this time-span could be extended to 2.5 years. The authorities commit not to introduce any further impediments to the seizure of assets pledged as collateral.
- Corporate and personal insolvency legislation will be adopted by the House of Representatives at the latest **by March**, following consultation with EC and IMF and informing the ECB and ESM. The following reforms to insolvency arrangements will be adopted, in line with best international practices: (i) a modernized bankruptcy process for non-viable individuals, including an effective discharge subject to proper
- 1.25 safeguards; (ii) streamlined processes for non-viable individuals with no assets and no income, and with relatively small unsecured debt; (iii) a repayment scheme for viable individuals; (iv) an effective restructuring procedure for legal entities, including large borrowers; (v) a modernised and effective liquidation process for companies; and (vi) licensing and regulation of insolvency practitioners. The necessary regulations to operationalize the new insolvency procedures will be in place by **end-April**.
- Partially compliant** Six insolvency laws were adopted by the House of Representatives on 18 April 2015.

The repayment scheme can be either voluntary or compulsory. The scheme will be designed to encourage an agreement between creditors and an insolvent debtor under the voluntary procedure. In case of failure to agree on a voluntary repayment scheme, the compulsory tool will allow the imposition by a court, subject to certain criteria, of a repayment scheme on creditors with the objective to avoid bankruptcy and foreclosure of the primary residences of insolvent borrowers.

1.26 In line with this objective, the compulsory tool will include relevant eligibility criteria, including an upper limit on overall indebtedness, on the value of the primary residence and on the value of overall assets. In line with international best practices and given the imposition on creditors' rights to ensure that the incentives of the creditors and the debtor are fairly balanced, the compulsory repayment scheme would be subject to minimum requirements:

(1) creditors under a repayment scheme would not receive less than they would have received in the liquidation of the debtor's estate in bankruptcy,

(2) the law will require the debtor to use his/her full repayment capacity beyond what is required to cover reasonable living expenses to make payments under the plan.

(3) The repayment capacity of the debtor amounts to the disposable income after deduction of the reasonable living expenses. The notion of reasonable living expenses should be established in a uniform and objective manner.

(4) If an insolvent debtor applies for a compulsory repayment scheme, the law will clarify that the debtor's repayment capacity should be enhanced, including by using his/her assets.

In order to avoid abuse, the law will provide proper safeguards, including clear disclosure obligations of the debtor, independent verification of this information by the insolvency practitioner and appropriate sanctions for fraudulent behaviour. To ensure that guarantees perform their economic function, the treatment of guarantees in all insolvency processes will be determined, with due regard to the payment capacity of the guarantor.

Partially compliant Certain provisions included in the Personal Repayment Plan Law could weaken incentives in regard to so-called for non-viable debtors to promptly and realistically pursue debt restructuring. Some guarantors seem to be shielded from payment obligations without due regard to their payment capacity

Partially compliant Certain provisions could weaken incentives for non viable debtors to promptly pursue debt restructuring. Some guarantors seem to be shielded from payment obligations without due regard to their payment capacity.

The foreclosure framework will be fully operational **by March**. This notably requires the adoption of the regulation on the rules for sale by auctions, as required by the foreclosure law, and any other measures, procedures or actions that may be required for the effective implementation of the law. **Partially compliant with delay**
 1.27 The regulations have been submitted to the House of Representatives on 13 March 2015, but not yet adopted.

In the context of these reforms, the authorities will achieve the following tasks. The deadlines are dependent on the timely adoption of the insolvency framework:

Formulate recommendations on the Civil Procedure Code and Court Rules: (i) in order to ensure the smooth and effective functioning of the revised foreclosure law including the swift processing of appeals. The implementation of relevant legislative amendments should become effective **by end-March**; and (ii) in order to ensure the smooth and effective functioning of the envisaged new insolvency frameworks **by end-April**. The implementation of relevant legislative amendments will become effective **by end-June**. **Partially compliant with delay**
 The review of the Civil Procedure Rules and the Rules on Insolvency by the Supreme Court has started.

Following the report of the legal framework for obtaining updated information on the financial situation of delinquent borrowers, the authorities will also issue recommendations **by end-March** regarding the financial statements of debtors in the context of enforcement measures. The adoption of the relevant amendments to the Civil Procedure Code and Court Rules will become effective **by end-June**. **Non-compliant**
 The recommendations have not been prepared yet.

Following the study of impediments on attachments to financial assets and earnings of delinquent borrowers, the authorities will also issue its recommendations **by end-March** regarding the improvement of individual enforcement procedures. The adoption of the relevant amendments to the Civil Procedure Code and Court Rules will become effective **by end-June**. **Non-compliant**
 The recommendations have not been prepared yet.

The authorities will review the private sector debt restructuring legal framework **one year after its effective implementation** with a view to assessing results and define additional measures as needed.
 1.29

2. FISCAL POLICY

Fiscal Policy in 2014

Based on the programme's current macroeconomic and fiscal projection and reflecting the 2014 Budget, the Cypriot authorities will achieve a deficit of the general government primary balance of no more than EUR 210 million (1.3% of GDP) in 2014, corresponding to a headline deficit of 4.7% of GDP (respecting the 16 May 2013 Council Recommendation with a view to bringing an end to the situation of an excessive government deficit in Cyprus). To this end, Cyprus will fully implement the permanent measures included in the 2014 Budget, amounting to at least EUR 270 million in 2014.

Compliant In 2014, the authorities achieved a general government primary surplus of 2.6% of GDP, corresponding to a headline deficit of 0.2% of GDP, when netting out the effect of the one-off impact of the recapitalisation of the cooperative credit institutions amounting to EUR 1.5bn (8.6% of GDP).

Fiscal Policy in 2015

Based on the programme's updated budgetary projection, the Cypriot authorities will achieve a deficit of the general government primary balance of no more than EUR 258 million (1.6% of GDP) in 2015, corresponding to a headline deficit of 5.2% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus).

Compliant The updated programme projection for 2015 shows a surplus for the general government primary balance of 1.5% of GDP.

With a view to maintaining fiscal consolidation over the medium term, the authorities will submit for consultation with programme partners a proposal that will ensure the fiscal neutrality of the welfare system reform and the achievement of the 2015 fiscal deficit target. The final proposal will be agreed in consultation with programme partners by end-August 2014 and will be incorporated in the draft 2015 Budget, which will be adopted by the Council of Ministers by mid-September 2014.

Non-compliant While programme partners received a proposal, a political majority for the proposed measures was not found in the end and no significant additional measures have been incorporated in the 2015 Budget. However, due to the overall good fiscal performance, the 2015 deficit target is not at risk.

After review by and consultation with the programme partners the 2015 Budget Law will be adopted by December 2014. 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.

Compliant.

Fiscal Policy in 2016 - 2018

In 2016 the Cypriot authorities will achieve a general government primary balance surplus of at least EUR 201 million (1.2% of GDP), corresponding to a headline deficit of 2.2% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus).

Compliant The updated programme projection for 2016 shows a surplus for the general government primary balance of 2.5% of GDP.

3. FISCAL STRUCTURAL MEASURES

Health care expenditure

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

a) All necessary legislative changes related to the implementation of the Health Reform Plan will be approved by the House of Representatives **by end-November 2014** aiming at full implementation of the Plan **by Q2-2015**. The reform plan will take into account the restructuring of all public hospitals/public health facilities, the Ministry of Health, the Health Insurance Organisation (HIO), and other associated facilities/organisations. It will also take into account the findings of the functional review of the health sector public entities and the analysis of the function and structure of the Ministry of Health. The reform plan will provide for autonomisation of all public hospitals/public health facilities. Public hospitals will complete the shadow-budgeting for all inpatient cases on diagnoses-related groups **by Q3-2014** and for all in- and outpatient activities **by Q4-2014; by Q3-2014**, the detailed restructuring plan of the public primary healthcare centres will submitted for consultation with program partners

The NHS will be developed and implemented based on the fundamental principles of free choice of provider, social equality and solidarity, financial sustainability and universal coverage of a minimum benefit basket.

By October 2014, submit to Parliament, the amended NHS Law. All financial parameters of the first stage of NHS, including the total budget for primary healthcare-consultation, the level of insurance premium, capitation fee level, and minimum and maximum amount of patients per general practitioner, will be provided **by 1st September** for consultation with program partners.

Based on the detailed road map for the implementation of the NHS, the amended bill of NHS will also determine and clarify the respective role, governance and responsibilities (notably concerning the strategic policy, budget control, monitoring, audit and regulation) of the Ministry of Health and the HIO and will be approved by the House of Representatives **by Q4 2014**.

Finalize the tendering of the IT-infrastructure necessary for implementing the NHS **by December 2014**.

Partially compliant. The legislative changes are still under preparation. Specifically, the hospital autonomy bill has not been approved yet. The shadow-budgeting has been completed for the public sector. The draft plan for public PHC centres has been submitted to programme partners.

Partially compliant. The NHS bill has not been submitted to the House of Representatives yet. The financial parameters of the first stage of NHS have been submitted to programme partners for consultation.

Non-compliant. Latest information suggests that the tender will be initiated by end-May.

The policies of the Ministry of Health on pricing and reimbursement of medical goods and services, including those related to pharmaceutical expenditure, will be revised in agreement with programme partners to contain projected spending levels under NHS, **by Q3 2014**.

Non-compliant. The policies of the Ministry of Health on pricing and reimbursement of medical goods and services have not yet been revised, but we had positive discussions with the Ministry on this item.

An Implementation Support Team will be established by end-August 2014, drawing on national and international expertise, to assist the Ministry of Health with the implementation of NHS and health sector reforms.

Compliant. The WHO Regional Office for Europe has signed an Agreement with the Ministry of Health in mid-July to provide intense technical support to the implementation of the health system reforms. Two WHO experts have taken up work on the ground in Cyprus.

c) Starting in Q3-2014, prepare quarterly reports, to be submitted for consultation by program partner assessing the collection of compulsory health-care contribution for public servants and public servant pensioners and all co-payments for using public health care services against envisaged proceeds, and present suggestions for policy changes if needed;

Compliant.

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, capacity planning) **by Q4-2014**, in order to ensure that the agreed budget limits of public health expenditure are not exceeded, whilst ensuring equitable access to healthcare;

Non-compliant. A binding set of contingency measures has not been adopted by the Council of Ministers, but a paper has been submitted to programme partners.

e) 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, and submit **by Q3 2014** the conclusions of the review for consultations with program partners;

Compliant.

f) Continue to publish clinical and prescription guidelines and to audit their implementation; continue to establish the system for health-technology assessment.

Compliant.

g) 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), with a report to be submitted for consultation by program partners **by Q3-2014**.

Compliant. The report on the basket of publicly-reimbursable medical services has been submitted to programme partners.

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

Public Financial Management

3.3 The Cypriot authorities will:

- improve the risk-assessment analysis associated with government guarantees. To this end, submit to programme partners by **Q3-2014** the final version of the risk assessment report prepared by the Public Debt Management Office. The report shall identify guarantees that are expected to result in calls in the current and following year;

Compliant. The risk assessment report has been shared with programme partners in due time.

- adopt a comprehensive medium-term debt-management strategy, **by end-October 2014**, aimed at: (i) smoothing the debt redemption profile and reducing refinancing risk; (ii) diversifying across instruments and types of investors; (iii) ensuring a smooth functioning of the domestic Treasury bill market; and (iv) enhancing risk-assessment of contingent liabilities from government guarantees. This will help paving the way for a sustainable return to market access in due time.

Compliant. The medium-term debt management strategy has been adopted by the Council of Ministers in December 2014.

- issue guidelines for public investment management, including project appraisals in line with the FRBSL provisions **by Q3-2014**. The authorities commit not to enter into any new tendering process and not to sign any public private partnership (PPP) contract before the issuance of the guidelines for public investment management; and

Non-compliant. The revised public investment guidelines have not yet been issued. Issuance is now expected for May 2015.

regularly update the PPPs inventory, including contingent liabilities and include it both in the annual budget law and in the annual financial report.

State-owned enterprises and privatisation

3.5 The Cypriot authorities will implement the privatisation plan submitted to the programme partners to help improve economic efficiency by encouraging more vigorous competition and greater capital inflows and restore debt sustainability. The plan includes the privatisation of, inter alia, CyTA (telecoms), EAC (electricity), CPA (commercial activities of ports), as well as land assets. CyTA and CPA will be privatised within the programme period and EAC by mid-2018.

In order to pursue the privatisation process in the most diligent way, the Cypriot authorities will:

- ensure that the newly-established Privatisation Unit is fully staffed **by April 2015**, in line with the provisions of the Privatisation Law;
Partially compliant. The Privatisation Unit has not yet been provided office premises to all its staff, and therefore does not yet fully comply with the provisions of the Privatisation Law (Article 8.4).
- for the privatisation of Cyprus's Telecommunications Authority (CyTA):
 - o appoint the legal and the technical advisers **by February 2015**;
Compliant. All CyTA advisers have been appointed.
 - o convert CyTA into a Limited Liability Company through the adoption of CyTA's corporatisation law by the Council of Ministers **by April 2015** and by the House of Representatives **by June 2015**;
Ongoing. Legal drafting will be final after agreement on the employees' status with trade unions. Both dates have been shifted to June and September, respectively.
 - o in parallel, prepare, through the Inter-Ministerial Committee, and on the basis of the recommendations of the advisers, the privatisation structure and the transaction strategy, including the envisaged ownership structure.
- for the privatisation of Limassol Port's commercial activities:
 - o prepare for consultation with programme partners the assessment of market conditions and the evaluation of Limassol Port (competitive position, physical and operational conditions) **by February 2015**;
Compliant. The assessment was carried up and presented to the Commission services.
- for the privatisation of the Electricity Authority Company (EAC):
 - o appoint the independent technical adviser **by April 2015**;
Non-compliant. The technical adviser will be conducting the study on EAC's unbundling, the tender of which has been delayed, due to increasing pressure from EAC's trade unions.
- for the sale of land assets:
 - o appoint an independent adviser with relevant expertise that will develop a plan with detailed intermediate steps and timings for disposing of the identified land assets **by June 2015**;
Ongoing. The tender process has been launched and is expected to be finalised by mid-June.

Revenue administration, tax compliance and international tax cooperation

- 3.6 The Cypriot authorities will continue reforming the revenue administration with the objective to reinforce the efficiency and effectiveness of revenue collection and the fight against tax fraud and evasion, with a view to increasing fiscal revenue.
- implement their new debt collection action plan, with a view to reducing collectible and unencumbered debt, and **by mid-March-2015** initiate a pilot run on garnishing of bank accounts, covering an agreed number of cases; and
- Compliant with delay** The pilot run was initiated at end-March and is still on-going.
- submit to programme partners **by Q1-2015** the final comprehensive compliance strategy and **by April-2015** detailed action plans for each of the headquarter units in the Design and Monitoring Division, outlining the steps to implement the strategy, including training of staff.
- Partially compliant** with respect to the compliance strategy - The strategy was submitted to programme partners but it was not sufficiently demonstrated that it is firmly based on risk analysis and an evaluation of different risk treatment strategies. **Non-compliant** with respect to the action plans - The action plans have not yet been finalised.
- To progress with the operationalization of the integrated and function-based tax agency, in line with the adopted integration plan, the following steps will be taken:
- by February 2015**, the authorities will progress decisively with middle and senior management appointments, notably a new project manager, all heads of headquarter units in the design and monitoring department and all business process owners and the head of the Famagusta District Office;
- Partially compliant** Most appointments have taken place but the appointments of a new project manager and a head of the headquarter unit responsible for planning and performance reporting are still missing.
- 3.7 The Cypriot authorities will safeguard the timely and effective exchange of information on 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 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;

continue improving 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;

ensure that the tax authorities have continuous access to databases of other public entities in order to facilitate and expedite the provision of the requested information **by Q4-2014**; and

continue with the swift implementation of the commitments taken to reverse the negative opinion by the OECD Global Forum and provide an updated progress report to programme partners **by Q3-2014**.

In addition, the authorities will monitor closely further progress in responding timely to tax information requests by EU and third countries. The authorities will submit to the programme partners quarterly performance updates (within 14 days of the end of the quarter).

Compliant The authorities have prepared amendments to address remaining concerns on the implementation of Directive 2011/16/EU, which may allow to close the related Pilot that had been launched by DG TAXUD. Abidance with the timeframes set out in Art. 7 of the Directive has substantially improved. New statistics with respect to the time frames in Regulation 904/2010 were not yet available.

Compliant The practice of follow-up examinations has continued and led to additional tax revenue raised. It is expected that improved quality of information received as well as enhanced cross-checks with other databases will further enhance the use of information received.

Partially compliant Access to databases has improved but continuous access will only be ensured through the implementation of the government data warehouse, expected for end 2015.

Compliant Cyprus has submitted a progress report to the OECD Global Forum and requested a supplementary review. An on-site visit by the peer reviewers took place in March 2015.

Compliant The performance statistics are always provided on time and show a substantial improvement in the response times.

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.

Partially compliant Information under the FISC153 and breakdown by paying agent has been provided. However, no audits of paying agents have taken place so far. The authorities have included such audits in their work plan for 2015 and will report by the end of the year.

Immovable Property Tax Reform

3.8 The Cypriot authorities will reform the immovable property tax with the objective to improve the fairness of the tax burden and to increase the efficiency of the tax administration. To this end, the authorities will:

implement the recurrent immovable property tax for the tax year **2015** based on a General Valuation (GV) for all immovable properties, determined on the basis of tangible building- and plot related characteristics. The design of the immovable property tax should ensure a broad tax base and IPT proceeds not lower than in 2013. A draft of the proposed tax rates and thresholds will be submitted for timely consultation with programme partners **by Q4-2014**. Following consultation with programme partners, the final design of the immovable property tax will be adopted by the House of Representatives by **Q1-2015**;

Non-compliant. The proposed tax rates and thresholds have not yet been presented to the programme partners.

Non-compliant. The immovable property tax reform has not yet been adopted by the House of Representatives.

adopt legislation specifying the frequency of the mandatory update of the values in line with international best practices by **Q1-2015**, following consultation with programme partners;

Non-compliant. Legislation on the frequency of the mandatory update of the values has not yet been adopted.

implement by **Q1-2015** the recommendations of a study on the scope for consolidating the collection and administration of the municipal and communal recurrent property tax and sewage tax. The study, to be completed by **Q3-2014**, will also review existing exemptions and derogations from property taxation. Moreover it will report on the scope for shifting revenues from transaction fees and taxes to recurrent taxation. Furthermore, it will provide an initial review of the tax regulations relevant for the foreclosure process, with a view to minimising the cost of foreclosure and subsequent sale of foreclosed property. **By Q3-2014**, the authorities will also review the tax regulations that may impede the leasing of immovable property;

Non-compliant. Not yet implemented.

conduct an assessment of the variance between GV assessed values and market price by **Q4-2014**, as well as an assessment of the relevance of the parameters used in the Computer Assisted Mass Appraisal (CAMA) model for the GV. Identify possible missing parameters and refine, if needed, the CAMA in light of this assessment by **Q1- 2015**;

Compliant.

by **Q3-2014**, adopt a strategy to correctly identify all property owners in the property register;

Non-compliant. Authorities are working on a strategy, the result of which has not been communicated to the programme partners.

present to the programme partners by **Q1-2015** an updated communication strategy aiming at informing of the goals of the property tax reform, the implications for citizens and the procedures of the new reform, as well as an updated comprehensive objections' management strategy to effectively and timely deal with appeals.

Non-compliant. The communication strategy has not yet been submitted.

Public Administration Reform

3.9 The Cypriot authorities have commissioned and will commission reviews of possible further reforms of the public administration. The reviews include a horizontal and a sectoral element.

With a view to the reform being adopted in 2015, the reform plan will be prepared for consultation with programme partners by **March 2015**. The reform plan and accompanying legal proposals will be adopted by the Council of Ministers by June 2015 and submitted to the House of Representatives.

Ongoing. The reform plan is under discussion with programme partners and is expected to be ready by May.

the first batch consists of the review of the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies. Based on the findings of the World Bank and the UK public administration report, the Council of Ministers will adopt the remaining reform plans for local governments, after consultation with programme partners, by June 2015. The relevant legislation indicated as high priority on the Companies Registrar will be adopted **by March 2015** and its reform will start to be implemented by June 2015. The relevant legislation in relation with the reforms in Agriculture, Education, and local governments indicated as high priority will be adopted by the House of Representatives by October 2015 and their reforms will start to be implemented by January 2016.

Ongoing. The law on the Companies Registrar is currently under discussion by the Parliamentary Committee.

Welfare System

3.10 To continue the implementation of the adopted welfare reform and monitor the implementation of the GMI, including its fiscal impact, the Cypriot authorities will take the following steps:

the monitoring unit will provide quarterly costing updates of the GMI, at the end of each quarter, starting in **Q1-2015**;

Compliant with delay The costing update was provided at the end of April.

4. LABOUR MARKET

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. A tripartite agreement will be pursued with social partners **by Q4-2014** for the suspension of wage indexation in the private sector until 2016 and the application thereafter of the reformed wage indexation system (COLA) applicable to the public sector (lower frequency of adjustment, suspension at times of recession and partial indexation).

Partly compliant. COLA in the private sector has been suspended until end-2016 but there has been no agreement of the application of a 50% indexation system once COLA resumes.

Activating the unemployed and combating youth unemployment

4.4 The Cypriot authorities will continue the implementation of measures to address the identified shortcomings of the system of activation policies, including:

i. the development of a coherent methodology for the continuous monitoring and evaluation of activation measures, to be applied consistently across the different ALMP. A comprehensive report will be presented **by Q3-2014** and as of then the new methodology will be applied, thereby enabling the assessment of the performance and effectiveness of all measures;

Compliant. The report on the comprehensive methodology for the continuous monitoring and evaluation of activation measures has been adopted and shared with programme partners.

ii. measures to enhance the administrative capacity of the public employment services via increased staff mobility and/or outsourcing of specific tasks **by Q3-2014**; and

Partly compliant. Little progress has been made on the enhancement of public employment services (PES), but with a budget now secured, reforms should gain speed in this area.

iii. measures to ensure the effective cooperation between the public employment services, the social welfare services and the benefit-paying institutions in the activation of the unemployed who are recipients of social assistance, including by establishing clear procedures for the automatic exchange of information and a transparent system linking benefit receiving with job-search efforts.

Partly compliant. Progress has been made in ensuring communication between PES, and benefit providing entities, but processes still need to be formalized.

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 employment opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities will submit **by Q3-2014** the final National Action Plan for Youth Employment, which will include, *inter alia*, measures envisaged for support under the Youth Employment Initiative including also the implementation of the Youth Guarantee, in line with the conclusions of the European Council of June 2013. [...] For this purpose, the authorities will submit **by Q3-2014** a comprehensive note summarising the full list of all active labour market policies (existing and envisaged) with the relevant intended aims, recipients and budgetary allocations.

Compliant. The National Action Plan for Youth Employment has been adopted and its implementation has started. The authorities have shared with programme partners a list of active labour market policies for 2014, and will continue to share updates.

5. GOODS AND SERVICES MARKET

Services Directive and regulated professions

- 5.1 On the basis of the comprehensive review of requirements affecting the access and exercise of activity of the regulated professions sector (such as lawyers, engineers, architects), the Cypriot authorities will eliminate by law the requirements that are not justified or proportional **by Q3-2014**.
- Compliant.** The only pending matter is to agree on the shareholding distribution of the engineers' companies. This will be followed by the Commission services and beyond the scope and duration of the programme.

Housing market and immovable property regulation

- 5.3 The Cypriot authorities will:

by Q3-2014, submit to the House of Representatives, after consultation with the programme partners, amendments to the Street and Building Permit Law to ensure the enforcement of the deadlines for issuance of certificates of completion by the supervisor engineers;

Compliant. The authorities have submitted the amendments to the House of Representatives on this. This is now pending in front of the House of Representatives.

by end-November 2014, the House of Representatives will adopt amendments of the Transfers and Mortgaging Property Law in order to accelerate the timeframe for banks' consent on the issuance of title deeds.

Compliant. The change foreseen at the time of the July MoU was adopted, enabling the banks to electronically access the database of the DLS and give their consent on the issuance of title deeds.

by August 2014, create a working group under the responsibility of the Ministry of Interior, which, in close cooperation with the Task Force on title deeds under the MoU provision 1.31 and the Task Force for Growth, will review and streamline all procedures leading from the planning permit application to the issuance of title deed. This working group will also provide the necessary assistance to the Task Force on title deeds under the MoU provision 1.31, to allow for a quantification of this problem. **By Q3-2014**, submit for consultation with programme partners a report with recommendations on how to streamline these procedures, including a catalogue for tolerated deviations from building and planning permits as well as binding deadlines for each of those procedures and means to enforce them, with a view to their implementation **by Q1-2015**.

Compliant. The working group has been created

Ongoing. The report has been delivered on time, but there are exchange of ideas with programme partners to make the changes more comprehensive.

Non-compliant. Many of the recommendations have not yet been implemented.

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). The ex-officio cases will automatically be counted in the backlog from the date the certificate of final approval is being issued by the respective Local or District Authority. To that end, **by end-September 2014**, provide to programme partners granular data on the stock of backlogs of permits, deeds, certificates, and mortgages associated with the underlying properties, and a strategy identifying ways to reduce this backlog and continue publishing the quarterly progress reviews, starting **in Q3-2014**;

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**; and

improve the pace of court case handling, in order to eliminate court backlogs **by Q1-2016**. To that end, provide detailed statistics on court backlogs and duration of court proceedings to programme partners on a quarterly basis starting **in Q4-2014**, submit a draft action plan for the elimination of court backlogs, including the electronic filing of new documents **by end-October 2014**, and enact legislation to establish an Administrative Court **by Q4-2014**.

Non-compliant. Although backlog of cases has been reduced significantly (and the issuance rate accelerated), the target of 2,000 was not achieved.

Ongoing/Non-compliant. Granular data has been provided until October 2014, while the requirement is that the quarterly progress needs to be published.

Compliant.

Non-compliant. The action plan submitted in December is not detailed to significantly improve the pace of court handling and to reduce the backlog drastically.

Ongoing/Non-compliant. Statistics were provided in December 2014. The MoU requirement is for a quarterly submission was not respected.

Non-compliant. The legislation on establishing an Administrative Court was not yet enacted.

Tourism

5.4 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:

present a progress report on the implementation of the tourism action plan twice per year, including an assessment of its implementation based on performance indicators, **by Q1 and Q3** every year, starting from 2014;

Ongoing. The report is being submitted as agreed.

present an updated plan enhancing the coordination of the various tourism stakeholders and relevant authorities **by Q3-2014**. The plan shall include concrete actions and a roadmap with a concrete timeline leading to an effective mechanism for coordination, while specifying who is responsible for the tourism strategy and how the Council of Ministers is involved in the process;

Compliant. Concrete thematic groups have been identified, whereby stakeholders and relevant authorities are involved.

provide an assessment of the current CTO law in order to identify, together with programme partners, which articles may hamper competition in the tourism sector **by Q1-2015**, taking into account the public administration functional review's second batch;

Non-compliant. An assessment of the current regulatory framework governing the tourism sector (including the CTO law) identifying the impediments to competition in the tourism sector by September 2015.

in view of the reorganisation of CTO's various units, the authorities will submit a roadmap **by Q4-2014**, including milestones needed to reach the targets set in the tourism strategy. This roadmap will provide the basis for monitoring of the tourism strategy implementation;

Compliant. A roadmap has been submitted and will be complemented by a national tourism strategy later in the year.

start implementing an aeropolitical strategy leading to the adaptation of Cyprus' external aviation policy, taking into account the EU external aviation policy and the EU aviation agreements, while ensuring sufficient air connectivity. The action plan approved by the Council of Ministers in May 2014 will be implemented **as of Q3-2014** and will be reviewed annually by the Cypriot authorities, in consultation with the programme partners.

Ongoing. The implementation of the action plan is taking place and is being monitored on an annual base.

Energy

5.5 The Cypriot authorities will:

- ensure, without delay, that the Third Energy Package is fully and correctly implemented;
- formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy will be developed and updated under the full authority of the Cypriot Government and should include at least the following three key elements, to 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. This plan should cover: the required investments, associated costs, financing sources and methods, ownership structure; major planning risks and bottlenecks taking into account also technical and commercial uncertainties; a projection of the revenue streams over time; the configuration and timing for the development of the necessary transmission infrastructure, accounting for European projects of common interest; and an appropriate sales framework for the off-shore gas supply for both exports and domestic markets aimed at maximising revenues. Next update **by Q4-2014**.

Compliant. The updated roll-out plan has been shared with programme partners.

2. a *comprehensive outline of the regulatory regime and market organisation* for the restructured energy and gas sector, with a view to introducing open, transparent, competitive energy markets. [...] This assessment will be followed by an analysis (**by Q3 2015**) of the cost price of different sources of renewables compared to conventional primary energy sources; iii) envisaged measures to improve the capacity and independence of CERA to carry out its functions, including sufficient staffing. An updated draft outline will be provided **by Q3-2014**, with a view to a final outline **by Q4-2014**; and

Compliant. The comprehensive outline of the regulatory regime and market organisation has been provided to programme partners.

3. an 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. 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. The resource fund, established in the FRBSL (see 3.3), should be based on clear rules governing inflows and outflows, coupled with clear rules regarding dividends, fees and costs of government entities and stakes in the energy sector. These rules should be provided for in the FRBSL and detailed in implementing legislation of FRBSL, an advanced draft of which will be submitted to programme partners for consultation **by Q3-2014**, with a view to submission to the House of Representatives **by Q4-2014**. The resource fund law, which defines the governance structure of the resource fund, will be submitted to the House of Representatives **by Q4-2014**.

Non-compliant. Both the resource fund law as well as the rules governing the fund's in- and outflows have not yet been submitted to the House of Representatives. Submission of both items to the House of Representatives is now expected for Q2-2015.

6. Technical Assistance

- 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 an updated request for technical assistance needs during the programme period, including the on-going technical assistance projects **by end-December 2014**. 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.
- 6.1 **Compliant**

7. Growth Strategy

- By Q3-2014, the authorities will provide, in consultation with the programme partners, an action plan for the development, and implementation of the growth strategy. The Cypriot authorities may request technical assistance to further develop this strategy.
- 7.1 **Compliant**

ANNEX 2

Macroeconomic projections

Table A2.1: Selected economic indicators

	2011	2012	2013	2014	2015	2016	2017
Real economy							
	<i>(percent change)</i>						
Real GDP	0.3	-2.4	-5.4	-2.3	0.2	1.4	2.0
Domestic demand incl. inventories	-2.0	-3.8	-9.7	-1.2	-0.1	1.1	1.3
Total consumption expenditure	1.6	-1.1	-5.8	-1.5	0.0	0.8	1.0
Private consumption expenditure	1.8	-0.7	-6.0	0.4	0.4	1.1	1.2
Government consumption expenditure	0.7	-2.7	-4.9	-8.7	-1.7	-0.8	-0.2
Gross fixed capital formation	-9.4	-20.7	-17.1	-18.8	-0.9	3.6	4.0
Exports of goods and services	4.4	-1.6	-5.0	5.9	0.5	1.5	2.9
Imports of goods and services	-0.6	-4.7	-13.6	8.1	-0.1	1.0	1.8
Contribution to growth							
	<i>(percentage points)</i>						
Domestic demand (excl. inventories)	-0.7	-4.9	-7.6	-3.8	-0.1	1.1	1.3
Foreign trade	2.4	1.7	4.6	-0.9	0.3	0.3	0.7
Changes in inventories	-1.4	1.0	-2.3	2.6	0.0	0.0	0.0
Inflation							
	<i>(percent change)</i>						
GDP deflator	2.0	2.0	-1.4	-1.2	-0.9	0.7	1.2
HICP	3.5	3.1	0.4	-0.3	-0.8	0.9	1.3
Labour market							
	<i>(percent change, unless otherwise stated)</i>						
Unemployment rate (% of labour force)	7.9	11.9	15.9	16.1	16.1	15.1	13.8
Employment	0.5	-4.2	-5.2	-1.9	0.0	1.2	1.6
Compensation per employee	2.5	-0.8	-6.0	-4.7	-0.3	1.1	2.3
Labour productivity	-0.1	1.9	0.1	-0.4	0.3	0.2	0.4
Unit labour costs	2.6	-2.7	-6.1	-4.2	-0.6	0.9	1.9
Public finance*							
	<i>(percent of GDP)</i>						
General government balance	-5.5	-5.8	-4.9	-0.2	-1.5	-0.1	0.7
Total revenue	36.9	36.2	36.4	40.3	39.3	39.2	38.8
Total expenditure	42.8	42.1	41.4	40.5	40.8	39.3	38.1
General government primary balance	-3.3	-2.9	-1.8	2.6	1.5	2.5	3.0
Gross debt	66.0	79.5	102.2	107.5	106.3	98.8	92.9
Balance of payments							
	<i>(percent of GDP)</i>						
Current external balance	-3.2	-5.7	-2.0	-4.0	-4.3	-4.4	-4.3
Ext. bal. of goods and services	-3.4	-1.9	2.5	2.8	3.3	3.4	3.8
Exports goods and services	49.5	49.7	50.8	55.4	55.1	55.5	56.1
Imports goods and services	53.0	51.7	48.3	52.7	51.8	52.1	52.3
Balance of services	19.8	18.9	20.2	20.1	20.0	20.3	20.9
Balance of goods	-23.2	-20.8	-17.7	-17.4	-16.7	-16.9	-17.0
Balance of primary income	1.3	-2.8	-3.1	-5.3	-5.7	-6.2	-6.6
Balance of secondary income	-1.0	-1.0	-1.4	-1.5	-1.9	-1.6	-1.5
Memorandum item							
	<i>(EUR bn)</i>						
Nominal GDP	19.5	19.4	18.1	17.5	17.4	17.7	18.3

*Net of the one-off recapitalisation of the cooperative banking sector amounting to 8.6% of GDP in 2014.

Source: Commission services.

Table A2.2: Use and supply of goods and services (volume)

<i>percent change unless otherwise stated</i>	2011	2012	2013	2014	2015	2016	2017
1. Private consumption expenditure	1.8	-0.7	-6.0	0.4	0.4	1.1	1.2
2. Government consumption expenditure	0.7	-2.7	-4.9	-8.7	-1.7	-0.8	-0.2
3. Gross fixed capital formation	-9.4	-20.7	-17.1	-18.8	-0.9	3.6	4.0
4. Domestic demand excl. inventories	-0.7	-4.7	-7.5	-3.8	-0.1	1.1	1.3
5. Changes in inventories (contr. to growth)	-1.4	1.0	-2.3	2.6	0.0	0.0	0.0
6. Domestic demand incl. inventories	-2.0	-3.8	-9.7	-1.2	-0.1	1.1	1.3
7. Exports of goods and services	4.4	-1.6	-5.0	5.9	0.5	1.5	2.9
7a. - of which goods	14.7	0.1	-4.4	13.9	-2.5	0.3	1.8
7b. - of which services	1.2	-2.2	-5.2	3.0	1.7	2.0	3.3
8. Final demand	0.0	-3.1	-8.1	1.2	0.1	1.3	1.9
9. Imports of goods and services	-0.6	-4.7	-13.6	8.1	-0.1	1.0	1.8
9a. - of which goods	-3.2	-8.6	-14.8	9.4	-2.0	0.4	1.3
9b. - of which services	5.2	3.6	-11.4	5.8	3.2	2.0	2.6
10. GDP at market prices	0.3	-2.4	-5.4	-2.3	0.2	1.4	2.0
<i>(Contribution to change in GDP)</i>							
11. Final domestic demand	-0.7	-4.9	-7.6	-3.8	-0.1	1.1	1.3
12. Changes in inventories	-1.4	1.0	-2.3	2.6	0.0	0.0	0.0
13. Net exports	2.4	1.7	4.6	-0.9	0.3	0.3	0.7

Source: Commission services.

Table A2.3: Use and supply of goods and services (value)

<i>percent change unless otherwise stated</i>	2011	2012	2013	2014	2015	2016	2017
1. Private consumption expenditure	4.9	2.3	-6.1	-1.0	-1.1	2.1	2.6
2. Government consumption expenditure	4.2	-3.6	-9.6	-13.0	-1.9	-0.5	1.5
3. Gross fixed capital formation	-10.7	-20.7	-17.4	-22.1	-1.7	5.1	6.0
4. Domestic demand excl. inventories	1.5	-3.0	-8.4	-6.0	-1.3	2.0	2.8
5. Changes in inventories (contr. to growth)	0.0	0.2	-0.2	0.2	0.2	0.2	0.2
6. Domestic demand incl. inventories	0.1	-1.8	-10.7	-3.7	-1.3	2.0	2.8
7. Exports of goods and services	6.1	0.0	-4.6	5.4	-1.3	2.9	4.3
7a. - of which goods	16.3	0.7	-2.4	15.4	-5.6	0.9	2.0
7b. - of which services	3.0	-0.2	-5.3	1.8	0.4	3.7	5.2
8. Final demand	2.0	-1.2	-8.7	-0.6	-1.3	2.3	3.4
9. Imports of goods and services	1.6	-2.8	-12.6	5.3	-2.4	2.7	3.6
9a. - of which goods	-0.4	-6.8	-13.6	3.7	-4.9	2.1	3.1
9b. - of which services	6.0	5.6	-10.8	8.1	2.0	3.7	4.4
10. Gross national income at market prices	7.5	-4.4	-7.0	-5.6	-1.2	1.5	2.7
11. Gross value added at basis prices	3.1	-0.6	-6.1	-4.2	-0.7	2.1	3.2
12. Gross domestic product at market prices	2.2	-0.4	-6.7	-3.4	-0.7	2.1	3.2

Source: Commission services.

Table A2.4: Implicit deflators

<i>percent change</i>	2011	2012	2013	2014	2015	2016	2017
1. Private consumption expenditure	3.0	3.0	-0.1	-1.4	-1.5	0.9	1.3
2. Government consumption expenditure	3.5	-0.9	-4.9	-4.7	-0.2	0.2	1.7
3. Gross fixed capital formation	-1.4	-0.1	-0.3	-4.0	-0.8	1.4	1.9
4. Domestic demand incl. inventories	2.2	2.0	-1.1	-2.4	-1.2	0.8	1.4
5. Exports of goods and services	1.7	1.7	0.4	-0.5	-1.8	1.3	1.4
6. Final demand	1.7	1.7	0.4	-0.5	-1.8	1.3	1.4
7. Imports of goods and services	2.2	1.9	1.1	-2.6	-2.3	1.7	1.8
8. Gross domestic product at market prices	2.0	2.0	-1.4	-1.2	-0.9	0.7	1.2
HICP	3.5	3.1	0.4	-0.3	-0.8	0.9	1.3

Source: Commission services.

Table A2.5: Labour market and costs

<i>Percent change unless otherwise stated</i>	2011	2012	2013	2014	2015	2016	2017
1. Labour productivity	-0.1	1.9	0.1	-0.4	0.3	0.2	0.4
2. Compensation per employee	2.5	-0.8	-6.0	-4.7	-0.3	1.1	1.5
3. Unit labour costs	2.6	-2.7	-6.1	-4.2	-0.6	0.9	1.9
4. Total population	2.6	1.5	-0.2	-0.7	0.4	0.4	0.4
5. Population of working age (15-64 years)	2.9	1.5	-0.8	-0.1	-0.2	-0.2	-0.2
6. Employment	0.5	-4.2	-5.2	-1.9	0.0	1.2	1.6
7. Unemployment rate (1)	7.9	11.9	15.9	16.1	16.1	15.1	13.8

(1) Eurostat definition, % of labour force.

Source: Commission services.

Table A2.6: External balance

<i>EUR bn unless otherwise stated</i>	2011	2012	2013	2014	2015	2016	2017
1. Exports of goods (fob)	2.5	2.5	2.4	2.8	2.7	2.7	2.7
2. Imports of goods (fob)	7.0	6.5	5.6	5.9	5.6	5.7	5.9
3. Trade balance (goods, fob/fob) (1-2)	-4.5	-4.0	-3.2	-3.0	-2.9	-3.0	-3.1
<i>3.1 p.m. (3) as % of GDP</i>	-23.2	-20.8	-17.7	-17.4	-16.7	-16.9	-17.0
4. Exports of services	7.2	7.2	6.8	6.9	6.9	7.2	7.5
5. Imports of services	3.3	3.5	3.1	3.4	3.4	3.6	3.7
6. Service balance (4-5)	3.9	3.7	3.7	3.5	3.5	3.6	3.8
<i>6.1 p.m. 6 as % of GDP</i>	19.8	18.9	20.2	20.1	20.0	20.3	20.9
7. External balance of goods and services (3+6)	-0.7	-0.4	0.5	0.5	0.6	0.6	0.7
<i>7.1 p.m. 7 as % of GDP</i>	-3.4	-1.9	2.5	2.8	3.3	3.4	3.8
8. Balance of primary and secondary incomes	0.0	-0.7	-0.8	-1.2	-1.3	-1.4	-1.5
<i>8.1 - of which, balance of primary income</i>	0.2	-0.5	-0.6	-0.9	-1.0	-1.1	-1.2
<i>8.2 - of which, balance of secondary income</i>	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3
<i>8.3 p.m. 8 as % of GDP</i>	0.3	-3.7	-4.5	-6.8	-7.6	-7.8	-8.1
9. Current external balance (7+8)	-0.6	-1.1	-0.4	-0.7	-0.7	-0.8	-0.8
<i>9.1 p.m. 9 as % of GDP</i>	-3.2	-5.7	-2.0	-4.0	-4.3	-4.4	-4.3
10. Net capital transactions	0.0	0.0	0.2	-1.6	-0.1	-0.1	-0.1
11. Net lending (+)/net borrowing (-) (9+10)	-0.6	-1.1	-0.1	-2.3	-0.9	-0.9	-0.9
<i>11.1 p.m. 11 as % of GDP</i>	-3.0	-5.5	-0.6	-13.1	-5.1	-4.9	-4.8

Source: Commission services.

Table A2.7: Fiscal accounts

	2011	2012	2013	2014*	2015	2016	2017
	levels, EUR m						
Taxes on production and imports	2,711	2,722	2,491	2,615	2,556	2,593	2,712
Taxes on income and wealth	2,065	1,932	1,873	1,806	1,730	1,788	1,816
Social contributions	1,566	1,510	1,362	1,557	1,556	1,595	1,668
Other current resources (1)	859	865	877	1,069	990	977	897
Total current revenue	7,200	7,028	6,604	7,048	6,832	6,953	7,093
Capital transfers received	12	11	6	5	5	5	5
Total government revenue	7,212	7,039	6,610	7,053	6,837	6,958	7,098
Compensation of employees	2,882	2,825	2,573	2,299	2,273	2,260	2,331
Intermediate consumption	871	811	744	655	623	629	610
Social transfers	2,630	2,606	2,509	2,576	2,599	2,603	2,579
Interest payments (2)	430	566	563	498	517	458	423
Subsidies	85	95	95	80	80	81	82
Other current expenditure	533	520	392	417	411	377	356
Total current expenditure	7,419	7,414	6,872	6,525	6,503	6,409	6,381
Total capital expenditure (3)	903	746	624	571	588	569	590
Total expenditure	8,334	8,169	7,501	7,097	7,090	6,978	6,971
General government balance, EDP	-1,070	-1,130	-891	-44	-253	-19	127
General government primary balance	-640	-563	-327	455	264	439	550
	% of GDP						
Taxes on production and imports	13.9	14.0	13.8	14.9	14.7	14.6	14.8
Taxes on income and wealth	10.6	10.0	10.3	10.3	10.0	10.1	9.9
Social contributions	8.0	7.8	7.5	8.9	9.0	9.0	9.1
Other current resources (1)	4.4	4.5	4.8	6.1	5.7	5.5	4.9
Total current revenue	36.9	36.2	36.4	40.3	39.3	39.2	38.7
Capital transfers received	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Total government revenue	37.0	36.3	36.5	40.3	39.3	39.2	38.8
Compensation of employees	14.8	14.6	14.2	13.1	13.1	12.7	12.7
Intermediate consumption	4.5	4.2	4.1	3.7	3.6	3.5	3.3
Social transfers	13.5	13.4	13.9	14.7	14.9	14.7	14.1
Interest payments (2)	2.2	2.9	3.1	2.8	3.0	2.6	2.3
Subsidies	0.4	0.5	0.5	0.5	0.5	0.5	0.4
Other current expenditure	2.7	2.7	2.2	2.4	2.4	2.1	1.9
Total current expenditure	38.1	38.2	37.9	37.2	37.4	36.1	34.8
Total capital expenditure (3)	4.6	3.8	3.4	3.3	3.4	3.2	3.2
Total expenditure	42.8	42.1	41.4	40.5	40.8	39.3	38.1
General government balance, EDP	-5.5	-5.8	-4.9	-0.2	-1.5	-0.1	0.7
General government primary balance	-3.3	-2.9	-1.8	2.6	1.5	2.5	3.0
Nominal GDP	19.5	19.4	18.1	17.5	17.4	17.7	18.3

* Net of the one-off recapitalisation of the cooperative banking sector amounting to 8.6% of GDP in 2014

(1) The February projection for 2014 includes the distribution of exceptional dividends by the CBC. The 2015 and 2016 numbers do not yet account for extraordinary dividends, but will be adjusted once the decision is taken by the CBC, in line with its duties under the Treaty and the Statute.

(2) This includes an annual interest saving of EUR 30m related to the CBC asset-debt swap, which is subject to a decision of the CBC board in full respect of the independence of the CBC, the Treaty and the rules and procedures of the Eurosystem.

(3) For 2013, this includes compensation of pension funds amounting to 1.8% of GDP in 2013.

(3) For 2013, this includes signing fees for gas exploration amounting to 1.1% of GDP, which are treated as negative capital expenditure (disposal of non-produced assets).

Source: Commission services

Table A2.8: Debt developments

	2011	2012	2013	2014*	2015	2016	2017
EDP deficit (% of GDP)	-5.5	-5.8	-4.9	-0.2	-1.5	-0.1	0.7
EDP gross debt (% of GDP)	66.0	79.5	102.2	107.5	106.3	98.8	92.9
	levels, EUR bn						
EDP deficit	-1.1	-1.1	-0.9	0.0	-0.3	0.0	0.1
Gross debt	12.9	15.4	18.5	18.8	18.5	17.5	17.0
Change in gross debt	2.1	2.6	3.1	0.3	-0.3	-0.9	-0.5
Nominal GDP	19.5	19.4	18.1	17.5	17.4	17.7	18.3
Real GDP	19.1	18.7	17.7	17.3	17.2	17.4	17.8
Real GDP growth (% change)	0.3	-2.4	-5.4	-2.3	-0.5	1.4	2.0
	% of GDP						
Gross debt ratio	66.0	79.5	102.2	107.5	106.3	98.8	92.9
Change in gross debt ratio	10.2	8.0	22.7	5.3	-1.2	-7.5	-5.8
	Contribution to change in gross debt						
Primary balance	3.9	2.9	1.8	6.0	-1.5	-2.5	-3.0
Snow-ball effect	0.8	3.1	8.8	6.5	3.7	0.4	-0.7
of which							
Interest expenditure	2.4	2.9	3.1	2.8	3.0	2.6	2.3
Real growth effect	-0.2	1.6	4.6	2.4	-0.3	-1.5	-1.9
Inflation effect	-1.4	-1.3	1.2	1.2	1.0	-0.7	-1.2
Stock-flow adjustments	5.5	2.0	12.1	-7.1	-3.4	-5.4	-2.1

* Net of the one-off recapitalisation cost of the cooperative banking sector amounting to 8.6% of GDP in 2014

Source: Commission services

Memorandum of Understanding on Specific Economic Policy Conditionality

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

1. to restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence by thoroughly restructuring and downsizing credit institutions and strengthening supervision;
2. 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
3. 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.

- **Financial sector reforms**

A. Regulation and supervision

Maintaining liquidity in the banking sector

- After the complete removal of all restrictive measures on 6 April 2015, 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. Although liquidity has improved, additional government guarantees for the issuance of bank bonds remain available to be used as collateral against liquidity, but only if necessary to safeguard financial stability, in line with State aid rules.
- The CBC will continue to receive the updated condensed capital and funding plans of core banks **on a quarterly basis**, and within two months of the end of each quarter, and will transmit them to the ECB, the EC, the ESM and the IMF. The funding and capital plans should realistically reflect the anticipated deleveraging in the banking sector, the resolution of non-performing assets, and the reduction of borrowing from the central bank, with the objective to avoid asset fire sales and a credit crunch.

Regulation and supervision of banks and cooperative credit institutions

- The credit register is already operational for credit assessment purposes. The authorities will implement its use for supervisory and macro-prudential purposes, with a preliminary report **by end-September**. The authorities will further expand the data elements held in the register and continue to improve data quality.
- BoC and the coops will continue to submit a **quarterly report** describing the progress with the implementation of the restructuring plans. The reports will contain the agreed set of key performance indicators, including selected operational and, where relevant, financial indicators.
- The authorities will study the financial situation of borrowers. The study will, among other things, assess the extent of strategic default, with the objective of improving the effectiveness of debt resolution policies. The findings of the survey will be published in a report **by end-July**.
- The CBC will ensure it has sufficient staff to carry out its functions in full independence as stipulated by the Treaties. The CBC, taking into account the tasks undertaken in relation to these policy measures new tasks following the creation of the SSM, and enforcement of the existing regulatory framework, has already assessed the staffing needs in the micro-prudential supervisory area and the recruitment process will be completed **by end-June**. The needs in other business areas of the CBC will be reviewed **by end-July** and for the Resolution Unit **by end-June**.
- Taking into account the formal letter of notice sent by the EC on 27 March 2015, the authorities will finalise without any further delay the transposition

into national law of the Bank Recovery and Resolution Directive. The authorities will also ensure the timely transposition of the Deposit Guarantee Scheme Directive. To this end, the CBC will make available the necessary resources as a matter of urgency.

Regulation and supervision of insurance companies and pension funds

- In order to streamline non-banking supervision, the authorities will prepare an action plan for the integration of the insurance sector supervision and the pension funds supervision. The options for improving the quality of the non-banking supervision and ensuring appropriate implementation of Solvency II and also for increasing the independence and improving the governance and administrative capacity of the non-banking supervision, taking into account international best practices, will be reviewed in a report to be prepared by the authorities, **by end-September**. The report will set priorities for next steps, including an inventory of pension funds, their volume and composition of assets, type of pension scheme plan and composition of membership. A legislative proposal will be prepared taking into consideration the recommendations of the report and will be submitted to the House of Representatives **by end-December**.

Addressing corporate and household indebtedness

- The Cypriot authorities will continue monitoring 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. The annual Financial Stability Report, to be published **by end-September**, will include an extended analysis of corporate and household indebtedness. In addition, quarterly monitoring reports will continue to be submitted and their scope and content will be further enhanced.
- Measures will be taken to strengthen the management of non-performing loans and to deal with troubled borrowers, taking into account the developments and timelines in the SSM. A framework for targeted private-sector debt restructuring is being established.
- Banks will continue to report **quarterly** on restructuring progress and management of NPLs, using the agreed specific performance indicators and targets (e.g. number of loans restructured, cash collections, etc.). Furthermore, banks will continue to report monthly on early arrears (e.g. number and amount of past due loans within 1-90 days, type of actions taken, and number and amount of cured or uncured loans).
- The CBC will make available on its website a comprehensive and user-friendly guide on the practical application of the amended Arrears Management Directive, published on 3 April, and of the Code of Conduct. Effective compliance with the Arrears Management Directive and the Code of Conduct will be ensured.
- To ensure that banks offer a long-term sustainable restructuring solutions, the CBC will agree with banks on institution- and portfolio-specific targets to be set for the various phases of the restructuring process on a quarterly rolling basis. Each quarter, and for the first time **by end-July**, the CBC will publish these targets, on an aggregated basis and for the ongoing and following quarters together with the past performance of the banks and an explanation for any possible discrepancy between targets and actual performance, as well as for the revision of the targets.

- Following the requirements introduced by the CBC in January, the banks and coops will continue to submit regularly to the CBC in the quarter following the reporting period the reports prepared by their external auditors on the effectiveness of their debt restructuring arrangements and strategies for the periods ending in June 2015, December 2015, and June 2016. Relying on the finding of the reports, the CBC will assess the appropriateness of restructuring solutions and submit to the SSM the findings and recommendations on the banks' internal policies and processes regularly, and for the first time **by end-June** based on the reports for the period ending in December 2014.
- Legal amendments to the Law on the Financial Ombudsman were adopted in July 2014. **By end-June**, further legal amendments will be adopted in order to clarify that the responsibility for assessing compliance with the Arrears Management Directive is not transferred to the mediators but remains with the CBC.
- The Cypriot authorities, in view of financial stability considerations and on-going bank restructuring, commit not to introduce any new regulations which would interfere with the setting of bank lending rates. In particular no ceilings on bank lending rates would be introduced. Furthermore, the Cypriot authorities will reassess **by end-June** the recently adopted law entitled "The liberalisation of the interest rate and other related matters (amending) Law of 2015", for its compatibility with national law and international best practice and notably its retro-active application.
- In order to stimulate a market for distressed assets and to facilitate the issuance of securities by securitisation vehicles, the authorities will allow and facilitate lenders to transfer existing individual loans together with all collateral and securities to third parties at minimal transaction costs without having to obtain the consent of the borrower, while providing sufficient safeguards to the borrowers under the Code of Conduct. Banks and non-bank entities should be able to acquire loan portfolios. Any information obligation of the creditor should not be an impediment for the transfer and/or securitization of loans. To this end, the Cypriot authorities have carried out an assessment of existing impediments and of required legislative amendments. This assessment included a review of the regulatory framework for non-bank third parties and a Task Force on the removal of the impediments has been set up.
 - i. the authorities will, after taking into account comments by programme partners, present a draft law to programme partners, that enables the sale of loans in line with the principles and objectives mentioned above and which is in line with international best practices and EU law, **prior to the granting of the seventh disbursement of financial assistance. By end-June**, the legislation will be approved by the Council of Ministers.
 - ii. The identified impediments to the securitisation of assets will be removed and a legal proposal enabling securitisation of assets, in line with international best practices and EU law, will be submitted to the House of Representatives **by end-July**.
- As a matter of priority, the amendment to the Banking Law limiting the sale of loans to third parties will be repealed.

Legal framework for private debt restructuring

- All legal, administrative or other hurdles currently constraining the seizure and sale of loan collateral shall be removed so that the assets pledged as collateral

can be recovered within a reasonable period deemed to be a maximum time-span of 1.5 years from the initiation of the relevant proceedings. In the case of primary residences, this time-span could be extended to 2.5 years. The authorities commit not to introduce any further impediments to the seizure of assets pledged as collateral.

- **Prior to the granting of the seventh disbursement of financial assistance**, the authorities will, after taking into account comments by programme partners, present draft legislation to programme partners, that
 - ensures that property buyers who have paid the purchase price in full, will have their title deeds transferred within 6 months after their issuance;
 - puts obligations on all parties involved to ensure that the procedures releasing encumbrances and transferring the title can operate without delay and as automatically as possible; and
 - provides safeguards against abuse, inter-alia by introducing a mandatory escrow account to route all payments related to a property transaction, as well as adequate compensation for the parties involved, if available.

By end-June, the legislative measures will be adopted by the Council of Ministers.

Furthermore, the CBC will, in close cooperation with Ministry of the Interior, provide to programme partners a financial sector impact assessment regarding title transfers and lifting of encumbrances **by end-June**.

The authorities will propose legal or contractual standards for property sales contracts and connected loan and mortgage arrangements **by end-October**, as well as further legislative and administrative measures necessary to incentivize the swift transfer of title deeds **by end-October**.

- The authorities will monitor on a continuous basis the implementation and performance of the recently adopted insolvency framework and ensure that it supports its objectives and principles, notably speeding up the reduction in the stock of non-performing loans, and reflects international best practice. In particular, monitoring and, where relevant, amendments will focus on:
 - identifying impediments to the effectiveness of the procedures, including measures which could weaken incentives for non-viable debtors to promptly pursue debt restructuring, in particular with regard to companies.
 - ensuring that the relief in legacy guarantees does not jeopardise the economic function of guarantees going forward, in particular for companies, and that the payment capacity of the guarantor is taken into account.

In consultation with program partners, the authorities will submit to the Council of Ministers **by end-September** any necessary adjustments to the insolvency and foreclosure frameworks, including legislative changes. Moreover, the authorities will conduct a comprehensive review of the private sector debt restructuring legal framework **by early 2016**, with an action plan of modifications to the framework to correct any deficiencies.

- Most of the legal and institutional arrangements are in place in order to start the implementation of the new insolvency regime. Any necessary additional administrative acts and regulations will be adopted **by end-August**. Amendments to the regulations regarding the liquidation of companies will be put in place **by end-October**. The authorities will step up efforts in order to

minimize the transition period and to ensure the full functioning of the Insolvency Service, including IT infrastructure, and the availability of trained and licenced insolvency practitioners at the earliest possible. To this end, an action plan will be submitted to program partners by **end-June**.

- Following the adoption of the regulation on the rules for sale by auctions, as required by the foreclosure law, any other measures, procedures or actions that may be required for the effective implementation of the law will be immediately implemented.
- As further measures with regard to the legal framework for the restructuring of debt, the authorities will in particular achieve the following:
 - the authorities will formulate recommendations on the Civil Procedure Code and Court Rules: (i) in order to ensure the smooth and effective functioning of the revised foreclosure law including the swift processing of appeals. The implementation of relevant legislative amendments should become effective **by end-July**; and (ii) in order to ensure the effective functioning of the new insolvency frameworks. The implementation of relevant legislative amendments will become effective **by end-September**. The recommendations and action taken by the authorities should also aim at improving the pace of court handling and the reduction of backlogs in courts.
 - following the report on the legal framework for obtaining updated information on the financial situation of delinquent borrowers, the authorities will also issue recommendations **by end-July** regarding the financial statements of debtors in the context of enforcement measures. The adoption of the relevant amendments to the Civil Procedure Code and Court Rules will become effective **by end-October**.
 - following the study of impediments on attachments to financial assets and earnings of delinquent borrowers, the authorities will also issue its recommendations **by end-July** regarding the improvement of individual enforcement procedures. The adoption of the relevant amendments to the Civil Procedure Code and Court Rules will become effective **by end-October**.

B. Recapitalisation and restructuring of financial institutions

Restoring adequate capital buffers

- The authorities adopted the transposition of CRD IV on 29 January 2015 and will fix the minimum Common Equity Tier 1 ratio at 8% under Pillar 1 **by end-June**.

Management of legacy Laiki

- The Resolution Authority will prepare, **by end-June**, a time-bound plan for completing the resolution of Laiki and will implement it without delay.

Restructuring of Bank of Cyprus

- BoC has progressed with the implementation of its restructuring plan and has divested operations and stakes abroad ahead of schedule. Moreover, the CBC agreed with BoC on the operational and financial indicators on progress with implementing the restructuring plan that will be communicated **quarterly** to the public, together with the financial accounts.

Restructuring and recapitalisation of cooperative credit institutions

- The Cooperative Group will ensure timely and complete implementation of the already agreed restructuring plan and take further measures to improve its operational capacity, notably in the following areas: i) arrears management, ii) Management Information System (MIS), iii) governance and iv) strengthening management capacity. As regards management of arrears, the Group will continue to ensure all relevant units have an appropriate level of skilled and professional staff, including, at a first stage, by redeployment of existing resources and, at a second stage, leveraging on external expert service-providers. The CCB will continue to assume primary responsibility for all loans in arrears. Direct reporting lines to the relevant units of the CCB will be established for all staff of the Group engaged in arrears management. Use of the appropriate legal tools and of collection methods related to collateral will be demonstrated. The increased capacity of the Group to manage NPLs by the NPL Management Division will be fully used and will translate in the improvement of objective and verifiable indicators. Based on the review of the sector's policies and operational capacity on debt resolution, which relied also on technical assistance from the IMF, the CCB will design **by end-June** a time-bound plan for addressing the identified deficiencies in a timely manner.
- In order to equip senior management with adequate decision-making tools, the MIS will be improved. The overall IT infrastructure will be updated and fully integrated into the organisational structure of the Group, with the view of providing all the necessary data on a timely and accurate basis. The quality and validity of the existing data will be verified and monitored.
- To streamline execution of tasks, governance will be strengthened, avoiding parallel decision-making structures, also relying on technical assistance from the IMF through appropriate changes **by end-June**. By the same time, the CCB will make progress towards the centralisation of the control functions to the extent possible. The CCB will ensure strict compliance of the individual CCIs with all its policies. To strengthen the governance of the CCB over the CCIs, the amendment of the affiliation directive will be finalised **by end-June**.
- To ensure the implementation of the restructuring plan, the Group will continue to improve its management capacity and meet the employment targets according to the schedule communicated to the EC on 26 March 2015.

- The CCB will ensure the timely implementation of the time-bound action plan for addressing the deficiencies identified with respect to Financial Control and Reporting starting **by end-July**.
- Compliance with the relationship framework between the State and the CCB will be reviewed **on a quarterly basis** by the monitoring trustee, who will also report any breaches of the framework to the EC. The authorities will inform the ECB, the ESM, and the IMF of the conclusions of that report and the follow-up. To this end, the relationship framework will be amended by **end-May**. The effectiveness of the Management Unit of the Ministry of Finance will be reinforced with financial experts **by end-June**.
- To preserve confidence in the sector, the CBC agreed with the CCB and the Ministry of Finance Management unit on the operational and financial indicators on progress with implementing the restructuring plan that will be communicated **quarterly** to the public.

C. Increasing financial transparency

- Based on the findings of the April 2013 audit undertaken by MONEYVAL and an independent auditor, the Cypriot authorities have progressed in enhancing the anti-money laundering (AML) framework in line with best practices and are committed 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:
 - i. 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).
 - ii. Ensure transparency and timely access to information on beneficial ownership of trusts (Action Plan – section 4). The programme partners take note of the establishment by the Cypriot authorities' of trust registers with the supervisory authorities (Action Plan – section 4.3.1)
 - iii. The supervisory competent authorities are reviewing 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). The competent supervisory authorities are committed to take appropriate remedial and/or enforcement actions whenever breaches of compliance are revealed.
 - iv. 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.

To address concerns that Cypriot corporations and trusts might be misused, the Cypriot authorities have revised 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 related to money laundering and tax matters.

To ensure that adequate, accurate and current basic information on all types of legal persons registered in Cyprus could be obtained by the Registrar of Companies and be accessible by the public in a timely manner, the Cypriot authorities have committed to reform the Department of Registrar of Companies as foreseen in section 3.9.

The Cypriot authorities commit to maintain efforts to ensure that the widest possible exchange of information with other FIUs is achieved, either spontaneously or in response to requests. The Cypriot FIU has taken the initiative to provide the programme partners with a breakdown of requests made and received and spontaneous disseminations on a quarterly basis (within 14 days of the end of the quarter), starting with Q4 2013, and publish this information on the FIU website on an annual basis.

To protect the integrity of the financial sector, the CBC took swift action to put the local branch of FBME Bank Ltd. under resolution following the measures taken by its correspondent banks after its designation by the US authorities as a financial institution of primary money laundering concern, has undertaken an AML investigation, and will take appropriate supervisory action based on the results.

- **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, 3% to 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, in particular reducing 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 correct the excessive general government deficit by 2016; and (4) to maintain fiscal consolidation over the medium term, converging towards Cyprus' medium-term budgetary objective of a balanced budget in structural terms, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures (see Section 3), including the implementation of a Medium-Term Budgetary Framework designed in accordance with EU specifications.

The Cypriot authorities adopted a number of fiscal measures for 2012-2014 and have progressed in relation to fiscal-structural reforms. The authorities commit to the full implementation of these measures (see Annex 1) and to regularly monitor the budgetary effect of the measures taken. 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 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,⁹ will be saved or used to reduce debt. To the extent that over-performance is deemed permanent, this can reduce the need for additional measures in the outer years. Measures, such as tax amnesties, that could have an adverse impact on tax compliance and foster tax fraud and evasion, thereby counteracting efforts in line with paragraph 3.6 of this Memorandum, will not be undertaken over the course of the programme period.

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 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 2014-2020 programming periods, while taking into account available EIB funding. The authorities will ensure that the institutional

⁹ 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 5.5, second bullet-point, indent 3

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 and informing the ESM 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 2015

Based on the programme's updated budgetary projection, the Cypriot authorities will achieve general government primary surplus of at least EUR 264 million (1.5% of GDP) in 2015, corresponding to a headline deficit of 1.5% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus).

Fiscal policy in 2016-18

In 2016 the Cypriot authorities will achieve a general government primary balance surplus of at least EUR 439 million (2.5% of GDP), corresponding to a headline deficit of 0.1% of GDP (respecting the 16 May 2013 Council Recommendation on correction of the excessive deficit in Cyprus).

The Cypriot authorities will achieve a general government primary balance of 3% of GDP in 2017 and 3% to 4% of GDP in 2018.

These targets and the underlying updated budgetary projection will be embedded in the 2016-2018 Fiscal Strategy Statement, which will be adopted by the Council of Ministers **by Q2-2015**. After review by and consultation with the programme partners, the 2016 Budget Law will be adopted by **December 2015**. Ceilings for the period 2016-2018 will be established and will accompany the 2016 Budget Law document. Any deviation from the budgetary objectives contained in the 2015-2017 framework will be properly documented and reasons for such deviations will be provided to the programme partners.

If required, the Cypriot authorities will present the programme partners with a provisional list of measures to attain the primary surplus targets in 2017 and 2018.

- **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) take further steps to improve the efficiency and coverage of the healthcare system, while controlling the growth of health expenditure; (3) enhance tax revenues by improving tax compliance and collection; (4) 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; (5) 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 (6) elaborate a programme for improving the efficiency of state-owned and semi-public enterprises and initiate a privatisation programme.

Pension reform

3.1. While acknowledging that the Cypriot authorities have recently introduced substantial reforms (as noted in Annex 1), which, according to the results of the actuarial study which were peer reviewed in the Ageing Working Group of the Economic Policy Committee in September 2013, have adequately addressed the issue of the high projected increase in pension spending and secured the long-term financial viability of the pension system through 2060, it remains important to monitor the long term financial sustainability of the system and consider further reform steps, if needed.

Health care reform

- To strengthen the sustainability of the funding structure and the efficiency of public healthcare provision, the following measures will be adopted:
 - **By Q2-2015**, and taking into account the related WHO studies, the hospital autonomization bill will be adopted by the Council of Ministers and submitted to the House of Representatives;
 - A detailed road map for the implementation of hospital autonomization will be submitted to programme partners **by Q2-2015**;
 - **By Q3-2015**, the detailed restructuring plan of the public primary healthcare centres will be prepared for consultation with programme partners, based on the recommendations put forward in the respective report;

- The authorities will continue delivering quarterly reports assessing the collection of private co-payments and compulsory health-care contribution for public servants and public servant pensioners.
- The Implementation Advisory Team will, in close cooperation with the Support Group for Cyprus, assist the Ministry of Health with the implementation of healthcare reforms and hospital autonomization. Further, the Cypriot authorities will consult in a timely manner with programme partners and provide all necessary information.

Taking into account the economic conditions, the implementation of the necessary complementary reforms, the results of the updated actuarial study, a National Health System (NHS) will be implemented to be fully in place in **2017**. The NHS will be developed and implemented based on the fundamental principles of free choice of provider, social equality and solidarity, financial sustainability and universal coverage of a minimum benefit basket. NHS will be initially based on a single payer system. A multiple insurance system can be implemented if and when the necessary preconditions for achieving fiscal sustainability as well as efficiency and affordability gains (i.e. consumer information and transparency, contestable markets, freedom to contract, competition regulation and risk-adjustment) can be ensured. The authorities will take a decision on the final design of NHS and adopt the relevant legislations according to a timetable that will ensure implementation of the NHS in 2017. In order to ensure that the final design of the NHS is fiscally sustainable, the Council of Ministers will adopt, after consultation with programme partners, a binding set of contingency measures under NHS (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, capacity planning), which will ensure that the agreed budget limits of public health expenditure are not exceeded, whilst equitable access to healthcare is guaranteed.

Public financial management

- The Cypriot authorities will:
 - Improve further the risk-assessment analysis and management, associated with government guarantees. To this end, submit to programme partners **by Q2-2015** an updated version of the risk assessment report;
 - Drawing on the recommendations from technical assistance provided by the ESM and the IMF, submit to programme partners **by Q2-2015** an action plan for strengthening sound practice standards for the Public Debt Management Office;
 - issue guidelines for public investment management, including project appraisals in line with the FRBSL provisions **by May-2015**. The authorities commit not to enter into any new tendering process and not to sign any public private partnership (PPP) contract before the issuance of the guidelines for public investment management; and
 - regularly update the PPPs inventory, including contingent liabilities and include it both in the annual budget law and in the annual financial report.

State-owned enterprises

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

- the law regulating the creation and the functioning of SOEs at the central and local levels will be adopted by the House of Representatives **by June 2015**. The law will enhance the monitoring powers of the central administration, while including reporting on SOEs in the context of the annual budgetary procedure. No additional SOEs will be created until the law has been adopted;
- each SOE under internal review will submit a strategic plan with detailed milestones and timelines to the competent minister for approval, in consultation with programme partners, and in line with the FRBSL and SOEs Law provisions, **at the latest 3 months after the completion of each internal review**.

Privatisation

3.3. The Cypriot authorities will implement the privatisation plan submitted to the programme partners to help improve economic efficiency by encouraging more vigorous competition and greater capital inflows and enhance debt sustainability. The plan includes the privatisation of, inter alia, CyTA (telecoms), EAC (electricity), CPA (commercial activities of ports), as well as land assets. CyTA and CPA will be privatised **within the programme period and EAC by mid-2018**.

An appropriate regulatory framework is a prerequisite for the privatisation of natural monopolies. 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 the relevant secondary legislation. Privatisation will be conducted in conformity with State aid rules, as required by the Commission's Guidance Paper.¹⁰

In order to pursue the privatisation process in the most diligent way, the Cypriot authorities will:

- ensure that the Privatisation Unit is fully operational as soon as possible, in line with the objectives and provisions of the Privatisation Law;
- for the privatisation of Cyprus's Telecommunications Authority (CyTA):
 - convert CyTA into a Limited Liability Company through the adoption of the necessary legislation for CyTA's corporatisation by the Council of Ministers **by June 2015** and by the House of Representatives **by September 2015**;
 - in parallel, prepare, through the Inter-Ministerial Committee, and on the basis of the recommendations of the advisers, the privatisation structure and the transaction strategy, including the envisaged ownership structure.
- for the privatisation of Limassol Port's commercial activities:

¹⁰ http://ec.europa.eu/competition/state_aid/studies_reports/swd_guidance_paper_en.pdf

- prepare for consultation with programme partners a detailed privatisation plan, a valuation of the transaction and the specificities of the Port's method of privatisation **by June 2015**, after consultation with, and notification to, the relevant European Commission services;
 - launch the call for the Expression of Interest for the concession agreement **by June 2015**;
 - adopt the law enabling the conversion of the Cyprus Port Authority (CPA) into a regulatory body **by May 2015** and establish CPA's appropriate regulatory framework **by October 2015**, after consultation with, and notification to, the relevant European Commission services.
- for the privatisation of the Electricity Authority Company (EAC):
 - finalise **by May 2015** the bidding process for the study on the unbundling and ownership structure of EAC. The study will comprise an international benchmarking, including cost structures of comparable electricity companies operating in a similar environment;
 - appoint the independent adviser conducting the study **by July 2015**;
 - submit the study for consultation with programme partners **by November 2015**, including an interim report **by September 2015**;
 - taking into account the study, and in consultation with programme partners, the Council of Ministers will decide, **by December 2015**, on a form of effective and efficient unbundling, in line with the principles of the Third Energy Package, which ensures the customer's free choice of supplier and guarantees non-discriminatory access to energy networks to the benefit of suppliers and customers. This unbundling will be implemented **by Q1-2016**. The Council of Ministers' decision will take into account the overall impact on the economy and the economic efficiency gains of the unbundling of EAC's operations into different legal entities.
 - for the sale of land assets:
 - appoint an independent adviser with relevant expertise that will develop a plan with detailed intermediate steps and timings for disposing of the identified land assets **by June 2015**;

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**, which will be used for public debt reduction.

Revenue administration, tax compliance, and international tax cooperation

- The Cypriot authorities will continue reforming the revenue administration with the objective to reinforce the efficiency and effectiveness of revenue collection and the fight against tax fraud and evasion, with a view to increasing fiscal revenue.

A comprehensive compliance strategy will be put in place **by Q2-2015**. The strategy will be firmly based on analytical work on risk identification and analysis, as well as on an evaluation of different risk treatment strategies. To this end, the authorities will

- implement their new debt collection action plan, with a view to reducing collectible and unencumbered debt, while continuing the pilot run on garnishing of bank accounts, and prepare a quarterly progress report on the action plan's implementation starting in **Q2-2015**; and
- submit to programme partners **by Q2-2015** detailed action plans by each of the headquarter units in the Design and Monitoring Division, outlining the steps to implement the compliance strategy in the Tax Department, including training of staff.

To progress with the operationalization of the integrated and function-based tax agency, in line with the adopted integration plan, the following steps will be taken:

- **by Q2-2015**, a single registration process will be put in place; and
- the new tax procedure code, consistent with the compliance strategy and future business processes, will be adopted by the Council of Ministers **by Q3-2015**.
 - The Cypriot authorities will safeguard the timely and effective exchange of information on 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 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;
 - continue improving the systematic follow-up and use of information received from other countries about savings income payments received by Cyprus resident individuals and savings income payments received by entities and legal arrangements such as trusts under Cyprus law, notably entities and legal arrangements the beneficial owners of which are resident in other EU Member States; and
 - ensure that the tax authorities have continuous access to databases of other public entities in order to facilitate and expedite the provision of the requested information **by Q4-2015**; and
 - building on the corrective action already taken, continue with the swift implementation of the commitments taken with a view to reversing the negative opinion by the OECD Global Forum in the Peer Review Group 2015 annual meeting.

In addition, the authorities will monitor closely further progress in responding timely to tax information requests by EU and third countries. The authorities will submit to the programme partners quarterly performance updates (within 14 days of the end of the quarter).

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. **By Q4-2015**, the Cypriot authorities will provide to the European Commission a report on the results of audits of at least 4 out of the total of 16 paying agents established in Cyprus. 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 Cypriot authorities will reform the immovable property tax with the objective to improve the fairness of the tax burden and to increase the efficiency of the tax administration. To this end, the authorities will:
 1. implement the recurrent immovable property tax for the tax year **2015** based on a General Valuation (GV) for all immovable properties, determined on the basis of tangible building- and plot related characteristics. The design of the immovable property tax should ensure a broad tax base and IPT proceeds not lower than in 2013. A draft of the proposed tax rates and thresholds will be submitted for timely consultation with programme partners. Following consultation with programme partners, the final design of the immovable property tax will be adopted by the Council of Ministers **by May 2015** and submitted to the House of Representatives by **Q2-2015** with a view to adoption in due time for being applied for the collection of the 2015 immovable property tax.
 2. adopt legislation specifying the frequency of the mandatory update of the values in line with international best practice **by Q2-2015**, following consultation with programme partners;
 3. implement **by Q2-2015** the recommendations of a study on the scope for consolidating the collection and administration of the municipal and communal recurrent property tax. **By Q2-2015**, the authorities will also review the tax regulations that may impede the leasing of immovable property;
 4. continue the assessment of the relevance of the parameters used in the Computer Assisted Mass Appraisal (CAMA) model for the GV, on a quarterly basis;
 5. present to the programme partners **by Q2-2015** an updated communication strategy aiming at informing the goals of the property tax reform, the implications for citizens and the required procedural steps.

Public administration reform

- The Cypriot authorities have commissioned and will commission reviews of possible further reforms of the public administration. The reviews include a horizontal and a sectoral element.

Based on the findings of the horizontal review submitted in 2014, the Cypriot authorities will prepare a reform plan, which will be based on the following principles:

- reform the structure of public sector wages, in order to safeguard the fiscal sustainability of the public sector wage bill and the consistency with the medium-term fiscal targets. This will be ensured by reforming the wage setting mechanism and make salary increases subject to overall economic and fiscal conditions on the basis of objective indicators. The mechanism will ensure that the compensation of employees in the general government as a share of GDP will remain on a descending path over the medium-term.
- introduce a new appraisal system and a new promotion system that will establish a stronger link between merit and promotion by: (i) widening the base of eligible candidates, (ii) increasing the weight of merit in promotion decisions, including by introducing objective assessment criteria, written exams and/or assessment centres, and (iii) by involving more directly the Heads of Departments in promotion decisions;
- enhance staff mobility, by: (i) opening the promotion posts to the wider civil service, (ii) introducing a system of transfers within the public sector, (iii) a wider use of secondments and duty assignments, and (iv) ensuring that mobility is taken into account in the assessment of relevant experience in promotion decisions.

With a view to the reform being adopted in 2015, the reform plan will be prepared for consultation with programme partners **by May 2015**. The reform plan and accompanying legal proposals will be adopted by the Council of Ministers **by June 2015** and submitted to the House of Representatives.

The sectoral element will examine:

- the role, competences, organisational structure, size and staffing of relevant ministries, services and independent authorities;
- the possibility of abolishing, merging or consolidating non-profit organisations or companies and state-owned enterprises; and
- the possibilities for the re-organisation and re-structuring of local government,

and comprises two batches:

- a) the first batch consists of the review of the Ministries of Agriculture, Education and Health, as well as local government and the Department of Registrar of Companies. Based on the findings of the World Bank and the UK public administration report, the Council of Ministers will adopt the remaining reform plans for local governments, after consultation with programme partners, **by June 2015**. Following the adoption of the legislation indicated as high priority on the Companies Registrar, its reform will start to be implemented **by June 2015**. The relevant legislation in relation with the reforms in Agriculture, Education, and local governments indicated as high priority

will be adopted by the House of Representatives **by October 2015** and their reforms will start to be implemented **by January 2016**.

- b) the second batch will cover all remaining Ministries (Labour, Welfare and Social Insurance, Communications and Works, Energy, Commerce, Industry and Tourism, Interior, Defence, Justice and Public Order, Foreign Affairs), and the Ministry of Finance, including the Treasury and the Directorate General for European Programmes, Coordination and Development (ex: Planning Bureau) being covered under the PFM. It will also include all SOEs. Finally, it will cover the Constitutional and Independent Services (see Annex for detailed list). The results of the second batch will be presented **by Q4-2015**. They will include implementation timelines with detailed intermediate steps. Based on the findings of this review, the Cypriot authorities will agree on a reform plan after consultation with programme partners, which will be approved by the Council of Ministers **by Q1-2016**. The relevant legislation in relation with the reforms indicated as high priority will be adopted by the House of Representatives **by Q2-2016**. The reform will start to be implemented **by Q3-2016**, in accordance with the reform plan.

Welfare system

- The Cypriot authorities introduced a Guaranteed Minimum Income (GMI) aimed at strengthening the protection of vulnerable households while ensuring an appropriate balance between welfare benefits and work incentives. The Cypriot authorities have started implementing the new GMI as of mid-July 2014. Besides the introduction of the GMI, the adopted welfare reform plan also includes measures aimed at consolidating and streamlining other social benefits, and at improving the targeting of these benefits.

To continue the implementation of the adopted welfare reform and monitor the implementation of the GMI, including its fiscal impact, the Cypriot authorities will take the following steps:

- the monitoring unit will continue providing quarterly costing updates of the GMI, at the end of each quarter, starting in **Q1-2015**;
- **by Q2-2015**, prepare for consultation with programme partners, plans to consolidate disability benefits, in line with the adopted welfare reform;
- **by Q2-2015** submit for consultation with programme partners, a proposal to consolidate the student grant, the student package and the benefits previously administered by the Cyprus Scholarship Foundation into one scheme, with a view to implementing the single scheme for the academic year 2015-2016;
- **by Q3-2015**, the monitoring unit will provide an assessment report of the GMI and an analysis of the profile and coverage of beneficiaries;
- on the basis of a single view on social benefits under various ministries, drawing on their respective registries of benefits, **by Q1-2016**, the monitoring unit will finalize an assessment report of the welfare reform, including possible refinements in administrative structures and benefits.

6. Labour market

Key objectives

While the Cypriot labour market was characterised by high employment rates and low unemployment in the years leading up to the crisis, the unwinding of unsustainable imbalances and worsening of macroeconomic conditions and prospects have resulted in rapidly rising unemployment and important labour market challenges over the medium-term. Labour market reforms can mitigate the impact of the crisis on employment, limit the occurrence of long-term and youth unemployment, facilitate occupational mobility and contribute to improving the future resilience of the Cypriot economy in the face of adverse economic shocks. In this context, the objectives are: (1) to implement a reform of the system of wage indexation commensurate with ensuring a sustainable improvement in the competitiveness of the economy and allowing wage formation to better reflect productivity developments; (2) to 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

- 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. Wage indexation has been suspended in the private sector until end-2016. A tripartite agreement will be pursued with social partners **by Q4-2015** to ensure that the reformed wage indexation system (COLA) applicable to the public sector (lower frequency of adjustment, suspension at times of recession and partial indexation) is also adopted by the private sector when the period of COLA suspension ends.

Minimum wage

- 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

- 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 implementation of the

reform of the social welfare system, which ensures 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, should be pursued as described in section 3.10.

- The Cypriot authorities will continue the implementation of measures to address the identified shortcomings of the system of activation policies, including:
 - continuous monitoring and evaluation of all activation measures, in accordance with the newly adopted comprehensive methodology. A first report on the implementation of the monitoring system will be prepared for consultation with programme partners **by Q4-2015**;
 - measures to enhance the administrative capacity of the public employment services. In this regard, a detailed description of all actions taken or envisaged in the short-term to improve the provision of PES services, including organizational changes will be prepared for consultation with program partners **by Q2-2015**. In addition, the tender for the recruitment of additional staff, through the 2014-20 ESF Operational Programme budget, will be launched **by end-May 2015**, and all staff will be operational **by end-October 2015**; and
 - measures to ensure the effective cooperation between the public employment services, the social welfare services and the benefit-paying institutions in the activation of the unemployed who are recipients of social assistance, including by establishing clear procedures for the automatic exchange of information and a transparent system linking benefit receiving with job-search efforts. A comprehensive note detailing the concrete measures undertaken in this regard, covering steps to avoid welfare dependency, and the links with social welfare services, will be prepared for consultation by program partners **by end-May 2015**.
- Having experienced one of the steepest increases in the youth unemployment rate in the EU, and a rapid rise of young people not in employment, education or training (NEETs), Cyprus was urged to take swift action to create employment opportunities for young people and improve their employability prospects. To this end, the Cypriot authorities have recently adopted a National Action Plan for Youth Employment, which includes, inter alia, measures envisaged for support under the Youth Employment Initiative covering also the implementation of the Youth Guarantee, 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 and be coherent with the reform of the social welfare system (section 3.10) and the agreed budgetary targets. For this purpose, the authorities will prepare for consultation with programme partners a comprehensive list of all active labour market policies running in the period 2014-2015, with objectives, target group, recipients per year, budgetary allocations, and call dates **by end-May 2015**. This list will be updated to include also measures to be implemented in the period 2015-2016, **by Q3-2015**.

7. Goods and services markets

Key objectives

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

Services Directive and regulated professions

- On the basis of the comprehensive review of requirements affecting the access and exercise of activity of the regulated professions sector, the elimination of unjustified requirements for the specific case of engineers remains subject to close monitoring and possible further actions by the Commission, so as to ensure compliance with EU law.

Competition, transparency and sectoral regulatory authorities

- The Cypriot authorities will strengthen the independence and the effectiveness of the Commission for the Protection of Competition (CPC) by:
 1. continuously ensuring that CPC has sufficient and stable financial means, as well as qualified personnel, in order to enhance its effective and on-going operation; and
 2. continuously promoting a more active role of the CPC in the area of advocacy, with the objective of safeguarding and promoting competition.

The Cypriot authorities will continuously ensure that the General Auditor's Office has sufficient personnel to carry out its functions and increased tasks, and that it is financially independent, as originally stipulated by the European Commission's Monitoring Report on the Implementation of the Commitments made in the Accession Negotiations by Cyprus (Chapter 28, Financial Control/External Audit) and as restated in the 2014 EU Anti-Corruption Report.

The Cypriot authorities will continuously ensure that powers and independence of the National Regulatory Authorities (NRAs) are effective in accordance with the EU Regulatory Framework.

Housing market and immovable property regulation

- Action is required to ensure property market clearing, efficient seizure of collateral, and swift transfer of property rights. 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 ensure that:

- **by Q2-2015**, the House of Representatives will adopt amendments to the Street and Building Permit Law to ensure the enforcement of the deadlines for issuance of certificates of completion by the supervisor engineers;
- the working group on title deeds issuance will review all procedures from the planning permit application to the issuance of title deeds (working closely with the Task Force on title deeds). **By end-June 2015**, the Cypriot authorities will submit for consultation with programme partners a report detailing the main obstacles for the title deeds issuance and recommendations on ways how to streamline these procedures during 2015, including a catalogue of tolerated deviations from building and planning permits. A further comprehensive streamlining of building, planning and title deed procedures will be proposed by the authorities following the completion of the in-depth analysis in progress.
- the title deed issuance backlog of immovable property units with title deed issuance pending for more than six months drops to less than 3,500 units **by Q4-2015** (backlog refers to (i) applications, (ii) units that are eligible for the "ex-officio" issuance of title deeds, required certificates and permits). The ex-officio cases will automatically be counted in the backlog from the date the certificate of final approval is being issued by the respective Local or District Authority. To that end, the Cypriot authorities will continue to provide to programme partners granular data on the stock of backlogs of permits, deeds, certificates, and mortgages associated with the underlying properties and continue publishing the quarterly progress reviews.

Tourism

- 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 as part of the Action Plan for Growth. To that end, the Cypriot authorities will:
 - present a progress report on the implementation of the tourism sector's action plan every **Q1** and **Q3** in 2015-16;
 - provide an assessment of the current regulatory framework governing the tourism sector (including the CTO law), in order to identify, the impediments to competition in the tourism sector **by September 2015**. The assessment will be based also on the views of the established thematic stakeholder groups and in consultation with programme partners;
 - in order to prepare a national tourism strategy, the authorities will select the consultant to conduct a study **by June 2015**. An interim report will be submitted for

consultation to the programme partners **by November 2015**, with a view to conclude it **Q1-2016**;

- continue implementing an aeropolitical strategy leading to the adaptation of Cyprus's external aviation policy, taking into account the EU external aviation policy and the EU aviation agreements, while ensuring sufficient air connectivity. The corresponding action plan will be reviewed annually by the Cypriot authorities, in consultation with the programme partners.

Energy

- The Cypriot authorities will:
 - ensure, without delay, that the Third Energy Package is fully and correctly implemented;
 - formulate a comprehensive strategy for the rearrangement of the Cypriot energy sector. This strategy will be developed and updated under the full authority of the Cypriot Government and should include at least the following three key elements, to be presented to the programme partners for consultation according to the timeline specified below:
 - a *roll-out plan* for the infrastructure required for the exploitation of natural gas. This plan should cover: the required investments, associated costs, financing sources and methods, ownership structure; major planning risks and bottlenecks taking into account also technical and commercial uncertainties; a projection of the revenue streams over time; the configuration and timing for the development of the necessary transmission infrastructure, accounting for European projects of common interest; and an appropriate sales framework for the off-shore gas supply for both exports and domestic markets aimed at maximising revenues. Next update **by Q3-2015**.

Prior to approving the Field Development Plan (FDP) of the Aphrodite gas field, the Cypriot authorities will undertake a financial and budgetary impact analysis of the FDP. The impact assessment will evaluate in detail the potential financial and budgetary impacts on the general government position as well as financing arrangements of the investment project chosen, with a particular focus on budgetary commitments that may arise;

- a *comprehensive outline of the regulatory regime and market organisation* for the restructured energy and gas sector, with a view to introducing open, transparent, competitive energy markets, which has been provided by Q4-2014 and lays out different options for the regulatory regime and market organisation. Based on this document, the Cypriot authorities will take a decision on the preferred option, taking into account the latest developments and the envisaged timeline for EAC unbundling. The Cyprus authorities will also provide to programme partners an analysis of the cost price of different sources of renewables compared to conventional primary energy sources (**by Q3-2015**).
- an 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. 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.

The resource fund, established in the FRBSL, should be based on clear rules governing inflows and outflows, coupled with clear rules regarding dividends, fees and costs of government entities and stakes in the energy sector. These rules are provided for in the FRBSL, but will be detailed in implementing legislation of FRBSL, which will be submitted to the House of Representatives **by Q2-2015**. The resource fund law, which defines the governance structure of the resource fund, will be submitted to the House of Representatives **by Q2-2015**.

8. 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 an updated request for technical assistance needs during the programme period, including the on-going technical assistance projects **by end-June 2015**. 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.

7. Growth Strategy

7.1. By **June 2015** the authorities will provide a monitoring report reflecting the progress in implementing the existing Action Plan for Growth. The monitoring report will also include an update on any studies which are in-preparation or on-going and are related to this Action Plan. The Cypriot authorities may request technical assistance to implement the Action Plan for Growth.

Annex 1

Budgetary measures adopted by Cyprus in or after December 2012

Fiscal measures with effect in 2012

Expenditure measures

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

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

Fiscal measures with effect in 2013

Expenditure measures

I.9 Ensure a reduction in total outlays for social transfers by at least EUR 113 million through: (a) the abolition of a number of redundant and overlapping schemes such as the

mothers allowance, other family allowances and educational allowances; and (b) the abolition of supplementary allowances under public assistance, the abolition of the special grant and the streamlining of the Easter allowance for pensioners.

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

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

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

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

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

- i. freeze public sector pensions;
- ii. increase the statutory retirement age by 2 years for the various categories of employees; increase the minimum age for entitlement to an unreduced pension (by 6 months per year) to be in line with the statutory retirement age; while preserving acquired rights, introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral;
- iii. reduce preferential treatment of specific groups of employees, like members of the army and police force, in the occupational pension plans, in particular concerning the contribution to the lump-sum benefits;
- iv. introduce a permanent contribution of 3% on pensionable earnings to Widows and Orphans Fund by state officials who are entitled to a pension and gratuity. Introduce a contribution of 6.8% on pensionable earnings by officials, who are entitled to a

pension and gratuity but are not covered by the government's pension scheme or any other similar plan;

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

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

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

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 %.

In addition:

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.

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.
- I.36 Ensure additional expenditure savings by a further reduction of public sector allowances and streamlining of overtime compensation, 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;
- I.37 A further targeting of social pensions;
- I.38 An abolition of income tax exemption for certain pension schemes;
- I.39 A reduction in the tax-free threshold for lottery gains;

Revenue measures

- I.40 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.41 Increase the standard VAT rate from 18% in 2013 to 19% in 2014.
- I.42 Increase the reduced VAT rate from 8% to 9%.
- I.42 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.43 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.
- I.44 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.

I.45 An introduction of a contribution of 3% on salaries of casual employees servicing on a contract basis, who receive gratuity including volunteers of 5 years services and police constables.

Annex 2**The AML Action Plan by Cyprus on customer due diligence and entity transparency**

	<i>Heading/Deficiency</i>	<i>Action</i>	<i>Timeline</i>
1	<u>Customer Due Diligence</u>		
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.	Compliant
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.	Compliant Ongoing
	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.	Compliant
	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.	Compliant
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.	Compliant Ongoing

2	<u>Reliance/introduced business</u>		
	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.	Compliant
	Training/awareness in institutions.	2.2.1 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. 2.2.2 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.	Compliant 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.	Compliant
3	<u>Suspicious Transaction Reporting</u>		
	Changes in the legal framework.	3.1 MOKAS to reiterate 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.	Compliant
4	<u>Transparency of beneficial ownership</u>		
4.1	<u>Access to information</u>		
	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 ¹¹ 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	Compliant Compliant

¹¹ Under Cyprus law, there is no legal concept of “nominee director”, but it is used with reference to professionals who provide director services.

		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).	
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. 4.2.2 Ensure the department of the registrar is appropriately resourced.	Compliant Ongoing
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.	Compliant
5	<u>Supervision of financial institutions</u>		
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, ¹² in order to conduct adequate, timely and proactive risk-based AML/CFT supervision.	Compliant
		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. ¹³ 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. ¹⁴	Compliant

¹² in accordance with BCP 2 and FATF 26-27

¹³ FATF Immediate Outcome (IO) 3

¹⁴ See BCP 2.6c

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: <ul style="list-style-type: none"> i. a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas,¹⁵ and delivery channels; ii. 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; iii. institutional risk profiles; iv. specific AML/CFT supervisory strategies (adapted to institutional risk profiles). 	Compliant
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: <ul style="list-style-type: none"> -Corporate Governance; -Risk Assessment Systems; -Policies & Procedures; -Compliance Function; -Internal & External Audit Functions; -Training Program. 	Compliant
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: <ul style="list-style-type: none"> v. newly developed offsite and onsite risk-based tools; vi. customer acceptance policies; vii. customer due diligence (CDD); viii. monitoring of transactions; ix. identification and reporting of STR; x. funds transfers; xi. correspondent banking; xii. recordkeeping; xiii. compliance function; xiv. internal controls; xv. audit functions; xvi. corporate governance; xvii. risk assessment systems 	Partially compliant Q2 - 2015
		5.4.2 Provide CBC supervisory staff with ongoing training to ensure adequate knowledge of risks and supervisory techniques.	Ongoing

¹⁵ 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).

5.5	Implement adequate supervision	5.5.1.a. CBC to establish corrective actions and follow-up on the cases revealed by Deloitte.	Compliant
		5.5.1.b. Apply appropriate enforcement actions with regard to any breaches of compliance, and apply sanctions if applicable.	Compliant
		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.	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. 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.	Compliant Compliant Compliant Compliant
		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.	Compliant Ongoing
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.	Ongoing
6.2	Develop risk-based tool(s) for Offsite surveillance/monitoring activities prior to	6.2.1 Design, develop, adopt, and pilot a risk assessment methodology and tool(s) that provides for: xviii. a comprehensive analysis of inherent ML/TF risks within the following risk factors: customers, products & services, geographic locations/areas, and delivery channels; xix. an assessment of the internal control environment that should be in place to mitigate and/or control the	Compliant

	implementation	<p>inherent ML/TF risks, as identified and measured;</p> <p>xx. risk profiles;</p> <p>xxi. specific AML/CFT monitoring strategies (adapted to institutional risk profiles).</p>	
		<p>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.</p> <p>6.2.2.2 Assign ML/TF risk profiles to businesses and professionals reviewed under the pilot exercise.</p> <p>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.</p>	<p>Compliant</p> <p>Compliant</p> <p>Compliant (CBA and ICPAC)</p> <p>Compliant (CySEC,)</p>
6.3	Develop risk-based tool(s) for Onsite inspections prior to implementation	<p>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:</p> <ul style="list-style-type: none"> - Risk Assessment Systems - Policies & Procedures - Compliance Function - Training Program 	Compliant
6.4	Establish Formal AML/CFT Training Program	<p>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:</p> <p>xxii. newly developed offsite and onsite risk-based tools</p> <p>xxiii. customer acceptance policies</p> <p>xxiv. customer due diligence (CDD)</p> <p>xxv. monitoring of transactions</p> <p>xxvi. identification and reporting of STR</p> <p>xxvii. recordkeeping</p> <p>xxviii. compliance function</p> <p>xxix. risk assessment systems etc.</p>	Ongoing
6.5	Implement adequate supervision	<p>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.</p>	Ongoing
		<p>Subsequent to the successful development of the tools stipulated under 6.2 and 6.3, the Supervisory authorities will undertake the following:</p>	Compliant (CBA and ICPAC)

		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 2015	Compliant (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.	Compliant (CBA and ICPAC) Ongoing (CySEC)

Annex 3

The Public Administration Review: Second Batch of Studies

The second batch of studies will cover the following areas:

Ministries and the Departments/Services falling under each Ministry

- i. Ministry of Labour, Welfare 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 the Directorate General for European Programmes, Coordination and Development (ex Planning Bureau), is being reviewed under the PFM.

Constitutional Powers /Services

- Law Office
- Audit Office
- 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
- Refugee's Review Body

Cyprus: Letter of Intent

Nicosia, May 29 2015

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington DC

Dear Ms. Lagarde:

In the attached update of the Memorandum of Economic and Financial Policies (MEFP), we describe progress and policies toward the objectives of the economic program of the Cypriot government, which is being supported by an arrangement under the Extended Fund Facility (EFF).

Recent developments have been encouraging. The output contraction in 2014 was less than projected, and we expect a return to positive economic growth in the second half of 2015. Our financial system is recovering as demonstrated by the Comprehensive Assessment carried out by the European Central Bank, and more recently, by a stabilization of our deposit base and increasing banking system liquidity. This allowed us to remove the remaining external payment restrictions on April 6, 2015. Our access to market financing has improved, as reflected in the successful debt issuance on international capital markets in April, the second one since the 2013 crisis. The Cypriot economy is now much more resilient to regional and global economic shocks.

We remain fully committed to the reform program, and fiscal performance has continued to exceed expectations. We achieved a primary surplus of close to 3 percent of GDP in 2014 (excluding the recapitalization of the cooperative sector), easily surpassing the program projections and signaling that our fiscal adjustment effort is well ahead of schedule. Fiscal performance has been in line with expectations in the first part of 2015. All quantitative performance criteria (PC) for end-September 2014 and indicative targets for end-December 2014 were observed, with the exception of the PC on the ceiling on the stock of general government debt at end-September 2014. This target was missed due to a delay in completing the debt-asset swap between the government and the Central Bank of Cyprus. The delay was temporary, and we are finalizing the swap.

We have made significant progress on the structural reform agenda of the program, and most of the structural benchmarks (SB) were met. However, the political environment has remained challenging, in particular with the governing party holding a minority in the Cypriot House of Representatives. As a result, reforms to the private debt restructuring framework were delayed, which led to difficulties in completing program reviews. Notably, we regret that delays in the entry into force of the amendments to the foreclosure law resulted in the cancellation of the 5th review. In addition, preparing the insolvency legislation and the implementing regulations for the foreclosure legislation took longer than originally planned. However, all these elements are now

in place and Cyprus has now established a modernized private sector debt restructuring legal framework. This is a key step to addressing the high level of non-performing loans (NPLs) in the banking system, which is critical to getting credit flowing again in support of the economic recovery and job creation.

Looking forward, in support of our program objectives,

- In the financial sector, we will continue to prioritize addressing the high level of NPLs. Following on the reforms to date, we will make the private debt restructuring framework fully operational, including by tackling the current backlog of unissued and un-transferred title deeds, monitoring the implementation of the new insolvency and foreclosure frameworks on an ongoing basis and further improving them as needed. We will also continue to strengthen financial sector supervision and build the capacity of the banking system to restructure loans in a sustainable manner.
- We will continue to pursue a prudent fiscal policy.
- We will advance on our structural reform agenda, notably on tax administration, the management of fiscal risks, and public administration reform. We will also move forward on critical growth-enhancing reforms, including the privatization program.

Financing of our program remains adequate, and based on the above, we request the following:

- Completion of the fifth, sixth, and seventh reviews under the EFF arrangement and three purchases under this arrangement in the amount of SDR 74.25 million each.
- Waiver for non-observance of the end-September 2014 PC on the ceiling on the stock of general government debt.
- Establishment of new quantitative PCs for end-June 2015, end-September 2015, and end-December 2015 (Table 1).
- Re-phasing of the remaining undisbursed amount evenly over three reviews instead of four as per the original schedule to take into account the delays in the reviews (Table 3).

We are fully committed to the policies set forth in the attached MEFP, which we believe are sufficient 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/

Chrystalla Georghadji
Governor of the Central Bank of Cyprus

Cyprus: Memorandum of Economic and Financial Policies

a. Recent Developments and Outlook

The recession moderated last year. Output contracted by 2.3 percent in 2014 compared to the fourth review forecast of 4.2 percent and to 5.4 percent in 2013, as the resilience of domestic demand more than compensated for the deterioration of the external balance due to import growth. The labor market has shown signs of stabilization reflecting wage adjustment and a reduction in the foreign labor force, but unemployment remains high. The banking sector has continued on its path to recovery, with deposits stabilizing and liquidity increasing, while private sector credit continued to contract. In April, we lifted all remaining external restrictions and successfully tapped the international bond market for a second time since the banking crisis.

Our economy is expected to start recovering during 2015, despite headwinds from external developments. After almost four years, growth in the first quarter has been positive and we envisage growth of 0.2 percent for the year. We expect that a decline in demand from Russia will be more than offset by higher private consumption, reflecting improved purchasing power from lower energy prices. For the following years, we have kept our growth projections broadly unchanged, continuing to expect output to expand at a moderate pace, supported by a gradual recovery of private consumption and investment. Average inflation is expected to decline further this year, reflecting the pass-through of lower global oil prices. Risks to this outlook remain broadly balanced. On the external front, a stronger contraction of the Russian economy could negatively affect our exports while the depreciation of the euro could be an upside risk. Direct spillovers from Greece are expected to be manageable due to diminished trade and financial links but we remain vigilant to any possible impact from adverse shocks. On the domestic front, slower than anticipated progress in addressing NPLs could delay balance sheet repair and hold back credit growth, thereby postponing the recovery and constraining medium-term growth.

o Financial Sector Policies

a) Addressing High NPL Levels

Addressing the high level of NPLs in our banking system is a central priority. The NPL ratio reached 59 percent for the core domestic banking sector at end-December 2014. To address this problem, we are focused on strengthening the legal framework and supervisory tools for arrears management. The establishment of functional foreclosure and insolvency regimes is expected to provide incentives to creditors and debtors to negotiate voluntary debt restructurings and expedite the clean-up of balance sheets.

b) Legal Framework

- c) **Foreclosure framework.** We have enacted amendments to the foreclosure law to streamline the foreclosure process. The changes should provide incentives for creditors and debtors to negotiate voluntary debt restructurings. To make the amended foreclosure law fully operational, we have adopted the necessary regulations. We are currently reviewing the relevant civil procedure and court rules and will adopt, by end July 2015, necessary changes, including legislative amendments if warranted. These changes will facilitate the effective implementation of the foreclosure framework and will enable the courts to process cases on a timely basis.

1. Insolvency framework. In mid April parliament adopted a package of laws to reform our insolvency framework.

- **Legislation.** The new legislation represents significant progress towards modernizing our corporate and personal insolvency legislation in line with our July 2014 strategy. The framework provides incentives for repayment and restructuring of debt while allowing for speedier and more efficient rescue and rehabilitation of debtors. The adopted package consists of five pieces of legislation: (1) amendments to the Company Law to allow for faster and more cost effective liquidation of insolvent, nonviable companies; (2) a Law on Examinership to facilitate the restructuring and rehabilitation of viable companies; (3) a Law and regulations on Insolvency Practitioners which establish a framework for the qualification, licensing and regulation of insolvency practitioners; (4) amendments to modernize the Bankruptcy Law to allow for a “fresh start” for insolvent debtors through their discharge after three years of bankruptcy, subject to proper safeguards; and (5) a Law on Personal Insolvency, which allows for the restructuring of secured and unsecured debts of insolvent individuals, as well as debt relief for individuals with virtually no income or assets.
- **Implementation.** We are now taking steps to establish and launch the new Insolvency Service which will centralize the administration of the new insolvency framework. Most of the legal and institutional arrangements are in place in order to start the implementation of the new insolvency regime. Administrative acts and regulations needed to fully ensure the functioning of the Insolvency Regime will be adopted by end-August 2015 (**new structural benchmark**). The implementation of the new laws will also require substantial capacity building for the actors responsible for its implementation, including the courts. We will prepare an action plan with that objective in mind. Finally, we plan to review by end-September the relevant civil procedure and court rules to ensure that they facilitate effective functioning of the new insolvency processes and reduce the courts’ workload to increase court capacity to process cases on a timely basis.
- **Monitoring.** We will continuously monitor implementation of the new insolvency framework, with a view to identify possible deviations from international best practices and to enhance its effectiveness. In particular, explicit provisions allowing debtors to apply to the court for suspension of enforcement, without any obligation on the part of the debtor, could weaken incentives for non viable debtors to promptly pursue debt restructuring. In addition, provisions have been added that could shield guarantors from payment obligations

without due regard to their payment capacity. To ensure that the new insolvency framework achieves its objectives, we will monitor its performance on a continuous basis.

- A. **Review of the framework.** In consultation with program partners, we will submit to the Council of Ministers by end September 2015 any necessary adjustments to the insolvency and foreclosure frameworks, including legislative changes (**new structural benchmark**). Moreover, we will conduct a comprehensive review of the private sector debt restructuring legal framework by early 2016, with an action plan of modifications to the framework to correct any deficiencies.
2. **Title deeds.** We are taking steps to address the problem of immovable properties that were purchased without proper transfer of title to ensure, *inter alia*, smooth functioning of the foreclosure and debt restructuring processes. By end-June 2015, the Council of Ministers will adopt legislation ensuring that the ownership of titles reflects the economic ownership of the property at all times (**new structural benchmark**). The legislation will enable swift transfer of titles and the release of encumbrance while providing safeguards against abuse. It will cover future property transactions as well as legacy cases. For legacy cases, it will provide for a rule-based mechanism aimed at treating buyers, sellers, and holders of collateral in an equitable manner taking into account compliance with their obligations related to the property transaction and enabling adequate compensation if available. The legislation will be informed by a financial sector impact assessment performed by the CBC in close cooperation with the Ministry of Interior. By end-October 2015, we will present to program partners legal or contractual standards for property sales contracts and connected loan and mortgage arrangements. We will also propose further legislative and administrative measures necessary to incentivize the swift transfer of title deeds.

d) Banks' arrears management capacity

We are strengthening the capacity of the banking system to restructure loans in a sustainable manner. We are now focused on boosting incentives for banks to step up their restructuring efforts according to the following priorities:

3. **Revision of the Arrears Management Framework and Code of Conduct.** We have adopted a revised Arrears Management Framework and Code of Conduct, limiting protections to individuals as well as small and micro-enterprises—all up to a pre-determined threshold—and covering issues related to the treatment of guarantors and consistent with the insolvency framework. Also, to increase borrowers' awareness of their rights and obligations, the CBC will make available on its website a comprehensive and user-friendly guide to the restructuring process under the Code of Conduct.
4. **Sustainable restructuring solutions.** We will closely monitor and enforce banks' compliance with the arrears management framework and the code of conduct. To this end, the CBC will assess the appropriateness of restructuring solutions, including by relying on the semi-annual sustainability audit that is available since end-May 2015 for the first time and will be repeated twice yearly. By end-June 2015, the CBC will provide to the SSM its findings and recommendations regarding revision of banks' internal policies and processes for follow-up.
5. **Debt resolution targeting framework.** To encourage banks to reduce NPLs and ensure continuous monitoring, the CBC will agree with banks on institution- and portfolio- specific targets for the various phases of the restructuring process for at least the following two quarters,

on a rolling basis. The CBC will publish the aggregate targets and the banks' past performance after each quarter, for the first time by end-July 2015 (**new structural benchmark**), explaining discrepancies between targets and actual performance, as well as any revisions of targets. The data quality and coverage of our supervisory reporting framework for NPLs and restructuring will be improved by requiring banks to submit data in line with revised requirements starting with the third quarter of 2015.

6. **Financial situation of borrowers.** A comprehensive understanding of the borrowers' financial situation is critical to ensure the effectiveness of debt resolution policies and to assess the magnitude of strategic defaults. For this purpose, the CBC is carrying out a study of the financial situation of borrowers and will publish the findings by end-July 2015.
7. **Banks' capital planning and budgeting.** The CBC has required core banks to submit updated condensed capital and funding plans, based on updated and consistent economic assumptions, including on the resolution of non-performing assets. These plans will be updated on a quarterly basis.
8. **Secondary market for loans.** A task force is currently evaluating necessary actions to promote the development of a secondary market for distressed assets by facilitating the transfer of existing loans. Necessary changes to the legislative framework to remove existing impediments to the securitization of assets, including removal of the requirement to obtain prior consent of borrowers, will be submitted to Parliament by end-July 2015. Moreover, by end-June 2015, necessary legislation will be approved by the Council of Ministers to enable the sale of loans to non-banks, while retaining the protections of borrowers offered under the Code of Conduct.

e) **Restructuring of the Cooperative Credit Sector**

We are continuing to restructure the coops sector. The sector has already undergone a thorough restructuring and has successfully passed the ECB's Comprehensive Assessment. Measures have been taken to strengthen its executive management, and the sector's information technology provider has been put under the control of the Cooperative Central Bank (CCB). Nevertheless, more efforts are needed to strengthen the sector's capacity. Progress with loan restructuring has been slow, in part due to operational, staffing, and information technology deficiencies. We are focusing on three main areas:

1. **Arrears management:** We have carried out a review of the sector's policies and operational capacity on debt resolution. We have required the coops to submit by end June 2015 a time-bound action plan outlining how identified deficiencies will be addressed on a timely basis and how the arrears management capacity of the sector can be strengthened through external operational support.
2. **Governance:** By end June 2015, we will streamline responsibilities of the CCB's divisions and enhance the efficiency of the sector's control functions, including by centralizing them at the CCB to the extent possible. To strengthen the oversight of the CCB over the Cooperative Credit Institutions (CCIs), we will amend the affiliation directive by end-June.
3. **Financial control and risk processes:** The CCB has carried out an independent audit of financial control and reporting processes, including of management information systems. It also submitted to responsible supervisors in March a time-bound action plan to address

identified deficiencies in a timely manner. To this end, by July 2015, the CCB will submit an implementation strategy that ensures a smooth transition, including by enabling the CCB to manage the additional responsibilities.

f) Normalizing Financial Flows

We will continue to ensure adequate liquidity in our banking system. Following the full liberalization of deposits and external flows, the CBC continues to monitor conditions and stands ready to take appropriate measures to maintain sufficient liquidity in the system, following the procedures and rules of the Eurosystem. Although liquidity has improved, additional government guarantees in line with state aid rules for the issuance of bank bonds could be used as collateral against liquidity, but only if necessary to safeguard financial stability.

g) Strengthening Financial Sector Regulation and Supervision

We will continue strengthening banking supervision. To this end, we have two near-term priorities:

9. Transition to the SSM. The CBC has presented a supervisory work plan of its involvement in the SSM supervisory activities in 2015. To ensure sufficient resources are available to carry out its duties, the CBC has hired ten additional staff. We will determine further staffing needs by end-June 2015, also taking into account increased responsibilities in the area of bank resolution.

10. Resolution of Laiki. The resolution authority will finalize in June 2015 a plan for completing the resolution of Laiki. The full implementation of the plan will be completed without delay.

We are reinforcing insurance and pension fund supervision. By end-September 2015, we will present a report with proposals to improve the capacity and governance of the insurance and pension fund supervisors in line with international best practice. The report will set priorities for the next steps and will provide a comprehensive inventory of pension and provident funds. The corresponding legislative proposal will be submitted to Parliament by end-December 2015.

h) Strengthening the AML Framework

We are strengthening the implementation of the AML/CFT framework. We continue working on the following areas:

11. AML/CFT supervision of banks: To maintain financial sector integrity and stability, the CBC implemented in 2014 a new risk-based AML/CFT supervision methodology. The CBC completed the remaining onsite inspections reports from the 2014 supervisory plan in March 2015 and will apply, as needed, appropriate supervisory measures. The CBC has adopted its risk based supervision plan comprising 13 credit institutions (including 4 CCIs) that will be implemented by end December 2015. The CBC also took swift action to put the local branch of FBME Bank Ltd. under resolution after its designation by the US authorities as a financial institution of primary money laundering concern and will continue taking appropriate supervisory actions.

12. AML/CFT supervision of professions: The supervisors of lawyers, accountants, and trust and company service providers will adjust the risk-based tools by end June 2015. These will be used to develop comprehensive annual inspection programs that will be implemented by end December 2015.

13. Registrar of Companies: Parliament will adopt the amendments to the company law by mid July 2015 to streamline the process of registration and de-registration of non-compliant companies and strengthening the Companies Registrar enforcement powers. Following the adoption of the legislation by the House of Representatives, we will start implementing its reform by the end of July 2015

○ **Fiscal Policy**

The cash primary surplus—excluding the recapitalization of the cooperative sector—was 2.8 percent of GDP in 2014, exceeding our target by a large margin. This outcome reflects (i) stronger than anticipated economic activity which led to higher tax revenues and social security contributions; (ii) a faster than expected reduction in the number of early retirements, which lowered our wage bill; and (iii) containment of discretionary spending which led to lower outlays on intermediate consumption and capital expenditure.

We have revised our primary balance target for 2015 to reflect the 2014 over-performance and the downward revision to growth. We will target a cash primary balance of 1 percent of GDP. This will lock in some of the fiscal savings from 2014 while accommodating (i) a loss of revenues due to the implementation of European directives on changes to the VAT place of supply for certain services; (ii) the contribution to the National Resolution Fund; (iii) lower central bank dividends; and (iii) several one off factors including a retroactive contribution to the EU budget arising from the ESA 2010 GDP revision, compensation payments to pension funds related to bank restructuring, and other specific outlays. We have also revised our 2016 and 2017 cash primary balance targets to surpluses of 2.4 and 3 percent of GDP respectively to take into account the better than anticipated 2014 outcome and the largely one off nature of the main factors triggering the reduction in the primary surplus in 2015 with respect to 2014. With bank capitalization and fiscal needs less than projected and a consequently improved debt path, we are targeting a primary surplus in a range of 3 to 4 percent of GDP in 2018 and thereafter instead of 4 percent previously, which is sufficient to maintain our debt on a clear downward path.

○ **Structural Reforms**

We are implementing a comprehensive welfare reform that ensures a guaranteed minimum income (GMI) for all those in need. We have set up a fully staffed unit to monitor progress with implementation of the reform and have started paying out benefits. Looking forward, we will take actions to ensure that the new welfare system is fully in place and that outcomes are promptly analyzed in order to determine possible refinements:

14. By end-June 2015, we will prepare plans to consolidate disability and education benefits in line with the adopted welfare reform.

15. By end-September 2015, we will require recipients of social benefits to declare all the benefits they receive (including non-GMI benefits). We will also finalize in the same timeframe an assessment report of the implementation of the GMI, including main outcomes, the number of applications, fiscal costs, targeting accuracy, and coverage. The assessment will also discuss possible refinements going forward.

16. By end-December 2015, we will build a registry of benefits in line with our new welfare law including the profiles and eligibility of all beneficiaries, cross-checked with other databases.¹⁶ By end March 2016, and with the registry in place, we will re-examine the overall welfare reform to realize efficiency gains from the consolidation of all information on welfare programs.

We are advancing our tax administration reform. We have passed legislation integrating the two tax authorities into a single Department of Taxation and to enhance tax collection enforcement powers. Our efforts are concentrated on two fronts:

17. *Addressing tax arrears and evasion:* In line with the newly adopted collection enforcement powers, we have finalized our tax debt recovery plan, which will form part of our wider compliance improvement strategy. On that basis, we have started implementation of our tax debt recovery plan including through the use of bank garnishing powers on a pilot basis. To monitor progress, we will prepare quarterly implementation reports specifying targeted groups, collection enforcement measures used, and recovered debt. The first quarterly progress report will be prepared by end-June 2015.

18. *Reforming the revenue administration:* In January, we established the new large taxpayer office (LTO) covering 40 percent of our total revenue collections. Going forward, we will establish a single registration process for all domestic taxes by end-June 2015, and by end-December 2015, the LTO will be fully functional including taxpayer services, risk assessment and compliance activities aiming to expand coverage to 50 percent of total revenue collections. In line with this goal, we will allocate appropriate human resources. We will also establish an integrated legal framework for tax procedures under a new tax procedures code, to be approved by the Council of Ministers by end September 2015.

We are enhancing the management of fiscal risks arising from government guarantees and finalizing the implementation of the Fiscal Responsibility and Budget Systems Law (FRBSL).

The stock of government guarantees (20 percent of GDP) may pose risks to our public finances. With a comprehensive guarantee database now in place, the Council of Ministers will approve by end June 2015 the institutional framework to monitor and manage existing and new government guarantees (**new structural benchmark**). The framework will define clear responsibilities for the MoF and other line ministries, as well as guidelines and procedures for the issuance of new guarantees, the management of existing guarantees based on their assessed risk, and the restructuring and recovery of called guarantees. We will also improve our risk assessment analysis with a view to updating our risk assessment report by end-June 2015. In order to ensure the full implementation of the FRBSL, the public investment guidelines have been finalized and submitted to the Council of Ministers. The Council of Ministers will approve the guidelines by early June. The pending FRBSL regulations will then be approved by the Council of Ministers by end-June 2015 and by the Parliament by end-September 2015.

¹⁶ The registry of benefits will entail establishing a single view of social benefits for each beneficiary via an interface which will link three registries: Ministry of Labor, Welfare and Social Insurance, the Ministry of Education and Culture and the Ministry of Interior.

We are taking actions towards the privatization of state-owned enterprises. Privatization is expected to improve economic efficiency, help to reduce our public debt, and encourage foreign direct investment. We have established a privatization unit which is now operational. We have also selected advisors for the privatization of the telecom company (CyTA) and the commercial activities of the ports authority (CPA) in the Limassol port. Looking forward, legislation will be adopted to convert CyTA into a limited liability company by end-September 2015 and the regulatory framework will be amended as necessary for the privatization of the CPA, by end-October 2015. By end July 2015, we will hire an independent energy advisor to prepare a study for the legal unbundling and ownership structure of the electricity company (EAC) as well as the required regulatory review. The legal unbundling will be implemented by end-March 2016.

We are continuing reforms in other areas aimed at boosting growth prospects and strengthening the public administration.

19. We are implementing the Action Plan for Growth for which a key aim is improving the business environment. To this end, we will develop by a time-bound action plan to strengthen the enforcement of contracts, including streamlining judicial procedures. We will also prepare, by end-September 2015, an action plan with measures to simplify regulations and licensing requirements hampering the operation of businesses.
20. To enhance the effectiveness of our public administration, while also ensuring its affordability, by end-June 2015, a reform package including a revision of the wage setting framework and the opening of promotion posts to the wider civil service, will be submitted to the Council of Ministers for adoption by Parliament by end-December 2015 (**new structural benchmark**). Salary and employment decisions will be consistent with a public wage bill as a share of GDP on a descending path over the medium term. We will complement this with reforms to enhance staff mobility to promote the efficient allocation of human resources.

- **Program Financing and Monitoring**

Financing for our program is assured. In line with the practice in most other European countries, we will transfer the rights and liabilities associated with coins issuance from the CBC to the MoF and receive additional financing of €100 million associated with this transfer by end-December 2015. In addition, the CBC is expected to transfer an additional €100 million in central bank profits to the government during 2016, in line with CBC duties under the Treaties and the Statute. We intend to issue additional debt in the international markets in the second half of this year to smooth maturities and minimize refinancing risk after the program, in line with our debt management strategy, market conditions permitting.

Despite delays in completing the reviews, fiscal outturns have been very strong, and we have largely caught up with reforms. In view of this performance, we request completion of the combined fifth, sixth, and seventh reviews under the Extended Fund Facility Arrangement, and a disbursement of SDR 222.75 million. We also request that the remaining amount under the EFF (SDR 297 million) be re-phased in three equal disbursements over the remainder of the arrangement.

Implementation of policies under our program will continue to be monitored through quarterly PCs and reviews. Our program includes continuous performance criteria, indicative targets, and structural benchmarks defined in Tables 1 and 2 and in the Technical Memorandum of Understanding (TMU). There are also continuous performance criteria on the non-accumulation of external payment arrears, on non-imposition of restrictions of payments and transfers for current international transactions, and on non-introduction of multiple currency practices.

We authorize the IMF to publish the Memorandum of Economic and Financial Policies, its attachments, and the related staff report.

Table 1. Cyprus: Quantitative Conditionality 1/ (Millions of euros unless otherwise specified)										
	Performance Criteria			Indicative Targets			Performance Criteria			
	Sep-14		Actual	Dec-14		Actual	Jun-15	Sep-15	Dec-15	
	Target	Adjusted target 4/		Target	Adjusted target 4/					
Floor on the general government primary balance 2/	40	29	552	-253	-265	493	-71	232	167	
Ceiling on the general government primary expenditure 2/	4,784	4,795	4,499	6,864	6,876	6,539	3,124	4,654	6,670	
Ceiling on the stock of general government debt 5/	18,172		18,393	18,994	18,914	18,819	19,966	18,833	18,473	
Ceiling on the accumulation of new general government guarantees 2/	207		124	312		165	40	91	131	
Ceiling on the accumulation of external arrears 2/ 3/	0		0	0		0	0	0	0	
Ceiling on the accumulation of domestic arrears 2/	0		-0.1	0		-0.1	0	0	0	
Ceiling on the accumulation of tax refund arrears by the general government 2/	10		9	10		8	33	33	33	

1/ As defined in the technical memorandum of understanding.
2/ Cumulative since January of the corresponding year.
3/ Continuous performance criterion.
4/ The primary balance and primary spending targets were adjusted down and up, respectively, by €10.8 million in September and by and €12.2 million in December to reflect compensation payments to pension funds.
5/ The December 2014 debt target was adjusted down by €80 million as only 20 million of the expected 100 million disbursement of the Cyprus Entrepreneurship Fund loan was received in Q4.

Table 2. Cyprus: Revenue Administration Indicative Targets 1/ (Cumulative number of audits since January 2014)								
	Indicative targets							
	Mar-14	Jun-14		Sep-14		Dec-14		
		Target	Actual	Target	Actual	Target	Actual	
Number of comprehensive field audits of large taxpayers 1/	0	2	2	4	4	6	6	
Number of comprehensive field audits of high risk taxpayers 2/	0	8	6	16	16	24	22	

1/ Large taxpayers are defined as those with annual turnover above a certain threshold as defined by the tax administration procedures.
2/ High risk taxpayers are defined as those that meet selection criteria set by internal tax administration procedures.

Table 3. Cyprus: Proposed Conditionality

Measures	Timing
<i>Prior Actions for the Combined Reviews</i>	
Adoption by Parliament of amendments to the Foreclosure Law	Before Board Meeting
<i>Structural Benchmarks</i>	
Adoption by the Council of Ministers of legislation ensuring that the ownership of titles reflects the economic ownership of the property at all times	End-June 2015
Adoption by the Council of Ministers of the institutional arrangements to monitor and manage government guarantees	End-June 2015
Publication by the CBC of the targets of loan restructuring, and banks and coops' aggregate performance against them	End-July 2015
Adoption of administrative acts and regulations needed to fully ensure the functioning of the insolvency regime	End-August 2015
Submission to the Council of Ministers of necessary adjustments to the insolvency and foreclosure frameworks	End-September 2015
Parliamentary approval of reform package including a revision of the wage setting framework	End-December 2015

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, European Commission and ECB on a timely basis before modifying measures contained in this letter, or adopting new measures that would deviate from the goals of the program, and provide the European Commission, ECB and the Fund with the necessary information for program monitoring.
 - 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. In particular, the exchange rates for the purposes of the program are set €1 = U.S. 1.1221 dollar, €1 = 134.90 Japanese yen, €1.25403 = 1 SDR.
 - For reporting purposes, the Ministry of Finance (MOF) and the Central Bank of Cyprus (CBC) will employ the reporting standards and templates considered to be appropriate given the transmission of data covered by this TMU, unless otherwise stated or agreed with the EC, the ECB and the Fund.

1. Quantitative Performance Criteria and Indicative Targets

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

- For the purposes of the program, the general government includes the institutions listed under this category according to ESA 2010 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 2010.
 - *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 2010.* This includes any new budgetary institution, special fund, social security fund, semi-government organization, municipality, village authority, and any other entity created during the program period to carry out operations of a fiscal nature. The government will inform the IMF, European Commission and ECB staff of the creation or any pending reclassification of any such new funds, programs, or entities immediately. The general government, as measured for purposes of the program monitoring, for a given year shall not include entities that are reclassified from outside general government into general government during that year.
- 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, European Commission and ECB staff.
- The floor on the GGPCB will be adjusted as follows:

- The 2015 targets will be adjusted downwards by the payments to compensate pension funds for the losses related to the resolution of Laiki Bank up to €4.5 million.
- The 2015 targets will be adjusted upwards by the dividends received from the CBC in excess of €133 million and in excess of €58 million from the semi-government organizations.
- The 2015 targets will be adjusted downwards by the dividends received from the CBC below €133 million and below €58 million from the semi-government organizations.
- The 2015 targets will be adjusted downwards by the payments to cover called government guarantees up to €80 million.

Ceiling on the General Government Primary Expenditure (performance criterion)

- 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, European Commission and ECB staff.
- The 2015 ceilings on the GGPE will be adjusted upwards by the payments to compensate pension funds for the losses related to the resolution of Laiki bank up to €4.5 million.
- The 2015 ceilings will be adjusted upwards by the payments to cover called government guarantees up to €80 million

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

- The general government debt constitutes total outstanding gross liabilities as defined by ESA 2010. This includes the debt of all institutions included in the general government as defined above and other ESA 2010 adjustments. Debt will be measured at nominal value. The program exchange rate will apply to all non-euro denominated debt.
- The ceiling on the general government debt will be adjusted:
- Upwards (downward) by the amount of any upward (downward) revision to the stock of end-December 2014 general government debt.
- Upwards (downwards) by the amount of any increase (decrease) to the disbursement of the Cyprus Entrepreneurship fund EIB loan, currently projected at €20 million for 2015.
- 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, European Commission and ECB staff.

- Upwards by the amounts disbursed under the EIB loan to finance projects authorized in the 2015 budget under the National Strategic Reference Framework.
- Upwards by €600 million if the debt-to-asset swap between the government and the central bank is not finalized according to the current timeline.
- Upwards by the size of the revision of the stock of general government debt due to methodological changes in the definition of the government sector.

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

- 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 December 2014 was €2.95 billion. For reporting purposes, the stock of guarantees within the year will be derived on the basis of material fluctuations.
- 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.
- Upwards (downwards) by the amount of any increase (decrease) of the disbursement of EIB and/or Council of Europe Development Fund loans to be guaranteed by the government in 2015 relative to the amounts presented in Table 1 of the MEFP. The annual provision of guarantees cannot exceed €131 million.

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

- 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-December 2014 was €0.

Ceiling on the Accumulation of Domestic Arrears (performance criterion)

- Domestic expenditure arrears are defined as unpaid invoices that have past the due date by 90 days by the budgetary central government, extrabudgetary funds, semi-government organizations, and local governments excluding village communities. 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 2014 was €9.6 million. Increases below €1 million will not be considered a breach of the performance criterion.

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

- 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-December 2014 was €117.3 million. The stock of VAT refund arrears shall not exceed 150 million euros.

B. Monitoring of Prior Actions, Structural Benchmarks and MEFP Commitments

- **Adoption by parliament of amendments to the Mortgage Law (“Foreclosure law” (prior action))**

Specification. The new foreclosure procedure will include the following elements:

1. The only condition for the initiation of the foreclosure procedure will be a default on payment of more than 120 days past, while acknowledging that the mortgage creditor may be otherwise stayed from pursuing enforcement of its remedies by operation of other laws or rules;
 2. It will contain swift procedures for obtaining market valuation of the property by independent valuers;
 3. It will allow for an initial auction with a reserve price at 80% of the market value, with a subsequent lowering of the reserve price to no less than 50% after three months of the initial auction, and a new valuation after 12 months of unsuccessful auctions or sales after the initial auction, maintaining, a reserve price of no less than 50% of this new valuation;
 4. It will contain precise deadlines for all procedural steps and respective preclusive periods for appeals;
 5. It will contain provisions to safeguard the integrity of the foreclosure process, including through transparency and anti-fraud provisions.
Regulations issued pursuant to the new law will facilitate a swift and transparent sale process without delays or hurdles.
- AML supervision’s implementation:
 - On a quarterly basis, in the context of program reviews, the supervisory competent authorities will, on a confidential and anonymized basis grant Fund staff access to supervisory assessments and information about enforcement actions applied for non-compliance and/or violations of laws and regulations.
 - With regard to the CBC, in line with the 2015 annual inspection program, onsite supervision missions will start in the first quarter and step-up during the year. The total number and quarterly profile of these inspections, as well as staffing objectives and levels will be subject to periodic review by the CBC and the Fund in light of experience.
 - Exchange of financial intelligence:
 - The Financial Intelligence Unit (FIU) will communicate to Fund staff, on a quarterly basis, detailed statistics on financial information exchanged with other FIUs, both upon request and spontaneously, with a breakdown by country

C. Reporting Requirements

- 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.

ANNEX 4

Programme Documents

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.	27 days after the end of the month, except end-December data which will be provided 30 days after the end of the month
Debt Issuance, Amortization, and interest cost details by type of debt instrument, maturity, currency, type of debt holder (resident, non-resident). Details on any financial balance sheet transactions	Monthly	MOF. Public Debt Management Unit.	27 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.	27 days after the end of the month
Budgetary Central Government deposits in the Consolidated Fund and in the Banking System.	Monthly	MOF. Public Debt Management Unit.	5 days after the end of the month
Stock of expenditure arrears and their corresponding monthly flows (i.e. inflows, outflows) by type of expenditure.	Monthly	MOF. Treasury Department.	15 days after the end of the month
Stock of VAT refund arrears	Quarterly	Tax Department.	15 days after the end of the quarter
Stock of government guarantees and their monthly flows by institution.	Quarterly	MOF. Treasury Department.	27 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

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