

Problems and Measures for the Turkish Cypriot Financial Sector with particular emphasis on Banking Sector

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ABSTRACT

This study concentrates on the problems and measures for the Turkish Cypriot (TC) financial sector with particular emphasis on banking sector. Banking sector as the backbone of the financial sector constitutes 78 % of the sector. Regarding banking sector its financial structure and productivity in terms of personnel and branch showed a positive development. The crucial problems of TC financial sector are negative consequences of dollarization, lack of direct access to international financial markets, limited number of financial products, insufficient capital, unfavorable market structure and concentration, leading role of state banks and lack of international acceptable status of land ownership. Financial, structural and institutional measures should be taken to mitigate these crucial problems.

Keywords: Turkish Cypriot Financial Sector, Banking, Problems, Measures

JEL Code: G20

1. Introduction

Financial institutions (intermediaries) of TC primarily consist of commercial banks, international banking units¹ (<http://www.kktcmb.trnc.net>), cooperatives, insurance companies, foreign currency bureaus, credit and investment companies (TCC Central Bank 2006, p. 29). Among these, commercial banks play the major role when their total assets are considered. Commercial banks are followed by offshore banks, cooperatives, insurance companies and foreign currency bureaus respectively. In this study basic problems of TC financial sector will be examined and the measures making use of SWOT analysis will be recommended to solve these problems.

2. Main Indicators

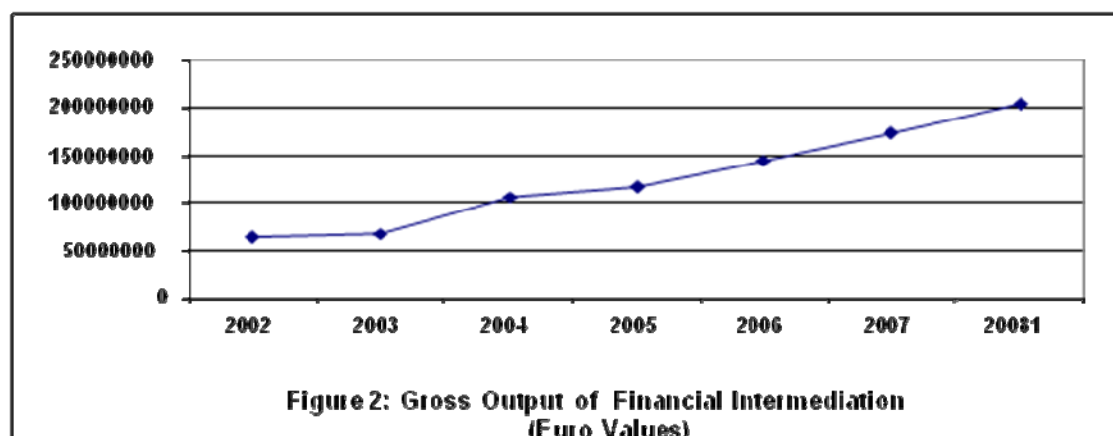
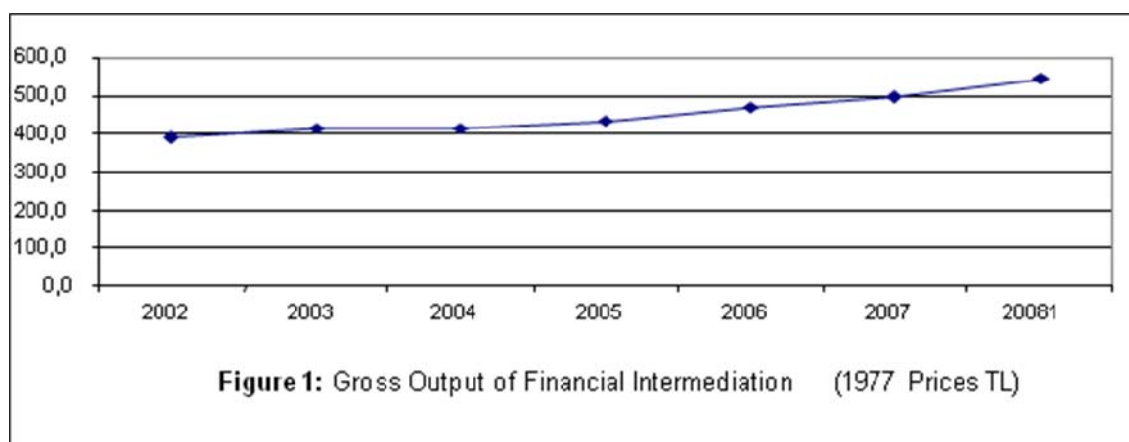
According to gross output of financial institutions at 1977 prices a yearly steady increase is observed for the relevant period (Table 1 and Figure 1). When the same output levels at euro values are examined output increases are greater relative to 1977 prices (Figure 1 and Figure 2). The almost same difference is seen when growth rates are taken into account. Such that growth rates at euro values are greater than the growth rates at 1977 prices (Figure 3). This difference is the result of real exchange rate showing that relative value of TL against euro increased during this period.

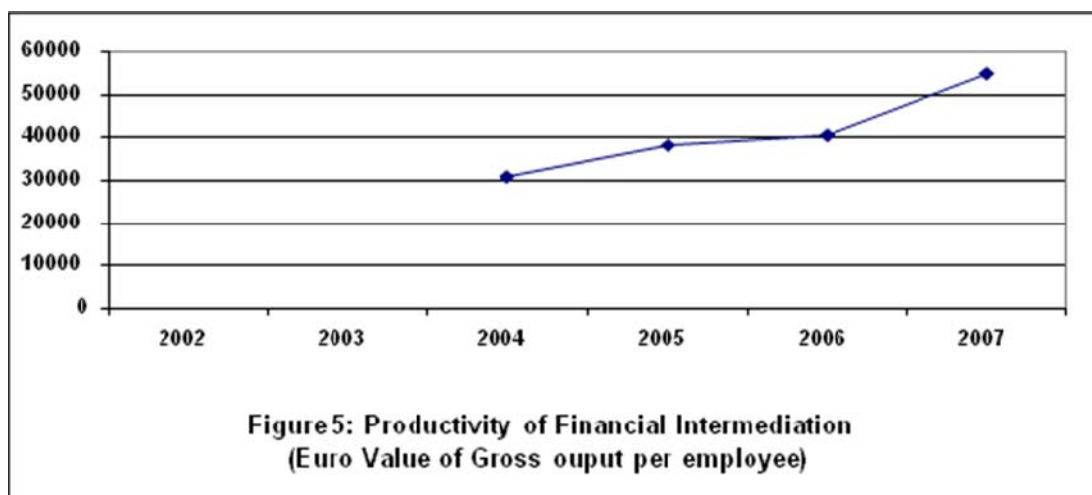
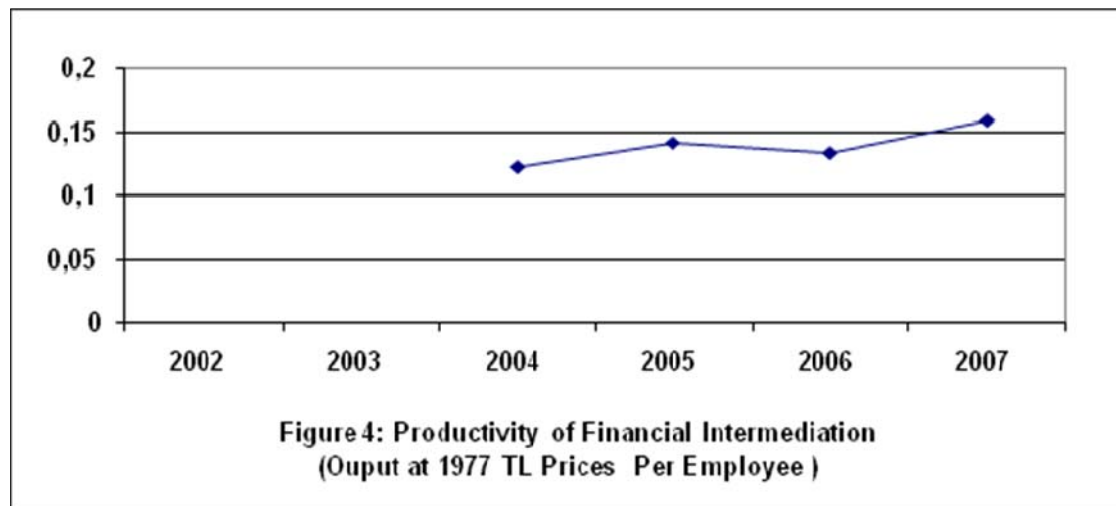
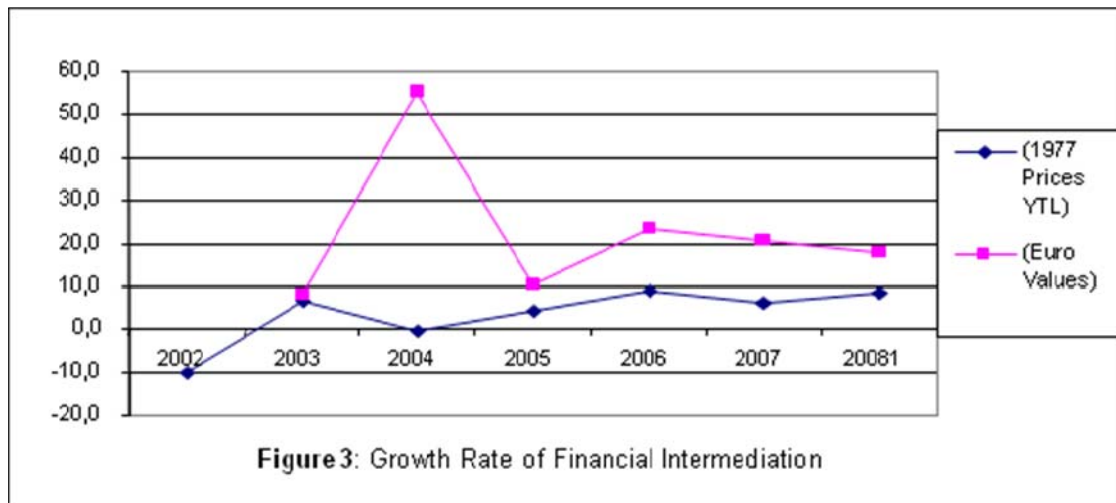
Starting from 2004 State Planning Organization started to prepare employment statistics according to Household Labor Force Survey rather than value added used till 2005. However, these figures are only available for the years between 2004 and 2007 as shown in Table 1. This explains the reason of why we used only these four years in calculating productivities. These employment figures are used to calculate the productivity of financial intermediation in Northern Cyprus as shown in Figure 4, Figure 5 and Table 1. Productivity as the gross output per employee is obtained according to both euro values and 1977 prices. As reflected by the figures similar pattern can be seen except the year of 2006. When the productivities based on euro values are examined productivity of each year relative to previous year raised while the same pattern except 2006 was exhibited according to that of 1977 prices.

¹ International Banking Units Law (41/2008) has put in to force at 5th August 2008 and it has repelled the existing Offshore Banking Law (46/2000). With this new law all offshore banks are required to change their extension names from offshore to International Banking Unit

Table 1: Main Indicators of Financial Intermediation in Northern Cyprus (2002-2008)

	2002	2003	2004	2005	2006	2007	2008 ¹
Gross output of Financial Institutions (1977 Prices YTL)	390,3	416,3	414,9	432,4	470,7	500,5	543,4
Gross output of Financial Institutions (Current Prices YTL)	89.952.347,0	115.256.266,8	187.245.581,7	195.523.141,4	259.316.015,9	309.354.672,4	389.601.599,6
Gross output of Financial Institutions (Euro Values)	62991839,64	67957704,48	105549933,3	116507651,9	143633552,6	173269111,9	204022622,3
Growth rate of financial intermediation (1977 Prices YTL)	-10,1	6,7	-0,3	4,2	8,9	6,3	8,6
Growth rate of financial intermediation (Euro Value)		7,88	55,32	10,38	23,28	20,63	17,75
Employment (number of employees)			3403	3044	3541	3142	
Gross output of financial intermediation per employee (1977 Prices YTL)			0,12	0,14	0,13	0,16	
Gross output (Euro) of Financial Intermediation per employee			31016,73033	38274,52427	40562,99142	55146,12091	

¹Provisional FiguresSource: SPO (2009), *Economic and Social Indicators 2007*, State Planning Organization Follow up and Coordination Department, Nicosia



3. Analysis of Sector

3.1 Structure of Sector

As cited in the introductory part financial institutions (intermediaries) of TCC primarily consist of commercial banks, international banking units, cooperatives, insurance companies, foreign currency bureaus, and credit and investment companies. The asset structures of these financial institutions are shown in Table 2. As shown in the table total assets of the sector decreased to 4542.7 from 4675.6 million (€) due to the shrinking in offshore banks and insurance companies.

Table 2: Assets of Financial Institutions in Northern Part of Cyprus

Million Euro (€)	2007	2008
Commercial Banks	3329	3545
Offshore Banks	1170	764
Cooperatives	110	177
Insurance Companies	63.3	52.6
Foreign currency bureaus	3.3	4.1
Credit and investment companies	Not Available	Not Available
Total	4675.6	4542.7

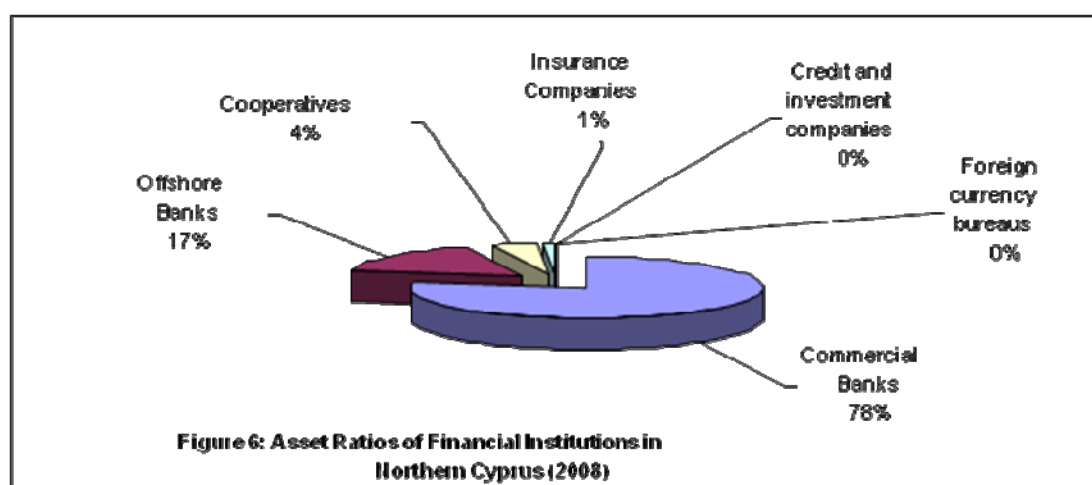
Source: 1- Central Bank of Northern Cyprus (Unpublished Data)

2- Bulletin of Central Bank of Northern Cyprus (2008 - IV), p. 77.

3- Bulletin of Central Bank of Northern Cyprus (2009 - II), pp. 39-40.

4- Cooperative Affairs Department of Northern Cyprus

When analyzed in terms of asset ratios of different types of financial institutions commercial banks have the lion's share by the ratio of 78 percent. Commercial banks are followed by offshore banks (17 %), cooperatives (4 %) and insurance companies (1%) respectively (Figure 6).



The main indicators and structure of commercial banks playing the major role of financial intermediation in Northern Cyprus will be explained in detail as follows.

3.2 Growth and Productivity of Banking Sector

Total number of commercial banks decreased from 25 to 24. Among the different types of banks only the number of foreign branch banks increased for the period between 2002 and 2008 (Table 3).

When the number of commercial bank branches is analyzed, it is seen that even though total number of commercial banks decreased total number of commercial bank branches increased from 138 to 170 between 2002 and 2008 (Table 4). Among the different types of banks only the number of public sector banks' branches reflecting the decline in the number of public sector banks decreased for the relevant period.

Table 3: Developments in Number of Commercial Banks in Northern Cyprus (2002-2008)

	2002	2003	2004	2005	2006	2007	2008
Public Sector Banks	3	3	3	2	2	2	2
Private Banks	18	16	16	15	15	15	15
Foreign Branch Banks	4	5	6	6	6	7	7
Total	25	24	25	23	23	24	24

Source: Bulletin of Central Bank of Northern Cyprus (2008 - IV), p. 35.

Table 4: Developments in the Number of Commercial Bank Branches in Northern Cyprus (2002-2008)

	2002	2003	2004	2005	2006	2007	2008
Public Sector Banks	29	29	29	23	23	24	27
Private Banks	95	87	88	83	83	95	111
Foreign Branch Banks	14	18	21	25	28	30	32
Total	138	134	138	131	134	149	170

Source: Bulletin of Central Bank of Northern Cyprus (2008 - IV), p. 35.

Parallel to the rise in the number of commercial bank branches employment in the banking sector increased from 2052 to 2372 between 2002 and 2008. Expectedly, on the employment in public sector banks decreased due to the reduction in terms of both banks and branches (Table 5).

Table 5: Personnel Distribution of Commercial Banks in Northern Cyprus (2002-2008)

	2002	2003	2004	2005	2006	2007	2008
Public Sector Banks	871	866	941	857	491	518	558
Private Banks	990	1018	1086	1171	1257	1386	1432
Foreign Bank Branches	191	209	249	269	296	345	382
Total	2052	2093	2276	2297	2044	2249	2372

Source: Bulletin of Central Bank of Northern Cyprus (2008 - IV), p. 36.

Financial structure of T/C banking sector is shown in Table 6. As understood from the table scale of the sector improved in all respects consisting of assets, credits, deposits and equity. Such that total assets increased from 1577 million (€) to 3545 million (€) while the total equity of the sector increased from 113 million (€) to 345 million (€).

Table 6: Financial Structure of Banking Sector in Northern Cyprus (2002-2008)

Million Euro (€)	2002	2003	2004	2005	2006	2007	2008
Total Assets	1577	1709	2051	2512	3087	3329	3545
Total Credits	418	460	660	934	1285	1531	1796
Total Deposits	1329	1469	1819	2164	2592	2765	2913
Total Equity	113	87	109	161	187	317	343

Source: Bulletin of Central Bank of Northern Cyprus (2008 - IV), p. 77,

When the figures of commercial bank branches, employment and financial structure are utilized in Table 4, Table 5 and Table 6, we can make productivity assessment of banking sector as shown in Table 7 and Table 8. Table 7 indicates the personnel productivity of T/C banking sector in terms of assets per employee, credits per employee, deposits per employee and equity per employee. As a positive improvement, productivity at least doubled in each respect.

Table 7: Personnel Productivity of Banking Sector in Northern Cyprus (2002-2008)

Million Euro (€)	2002	2003	2004	2005	2006	2007	2008
Total Assets per employee	0,77	0,82	0,90	1,09	1,51	1,48	1,49
Total Credits per employee	0,20	0,22	0,29	0,41	0,63	0,68	0,76
Total Deposits per employee	0,65	0,70	0,80	0,94	1,27	1,23	1,23
Total Equity per employee	0,06	0,04	0,05	0,07	0,09	0,14	0,14

Table 8 indicates the branch productivity of T/C banking sector in terms of assets per branch, credits per branch, deposits per branch and equity per branch. Similar to improvement in employment productivity

branch productivity of T/C banking also enhanced. While the highest productivity increase is observed in credits (243.5 percent), lowest increase belongs to deposits (78 percent).

Table 8: Branch Productivity of Banking Sector in Northern Cyprus (2002-2008)

Million Euro (€)	2002	2003	2004	2005	2006	2007	2008
Total Assets per branch	11,43	12,75	14,86	19,18	23,04	22,34	20,85
Total Credits per branch	3,03	3,43	4,78	7,13	9,59	10,28	10,56
Total Deposits per branch	9,63	10,96	13,18	16,52	19,34	18,56	17,14
Total Equity per branch	0,82	0,65	0,79	1,23	1,40	2,13	2,02

3.3 Problems

In the light of academic and other studies in addition to interviews with CEOs of the T/C commercial banks the following structural, operational and other vital problems of banking and financial sector can be expressed:

- **Dolarization**

In Northern Part of Cyprus, there is no relation between the inflation target and its monetary policy due to the fact that Turkish Lira has been in circulation as a legal tender during the period of dollarization. This makes the inflation occurring within Turkey as the basis originator of inflation for TRNC. Figure 7 illustrates the inflation for Northern Cyprus and Turkey in parallel with respect to each others. Time-series analysis conducted to examine the interaction between the inflation rates of two countries shows that they are co-integrated (Şafaklı and Özdeşer 2010, pp. 126-127).

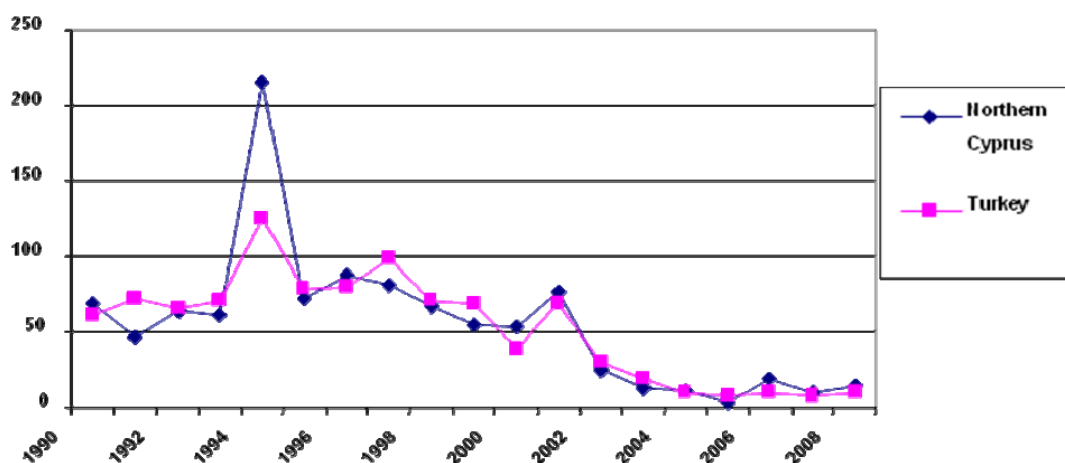


Figure 7: Inflation Rates in Turkey and Northern Cyprus (1990-2008)

Sources: Northern Cyprus State Planning Organization- State Statistical Institute of Turkey-Central Bank of Turkey

As a result of dolarization, systematic risk arising from Turkey will almost have full contagion effect on the T/C economy. Therefore, rise of systematic risk will negatively affect the process of financial intermediation and hence the economy as a whole.

- **Lack of Direct Access to International Financial Markets**

It has been a real task for local banks to offer electronic retail banking services such as overseas fund transfers, credit cards, POS and ATMs as these services require membership to foreign global networks like SWIFT, Visa and MasterCard; unfortunately, being operating in an unrecognized country, local banks have been denied membership to such networks and hence they are currently unable to issue their own international credit cards and register their local ATMs to global networks (even to the Turkish Interbank Card Center network-BKM network). This has created an unfair competition in the banking sector, as Turkish banks were able to penetrate into the market easily while the locals could only accomplish a minimal success

in doing so. The fact that a local bank should cooperate with another party (a Turkish bank in this case) in order to provide credit card and POS services, negatively affects its operation in terms of high expenses, difficulties in independent operation and decision-making.

- **Problems of Banking Operations**

Due to an absence of any capital market, the banks are the only conduits for financial intermediation. The T/C banking sector is not under any strain from financial disintermediation, as is the case in developed economies. Traditionally the banks have offered depositors limited choice in the type of savings accounts. However, as the depositors become more financially aware, through the economy pages of daily newspapers (local and from Turkey), the demand for other types of financial instruments is being satisfied. This demand is for Turkish Securities and for Turkish Treasury Bonds. Banks operating in Northern Cyprus as branches of mainland Turkish banks have an advantage here, since they are integrated into the Turkish banking sector, and thereby have access to the money and capital markets of Turkey. Hence, this service began to be provided through these branches as a reaction to depositor demand. Reacting to this demand local T/C banks also began to offer these services, though on a much lower level, since they cannot enter the money and capital markets directly, and must go through their correspondent banks. Naturally, the provision of these services will increase costs and weakens their competitiveness compared to foreign bank branches.

- **Insufficient Capital**

The initial capital requirement for establishing a new bank in the TRNC has now, according to the legislation passed on 14th February 2001, increased the amount from 50 billion Turkish Liras to 2 million US dollars (approximately 1.43 million Euros). In comparison, this amount is 5 million Euros in the European Union (Şafaklı 2003a). In other words, when compared with EU banking sector initial capital requirement should be triplicated for T/C banking sector.

Even though the ratio of equity to assets for the whole T/C banking sector increased from 7.2 percent to 9.7 percent between 2002 and 2008, especially small scale banks have faced serious problems in fulfilling the capital requirements. Parallel to this fact, two banks confiscated in Northern Cyprus as a result of decision of T/C Central Bank dated as December 12, 2009. The management and control of Continental Bank and Yeşilada Bank were seized while the banking and deposit-collecting permit of Denizbank were halted. Continental Bank and Yeşilada Bank have been experiencing problems in capital and equity capital for the last few years. As the inspectors' report determined there was no possibility for the improvement of the banks' current situations, the decision was made to transfer these banks to Cyprus Savings Deposit Insurance and Financial Stability Fund. Additionally, As of Dec. 31, 2008, the Denizbank's equity capital dropped below \$2 million and failed to meet the necessary equity capital in cash until the end of April (Yener 2009)².

- **Unfavorable Market Structure and Concentration**

The market share of the banks examined on the basis of state banks, private banks and foreign banks groups. According to 2008 central bank data, 34.68% of total assets held by state banks, 33.46% by private banks and 31.86% by foreign branch banks. In terms of deposits, state banks held 35%, 35 by private banks and 30% by foreign branch banks. When market share analysed in terms of credits, proportionality in between assets and deposits disappear for the foreign branches. Foreign banks that have around 30 % of assets and deposits, provides merely 19.4% of the total credits. On the other hand, state banks and private banks provide 48.78% and 31.82% of the total credits respectively. From these points it is quite clear that foreign banks do not have necessary positive impact to T/C economic growth because of the reality that they transfer savings of public to overseas (Bektaş 2005). Taking into account the economic fact that there is a strong correlation between the ratio of credit extended to the private sector to GDP and real GDP per capita (Cecchetti 2008, pp. 247-248) unfavorable credit structure is observed. Such that As of Dec. 31, 2008 the distribution of the aggregated loan portfolio was as follows: Public enterprises (33.06%), foreign and domestic trade (16.7%), consumer finance (45%), building and construction (3.2%), small and medium enterprises (1.6%), and other (0.04%). The ratio of public sector loans has come down from 53% in 2001 but continues to grow in absolute terms and hence represents a particular credit risk to the banking sector. The growth in loans to small and medium enterprises (SME) has been minimal; the ratio of SME loans to total bank loans is nearly insignificant. In addition to 33.06% of credits extended to public sector, 45% of credits are used for personal consumption usually represented by the use of credit cards. Therefore, the amount of credits that can be used for investment purpose is very limited. Concentration ratios are also important for

² <http://www.kktcmb.trnc.net/BASINACIKLA/ba-111209.html>

the market structure of the banking sector. Five largest banks shared 63.7% of the assets, while largest 10 banks own 85.4% of the assets. Remaining 14 banks represent only 14.6% of the assets. Among these 14 banks, 3 banks have less than 3%; 3 banks have less than 2%; and 8 banks have less than 1% in terms of the ratio of their assets to sector total. This shows that small scale banks have potentially lower level of competitiveness.

- **Leading Role of State Banks**

As it is theoretically asserted state banks negatively affect the rational allocation of funds and market efficiency (Sherif 2001). Except Germany, in chief countries of EU such as France, Italy and specially West Europe privatization of state banks led to positive effect on efficiency and profitability and increased concentration as a result of financial consolidation (Deutsche Bank Research, 2004). State banks account for about one-quarter of all commercial lending in Germany, more than Deutsche Bank and the other big private banks combined. Because of the state banks' this leading role commercial bankers say the state supported banks have an unfair competitive advantage because they face less pressure to be profitable and, with the state as owners, enjoy credit ratings better than their balance sheets would normally justify. Furthermore, pressure on the state banks is also coming from European Union antitrust authorities. Even though the European Commission is not opposed to public ownership of banks in principle, their concern is that "the banks should be viable without further injections of public money"³. By applying the policy of government aid control more rigidly, the European Commission (EC) has triggered off a process of liberalisation in the German public banking sector⁴.

In Northern Part of Cyprus, the role played by state banks resemble to Germany. As cited above 34.68% of total assets is held by state banks. Furthermore, percentages of equity, deposits and credits kept by state banks are 29.17, 35.18 , and 48.78 respectively. As understood credit market is mainly controlled by state banks. However, majority of state bank credits unfavorably go to public sector rather than private sector. This ratio amounts to 75 % according to 2008 figures.

- **Lack of International acceptable status of Land Ownership**

According to estimates, about 85% of the privately owned land in the northern part of Cyprus is of Greek Cypriot ownership. Hence, banks are reluctant to accept such properties as collateral and in such cases would either reject a loan request or reduce the term and the amount of the loan. In this respect, problem becomes more complicated as a result of judgements of European Court of Human Rights (ECHR) and European Court of Justice stating that original owners of most of the property in TRNC reside in South Cyprus and their property should be compensated and returned (Şafaklı and Altuner 2009, p. 2593). Furthermore, private enterprises are mostly characterized by weak governance (no proper accounting, no acceptable audited accounts, inadequate technical and commercial management capabilities) and inefficient technology. As a result TC commercial banks face difficulty in assessing the creditworthiness of private companies and therefore resort to collateral based lending with fairly short-term maturities. In addition, the predominantly weak capital base of private enterprises represents a significant debt leverage constraint.⁵

- **Other Problems**

In addition to important problems mentioned above the following secondary problem should also be identified.

-Financial sector supervision is highly segregated among a number of supervisory authorities. Working towards consolidation of supervisory authorities, reviewing the governance and organizational structure and developing a consistent regulatory framework for financial activities – these are just some of the challenges the northern part of Cyprus is currently facing (World Bank 2006, p. 157). Except Central bank independency and accountability of other supervisory authorities is questionable. Especially some cooperatives that are not effectively supervised practically perform banking functions without being subject to banking rules and regulations. This case leads to unfair competition against commercial banks while potentially creating moral hazard and adverse selection problem.

-Legal and institutional framework for factoring, leasing, forfeiting and financial derivatives is not yet established.

³<http://www.mydigitalfc.com/companies/state-banks%E2%80%99-losses-create-more-room-rivals-germany-802>

⁴<http://www.springerlink.com/content/348pq7356h6kt38v/fulltext.pdf?page=1>

⁵http://ec.europa.eu/enlargement/pdf/turkish_cypriot_community/objective_5_taiex_en.pdf

- One of the risks remaining in the banking sector is the level of public sector debt being carried on the balance sheets of the private sector banks. While the majority of this debt is being carried by two banks, the absolute level of exposure is growing, and remains high. The high level of public sector debt is due, in part, to loan exposures booked with public sector entities in the years leading up to the banking crisis, and the subsequent capitalization of interest and extension of maturities on a number of these exposures. (World Bank 2006, p. 161).
- Market information on the financial system and information produced by the financial system is scarce and of insufficient quality. Banks do not have good access to information on the enterprise sector because a large number of firms do not use international accounting standards and are not audited every year. Such a situation biases banks towards older or well-known clients with whom they have dealt in the past (World Bank 2006, p. 164).
- The problematic corporate governance structure of the Development Bank (being closely linked with the political system through appointment of senior management and the board of directors) could potentially compromise the ability of the Development Bank to perform efficiently (World Bank 2006, p. 165).
- Pillars of Basel II of which particularly way of quantifying credit risk and market discipline are not yet planned to be implemented.
- In case of credit default, unnecessary delay of administrative, legal and bureaucratic procedures especially related to liquidating collateral increases credit risk and hence interest rate. Lag of commercial court and police and/or prosecuting attorney dealing with financial matters are the main factors causing this unnecessary delay.
- Premiums of deposit insurance are fixed regardless of bank's default risk.
- The bonds issued by Development Bank that commercial banks are obliged to purchase raise the banks' cost of funds and reduce their liquidity.
- Banks having very low concentration ratios are neither institutionalized nor represent effective corporate governance.

4. SWOT Analysis

In order to develop a pro-active strategy for the banking and financial sector SWOT analysis as detailed in Table 11 is conducted.

Table 11: SWOT Analysis of Banking and Financial Sector in Northern Cyprus

<u>STRENGTHS</u>	<u>OPPORTUNITIES</u>
<ul style="list-style-type: none"> • The "Central Bank of Northern Cyprus" and the banks themselves are now highly experienced in dealing with shocks to the banking system, and the implementation of corrective action. • The "Central Bank of Northern Cyprus" is relatively independent (Şafaklı 2006a). • The savings Deposit insurance Fund guarantees 100% of private deposits and accumulated great expertise in resolving the bank problems regarding soundness of banks as well as liquidation procedures, while concurrently protecting deposits. In the initial phase of the crisis it was assisted by the Central Bank of Turkey. • The financial sector in northern Cyprus is well experienced in handling foreign exchange and the risks posed by these currencies. • The banking sector is highly competitive. • High potential of physical and intellectual capital needed to provide electronic banking services. • Existence of universities having banking and finance department that are equipped both domestic and foreign customers with required training. 	<ul style="list-style-type: none"> • To provide more credit to local clients whether individuals or business. • To extend longer term loans beyond 5 years. • To provide services to Turkish companies investing in northern Cyprus. • To merge with other banks and become stronger. • To gain competitive advantage by providing a broader range of services. • To provide Cyprus island wide services. • To provide financial services for trade with Turkey under the EU-Turkey Customs union. <p>Opportunities most probably available to banking and financial sector under the assumption of Cyprus settlement:</p> <ul style="list-style-type: none"> • The Ease of integration to international financial markets • Better investment climate for foreign investors • Stimulation of financial markets • The organized Stock Exchange in Northern Cyprus will probably start functioning. • The usage of Euro (€) and more stable economy will lead to decrease in the cost of financing and hence in the credit risk. • Better investment environment will lead to more efficient financial intermediation. • Local banks will be able to offer electronic retail banking services such as overseas fund transfers, credit cards, POS and ATMs as these services require membership of internationally recognized country to foreign global networks like SWIFT, Visa and MasterCard (Şafaklı 2003b). • International financing activities such as letter of credits will be regarded and taken into account by foreign countries. This will have positive effect on the country's economy.

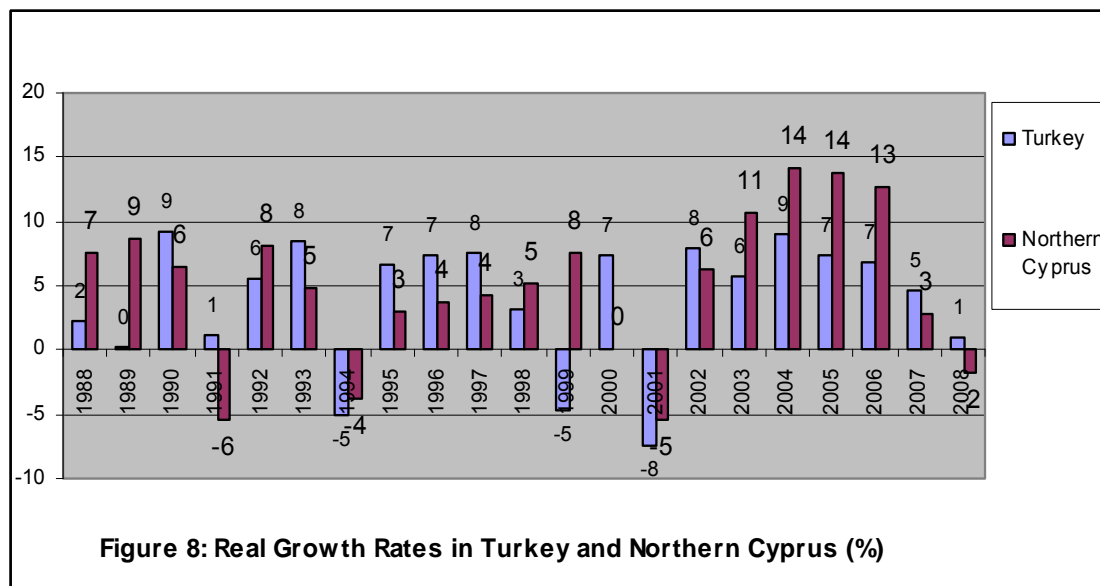
<p>WEAKNESSES</p> <ul style="list-style-type: none"> • There is not enough capital accumulation in the banking sector. • Due to international political issues, lack of access to the international money markets limits the ability of the banks to participate in interbank markets or obtain longer term funding. • High costs in international money transactions are another negative effect of the international political situation. • The diversification of banking products is still very limited in the market. Most banks provide traditional banking services only. • The banks have limitations in the use of international financial tools (such as SWIFT transfers) because of the political situation. SWIFT requires clearance from a recognized monetary regulatory authority. Nevertheless, HSBC applies SWIFT, and ING and BNP Paribas appear to utilize it, but local banks are at a disadvantage. • Major foreign loans by banks may require an internationally recognized regulatory authority; the "central bank" of NC may not be recognized for this purpose. Major international banks have refused loans to TC banks for this reason. • The uncertain land ownership situation in NC creates exceptional risks, with Turkish banks tending to avoid loans on Greek Cypriot land. • There are 8 banks with less than 1% of deposits that should be merged with other banks. • Credit is too small a proportion of deposits, but is rising in the case of local banks, though Turkish branches invest a higher proportion in Turkey. • Placement of funds in the Turkish market for Government bonds poses risks to the system arising from the danger of currency devaluation/depreciation. • The banks only serve their customers and local businesses to a limited extent. • Non-performing loans for both the public sector and business are hidden and could pose serious problems to the system (particularly to the TC Central Cooperative and Vakıflar banks). • State banks constitute high portion of the sector leading to irrational allocation of resources (Şafaklı 2006b). • The provision of money laundering services, especially by off-shore banks that are renamed as International Banking Units, poses a risk. • The provision of loans to shareholders of holding companies controlling some of the banks, was a major problem in the 1999-2001 crises, and may still be a problem despite improved supervision. • Hidden non-performing loans of the authorities and "state enterprises". • Necessary legal and institutional structures for leasing, factoring and financial derivatives are not yet established. 	<p>THREATS</p> <ul style="list-style-type: none"> • Economic problems in Turkey, particularly instability or significant depreciation of the NTL. The dangers are moderated today because almost 50% of deposits are in major currencies (dollar, sterling, euro). • Non-performing loans of the public sector. • Economic recession and increased risks of failure by companies. • Inflation rates higher than in Turkey reducing the value of interest payments of Turkish bonds. • Possible continuation of corrupt practices by holding companies controlling banks. • Off-shore banks and involvement in money laundering. • Connections between organized crime, casinos and banking (particularly in the off-shore banking sector). <p>Threats to banking and financial sector under the assumption of Cyprus settlement:</p> <ul style="list-style-type: none"> • More intense domestic and international competition reducing profit margins and hence necessitating increase in productivity and efficiency. • More intense competition will negatively affect the success of small scale banks. • More intense competition will negatively affect the success of local banks having insufficient capital. • More intense competition will negatively affect the success of local publicly closed, family owned banks.
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5. Consideration of Economic Crisis

As it is clearly apparent from the section related to dollarization, T/C economy is correlated with Turkey's economy. Indirect access of Northern Cyprus to international financial markets via Turkey besides dollarization makes Northern Cyprus vulnerable to Turkey's systematic risks. Therefore, economic and financial crisis occurring in Turkey potentially give rise to greater effect on T/C economy when compared with the impact of Global crises. As shown in Figure 8 Turkey's 1994 and 2001 crises almost affected the T/C economy in the same direction.

Similar to inflation rates real growth rates in two countries are found to be significantly correlated ($r = 0.539$). As indicated in Figure 8 except 3 out of 21 years' real growth rates in Turkey and Northern Cyprus followed

the same trend at different rates. According to period of 1998 -2008 average growth rate in Turkey and Northern Cyprus became 4.014 and 4.9 percent respectively. Particularly for the period between 2003 and 2008 average growth rate in Northern Cyprus (8.7%) was greater than that of Turkey (5.8%) due to the positive effect of Annan Plan on the T/C investment climate.



Source: Northern Cyprus State Planning Organization- State Statistical Institute of Turkey

6. Conclusions

As a summary the following conclusive remarks can be made:

- When the relevant period is considered total output of financial intermediation increased in real terms. Average real growth rate for this period was approximately 3.5 percent. Parallel to this growth productivity of the sector also did go up by about 30 %.
- Backbone of the financial sector is banking constituting almost 80 percent of the sector asset. While the number of banks decreased total number of bank branches raised by 23 percent for the period. According to Euro values balance sheet figures of banking sector improved and this led to increase in personnel productivity and even branch productivity despite of the substantial rise of bank branches.
- Financial interdependence between T/C and G/C economies is limited to check clearing of T/C banks through Greek correspondent banks.
- T/C authorities perceived the necessity of harmonizing financial sector with EU acquis.
- T/C financial and banking sector have severe problems that require structural and operational measures for the competitiveness of the sector. These problems are systematic risk component of dolarization; indirect access to international financial markets; problems of banking operations; insufficient capital; unfavorable market structure and concentration; leading role state banks and lack of international acceptable status of land ownership.

7. Recommendations

When the global trend of financial and banking sectors in the world is considered, there is no any doubt that financial structure of commercial banks should be strengthened in order to overcome the crises and other problems and survive in domestic and international intense competition. In this perspective, T/C financial and banking sector should be restructured. Within the framework of sectoral problems and SWOT analysis mentioned above, the followings can be recommended:

- The process of harmonization with EU acquis should be hastened and coordinated at the top level of government.
- Initial capital requirement should be increased to 5 million Euros as EU. While complying with EU acquis, T/C commercial banks will be motivated to merge and weak financial structure of small banks will be strengthened. In addition to this, incentives such as reducing reserve requirements, paying higher

deposit rates on funds held with the “Central Bank”, reducing deposit insurance premiums and/or tax reductions should be given to banks in order to be motivated to merge.

- Necessary measures should be taken to implement the Basel II accord as adopted in EU. Sector should be prepared to adopt the three pillars of Basel II. Such that, better credit risk treatment and quantifying risk sensitivity and the minimum capital charges associated with these risks of Pillar 1; making qualitative judgments on the ability of each bank to measure and manage its own risk of Pillar 2; and enhancing effective market discipline facilitated by introducing high disclosure standards with regard to bank capital of Pillar 3 should be considered in adopting Basel II. Furthermore, legal and institutional framework of external credit assessment firms (credit rating agency) should be constituted.
- Financial ombudsman should be established since the importance of customer orientation increased in today's competitive environment of intense competition. Establishment of financial ombudsman also necessitates the determination and declaration of codes of banking ethics that are missing in T/C financial sector.
- State banks should be privatized and/or merged and their management should be controlled strictly by Central Bank regulation and supervision. In addition to state commercial banks Management of Development Bank should also be subjected to Central Bank's regulation and supervision in order to make sure that funds are rationally utilized.
- Cooperative saving banks and credit societies accepting deposits and granting loans should be confined to offer these services to their own members. Otherwise, the same tax and regulatory regime should be applied to them to eliminate unfair competition against commercial banks. The supervision and regulation of these cooperative micro banks should be conducted either by Turkish Cypriot Cooperative Central Bank (TCCCB) or directly by Central Bank. Furthermore, supervisory authorities responsible for insurance funds, exchange bureaus, social insurance funds and stocks exchanges should also be independent of political intervention.
- Legal and institutional framework for factoring, leasing, forfeiting and financial derivatives should be established
- Public awareness of deposit insurance system should be increased and default risk of commercial banks should be taken into account while adjusting premiums rather than applying uniform rates. Moreover, current deposit insurance system based on the bank account itself should be changed. Such that maximum amount of deposit insured per person rather than maximum amount of deposit insured per account should be accepted as criterion.
- Commercial court together with police and/or prosecuting attorney dealing with financial matters should be instituted.
- Credit guarantee fund or mortgage guarantee fund should be effective and rationally put in practice with the purpose of minimizing the negative effect of the problem of property whose owner resides in South Cyprus.

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