

# Special Assessment of the Effectiveness of Customer Due Diligence Measures in the Banking Sector in Cyprus

Report produced by a team of international experts under the auspices of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL) in response to a request by the President of the Eurogroup Working Group

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## A. EXECUTIVE SUMMARY

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### Background information

1. MONEYVAL accepted the invitation of the President of the Eurogroup Working Group to conduct an assessment of whether Customer Due Diligence (CDD) measures are implemented effectively within the Cypriot banking sector. The assessment was conducted between 19 and 29 March 2013. This evaluation is unique as no other jurisdiction has hitherto submitted to such an exceptional and focussed Anti-Money Laundering and Combating Financing of Terrorism (AML/CFT) evaluation covering the effectiveness of one part only of its AML/CFT system. This assessment is largely interview-based and has not been verified by access to customer data or files in the banks.

### Key findings

2. Substantial international business, which is mainly tax-driven, is conducted in and through the Cypriot banking sector. Such international business involves various features such as complex corporate structures, cross-border transactions with counter-parties in various jurisdictions, introduced business, the use of nominee shareholders/directors, trusts, client accounts and cash-collateralised loans. These features are inherently vulnerable to misuse for money laundering (ML) and financing of terrorism (FT) purposes and pose the highest ML/FT risk to the banking sector in Cyprus.
3. In general, the banks interviewed demonstrated high standards of knowledge and experience of AML/CFT issues, an intelligent awareness of the reputational risks they face and a broad commitment to implementing the customer due diligence (CDD) requirements set out in the law and in subsidiary regulations issued by the Central Bank of Cyprus (CBC). Implementation of CDD measures, as described by the banks, appeared strong under most headings. However, a range of shortcomings with the potential to undermine the effectiveness of CDD was identified in many of the banks interviewed. In one bank the assessors had particular concerns about the overall effectiveness of their CDD procedures. This report focuses mainly on the risks and shortcomings identified and includes recommendations for remedial action.
4. A large part of the international business is introduced to banks by professionals and trust and corporate service providers, the latter known in Cyprus as Administrative Service Providers (ASPs). The banks therefore place significant reliance on the business introducers in Cyprus

or other countries to certify the authenticity of many of the documents provided for CDD purposes and to perform some other elements of CDD. It is the assessors' view that reliance on introducers constitutes one of the largest areas of vulnerability for the banking sector in Cyprus. Given the significant role played by introducers in attracting international business to Cyprus, it was noted with concern that one of the categories of introducers (ASPs) although made subject to regulation is not yet supervised in practice for compliance with AML/CFT requirements and the supervision of the other categories of introducers (lawyers and accountants) needs to be strengthened further.

5. All banks have procedures in place to determine the identity of the beneficial owner controlling the customer. In those cases where the customer is introduced, the identity of the beneficial owner is typically presented to the bank as part of an overall package of CDD documentation provided by the introducer. However, banks remain in many cases one or more steps removed from direct contact with the beneficial owner, still more where chains of introducers are used. In such cases, banks should implement the highest level of enhanced CDD, which could include (as indicated by some banks in Cyprus as already their practice in high risk cases) direct contact with the ultimate beneficial owner in a larger number of cases.
6. None of the banks could point to the existence of an overall AML/CFT risk assessment conducted at the level of and specific to the individual bank which could be used to determine the risk appetite of the bank across the whole range of its potential business lines. Additionally, in a significant number of banks their compliance function is not always adequately consulted in the acceptance of high risk customers. These findings, in combination, constitute material deficiencies in light of the level of high risk international business being conducted in the banking sector.
7. Some of the banks interviewed maintain business with a significant number of politically exposed persons (PEPs). The measures being applied to PEPs are not yet fully effective in some of the banks interviewed in respect of measures to determine the source of wealth of PEPs, identifying family members and close associates of PEPs and identifying a customer who subsequently becomes or is found to be a PEP.
8. Various banks appear not to obtain sufficient information to create a meaningful economic and business profile of the customer and beneficial owner at the inception of a business relationship. This may undermine the effectiveness of ongoing monitoring carried out in the course of the relationship.

9. The substantial number of alerts generated by automated ongoing monitoring systems on high risk accounts appears to be disproportionate to the number of staff managing such alerts. As a consequence, insufficient consideration may be given to these alerts before being cleared. Not many suspicious activity reports (SARs) appear to have been made as a result of ongoing monitoring, which may call into question the effectiveness of the current monitoring systems.
10. Although tax incentives are important in attracting business to Cyprus, the assessment team was advised that not many SARs are submitted by banks in relation to tax-related suspicions of ML. Notwithstanding the fact that, as a result of a recent amendment, certain tax crimes (including tax evasion) are now predicate offences for ML, many banks interviewed are either unaware or unclear about the full implications of such changes.
11. Overall, therefore, the assessors are concerned that the combination of a number of features associated with international banking business (e.g., introduced business *plus* complex structures *plus* use of nominees) may in higher-risk cases bring the cumulative level of inherent risk beyond a level that is capable of being effectively mitigated by the CDD measures currently being applied.

#### Methodology

12. The MONEYVAL team selected 13 of the 41 banks for interview. This is a much larger sample of banks than would be interviewed in a regular MONEYVAL (or FATF) evaluation. The banks interviewed represent 71 per cent of the deposits and 76 per cent of the loans in the banking sector. The coverage included the 7 largest banks operating as at the 31 December 2012 and other banks identified by the CBC as having significant international business

#### The nature of the business and main vulnerabilities

13. Cyprus has been marketing itself in recent years with considerable success as an international banking sector. The nature of the international business conducted includes acting as a conduit for flows into and out of Cyprus for which there is often no underlying business activity within the Cypriot economy – in effect offshore business. It is clear that the levels of international banking business conducted in/through Cyprus have, at least until recently, been substantial and have grown materially in the period 2010-2012. In many ways the business carried out in Cyprus with non-residents is not intrinsically different from international business conducted by numerous other jurisdictions.

14. The rationale for much of the international business conducted appears to be tax driven, largely arising from the wide range of double tax treaties (DTAs) entered into by the Cypriot authorities. Although other countries are also active in negotiating DTAs, cultural ties and historical factors are offered by the Cypriot authorities to explain why they have been particularly successful in attracting business from Russia. Foreign interest generally in Cyprus is also attributed to the fact that the Cypriot legal system is based on English law, and provides access to Common Law structures for the protection of wealth, unavailable in home jurisdictions.
15. Significant levels of international business involve the setting up of Cypriot companies. At the end of February 2013, 270,741 companies were included on the register, 56,815 of them being registered since the start of 2010. While no statistics are available, it is thought that the majority of companies formed in Cyprus for non-Cypriot residents in recent years have been formed for Russian persons.
16. Cyprus international business also commonly involves the setting up of a range of complex corporate structures, with different layers of entities situated in multiple jurisdictions and cross border transactions involving counterparties spread across different parts of the world. These structures frequently contain one or more features, each of which individually is classified by the Financial Action Task Force (FATF) as potentially high risk. Such features frequently include the use of nominee shareholders/directors, trust and client accounts, and occasionally include legal entities with (non-Cypriot) bearer shares and the provision of cash collateralised loans.
17. It is estimated that 75 per cent of international business is introduced by Cypriot introducers (sometimes involving chains of introducers from outside Cyprus) rather than sourced directly. These introducers are typically lawyers and accountants, who are regulated by their professional bodies for AML/CFT purposes and also ASPs, who were unregulated in Cyprus until very recently. The assessors noted that most introducers also provide trust and corporate services. This can involve the banks placing significant reliance on the business introducers in Cyprus or other countries to certify the authenticity of many of the documents provided in the CDD process and to collect information required in the course of ongoing monitoring. Although reliance is an acceptable mode of satisfying CDD requirements, in some cases this may expose the banks to the risk of using false documentation or leave them exposed should there be subsequent changes in ownership or control of the entities without their knowledge. The assessors are of the view that Cypriot banks' reliance on introducers represents one of the largest areas of vulnerability for them.

Preventive measures and recommendations

18. The Cypriot authorities have taken a range of legislative measures, in line with FATF and European Union standards, to minimise the risk of abuse for ML/FT purposes. Basically sound preventive requirements have been in place for several years at the levels of customer identification, identification of beneficial owner, record-keeping and reporting of suspicious activities. These requirements are set out in primary legislation (the Prevention and Suppression of Money Laundering and Terrorist Financing Laws of 2007 and 2010 as amended) and in secondary legislation (the Directive issued by the Central Bank of Cyprus (CBC) to banks (the CBC Directive)). The banks explained how they implement the obligations in the CBC Directive to obtain all the documents needed to adequately comply with CDD requirements. It was noted that the banks have systems in place to monitor high risk business on an ongoing basis. CDD in the banking sector is also subject to a programme of inspections by the CBC.
19. In general, bank managements appear conscious of AML/CFT risks and supportive of strong preventive measures, including, where warranted, the rejection of some high risk business and/or closing of existing accounts. Though few banks were able to provide firm statistics, the assessors concluded that a small but steady number of clients are formally rejected, with the most common reason being unwillingness to provide requested information. The assessors were frequently told that, in deciding whether to accept new business, emphasis was placed on the economic and financial rationale for conducting the business through Cyprus. This was, however, rarely presented to the assessors as an example of reasons for specific business being refused. A number of banks interviewed mentioned that the banks' compliance function had been granted a casting vote in decisions to reject new higher-risk business. In some Cyprus banks higher risk business can only be accepted with the prior approval of the compliance department. However, in a significant number of banks it appeared that compliance is involved in these decisions only where there is a query from the relationship manager. The assessment team considers that banks should review their policies and procedures for accepting higher risk customers and, where not already the case, ensure that ML/FT risk issues are taken fully into account. This process should involve the expertise of the compliance function in an enhanced advisory role. Banks should also ensure that their compliance functions are adequately resourced, in particular to facilitate effective ongoing monitoring. It would also be valuable, for the banks' own risk management purposes, to record rejected business more systematically, with particular emphasis on reasons for rejection.



20. In all cases banks interviewed confirmed that they have Board-approved AML/CFT policy statements, though there were material variations in their scope and content. In the small number of cases in which the assessors had the opportunity to review the broad content, they appeared to be comprehensive and generally to reflect the CBC Directive. While all banks interviewed apply risk assessments and classify customers into different risk categories, none of the banks interviewed could point to the existence of any overall AML/CFT risk assessment conducted at the level of and specific to the individual bank. In a jurisdiction where banks are conducting substantial amounts of business classified as potentially high risk by the FATF, the examiners would expect that the policies of the banks would already have reflected advanced international practice in this area, particularly as it is already a national requirement in Cyprus. What appeared to be absent in most cases was evidence of the type of overall analysis of risk which could be used to determine the risk appetite of the bank across the whole range of its potential business lines. Indeed, it appeared to the team that some banks mechanically address the points listed in the CBC Directive rather than conducting their own risk analysis, as required. The assessors consider that each bank should combine all of its risk analyses into an overall AML/CFT risk policy document, for Board approval. The assessors consider that this should be based on a thorough and meaningful process, which should include in particular any risk areas that might not previously have received sufficient attention. This analysis should be updated on a regular basis.
21. All banks apply measures to identify the beneficial owner. In respect of those clients that are introduced to the banks, the identity of the beneficial owner is usually presented to the banks as part of an overall package of CDD documentation provided by the business introducer. This goes some way to explaining why most banks stated that they had no difficulty in identifying the beneficial owner. This statement was confirmed, to some extent, by the Cypriot Financial Intelligence Unit (MOKAS), which indicated that information on beneficial owners accompanies SARs sent by the banks. However, it was concluded by the assessors that, despite the documentation provided by the business introducers, banks remain in many cases one or more step(s) removed from the beneficial owner. The assessors consider it likely that there remain cases for a number of the banks where they have not had face-to-face contact with the beneficial owner, which may include situations normally classified as higher-risk. While this is not unique to Cyprus, it underlines the level of dependence on others to provide assurances, documentation and certification. Banks should implement the highest level of enhanced CDD, which could include (as indicated by some banks in Cyprus as already their practice in high risk cases) direct contact with the ultimate beneficial owner in a larger number of cases.

22. Given the significant role played by introducers in attracting international business to Cyprus, it was noted with concern that one of the categories of introducers (ASPs), though recently made subject to regulation, is not yet supervised in practice and the supervision of the other categories of introducers (lawyers and accountants) needs to be strengthened further. Banks should apply stricter controls on the use of business introducers, which involve not only the requirement that the introducer should be regulated, but also satisfying themselves, on an ongoing basis, that the quality of AML/CFT procedures applied by business introducers is adequate. Where a significant number of SARs is subsequently identified by the banks related to customers introduced by a particular introducer, those banks which do not already do so should consider terminating business relations with such introducers.
23. With regard to individual components of CDD, weaknesses in the establishment of the business and economic profile of the customer have been identified. Banks should ensure that the customer business and economic profiles – particularly for high risk customers – are detailed, meaningful, accurate and regularly updated in order not to undermine the proper application of ongoing monitoring and that the purpose of the business relationship is identified and recorded in all cases.
24. Additionally, the assessors were not persuaded that ongoing monitoring procedures were always being applied effectively. The substantial number of alerts which are generated by automated systems, as a result of the large number of high risk accounts, appear to be disproportionate to the number of staff available to manage and clear these alerts following sufficiently thorough consideration. Indeed, on the basis of information provided, not many cases of ML/FT suspicion are identified through ongoing monitoring. Banks should review the resources allocated to the monitoring of high risk international business and, where necessary, increase resources of compliance departments to fully investigate and properly review all the alerts raised on high risk accounts.
25. The assessors observed that the implementation of the FATF standard on politically exposed persons (PEPs) is not yet fully effective in all its aspects in some of the banks interviewed. While these deficiencies are not uncommon in many jurisdictions, they are important in the context of Cyprus, given the significant number of politically exposed customers with accounts in some of the banks. While in most cases banks were able to demonstrate the effectiveness of procedures to identify source of funds, measures to determine the source of wealth of PEPs were not always convincing. Measures to identify immediate family members and close associates of PEPs need to be reviewed and strengthened. Some of the banks also

do not yet have adequate measures to identify in a timely manner cases where an existing customer becomes or is subsequently found to be a PEP.

26. The assessors noted a large backlog of amendments to registration documents at the Company Registry and a lack of follow up of a significant number of unsubmitted annual returns and financial statements. This raises questions about the ability of banks to fully apply CDD measures with respect to legal persons registered in Cyprus, especially given the speed with which company structures can be changed, which may go unnoticed by the financial institutions. Adequate resources need to be given to the Company Registry to rectify this situation.
27. The assessors noted a widespread use by non-residents of Cypriot legal entities as holding companies for tax minimisation purposes. They were advised that not many SARs were submitted by banks in relation to tax-related suspicions of ML. The assessors expect that a recent and welcome legislative amendment, which renders certain tax crimes (including tax evasion) predicate offences for ML, will result in more tax-related SARs. However, many of the banks and other obliged persons with whom the team met were either unaware or unclear about the full implications of these changes. The competent authorities should amend their directives to explain that tax evasion (including foreign tax evasion) is now within the scope of the STR reporting requirement and they should ensure that these changes are fully understood by the private sector through awareness-raising initiatives.
28. Overall therefore, the assessors are concerned that the combination of a number of features associated with international banking business (e.g., introduced business *plus* complex structures *plus* use of nominees) may in some cases bring the cumulative level of inherent risk beyond a level that that is capable of being effectively mitigated by the CDD measures currently being applied. Indeed, the cumulative inherent risk may exceed the sum of each individual risk element. The assessment team therefore considers that the accumulation of high risks emanating from the use of complex structures, combined with introduced business, warrants the application of the highest level of enhanced due diligence, which needs to be fully reflected in the bank-specific risk assessments. Concretely, banks should as part of their overall risk policy:
  - i. Recognise that the accumulation of risks in complex business in itself presents overarching risk;
  - ii. Determine their appetite for such complex business bearing in mind whether the bank is in a position to effectively monitor and control the cumulative risks sufficiently to

mitigate the possibility of abuse for purposes of ML (including in respect of tax crimes) and FT;

- iii. Set out the enhanced measures which need to be taken to mitigate these overarching risks;
- iv. Specify cases where it is appropriate based on an assessment of the risks to reject or terminate a client relationship.

29. Specific recommendations in relation to both the vulnerabilities inherent within the international business conducted by the banks, and in relation to the need for more effective implementation of particular CDD measures are made at the conclusion of this report.

## B. ASSIGNMENT

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30. On 9 March 2013 Thomas Wiesner, the President of the Eurogroup Working Group, wrote to the Executive Secretary of MONEYVAL<sup>1</sup> in the context of the Cypriot request for financial assistance from the Euro area (Annex 1). The finance ministers of the Euro area had agreed with Cyprus that an independent evaluation of the AML/CFT framework should be commissioned and the Troika institutions had agreed that MONEYVAL's participation would be helpful. Specifically MONEYVAL was invited to conduct an assessment of whether CDD requirements are effectively implemented in the banking sector.
31. The MONEYVAL Executive Secretary consulted with the Chairman and Vice Chairman of the Committee, who considered that in these exceptional circumstances, participation by MONEYVAL was necessary. The Executive Secretary responded positively to the request on 12 March 2013 (Annex 2).
32. The terms of reference as agreed between MONEYVAL and the programme partners appear at Annex 3.<sup>2</sup> MONEYVAL's evaluation is conducted under the FATF Recommendations 2003 and the Methodology for Assessing Compliance with the FATF 40 Recommendations and the FATF 9 Special Recommendations 2004. This choice was made because the programme of evaluations under the 2012 revised FATF Recommendations has not yet been commenced by either FATF or MONEYVAL nor has the European Union Directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (Directive 2005/60/EC) been updated to reflect the revised standards.
33. It was envisaged that MONEYVAL would work in parallel with an auditor to be agreed by the Central Bank of Cyprus and programme partners. Due to the delay in the appointment of the auditors, the sharing of preliminary key findings by MONEYVAL and the auditors could not take place on 27 March 2013 as had been specified in the terms of reference. In the absence of such opportunity for the sharing of findings, MONEYVAL considered it inappropriate to present its report as final as of 31 March 2013. The key findings were shared

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<sup>1</sup> MONEYVAL is an independent monitoring body of the Council of Europe entrusted by the Committee of Ministers with the task of assessing compliance with the principal international standards to counter money laundering and the financing of terrorism and the effectiveness of their implementation as well as with the task of making recommendations to national authorities in respect of necessary improvements to their systems (see MONEYVAL's statute, Appendix to Resolution CM/Res(2010)12). MONEYVAL is an Associate Member of the Financial Action Task Force (FATF). Cyprus is one of the States evaluated by MONEYVAL.

<sup>2</sup> Following the on-site visit by the MONEYVAL team, the terms of reference were revised to include additional information in relation to the tasks to be undertaken by the audit team. The MONEYVAL team did not receive the revised terms of reference.

on 20 April 2013 subsequent to MONEYVAL's onsite mission, which took place from 19 to 29 March 2013.

34. The MONEYVAL evaluation team comprised:

- Mr Benoit Bienfait – Adviser (Prudential Policy & Financial Stability) National Bank of Belgium
- Mr Terence Donovan – Financial Expert (former Central Bank of Ireland)
- Mr Philipp Röser – Financial Scientific Expert to MONEYVAL (Liechtenstein)
- Mr Andrew Strijker – Cluster Co-ordinator Anti-Money Laundering and Anti-Corruption, EC/Task Force for Greece and Financial Scientific Expert to MONEYVAL (the Netherlands)
- Mr Richard Walker – Director of Policy and International Affairs, Guernsey Financial Services Commission (UK Crown Dependency of Guernsey)

35. The assessment team was led by Mr John Ringguth, the Executive Secretary of MONEYVAL, who was assisted by Mr Michael Stellini from the MONEYVAL Secretariat.

36. This evaluation is unique as no other jurisdiction has hitherto submitted to such an exceptional and focussed AML/CFT evaluation covering the effectiveness of one part only of its AML/CFT system. Evaluations in FATF and MONEYVAL's regular evaluation cycles usually cover the whole financial sector, as well as the legal and law enforcement sectors.

## C. SCOPE AND METHODOLOGY

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37. This assessment, in line with the terms of reference, focuses primarily on effectiveness of implementation of CDD measures in the banking sector as at March 2013 against the 2003 FATF Recommendations. The assessment team have considered the Prevention and Suppression of Money Laundering and Terrorist Financing Laws of 2007 and 2010 as amended (AML/CFT Law) and the Directive issued by the CBC to banks in accordance with Article 59(4) of the AML/CFT Law (the CBC Directive) which forms the relevant legal framework for AML/CFT preventive measures for the banking sector. A technical re-assessment of this law and directive has not been undertaken since no major technical changes have taken place since the last evaluation conducted by MONEYVAL in June 2010 (report adopted on 27 September 2011) as part of its fourth round of evaluations<sup>3</sup>. An overview of the findings of the Fourth Round MONEYVAL report relevant to this assessment and the extent of the action taken by the Cypriot authorities so far is included at Annex 4.
38. The objective in the terms of reference envisages the assessment to be conducted for a meaningful share of the banking system in Cyprus. In selecting banks for interview the assessors took into account, among other things, the level and composition of foreign-related deposits and loans in Cypriot banks, based on statistics provided by the CBC. A much larger sample of banks was interviewed than is possible in a normal MONEYVAL evaluation.
39. The team selected 13 of the 41 banks<sup>4</sup> which were authorised to conduct banking business in Cyprus at the time of assessment. The banks interviewed represent approximately 71 per cent of the deposits and 76 per cent of the loans in the banking sector, including banks that did not exceed the threshold of EUR 2 billion of total deposits<sup>5</sup>. The sample included the 7 largest banks operating as at the 31 December 2012. The selection was made to cover the big Cypriot owned commercial banks together with branches and subsidiaries of foreign banks originating from Russia, Ukraine, Greece, Lebanon and Tanzania. The selections also paid attention to the levels of deposits and loans involving Cyprus companies belonging to non-residents and without physical presence (the so-called “brass-plate companies”).

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<sup>3</sup> The follow up round of assessments by MONEYVAL was undertaken at the conclusion of the MONEYVAL third round (which mirrored the FATF 3<sup>rd</sup> round). The purpose of this MONEYVAL 4th round is to maintain peer pressure on its states and jurisdictions, pending completion of FATF’s 3rd round and the review of the FATF Recommendations which led to the recent revision of the FATF standards.

<sup>4</sup> There is also one representative office of a foreign bank.

<sup>5</sup> The Terms of Reference sets a EUR 2 billion threshold of total deposits for banks which should be included in the exercise by the auditors.

40. The assessors conducted lengthy and informative meetings (each typically of 4-5 hours duration) with the following banks:

Bank of Cyprus plc	Local bank
Cyprus Popular Bank plc (Laiki Bank)	Local bank
Hellenic Bank plc	Local bank
Piraeus Bank (Cyprus) Limited	Subsidiary of a Greek Bank
EFG Eurobank Ergasias S.A.	Subsidiary of a Greek Bank
FBME Bank Limited	Branch of Tanzanian Bank
National Bank of Greece (Cyprus) Limited	Subsidiary of a Greek Bank
PrivatBank Commercial Bank	Branch of a Ukrainian bank
Societe Generale Bank – Cyprus Limited	Subsidiary of a Lebanese bank (part of Societe General Group)
Cyprus Development Bank plc	Local bank
Russian Commercial Bank (Cyprus) Limited	Subsidiary of a Russian bank
Alpha Bank Cyprus Ltd	Subsidiary of a Greek bank
Promsvyazbank JS Commercial Bank	Branch of a Russian bank

41. In the course of the interviews, the team met with compliance staff in all banks, and, according to availability, senior management, internal audit, relationship managers, and representatives of international business units which operate in the large majority of banks. All meetings with the private sector took place in the absence of representatives of the supervisory authorities, as is customary in MONEYVAL evaluations.
42. The findings and recommendations of the team are largely interview-based and the results depend on the information provided primarily in those interviews. MONEYVAL has not verified the information provided in interviews by access to customer data or files in the banks. Given that the terms of reference envisage two complementary exercises by MONEYVAL and the auditors, it is understood that such verification through customer data or files has been undertaken as part of the auditors' sampling, as approved by the CBC and the programme partners in accordance with the terms of reference.
43. The CBC and the banks were requested to provide statistics on deposits made and loans granted by (i) country of residence and (ii) country of origin, for both owners [customers] and beneficial owners as specified in the terms of reference. The assessment team was informed that statistics based on the beneficial owner could not be made available for the banking system in time for inclusion as part of MONEYVAL's assessment. The assessment team



understands that a breakdown of deposits and loans of the top 100 customers was subsequently provided by the banks to the audit team.

44. At least 60 relevant topics were addressed in the course of every interview with banks under the broad headings of:

- Structure and status of AML/CFT compliance within the banks
- Governance issues: the role of banks' Boards in determining ML/TF risk policy
- AML/CFT Risk Policy
- Staff training on AML/CFT
- Role of internal audit and group compliance (where applicable)
- Identification and verification measures
- Identification and verification of beneficial ownership
- Client Acceptance
- Higher risk categories of customers
- Information on the purpose and intended nature of the business relationship
- Ongoing monitoring
- Politically Exposed Persons
- Correspondent banking relationships
- Wire transfers
- Record-keeping measures
- Suspicious activity reporting.

45. The assessors discussed in detail the AML/CFT policies and procedures of each bank. The banks were required to demonstrate to the assessors the extent to which the policies and procedures are implemented in practice. To this end, practical questions were posed, including scenarios associated with customer acceptance in the particular context of Cyprus, and the process of identifying beneficial owners. The evaluators also focussed on the incidence of rejected business, business terminated after commencement of business relations, and resolution of any disputes between compliance and customer on-boarding departments.

46. The team met with the CBC to discuss their supervisory practices and findings insofar as they were relevant to the assessment of the effectiveness of implementation of CDD in the banking sector. An overview of the supervisory work conducted by the CBC is presented at Annex 5. The team also met with the MOKAS to verify information received from the banks in relation to their transmission of suspicious activity reports.

47. Introducers play a critical role in the international business profile of many banks' customers and in the CDD processes of banks. Accordingly, the evaluators considered it necessary within their terms of reference to interview a small number of introducers and also their regulators (Cyprus Securities and Exchange Commission (CYSEC), the Cyprus Bar Association (CBA) and Institute of Certified Public Accounts of Cyprus (ICPAC). For an overview of the functions of these regulators reference may be made to Annex 6. Similarly, the assessors interviewed the Company Registry since it also has an impact on the effectiveness of CDD in respect of legal persons. Further information on the Company Registry is available at Annex 7.
48. As it is outside the scope of the terms of reference for this assessment, the assessment team was not in a position to evaluate the effectiveness of the work of the CBC, the CYSEC, the CBA, the ICPAC, MOKAS and the Company Registry, except where considered strictly relevant to the assessment of the effectiveness of implementation of CDD by the banks themselves.
49. A list of all the entities met on-site by the assessment team is presented at Annex 8.

## D. THE BANKING SECTOR AND INTERNATIONAL BUSINESS IN CYPRUS

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### The Banking Sector

50. According to figures provided by the CBC, as at 31 December 2012, the banking sector held approximately EUR 70 billion in deposits and EUR 72 billion<sup>6</sup> in loans.
51. At the commencement of the assessment there were 6 banks in Cyprus that were majority-owned by resident shareholders<sup>7</sup>. Collectively, these banks account for approximately EUR 52 billion in terms of deposits and EUR 47 billion in terms of loans, with the largest share held by Bank of Cyprus, Cyprus Popular Bank, Hellenic Bank and Cooperative Credit Institutions. The ownership structure of local banks varies. Three banks were fully owned by resident shareholders<sup>8</sup>.
52. Branches and subsidiaries of foreign banks constitute the rest of the banking sector in Cyprus. The geographical spread of the foreign banks operating in Cyprus is as follows:

<b>Foreign bank</b>	<b>Branches in Cyprus</b>	<b>Subsidiaries in Cyprus</b>
<b>EU Member State</b>	11	5
<b>Non-EU Member State</b>	16	3

53. In terms of customer base, as at 31 December 2012, banks collectively held approximately EUR 38 billion in deposits and EUR 49 billion in loans for Cypriot residents (61 per cent) and EUR 32 billion in deposits and EUR 23 billion in loans for non-residents, including brass-plate companies (39 per cent). The table below provides an overview of the customer base of the entire banking sector in Cyprus.

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<sup>6</sup> All the data featuring in this section was provided by the CBC and represents the sector in terms of deposits and loans held by banks as at 31 December 2012.

<sup>7</sup> Bank of Cyprus plc, Cyprus Popular Bank plc (also known as Laiki Bank), Cyprus Development Bank plc, Hellenic Bank plc, Housing Finance Corporation and Cooperative Credit Institutions

<sup>8</sup> Bank of Cyprus plc, Cyprus Popular Bank plc (also known as Laiki Bank), Cyprus Development Bank plc

<b>Customer</b>	<b>Deposits (billion EUR)</b>	<b>Loans (billion EUR)</b>
<b>Resident</b>	38	49
<b>Brass-plate companies<sup>9</sup></b>	5.3	4.7
<b>Greece</b>	4.6	2.1
<b>Russia</b>	4.9	4.2
<b>Other EU</b>	2.9	5.4
<b>Other Non-EU</b>	14.2	6.7
<b>Total</b>	69.9	72.1

### International Business

54. Cyprus has been marketing itself in recent years with considerable success as an international banking centre, having moved away some years ago from the bank ownership and licensing structures which had characterised it previously as an offshore centre. However, the nature of the international business conducted continues to include acting as a conduit for flows of funds into and out of Cyprus, for which there is often no underlying business activity within the Cypriot economy – in effect, offshore business. This type of business carries with it a number of vulnerabilities, which are described in the body of the report (under Section E).
55. The Cypriot banking system is large in relation to the domestic economy, continuing to represent at the time of this assessment eight times the national GDP. It is clear that the levels of international banking business conducted in/through Cyprus have, at least until recently, been substantial and have grown materially in the period 2010-2012.
56. The assessors sought to quantify the volume of international business in their meetings with banks, service providers and some of Cypriot authorities and through review of available statistics. The team was not provided with clear and comprehensive statistics in this regard and was informed that accurate information is not yet available that would pull together the various strands of this business.
57. However, information was provided by the CBC in respect of direct exposure of the banking system to non-residents in aggregate and also broken down by Greek and Russian persons

<sup>9</sup> The CBC was not in a position to provide a breakdown of the country of origin of the beneficial owners behind these legal entities.

(who account for the highest proportion of non-resident accounts), persons from other European Union countries and persons from other non-European Union countries. As at the end of December 2012, the position was stated by the CBC as follows:

<b>Customer (excluding brass-plate companies)</b>	<b>Deposits (billion EUR)</b>	<b>Loans (billion EUR)</b>
<b>Russia</b>	4.9	4.2
<b>Greece</b>	4.6	2.1
<b>Other EU MS</b>	2.9	5.4
<b>Other non-EU MS</b>	14.2	6.7
<b>Total</b>	<b>26.6</b>	<b>18.4</b>

58. Data was not provided for later dates and the current position is likely to differ significantly from that shown above.
59. The figures above do not present anything close to the full picture in relation to non-resident business, in particular for Russia. For example, it is common for Cypriot-registered companies (by definition resident companies) to be used to hold non-resident assets as part of structures. An accurate statistical analysis cannot be included as comprehensive data on loans/deposits by country of origin or residency of beneficial owner was not made available for the purposes of this assessment.
60. Notwithstanding, the absence of concrete data on non-resident account holders, the banks interviewed observed that non-resident customers, when looked at as ultimate beneficial owners, account for a substantial part of Cypriot banking business. In some banks interviewed, the percentage of non-resident customers was in excess of 70 percent. The CBC was in the course of collecting data from the banks classified on the basis of country of residence of beneficial owner. This initial exercise was due for completion by mid-April, too late to be of assistance for this assessment. However, some banks had already compiled at least preliminary data and were therefore in a position to assist the assessment team with estimated country-by-country breakdowns.
61. The rationale for much of the international business conducted appears to arise from the wide range of double tax agreements (DTAs) entered into by the Cypriot authorities, in particular the DTA with Russia, a protocol to which was recently amended. Although other countries are also active in negotiating DTAs, including with Russia, cultural ties and historical factors

are offered by Cypriots as explaining why they have been particularly successful in attracting business from Russia. Interest by Russian persons in Cyprus is also attributed to the fact that the Cypriot legal system is based on English law, which is of benefit in many ways including in preparing companies for share listing (IPOs) on the London Stock Exchange and provides access to Common Law structures for the protection of wealth unavailable elsewhere. The current Cypriot 10 percent corporate tax rate<sup>10</sup> is also an important factor.

62. Banks and company service providers were helpful in explaining to the team the economic and business rationale for the use of a number of different tax-driven structures, typically involving the use of Cypriot-registered holding companies and/or a variety of cross-border banking facilities. In all cases, the interviewees maintained that the services provided were legitimate tax-minimisation arrangements, taking advantage of well-known provisions of the tax code. It is not within the scope of the mission to form a view on the legitimacy or otherwise of these arrangements and they are referenced in this report principally due to their relevance in explaining the high levels of international financial services business in Cyprus and to provide a basis for discussion of the challenges they can present to banks in seeking to implement effective CDD. This is addressed as part of the analysis in this report of the effectiveness of CDD.

#### Trust and Company Services and Business Introducers

63. The assessors noted that, in many cases, the international tax-based business entails the creation of corporate structures. As a result, the provision of trust and corporate services by registered lawyers, accountants and ASPs is widespread in Cyprus. Such services include the formation of holding company structures involving Cypriot-registered companies, combined with companies in other jurisdictions such as the British Virgin Islands, Belize, Seychelles or certain states in the United States of America. The use of business introducers and of nominee shareholders or directors is common. Trust structures are also used and non-Cypriot bearer shares also occasionally feature.
64. Lawyers, accountants and ASPs, when acting as business introducers, also handle all the necessary procedures for the opening and operation of bank accounts with Cypriot banks. Indeed, significant international business is introduced to the banks by such third parties. Some banks received comparatively little introduced business but in others it was close to 100

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<sup>10</sup> Financial services practitioners who commented on the issue expressed the opinion that the proposed increase in the corporate tax rate to 12.5 per cent was unlikely in itself to impact materially on the levels of international business being conducted through Cyprus.

percent. Based on the interviews, the assessment team considers that perhaps 75 percent of international business in the banking sector is introduced.

65. It is not known precisely what proportion of trust and corporate services business is accounted for by lawyers, accountants and ASPs. However, it is estimated that some 260 administrative service providers will apply for authorisation by June 2013. The assessment team was informed that some 270 firms of lawyers provide administrative services so far, while 850 accountants undertake such business, of which ICPAC expects 200 firms to apply to them for a licence. A very large majority of all service providers have five or fewer staff.
66. Some of the banks also accepted business introduced by firms outside Cyprus. The assessment team was advised that introducers from outside Cyprus were generally limited to those from other EEA countries. The assessment team was not in a position to confirm this.
67. It was difficult to obtain a sense of the level of business undertaken by individual introducers in Cyprus. One statistic provided by the CBA is its estimate that no law firm administers more than a thousand companies. It was also suggested that it would be usual for a firm of five lawyers engaging in administration activity to administer some fifty companies.

#### Companies

68. Given that significant levels of international business involve the setting up of Cypriot companies, the assessment team considered it appropriate to examine the extent to which Cypriot companies are owned by non-residents. A description of the type of legal entities that may be registered in Cyprus is provided at Annex 9.
69. At the end of February 2013, 270,741 companies were included on the register, with an estimated 90 percent being companies limited by shares. The number of company formations over the last five years is demonstrated in the table below.

<b>Year</b>	<b>Companies formed</b>
<b>2012</b>	17,999
<b>2011</b>	19,538
<b>2010</b>	19,278
<b>2009</b>	16,101
<b>2008</b>	24,453

70. Companies limited by shares (private companies) are by far the most common form of company. Of these 98 percent were estimated as being general trading companies or companies which hold investments or immoveable assets.
71. Neither the registry nor any other authority currently maintains information of any kind on the beneficial ownership of Cypriot companies. It was clear from the totality of the interviews conducted by the review team that a large proportion of Cypriot companies are owned by Russians in particular, and Ukrainians. A large proportion of the remainder are owned by Western Europeans, with a small minority coming from the rest of the world with some markets expected to develop such as China and Israel.



## **E. FINDINGS AND RECOMMENDATIONS**

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### Introduction

72. As noted, the assessment team held detailed discussions with 13 of the 41 banks operating in Cyprus, chosen to provide a meaningful representation by size and type of business of the overall banking system, with particular focus on international business. Since, as mentioned earlier, international business often involves the provision of trust and corporate services, several providers of these services were also met by the assessment team to form a comprehensive view of the manner in which the international business is conducted in Cyprus.
73. While the points for discussion during the meetings broadly followed the topics addressed in Recommendations 5, 6, 7, 10, 11, 13 and Special Recommendation VII of the 2003 FATF Recommendations, particular emphasis was placed in the discussions on the measurement, prioritisation and management of ML and TF risk in the banks, in the particular context of the scale of international business which has been conducted in or through Cyprus.
74. As explained earlier, the team was not in a position to directly test the responses provided by the banks by having access to customer records or files; in that respect, the approach taken was similar to a regular AML/CFT assessment, with the exception that the interviews with the banks were significantly longer and much more detailed.

### Structure and status of AML/CFT compliance within the banks

75. The assessors sought to determine the degree of independence granted to the compliance function in each bank interviewed and the extent to which the voice of the compliance function is listened to particularly when important customer-acceptance decisions are taken. While each bank explained its own unique approach, a number of the banks interviewed maintained that the compliance function had been granted a casting vote in decisions to accept or reject new higher-risk business. In most of the other banks, the compliance function expressed confidence that their concerns would nonetheless be addressed, for example by seeking additional information and documentation from or in relation to the prospective customer. In a significant number of banks, it appeared that compliance would become involved only where a query was referred to them from the relationship manager. The assessors noted the position in certain banks that higher-risk business can only be accepted with the prior approval of the compliance function. With a few exceptions, compliance

officers appeared satisfied with the level of available human resources. A number of banks advised that they are planning or implementing enhancements to existing IT systems, particularly to improve efficiency in ongoing monitoring.

- 76. When accepting higher risk customers, banks should ensure, where not already the case, that ML/FT risk issues are taken fully into account, with the process involving the expertise of the compliance function in an enhanced advisory role.**

Governance issues: the role of banks' Boards in determining ML/TF risk policy

77. The assessors explored with each bank interviewed the manner in which the compliance function is represented on or reports to the Board itself or its committees (e.g. Audit Committee, Risk Committee). The responses varied reflecting the internal structures of each bank but, typically, the heads of compliance or money laundering compliance officers (MLCOs) were not Board members. The most common pattern is that they reported through the Audit Committee or had a reporting line to the director responsible for risk management.
78. In terms of management reporting for AML/CFT, at a minimum each bank prepared the annual report of the MLCO which, in addition to submission to the Board, is also provided to the CBC. In most cases, however, the banks could point to more frequent reporting, sometimes quarterly, to the Board or a Board committee, addressing such AML/CFT matters as changes in the law or requirements, progress reports on AML/CFT IT systems or other projects, SARs reported in the previous period (including an outline of the cases) and staff training plans. Not having sight of any of these reports, the assessors cannot form any conclusion regarding their effectiveness. In general, however, bank managements appear conscious of AML/CFT risks and supportive of strong preventive measures, including where warranted the rejection of some high-risk business and/or closing of existing accounts. In a number of interviews, management representatives stressed the priority given to protecting the reputation of the bank.

AML/CFT Risk Policy

79. In all cases, banks interviewed confirmed that they have Board-approved AML/CFT policy statements, though the assessors found material variation in their scope and content. In the discussions, a few banks did not distinguish high-level policy from detailed AML/CFT procedures, but this was in cases where the entire procedures manual is subject to Board approval. In the small number of cases in which the assessors had the opportunity to review

the broad content of these documents, they appeared to be comprehensive and to reflect closely the content of the CBC Directive. In most cases, the pattern was found to be as follows:

- A Board-approved high-level policy statement in support of the fight against money laundering/terrorist financing, sometimes in the nature of a mission statement or, in a couple of cases, including many detailed operational decisions;
- A Board-approved customer acceptance policy statement which addresses all or most of the high-risk business categories specified in the CBC Directive, perhaps with some categories added by the individual bank; and
- A detailed AML/CFT procedures manual (in some cases combined with one or both of the above documents).

80. The assessors did not have the opportunity to examine these documents in detail but have no reason to be critical of them, per se. However, the assessors note that none of the banks interviewed could point to the existence of any overall AML/CFT risk assessment conducted at the level of and specific to the individual bank. In a jurisdiction where banks are conducting substantial amounts of business classified as potentially higher risk by the FATF, the assessors would expect that the policies of the banks would already have reflected advanced international practice in this area. The assessors note that the CBC Directive has, since 2008, required each bank to prepare and maintain a risk assessment report. Perhaps the issue is one of interpretation, as the assessors observed that many of the practical steps that should flow from such a risk assessment are already in place (e.g. classifying customers into high/medium/low categories).

81. What appeared to be absent in most cases was evidence of the type of overall analysis of risk in each bank which can be used to determine the risk appetite of the bank across the range of its potential business lines. In some cases, it was clear that risk-based decisions had been made to restrict or exclude some business lines and to apply additional conditions or documentary requirements for others. However, it appeared to the team that some banks mechanically address the points listed in the CBC Directive rather than conducting their own risk analysis, as required.

**82. Each bank should combine all of its risk analyses into an overall AML/CFT risk policy document, for Board approval, based on a thorough and meaningful consideration**

**which should include in particular any risk areas that might not previously have received sufficient attention. This analysis should be updated on a regular basis.**

Role of internal audit and group compliance (where applicable)

83. The AML/CFT function is subject to internal audit (at local or group level, as appropriate) in each of the banks interviewed. In addition, for banks that are part of international groups, there was evidence of checking also by one or more levels of group compliance.

Identification measures

84. In line with the CBC Directive, banks confirmed that they identify customers in all cases and do not operate anonymous or numbered accounts. For international business, most customers are corporate entities and supporting documentation is obtained to confirm the identification of the customer, the directors and the owners. Although some of these structures are complex and can involve legal entities in two or more jurisdictions, there was a consistency in the responses of the banks that they are required to, and do in practice, identify all relevant parties through all layers of these structures. The assessors did not come upon any examples to suggest lack of understanding or weak compliance on this aspect.

Verification measures

85. Most of the banks were persuasive in their discussions with the assessors that they take seriously the implementation of the obligations in the CBC Directive to obtain all of the documents needed to provide verification of ownership of accounts, covering personal, corporate and other business entities effectively. The compliance and/or business line personnel from the banks provided comprehensive explanations of procedures for even the most complex structures encountered, with a confidence that indicated sound practical experience.
86. However, a few banks indicated that projects to update verification documentation for customers existing at the time of the material upgrading of the Cypriot AML/CFT requirements in 2007/8 were, to some extent, still in progress. The banks concerned informed the assessors that the outstanding work related to retail business and the omissions were mainly technical in nature (e.g. no copy of utility bill, out-of-date identification document) but may also include incomplete customer profile to provide the base line for ongoing due diligence. In general, most of the customer base, including larger, riskier, and corporate

customers appeared to have been addressed at this stage. The assessors are not in a position to confirm the extent of the gaps or determine whether they are sufficiently material to undermine the findings of the current exercise.

**87. Banks should update any remaining outstanding CDD in relation to existing customers without further delay.**

88. As discussed in some detail in this report, the channels used by a significant number of Cypriot banks to source and maintain international business, and in some cases the complexity of the structures involved, create challenges for the effective implementation of CDD measures. For purposes of verification, in order to comply with the FATF standard, banks need to obtain “reliable, independent source documents, data or information”. The banks were generally persuasive in their explanations that they insist on obtaining documentation to confirm, for example, registration of companies, trust agreements appointing nominee shareholders or directors, trust deeds (or relevant extracts therefrom). The approach they adopt is similar to that encountered in other banking systems that attract offshore business. However, the assessors noted that this entails placing significant reliance on others (often business introducers) in Cyprus or other countries to certify the authenticity of many of the documents provided. In some cases, this may expose banks to the risk of using false documentation or leave them exposed should there be subsequent changes in ownership or control of the entities, without their knowledge. It is difficult for the assessors to offer specific recommendations to mitigate these risks, as they are inherent in at least some of the offshore-type business conducted in centres such as Cyprus. However, documentary verification should be just one element of effective CDD and, for example, the strong focus in the case of Cyprus on the beneficial owner(s) behind the corporate business and on understanding the rationale for business proposals (as discussed below), are important elements in risk mitigation.

89. In their reliance on business introducers, banks are exposed to any weaknesses that arise in CDD conducted by the introducers. Given the significant role played by introducers in attracting international business to Cyprus, it was noted with concern that one of the categories of introducers (ASPs) is not yet supervised in practice and the supervision of the other categories of introducers (lawyers and accountants) needs to be strengthened further. The assessors were made aware of cases in which banks placing reliance on introducers did not appear to be reviewing the introducers’ AML/CFT procedures subsequent to the assessment conducted at initial acceptance.

90. **Banks should implement stricter controls on the use of business introducers to ensure not only that the introducer is regulated but also that the introducer's AML/CFT procedures are reviewed on an ongoing basis. In accordance with best practice reported to the assessors by several banks, where concerns arise on the reliability of CDD conducted by a particular business introducer, or a significant number of SARs relate to customers they introduce, banks should always consider terminating business relations with the introducer..**
91. The MONEYVAL fourth round mutual evaluation report expressed concerns about the ability of financial institutions to fully apply CDD in relation to legal persons given the large backlog of amendments to registration details at the company registry. In addition to the backlog identified in the evaluation report, the registry receives only 60,000 to 70,000 of the annual returns and financial statements required by law. Few of the companies not providing these documents are followed up. It is not known how many of the companies not filing annual returns and financial statements are beneficially owned by non-Cypriots. This widespread failure to provide annual returns and financial statements also means that industry cannot fully apply customer due diligence measures where business relationships involve Cypriot companies.
92. **The Company Registry should be provided with the staff and other resources necessary to remove the backlog of amendments to company registration documents and to follow up unsubmitted annual returns and financial statements.**

#### Identification and verification of beneficial ownership

93. Banks interviewed advised the assessors that they pay particular attention to satisfying themselves that they know and have verified the identity of the natural person(s) who own or control the business structures doing business with the banks. A number of banks interviewed had IT systems for the compliance function which classified business relationships based on the country of residence or origin of beneficial owner. Others were in varying stages of developing this analysis at the time of the assessment.
94. The banks interviewed were persuasive when explaining the steps they took in general, and for higher-risk business in particular, that they had identified and verified the identity of beneficial owners (for all shareholdings exceeding 10% in accordance with the Cypriot legal requirement) across a range of corporate structures and arrangements. This needs to be considered, however, in the context of the risk profile of international banking business

conducted in/through Cyprus. The assessors consider that the characteristics of some of the business may create particular vulnerabilities for which, even with their best efforts, the banks may struggle to be certain that the claimed beneficial owner is - and continues to be during the life of the relationship - truly the natural person who is the owner or controller (e.g., in the case of some of the more complex introduced business cases). Other categories of business, though appearing complex in its final form, might not challenge the banks in conducting effective CDD for the reason that the beneficial owner is already well known to them and the business proposals and structures are built from Cyprus, with the beneficial owner as the starting point. In the case of a couple of banks interviewed, the explanation of the basis for being satisfied as to the beneficial owner was less compelling, focussing more on documentary procedures which, though from the discussions appeared to be comprehensive, would not in all cases guarantee that a bank 'knows who the beneficial owner is'. However, the scope of the assessment did not provide the assessors with the opportunity to independently test individual files and the practice of the Cypriot banks appeared on the face of it to meet the international standard in this area.

95. All banks interviewed made references to their practices in seeking to achieve face-to-face contact at some point with ultimate beneficial owners, particularly in relation to their largest and highest-risk customers. Methods described include one or more of the following:

- The relationship manager arranges a face-to-face visit to the business premises of an important customer, perhaps as part of a broader marketing trip;
- The customer is encouraged to visit the bank in Cyprus (not unusual for a customer to take a direct interest in the bank given the large amounts of the customer's funds the bank may have under its control);
- Some banks have group structures or maintain foreign branches and/or representative offices (e.g. most commonly in Russia but also in Greece, Ukraine and a range of other countries) that can provide a point of contact with customers and can facilitate the direct application of CDD measures, such as taking a copy of a passport. However, the extent and feasibility of use of this method is not clear to the assessors where the bank is dependent on, for example, a single representative office in Moscow to reach customers in a wide geographical area.

In the absence of direct access to customer files, the assessors could not confirm the extent of direct contact with beneficial owners by banks in Cyprus. Having regard in particular to the importance of introducers as a source of business for the banks, the assessors consider it likely that there remain cases for a number of the banks where they have not had face-to-face contact with the beneficial owner that may include situations normally classified as higher-risk. While this situation is not unique to Cyprus, it underlines the inherent riskiness from an

AML/CFT perspective of much of the international banking business conducted through Cyprus and the level of dependence on persons other than the beneficial owner to provide assurances, documentation and certifications.

96. **Banks should implement the highest level of enhanced due diligence, which could include (as indicated by some banks in Cyprus as already their practice in high risk cases) direct contact with the ultimate beneficial owner in a larger number of cases.**

Client Acceptance – economic and financial rationale for conducting business in/through Cyprus

97. The assessors noted that on deciding whether to accept new business, emphasis was placed by most banks on the economic and financial rationale for conducting the business in/through Cyprus, obtaining a plausible explanation for the choice of business structure or model, and conducting at least some measure of checking on the source of funds and/or wealth. While a number of other banks also mentioned conducting a reasonableness test before accepting new business, the assessors were left with the impression that the checks conducted in these cases might not have been so deep. Even for the remaining small number of banks that did not emphasise this point, there were nonetheless references to rejecting implausible business proposals (e.g. a 24 year old wishing to open an account to deposit a large sum and claiming to have wealth running into millions, without any supporting evidence and where an internet search did not provide any corroboration, would be rejected as either a potential fraud or as a ‘front’ for an unidentified other person).
98. The assessors requested statistics from the banks on the number of new account opening requests which have been refused or new business proposals rejected, as well as on terminations of ongoing relationships due to potential ML/TF concerns. While few banks could provide firm statistics, from available data and anecdotal evidence, the assessors conclude that a small but steady number of clients/prospective clients are formally rejected, with the most common reason being an unwillingness to provide the bank with requested supporting information. However, some banks also pointed out that many more cases may be turned away as unsuitable at the point of initial contact and never get to the stage of a formal account-opening application.
99. The assessors are not in a position to verify this information and suggest that it would be valuable for the banks’ own risk management purposes to record rejected business information more systematically, with the particular emphasis on the reasons for rejection.



This could be useful, inter alia, in identifying trends and as an additional component of staff training.

#### Higher risk categories of customers

100. A significant proportion of international business conducted in/through Cyprus would be considered by the assessors to have higher-risk characteristics. By definition, the international business is with non-residents and it is not unusual to have multiple jurisdictions and multiple parties involved in the transactions. As explained elsewhere in the report, much of the new business is introduced, from either domestic or cross-border sources. Information was given also on tax-driven business models and practices, including cash collateralised loans. Private banking and/or wealth management services are offered by a number of Cypriot banks. Use of trusts (some created under Cypriot law but more commonly created under the laws of other jurisdictions) as part of customer ownership structures is not uncommon and there remain some residual cases where company ownership is evidenced by non-Cypriot bearer shares. All of these are examples of practices that come within the definition of potentially high risk categories of customers in the FATF Recommendations and, as such may warrant the application of enhanced due diligence.

101. The banks interviewed explained that they conduct comprehensive risk-based due diligence checks. While the distinction between ‘normal’ due diligence and ‘enhanced’ due diligence might be difficult to define consistently for the Cypriot banks, reflecting the high levels of inherent risk in the scope of their due diligence, the levels of checking which the banks said they conducted appeared generally proportionate, except in the case of one bank.

102. The following paragraphs outline the findings of the assessors with regard to each of these categories of potentially higher-risk business and in relation to the implementation of enhanced levels of due diligence by the Cypriot banks interviewed.

#### *Introduced business*

103. The modalities of introduced business in the context of international banking business in Cyprus were outlined earlier in this report. By reference to the FATF standard, the assessors worked on the basis that this business does not typically represent a full reliance on third parties (i.e., validly, where certain conditions are met, relying on a regulated third party to conduct CDD and retain related documentation, to be obtained by

the relying bank only if requested). While all of the Cypriot banks maintained that they conduct their own full CDD in relation to business introduced to them, the assessors took the view that the Cypriot approach is something of a hybrid in that banks still place substantial reliance on the introducer in certain respects e.g., in making face-to-face contact with the customer, in sourcing and certifying identification documentation and in providing the business rationale for the overall scheme or structure. If the work of the introducer is sub-standard, this creates an exposure for the bank. Banks are aware of this exposure and, in discussions with the assessors, could point to at least a small number of cases in which they had discontinued their relationship with an introducer and removed them from their approved list based on one or more bad experiences – typically at the early stages of a new relationship.

104. It was noted that in the course of its inspection programme in the last three years the CBC identified a number of cases where banks placed reliance on third parties that did not fulfil the conditions required under the AML/CFT Law and the CBC Directive and most of the sanctions that were imposed by the CBC during this period were related to such breaches.

105. Most banks that accept business from introducers reported that they restrict the scope of such acceptance to Cypriot introducers, although cross-border intragroup introductions are also common. At least one bank interviewed sources its business mainly from non-Cypriot EEA introducers. Moreover, during the course of an interview conducted with one introducer who introduces business to six banks in Cyprus, it emerged that it was not unusual for customers to be introduced to a bank through a chain of more than one introducers, including where originating from other jurisdictions, which could include non-EEA countries. While the assessors accept that CDD work in these cases is nonetheless ‘conducted’ by the Cypriot bank, in line with the procedures set out in the CBC Directive, acceptance of business in this manner would still involve accepting confirmations and certifications through a chain of sources over which the banks has little or no control. It is this level of reliance on others – including in other jurisdictions – which increases the risk of misunderstanding or misrepresentation along the chain, potentially undermining the value of the CDD.

106. An outline of the supervisory framework for introducers can be found in Annex 6.

*Nominee shareholders and directors*

107. The use of nominees (as shareholders and/or directors) is a typical feature of companies registered as part of structures coming to banks, whether from business introducers or otherwise. In many cases, the banks informed the assessors that they insist on obtaining a certified copy of the trust agreement under which the beneficial owner appoints the nominee to act on his behalf. The assessors can accept that this approach should be effective in minimising the risk. However, the assessors were made aware in one of the interviews that a further issue can arise with introduced business where a beneficial owner insists on being the sole signatory on the bank account of a company for which a business introducer is acting as director. Typically, the bank relies on the introducer for access to information but in these circumstances he might no longer be in effective control of the use of the account. In addition to potentially creating difficulties for the introducer in meeting his legal obligations as a company director, this situation may also increase risk for the bank of misuse of the company account by the beneficial owner.

#### *Corporate Structures*

108. The assessors had extensive discussions with the banks on the range of corporate structures – newly created or migrated to them – which they encounter as part of their international banking business. Typically, as outlined elsewhere in this report, they relate to holding company structures, for purposes of tax minimisation and/or asset protection. In many structures, Cypriot-registered shelf companies are used in conjunction with companies registered in (or trusts under the laws of) other jurisdictions, to further reduce applicable taxes.

109. The banks explained that they conduct CDD at all levels of each structure until they are satisfied that the structure makes economic sense, and they have confirmed the registration of each of the companies and the identity of all beneficial owners. In the absence of access to customer files, the assessors could not confirm this directly. While this business, on the face of it, would normally be considered high-risk, the assessors could accept that where a bank was from the outset closely involved or informed of the creation of the structure, enhanced ongoing due diligence might not always be warranted. Although most of the banks interviewed acknowledged that some of the business they accept involves more complex structures, and is therefore treated by them as higher-risk in nature, they apply the same approach of working through the structure to satisfy

themselves that they have documentary evidence of registration and ownership at each level and are satisfied also that they know the beneficial owner(s).

110. With regard to trusts (mostly non-Cypriot), there was a divergence among the banks on the conduct of due diligence. Approximately half of the banks interviewed who accept at least some trust structures, which the assessors understand are not very widely encountered, insist on access to the full trust deed. The remainder accept extracts showing the names of the parties involved and thus run the risk that key information might have been withheld from them. In all cases, the banks explained that, in accordance with the CBC Directive, they identify – and verify the identity of – a range of parties to the trust, including the trustees, settler and beneficiaries. In the absence of access to customer files, the assessors consider that the due diligence described would comply with best international practice, but also note that trust structures and other such legal arrangements can in practice be constructed in a manner that can mislead and the application and beneficial ownership of trust assets can be controlled in ways which are not necessarily specified in the trust deed itself. As for other business types described in this section, the further removed the Cypriot bank is from the beneficial owner, the more vulnerable it is to being misled. However, based on the information made available to the assessors, no particular example of weak CDD for trusts was identified.

#### *Cash-collateralised loans*

111. While most banks interviewed confirmed that they have provided at least some back-to-back or cash-collateralised facilities, they were seen to be of more significance in a small number of the banks and there appeared to the assessors to be a particular Russian connection to such facilities. Examples quoted to the assessors included the routing of financing of a Russian business through a Cypriot bank by incoming deposit supporting an outgoing loan by the bank to the Russian business. In this way, the arrangement serves the needs of both asset protection and the likelihood that the businessman would get repayment of his investment. If structured correctly, certain tax advantages also accrue.
112. Inherently, cash-collateralised loans eliminate credit risk. However, they may carry material ML or TF risk. Banks interviewed that engage in this business emphasised the importance of getting comfort on two main aspects; (1) that the incoming deposited funds can be confirmed to come from a legitimate source and (2) that the business receiving the loan actually exists and can demonstrate its economic rationale.

113. These points are supplemental to the key issue of knowing the beneficial owner and conducting all other standard CDD. As the assessors were not in a position to examine individual cases, no conclusion can be drawn in relation to the effectiveness of CDD for this area, beyond noting that it is potentially very high risk business, not least due to the difficulty of obtaining independent and reliable verification of the source and legitimacy of incoming funds.

#### *Client Accounts*

114. As is normal, many of the banks operate client accounts, mostly as pooled accounts for lawyers, but in some cases also for accountants and at least potentially real estate agents. It is included here as a category of potentially high-risk business due to the use of such accounts as part of the process of concluding deals for non-resident clients. The range of enhanced due diligence applied to client accounts varied across the banks interviewed. In all cases, banks stated that they complied with the requirement in the CBC Directive to apply CDD measures to all transactions in such pooled accounts above EUR15,000, including obtaining documentation in support of each transaction. One bank opted to go further, in also requiring the small number of lawyers for whom they operate accounts to designate sub-accounts for each client for clarity. In this area, the assessors are satisfied that the practices of the banks, in accordance with the requirements specified by the Cypriot authorities, are in line with international best practice. However, no view is offered on the transactions of the lawyers themselves as this topic is beyond the scope of the assessment.

#### *Bearer shares*

115. According to the banks interviewed, bearer shares (non-Cypriot) still feature in some of the structures they have accepted but only a few examples remain, with most shares having been registered in recent years. It is to be noted that it is not possible to issue shares in bearer form for a Cypriot-registered company. In the few relevant cases, the banks explained they have either immobilised the bearer shares themselves by maintaining physical custody or, more rarely, rely on a custodian (typically a bank outside Cyprus) to provide a written undertaking that they hold custody of the shares. In addition, the banks obtain on an annual basis from the beneficial owner a written confirmation of changes, if any, relating to the ownership of the bearer shares. The assessors welcome the reduction in use of bearer shares. The assessors could not form a firm view on the effectiveness of the CDD measures in this case. As described, they

appear to depend heavily on the integrity of the beneficial owner and his willingness to provide accurate information on the true ownership of the shares and any changes therein, particularly changes occurring between the annual reviews.

#### *Use of cash*

116. Based on the interviews with the banks, the assessors did not find extensive evidence of account opening in Cyprus funded by large cash deposits, except for a small number of specific cases. In addition to the to-be-expected deposits from cash-generating local businesses, a couple of banks highlighted trends in the recent past of Greek residents withdrawing funds from the Greek financial system, travelling to Cyprus with cash to be deposited in Cypriot banks. A similar practice, though with a different domestic cause was reported in the case of Egyptian Coptic Christians. In all cases, the banks confirmed that, in accordance with the CBC Directive, they would not accept amounts in excess of EUR 10, 000 without the required evidence of declaration to Cypriot customs on arrival in the country. In addition, normal CDD procedures are applied and one bank also detailed the background checks they conduct to provide comfort that the original source of funds/wealth is from legitimate sources.

#### *High-risk jurisdictions*

117. When questioned on their approach to country or geographical risk, the banks generally referred to avoiding business with countries subject to UN sanctions (current and, in some cases, historical) and countries on lists published by the FATF as having weak AML/CFT requirements. A few banks applied analysis to determine on a risk basis some additional countries or regions from which they would not be prepared to accept business. In general, however, and reflecting the geographical location of Cyprus, banks are open to accepting business globally, and more particularly from most countries in the region – in some cases, they have access to local knowledge or are part of a banking group that already has a presence in the country of origin of business, placing them in a better position to assess country risk.

118. This section has highlighted a number of individual features of international banking business conducted in/through Cyprus, none of which are unique to Cyprus and many of which can be found in banking systems worldwide. Reference has also been made in this report to the extent to which CDD requirements are specified for these types of higher-risk

business in the very comprehensive CBC Directive. In general, and based on detailed interviews with the banks rather than direct checking by the assessors, the implementation of CDD measures in relation to these risks was seen to be proportionate to the individual risks, with a possible exception in the case of one bank.

119. Nevertheless, the assessors have a residual concern. The combination of a number of features associated with international banking business (e.g. introduced business *plus* complex structures *plus* use of nominees) may in some cases bring the cumulative level of inherent risk beyond a level capable of being effectively mitigated by the CDD procedures currently being applied. To provide one hypothetical example, in a case where a business proposal is received by a bank from a business introducer, in respect of a beneficial owner who is not already known to the bank and has just been referred indirectly to the business introducer, without face-to-face contact, and contains a proposed structure that includes more than one of the elements outlined above (cash collateralised loan, bearer shares, trust and nominee structures), the cumulative inherent risk may materially exceed the sum of each individual risk element.

120. A key issue is the extent to which this risk accumulation is recognised by the current approach to compliance (based mainly on obtaining documentary evidence for each component). In seeking to mitigate the risks it is best practice for a bank to have determined in advance its risk appetite for such complexity and to have set predefined limits for business acceptance. Another key issue is whether or not controls can be put in place to provide the bank with certainty regarding the customer's use of the structures and arrangements thus minimising the possibility of:

- abuse of the relationship for ML (including tax evasion) or TF; or
- changes made in beneficial ownership or structures being made without the immediate knowledge of the bank.

121. Therefore, the assessment team considers that the accumulation of high risks emanating from the use of complex structures combined with introduced business warrants the application of the highest level of enhanced due diligence and, which should be fully reflected in the bank-specific assessments.

122. **Concretely banks should as part of their overall risk policy:**

- i. Recognise that the accumulation of risks in complex business in itself presents overarching risk;**

- ii. **Determine their appetite for such complex business bearing in mind whether the bank is in a position to effectively monitor and control the cumulative risks sufficiently to mitigate the possibility of abuse for purposes of ML (including in respect of tax crimes) and FT;**
- iii. **Set out the enhanced measures which need to be taken to mitigate these overarching risks;**
- iv. **Specify cases where it is appropriate based on an assessment of the risks to reject or terminate a client relationship.**

123. **The accumulation of high risks has implications for the CBC's supervisory work, in particular in relation to those banks most exposed to such risks. The CBC should take these considerations into account and incorporate them appropriately when updating the CBC Directive.**

Information on the purpose and intended nature of the business relationship

124. The banks interviewed explained that information is routinely collected on the business and economic profile of a customer at the outset of the business relationship. This is in line with the CBC Directive, which set outs a detailed list of information that each bank is required to obtain on the customer, including the purpose and reason for opening the account, the anticipated account turnover, the nature of transactions and a clear description of the main business/professional activities/operations. Examples were provided by banks on the type of information and documentation which is generally obtained. Although on the basis of the interviews conducted the assessment team was satisfied that banks were sufficiently aware of this requirement, some of the banks indicated that one of the shortcomings identified during internal audit work and CBC on-site inspections was insufficient collection of information on the economic profile of certain customers.

125. **Banks should ensure that the purpose of the business relationship is identified and recorded in all cases and that the economic and business profile of high risk customers is detailed, meaningful, accurate and regularly updated, where this has not already been done.**

Ongoing monitoring

126. The role of banks' compliance functions with regard to ongoing monitoring and implementation of CDD measures can be divided as follows:



- Systematic transaction monitoring;
- Periodic review, including review of CDD at intervals determined by risk classification;
- Bringing CDD for existing customers up to current standards (deficiencies referenced earlier in this report).

127. All banks interviewed indicated that they had in place some means of checking transactions against expected activity for a customer and also checking against a set of indicators for potential money laundering or terrorist financing. A variety of approaches was described to the assessors, with varying degrees of scope, automation, and sophistication. A few banks were in the course of developing or expanding their automated systems and appear to be currently over-dependent on manual procedures. Almost all of the banks interviewed stressed the extent of the work done by their compliance functions, often in conjunction with relationship managers, to obtain comfort that individual large transactions are legitimate. The assessors were informed that invoices, contracts and other relevant supporting documentation is routinely requested from customers and examined for legitimacy before transactions can be cleared to proceed.

128. Without access to customer files, the assessors cannot directly confirm the depth or scope of this checking. However, as stated earlier, some banks indicated that one of the shortcomings identified by the CBC during on-site inspections was the collection of insufficient information on the business and economic profile of the customer. The assessors believe that such shortcomings, if they are of a more widespread nature, could have a significant bearing on the effectiveness of ongoing monitoring conducted by banks.

129. Furthermore, in view of the significant number of customers categorised as high risk by banks in Cyprus, the assessors were advised that automated checking systems can generate a high daily volume of alerts requiring attention. Given the substantial number of alerts involved, questions arise about the depth of necessary investigation into individual alerts. In a high risk environment, this also raises questions on the overall manageability of alert clearance, following sufficiently thorough consideration. Indeed, the assessors noted that not many cases of ML or TF suspicion are being identified through the automated monitoring systems.

130. **Banks should review the resources allocated to the monitoring of high risk international business and where necessary increase resources of compliance departments to fully investigate and properly review all the alerts raised on high risk**

**accounts. Any banks not already conducting such transaction checking thoroughly across the full range of their higher-risk business should be required to improve the effectiveness of their implementation.**

131. During the course of the on-site visit, 'Restrictive Measures on Transactions' were imposed by the Cypriot authorities to prevent capital flight. The assessment team asked for a confirmation from the CBC that no transfers had been carried out in breach of these restrictive measures, which was confirmed. Subsequently, media reports alleged that some capital had left the country in breach of these controls. In itself, this topic is outside the scope of this report. However, if these allegations are subsequently found to have some basis in fact, it may also have implications that bear on the effectiveness of ongoing monitoring of accounts, particularly if found to be connected to proceeds of crime.

#### Politically Exposed Persons

132. The customer base of some banks includes a significant number of PEPs. In most cases, the identification procedure of PEPs consists of a direct question included in the account-opening form. Checks are also carried out on various commercial databases and other open internet sources. In most cases account-opening forms examined by the assessment team did not include questions regarding 'immediate family members' or 'close associates'. Identification of such persons is generally dependent solely on the use of a single commercial database.
133. The assessment team concluded that some of the banks do not appear to have adequate measures in place to identify cases where an existing customer becomes or is subsequently found to be a PEP, despite being a requirement under the CBC Directive. Banks informed the assessment team that this situation would be identified as part of annual CDD reviews or, in the case of some banks, more frequently. The assessment team considers that this would generally be caught only where the client had already been identified as high risk. The review procedures for normal risk customers have a much longer time scale, typically 3 to 5 years.
134. In most cases the banks interviewed were able to demonstrate the effectiveness of their procedures with regard to obtaining information on the source of funds. However, with regard to obtaining comfort on the source of wealth, the explanations provided by the banks were not always persuasive. One bank indicated that no one had given them a definite answer

on what they ought to do in this respect and considered it beyond their terms of reference to enquire.

135. **Banks should strengthen the implementation of due diligence procedures in relation to PEPs, particularly when seeking to identify ‘family members’ and ‘close associates’ of PEPs, ascertaining source of wealth, and identifying customers who subsequently become PEPs. These issues may point to a need for the competent authorities to issue further guidance on establishing sources of wealth.**

#### Correspondent banking

136. Only few banks interviewed reported providing cross-border correspondent banking relationships to respondent institutions. Where they exist, ‘vostro’ accounts are mainly used for cross-border payments and foreign exchange. Many of these accounts appear to be held for financial institutions situated in countries outside the Euro area. In establishing such relationships, information on the business and reputation of the respondent institution is generally obtained from “The Bankers’ Almanac” and other online commercial databases.

137. The assessment of the AML/CFT control of respondent institutions is based on a questionnaire either developed internally or else based on the questionnaire created by the Wolfsberg Group. The establishment of correspondent relationships is in all cases approved by the highest level of management. The responsibilities of each institution are set out in the formal agreement entered into with the respondent bank. All of the banks providing correspondent services advised the assessors that they do not provide the services of “payable-through accounts” to respondent institutions.

138. It is to be noted that the Cypriot legal framework, contrary to the FATF standards, does not require the application of enhanced CDD in relation to correspondent relationships established with respondent institutions situated within the European Economic Area.

#### Wire transfers

139. Banks in Cyprus are required to comply with the obligations set out in European Union Regulation 1781/2006 on information on the payer accompanying transfers of funds, which is directly applicable in all European Union member states. Further guidance is provided in the CBC Directive. Although there was no opportunity to inspect the systems implemented by banks through files and records, the assessment team was satisfied from the

information they were given that all banks interviewed maintain adequate banking systems to automatically prevent transfers of funds that are not accompanied by complete information on the payer (name, address and account number). Complete information on the payer is verified on the basis of information obtained from a reliable and independent source. Most banks pointed out that this obligation was applied irrespective of the EUR 1,000 threshold set out in the CBC Directive. The majority of wire transfers are carried out from the account of an existing customer, where verification of the payer's identity would have already been carried out at the account-opening stage.

140. For incoming wire transfers, some banks reported that transfers containing incomplete information on the payer are automatically identified by the banking systems and rejected. Other banks reported that such transfers trigger an automatic report and the execution of the transfer is temporarily suspended. Within the suspension period, the bank requests the ordering bank to furnish the missing information. Where such a request is not satisfied the transfer is rejected.

141. Incomplete information on the payer is included in the internal procedures of all banks as a factor in assessing whether the transfer of funds is suspicious and whether it must be reported to MOKAS. However, the evaluation team noted that some banks do not keep a record on whether a particular ordering financial institution regularly fails to supply the required information on the payer, and to consider restricting or terminating the business relationship with such an ordering financial institution. On the other hand, one bank informed the evaluation team that an ordering financial institution was reported to MOKAS for the repeated failure to provide complete information on the payer and the business relationship with that ordering financial institution was terminated.

#### Record-keeping measures

142. All banks indicated that they satisfied record-keeping requirements and it was usual for the assessment team to be advised that records are maintained for longer than the minimum five year period, with periods of seven years, ten years and indefinitely being mentioned. Records are maintained either in paper or electronic form. Paper records were maintained either within the banks or in archive facilities. In some cases, banks were undertaking projects to scan paper records.

143. The CBC confirmed that information was made available promptly during its on-site inspections and in response to requests for information during off-site supervision such as investigations. MOKAS also confirmed that information was made available promptly.

Suspicious activity reporting

144. The assessment team sought to understand the reporting patterns of the banks interviewed, since the number and quality of SARs is an indicator of the quality of CDD. In general, the banks interviewed appeared to have a sound knowledge and awareness of reporting requirements.
145. Procedures and processes between the banks were similar. Internal reports are submitted to the compliance department by all the staff of the banks. These reports are investigated and, when the compliance department identifies concrete suspicions, a formal report is filed with MOKAS. It was also common for compliance departments to make reports to MOKAS not arising from staff reports but through their own monitoring or receipt of information from third parties, including the media. The number of SARs reported varied between banks. One bank had made 417 SARs to MOKAS from 2010 to 2012, while another had made two or three a year during this period.
146. MOKAS indicated that reports are always accompanied, where relevant, by information on the identity of beneficial owners involved in reported transactions, together with copies of passports. This appears to indicate that all banks obtain and maintain information on the beneficial owner.
147. Several banks noted that suspected fraud, particularly investment frauds, accounted for the majority of reports made to MOKAS. One bank added that corruption in relation to Greek business accounted for a number of reports. A majority of SARs appeared to be made in relation to business relationships which had been introduced and which included company structures. As already noted, the assessment team recommends that where a significant number of SARs emanated from a particular business introducer the banks concerned should always consider terminating business relations with that introducer. The residence of the subjects of the SARs also appeared to be broadly in proportion to the business base of the banks, although the suspected money laundering arising from fraud tended to emanate from Western European countries rather than from, for example, Russia or Ukraine. No other patterns in relation to SARs were reported by the interviewed banks.

148. As noted above, tax advantages available in Cyprus account for much of its international business. The identification by banks of suspicious activities involving tax and the analysis by MOKAS can lead to the identification of money laundering through tax crimes and other major predicate offences. In this way the SAR regime can mitigate some of the risks inherent in high-volume international business.
149. The fourth round MONEYVAL report noted that there were no restrictions on the reporting of suspicious activities regarding tax. Some tax offences under the Customs Code Law 2004 were already predicate offences to ML at the time of the last evaluation, as they carried penalties in excess of one year's imprisonment. MOKAS confirmed to the present assessment team that they do receive some SARs, but not many, involving tax offences, notwithstanding the fact that tax incentives are important in attracting business in Cyprus. Tax evasion under the Assessment and Collection of Taxes Law, however, was not a predicate offence to ML in 2010. The Cypriot authorities, by an amending law of 21 December 2012, raised the maximum penalty for fraudulent omission or delay to pay amounts of tax to the level required to render it a predicate offence for ML. Significantly, the Cyprus authorities accept that conduct committed abroad which would constitute a predicate offence domestically is also within the SAR reporting requirement. Thus, potentially SAR reports can now be made in respect of suspicions of foreign tax evasion offences identified particularly in international business transactions. Many of the banks and other obliged persons with whom the team met were either unaware or unclear about the full implications of these changes.
150. **The competent authorities should amend their directives to explain the new provisions on the introduction of tax crimes (including tax evasion) as predicate offences to ML. Careful guidance needs to be given on the assessment of risk in this context, including on business structures likely to be used for tax evasion purposes. Guidance should also be given on the identification of suspicious activities related to domestic and foreign tax evasion.** The amendments to the directives should be accompanied by awareness-raising initiatives by the regulators and MOKAS to ensure that the potential consequences of these changes are fully appreciated quickly by the private sector.
151. MOKAS may wish to consider focussing its analysis on tax-evasion-related ML once the new changes have been fully explained to the private sector. Where there is sufficient evidence, MOKAS will wish to ensure that investigation and prosecution are pursued in this area. Since the ML risk in Cyprus may involve tax crimes in foreign jurisdictions, MOKAS will wish to give high priority to the provision of relevant information spontaneously to its partners in and outside the European Union.

152. The team would expect the level of reporting on tax-related ML to increase considerably as a result of these developments.
153. The recent legislative changes may also help to improve Cyprus' domestic success rate in stand-alone ML cases, where foreign authorities are able to provide sufficient material to establish the underlying predicate tax offence in ML proceedings brought in Cyprus.
154. Overall, the assessment team found the framework for identifying and reporting suspicion to be basically sound, although, as noted above, the banks reported that not many SARs emanated directly from ongoing monitoring. Given the need for more SAR awareness-raising within the banks themselves in the immediate future connected with the recent tax changes, there is a need for additional staff training, for which a recommendation is included below.

Staff training on AML/CFT

155. Banks outlined to the assessors the range of training provided for compliance staff and client-facing staff regarding AML/CFT issues. While there were encouraging accounts of the use of case studies and particular emphasis on high-risk business, from the range of responses, the assessors had some concerns that:
- The amount of time devoted to training of client-facing staff may be insufficient;
  - In some cases, it appeared that little specialist training had been provided to the compliance function staff.
156. **Banks should review their current staff training arrangements, both for client-facing staff and for the compliance function, and enhance the training where necessary to reflect best practice, taking into account in particular the types of higher-risk business that staff are liable to encounter. All banks should focus training, *inter alia*, on the importance of creating and regularly updating economic and business profiles of customers, ongoing monitoring, and the identification of suspicion (particularly in the international business context).**

## **F. CONCLUSIONS**

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157. The assessment team has drawn a number of conclusions on the banking system in Cyprus and the effectiveness of the CDD implementation by the banks. The nature of these conclusions is twofold. The first set of conclusions relates to the vulnerabilities which are inherent within the business conducted by the banks. The second relates to weaknesses identified by the assessors in the implementation of CDD measures by banks.

158. As stated, a significant part of the business conducted by banks in Cyprus is international in nature and, commonly, involves the setting up of complex corporate structures, with different layers of entities situated in two or more jurisdictions and cross-border transactions involving counterparties in different parts of the world. The use of nominee shareholders/directors, client accounts and cash collateralised loans are often part of such business. Although tax incentives are important in attracting business in Cyprus, not many SARs have been submitted by banks with regard to tax-related money laundering.

159. Furthermore, a large part of the business is introduced to the banks by Cypriot lawyers, accountants and ASPs rather than sourced directly. In some cases, the customer is not directly introduced to the bank by a Cypriot introducer but through a chain of introducers sometimes situated outside Cyprus.

160. As a result, understanding the rationale behind the business and identifying the persons controlling the business may present particular difficulties, despite the banks' best efforts to obtain adequate information. Reliance is often placed on the introducer for such purposes. Although such reliance is an acceptable mode of satisfying CDD requirements, it can present a number of challenges. The bank, in most cases, remains one or more steps removed from direct contact with the beneficial owner. Additionally, the level of information on the customer is only as good as the quality of CDD documentation and certification provided by the introducer and changes in the business structure or the beneficial owner may potentially take place without the bank's knowledge.

161. Overall, it was concluded that while the business carried out in Cyprus is not intrinsically different from international business carried out in other jurisdictions, the magnitude of the business and the combination of various features which are characteristic of the Cypriot regime may raise the degree of cumulative risk to a level that is difficult to manage.



162. Weaknesses within the effective implementation of CDD requirements, which further augment the risk of abuse, were identified. Procedures dealing with ML/FT risk are typically based on the risk-categories set out in the CBC Directive rather than on an assessment of the real and potential risks posed by the type of customers and services offered by the bank. Compliance staff are not always consulted in the process for acceptance of new high-risk customers. The business and economic profile of customers is not always detailed enough to provide an adequate baseline for meaningful ongoing monitoring. The substantial number of alerts generated by automated monitoring systems can be disproportionate to the number of staff managing these alerts. The amount of time devoted to training of front-line staff appears to be insufficient and little specialist training is provided to the compliance function staff. Some of the banks do not appear to have adequate measures in place to identify cases where an existing customer becomes or is subsequently found to be a PEP. Measures to identify 'immediate family members' or 'close associates' of PEPs and to obtain information on the source of wealth of PEPs are generally weak. Not many SARs are submitted by banks in relation to tax-related suspicions of ML.

163. In light of the vulnerabilities and weaknesses identified by the assessors, various recommendations are being made in Section G to ensure expedited and targeted action by the banking sector.

## G. RECOMMENDED ACTION PLAN

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*Each recommendation below includes in brackets proposals as to the priority and suggested timescale for implementation.*

1. Each bank should combine all of its risk analyses into an overall AML/CFT risk policy document, for Board approval, based on a thorough and meaningful consideration which should include in particular any risk areas that might not previously have received sufficient attention. This analysis should be updated on a regular basis.

Concretely, banks should as part of their overall risk policy:

- i. Recognise that the accumulation of risks in complex business in itself presents overarching risk;
- ii. Determine their appetite for such complex business bearing in mind whether the bank is in a position to effectively monitor and control the cumulative risks sufficiently to mitigate the possibility of abuse for purposes of ML (including in respect of tax crimes) and FT;
- iii. Set out the enhanced measures which need to be taken to mitigate these overarching risks;
- iv. Specify cases where it is appropriate based on an assessment of the risks to reject or terminate a client relationship.

*[High priority – 6 months and ongoing]*

2. In cases involving an accumulation of high risks, particularly where emanating from the use of complex structures combined with introduced business, banks should strengthen their current procedures in line with their updated risk policy and consistently implement the highest level of enhanced due diligence. This could include (as indicated by some banks in Cyprus as already their practice in high risk cases) direct contact with the ultimate beneficial owner in a larger number of cases. *[High priority – 6 months and ongoing]*

3. Banks should implement stricter controls on the use of business introducers to ensure not only that the introducer is regulated but also that the introducer's AML/CFT procedures are reviewed on an ongoing basis. In accordance with best practice reported to the assessors by several banks, where concerns arise on the reliability of CDD conducted by a particular business introducer, or a significant number of SARs relate to customers they introduce, banks should always consider terminating business relations with the introducer. *[High priority – 6 months and ongoing]*

4. When accepting higher risk customers, banks should ensure, where not already the case, that ML/FT risk issues are taken fully into account, with the process involving the expertise of the compliance function in an enhanced advisory role. *[High priority – 6 months and ongoing]*
5. Banks should review the resources allocated to the monitoring of high risk international business and where necessary increase resources of compliance departments to fully investigate and properly review all the alerts raised on high risk accounts. Any banks not already conducting such transaction checking thoroughly across the full range of their higher-risk business should be required to improve the effectiveness of their implementation. *[High priority - ongoing]*
6. Banks should strengthen the implementation of due diligence procedures in relation to PEPs, particularly when seeking to identify ‘family members’ and ‘close associates’ of PEPs, ascertaining source of wealth, and identifying customers who subsequently become PEPs. These issues may point to a need for the competent authorities to issue further guidance on establishing sources of wealth. *[Medium priority – 12 months]*
7. Banks should ensure that the purpose of the business relationship is identified and recorded in all cases and that the economic and business profile of high risk customers is detailed, meaningful, accurate and regularly updated, where this has not already been done. *[Medium priority – 6-12 months, risk prioritised]*
8. Banks should update any remaining outstanding CDD in relation to existing customers without further delay. *[Medium priority – 6-24 months, risk prioritised]*
9. Banks should review their current staff training arrangements, both for client-facing staff and for the compliance function, and enhance the training where necessary to reflect best practice, taking into account in particular the types of higher-risk business that staff are liable to encounter. All banks should focus training, *inter alia*, on the importance of creating and regularly updating economic and business profiles of customers, ongoing monitoring, and the identification of suspicion (particularly in the international business context). *[Medium priority – 12 months and ongoing]*

*The following supplemental recommendations are included as they are directly relevant to placing the banks in a position to implement effective CDD measures:*

10. The competent authorities should amend their directives to explain the new provisions on tax crimes (including tax evasion) as predicate offences to ML. Careful guidance needs to be

given on the assessment of risk in this context, including on business structures likely to be used for tax evasion purposes. Guidance should also be given on the identification of suspicious activities related to domestic and foreign tax evasion *[Medium priority – 6-12 months]*

11. The accumulation of high risks has implications for the CBC's supervisory work, in particular in relation to those banks most exposed to such risks. The CBC should take these considerations into account and incorporate them appropriately when updating the CBC Directive. *[Medium priority – 12 months]*
12. The Company Registry should be provided with the staff and other resources necessary to remove the backlog of amendments to company registration documents and to follow up unsubmitted annual returns and financial statements. *[Medium priority – 12 months]*
13. The supervisory regime for ASPs should be brought fully into effect as quickly as possible and the AML/CFT supervision of lawyers and accountants, in their role as business introducers, should be further strengthened. *[Medium priority – 12 months and ongoing]*

**GLOSSARY**

Administrative service providers (ASPs)	<p>Persons authorised by CYSEC to provide the following services:</p> <ul style="list-style-type: none"> <li>• The managing or directing of trusts;</li> <li>• The undertaking or provision of the service of managing companies, including but not limited to the managing of companies, general or limited partnerships, or other organisations with or without separate legal personality and the provision of the following services;</li> <li>• Providing directors for legal persons;</li> <li>• Holding the share capital of legal persons and registering the holder in the respective registers of shareholders on behalf of legal persons;</li> <li>• Provision of address of registered office and /or the official mail/electronic address of companies;</li> <li>• Provision of other similar services;</li> <li>• Opening or managing bank accounts; safe keeping of financial instruments on behalf of clients and other related services unless this is provided as an ancillary service in the framework of the Investment Services and Activities and Regulated Markets Law.</li> </ul>
Bearer shares	Negotiable instruments that accord ownership in a corporation to the person who possesses the bearer share certificate.
Beneficial owner	The natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement.
Brass-plate companies	Legal entities registered in Cyprus with non-resident ownership with no physical presence in Cyprus.
Business introducer	A lawyer, accountant or an ASP who introduces customers to banks in Cyprus and is subject to the AML/CFT requirements of Cypriot Law.
Competent authorities	CBC, CYCSEC, CBA, ICPAC and MOKAS

Correspondent banking	The provision of banking services by one bank (the “correspondent bank”) to another bank (the “respondent bank”). Large international banks typically act as correspondents for thousands of other banks around the world. Respondent banks may be provided with a wide range of services, including cash management (e.g. interest-bearing accounts in a variety of currencies), international wire transfers of funds, cheque clearing, payable-through accounts and foreign exchange services.
Customer Due Diligence (CDD)	Measures set out in Recommendation 5 of the FATF Recommendations to be applied by financial institutions before establishing a business relationship with a customer and on an ongoing basis thereafter, for the purpose of, <i>inter alia</i> , identifying and verifying the identity of a prospective customer, obtaining information on the nature and purpose of the prospective business relationship and monitoring the business relationship after its establishment.
Designated non-financial businesses and professions (DNFBPs)	Designated non-financial businesses and professions means: <ul style="list-style-type: none"> <li>a) Casinos (which also includes internet casinos).</li> <li>b) Real estate agents.</li> <li>c) Dealers in precious metals.</li> <li>d) Dealers in precious stones.</li> <li>e) Lawyers, notaries, other independent legal professionals and accountants – this refers to sole practitioners, partners or employed professionals within professional firms. It is not meant to refer to ‘internal’ professionals that are employees of other types of businesses, nor to professionals working for government agencies, who may already be subject to measures that would combat money laundering.</li> <li>f) Trust and Company Service Providers refers to all persons or businesses that are not covered elsewhere under these Recommendations, and which as a business, provide any of the following services to third parties: <ul style="list-style-type: none"> <li>• acting as a formation agent of legal persons;</li> <li>• acting as (or arranging for another person to act as) a</li> </ul> </li> </ul>

director or secretary of a company, a partner of a partnership, or a similar position in relation to other legal persons;

- providing a registered office; business address or accommodation, correspondence or administrative address for a company, a partnership or any other legal person or arrangement;
- acting as (or arranging for another person to act as) a trustee of an express trust;
- acting as (or arranging for another person to act as) a nominee shareholder for another person.

FATF Recommendations      The 2003 Forty Recommendations and the Nine Special Recommendations on Terrorist Financing.

Financial Action Task Force (FATF)      An inter-governmental policymaking body whose purpose is to establish international standards, and to develop and promote policies, both at national and international levels, to combat money laundering and the financing of terrorism.

Financial Intelligence Unit (FIU)      Recommendation 26 of the FATF Recommendations requires countries to establish a FIU that serves as a national centre for the receiving (and, as permitted, requesting), analysis and dissemination of STR and other information regarding potential money laundering or terrorist financing. The FIU should have access, directly or indirectly, on a timely basis to the financial, administrative and law enforcement information that it requires to properly undertake its functions, including the analysis of STR.

MOKAS      The Cypriot FIU

Payable-through accounts      Correspondent accounts that are used directly by third parties to transact business on their own behalf.

Politically Exposed Persons (PEPs)      Individuals who are or have been entrusted with prominent public functions in a foreign country, for example Heads of State or of

government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials. Business relationships with family members or close associates of PEPs involve reputational risks similar to those with PEPs themselves. The definition is not intended to cover middle ranking or more junior individuals in the foregoing categories.

Predicate offence	The underlying criminal activity that generates funds to be laundered.
Suspicious Activity Reports (SARs)	Recommendation 13 of the FATF Recommendations requires financial institutions to report to the FIU when they suspect or have reasonable grounds to suspect that funds are the proceeds of a criminal activity.
Wire transfers	Any transaction carried out on behalf of an originator person (both natural and legal) through a financial institution by electronic means with a view to making an amount of money available to a beneficiary person at another financial institution. The originator and the beneficiary may be the same person.



ANNEX 1



EUROGROUP WORKING GROUP

THE PRESIDENT

Brussels, 09 March 2013  
ecfin.cef.cpe(2013)384422

Dear Mr. Ringguth,

Cyprus has requested financial assistance from the euro area in 2011, and the Eurogroup is now targeting political endorsement of such assistance around the second half of March.

As part of the preparations for an adjustment programme that would underpin the assistance, the finance ministers of the euro area have agreed with Cyprus on commissioning an independent evaluation of the implementation of the anti-money laundering framework in Cypriot financial institutions. Since the available timeframe is regrettably tight, convincing progress on this evaluation would need to be made at an unusually accelerated pace.

I understand that the Troika institutions (the European Commission, ECB and IMF) and Cyprus have agreed that Moneyval's participation in this process would be invaluable. I would like to express my support for such an approach in view of Moneyval's widely recognised expertise in this field.

Specifically, one would envisage Moneyval conducting an assessment of whether customer due diligence (CDD) requirements are effectively implemented in the banking sector. This assessment would follow the FATF methodology, and could be carried out in collaboration with international experts.

As chairman of the Eurogroup Working Group, I would very much appreciate if you could signal at the earliest opportunity whether Moneyval can consider undertaking such an evaluation. In case the reply is favourable, I would request that you contact the Central Bank of Cyprus to agree on the practicalities of the next steps.

Yours sincerely,

Thomas Wieser

Mr. Mr John RINGGUTH  
Executive Secretary to MONEYVAL  
Council of Europe  
67075 Strasbourg CEDEX, FRANCE  
[john.ringguth@coe.int](mailto:john.ringguth@coe.int)

**ANNEX 2**

**SECRETARIAT GENERAL**

DIRECTORATE GENERAL  
HUMAN RIGHTS AND RULE OF LAW

**MONEYVAL**



Please quote: DGI/JR/cg

Mr Thomas Wieser  
President  
Eurogroup Working Group  
European Commission  
Rue de la Loi, 170  
1040-Bruxelles

Strasbourg, 12 March 2013

Dear Mr Wieser,

Thank you for your letter of 9 March.

I confirm that MONEYVAL is prepared to conduct such an assessment on an exceptional basis. I expect the terms of reference will be agreed today.

We hope to be able to begin our work in Cyprus on 19 March.

Yours sincerely,

John Ringguth  
Executive Secretary to MONEYVAL

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**ANNEX 3**

**KEY ELEMENTS FOR A THIRD PARTY AML AUDIT OF THE EFFECTIVE IMPLEMENTATION OF CDD  
MEASURES WITH REGARD TO DEPOSITS AND LOANS**

Objective:

Assess whether Customer Due Diligence (CDD) requirements are effectively implemented in accordance with the Cypriot legal framework<sup>11</sup> and international standards for a meaningful share of the banking system's balance sheet. Assessment should also be made about the level and composition of foreign-related deposits and loans in Cypriot credit institutions.

Scope:

- Moneyval in collaboration with international experts will conduct an assessment, according to the FATF 2003 Recommendations and 2004 Methodology, of the CDD compliance in the banking sector, Moneyval will focus on the effectiveness of implementation.
- An independent auditor will focus on the measures implemented by the credit institutions to prevent criminals from being the beneficial owners of customer deposits in, or loans from, Cypriot credit institutions.
  - All credit institutions<sup>12</sup>, over a threshold of EUR 2 billion of total deposits (by end-2012) should be included in the exercise.
  - Sampling modalities to achieve the audit's general objectives will be approved by the CBC and the programme partners.
  - The exercise will focus on stocks (deposits and loans) rather than flows (transfers from and to Cyprus). However, in the context of the analysis of stocks, the auditor will have to ensure that credit institutions have adequate knowledge of the origin and destination of funds.
  - Because of time constraints, this audit will not cover the adequacy of the internal systems in place in credit institutions to detect ML/TF.
  - This audit will also contain an analysis of the breakdown of deposits made and loans granted by i) country of residence, and ii) by country of origin, for both the owners and beneficial owners.
  - The data collected will be used solely for the exercise of this implementation review.

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<sup>11</sup> The 2007 AML Law and the 2008 Central Bank of Cyprus (CBC) Directive on the prevention of money laundering and terrorism financing

<sup>12</sup> As defined in Art. 2.1(1) of the Third Anti-Money Laundering Directive, 2005/60/EC

Methodology/Sampling<sup>13</sup>:

The audited institutions will present the auditor with a breakdown of deposits made and loans granted by i) country of residence, and ii) country of origin, for both the owners and beneficial owners, as well as the individual share and origin of the top 100 owners and borrowers.

MoneyVal and the independent auditor will be granted access to all the information necessary to perform their respective tasks.

Process:

The auditor will perform this work in order to:

- Ensure that customers were identified and that their identity was adequately verified.
- Ensure that beneficial owners were identified and that reasonable measures were taken to verify their identity.
- Ensure that the purpose and intended nature of the business relationship was understood and documented.
- Ensure that ongoing due diligence was conducted.
- Ensure that customers designated as higher risk were effectively subject to enhanced due diligence.
- Ensure that unusual and/or suspicious activities/transactions on the accounts, are properly detected and recorded.
- Ensure that other customers and beneficial owners were risk rated and that enhanced CDD measures were applied.
- The auditor will not perform any investigations, but will analyze the information provided by each bank in light of the legal framework and best practices, including with regard to risk profile.

Output:

By March 27, 2013 Moneyval and the auditor will prepare preliminary key findings on the overall credit sector's level of compliance with the AML legal framework. These findings will not contain any confidential information and will only be shared within Moneyval, the auditor, the CBC and programme partners (EC/ECB/IMF).

Upon completion of the work, Moneyval will present its assessment of the compliance with CDD measures against the FATF standards, focussing on effectiveness of implementation. Moneyval will also submit main findings and recommendation with this assessment. The results will be taken into account in Moneyval's own processes in the future.

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<sup>13</sup> To be agreed with the contractor, but likely to involve on-site meeting with the CBC and credit institutions.

The auditor will present a report containing comments and conclusions with regard to both the overall credit sector's and individual institutions' level of compliance with the Cypriot legislation on CDD. The report should present quantitative data on the level and breakdown of deposits made by and loans granted to foreign nationals, and indicate the extent to which this data is reliable (e.g. if beneficial ownership information is not properly verified, the quantitative data might not be comprehensive).

For each bank, the auditor will also provide an individual report listing customers in the sample and related CDD compliance analysis (allocating a number by customer in order to preserve confidentiality).

The auditor will cross-check the information received from the bank under 1. above with the results of its work.

The relevant reports from Moneyval and the auditor should be delivered to the CBC as well as to the Minister of Finance and to the programme partners by March 31, 2013. The programme partners will report to the Eurogroup on the level of implementation of preventive measures by financial institutions, based on the findings of Moneyval's and the auditor's reports.

#### Contracting:

The work will be carried out as follows: i) the CBC will commission an independent auditor of the utmost integrity who would be bound by the provisions of the CBC Law, and in particular by the provisions for professional secrecy therein; and ii) the President of Eurogroup Working Group will make a request for an assessment by MONEYVAL which could include international experts. The independent auditor should be agreed by CBC and programme partners. The auditor will be contracted, in full respect of EU public procurement rules<sup>14</sup>. Preference should be given to an auditor with no existing business relationship with the Cypriot government, related agencies, or Cypriot financial institutions.

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<sup>14</sup> According to Directive 2004/18/EC the accelerated procedure set out in Art.38.8a allows for a shortened tender procedure (10 days if the notice was sent by electronic means, in accordance with the format and procedure for sending notices indicates in point 3 of annex VIII of the Directive). The dates indicated above are based on the work of the auditor starting on March 19.

## ANNEX 4

### **The Fourth Round MONEYVAL Assessment of Cyprus**

1. As a member of the Council of Europe, Cyprus is subject to MONEYVAL's evaluation process which assesses countries' compliance with the FATF Recommendations. At the time of this assessment, the last evaluation of Cyprus had been carried out in June 2010 (report adopted on 27<sup>th</sup> September 2011) under MONEYVAL's fourth evaluation round.<sup>15</sup> This section of the report provides an overview of the findings related to Customer Due Diligence and other related measures set out in the fourth round Mutual Evaluation Report (MER) of Cyprus. It is to be noted that the assessment of preventive measures was not based on an assessment of the banking sector only, as is the case in the current assessment, but on the financial sector as a whole.
  
2. Under the fourth round assessment, the legal provisions in the Cypriot AML Law providing for the application of CDD requirements were found to be broadly in place. A few minor technical shortcomings were identified which mainly related to issues arising as a result of the slight non-alignment between Directive 2005/60/EC and the FATF Standards on simplified CDD and the treatment of correspondent banking relationships with respondent banks situated in a member state of the European Union. In terms of the effective application of CDD requirements by the financial sector, the evaluators noted that although awareness and understanding of the CDD obligations were generally sound, certain sectors, particularly the insurance and the money/value transfer sectors, displayed a weak understanding of the concept of beneficial ownership, especially insofar as the identification of beneficial owners of a foreign legal entity or arrangement is concerned. Potential effectiveness issues were also noted with respect to the identification and verification procedures of legal entities registered with the Registrar of Companies in Cyprus due to the incomplete data which was available at the registry.
  
3. The evaluators also noted that the AML Law sufficiently covered the requirements dealing with politically-exposed persons (PEPs), although various minor deficiencies were identified. The definition of a PEP was found not to extend to foreign PEPs residing in Cyprus and the application of PEP-related measures did not cover beneficial owners. Furthermore, the

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<sup>15</sup> MONEYVAL is the only AML/CFT assessment body conducting a follow-up round of assessments following the conclusion of the third round of global evaluations under the 2003 FATF Standards. This follow-up round is a partial re-assessment of the effectiveness of implementation of some, but not all, of the 2003 FATF Standards, namely R. 1, 3, 4, 5, 10, 13, 17, 23, 26, 29, 30, 31, 35, 36, 40, SR I, II, III, IV and V, as well as those other FATF recommendations rated non-compliant or partially compliant in the third round. As such, comparisons between third round results and fourth results may be misleading.

requirement to obtain senior management approval to continue a business relationship where an existing customer is found to be or subsequently becomes a PEP was not provided for in the law. However, the evaluators concluded that the practical application of PEP requirements appeared to be effective, despite the strong reliance on commercial databases to identify PEPs.

4. Measures related to record-keeping were considered to be compliant with the FATF standards. In practice, financial institutions went beyond the five-year record-keeping period and it appeared that no difficulties had been experienced by competent authorities in obtaining the recorded information in a timely manner. Positive findings were also reported in relation to the application of wire-transfer rules. Financial institutions met by the evaluators appeared to have an adequate level of awareness of the measures which are required to be applied.
5. With regard to the reporting regime, the evaluators observed that financial institutions focussed their resources on the risks emanating from international business, which as noted elsewhere in this report is prevalent in Cyprus. In fact, the large majority of SARs filed with MOKAS related to non-resident customers. Although the level of reporting appeared to be satisfactory, most SARs were submitted by banks. The other financial institutions were less active in this area.
6. The AML/CFT supervisory structure was found to be broadly sound. All the necessary powers to perform supervisory functions were largely in place. Nevertheless, concerns were raised regarding the absence of a risk-based approach to supervision by some supervisory authorities and the noticeable decrease in the number of on-site inspections carried out. Additionally, the overall number of sanctions imposed for AML/CFT breaches appeared to be low in proportion to the size of the financial sector.
7. The evaluators determined that compliance with DNFBP requirements was not adequate. Although Trust and Company Service Providers were required to comply with the provisions of the AML Law, they were still unregulated at the time of the assessment. Moreover, the scope of application of the AML Law to the accountancy profession did not appear to adequately cover all the activities included in the FATF Standards. Weaknesses were noted in the effective application of CDD measures in relation to the identification of beneficial owners. A low level of STR reporting was also identified. With regard to the supervision of designated non-financial businesses and professions (DNFBPs), various shortcomings were identified. In particular, the evaluators found insufficient evidence to conclude that effective

supervision had been carried out, mainly as a result of a lack of resources. Additionally, no sanctions had been imposed on DNFBPs for failure to comply with AML/CFT requirements.

Action by Cyprus since the fourth round

8. Cyprus is due to present an update in December 2013 to the MONEYVAL plenary.
9. Information provided for the purposes of this assessment of CDD measures in the banking sector shows that the AML Law has not yet been amended since the fourth round MONEYVAL assessment. Thus, the technical compliance issues found in the MER have not been addressed. However, this assessment team was informed that a draft bill amending the AML Law, which is to be presented to parliament shortly, contains a number of changes:
10. Clarifying that third parties on which banks are authorised to rely may operate in the Cypriot republic or in other countries of the European Economic Area;
  - a. Revising the provisions dealing with simplified CDD measures to address the deficiencies identified in the fourth round MONEYVAL report, which permitted banks and other financial institutions not to apply any form of CDD measures with respect to certain categories of customers and products;
  - b. Amending the definition of a PEP to cover foreign PEPs residing in Cyprus.
11. The new legal provisions do not address the following deficiencies identified by the fourth round evaluators:
  - a. Requiring senior management approval in those cases where an existing customer becomes or is subsequently found to be a PEP (for the insurance sector);
  - b. Require the implementation of a risk-based procedures to determine whether the beneficial owner of a business relationship or transaction is a PEP (for the insurance sector);
  - c. Requiring banks and other financial institutions to establish the source of wealth and source of funds in all circumstances;
  - d. It is noted that the draft provisions do not appear to address the issue of domestic PEPs as required under the revised FATF Recommendations (2012).
12. The Company Registrar advised the present assessment team that the registry moved to an electronic system of company formation from the end of 2012. The new IT system is expected to release staff to deal with the backlog of non-updated information. The registrar anticipates that the registry will be in a stronger position by the end of 2014.



## ANNEX 5

### **Supervision of Banks**

1. According to the AML/CFT Law, the Central Bank of Cyprus (CBC) is responsible for the AML/CFT supervision of banks.
2. The Banking Supervision & Regulation Department of the CBC includes an AML/CFT inspection team responsible for the AML/CFT off-site and on-site supervision. The CBC indicated to the assessors that a decision has been made to increase the staff complement of the AML/CFT inspection team.
3. The CBC has developed a risk-based methodology for off-site and on-site monitoring compliance with AML/CFT requirements by banks. A risk assessment is performed by the CBC during the first weeks of each year with a view to establishing its supervisory program. On this basis, the CBC places more emphasis on banks which carry out sizeable international business activities. Each bank is assessed with regard to the risks that it is exposed to, taking into account its size, complexity and nature of the business. For instance, on the basis of the assessment by the Advisory Authority against Money Laundering and Terrorist Financing that the main risks for Cyprus emanate from the international business activities at the layering stage, the CBC decided to give more emphasis in the framework of its supervisory plan for the year 2012 to banks which carry out sizeable international business activities.
4. The decision as to which financial institutions will be examined is also influenced by the findings of previous examinations, by the date of the last on site examination, as well as by information (financial and non-financial) collected during off-site monitoring. A priority ranking for inspections is then defined. For each bank included in the list of inspections for the year, the CBC determines which units/departments need to be visited. According to the Cypriot authorities, the accuracy of decisions made by the CBC regarding its AML/CFT inspection programme is facilitated by the relatively limited number of Cypriot banks and is also based on close knowledge of each bank by the Supervision Department.
5. *Off-site supervision:* Banks are required by the CBC to report monthly data regarding large cash deposits from customers, large incoming and outgoing fund transfers, the number of internal reports submitted to the Money Laundering Compliance Officer (MLCO), and the number of suspicious activity reports sent to MOKAS. Moreover, the off-site examination is also based on more qualitative information contained in the annual activity report that the

MLCO of each bank is required to submit to the Board of Directors and forwarded to the CBC. This includes, *inter alia*, information relating to inspections and reviews performed by the MLCO and the bank's Internal Audit Unit, the material deficiencies and weaknesses identified in the bank's AML/CFT policies, procedures and controls applied by the bank in relation to high risk customers, as well as information regarding the number and characteristics of high risk customers (companies with bearer shares, trusts, politically exposed persons, etc.), the systems and procedures applied by the bank for the on-going monitoring of accounts and transactions, the training attended by the MLCO team as well as provided to the bank's staff, and the structure and staffing of the MLCO's section. The off-site supervision is also based on regular meetings with Senior Management, Internal Auditor, and MLCO of banks. In addition, external information obtained through the cooperation with other supervisory authorities, the law enforcement authorities and MOKAS constitute other important bases for the off-site supervision. This is complemented by review of public sources of information (including the local and foreign press). Information and alerts coming from other businesses or the public are also taken into consideration.

6. The information received is assessed to ensure banks' compliance with the legal and regulatory framework, allowing the CBC to identify outliers requiring closer attention with the aim to foster compliance improvements, as well as to identify priority areas for supervisory planning in the banking sector.
7. *On-site supervision:* When an on-site inspection is about to be conducted, the bank concerned is informed of this in advance in writing. The notification letter lists the detailed information that must be made available to the inspectors. The extent of the required information depends on the characteristics of the inspected bank and the precise object of the on-site inspection. However, such required information typically includes: detailed information regarding the customers, accounts and business relationships, information regarding the AML/CFT structure, organisation, policy and procedures of the bank, the AML/CFT policy and procedures for account opening, the on-going monitoring system in place (IT system, risk indicators, the related procedural manual), the last audit reports regarding the compliance function, the annual compliance program, and the reports by the MLCO regarding controls conducted over the two last years, the internal reports of ML/TF suspicions made by employees to the MLCO and the SAR transmitted by the MLCO to MOKAS over the three last years.
8. The on-site inspections cover the examination of the compliance of the AML/CFT measures in place with all applicable legal and regulatory requirements as well as the evaluation of the

effectiveness of their implementation through sample testing. The CBC developed an examination program (“AML Audit Program Banks” and “Checklist Customer Due Diligence”) that incorporates a review of all the legally-required AML/CFT elements.

9. Findings made during the inspections are detailed in a written report that also contains recommendations for the bank and identifies, where necessary, corrective measures to be implemented within a fixed time frame. The bank is required to report periodically to the CBC on the progress made in the effective implementation of these measures.
10. Over the last 5 years, the number of on-site inspections (including both focussed visits and full scale inspections with an AML/CFT element) is as follows:

<b>Year</b>	<b>Number of inspections</b>
<b>2012</b>	4 <sup>16</sup>
<b>2011</b>	10
<b>2010</b>	8
<b>2009</b>	11
<b>2008</b>	18

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<sup>16</sup> The Cypriot authorities pointed out that the comparatively lower number of on-site inspections in 2012 by the CBC was the result of the increased workload arising out of the Cypriot Presidency of the Council of the European Union in the second half of 2012 and CBC interaction with the Eurogroup in view of the financial assistance programme.

## ANNEX 6

**Supervision of ASPs, Lawyers and Accountants for AML/CFT Purposes***Cyprus Securities and Exchange Commission*

1. CYSEC is responsible for enforcing compliance with the Law Regulating Companies Providing Administrative Services and Related Matters of 2012. The law came into force in December 2012 and covers all persons providing administration services other than firms of lawyers regulated by the Cyprus Bar Association and accountants regulated by ICPAC (ASPs).
2. Administrative services are defined by section 4 of the law as being:
  - a. The managing or directing of trusts;
  - b. The undertaking or provision of the service of managing companies, including but not limited to the managing of companies, general or limited partnerships, or other organisations with or without separate legal personality and the provision of the following services;
  - c. Providing directors for legal persons;
  - d. Holding the share capital of legal persons and registering the holder in the respective registers of shareholders on behalf of legal persons;
  - e. Provision of address of registered office and /or the official mail/electronic address of companies;
  - f. Provision of other similar services;
  - g. Opening or managing bank accounts;
  - h. Safe keeping of financial instruments on behalf of clients and other related services unless this is provided as an ancillary service in the framework of the Investment Services and Activities and Regulated Markets Law.
3. There are some exemptions to the services covered by the law, including the holding of up to 10 directorships. This figure was reached after a mapping exercise.
4. Subject to these exemptions, persons currently undertaking administrative services and requiring to be licensed had to provide a notification to CYSEC by 21 February 2013. All applications for authorisation by existing businesses need to be made by 21 June 2013. The purpose of the notification requirement was to provide CYSEC with basic information on the existence of each firm, their business activities and their client base so that it could

understand the potential scope of its regulated constituency. In total CYSEC received 320 notifications. Following receipt of these notifications, CYSEC had expected some 250 firms to make a formal application for authorization. CYSEC now expects a much smaller constituency of authorised businesses. The period between notification and the deadline for applications will allow firms to take steps to become compliant with the legislation or cease doing business or understand that in practice it need not apply for authorisation. For example, sole practitioners cannot be authorised and must therefore restructure the business so that it is undertaken by a legal person. Some firms are withdrawing from the business. To date five applications have been received and two authorisations issued.

5. When dealing with applications CYSEC undertakes a screening process for shareholders and directors, reviews the responses to a detailed questionnaire and the AML/CFT procedures manual which is required. There is a fit and proper test. Firms are also required to appoint an internal AML compliance officer and either appoint an internal lawyer or establish a relationship with an external firm of lawyers. No outsourcing outside Cyprus is permitted. CYSEC will have two years from the 21 June deadline to resolve all applications received by that date. This potentially allows some ASPs a two year transitional period to undertake their business before their applications are resolved.
6. In practice information about the ASP sector remains very limited. The largest employer has some 180 staff. It is estimated by CYSEC that five ASPs have more than 100 staff. Many firms have five or fewer staff. CYSEC considers that the lawyer, accountancy and ASP sectors are approximately similar in size. CYSEC is not yet in an informed position to understand the business models and customer base of ASPs to any great degree or the ML/FT risk profile of the ASP sector. It is currently working on a ML/FT risk assessment project. A firm of consultants has been chosen to provide software for assessing the risk profile of ASPs. CYSEC intends to undertake a risk based approach to supervision and confirmed that it will use off-site supervision to inform its on-site inspection programme. No decision has been taken on how many on-site inspections will be undertaken but the preliminary thinking is that one third of authorised persons will be inspected each year. It was clear to the review team that CYSEC is taking its job of supervising the ASP sector seriously.
7. The day to day work of supervision will be carried out by an existing department of supervisors which is already responsible for investment supervision. Legal challenges will be taken forward by the legal department. It is considered that, as the ASP regime is an AML/CFT regime, it will be less onerous than investment supervision. However, if the initial estimate of 250 authorised ASPs is correct, this would mean over 80 on-site inspections a

year would need to be undertaken by a team already undertaking supervision of investment entities. The review team considers that CYSEC has underestimated the amount of work necessary to undertake a programme of on-site and off-site supervision, together with associated work, for 250 authorised entities. It will also be important for CYSEC to commence its programme of inspections as soon as possible after the deadline for applications has passed and, at latest, in the fourth quarter of 2013.

#### *Cyprus Bar Association*

8. The supervisory body for lawyers is the Cyprus Bar Association (CBA). The CBA maintains three registers, namely a register for practising lawyers, a register of firms and a register of lawyers engaging in administrative service provider work. There are some 2,500 practising advocates. To date some 270 firms have been registered with the CBA to provide trust and corporate services. The CBA expects this figure to rise to 500.
9. The CBA has issued a comprehensive directive on the prevention of money laundering and terrorist financing to its members. The directive lays down the AML/CFT obligations of lawyers.
10. Lawyers are required to conduct customer due diligence when forming companies.
11. In conducting on-site inspections the CBA has focussed on the largest firms while being mindful of the risks posed by small firms. Three hundred and seventy seven on-site inspections have been undertaken since 2010 when the AML/CFT regime was established. The CBA is moving towards a formal risk based approach, which is expected to be finalised in April.
12. Most business relationships seen during inspections involve holding companies, mainly holding real estate. There are some trading companies. A few firms of lawyers specialise in forming and administering ship management companies.
13. The CBA considered that adequate customer due diligence on the beneficial ownership of client structures is carried out. Only one structure including bearer shares had been seen during on-site inspections. Customer due diligence in relation to PEPs is thought to be good. Some business relationships include general or specific powers of attorney authorised by the directors of client companies. General powers of attorney are less common than specific powers of attorney. The CBA sees the former as high risk. Customer due diligence is

undertaken on the persons to whom the power is provided. From the CBA perspective, banks do conduct customer due diligence on lawyers acting as introducers; in addition, lawyers maintain complete customer due diligence in their offices and do not themselves rely on third parties.

14. The compliance team at the CBA comprises two staff. They conduct all of the on-site inspections. No sanctions have been issued except for 10 warning letters. Remedial action is required by firms within specified deadlines. Confirmation is not explicitly required by firms at the expiry of a deadline that remediation has been completed. The adequacy of remediation is checked when follow-up on-site inspections are carried out. However, it seems not to be standard practice to deliver a written report after each inspection, which complicates the remediation.
15. The CBA is taking its role as an AML/CFT supervisory authority seriously. Nevertheless, an increase in the number of staff engaged in AML/CFT supervision (as is already planned) would allow a comprehensive risk based approach to be undertaken to on-site and off-site supervision. Also, the issue of ten warning letters, absence of standard written reports and no other sanctions after 377 on-site inspections suggests that the approach to sanctions should be recalibrated.

*Institute of Certified Public Accountants of Cyprus*

16. The competent authority for regulating the accounting profession in Cyprus is the Institute of Certified Public Accountants (ICPAC). ICPAC has more than 3,300 professional accountants of which 850 are practising members. Most of the practising members provide their services through one of the 540 accountancy firms. ICPAC has sub-contracted the quality control function of accountants and accountancy firms to the Association of Chartered Certified Accountants (ACCA) in the United Kingdom. The outsourcing agreement includes amongst others items the examination of AML procedures (amongst other regulatory requirements). While recognizing the potential merits of this arrangement, MONEYVAL recommended in its 4<sup>th</sup> Round report that the Cyprus authorities should provide for a legal basis for this outsourcing of the quality control function to ACCA. This recommendation has not been implemented so far.
17. According to ICPAC all licensees have been subject to ACCA inspections at least once over the last six years. According to the ICPAC representatives those inspections took on average one to two days depending on the business size of the license holder. It has to be stressed that

the quality of the AML/CFT controls is just one of several components that are examined at the occasion of these inspections (other components mainly relate to compliance with company law requirements). The net time dedicated to the AML/CFT component could not be clearly established.

18. According to ICPAC representatives the inspections comprise both the examination of internal procedures, policies and controls in place as well as an examination of the effective implementation by reviewing a sample of customer files. However, the content of these examinations appears to be mainly driven by the professional standards applied by ACCA. The particularities and specific risks faced by Cyprus appear not to be adequately taken into account in the AML/CFT inspection programme. Furthermore, the information received by ICPAC on the results of the inspections carried out by ACCA appears to be limited.
19. ICPAC representatives informed the evaluation team that no sanctions or written warnings have been imposed so far, as a result of the onsite inspections carried out by ACCA. In the case that ACCA identifies deficiencies in the AML/CFT controls of inspected licensees, they are regularly requested to remedy those shortcomings within a given timeframe.
20. The evaluation team was informed that a recent amendment of the Auditors Law introduced a separate licensing category for accountants or accountancy firms providing administrative services. The amendments became effective on 1 January 2013. As of July 2013 accountants not holding such a certificate cease to be entitled to provide administrative services. A separate register for these licensees will be kept and will be available on the website of CYSEC.
21. In response to this development, ICPAC intends to adapt its supervisory activities. ICPAC informed the evaluation team that the quality control function outsourced to ACCA will be redesigned. A more tailor-made AML review for this new licensing category will be established. According to ICPAC these licensees will be subject to ACCA inspections at least once every three years. According to ICPAC representatives this supervision cycle and the content of the examination will be modelled on the supervisory approach by CYSEC.
22. ICPAC has issued a comprehensive Directive outlining the AML/CFT requirements for its members. The Directive has been revised in December 2011 following the revision of the Cypriot AML/CFT Law. ICPAC also regularly provides comprehensive AML/CFT training to its members. The level of suspicious activity reporting by accountants appears to be very low.



23. Overall, the evaluation team takes the view that the AML/CFT supervision of the accountancy sector needs further strengthening. The measures envisaged following the introduction of a separate licensing category for accountants or accountancy firms providing administrative services appear to point in the right direction.

## ANNEX 7

### The Company Registry

1. The Department of Registrar of Companies and Official Receiver is part of the Ministry of Commerce, Industry and Tourism. It registers companies, limited partnerships, general partnerships, business names, and branches of foreign companies undertaking business in Cyprus. Some 70 staff work in the companies section of the registry.
2. Since the end of 2012 companies can be formed electronically, with filings also being made electronically.
3. Routine filings required by company law include changes of director, shareholder, the allotment of shares and change of name.
4. Annual returns and financial statements are also required to be filed. Under section 118 of the company law the annual return should include the following information:
  - a. The address of the registered office;
  - b. The address where any register of debentures is kept if it is kept other than at the registered office;
  - c. A summary of the share capital distinguishing between shares issued for cash and shares issued as fully or partly paid up otherwise than in cash;
  - d. Particulars of the total amount of indebtedness of the company;
  - e. A list of the members of the company and persons who have ceased to be members since the last return, together with the number of shares held by each member;
  - f. Particulars in relation to the directors and any secretary.
5. Annual returns are not required to be made by a company in its year of incorporation or if it is not required to hold an annual general meeting.
6. When annual returns are checked by the registry it appears to be unusual for the routine filings not to have been provided. Where routine filings are discovered as not having been made (bearing in mind the only opportunity to make checks in practice is when checking annual returns) the company registrar writes to the company. Any stronger enforcement action requires an application to the court and, in any case, any fine is imposed by the court. Accordingly, there is no incentive for the registrar to take enforcement action. Striking off a company requires the approval of the Attorney General.

## ANNEX 8

### **List of entities met during the on-site mission**

Central Bank of Cyprus  
MOKAS (FIU)  
Cyprus Securities and Exchange Commission  
Institute of Certified Public Accountants of Cyprus  
Cyprus Bar Association  
Cyprus Popular Bank plc (Laiki Bank)  
Hellenic Bank plc  
Piraeus Bank (Cyprus) Limited  
EFG EuroBank Ergasias S.A.  
FBME Bank Limited  
National Bank of Greece (Cyprus) Limited  
PrivatBank Commercial Bank  
Societe Generale Bank – Cyprus Limited  
Cyprus Development Bank plc  
Russian Commercial Bank (Cyprus) Limited  
Alpha Bank Cyprus Ltd  
Promsvyazbank JS Commercial Bank  
Representatives from the Accountancy and Audit Profession  
Representatives from the Legal Profession

**ANNEX 9****Overview of Legal Entities in Cyprus**

1. Three types of company are available under Cypriot company law, namely companies limited by shares, companies limited by guarantee (with or without share capital) and public limited companies. Limited partnerships and general partnerships can also be formed. The law does not provide for the issue of bearer shares.
2. Companies can be registered with one shareholder. Companies limited by shares owned by Cypriots would normally not have nominee shareholders. Conversely, companies limited by shares owned by non-Cypriots normally would have nominee shareholders.
3. It is normal for firms of lawyers, accountants or other company service providers to provide directors. This is beneficial for tax reasons. There are few corporate directors in light of the need for directors to take decisions and hold meetings in Cyprus for tax purposes. There appears to be no pattern to the use of corporate directors.
4. There are fewer than 500 public limited companies. The vast majority of these, an estimated 98%, are small and medium enterprises, with some 60% being estimated as owned by Cypriots. Traditionally, such companies were owned by Cypriot families. It is thought that the majority are now being established by non-Cypriots.
5. There are some 15,000 companies limited by guarantee. Some 99% of these were estimated as being owned by Cypriots with the small number of foreign owned companies being established by, for example, foreign charities.
6. Limited partnerships are mostly owned by Cypriots (an estimated 99%) for small businesses. It is considered to be a stepping stone to the formation of a company if the business is successful. Non-Cypriot owned limited partnerships are mostly established for projects, including joint venture structures. Each limited partnership must have a general partner. There are some 11,000 general partnerships. They include traders, small family businesses, societies and firms of accountants and lawyers.
7. Branches of companies establishing a place of business in Cyprus must also be registered. Some 1,500 to 1,700 branches are registered. Ownership of the branches is diversified.

Countries named as having persons owning branches were the US, the UK, Belize and France.