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Cyprus

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Kilikitas & Co Law

Introduction

Almost a decade after the peak of the Cypriot financial crisis in 2013 and the unprecedented economic and social disruption caused by the global pandemic, the banking sector in Cyprus has shown remarkable resilience.

Banks' balance sheets have improved considerably owing to a series of measures including strengthened regulation and supervision of banks, reform of the legislative framework (including the introduction of securitisation and foreclosure legislation) and the creation of a market for distressed assets.[1] With non-performing loans ("**NPLs**") falling from €28.3 billion in 2014 (48%) to an all-time low of €4.3 billion (15.2%) in October 2021, Cyprus' progress is commendable; however, by European standards, the figure still remains well above the EU average of 2.1%. It is anticipated, however, that the proposed sale by Alpha Bank Group of its portfolio of NPLs and real estate properties with a total gross book value of €2.4 billion to Cerberus Capital Management, which is expected to complete in the third quarter of 2022, will go a long way in further reducing Cyprus' outstanding NPL portfolio.

Speaking at the Annual General Meeting of the Association of Cyprus International Financial Firms ("**ACIFF**") on 11 February 2022, the Governor of the Central Bank of Cyprus ("**CBC**"), Constantinos Herodotou, said that Cyprus has a strong balance sheet and has improved its loss absorption capacity, despite the pressures of the ongoing pandemic, noting in particular the increase in the capital position and liquidity ratio of Cypriot banks, which is currently well above the EU average. In terms of liquidity, Cypriot banks have seen a marked increase in the level of deposits, which stand at their highest level since 2014, indicating increased depositor confidence in the banking system.

In order to keep up with global trends and the exponential growth of the fintech market, the CBC Governor expressed that a possible transformation of traditional banks' business models towards digitalisation may give them a head start in boosting longer-term profitability, which he believes is essential in creating the necessary buffers to absorb unexpected losses created by events such as the pandemic. Certain areas of the Cypriot economy have already seen an acceleration in digitalisation, such as the Cypriot court system with the launch of the much-awaited electronic court registration system (iJustice), which was fully implemented on 1 February 2022. Furthermore, the Cyprus Securities and Exchange Commission ("**CySEC**") has also implemented an electronic platform for the digital submission of certain licensing applications as well as a digital registry for crypto-asset service providers ("**CASPs**") in a bid to further enhance Cyprus' attractiveness as a global fintech investment hub.

That said, digitalisation comes with operational and financial risks, including (i) climate change risks that, in the transition to green energy, will increase banks' exposure to high carbon-emitting businesses, and (ii) other emerging risks, such as data protection,

cyber risk incidences and increased risks for money laundering.[2] It is hoped that certain initiatives taken by the European Commission, such as the Digital Operational Resilience Act ("**DORA**"), which is currently in the pipeline, and the revision of the second Payment Services Directive, may, to a large degree, mitigate these risks.

Cyprus is certainly no exception to the global expansion of the fintech market in the banking space; currently there are 15 authorised e-money institutions and 10 authorised payment institutions with 44 applications pending with the CBC (double the number of applications compared to just one year ago). In comparison, there are only a total of 11 domestic and foreign authorised banks and subsidiaries operating in Cyprus.[3]

Without a doubt, with increased competition from non-bank financial and fintech institutions, traditional banks will need to quickly evolve and explore new ways of acclimatising to the increasingly digital banking landscape, particularly if they are to retain their competitive edge. Steps have already been taken in this direction with the Association of Cyprus Banks' ("**ACB**") entry in May 2020 into a memorandum of understanding with the government's Deputy Ministry of Research, Innovation and Digital Policy, which aims to facilitate and promote digital transactions and banking services supported by the use of electronic identification of customers and electronic signature of documents; however, there is room for more to be done.

In the words of Alexandra Maniati, EBF Senior Director of Innovation and Cybersecurity, "[t]he digital transformation changes services and operations fundamentally. It brings innovative potential but also challenging distortions to the single market. To compete, banks need a level playing field *vis-à-vis* actors who carry a lighter regulatory and oversight backpack", adding that the "[single] rulebook needs to be updated".

Regulatory architecture: Overview of banking regulators and key regulations

The Banking Union consists of two main pillars: the Single Supervisory Mechanism ("**SSM**"); and the Single Resolution Mechanism ("**SRM**"). The Banking Union is automatically applicable to all Eurozone Member States as from November 2014, as well as any other EU Member States choosing to participate on the basis of close cooperation arrangements between the European Central Bank ("**ECB**") and national competent authorities (such as Bulgaria and Croatia).

The legislative and institutional framework for banking supervision in the euro area is defined by the SSM as being the first pillar of the Banking Union and established by the SSM Regulation (1024/2013). To ensure harmonised supervision in line with the Single Rulebook, supervisory responsibilities are distributed between national competent authorities and the ECB. The ECB assumes the lead role over credit institutions (being banks and certain other deposit-taking entities), and the extent of supervisory responsibilities allocated both to it and to the national competent authorities is determined on the basis of the "significance" of banking entities.

The ECB is ultimately responsible for directly supervising the most significant European banking entities, which are classified on the basis of criteria including (but not limited to) size, economic significance, liquidity and cross-border activities. National competent authorities continue to monitor remaining European banks not subject to the direct supervision of the ECB, but always under the indirect supervision of the ECB, based on guidelines and instructions issued by the latter.

In November 2021, the ECB published its updated list of significant supervised entities, in which three Cypriot banks were listed as significant, namely Bank of Cyprus Holdings

Public Company Limited, Hellenic Bank Public Company Limited and RCB Bank LTD. Significance was assessed on the basis that they each held assets equivalent to more than 20% of the country's GDP.

In Cyprus, banks are regulated exclusively by the ECB and the national competent authority being the CBC. The CBC is also the national competent supervisory authority for payment institutions, electronic money institutions, *bureaux de change* businesses and credit-acquiring companies operating in Cyprus.

The CBC operates within the legal framework of the Central Bank of Cyprus Laws of 2002 to 2017 and Law 138(I) of 2002, as amended, and its main functions include, *inter alia*:

(a) contributing to the formulation and implementation of the European Community's monetary policy in its capacity as member of the European System of Central Banks;
(b) the licensing and supervision of credit institutions in accordance with the provisions of the Credit Institutions Laws (hereinafter defined);
(c) the macroprudential oversight of the financial system with the objective of ensuring its stability; and
(d) promoting, regulating and overseeing of payment, clearing or settlement systems.

The key laws and regulations governing the Cypriot banking sector (which are by no means exhaustive) are:

- the Business of Credit Institutions Laws of 1997 to No 5 of 2021, Law 66(I) of 1997, as amended ("**Credit Institutions Laws**") transposing Directive 2013/36/ EU ("**CRD IV**");
- Council Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 ("**CRR**") setting out own-funds requirements, limits on large exposures, and requirements regarding public disclosure reporting of leverage measures;
- the Macro-prudential Supervision of Institutions Law of 2015 to 2021, Law 6(I) of 2015, as amended, which transposes the relevant provisions of Directive 2019/2034/ EU and amending Directives 2002/87/EC, 2009/65/EC, 2011/61/EU, 2013/36/EU, 2014/59/EU and 2014/65/EU on the requirements for the establishment of additional capital buffers against systemic and other risk;
- the Investment Services and Activities and Regulated Markets Law of 2017 to 2021, Law 87(I)/2017, as amended, transposing the EU Markets in Financial Instruments Directive ("**MiFID II**") ("**IS Law**");
- Council Regulation (EU) No 1093/2010 of 24 of November 2010 establishing a European Supervisory Authority (the European Banking Authority ("**EBA**")), as amended by Regulation (EU) No 1022/2013 as regards the conferral of specific tasks on the ECB;
- Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions ("**SSM Regulation**");
- Council Regulation (EU) No 468/2014 of 16 April 2014 establishing the framework for cooperation within the SSM between the ECB and the national competent authorities and with national designated authorities;
- Council Regulation (EU) 806/2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms ("**Resolution Regulation**");
- the Resolution of Credit Institutions and Investment Firms Law of 2016, transposing Directive 2014/59/EU of May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms ("**Resolution of Credit Institutions Law**");

- the Central Bank of Cyprus Laws of 2002 to 2017, Law 138(I) of 2002, as amended, setting out the role and responsibilities of the CBC including macroprudential and microprudential supervision;
- the Law on the Establishment and Operation of Deposit Guarantee and Resolution of Credit and Other Institutions Scheme Law, Law 16(I) of 2013, as amended ("**DGS Law**");
- the Prevention and Suppression of Money Laundering and Terrorist Financing Law of 2007 to 2021, Law 188(I)/2007, as amended, implementing the provisions of the 5th AML Directive (EU) 2018/843 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing ("**AML Law**");
- the Payment Services and Access to Payment Systems Laws of 2018 to 2019 transposing the provisions of Directive (EU) 2015/2366 of 25 November 2015 on payment services in the internal market; and
- the Electronic Money Laws of 2012 to 2018, Law 81(I)/2012, as amended, transposing Directives 2009/110/EC on the taking up, pursuit and prudential supervision of the business of electronic money institutions and 2015/2366/EC on payment services in the internal market.

Key directives and decrees issued by the CBC pursuant to the Credit Institutions Laws include the CBC Directive on Internal Governance of Credit Institutions of 2021 ("**Governance Directive**") and the CBC Directive on the Assessment of the Suitability of Members of the Management Body and Key Function Holders of Authorised Credit Institutions of 2020 ("**Suitability Directive**"). These are further examined later in this chapter.

The Credit Institutions Laws apply to "authorised credit institutions" (as defined in such laws), as well as to credit institutions authorised in another EU Member State that choose to carry out their activities in Cyprus on a cross-border basis or by the establishment of a branch. A credit institution authorised and supervised by the competent authorities of another Member State may carry out in Cyprus the activities listed in Annex IV to the Credit Institutions Laws (see below) without the requirement to separately obtain a licence from the CBC, provided that these activities are covered by its existing licence, and that it notifies the CBC of its intention to do so.

"Authorised credit institutions" refer to either (a) credit institutions established in the Republic and authorised under the provisions of the Credit Institutions Laws and include the Housing Finance Corporation, as governed by the Housing Finance Corporation Act of 2000 to 2021, Law 132(I) of 2000, or (b) branches of third-country institutions.

Specifically, a "bank" is considered to be (i) a company established in Cyprus under the Companies Law, Cap. 113 (as amended) ("**Companies Laws**") and authorised under the Credit Institutions Laws, or (ii) a credit institution established and authorised in a third country (non-EEA) under equivalent legislation of that country, operating through a branch in Cyprus, and authorised under the Credit Institutions Laws. The Housing Finance Corporation is excluded from the definition of a "bank" given that its legal form is outside the ambit of the provisions of the Companies Laws.

A credit institution must be licensed to carry out the activities listed in Annex IV to the Credit Institutions Laws, which include, to name a few, the acceptance of deposits and other repayable funds, lending, entering into transactions for own account or for its customers in financial instruments, custody, portfolio management and payment services.

The Credit Institutions Laws specifically prohibit the carrying out of certain commercial activities by credit institutions, such as the acquisition of real estate or any interest in real estate other than where the property is acquired in the ordinary course of business or within

the context of security enforcement proceedings (provided it is disposed of within a period of three years). The Credit Institutions Laws specifically prohibit a credit institution from carrying on (whether for its own account or on a professional basis) any other activity unless that activity is specifically included in Annex IV of such laws or unless the activity constitutes the undertaking of ancillary services (as defined in Article 4, paragraph 1(18) of the CRR).

Recent regulatory themes and key regulatory developments in Cyprus

Since the 2013 financial crisis, major structural reforms have been introduced in the Cypriot banking sector in an effort by the Cyprus government to maintain financial stability. Some of those reforms (including those currently under discussion) are summarised below.

Ring-fencing

The pandemic has brought into the spotlight the need to upgrade the operating rules of the banking system on capital requirements or "ring-fencing". Driven by the work of the G20 and the Basel Committee for Banking Supervision ("**BCBS**"), in October 2021 the European Commission approved a proposed revised package of EU banking rules, including revisions to the CRR and CRD, in an attempt to finalise the implementation of Basel III international standards by enhancing existing EU legislation to (i) strengthen credit institutions' resilience to economic shocks by ensuring that the methodologies used to calculate their capital requirements do not underestimate risks and that the capital required to cover those risks is sufficient, (ii) require banks to systematically identify, disclose, and manage ESG risks as part of their risk management process to facilitate the transition to green energy, and (iii) harmonise certain supervisory powers and tools aimed at enhancing supervisory capabilities and powers of enforcement/imposition of sanctions in response to concerns on the inadequate supervision of fintech groups (brought to the surface by the Wirecard scandal).[4]

Recovery and resolution regimes affecting Cypriot credit institutions

The following regimes are relevant:

- Business continuity plans – under the Governance Directive, credit institutions are required to have adequate contingency and business continuity plans in place to ensure that they can continue to operate in the event of severe business disruption. They must establish liquidity recovery plans that set out adequate strategies and appropriate implementation measures to address potential liquidity shortfalls, and must be reviewed by credit institutions at least annually and presented in the form of a report to senior management and approved so that internal policies and procedures can be adapted accordingly. Credit institutions must be proactive in taking necessary operational steps to ensure that liquidity recovery plans can be implemented promptly such as holding collateral, where necessary, in the currency of another Member State or in the currency of a third country to which the credit institutions are exposed.
- The insolvency framework – the legal provisions relating to the winding-up of banks incorporated in Cyprus are set out in Part XIII of the Credit Institutions Laws (incorporating Article 32 of the Bank Recovery and Resolution Directive ("**BRRD**")), Part V of the Companies Laws, Cap. 113 (as amended) and the insolvency rules issued pursuant to the Companies Laws. The Cyprus government has expressed a need for the domestic insolvency framework governing the liquidation of credit institutions to be modernised and reformed so as to contribute to institutional, administrative and growth-sustaining structural reforms in Cyprus in line with best practices expressing that the

current legal framework is inefficient, outdated and lacks the necessary flexibility and tools needed by competent authorities for the effective liquidation of an insolvent credit institution.[5] Reform proposals are aimed at introducing precautionary capitalisation either in the form of guarantees or injection of own funds or purchase of capital instruments as well as government stabilisation tools for the purpose of participating in the resolution of an institution.

- The resolution regime for banks is based on the Resolution Regulation and Resolution of Credit Institutions Law. The Resolution of Credit Institutions Law designates the CBC as the resolution authority ("**RA**") in relation to entities and groups not listed in Article 7(2) of the Resolution Regulation. The RA is required to draw up a resolution plan for each authorised credit institution not being part of a group that is subject to consolidated supervision. The resolution plan covers matters such as the actions that the RA can take and the resolution tools it may apply, namely:
  (a) the sale of business tool;
  (b) the bridge institution tool;
  (c) the asset separation tool; and
  (d) the bail-in tool.

The Resolution of Credit Institutions Law applies to banks established in Cyprus and, subject to the conditions set out in that law, to branches of banks of third countries (non-EEA) established in Cyprus.

The RA can apply the resolution tools individually or in any combination other than the asset separation tool, which can only be applied in conjunction with another resolution tool.

Certain liabilities, such as covered deposits (up to €100,000) and liabilities to employees for accrued salary, pension benefits, or other fixed remuneration, are excluded from the application of the bail-in tool, except for the variable component of remuneration that is not regulated by a collective bargaining agreement.

Innovation, fintech and distributed ledger technology

Innovation and technology are a key priority for Cyprus. CySEC has taken a significant leap in this direction by establishing an "Innovation Hub", being a regulatory sandbox aimed at addressing and exploring the quickly evolving developments in the fintech and regtech (including AI, big data, cloud computing, machine learning), blockchain and other distributed ledger technology ("**DLT**") spaces. Firms (regulated or not) are able to test innovation without having to meet all of the standard regulatory requirements from the outset and it is expected (based on experiences drawn from other jurisdictions, particularly the UK) that the Innovation Hub will foster innovation in the financial technology sector, as well as alternative finance platforms and solutions, by enabling start-ups and other innovative businesses to diversify their product or service offerings. Through the Innovation Hub, ongoing discussions between market participants and regulatory authorities are encouraged in order to ensure that any regulatory acts/decisions achieve an appropriate balance between facilitating innovation and mitigating risks.

Worth noting is that Cyprus became a party to the European Blockchain Partnership on 4 June 2018 and, along with six other EU Member States (France, Greece, Italy, Malta, Portugal, and Spain), signed the joint "*Declaration of the Southern Mediterranean Countries on Distributed Ledger Technologies*" on 4 December 2018, with the aim of enhancing cooperation in the digital sector and rendering Southern Europe a leader in emerging technologies such as DLT.

To this end, the Distributed Ledger Technology Law of 2021 (which is in draft form and pending enactment) aims to comprehensively set out the regulatory framework to facilitate the application of DLT in Cyprus. This law is intended to regulate the property status of tokens, the different records in blockchain and other DLT, as well as the application of smart contracts whilst at the same time striking a balance between the need for promotion and proper use of new technologies *versus* the avoidance of money laundering and protecting consumer rights.

Once enacted, it is anticipated that progress on other fronts will follow, including amendments to the current AML Law, the Companies Laws and applicable tax laws, which will primarily be targeted at integrating fintech infrastructure into the public sector in alignment with national strategy. Cyprus' Ministry of Energy, Commerce and Industry has also recently announced a series of subsidies to be disbursed during the course of 2022 aimed, *inter alia*, at private-sector businesses seeking to improve or upgrade their digital infrastructure within the framework of Cyprus' Recovery and Resilience Plan and financed by the EU Recovery and Resilience Mechanism.

Furthermore, CASPs, who are now caught by the definition "obliged entities" under the AML Law and who, in short, provide services in or from Cyprus, are now required to officially register with CySEC. The "*Directive for the Prevention and Suppression of Money Laundering and Terrorist Financing (Register of Crypto Asset Service Providers)*" defines the regulatory framework in relation to the operation and management of CASPs.

Crypto-assets are defined as a digital representation of value that was not issued or guaranteed by a central bank or public authority, is not necessarily linked to a legally established currency, and does not have the legal status of currency or money, but is accepted as a medium of exchange or investment by individuals and can be transferred, stored, or traded electronically and includes fiat money, e-money, and financial instruments as defined in the IS Law. A CASP is defined as a person who provides or performs one or more services and/or activities (including but not limited to exchange, custody or safekeeping of crypto-assets or the provision of financial services in relation to the distribution, offering and/or sale of crypto-assets, including the initial offering) for another person or on their behalf. The person on whose behalf the services are provided must not come within the definition of "obliged entities" under the AML Law.

Bank governance and internal controls

The key requirements relating to the governance of banks in Cyprus are set out in the Credit Institutions Laws (and directives issued pursuant thereto, namely the Governance Directive and Suitability Directive), the Companies Laws and well-established principles of common law (particularly as regards directors' fiduciary duties).

Section 19 of the Credit Institutions Laws specifically requires that every credit institution has in place a sound governance framework, including a clear organisational structure with transparent and consistent lines of responsibility, effective processes for identifying, managing, monitoring and reporting risks to which it is or may be exposed, and adequate internal control mechanisms, including appropriate administrative and accounting procedures and remuneration policies, and practices that are consistent with and promote sound and effective risk management principles.

The recently implemented Governance Directive (superseding and entirely replacing the CBC Directive on Governance and Management Arrangements in Credit Institutions of 2014) incorporates the governance and internal control principles contained in the CRD IV and the CRR as well as additional guidelines issued by the EBA.

In terms of governance arrangements, the Governance Directive addresses, *inter alia*, matters relating to, *inter alia*, a credit institution's management body and senior management including composition, lines of responsibility, and processes for identifying, managing, monitoring and reporting risks and remuneration policies and practices, the most relevant of which are:

(i) *The management body*

- The management body must consist of no less than seven and not more than 13 members.
- The size and composition of the management body is determined on the basis of the principle of proportionality, ensuring that the majority of the members and the chairperson of the governing body are independent (as defined in the Suitability Directive).
- There must be at least two executive members (of which one assumes the role of chief executive officer); however, the executive members must not constitute more than 25% of the total number of members.
- It must be sufficiently diverse as regards gender, age, academic qualifications and professional experience so as to be able to provide independent judgment, and collectively, to have the requisite degree of knowledge, skills and experience to effectively assess the credit institution's risks.
- The members of the governing body may not appoint alternate members to represent them in their absence.

Senior management and/or key personnel must be sufficient in number and have the necessary expertise to effectively manage the bank's operations. Both the management body and key function holders must comply with the requirements of the Suitability Directive in that they must be assessed by the credit institution to be of sufficiently good repute, honesty and integrity, and have the knowledge and experience to effectively discharge their responsibilities. They must also be in a position to dedicate sufficient time to the proper performance of their duties having regard to the number of other positions held by such person on other boards/ventures. The credit institution is obliged to provide the CBC with the results of its suitability assessment for compliance purposes and, in the case of significant entities supervised by the ECB, the ECB.

(ii) *Committees*

Committees of appropriate size, composition, structure and responsibilities must be put in place to effectively carry out the roles and responsibilities of the management body including an audit committee, a risk committee, a nomination committee and a remuneration committee. The Governance Directive establishes the composition and eligibility criteria, as well as each committee's terms of reference and functions.

(iii) *Remuneration policies*

Credit institutions are required to comply with the Governance Directive on sound remuneration policies, which requires that such policies (i) enhance effective risk management by curbing excessive risk-taking behaviour, (ii) are established and monitored at the management body level with key function holders in the risk management and compliance functions directly overseen by the remuneration committee, (iii) ensure that remuneration criteria for staff engaged in control functions are independent from the performance of operations they oversee, (iv) ensure that remuneration of senior management is disclosed to shareholders, (v) take into account the national benchmark and market practice on wage-setting, (vi) define appropriate

ratios between the fixed and variable components of the relevant staff member's aggregate remuneration, and (vii) impose limitations on variable remuneration, which should reflect performance that is sustainable and risk-adjusted.

Where remuneration is performance-linked, the total amount of remuneration is calculated to reflect longer-term performance of the credit institution as well as the individual. Similarly, remuneration should not be guaranteed (except in particular circumstances and for a limited set duration).

Internal control environment

When implementing the internal control framework, credit institutions are required to provide for an appropriate segregation of duties particularly where conflicts may arise in the processing of transactions or in the provision of services. In such cases, there must be mechanisms in place to delegate duties or supervisory and reporting responsibilities to different persons as well as the imposition of information barriers, for example, through the physical separation of certain departments.

Given the close relationship between the activities of the internal control system functions, the credit institution must ensure that there is a clearly defined allocation and separation of responsibilities, in particular with regard to the responsibility for measuring risks and identifying, verifying and assessing the adequacy of the relevant internal control processes and arrangements.

The Governance Directive outlines four critical functions that must be integrated into a credit institution's internal control framework as follows:

- a risk management function that is actively involved in the development of the credit institution's risk strategy, ensuring that all major risk management decisions are responsible, and the implementation of effective risk management procedures;
- a regulatory compliance function that monitors compliance with legal, regulatory, and business requirements, and ensures that new products and procedures comply with applicable legal frameworks;
- an internal control function, which is independent of the other internal control framework functions and assesses whether all of the credit institution's activities comply with its internal policies and procedures as well as external requirements; and
- an ICT and security risk management function.

The heads of the four functions must report and be accountable directly to the board of directors and their performance evaluated by the board. They are required to submit annual reports on the main developments applicable to each of their functions as well as to regularly report to the related committees of the board (for example, the risk and compliance committees).

At least once every three years, the internal control framework must be evaluated by an external auditor (who is not the credit institution's day-to-day auditor). The scope of the assessment must be submitted in advance to the CBC, and the same auditors may not conduct more than two such audits consecutively.

Outsourcing arrangements

The management body is required to review a credit institution's outsourcing arrangements on a periodic basis and at least once every three years. The outsourcing policy must factor the impact of outsourcing on the business activities of the credit institution and the risks it faces, such as operational risks, including legal, ICT and security risks, reputational and concentration risks.

The policy should include reporting and monitoring of the arrangements to be put in place from the outset up to and including the termination of the outsourcing agreement. It must also include the preparation of the business feasibility report for outsourcing, the procurement of the outsourcing contract, the execution of the contract until its termination, contingency plans and exit strategies.

The credit institution is fully responsible for all outsourced services and for the activities and management decisions arising from it, and a credit institution's outsourcing policy should make it clear that outsourcing does not relieve the credit institution of its regulatory obligations and its responsibilities to its customers. The policy should state that outsourcing arrangements should not interfere with the exercise of effective supervision over the credit institution and should not conflict with supervisory restrictions on services or activities.

Credit institutions must appoint a member of their staff (an outsourcing officer) as the lead person for managing and overseeing the risks of outsourcing arrangements as part of the credit institution's internal control framework and for overseeing the documentation on any outsourcing arrangements.

Banks must keep an up-to-date record of all outsourcing agreements and make it available to the CBC upon request. Outsourcing critical functions is subject to prior approval by the CBC, and banks should not outsource a critical function if the CBC has either objected to the proposed outsourcing or requested that corrective measures be taken in relation to it (unless the CBC is satisfied with the corrective measures having been taken). The term "critical functions" is defined in accordance with applicable EBA guidelines and also includes the management of the bank's core information systems. Outsourcing of non-critical functions must be reported to the CBC on a yearly basis, but does not require prior approval from the CBC.

Bank capital requirements

The Basel III standards on liquidity requirements in respect of the liquidity coverage ratio have been implemented in Cyprus by virtue of the CRR (which is directly applicable in Cyprus) and the Credit Institutions Laws transposing the CRD IV.

Capital requirements

The capital adequacy framework for banks in Cyprus comprises the CRR, the CRD IV, and the Resolution of Credit Institutions Law, which, *inter alia*, require banks to maintain the following own-funds requirements at all times:

- a Common Equity Tier 1 (as defined in the CRR) capital ratio of 4.5%;
- a Tier 1 (as defined in the CRR) capital ratio of 6%; and
- a total capital ratio of 8%.

Systemically important banks are required to maintain an additional capital buffer.

Liquidity requirements

Along with meeting the general liquidity coverage requirement set forth in Article 412(1) of the CRR, banks must ensure that long-term assets and off-balance-sheet items are adequately funded through a diverse set of stable funding instruments under normal and stressed conditions.

Council Regulation (EU) No 2015/61 of 10 October 2014, amending Council Regulation (EU) No 575/2013 on the liquidity coverage requirement for credit institutions, establishes detailed rules implementing the liquidity coverage requirement set out in Article 412(1) of the CRR. Since 1 October 2015, Regulation (EU) No 2015/61 is directly applicable in Cyprus. As from 1 January 2018, the liquidity coverage ratio reached 100%, as required by the CRR.

The CBC has issued a directive to banks on the calculation of prudential liquidity in all currencies, outlining, among other things, the principles that banks should follow when managing liquidity risk.

Leverage ratio

The CRR requires banks to calculate and report their leverage ratios to the CBC. Leverage ratios are expressed as percentages and are calculated by dividing the bank's capital measure (Tier 1 capital) by the bank's total exposure measure. At the reporting reference date, the bank must calculate the leverage ratio. Regulation (EU) No 2019/876 (which amends the CRR) established a 3% leverage ratio requirement, which became effective on 28 June 2021.

The Financial Stability Board's standards on Total Loss-Absorbing Capacity ("**TLAC**") have been implemented into EU law (and apply in Cyprus) in respect of global systemically important credit institutions only.

Rules governing banks' relationships with their customers and other third parties

There are extensive rules dealing with all aspects of banks' relationships with their customers and third parties (such as the detailed rules on outsourcing examined above), the majority of which are founded primarily in EU legislation, as implemented into domestic laws and as further supplemented by CBC directives and regulations. Recent developments of particular relevance to banks are anti-money laundering requirements, lending and conflict management.

Further, the Banking Code of Conduct established by the ACB applies in relation to bank/customer relations and is aimed at enhancing good banking practice standards, encouraging transparency and strengthening mutual trust among banks and their customers. The Banking Code lays down rules and practices for the fair and reasonable dealings between banks and customers and is aimed at improving the quality of products and services.

Deposit-taking and deposit protection

Under the Credit Institutions Laws, the taking of deposits or of other repayable funds from the public on a professional basis is an activity reserved for authorised credit institutions. Insofar as the activities set out in Annex IV of the Credit Institutions Laws are concerned, no statutory provisions on client categorisation requirements are imposed on credit institutions, as under the IS Law. Under the IS Law, institutions engaged in the provision of financial services are required to categorise their clients into one of three categories prior to the inception of the business relationship. The three categories are "retail", "professional" and "eligible counterparty", each of which have different levels of protection, limitations and rights.

The DGS Law provides the mechanism for guaranteeing deposits. In a nutshell, deposits of up to €100,000 are covered by the guarantee of deposits and resolution of credit and other institutions scheme, and a credit institution may only accept deposits provided that it participates in the deposit guarantee scheme established pursuant to the DGS Law.

Lending

On lending activities, the CBC Code of Conduct on the Handling of Borrowers in Financial Difficulties ("**Borrowers Code**") is incorporated into the CBC's Directive on Arrears Management of 2015.

Credit institutions must apply the Borrowers Code to individuals, microbusinesses, and small businesses (with certain exceptions) that have been granted loans totalling up to €1 million, including loans to their connected persons who must themselves be eligible

borrowers. The Borrowers Code establishes the framework within which credit institutions must operate when dealing with eligible borrowers who are in arrears on their loans. Such borrowers must be treated fairly with the goal of enabling them to service their NPLs by establishing clear guidelines for the development of efficient and effective strategies, policies, structures, procedures, and mechanisms for managing arrears and achieving fair and viable restructurings of credit facilities for borrowers experiencing financial difficulties.

On interest rates, LIBOR ceased to apply for all currencies (other than USD) on 31 December 2021. The Financial Stability Board[6] and local regulators and working groups recommended that market participants use, wherever possible, robust alternative reference rates to LIBOR in new contracts. The Eurozone has pursued a multiple rate strategy, with EURIBOR continuing to exist alongside risk-free rates following LIBOR's discontinuation (EONIA EUR LIBOR).

Mechanisms for addressing customer complaints

Credit institutions are obliged to follow the Guidelines for Handling Consumer Complaints in the Securities and Banking Sectors (jointly issued by the European Securities and Markets Authority and the EBA and fully endorsed by the CBC).

In short, the guidelines require credit institutions to establish a complaints management policy and function. Separately, under the Governance Directive, credit institutions are required to establish and operate an appropriate customer complaint procedure.

If a credit institution fails to satisfactorily resolve a customer complaint, the customer may lodge a complaint with the Financial Ombudsman appointed pursuant to the provisions of the Law on the Establishment and Operation of a Uniform Body for the Out-of-Court Resolution of Financial Disputes (Law 84(I)/2010, as amended) ("**Financial Disputes Law**"), provided certain requirements are met including the value of the claim (which must not exceed €170,000). A consumer is defined in the Financial Disputes Law as any natural or legal person. In the case of a legal person, annual turnover in the year preceding the year in which the complaint is submitted to the Financial Ombudsman must not have exceeded €250,000. The Financial Ombudsman has the authority to investigate a complaint only after the consumer has made an attempt and been unsuccessful in resolving it with the financial institution. The Financial Ombudsman's decision is not binding on the parties, but they may accept it at their discretion.

Individual consumer complaints are not investigated by the CBC.

Cross-border banking activities

As mentioned earlier in this chapter, inbound cross-border banking activities cannot be carried out in Cyprus unless the entity concerned is authorised to do so either under the Credit Institutions Laws or, in the case of a credit institution authorised in another EU Member State, on the basis of relevant passporting provisions.

Anti-money laundering

The AML Law requires credit institutions to implement adequate and appropriate policies, controls and procedures, proportionate to their nature and size, to mitigate and effectively manage the risks related to money laundering and terrorist financing. These policies are particularly relevant to client identification and due diligence as well as transaction monitoring. Complicated or unusually large transactions and all unusual transactions that are executed without an obvious financial or legitimate purpose are inherently considered particularly susceptible to money laundering or terrorist financing offences and require intense scrutiny.

Credit institutions must perform client identification and due diligence procedures in relation to a client when establishing the business relationship (and where the circumstances require, on an ongoing basis throughout such relationship). Similarly, the procedures apply to the execution of any occasional transaction exceeding €15,000 or more, regardless of whether the transaction is carried out in a single tranche or a series of tranches that appear to be linked, or if the transaction is a transfer of funds greater than €1,000 pursuant to Article 3(9) of the Funds Transfer Regulation ((EU) No 2015/847).

The extent of documentation and information that credit institutions must obtain in order to verify the identity of their counterparties depends on customer type (either natural or legal persons). Additionally, there are detailed provisions relating to the procedures that credit institutions must follow when accepting cash deposits, including cash imported from abroad and foreign currency deposits.

* * *

Endnotes

1. "The evolution of the Cyprus banking system: a reform story and its challenges." Keynote Speech by the Governor of the Central Bank of Cyprus, Chrystalla Georghadji, at the event organised by the Representation of the European Commission in Cyprus and the Central Bank of Cyprus on the "Achievements and Challenges of the Banking Sector in Cyprus: the European Perspective", Nicosia, 30 October 2017.
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3. "Fintech Evolution in the Banking System and Managing Consequent risks", CBC Governor's Speech, 8 December 2021.
4. "Banking Package 2021: new EU rules to strengthen banks' resilience and better prepare for the future", European Commission, Press Release, 27 October 2021.
5. Cyprus' Recovery and Resilience Plan 2021–2026.
6. Progress Report to the G20 on LIBOR Transition Issues dated 6 July 2021, https://www.fsb.org/wp-content/uploads/P060721.pdf.

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Marinella Kilikitas
Tel: +357 25 361 333 / +357 96 716 661 / Email: marinella@kilikitas.com

Following her undergraduate studies in law at the University of Southampton, Marinella completed the LPC at the College of Law, Store Street, London. She became a member of the Cyprus Bar Association in 2005 and shortly thereafter joined the thriving corporate and commercial department of the largest law firm in Cyprus (in terms of size). Prior to establishing her own practice, Marinella was Head of the Corporate/Commercial Department of a mid-sized reputable Cyprus law firm.

Throughout her career she has been involved in a number of high-profile blue-chip transactions for a vast range of multinationals and magic circle law firms. She specialises in cross-border mergers and acquisitions, joint ventures and corporate restructurings, corporate governance, banking and finance (including legal opinions and due diligence), financial services/ banking regulatory matters and equity capital markets work.

She is a regular contributor to legal publications and articles and has contributed to a number of prestigious publications, including the Cyprus chapters of *ICLG – Mergers & Acquisitions* 2017, 2018 and 2019 and *ICLG – Lending & Secured Finance* 2017, 2018 and 2019, respectively.

Marinella is recognised by *The Legal 500* (EMEA CYPRUS, Corporate & Commercial 2018, 2019 and 2020).

She speaks English (native) and Greek (fluent).

Kilikitas & Co Law

21 Walter Gropius Str., 3076 Limassol, Cyprus
Tel: +357 25 361 333 / +357 96 716 661 / URL: www.kilikitas.com

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