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THE EFFECT OF THE MEMBERSHIP OF CYPRUS TO EUROPEAN UNION ON THE BANKING SYSTEM IN TRNC

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ABSTRACT

There are considerable uncertainties about the future of the Turkish Republic of Northern Cyprus. One strong possibility is that the Cyprus problem will be solved and Cyprus will join the European Union. This will certainly be a great change in the TRNC and these changes are expected to have great effect on the banking system. It is therefore necessary to understand what the future of banking will be under the EU.

The study will be presented in three main parts. The first part will be about the banking sector of the TRNC. This will include a part about the recent developments in the banking sector. The next part will be about the banking environment in the European Union. The following part will be about the possible impact of the European Union membership on the banking sector. The study will end with a conclusion.

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1. INTRODUCTION

Monetary Union and the introduction of Euro is expected to have a considerable effect on the member states. The following study will be an argument about the possible impact of Cyprus membership to EU on the financial sectors. At the moment TRNC is using Turkish Lira as national currency unit. At the same time there is a total freedom to use any other currency. The banks can open foreign currency accounts and individuals can carry checkbooks that they can write foreign currency checks.

To find an answer to our question we have to look into the banking system of TRNC. We will also look at the developments in EU. Turkey is also using Turkish Lira and as far as we know the banking sector is very good in Turkey.

We can make a large list of the economic difficulties in North Cyprus. We can talk about the economic embargoes, difficulties in transport, shortage of finance, mismanagement and so on. But the most important of all the difficulties is the political uncertainty and shortcomings in central banking and total inability in making monetary and fiscal policies.

The study will be presented in three mainpart.The first part will be about the banking sector of the TRNC.This will include a part about the recent developments in banking sector. The next part will be about the banking environment in the European Union. The following part will be about possible impact of the European Union membership on the banking sector. The study will end with a conclusion.

2. BACKGROUND OF THE BANKING SECTOR IN TRNC

TRNC is a free market economy. There are very flexible rules and regulations in every aspect. In the market guided economies, formation and operation of banks are not very difficult. So the first thing one can realize is the huge number of banks in operation. This can be easily seen in TRNC. There are many banks operating in such a small country. The real competition is in the interest rates. The banks aim to give as high interest as possible, to the depositors, and charge the lowest possible to the borrower.

All the banking activities in TRNC are regulated by the Central Bank and decision of the Board of Ministers.

There are two main grounds where banks can compete, firstly the interest rates and secondly, the quality of service. The image of a bank is very important. Any person who is to choose a bank, first thinks of the safety of their money, specially if they are depositing money. Secondly they look for high interest. Thirdly they look for quality services. In small countries like TRNC people are used to personal attention. In many cases trust and good service may attract clients even if the interest rates are slightly lower.

Like any other commercial set-up the Bank's objective in providing the services to borrowers and depositors is the generation of profit. The more money they can lend, the more profit the Banks can earn. However a Bank can not lend out all the funds which it obtains on deposit which it must retain enough money in liquid form to be able to meet depositor's request for repayment. In this lies the Banker's dilemma because the more liquid the form in which the funds are held, less the rate of return. Cash holdings, being the most liquid form of asset, generate no profit at all. The bank must therefore effect a careful balance between the maximizations of lending and minimization of liquidity to the lowest level consistent with safety. The conflicting requirements of profitability and liquidity can be reviewed as resulting directly from the conflicting desires of two groups who have provided the Bank's financial resources. The shareholders and the depositors. The shareholders jointly own the Bank and look to it to provide a return on their capital. The depositors have provided the vast bulk of the funds used by the bank and require safety and the ability to get their money out in accordance with the terms agreed upon at the time of deposit. A successful bank has to reconcile the interests of these groups. To some extend this task is taken out of the bank's hands by official controls but there is still considerable room for manoeuvre.

Under the Central Bank of the TRNC Law, the minimum ratio of the overall liquidity, which Banks shall maintain against their liabilities, shall be fixed by the Bank. Besides this overall liquidity Banks are required to deposit additional reserves in a special blocked account to be opened by the Bank. The ratio of the additional cash reserves to total deposits, excluding interbank deposits, shall be fixed by the Bank in the light of general economic conditions in the country. In the TRNC the minimum ratio of the overall liquidity which banks shall maintain against their liabilities were fixed at 10% in the minimum, in the Banking Law of 1976 and has remained the same ever since. The ratio applicable to additional cash reserve which the banks are required to lodge in a special account by the Bank is 15% for Turkish Lira deposits and 20% for foreign currency deposits. (Erülgen, 2003)

In the TRNC the Central Bank is empowered to fix the maximum rates of interest receivable or payable as the case may be, on Turkish Lira and foreign currency deposits of all description and on credit transactions of Banks, cooperative banks and other establishments, as well as the nature and maximum limits of other benefits to be supplied and expenses to be recovered and in the case of deposits the duration of fixed terms and whether interest should be left free wholly or in part and their dates of enforcement. These matters are put into operation on the recommendation of the Minister of Finance? and by decision of the Council of Ministers as from the date of publication in the Official Gazette. Rates of interest so fixed and the matters connected with the rates of interest shall be applicable also to all debt-credit relationships outside the banks.

Under the banking law of the TRNC extensive powers have been given to the Central Bank regarding control of the banks. These include the ascertainment and analysis of the relationship and balance between assets of banks, debts due, their capital, debts and profit and loss accounts and all other factors affecting financial structure. Several administrative measures have been provided for this end. For instance where it is established that in contravention of specified laws, transactions likely to jeopardize the secure operation of a bank and of its participitations have taken place, subject to the right to institute legal proceedings against the bank employees responsible for the operation in question, upon the demand of the controlling body it would become mandatory to terminate their appointment. Subject to the right to institute legal proceedings against responsible employees of the banks in question the Central Bank of the TRNC is empowered to terminate advance and rediscount credits a revoke credits already issued.

It is possible within two ways that are in the bank by the central bank auditors and from the center of the central bank by considering the submitted reports, which includes, end of month balance sheet, liquidation ratios and quarterly income statement. The central bank must act to take administrative decisions according to these submitted reports. These reports are to presented to the chairman for taking the corrective actions if they include any absence thing in it the chairman is able to worn them and taking the corrective action. This corrective action includes the blaming of the top managers to the ministry of the economy and finance and only they are in charge of transferring the case to the attorney general or not.

As of December 2000 central bank prepared the account submit program for personal computers in order to have the clear and easy view upon the report presentation to them, the program standardized for every particular bank to prevent the possible mistakes and the banks charged to present particular reports by the format of that special program (www. kktcmb.trnc.net, 2003)

The object of the central Bank is to implement money / credit policies and regulate the banking system in accordance with development plans and annual programmes with a view to assisting economic development. (www. kktcmb.trnc.net, 2003)

1.A. To do all necessary acts for the realisation of the main object specified. The regulation and the control of the monetary and banking system of TRNC.

B. Having in mind economic conditions to fulfill all acts necessarily undertaken by central banks; and

C. To control banks, cooperative banks and other institutions established for the purpose to giving credit.

2. Subject to the generality of the provisions above the powers of the bank are:

A. To regulate a volume of money and credit.

B. To regulate international reserves of TRNC. And to administer same.

C. To act as financial and economic advisor of the state by expressing views on matters that may be referred to it by the council of ministers in relation to policy on money and credit.

D. In international relations of financial and economic nature to act as financial agent of the state.

To act as banker of the state and also as banker and financial agent of banks that may so wish.

The Central Bank of TRNC is only connected with the other banks operating in the state; it never considers the third parties or a private person and the have any business relationship with the state.

F. It audits the legal compulsory deposits of the banks.

3. RECENT DEVELOPMENTS IN THE BANKING SECTOR OF TRNC

According to Şafaklı (2003) Banks in TRNC are established and function under the law 39/2001 in TRNC, which was accepted and published in the official gazette numbered 122 on 23 November 2001. At present there are 25 banks operating under this law. These banks are as follows:

State Banks	: 2
Cooperative Banks	: 2
Foreign Banks	: 5
Local commercial banks	: 16
Total	25

The number of banks prior to the crises was 37. 12 of these banks ceased their operations due to weakening financial positions, bankruptcy, or mergers. Apart from the 25 banks that are presently operating there are also 32 offshore banks that operates in TRNC.

According to the law 39/2001 the minimum paid up capital requirement for banks is $2,000,000 (Two million American Dollars)

Turkey faced major economic crises at the end of the 1999, in November 2000 and finally in February 2001 which led to substantial devaluation in the Turkish Lira. These crises had magnified negative effects on the TRNC economy, which uses Turkish Lira as official currency. The estimated costs of the banking crises are 200 trillion Turkish Lira. This figure is 50% of the GDP in 1999. Floating exchange rate was adopted after the crises. This led to reduction of consumers' buying capacity at 50%, loss of production and recession. GNP in 1999 with the 1977 prices was at 9,090.8 million TL; the same figure in 2000 was 9037.9 million TL, and 8,545.9 million TL in 2001 (Bayar, 2003).

Economic policies, which started to take shape in the beginning of the 1980's, were influenced by liberalization movements around the world. Governments who adopted more liberal economic policies prepared the ground for competition by allowing more banks to be established. The liberalization movements had been specially effective in the banking sector. Numbers of the banks in the beginning of the 1980s were only 12. At the time of the bank crises the number of the banks tripled to 36. Allowing many small cooperatives and the credit and finance firms to deal in the finance industry gave rise to intensive competition. While the actors in the industry had risen the government and the related authorities failed to keep track. The industry lacked appropriate regulations. Lack of regulation and inspection left he banks on their own with their own destiny. This situation increased the fragility of the banks. Holding banks were especially fragile and the crises originated from Turkey led to collapse of these banks.

As known, the banking crises in TRNC started when the Yurtbank was taken over by the authorities and the clients of the Nicosia branch queued up to draw back their deposits. The fear of further banking crises was quickly expand. Weak banks quickly run into trouble after the immense demand for withdrawals. Holding banks such as the Hür bank, Kıbrıs Finansbank, Everestbank, and Cyprus Credit Banks, and later the Cyprus Industry Bank, and Peyak failed to continue their operations (Erkut, 2003).

Reasons of the bank failures that had a cost of $200,000,000 will be looked into in the following part of the study.

Banking crises in TRNC was largely influenced from the outside developments. Therefore the reasons of failures will be investigated under two headings, namely the external and internal influences.

a) External Reasons

As explained earlier TRNC is using Turkish Lira as official currency and therefore ant positive or negative development in the Turkish economy has direct influence on the TRNC economy. Weak Turkish economy, devaluation, high inflation and high interest rates had direct effects on TRNC economy.

b) Internal reasons

Following are the basic reasons for bank failures:

3.1 Legal regulations

When looked at the bank failures in the developing countries similar trends take place. As these countries try to liberalize their economies they allow more competition in the market. However failing to make necessary regulations and keep track of the developments lead to problems.

In TRNC, while the governments encouraged liberalization in the finance industry, they failed to introduce appropriate regulations that would facilitate the finance companies to institutionalize.

It is clear from the accounts of the failed banks that these banks had in adequate paid up capital ratios, had accumulated bad debt, and were mismanagement.

Ratio of the credits to the capital played a critical role in failure, Capital adequacy control alone could be a critical tool controlling the banks health. Laws prior to the crises included no ratio requirements.

3.2 Auditing and Observation

Auditing and observation mechanism is a necessary activity in order to detect the problems and remedy them before the crises actually take place. However the lack of adequate personnel and lack of any implementation power had failed the authorities to carry out these activities before the crises. Lack of inspection relaxes the industry and breaking the rules become a habitual incident. Banks neglect the regulations and take unnecessary high risk.

In TRNC, Auditing and observation of the banks are carried out by the Central Bank and the Ministry of the Economy and Finance. There are also both internal and external auditors. However there were no standard auditing mechanisms. Auditors also lacked power. Hence the auditors had not been able to obtain the necessary information to perform appropriate inspections. Management with bad intention could easily hide information. The system lacked appropriate observation, inspection and auditing.

Internal auditors were biased in favor of the banks and the external auditors lacked appropriate power to make proper investigation in the TRNC Banking sector.

Lack of observation and inspection inevitably led to bank failures (Şafaklı 2003, pp.217-232)

Holding Banks

Holding banks have different structural set up than the other commercial banks. Such banks are just one of the strategic business units of the holdings and other organizations take place in different sectors under the same umbrella. The bank is usually used for the finance of the holding companies. Such financing usually done by taking high risks.

Most of the banks newly established in TRNC after 1980s are holding banks. Law capital requirement and flexible and inadequate banking law encouraged many holdings to start their own banks. Large margin between the deposit accounts and the credit accounts was another influence on entering banking activities.

A Law capital requirement was one of the most important influences on the businessman to start their own banks. By establishing their own bank, instead of borrowing at very high credit interests they would be able to collect deposits at lower interest and use it for their business purposes. In the long run however mismanagement of the accumulated funds whish had been invested in non-productive fields weakened the banks position.

Another important reason for the bank failures were the lack of liquidity of the banks. The holding banks failed to keep enough liquid money since they rather used these in their business ventures. Once the rush had started these banks failed to meet the demand of the clients.

Role of the central bank, and the money issuing issues had been discussed at many occasions. Without going into these issues, the study will look into the role of the Central Bank as the last resort for crises.

Central banks may sometimes print money and supply the banks in crises to save them. The Central Bank of TRNC has no money printing capacity and also lacked any funds to make available for the banks in crises. Hence the Central Bank had failed to make necessary interference to avoid systemic failures.

3.3 Credit Risk and Management

Investigations show that the failed banks lacked professionalism in assessing the credit applications. They neglected to take into consideration the active/passive ratios, liquidity ratios, capacity, character and cash flows of the applicants. They gave credit with high risk without taking appropriate collaterals (Ege, 2003). Banks also failed to follow up the destiny of these credits. The credits usually ended up in low-return investments. As it will be explained in the ethical dimensions of the bank failures the owners and managers of the banks were given credit above the limits identified by the banking law.

- banks had no effective internal auditing mechanism
- ›anks entered speculative activities with the board of directors permission
- failed banks gave very high real interest rate. For example failed Everest Bank gave 25% interest rate for foreign currencies while the Cooperative Central Bank gave only 18%.
- Cooperative banks performed just like the commercial banks while they had no obligations that the banks had.

3.4 Capital Adequacy

Unlike the other instuitions, capital is a safety factor for the banks. In general about 70% of the actives of the banks comprise the credits (Rose 2002, pp.115). Paid up capital plays as the safety valve against the credit risk. According to the BIS (Bank for International Settlements) criteria the ratio of the bank capital to the rest of the risk assets should be at least 8% (Şafaklı 2003 pp. 217-232). Capital adequacy ratios are most important instruments in determining the health of any bank. It was explained before that there was no effective inspection and auditing of the banks prior to the crises. The legal capital requirement for a bank prior to the crises was only 50 billion Turkish Lira. Low capital requirements led to inflation in the banks.

3.5 Changing Environment

After the bank crises in 2001 minimum capital requirement for banks to operate was raised from 50 billion Turkish Lira to 2 million American Dollars. This figure is still low relative to the international norms. For example minimum capital requirement in the EU countries is 5 million Euros, and the requirements in the South Cyprus is 3 million Cyprus pounds (Erülgen,2003).

Looking into the basic reasons of bank failures in TRNC, it is found out that almost all the ethical principles were broken prior to the crises. Among the ethical issues the ones that contributed most to the bank failures were the operations against the law and regulations and political interference.

* Working against the regulations

Following are the findings of the Central Bank that the failed banks conducted against the regulations.

- Not confirming to the legal levels of liquidity, and deposition of appropriate rate of deposits to the central bank.
- Presentation of misleading and intentionally wrong accounts to the Central Bank.
- Misleading information on the deposits in respect of the safety fund.
- Ignoring the directives of the Ministry of Finance.
- Giving Credits to the owners and the board members or their business entities in excess of the defined limits in the banking law. Most of these credits were invested in wrong areas with high risk and such situation had been a primary

reason for bank failures. Connected credit ratios of the failed banks Hürbank, Everest Bank, Finance Bank and the Yurtbank ranged from 58.8% to 92.3% (Erkut, 2003).

- Banks accepted unaccounted deposits.

Political Interference

One of the most important factors in the banking sector is the political influence on the system. Authorities that are responsible for inspection and regulations are responsible towards the political authority. The reason for bank inflation prior to the crises is due to the fact that the decision-making authority for giving permissions for new banks was the Ministry and the Board of Ministry. Decisions were made according to the political interest and not the economy.

Prior to the crises the banking sector was under the influence of the Ministry of Finance and board of the Ministers. Politicians act according to their political interest but not according to the economic and public needs. This attitude created problems in the long run. Political authority who lacks the basic knowledge and expertise on banking is another shortcoming and important effect on the crises.

Bank deposits at the Central Bank was used inappropriately by the political authorities and were not available for the Central Bank to be used as an instrument to resolve the crises. Insufficiency of the Central Bank to avoid the crises had contributed to the bank failures.

Apart from the above factors most bank managers had hidden information or gave false information to the auditors. Internal auditors acted non-professionally and didn't carry out effective auditing. Favorism towards the board members and the owners, accepting unaccounted deposits and discrimination among clients are some of the other ethical misconducts in the banking sector that was frequently witnessed prior to the crises.

4. EU BANKING SYSTEM

The European Union is a well-organised and experienced economic union. In the banking sector there had been many difficulties in the past, in the sense that the currency exchanges and the transactions between the different members states were very costly. The banking sector in TRNC is more less in a situation similar to the EU member countries prior to 1986. Up until the mid-1980s most EU banking systems were characterised by a relatively high degree of government control and restrictions, which inhibited competition in both domestic and cross-border business areas. Interest rate restrictions were widespread and capital controls remained in force in Belgium, France, Greece, Portugal and Spain. Banks in France, Italy, Spain and Portugal were also prohibited from being members of their domestic stock exchanges, and various countries had regulations prohibiting banks from offering insurance and other non-banking financial services (Kocaman, 2003). Branching restrictions existed in France, Italy and Portugal and even mandatory balance sheet investment requirements were required in Portugal and Spain. In certain countries foreign bank entry was restricted and in the majority of countries branch endowment capital required.

In such a constrained EU banking environment, commercial banks had sought to compete on non-price terms through expansion of their branch networks, while throughout the early 1980s the total number of banks continued to fall; the latter being a reflection of consolidation mainly in the mutual banking sector.

By the mid-1980s banks were positioning themselves to what they perceived as the main future strategic drivers of the industry and the implementation of new technology was viewed as the key to these developments. Regulatory developments were perceived as less important.

European bankers saw a future characterised by increased product innovation, enhanced marketing opportunities and organic growth. Their main strategic focus rested on building on their established franchises and diversifying into areas such as securities trading and insurance. As there had only been limited progress in removing barriers to trade in financial services the threat of foreign competition was viewed as limited and future acquisition activity was expected to be relatively small and mainly of a diversifying nature.

4.1 PRESENT BANKING SYSTEM IN EU

The start of the "Single Monetary Policy" SMP, which helped to change the strategic focus of European banks, might usefully be seen as February 1986 with the implementation of the Single European Act.

In order to establish a single market, the EU introduced a series of Key Directives - the Second Banking Directive of 1988 and the attendant Own Funds and Solvency Ratio Directives being the most important - which aimed at liberalising the banking and credit sector at a national and international level. These legislative changes ran parallel with other major policy initiatives such as interest rate deregulation and the abolition of capital controls. Concurrently, in key supervisory areas like capital adequacy the EU regulatory system developed in line with international convergence objectives and criteria.

By the late 1980s and early 1990s EU banking and credit sectors had embarked on a significant process of legislative implementation aimed at both fostering more liberalised domestic banking markets and creating a single European banking market.

Although the pace and pattern of change varied across individual countries it is possible to distinguish between a highly regulated EU banking system that existed in most countries up until the mid to late 1980s, followed by a transitional phase from the late 1990s to 1993. The final phase, de-regulated/re-regulated era, refers to the period from transition to 1994 when almost all EU Directives introduced prior to that date had been implemented into national law.

4.2 SUPERVISION OF BANKS IN EU

Prior to the new changes the individual member countries had their own supervisory organizations. On 1 June 1998, the national banks of the member states made a new law. This transferred responsibility for banking supervision in the member countries from the local supervisory authorities such as the central banks to the Financial Services Authority (FSA) of the EU.

The primary objective of the FSA (in its role as supervisor of banks) is to fulfill the responsibilities relating to the safety and soundness of banks placed on it by the Banking Act 1987 with the aim of strengthening, but not ensuring, the protection of depositors. Under the Banking Act, no-one may accept deposits from the public, as part of a deposit taking business, without authorisation from the FSA (although some kinds of institution, most notably building societies, which are authorised and supervised by the Building Societies Commission, are exempt from this part of the Banking Act, and branches of banks incorporated in other European Economic Area (EEA) Member States, namely other EU Member States, Norway, Iceland and Lichtenstein, may accept deposits in the member country on the basis of the authorizations provided by their home supervisor). Authorization is not lightly given. There are a number of financial tests, and the FSA has to be satisfied about the quality and honesty of the management concerned. Once authorized, a bank is monitored by the FSA's Financial Supervision Directorate .

The FSA carries out 'prudential' supervision of banks which includes determining whether they are financially sound. This supervision is undertaken within a risk based framework called RATE. As a general rule, the FSA does not concern itself with the individual contractual relationships a bank has with those who borrow from it, or its customers more widely, unless these matters raise clear prudential questions. Neither does the FSA become involved in the disputes that sometimes arise between banks and their customers, unless these raise doubts over whether a particular bank continues to satisfy the authorization criteria in the Banking Act. For these purposes there is an established complaints procedure operated through the Banking Ombudsman. Moreover the banks and building societies have also published a code of conduct to govern their relations with customers and the handling of complaints.

In order to be and remain authorized, an institution has to satisfy the FSA that its business is conducted in a prudent manner which includes having adequate capital; adequate liquidity (that is sufficient ready money to meet its obligations when due); a realistic business plan and adequate systems and controls; that it has made adequate provision in its accounts for bad and doubtful debts; and that its business is carried on with integrity and skill. Its Directors, Managers and Controllers must be "fit and proper" for the positions they hold. How the FSA interprets these terms is set out in a "Statement of Principles" originally issued (by the Bank of England) shortly after the 1987 Act came into force and updated in 1993 (a further update will be issued by the FSA shortly), and in a two volume Guide to Banking Supervisory Policy, some principal elements of which are summarized below. Those who satisfy the FSA that they meet the required standards are generally referred to as "authorized institutions" - the title "bank" is reserved under the Act for those with more than £5million of capital (or incorporated abroad). But for convenience the term "bank" is used here to cover all of the authorized population.

Following the implementation of the EC Second Banking Co-ordination Directive from 1 January 1993, banks incorporated in other EU Member States (now known as European authorized institutions) no longer require the FSA's authorization to accept deposits in the UK. Instead they may do so on the basis of the authorisation provided by their home supervisor. The responsibility for the prudential supervision of these branches rests with the authorities in their home country and not with the FSA. The FSA has a duty to co-operate with the home country authorities and additionally retains shared responsibility with them for the supervision of the liquidity of branch operations. From January 1994, these arrangements were extended to all countries of the EEA. The Second Banking Co-ordination Directive has also introduced a new freedom of establishment for UK-incorporated banks, permitting them to branch or to provide services throughout the EEA on the basis of their authorisation in the UK. Supervision of their branches in other EEA countries, with the exception of the liquidity of the branches, is the responsibility of the FSA (http://www.europa.eu.int).

The main elements of the FSA's prudential supervision are as follows:

1. A Capital Requirement
2. Large Exposures
3. Liquidity
4. Provisions
5. Systems and Controls
6. Directors, Controllers and Managers

5. POSSIBLE MEMBERSHIP OF CYPRUS

Cyprus is one of the ten candidate countries for membership to EU. If this happens and North Cyprus also becomes a member, our banking sector will undergo some changes. There are already some approximation measures, which have been carried out. Cyprus can only become a full member after adopting these measures. The candidate countries have the task of transposing the relevant directives covering the financial services sector a challenge. Putting into place a highly sophisticated and developed capital markets and financial services sector is something which cannot be rushed. It takes time and experience for even the more developed market economies.

The existing member states over the years have built up an impressive amount of legislation concerning this still evolving and sometimes politically controversial sector. "It has taken almost 25 years for the existing EU member states to transpose all of the necessary financial services directives. These are countries which already had well developed financial services sectors," observes a spokesman for the European Insurance Committee.

Cyprus will have to regulate the banking system according to the Single Monetary Policy and this will help the banking sector in many ways.

5.1 Impact on the Deposit and loan prices

The banks in Cyprus will not only compete with each other in the island but they will compete with the giant banks of Europe. Competition will intensify in all EU banking and credit markets after the accession and this will be reflected by a decrease in financial service prices in various market segments across countries. SMP will be largely responsible for loan and deposit price reductions.

The price of retail loans and mortgages will also fell to the levels of Europe.

5.2 Fee levels

Banks charge certain fees for their services. Fee levels will fall after becoming a member.

5.3 Change in price levels:

Experience of the previous activities indicate that although there are variations in the price levels between different countries, adoption of the SMP will have positive effects on prices as well. When we look at the countries who already adopted the SMP, we see that while there are significant price differences across countries, Credit card prices, however, have fallen across all EU systems and the range of prices has narrowed by about 30 per cent. The range of mortgage prices between member states has also narrowed, although as the price of mortgages has not decreased across-the-board it is not possible to say whether this convergence is towards a lower average price.

For commercial loans, current cheque accounts and personal equity transaction costs, substantial price differences across countries persist. Moreover, in 1994 differences of over 100 per cent remained for the cost to consumers of cross-border payment transfers. (Erkut,2003)

5.4 The Impact on Consumers

The end result of changing bank system will of course effect the consumer. The effect will be similar to the experience of the old EU members. When we look at the impact of implementation of SMP to the member states, we see that there is no strong evidence that, in response to the SMP, banks have changed their strategies in ways that threaten the stability of banking systems in the EU. This partly reflects the need for banks in a number of EU countries to meet more demanding cautious requirements, but also reflects increased concern by banks to earn an adequate return on equity.

Consumers are benefiting from a wider range of financial products and services as a result of SMP and new channels of delivery have opened up (direct banking) as increased competition puts pressure on banks to contain and reduce costs. We expect a similar impact on the Turkish consumers in TRNC.

5.5 Internationalisation of banking

Membership of EU, will help local banks to become internationally recognised. They will be able to open branches in the countries where there are large Turkish populations, mainly in England. At the moment opening a branch in a foreign country is almost impossible.

Trade in financial services will be increased across a range of financial markets. The greatest increases will be in off-balance sheet activities, investment management and in the corporate loan segments. (Erülgen, 2003)

Cross-border acquisitions will also increase sharply. In addition cross-border joint ventures and strategic alliances will also increase after the membership.

6. CONCLUSION

What happens to the banking activities if TRNC becomes a member of EU? The answer is not really very easy, but as we discussed above, it is obvious that the EU is in the process of perfecting their banking systems. With the introduction of the single currency, the ambition is to minimize the banking costs.

At present in Cyprus, using the Turkish Lira, we can not say that the banking system is very efficient. The cost of capital is very expensive. TRNC banks are not able to obtain low interest rate finance from the international markets. Membership to EU, if ever possible will mean the abolition of the financial embargoes.

TRNC has one important advantage over the other member states. That is the functioning of the Central Bank and not having a currency of our own. TRNC will be able to use the EURO more readily than any other state.

If the membership becomes a reality, the banks in Cyprus will be part of the EU banking system. EU banking systems up until the mid-1980s similar to our system today, were characterised by relatively high levels of government controls and restrictions which inhibited competition and maintained in most cases protected domestic banking environments. Banking markets were highly segmented and the threat of foreign competition was perceived as minimal. The strategic focus of banks at this time was to build on their established franchises using their strong branch networks and deposit bases as the main competitive advantage. Implementation of new technology and gradual organic diversification into areas such as insurance and securities brokerage were seen as the way forward. The changing regulatory environment was not perceived to be the main strategic driving force in the industry.

We can safely assume that we will go through the experience of the EU member states after the adoption of the SMP in 1986. The perception and strategic focus of the European banking sector altered rapidly as a consequence of the Single European Act in 1986 and the rapid moves to a single EU banking market. The Second Banking Directive (1988) and the attendant Own Funds and Solvency Ratio Directives gave a further impetus to these developments with the latter regarded as particularly important by banks. In addition the domestic deregulation of interest rate restrictions, capital controls, branching restrictions and so on also had the impact of changing the strategic focus of the industry.

The generalised impact of the SMP forces intensified banking competition and shifted the strategic focus of banks towards greater competition. Both domestic and cross-border acquisition business accelerated as did trade in banking and credit services.

Markets became more international and foreign operators established a significant presence in certain systems, especially at the wholesale end of the corporate banking market. As domestic regulations were relaxed or/and abolished, and as EU legislation was implemented, demarcation lines between particular business areas were broken down.

The universal banking model became the 'norm' across EU markets, facilitating the development of bancassurance business as well as capital markets and other non-mainstream banking activities.

The increasingly competitive environment brought about by these developments resulted in both defensive and/or offensive reactions by banks. Banks in the previously more protected markets, such as in Italy, Spain and Portugal, witnessed domestic mergers between large banks in a strategic attempt to protect market share from possible foreign competitors.

The same can perhaps be said of banks operating in the smaller more concentrated EU markets, such as in the Netherlands which experienced similar consolidation. In fact in many cases, the bulk of evidence suggests that the proximate strategic focus by banks appears to have been initially defensive.

Market positioning, product diversification and innovation, improved efficiency and increased size have all been strategically prioritised in the new, more pro-competitive banking environment facilitated by the SMP. Profitability and efficiency appear to be more important strategically than size alone.

There now exists a much more competitive and market driven EU banking system with a greater focus on cost and profit efficiency. Banking markets have become more international and the traditional banking franchise has broadened so much that, in most countries, it is now unrecognisable from what existed in the mid-1980s.

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