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**THE PROTECTION OF DEPOSITORS IN NORTHERN CYPRUS
WITHIN THE FRAMEWORK OF EU BANKING REGULATIONS**

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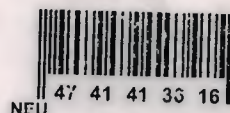


TABLE OF CONTENTS



ABSTRACT	2
1. Introduction	3
2. Conceptual framework of depositor protection	4
2.1 The direct relationship between Banking Regulation & Depositor Protection.....	4
2.2 Deposit insurance and safety net.....	5
2.3 Definition of risk & alternative methods for depositor protection.....	7
2.4 Some regulations for depositor protection.....	8
3. Depositor protection in the European Union.....	9
3.1 Relationship between capital adequacy and depositor protection.....	9
3.2 BASEL committee within the EU.....	10
3.3 Amendment to the Deposit Protection Act	14
3.4 The Banking Deregulation Process in the EU	18
4. Depositor protection in TRNC	19
4.1 Banking sector of TRNC	19
4.2 Deposit regulation in TRNC prior to banking crises.....	21
4.3 Development of the banking industry after banking crises in TRNC.....	23
4.4 Central Bank of Northern Cyprus.....	27
5. Conclusion and Recommendations	31
REFERENCES	32

ABSTRACT

This paper describes the position of Northern Cyprus, before and after the banking crises which took place in the year 2000, from a depositor protection perspective, as well as describing the depositor protection within the European Union. However, the central bank of TRNC has legislated new amendments, that are believed to move Northern Cyprus to a closer step to the European Union standards. This paper is going to explain the main reasons of the banking crises, and how the new amendments are going to solve the banking industry problem.

Financial institutions through banks, as they need to know that there is no risk of losing their deposits, or at least guarantee that the risk is low. Of course the point comes down to information that shows the bank's financial position to make the decision and facilities of the bank. But such information is confidential.

The financial position of any bank could change quickly because of the large amount of liquidity that might be changing so fast, so even if individuals have looked at the bank's balance sheet they would not understand the position of the bank, so the government has legislated more regulations in order to protect all the depositors against losses of funds, and this is the real subject of this paper that's going to show how the regulation works.

This paper is going to explore the equity at risk as well as the insurance and the safety net. Bank's capital is one of the topics of this paper. However, the banking crises of Northern Cyprus are going to be explained.

In light of what have been mentioned above, this paper is going to explain the regulation that was made for protective purposes in the European Union, and how Northern Cyprus has to maintain some standards in order to become a member of EU.

1. Introduction

Banks have always been treated as a matter of public interest, that's why it was really necessary that the government should restrict the banks with specific rules, to make sure this public interest is treated fairly. This paper is going to explain the principles of the banking regulation within the European Union, focusing on the regulation concerning depositor protection.

Depositor protection is the most important reason of banking regulation, this is because individuals as well as businesses are making financial transactions through Banks, so they need to make sure that there is no risk of losing their deposits, or at least guarantee that the risk is low. Of course the public cannot access to information that shows the bank's financial position, for example the assets and liabilities of the bank, that such information is confidential.

The financial position of any bank could change quickly because of the large amounts of liquidity that might be changing so fast, so even if individuals have looked at the bank's balance sheet they would still misunderstand the position of the bank, so the government has legislated those regulations in order to protect all the depositors against losses of funds, and this is the real subject of this paper that's going to show how the regulation works.

This paper is going to explore the equity at risk as well as the insurance and the safety net. Bank's capital is one of the topics of this paper. However the banking crises of Northern Cyprus are going to be explored.

In light of what have been mentioned above, this paper is going to explain the regulations that are made for protective purposes in the European Union, and how Northern Cyprus has to maintain similar standards in order to become a member of EU.

2. Conceptual framework of depositor protection

This chapter demonstrates the concept of depositor protection, and points it out as one of the objectives of banking regulations, as well as defining risk as a serious threat to banks, and lists a number of methods that banks utilize to guarantee depositor protection. However, the deposit insurance is going to be highlighted within this chapter, along with some other regulations for depositor protective purposes.

2.1 The direct relationship between Banking Regulation & Depositor Protection

It's a good question to be asked, that why banks should be regulated? As it was mentioned in the introduction of this paper, banks are always treated as a public interest matter, so it will be necessary that the rules of the government concerning this matter to be legislated.

The decisions of the banks have to be regulated to guarantee the depositors and consumers protection as well as to guarantee the financial system to be efficient and competitive. As a consequence, such regulation was evolved and developed to serve numerous goals, those which have been changing over time that were even in conflict with each other.

In general any bank that is new cannot enter the industry no matter in which country this bank is, without government approval. Each bank's principal regulatory agency is supposed to sanction the different types of deposits as well as some other financial instruments that are sold by some banks to the public in order to raise funds. There should be bank examiners that review the quality of the bank's loans, all the investments and also the adequacy of its capital. These revisions have to be made carefully, in case a bank is seeking to expand, whether if a building is going to be constructed or if the bank was going to merge with another one, also the case of setting up a branch office or acquiring or thinking of starting a non-bank business, in all of these cases that are mentioned above, the bank should first obtain a regulatory approval (Rose, 1993, pp 67).

Table 1: Traditional style regulator framework

	BANKS	INVESTMENT FIRMS	INSURANCE COMPANIES
Objectives	Systemic stability Neutralize moral Hazard Depositor protection	Investor protection	Consumer protection
Techniques	LLR/deposit insurance Capital requirements (going concern basis) On-site-examinations	Liquid capital Mark-to-market Valuation (liquidation basis)	Actuarial solvency
Regulator	Central bank/bank Regulator	Securities regulator	Insurance regulator

Source: (Dale and Wolfe, 1998)

2.2 Deposit insurance and safety net

Depositor protection is the most important reason for banking regulation. It should be clear that the protection of depositor depend on factors other than the bank activities themselves. As a matter of fact only a small number of the bank's assets are to be considered riskless, in practice commercial banking aspects might be implicated for depositor safety as well as the deposit insurance company.

According to US bank crisis that took place in the 1930s, legislators had to have more concern that such crisis should never occur again. Therefore, a body of provisions has been approved by the Congress that was incorporated in this Act, that it's supposed to form a kind of security for financial organizations as well as for depositors, that is called safety net.

Deposit Guarantee Fund was one of the items that were included by protective legislation for the banking system in order to provide a series of minimum balances to the depositors of failed banks. Another important item

was that the Federal Reserve having the right and the power to step in and provide immediate liquidity to banks experiencing difficulties in cashing deposit withdrawals.

As a matter of fact the problem was not the idea itself of having insurance, but is this insurance should include such activities that aren't directly related to traditional banking activities?. Stock market operations are such a good example of these indirect activities. However the heavy losses that were suffered by some banks with financial derivatives and public debt trading in 1993 and 1994; are one of the two events that took place recently that would assure a statement that says prudence in bank supervision should be careful to not extend its financial operations to include other than activities that are strictly related to traditional commercial banking is correct

The second event that would also assure the mentioned statement is correct is the difficulties with major industrial and real estate operations that have made it hard to some universal banks, such as Banesto and Credit Lyonnais. Although it wasn't for sure that these difficulties are really a good example of the moral risk problem, but still depositors have the right to know if they deposit funds in a secure institutions or are these institutions taking the risk on purpose (Canals, 1997, pp 78-79).

There was an argument between the big banks and the small ones about the insurance coverage. And this argument now is heating up again as the Federal Deposit Insurance Corp. tries to define its function as the financial industry gradually develops. Deciding the FDIC's function is getting more complicated as more non-banks gain access to deposit insurance.

The equity markets now on the edge, and the consumers are becoming more concerned about their funds' safety and also becoming less excited about getting the highest possible returns. The insurance funds are so well capitalized, most banks and thrifts are demanding the FDIC to find some way to return a part of the excess to them. Kenneth A. Guenther, executive vice president of the Independent Community Bankers of America, would help smaller banks and compete against the behemoths of the banking world. Currently, except for a handful of poorly capitalized banks, no banks pay premiums for their deposit insurance because the 1.25% minimum is safe. the insurance funds to move closer to the 1.25% minimum that is fixed and controlled by the law of all insured deposits (US Banker, 2000).

2.3 Definition of risk & alternative methods for depositor protection

It will be useful to start by defining the risk in general as an introduction to the systemic risk. The risks basically affect the bottom line of the firm, it is relatively simple to define the risk that a financial firm encounters. Actually risk is the possibility that a firm's actual income will turn out to be lower than the expected value of its earnings. Regulators are likely to be concerned about such cases where the shortfall could be sufficiently large to result in a loss which reduces the firm's equity and retained earnings or in the unusual case to exceed the shareholders' funds and result in the insolvency of the firm. This provides the following generalized definition of risk $Risk_t = P_t (Earning_{t+1} < E_t(Earning_{t+1}))$ where: $Risk_t$ is the measure of risk at time t , P_t is a measure of probability at time t , $Earning_{t+1}$ is the actual observed earnings at time $t+1$, $E_t(Earning_{t+1})$ is the expected value, measured at time t , of earnings at time $t+1$ from which it possible to derive those cases which are of particular concern to regulator. Actually $RRisk_t = P_t (Earning_{t+1} < 0)$ where: $RRisk_t$ is the measure of regulatory risk at time t . Since for the vast majority of firms it's possible to assume that the expected earnings are positive, it's possible to see that $RRisk_t$ is simply a sub set of the general definition of risk. As a result anything which a firm does to reduce its exposure to risk will also necessarily reduce its exposure to the regulatory measure of risk.

After introducing the definition of risk in general. The term 'systemic risk' has to be introduced too. In particular, the term is used to refer both to a sudden crisis of confidence and withdrawal of liquidity from a market. However, in order to meet the Basel Committee definition the risk has to be international in character and systemic in nature. Before going any further, the Basel committee is going to be introduced in the next chapter. However, the most appropriate description of systemic risk is, the risk that something which goes wrong in one firm or market will, because of the close linkages which now exist between firms and markets, spill over to affect other firms and markets (IFCI risk.ifci.ch).

It will be necessary to name some of the methods used for the protection of depositors.

- **variable rate deposit insurance** is a system in which deposit insurance premiums are being allowed to increase with the risk. Detailed regulations for controlling banking risks are less essential, any way banks have a strong financial incentive to control risks. However, this system has been criticized in two areas, riskier banks would be the primary contributors to the deposit insurance fund, actually variable rate premiums would hit weak banks when they could least afford it. As a second point to this area, measuring risk and constructing an optimal premium schedule could be proved to be difficult. In case the premiums failed to measure risks properly, restrictions on bank activities and operations might still be necessary. The issue of setting variable rate premiums would seem to be a question of faith in the ability of the current regulatory process to measure risks sufficiently.
- **100 percent reserves** which require banks to back their deposits fully with reserves. In order to support this proposal the following arguments have been used. Depositors are protected without the need for a bank supervisory system. 100 percent reserves would allow close control of the money supply, and finally lending and deposit withdrawal are not interrelated.
- **Shift towards less regulated accounts** which allows less regulated accounts to expand and make depositors rely more on self-protection (Spong, 1985, pp 84-87).

2.4 Some regulations for depositor protection

The following are regulatory procedures designed to protect depositors and control banking risks, these procedures help to develop an overall view of a bank and its ability to protect depositors.

- **Bank examinations:** Information collection is the basic duty of bank examiners that is used to indicate the current financial condition of a bank and find out that this information is correct and if it's used according to the applicable laws and regulations of such a specific

case. Actually all the parts of the process concerning a bank's operations are covered in an examination, and there are special reports that to be submitted and discussed between the examiners themselves on the trust activities as well as the electronic data processing operations, and of course to make sure that the discussed activities which are mentioned above are true in terms of depositor protection laws. The examiners will try to analyze any interrelationships besides assessing the general condition of a bank after they finish looking at such individual activities and departments in the examined bank. Mostly all banks are generally examined at a variable frequency in which this frequency is concerning a bank's condition.

- **Reporting requirements:** Banks must file various reports with their supervisors. Some reports, such as insider loans, are used for specific regulatory objectives, while others inform bank supervisors of the bank's current condition and performance. An example is the report of income which lists a bank's revenues and expenses as well as such items as dividends and contributions to capital, however this report is required quarterly. Most bank reports are available to the public and serve to give investors and bank customers information on a bank's operations and performance, this information is particularly important for large depositors with accounts exceeding the insurance limits (Spong, 1985, pp 78-82).

3. Depositor protection in the European Union

In the last chapter of this paper, the concept of depositor protection was introduced, as an introductory to this chapter that will specify its attention to the European Union.

3.1 Relationship between capital adequacy and depositor protection

A commercial bank has to have sufficient capital so that it will be able to provide some kind of protection for expected and possible loan losses or other kinds of problems, which could affect the depositor protection

negatively. However, the commercial bank is also in need for such funds in order to cover its internal needs and for its expansion, an security that is being added for the depositor as well as the deposit insurance system. Further more, higher capital serves to raise the financial stake that stockholders have in the safe and sound operation of a bank. As a result, bank regulators view capital as an important element in avoiding the banking risks to an acceptable level. Capital adequacy determinations have caused problems for bank regulators and bankers, because such capital needs are usually relying on the factors that are mostly like the bank characteristics, economic conditions, and the practices of the banks. Not so long time ago when the large banks started to maintain lower capital ratios than the small ones, since they were thought of as the most diversified. There also were fewer deposit fluctuations and better access to capital markets.

Prior to the control of the assessment of any bank's capital is to be made, there is a decision that should be taken on what forms capital. This is necessary because many of the balance sheet items include some, but not all, of the attributes of capital. Subordinated debt can protect the bank depositors, but the problem that it has a limited life and demands on bank revenues, it cannot be called a permanent form of capital, (European Report, 2000).

3.2 BASEL committee within the EU

It was such an important event that the publication of the Basel Committee's paper of the official plans that would suggest improvement changes for the capital adequacy framework for the banks, in the development of international financial regulation.

The existing 1988 official agreement that had the purpose to establish such a common capital adequacy framework for banks. Has also become the international standard by which banks are examined in terms of their capitalization, and this is true within the EU as the agreement has once again becoming the standard for capital adequacy for securities of the firms. However, as the Basel Committee recognizes, the 1988 approach has become importantly no longer useful as a result of the market developments and as a result of this the Committee has started a discussion in which the experts would give their opinions about what should be done with a view to a framework which is more modernized.

The Committee is officially suggesting the mentioned above approach which has the following three elements:

- A more modernized capital adequacy framework in which it looks for relating the minimum capital requirements in such a more accurate way in order to try to be protected from the risks which the banks usually face.
- An improved process for supervisory review of the banks.
- An improved market discipline through better public disclosure.

Actually the new system has the duty to help to show the clearest kinds of regulatory arbitrage and why there are no incentives to good practice in credit risk management which are associated with the 1988 Accord. The Basel Committee's initiative in inviting a discussion about the future framework for regulatory capital.

The fact that the framework which is agreed upon at the end of the current consultation period will almost certainly establish the foundations for capital regulation for the next ten years not just for commercial banks but for all internationally active financial firms, it is important to consider whether the underlying theoretical basis for the Basel Committee's capital is appropriate for the firms to which it will apply in the future. Somehow it is important to recognize that the Basel Committee approach is based on a traditional banking view of the world, where the basic risk that a firm usually faces is the credit risk in its portfolio of lending.

The approach is based on the fundamental assumption that credit losses are essentially random events which are only realized and passed through the p&l account as and when they arise. As a result, within this approach capital is viewed as the primary protector against the credit losses which are inherent in the balance sheet and regulatory capital is a primary tool to protect against the systemic risk associated with a rise in realized credit losses. In the future it is somehow highly questionable whether this approach to setting regulatory capital will remain appropriate for the internationally active financial firms to which the specified financial agreement will be in practice able to apply either directly, because they are regulated as banks, or indirectly because they are subject to the Capital Adequacy Directive within the EU (IFCI risk.ifci.ch)

- **Banking supervision - Review of Basel Capital Accord complements review of EU bank capital Directives**

Acting European Commissioner for Financial Services Mario Monti welcomed the publication on 3 June in London by the Basle Committee on Banking Supervision of a consultative paper on the Review of the Basle Capital Accord. "The European Commission shares the need for a review of capital standards", commented Mr Monti. "Progress in the framework of the Basle Committee will complement work already underway by the Commission, in collaboration with EU banking regulators and supervisors in the Banking Advisory Committee, on a review of the present EU rules on capital standards, namely the Directives on the Solvency Ratio and Own Funds."

Table 2: The aims of key EC financial market directives

DIRECTIVE	AIMS
Capital Adequacy	To harmonize minimum capital requirements for investment firms and bans engaged in securities business
Investment Services	To liberalize EC financial markets. Sets out the single passport principle whereby firms authorized to operate in one EC country can operate via branches in an other
Solvency Ratio	To harmonize minimum capital standards for banks. Sets out different risk weights for different categories of loans and financial items
Second Banking Coordination	To liberalize banking operations by applying the single passport principle whereby banks authorized to operate in one EU country can operate branches via any other
Consolidated Supervision	To enable supervision on a

	consolidated basis of all banking groups including those whose parent are not credit institutions
Own Funds	To define the types of capital that banks may hold to satisfy the solvency ratio directive
Large Exposure	To harmonize limits on the extent of lending to any borrower
Deposit Guarantee	To set minimum standards for guarantees applied to bank deposits
Investor Protection	To set minimum standards of customer (proposal) protection for transactions with securities firms

Source: (Dale and Wolf, 1998)

The consultative paper on the Review of the Basle Capital Accord (which was originally established in 1988) published on June 3 1999 by the Committee on Banking Supervision of the Bank of International Settlements - BIS - (known as the "Basle Committee") will complement a review already underway of EU legislation on bank capital requirements. The Basle Committee announced that its consultation process will take until the end of March 2000 and that it will then come forward with definitive recommendations for improved banking supervisory practices in the field of bank regulatory capital.

The European Commission, in collaboration with EU banking regulators and supervisors in the Banking Advisory Committee, already set work in hand in the Spring of 1998 on a review of the present EU rules on bank capital requirements. The origin of the present EU Directives now dates back more than a decade and the Commission is aware that EU legislation must keep pace with developments in the market and accurately reflect underlying risks.

The Commission's work is proceeding in parallel with that in the Basle Committee, in which 8 EU-Member States and the regulators of our main banking competitors participate. As announced in its Communication of October 1998, the Commission's objective is that the EU should take a leading role in the discussions to maintain a level playing field both within and beyond the EU while taking particular account of the heterogeneous structure

of the EU's banking and investment firm sector. The EU's Council of Finance Ministers and the Vienna European Council have supported this objective.

The Commission's Action Plan on Financial Services of 11 May was endorsed by the 25 May Finance Council and submitted to the European Council in Cologne. It expressed the Union's commitment to strive to maintain the highest standards of prudential regulation for its financial institutions.

As a complement to the Basle consultative process, the Commission will issue its own consultation paper on the review of regulatory capital in the Autumn. The Commission's consultative paper will focus on issues of particular concern in the EU context. The Commission envisages that the consultation process on its paper will take place at national level in order to minimise overlap with the Basle consultative process. National authorities will thus focus on those issues that are of most concern to each Member State.

The Commission's Action Plan on Financial Services indicated that it might come forward with proposals for Directives to amend the present EU capital framework in spring 2000. These proposals would draw on the response to the Commission's consultations and take account of parallel developments in the Basel Committee ([IFCI risk.ifci.ch](http://risk.ifci.ch)).

3.3 Amendment to the Deposit Protection Act

The Deposit Protection Act of 1996, which is based on Directive No. 94/19/EC of the European Parliament and the Council of the EU on deposit-guarantee schemes (dated 30 May 1994), has been amended and augmented by Act No. 154/1999 Z.z. (hereinafter referred to as 'Amendment to the Deposit Protection Act').

The Deposit Protection Act is based on the principle of solidarity and collective responsibility of all banks and branches of foreign banks for inaccessible deposits. This Act is one of the basic legal pillars on which the stability of the banking system rests in the Slovak Republic. The Amendment to the Act does not interfere with the above principle or other principles on which the said Deposit Protection Act is based.

In the light of the Background to the Revised Act, the Amendment to the Deposit Protection Act was passed with the following chief objectives:



- to shorten the time limit set for the payment of compensation for inaccessible deposits;
- to make the activity of the Deposit Protection Fund more effective;
- to maintain the stability of the banking system during payment of compensation for inaccessible deposits.

In this short article, it is only possible to mention some of the changes made in the Deposit Protection Act and the other two banking laws specified above. According to the Amendment to the Deposit Protection Act, a non-anonymous deposit is a deposit held by a private individual in a registered bank account (accompanied by the name, surname, address, and date of birth of the account holder). For the purposes of this Act, the date of birth shall include the depositor's birth certificate number. Other deposits that do not meet the above criteria are considered to be anonymous deposits. Such deposits are not covered by the Deposit Protection Act. The Amendment to the Act explicitly excludes bills of exchange and cheques from protection. The annual contribution for a specific year shall be set by the Deposit Insurance Fund for all banks and branches of foreign banks in advance. This must be done not later than 20 December of the preceding year. The amount of the annual contribution shall remain unchanged during the course of the year.

The National Bank of Slovakia may declare a bank unable to refund deposits on its own initiative as well - after revealing some proof of this fact in accordance with the Deposit Protection Act - even without receiving a notification from the bank or the conservator. This provision is designed to make it impossible for a bank or its conservator to block a declaration by the bank of its incapacity to refund deposits.

With regard to the fact that the Statistical Office of the SR can provide official data on average wages for the previous year in April at the earliest, a change had to be made in the provision of Article 9 para 2 of the Deposit Protection Act. According to this change, a depositor shall be entitled to compensation for an inaccessible deposit in the amount of the deposit; however, the maximum amount of compensation is set at thirty (sixty in the case of home savings deposits) times the average monthly wages in the Slovak Republic as stated by the Statistical Office of the SR for the last four

quarters prior to the date when the deposits became inaccessible. At the same time, the calculation of the amount of compensation for an inaccessible deposit has been modified so that the amount shall be reduced by the total of statute-barred deposits and liabilities of the depositor vis-a-vis the bank on the date when the deposits became inaccessible. For the purposes of the Deposit Protection Act, interest and other items due on the deposits shall be calculated up to the date the deposits became inaccessible.

According to the Amendment to the Deposit Protection Act, the owners of statute-barred deposits and depositors who had - over a period of one year before the date when the deposits became inaccessible - a special relationship with the bank (as defined in the Banking Act), are not entitled to compensation. On the basis of this provision, persons who have a special relationship to the bank but are in no way responsible for the fact that bank has become unable to refund deposits, shall not be put at a disadvantage. The Amendment to the Deposit Protection Act has extended the category of persons who are not entitled to compensation for inaccessible deposits. This concerns persons who have committed a criminal offence (for which they have been prosecuted and sentenced by a court of law), causing the bank to become unable - partly or completely - to refund deposits, or who have acquired deposits in connection with the laundering of proceeds from criminal offences for which they have been prosecuted and sentenced by a court of law. Under the conditions set out in the Amendment to the Deposit Protection Act, the Deposit Protection Fund shall suspend - in the cases specified above - the payment of compensation for inaccessible deposits.

The Amendment to the Deposit Protection Act specifies the procedure to be followed by banks in paying compensation to depositors for inaccessible deposits. A private individual (natural person) must present a proof of identity and prove, according to the type of deposit, that he has title to the deposit and that he is entitled to receive payment.

Such a claim is usually proved by means of a document of title to the deposit or a copy of a decision made by the relevant authority. Depositors can be identified on the basis of a valid identity card, passport, diplomatic passport or, in the case of non-residents, on the basis of a residence permit issued in the Slovak Republic. In order to ensure smooth and fast compensation for inaccessible deposits in cases where a depositor has several deposit accounts with a bank and their total volume

exceeds the amount of compensation set in accordance with the Deposit Protection Act, compensation for such deposits shall be paid in the chronological order the deposit accounts were opened with the bank, up to the set amount.

However, the depositor and the deposit protection fund are free to agree upon a different solution. As a rule, compensation is paid in a single amount.

The procedure to be followed by depositors in applying for the payment of compensation for inaccessible deposits has been modified so that, after expiration of the set time-limit, applications for compensation for inaccessible deposits must now be made in writing. To ensure the payment of compensation for inaccessible bank deposits in cases where the deposits have become inaccessible on the basis of the decision of a court of law in a bankruptcy case or settlement, new provisions have been added to Article 12 para 4 of the Deposit Protection Act. For the purposes of compensation payments for inaccessible deposits in a bank, the Deposit Protection Fund needs certain information and data from the bank concerned. For that reason, banks are obliged to provide - on the basis of a written request - information and records of the deposits and liabilities of their clients including specimen documents. In addition, the Fund is entitled to exercise control over compliance with the Deposit Protection Act and the general terms and conditions of compensation for inaccessible bank deposits and related directives on the payment of compensation. The Deposit Protection Fund may request, in justified cases, the National Bank of Slovakia to verify certain information to which it would normally have no access owing to the banking secrecy requirements. A new source of income for the Deposit Protection Fund is proceeds from the sale of government securities, issued to finance the payment of compensation for inaccessible deposits. The Deposit Protection Act lays down that decisions passed by the Board of the Fund shall be signed by at least two of its members; one of them will be the Chairman or the Vice-Chairman of the Board. This will ensure the principle of so-called 'four eyes'.

The Amendment to the Deposit Protection Act has extended the supervisory powers of the Supervisory Board of the Deposit Protection Fund to include the general terms and conditions of compensation for inaccessible deposits in banks and branches of foreign banks. Tasks connected with the creation of professional, technical, organisational, and administrative

conditions for the activities and everyday running of the Fund and its bodies shall be ensured by the Office of the Deposit Protection Fund, which consists of the employees of the Fund and which is under the control of the Chairman of the Executive Board of the Fund. On the basis of the Amendment to the Deposit Protection Act, the obligation of confidentiality has been extended to the employees of banks and/or branches of foreign banks, through which depositors are compensated for their inaccessible deposits, and to other persons engaged in the activities of the Deposit Protection Fund. At the same time, the Board of the Fund may release the members of the Board, Executive Board, and Supervisory Board from the obligation of secrecy. Other persons may be released from the obligation of confidentiality by the Executive Board of the Deposit Protection Fund.

According to the approved Amendment to the Deposit Protection Fund, if the National Bank of Slovakia reveals a breach of the law pertaining to deposit protection, it may propose that the members of the Deposit Protection Fund responsible for the breach be removed from office. The proposal must be carried out without undue delay (Hettes, 1999).

3.4 The Banking Deregulation Process in the EU

A single financial market has been created, in which it requires two elements. The first is to freely establish banks and in the provision of financial services in the EU countries. The second one is a response to the removing of restrictions on capital flows.

The official permission of the first banking directive was the new beginning toward financial country's unification within the EU. Which applied to all credit institutions. This directive established the minimum requirements for licensing and supervising credit institutions. This directive required that member countries have a system for licensing new banks based on two main criteria:

- A minimum capital volume and an honest and experienced management team.
- The formulation of the principles for future harmonization of the banks liquidity and solvency ratios.

Furthermore, the second directive reserves the competence for supervising the banks' solvency and liquidity to the home country, while transferring to the host country regulation of the implementation of monetary policy and other practical rules of functioning. This is what is meant by the expression "home country control and host country rules".

The second area refers to the application of the principle of the reciprocity to countries outside the EU. In accordance with a basic provision of the bank license, a bank from a non-EU country may establish a subsidiary in an EU country. One final important aspect of the second directive is the limitation of risks. In accordance with this, banks may not own interests in industrial and commercial sectors in excess of 10 per cent of equity capital. A complementary movement with respect to the liberalization of capital movements has accompanied this move promoted by the second banking directive. These measures have led to increased rivalry in the different financial markets (Canals, 1997, pp 320-322).

4. Depositor protection in TRNC

This chapter deals with the case of depositor protection in TRNC, and gives a fair idea about the Central Bank of the Turkish Republic of Northern Cyprus and the banking sector as well.

4.1 Banking sector of TRNC

North Cyprus is a small island faced by the disadvantages of having limited natural resources and a small market. Like many typical small economies it passed its economic development on services sector. Banking and financial institutions, which are one of the main service sectors, are important in accumulating the savings, channeling them to investments and contributing to the economic development of the country.

After 1990 an inflation of banks is observed in north Cyprus. About 21 more banks were established whose owners were mostly non-residents of north Cyprus. This inflation of banks is said to be due to the expectations that Cyprus would become a member of the EU and these newly established

banks would have the advantage of being established and will benefit from membership to the EU. Besides, some banks were established in north Cyprus and opened branches in Turkey, as establishing a bank in Turkey is very difficult compared to Cyprus. During this period the respectability of the banks was reduced. One bank was liquidated, one bank is put under the control of the government, and two banks were closed. Apart from the commercial banks, 38 off shore banks were established, and five of them are under liquidation. Also, there are 32 foreign currency bureaus in north Cyprus.

However, there are 36 registered domestic banks with their main office in north Cyprus. The two domestic banks, which are authorized for all banking activities, are public origin whereas the remaining 34 are financed by the private sector. Three of these banks are revoked from operation and one is under liquidation. 21 of these banks were established after 1990 and some of them operate with one branch in Nicosia.

There are a number of cooperative banks, which carry out most of the banking transactions except the commercial transactions of international nature. They operate their businesses under the supervision umbrella of cooperative central bank Ltd. The famous ones of such cooperative banks are Mez-coop bank ltd, Famagusta cooperative bank ltd.

The main problems and complaints of the commercial banks could be noted as follows:

- The complaints of the commercial banks are basically on the number of authorized banks. Restrictions to the new formations of commercial banks must be threatened to the fact that north Cyprus financial market is too small to run such a number of credit institutions profitable.
- They suggest that an increased amount of banks normally brings a high competition between the financial institutions. This increases the cost deposits and lending. This situation dramatically reduced the total private investments in north Cyprus.
- Heavy cost of lending brought financial discomfort to the current accounts of check users. The number of prosecuted accounts to the debt balance of debtors and the number of customers who are restricted from using checks increased dramatically.
- The small financial market of north Cyprus and heavy economic disables of the available firms obliges banks to transfer the large portion of available funds to foreign countries for the sake of security in

exchange very small commission or profit margin above the break even cost of these funds (Bozkurt, Atesin, Kansu, 1998, pp 541-542)

- High inflation rate ruling in north Cyprus suffered banks' assets and the original capital such that they do not reflect their real values. Banks are forced to pay corporation tax on the profit, which does not represent the real value of the net profit before tax assessment. In other words government tax office imposes corporation tax without considering the portion in net profit the inflation losses of net capital.

4.2 Deposit regulations in TRNC prior to banking crises

The banking laws of North Cyprus has laid down special provisions with regard deposits, such that a bank has to maintain certain ratios between their capital on the one hand and deposits to be accepted and guarantees and other undertakings to be given on the other (banking laws of the TRNC, 11/1976, Art. 6.6).

This duty was given to the ministry of finance to regulate these ratios through notification first time has been published in 1976 and renewed in 1994 for the last time. Accordingly a bank with a capital and reserve base of 10 billion TL, can accept savings 15 times of this amount. Besides the amount of the guarantees that a bank could give exceeding 5 times of its capital and reserves.

- **Saving deposit insurance fund law**

The following law is enacted by the Assembly of the Turkish Republic of North Cyprus. *This law may be cited as Savings Deposit Insurance Fund Law.* In this law unless the context otherwise requires: "*Inability to pay debts*" means the circumstances in which a bank finds itself unable to pay its debts under section 212 of the Companies Law. "*Council of Ministers*" means the Council of Ministers of the TRNC. "*Ministry*" means the ministry responsible for financial affairs. "*Bank of Banks*" means banks carrying on business within the boundaries of the TRNC, and branches of such banks. "*Banking operation*" means acceptances of deposits, granting of all kinds of credit and guarantee, execution wholly or in part of all other kinds of banking services and transactions pertaining thereto. "*Fund*" means the Savings Deposit

Insurance Fund established under article 4. "*Central Bank*" means the Central Bank of TRNC. "*Savings deposit*" means Turkish Lira and Foreign Currency internal and External deposits shown under this title and not being of a commercial nature.

Purpose: The purpose of this Law is to insure savings deposits lodged in banks by real persons.

Establishment of fund: By this Law, a fund named Savings Deposit Insurance Fund is established within the Central Bank.

Scope: Under the provisions of this Law banks established for the purpose of carrying on banking operations within the boundaries of TRNC and branches of foreign banks within the TRNC are obliged to have their savings deposits insured. Cooperative Credit Societies which are of limited liability under section 4 of the Cooperative Societies Law may have their saving deposits insured subject to decision of the Board of Directors and approval of the Registrar of the Cooperative Societies.

Types of currencies to be deposited as insurance premiums: Insurance premiums shall be paid into the Fund, in the case of Turkish Lira saving deposits in Turkish Liras, in the case of foreign currency internal and external deposits in US dollars, pound sterling, DM and Cyprus Pound as the case may be according to the type of the foreign currency deposits and in the case of all other foreign currencies in US dollars representing the equivalent of such foreign currency.

Amount to be insured: In a bank the maximum insurable saving deposit is Stg. 7,000 or equivalent in Turkish Lira saving deposits or its equivalent in foreign currency saving deposits belonging to a real person.

Mode of payment: The mode and conditions of payment as well as the mode and conditions for the use of Fund resources shall be specified in regulations to be prepared by the Ministry and approved by the Council of Ministers after taking into consideration the cash position of the Fund.

Winding-up demand: When a bank is unable to pay its debts the fund shall apply to the Court for winding-up order in respect of payments made by it to saving deposit holders of such bank as insurance compensation.

(Central Bank of TRNC 1998, Bulletin No: 26)

Table 4: Deposits in the banks of north Cyprus (m \$).

DEPOSIT	1991	%	1996	%	GROWTH RATE %
Turkish Lira					
Sight deposits	29.3	14.5	97.2	40.2	46.3
Time deposits	159.1	78.9	144.4	59.8	1.8
Total	201.7	61.9	241.6	37.3	4.0
Foreign					
Sight deposits	42.0	33.9	132.2	32.5	43.0
Time deposits	82.0	66.1	274.3	67.5	46.9
Total	124.0	38.1	406.5	62.7	45.6
Grand total	325.7		648.1		19.8

(Bozkurt, Atesin, Kansu, 1998, pp 533).

The Turkish Lira deposits increased from 9,846,757.4 million TL in 1995 to 213,915,392 million TL in 2000. The increase in the amount of deposits was due to the rise of interest rates which attracted more deposits and diverted sight deposits to time deposits. The foreign currency deposits which were 333.8 million US \$ in 1995 increased by 45% and reached to 484 million US \$ in 2000.

4.3 Development of the Banking Industry after banking crises in TRNC

In year 2000 a series of banking crises have taken place in Northern Cyprus. However a number of reasons have caused these crises, the main reason is that Cypriot banks are in a very poor position. The reason of this position, is the large number of domestic banks operating in Northern Cyprus, that because Cyprus is a very small country with a very small population as well. As a result, most of the times a bank gives credit, it faces a big difficulty in collecting them.

The fact is that the Cypriot citizens have lost their trust in the domestic banks of TRNC, and have led their attention to the foreign banks located in

the country, and some of them have even transferred their funds abroad. The most reasonable explanation for this problem, is that the central Bank unfortunately was not quite serious about legislating the required laws that protect depositors from such fund losses. The banking crises were the result of more than what have been mentioned above, actually these crises to some extent were driven from Turkey. The central bank of Northern Cyprus did not issue domestic currency, but instead have used the Turkish Lira as a medium of exchange. However the Turkish economy is in a very dangerous position, that the inflation rate is very high so the TL is losing its value. And this was one of the reasons that have affected the Cypriot banking sector, which caused these crises to the banking industry.

Furthermore, low capital adequacy ratio and the low level of owner's equity capital, are a very good indicator in which it shows crucial effects that caused such crises to the banking industry as a whole. This has led the central bank president to think again of a good solution for this serious reality that Cyprus faces, especially with the fact that nowadays every Cypriot citizen is dreaming about his or her country is going to join the European Union. Consequently, Cypriot people will have better conditions in their lives.

There were actually ten banks that have suffered from those crises, in which five of them have collapsed and the other five yet under the control of central bank. So in order to maintain such a good efficiency, there has to be more banking mergers so that the capitals of those small banks become the capital of bigger banks. By this way the banking sector could gradually get the trust of the people back, and then the banking industry in general will develop. The new amendments to banking mergers have been legislated in 2001, one year after the crises occurred. However, because of the obvious importance of banking merger to Northern Cyprus after the banking crises have taken place, the central bank has legislated new laws in which the merger of a bank with one or more banks or transfer of all its liabilities, claims and deposits to another bank shall require the permission of the Central Bank. If, within three months after the date of permission, the competent bodies of the concerned banks fail to adopt the necessary decisions and to start the merger, then the permission granted shall become null and void. The principles and procedures concerning mergers and acquisitions shall be set out in a notification issued

- On the condition that the permission is granted by the Central Bank and acquisition and merger operations have commenced within 3 months from the date of the permission, for a bank to merge with another bank or more than one bank or by ending its existence as a corporate body, and shall be exempted from the corporate tax.
- For the merger that will take place, the amount of deductible loss, appeared in the balance sheet prior to merger, may be cited as expenditure, subject to the condition of not exceeding 5 years from the corporate income of the institution that has been taken over or merged.
- The banks whose participations capital shares belong, to the Fund, the securities received in its favour with the receivables in pursuit and other balance sheet items, will be subjected to acquisition, merger or sell out by the Fund.

With the purpose of helping the merger to be successful, the Central Bank is empowered to decrease or postpone the additional reserve requirements of the banks merged, to the periods that it will determine. In case that the banks whose capital shares are either totally or partially belong to the Fund, are subject to acquisition, merger or sell out completely or partially, the assets and/or liabilities of the bank in question shall be carried out according to the principles and procedures set out by the Central Bank
(Central Bank www.kktcmb.trnc.net)

After the new merger laws are introduced, the reserves and the provisions pertaining to deposits have to be highlighted in order to give an idea about the new amendments that also took place in 2001.

Reserves For Probable Losses

- Banks are obliged to reserve 10% (ten percent) portion of their annual net profits for probable losses. This obligation continues until the total reserved amount becomes equal to the amount of the paid up capital.
- These reserves shall be used for the payment of the losses, only.

- These reserves shall be used for the payment of the losses, only.

Classification Of Deposits

Saving deposits are the accounts opened under this title by natural persons and not subject to commercial transactions. However, drawing cheques exclusively on demand savings deposit accounts shall not be considered as a commercial transaction.

Banks shall separate savings deposits from other types of deposit accounts and classify deposit accounts according to terms and types thereof as determined through an official notification produced by the Central Bank and published in the Official Gazette.

Withdrawal of Deposits

The provisions of the Laws currently in force being preserved, the rights of depositors to withdraw their deposits, shall not be limited in any manner or at any time. The conditions agreed upon by and between the holders of the demand deposits, term deposits and the bank with regard to maturity and notice period and the deposits that have been blockaded with the consent of depositors are preserved.

Privileges Of The Owners Of Savings Deposits

If banks terminate their operations or are liquidated, the holders of savings deposits for the part of their deposits which is not insured shall have a first degree privileged claim, which shall be subordinate to those of the Fund, as opposed to other creditors with 90% portion of their dues, on the existing balance held in such banks.

Prescription On Deposits

- Upon written requests given in by depositors, banks shall send them the statement of their accounts at least once a year
- Any deposit, bailed goods or claims of any kind with banks, over the Turkish Lira equivalent of \$20 in value, that have not been claimed for a period of ten years or more from the date of the last withdrawal of

- Those deposits, bailed goods or claims transferred to the Central Bank of which amounts and values do not exceed the Turkish Lira equivalent of \$20 shall be transferred to the Savings Deposits Insurance Fund by the banks in question.
- The period of prescription in the accounts that have conditionally been opened on the names of small children and merely for making payments to them starts working out as of the date of adolescence of the minor child.

As it has been mentioned above, the banking industry of TRNC has encountered serious crises in 2000 in which ten banks were involved. However, because of many reasons that were discussed above, the central bank was forced to take action against these crises by legislating new laws protecting depositors. Those amendments only one year to be legislated, but yet the industry is not sufficient enough. My point of view is to reduce the number of banks to only ten, and to increase the initial capital to four million dollars, so that it will be almost close to that one of South Cyprus and European Union, that it's just a matter of time for Cyprus to enter the EU. Right now the initial capital is two million dollars and is better than the previous one which used to be 50 million TL that was really very low (Central Bank www.kkctmb.net)

4.4 Central Bank of Northern Cyprus

The Central Bank of Cyprus had to legislate new laws after the mentioned banking crises in the previous section have occurred. The new regulations of the Central Bank were legislated in year 2001, only one year after those crises were occurred. However, the new laws are quite serious and reasonable more than the laws obtained before the crises. The new regulations focused to some extent on the banking merger, that now it seems reasonable for domestic banks of Northern Cyprus to merge with one another,

regulations focused to some extent on the banking merger, that now it seems reasonable for domestic banks of Northern Cyprus to merge with one another, in order to strengthen the banking industry, so that it becomes more secure for Cypriot citizens to get their trust again.

Duties of the Central Bank

- To attain the primary objective indicated in Article 4 of the present Law, carry out all the transactions required for the regulation and supervision of the monetary and banking system of the Turkish Republic of Northern Cyprus;
- To carry out the transactions that have to be normally made by Central Banks, by taking the economic conditions into consideration;
- To supervise the banks and other institutions established for granting credits;
- To take measures that would ensure stability in the financial system and take regulatory measures with respect to monetary and foreign exchange markets;
- To monitor the financial markets;
- To establish payment agreement systems, make regulations that would ensure the uninterrupted working and supervision of the existing or future systems, and determine the methods to be employed, including the electronic media.

The powers of the Central Bank

- To regulate the volume of money and credits;
- To regulate and administer the international reserves of the Turkish Republic of Northern Cyprus;
- To act as the financial and economic advisor of the State, by way of stating its views on those issues of monetary and credits policy, on which the Council of Ministers requires scrutiny;
- To act as the financial agent of the State with respect to the international financial and economic relations;

- To act as the banker of the State and to act as the banker of those banks that require this and become their financial agency;
- To grant advances to the Insurance Fund of Savings Deposits in line with procedures and principles it shall determine, in cases of emergency and in the event that resources of the Fund fails to meet the needs;
- To seek information and collect statistical data from the banks and other financial organizations and other establishments and organizations that are in charge of regulating and supervising these, with the aim of monitoring the financial markets;
- To prevent all sorts of transactions and applications that might jeopardize the rights of the depositors and the orderly and secure operating of the banks, and that might create significant damages to the economy, also, to take and implement all the necessary decisions and measures designed to ensure the effective operating of the credit system;
- To administer the gold and foreign exchange reserves of the country;
- To grant credits to the banks as the final authority for credits.

Reserve Requirements

- The lowest rate of liquidity that the banks will have in return of their commitments shall be determined by the Central Bank.
- The rate of the reserve requirement, which is to be calculated by taking the commitments of the banks and other financial institutions regarded appropriate by the Central Bank.
- Commitments subject to the reserve requirement and the period of time for depositing the reserve requirement, shall be determined by the Central Bank.
- As far as those who have not established the overall liquidity or have established it incompletely in the due course of time, are concerned,

The Central Bank shall impose a default interest, in accordance with principles and conditions it shall lay down, over the parts that fall short.

- Upon the demand of a bank, the deposits of which are being withdrawn at an extraordinary rate, the Central Bank shall return at once the reserve requirement with respect to the reported decrease.
- Reserve requirements that the banks deposited at the Central Bank of Cyprus before 20.07.1974 and that are currently found with the Central Bank of the Greek Cypriot Administration shall be taken into account.

Bulletin of the Central Bank

The Central Bank shall issue a quarterly bulletin. Besides statistical information, such bulletins shall contain monetary and credit policies of the Central Bank. In the event that the possibility that the determined goals shall not or cannot be reached within the declared terms appears, the Central Bank shall report its reasons and the measures that must be taken in writing, to the Government and makes them public (Central Bank www.kktcmb.net).

It's a good improvement to know that the minimum amount of paid up capital must be of Turkish Lira equivalent to \$2,000,000. However, the Central Bank is empowered to increase the minimum amount of capital up to its double. So there will be some kind of challenge to Cyprus, to develop itself in a manner that guarantee its success.

Issuing a separated currency as a medium of exchange for Cyprus instead of TL, I think it will be useless, and what I believe to be the best solution for Cyprus, is to prove its banking regulations, that may be the Euro is going to become the future medium of exchange for Cyprus as a whole.

5. Conclusion and recommendations

In this paper, it was argued that depositor protection is being created because of its importance for the public who deposit their funds in the banks. Consequently, the decisions of the banks have to be regulated to guarantee the depositors and consumers protection as well as to guarantee the financial system to be efficient and competitive. However, deposit insurance was one of the solutions for this matter, which any bank entering the industry has to be insured.

The central conclusion of the paper is therefore that any system which has been launched for the deposit protection should deal with risk, so that the bank is still able to survive losses after such crisis has occurred. Systematic risk is one in which the Basel Committee of EU tried to use some methods to deal with it. And these methods have become an international standard.

Actually there is a relationship between depositor protection and capital adequacy, because of the negative effects that could be incurred when a bank does not have sufficient funds to pay back depositors as they withdraw their deposits. As a result, a bank has to have sufficient capital so that it will be able to provide some kind of protection for expected and possible loan losses or other kinds of problems, which could affect the depositor protection negatively.

In comparison with the European Union, the banking sector of North Cyprus is very small, which causes many investors to invest abroad. Although there is a large number of authorized banks, this is the main reason behind the bankruptcy of several financial institutions, as well as making it very difficult for any commercial bank to achieve a profit. So that the number of banks operating in TRNC as to be reduced to ten.

However, after the crises mentioned in this paper about Northern Cyprus, the initial capital for establishing a bank although it was increased to two US dollars, but yet it has to be increased two times as large.

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