Governor Gazi Erçel's evaluation on Turkish banking sector for 1999 and 2000 within the scope of stand-by agreement with IMF

At the end of 1999, a **Stand-By Agreement** was signed with the International Monetary Fund, which aims at fighting with inflation, implementing monetary and exchange rate policies as well as fiscal policy strategies and structural reforms. The disinflation program, which is the core target of the agreement, rests on **three pillars:**

- **Up-front fiscal adjustment at the very beginning of the program**
- **A firm exchange-rate commitment supported by consistent income policies**
- **Structural reforms**

The disinflation program has been supported by the structural reforms in three fundamental areas; namely ***banking sector, social security and international arbitration.*** The most recent structural reforms are the reflections that Turkey has finally decided to act upon its long lasting problems. It is widely recognized that the chronic high inflation is the main problem that hinders the economy from attaining a sustainable rate of growth and integrating into the global world economy. A more effective supervision and surveillance of banking systems are of the greatest importance among today's international banking regulations. In this context, Turkey is now more eager to take additional measures that will strengthen the financial structure of banking sector and lead to a more effective supervision and surveillance of the system.

The most radical change towards strengthening the supervision and financial structures of banks is ***the new Banking Law***. With the new Banking Law, which was prepared by taking into account the European Union directives and other generally accepted international practices, the compliance with the international standards in the field of banking supervision, which is an on-going process, was mostly achieved, in addition to increase the efficiency of supervision and surveillance of banking system

towards the main target of establishing stability and soundness of the system. The main changes to be brought by the new Banking Law No.4389, which was superseded by the Law No.4491, are as follows:

1. Establishment of **Banking Regulation and Supervision Board (BRSB)** as an organizationally and financially autonomous body, independent of political authority,

2. Transfer of powers on banking supervision and surveillance to **Banking Regulation and Supervision Board**,

3. The requirements of bank foundation were made more demanding,

4. Banks are required to establish appropriate internal control and risk management systems,

5. Definition of large exposures and credit limits,

6. More detailed and comprehensive measures shall be taken against banks, whose financial conditions weaken severely,

7. Personal obligations of bank shareholders and managers for the misuse of bank resources shall be increased,

The other complementary regulatory changes towards increasing the effectiveness of the banking system are given below:

1. **Foreign Currency Net General Position,** which was fixed as 20% at the maximum, shall be calculated on a consolidated basis, starting from June 2000.

2. **More severe loan loss provisioning regulation** prepared in line with the EU directives and the other international standards, shall imply that banks shall classify their loan portfolios by 5 sub-groups; namely standard, closely-monitored, sub-standards, doubtful and loss, starting from January 2000.

3. **Capital adequacy ratio** shall be calculated on a consolidated basis starting from June 2000.

All these measures and regulations will strengthen the public confidence in the banking sector and will also play an important role in removing the distortions that prevent the efficient functioning of the banking system. Furthermore, taking necessary measures to eliminate the negative effects caused by public banks on the banking system and ultimately privatizing these banks by transforming them into establishments that will operate under free market conditions will be accomplished in the near future.

A sustainable increase in the rate of growth is expected besides the expected decline in the rate of inflation to be achieved as the implementation of structural reforms and fiscal discipline reduce public sector borrowing requirement. The regulatory changes and structural reforms made so far will provide a comparably suitable environment for the banking sector in the next decade. The **asset and liability composition** of the banking sector are likely to change in the coming years, leading to increase in the variety of financial instruments and services. Along with these developments, banks will be able to transfer their financial resources increasingly to the real economy and retail banking services. Moreover, in a stable macroeconomic environment in the near future, banks will have to reevaluate their **risk management strategies** in line with the disinflation process.

Nowadays, which the significant changes are experienced in international banking systems, mainly in risk management, banking is being discussed at global level. From the global standpoint, it is the ability to comply with the internationally accepted rules and standards to be taken into consideration in the evaluation of banking systems, rather than the sizes of the banking systems. In the Turkish banking system, which is also under the process of rapid globalization with the international markets, income-expenditure composition of our banks is expected to change in a way in to increase other operational income and to decrease other operational expenses related to non-banking activities, as a result of enhanced competition and squeezed profit margins. . Moreover, the importance of risk management techniques and analysis, internal control

systems in particular, are expected to gain much more importance in line with the changes in banking techniques and practices at the global level.

Establishment of an independent supervisory system, which allows the surveillance and measurement of risks faced in the banking systems and the assessment of the situation of the systems against those risks, has become one of the basic requirements of this era. Improvement Improving and introducing appropriate prudential requirements in line with international standards and best practices, such as ***regulations on capital adequacy, including market risk; accounting standards applicable to banks for prudential reporting and financial disclosure purposes and internal risk management procedures*** are among the important additional steps to be taken in 2000, in order to regulate the Turkish banking system and to maintain the market discipline with respect to the surveillance and supervision of the system.

I believe that while talking about **strengths** of Turkish banking sector**, Turkey's success** ***in adapting to international banking regulations*** and ***her unceasing efforts towards this goal*** is worth to be mentioned. As compared to similar developing countries, it will not be wrong to say that Turkish public authorities and banking system closely monitor the developments in the international financial systems and they are quite sensitive to enforce the necessary regulations within this scope. With the awareness of the fact that the soundness of the banking system is of vital importance in an environment where banks are major player in financial system and are involved in international banking activities, Turkey is continuing to take measures to improve both the quality and the effectiveness of banking surveillance system on basis of the EU directives and BIS principles. Success of Turkish banking system in adapting itself to the international banking practices and regulations and the effective surveillance and supervision of the finance system will strengthen our country's position as compared to other developing markets at the international platform.

Its progress ***in globalization process*** is quite a plus for Turkish banking sector. Parallel to the process of opening up of the economy and globalization efforts, Turkish banks have made significant progress in **investments and organizations abroad**. They opened branches abroad and took important steps to increase their shares in

international markets by acquiring financial participations and partnerships. As of the end of 1999, Turkish banks have 41 branches that operate in 9 different countries, 61 foreign representative offices in 10 different countries and also 69 financial participations established in 23 countries.

Taking the advantage of its geographical position, Turkish banking sector share its experiences with developing countries of Asia and Europe and has the capacity to assume leadership for these countries in all branches of banking.

Turkish banking sector has reached to an important level with respect to ***human resources and technological infrastructure***. With the awareness of the fact that the need for highly qualified managers and specialized personnel is obvious during the process of integration with the global financial system, Turkish banks have become highly deliberate in the utilization of human resources. The number of university graduates and postgraduates has shown an increasing trend over the last decades. The increase in the number of banks and qualified personnel, in turn, enhanced the competition and contributed to broad utilization of new financial instruments and techniques. Furthermore, Turkish banks gained more intuition to attain a dynamic structure through automation. During the last decade, Turkish banks became more automated and efficient, along with their foreign counterparts. Presence of intense competition and efforts to be able to integrate with global financial markets has motivated banks to improve the quality and the variety of services by utilizing more of an information technology and international payment system. The number of Automatic Teller Machines (ATMs) reached 8.627 in the last decade. As a result of this, some of the major banks in the sector have started to provide interactive banking services to decrease their costs and increase the efficiency of banking transactions and be the part of **Electronic Fund Transfer** system (EFT) for their internal banking transactions and of **SWIFT** for external transactions. All these developments are advantages of our banks while competing in international markets.

All these factors, which are the significant indicators of development in the international banking system, improve the competitiveness of the sector. In addition, close follow up of domestic and foreign market is an important advantage to our banks. Within the

framework of radical measures taken towards restructuring the banking system, settlement of some issues that exist in the previous years, such as the elimination of problematic banks from the system can be seen as a favorable development.

Looking at all these positive developments, it would not be wrong to say that the Turkish banking sector has progressed to the level whereby it is able to compete with its counterparts throughout the world in terms of the variety of services offered and the modern means applied in doing so. Thanks to its well-trained personnel and high technological infrastructure, the sector has the capacity to adapt to the innovations of 2000's.

Despite all these before mentioned favorable aspects, there are also some deficiencies and weaknesses influencing the well being of Turkish banking sector, with regard to its current structure and legal regulations.

First of all, **failure in maintaining economic stability and increasing volatility and uncertainty, leading to short-term thinking and behavior** in the markets, have been preventing Turkish banks from setting stable policies for the future. Prevailing conditions of Turkish economy can change activities and priorities of Turkish banking sector. High rate of inflation, failure in maintaining macroeconomic stability, low depth of financial sector and immature nature of non-bank financial intermediation are among the major obstacles that negatively affect the development of the Turkish banking sector. I believe that the negative impacts of these problems will be eliminated as the program succeeds.

Despite the latest privatizations effected in recent years, public banks have continued to keep their prominent role in the banking sector. It is widely accepted that the significant shares of public banks in the consolidated balance sheet and their activities in the sector with their current structures have negative effects on the funding costs and competition conditions in the system.

Due to global crises and stagnation in the domestic economy, credit risk has gained importance in the asset quality of the banking system. The recent global crisis, initially began in Southeast Asia countries and then spread to Russia, whose its impacts deeply experienced in Turkey caused a slow-down in economic activities of some sectors. This phenomenon left its traces on credit portfolios of our banks too. In addition to a number of problems faced in loan repayments, past-due loans **of the banking sector** tended to rise due to the transfer of some loans, extended by the banks that were assigned to the Savings Deposits Insurance Fund (SDIF), to these accounts these developments.

As it is known, international regulations on banking are based on the linear relation between risk and equity. Some banks in the Turkish banking sector suffer from the lack of adequate capital. Inability to strengthen the level of capital resources parallel to increasing volume of transactions has led the assignment of some banks to the Savings Deposit Insurance Fund. Therefore, it is of great importance that resources of our banks should be improved in order to be able to remain competitive in the global banking business and to make our banks more efficient in managing their risks.

Full coverage of savings deposits is one of the factors that prevent the efficient functioning of banking systems. Moreover, it appears as an obstacle to establishing the market discipline within the sector. As we all know, because of the full coverage of savings deposits, both banks and depositors can assume risks in order to obtain higher returns. In their efforts to obtain higher returns, savers in particular can ignore the risks to which the institutions they have preferred are exposed. Even though all the negative aspects of the current deposit insurance practice is well known, we have to admit that prevailing condition of the global financial environment and the resultant effects on the Turkish financial system have been preventing us to take necessary steps to change existing deposit insurance scheme.

During the periods of crisis or in times of such expectations, countries often resort to practice of temporary full coverage as observed in Indonesia, Japan, Thailand, Mexico, Colombia and Equator. Most of these countries have preferred **temporary full coverage** in times of crisis with intent to return to limited deposit insurance practice following the establishment of stability in their banking systems. Indonesia, Japan and Thailand are planning to change the scope of full coverage after the Asian crisis is over.

On the other hand, Colombia and Equator intend to transmit to limited deposit practice in 2001 and Mexico in 2005.

New Banking Law No.4491, which contains a number of regulations lacking in the past, shall entrust SDIF with powers required to rehabilitate problematic banks. This is a remarkable progress towards solving the problems caused by the scope of deposit insurance. The new Banking Law provides that Banking Regulation and Supervision Board shall represent and manage Savings Deposits Insurance Fund. Merger or transfer of a bank whose financial position weakened severely to the Fund shall be subject to the approval of the Board. In the light of these evaluations, if the necessary macroeconomic conditions are maintained in Turkey, I believe that current scope of deposit insurance will gradually be reduced to the international level according to a calendar to be set.

Failure in exercising the consolidated supervision in the Turkish banking system in accordance with the international standards appears as another deficiency. Yet I believe that inclusion of technical infrastructure required for consolidated supervision and of regulations governing the calculation of standard financial ratios on consolidated basis in the new Banking Law are significant steps towards the consolidated supervision. Moreover, the new Banking Law governs that **Banking Regulation and Supervision Board** (BRSB) shall have the power to enter into agreements with foreign supervisory authorities towards information exchange. All these amendments will further increase the confidence of international markets to Turkish banking system.

Another important issue that should be carefully examined is the **new capital adequacy** framework of the **Basel Committee.** If the proposals of the new Accord are put into effect, it should be taken into account that they are likely to have significant adverse impacts both on real economy and financial sector in the coming years.

With respect to claims on banks under the implementation of the new capital adequacy proposals, Turkish banks would benefit substantially by the assignment of lower risk

weights under the risk weighting based on the credit rating of banks itself. Thus the borrowing opportunities and external credit lines of these banks would be increased, in addition to decreasing cost of external financing. On the other hand, if bank ***risks are weighted according to the sovereign ratings of the obligor country***, Turkish banks would be subject to 100 % risk weight because of the Turkey's low country rating. This is likely to limit the borrowing opportunities of Turkish banks, while increasing the cost of external financing. Because of these reasons, I believe that it is very important for us to improve the external credit rating of both Turkey and our banks in order to reduce high borrowing costs that we have endured up today. Our purpose is to bring a realistic and sound solution to this problem by increasing foreign credit mark through these policies.

Finally, with recent regulations and measures, Turkish banking system has taken a strong position both in legal and functional respects. This strength is at higher levels when compared to most systems of the region, Europe and the world. Evaluations to be made in the light of these facts will produce more sound and constructive results.