ASSESSMENT OF THE SUPERVISION ROLE OF THE NORTH CYPRUS CENTRAL BANK

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Abstract: Central Banks, bank of the banks, have very important role for ensuring price stability and financial stability. There are many tools that can be used for the price stability and financial stability. Among them, regulating and supervising the system is extremely important especially for the countries like North Cyprus that do not have its own currency and have limited monetary policy tools to control the financial sector. Apart from its other roles, North Cyprus Central Bank supervision role is very important and effective over the banks. As a result of the financial crises around the world, drawbacks of the traditional supervision were realized and supervisory authorities started shifting towards the Risk Based Supervision (RBS) technique. This particular study, abstract the North Cyprus Central Bank’s supervision role. At the same time, it gives the framework of the RBS technique and suggests some advises.

Keywords: Bank Supervision, Financial Stability, Risk Based Supervision, North Cyprus Central Bank, Basel


Anahtar Kelimeler: Banka Denetimi, Finansal İstikrar, Risk Odaklı Denetim, Kuzey Kıbrıs Merkez Bankası, Basel

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1. INTRODUCTION

The aim of the paper is to analyze the Supervisory Role of the Central Banks (CBs) other than the Monetary Policy issues. It is well known that the primary objective of the CBs is to maintain financial stability. Financial stability can be ensured by the monetary policy tools and by the effective supervision of the Financial Institutions, especially Banks. The structure of the North Cyprus CB and the supervisory role of the North Cyprus CB is subject of discussion, because North Cyprus CB does not have its own currency. Thus, it has limited power to use monetary policy tools for the financial stability. However, it has unlimited power to supervise and regulate the system by its regular supervisions.

As a result of a consecutive financial crisis, responsibilities of the Central Banks tended to elaborate the institutionalization of the supervision. With this respect, as a result of the global financial crisis in the past, series of Basel-I and Basel-II were implemented. After the mortgage crisis, which took place in the USA in 2007, extended to Europe, and created deep financial crisis, the Basel-III arrangements came into order. As problems diverse and legal arrangement deficiencies come out, international organizations, like Bank for International Settlement (BIS), came up with radical changes over the banks by asking new, needed and beneficiary arrangements. The only way of controlling those imposed arrangements is the subject of effective supervision.

Furthermore, CBs have to be focused on price stability with financial stability. CBs have privileged positions to monitor the financial markets and the economic cycles and as a result, they have valuable information. CBs have autonomous power and information accumulation, which put them into the heart of the finance world as an advisory institution of the whole system. CBs mostly have supervision task and partially they have advisory role for the banking sector (Mankiw and Taylor 2011: 831).

The purpose of the paper is to study the supervision technique that is used in practice at North Cyprus CB and evaluating the strengths and weaknesses of it. At the same time, to guide the supervisors for the RBS technique. Finally, similarities and differences of its role with other countries CBs will be discussed and some suggestions will be afforded. Understanding the importance of the reactive supervision techniques and hint the management for the potential lost. The results of this study will be a useful guide for the North Cyprus CB supervisors, Banks Internal Auditing Departments and for the External Auditors. This paper hopefully will add value to the literature since it is the only academic research on the subject for the North Cyprus which is a rare case. The design of the research is based on literature survey and secondary data collection.
It is believed that, Risk Based Supervision (RBS) is the way that CBs (or other legal authorities) moving on, however, traditional supervision should continue together with the RBS for many years. RBS, proactive technique for supervision, have priorities over traditional supervision technique which is mostly reactive. On the other side, RBS technique needs well donated historical data sets for the scenario analysis and stress tests, also well donated staff to conduct a forecasting analysis.

In part two, you may find the information about the Central Banks and their functions. In part three, history and basic functions of the North Cyprus CB and its differences from other CBs are discussed. In part four, the topic will be the discussion of risk management. How financial stability was ensured by the North Cyprus CB with bank supervision, the needs for alternative supervision techniques, comparisons of the traditional supervision with the RBS technique will be analyzed. In part five, historical background of the supervision, traditional supervision and RBS techniques will be evaluated in depth. Strengths and weaknesses of both techniques will be analyzed and some suggestions will be introduced. In part six, you will find the general conclusion and some advises for better and effective supervision mechanism of the financial markets in North Cyprus.

2. THE ROLE OF THE CENTRAL BANKS IN EFFECTIVE SUPERVISION

2.1 The Background of The Basel Arrangements

The primary aim of the Central Banks is to ensure and to keep price stability. For example, FED “sets the nation’s monetary policy to promote the objectives of maximum employment, stable prices, and moderate long-term interest rates” (www.federalreserve.gov). ECB will control the supply of euros and set short-term interest rates. It will probably pay little attention to foreign exchange rates. The ECB’s main task is to maintain the euro’s purchasing power and thus price stability in the euro area (www.ecb.int).

The subprime lending crisis in the USA triggered the global financial crisis and devastated most of the economies. There are many reasons for this global financial crisis ranging from securitization to housing bubble (Bianco, 2008: 3-11).

Together with the Monetary Policy (MP) tools, to achieve objectives listed above, CBs have supervisory power to control and regulate the financial market for the stability purpose. “From the standpoint of monetary- and macroeconomic-stabilization policy, supervision aids the central bank’s functions because, it gives the central bank useful information. Knowledge of the state and health of the banking system can improve both analysis and forecasting” (Haubrich and Thomson, 2005: 8). With those analysis and information it can be easy to act proactively. Without modern forms of bank regulation, and supervision therefore one bank failure might lead to another (Baumol and Blinder, 1991: 224). “A supervisory role may create benefits in
informing the central bank’s response to banking sector stresses. According to the Fed, during the recent financial turmoil, the ability of the Fed to obtain information directly from key institutions and from supervisory reviews has been invaluable for understanding financial developments and their impact on the economy. The desirability of access to supervisory information has recently also been underscored by other central banks, such as the ECB, in particular to inform the monetary response to crisis situations. Empirical research confirms that, access to supervisory information confers an advantage in assessing the outlook for output and inflation” (Nier, 2009: 16).

2.2 Basel-I To Basel-III: Road Map

The inadequacy of the supervision of the financial giants, like banks, has become clearer after recent crisis. The causes of the crisis were not understood by the financial stability authorities to prevent upcoming crisis. Time mismatch of banks’ balance sheet (short term funding of assets), off-balance sheet risks and securitization were the main problems that were not detected and prevented by the financial stability authorities proactively before they caused a problem (Bindseil and Lamoot, 2011: 2-4).

The well-known main headings of the global crisis are excess liquidity, carelessly extended loans, securitization, lack of transparency, conflict of interests of rating agencies, regulatory and supervisory institutions out of phase with changing risk environment (Alantar, 2008: 2-4).

A. Basel-I

The main outcome of Basel-I arrangement is to guide the banks to have adequate capital for the banks. Basel-I have three main dimensions for the bank’s capital sufficiency. First one is the standards of the capital adequacy ratio, which was %8. Second dimension is the regulatory capital of the banks that puts under two main headings Tier-1 and Tier-2. Tier-1 is number one quality capital like a common equity and preferred stock. Tier-2 is accepted as supplementary capital like subordinated term debt and hybrid instruments. Final dimension is about unique process of calculating regulatory capital ratio of the banks (King and Tarbert, 2011: 1,2).

B. Basel-II

Basel-II has 3 pillars. Pillar-1 is minimum capital requirements, Pillar-2 is revision of supervisory process and the Pillar-3 is market discipline. Risk Weighted Assets (RWA) in Basel-I consists of credit risk, however, Basel-II puts market risk together with the operational risk in Basel-I arrangement. RWA, market risk and operational risk motivate banks to increase their well donated quality capital levels (King and Tarbert, 2011: 3,4).
C. Basel-III

Both Basel-I and Basel-II were micro prudential arrangements or bank specific level arrangements. On the other hand, Basel-III is highly macro prudential group of arrangements (King and Tarbert, 2011: 1,2). As previous Basel arrangements, Basel-III focuses on quantity of the capital and its strong components. However, this time both quantity and quality of the capital is subject to suggestions. At the same time, recent global harmful crisis has taken attention to the liquidity. It is well understood that, cost of holding liquid assets is less worsen things than the cost of the crisis. Furthermore, Basel-III has proposed the changes of banking supervision (Elliott, 2010: 1).

2.3 Supervisory Function of the CBs

Beside the MPs, CBs have supervisory and monitoring task to regulate and control the financial sector. With those instruments, CBs can able to control the money supply and keep financial stability (Dornbusch et.al, 2008: 398). “Some Central banks provide all these functions; others employ two or more organizations. Most Central banks are owned by their respective governments (such as Bank Of England, Banque De France, Reserve Bank Of India), others (such as Belgian Central Bank and Bank Of Japan) have mixed ownerships, and two (Germany’s Bundesbank and the US Federal Reserve System) are owned by private banks” (www.businessdictionary.com/).

With the Financial Services Authority (FSA) in the UK example, some country CBs started to separate their MP agency from the supervision. The main driving forces behind this tendency are changing, more blurred, structure of the financial system, and continuing concerns with conflicts of interest. Most developed countries that have deep and big size financial markets tend to have separate supervision authority. (Goodhart, 2000: 1). “In the literature, several arguments have been developed against and in favor of combining the two functions under the same agency. These arguments assume that in one way or another, CB’s supervisory duties affect monetary policy and vice versa. To date, however, there is little empirical evidence establishing the existence of such cross-effects, since data on bank supervision has been—and for the most part is still—confidential in most countries. Given the data limitations, most of the early studies provide only indirect evidence of such cross-effects” (Ioannidou, 2003: 1).

The “Norway was the first country to establish a single supervisor in 1986, the Iceland in 1988, five other countries, members of the European Union - Austria, Denmark (1988), Germany (2002), Sweden (1991) and United Kingdom (2001) - have assigned the task of supervising the entire financial system to a single supervisor (single authority) as a different and independent institution from the central bank. Also new members of EU - Estonia (1999), Latvia (2001), Malta (2002), Hungary (2000), Czech Republic (2006), Slovakia (2006) and Poland (2006) - have reformed
their structures, concentrating all the powers in a single authority, while out of Europe the unified agency was established in Korea (1997) and Japan (2001). General arguments for retaining supervision in the national central bank (NCB) are: independence, revenues, technical expertise and good staff of the NCB; information-related synergies between supervision and core central banking especially the NCB monetary policy; focus on systemic risk - the central bank is often running or overseeing the large value payments system which is important if the central bank is requested to provide liquidity support in a crisis situation. But there three arguments are most frequently presented against retaining bank supervision in the NCB – the major is a conflict between supervision and monetary policy, and moral hazard; second is the tendency towards conglomeration and the blurring of the distinctions between financial products and intermediaries; and third - the need to avoid an excessive concentration of power in the CB” (Zeidler, ND: 3). Monetary policy issues can be separated from the supervision. Even so, the continuing role of the central bank as the only available source of immediate last resort liquidity means that the two bodies would have to work in practice very closely together (Goodhart and Schoenmaker, 1995: 556).

“The analyses of the national legal frameworks for central bank involvement in banking supervision revealed that, the trend towards consolidation of the supervisory authorities is not always linked to a tendency to diminish or suspend NCB powers in the area of banking supervision. In the jurisdictions where the supervisory function is not performed by the central bank, NCBs have nevertheless remained involved in supervision in many different ways. However, there is no common pattern to this involvement” (Apinis, et.al, 2010: 32).

3. BANK SUPERVISION ROLE OF THE NORTH CYPRUS CB

The supervisory authorities must analyze objectively the financial conditions of each financial institution and of the financial system as a whole. Their impartiality cannot be achieved without a high level of political and institutional independence. A supervision authority must also be credible because its regulations and decisions must be respected. The credibility and transparency of its actions ensure the independence and on the other hand, an independent supervision authority becomes more credible. The supervision authorities must be accountable for their actions and should not be exposed to moral hazard. The accountability must not interfere with their independence. The transparency, the accountability, the independence and the credibility characterize successful and prudent Central Banks in their effort to reduce inflation and, at the same time, represent the attributes of an efficient supervisory authority (Albulescu, 2008: 2).

Auditing is a systematic process that focuses on certain period to check the accuracy and reliability of the data and knowledge. Today, policymakers in all
countries, troubled by the financial crisis of 2007-2008, are carefully reconsidering the features of their supervisory structure. Over the last ten years, the financial supervisory structure and the role of the central bank in supervision therein has undergone radical transformation. In the wake of the 2007-08 financial crises, more countries are considering reforms, while others, who went through a round of reforms, are looking at the structures once again (Masciandaro and Quintyn, 2009: 1).

The major objectives of regulating the banks are to reduce the risk of failure, and to achieve some desired social goals. Bank regulations are designed to prevent commercial banks from becoming too risky and thus maintain public confidence in the country’s financial system.

In order to make it clear and understandable bank supervision issues, and increasing the quality of the bank supervision over the world, under the Basel Committee on Banking Supervision (BCBS), harmonization of the international standards of calculating national capital adequacy and add on minimum standards, member countries signed a ‘Capital Adequacy Reconciliation’ which is called Basel-I. After the declaration of the Basel-I, The Capital Adequacy Systems Uniformed and Market Risk added to the regulation at 1996. Basel-I helped the banking sector getting stronger, stable and competitive internationally. At 2006 Basel-II has become a reality together with the Basel-I. The first coming change of the Basel-II is the management of the risk with the multidimensional instead of single dimension. For that perspective, calculating the capital requirement after new desires, determining and managing the potential risks, measuring credit, market and operational risks with the statistical and mathematical risk measurement methods came into force. On September 2010, Basel-III accord was accepted to gradually transition in 2013-2019 periods. Basel-III criterions are an arrangement that came to the agenda after the financial crises and aiming to fulfill the lacking subjects of the Basel-II (Arslan, ND: 52, 53).

The banking system and the other institutions have established for the purpose of extending loans. CB as an autonomous institution is responsible for the regulation and the supervision of the above mentioned institutions (www.kktcmerkezbankasi.org/).

In order to control and regulate the financial system, North Cyprus CB supervises the system regularly. According to the composite rating (CAMEL, Sensitivity analyses was not started yet) of the Banking Regulation and Monitoring Department and asset size of the bank in the sector, Banking Supervision Unit prepares an annual program and assigns the supervision groups for supervision. Each group consists of one Bank Supervisor (or Senior Supervisor) and an Examiner. Each group supervises 4-6 On-Shore Banks (full subjects) and special issues like loans and capital increases. Also 2-3 International Banking Units are audited for the year. Denunciation, Media News and Serious Gripes can also be the subject of special auditing.
3.1 Steps of the Supervision Methodology

On site supervision is a dynamic process that must be adapted to the changing financial world. Supervisions are based on CAMELS (Basel Standards). Basel is leading entity that matches that need. Supervision techniques also changes parallel to changes and revisions of Basel criteria. North Cyprus CB Supervision Unit follows closely those changes and rearranges its supervision methodology accordingly. Methodology that is being used by the North Cyprus CB Supervision Unit is as follows. Since 2011 transitions from Traditional Supervisions (TS) to the Risk Based Supervisions (RBS) was started. Only for the transitional period, both TS and RBS is being used by the auditing groups. TS of the banks analyses Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity. On the other side, RBS techniques detect the field of activities of the banks and analyze them according to the risks. Those risks are; Credit Risk, Market Risk (exchange and interest rate risk), Legislation Risk, Operational Risk and Liquidity Risk. The main innovation of the RBS compare with the TS is; RBS needs much deeper forecast analysis. Namely, banks have to measure and run scenario analysis regularly to act proactively against potential loses which means CB supervisors must have access to and have the ability to check and control them. Finally, looking at it from technical perspective, TS is reactive, RBS is proactive approach to supervision. Also with the RBS, CB supervisors’ advisory and mentoring role have increased. There is onsite and off-site supervision for the banks. Banking Regulation and Monitoring Department requests daily, weekly, monthly and yearly data forms from the banks and cross checks them for the referential integrity and reliability. It was started with 23 forms which at the moment are 32 forms and may increase in the future according to the need for making better analysis of the sector. On site supervision techniques consist of, analyzing Balance Sheets (BS), Income Statements (IS), Capital Adequacy Ratios (CAR) and other financial statements. At the same time, all laws and regulations related with the banks is subject of supervision. Supervision process briefly summarized below.

**Step-1:** Is verification of the financial statements with the banking program.

**Step-2:** Is investigating all items of the BS and IS statement of accounts period of year.

**Step-3:** Collecting necessary documents.

**Step-4:** Writing and submitting the report to the Banking Supervision Unit.

**Step-5:** Discussing the report at the committee and Board of Directors.

**Step-6:** Writing the results of the report to the audited Bank about the findings.
4. THE AIMS OF THE RISK MANAGEMENT

We have seen that extreme market movements happen with some regularity and that financial risk can be taken in many ways, some of them rather complex. There is a long and inglorious history of financial losses resulting from failing to manage these financial risks. Shareholders, regulators and other stakeholders have very little tolerance for bad news. At its broadest, then, risk management is a process to ensure that undesirable events do not occur (Murphy, 2008: 46). First coming stage of the risk management is identification of the risk. Identified risk is the basis for the analysis and control of the risk management. Risk managers must well identify the risks that treat their organizations in order to manage them successfully, otherwise risks will become non-manageable (Tchankova, 2002: 1).

4.1. Risk Management Systems (RMS)

Risk can simply be defined as an unprotected situation against the uncertainty. The first step for being protected from uncertainty is to make forecasts against the risks. It is much more important to be ready for the financial sector risks that can occur just in seconds, as a result of tight financial integrations over the world. The assessment of risks determines the response to these risks. The response to risks or the management of risks is the process of determining whether or how much of the risk is acceptable and what action should be taken (Prinsloo, 2008: 240)

Financial Risk can simply be defined as ‘possibility of losing economic utility after financial transactions might cause a money lost, loss or expenditure rise’ that may occur again by uncertainty. Brokerage costs lowers as finance sector competition grows. On the other side, their risks also increase. Additional to the principal capital repayment risk, there are many other uncontrollable quantifiable exogenous risks that brokerages might come face to face.

In order to manage the risk effectively, Banks should build up the RMS. RMS means the oversight carried out by the Board of Directors and the senior management of a bank, policies developed on risk management, rules for implementation relating to these, determination of risk limits and mechanism for their implementation, risk management and risk monitoring activities, management information systems and internal control function. The survey prepared for this purpose, and attached as an annex to this paper will be used in (controlling) analyzing the effectiveness of the RMS.

According to the Basel Accord, banks should keep minimum %10 (first it was %8) capital against their potential risks that was listed above. For that respect, there are many arrangements done by the legal authorities for the banking sector. The current arrangement is related with the RBS technique to make forecast and measuring the risks of the banks by using Value at Risk (VAR) statistical technique and run a stress and scenario analysis. At the same time, banks should prepare their Risk Matrix’s and be familiar and ready for the risky activities and prepare
themselves against potential loss. The well donated RMS can be measurable if required in terms of transaction, portfolio, unit and branch of business, for effective RMS, banks need to complete their institutionalization. For that reason, ‘Internal Systems’ notification is very comprehensive and according to that notification banks must constitute an Internal Control responsible, Internal Auditing Unit, Risk Unit and Compliance Officer (www.kktcmerkezbankasi.org/).

4.2. Risk Matrix (RM)

This is a method of analysis used to determine the activities of a bank, aggregated risk categories inherent in such activities, their levels, the way such risks develop, the adequacy of risk management systems in these fields of activities and the level of the residual risk and the way it develops in terms of the risks carried by bank and for the whole bank. Risk Matrix is a flexible and dynamic tool for analysis which demonstrates the risk profile of the bank in each activity, the efficiency of risk management systems, the level of the Residual Risk in the risk categories identified for the whole bank and the changes in the risk profile of the bank. RM is a guide for bank management and CB supervisors in the North Cyprus. 513 questions are designed to examine all the functions of the banks and draw a road map for better institutionalization. At the same time it gives chance to the CB supervisors to audit the existence of the effectiveness of the system. Also, banks must build up the Management Information Systems (MIS) to define and measure the risks or to follow the important changes at their risk profiles. Statistical forecast analysis and scenario analysis of a developed model needs package econometric and statistical programs (www.kktcmerkezbankasi.org/).

4.3. Basel-III

The Bank For International Settlement (BIS) has focused on necessary arrangements and generated BASEL-III as a result of harmful experiences of the recent crisis. The main lesson learned from the crisis was the existence of new type of the risky assets in the balance sheet of the banks. The subprime mortgage loan and the mortgage backed securities are most known common risky assets which caused the recent financial crisis. Because of this, BASEL-III has foreseen proactive measurements instead of the reactive measurements for the financial system (Arnold, 2011: 377,378). Basel-III, strengthens micro prudential regulation and supervision, and adds a macro prudential overlay that includes capital buffers.

BASEL-III has mainly concentrated and arranged twofold indicators, which are capital and liquidity of the banking sector.

A. Capital

Capital subdivided into three pillars. Pillar-1 is about the capital and the risk coverage. Pilar-2 is about the risk management and the supervision. Pillar-3 is about the market discipline.
Pillar-1 rearranges the capital in terms of both quantity and quality. Banks must prepare themselves against the risks for the worst scenarios. For that purpose, lost absorbing capital accepted as a well-qualified capital by the Basel-III regulations. With this regulation, core capital, namely common equity, would include the best capital instruments in it.

At the same time, Basel-III have been increased the regulatory capital, Tier-1 capital, from 4 percent to 6 per cent and minimum requirement for common equity was raised from 2 per cent to 4.5 per cent.

Basel-III brings out the conservation capital for ups and downs of the economy. In order to lessen the worst effects of the economic fluctuations, the conservation capital rate will be 2.5 per cent and this is compulsory minimum rate that banks must hold. The conservation capital will be financed through common equity. During the worst periods of the fluctuations, if conservation capital rate falls below the 2.5 per cent, the bank management would freeze any kind of dividend payment or bonuses to the shareholders and bonuses to employees till the required per cent is reached again.

Another topic shaped under Pillar-1 is the arrangement for the risk coverage. The recent mortgage crisis makes it clear that, risk has many dimensions that must be considered more carefully. These are complex off-balance sheet items, counterparty risk, securitizations and bank exposures. Basel-III arrangements put on a protection buffer over them in order to eliminate the risky activities.

The final topic at Pillar-1 is about the leverage ratio. According to this arrangement, banks are to be coercing to hold leverage ratio for their off-balance sheet exposures and total assets, which are determined by certain conservation rates, with the owners’ capital. Containing leverage ratio will be minimum rate and it will be non-risk-based. The ratio will be implemented gradually to the %:36 after a transition period.

Pillar-2 is about the risk management, internal capital requirement evaluation processes of the banks and supervision processes of the legal authorities. All the arrangements that came into agenda need effective and comprehensive supervision to ensure that the risks of the banks managed correctly. Many complex bank instruments, globally integrated financial markets and risk appetite of the stakeholders needs close investigation from the financial servicing authorities. Pillar-2 draws the framework for the risk, the effectiveness of the internal management process, the controlling and the managing risks.

Pillar-3 is about the structural market discipline. It gives a chance to the participants of the market to evaluate the capital adequacy of the banks clearly. Pillar-3 targets to have more information about the securitization risks of the banks and puts on clear definitions about the risks to prevent the uncertainty in the market.

Addition to those pillars, BIS committee has agreed on the framework of the Systemically Important Financial Institutions (SIFIs) which are acting globally. At the Basel-III deployments, SIFIs needs to have higher capacity for the potential losses.
Because, recent crisis teach us that, SIFIs are reflecting the greater risks that pose to the financial system. The ratio of the additional capital requirement will be 1%-2.5% and it can be changed according to the bank’s systemic risk for the banking sector.

B. Liquidity

Basel-III has also considered the global liquidity standards of the banks. The term mismatch of the assets and the liabilities of the banks cause huge, uncontrollable risks for the banks and for the financial sector. The financial crises that started in the USA and spilled over to the rest of the world prove the importance of the liquidity and the priority of effective liquidity control. Stress tests reflect the provision of the incentives for banks to use stable sources of funding. At the same time, Basel-III has determined the framework of ongoing control and onsite monitoring guidelines, which are bases for the on-site supervision. According to those guidelines, funding scenarios, funding ratios and liquidity risk management practices are set.

4.4 Traditional Supervision

As kind of bank instruments increase in numbers and financial statements get more complex, supervising them became more complicated. Such complexity together with the globalization and technological developments raised the importance of the proactive checking and preventions against the financial institutions transactions. After many different types of financial crises, systematic reactive supervision technique started to be transformed towards the risk based proactive supervision technique. At traditional auditing, supervisors look after to the whole accounts of the financial statements either have a high or less importance. On the other side, RBS technique identify areas of the financial statements where there is a higher risk of material misstatement and concentrate audit efforts in those areas, caused by either high inherent or control risk. Also identifies lower-risk areas in which to perform less extensive procedures (Allison and Herman, 2004: 5).

“Supervisory functions entail an array of tasks, which can be grouped into three classes: (i) investor protection activities, which are focused mainly on the issuance and enforcement of rules on the conduct of business and the disclosure of information; (ii) micro-prudential supervision, which includes all on and off-site surveillance of the safety and soundness of individual institutions, aiming in particular at the protection of depositors and other retail creditors; and (iii) macro-prudential analysis, which encompasses all activities aimed at monitoring the exposure to systemic risk and at identifying potential threats to stability arising from macroeconomic or financial market developments, and from market infrastructures. While the third type of task is performed, in some way, by all central banks, the activities relating to investor protection, especially in the securities markets, are very rarely included in their mandate. For separate supervisory agencies, the opposite is generally true, i.e. a strong emphasis on investor protection is usually coupled with a minor role in the monitoring of systemic risk. The critical issue when discussing the most efficient institutional framework is the performance of micro-prudential
supervision, which most NCBs tend to view as being strictly linked to systemic concerns and which separate agencies interpret as being geared to protect depositors and investors” (www.ecb.int).

Table 1, is the summary of comparison of TS and RBS.

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<tr>
<th>Traditional Approach</th>
<th>Risk-Based Approach</th>
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<td>Transaction-based testing</td>
<td>Process-oriented</td>
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<td>Point-in-time assessments</td>
<td>Continuous assessments</td>
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<td>Standard procedures</td>
<td>Risk-profile driven procedures</td>
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<td>Historical performance (reactive)</td>
<td>Forward looking indicators (pro-active)</td>
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<td>Focuses on risk avoidance</td>
<td>Focuses on risk mitigation</td>
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Traditional Approach is Transactions-based testing, Point-in-time assessments, Standard procedures, Historical performance, Focuses on risk avoidance. Risk- Based Approach is Process-oriented, Continuous assessments, Risk-profile driven procedures, Forward looking indicators, Focuses on risk mitigation (Hotay, 2009: 10).

4.5. RBS Technique

It is clear that dynamism of the financial sector, especially the banks, are leading units of the financial economy and that particular bridge task impose them particular role for the reel sector also. Together with that dynamism, globally integration of the sector with the rest of the world makes transactions faster, complex and riskier. For all that reasons, there were dramatic financial crises, that was affected most of the world countries. As a result of the huge losses, world countries tend to find way of escaping from the risk by acting coordinately, and start to rearrange themselves to the future by RBS.

“RBS places strong emphasis on understanding and assessing the adequacy of each bank’s risk management systems which are in place to identify, measure, control and monitor risk in an appropriate and timely manner. It is an ongoing process whereby the risks of a bank are assessed and an appropriate supervisory plan is designed and executed in an efficient manner. Its key characteristic is flexibility” (Hotay, 2009: 9,10).

RBS is a structured, forward-looking process designed to identify key risk factors to which individual banks and the entire financial industry are exposed. By using it, the Central Bank’s supervision staff would assess risk management policies and
practices used to mitigate risk in commercial banks. RBS focuses the level of supervisory attention on those areas in a bank deemed by the supervisors to be of highest risk, or institutions that pose the greatest risk systemically to the banking system, while concurrently enabling the Central Bank to do so by employing its resources effectively and efficiently. RBS program considers all key functional activities (both business lines and operational areas) of commercial banks, and within each key functional area, evaluates the level of risk quality of risk management, and direction of risk (increasing, decreasing or remaining stable).

In RBS, both onsite examinations and off-site surveillance are integrated into the process such that each one feeds into the other. They are so interdependent and integrated such that one cannot function properly without the other. In RBS, supervisory resources are rationalized by focusing on areas of greatest risk. This increases supervisory efficiency. RBS is a recommended best practice in the world. Basel Core Principles for Effective Banking Supervision (BCPs) as revised in 2006, recognize the importance of banks having systems for managing various risks to which they are exposed.

4.6. RBS Process

The RBS framework that is implemented by the Central Bank is listed below.

Step 1: Understanding the Institution

The first step is to develop an understanding of the bank’s characteristics and risk profile. Information reviewed to construct a profile of the institution is gathered from various sources including discussions with management, the supervisory early warning system, off-site or on-site inspection reports and market intelligence.

Step 2: Assessing the Institution’s Risk

Examiners are required to make risk assessments to ensure effective identification of the strengths and vulnerabilities of an institution. These assessments focus supervisory efforts on those risks posing the most severe challenge to the safety and soundness of a bank.

Step 3: Planning/Scheduling Supervisory Work

A Supervisory Plan is developed following the risk assessment. The plan demonstrates how the supervisory concerns identified in the assessment, and deficiencies noted in the previous examination, are or will be addressed.

To be effective, planning requires a statement of inspection and an identification of the related strategies for their achievement. The Plan should include a schedule of off-site and on-site supervisory activities to be undertaken for the determined planning horizon. Generally, the planning horizon is one year, but it should be reviewed during the year and in the event, that circumstances change, it must be modified.
The Plan also should identify areas in the bank that will be examined and the reasons that will be subject to examination.

**Step 4: Defining Examination Activities**

Prior to commencement of an on-site examination, details of the procedures and activities to be performed are defined in a Scope Memorandum. This Memorandum will set out the objectives of the examination and its scope. It also will delineate staffing needs and timeframes for given activities. Thus, it serves as a roadmap to the examination team regarding objectives of the examination, procedures to be followed and resource allocation.

**Step 5: Performing On-Site Examinations**

Examinations procedures will be customized to the characteristics (condition and risk profile) of each institution, bearing in mind its size and complexity. Standardized assessment procedures will be used for all on-site examinations. However, under RBS, these will be utilized only to the level necessary to adequately assess management’s ability to identify measure, monitor and control its risks. In some banks, the assessment procedures will be sufficient; in others, more extensive transaction testing will be needed to fully assess the extent of risk exposure.

**Step 6: Continuous Off-Site Supervision**

Off-site supervision is two-pronged. One is routine analysis and the other is follow-up to ensure timely application of corrective actions so that the bank is achieving the desired result. Off-site analysis is conducted through analysis of financial data submitted through regulatory reports, meetings scheduled with management of the institution, and utilization of data produced through the early warning system.

There are some expectations from the RBS technique. They are listed as follows;
1. Increasing efficiency and effectiveness.
2. Dynamic and ongoing procedures.
3. Harmonization with the international standards (BASEL and European Union).
4. Detecting important changes at risk profiles of the banks as financial activities and products change and become more complex.
5. Using new supervision techniques for effective supervision of the changing risk profiles of the banks.
6. Taking necessary actions for the effective risk management and lowering the possibility of the lost.
7. Focusing to the causes of the problem instead of the results of the problem and preventing reoccurrence of them.
8. Abating the systemic risks.
9. Effective internal control and risk management systems and augmenting the stability against the crises (BDDK, 2011: 13,14).
RBS emphasizes the fact that, the responsibility for risk management lies with the bank. The Central Bank’s supervision staff assesses how well a commercial bank manages its risks over time rather than only assessing the financial condition of the institution at a single point in time. Moreover, RBS permits the Central Bank to concentrate on systemic risks and/or institutions that pose the greatest risk to the banking system.

Implementation of RBS does not mean a complete departure from the traditional approach. The quality of the risk management systems in an institution will determine the level of transaction testing done during an on-site examination. Therefore, in institutions where risk management systems and internal controls are deemed to be satisfactory, or the risks are considered low, transaction testing will be minimal. Conversely, where the risk management systems and internal controls are inadequate, more extensive transaction testing would be warranted to fully assess the degree of risk exposure. The adequacy of the bank’s internal audit function, and the reliability of the auditor’s work, also will dictate both the areas deemed necessary to be examined and the degree of transaction testing.

4.7. Strengths and Weaknesses of the RBS Technique

In comparison to the traditional approach, RBS is supervision on a continuum. Under the traditional approach, examinations were an annual event, and communication between the on-site and off-site staff of the Central Bank and bank management were rare. The CAMELS rating assigned at the examination also was static. Under RBS, continuous monitoring necessitates more frequent contact with bank management through targeted, specialized examinations, meetings with bank management (typically two or three scheduled meetings) to discuss issues in the bank, and changes to the CAMELS rating, which can be recommended either by the off-site or on-site staff. More frequent contacts also facilitate the relevance of the Institutional Profile and Risk Matrix. The effective implementation of the RBS framework requires enhanced cooperation and communication between departments in banking supervision. Of critical importance is the relationship between on-site and off-site supervision. Processes are being established to facilitate cooperation between these units.

The main strengths of the RBS technique for the North Cyprus case are as follows; RBS is proactive, reliable, valid, generally accepted, have guidelines principles and causes team work from top to bottom. With RBS technique the auditor performs a more effective and efficient audit, focused on higher-risk areas and saves time.

The main weaknesses of the RBS technique for the North Cyprus case are as follows; RBS is complex, costly, must accompany with the traditional supervision for long time and needs well qualified people.

RBS is a reality that banks must go along with it. All kinds of risks, either credit, market or liquidity risk, tell us that risk is there. We have to accept this reality and be ready for them. There are fluctuations in the economy, which means potential risks.
The important factor to be realized is the fact that we have to prepare ourselves for ups and downs, and protect ourselves against the risks. By this way we can keep our loss at a minimum.

RBS provides a means of distinguishing what matters, that is to say, in which areas the Central Bank should expend its limited supervisory resources and concentrate its supervisory efforts. It provides supervisors with the flexibility required to focus on areas exhibiting material, current and potential risks. Activities posing the highest risk receive the most scrutiny. Under this approach, examiners do not attempt to restrict risk-taking, but rather to ensure that commercial banks identify measure, monitor and control the levels and types of risk they assume. Supervisory attention thus remains properly focused on institutions exhibiting serious weaknesses or adverse trends.

The RBS approach provides the Central Bank and the banking industry with the following benefits:

1. Facilitates planning and allocation of supervisory resources based on risk,
2. Reduces the need for supervisory intervention in areas and institutions of low risk,
3. Encourages frequent, open communications between commercial banks and the supervisors,
4. Provides sufficient flexibility to allow examiners to tailor the supervisory efforts to the risk present,
5. Provides a framework for the enhancement of the supervisory review process prescribed under Basel-II (Pillar Two),
6. Supervisory approaches are broadly categorized as either risk-based or compliance-based, the latter being used in relation to a more “traditional” approach. The traditional approach to supervision is balance sheet driven and transaction oriented. It places significant reliance on transaction testing procedures. In general, the risk-based and traditional approaches have some similarities, but the differences are striking.
5. CONCLUSION

The importance of the financial markets increases from day to day within the modern economies. Any problem in these markets, can directly affect the other sectors and the whole economy. Banks generally manage the depositor’s money, so activities of them directly affect many people. That’s the main reason for effective monitoring and supervision required over them. Besides all, banks need liquidity and trust in order to survive thus making them different than the other businesses. They are interconnected with the other sectors. In order to make decisions with the accurate data sets, there is a high need for qualified and specialized bankers.

It is found that Risk Based Supervision (RBS) is the way that CBs (or financial servicing authorities) moving on, however traditional supervision should continue together with the RBS for many years. RBS, proactive technique for supervision, have priorities over traditional supervision technique which is mostly reactive. On the other side, RBS technique needs well donated data sets for the scenario analysis and stress tests, also extremely well donated supervisors to conduct a forecasting analysis.

Having single legal supervisory authority at Small Countries like North Cyprus is sufficient to control and regulate the financial market. Especially for the North Cyprus CB case, which does not have her own currency and have limited monetary policies to control price stability and financial sector, the only important role is the Regulation and Supervision of the banking sector. North Cyprus CB altered radically after serial changes at laws and regulations, particularly with the new CB law that gave her autonomy in 2001. As a result of these changes and experiences gained through financial crisis, North Cyprus CB completed its institutionalization process and supervision started putting pressure over the sector to do so. Tight monitoring and regulation together with systematic supervision of the sector started producing positive results. At the same time, in accordance with the Basel standards, the necessities of new arrangements and contribution to forecast the potential lost areas become very important. As balance sheets of the Banks grow and the instruments with in the balance sheets diversify and become more complex, the need to foresee those risks requires the legal supervisory authority to move from traditional supervisory techniques to the RBS techniques. Currently, there are 24 banks and 9 International Banking Unit (IBU) in the sector under the control of the CB. Despite this, CB Supervision Unit consists of 14 supervisors which mean efficiency is not at a desirable level. With the RBS technique, efficiency is expected to increase to the desirable level.

Current banking law does not have enough sanctions, as like the other banking laws contribution around the world. Also, it doesn’t administrative fines over the banks to pressure them to obey the ‘Internal Systems’ notification. There is a new Banking Law draft which is almost ready for enacting. New draft law is expected to have all the necessary arrangements to put pressure over the banks for taking necessary steps for institutionalization and applying the internal systems effectively.
Among the reasons for the crises are, increasing complexity of the securitized credit model, rapid extension of loans and falling credit standards, property price booms, increasing leverage in the banking and shadow banking system, underestimation of bank and market liquidity risk, self-reinforcing cycle of irrational exuberance. After the financial crisis over the world in 2007, importance of detecting, measuring and preventing of the risks became more important. Together with the past experiences, series of standards come out for close and strong controlling of the banks. As a result, RBS technique for the banks started to get more important and it is definitely a more effective technique at supervisions.

At the same time, banking sector has not institutionalized in a desired level to meet the RBS requirements. Furthermore, other laws and regulations, which are subject of the Ministry of Finance and the Ministry of Economy, need a revision to be update and they must be parallel with the laws and the regulations of the banking sector and must have strong implication initiatives. The effective supervision of the Banks does not make any sense without effective controlling of the real sector.

Beside all these, the North Cyprus banking sector and the CB regulations are far from most of the Basel standards. CB has been adopting the requirements of Basel-I and Basel-II since 2001, however, Basel Committee has already declared Basel-III. The causes of the crises show us the need of new arrangements and the regulations. With this respect, the requirements of Basel accords have changed accordingly and most of the time, there is a need to have comprehensive radical changes. Thus, the North Cyprus CB must be able to adopt itself to these new and rapid developments by harmonizing its laws and regulations with the Basel accords in order to control the banking sector effectively.

The main limitations of the RBS technique for the North Cyprus are the lack of historical data sets, scenario and stress test analysis and institutional lack of awareness of the sector for Risk Based Supervisions. For these reasons, traditional supervision will continue together with the RBS for many years. It is not possible to move from traditional supervision to the RBS in a short period, but it is clear that risk is everywhere and causes devastating losses for communities, which means that the final destination that we all arrive will be the RBS.
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I graduated from Eastern Mediterranean University (EMU) in 1997 from Business Administration Department. I have M.S in Economics from the same university in 1999. I worked as a research assistant and a lecturer at EMU Economics department between the years 1997-July 2002. In August 2002 I was started to the Bank Inspection and Supervision Unit of the Central Bank as an examiner. In 2006, I was promoted to the position of a supervisor in the same department. In 2011, I started my PhD studies in Business Administration Department of the Cyprus International University and presently I am continuing with my studies.