

# A Research on the Ethical Dimension of Banking Crises in the Turkish Republic of Northern Cyprus (TRNC)

By: Okan Veli Safakli

OSAFAKLI@NEU.EDU.TR

## Abstract

In an era of sustainable economic development models there is an increased attention on sectoral compatibility, environmental protection, and professional ethics. As in the past, the banking and finance sector is still considered to be the heart of all development models. Financial institutions such as banks provide the necessary funds for all the manufacturing or service organizations in all the sectors. Therefore stability in the finance sector is necessary for the stability in all the other sectors. Analysing the recent bank and business failures it can be seen that the business and professional ethics is one of the most important elements of stability in banking and finance industries. In this respect, the basic objective of this study is to look at the ethical issues among the reasons for the recent bank failures and outline the professional and business ethics that has to be adopted in order to provide stability in the banking and finance sector of TRNC. As the summary It can be asserted that the most serious ethical problems which led to financial crises in TRNC were, connected lending, credits without adequate collaterals, favoritism by the management, inadequate use of funds, dealing in non-financial activities, political interference, lack of accountability, illegal use of funds, lack of transparency, and risky investments with low returns.

## 1. Introduction

Analysis of the bank and financial institution failures in different parts of the world shows that the ethical issues are among the most important reasons behind these failures. Failure to adopt the banking laws and regulations is among the primary reasons for bank failures. Even the larger banks are deemed to fail by not adopting to the banking regulations (Ayyoup 2002). Some of the common non-ethical behaviours in the banking sector are, bribery, misuse of authority, and exploitation (Hauri 2000; Carse 1999). ICAC (Independent Commission Against Corruption) investigated around 250 banks for corruption between 1997 and 2001 and found out that many top professionals/managers acted as if they are the owners of the banks and the banks' funds (Lai 2001). Another ethical dimension in banking industry is named as the connected lending (Eichengreen & Rose 1988, pp.2; Hoenig, 1999). Connected lending is described as lending to the owners, managers, and the relatives and close business associates. According to the 1992 Basel report as many as 90% of the countries limit the credit level at maximum 60% of the total paid up capital for a single client. In developed countries the maximum amount of credit for a single client is limited at 25% of paid up capital (Goldstein & Turner 1996, pp.21). While some of the connected lending may be done in bad faith, failure for appropriate risk analysis also causes problems in connected lending (Karabulut 2002, pp.55). Lack of transparency, which is shown as a microeconomic reason for bank failures, is also an ethical issue. Lack of transparency, which emanates from lack of regulations, prevents the clients and the shareholders from obtaining adequate information (Coşkun 2001, pp.4). Some of the other ethical issues concerning the banking industry are the political interferences, such as using influence to finance risky public investments (Parasız 2000, pp.227; Öçal & Çolak 1999, pp 284-285). Moral hazard risk is present when one of the parties

has false intentions, gives wrong information, exaggerated and overvalued collaterals, and taking inappropriate risks for gaining personal profit at the banks' expense (Süer 2002, pp.21; Mishkin 1998, pp.35). In this respect, the main aim of this study is to research on the causes of banking crises in the Turkish Republic of Northern Cyprus (TRNC) with particular emphasis on ethical dimension. With this perspective, first, ethical dimension of the banking industry will be outlined. The study will follow with the findings of the research on the bank failures. The report will intensify on the ethical issues and recommendations will be offered in order to avoid such problems.

## 2. Concept of ethics in banking

Financial sector in general and banking sector in particular are important instruments of speedy economic growth and development. Other than financing, banks play an important role in restructuring the economy and to bring about a long-term sustainable macroeconomic stability. Banks are critical organizations for stability and development of the economy. Success of the banks, both in short and long term depend on trust and confidence between the all parties (Arrow 1972; Deiss 2001). Ethical values and behaviour play very important role in creating and maintain mutual trust and confidence. Banks should never forget the importance of ethical behaviour while aiming to maximize their profit.

Conceptually, ethics refers to well base standards of right and wrong that prescribe what humans ought to do, usually in terms of rights, obligations, benefits to society, fairness, or specific virtues. Moral and ethics are closely related. In many instances ethics is used as alternative name for moral (TBB 2003a, pp.2). When looked at the banking sector, ethics can be described as the appropriate behaviour to create mutual benefit for the stakeholders such as the clients, depositors, shareholders and the employees. In other words while carrying out the business activities

the bank must aim at the goodness, rightfulness and the lawfulness rather than bad, wrong and unlawfulness (Hong Kong monetary Authority 1999, pp.71). Within these principles, the banks must carry out their responsibilities by implementing an effective and efficient deposit-credit system, to avoid any negative effect to the public, to be environmentally concerned in the public interest, to obtain confidence by safeguarding the clients' interest and to provide overall stability within and around the bank (Awoke 2003, pp.2). After this conceptual introduction, banking ethics can be described as honesty, impartiality, trustworthiness, compatibility to the banking regulations, and transparency (TBB 2003b; Office of the Banking Adjudicator 2003; Longstaff 1993). Short explanations of these are as follows:

- + Honesty: Banks must be honest to their clients, employees, shareholders, competitors and the other organizations that they are in touch (Australasian Institute of Banking & Finance 2003).

- + Impartiality: Banks should not differentiate between the clients, or the clients and the employees or between any of the stakeholders.

- + Trustworthiness: Banks must carry out all their activities timely, precisely, accountably, and accurately, and inform their clients accordingly (Hellenic Bank Association 1977, pp.12)

- + Compatibility to the banking regulations: banks must carry out all their activities in accordance to the banking rules and regulations (Hungarian Banking Association 1999, Ayyoub 2002).

- + Transparency: Banks must give clear and easily understandable information about their products, services, risks and benefits to their clients. (Hellenic Bank Association 1997 pp. 11)

### 3. Results of the banking crises in TRNC

Banks are established and function under the law 39/2001 which was accepted and published in the official gazette numbered 122 on 23 November 2001. As of 2004, there are 2 state banks, 2 cooperative banks, 15 commercial private banks and 6 foreign branch banks, totaling to 25 banks operating in TRNC (TRNC Central Bank 2005, p. 29). 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.

According to the law 39/2001 the minimum paid up capital requirement for banks is \$2,000,000 (Two million American Dollars) (İhtisas Komisyonu 2002, pp.2).

As stated earlier 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 cost of the banking crises is 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 (DPÖ 2002, pp.2-3).

As natural consequences of the bank failures the bank accounts were adversely affected. After the crises of 2001 there are negative developments in the saving accounts. Total savings in the January-May period in 2000 had increased by 27.9% at current prices from 172,426,892.0 million TL to 220,469,922.0 million TL. The increase in the same period in 2001 dropped to

12.7% from 292,771,506.0 million TL to 329,882,343.0 million TL. But since the increase in the consumer's price index in the same period increased by 34.53%, this means that there is decrease in the savings in real terms.

There is also a real decrease in the savings in the 12-month period. The increase in the consumer prices in May 2000 – May 2001 were 70.8% while the increase in the savings in the same period was only 49.6%. The share of the current accounts in the total savings in the period January May 2000 was increased to 19.6% from 14.1% the year before. The rate of the interest accounts decreased to 80.4% from 85.9% in the past period. The share of the current accounts in total accounts in 2001 decreased to 23.5% from 29%. The share of the interest accounts increased to 76.5% from 71%.

Total current accounts in twelve-month period May 2000-May 2001 decreased by 15.1% from 504,249.1 thousand dollars to 428,928.8 thousand dollars. Interest currency accounts reduced by 25.2% from 328,879.6 thousand dollars to 246,025.6 thousand dollars. The current currency accounts has slightly increased by 3.9% from 175,369.5 thousand dollars to 182,263.2. Currency transactions are reducing year by year. Reduction in the May 2000-May 2001 period was as high as 48.1% from 3,460.1 thousand dollars to 2,015.3 dollars.

Total banking investment/credits during January-May 2000 period had decreased by current prices at 10.5% to 493,666,251.0 million TL from 551,339,571.0. The investment credit in the same period of 2001 increased by 39.8% from 525,442,898.0TL to 729,673,065.0 million Turkish Lira.

When the 12-month period, May2000-May 2001 is taken increase in the investments is at 47.8%. The consumer price increase in the same period is at 70.8%, which means that the growth is negative in real terms. The credits given out in this period intensified to public organizations, international trade, personal and business credits (DPÖ 2001, pp.50-53).

### 4. Basic causes of bank failures in TRNC and the dimension of ethical issues

Liberalization movements around the world influenced economic policies, which started to take shape in the beginning of the 1980's. Governments who adopted more liberal economic policies prepared the ground for competition by allowing more banks to be established. The liberalization movements had been especially effective in the banking sector. Number of the banks in the beginning of the 1980s was 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 the 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.

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 expands. 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 (Bektaş

2003).

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

#### 4.1 Basic Causes of the Bank Failures in TRNC

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 any 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 Causes

Following are the basic internal causes for bank failures:

##### 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 institutionalise.

It is clear from the accounts of the failed banks that these banks had inadequate 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.

##### 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 becomes a habitual incident. Banks neglect the regulations and take unnecessary high risk.

In TRNC, the Central Bank and the Ministry of the Economy and Finance carry out Auditing and observation of the banks. 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 favour 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 2003a, 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. Taking high risks did such financing usually.

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.

Law capital requirements were 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 which 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.

##### The Central Bank

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.

##### 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 (Akgüç 2000, pp.15). 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
- Banks 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.

##### Capital Adequacy

Unlike the other intuitions, 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 2003a, 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. Figure 1 shows the increase of the banks from 13 to 37 in just three years time while figure 2 shows the ratio of the equity capital to the GNP.

counts 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% (Cyprus today 2000).
- Banks accepted unaccounted deposits.

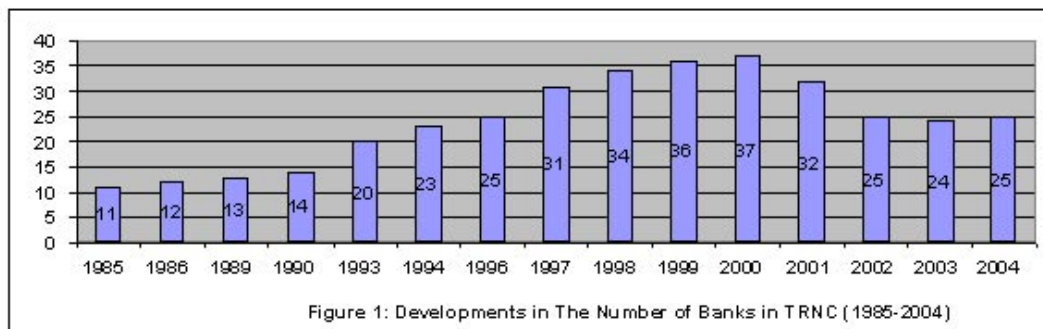


Figure 1: Developments in The Number of Banks in TRNC (1985-2004)

Source: (Şafaklı 2003b; TRNC Central Bank 2004, p. 25; Banks Association of Northern Cyprus (Unpublished Data))

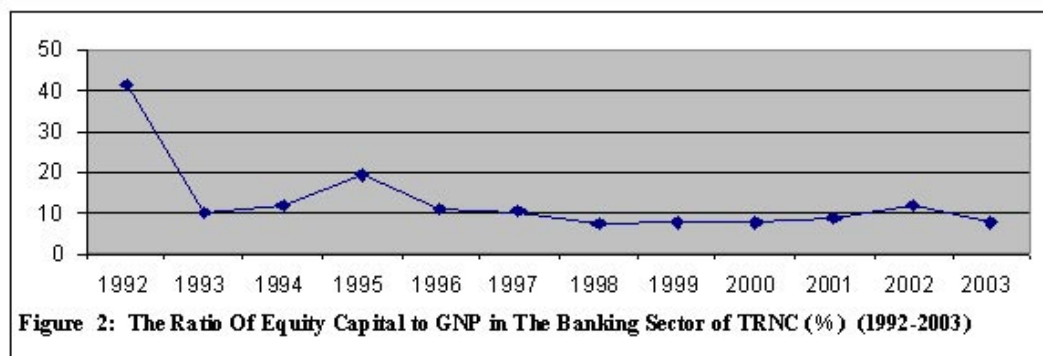


Figure 2: The Ratio Of Equity Capital to GNP in The Banking Sector of TRNC (%) (1992-2003)

Source: (Şahinkaya 2002, p. 275; SPO 2002, p. 177; <http://www.ildtomb.trnc.net/veriler/veriall.html>; SPO 2004, pp. 6-7; TRNC Central Bank 2004, pp. 23-24).

Findings of a survey carried out in 18 different countries including TRNC, South Cyprus and Turkey proved that TRNC was number one in the list for the number of banks per capita (Şafaklı 2003b).

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 (Bıçak & Menteşoğlu 1998, pp.539; Düzgün 1999, pp.239-240).

## 4.2 Ethical Dimension of the Bank Failures in TRNC

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 ac-

### 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.

## 5. Research method and main findings

In order to confirm the critical factors effective on the banking crises in the TRNC put forward in the descriptive analysis above, a research has been carried out in July 2005. For this research, 275 depositors of liquidated banks in different regions of TRNC were chosen randomly and they were interviewed face to face. The main findings of the research expressed in per-

centages are as follows:

## 5.1 Demographic Results

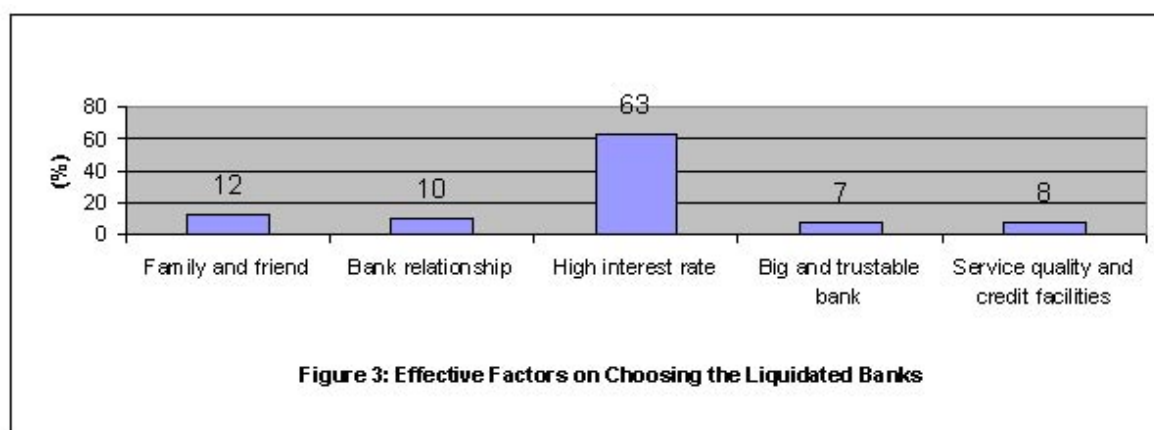
Demographic profile of depositors as shown in Table 1 is summarized as follows:

- Majority of depositors (66%) are male.
- When looked at the age distribution of depositors, it is seen that 70% of them are 34 and above.
- According to marital status, 66% of depositors are married.
- Educational status of depositors shows that they carry high intellectual capacity. Such that 78% of them have the educational level of high school or above while 41% of them possess university and postgraduate degree.

Factor	Category	Percent (%)
Sex	Male	66
	Female	34
Age	18-25	12
	26-33	18
	34 and above	70
Marital Status	Single	27
	Married	66
	Widow	7
Education	Primary	10
	Secondary	12
	High school	37
	University	30
	Post graduate	11

## 5.2 The Reason of Choosing Liquidated Banks and Responsible Authorities

- When interviewed with depositors, majority of them (63%) stated that basic motive driving them to deposit in liquidated banks was high interest rates (Figure 3).



- According to depositors' evaluation, fraud of bank owners represents the basic responsibility and/or guilty for the bankruptcy of liquidated banks (Figure 4).

## 5.3 Asymmetric Information and Ethical Behavior

In addition to the results of the research above, other per-

ceptions of depositors related to specially asymmetric information and ethical behavior are specified in Table 2 by using Likert type scale. Factors affecting the occurrence of the banking crises in TRNC have been inquired with a scale as follows: 1- I definitely disagree, 2- I disagree 3- I hesitate 4- I agree 5- I definitely agree. Two methods that are, percentage and arithmetic mean have been applied for the analysis of the findings obtained by the scale. For arithmetic mean calculation, the scale values have been used as (I definitely disagree=-2, I disagree=-1, I hesitate=0, I agree=+1, I definitely agree=+2). Findings obtained within this framework as shown in Table 2 have been summarized as follows:

- Depositors of liquidated banks did not have enough information about the financial position and riskiness of banks.
- The liquidated banks did not implement ethical principle of transparency.
- Depositors were not well informed about the deposit insurance system in TRNC.
- Liquidated banks illegally and unethically used the deposits for their own interest. Parallel to this, research also shows that owners of liquidated banks did not obey the ethical values (transparency, honesty) and unethical behavior of banks played important role in the occurrence of banking crises. Therefore, Board of Directors and top managers played an important role in the bankruptcy of liquidated banks
- Because of the asymmetric information and lack of professionalism, depositors did not feel the need of financial and other type of data about the liquidated banks.
- Naturally, as stated in the relevant theory, banks run accelerated the bankruptcy of banks.
- Research findings also show that TRNC Central Bank was not independent. Therefore, government intervention intended to finance specially budget deficit negatively influenced the banking crises and bankruptcy of liquidated banks.

## 6. Conclusion and recommendations

As a conclusion it could be stated that the ethical misconduct played an important role in bank failures in TRNC. The owners, the board of directors, top executives and the internal auditors

had been involved in unethical conduct prior to the bank failures. Furthermore, government intervention to Central Bank's independence proved to be both unethical and detrimental to the liquidity of banking sector. Moreover, high degree of asymmetric information and lack of transparency in the banking

sector of TRNC are other realities stated contrary to ethical behaviour. Risks were immensely increased since almost all the banks gave connected credits to the owners and the privileged board of directors. Most of such credits failed to be paid back. Allowing new banks to be established with as low as 50 billion TL capital was another critical mistake that contributed for the bank crises.

After the economic crises and the bank failures, the political

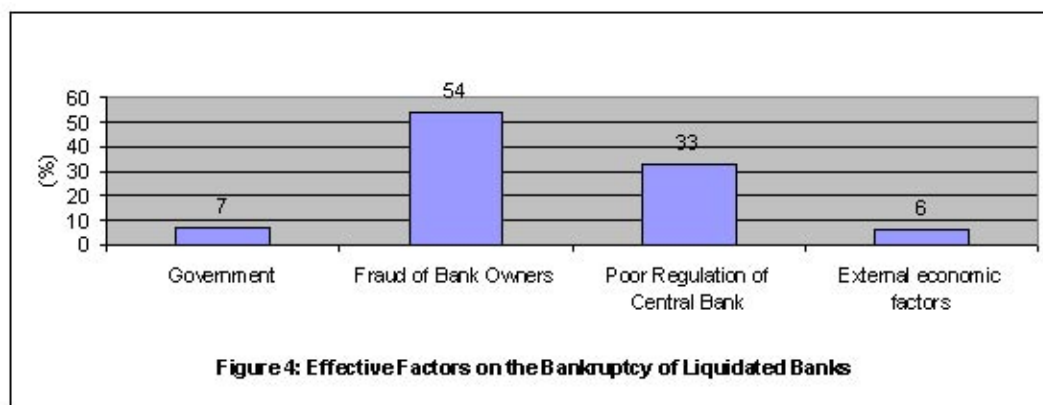
influence has been reduced on the sector. Permissions for new banks and branches are now left for the Central Bank. The Central Bank has also been removed from political influence. There are still a lot has to be done to build up ethical principles in the banking sector. In this respect, the following recommendations can be made:

• Holding Banks should be constantly under focus in order avoid connected lending.

• The Central Bank should publish a guide on ethical conduct and distribute these to the banks.

• Among the many criteria good personality, honesty and professionalism should be some of the values required for top executives, board membership and managers.

• Internal auditing should be carried out independently and



impartially.

• Training should be provided by the Central Bank to improve awareness on ethical issues.

• A transparent system must be created whereby the unethical behaviour of any bank is publicly known.

Table 2: Perception of Depositors Related to Banking Crises in TRNC

	1 (%)	2 (%)	3 (%)	4 (%)	5 (%)	Arithmetic Mean
Depositors were well informed about the financial performance and riskiness of liquidated banks	34	44	9	9	4	-0,96
Liquidated banks were transparent	28	41	19	11	1	-0.84
Depositors were well informed about the deposit insurance system	22	41	21	13	29	-0.14
Owners of liquidated banks obeyed the ethical values (transparency, honesty)	44	32	14	6	4	-1.06
Liquidated banks illegally used the deposits for their own interest	5	15	21	30	29	+0.63
Depositors did not want to learn the financial position of liquidated banks	7	18	13	44	18	+0.48
Board of Directors and top managers played an important role in the bankruptcy of liquidated banks	6	12	15	40	27	+0.70
Banks run accelerated the bankruptcy of banks	5	17	18	46	14	0.47
Dependent position of TRNC Central Bank negatively influenced the banking crises	6	14	25	40	15	0.44
Unethical behavior of banks played important role in the occurrence of banking crises	5	13	22	43	17	0.54

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## Okan Veli Safaklı

Near East University,  
Department of Banking and Finance,  
Nicosia-Northern Cyprus,  
Mersin 10 Turkey  
E-Mail: [osafakli@neu.edu.tr](mailto:osafakli@neu.edu.tr)