BASIC PROBLEMS OF THE BANKING SECTOR IN THE TRNC WITH PARTIAL EMPHASIS ON THE PROACTIVE AND REACTIVE STRATEGIES APPLIED

KKTC BANKACILIK SEKTÖRÜNÜN TEMEL SORUNLARI VE UYGULANAN PROAKTİF VE REAKTİF STRETEJİLERİN KISMİ OLARAK VURGULANMASI

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ABSTRACT: The banking crisis of the Turkish Republic of Northern Cyprus (TRNC), which occurred at the beginning of the year 2000, has resulted in the liquidation of ten banks and ended up with economic losses of approximately 200 trillion TL, almost equivalent to 50% of GNP for 1999. The main reason for such huge losses for the TRNC economy is due to the fact that the commercial banks and the institutions responsible for regulation, monitoring, supervision of the financial sector together with those running the monetary policies did not have an organizational appreciation of proactive strategies. The amendments made to the Banking Law after the crises to reestablish stability within the sector could not go beyond reflecting the concept of reactive strategies and hence, did not include any proactive strategies necessary for eliminating the negative consequences of probable external factors.

The main aim of this study is to analyze the basic problems of the banking sector in Northern Cyprus with partial emphasis on the applied proactive and reactive strategies and make recommendations accordingly.

This study will include the following consecutive parts:
- The concepts of proactive and reactive strategies
- The current status and functionality of the TRNC Banking Sector
- An analysis of the TRNC banking crisis
- Structural problems of the banking sector in the TRNC
- Conclusion and Recommendations

Keywords: *TRNC, Banking Sector, Proactive and Reactive Strategies*

***ÖZET*:** *Kuzey Kıbrıs Türk Cumhuriyeti'nde (KKTC) 2000 yılının başında başlayan banka krizleri, 10 bankanın tasfiyesine ve 1999 Gayri Safi Milli Hasıla'sının (GSMH) % 50'sine tekabül edecek şekilde ekonomide 200 trilyon TL'lik kayıplara yol açmıştır. Söz konusu banka krizlerinin temel sebepleri ise bankacılık ile ilgili gözetleme, denetleme ve düzenlemeden sorumlu kurum ve kuruluşların proaktif stratejileri benimsememeleridir. Kriz sonrası sektörde istikrarı getirmek için başta yasal olmak üzere yapılan düzenlemeler, reaktif stratejilerin bir gereği olup özellikle dış çevrenin yaratacağı ve gelecekte olabilecek olumsuz unsurları dikkate almaktan uzaktır.*

Bu çalışmanın temel amacı KKTC bankacılık sektörünün temel sorunlarını uygulanan reaktif ve proaktif stratejilere de vurgu yaparak analiz etmek ve bu yönde öneriler geliştirmektir.

Çalışmada sırasıyla aşağıdaki kısımlar yer alacaktır.

- *Proaktif ve reaktif strateji kavramı*
- *Bankacılık sektörünün yapısı*
- *KKTC bankacılık krizinin analizi*
- *KKTC bankacılık sektörünün yapısal sorunları*
- *Sonuç ve Öneriler*

Anahtar Kelimeler: *KKTC, Bankacılık Sektörü, Proaktif ve Reaktif Strateji*

1. Introduction

Banking crises have become commonplace during the past two decades, but the range of experience in terms of the nature of crisis, causes and effects, varies widely across countries and at different periods in time.

Much of the theory on banking crises focuses on the special characteristics of banks, such as maturity and currency transformation and asymmetric information, which make the industry particularly vulnerable to collapse following adverse shocks (e.g. Jacklin and Bhattacharya, 1988 and Diamond and Dybvig, 1986). Institutional features of economies, such as the existence of deposit insurance and market-determined interest rate structures, are also emphasized in the literature as impacting the profitability of banks and the incentives of bank managers to take on risk in lending operations. The special features of banks, combined with particular institutional characteristics of economies, frequently lead to the emergence of banking problems when adverse macroeconomic shocks such as a fall in asset prices (impacting bank capital and/or collateral underlying loans) or economic activity (more delinquent loans) occurs. Adverse economic shocks may be of domestic origin (e.g. recession, inflation, budget deficits, credit slowdown) or external (e.g. external balance, exchange rate depreciation).

Several common features of countries experiencing banking problems emerge from numerous case studies. An International Monetary Fund (IMF) (1998) report summarizes this literature and identifies several general categories of problems frequently associated with financial crises: unsustainable macroeconomic policies, weaknesses in financial structure, global financial conditions, exchange rate misalignments, and political instability. Macroeconomic instability, particularly expansionary monetary and fiscal policies spurring lending booms and asset price bubbles, has been a factor in many episodes of banking sector distress, including most experienced by the industrial countries in the postwar period. External conditions, such as large shifts in the terms of trade and world interest rates, have played a large role in financial crises in emerging-market economies. By affecting the profitability of domestic firms, sudden external changes can adversely affect banks' balance sheets.

Weakness in financial structure refers to a variety of circumstances ranging from the maturity structure and currency composition of international portfolio investment flows to the allocation and pricing of domestic credit through banking institutions. These weaknesses generally arise in times of rapid financial liberalization and greater market competition, when banks are taking on new and unfamiliar risks on both the asset and liability side of balance sheets. Weak supervisory and regulatory policies under these circumstances have also increased moral hazard by giving an incentive for financial institutions with low capital ratios to increase their risk positions in newly competitive environments, and allowing them to avoid full responsibility for mistakes in monitoring and evaluating risk. Further, deficiencies in accounting, disclosure, and legal frameworks contribute to the problem because they allow financial institutions (or financial regulators) to disguise the extent of their difficulties. Governments have frequently failed to quickly identify problemed institutions, or to take prompt corrective action when a problem arises, resulting in larger and more difficult crises.

The TRNC banking sector which comprises almost all of the financial sector in the TRNC, has grown in numbers considerably under the influence of the liberalization trend of the 1980s; on the other hand, due to its deficiencies typical to those that cause crises as mentioned above, the sector could not go through a similar development to establish a sound and a reliable system and hence it has become vulnerable. These deficiencies that made the sector vulnerable and finally took it all the way to a crisis have been analyzed in this study. A part of the study has been allocated to the resulting reactive strategies put into action right after the crisis and a further discussion of possible proactive strategies have also been included.

2. Concepts Of Proactive And Reactive Strategies

A proactive strategy attempts to influence events in the environment rather than simply react to environmental forces as they occur. Its distinctive characteristic makes proactive strategy a powerful approach to considering uncertain future situations and hence it is useful to break through a current situation and is efficient to conceive alternatives. Moreover, pursuing a proactive strategy is competitive under an uncertain business condition.

On the other hand, a reactive strategy is a popular and an efficient problem solving approach, but it is applicable only when business conditions are stable. Reactive strategy is persuasive as it has causal explanations and is powerful when continuous improvement is targeted. Moreover, reactive strategies are time-efficient.

Reactive and proactive strategies can also be referred to as "today-for-today" and "today-for-tomorrow" strategies respectively. In this respect, planning for today requires a clear, precise definition of the business - a delineation of target customer segments, customer functions, and the business approach to be taken; planning for tomorrow is concerned with how the business should be redefined for the future. Planning for today focuses on shaping up the business to meet the needs of today's customers with excellence. It involves identifying factors that are critical to success and smothering them with attention: planning for tomorrow can entail reshaping the business to compete more effectively in the future. Planning for today seeks to achieve compliance in the firm's functional activities with whatever definition of the

business has been chosen: planning for tomorrow often involves bold moves away from existing ways of conducting the business. Planning for today requires an organization that mirrors current business opportunities; planning for tomorrow may require reorganization for future challenges.

In short, planning for today, or in other words a reactive strategy, is about managing current activities with excellence; on the other hand, pursuing a proactive strategy involves planning for tomorrow and is about managing change.

Although both reactive and proactive strategies involve some type of change, reactive strategy is about the "tuning up" kind of change that needs to take place to ensure that functional activities are well aligned with strategy whereas the proactive strategies are pursued to create change, not merely anticipating it. Proaction not only involves the important attributes of flexibility and adaptability toward an uncertain future, but it also takes the initiative in improving business (Bateman, 1999).

Both reactive and proactive strategies have their own strengths and weaknesses; for example, the outcomes of proactive strategies are only possible - not plausible – scenarios and they are less persuasive when compared with reactive strategies as no causation is involved. Reactive strategies are thought to be more applicable to daily business thinking than proactive strategies and at the same time they-reactive strategies- are more time efficient since proactive strategies are time-consuming in the planning stage - though agile in the implementation stage.

A reactive strategy might sometimes seem to be preferable over a proactive strategy when its strengths over proactive, especially in areas of plausible scenarios, persuasiveness and time-efficiency are considered; however, the fact that a reactive strategy cannot propose drastic changes and is powerless when business conditions are uncertain, imposes a deficiency in its utilization and this is to be carefully noted under the possibility that "tuning-up" of existing systems and processes (pursuing a today-for-today/reactive strategy) will not be sufficient for organizational performance and success in the uncertainty of the future. On the other hand, proactive strategies involve defining new problems, finding new solutions, and providing active leadership through an uncertain future (Bateman, 1999). As Abell (1999) puts forward in medical analogy, measuring temperature, blood pressure and other vital signs of a patient are part of a today-for today (reactive) way of thinking; for insuring a healthy future it is necessary to act proactively by looking below the surface at the root causes of disease or health and meanwhile taking the necessary measures in order not to eliminate the risk of any future temperature and the blood pressure elevations.

3. Current Status And Functionality Of TRNC Banking Sector

The number of banks in the TRNC has drastically gone down from 37 in 1999 to the current 25 (Northern Cyprus Bankers' Association, 2003). The driving force behind this fall has been the economic and financial crises, which swept the country starting from late 1999 through 2000 and most of 2001.

There are 25 banks now functioning under the new Banking Law has come into force in November 2001. The new law includes a large number of amendments in its

content (when compared with the original 1976 law) in an attempt to safeguard the banking system against future probable crises.

The distribution of the banks by sectors is given below:

Table 1: Distribution of Banks

SECTOR	NUMBER
State Banks	2
Cooperative Banks (operating under the Banking Law)	2
Commercial Banks	16
Foreign Banks	5
TOTAL	**25**

Source: Northern Cyprus Bankers' Association, 2002.

Along with the 25 local banks, there are 32 off-shore banks operating in the TRNC. Most of the off-shore banks are owned and operated by their parent banking corporations headquartered in Turkey.

The share of the banking sector in GDP has been steadily going down since 1999, until then it had followed an upward trend. Its share was 6.3% with 568.4 million TL (in 1977 prices) and has decreased to 4.8% with 416.1 million TL (in 1977 prices – see Table 2 and Table 3). Again, the economic crises have been the main driving force behind this decline. It is interesting to note that the current share is almost the same as the sector's share back in 1992; hence, it could be deduced that the crisis took the sector ten years back in development.

Table 2: Sectoral Developments in Gross National Product (GNP)

Sectors	(1977 Prices Million TL) 1996	1997	1998	1999	2000	2001	(1977 Prices Million TL) 2002[1]
1. Agriculture	870.8	601.0	636.2	822.0	713.5	828.4	869.3
1.1. Agriculture and Livestock	670.1	539.0	573.1	734.4	619.7	770.7	806.4
1.2. Forestry	155.3	14.9	15.7	40.0	42.9	12.7	17.6
1.3. Fishing	45.4	47.1	47.4	47.6	50.9	45.0	45.3
2. Industry	982.2	1,017.7	1,029.6	1,054.2	1,096.0	1,025.0	1,057.4
2.1. Quarrying	24.4	26.4	27.6	27.9	31.2	27.0	27.4
2.2. Manufacturing	815.6	841.1	842.9	853.3	884.0	822.8	851.6
2.3. Electricity – Water	142.1	150.2	159.1	173.0	180.8	175.2	178.4
3. Construction	523.3	647.5	694.6	708.6	841.4	669.6	643.2
4. Trade-Tourism	1,244.5	1,317.9	1,450.9	1,558.7	1,474.6	1,246.4	1,366.3
4.1. Wholesale and Retail Trade	1,033.6	1,076.2	1,201.4	1,280.9	1,186.4	991.8	1,084.4
4.2. Hotels and Restaurants	210.9	241.7	249.5	277.8	288.2	254.6	281.9
5. Transport-Communication	856.9	937.3	974.6	1,043.3	1,113.6	1,108.2	1,128.2
6. Financial Institutions	*423.7*	*482.1*	*524.4*	*568.4*	*529.6*	*434.3*	*416.1*
7. Ownership Of Dwellings	417.2	428.7	440.6	451.7	461.7	475.8	493.4
8. Business and Personal Services	518.5	655.7	679.2	784.0	700.0	800.1	801.0
9. Public Services	1,351.1	1,358.6	1,406.1	1,438.6	1,483.3	1,461.7	1,460.0
10. Import Duties	449.5	521.1	547.6	584.4	604.5	486.2	523.7
11. GDP	7,637.7	7,967.6	8,383.8	9,013.9	9,018.2	8,535.7	8,758.6
12. Net Factor Income From Abroad	35.7	22.8	84.3	76.9	19.7	10.2	10.7
GNP	**7,673.4**	**7,990.4**	**8,468.1**	**9,090.8**	**9,037.9**	**8,545.9**	**8,769.3**

[1]Provisional Figures

Source: State Planning Organization, 2002

Table – 3 Sectoral Distribution of Gross Domestic Product (1977 Prices, %)

Sectors	1996	1997	1998	1999	2000	2001	2002[1]
1. Agriculture	11.4	7.6	7.6	9.1	7.9	9.7	9.9
1.1. Agriculture and Livestock	8.8	6.8	6.8	8.2	6.8	9.0	9.2
1.2. Forestry	2.0	0.2	0.2	0.4	0.5	0.2	0.2
1.3. Fishing	0.6	0.6	0.6	0.5	0.6	0.5	0.5
2. Industry	12.9	12.8	12.3	11.7	12.2	12.0	12.1
2.1. Quarrying	0.3	0.3	0.3	0.3	0.4	0.3	0.3
2.2. Manufacturing	10.7	10.6	10.1	9.5	9.8	9.6	9.7
2.3. Electricity - Water	1.9	1.9	1.9	1.9	2.0	2.1	2.1
3. Construction	6.8	8.1	8.3	7.8	9.3	7.8	7.3
4. Trade-Tourism	16.3	16.5	17.3	17.3	16.4	14.6	15.6
4.1. Wholesale and Retail Trade	13.5	13.5	14.3	14.2	13.2	11.6	12.4
4.2. Hotels and Restaurants	2.8	3.0	3.0	3.1	3.2	3.0	3.2
5. Transport-Communication	11.2	11.8	11.6	11.6	12.3	13.0	12.9
6. Financial Institutions	*5.5*	*6.0*	*6.2*	*6.3*	*5.9*	*5.1*	*4.8*
7. Ownership Of Dwellings	5.5	5.4	5.3	5.0	5.1	5.6	5.6
8. Business and Personal Services	6.8	8.2	8.1	8.7	7.8	9.4	9.1
9. Public Services	17.7	17.1	16.8	16.0	16.4	17.1	16.7
10. Import Duties	5.9	6.5	6.5	6.5	6.7	5.7	6.0
GDP	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

[1]Provisional Figures
Source: State Planning Organization, 2002

As seen from Table 4 (Real Growth Rates), almost all sectors in TRNC economy have been considerably affected by the economic crises after 1999. The growth rates, which had been in an upward trend until then, dropped heavily in 2000 and 2001. However, the downward trend seems to be stabilizing for 2002, except for the Construction and the financial sectors. For 2002, a positive real growth rate is expected for all sectors; however, it seems that the recovery for the banking sector (and the construction sector) will take a longer time as still a negative growth rate is projected for this vital sector of the TRNC economy. A negative growth rate of –4.2% is the lowest among all sectors for 2002.

Table – 4   Real Growth Rates of Sectoral Value Added (%)

Sectors	1996	1997	1998	1999	2000	2001	2002[1]
1. Agriculture	8.9	-31.0	5.9	29.2	-13.2	16.1	4.9
1.1. Agriculture and Livestock	-0.4	-19.6	6.3	28.2	-15.6	24.4	7.3
1.2. Forestry	90.6	-90.4	5.4	154.8	7.3	-70.4	38.6
1.3. Fishing	-0.4	3.7	0.6	0.4	6.9	-11.6	0.7
2. Industry	-1.9	3.6	1.2	2.4	4.0	-6.5	3.2
2.1. Quarrying	-0.4	8.2	4.3	1.2	11.8	-13.5	1.5
2.2. Manufacturing	-2.6	3.1	0.2	1.2	3.6	-6.9	3.5
2.3. Electricity – Water	1.6	5.7	5.9	8.7	4.5	-3.1	1.8
3. Construction	3.1	23.7	7.3	2.0	18.7	-20.4	-3.9
4. Trade-Tourism	-10.6	5.9	10.1	7.4	-5.4	-15.5	9.6
4.1. Wholesale and Retail Trade	-10.0	4.1	11.6	6.6	-7.4	-16.4	9.3
4.2. Hotels and Restaurants	-13.4	14.6	3.2	11.3	3.7	-11.7	10.7
5. Transport-Communication	5.5	9.4	4.0	7.0	6.7	-0.5	1.8
6. Financial Institutions	*3.5*	*13.8*	*8.8*	*8.4*	*-6.8*	*-18.0*	*-4.2*
7. Ownership Of Dwellings	1.6	2.8	2.8	2.5	2.2	3.1	3.7
8. Business and Personal Services	84.8	26.5	3.6	15.5	-10.7	14.3	0.1
9. Public Services	2.6	0.6	3.5	2.3	3.1	-1.5	-0.1
10. Import Duties	4.9	15.9	5.1	6.7	3.4	-19.6	7.7
11. GDP	3.8	4.3	5.2	7.5	.	-5.4	2.6
12. Net Factor Income From Abroad	-63.5	-36.1	269.3	-8.8	-74.4	-48.2	4.9
GNP	**2.9**	**4.1**	**6.0**	**7.4**	**-0.6**	**-5.4**	**2.6**

[1]Provisional Figures
Source: State Planning Organization, 2002

The banking sector had been booming until the crisis and a true indication of this had been the number of people employed in the sector. Until 2000, both the employment and its share in the economy had been increasing; however, due to a decrease in number of banks by 12 as a result of the banking crisis, these figures have gone down in the recent years. Currently, only 2.6% (2,397 people) of the working population is employed in the sector, and this number is equal to the sector's share of back in 1988, 14 years ago.

Table – 5 Sectoral Distribution of Working Population

Sectors	1996	%	1997	%	1998	%	1999	%	2000	%	2001	%	2002[5]	%
1. Agriculture[1]	16,862	21.0	16,188	9.5	15,864	8.7	15,547	7.8	15,236	7.1	14,931	6.5	14,632	15.8
1.1. Agriculture and Livestock	-	-	-	-	-	-	-	-	-	-	-	-	-	-
1.2. Forestry	-	-	-	-	-	-	-	-	-	-	-	-	-	-
1.3. Fishing	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2. Industry	8,356	10.4	8,428	0.1	8,481	0.0	8,552	9.8	8,715	9.6	8,715	9.6	8,889	9.6
2.1. Quarrying	978	1.2	1,014	1.2	1,037	1.2	1,043	1.2	1,105	1.2	1,105	1.2	1,123	1.2
2.2. Manufacturing	6,107	7.6	6,120	7.3	6,125	7.2	6,153	7.0	6,234	7.0	6,234	6.9	6,382	6.9
2.3. Electricity – Water	1,271	1.6	1,294	1.6	1,319	1.6	1,356	1.5	1,376	1.5	1,376	1.5	1,384	1.5
3. Construction	9,792	12.2	11,547	3.9	12,177	4.3	12,361	4.1	14,104	5.8	14,104	5.6	14,104	15.3
4. Trade-Tourism[2]	8,367	10.4	8,730	0.5	9,095	0.6	9,536	0.9	9,630	0.8	9,630	0.7	10,565	11.4
4.1. Wholesale and Retail Trade	5,470	6.8	5,535	6.7	5,826	6.8	6,000	6.9	6,000	6.7	6,000	6.7	6,496	7.0
4.2. Hotels and Restaurants	2,897	3.6	3,195	3.8	3,269	3.8	3,536	4.0	3,630	4.1	3,630	4.0	4,069	4.4
5. Transport-Communication	6,734	8.4	7,192	8.6	7,389	8.7	7,747	8.8	8,104	9.1	8,104	9.0	8,221	8.9
6. Financial Institutions	*2,456*	*3.1*	*2,693*	*3.2*	*2,858*	*3.4*	*3,026*	*3.5*	*2,397*	*2.7*	*2,397*	*2.7*	*2,397*	*2.6*
7. Business and Personal Services[3]	10,848	13.5	11,454	3.8	11,750	3.8	13,057	4.9	13,057	4.6	14,401	5.9	15,469	16.8
8. Public Services[4]	16,899	21.0	16,972	0.4	17,399	0.5	17,689	0.2	18,084	0.2	18,084	0.0	18,084	19.6
Total Employment	**80,314**	**100**	**83,204**	**100**	**85,013**	**100**	**87,515**	**100**	**89,327**	**100**	**90,366**	**100**	**92,361**	**100**

[1] Sub-sectoral distribution of Agriculture was not possible after 1982 due to lack of data.
[2] Trade and tourism sectors were considered separately after 1982.
[3] Business and Personal services were included in Public Services before 1983.
[4] SEE and Municipalities are included.
[5] Provisional Figures
Source: State Planning Organization, 2002

Before the banking crisis, there had been a steady increase in deposits hold at the banks as seen in Table 6, with the maximum reached with 837.2 million USD at the end of 1999. The crisis not only hampered the banks' reliability but also gave rise to a major decline in the amount of deposits as a direct consequence of this reliability syndrome. A decline by 4.12% in 2000 together with an only a fraction of an increase in 2001 are true indicators for the reliability problem in the banking sector. Additionally, lower purchasing power and unemployment as direct consequences of the economic crisis together with stagnation were other factors behind the decline in bank deposits.

On the other hand, it is worth noting that there has been a considerable increase in deposits in the first five months of 2002. One reason for this is the obvious reestablishment of the deposit-makers' confidence in the banking sector; the public, once hesitant to make deposits at the banks after the banking crisis, have "come back" and fed the system once again. The other reason for this increase could be due to the still stagnant economy; as seen from Table 7, banks have been having a hard time in lending out money as a result of the economic crisis after 1999; the yearly

percentage change in loans have been under the inflation rate since the end of 1999 and this situation is still prevalent even today. This indicates that there is a very small amount of investment made for businesses and almost no alternative investment instrument (though very few do exist, they are unfortunately not very common among the public yet) in the country and as a result, a large sum of loose money goes into the bank deposits. (The considerable increase in deposits in the first five months of 2002 is also due in part to the uncommon drop in the USD exchange rate between December 2001 and May 2002; this has resulted in an above normal increase in the USD equivalent of TRL deposits, affecting the total considerably.)

Table 6: Deposits at the banks and % change

YEAR	TL DEPOSITS (Million TRL)	FOREIGN CURRENCY DEPOSITS (USD)	TOTAL DEPOSITS (in TRL equivalent, trillion TRL)	TOTAL DEPOSITS (in USD equivalent, million USD)	% Change in Deposits (in USD equivalent)
1996	18,769,501	406,523,100	61.42	581.3	-
1997	41,818,380	454,743,300	134.42	659.1	13.38
1998	73,750,887	499,541,300	229.25	735.7	11.62
1999	172,426,892	517,629,300	529.69	837.2	13.80
2000	213,915,391	484,021,800	538.82	802.7	- 4.12
2001	419,443,317	514,068,300	1,159.6	805.4	0.34
May 2002	556,667,057	570,773,300	1,351.7	970.4[1]	20.48[1]

Source: TRNC Central Bank Bulletin No: 28 dated 28 Sept.2000 and State Planning Organization.

Table 7: Bank Loans

YEAR	Loans (Million TRL)	% Change from Previous Year	Inflation Rate (Retail Price Index)
1996	46,047,462	83.74	87.5
1997	111,655,377	142.48	81.7
1998[1]	236,078,442	111.43	66.5
1999[1]	551,399,571	133.57	55.3
2000	525,201,259	- 4.75	53.2
2001	752,698,681	43.31	76.8
May 2002	759,590,937	0.92	7.33

[1] In 1998 and 1999, the loans are reported to be greater than the deposits; there could be two reasons for this: either there is a   difference in methods used by the Central Bank and the State Planning Organization, especially in using the appropriate exchange rate in converting TRL amounts to USD and vice versa or Development Bank's loans have also be taken into account – Development Bank is not a deposit-taker, hence loans could be higher than the deposits.
Source: State Planning Organization, 2002

4. Analysis Of The TRNC Banking Crisis

Early in 1999, being aware that there were a large number of banks with difficulties, the TRNC Economy and Finance Ministry, which was responsible for regulating the banks at that time, resolved to start the process of rehabilitation for the banking sector.

The production and circulation of the banking law draft goes back to the summer of 1999. The proposed new banking law was based largely on the banking law of Turkey, and was deemed to be an improvement on the 11/1976 Banking Law passed in 1976.

One of the major problems with the 11/1976 Banking Law was that it allowed for the creation of new banks with a minimum capital requirement of TRL 50,000 million (as at 30 June, 1999 this amount was equivalent to USD 119,683). The proposed law sought to increase the minimum capital requirement to USD 2,000,000 and gave existing banks two years to raise their capital and reserves to this level.

Another major departure from the existing law was to link maximum lending limits to the capital and reserves of the banks, instead of the banks' deposits.

The proposed law was opposed by a number of prominent bank owners, which saw the proposals as an intention to drive the local banks out of business, and leave the sector in the hands of banks from Turkey.

This resistance meant that the year 1999 passed without any concrete efforts being made to rehabilitate the banking sector, and led to the banking crisis of the year 2000.

Studies of systemic banking crises have identified the following factors as being their roots causing:
- Poor risk analysis by banks (Black, 1995: 6-8),
- Weak internal credit control systems,
- Connected lending (Hoenig, 1999;Aydın, 2000:13-30),
- Insufficient capital,
- Ineffective regulation, monitoring and supervision by regulatory agencies,
- Weak internal governance,
- Speculative activities,
- High leverage. (Llewellyn, 1999; Caprio, 1998; Huang ve Vajid, 2002; Erdönmez ve Tülay 2001 ; Sundararjan ve Balino, 1991)

Poor risk analysis by banks occurs at excessive credit creation times which is associated with the expansion phase of the business cycle. A crisis is triggered when the bubble bursts. Recent experience has shown that both bank lending booms and declines in asset prices have often preceded banking crises.

Weak internal credit control systems mean that a bank fails to effectively monitor its loan book. Hence, problem loans are not spotted early enough to reduce the loss to the bank.

Connected lending is a feature of many insolvent banks. This is where the bank is lending to companies or development projects connected with the bank owners or managers. Often the bank at below market interest rates and with no collateral security agrees these loans. The bank does not call in the loans even if the endeavor being financed is blatantly unprofitable, in the hope that things will turn more favorable in the future.

Insufficient capital means that the bank has no cushion to soften the shock of an economic downturn. The Bank for International Settlements (BIS) has set out a minimum capital ratio standard for all international banks. A committee of prominent central bankers, referred to as the Basle Committee (Basle is the city where the BIS is situated) set a minimum of 8% capital to risk weighted assets ratio. This standard has been adopted throughout the world, including the TRNC. The capital to risk weighted assets ratio is a more important measure of a bank's soundness than the total capital and reserves it possesses.

Ineffective regulation, monitoring and supervision by regulatory agencies, this is especially a factor in a banking crisis when there has been liberalization of the financial sector. Banks rush into new risks without proper assessment and the supervisory authorities are unprepared for the new activities. Interest rates may be liberalized, banks lose the protection they previously enjoyed under the regulated term structure of

interest rates, which normally keep short-term rates below long-term rates. The competition for deposits pushes interest rates higher, thereby increasing the interest rate charged on loans, which may cause some loans to become non-performing.

Weak internal governance means that the bank is unable to control rogue elements within itself, usually in the proprietary trading section. This is where the bank dealers in marketable securities undertake trades on behalf of the bank, the bank is in effect speculating on its own account. Poor internal controls may result in traders taking on more risk than is authorized, should the trade result in a profit, the bank's traders stand to receive a big bonus for the year, however any loss will have to be borne by the bank's shareholders, and the traders may only lose their jobs.

Speculative activities are similar in character to the rogue trader activity, however this time the speculation is undertaken with the consent of the bank's top management.

High leverage may apply to the bank, where it is taking on greater risk than its capital can carry, pushing its capital to risk weighted assets below the minimum of 8%, or it may apply to the borrowers, where the bank is happy lending to ventures at high leverages, that is the borrowers are committing only a small fraction of their own funds into the venture and using mainly bank finance. Any venture, which is highly leveraged with borrowings, is at risk to rises in interest rates; even a small rise may push its operations into loss.

Low GDP growth, excessively high real interest rates and high inflation increase the likelihood of systemic banking crises, according to Demirgüç-Kunt and Detragiache(1998:83). However, they point out that a weak macroeconomic environment is not the sole factor, and that structural characteristics of the banking sector and of the economic environment in general also play a role.

Analyzing the TRNC banking crisis of 2000, we can see that all of the eight factors listed above were true for the period, and that the macroeconomic environment was also very weak.

The five-year period prior to the banking crisis was a period of high real interest rates and during this period the number of banks increased from twenty to thirty-seven. These two facts are among the causes of the banking crisis.

The increase in the number of banks was not followed by an increase in the number of banking supervisors, working in the banking supervision section of the TRNC Central Bank. Consequently, the supervisors were unable to effectively inspect the banks. Many of the newly formed banks and some of the established banks were operating with insufficient capital.

High real interest rates caused deterioration in the quality of the loans granted by banks. Many borrowers became unable to service their loans. Interest piled up on the existing loans at ever-increasing amounts; such that some borrowers were left in a position, whereby the collateral security they had put up for the loan became worth less than the sum owed to the bank. In this scenario, the borrower has no incentive to repay the loan.

Instead of provisioning against possible loan loss, banks were renewing loan agreements to cover the original loan and the interest accrued. However important these two factors were in the making of the banking crisis, the major factor was the connected lending and looting of the banks by their owners and managers.

Some bank owners were using their banks to channel funds into their own, mostly unprofitable, trading activities even though The 11/1976 Banking Law limited the amount of this type of connected lending in such a way that maximum limit could not exceed 2% of total deposits or 10% of capital and reserves, whichever being the larger amount. Unfortunately, although it was common knowledge that some banks had exceeded this limit no action was taken against the bank owners.

It was later revealed that the amount of connected lending in the insolvent banks ranged from 50% to 90% of total loans, far in excess of statutory limits.

The banking crisis was triggered by the taking over of Yurtbank AŞ by the Savings Deposit Insurance Fund in Turkey in December 1999, Yurtbank AŞ had a sister bank in the TRNC, in both banks the majority shares were belong to the Balkaner group. Depositors began to withdraw funds from Kıbrıs Yurtbank Ltd, and the bank run quickly spread to other banks. By the end of January 2000, four banks had succumbed to the bank run, and were placed under state control.

In an attempt to stop the flight of deposits from the perceived weaker banks, in February 2000, the state passed a law providing 100% guarantee to depositors, at the same time increasing the deposit protection fund insurance premium from 0.4% of deposits to 1% of deposits per annum.

However, the total guarantee was not on its own sufficient to stop the flight of funds from some banks, and by the time the crisis had run its course, at the end of 2001, twelve banks had failed.

5. Structural Problems Of The Banking Sector In the TRNC
Banking sector of the TRNC is surrounded by serious structural problems, which carried more importance after banking crises. These problems can be summarized under the following headings.

5.1 Problems Of Monetary Policy In The TRNC
The legal tender in the TRNC is the Turkish Lira. Because of the use of another country's currency, the TRNC Central Bank has little control over monetary policy. In effect, the only monetary control instrument available to it is the reserve requirement. Currently the minimum reserve requirement on Turkish Lira deposits is 14% and on foreign currency deposits 15%. There is also a liquidity requirement of 10% on all deposits, payment orders and realized tax liabilities. The only liquid assets, which qualify for the liquidity requirement, are:
  (a) Cash;
  (b) Current account balances at the TRNC Central Bank;
  (c) Payable on demand TRNC bonds;
  (d) TRNC Development Bank bonds with a maximum maturity of one year;
  (e) Discount facility provided by the TRNC Central Bank. (TRNC Central Bank Notice No: 362 dated 30 July 1993)

There is no money market in the TRNC, the TRNC Central Bank has tried several times to start an interbank money market, organized within itself, but these attempts have never come to operation. The absence of an interbank money market has meant that the fallout effect of banks becoming insolvent has not directly affected the healthy banks.

5.2 Problems Of Banking Operations In The TRNC

Due to an absence of any capital market, the banks are the only conduits for financial intermediation. The TRNC 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 the TRNC 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 TRNC 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.

The standard strategy followed by TRNC banks has been to seek deposits, which are then channeled into assets such as loans and Turkish Treasury Bonds. Because of the fact that the interest differential between deposits and Turkish Treasury Bonds is usually high enough to warrant banks to hold Treasury Bonds as a major part of their assets, the banks have not been under any pressure to find a strategy, which would stimulate the demand for loans. Branch networks were created to maximize the collection of deposits, this is shown by the fact that there is only one bank branch in the Lefkoşa Organized Industrial Park, and this was opened relatively recently in 1998.

There was no effort by any bank to adopt a strategy to challenge the traditional activity. All banks followed a reactive strategy, competing with each other according to each bank's own characteristics.

Banking supervision, under the authority of the TRNC Central Bank, also followed a reactive strategy. Until recently, the supervisors seldom visited the banks, due in part to the fact that the number of banks they had to supervise did not match to the number of bank supervisors. Supervision relied heavily on the monthly reports prepared by each bank and sent to the Central Bank.

However, after the banking crisis of 2000, the TRNC Central Bank began to foster change in the banking sector. Regarding banking supervision as its primary task, the TRNC Central Bank has recruited new personnel for the banking supervision department. The status quo has been shaken up by the issuing of ten new notices by the TRNC Central Bank, regulating everything that banks do. Their strategy is to work proactively with the banks, in order to create a stronger banking sector.

The new regulatory notices are aimed at bringing banking practices into line with international standards, especial attention is being accorded to capital adequacy, with the adoption of the Basle criteria of a minimum 8% capital adequacy ratio. Hence, it can be said that the strategy of the TRNC Central Bank is proactive in the way it is forcing change on the banking sector.

Proactivity in strategic outlook is not confined to the central Bank, some commercial banks are also rethinking their strategies and attempting to foresee customer demand, and thereby cater for customer needs, which have been identified. The local commercial banks are aware that in order to continue in business and increase value for shareholders, they must actively seek out and identify niche markets, otherwise their existence is under threat coming from the branch offices of the large Turkish banks operating in the TRNC.

5.3   Problems Of Electronic Banking In The TRNC

Starting in late 1980s local banks began implementing branch automation systems to offer their traditional services like checking & savings accounts, money transfers, trade transactions, but they have not planned, implemented or integrated these systems in way that they would bring them a competitive advantage and help them not to lose any customer to their competitors. In a way, these IT implementations were not a part of a proactive strategy; they were simply aimed to cut down the work load on the banks' own staff and lower expenses – a direct consequence of a reactive thinking ("too much work for staff, high expenses for the bank, do something to ease things").

Things started to change later on in mid 1990s when customers, especially the younger ones, started to demand the same services that others have been receiving in other parts of the world, especially in Turkey. As a result, some local banks realized that they need information systems that are critical for their long-term prosperity and more importantly for their survival. This was then a catalyst for few local banks to reconsider their information systems. They realized that if they had continued to do business as before with their current banking systems, they could have easily lose the competition to other banks, especially to those based in Turkey and having branches in TRNC. A local bank made the initial step with the introduction of ATM services in mid 1990s. The decision for offering ATM services was one of a kind, as it was an outcome of both reactive thinking (same services offered by Turkish Banks in TRNC) and proactive thinking (act before losing the competition to Turkish Banks).

In the last few years, local banks have been eager and fast in getting into the retail banking market through credit cards and POS (point of sale) terminals. Local banks have always had loyal customers but after the recent striking economic events, customer loyalty has diminished and local banks started losing customers against their competitor Turkish banks (local branches of mainland Turkish banks) with extensive retail banking capabilities. In order to compete with their Turkish rivals in the retail field of electronic banking, local banks offer the same services in cooperation with some banks in Turkey, though less efficiently and with almost no profit. This act has been an outcome of both reactive and proactive thinking such that it is reactive as the efforts have aimed to satisfy the current needs of the customers, and proactive in the sense that the local banks would have otherwise lost their customer portfolio to the Turkish Banks.

 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.

Another factor, which directly affects the electronic banking penetration in the sector, is the population size of the country. When combined with the adverse effect of the high number of banks in the sector, the small population and the resulting small customer portfolio per bank make electronic banking investments almost infeasible. Electronic banking services require a high initial investment and a continual operating expenses and it is not feasible to provide such services to customer portfolios in terms of only few thousands. On the other hand, Turkish banks in TRNC do not make any initial investment as they simply use the already established infrastructure in Turkey; moreover, their operating costs for electronic banking services are much lower due economics of scale.

Local banks have been trying constantly to keep up with the technology and provide the same electronic banking services their Turkish competitors have been providing. Major local banks now offer credit card, POS and ATM services, and a couple of them have on-going internet banking projects; however, due to the unfavorable conditions – operating in an unrecognized country, small population size (small customer base) and the high number of banks on top of these – electronic banking services offered by local banks have not reached to a satisfactory level within the TRNC.

5.4   The Impact Of The Cyprus Problem On The Banking Sector

The TRNC is not recognized internationally. Non-recognition has caused some problems to the banking sector; chief among these is the absence of foreign direct investment. Other practical difficulties include the exclusion of TRNC banks from worldwide organizations such as SWIFT (a secure electronic fund transfer and communication system among international banks) and the card payment companies VISA and MASTERCARD.

The prospect of a solution to the Cyprus Problem presents the TRNC banking sector with opportunities and threats. The economy is expected to grow sharply; this will create increasing demand for banking services. The opportunity here is that local TRNC banks will pick up most of the increasing business. There is a perceived threat that strongly capitalized Greek-Cypriot banks will dominate the banking sector in a unified state, however, due to the nature of the industry and the emphasis on personal relationships, it is believed that the Turkish-Cypriot banks will lose business to the Greek-Cypriot banks.

6. Conclusion And Recommendations

In this study, basic structure of the TRNC banking sector, an analysis of the TRNC Banking Crisis and the structural problems of the TRNC banking sector have been evaluated. Furthermore, the importance of proactive strategies for the banking sector has been emphasized. The main findings of the study can be summarized as follows:

Proactive strategies will become increasingly important for the TRNC banking sector as the financial sector recovers from the effects of the banking crisis and begins to channel funds into the real sector.

The banking crisis resulted in an initial reduction of total deposits in the banking sector, which then steadied in 2001 and began to rise again in 2002.

As can be seen from Table 7 the growth of loans has not kept up with the rate of inflation for the past three years. In real terms, there has been a reduction in total loans granted by the banks. The primary problem for banks today, is to channel funds into viable projects, under the prevailing economically stagnant environment.

The causes of the banking crisis, which were outlined above, have been identified and are being addressed by the regulatory authorities. The TRNC Central Bank, responsible for banking supervision, has set out a proactive strategy for rehabilitating the banking sector, albeit with a degree of reactive tactics, such as closer monitoring of bank balance sheets and profit and loss statements.

The trend today is to separate the monetary control and banking supervision functions traditionally carried out by central banks. In the UK, banking supervision is now the responsibility of the Financial Services Authority (FSA) and in Turkey, banking supervision is the responsibility of the Banking Regulation and Supervision Board (BDDK), whereas previously in both these countries the central banks used to have banking supervision departments. Should the TRNC follow this example? Considering the size of the banking sector and the minimum function of the TRNC Central Bank, with regard to monetary control, the authors believe that banking supervision should remain in the hands of the TRNC Central Bank. This is especially important since the Central Bank has been granted autonomy from political control and is now independent to exercise its authority.

Because there are 25 banks operating in the TRNC, mergers and acquisitions between banks is a possibility, and could solve the problems of insufficient capital and the need to cut costs. The state should set an example here and merge the two state controlled banks, namely Kıbrıs Vakıflar Bankası Ltd and Akdeniz Garanti Bankası Ltd, however political considerations overshadow economic sense, the ruling coalition have shared out the control of the of the state banks among themselves and refused to agree on any merger. With regard to the private sector banks, the economic sense of merger is overshadowed by the prevailing sense of distrust among majority shareholders of different banks. The absence of a culture of distributed ownership of companies and banks, and the absence of laws safeguarding the rights of minority shareholders, are both impediments to mergers in the private sector.

Due to the adverse effects of operating in an unrecognized country with a small population (small customer base) and a high number of banks on top of that, electronic banking services offered by the local banks have not yet reached to a satisfactory level. However, a probable solution to the Cyprus problem will definitely open the doors for the local banking sector to international networks like SWIFT, Visa and MasterCard, as the obstacles and membership denials once faced will eventually perish and the locals will then be able to compete fairly with both Turkish and Greek Cypriot banks.

The following actions are recommended for creating a strong banking sector, invulnerable against future crises.
- The 100% guarantee of deposits places a considerable burden on the state and to the banks insured, due to the high (1% of deposits) premium, it also creates

an environment where depositors are not induced to punish risk-taking institutions, through the withdrawal of deposits. Therefore, the 100% guarantee should be phased out and the insurance premium reduced.

- Taxes and levies on loans should be removed, in order to bring down the cost of borrowing money.
- Credit skills of the banking institutions should be enhanced by introducing proactive credit skill-building measures.
- Innovation in products offered by banking institutions should be encouraged.

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