Capital Adequacy of Banks in North Cyprus from EU CRD IV Perspective

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ABSTRACT

The global debt crisis in 2007-2008 turned out to a Eurozone debt crisis in late 2009 and its effects are still on-going. The crisis caused authorities to recognise that in a global financial market with free and dynamic financial mobility it is harder to regulate and supervise the financial markets and institutions. This triggered regulators and supervisors around the world to make step to improve Basel II to Basel III in 2010. Being an active participant in this process EU adopted her own legislation and introduced CRD IV package which is also called Single Rulebook and Single Supervisory Mechanism in 2013. Apparently the aim is harmonisation of the legislation and supervision practices across the union.

With her unique political status, North Cyprus is a country where EU legislation will be applied after the Cyprus conflict is solved. This paper aims to analyse the capital adequacy of North Cyprus banking sector in terms compatibility of Own Funds to the latest changes in EU legislation with a final target to unveil the necessary steps to elevate capital composition of the banks in North Cyprus to the level of CRDIV of European Union.

To achieve these goals CRDIV package formed from Directive 2013/36/EU and accompanying Capital Requirements Regulation (CRR) (REGULATION (EU) No 575/2013) and North Cyprus' Regulation about the Procedures and Principles for the Evaluation of Banks' Capital Adequacy under Bank Law numbered 39/2001 were compared item by item in terms of Own Funds calculation.

The comparison revealed that with present regulation and current market conditions North Cyprus Banks will not have problems in terms of capital adequacy in adapting EU criteria. Their Own Funds meet the conditions of Regulation (EU) 575/2013 by means of Common Equity Tier 1 Capital. This consequence has several reasons but the main reason is the absence of complicated capital instruments and the institutions' capitals' being mostly composed of paid up capital. It is observed that Regulation (EU) 575/2013 spends too much energy on cleaning out capital instruments funded through subsidiaries by the institution itself. With uncomplicated capital instruments it is easier for the supervisor to detect cross holdings. This brings us to the point that the capital instruments should be in their simplest form to be used as common equity for financial institutions for a better supervised and functioning financial sector and institutions.

On the other hand it is inevitable to update North Cyprus regulation according to the Basel III criteria and CRD IV package of EU. For now some missing items in current regulations have insignificant effects due to current market conditions as in the case of capital instruments or practices as in the case of Defined Pension Fund Assets. The regulations on consolidated reporting standards and consolidated supervision of institutions and their affiliates seems most urgent topic to be updated in compliance with the IFRS rules.

Keywords: Basel III, CRD IV, Capital Adequacy Ratio, Own Funds, Tier 1 Capital

ÖZ

2007 – 2008 yıllarında ortaya çıkan küresel borç krizi 2009 yılının sonlarına doğru etkileri halen devam etmekte olan Avro Bölgesi krizine dönüşmüştür. Bu kriz, serbest ve dinamik sermaye hareketlerinin olduğu küresel finansal piyasaları düzenleme ve denetlemenin ne kadar zor olduğunu kavramalarına yol açmıştır. Bu farkındalık dünyadaki düzenleyici ve denetleyici otoriteleri Basel II'yi geliştirip 2010 yılında Basel III'ü yaratmaya teşvik etmiştir. Basel III sürecinin aktif bir katılımcısı olan Avrupa Birliği de kendi yasalarını bu değişikliğe adapte etmiş ve 2013 yılında Single Rulebook (Yeknesak Kurallar Kitabı) olarak da adlandırılan CRD IV'ü (Sermaye Düzenleme Direktifi IV) ve Yeknesak Denetim Mekanizması'nı (Single Supervisory Mechanism) yasalaştırmıştır. Görünen odur ki amaç birlik genelinde yasaları ve denetim uygulamalarını uyumlaştırmaktır.

Özel politik konumu dolayısı ile Kuzey Kıbrıs, Kıbrıs sorununun çözümünden sonra Avrupa Birliği yasalarının uygulanacağı bir ülkedir. Bu çalışma Kuzey Kıbrıs bankacılık sektörünün sermaye yeterliliğinin AB mevzuatında yapılan son düzenlemelerle tarif edilen Özkaynaklar'a uyumunu ve nihai olarak da Kuzey Kıbrıs bankalarının sermaye yapısının Avrupa Birliğinin CRD IV'de tanımladığı düzeye getirilmesi için gerekli adımları saptamak amacı ile yapılmıştır.

Bu amaca ulaşmak için 2013/36/EU Direktifi ve 575/2013 EU Regulasyonundan oluşan CRD IV paketi ile 39/2001 sayılı Bankalar Yasası altında düzenlenen Bankaların Sermaye Yeterliliğinin Ölçülmesi ve Değerlendirilmesine İlişkin Usul ve

Esaslar Hakkında Tebliğ'de yer alan Özkaynak hesaplamaları kalem kalem karşılaştırılmıştır.

Bu karşılaştırma mevcut yasal düzenlemeler ve güncel piyasa koşullarında Kuzey Kıbrıs bankalarının sermaye yeterliliği anlamında AB kıstaslarına uyum sağlamakta sıkıntı yaşamayacağını ortaya çıkarmıştır. Bankaların Özkaynakları 575/2013 EU Regülasyonunun 'Common Equity Tier 1 Capital' kıstasını sağlamaktadır. Bu sonucun birkaç sebebi olmakla birlikte esas sebebi karmaşık sermaye enstrümanlarının olmaması ve özkaynaklarının çoğunlukla ödenmiş sermayeden oluşmasıdır. 575/2013 EU Regülasyonunun kurumun kendisi veya iştirakleri tarafından fonlanan sermaye enstrümanlarını ayıklamakla çok fazla çaba harcadığı tespit edilmiştir. Karmaşık olmayan sermaye enstrümanları ile denetim otoritesinin çapraz fonlamayı tespit etmesi daha kolay olmaktadır. Bu da bizi daha iyi denetlenebilen ve faaliyet gösteren finans sektörü ve kurumları için sermaye kabul edilecek enstrümanların en yalın haline izin verilmesi gerektiği sonucuna ulaştırmaktadır.

Diğer taraftan Kuzey Kıbrıs yasalarının Basel III kıstaslarına ve CRD IV paketine uygun olarak güncellenmesi kaçınılmazdır. Şimdilik mevcut eksiklikler, sermaye enstrümanlarında olduğu gibi güncel piyasa koşullarından veya Kıdem Tazminatlarına ait Varlıklar kaleminde olduğu gibi sektörde uygulamasının bulunmamasından kaynaklanan sebeplerle kayda değer etki yapmamaktadır. Kurumların ve iştiraklerinin IFRS'e uyumlu olarak konsolide bazda raporlamasının yapılması ve denetlenebilmesine imkan sağlayacak yasal düzenlemelerin acilen yapılması gerekmektedir.

Anahtar Kelimeler: Basel III, CRD IV, Sermaye Yeterlilik Rasyosu, Özkaynaklar, Tier 1 Capital

To My Family

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LIST OF ABBREVIATIONS

BCBS	Basel Committee on Banking Supervision
BRRD	Bank Recovery and Resolution Directive
CEBS	Committee of European Banking Supervisors
CET1	Common Equity Tier 1
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DGS	Deposit Guarantee Schemes
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
ESFS	European System of Financial Supervision
ESMA	European Securities and Markets Authorities
ESRB	European Systemic Risk Board
EU	European Union
GDP	Gross Domestic Product
GHOS	Group of Central Bank Governors and Heads of Supervision
IFRS	International Financial Reporting Standards
IRB	Internal Ratings Based
NPL	Non-Performing Loans
RWAs	Risk Weighted Assets
SDIF	Savings Deposit Insurance Fund
SDIFSF	Savings Deposit Insurance and Financial Stability Fund
SRM	Single Resolution Mechanism

Chapter 1

INTRODUCTION

1.1 Background of the Study

North Cyprus has a unique political status. European Union (EU) declared Cyprus as a de facto divided European soil since 01 May 2004. Cyprus conflict has been a problem aged forty years these days. Peace talks supported by European Union and United Nations continue despite interruptions. The south part of Cyprus is recognised as Cyprus Republic and European Union legislation is applied and European Union institutions are in charge. On the other hand on the Northern part of the island Turkish Cypriots has established a republic in November 1985, although only recognised diplomatically by Republic of Turkey. However there is a community life going on for forty years which created an economy with households, enterprises and financial institutions. Also, there are institutions established regulating and supervising the community and their institutions. The establishment regulating and supervising the banking sector is the Central Bank which started functioning in June 1984. After the economic crisis in 1999 the Central Bank has been promoted to an autonomous status and became the sole authority on banking sector with Central Bank Law numbered 41/2001 and Banking Law numbered 39/2001. The Central Bank regulates and inspects the banking sector via Banking Regulation and Inspection Division and Inspection and Supervising Board. Besides regulation and supervision to maintain financial stability, The Central Bank also assigned to establish and run payment and settlement systems.

1.2 Purpose and Motivation of the Study

Banks' important role as financial intermediaries and the possible magnitude of the damage to economy of their failure brought overregulation together. Banks' capital is placed at the centre of these regulations because of its importance on banks' robustness, risk taking incentives and corporate governance. The first attempt of international convergence on bank capital was 1988 Basel Accord which was concentrated on credit risk. The newer versions of Basel included elements of market risk as well. The improvements in regulatory capital aimed to increase the capacity of banks' handling the economic or financial shocks with their own capital reserves (Santos, 2000).

The purpose of this paper is to assess the capital adequacy of North Cyprus banking sector in terms compatibility of Own Funds to the latest changes in EU legislation which were triggered by the global debt crisis in 2007. The motivation behind this analysis is the belief that for a better functioning financial sector the Banks in North Cyprus should eventually face the contemporary standards set by the international authorities, which is currently Basel Committee on Banking Supervision. It is a high possibility that this will be through EU legislation if peace talks ends with a federal regime, where united Cyprus will be a member of the European Union. According to my view capital adequacy should have the highest priority among the criteria to be complied.

1.3 Coverage and Scope of the Study

To accomplish the assessment, CRDIV package of European Union formed from Directive 2013/36/EU and accompanying Capital Requirements Regulation (CRR) (REGULATION (EU) No 575/2013) and North Cyprus' Regulation about the

Procedures and Principles for the Evaluation of Banks' Capital Adequacy under Bank Law numbered 39/2001 were compared item by item in terms of Own Funds calculation.

1.4 Limitations

This paper focuses on comparison of Own Funds between EU and North Cyprus Regulation. Capital adequacy of a financial institution is calculated as a ratio of Own Funds to Risk Weighted Assets (RWAs). The improved rules and methods of calculation of risk weighted assets are also supplied in Regulation (EU) 575/2013. Yet these detailed methods are outside of the scope of this paper and it is accepted that both regulations are capable of calculating the risk weighted assets amount precisely.

1.5 Structure of the Study

Section 2 starts with the effects of the global financial crisis in 2008 on the evolution of banking legislation in European Union. Afterwards the latest legal framework and the regulating and supervising institutions forming the Banking Union are explained. In Section 3, banking sector, banking legislation and supervision is briefed. Section 4 covers the comparative analysis between EU and North Cyprus Legislation and Practices on Capital Requirements. Finally conclusions and policy implications are in Section 5.

Chapter 2

BANKING LEGISLATION, SUPERVISION AND RESOLUTION IN EUROPEAN UNION

2.1 The Global Financial Crisis in 2008 and its Effect on the Evolution of Banking Legislation in EU

The crisis in 2008 uncovered that some of the institutions in the market had inadequate capital, both in quantity and quality. This in turn, forced governments to inject huge amounts of capital support to the failing institutions in order to maintain financial stability. According to EU Commission, €4.6 trillion state aid approved from October 2008 till October 2010 and more than €2 trillion were utilised from 2008 to 2009. Due to Eurostat data, EU GDP has narrowed by 6% in 2009 because of the negative effects on economy triggered by the financial crisis (European Commission Memo 13-690, 16 July 2013).

The financial regulators and supervisors realised that current capital regulations were not sufficient to keep banks resilient and ready to absorb market shocks. The quantity of capital was not enough if not supported by the quality. This rule comes into prominence in today's global market with complicated cross-border activities which have impacts more difficult to analyse.

Starting with the first Basel capital accord in 1988 the emphasis was on capital adequacy. It was believed that the more capital banks had they would respond

stronger against the economic shocks, remaining liquid and would not need to be bailed out with public funds. Additionally the more bank owners' share increases in the game, incentives for excessive risk taking by banks might be curbed (Demirguc-Kunt, Detragiache, Merrouche, 2010).

While struggling to eliminate the effects of the crisis in financial markets and economy, authorities were trying to clarify the reasons of the crisis and take the measures to prevent financial institutions from defaulting.

During the Pittsburgh Summit in September 2009, G20 leaders endorsed a number of measures developed by the Group of Central Bank Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee, to strengthen the regulation of the banking sector.

The Basel Committee published the latest global regulatory standards on bank capital adequacy and liquidity which are called Basel III in December 2010. The new version introduces stricter standards over Basel II, which were evolved through time and the lessons thought by the crisis. These improved standards aims to maintain:

i. Better and more capital
ii. More balanced liquidity
iii. Leverage backstop
iv. Capital requirements for derivatives or counter party risk
v. Capital Buffers

Basel III defines a stringent capital over Basel II, increase the risk weight of several assets in the banking book and introduce capital buffers, leverage ratio and liquidity

management. Above all increases the proportion of going concern capital, core tier 1 and will be phased in gradually from January 2013 until 2019. (Howarth and Quaglia, 2013).

The previous EU bank capital structure consisted of directives 2006/48/EC and 2006/49/EC together named Capital Requirements Directive (CRD). These directives were regulated considering the Basel II accord. CRD framed the minimum amounts of own financial resources for credit institutions and investment firms.

Following G20 and Basel Committee, EU amended directives on bank capital requirements to Capital Requirements Directive IV and Capital Requirements Regulation, implementing the new global standards on bank into the EU legal framework. CRD IV package rules are valid since 1 January 2014.

Between December 2010, when the Basel Committee declared the Basel III accord and June 2013 a period of negotiation, debate and struggle took place between European member states. This dispute stemmed from different financial structures of credit institutions of member states. As an example, in their paper Howarth and Quaglia (2013) argued that countries, such as Germany, opposed to high capital requirements that would restrict lending because of their less developed equity markets and greater non-financial company reliance on bank credit. On the other hand British government was less concerned about capital regulations as British banks were more ready to deleverage than German and French banks.

The big three were not the only group taking Basel III restrictions as a threat. 10 new EU member states were also concerned about the capital restrictions about Basel III

and expected CRD IV. Their main doubt was that Basel III posed threats to the parent-subsidiary funding relationships and early introduction of Basel III within emerging Europe could derail a nascent recovery in credit and, more broadly, in growth (Lehmann, Levi, Tabak, 2011).

EU applied CRD IV to the whole credit and deposit-taking institutions where BCBS designed Basel III for internationally active firms. The main reason for this is attaining unity and same standards through the financial market and to prevent shadow banking.

Being one of the financial stability concerns, shadow banking is defined as the financial activities occurring outside the regulated financial system. Research done by European Central Bank (ECB) in April 2012 has shown that the affiliation among regulated and non-bank-regulated sections of the financial sector has increased, incrementing the risk of contagion across sectors and member states. It is found that Eurozone banks depend more on funding from the financial sector these days compared to the previous years. Their sources include shadow banking entities, inclusive of securitisation vehicles. This source of funding is mainly short-term and therefore more susceptible to runs and to the drying-up of liquidity (Bakk-Simon et al., 2012).

EU designed CRD IV so that it is comprised of two parts. First item is a directive regulating the deposit-taking activities and the second item is a regulation organizing the prudential requirements that should be followed by those establishments. This aims to minimise the divergences among the member countries. EU members will be

obliged to adopt the directive into their national law, however according to EU legislation the regulation creates law that takes immediate effect in all states.

2.2 Banking Legislation, Banking Union and Bank Supervision in EU

The global financial crisis has uncovered a number of weaknesses in the supervision and regulation of cross border banks. One such weakness was the lack of effective cooperation among banking supervisors (D'Hulster, 2011). To overcome this lack of supervision EU has designed cooperating institutions of regulators and supervisors whose object is a smoothly running financial system and institutions. This organisation is called Banking Union as a whole. Banking Union in EU aims a Single Supervisory Mechanism covering the whole Euro-zone credit institutions; applying the same set of rules for each actor in the market which is the Single Rulebook; and in case all the precautions fail a Single Resolution Mechanism as a last resort who will handle the problem with funds backed by banks themselves. The legal infrastructure for Banking Union is set through Capital Regulations Directive (CRD IV) which is accompanied by Regulation (EU) 575/2013.

2.2.1 Committee of European Banking Supervisors

Efforts to facilitate further integration and increase the EU's competitiveness in global financial markets resulted in founding the Committee of European Banking Supervisors (CEBS) in 2003. CEBS was charged with three main tasks: Providing advice to the European Commission on EU legislation in the banking sector, contributing to consistent implementation of EU legislation across the EU and promoting convergence of supervisory practice and fosters co-operation between supervisors.

The Commission of the European Communities (The Commission) established CEBS on 05 November 2003 as an independent body for reflection, debate and advice for the Commission in the field of banking regulation and supervision.

From 01 January 2004 till 31 January 2010 CEBS functioned as an advisor to the Committee on banking regulation and supervision. During this period CEBS published yearly reports on its activities; guidelines on banking legislations and their application; consultations and opinions on calls for advice from the Commission and other financial institutions.

In their work CEBS followed the standard set by Basel Committee and IFRS. In the foreword of the first annual report the Chairman of the Committee, José María Roldán expressed the view on this subject with the words: 'Basel II and IFRS present a unique opportunity to promote greater co-operation between supervisors and greater consistency in supervisory approaches across the EU. CEBS is ideally positioned to take advantage of this opportunity.' (CEBS Annual Report, 2004, p. 3)

2.2.2 European Banking Authority

CEBS passed its duties on the European Banking Authority (EBA) on 01 January 2011. EBA was founded as a part of The European System of Financial Supervision (ESFS). ESFS is set up for the supervision of the financial sector and is made of three supervisory authorities: the European Securities and Markets Authorities (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA). The system also comprises the European

Systemic Risk Board (ESRB) as well as the Joint Committee of the European Supervisory Authorities and the national supervisory authorities[1] .

Rather than being an advisory committee like CEBS, EBA is established as an independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector. Its overall objectives are to maintain financial stability in the EU and to safeguard the integrity, efficiency and orderly functioning of the banking sector[2] .

2.2.3 Banking Supervision

On 12 September 2013 European Parliament adopted a package of legislative acts to set up a Single Supervisory Mechanism (SSM) for banks. The European Central Bank (ECB) was given specific tasks related to financial stability and banking supervision with the SSM. The European Central Bank (ECB) is in the centre of the supervisory system in the EU Banking Union. Since November 2014, ECB is supervising credit institutions in coordination with the local competent authorities. The ECB directly supervises significant banks, around 130 banks representing almost 85% of total banking assets in the euro area. Other credit institutions will be supervised by collaborating local authorities consistent to the ECB supervisory standards.

[1] http://www.eba.europa.eu/about-us
[2] http://www.eba.europa.eu/about-us

2.3 Bank Resolution and Deposit Guarantee Scheme

2.3.1 Bank Resolution

The framework for the recovery and resolution of credit institutions and investment firms is set by Directive 2014/59/EU which is also called Bank Recovery and Resolution Directive (BRRD).

With this directive it is aimed to provide resolution authorities with more comprehensive and effective arrangements to deal with failing banks at national level, as well as cooperation arrangements to tackle cross-border banking failures[3].

The Single Resolution Mechanism (SRM) is designed to manage the resolution of a financial institution facing difficulties. It is planned to manage the resolution process efficiently through a Single Resolution Board and a Single Resolution Fund.

The Single Resolution Board is established as the European Resolution Authority for the Banking Union and is planned to work in close cooperation with the national resolution authorities of participating Member States.

2.3.2 Deposit Guarantee Scheme

The Directive on Deposit Guarantee Schemes (DGS) (Directive 94/19/EC) was adopted in 1994. This directive maintained minimum harmonization approach and this approach resulted in important discrepancies between DGS such as the level of coverage, the scope of covered depositors and products and the pay-out delay. The financing of schemes was left entirely to Member States. The crisis experience taught Europe that this approach might result in improper functioning of internal market causing harm to financial stability.

[3] EC MEMO 14/297, 15 April 2014.

The most striking example is bank crisis in South Cyprus. Turned into long negotiations on choosing who will carry the burden. Finally the Troika of EU, ECB and IMF bailed out the necessary amount at the expense of haircuts from the deposits in South Cyprus Banks. This prolonged process raised question marks about the system in the heads of the taxpayers of the West European countries and the Greek Cypriots, who had their savings locked in the banks and were in the streets protesting both their government and the Troika.

The directive issued in March 2009 required Member States to increase coverage of their guarantee schemes initially to a level to cover minimum €50,000 of a deposit then elevate the coverage to €100,000 across the union by the end of 2010.

In 15 April 2014 the new DGS directive 2014/49/EU was adopted by the European Parliament instead of Directive 94/19/EC. The new directive ensures that €100,000 deposit guarantee per bank per person remains to be in force as regulated in March 2009. However the compensation of the guaranteed amount in 20 working days will gradually be decreased to 7 working days until 1 January 2024[4].

Member states are expected to raise DGS funds as 0.8% of covered deposits collected from banks over a 10-year period. The important point here is these funds will be collected from banks and it is aimed that taxpayers' money will not be used again for funding the losses of bank owners.

The importance and benefit of the deposit guarantee schemes proved in the recent global financial crisis. Apart from some exceptions like isolated runs to the Northern

[4] EC MEMO 14/296, 15 April 2014.

Rock in the UK and DSB Bank in the Netherlands that were quickly contained, a slow moving “run” on deposits in Greece on the back of growing fears of a euro breakup (total deposits declined by about 20 percent between 2010 and 2012), and a generalized run in Cyprus where authorities had declared that a tax on insured deposits could be imposed no widespread systematic bank runs by insured depositors were observed (Demirgüç-Kunt, Kane, Laeven, 2014).

Chapter 3

BANKING LEGISLATION AND SUPERVISION IN NORTH CYPRUS

3.1 Banking Sector of North Cyprus in Brief

Currently there are 22 onshore banks operating in North Cyprus licensed by the Central Bank of North Cyprus (Central Bank). Classified by the ownership composition; one: owned and run by state, one: owned by cooperatives and run by the state, one: cooperative bank and twelve: privately owned banks and seven branches of the banks operating in Turkey.

By the end of 2013, Banks operated with 224 branches and 2,882 employees. According to the Central Bank data on the date 31 December 2013, total assets of the sector was 13,355 million TL, total credits 8,406 million TL, total deposits 10,685 million TL and capitals 1,361 million TL[5].

3.2 Banking Legislation and Supervision in North Cyprus

Banking sector in North Cyprus is regulated by Bank Law numbered 39/2001 endorsed on 23 November 2001. This law is approved after banking crisis started in 1999 which caused 11 banks to fail and finally to be resolved.

Using Turkish Lira as main currency, North Cyprus economy was strongly affected from economic crises in Turkey in 1999, November 2000 and February 2001. Eleven

[5] Quarterly Bulletin, 2103-IV, North Cyprus Central Bank (2014).

of the banks operating in North Cyprus were not strong enough to overcome the effects of those economic crises and five of them were resolved by the Companies Registrar in 2000. In the following year Central Bank Law and Bank Law were amended with added powers on regulation and added duties on supervision to the Central Bank. On the other hand Savings Deposit Insurance Fund (SDIF) was founded at the same time. By the end of year 2001 six more banks failed and they were handed over to SDIF to be liquidated.

The crisis taught that banks with poor performance and supervision might end up with huge costs to the state. State paid 257,502,572USD in the period 2000 to December 2006 to the depositors of those banks[6].

In his study, published in the 4th International Congress of Cyprus Studies (November 2002), Bektas has concluded that the problems resulted in the failure of the North Cyprus banking system were: insufficient regulation, insufficient supervision and monitoring, the concentration of the sector in the form of banks owned by holdings, political intervention and absence of a central bank as a last resort.

In his article, Safakli (2002) concludes that main reasons of banking crises were: external factors, macroeconomic policies, legal arrangements, holding banks, lender of resort, credit risk & management, capital adequacy and ethical issues combined with the regulatory and supervisory deficiencies.

[6] Source: Central Bank of North Cyprus web Site: http://www.kktcmerkezbankasi.org

On her research about North Cyprus banks over years 1984 and 2002 Gunsel (2007) has observed that deficient capital, weak asset quality, exceeding interest expenses, incompetent liquidity and a small scaled bank size can all alter bank performance and lead to its failure.

With the new Bank Law and Central Bank Law endorsed in 2001, Central Bank was donated with liquidity measures like Required Reserve Rate and Liquidity Ratio, the Bank law assigned Central Bank with the duty of endorsing and conducting regulations about: accounting standards to be used by banks; capital adequacy ratio; quality of loans and other receivables and their provisions; internal systems and governance.

Central Bank supervises the North Cyprus Banking Sector with on-site and off-site supervisors who use CAMELS analysis, Composite Rating Analysis, daily, monthly, quarterly and yearly reports from banks about their financials and legally binding ratios they are obliged to meet.

The Central Bank is authorised to take preventive measures if a bank shows bad signals on liquidity or its assets might not be enough to meet its liabilities on their due date or the management is running the bank violating laws and ethical values about banking and in an unsafe manner. These preventive measures includes increasing liquidity ratio, increasing required reserve up to 100%, stopping dividend payments for a period, assigning a new member/s to the board or assigning a brand new board to run the bank. In case the capital of the bank is not adequate enough for the risks taken or in other words to meet regulations on capital adequacy, Central Bank is authorised to ask shareholders to increase capital. If all the preventive

measures are taken and the bank's financial situation is still in a weak position and is likely to fail which is a threat to the rights of the depositors and the financial system, the Central Bank has the authority to stop the banks activities and hand the management of the bank to the SDIF.

Saving Deposit Insurance Fund (SDIF) was founded in 2001. In 2009 with law numbered 32/2009 it was upgraded to Savings Deposit Insurance and Financial Stability Fund (SDIFSF) with extended duties on financial stability.

According to the law numbered 32/2009, SDIFSF covers the whole saving deposits owned by natural person. However the Central Bank is authorised to determine the coverage amount not being less than €20,000. Currently the insurance covers every account owned by a natural person up to €20,000.

SDIFSF is mainly funded by the insurance premiums paid by banks calculated over their deposits insured at the end of each quarter. The insurance premium rate is 0.25%. This rate is decreased by 0.01% for the banks whose capital Adequacy ratio is higher than or equal to 12% or for the banks which have an Assets to Equity ratio higher or equal to 10 or for those banks who has a NPL ratio less than equal to 3% or for those banks who has a Free Capital Ratio 60% or higher.

When the Central Bank decides to end a bank's activities and hand the management to the SDIFSF, giving the priority to depositors, SDIFSF resolves the bank using its own funds available, funds generated from the collection of the bank's loans and the liquidation of the assets available. SDIFSF is capable of borrowing through issuing securities if necessary.

Chapter 4

COMPARATIVE ANALYSIS BETWEEN EU AND NORTH CYPRUS LEGISLATION AND PRACTICES ON CAPITAL REQUIREMENTS

The European Union suffered losses caused by the sovereign debt crisis which turned out to be a Eurozone debt crisis in the end. Crisis-related losses incurred by European banks between 2007 and 2010 were calculated to be almost €1 trillion or 8% of EU GDP. According to the EU Commission reports approved state aid measures between October 2008 and October 2010 were €4.6 trillion or 39% of EU GDP.

Royal Bank of Scotland (UK), Bradford and Bingley (UK), KBC Group (BE), Bayern LB (DE), Commerzbank (DE), Lloyds (UK), Allied Irish Banks (IR), Bank of Ireland (IR), Cajasur (ES) were companies who had their capitals reinforced through Commission state aid decisions because their capital instruments did not meet their intended functions of absorbing losses and sustain liquidity.

Companies like Northern Rock (UK), HBOS (UK), Bradford and Bingley (UK) finally failed because they were not able to manage their liquidity risk effectively.

Following the Basel III agreement EU authorities changed Capital Requirements Directive accordingly which is called CRDIV (Directive 2013/36/EU). This directive

is accompanied by a regulation which is called Capital Requirements Regulation (CRR) (REGULATION (EU) No 575/2013)[7].

With these changes in legislation EU intends to improve capital structure of financial institutions in several aspects so that they manage to endure financial crisis without state aid and without being a threat to the stability of the financial system. EU aims financial institutions with better quality and higher level capitals which is available in need.

In North Cyprus, capital requirements are regulated by The Regulation about the Procedures and Principles for the Evaluation of Banks' Capital Adequacy. This regulation is endorsed by The Central Bank of North Cyprus under the Article 33 of Bank Law 39/2001. The Regulation was initially endorsed in February 2001 and several amendments and improvements were made from this date on.

In the following sections you will find comparison of the two legislations on banks' capital adequacy, aiming to unveil the necessary steps to elevate capital composition of the banks in North Cyprus to the level of CRDIV of European Union. The reader will observe parallel definitions and methods of calculations most of the time as a result of Basel Accord in the foundations of both legislations. Discrepancies mainly arise because North Cyprus legislation mainly compromised of Basel I where EU legislation is updated to Basel III accord. North Cyprus regulation does not allow consolidation of financial reports for supervision which is another main source of dissimilarity. Other source of distinction originates from the existence or depth of financial instruments and markets.

[7] European Commission Memo 13/690, 13.07.2013.

4.1 Definition of Capital Adequacy

Capital adequacy requirement is the quantity of capital an institution is required to have against the quantity of assets, which are supposed to meet unforeseen losses and is measured as ratio of capital to the RWA s. 'The amount of funds' to be compared to the risk weighted assets in that definition is called Own Funds.

Regulating Capital Adequacy is one of the major issues the banking authorities deal with. The Basel III agreement and following local regulations requires banks to use more equity to finance their assets compared to previous sets of rules. This is a thin line to walk on because increasing the capital adequacy ratio and the quality of capital might cause negative effects on required return on debt and equity, average cost of bank funding, scale of the economic costs generated by banking sector problems and other economic and social costs.

Miles, Yang and Marcheggiano (2011) have concluded that even relatively high raises in bank capital would only have small effect on lending rates in the long-run. They have estimated that in an extreme case if the bank capital doubled, the average cost of bank funding will increase by only around 10-40bps. But significant increase in capital requirements could create very large benefits by reducing the probability of systemic banking crises.

According to Slovik and Cournède (2011), the macroeconomic impacts of increasing capital adequacy ratio according to Basel III agreement will be a decline on GDP growth in the range of −0.05 to −0.15 percentage point per annum. This negative effect on economic output will arise from increase in bank lending spreads as banks

pass a rise in bank funding costs to their customers. On the other hand they have concluded that the decline in GDP can be offset by a reduction (or delayed increase) in monetary policy rates by about 30 to 80 basis points.

4.2 Own Funds

Regulation 575/2013 defines ‘Own Funds’ as the sum of Tier 1 capital, Additional Tier 1 capital and Tier 2 capital. On the other hand North Cyprus legislation defines ‘Own Funds’ as the sum of Core Capital and Contributed Capital.

This breakdown arises because both kinds of capital come in different forms and serve different purposes. The Tier 1 and Core Capital are considered to be the going concern capital. Going concern capital ensures that the establishment continues its business and helps to prevent insolvency. Tier 2 Capital and Contributed Capital are defined as gone concern capital designed to assure that the depositors and senior creditors can be paid back in case the bank fails. Gone concern capital includes instruments like hybrid capital and subordinated debt.

Table 4.1: Elements of Own Funds

	Own Funds in EU Regulation		Own Funds in North Cyprus Regulation
1	Tier 1 Capital	1	Core Capital
1.1	Elements of Common Equity Tier 1 Capital	1.1	Elements of Core Capital
1.2	Deductions From Common Equity Tier 1 Items	1.2	Deductions From the Core Capital
1.3	Additional Tier 1 capital	2	Contributed Capital
2	Tier 2 Capital	3	Deductions From Own Funds

On Table 4.1 elements of Own Funds are shown. Roughly speaking Tier 1 Capital of EU and Core and Contributed Capitals of North Cyprus are quite similar as they are both based on BCBS criteria. This similar basis is for the advantage of North Cyprus

banking sector for a possible compliance process. For a more detailed analysis, breakdown of elements are shown in Appendix A[8].

4.2.1 Common Equity Tier 1 Capital Items

First two Elements generating Common Equity Tier 1 (CET1) Capital are Capital Instruments and related share premium accounts. In North Cyprus there are no developed financial markets as in EU. There is no active stock exchange market or any other market and therefore financial instruments are not as diversified as in EU market. For this reason only capital instruments are shares belonging to the shareholders whose names are written on notes. Therefore in North Cyprus legislation there is no rules about capital instruments. Paid-up capital is the first element of Core Capital instead. Bank Law Article 6(1) (D) restricts paid-up capital to be 'In cash and free from collusion'. For this reason capital instruments and their share premium accounts in CET1 and Core Capital can be considered to be equal.

One other item that is a part of CET1 is Retained Earnings. This item matches with Profits of the Current Period of the Core Capital.

Accumulated Other Comprehensive Income of CET1 and Profits of the Previous Periods mentions the same item with different accounting terms.

Other Reserves of CET1 is defined in Article 4(117) of Regulation 575. This item is compensated with Legal Reserves and Discretionary and Extraordinary Reserves in Core Capital and Other Reserves in Contributed Capital of North Cyprus legislation. However including an item in Contributed Capital does not make North Cyprus

[8] Details of Tier 1, Additional Tier 1, Tier 2 Capitals and deductions from them are from Regulation (EU) 575 Articles 36 to 71. Core and Contributed Capitals and deductions from them are from North Cyprus Regulation about the Procedures and Principles for the Evaluation of Banks' Capital Adequacy.

Legislation more conservative at this point as Contributed Capital is not limited to 1.5% as in the EU method but The Contributed Capital amount is limited with the amount of Core Capital.

The last component Funds of CET1 is General Banking Risk. This item is met by Funds for General Banking Risk of Contributed Capital of North Cyprus regulation.

4.2.2 Deductions from CET1 versus Core Capital and Contributed Capitals

Both regulations contain deductions from Capital to reach Own Funds. In the following paragraphs deductions from CET1 versus Core Capital and Contributed Capitals are matched.

Losses for the Current Year, which is deducted from CET1 in calculation matches with Loss of the Period. Also Intangible Assets of CET1 deductions are met with Intangible Assets, Prepaid Expenses and Goodwill.

Yet Deferred Tax Assets That Rely on Future Profitability of CET1is an item not offset by North Cyprus Regulation. The Prospectus on Uniform Chart of Accounts and Balance Sheet Guide requires deferred taxes should be added to Provisions among the Liabilities. But this item is not included in the calculation of Own Funds or Capital Adequacy Ratio.

EU Legislation requires that institutions calculating risk-weighted exposure amounts using the IRB Approach shall deduct negative amounts resulting from the calculation of expected loss amounts from CET1.

The Communiqué on Internal Audit, Risk Management, Internal Control and Management Systems in Banks endorsed under Bank Law Article 15(3) requires banks to use Internal Ratings but there is no regulation about how this will be transposed to the Capital Adequacy calculation.

Defined Benefit Pension Fund Assets of the bank is another item to be deducted from CET1. On the other hand this item is not included in the calculation of Own Funds or Capital Adequacy Ratio of North Cyprus Regulation.

Most of the banks in North Cyprus left Defined Benefit Pension Plans in late 1990s and in early 2000s. The last bank applying this plan (which is owned by the state) has reached an agreement with the employees union on leaving Defined Benefit Pension Plans and it is settled that the accumulated amounts on behalf of each employee will be converted into deposits to be drawn at the retirement. Currently there is only one bank with a significant amount of Defined Benefit Pension Provision which belongs to employees started to work before 1997 (which is the date the bank left Defined Benefit Pension Plan). This amount is among the liabilities of the bank however the assets related to them are not specified. According to 2013 financial report the provision is approximately 1% of total assets and 65% of the total equity. The second ratio provided can be utilized as an indicator of the significance of the amount if it is to be deducted from Own Funds. Defined Benefit Pension Fund Assets should be specified and included in deductions from Own Funds by North Cyprus regulations as they can reach high volumes that have significant effect on Capital Adequacy Ratio.

The case which is described as ‘Direct, indirect and synthetic holdings by an institution of own Common Equity Tier 1 instruments, including own Common Equity Tier 1 instruments that an institution is under an actual or contingent obligation to purchase by virtue of an existing contractual obligation’ (l) is not applicable to North Cyprus Banks because 39/2001 Banking Law does not allow this kind of contracts and transactions. Therefore this deficiency does not have impact on calculation of Own Funds.

One other item is about deducting direct, indirect and synthetic holdings of the CET 1 instruments of financial sector entities where those entities have a reciprocal cross holding with the institution that the competent authority considers to have been designed to inflate artificially the own funds of the institution from CET1. There is no such item meeting this in North Cyprus regulation but Bank Law Article 27 already forbids transactions aiming to inflate the own funds through reciprocal cross holdings. Therefore this deficiency does not have impact on calculation of Own Funds.

Items about holdings of CET1 instruments hold by the institution as subsidiaries or affiliates are met by the phrase ‘All the capital invested by the institution into subsidiaries, affiliates and joint ventures are deducted from own funds.’ in North Cyprus legislation all instruments related with subsidiaries, affiliates and joint ventures are deducted from own funds are deducted from Core and Contributed Capitals.

Another item to be deducted is the amounts appropriate to Article 56. Article 56 of Regulation 575 regulates decreases stemming from the implementation of own funds requirements on consolidated basis.

Consolidated reporting is not regulated in North Cyprus legislation. For this reason this item does not have a match in North Cyprus Regulation.

Although the capital transferred to subsidiaries, affiliates and joint ventures (also losses or gains related with these institutions) are considered in calculating own funds, the consolidated reporting of financial statements and consolidated supervision is a deficiency of North Cyprus banking authority. Therefore the effect of the omitted amounts is considered to be included in current calculation however the real impact cannot be estimated at that point.

Regulation EU 575/2013 regulates the exposure amount of the items which qualify for a risk weight of 1 250%, where the institution deducts that exposure amount from the amount of Common Equity Tier 1 items as an alternative to applying a risk weight of 1 250% (or applying a risk weight of 12.5) for five cases.

i. According to that qualifying holdings outside the financial sector should be deducted. According to North Cyprus regulation amounts invested in subsidiaries, affiliates and jointly controlled partnerships should be deducted from own funds regardless they are financial institutions or not.

ii. Second item includes deductions stemming from securitisation positions, in accordance with Article 243(1) (b), Article 244(1) (b) and Article 258 (For these articles see Appendix F).

North Cyprus Legislation does not have any regulation about securitisation positions. They are treated like any other financial asset which a risk weight is not assigned by regulation and are placed among risk weighted assets which are multiplied by 100%.

iii. Is about deduction of free deliveries in accordance with Article 379(3) from CET1. Article 379 defines free deliveries as transactions that the institution has paid for before receiving (or vice versa) or at the point of a cross-border contract, one day or more has passed since payment or delivery.

In North Cyprus legislation these transactions are placed in RWAs, yet there is no mechanism to allow banks to deduct the amount from own funds related to free deliveries instead of including RWAs. This practice of EU does allow for a more precise calculation however that does not mean that the North Cyprus application is deficient at this point.

iv. Is about deduction of positions in a basket for which an institution cannot determine the risk weight under the IRB Approach, in accordance with Article 153(8);

Article 153 regulates risk weighted exposure amounts for exposures to corporates, institutions and central governments and central banks. Paragraph 8 of the article

says in a situation where an institution cannot determine the risk weight of such an exposure a 1,250 % risk weight should be applied.

In North Cyprus legislation there is no deduction from own funds related to exposures that risk weights could not be determined. All exposures are added to risk weighted assets with relative risk weight but none of them are deducted from own funds. In case a risk weight is not assigned to a financial asset by regulation that asset should be weighted 100%. Again this is not a deficiency of North Cyprus practice, however this kind of methods are good for a more precise calculation of Own Funds and may cause an institution to achieve a higher capital adequacy ratio or invest more funds to more profitable assets rather than low risk low yield ones.

v. Is about deduction of equity exposures under an internal models approach, in accordance with Article 155(4).

Article 155 is about risk weighted exposure amounts for equity exposures. For paragraph 4 see Appendix E.

North Cyprus regulation does allow institutions to use their internal models approved by the Central Bank in order to calculate the risk amounts other than using standard method. Yet there are no deductions from Core or Contributed Capitals related to these amounts calculated with internal methods, they are restricted with the RWA calculations.

The last item to be deducted from CET1 is about deducting predictable tax charges related to CET1 items.

North Cyprus regulation does not include a deduction of this kind. However Profit of the Period and Profits of the Previous Periods are already placed in the calculation after tax provisions are deducted therefore there is no need for an additional adjustment.

4.2.3 Additional Tier 1 Items

Additional Tier 1 capital items are Capital Instruments which meet the conditions listed in Article 52(1) and their related share premium accounts (For Article 52(1) see Appendix C).

As mentioned in previous sections, In North Cyprus legislation there is no rules about capital instruments. Paid-up capital is the first element of Core Capital instead. Bank Law Article 6(1) (D) restricts paid-up capital as 'In cash and free from collusion'. The capital items are in the simplest, basic form in North Cyprus. This might have arisen because of lack of advanced financial markets or for another reason however kept the banks' capital in the purest form and very close to CET1.

4.2.4 Tier 2 Capital Items

First component of Tier 2 capital is Capital Instruments and Subordinated Loans accepted as Tier 2 capital who meets the conditions listed in Article 63 and their related share premium accounts (For Article 63 of the Regulation EU 575-2013 see Appendix D).

Having discussed on Capital Instruments in previous sections we will focus on subordinated loans. North Cyprus legislation defines the criteria for subordinated loans in Article 2(c) of Regulation about the Procedures and Principles for the Evaluation of Banks' Capital Adequacy. In January 2015 several amendments were

introduced to said regulation. With these amendments Central Bank broadened control on subordinated debts. It is ensured that it will not be allowed for the institution to finance the subordinated debt directly, indirectly or reciprocally. Also conditions on registering a loan as a subordinated debt are tightened. On the other hand conditions of deleting the subordinated debt from the record are clarified. Items about subordinated debts' registration and allowance by the Central Bank to be added to Contributed Capital were added. And an item is added allowing subordinated debts to be converted in equity shares or to be reclassified if the bank is about to fail and the Central Bank had to intervene according to article 37 of Banking Law 39/2001.

With the latest amendments this regulation fully matches the criteria in the EU legislation about subordinated debts. This is an important topic which supervisors and regulators must assess carefully to clarify indirect or reciprocal financing over other institutions. This importance comes from the fact that subordinated debts are substitutes for capital and the supervisor must be sure that this fund will be there if needed.

The positive amounts of general credit risk adjustments, gross of tax effects and other amounts of 0.6% and 1.25% of risk weighted exposure amounts said in Regulation EU 575/2013 are not included in any of the capital items of North Cyprus Regulation. Again these two items are fine tunes for a better evaluation of required capital but their absence is not a deficiency for the North Cyprus Regulation.

4.3 Capital Requirements

4.3.1 Capital Requirements and Capital Adequacy in EU

Own Funds which we studied above is the numerator of the capital adequacy equation. In the denominator there is risk weighted assets (RWAs). Own Funds are expressed as a percentage of RWAs to reach the Capital Adequacy Ratio.

On their empirical study on effects of capital on banks' performance in terms of survival end market share during banking crises, market crises and normal times Berger and Bouwman (2013) had found out that capital helps small banks to increase their probability of survival and market share at all tested periods and capital enhances the performance of medium and large banks primarily during banking crises.

In their analysis on bank capital and systemic stability Anginer and Demirguc-Kunt (2014) reached the conclusion that higher quality forms of capital reduce the systemic risk contribution of banks, whereas lower quality forms can have a destabilizing impact, particularly during crisis periods. The results of their analysis show that regulatory capital is effective in reducing systemic risk and that regulatory risk weights are correlated with higher future asset volatility, but this relationship is significantly weaker for larger banks. The paper also finds that increased regulatory risk-weights not correlated with future asset volatility increase systemic fragility.

Risk weighted assets compromise the denominator of capital adequacy calculation. The improved rules and methods of calculation of risk weighted assets are also supplied in Regulation (EU) 575/2013. Yet these detailed methods are outside of the

scope of this paper and it is accepted that both regulations are capable of calculating the risk weighted assets amount precisely.

According to EU regulation the capital ratio an institution needs to hold is 8% in total. With the new regulation CET1 is increased from 2% to 4.5% in order to increase the quality of this capital. Additional Tier 1 has a share of 1.5% and Tier 2 capital is at 2%. In addition to this, five new capital buffers were introduced. They are the capital conservation buffer, the countercyclical buffer, the systemic risk buffer, the global systemic institutions buffer and the other systemic institutions buffer. Also EU legislation allows local authorities to impose extra capital to cover for other risks (Pillar 2) or the institutions are allowed to keep an extra capital amount on their will. Graphical illustration of new capital requirements are presented in Figure 1.

The Capital conservation buffer is designed to be 2.5% of the whole risk weighted assets of the institution and composed of CET1 items. The aim of Capital Conservation Buffer is to keep bank's CET1 capital ratio above 7%. In case of failure to be so, sanctions like limiting the amount of dividend and bonus payments applied to reconstruct the required CET1 amount.

The Countercyclical Buffer aims to decrease the institutions lending capacity in boom times by increasing the cost of loan. As the loaning capacity increases banks will be forced to fill this buffer therefore the cost of capital to fill this buffer will slow them down to an extent. The funds trapped in this buffer will be released when the economy slows down and demand for loans decrease.

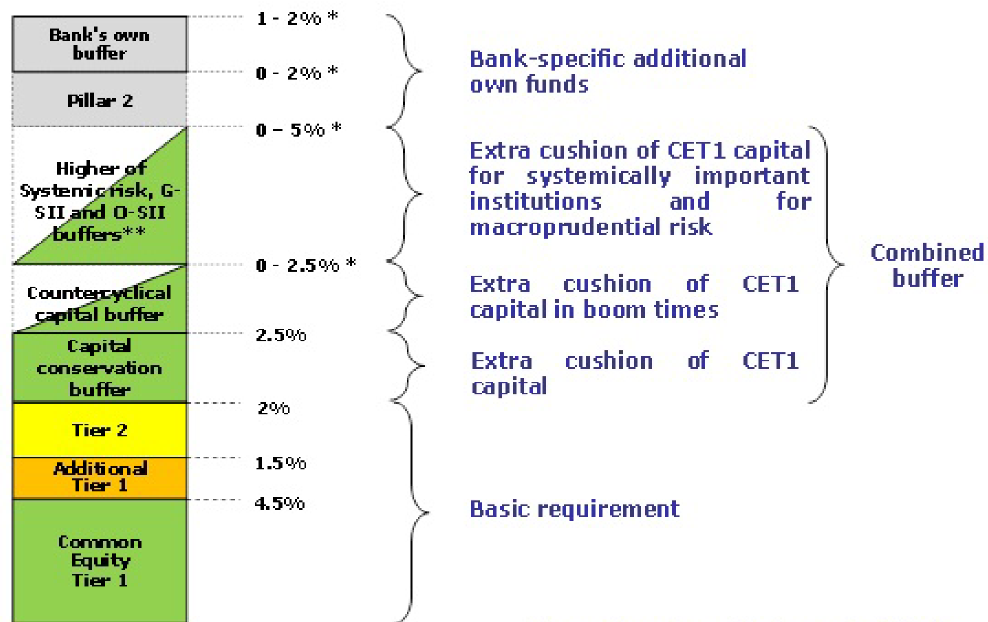

Figure 1: Capital Requirements According to CRD IV[9]

In search of anchors for setting the level of the countercyclical regulatory capital buffer requirements for banks Drehmann, Borio and Tsatsaronis (2011) had concluded after investigating the performance of different variables that the gap between the ratio of credit to GDP and its long-term backward-looking trend performs best as an indicator for the accumulation of capital. On the other hand other indicators, such as credit spreads, are better at indicating the release phase.

For the institutions that are defined as globally systemically important (G-SIFI) according to their size, cross border activities and interconnectedness another obligatory buffer is introduced and will be effective after January 2016. Those institutions will have to fulfil a G-SII Buffer composed of CET1 quality, which is going to be set among 1% and 3.5%.

[9] European Commission Memo 13/690 p.14, 16.07.2013.

For institutions that are classified as important domestically or EU wide another buffer is defined. O-SII buffer is limited to the %2 CET1of RWAs. It is not a mandatory buffer. The supervising authority may require the institution to establish if necessary. O-SII buffer will be applicable after 2016.

The Systemic Risk Buffer composed of compulsory G-SII and O-SII buffers are limited to 5% in total. Buffer rates above this ratio will be authorised by EU Commission regarding the opinions of EBA and ESRB.

The large banks were at the centre of the global financial crisis. Their increasing number, tendency to have lower capital ratios, less stable funding and more exposure to potentially risky market-based activities turned the focus of the debate on systemic risk on them. Laeven, Ratnovski and Tong (2014) had found that systemic risk grows with bank size and is inversely related to bank capital, and this effect exists above and beyond the effect of bank size and capital on standalone bank risk. This study and similar studies are important to indicate the significance of precautions on wellbeing of systematically important institutions.

4.3.2 Capital Requirements and Adequacy in North Cyprus

North Cyprus regulation uses the same measure as capital adequacy ratio, Own Funds as a percentage of risk weighted assets (RWAs). Since February 2001, when the first regulation on capital adequacy came in force, banks were asked to maintain a ratio of minimum 8%. After the global debt crisis Central Bank of North Cyprus made an amendment on the regulation and by July 2009 banks were required to maintain a capital adequacy of minimum 10%.

On January 2014 another important amendment was made to the regulation on capital adequacy and a 2% precautionary capital is added over 10% minimum capital.

In the January 2014 amendment other major changes has been made which would be in force from July 2014. One of these amendments is about deducting the loans granted to a risk group exceeding 25% of own funds of the institution, from the own funds. The significance of this adjustment comes from the bank law article 23(2) (A). Article 23(2) (A) allows banks to determine the upper limit to extend loan to a risk group according to two criteria whichever is higher. One of them is up to 25% of own funds and the other one is up to 4% of the total deposits to the bank, whichever is higher.

After this amendment banks were forced to make efforts on increasing their capital, not only their customers' deposits, in order to be able to finance their major loan customers. As a first response some of the banks decreased their exposures to major customers, some of them postponed to distribute dividends in order to maximize the amount of own funds to get adapted to this amendment. This was a difficult period for both banks and their loan customers. Some banks were very close to lose their important customers because the confidence established in long years was shaken as the banks were not able to extend any more loans or even call some utilised loans back. Some customers were constrained to establish new credit lines with other banks. This period possibly caused a temporary downturn in economic activity.

Another item in the January 2014 amendment was related with Bank Law Article 23(2) (C). This article regulates restrictions about credits which have state guarantee

as collaterals. According to 23(2) (C), the sum of all credits utilised by a bank cannot exceed the amount of own funds. The revised article 3(1) (h) says the amounts exceeding the value of own funds should be deducted from own funds.

The last amendment on 3(1) (h) in July 2014 was about qualified partners. Article 24(1) of banking law says that shareholders owning 10% or more shares of the institution and their risk group, cannot be credited more than 20% of own funds. 3(1) (h) declares that the amounts excess of this limit will be deducted from own funds as well.

In case of failure to maintain 12% precautionary capital or 10% minimum ratio banks are subject to the sanctions of article 37 of Bank Law 39/2001. Article 37 regulates the precautions about strengthening the financial structure of a bank.

In case of failure to maintain 12%precautionary capital or in cases where restrictions in article 3(1) (h) of the regulation exceeded are subject to sanctions for the following six months after the breach. Banks subject to these sanctions cannot:

- Open branches;
- Transfer capital to existing or new subsidiaries, affiliates and joint ventures;
- Extend new loans to board members, credit committee members, general managers, vice managers and their risk groups also to the risk group including the institution and to public authority;
- Buy new immovable;
- Invest in fixed assets exceeding 2% of their own funds at the period when the institution first breached.

In January 2015 a new set of amendments were introduced to capital adequacy regulation. These were complementary amendments to the set introduced in June 2014. The amendments include minor corrections about Contributed Capital; items allowing subordinated debts to be converted in equity shares or to be reclassified if the bank is about to fail and the Central Bank had to intervene according to article 37 of Banking Law; items about subordinated debts' registration and allowance by the Central Bank to be added to Contributed Capital; some additions to the deductions from own funds and adaptations in case of inconsistency with the regulation.

With the amendments in January 2015 Central Bank broadened control on subordinated debts. It is ensured that it will not be allowed for the institution to finance the debt directly, indirectly or reciprocally. Also conditions on registering a loan as a subordinated debt are tightened. On the other hand conditions of deleting the subordinated debt from the record are clarified.

With the amendment made in article 3 (1) (f) the expression 'Subordinated loans extended to the banks in North Cyprus' is altered covering all the subordinated debts extended to banks and other financial institutions locally and internationally to be deducted from Own Funds.

The amendment in January 2014 included article 3 (1) (h) which said all the credits extended by a bank and exceeds 25% of Own Funds will be deducted from Own Funds by the exceeded amount. With the addition of 3 (1) (h) (a) in January 2015 amendment, deposits made to any bank in Turkey with maturity not exceeding three months are subject to criteria in article 23(2) (A) of Bank Law which allows banks to

determine the upper limit to extend loan to a risk group according to two criteria whichever is higher. One of them is up to 25% of own funds and the other one is up to 4% of the total deposits to the bank, whichever is higher.

This change allowed banks with excess funds to make deposits to banks in Turkey. This amendment was done due to request from the banking sector itself. After the January 2014 amendment North Cyprus banks realized that they were not able to hold deposits by their correspondent banks in Turkey. Setting up new correspondences required time and splitting the amount both decreased the deposit rate and increased the fees for other banking instruments.

Another item added to Deductions from Own Funds is 'The excess of the deposits to the branches or headquarters in other countries and the funds utilized from them, if any'. This item aims mostly the branches of banks operating in Turkey. Formerly deposits to the branches or headquarters in other countries were treated as credits extended, but funds utilized were not taken into account.

Also prepaid taxes and dividends that are decided to be paid to shareholders are included in the items to be deducted from Own Funds. The second item is especially important here as dividends sometimes can be significant in capital adequacy ratio calculation and can mislead the evaluators.

In January 2015 amendment sanctions were subject to change as well. The sanctions on maintaining precautionary capital ratio loosened. Banks who are not able to maintain 12% will not be subject to Article 37 of Bank Law 39/2001 any longer.

However the other sanctions forbidding opening new branches; transferring capital to existing or new subsidiaries, affiliates and joint ventures; extending new loans to board members, credit committee members, general managers, vice managers and their risk groups also to the risk group including the institution and to public authority; buying new immovable and investing in fixed assets exceeding 2% of their own funds at the period when the institution first breached and restrictions on dividend payments are still valid.

These sanctions are regulated to last for six months. They aim to prevent the shareholders and management of the bank to distribute banks own funds and maintain the 2% buffer again. This is also an early warning to management and shareholders indicating they are on a path leading to strict and rigid restrictions of Article 37 of Bank Law 39/2001 unless they reverse the situation. This six month sanction is enough for a bank to replace the 2% with profits and other measure including capital injection.

Chapter 5

CONCLUSION AND POLICY IMPLICATIONS

The improvement from Basel II to Basel III is a result of deficits of the predecessor. The global debt crisis in 2007-2008 caused authorities to recognise that in a global financial market with free and dynamic financial mobility it is harder to regulate and supervise the financial markets and institutions.

The global debt crisis turned out to a Eurozone debt crisis in late 2009 and its effects are still ongoing. Following Basel Committee European Commission adopted regulations called CRD IV and established Single Supervisory Mechanism and Single Rulebook simultaneously. Apparently the aim is harmonisation of the legislation and supervision practices across the union.

Turning our scope to Bank Capital, with amendments in CRD and introducing CRR, EU increased the share of Common Equity Tier 1 Capital from %2 to 4.5% of 8%. The brand new capital buffers are also required to be in CET1 quality. The criteria of CET1 are also narrowed. This narrowing seems to aim decreasing diversification between member states on what is called CET1 capital. On May 2014 European Banking Authority has published the list of capital instruments across the EU that national supervisory authorities have classified as Common Equity Tier 1. The list includes the details such as the name of the instruments, governing law, voting rights, if the instrument is issued in addition to other instruments or is it related to a

state aid etc. It can be seen that some countries have over ten different kinds of capital instruments with various characteristics (Germany 17, France 10, Austria 10) on the other hand some member states have one or two capital instruments (The Netherlands 2, Denmark 2, Cyprus 2, Estonia 1).

Decomposition of CRD IV reveals us that the regulation is in the search of a form of capital that is always ready to be used in an emergency situation, when the economy is slowing down and liquidity of financial instruments are very low. Therefore capital instruments are put on a tough test to prove that they meet CET1 quality of Regulation (EU) 575/2013.

Table 5.1: North Cyprus Banking Sector Capital Adequacy Ratio

Capital Adequacy Ratio	2012	2013				2014		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
	20.61	20.28	19.25	19.42	18.60	17.40	17.48	17.66

Looking at the performance of North Cyprus Banking Sector over the last two years by means of capital adequacy ratio, it can be observed that it is well above 10%, North Cyprus' minimum capital adequacy ratio, 12% precautionary Capital ratio and 8% EU capital adequacy ratio. Yet our main concern is how they would perform in means of capital adequacy ratio if CRD IV criteria would be applied. Regulation (EU) 575/2013 has emphasis on quality of the capital and therefore CET1, the purest form of capital. The concentration of minimum required ratio is altered and the share of CET1 is increased from 2% to 4.5%. Furthermore added capital buffers are calculated in terms of CET1.

Analysing constituent items it can be observed that (See Appendix B) Tier 1 items of Regulation EU 575/2013 are fully matched with North Cyprus Regulation Core Capital and Contributed Capital (Together forming Own Funds). However there are 10 unmatched items among items that should be deducted from CET1 in calculating Own Funds. Among these 10 items only two deductions seem to have negative effects that may differentiate Own Funds of North Cyprus from CET1 of EU. These two items seem to have negligible effects when their share in the balance sheet of the financial sector of North Cyprus is considered. Other unmatched items which are estimated to have no effects are either items with no possibility to arise in North Cyprus due to regulations and market conditions or optional items that are not mandatory to use in CET1 calculation.

With present regulation and current market conditions North Cyprus Banks does not have major problems in terms of capital adequacy in adapting EU criteria. Their Own Funds meet the conditions of Regulation (EU) 575/2013 by means of Common Equity Tier 1 Capital. This consequence has several reasons. One of them is poor securities and financial markets. For this reason complicated capital instruments did not arise and the institutions' capital are mostly composed of paid up capital. Another reason is the limitations on subsidiaries and affiliates. Regulation (EU) 575/2013 spends too much energy on cleaning out capital instruments funded through subsidiaries by the institution itself. With uncomplicated capital instruments it is easier for the supervisor to detect cross holdings.

Considering the importance of the financial institutions for the development and sustainability of stable economies and the loss they can cause domestically and

globally, also regarding the increasing volume and diversity of the cross border activities, the capital instruments of financial institutions should be regulated very strictly. The capital instruments should be in their simplest form to be used as common equity for financial institutions for a better supervised and functioning financial sector and institutions.

On the other hand, North Cyprus regulation should be updated according to the Basel III criteria and CRD IV package of EU taking the advantage of similar basis stemming from Basel accord. For now some missing items in current regulations have insignificant effects due to current market conditions as in the case of capital instruments or practices as in the case of Defined Pension Fund Assets. But this should not hinder the regulator from keeping the regulations up to date. Among all others the regulations on consolidated reporting standards and consolidated supervision of institutions and their affiliates seems most urgent topic to be updated in compliance with the IFRS rules.

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APPENDICES

Appendix A: Details of Tier 1 Capital of EU vs. Core and Contributed Capitals

North Cyprus

	EU Regulation		North Cyprus Regulation
1	***Tier 1 Capital***	**1**	***Core Capital***
1.1	***Elements of Common Equity Tier 1 Capital***	**1.1**	***Elements of Core Capital***
a	capital instruments	i	Paid-up capital
b	share premium accounts related to the instruments referred to in point (a)	ii	Legal reserves
c	retained earnings;	iii	Discretionary and Extraordinary Reserves
d	accumulated other comprehensive income;	iv	Profit of the Period (After Tax Provision)
e	other reserves;	v	Profit of the Previous Periods
f	funds for general banking risk.	**1.2**	***Deductions From the Core Capital***
1.2	***Deductions From Common Equity Tier 1 Items***	vi	Loss of the Period
g	Losses for the current financial year;	vii	Loss of the Previous Periods
h	Intangible assets;	viii	Intangible assets
i	Deferred tax assets that rely on future profitability;	ix	Prepaid Expenses
j	For institutions calculating risk-weighted exposure amounts using the Internal Ratings Based Approach (the IRB Approach), negative amounts resulting from the calculation of expected loss amounts	x	Goodwill
k	Defined benefit pension fund assets on the balance sheet of the institution;	**1.3**	***Contributed Capital***
l	Direct, indirect and synthetic holdings by an institution of own Common Equity Tier 1 instruments, including own Common Equity Tier 1 instruments that an institution is under an actual or contingent obligation to purchase by virtue of an existing contractual obligation;	xi	Funds For General Banking Risk.
m	Direct, indirect and synthetic holdings of the Common Equity Tier 1 instruments of financial sector entities where those entities have a reciprocal cross holding with the institution that the competent authority considers to have been designed to inflate artificially the own funds of the institution;	xii	Tangible Fixed Assets Re-Valuation Differences
n	The applicable amount of direct, indirect and synthetic holdings by the institution of Common Equity Tier 1 instruments of financial sector entities where the institution does not have a significant investment in those entities;	xiii	Subsidiaries, Affiliates and Jointly Controlled Partnerships (Joint Ventures) Re-Valuation Differences
o	The applicable amount of direct, indirect and synthetic holdings by the institution of the Common Equity Tier 1 instruments of financial sector entities where the institution has a significant investment in those entities;	xiv	Subordinated Debts
p	The amount of items required to be deducted from Additional Tier 1 items pursuant to Article 56 that exceeds the Additional Tier 1 capital of the institution;	xv	Other Reserves
q	The exposure amount of the following items which qualify for a risk weight of 1 250 %, where the institution deducts that exposure amount from the amount of Common Equity Tier 1 items as an alternative to applying a risk weight of 1 250 %:	xvi	Securities Valuation Differences

i	Qualifying holdings outside the financial sector;	**1.4**	***Deductions From Own Funds***
ii	Securitisation positions, in accordance with Article 243(1)(b), Article 244(1)(b) and Article 258;	xvii	Amounts invested in Subsidiaries, Affiliates and Jointly Controlled Partnerships (Joint Ventures)
iii	Free deliveries, in accordance with Article 379(3);	xviii	Set-up Expenses and capitalized expenses
iv	Positions in a basket for which an institution cannot determine the risk weight under the IRB Approach, in accordance with Article 153(8);	xix	Losses in amounts invested in Subsidiaries, Affiliates and Jointly Controlled Partnerships (Joint Ventures)
v	Equity exposures under an internal models approach, in accordance with Article 155(4).	xx	Subordinated loans extended to local and international banks and other financial institutions
r	Any tax charge relating to Common Equity Tier 1 items foreseeable at the moment of its calculation, except where the institution suitably adjusts the amount of Common Equity Tier 1 items insofar as such tax charges reduce the amount up to which those items may be used to cover risks or losses.	xxi	The amounts loaned to a risk group, exceeding 25% of own-funds
1.3	***Additional Tier 1 capital***	xxii	The credits under state guarantee exceeding own funds in amount
s	Capital instruments, where the conditions laid down in Article 52(1) are met;	xxiii	The amounts over 20% of own funds extended as a loan to shareholders owning 10% or more shares of the institution
t	The share premium accounts related to the instruments referred to in point (a).	xxiv	The amounts of commodities and real estates (after amortisation) exceeding 50% of institutions own funds
2.1	***Tier 2 capital***	xxv	Amounts of Contributed Capital exceeding the amount of Core Capital
u	Capital instruments and subordinated loans where the conditions laid down in Article 63 are met;	xxvi	Prepaid Expenses and Prepaid Taxes
v	The share premium accounts related to instruments referred to in point (a);	xxvii	Dividends that are decided to be paid
w	For institutions calculating risk-weighted exposure amounts in accordance with Chapter 2 of Title II of Part Three, general credit risk adjustments, gross of tax effects, of up to 1,25 % of risk-weighted exposure amounts calculated in accordance with Chapter 2 of Title II of Part Three;	xxvii	The excess of the deposits to the branches or headquarters in other countries and the funds utilized from them, if any.
x	For institutions calculating risk-weighted exposure amounts under Chapter 3 of Title II of Part Three, positive amounts, gross of tax effects, resulting from the calculation laid down in Articles 158 and 159 up to 0,6 % of risk weighted exposure amounts calculated under Chapter 3 of Title II of Part Three.		

Appendix B: Summary Table of the Comparison of Own Funds Items

	Regulation 575 Item	North Cyprus Reg. Item	Effect if Unmatched
CET1 Items	a	i	
	b	i	
	c	iv	
	d	v	
	e	ii + iii+ xv	
	f	xi	
Deductions From CET1	g	vi	
	h	viii + ix + x	
	i	unmatched	Negative
	j	unmatched	No
	k	unmatched	Negative
	l	unmatched	No
	m	unmatched	No
	n	xvii	
	o	xvii	
	p	unmatched	No
	q(i)	xvii	
	q(ii)	unmatched	No
	q(iii)	unmatched	No
	q(iv)	unmatched	No
	q(v)	unmatched	No
	r	iv + v	
Additional Tier 1 Items	s	unmatched	No
	t	unmatched	No
Tier 2 Items	u	Article 2 c of reg. On CA	
	v	Article 2 c of reg. On CA	
	w	unmatched	No
	x	unmatched	No

Appendix C: Article 52 of Regulation (EU) 575/2013

1. Capital instruments shall qualify as Additional Tier 1 instruments only if the following conditions are met:

(a) the instruments are issued and paid up;

(b) the instruments are not purchased by any of the following:

(i) the institution or its subsidiaries;

(ii) an undertaking in which the institution has a participation in the form of ownership, direct or by way of control, of 20 % or more of the voting rights or capital of that undertaking;

(c) the purchase of the instruments is not funded directly or indirectly by the institution;

(d) the instruments rank below Tier 2 instruments in the event of the insolvency of the institution;

(e) the instruments are not secured, or subject to a guarantee that enhances the seniority of the claims by any of the following:

(i) the institution or its subsidiaries;

(ii) the parent undertaking of the institution or its subsidiaries;

(iii) the parent financial holding company or its subsidiaries;

(iv) the mixed activity holding company or its subsidiaries;

(v) the mixed financial holding company or its subsidiaries;

(vi) any undertaking that has close links with entities referred to in points (i) to (v);

(f) the instruments are not subject to any arrangement, contractual or otherwise, that enhances the seniority of the claim under the instruments in insolvency or liquidation;

(g) the instruments are perpetual and the provisions governing them include no incentive for the institution to redeem them;

(h) where the provisions governing the instruments include one or more call options, the option to call may be exercised at the sole discretion of the issuer;

(i) the instruments may be called, redeemed or repurchased only where the conditions laid down in Article 77 are met, and not before five years after the date of issuance except where the conditions laid down in Article 78(4) are met;

(j) the provisions governing the instruments do not indicate explicitly or implicitly that the instruments would or might be called, redeemed or repurchased and the institution does not otherwise provide such an indication, except in the following cases:

(i) the liquidation of the institution;

(ii) discretionary repurchases of the instruments or other discretionary means of reducing the amount of Additional Tier 1 capital, where the institution has received the prior permission of the competent authority in accordance with Article 77;

(k) the institution does not indicate explicitly or implicitly that the competent authority would consent to a request to call, redeem or repurchase the instruments;

(l) distributions under the instruments meet the following conditions:

(i) they are paid out of distributable items;

(ii) the level of distributions made on the instruments will not be amended on the basis of the credit standing of the institution or its parent undertaking;

(iii) the provisions governing the instruments give the institution full discretion at all times to cancel the distributions on the instruments for an unlimited period and on a non-cumulative basis, and the institution may use such cancelled payments without restriction to meet its obligations as they fall due;

(iv) cancellation of distributions does not constitute an event of default of the institution;

(v) the cancellation of distributions imposes no restrictions on the institution;

(m) the instruments do not contribute to a determination that the liabilities of an institution exceed its assets, where such a determination constitutes a test of insolvency under applicable national law;

(n) the provisions governing the instruments require that, upon the occurrence of a trigger event, the principal amount of the instruments be written down on a permanent or temporary basis or the instruments be converted to Common Equity Tier 1 instruments;

(o) the provisions governing the instruments include no feature that could hinder the recapitalisation of the institution;

(p) where the instruments are not issued directly by an institution, both the following conditions shall be met:

(i) the instruments are issued through an entity within the consolidation pursuant to Chapter 2 of Title II of Part One;

(ii) the proceeds are immediately available to the institution without limitation and in a form that satisfies the conditions laid down in this paragraph.

The condition set out in point (d) of the first subparagraph shall be deemed to be met notwithstanding the instruments are included in Additional Tier 1 or Tier 2 by virtue of Article 484(3), provided that they rank pari passu.

Appendix D: Article 63 of the Regulation EU 575-2013

Capital instruments and subordinated loans shall qualify as Tier 2 instruments provided the following conditions are met:

(a) the instruments are issued or the subordinated loans are raised, as applicable, and fully paid-up;

(b) the instruments are not purchased or the subordinated loans are not granted, as applicable, by any of the following:

(i) the institution or its subsidiaries;

(ii) an undertaking in which the institution has participation in the form of ownership, direct or by way of control, of 20 % or more of the voting rights or capital of that undertaking;

(c) the purchase of the instruments or the granting of the subordinated loans, as applicable, is not funded directly or indirectly by the institution;

(d) the claim on the principal amount of the instruments under the provisions governing the instruments or the claim of the principal amount of the subordinated loans under the provisions governing the subordinated loans, as applicable, is wholly subordinated to claims of all non- subordinated creditors;

(e) the instruments or subordinated loans, as applicable, are not secured, or subject to a guarantee that enhances the seniority of the claim by any of the following:

(i) the institution or its subsidiaries;

(ii) the parent undertaking of the institution or its subsidiaries;

(iii) the parent financial holding company or its subsidiaries;

(iv) the mixed activity holding company or its subsidiaries;

(v) the mixed financial holding company or its subsidiaries;

(vi) any undertaking that has close links with entities referred to in points (i) to (v);

(f) the instruments or subordinated loans, as applicable, are not subject to any arrangement that otherwise enhances

Appendix E: Article 155(4) of the Regulation EU 575-2013

Under the internal models approach, the risk weighted exposure amount shall be the potential loss on the institution's equity exposures as derived using internal value-at-risk models subject to the 99th percentile, one-tailed confidence interval of the difference between quarterly returns and an appropriate risk-free rate computed over a long-term sample period, multiplied by 12,5. The risk weighted exposure amounts at the equity portfolio level shall not be less than the total of the sums of the following:

(a) the risk weighted exposure amounts required under the PD/LGD[10] Approach; and

(b) the corresponding expected loss amounts multiplied by 12,5.

The amounts referred to in point (a) and (b) shall be calculated on the basis of the PD values set out in Article 165(1) and the corresponding LGD values set out in Article 165(2).

Institutions may recognise unfunded credit protection obtained on an equity position.

[10] PD: Probability of Default, LGD: Loss Given Default

Appendix F: Articles 243(1) (b), Article 244(1) (b) and Article 258 of the Regulation EU 575-2013

Article 243(1) (b): the originator institution applies a 1 250 % risk weight to all securitisation positions it holds in this securitisation or deducts these securitisation positions from Common Equity Tier 1 items in accordance with Article 36(1)(k).

Article 244(1) (b): the originator institution applies a 1 250 % risk weight to all securitisation positions it holds in this securitisation or deducts these securitisation positions from Common Equity Tier 1 items in accordance with Article 36(1)(k).

Article 258: Where a securitisation position is assigned a 1 250 % risk weight, institutions may in accordance with Article 36(1)(k), as an alternative to including the position in their calculation of risk-weighted exposure amounts, deduct from Common Equity Tier 1 capital the exposure value of the position. For these purposes, the calculation of the exposure value may reflect eligible funded credit protection in a manner consistent with Article 257.

Where an originator institution makes use of this alternative, it may subtract 12.5 times the amount deducted in accordance with Article 36(1)(k) from the amount specified in Article 252 as the risk-weighted exposure amount which would currently be calculated for the securitised exposures had they not been securitised.