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Proposal for a

COUNCIL DECISION

**addressed to the Republic of Cyprus on specific measures to restore financial stability
and sustainable growth**

EXPLANATORY MEMORANDUM

Cyprus has been under increasing pressure in financial markets, against the background of rising concerns about the sustainability of its public finances, including its weakened financial sector and the scale of potential public support measures. Although some of the imbalances have emerged as a result of negative spill-overs from the euro-area crisis and developments in Greece, others have been domestic and longer-lasting. Amidst consecutive downgradings by credit rating agencies of Cypriot sovereign bonds, the country became unable to refinance itself at rates compatible with long-term fiscal sustainability. In parallel, the banking sector was increasingly cut off from international market funding and major financial institutions recorded substantial capital shortfalls. The situation in the banking sector worsened dramatically in early-2013, due to a drop in confidence leading to continuous and substantial deposit outflows. In March 2013, the Eurogroup reached a political agreement on the key elements of a macroeconomic adjustment programme for Cyprus with a financial envelope of up to EUR 10 billion. Following financial turmoil, a bank holiday of 10 days was imposed, during which the sector was downsized substantially through resolution and restructuring of banks and separation of the Greek operations of Cypriot banks.

Against the background of these severe economic and financial disturbances, the Cypriot authorities officially requested financial assistance in the form of a loan from European Financial Stability Facility / European Stability Mechanism on 25 June 2012, as well as from the International Monetary Fund (IMF), with a view to supporting the return of the economy to sustainable growth, ensuring a properly-functioning banking system, and safeguarding financial stability in the European Union and in the euro area. On 27 June 2012, the Eurogroup invited the Commission, in liaison with the European Central Bank (ECB), the Cypriot authorities and the IMF, to agree on a macroeconomic adjustment programme, including the financing needs, and to take appropriate action to safeguard financial stability. On 16 March and 25 March 2013, the Eurogroup reached a political agreement with the Cypriot authorities on the key elements of a programme, which included the restructuring and substantial downsizing of the banking sector and the reinforcement of efforts on fiscal consolidation, structural reforms and privatisation. An important part of the agreement was that the recapitalisation of banks would be almost exclusively generated from within the banks (i.e. from shareholders and creditors). Deposits up to EUR 100,000 were to remain unaffected. Creditors were not to suffer losses superior to the losses they would have incurred, had the banks been wound up under normal insolvency proceedings. On 2 April 2013, an agreement at technical level was reached in respect of a comprehensive policy package to be implemented in a 3-year macroeconomic adjustment programme; the key objectives, measures and outcomes were laid down in a draft Memorandum of Understanding (MoU) between the Commission and the Republic of Cyprus.

The macroeconomic adjustment programme shall aim at restoring financial market confidence, re-establishing sound macroeconomic balances and enabling the economy to return to sustainable growth. To achieve these goals, the programme builds on three pillars. The first pillar is a financial sector strategy based on restructuring and downsizing of its financial institutions and strengthening its supervision, with efforts to address capital and liquidity shortfalls. The second pillar is an ambitious fiscal consolidation strategy, building on the consolidation efforts initiated in 2012, in particular through measures to reduce current primary expenditure, enhance government revenues, improve the functioning of the public sector and maintain fiscal consolidation in the medium-term. The aim is to correct the excessive general government deficit and put the gross public debt-to-GDP ratio on a firm downward path in the medium term. The authorities are committed to reducing the deficit to below 3% of GDP as soon as possible. The good implementation of Structural and other EU

Funds, as well as EU policy initiatives aimed at enhancing jobs and growth, should be preserved. This will contribute to the long-term growth path for Cyprus. The third pillar consists of an ambitious structural reform agenda, with a view to supporting competitiveness and sustainable and balanced growth, in line with country-specific recommendations addressed to Cyprus in 2012, and allowing for the unwinding of macroeconomic imbalances. Recalling the political agreement of 28 February 2013 on a Council Recommendation on Establishing a Youth Guarantee, opportunities for young people and their employability prospects should be maintained.

The programme covers the period 2013-2016.

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addressed to the Republic of Cyprus on specific measures to restore financial stability and sustainable growth

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 136(1), in conjunction with Article 126(6) thereof,

Having regard to the proposal from the European Commission,

Whereas:

- (1) Article 136(1) of the Treaty on the Functioning of the European Union (TFEU) foresees the possibility of adopting measures specific to Member States whose currency is the euro in order to ensure the proper functioning of economic and monetary union.
- (2) On 13 July 2010, the Council adopted a Decision under Article 126(6) of the TFEU stating that an excessive deficit existed in Cyprus¹ and issued a Recommendation to Cyprus under Article 126(7) of the TFEU with a view to bringing an end to the situation of an excessive government deficit stating that 'Cyprus's authorities should put an end to the present excessive deficit situation as rapidly as possible and at the latest by 2012'.
- (3) In the Recommendation on the National Reform Programme 2012 of Cyprus and delivering an opinion on the Stability Programme for Cyprus, 2012-2015², the Council recommended, inter alia, that Cyprus take action to achieve a durable correction of the excessive deficit in 2012, ensure sufficient progress with the debt reduction benchmark, strengthen regulatory provisions for the efficient recapitalisation of the financial institutions and improve competitiveness.
- (4) Cyprus has been under increasing pressure in financial markets, against the background of rising concerns about the sustainability of its public finances, including the required public support measures to the weakened financial sector. Although some of the imbalances have emerged as a result of negative spill-overs from the euro-area crisis, others have been domestic and longer-lasting.³ Amidst consecutive downgrades by credit rating agencies of Cypriot sovereign bonds, the country became unable to refinance itself at rates compatible with long-term fiscal sustainability. In parallel, the banking sector was increasingly cut off from international market funding and major institutions recorded substantial capital shortfalls.
- (5) In view of these severe economic and financial conditions, the Cypriot authorities officially requested financial assistance under the terms of a loan by the European

¹ OJ L 186, 20.7.2012, p. 30.

² OJ C 219, 24.7.2012, p. 13.

³ as specified in the 2012 In-depth Review for Cyprus and the 2012 country-specific recommendations addressed to Cyprus under the European Semester.

Financial Stability Facility / European Stability Mechanism on 25 June 2012, as well as from the IMF, with a view to supporting the return of the economy to sustainable growth, ensuring a properly-functioning banking system and safeguarding financial stability in the European Union and in the euro area. On 27 June 2012, the Eurogroup invited the Commission, in liaison with the ECB, the Cypriot authorities, and the IMF to agree on a macroeconomic adjustment programme, including the financing needs, and to take appropriate action to safeguard financial stability in the current very challenging environment with a risk of spill-over effects from sovereign market turbulence. On 16 March and 25 March 2013, the Eurogroup reached a political agreement with the Cypriot authorities on the cornerstones of a programme. The banking sector were to be restructured and downsized and efforts were to be stepped-up on fiscal consolidation, structural reforms and privatisation. Recapitalisation of banks were to be almost exclusively generated from within the banks (i.e. from shareholders and creditors).

- (6) In the current circumstances Cyprus should adopt a comprehensive policy package to be implemented in a 3-year macroeconomic adjustment programme over a period from 2013-Q2 to 2016-Q1.
- (7) The policy package should aim at restoring financial market confidence, re-establishing sound macroeconomic balances and enabling the economy to return to sustainable growth. It should be structured on three pillars. The first pillar should be a financial sector strategy based on restructuring and downsizing financial institutions and strengthening supervision of the sector, with efforts to address capital and liquidity shortfalls. The second pillar should be an ambitious front-loaded fiscal consolidation strategy in particular through measures to reduce current primary expenditure, enhance government revenues, improve the functioning of the public sector and maintain fiscal consolidation in the medium-term, while minimising the impact on disadvantaged people and preserving the good implementation of Structural and other EU Funds. The third pillar should consist of an ambitious structural reform agenda, with a view to supporting competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system, in consultation with social partners, and removing obstacles to the smooth functioning of markets. Recalling the political agreement of 28 February 2013 on a Council Recommendation on Establishing a Youth Guarantee, opportunities for young people and their employability prospects should be maintained.
- (8) Under the Commission's updated forecast for nominal GDP growth (-0.5% in 2012, -8.2% in 2013, -2.9% in 2014, 2.6% in 2015 and 3.7% in 2016), the debt-to-GDP ratio would amount to 87% in 2012, 109% in 2013, 123% in 2014, 126% in 2015 and 122% in 2016. The debt-to-GDP ratio would therefore increase rapidly until 2015 and move to a declining path thereafter, reaching an estimated 105% in 2020. Debt dynamics are affected by several below-the-line operations. Under the Commission's updated forecast for nominal GDP growth, the primary general government balance is projected to attain a deficit of EUR 395 million (2.4% of GDP) in 2013, a deficit of EUR 678 million (4.3% of GDP) in 2014, a deficit of EUR 344 million (2.1% of GDP) in 2015 and a surplus of EUR 204 million (1.2% of GDP) in 2016.
- (9) Increasing the long-term resilience of the Cypriot banking sector is critical to restoring financial stability in Cyprus and - given the strong interlinkages - preserving financial stability in the euro area as a whole. Substantial downsizing and restructuring of the Cypriot banking sector is under way. The House of Representatives adopted

legislation establishing a comprehensive framework for the recovery and resolution of credit institutions. Using this new framework, the Cypriot banking sector has been downsized immediately and significantly. To preserve the liquidity of the Cypriot banking sector, temporary administrative measures have been imposed.

- (10) The implementation of comprehensive and ambitious reforms in financial, fiscal and structural areas should safeguard the medium-term sustainability of the Cypriot public debt.
- (11) The Commission, in liaison with the ECB, and if relevant the IMF, should verify at regular intervals the rigorous implementation of the macroeconomic adjustment programme through missions and regular reporting by the Cypriot authorities, on a quarterly basis.
- (12) Throughout the implementation of the policy package, the Commission should provide additional policy advice and technical assistance in specific areas.
- (13) The Cypriot authorities should involve, in accordance with current national rules and practices, the social partners and civil society organisations in the preparation, implementation, monitoring and evaluation of the financial assistance programme.
- (14) Any form of financial assistance received to help implementing the policies under the macroeconomic adjustment programme must be in line with European Union legal requirements and policies, in particular with the Union economic governance framework. Any intervention in support of financial institutions must be carried out in accordance with the European Union's rules on competition. The Commission will ensure that any measures laid down in a Memorandum of Understanding in the context of requested ESM financial assistance is fully consistent with the present decision.

HAS ADOPTED THIS DECISION:

Article 1

1. In order to facilitate the return of the Cypriot economy to a path of sustainable growth and to fiscal and financial stability, Cyprus shall rigorously implement a macroeconomic adjustment programme, the main elements of which are laid down in Article 2 of this decision. The macroeconomic adjustment programme (hereafter the "programme") shall address the specific risks emanating from Cyprus for the financial stability of the euro area and shall aim at rapidly re-establishing a sound and sustainable economic and financial situation in Cyprus and restore its capacity to finance itself fully on the financial markets. The programme shall take due account of the recommendations addressed to Cyprus under Articles 121, 126, 136 and 148 TFEU as well as its actions to comply with them, while aiming at broadening, strengthening and deepening the required policy measures.
2. The Commission, in liaison with the ECB, and if relevant the IMF, shall monitor the progress made in the implementation of the programme. Cyprus shall give the Commission and the ECB its full cooperation. It shall in particular provide to the Commission and the ECB all the information that they deem necessary for the monitoring of the programme.
3. The Commission, in liaison with the ECB and, where appropriate, with the IMF, shall examine with the Cypriot authorities any changes and updates to the programme that may be needed in order to take proper account of, inter alia, any significant gap between macroeconomic and fiscal forecasts and realised figures

(including employment), negative spill-over effects, as well as macroeconomic and financial shocks. In order to ensure the smooth implementation of the programme and to help the correction of imbalances in a sustainable way, the Commission shall provide continued advice and guidance on fiscal, financial market and structural reforms. The Commission shall periodically assess the economic impact of the programme and shall recommend necessary corrections with a view to enhancing growth and job creation, securing the necessary fiscal consolidation, and minimising harmful social impacts.

Article 2

1. The key objectives of the Cypriot programme are: the restoration of the soundness of the Cypriot banking sector; the continuation of the on-going process of fiscal consolidation; and the implementation of structural reforms to support competitiveness and sustainable and balanced growth.
2. Cyprus shall pursue fiscal consolidation consistent with its obligations under the excessive deficit procedure by means of high-quality permanent measures while minimising the impact on disadvantaged people.
3. Cyprus shall adopt the measures specified in paragraphs 4 to 15.
4. In order to reduce the deficit to below 3% of GDP as soon as possible, Cyprus shall stand ready to take additional consolidation measures. Specifically, in the event of underperformance of revenues or higher social spending needs due to adverse macroeconomic effects, the government shall stand ready to take additional measures to preserve the programme's objectives, including by reducing discretionary spending, while minimising the impact on disadvantaged people. Over the programme period, cash revenues above the programme projections, including any windfall gains, shall be saved or used to reduce debt. If instead over-performance materialises, to the extent that it is deemed permanent, this can reduce the need for additional measures in the outer years.
5. Cyprus shall preserve the good implementation of Structural and other EU Funds.
6. With a view to restoring the soundness of the financial sector, Cyprus shall continue to thoroughly reform and restructure the banking sector and reinforce viable banks by restoring their capital, addressing their liquidity situation and strengthening their supervision. The programme shall foresee the following measures and outcomes:
 - (a) ensuring that the liquidity situation of the banking sector will be closely monitored and appropriate measures to maintain sufficient liquidity in the system in line with Eurosystem rules will be taken. The recently-imposed temporary restrictions on the free movement of capital (inter alia, limits on cash withdrawals, electronic payments and transfers abroad) will be closely monitored. The goal is that controls will remain in place no longer than strictly necessary to prevent serious and immediate risks for financial stability. The medium-term funding and capital plans of domestic banks relying on central bank funding or receiving state aid 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 regulations on the minimum liquidity requirements will be updated to prevent concentration in euro-denominated assets in the future;

- (b) establishing an independent valuation of the assets of Bank of Cyprus and Cyprus Popular Bank and quickly intergrating the operations of Cyprus Popular Bank into Bank of Cyprus. The valuation shall be completed quickly so as to enable the unfreezing of the relevant parts of the uninsured deposits at the Bank of Cyprus;
- (c) adopting the necessary regulatory requirements regarding an increase in the minimum core tier 1 capital adequacy ratio to 9% by end of 2013;
- (d) taking steps to minimise the cost to the taxpayers of bank restructuring. Undercapitalised commercial and cooperative credit institutions shall raise, to the largest extent possible, capital from private sources, including but not limited to bank shareholders and creditors, before state-aid measures are granted. Any restructuring or resolution plans shall be formally approved under state-aid rules, before such state aid is provided;
- (e) ensuring that a credit register is created, that the current regulatory framework on loan processes is reviewed and amended, if necessary, and that legislation strengthening the governance of commercial banks is adopted;
- (f) strengthening banks' governance, including by prohibiting lending to independent board members or their connected parties;
- (g) maximising recovery for non-performing loans, while minimising incentives for strategic default by borrowers. This will include easing constraints on the seizure of collateral and proper monitoring and managing of non-performing loans. The Central Bank of Cyprus will issue guidance to classify as non-performing all loans past due by more than 90 days;
- (h) aligning the regulation and supervision of cooperative credit institutions to those of commercial banks;
- (i) ascertaining the viability of cooperative credit institutions and developing, in consultation with the Commission and informing the ECB and the IMF, a strategy for the future structure, functioning and viability of the cooperative credit institution sector. The implementation of the strategy should be completed by mid-2015;
- (j) augmenting the monitoring of the indebtedness of the corporate and household sectors and establishing a framework for targeted private sector restructuring; and
- (k) further enhancing the anti-money laundering framework and ensuring full entity transparency, in line with best practice.

7. Over 2013, the authorities shall rigorously implement the 2013 Budget Law with additional permanent measures of at least EUR 351 million (2.1% of GDP). Cyprus shall amend the 2013 Budget Law to include the additional consolidation measures. Cyprus shall adopt the following measures:

- (a) On the expenditure side, the budget shall include the reduction of expenditure on housing schemes by at least EUR 36 million and a further scaled reduction of public sector wages, the streamlining of certain social benefits;
- (b) On the revenue side, the additional measures shall include increases in property taxes, the statutory corporate income tax rate, the tax rate on interest income, the bank levy, and in the fees for public services;

- (c) Cyprus shall reform the tax system for motor vehicles, based on environmentally-friendly principles and with a view to raising additional revenues;
- (d) Cyprus shall introduce measures to control healthcare expenditure and improve cost efficiency in the healthcare sector by enhancing public hospitals' efficiency, competitiveness and cost-effectiveness. In addition, Cyprus shall introduce a co-payment system for a limited number of medical services and pharmaceuticals; and
- (e) Cyprus shall ensure full implementation of consolidation measures adopted since December 2012.

8. The following measures shall apply as of 1 January 2014:

- (a) On the expenditure side, the budget shall include: a reduction in total outlays for social transfers through better targeting to yield at least EUR 28.5 million; a further reduction in the public and broader public sector wages; the introduction of a fee on public transportation card for students and pensioners; and structural reform measures in the educational sector to reduce wage expenditure; and
- (b) On the revenue side, the budget for 2014 shall include: an extension of the temporary contribution on gross earnings of public and private sector employees up to 31 December 2016; increases in the VAT; increases in excise duties; and an increase in the contributions to General Social Insurance Scheme.

9. In order to ensure the long-term sustainability of public finances, Cyprus shall implement fiscal-structural reforms, comprising, inter alia, the following measures and outcomes:

- (a) reforms of the general and public sector pension system in order to put the pension system on a sustainable path, while addressing the adequacy of pensions. If necessary, reforms will be further reinforced;
- (b) control the growth of health expenditure in order to strengthen the sustainability of the funding structure and the efficiency of public healthcare provision;
- (c) an improvement in the efficiency of public spending and the budgetary process by means of an effective medium-term budgetary framework as part of an improved public finance management, fully compliant with the Directive on requirements for budgetary frameworks and the Treaty on Stability, Coordination and Governance (TSCG);
- (d) adoption of an adequate legal and institutional framework for Public Private Partnerships designed according to best practices;
- (e) elaboration of a programme to achieve a solid corporate governance system for state-owned and semi-public enterprises and initiation of a privatisation plan to help improve economic efficiency and restore debt sustainability;
- (f) elaboration and implementation of a comprehensive reform plan to improve the effectiveness and efficiency of tax collection and administration, including measures to safeguard the full and timely applicability of laws and standards governing international tax cooperation and the exchange of tax information;

- (g) reform of the immovable property tax;
 - (h) reform of the public administration to improve its functioning and cost-effectiveness, notably by reviewing the size, employment conditions and functional organisation of public service in order to ensure an efficient use of government resources and a quality service provision to the population; and
 - (i) reforms of the overall structure and the levels of welfare benefits, with the aim of producing an efficient use of resources and ensuring an appropriate balance between welfare assistance and incentives to take up work.
10. Cyprus shall implement a reform of the system of wage indexation, after consultation with the social partners, and consistent with the objectives of improving the economy's competitiveness and reflecting developments in labour productivity. 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. Any change in the minimum wage shall be in line with the economic and labour market developments, and after consultation with the social partners.
11. Cyprus shall adopt the remaining necessary amendments to sector specific legislation in order to fully implement the Services Directive. Unjustified obstacles in services markets, in particular in relation to regulated professions shall be eliminated. The competition framework shall be improved by enhancing the functioning of the competent competition authority and by reinforcing the independence and powers of the national regulatory authorities.
12. Cyprus shall reduce to less than 2000 the title deed issuance backlog by end of 2014 and shall implement guaranteed timeframes for the issuance of building certificates and title deeds.
13. Cyprus shall amend the forced sale of mortgaged property and allow for private auctions within the shortest feasible timespans by the end of 2013. The pace of court case handling shall be improved and court backlogs shall be eliminated by the end of the programme.
14. Cyprus shall take initiatives to strengthen the competitiveness of the tourism sector. These initiatives shall include a review of the Tourism Strategy for 2011-2015, based on a study on how to improve the tourism sector business model, and a thorough analysis of the best means of achieving sufficient air connectivity for Cyprus.
15. In the energy sector, Cyprus shall transpose and fully implement the Third Energy Package. In addition, a comprehensive development plan for the rearrangement of the Cypriot energy sector shall be formulated. The plan shall encompass:
- (a) a roll-out plan for the infrastructure required for the exploitation of gas;
 - (b) an outline of the regulatory regime and market organisation for the energy sector and gas exports; and
 - (c) a plan to establish the institutional framework for the management of hydrocarbon resources, including a resource fund, which should receive and manage the public revenues from offshore gas exploitation and which is set up based on internationally-recognized best practices.

Article 3

This Decision is addressed to the Republic of Cyprus.

Article 4

This Decision shall be published in the *Official Journal of the European Union*.

Done at Brussels,

*For the Council
The President*