THE IMPACT OF AMNESTIES ON NON-PERFORMING LOANS IN NORTHERN CYPRUS

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ABSTRACT

The main aim of this study is to examine the impact of amnesties on non-performing loans (NPLs) in Northern Cyprus. The period in which amnesties were applied covers the years between 2012 and 2014. When the data before and after amnesties were considered it is determined that amnesties did create negative results due to moral hazard. It can be concluded that measures should concentrate on the causes of NPLs rather than amnesties in order to mitigate the problem of NPLs. These measures should consist of legal, institutional and administrative dimensions.

KEYWORDS: Non-performing loans, Moral Hazard, Amnesties, Northern Cyprus

INTRODUCTION

The main role of the basic credit cycle, which transcends the economies of the countries, is played by the banks. The loan cycle is simple: customer deposits finance loans. Loans allow lenders, businesses, individuals, governments, non-profit-seekers and many others to grow and invest, thereby creating more jobs that cause economic growth and prosperity. The welfare created through wealth eventually goes back to the bank as deposits and the economic cycle reenergises (American Bankers Association, 2014). This state makes banks deposits and loans as the most important items of the balance sheet. For example, data about Turkish banking sector clearly reveals this. In the Turkish banking sector, the share of loans to total assets was 63% followed by securities (14%) and reserve requirements (8%). Deposits with 53% share have the biggest share in the total liabilities followed by interbank loans (16%) and repo (7%). Additionally, the share of equity capital in total liabilities is 11 percent (BDDK, 2016). As can be understood, the sustainability and destiny of commercial banks depend on the profitability of loans. Therefore, banks' main source of income comes from interest on loans even though banks started to earn substantial amounts of non-interest income for other financial services (DeYoung and Rice, 2014). Therefore sound credit risk management framework is crucial for banks in order to enhance profitability and guarantee survival (Kolapo et al. 2012).

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The main indicator of credit risk in banking sector is non-performing loans (NPLs) (Ekrami and Rahnama, 2009). Expectedly, large amount of NPLs in the banking system will immediately result in bank failure. This overlaps with the findings of many researches (Barr and Siems, 1994; Demirguc-Kunt and Detragiache, 1998) on the cause of bank failures revealing This asset quality is a statistically significant determinant of bankruptcy, as it always has high rates of non-performing loans in unsuccessful banking institutions prior to failure (Biabani et al. 2012).

Relevant literature about the causes of NPLs can be summarised as follows:

- The study of Biabani et al (2012)   examined the variables that are correlated with NPLs. The variables having significant relationships with NPLs are reported to be average of account quantity, bounced check, credit background of customers, collaterals and duration of loans payment.

- According to research findings of Viswanadham and Nahid (2015) the level of NPLs are affected by GDP, interest rate, economic condition and bank's loan supervision capacity.

- Karim et al (2010) reported statistical results about NPLs: "The Tobit simultaneous equation regression results clearly indicate that higher non-performing loan reduces cost efficiency. Likewise, lower cost efficiency increases non-performing loans. The result also supports the hypothesis of bad management proposed by Berger and DeYoung (1997) that poor management in the banking institutions results in bad quality loans, and therefore, escalates the level of non-performing loans."

- The study of   Addae-Korankye, A. (2014) stated that inadequate loan sizes, improper client selection, high interest rate, lack of monitoring and poor appraisal are the causes of loan default.

- The study of Ekanayake and Azeez (2015) reveals these correlative relationships of NPLs with relevant variables: Positive correlation between NPLs and deteriorating bank's efficiency; Positive correlation between loan to asset ratio and NPLs; Negative correlation between level of credit growth and level of non- performing loans; and negative correlation between size of bank and loan defaults.

- The result of another study (Asfaw et al. 2016) "shows that poor credit assessment and credit monitoring are the major causes for the occurrence of NPL in DBE. Credit size (includes aggressive lending, compromised integrity in approval, rapid credit growth and bank's great risk appetite); high interest rate, poorly negotiated credit terms and lenient/lax credit terms, and elongated process of loan approval were bank specific causes for the occurrence of nonperforming loans."

- The research of Messai and Jouini (2013) revealed the positive and negative correlations that problem loans have with relevant variables. Such that it has negative correlations with the profitability of banks' assets and the growth rate of GDP while it has positive correlations with the loan loss reserves to total loans, unemployment rate and the real interest rate.

- According to research finding of Joseph et al. (2012) integrity of the borrower, natural disasters and government policy are the major causes of non-performing loans.

- Findings of Richard (2011) suggest that the main cause of NPLs is the use of borrowed funds for different purposes other than the agreed terms.

- The results of Louzis et al. (2012) related to Greek banking system reveal that, for all loan categories, macroeconomic variables and management quality mainly explain NPLs.

- The study of Farhan et al. (2012) is related to the perceptions of Pakistani bankers. According to their perceptions, non-performing loans have positive correlation with interest rate, energy crisis, unemployment, inflation, and exchange while they have negative correlation with GDP growth.

- The results of Haneef et al. (2012) reveal that appropriate mechanism for risk management in the Pakistani banking sector does not exist. It is also asserted that NPLs are increasing due to ineffective risk management.

- Overall findings of Makri et al. (2014) indicate that macroeconomic factors consisting of unemployment, annual percentage growth rate of gross domestic product and public debt and bank-specific factors that are rate of nonperforming loans of the previous year, return on equity and capital adequacy ratio have high degree of correlations with NPLs.

When the amount of NPLs starts to take politicians' attention, governmental amnesty policies aimed at forgiving interest and extending credit period can be provided rather than introducing comprehensive structural remedies closely related to determinants of NPLs as outlined above. However, the impacts of these amnesties are mixed as underlined by the selected literature below.

- According to Alm and Beck (1990) the general effect of tax exemptions on tax collections is indefinite. The impact of tax amnesties on tax compliance most probably will be positive if taxpayers anticipate a tougher enforcement package than the current regime will follow just after amnesty. Otherwise, the impact of it is expected to be negative.

- In the study of Luitel, H. S., & Sobel, R. S. (2007) it is reported that tax amnesties being repeated will generate less short-run revenue than the previous ones and these revenue losses will be magnified if long-run tax compliance are not institutionally supported and encouraged.

- Alm & Beck (1993) asserts that tax amnesties will unlikely increase new tax revenues. Furthermore, tax amnesties are not expected to contribute to voluntary compliance.

- According to Alm et al. (1990) tax amnesty will increase compliance if it is accompanied by tougher tax regime to which it may be considered as an effective transitory instrument.

- In his study, Aygün (2012) reveals a general agreement that amnesties will have negative effect when tax amnesties are used as a propaganda tool; when a comprehensive tax reforms are not implemented after tax amnesties; when tax amnesties are regarded as a short-term source of income; and when tax amnesties are repeatedly applied.

- According to Kargı (2012) tax amnesties do not increase tax revenues at the expected level in the long-run.

In this study, three amnesty measures that were implemented between the years of 2012 and 2014 and aimed at forgiving interest and extending credit period of NPLs will be analysed and findings will be discussed with the existing literature.

CASE OF NORTHERN CYPRUS

As pointed out above, banking sector mainly performs the financial intermediation function by transferring funds from suppliers (mainly depositors) to users as borrowers. As seen in Figure 1, loans are the main revenue generating element of banking asset, hence vital for their survival. About 80 percent of assets constitute loans. This means that credit is the most important source of risk surrounding banking sector. Furthermore, deposits being more than 55 percent carry the highest importance of sector funding.
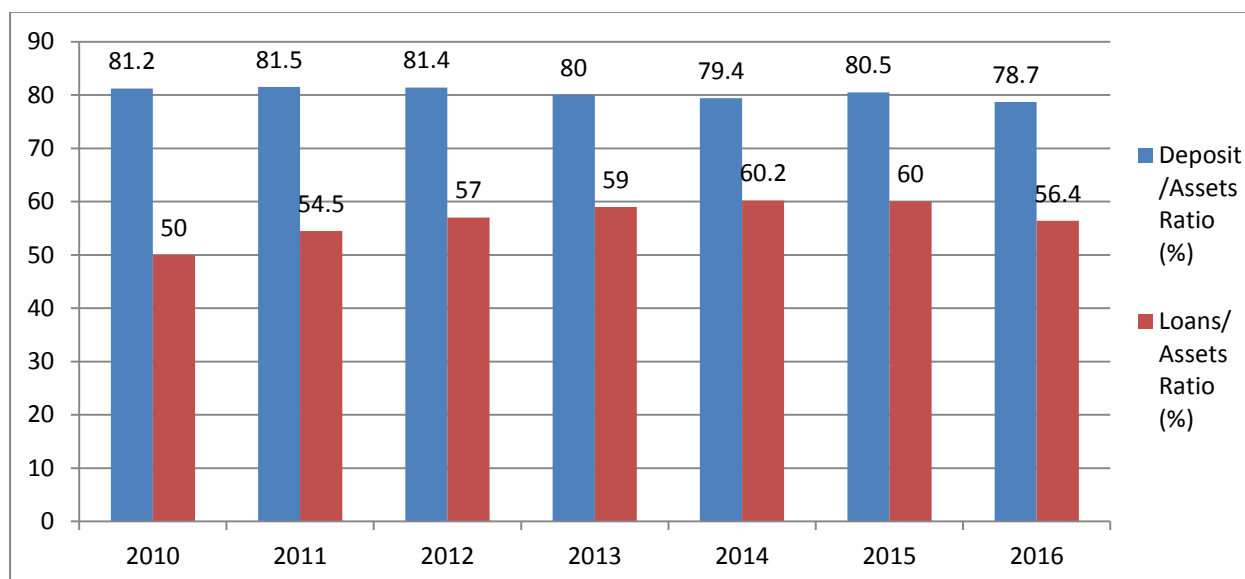

Figure 1: Deposit and Loan/ Asset Ratios of TRNC Banking Sector (2010-2016)

Source: (TRNC Central Bank, 2017)

Gross loans in TRNC are constantly increasing. While gross loans almost tripled from 2006 to 2012, they almost doubled from 2012 to 2016. Such that, gross loans increased from 2,3 billion TL to 6,8 and 12,7 billion TL for the years of 2006, 2012 and 2016 respectively (Figure 2).
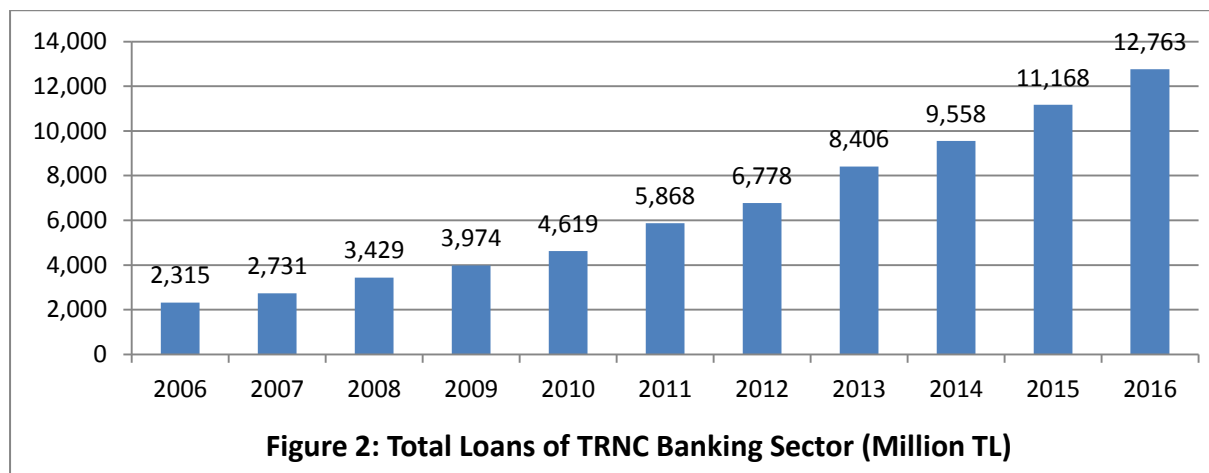

Figure 2: Total Loans of TRNC Banking Sector (Million TL)

Source: TRNC Central Bank

Because of the crying of civil society for the court decisions leading to jail of borrowers, legislation has been amended three times between 2012 and 2014. Legal amendment did aim at interest amnesty and maturity extension. These regulations numbered as 12/2012, 29/2013 and 48/2014 were enacted on (February 20, 2012), (December 5, 2013), and (June 17, 2014). However, these measures, contrary to the aim, created negative result in accordance with the concept of moral hazard. This can be observed by looking at the movement of non-performing loans.

Despite the measures taken between 2012 and 2014, non-performing loans continued to increase steadily. Non-performing loans, which were 491.9 Million TL in 2012, increased to 842.5 Million TL in 2016 (Figure 3).
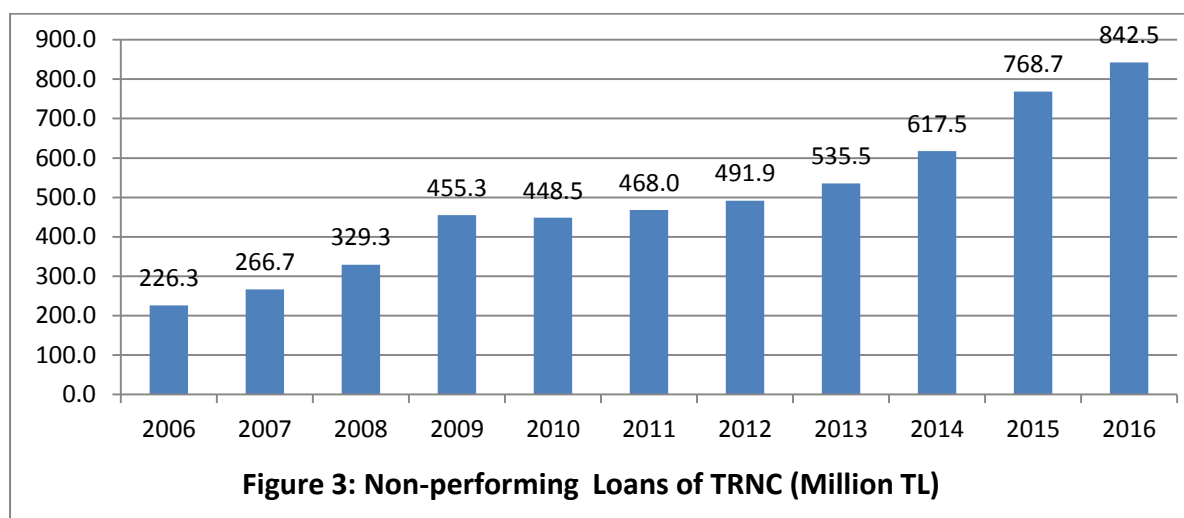
**Figure 3: Non-performing Loans of TRNC (Million TL)**

Source: TRNC Central Bank

It will be useful to firstly look at the rate of change in gross loans and non-performing loans in order to understand the effect of amnesty decisions in this regard. Interestingly, before the introduction of amnesties till 2012, changes in non-performing loans were low compared to the increase in gross loans. For example, in 2011, gross loans grew by 27%, while non-performing loans increased by 4.3%. However, just after the declaration of amnesties and their implementation, downturn became inevitable instead of the expected improvement. That is, in 2012, gross loans increased by 15.5% and the non-performing loans by 8.9%; while in the years 2014 and 2015, the change in the non-performing loans was more than the change in gross loans. Especially in 2015, gross loans increased by 16.8% while the non-performing loans increased by 24.5% (Figure 4).
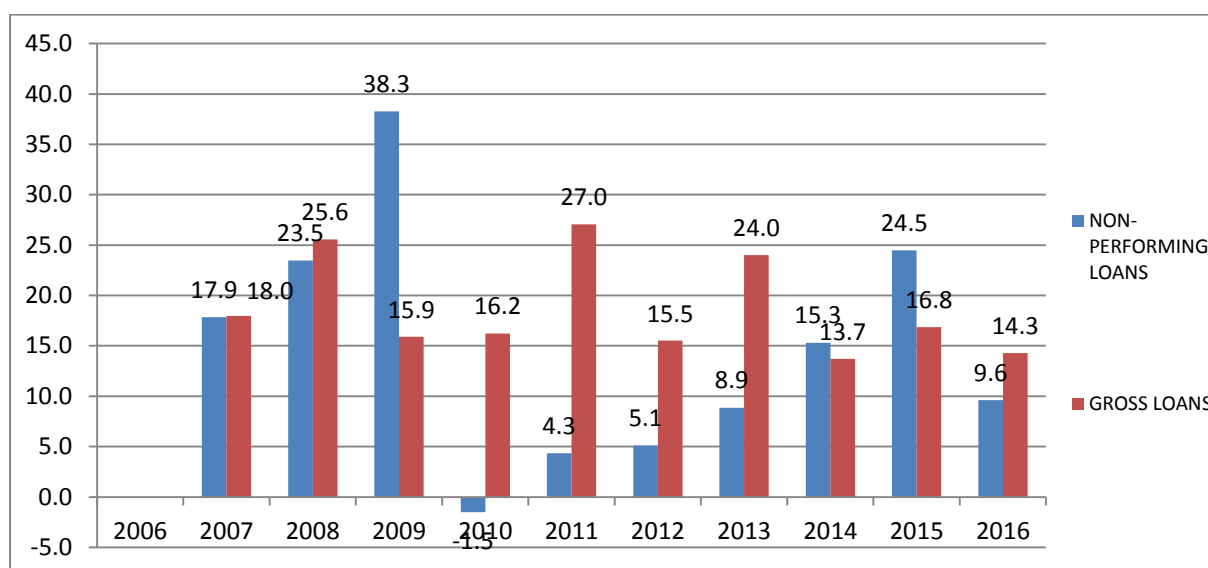

Figure 4: Percentage Change in Gross Loans and Non-performing Loans in TRNC (2006-2016)

Similar results as above are observed in relation to non-performing loans/gross loans ratios. While the ratio of non-performing loans to gross loans had continued to decline, it started to increase in 2013 immediately after the amnesty. This ratio, which was 11.9% in 2009, had steadily decreased to reach the lowest level of 6.4% in 2013. But it started to rise after this year and reached to 6.9% in 2015 (Figure 5).
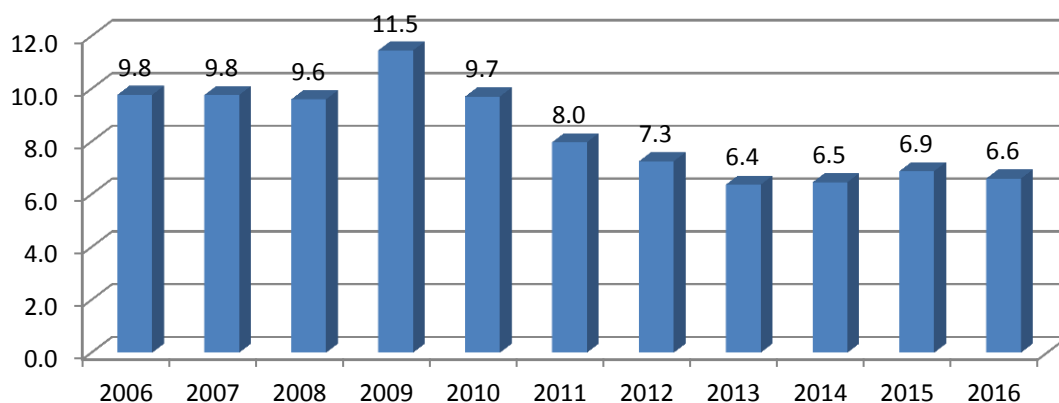
Figure 5: TRNC Nonperforming Loans/Gross Loans Ratio (%)

After analysing the nonperforming loans in Northern Cyprus, ıt will be beneficial to look at the ratios on nonperforming loans/total gross loans in selected countries. As seen in figure 6, the highest bank nonperforming loans to total gross loans (%) in the world are in South Cyprus (47%), San Marino (44.2%) and Greece (37%) respectively. On the other hand, there are countries in the world such as Macao SAR China, Uzbekistan and New Zealand, which have these ratios of less than 1% . Unfortunately, the ratio of bank nonperforming loans to total gross loans (%) of the TRNC is higher than Turkey (3.2%), World Average (3.9%), European Union (5.2%) and Euro Zone (5.4%).
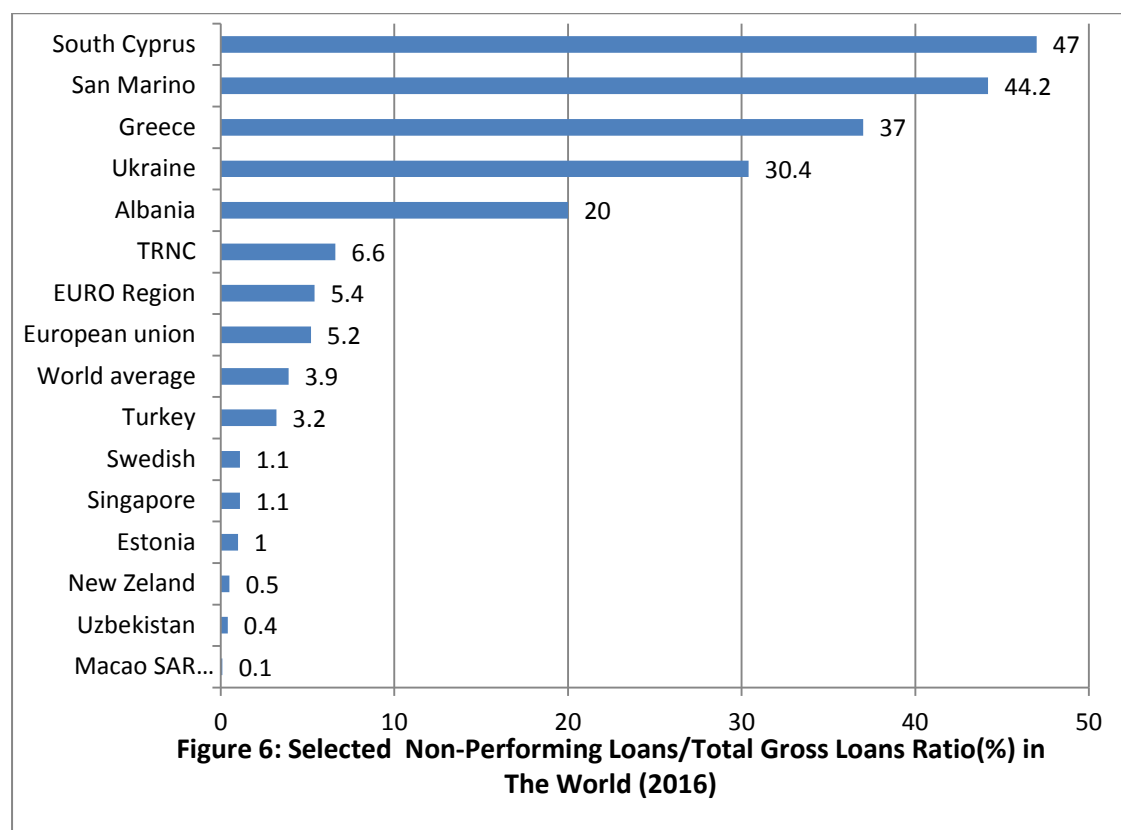
Figure 6: Selected Non-Performing Loans/Total Gross Loans Ratio(%) in The World (2016)

Source: (The World Bank, 2017)

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CONCLUSION

Repetitive structure of amnesties applied in the TRNC banking sector inevitably lead to moral hazard problem overlapping with the relevant literature (Aygün, 2012). Such that amnesties will have negative effect when tax amnesties are used as a propaganda tool; when a comprehensive tax reforms are not implemented after tax amnesties; when tax amnesties are regarded as a short-term source of income; and when tax amnesties are repeatedly applied.

Even though it is argued that new amnesty will not be introduced, governments could not convince borrowers due to previous experiences. Therefore, moral hazard negatively affects the motivation of servicing debt. Especially, the most fatal aspect of moral hazard problem is to distort the payment habits of credible customers by causing the erosion of their citizenship consciousness.

As can be understood from the case of Northern Cyprus above, remedy to NPLs cannot be found without taking the anatomy of problem into account. The anatomy of problem can be uncovered by analysing the causes of NPLs that can be summarised as asset quality, collaterals, bounced check, credit background of customers, duration of loans payment, average of account quantity with NPLs, poor management, high interest rate, inadequate loan sizes, poor appraisal, lack of monitoring, improper client selection, poorly negotiated credit terms, lenient/lax credit terms, elongated process of loan approval, integrity of the borrower, and lack of risk management.

It can be concluded that measures should concentrate on the causes of NPLs rather than amnesties in order to mitigate the problem of NPLs. These measures should consist of legal, institutional and administrative dimensions.

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