

The economic adjustment program for Cyprus

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

- To ensure financial stability by securing appropriate liquidity for the banking sector, addressing expected capital shortfalls and preserving the soundness of financial institutions, including restructuring and downsizing where needed;
- To continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit, in particular through measures to reduce current primary expenditure, and maintain fiscal discipline in the medium-term, in particular through measures to increase the efficiency of public spending within medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector; and
- To implement structural reforms to support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system and removing obstacles to the smooth functioning of services markets.

1. Financial sector regulation and supervision

Objectives

The banking sector has been severely affected by the broader European economic and sovereign crisis, in particular through its exposure to Greece. However, many of the problems for the sector are home-grown and relate to overexpansion in the property market. Furthermore, the financial sector is vulnerable because of its size relative to that of the domestic economy and the handling of problems in the sector has been complicated since banks have used gaps in the supervisory framework to delay the recognition of loan losses, thus leading to significant under-provisioning. The banking sector needs to become more transparent, credible and robust with a view to ensuring financial stability in the medium-term. To this end, the solvency of banks will be reinforced by restoring capital, their liquidity situation will be addressed, the non-performing assets will be tackled, and financial regulation and supervision, in particular of the cooperative credit institutions, will be strengthened along with the crisis management mechanisms.

Maintaining liquidity in the banking sector

- 1.1 As bank liquidity remains under pressure; banks are encouraged to strengthen their collateral buffers in a sustainable manner; the Central Bank of Cyprus, in consultation with the ECB, will continue to closely monitor the liquidity situation of

the banking sector and stand ready to take appropriate measures to maintain sufficient liquidity in the system.

- 1.2 Banks will establish and submit quarterly medium-term funding plans, to be communicated at the end of each quarter, starting from [September 2012], to the Central Bank of Cyprus, as well as to the European Central Bank (ECB), the European Commission (EC) and the International Monetary Fund (IMF). The plans should realistically reflect the anticipated deleveraging in the banking sector; reduce dependency on borrowing from the Central Bank, while avoiding asset fire sales and a credit crunch. The reporting template will be provided by the Central Bank of Cyprus.

- 1.3 Compliance with regulatory requirements of maintaining a foreign currency liquidity ratio of at least 70% and a euro liquidity ratio of at least 20% allowed a concentrated exposure of Cypriot banks to Greek sovereign debt. To avoid similar outcomes in the future, the Central Bank of Cyprus will update the liquidity regulations by [Q3 2012], namely by establishing minimum requirements for: i) diversifying investments in eligible liquid assets by imposing concentration limits of 25% of regulatory capital; and ii) investing at least 50% of the required liquidity into instruments of high credit quality with a maturity of up to 3 months. Banks will be required to comply with the new prudential liquidity regulations by the [end of 2014]. The Central Bank of Cyprus will introduce additional liquidity requirements for deposits from non-residents denominated in the euro to ensure that those deposits are put on an equal footing to deposits denominated in foreign currencies.

Restoring adequate capital buffers

- 1.4 The Central Bank of Cyprus will direct all banking groups to increase the minimum Core Tier 1 capital ratio from the present level of 8% to 10% by [31 December 2013] and to maintain this level for the duration of the program.

- 1.5 To further strengthen capital-adequacy requirements, the Central Bank of Cyprus will introduce a leverage ratio, consistent with the Basel III definition, of [X]% by [31 December 2013]

- 1.6 Undercapitalized credit institutions will be required to present quarterly plans to the Central Bank of Cyprus starting in [September 2012] explaining how they intend to fulfill the new capital requirements. The capital plans should be presented together with the funding plans based on a template provided by the Central Bank of Cyprus. Capital should to the largest extent possible be raised from private sources including internal measures, asset disposals and liability management exercises. For institutions receiving state aid under the program amounting to less than 2% of total risk-weighted assets, private sector participation in the recapitalization should be assured no later than by [31 March 2013]. Institutions requiring a larger amount of state aid, but which are not put into resolution, will be given time under [31 January 2013] to raise capital from private sources.

- 1.7 With the goal of minimizing the cost to tax payers, bank shareholders and junior debt holders will take losses before state-aid measures are granted. The contingent convertible bonds issued in the past by the banks, which allow for conversion into shares in case of breach of regulatory capital requirements, will be converted before state aid can be granted. For the banks that have benefited from state aid already, such conversions will be required as prior action. Furthermore, the authorities will enforce a write-down or conversion of any other outstanding Tier I and Tier II instruments into equity for the purpose of protecting the public interest in financial stability.

- 1.8 Credit institutions deemed viable based on their restructuring plans can, if other measures do not suffice, ask for recapitalization aid from the State. The authorities will immediately liaise with the European Commission to ensure timely delivery of the restructuring plans drawn up in compliance with EU state-aid rules. The terms and remuneration of the state aid will comply with the burden sharing requirements laid down in the EU state-aid rules, which aim at ensuring sufficient remuneration for the State and avoiding the subsidization of existing shareholders. The credit institutions benefiting from capital injections will be subject to specific management rules and restrictions, and to a restructuring process in line with EU competition and state-aid requirements. Banks that have already received recapitalization aid from the State will not be eligible for additional recapitalization aid nor will they be allowed to transfer assets to the asset management company (see below) before their restructuring plans have been formally approved under state-aid rules. Banks

that are deemed non viable will be subject to the new resolution framework outline below.

- 1.9 Noting that the European Banking Authority (EBA) deadline of 30 June 2012 has been missed by two banks and that public capital support has already been provided to one bank, while the State itself is under financial stress, a bank support facility of EUR [X] billion is foreseen under the program, which will also cover potential future capital needs, determined on the basis of a top-down capital exercise, as well as potential resolution costs. The resources of this facility will be deposited with a dedicated account held at the Central Bank of Cyprus or any relevant securities depository. The provision of capital from the facility will be in line with EU state-aid rules and will be disbursed on consultation with the EC, the ECB and the IMF.

Due diligence

- 1.10 The Cypriot authorities will conduct an accounting and economic value assessment (due diligence review) of the credit portfolios of Bank of Cyprus, Cyprus Popular Bank, Hellenic Bank and a representative sample representing the xx largest [or xx percent of assets of] cooperative credit institutions, as well as Alpha Bank Cyprus, and Eurobank Cyprus in order to inform their home authority. The assessment will include the Greek operations of the banks, notably the branches of Bank of Cyprus, Cyprus Popular Bank and Hellenic Bank. The aim of the assessment is to cover about 75% of assets of the consolidated Cypriot banking system (both domestically and foreign-incorporated). The assessment will be conducted by an external consultant who will have direct and full access to all information from the banks.
- 1.11 The due diligence review will be overseen by a Steering Committee and guided by Terms of Reference to be agreed upon in the Steering Committee. The Steering Committee will comprise representatives of the Cypriot authorities, the EC, the ECB, the EBA and the IMF. By [x August 2012], the consultant will have started the process of due diligence. The Steering Committee will examine the preliminary results of the exercise by [31 October 2012] and the final result will be available on [30 November 2012].
- 1.12 The due diligence review will include a general ledger verification: (i) data quality analysis, including an appropriate identification of restructured/ refinanced loans and lending to connected parties; (ii) verification of the proper classification of credits and verification of liabilities; and (iii) review of the calculation of impairment

losses, including a computation of the impact of an increase in provisioning requirements for both performing and non-performing loans.

- 1.13 The assessment of the economic value of the assets will include the appropriateness of loan origination, classification and arrears management to check and adjust the current classification and risk parameters. The information obtained from the due diligence review will be combined with additional bank specific data, as requested by the consultant, from official authorities and through direct interaction with banks as needed. In addition, a rigorous appraisal of the fair value of collateral and foreclosed assets will be carried out by the external consultant to complete the due diligence review.
- 1.14 The due diligence review will form the basis for the bank-by-bank stress test, using a baseline and adverse macroeconomic scenario, with elements to be agreed by the Steering Committee by [date]. The stress tests will be carried out by the Central Bank of Cyprus with the assistance of the external consultant. This stress test will build on the top-down exercise used to determine the overall size of the capital back-stop facility along with capital needs of each participating institution (banks and cooperative credit institutions) and will also use as input the banks medium-term funding and capital plans, which will be submitted for the first time by [30 September 2012]. The Central Bank of Cyprus in consultation with the EC, the IMF and the EBA, and in liaison with the ECB, will establish the specific capital needs of each participating bank by [30 December 2012] with a view to recapitalization or resolution, if necessary.

Regulation and supervision for banks and cooperative credit institutions

- 1.15 Strong efforts should be made to maximize bank recovery rates for non-performing loans, while minimizing the incentives for strategic defaults by borrowers. The administrative hurdles and legislative framework currently constraining the seizure and sale of loan collateral will be amended such that the property pledged as collateral can be seized and offered for sale within a maximum time-span of 1.5 years. The procedures guiding the repossession of cash and other financial assets, which are not pledged as collateral and are held by defaulted borrowers outside the lending institution, should be appropriately accelerated; taking into account also the

possibility of moving these assets within and outside the banking sector. The necessary legislative changes will be introduced by [31 October 2012].

- 1.16 Non-performing loans are threatening bank profitability and need to be properly monitored and managed in order to safeguard the banks' capital buffers. The Central Bank of Cyprus' guidance on the classification of loans as non-performing will be immediately amended to include all loans past due by more than 90 days. The time series for non-performing loans will be published including historical observations reaching back as far as possible. This amendment will be introduced by [31 August 2012].
- 1.17 The Central Bank of Cyprus will also create a central credit register listing all borrowers, from both commercial banks and cooperative credit institutions, to enable these institutions to check new loan applications against the register. The credit register will identify the borrowers who are or were in arrears. The legal framework for the credit register will be set up by [31 December 2012] and the central credit register will be operational by [30 June 2013].
- 1.18 After analysis of the results from the due diligence exercise, the Central Bank of Cyprus will review, by the end of [Q4 2012], its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning. Without prejudice to the conclusions of this evaluation and to existing regulatory and accounting framework in the EU, regulatory amendments will be introduced with a view to mitigating the impact of changes in collateral values on the value of impaired assets. The new prudential regulations will enter into force by the end of [Q1 2013].
- 1.19 The Central Bank of Cyprus will introduce supervisory mandatory structured intervention based on capitalization levels, drawing upon technical assistance provided by X, by end [September 2013]. Such tool should also be developed for the cooperative credit institutions.

- 1.20 The Central Bank of Cyprus will implement a unified data reporting system for the banks and the cooperative credit institutions by the end of [June 2013]. The publication of the statistical data will be extended to the cooperative credit institutions, for which the Central Bank of Cyprus will disclose aggregate data covering the same elements as for banks, including balance sheet items, income statements and prudential indicators.
- 1.21 Stress testing will be integrated into off-site bank supervision and will serve as an input into Pillar 2 assessments.
- 1.22 Cooperative credit institutions play a significant role in the financial of the domestic economy. Due to its economic relevance and legal specificities, as well as the excessive risk taking and a poor underwriting process that was widely observed among cooperative credit institutions, this segment of the financial sector requires stronger regulation and supervision. Authorities will fully harmonize the supervision of the cooperative credit institutions with the standards applied to commercial banks. The accounts of the cooperative credit institutions will be subject to an independent annual audit by an external auditing firm. [Moreover, the Central Bank of Cyprus will become the single supervisor of all credit institutions in Cyprus by the end of [2013]. The Cypriot authorities will present, for assessment by the EC, the IMF and the ECB, an appropriate proposal to achieve this by the [end of October 2012].] As a prior action, the supervision of the cooperative credit institutions will be detached from the Ministry of Commerce, Trade and Tourism and will be conducted independently of considerations for the development of the sector.

Bank resolution framework

- 1.23 The authorities will introduce legislation to ensure the application of all bank resolution methods that are foreseen in the proposal by the European Commission for a framework for the recovery and resolution of credit institutions. The Central Bank of Cyprus will become the single resolution authority for banks and cooperative credit institutions. The new resolution legal framework will aim, *inter alia*, to allow the Central Bank of Cyprus to mandate the sale of some or all of the assets and liabilities of an institution under resolution through a public tender process and to

enforce write-down or conversion of Tier I and Tier II instruments into equity, also in the context of a recapitalization with state aid. Furthermore, in order to ensure an appropriate level of private sector burden sharing, the framework will clarify that the shares and the subordinated debt instruments issued by the resolved institution will remain, under all circumstances, in the entity to be liquidated. The framework will be subject to consulting with the EC, ECB and IMF and will enter into force by [November 2012].

- 1.24 These resolution methods will be made applicable to individual cooperative credit institutions, affiliated and non-affiliated alike by [Q4 2012].

Asset Management Company

- 1.25 In order to resolve bad asset effectively and to reduce the financial sector's exposure to non-performing and non-core assets, the authorities will set up the Cyprus Asset Management Company (CAMC). CAMC will be able to acquire loans and other claims, including foreign exposure, in particular Greek assets, from credit institutions in Cyprus which have received or will receive state-aid. The scope of asset transfers will be based on efficiency of asset work-out processes for specific asset classes. Transfers will take place at the real (long-term) economic value of the assets established on the basis of a thorough asset quality review process, drawing on the individual valuations used in the due diligence exercise. These transfers will comply with EU competition rules, while the ECB and IMF will be consulted.

- 1.26 The objective of CAMC will be to maximize the recovery value of assets, which will be wound down within a medium-term perspective. As part of its funding strategy, CAMC will have the capacity to issue bonds that are guaranteed by the State. In exchange for the assets, the banks will receive a suitably small equity participation by CAMC, bonds issued by CAMC, cash and/or high quality securities. The bonds issued by CAMC will be structured in such a manner as to meet the conditions set out in the ECB'S "Guideline on monetary policy instruments and procedures of the Eurosystem."

- 1.27 CAMC will function under special legislation, to be adopted by [31 October 2012] and will be made operational by [31 December 2012]. This legislation will ensure that CAMC has an appropriate governance structure including an appointment and dismissal procedure on a fit-and-proper basis. Internal control procedures will be devised with an appropriate division of labor. Legal protection for the staff and directors will be ensured. Accountability will be guaranteed by submitting CAMC to internal and external audits as well as through the provision of information to the public and the Parliament, including through the publication of financial statements. Legal autonomy will be established to avoid interference by third parties. For the execution of its tasks, CAMC will be able to contact third parties such as lawyers and accountants. The treatment of profits and losses made by CAMC will be clarified in the legislation. The budget of CAMC will be sufficient to meet its operational costs.

Monitoring of corporate and household indebtedness

- 1.28 The authorities will step up the monitoring of the indebtedness of the corporate and household sectors and prepare quarterly reports, including an assessment of debt-servicing capacity and refinancing activities. The Financial Stability Report, published on a yearly basis every June, will include an extended analysis on corporate and household indebtedness. These enhanced monitoring actions will be put in place by [end December 2012]. Data from surveys will be used until the credit becomes fully operational.

Increasing financial transparency

- 1.29 The latest MONEYVAL report, adopted in September 2011, presented an overall positive evaluation of financial transparency in Cyprus, but pointed to some risks and vulnerabilities with respect to terrorist financing and money laundering. The Cypriot authorities should revise the AML/CTF (anti-money laundering/ counter-terrorist financing) law to provide the widest possible range of international cooperation to foreign counterparts in line with international standards. Furthermore, the Companies law and the Trustee law of 1992 should be revised in line with the FATF (Financial Action Task Force) standards to enable the competent authorities and financial institutions to obtain access to adequate, accurate and timely information on the beneficial ownership and control of legal person and on the transparency of

trusts. Trust and company service providers should also be subject to adequate AML/CTF requirements. Finally, supervision should be stepped up to ensure that the requirements with regard to beneficial ownership are effectively implemented, in particular for lawyers and accountants.]]

2. Fiscal policy

Objectives

Putting public finances on a sustainable path is of overriding importance in order to stabilize the economy and to restore the confidence of companies, citizens and foreign investors in the longer-term prospects of Cyprus as an economically-advanced and investor-friendly economy. In this context, the objectives are: (1) to continue the on-going process of fiscal consolidation, taking into account the worsened macro-economic conditions, in order to correct the excessive general government deficit as soon as possible; (2) to this end, to reduce the government deficit to at most [EUR 700] million (4% of GDP based on current projections) in 2012, at most [EUR 440] million ([2.5%] of GDP) in 2013 through high-quality permanent measures, in particular measures to reduce the growth in expenditure on social benefits and the public sector wage bill, while minimizing the impact of consolidation on vulnerable groups; and (3) to maintain fiscal consolidation over 2015 in the direction of [a balanced budgetary position], by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures (see section 3). Over the program period, revenues above program projections, including any windfall gains, will be used to reduce debt.

Fiscal policy in 2012

- 2.1 The authorities commit to achieving a general government deficit of no more than EUR [700 million] in 2012 ([4%] of GDP). Over the remainder of the year, the authorities will rigorously implement the Budget Law for 2012 and additional permanent measures with an end-of-year effect of EUR 175 million (1% of GDP). These additional budgetary measures will be presented for Troika review before submission to the Parliament.

The consolidation package will notably include the following measures, which will be adopted [end-September 2012], prior to the granting of the first disbursement of financial assistance:

Expenditure measures (estimated yield in 2012 of EUR 136 million)

- 2.2 End the practice of COLA for the wider public sector (no additional yield in 2012 and 2013)
- 2.3 Extend the wage freeze in the broader public sector and temporary contribution on gross earnings by two additional years until 31 December 2015. (no additional yield in 2012 and 2013)
- 2.4 Freeze the filling of vacant posts in the broader public sector for two additional years until 31 December 2015 and introduce measures to increase the mobility of civil servants within and across line ministries (see section 3.11).
- 2.5 Abolish the 13th salary for broader public sector employees and state officials. (estimated yield 2012: at least EUR 120 million per year).
- 2.6 Reduce the 13th public pension allowance in the Government Employee Pension Scheme (GEPS) by 50% for pensioners receiving a monthly allowance of EUR 1000-1500 and by 75% for pensioners receiving a monthly allowance above EUR 1500. (estimated yield in 2012: at least EUR 14 million)
- 2.7 Introduce an immediate 6% penalty on voluntary early retirement in the GEPS; the penalty rate will be fixed permanently in an actuarially neutral way as part of a comprehensive pension reform plan. (estimated yield in 2012: below EUR 1 million)
- 2.8 Introduce a permanent contribution towards pension entitlements for all public sector employees, similar to the contribution introduced in the general government. (estimated yield in 2012: below EUR 1 million; 2013: EUR 3 million)
- 2.9 Extend the wage freeze and temporary contribution on gross earnings to cover all state officials and permanent secretaries (129 individuals), including members of the Parliament. Include pensionable and tax-free allowances of these individuals in the calculation of their taxable income. Introduce a contribution of 6.8% on pensionable earnings of these individuals. Tax the hospitality allowance provided to senior government officials. (estimated yield in 2012: EUR 1 million and at least EUR 3.5 million in 2013)

Revenue measures (estimated yield in 2012 of EUR 23 million)

- 2.10 Increase excise duties on alcoholic drinks. Introduce excise duties of EUR 47.10 per hl on still wine, EUR 50.80 per hl on sparkling wine, and EUR 36.06 per hl on fermented still and sparkling beverages other than wine and beer. Increase excise duties on beers by 10% from EUR 4.78 per hl to EUR 6.00 per hl. Increase excise duties on ethyl alcohol from EUR 598.01 to EUR 898.02 per hl. (estimated yield in 2012: at least EUR 4 million; in 2013: at least EUR 12 million)

2.11 Increase excise duties on tobacco products, in particular on fine-cut smoking tobacco, from EUR 60/kg to EUR 150/kg. Increase excised duties in cigarettes by EUR 0.40/per packet of 20 cigarettes. (estimated yield in 2012: at least EUR 9 million; in 2013: at least EUR 45 million)

2.12 Increase excise duties on energy, i.e. on oil products, by increasing tax rate on motor fuels (petrol and gasoline) by EUR 0.08. (estimated yield in 2012: EUR 8 million; 2013: EUR 30 million)

2.13 Introduce a mechanism for regular review of excise taxes to secure the real value of excise tax revenue. (yield in 2012 to be estimated, expected to be small)

2.14 Increase tax on wealth by increasing the tax rate on deemed dividend distribution from 20% to 21% and the tax rate on interest accrues on deposits of local banks from 0.095% to 0.11%. (estimated yield in 2012: at least EUR 2 million; 2013: at least EUR 10 million)

Fiscal policy in 2013

2.15 The authorities will achieve a general government deficit of no more that [EUR 440] million ([2.5%] of GDP) in 2013. Over 2013, the authorities will rigorously implement the Budget Law, which will include additional permanent measures of at least EUR 360 million (2.5% of GDP).

THE 2013 Budget Law will be presented for Troika review before submission to the Parliament [and will be adopted before the first disbursement of the financial assistance]. The budgetary target will be part of a medium-term Budgetary Framework, which lays down binding expenditure ceiling for the next three years (2013-2015) and which will be embedded into the Budget 2013.

2.16 The following measures will be carried out under the 2013 Budget Law [at the latest December 2012] and will apply from 1 January 2013, unless otherwise specifies:

Expenditure measures (estimated yield in 2013: EUR 413 million)

2.17 Implement an additional reduction in wages and salaries of the general government in 2013, which will ensure a total reduction of the general government in 2013, which will ensure total reduction of the general government wage bill of a cumulative 15% over 2012-13, including through the abolition of obsolete allowances provided to all public sector employees (authorities to specify). (estimated yield in 2013: EUR 166 million)

2.18 Ensure a reduction in total outlays for social transfers, other than those specified in points 2.19. and 2.20., by 10% through simplification, better targeting, eliminating

- redundant benefits and/or reducing the benefit level (authorities to specify). Abolish those measures approved by the Council of Ministers in 2007, which are not targeted or are covered by other existing schemes. (estimated yield in 2013: EUR 75 million)
- 2.19 Ensure a reduction in total outlays on the special dietary allowance, the Easter allowance and the Christmas allowance by at least EUR 15 million. Abolish the heating allowance, since all social welfare recipients benefit from a special scheme subsidizing the cost of electricity. (estimated yield in 2013: EUR 20 million)
- 2.20 Consolidate housing-related schemes by bringing total expenditure back to 2008 levels [i.e. EUR 217 million] in the 2013 budget and to 2007 levels [i.e. EUR 150 million] in the 2014 budget, while ensuring the protection of those at the highest risk of poverty. Provide a legal basis to use current income of assisted households rather than income at time of application, for the calculation of recurrent housing assistance and abolish housing assistance to households exceeding certain income thresholds by Q4-2012. Streamline housing assistance schemes, including their administrative management, in the context of a wider reform of the social protection system Q4 -2013. (estimated yield in 2013 and 2014: EUR 70 million)
- 2.21 Reduce transfers from central government to state-owned enterprises and semi-public institutions. Apply the same wage policy described in 2.4. and 2.17. in the broader public sector as in the general government. (estimated yield in 2013: EUR 45 million)
- 2.22 [Take further steps to control the growth of health expenditure, yielding annual savings of EUR 25 million (section 3.2).]
- 2.23 Ensure a reduction of the number of public sector staff over the period of 2013-2015 by an additional 250 per year (i.e. 1250 each year in total). Define a precise plan, including a time schedule for recruiting one employee for every four retirements. (yield in 2013 to be estimated)
- 2.24 Reform the shift-work system and reduce overtime remunerations in the broader public sector by 20% in 2013 and by additional 10% in 2014. In addition, the amount of overtime paid will not increase in 2015. (estimated yield in 2013: EUR 17 million; in 2014: EUR 7 million)
- 2.25 Increase the statutory VAT rate from 17% to 18%. (estimated yield in 2013: EUR 50 million)
- 2.26 [Increase revenue by EUR 10 million through an increase in the annual road tax for large and luxury personal vehicles and utility cars.]

- 2.27 Increase the revenues from fees for public services, including education, to yield around EUR 30 million. The fees will be linked to associated costs and will cover at least 20% of these costs.
- 2.28 Ensure additional revenue from property taxation of at least EUR 20 million. Ensure technical implementation of the area-based tax base valuation system to achieve full coverage of the cadastre. Implement recurrent property tax based on the new tax base. In this context, implement differentiated treatment of primary and secondary residences. (estimated yield in 2013: at least EUR 20 million)
- 2.29 Introduce a standstill rule for all tax expenditure, blocking the creation of new items of tax expenditure and the enlargement of existing items. The rule will apply to all kinds of tax expenditure, of temporary or permanent nature, at the central and local levels.

Fiscal policy in 2014-2015

- 2.30 The authorities will achieve a general government deficit of no more than EUR XXX million in 2014 (1.X% of GDP) and a [close to] balanced budget in 2015. The 2014 and 2015 Budget Law measures will be presented for Troika review before submission to the Parliament.

3. Fiscal-structural measures

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's exposure to external shocks. In this context, the objectives are: (1) to improve the efficiency of public spending and the budgetary process by means of an effective Medium-Term Budgetary Framework (MTBF) that is fully compliant with the Directive on requirements for budgetary frameworks and the Treaty on Stability, Coordination and Governance (TSCG); (2) implement further reforms of the pension system to address the high projected increase in pension spending; (3) take further steps to control and growth of health expenditure; (4) enhance tax revenues by improving tax compliance and collection; (5) undertake reforms of the public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional

organization of public services; (6) undertake reforms of the overall benefit structure with the aim of producing an efficient use of resources and ensuring an appropriate balance between welfare assistance and incentives to take up work; (7) elaborate a program for improving the efficiency of state-owned and semi-public enterprises and initiate a privatization program.

Pension reform

3.1 While reform measures have been undertaken recently, the implementation of further reforms of the pension system to address the high protected increase in pension spending is necessary in order to put the pension system on a sustainable path. The following measures will be taken to reduce the increase in pension spending and to ensure the viability of the pension system, while addressing the imbalances in and reducing the government contribution to the pension system.

In view of this, the authorities have agreed to implement the following measures by 31 March 2013:

- Reform the Government Employee Pension Scheme (GEPS) so that the parameters are the same as for the General Social Insurance Scheme (GSIS), allowing for a phase-in period of no more than five years to avoid abrupt changes in person entitlements and
- Adjust the penalties for voluntary early retirement cases in the GEPS and the GSIS (reduction if pension entitlements). The penalties should be actuarially neutral: i.e. the reduction in pension benefits should at least counterbalance the increase in expenditure due to a longer pay-out period and the loss in revenue due to a shorter contribution period.

In addition the following measures will form part of a comprehensive reform, which should be adopted by 31 March 2013 and implemented at the latest January 2014 onwards:

- For the GEPS and the GSIS, devise and implement an automatic mechanism linking the establishment of the statutory retirement age and the contributory period for a full pension to changes in life-expectancy at the statutory retirement age;
- For the GEPS and the GSIS, extend the minimum contributory period from the current 10 years to at least 15 years;
- Streamline the number of combinable pension benefits available and introduce a cap on the total monthly amount of pension benefits that can be received; in particular no public sector employee should receive more than one pension from government pension scheme.

- Dissolve/reform the Social Security Fund (GSIS reserve funds), as it currently represents an implicit state contribution to the pension system;
- Proportionately reduce or tax public sector pension levels that exceed the average wage level; and
- Conduct an actuarial study within six months of the start of the program to provide additional reforms options to ensure the financial viability of the national pension system. The actuarial study should project the scheme's finances on a cash basis. Given the financial sustainability focus, the study should exclude any form of government contribution (i.e. the additional contribution currently at around 4 percent and the interest on bonds of the reserve fund) with the exception of the normal payment of pension contributions on behalf of its employees. The study should analyze the impact of additional reforms options, if needed, such as benefit reductions, an increase in the statutory retirement age and increase in contribution rate increases or combinations thereof. Preference will be given to the first two options, given the negative impact of contribution rate increases on labor costs.

Health care expenditure

3.2 The authorities will come forward with concrete proposals to exert stronger control over the growth of public healthcare expenditure. The following steps will be considered and presented for Troika review before their implementation [Q1-2013]:

- Introduce a co-payment system for medical services and pharmaceuticals;
- Review the rules for prescription of drugs and complimentary diagnostic exams on the basis of international prescription guidelines and encourage physicians at all levels to prescribe generic medicines;
- Strengthen the monitoring mechanism and auditing of public healthcare expenditure, of all public hospitals and clinics, allocate budgets to individual public hospitals and clinics and strengthen commitment control procedures;
- Introduce a coherent regulatory framework for pricing and reimbursement of goods and services based on the actual level of costs incurred;

- Revisit the functioning of the procurement system of medicine from wholesale companies on the basis of experience of other Member States in order to facilitate the availability of less expensive pharmaceuticals;
- Conduct health technology assessment to enable a change in the delivery of healthcare, making it more effective and cost-effective; and
- Adopt and implement a restructuring plan for public hospitals and clinics to ensure a proper balance across management, administrative and clinical staff and efficient operational management, including by steps to strengthen staff mobility.

Budgetary Framework

3.3 The authorities will:

- Enable into the Budget 2013 law a Medium-Term Budgetary Framework, designed in accordance with the EU specifications for MTBFs, which lays down binding expenditure ceiling for the next three years (2013-2015) [before the first disbursement of the financial assistance];
- Adopt a law transposing Council Directive 2011/85/EU on requirement for budgetary frameworks, and provisions pertaining to the fiscal compact of the Treaty on Stability, Coordination and Governance (TSCG) in accordance with Article 3(2) of the TSCG and on the basis of the Common Principles for the national fiscal correction mechanisms laid down in Commission Communication COM(2012)342 [Q4-2012];
- Complete the adoption of the essential provisions referred to above with implementing texts [Q3-2013]
- [Q3-2013]; and
- Ensure a consistent approach in internal auditing throughout general government by preparing common methodological guidelines compatible with international standards [Q4-2013].

Public debt management

- 3.4 To support the development of an appropriate framework for the management of sovereign debt, including a more prudent and independent debt management strategy building on the issuance of long-maturity instruments and fully assessing the financial risk contained in granting government guarantees, the authorities will adopt and implement a Public Debt Management Law, the draft of which was submitted to the Parliament in May 2012 [Q4-2012].

Public Private Partnerships

- 3.5 The authorities will:

- Carry out a review of major PPPs as regards: the financial risks liabilities falling on the public budget; their contribution to the public budget (revenue streams); the effectiveness of attracting private capital and expertise; the efficiency and quality of the required service provision, including possible over-provision of both quantity and quality of the services in question; and their impact on market functioning. An interim report on this review will be delivered by Q1-2013 for review and approval by the Troika. The final report will be delivered by Q3-2013, for the purpose of review and approval by the Troika. In subsequent years, reporting on PPPs should take place in context of the annual budgetary procedure;
- Based on the conclusions of the review put in place a strengthened legal and institutional framework for PPPs, including ex-ante assessment and monitoring of the financial and fiscal risks of engaging in PPPs and concessions as compared to other public investments. A proposal for such a strengthened legal and institutional framework for PPPs should be drafted by Q1-2014; and
- Commit to not engage in any new PPP agreements before the approval of the interim report and

State-Owned Enterprises and Privatization

- 3.6 As regards State-Owned Enterprises (SOEs) other state-owned assets, the authorities will:

- Establish an inventory of assets, including real estate, owned by central government, municipalities and regional administrations, which to be prepared in view of possible divestments or restructurings. To this end, the inventory will indicate which State-Owned Enterprises could be subject to divestment, which could be subject to restructuring and which could be considered for liquidation [Q3-2013]

- Reduce the operational costs of SOEs by at least 15% on average compared with 2010, to be implemented in the 2014 budget, including proposing company-specific cuts that are consistent with a realistic economic and financial assessment [Q4-2013];
- Prepare a plan to strengthen the governance of SOEs in accordance with international best practices and draft a report reviewing the operations and finances of SOEs. The report will assess these companies' business prospects, the potential exposure of the government to the SOEs and the scope for orderly privatization. The authorities will adopt the necessary legal changes to fulfill this requirement. No additional SOEs will be created until this review is completed [Q3-2013]; and
- Submit to the Parliament a draft law to regulate the creation and functioning of SOEs at the central and local levels and enhance the monitoring powers of the central administration, including reporting on SOE's in context of the annual budgetary procedure. [Q3-2013].

3.7 The authorities will initiate a privatization program. This should consider privatization prospects of major state-owned and semi-owned and semi-public companies, inter alia Cyprus Airways and Cyprus Telecommunications Authority, as well as smaller firms and other companies, which are not natural monopolies. The privatization program should be determined on the basis of the inventory of assets noted above – to be achieved by the end of the program. To this end, the following measures will be taken:

- A concrete privatization roadmap, including company-specific timetables, will be prepared by [Q4-2012].

Revenue administration and tax compliance

3.8 The authorities will propose a comprehensive reform plan to improve the effectiveness and efficiency of tax collection and administration. The reform plan will consider: [Q4-2012]

- Adopting legislation to attribute personal responsibility for payment of company taxes to those, who truly and effectively control a company, and to levy a personal fine on them in case of non-payment;
- Adopting legislation that would prohibit alienation of any property held by the taxpayers, should the testator not pay or not guarantee payment of all tax obligations, including tax on capital gains arising from alienation/sale if the last property;
- Adopting legal changes that would limit the possibility for companies to carry forward losses in order to offset corporate company tax payments;
- Encouraging mobility of staff between different tax administration entities, namely via publication of the tax gap for main revenue categories (the difference between the tax that should be paid and the amount actually collected) and establishing clear performance objectives, as well as revenue collection results , for each tax administration entity;
- Rationalize the tax administration, e.g. by creating a specialized office for high net worth tax payers, streamlining the coordination between Customs & Excise and VAT services and centralizing and merging tax offices.

3.9 The authorities will as part of its comprehensive reform plan prepare a report on how to optimize the use of information systems in the tax administration and proposing concrete steps [Q4-2012]. The report will include:

- A proposal for improving IT systems in order to ensure the compatibility/integration between revenue administration and tax courts, as well as the interconnection of all tax offices;
- Concrete measures to further enhance the use of e-filing of tax returns and e-payment, namely through an assessment of the feasibility of discontinuing of

payments in cash and cheques in tax offices, which should be replaced by bank transfers; and

- A proposal for improving the exchange of information between relevant authorities for tax collection purposes, taking into account privacy concerns.

3.10 Following diagnostic technical assistance, the authorities will engage in the following reforms [Q4-2013]:

- Take measures to increase tax compliance, aimed at reducing informal activities and reducing the administrative burden on businesses. The aim is to achieve voluntary compliance insofar as possible, with a proper balance between taxpayer services and enforcement; and
- Step up administrative tax fraud investigations and enhance the cooperation between the tax and judicial systems, while addressing potential bottlenecks in the tax appeal system, e.g. through the strengthening of arbitration procedures.

Public administration reform

3.11 The public sector represents a large share of public expenditures in Cyprus. To ensure an efficient use of government resources, while delivering a quality service to the population; the authorities will undertake the following reform measures [Q4-2012]:

- Remove all impediments to staff mobility (including permanent movement of staff) within the general government sector;
- Revise working time arrangements so as to minimize the need to resort to overtime payments and shift allowance;
- Streamline allowances; and

- Implement a performance-based appraisal system and link to it the salary adjustment of staff,

In addition, the authorities will commission an independent external review of possible further reforms of the public administration. The terms of reference will be agreed with the program partners in Q3 2012

The review will cover the following areas:

- The appropriate size of the public sector to provides an efficient administration using the full potential of e-government;
- The appropriate remuneration and working conditions in relation to the private sector;
- The potential for development of part time work;
- The potential for streamlining staff categories; and
- The appropriateness of the public sector pay and working conditions for semi-governmental organizations.

The review will be published in Q1-2013. The authorities will discuss the main findings of the independent review with the program partners and present a time-bound comprehensive action plan to follow up on its recommendations [Q2-2013]. The authorities will adopt a reform of the public administration based on the findings of the review to take full effect as of the 2014 budget implementation.

Administration of the welfare system

3.12 The welfare system in Cyprus encompasses a broad range of individual benefits provided by different Ministers and Departments. To ensure efficient use of public funds within the welfare system, while at the same time ensuring an appropriate

balance between welfare assistance and incentives to take up work, the authorities will carry out a reform of the welfare system. The reform will build on a full inventory of all social transfer programs in cash and in kind to be delivered by [Q3-2012].

The reform will cover the following elements:

- Introduce better targeting of various social transfers, so as to reduce total number of beneficiaries while protecting the most vulnerable;
- Streamline the number of benefits available through merging and phasing out of benefits;
- Introduce a cap on the total amount provided to beneficiaries of multiple social benefits;
- Reconsider the appropriate levels of individual benefits and the index for adjustment of benefit levels; and
- Tighten the eligibility conditions for both initial and continues access to benefits.

The reforms must be consistent with the fiscal targets defined in the MoU. The authorities will discuss the proposed reforms with the program partners and will present draft legislation to reform the welfare system by [Q1-2013].

4. Labour Market

Objectives

While Cyprus' labor market was characterized by high employment rates and low unemployment in the years leading up to the crisis, the unwinding of unsustainable imbalances and worsening and important labor market challenges over the medium-term. Labor market reforms can mitigate the impact of the crisis on employment, limit the occurrence of long-term and youth unemployment, facilitate occupational mobility and contribute to improving the future resilience of the Cypriot economy in the face of adverse economic shocks. In this context, the objectives are: (1) to implement a reform of the

system of wage indexation commensurate with ensuring a sustainable improvement in the competitiveness of the economy and allowing wage formation to better reflect productivity developments; (2) to prepare and implement a comprehensive reform of public assistance in order to achieve an appropriate balance between public assistance and incentives to take up work, target income support to the most vulnerable, strengthen activation policies and contain the public finance impact of rising unemployment; and (3) to help attenuate adverse competitiveness and employment effects by linking any change in the minimum wage to economic conditions.

Cost of living adjustments (COLA) of wages and salaries

4.1 The authorities will reform the wage-setting framework in such a way so as to improve real wage adjustment, with the aim of preserving employment in the presence of adverse shocks and avoiding losses in competitiveness both in expansions and recessions. To this end, the authorities will:

- End the practice of wage and salary indexation (COLA) in the wider public sector; and
- Pursue the termination of the practice of wage indexation in the private sector in a tripartite agreement with social partners [Q4-2012]. The agreement will act on relevant elements of the indexation system. Within the framework of this agreement, the COLA should not be applied during the program period.

Minimum wage

4.2 With a view to preventing possible adverse competitiveness and employment effects, the authorities commit that, over the program period, any change in the minimum wage which covers specific professions and categories of workers will take place only if justified by economic and labor market developments and after consultation of the program partners.

Public assistance reform and activation of the unemployment

4.3 The increase in unemployment underlines the need for an overall assessment of available instruments for income support (after expiration of unemployment insurance benefits) and activation policies. The planned reform of public assistance should be effective in safeguarding incentives to take up work. Therefore, the authorities will:

- Commission an independent review on existing institutions and instruments to provide income support after the expiration of unemployment insurance benefits and activate the unemployed, with a view to improving work incentives and activation. In particular, the review will cover the cooperation between the public employment service and the benefit-paying institutions in the activation of the unemployed. The terms of reference for the review will be submitted to program partners by Q3-2012. The review will be completed by Q4-2012. [The delivery of the review will be accompanied by an assessment by the authorities of the need and possibilities for re-directing the European Social Fund finances towards the objectives outlined in the review.];
- Present an action plan on activation policies; and
- Consider the effect on work incentives when presenting legislation to reform public assistance. Program partners will be consulted on the draft legislation before its adoption by the Council of Ministers [Q4-2012].

5. Goods and services markets

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 warranted. Finally, improving the regulation of administration related to the real estate sector will contribute to the overall functioning of the housing market and foster foreign demand at a time when the prospects of this sector are severely affected by downside risks.

Product market efficiency

- 5.1 The authorities will implement measures with a view to improving competition in the non-tradable sector. This can be achieved by, inter alia, reducing unwarranted rents in regulated sectors, promoting greater efficiency in the telecommunication sector through a reduction of costs, market-oriented pricing in the energy sector,

reducing costs for licenses in the transport sector, and abolishing fees for transfer of licenses in the retail trade sector. The authorities will take measures to improve competition in quasi-monopolistic wholesale markets and in the construction sector (Q4-2012).

Services Directive: Sector-specific legislation

5.2 The authorities will adopt the remaining necessary amendments to the sector-specific legislation in order to fully implement the Services Directive, easing the requirements related to entry and establishment. In addition, requirements concerning minimum tariffs should be eliminated unless they have a clearly defined economic justification. Amendments will be presented to the Parliament [Q4-2012] and minimum tariff requirements without justification will be abolished by [Q1-2013].

Services Directive: Regulated professions

5.3 The authorities will:

- Eliminate restrictions to the use of commercial communication (advertising) in regulated professions, as required by the Services Directive [Q4-2012]; and
- Further improve the functioning of the regulated professions sector (such as lawyers, engineers, architects) by carrying out a comprehensive review of requirements affecting the exercise of activity and eliminating those that are not justified or proportional [Q1-2013].

Housing market and immovable property regulation

5.4 To ensure market clearing of the property market, allow for efficient seizure of property collateral, and for market-based assessment of property prices, as well as alleviating the factors deterring both domestic and foreign demand, in particular the risks of legal disputes that may arise from incomplete documentation of ownership and property rights, the authorities will implement the following measures:

- Strengthen existent enforcement procedures and, if necessary, plan for additional legal measures to ensure the issuance of the remaining outstanding Title Deeds by Q4-2013;
- Provide a monthly review of the town-planning amnesty, and plan for additional incentives to reduce the majority of pending building permit certificates that are required for the insurance of title deeds by Q3-2012;

- Implement consolidated electronic access to the registries of title deeds, mortgages, sales contracts and cadastre by Q3-2013. Report on a possible legal basis and regulation to produce a unified land registry (of immovable property sales contracts, title deeds, and mortgages) and a registry of indefeasible property rights [Q4-2012];
- Fully implement Directive 52/2008 EC on mediation in civil and commercial matters and extend the coverage of the directive implementation to out-of-court settlement of domestic disputes.

Tourism

5.5 Tourism is an important export sector and is of great importance to domestic value added and employment. During recent years, tourism has experienced a gradual erosion of both price and non-price competitiveness mainly due to high labor costs as a result of out-dated terms and conditions of the Collective Agreement for hotel employees and the COLA, high electricity/energy costs, high tariffs applied for the central sewage system and water supplies, high cost of food and other hotel supplies, more difficult access to bank financing, excessive red-tape in the granting of necessary licenses and permits, as well as restrictive provisions of the bilateral air-service agreements. To reinvigorate the competitiveness of the tourism sector, the authorities will:

- Support efforts to review and amend the terms and conditions of the Collective Agreement for hotel employees to further lower hiring and employment costs, as well as the abolition of the application of COLA for tourism sector employees [Q2-2013];
- Following an effectiveness-of-spending review to be undertaken by end of 2012, assess if the proposed budget of the Cyprus Tourism Organization for 2013-2015 is adequate to implement the planned measures/actions of the Tourism Strategy 2011-2015; additional allocations, if deemed appropriate, will be agreed with the program partners;

- In view of cost competitiveness considerations, support a comprehensive review of the electricity, central sewage and water supply tariffs charged to hotels, with the aim of streamlining the respective tariffs with those charged to households [Q2-2013]; and
- Carry out a study on how to improve the tourism sector business model, in particular, with a view to lengthening the tourist season, promoting resident tourism during winter time and defining niches such as medical tourism [Q4-2012].