Memorandum of Understanding on Specific Economic Policy Conditionality

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

- to restore the soundness of the Cypriot banking sector by thoroughly restructuring, resolving and downsizing financial institutions, strengthening of supervision, addressing expected capital shortfall and improving liquidity management;

- 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 consolidation in the medium-term, in particular through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector; and

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

1. Financial sector regulation and supervision

Key Objectives

The banking sector has been severely affected by the broader European economic and sovereign crisis, in particular through its exposure to Greece**. However, many of the problems for the sector are home-grown and relate to overexpansion in the property market as consequence of banks' poor risk management practices.** Furthermore, the financial sector is vulnerable because of its size relative to that of the domestic economy. The handling of problems in the sector has been complicated by the sensitivity of collateral valuations to property prices, and banks have used certain gaps in the supervisory framework to delay the recognition of loan losses, thus leading to significant under-provisioning. The banking sector needs to be thoroughly reformed and restructured in depth in line with state-aid rules. **The solvency of viable 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, including those of the cooperative credit institutions, will be strengthened along with the crisis management mechanisms. Non-viable institutions will be resolved. At the end of the restructuring process, the sector will be smaller, stronger, and more resilient.**

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 in line with Eurosystem rules.

1.2. Banks borrowing from central banks will establish and submit quarterly medium-term funding plans, to be communicated at the end of each quarter, starting from [December 2012], to the Central Bank of Cyprus, which will be transmitted 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 and reduce dependency on borrowing from the central banks, while avoiding asset fire sales and a credit crunch. The reporting template and the macroeconomic scenario will be provided by the Central Bank of Cyprus. The plans should gradually reduce dependency on exceptional liquidity support at a pace consistent with our macroeconomic framework.

1.3. The lack of concentration limits in the liquidity framework 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 such that minimum requirements will be established for: i) diversifying investments in eligible liquid assets by imposing concentration limits of 25% of regulatory capital and 50% for the domestic sovereign; ii) investing at least 50% of the required liquidity into instruments of high credit quality with a maturity of up to 3 months and iii) non-resident deposits (euro and foreign) such that the minimum liquidity ratio is set at 60%. The exposure to the domestic sovereign exceeding the concentration limit at the time of signing of this Memorandum of Understanding, will be allowed to be held until maturity. The Central Bank will strictly enforce these measures. Banks will be required to comply with the new prudential liquidity regulations by the [mid 2015].

Due diligence

1.4. The Cypriot authorities are conducting an accounting and economic value assessment (due diligence review) of the credit portfolios of Bank of Cyprus, Cyprus Popular Bank, Hellenic Bank and a sample representing about 63% of the cooperative credit institutions' assets, as well as Alpha Bank Cyprus, and Eurobank Cyprus in order to inform their home authority. The assessment, which is overseen by a Steering Committee including representatives of the Cypriot authorities, the EC, the ECB, the EBA and the ESM (as members) and the IMF (as observer), formally started on 4 October 2012, with the selection of the external consultant. This due diligence review includes both an accounting review and an assessment of the economic value of banks' assets. It also forms the basis for the bank-by-bank stress tests. Details about the expected deliverables of the due diligence exercise have been provided in the Terms of Reference (attached to this Memorandum of Understanding), approved by the Steering Committee and subscribed to by the external consultant. The due diligence review's preliminary results will be [were] submitted to the Steering Committee by [on] [7 December 2012], with the final report made available by [mid-January 2013].

1.5. The due diligence review will form the basis for a bank-by-bank stress test, using a baseline and adverse macroeconomic scenario, with elements agreed by the Steering Committee at the beginning of November 2012. The stress tests will be carried out by the Central Bank of Cyprus with the assistance of the external consultant and in consultation with the EC, the ECB and the IMF. 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). 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 [31 January 2013] with a view to recapitalisation or resolution, if necessary.

<u>Restoring adequate capital buffers</u>

1.6. 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 9% by [31 December 2013]

1.7. Undercapitalised credit institutions will be required to present quarterly capital and funding plans to the Central Bank of Cyprus starting in [March 2013], explaining how they intend to fulfil the new capital requirements. These plans will be based on a template provided by the Central Bank of Cyprus in consultation with the EC, the ECB and the IMF and are in the same format as those required from banks borrowing from central banks. 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 recapitalisation or transferring assets to an asset management company representing aid amounting to less than 2% of total risk-weighted assets, private sector participation in the recapitalisation should be assured no later than [30 September 2013]. Institutions requiring a larger amount of state aid, but which are not put into resolution, will be given time until [30 June 2013] to raise capital from private sources.

1.8. With the goal of minimising the cost to tax payers, bank shareholders and junior debt holders will take losses before state-aid measures are granted. Before any state recapitalisation is granted, the Central Bank of Cyprus will require a conversion of any outstanding junior debt instruments into equity for the purpose of protecting the public interest in financial stability, including by implementing voluntary or, if necessary, mandatory subordinated liability exercises (SLE). In order to facilitate a voluntary SLE, a small premium can be offered in line with state aid rules. To this end, the necessary legislation will be introduced no later than [January 2013]. The Central Bank of Cyprus together with the EC, the ECB and the IMF will monitor any operation converting junior debt instruments into equity.

1.9. Credit institutions deemed viable based on their restructuring plans can, if other measures do not suffice, ask for recapitalisation aid from the State or for a transfer of assets to an asset management company. Banks in need of aid from the State will not be recapitalised nor will they be allowed to transfer assets to an asset management company before their restructuring or resolution plans have been formally approved under state-aid rules. In order to ensure timely recapitalisation, the authorities should submit to the EC restructuring plans drawn up in compliance with EU state-aid rules, also informing the ECB and the IMF: by [mid-February 2013] for the institutions that already received state aid and by [end-April 2013] for the other institutions. 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 subsidisation of existing shareholders, with due consideration for financial stability and banks' profitability. The credit institutions benefiting from capital injections and/or transfer of asset will be subject to specific management rules and restrictions, and to a restructuring process in line with EU competition and state-aid requirements, which will be scrutinised by an external monitoring trustee. Banks that are deemed non-viable will be subject to the new resolution framework outlined below.

1.10. 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 up to EUR [10] billion is foreseen under the programme, 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 exact amount per bank will be determined in the due diligence exercise. The resources of this facility will be deposited with a dedicated account held at the Central Bank of Cyprus or any relevant securities depository based on the timeline for resolution and recapitalisation. The provision of capital from the facility will be in line with EU state-aid rules and will be disbursed in consultation with the EC, the ECB and the IMF.

Regulation and supervision for banks and cooperative credit institutions

1.11. Strong efforts should be made to maximise bank recovery rates for non-performing loans, while minimising the incentives for strategic defaults by borrowers. The administrative hurdles and the legislative framework currently constraining the seizure and sale of loan collateral will be amended such that the property pledged as collateral can be seized within a maximum time-span of 1.5 years from the initiation of legal or administrative proceedings. In the case of primary residences, this time-span could be extended to 2 years. The necessary legislative changes will be implemented by [end 2013], macroeconomic conditions permitting.

1.12. 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 amended to include all loans past due by more than 90 days. This amendment will be introduced by [31 December 2012]. The time series for non-performing loans will be published including historical observations reaching back as far as possible.

1.13. The Central Bank of Cyprus will also create a central credit register listing all borrowers and beneficial owners, from both commercial banks and cooperative credit institutions, to enable these institutions to check new loan applications against the register. The credit register will identify the borrowers who are or were in arrears. The legal framework for the credit register will be set up by [30 June 2013] and the central credit register will be operational by [31 December 2013].

1.14. After analysis of the results from the due diligence exercise, the Central Bank of Cyprus will review, by the end of [June 2013], its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning. Without prejudice to the conclusions of this evaluation and to the 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 [September 2013]. Additionally, legislation will be passed by [end June 2013] to strengthen governance by prohibiting commercial banks from lending to independent board members, including their connected parties, and removing any board members in arrears on existing debts to their banks, while lending to other board members will be prohibited above a certain threshold, which will be calibrated by the Central Bank of Cyprus. Loans and other credit facilities to each board member will be disclosed to the public. A majority of directors in banks' boards will be independent.

1.15. The Central Bank of Cyprus will introduce supervisory mandatory structured intervention based on capitalisation levels, drawing upon technical assistance, by end [September 2013]. Such a tool should also be developed for the cooperative credit institutions.

1.16. 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.

1.17. Stress testing will be integrated into regular off-site bank supervision and will serve as an input into Pillar 2 assessments.

1.18. Cooperative credit institutions play a significant role in the financing of the domestic economy and an important objective of the programme is to strengthen the cooperative credit sector. Due to its economic relevance and legal specificities, as well as deficiencies in risk assessment, this segment of the financial sector requires restructuring and resolution as well as stronger regulation and supervision. The authorities will align the regulation and supervision of cooperative credit institutions to that of commercial banks. By end [December 2012], their supervision shall be conducted independently of considerations for the development of the cooperative credit institutions sector. The supervision of cooperative credit institutions will be detached from the Ministry of Commerce, Trade and Tourism and integrated into the Central Bank of Cyprus by the end of [June 2013], for which legislation will be passed by [end March 2013]. The Cypriot authorities will present, for assessment by the EC, the IMF and the ECB, a time-bound, actionable plan to achieve this by the [same deadline]. By end February 2013, legislation will be introduced to authorise the Central Bank of Cyprus to instruct the current cooperative credit sector supervisor to intervene, also at the level of individual cooperative credit institutions. The accounts of cooperative credit institutions, above a size to be decided by the Central Bank of Cyprus in consultation with the EC, the ECB and the IMF, will be subject to an independent annual audit by an external internationally-recognised auditing firm. The Central Bank of Cyprus will have the right to overturn the selection of an auditor by any cooperative credit institution. Additionally, legislation will be passed by [end June 2013] to strengthen governance by prohibiting cooperative credit institutions from lending to natural persons that are non-members, independent board members, including their connected parties, and removing any board members in arrears on existing debts to their cooperative credit institutions, while lending to other board members will be prohibited above a certain threshold, which will be calibrated by the Central Bank Cyprus. Loans and other credit facilities to each board member will be disclosed to the public. A majority of directors in cooperative credit institutions' boards will be independent. Upon completion of the resolution process in 2014, the supervisory framework of the cooperative credit sector can be revisited.

Modernising the bank resolution framework

1.19. The authorities will introduce legislation establishing a comprehensive framework for the recovery and resolution of credit institutions, drawing inter alia on the relevant proposal of the European Commission[1]. The framework will be subject to consultation with the EC, the ECB and the IMF and will enter into force by [end-January 2013]. 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

[1] http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm#framework2012

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 recapitalisation 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.

Restructuring and resolution of cooperative credit institutions

1.20. In consultation with the EC, the ECB and the IMF, the Central Bank of Cyprus, assisted by the current supervisor, will ascertain the viability of cooperative credit institutions individually and design a strategy for restructuring viable and resolving non-viable institutions. In order to make possible the resolution of individual institutions, all necessary and appropriate measures will be taken, including the temporary suspension of the mutual guarantee framework for cooperative credit institutions.

1.21. This strategy, including the possibility of the application of mergers, restructuring and resolution, will be submitted to the EC, also informing the ECB and the IMF by [end-April 2013] and will distinguish between viable and non-viable institutions. The guiding principle shall be least-cost resolution. Implementation of the strategy should be completed by [31 December 2014]. Until this strategy has been agreed, there will be no change in the structure of the sector, without prior consultation with the EC, the ECB and the IMF.

1.22. Upon finalisation of the restructuring and resolution process, the cross guarantees may be re-introduced provided that a new governance structure can be established, which allocates clear levels of continued accountability and provides for proper incentives to avoid moral hazard, having regard to a two-tier supervisory system applied in other EU countries.

Segregation of non-performing assets

1.23. In order to resolve bad assets effectively and to reduce the financial sector's exposure to non-performing and non-core assets, the authorities will decide by [end January 2013] on the setting-up of an asset management company (AMC) or other vehicles, the organisation structure and scope of which is to be determined in consultation with the EC, the ECB and the IMF. An AMC or other vehicles will be able to acquire loans and other claims, including foreign exposure from credit institutions in Cyprus that have received or will receive state aid. The scope of asset transfers will be based on the efficiency of asset work-out processes for specific asset classes. Transfers will take place at the real (long-term) economic value of the assets as established on the basis of a thorough asset quality review process, drawing on the individual valuations used in the due diligence exercise. The transfer prices will comply with EU competition rules, while the ECB and the IMF will be consulted thereon.

1.24. The objective of asset segregation will be to maximise the recovery value of assets, which will be wound down within a medium- to long-term perspective. As part of its funding strategy, an AMC or other vehicles will have the capacity to issue bonds that are guaranteed by the State. In exchange for the assets, the banks will receive a consideration which may take the form of a suitably small equity participation in an AMC or other vehicles, bonds issued by an AMC or other vehicles, cash and/or high quality securities. The bonds issued by the AMC 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".

1.25. An AMC or other vehicles will function under appropriate legislation, to be adopted by [end March 2013] and will be made operational by [31 May 2013]. This legislation will ensure that an AMC or other vehicles have 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 labour. Legal protection for the staff and directors will be ensured. Accountability will be guaranteed by submitting an AMC or other vehicles 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, an AMC or other vehicles will be able to contract third parties such as lawyers and accountants. The treatment of profits and losses made by an AMC or other vehicles will be clarified in the legislation. The budget of an AMC or other vehicles will be sufficient to meet its operational costs.

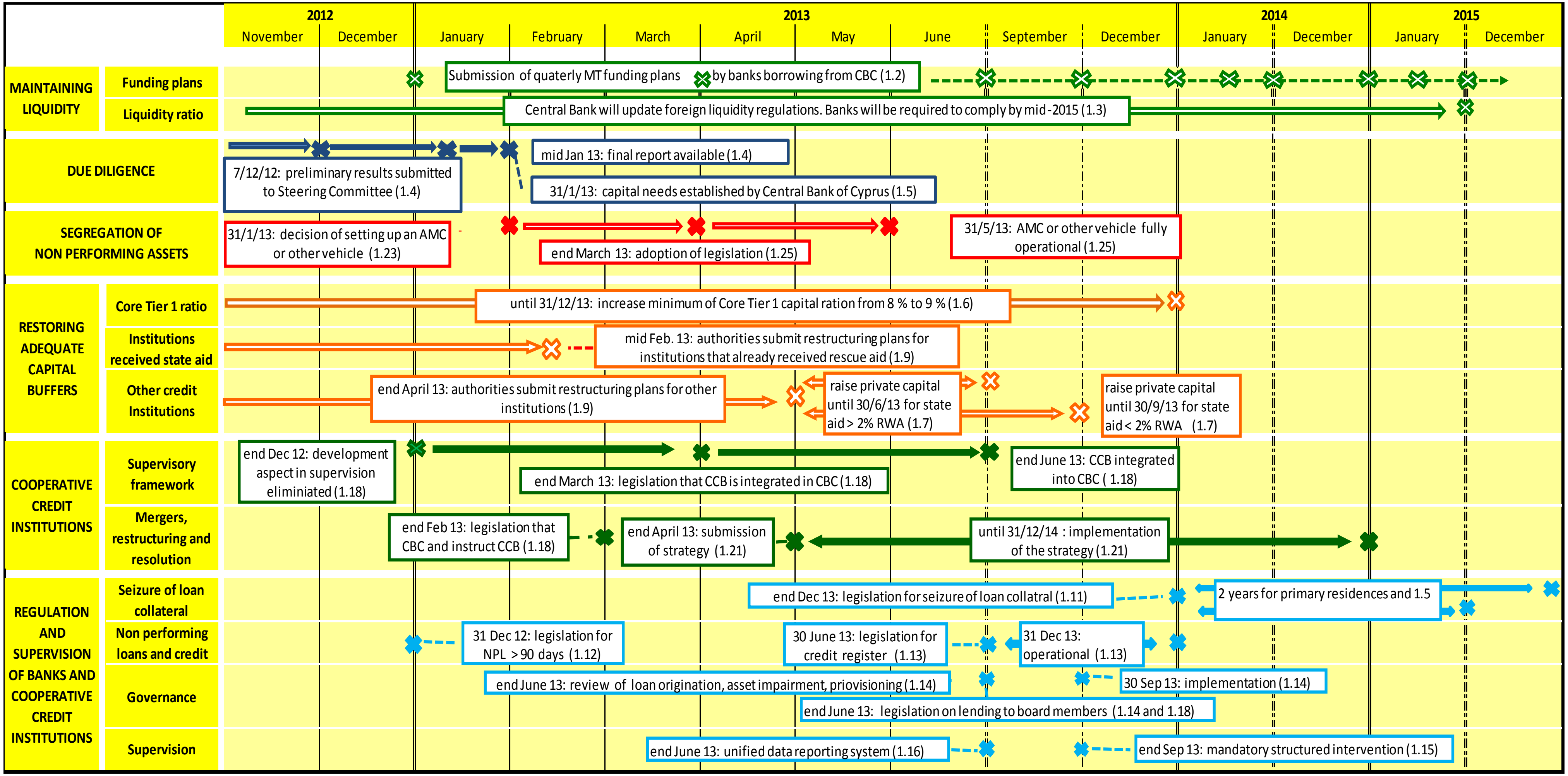
Monitoring of corporate and household indebtedness

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

Increasing financial transparency

1.27 The anti-money laundering (AML) framework will be strengthened in line with best practice. While Cyprus' AML regime received an overall positive evaluation in the 2011 MONEYVAL report, the authorities are committed to further enhancing their standing by taking a number of measures, in line with recommendations made by IMF staff. First, the legal framework will be revised to enable the provision of the widest possible range of cooperation to foreign counterparts (including with regard to the laundering of the proceeds of tax crimes involving fraudulent activity), and by giving precision to the scope of cooperation by the financial intelligence unit [by end-December 2012]. Furthermore, to address concerns that Cypriot corporations and trusts might be misused, the authorities have committed to an action plan to revise and effectively implement the legal framework, in order to ensure that adequate, accurate and timely information on the beneficial ownership of Cypriot legal persons and arrangements can be provided to foreign counterparts in response to requests related to money laundering and tax matters [by end December 2012]. Finally, the supervision department of the Central Bank of Cyprus will review its off-site and on-site supervisory procedures to further implement a risk-based approach to AML supervision [by end-March 2013]. In particular, the off-site supervisory tool will include monthly reporting by financial institutions on the breakdown by country of origin of the main depositors and the main beneficiaries of loans (and of their beneficial owners).

Time span for conditionality in the financial sector



2. Fiscal policy

Key objectives

Putting public finances on a sustainable path is of overriding importance in order to stabilise the economy and to restore the confidence of companies, citizens and foreign investors in the longer-term 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 in order to achieve a 4% of GDP primary balance in 2016 and maintain at least such a level thereafter; (2) to correct the excessive general government deficit as soon as possible; (3) to this end, to take fiscal measures totalling 7¼% of GDP during 2012-16 as follows: 2012-13: 3% of GDP; 2014: 1¾% of GDP; 2015: 1½% of GDP; and 2016: 1% of GDP, in order to achieve the annual budgetary targets as set out in this Memorandum through high-quality permanent measures, in particular measures to reduce the growth in expenditure on the public sector wage bill and social benefits, while minimising the impact of consolidation on vulnerable groups; and (4) to maintain fiscal consolidation over the medium term, converging towards Cyprus' medium-term budgetary objective, by containing expenditure growth, improving the structure of taxation and undertaking fiscal-structural measures (see section 3), including a Medium-Term Budgetary Framework designed in accordance with EU specifications.

In the event of underperformance of revenues or higher social spending needs due to adverse macroeconomic effects, the government should stand ready to take additional measures to preserve the programme objectives, including by reducing discretionary spending. Over the programme period, cash revenues above programme projections, including any windfall gains, will be used to reduce debt. If instead over-performance materialises, to the extent that it is deemed permanent, this can reduce the need for additional measures in the outer years.

Fiscal policy in 2012

2.1. The authorities commit to achieving a general government deficit of no more than EUR 1036 million in 2012 (5.8% of GDP). To this end, the authorities will amend the 2012 Budget Law and immediately implement additional permanent measures with an end-of-year effect of at least EUR 42 million (0.25% of GDP). The amended Budget Law, containing a detailed specification of the additional budgetary measures, will be presented for review by the programme partners before submission to the House of Representatives.

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

Expenditure measures

2.2. 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%.

2.3. Extend the suspension of the practice of COLA for the public and broader public sector until the end of the programme (end-2015) (see section 4.1).

2.4. 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.

2.5. Reduce the number of public sector employees by at least five thousand over the period of 2012-16 by: i) freezing the hiring of new personnel on first entry posts in the broader public sector for three additional years until 31 December 2016; ii) implementing a policy of recruiting one person for every four retirees (horizontal); iii) introducing measures to increase the mobility of civil servants within and across line ministries (see 3.11); and iv) implementing a four-year plan aimed at the abolition of at least 1880 permanent posts (see 2.21).

2.6. 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.

<u>Revenue measures</u>

2.7. Ensure additional revenues from property taxation by: (i) updating the 1980's prices by applying the CPI index over 1980 to 2012; and (ii) amending tax rates for the value bands. The new rates, which will apply to the updated values, are as follows:

For values of EUR 0- 150,000 coefficient of 0‰
For values of EUR 150,001- 500,000 coefficient of 6‰
For values of EUR 500,001- 1,000,000 coefficient of 8‰
For values of EUR 1,000,001 and above coefficient of 10‰

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

2.9. 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.

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

<u>Fiscal policy in 2013</u>

2.11. The authorities will achieve a general government primary deficit of no more than EUR 122 million (0.7% of GDP) in 2013[2]. Over 2013, the authorities will rigorously implement the 2013 Budget Law with additional permanent measures of at least EUR 480 million (2.75% of GDP), including the effect of permanent measures from the previous year.

The 2013 Budget Law will be presented for review by the programme partners before submission to the House of Representatives and will be adopted by [end-December 2012],

[2] Excluding extraordinary revenues related to the energy sector

prior to the first disbursement of the financial assistance. The budgetary target for 2013 will be embedded in a Medium-Term Budgetary Framework (MTBF), which will be adopted accompanying the 2013 Budget Law. This MTBF shall lay down binding expenditure ceilings for the budget years 2013-2015 for each government entity.

2.12. The following measures will be carried out under the 2013 Budget Law and will apply as of 1 January 2013, unless otherwise specified:

Expenditure measures

2.13. 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; (b) the abolition of supplementary allowances under public assistance, the abolition of the special grant and the streamlining of the Easter allowance for pensioners; (c) reducing the costs for various housing schemes by at least EUR 35 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. (see 3.12).

2.14. 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).

2.15. 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.

2.16. 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.

2.17. 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; and

iii. apportioning the pension rights of a diseased pensioner between multiple husbands or wives in accordance to their years of marriage; and

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

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

2.19. 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.

2.20. Ensure a reduction of seasonal hourly paid employees by 992 from 1806 in 2012 to 814.

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

Revenue measures

2.22. 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.

2.23. 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.

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

2.25. Increase the standard VAT rate from 17% to 18%.

2.26. 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.

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

2.28. Increase fees for public services by at least 17% of the current values.

2.29. Introduce measures to control healthcare expenditure (see 3.2). In particular, improve cost efficiency in the healthcare sector by enhancing public hospitals' efficiency, competitiveness and cost-effectiveness. Also, introduce a co-payment system for a limited number of medical services and pharmaceuticals.

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

2.31. Introduce legal changes to limit to at most 5 years the possibility for companies to carry forward losses to offset corporate tax payments.

<u>Fiscal policy in 2014</u>

The authorities will achieve a surplus of the general government primary balance of at least EUR 175 million (1% of GDP) in 2014[3] by implementing additional permanent measures of at least EUR 307 million (1.75% of GDP), including the effect of permanent measures from the previous years.

The budgetary target and the additional permanent measures for 2014 will be embedded in the Medium-Term Budgetary Framework (MTBF), accompanying the 2013 Budget Law, prior to the first disbursement of the financial assistance. The 2014 Budget Law will be presented for review by the programme partners before submission to the House of Representatives [mid-September 2013] and will be adopted by [mid-December 2013]. The MTBF accompanying the 2014 Budget Law shall lay down binding expenditure ceilings for the budget years 2014-2016 for each government entity.

The following measures will be carried out under the 2014 Budget Law and will apply as of 1 January 2014, unless otherwise specified:

<u>Expenditure measures</u>

2.32. 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.

2.33. 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.

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

2.35. Increase teaching time of teachers by one academic period in due time to have full effect in budget year 2014.

<u>Revenue measures</u>

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

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

2.38. Increase the reduced VAT rate from 8% to 9%.

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

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

[3] Excluding extraordinary revenues related to the energy sector

Fiscal policy in 2015-16

The authorities will achieve a surplus in the 2015[4] general government primary balance of at least EUR 489 million (2.7% of GDP) and a surplus in the 2016[5] general government primary balance of at least EUR 752 million (4.0% of GDP).

The 2015 and 2016 Budget Laws will be presented for review by the programme partners before submission to the House of Representatives and will be adopted, respectively, by mid-December 2014 and mid-December 2015.

3. Fiscal-structural measures

Key objectives

Cyprus enjoyed above euro-area average growth rates for more than a decade and in parallel expanded its public sector employment, support and services considerably. Looking ahead, if the public sector is to provide appropriate support for the sustainable and balanced growth of the Cypriot economy, fiscal-structural reform steps are needed to ensure the long-term sustainability of public finances, to provide the fiscal space necessary to support the diversification of the economy, and to alleviate the adverse impact on jobs and growth arising from Cyprus'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 the growth of health expenditure; (4) enhance tax revenues by improving tax compliance and collection; (5) undertake reforms of the public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public services; (6) undertake reforms of the overall benefit structure with the aim of producing an efficient use of resources and ensuring an appropriate balance between welfare assistance and incentives to take up work; and (7) elaborate a programme for improving the efficiency of state-owned and semi-public enterprises and initiate a privatisation programme.

Pension reform

3.1. While reform measures have been undertaken recently, the implementation of further reforms of the pension system to address the high projected increase in pension spending is necessary in order to put the pension system on a sustainable path. The overarching objectives of the reform are: i) to reduce the increase in pension spending, ii) to ensure the long-term financial viability of the pension system through 2060, and iii) to limit the fiscal subsidy to the General Social Insurance Scheme for credited contributions for current and future pensioners and for the non-contributory pension.

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

[4] Excluding extraordinary revenues related to the energy sector

[5] Excluding extraordinary revenues related to the energy sector

- Separate in accounting terms the non-contributory pension benefit from the insurance-based (contributory) pension scheme. The non-contributory part will be tax financed;

- for the General Social Insurance System (GSIS): (i) increase the minimum age for entitlement to an unreduced pension by 6 months per year to be brought in line with the statutory retirement age; (ii) introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral; (iii) introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018; and (iv) gradually (1 year per year) extend the minimum contributory period in the system from the current 10 years to at least 15 years over the period 2013-17;

- for the Government Employee Pension Scheme (GEPS): (i) increase the statutory retirement age by 2 years for the various categories of employees; (ii) increase the minimum age for entitlement to an unreduced pension (by 6 months per year) to be in line with the statutory retirement age; (iii) while preserving acquired rights, introduce an early retirement penalty of 0.5% per month of early retirement so as to make early retirement actuarially neutral; (iv) introduce an automatic adjustment of the statutory retirement age every 5 years in line with changes in life expectancy at the statutory retirement age, to be applied for the first time in 2018; (v) introduce a change of indexation of all benefits from wages to prices; and (vi) pension benefits will be calculated on a pro-rata basis taking into account life-time service as of January 2013;

- ensure that total annual public pension benefits for public sector employees and state officials do not exceed 50% of the annual pensionable salary earned at the time of retirement from the post with the highest pensionable salary of the official's career in the public sector and broader public sector;

- 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; and

- ensure that all of the above measures aimed at the GEPS will apply also to pension schemes in the broader public sector and to pension schemes for hourly-paid public employees.

An actuarial study for the GSIS will be carried out by end of June 2013 to provide additional reform options to ensure the long-run viability of the national pension system. The actuarial study should project the scheme’s finances on a cash basis. Given the financial sustainability focus, on the revenues side, the study should not take into account any government subsidy (i.e. contribution that is currently at 4.3% of the payroll and the return on the accumulated notional reserves as at the start of the projection period) with the exception of credited contributions and the contributions made by the government as an employer on behalf of its employees. On the expenditures side, the study should only take into account benefits related to contributions paid and credited contributions, i.e. excluding the costs related to the top-up for the minimum pension (which is considered to be tax financed). The study should analyse the impact of additional reform options such as benefit reductions (while considering adequacy), an increase in the statutory retirement age and increases in contribution rates or combinations thereof taking into account the impact on labour costs.

After consultation and agreement with programme partners, if needed, a comprehensive reform with the aim of establishing the long-run viability of the system, will be carried out; and, this reform will be adopted by end September 2013 and enter into force on 1 January 2014.

Health care expenditure

3.2. To strengthen the sustainability of the funding structure and the efficiency of public healthcare provision, the following steps will be considered and presented for programme-partner review before their implementation:

- assess and publish before parliamentary discussion the potential risks and benefits of the planned introduction of the National Health System (NHS) in an updated actuarial study, taking into account possible proposals for implementing NHS in stages [Q1-2013];

- make the award of the tender for the IT-infrastructure conditional upon the results of the study and the decision for implementing NHS;

- 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, while leaving the current threshold for beneficiaries class "A" unchanged [Q2-2013];

- 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 increasing fees for using higher levels of care for all patients irrespective of age [Q1-2013];

- set-up a system of family doctors acting as gate-keepers for access to further levels of care, including effective financial disincentives for bypassing family doctors and for using emergency care services in non-urgent situations [Q1-2013];

- create protocols for laboratory tests and the prescription of pharmaceuticals based on thorough scientific evidence, including financial disincentives (co-payment) to minimize the provision of medically unnecessary laboratory test and pharmaceuticals [Q2-2013];

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

- conduct an assessment of the basket of the top 10 publicly reimbursable healthcare products in terms of annual spending to increase cost-effectiveness of the basket of publicly reimbursed products and prepare the implementation of 10 new clinical guidelines focusing on high annual volume and high cost diseases [Q1-2013];

- adopt a restructuring plan for public hospitals improving quality and optimizing costs and redesigning the organisational structure of the hospital management, by putting into practice recommendations from the 2009 "Public Hospital Roadmap" [Q1-2013];

- start coding inpatient cases by the system of diagnosis-related groups (DRGs) with the aim of replacing the current hospital payment system by payments based on DRGs [Q3-2013];

- in a first step, establish non-stop working time in the Health Service, in conjunction with moving the starting time by half an hour (from 7.30 to 8.00) and extending the flexibility period from a half to one hour. With this modification, the weekly working hours of public officers remain unchanged, but are distributed throughout the year as follows: 37 ½ hours per week, 7 ½ hours per day, daily (Monday to Friday): 8.00/9.00 to 15.30/16.30. The same applies for the transitional period of 1.1.2013-31.8.2013 but the starting time remains the same (7:30) and thus the ending time is moved back by half an hour (15:00/16:00). Following a review, in a second step, revise the regular working hours and stand-by shifts of healthcare staff, including rules to increase the mobility of staff; revise current regulations on overtime pay and fully implement existing laws on recording/monitoring overtime payments (see 3.11) [Q1-2014]; and

- define a basket of publicly reimbursable medical services based on objective, verifiable criteria including on cost-effectiveness criteria [Q2-2013].

Budgetary framework

3.3. The authorities will:

- embed the budgetary target for 2013 in a Medium-Term Budgetary Framework (MTBF), which will be adopted accompanying the 2013 Budget Law. This MTBF shall lay down binding expenditure ceilings for the budget years 2013-2015 for each government entity;

- adopt a law transposing Council Directive 2011/85/EU on requirements for budgetary frameworks, and provisions pertaining to the fiscal compact of the Treaty on Stability, Coordination and Governance (TSCG) in accordance with Article 3(2) of the TSCG and on the basis of the Common Principles for national fiscal correction mechanisms laid down in Commission Communication COM(2012)342 [Q1-2013];

- provide for the establishment of a Fiscal Council with a statutory regime, functions, nomination procedures of its governing body and funding arrangements grounded in law [Q1-2013]; and

- complete the adoption of the essential provisions referred to above with implementing texts [Q2-2013].

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 (PPPs)

3.5. The authorities will:

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

- put in place an adequate legal and institutional framework for PPPs designed according to best practices, including ex-ante assessment and monitoring of the fiscal risks of engaging in PPPs and concessions as compared to other public investments. A proposal for such a strengthened legal and institutional framework for PPPs should be drafted [Q2-2013] and implemented [Q4-2013]; and

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

State-Owned Enterprises and privatization

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

- establish an inventory of assets, including real estate, owned by central government, municipalities and regional administrations, 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, including via 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 (see 3.11). The report will assess these companies' business prospects, the potential exposure of the government to the SOEs and the scope for orderly privatisation. The authorities will adopt the necessary legal changes to fulfil 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 the 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. If necessary to restore debt sustainability, the Cyprus authorities will consider a privatisation programme for state-owned and semi-public companies.

Revenue administration, tax compliance, and international tax cooperation

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

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

- attribute personal responsibility to the responsible manager for fraudulent filing of company taxes;

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

- harmonise the legislation among tax types so that not paying taxes is a criminal offense regardless of the type of tax and that there is an administrative appeals process for all of these taxes before going to the courts;

- require all citizens over the age of 18 to secure a taxpayer identification number for purposes of direct taxes. The registration form should request the taxpayer to request the identifier used in other government databases that would indicate income or assets, such as for example, the social security database;

- require pre-payment of at least 50% of the estimated tax obligations in dispute if a person formally appeals a tax assessment, combined with the introduction of administrative resolution processes;

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

- where not in place, establish clear performance objectives, including on revenue collection results, for each revenue administration entity, and improved transparency regarding the performance of revenue administration entities, e.g. via publication of the tax gap for main revenue categories (the difference between the tax owed and the amount actually collected);

- rationalise the revenue administration, e.g. by reinforcing a specialised office for high net worth tax payers, and improving the coordination between the Inland Revenue Department on one side and the Customs & Excise Department and VAT Service on the other side;

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

- enhance the efforts to reduce administrative burden on businesses, with a view to reducing informal activities and achieving voluntary compliance to the widest possible extent. In this respect, systematically measure the time and cost for taxpayers to complete revenue administration procedures such as registration or filing;

- step up administrative tax fraud investigations and enhance cooperation between the tax and judicial systems, while addressing potential bottlenecks in the tax appeal system, e.g. through the strengthening of arbitration procedures;

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

- remove from the income tax law the Director's prerogative to act as deemed necessary in relation to the application of the Law's provisions, including the decision on the withdrawal of lawsuit for unpaid taxes.

In Q1-2013, Cyprus will receive a diagnostic technical assistance mission from the IMF which will conduct a comprehensive assessment of the Inland Revenue Department and the Customs and Excises Department. It will be a high level review across all aspects of tax administration – strategies, organization, processes, and procedures – looking at a range of performance related information. The assessment will include consideration of organizational changes, including the benefits of unified revenue administration organized on functional and taxpayer segment lines.

3.9 The Cypriot authorities will safeguard the timely and effective exchange of information in regard to tax matters, fully ensuring the applicability of laws and standards governing international exchange of tax information. In this respect, the Cypriot authorities will enhance the practice of timely delivery of relevant and accessible tax information to other EU Member States. The Cypriot authorities will fully implement Directive 2011/16/EU on administrative cooperation in the field of taxation by 1 January 2013 and abide by Art 7 of the Directive and Art 10, 19 and 21 of Council Regulation 904/210 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. Moreover, the authorities will implement the recommendations put forward in the in-depth review of Cyprus' legal and regulatory framework under the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes and commit to address any shortcomings to be identified in the forthcoming evaluation of implementation issues.

<u>Immovable Property Tax Reform</u>

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

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

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

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

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

- in order to retain a stimulus to property demand and reduce distortions in property prices, provide for an extension of the reduction in property transaction fees until 2016 [Q1 2013].

In addition, the following studies should be initiated by [early 2013], and their recommendations implemented at the latest from [1 January 2015] onwards:

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

- a further study on the scope of consolidating the collection and administration of the municipal recurrent property tax and sewage tax. The study will also review existing exemptions and derogations from property taxation. It will also report on the scope of shifting revenue from transaction fees and taxes to recurrent taxation [early 2015].

Public administration reform

3.11. The public sector represents a large share of public expenditures in Cyprus. To ensure an efficient use of government resources, while delivering a quality service to the population; the authorities will undertake the following reform measures [Q1-2013]:

- reduce impediments to staff mobility within the public and broader public sector, inter alia, by removing restrictions arising from the Public/Broader public service Laws as to the duration and placement of secondments, as well as the need for employee consent; and

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

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 programme partners [Q4-2012].

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

Part 1:

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

- examination of the possibility of abolishing or merging/ consolidating Non-profit Organisations/ Companies and publicly owned enterprises; and

- re-organisation/ re-structuring of local government.

Part 2:

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

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

The first part of the review will be published [Q4-2013]. The second part of the review will be published [Q2-2014]. Based on the findings of the review, the authorities will agree upon a reform with the programme partners, submit it to the Parliament for approval and implement a reform of the public administration (part 1 by [Q1-2014] and part 2 [Q3-2014]).

Welfare system

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

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

The reforms must be consistent with the fiscal targets defined in this Memorandum of Understanding.

4. Labour market

Key objectives

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

Cost of living adjustment (COLA) of wages and salaries

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

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

As foreseen in section 2.3 of this agreement, the suspension of wage indexation in the wider public sector will remain in place until the end of the programme (end-2015).

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

Minimum wage

4.2. With a view to preventing possible adverse competitiveness and employment effects, the 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 upon consultation and agreement with the programme partners.

Public assistance and activation of the unemployed

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

- present an action plan on activation policies by [Q2-2013];

- ensure that the planned reform of public assistance includes measures aimed at activating benefit recipients by facilitating their reinsertion in the labour market, reducing disincentives to work and imposing job-search requirements for continued benefit receipt;
- submit the draft legislation to programme partners by [Q4-2012] for consultation and agreement; and
- review and enhance the cooperation between the public employment service and the benefit-paying institutions in the activation of the unemployed.

5. Goods and services markets

Key objectives

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

Services Directive: Sector-specific legislation

5.1. The 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 and/or are justified by an overriding reason of public interest. Amendments will be presented to the Parliament [Q1-2013] and minimum tariff requirements without justification will be abolished by [Q2-2013].

Services Directive: Regulated professions

5.2. The authorities will:

- eliminate any existing total bans on the use of a form of commercial communication (advertising) in regulated professions, as required by the Services Directive [Q1-2013]; and
- further improve the functioning of the regulated professions sector (such as lawyers, engineers, architects) by carrying out a comprehensive review of requirements

affecting the exercise of activity and eliminating those that are not justified or proportional. Requirements affecting the access to the activity shall be assessed in order to repeal those which are not justified or proportionate after the adoption of the Directive amending Directive 2005/36/EC on the recognition of professional qualifications and Regulation on administrative cooperation through the Internal Market Information System, and in accordance with the evaluation, methodology and timeframe to be defined in the said amending Directive.

<u>Competition and sectoral regulatory authorities</u>

5.3. The authorities will:

- ensure the independence and enhance the effective functioning of the Commission for the Protection of Competition and its ability to enforce effectively the competition rules [Q4-2013]; and

- ensure the necessary independence and power of the national regulatory authorities (NRA) and enhance their ability to exercise their responsibilities and to carry out effectively their tasks, including monitoring the competitive situation in their respective sector [Q4 -2013].

<u>Housing market and immovable property regulation</u>

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

The authorities will:

- provide for mandatory registration of sales contracts for immovable property by [Q2 2013]. By [Q4-2014], eliminate the title deed issuance backlog to less than 2,000 cases of immovable property sales contracts with title deed issuance pending for more than one year. The authorities will enhance cooperation with the financial sector to ensure the swift clearing of encumbrances on title deeds to be transferred to purchasers of immovable property, and implement guaranteed timeframes for the issuance of building certificates and title deeds;

- publish quarterly progress reviews of the issuance of building and planning permits, certificates, and title deeds, as well as title deed transfers and related mortgage operations throughout the duration of the programme;

- implement electronic access to the registries of title deeds, mortgages, sales contracts and cadastre for the financial sector and government services [Q4-2014]. Personal data privacy legislation shall be reviewed and amended to alleviate legal impediments to such electronic access, in particular concerning the procedures for proof of legal interest [Q2-2013];

- introduce legislation on amending the procedure on the forced sale of mortgaged property to allow for private auctions as under the rules for immovable property recovery under bankruptcy regulations. The authorities shall enact regulations to provide for the conclusion of such private auctions within shortest feasible timespans (see 1.11) [by end 2013]; and

- better target the rules of court to improve the pace of court case handling. The authorities shall assess the need for additional measures – including if necessary legislative reforms - to eliminate court backlogs by end of the programme. Moreover the authorities shall provide for specialized judges akin to the rules for criminal case handling in order to expedite the handling of cases under commercial and immovable property laws [Q2-2013].

Tourism

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

- carry out a study on how to improve the tourism sector business model, in particular, with a view to lengthening the tourist season, increasing occupancy rates of hotels and promoting resident tourism during winter time, developing a multi-dimensional and high quality tourism, *inter alia,* by defining thematic niches such as sport, cultural and medical tourism, developing individual tourism, promoting professionalism of tourist service providers and ensuring the dissemination of best-practices on upgrading the quality of the services provided, improving the role of tourism-related infrastructure investment. The Tourism Strategy for 2011-2015 will be reviewed and, if necessary, revised based on the study's findings [Q1-2013];

- facilitate condo hotel projects with the aim of enhancing access to financing investment in hotel development, including the removal of any legal impediments [Q1-2013]; and

- in order to enhance attractiveness of the country as a destination and hub, engage in a gradual transition to an open skies regime through the conclusion of bilateral and multilateral free access agreements on the basis of reciprocity, in line with EU requirements.

Energy

5.6. The authorities will:

- ensure, without delay, that the Third Energy Package has been completely transposed and fully implemented and notify the European Commission that the necessary legislation has been transposed; indicate the date of delivery of the first commercial supply of natural gas under a long-term supply contract, thereby ending Cyprus' derogation of an isolated energy network and initiating the application of the emergent market derogation; and indicate the intended duration of the latter derogation;

- undertake a study on the financial aspects of the transition towards the exploitation, use and export of natural gas, as a first step in the formulation of a comprehensive development plan for the rearrangement of the Cypriot energy sector. This plan should include the following elements: a projection for the roll-out of the infrastructure, in particular the investments, associated costs and financing sources, which could include revenues from the sale of rights; details on the financing and ownership of the related physical assets; an assessment of any major planning and financing bottlenecks and risks; an estimate of the revenue stream over time, both overall revenues and those falling in the public domain, and the establishment of appropriate governance structures. In addition, the plan should take account of the current uncertainty over the actual size of domestic, offshore, commercially-viable natural gas fields and possible changes in international gas prices and demand, and should be based on alternative world energy scenarios from an internationally reputed organisation. A first outline of this development plan will be submitted to programme partners [Q2-2013];

- provide an outline of the regulatory regime (CERA) and market organisation, which would be conducive to the introduction and proper functioning of open, transparent, competitive energy markets, taking into account the size of the Cypriot economy, the integration of Cyprus' energy system into regional markets, the principle of independent regulatory oversight, and the EU targets for energy efficiency, renewable energy and carbon emission. Specifically, the outline should include the following elements: the potential to set-up wholesale markets for gas and electricity, of which the latter should be open to non-producing traders; the freedom for customers to make an effective choice of supplier; full unbundling of gas suppliers and customers, in particular electricity companies; and a single sales organisation for the off-shore gas supply (for both exports and domestic markets), aimed at maximising revenues [Q3 2013]; and

- prepare and adopt legal steps enabling the establishment of a resource fund, which should receive and manage the public revenues of offshore gas exploitation. In order to ensure transparency, accountability and effectiveness, the resource fund should benefit from a solid legal base and governance structure, drawing on internationally-recognized best practices. In particular, clear rules governing inflows and outflows should be established as part of Cyprus' budgetary framework, giving due respect to the need to develop the hydrocarbon industry, including the necessary infrastructure, the importance of bringing Cyprus' public debt on a steady downward path and the need to invest for future generations. As a first step, the Cypriot authorities should submit its draft legal framework for review by the programme partners taking into account international best practices, as well as a detailed action plan [Q2-2013].