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PROPOSAL

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Delegations will find attached a proposal from the Commission, submitted under a covering letter from Mr Jordi AYET PUIGARNAU, Director, to Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union.

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Brussels, 26.8.2013
COM(2013) 602 final

2013/0290 (NLE)

Proposal for a

COUNCIL IMPLEMENTING DECISION

**on approving the macroeconomic adjustment programme for Cyprus and repealing
Council Decision 2013/236/EU**

EXPLANATORY MEMORANDUM

On 25 June 2012 Cyprus submitted a request for financial assistance from the European Stability Mechanism (ESM). On 25 April 2013 the Council decided (Council Decision 2013/236/EU) that Cyprus shall rigorously implement a macroeconomic adjustment programme, which shall address the specific risks emanating from Cyprus for the financial stability of the euro area and shall aim to rapidly re-establish a sound and sustainable economic and financial situation in Cyprus.

On 24 April 2013 the ESM Board of Governors decided to grant, in principle, stability support to Cyprus and approved the Memorandum of Understanding on Specific Economic Policy Conditionality (hereinafter referred to as the "MoU") and its signing by the Commission on behalf of the ESM. On 8 May 2013 the ESM Board of Directors approved the financial assistance facility agreement.

The macroeconomic adjustment programme aims 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 by 2016. 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 Council Recommendation of 22 April 2013 on establishing a Youth Guarantee¹, opportunities for young people and their employability prospects should be enhanced.

The 3-year programme covers the period from mid-2013 to mid-2016.

In line with Article 1(2) of Decision 2013/236/EU, the Commission, in liaison with the ECB, and, where appropriate, with the IMF, has conducted the first review to assess the progress on the implementation of the agreed measures as well as their effectiveness and economic and social impact. As a result the MoU has been updated in the areas of financial sector reform, fiscal policy and structural reforms. For the financial sector, the revised MoU includes agreement on publishing a roadmap for the gradual relaxation of capital controls, based on milestones and consistent with the banks' liquidity situation. Moreover, the revised MoU requires establishing the legal framework for a new governance structure to manage the stake of the State in the cooperative credit sector. Finally, an action plan on customer due diligence and entity transparency has been agreed as part of Cyprus' anti-money laundering efforts. With regard to fiscal policy, the revised MoU contains a commitment to adopt a compensation

¹ OJ C 120, 26.4.2013, p. 1.

scheme for provident fund and retirement funds in the Cyprus Popular Bank, which should ensure comparable treatment with such funds in the Bank of Cyprus. Also, it is established that in order to ensure the effective implementation of EU funds, the Cypriot authorities should ensure that the necessary national funds remain available to cover national contributions. Finally, in line with Regulation (EU) No 472/2013, the revised MoU requires Cyprus to submit a request for technical assistance for the programme period and undertake a comprehensive audit of its public finances. In the area of structural reforms, the revised MoU details the planned reform of public assistance, which should ensure that social assistance serves as a safety net to ensure a minimum income for those unable to support the basic standard of living, while safeguarding incentives to take up work. Moreover, it is required that Cyprus prepares detailed policy proposals with regard to addressing shortcomings in its activation policies and that Cyprus takes swift action to create opportunities for young people and improve their employability prospects, in line with the objectives of the Council Recommendation on Establishing a Youth Guarantee.

Following the entry into force of Regulation (EU) No 472/2013, the macroeconomic adjustment programme is now to be adopted in the form of a Council implementing decision. For reasons of legal clarity and certainty, the Commission therefore proposes to readopt the programme on the basis of Article 7(2) of Regulation (EU) No 472/2013. The substance of the programme is in essence identical to the one approved by Council Decision 2013/236/EU, but also incorporates the results of the review carried out in accordance with Article 1(2) of Decision 2013/236/EU. At the same time, it is proposed to repeal Council Decision 2013/236/EU.

The proposed decision will ensure full consistency between the Union multilateral surveillance framework established by the TFEU and the policy conditionality underpinning the economic adjustment programme. Notably, Article 10 of Regulation (EU) No 472/2013 provides for consistency in reporting and monitoring obligations.

Proposal for a

COUNCIL IMPLEMENTING DECISION

**on approving the macroeconomic adjustment programme for Cyprus and repealing
Council Decision 2013/236/EU**

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability, and in particular Article 7(2) and (5) thereof,

Having regard to the proposal from the European Commission,

Whereas:

- (1) Regulation (EU) No 472/2013 applies to Member States already in receipt of financial assistance, including those from the ESM, at the time of its entry into force.
- (2) Regulation (EU) No 472/2013 sets the rules for the approval of macroeconomic adjustment programme for Member States in receipt of financial assistance, which need to be consistent with the provisions of the Treaty of Establishing the European Stability Mechanism (ESM).
- (3) Upon a request of 25 June 2012 by Cyprus for financial assistance from the European Stability Mechanism (ESM), the Council decided on 25 April 2013 (Council Decision 2013/236/EU) that Cyprus shall rigorously implement a macroeconomic adjustment programme.
- (4) On 24 April 2013 the ESM Board of Governors decided to grant, in principle, stability support to Cyprus and approved the Memorandum of Understanding on Specific Economic Policy Conditionality (hereinafter referred to as the "MoU") and its signing by the Commission on behalf of the ESM.
- (5) In line with Article 1(2) of Council Decision 2013/236/EU, the Commission, in liaison with the ECB, and, where appropriate, with the IMF, has conducted the first review to assess the progress with the implementation of the agreed measures as well as their effectiveness and economic and social impact. As a consequence of this review, an update was made to the existing macro-economic adjustment programme, reflecting the steps taken by the Cypriot authorities by the second quarter of 2013.

- (6) Following the entry into force of Regulation (EU) No 472/2013, the macroeconomic adjustment programme is now to be adopted in the form of a Council implementing decision. For reasons of legal clarity and certainty, the programme should be readopted on the basis of Article 7(2) of Regulation (EU) No 472/2013. The substance of the programme should remain identical to the one approved by Council Decision 2013/236/EU, but also incorporate the results of the review carried out in accordance with Article 1(2) of Decision 2013/236/EU. At the same time, Council Decision 2013/236/EU should be repealed.
- (7) The Commission, in liaison with the ECB and the IMF, has conducted the first review to assess the progress on the implementation of the agreed measures as well as their effectiveness and economic and social impact. As a result, the MoU has been updated in the areas of financial sector reform, fiscal policy and structural reforms, notably with regard to (i) a roadmap for the gradual relaxation of capital controls, (ii) establishing the legal framework for a new governance structure to manage the stake of the State in the cooperative credit sector, (iii) an anti-money laundering action plan, (iv) a compensation scheme for provident fund and retirement funds in the Cyprus Popular Bank, (v) ensuring that the necessary national funds remain available to cover national contributions for projects funded by the Structural and other EU funds, (vi) providing details of the planned reform of public assistance, and (vii) preparing detailed policy proposals for activation policies and taking swift action to create opportunities for young people and improve their employability prospects. The implementation of comprehensive and ambitious reforms in financial, fiscal and structural areas should safeguard the medium-term sustainability of the Cypriot public debt.
- (8) Throughout the implementation of Cyprus' comprehensive policy package, the Commission should provide additional policy advice and technical assistance in specific areas. A Member State subject to a macroeconomic adjustment programme experiencing insufficient administrative capacity shall seek technical assistance from the Commission, which may constitute, for that purpose, groups of experts.
- (9) The Cypriot authorities shall seek the view, in accordance with current national rules and practises, of social partners and civil society organisations in the preparation, implementation, monitoring and evaluation of the macroeconomic adjustment programme,

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 "programme"), the main elements of which are laid down in Article 2 of this Decision. The programme shall address the specific risks emanating from Cyprus for the financial stability of the euro area and shall aim to rapidly re-establish a sound and sustainable economic and financial situation in Cyprus and restore its capacity to finance itself fully on the international financial markets. The programme shall take due account of the Council recommendations addressed to Cyprus under Articles 121, 126, 136 and 148 TFEU

as well as Cyprus' actions to comply with them, while aiming to broaden, strengthen and deepen the policy measures required.

2. The Commission, in liaison with the ECB and, where appropriate, with the IMF, shall monitor Cyprus' progress in implementing its programme. Cyprus shall give the Commission and the ECB its full cooperation. It shall, in particular, provide them with all the information that they deem necessary for the monitoring of the programme. The Cypriot authorities shall consult ex-ante with the Commission, the ECB and the IMF on the adoption of policies that are not included in this Implementing Decision but that could have a material impact on the achievement of programme objectives.
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 ensure the provision of continued advice and guidance on fiscal, financial market and structural reforms.

The Commission shall at regular intervals 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. In this context, the macroeconomic adjustment programme, including its objectives and the expected distribution of the adjustment effort, shall be made public.

Article 2

1. The key objectives of the programme shall be: to restore the soundness of the Cypriot banking sector; to continue the on-going process of fiscal consolidation; and to implement 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 vulnerable groups.
3. In order to bring its deficit below 3% of GDP by 2016, Cyprus shall stand ready to take additional consolidation measures. Specifically, in the event of underperformance of revenue or higher social spending needs due to adverse macroeconomic effects, the Cypriot Government shall stand ready to take additional measures to preserve the programme's objectives, including by reducing discretionary spending, while minimising the impact on vulnerable groups. Over the programme period, cash revenue above the programme projections, including any windfall gains, shall be saved or used to reduce debt. Conversely, over-performance,

to the extent that it is deemed permanent, can reduce the need for additional measures in the outer years.

4. Cyprus shall preserve the good implementation of Structural and other EU Funds, in respect of the programme's budgetary targets. In order to ensure the effective implementation of EU funds, the Government will ensure that the necessary national funds remain available to cover national contributions, including non-eligible expenditure, under the European Structural and Investment Funds (ERDF, ESF, Cohesion Fund, EAFRD and EFF/EMFF) in the framework of the 2007-2013 and 2014-20 programming periods, while taking into account available EIB funding. The authorities shall ensure that the institutional capacity to implement current and future programmes is improved and the appropriate human resources of Managing Authorities and implementing bodies are available.
5. With a view to restoring the soundness of its 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 provide for the following measures and outcomes:
 - (a) ensuring that the liquidity situation of the banking sector shall be closely monitored. The temporary restrictions on the free movement of capital (inter alia, limits on cash withdrawals, payments and transfers) shall be closely monitored. The goal is that controls shall remain in place only for as long as is strictly necessary to mitigate serious risks for the stability of the financial system. A roadmap for the controls' gradual relaxation has been published, based on milestones and progress with the programme implementation and consistent with the banks' liquidity situation. 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 shall be updated to prevent excessive issuer concentration in the future;
 - (b) adopting the necessary regulatory requirements regarding an increase in the minimum core Tier 1 capital adequacy ratio to 9% by the end of 2013;
 - (c) taking steps to minimise the cost to taxpayers of bank restructuring. Undercapitalised commercial and cooperative credit institutions shall raise, to the largest extent possible, capital from private sources before State aid measures are granted. Any restructuring plans shall be formally approved under State aid rules, before such State aid is provided. Commercial banks with a capital shortfall may, if other measures do not suffice, ask for recapitalisation aid from the State in line with State aid procedures;
 - (d) ensuring that a credit register is created, that the current regulatory framework on loan origination and management processes is reviewed and amended, if necessary, and that legislation strengthening the governance of commercial banks is adopted;

- (e) strengthening banks' governance, including by prohibiting lending to independent board members or their connected parties;
 - (f) maximising recovery for non-performing loans, while minimising incentives for strategic default by borrowers. This shall include easing constraints on the seizure of collateral and proper monitoring and managing of non-performing loans;
 - (g) completing the harmonisation of the regulation and supervision of cooperative credit institutions with those of commercial banks;
 - (h) implementing the strategy for the future structure, functioning and viability of the cooperative credit institution sector, as designed by the Central Bank of Cyprus in consultation with the Commission, the ECB and the IMF;
 - (i) enhancing the monitoring of the indebtedness of the corporate and household sectors and establishing a framework for targeted private sector debt restructuring to facilitate new lending and diminish credit constraints;
 - (j) further strengthening the anti-money laundering framework and implementing an action plan ensuring the implementation of improved practices with regard to customer due diligence and entity transparency, in line with best practice;
 - (k) submitting legislation for mandatory supervision based on capitalisation levels;
 - (l) integrating stress-testing into regular off-site bank supervision;
 - (m) introducing mandatory disclosure requirements to ensure that banks regularly communicate to markets progress in restructuring their operations; and
 - (n) establishing the legal framework for a new governance structure to manage the stake of the State in the cooperative credit sector.
6. Over 2013, the Cypriot authorities shall rigorously implement the 2013 Budget Law (as amended), including the additional permanent measures adopted prior to the granting of the first disbursement of financial assistance, which should amount to at least EUR 351 million (2.1% of GDP). Cyprus shall adopt the following measures:
- (a) a reform of its tax system for motor vehicles, based on environmentally-friendly principles and with a view to raising additional revenue in the medium term; and
 - (b) a compensation scheme for provident and retirement funds in Cyprus Popular Bank, which should ensure comparable treatment with such funds in the Bank of Cyprus, should take into account the cash-flow and actuarial position of each fund and should minimise the impact on the general government deficit. Given the social welfare nature of such funds, the 2013 general government deficit target may be revised to incorporate the budgetary impact of this scheme;
 - (c) full implementation of the consolidation measures adopted since December 2012.

7. The following measures shall be applied by Cyprus 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; a further reduction in the public and broader public sector wages and overtime compensation; the introduction of a fee on public transport cards for students and pensioners; and structural reform measures in the educational sector to improve the use of resources; 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 VAT; increases in excise duties; and an increase in the contributions to the General Social Insurance Scheme.
8. 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) if necessary, further reforms of the general and public sector pension system to ensure the long-run viability of the pension system, while addressing the adequacy of pensions. Reform options shall be provided by an actuarial study;
 - (b) control of the growth of health expenditure in order to ensure sufficient means for fundamental health care by strengthening the sustainability of the funding structure and the efficiency of public healthcare provision; implement a National Health System, ensuring its financial sustainability while providing universal coverage;
 - (c) 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, hereby contributing to the budgetary consolidation efforts taking into account the need to ensure sufficient means for fundamental policies, such as education and health care. This framework shall be fully compliant with the Council Directive of 8 November 2011 on requirements for budgetary frameworks of the Member States² and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, signed in Brussels on 2 March 2012;
 - (d) adoption of an adequate legal and institutional framework for Public Private Partnerships designed according to best practice;
 - (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 fight against tax fraud and evasion and safeguard the full and timely application of laws and standards governing international tax cooperation and the exchange of tax information;

² OJ L 306, 23.11.2011, p. 41.

- (g) reform of the immovable property tax regime;
 - (h) reform of the public administration to improve its functioning and cost-effectiveness, in particular by reviewing the size, employment conditions and functional organisation of the public service in order to ensure the efficient use of government resources and the provision of a quality service to the population;
 - (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. The planned reform of public assistance shall ensure that social assistance serves as a safety net to ensure a minimum income for those unable to support the basic standard of living, while safeguarding incentives to take up work; and
 - (j) undertaking a comprehensive audit of its public finances in order, inter alia, to assess the reasons that led to the building up of excessive levels of debt.
9. Cyprus shall ensure that the suspension of wage indexation in the wider public sector remains in place until the end of the programme. Any change in the minimum wage shall be in line with the economic and labour market developments, and shall be adopted after consultation with the social partners.
10. Cyprus shall prepare detailed policy proposals with regard to addressing identified shortcomings in its activation policies. Cyprus shall take swift action to create opportunities for young people and improve their employability prospects, in line with the objectives of the Council Recommendation on Establishing a Youth Guarantee. The design, management and implementation of the measures targeted to youth shall be well integrated within the broader system of activation policies and be coherent with the reform of the social welfare system and the agreed budgetary targets.
11. Cyprus shall adopt any remaining necessary amendments to sector-specific legislation required in order to fully implement Directive 2006/123/EC of the European Parliament and of the Council on services in the internal market³. Unjustified obstacles in the 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 ensure a reduction in the title deed issuance backlog, shall take action to accelerate the swift clearing of encumbrances on title deeds to be transferred to purchases of immovable property, and shall implement guaranteed timeframes for the issuance of building certificates and title deeds.
13. Cyprus shall amend the rules on the forced sale of mortgaged property and shall allow for private auctions within the shortest feasible timespan. The pace of court case handling shall be improved and court backlogs shall be eliminated by the end of the programme. Cyprus shall take initiatives to strengthen the competitiveness of its tourism sector, by providing a concrete action plan leading to the implementation of

³ OJ L 376, 27.12.2006, p. 36.

the quantified targets identified, inter alia in the recently revised Tourism Strategy for 2011-2015. Cyprus shall report on air connectivity needs as the basis for an aeropolitical strategy.

14. In the energy sector, Cyprus shall fully implement the Third Energy Package, notwithstanding Article 44.2 of the Electricity Directive and Article 49.1 of the Gas Directive. Cyprus shall consider whether to make use of the derogations provided to it in the aforementioned articles. In parallel, a comprehensive development plan for the rearrangement of the Cypriot energy sector shall be formulated. That plan shall encompass:
 - (a) a roll-out plan for the infrastructure required for the exploitation of gas, taking into account commercial options and risks;
 - (b) a comprehensive outline of the regulatory regime and market organisation for the restructured energy sector and gas exports, including for a licensing and tax regime that maximises revenues; and
 - (c) a plan to establish the institutional framework for the management of hydrocarbon resources, including a resource fund, which should receive and manage public revenue from offshore gas exploitation and which is set up on the basis of internationally-recognised best practice.
15. Cyprus shall submit a request to the European Commission for technical assistance during the programme period. The request shall identify and specify the areas of technical assistance or advisory services which the Cypriot authorities consider essential for the implementation of its macroeconomic adjustment programme.

Article 3

Council Decision 2013/236/EU is repealed.

Article 4

This Decision is addressed to the Republic of Cyprus.

Done at Brussels,

*For the Council
The President*