

1. Financial sector regulation and supervision

Objectives

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

Maintaining liquidity in the banking sector

1.1. As bank liquidity remains under pressure; banks are encouraged to strengthen their collateral buffers in a sustainable manner: the Central Bank of Cyprus, in consultation with the ECB, will continue to closely monitor the liquidity situation of the banking sector and stand ready to take appropriate measures to maintain sufficient liquidity in the system.

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

Contains sensitive information, not for further distribution

Central Bank, while avoiding asset fire sales and a credit crunch. The reporting template will be provided by the Central Bank of Cyprus.

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

Restoring adequate capital buffers

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

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

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

1.7. 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. The contingent convertible bonds issued in the past by the banks, which allow for conversion into shares in case of breach of regulatory capital requirements, will be converted before state aid can be granted. For the banks that have benefitted from state aid already, such conversions will be required as prior action. Furthermore, the authorities will enforce a write-down or conversion of any other outstanding Tier I and Tier II instruments into equity for the purpose of protecting the public interest in financial stability.

1.8. Credit institutions deemed viable based on their restructuring plans can, if other measures do not suffice, ask for recapitalisation aid from the State. The authorities will immediately liaise with the European Commission to ensure timely delivery of the restructuring plans drawn up in compliance with EU state-aid rules. The terms and remuneration of the state aid will comply with the burden sharing requirements laid down in the EU state-aid rules, which aim at ensuring sufficient remuneration for the State and avoiding the subsidisation of existing shareholders. The credit institutions benefiting from

Contains sensitive information, not for further distribution

capital injections will be subject to specific management rules and restrictions, and to a restructuring process in line with EU competition and state-aid requirements. Banks that have already received recapitalisation aid from the State will not be eligible for additional recapitalisation aid nor will they be allowed to transfer assets to the asset management company (see below) before their restructuring plans have been formally approved under state-aid rules. Banks that are deemed non viable will be subject to the new resolution framework outlined below.

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

Due diligence

1.10. The Cypriot authorities will conduct an accounting and economic value assessment (due diligence review) of the credit portfolios of Bank of Cyprus, Cyprus Popular Bank, Hellenic Bank and a representative sample representing the xx largest [or xx percent of assets of] cooperative credit institutions, as well as Alpha Bank Cyprus, and Eurobank Cyprus in order to inform their home authority. The assessment will include the Greek operations of the banks, notably the branches of Bank of Cyprus, Cyprus Popular Bank and Hellenic Bank. The aim of the assessment is to cover about 75% of assets of the consolidated Cypriot banking system (both domestically and foreign-incorporated). The assessment will be conducted by an external consultant who will have direct and full access to all information from the banks.

1.11. The due diligence review will be overseen by a Steering Committee and guided by Terms of Reference to be agreed upon in the Steering Committee. The Steering Committee will comprise representatives of the Cypriot authorities, the EC, the ECB, the EBA and the IMF. By [x August 2012], the consultant will have started the process of due diligence. The Steering Committee will examine the preliminary results of the exercise by [31 October 2012] and the final results will be available on [30 November 2012].

1.12. The due diligence review will include a general ledger verification: (i) data quality analysis, including an appropriate identification of restructured/refinanced loans and lending to connected parties; (ii) verification of the proper classification of credits and verification of liabilities; and (iii) review of the calculation of impairment losses, including a computation of the impact of an increase in provisioning requirements for both performing and non-performing loans.

Contains sensitive information, not for further distribution

1.13. The assessment of the economic value of the assets will include the appropriateness of loan origination, classification and arrears management to check and adjust the current classification and risk parameters. The information obtained from the due diligence review will be combined with additional bank specific data, as requested by the consultant, from official authorities and through direct interaction with banks as needed. In addition, a rigorous appraisal of the fair value of collateral and foreclosed assets will be carried out by the external consultant to complete the due diligence review.

1.14. The due diligence review will form the basis for a bank-by-bank stress test, using a baseline and adverse macroeconomic scenario, with elements to be agreed by the Steering Committee by [date]. The stress tests will be carried out by the Central Bank of Cyprus with the assistance of the external consultant. This stress test will build on the top-down exercise used to determine the overall size of the capital back-stop facility along with capital needs of each participating institution (banks and cooperative credit institutions) and will also use as input the banks medium-term funding and capital plans, which will be submitted for the first time by [30 September 2012]. The Central Bank of Cyprus in consultation with the EC, the IMF and the EBA, and in liaison with the ECB, will establish the specific capital needs of each participating bank by [30 December 2012] with a view to recapitalisation or resolution, if necessary.

Regulation and supervision for banks and cooperative credit institutions

1.15. 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 legislative framework currently constraining the seizure and sale of loan collateral will be amended such that the property pledged as collateral can be seized and offered for sale within a maximum time-span of 1.5 years. The procedures guiding the repossession of cash and other financial assets, which are not pledged as collateral and are held by defaulted borrowers outside the lending institution, should be appropriately accelerated; taking into account also the possibility of moving these assets within and outside the banking sector. The necessary legislative changes will be introduced by [31 October 2012].

1.16. Non-performing loans are threatening bank profitability and need to be properly monitored and managed in order to safeguard the banks' capital buffers. The Central Bank of Cyprus' guidance on the classification of loans as non-performing will be immediately amended to include all loans past due by more than 90 days. The time series for non-performing loans will be published including historical observations reaching back as far as possible. This amendment will be introduced by [31 August 2012].

1.17. The Central Bank of Cyprus will also create a central credit register listing all borrowers, from both commercial banks and cooperative credit institutions, to enable these institutions to check new loan applications against the register. The credit register will identify the borrowers who are or were in arrears. The legal framework for the credit register will be set up by [31 December 2012] and the central credit register will be operational by [30 June 2013].

1.18. After analysis of the results from the due diligence exercise, the Central Bank of Cyprus will review, by the end of [Q4 2012], its current regulatory framework with respect to loan origination processes, asset impairment and provisioning, and the treatment of collateral in provisioning. Without prejudice to the conclusions of this evaluation and to existing regulatory and accounting framework in the EU, regulatory amendments will be introduced

Contains sensitive information, not for further distribution

with a view to mitigating the impact of changes in collateral values on the value of impaired assets. The new prudential regulations will enter into force by the end of [Q1 2013].

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

1.20. The Central Bank of Cyprus will implement a unified data reporting system for the banks and the cooperative credit institutions by the end of [June 2013]. The publication of the statistical data will be extended to the cooperative credit institutions, for which the Central Bank of Cyprus will disclose aggregate data covering the same elements as for banks, including balance sheet items, income statements and prudential indicators.

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

1.22. Cooperative credit institutions play a significant role in the financing of the domestic economy. Due to its economic relevance and legal specificities, as well as the excessive risk taking and a poor underwriting process that was widely observed among cooperative credit institutions, this segment of the financial sector requires stronger regulation and supervision. Authorities will fully harmonise the supervision of the cooperative credit institutions with the standards applied to commercial banks. The accounts of the cooperative credit institutions will be subject to an independent annual audit by an external auditing firm. [Moreover, the Central Bank of Cyprus will become the single supervisor of all credit institutions in Cyprus by the end of [2013]. The Cypriot authorities will present, for assessment by the EC, the IMF and the ECB, an appropriate proposal to achieve this by the [end of October 2012].] As a prior action, the supervision of the cooperative credit institutions will be detached from the Ministry of Commerce, Trade and Tourism and will be conducted independently of considerations for the development of the sector.

Bank resolution framework

1.23. The authorities will introduce legislation to ensure the application of all bank resolution methods that are foreseen in the proposal by the European Commission for a framework for the recovery and resolution of credit institutions¹. The Central Bank of Cyprus will become the single resolution authority for banks and cooperative credit institutions. The new resolution legal framework will aim, *inter alia*, to allow the Central Bank of Cyprus to mandate the sale of some or all of the assets and liabilities of an institution under resolution through a public tender process and to enforce write-down or conversion of Tier I and Tier II instruments into equity, also in the context of a 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. The framework will be subject to consultation with the EC, ECB and IMF and will enter into force by [November 2012].

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

Asset management company

Contains sensitive information, not for further distribution

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

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

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

Monitoring of corporate and household indebtedness

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

Increasing financial transparency

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

Contains sensitive information, not for further distribution

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