

SECTION II

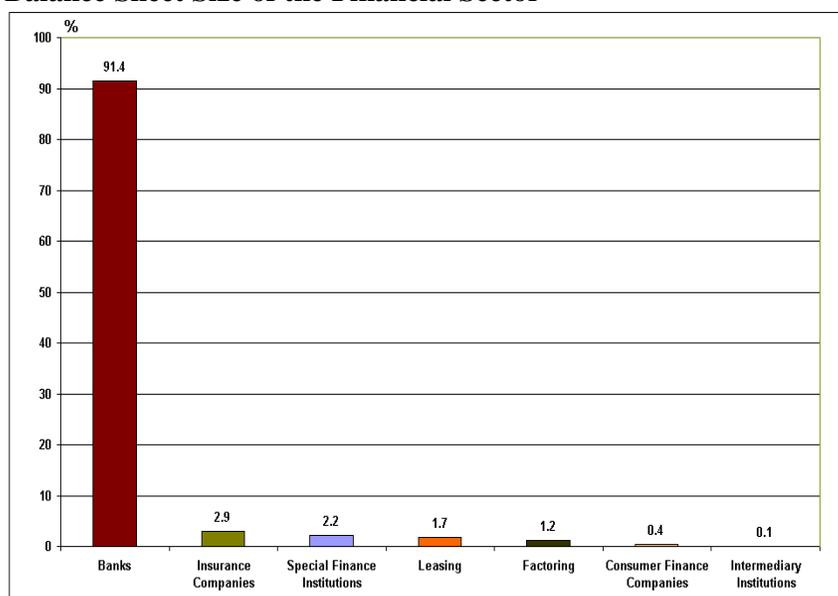
BANKING SECTOR AND OTHER FINANCIAL INSTITUTIONS

II.1.GENERAL STRUCTURE

In line with the favorable economic developments in the Turkish economy, the financial sector has shown a stable course of growth throughout 2004. The high growth performance of the GDP, which was realized as 8.9 percent in 2004, along with the decrease in inflation and interest rates and increased domestic demand and other factors such as new opportunities for the improvement of the financial sector, new regulations, risk focused management of financial institutions and the strengthened supervision of financial institutions, all contributed to the profitability as well as stable growth and development of the financial sector.

Favorable economic conditions in 2004 have contributed to the growth of financial sector.

Chart II.1.1
Balance Sheet Size of the Financial Sector¹



Source: BRSA-CBRT, Treasury, Association of Turkish Capital Market Intermediary Institutions

¹ As of December 2004

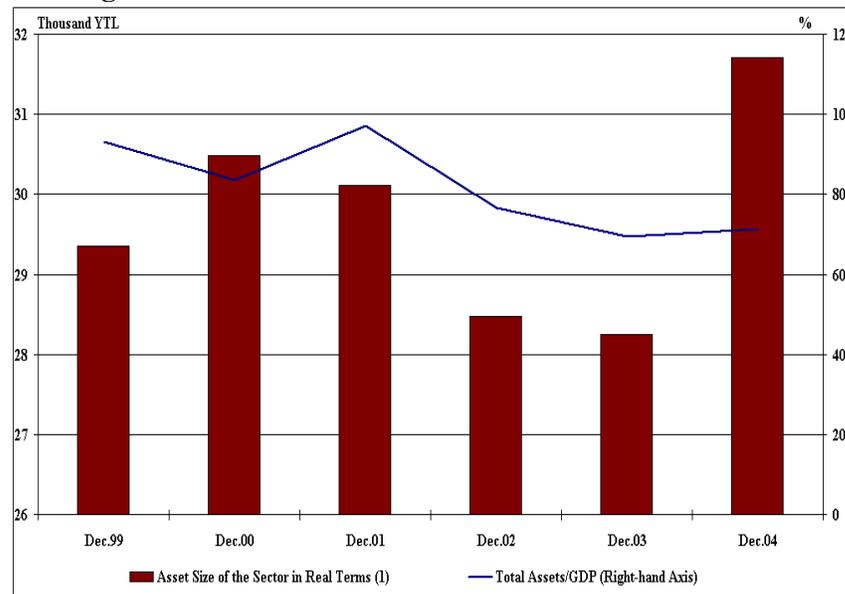
About 91.4 percent of the financial sector assets are composed of bank assets.

There are currently 48 Banks, 5 Special Finance Institutions, 58 Insurance Companies, 92 Factoring, 81 Leasing, 7 Consumer Finance Institutions and 151 Intermediary Institutions operating in the Turkish financial sector⁹. About 91,4 percent of financial sector assets consists of bank assets. Although individual sectors other than banking have not reached the desired size yet; insurance and leasing sectors have especially made significant progress relative to past periods (Chart II.1.1). In this section, banks, special finance institutions (SFI), pension funds, insurance, reinsurance and consumer finance companies are analyzed.

II.1.1. Banking Sector

Banking sector assets increased by 23 percent at the end of 2004, when compared to the previous year and amounted to 306.5 billion New Turkish liras. In real terms, the total assets of the sector increased by 12.3 percent and reached 31.7 thousand New Turkish liras from 28.2 thousand New Turkish liras. (Chart II.1.1.1).

Chart II.1.1.1
Banking Sector Balance Sheet in Real Terms and Its Share in GDP



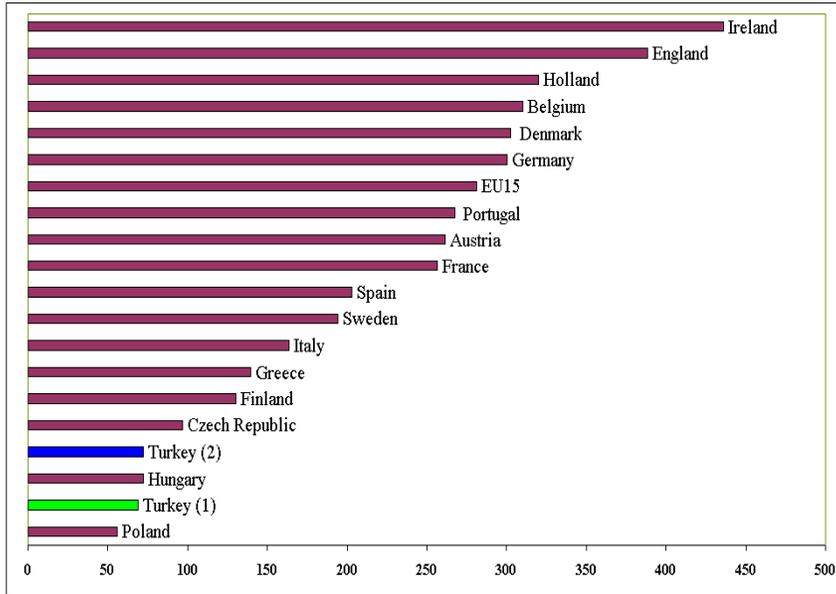
Source:BRSA-CBRT

¹ Asset size of the banking sector is expressed in real terms by using "1994=100 CPI" .

⁹ Data of banks and SFI are from the BRSA –CBRT, data of insurance, factoring, leasing and consumer finance institutions are from Treasury and data of Intermediary Companies are from Association of Capital Market Intermediary Institutions.

Since the application of inflation accounting was terminated, total assets of the sector increased by 5.6 percent compared to year-end 2004 and reached 324.7 billion New Turkish liras in May 2005.

Chart II.1.1.2
Comparison of the Turkish Banking Sector Asset Size/GDP Ratio with Selected EU Members¹



Turkish banking sector total asset size to GDP ratio is comparable with the new members of the EU.

Source: SSI, BRSA, CBRT, ECB Report, 2004

¹ Turkey (1) indicates the data of 2003, Turkey (2) indicates the data of 2004. For the EU members data of 2003 is used.

It can be seen that the asset size of the Turkish banking sector to GDP ratio was realized as 69 percent in 2003 and it was well under that of the EU15¹⁰, which was 281 percent.

Total asset size of the Turkish banking sector to GDP ratio was 72 percent at the end of 2004, and when the ratio is compared to the new EU members, it is the same with Hungary, higher than Poland and lower than the Czech Republic (Chart II.1.1.2).

¹⁰ Belgium, France, Germany, Italy, Luxembourg, Poland, Denmark, Ireland, United Kingdom, Greece, Portugal, Spain, Austria, Finland and Sweden

Table II.1.1.1
Comparison of the Balance Sheet Items with Selected EU Countries¹

	Deposits / GDP (%)	Loans / GDP (%)	Loans / Deposit (%)	Loans / Total Assets (%)	Total Assets / Number of Banks (Million Euro)
Belgium	137	107	78	35	7,676
Denmark	53	155	295	51	2,802
Germany	115	142	124	47	2,873
Greece	92	72	79	52	3,613
Spain	109	117	108	58	4,333
France	77	92	120	36	4,254
Ireland	121	158	130	36	7,190
Italy	57	87	152	53	2,653
Luxemburg	883	505	57	18	3,814
Holland	124	166	134	52	3,061
Austria	99	124	125	48	720
Portugal	105	142	135	53	1,743
Finland	53	66	124	51	508
Sweden	47	106	224	55	2,339
United Kingdom	115	140	122	36	14,496
EU15 Total ¹	98	121	124	43	3,513
Czech Republic	64	38	60	39	2,218
Hungary	43	42	97	59	1,692
Poland	39	28	73	51	1,727
Turkey					
Dec.03	43	21	48	30	2,862
Dec.04	45	25	55	34	3,322

Source: BRSA-CBRT, ECB Report 2004, ECB Report-January 2005

¹ Data of EU countries is as of 2003. For the EU15 data of credit institutions is used, for Turkey and for the new three members data of banks is used.

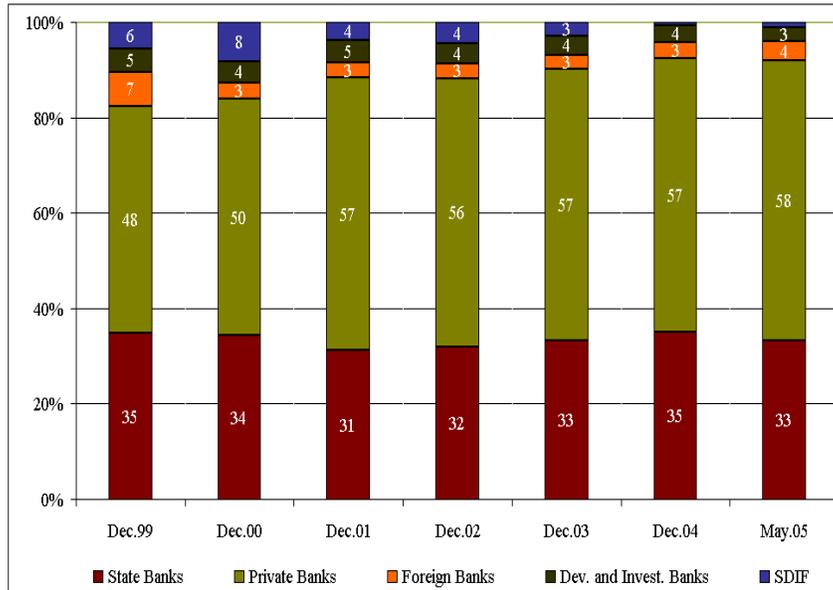
When the Turkish banking sector is compared to selected EU countries, it can be seen that the total deposits to GDP ratio was lower than the EU members at the end of 2003 except Poland and Hungary, total loans to GDP and loans to deposits ratios were under the level of selected EU members (Table II.1.1.1). Due to the effects of the banking sector restructuring process, the high public sector debt requirement and the shrinking of domestic demand, the loans to GDP ratio declined, but on the other hand, the securities¹¹ to GDP ratio was realized as 29 percent in 2003.

¹¹ Securities = Securities in the trading portfolio+Securities Available for sale+Securities to be held until maturity (net). In 2004, 97 percent of securities portfolio consist of Government Domestic Debt Instruments.

As of December 2004, the loan to deposit ratio increased to 55 percent, while the loans to GDP ratio went up to 25 percent. However, the loans to GDP ratio was still lower than the EU15 level (Table II.1.1.1).

In 2003, the share of total loans in total assets of the banking sector was about 30 percent and was lower than EU countries except Luxembourg. As of December 2004, the loans to total assets ratio increased to 34 percent. Asset size per bank was 2.8 billion Euros according to 2003 data and was higher than most EU countries, including new members. This amount has reached 3.3 billion Euros at the end of December 2004 (Table II.1.1.1).

Chart II.1.1.3
Distribution of the Banking Sector Asset Size by Groups¹



Source: BRSA-CBRT

¹ Groups on the Chart: “State”: state-owned deposit banks, “Private”: privately owned deposit banks, “Foreign”: “Foreign owned deposit banks. “Development and Investment ”: state (3), private (8) and foreign (2) banks which don’t accept deposits, “SDIF”: Banks under the administration of Saving Deposits Insurance Fund.

The share of 18 private banks in the Turkish banking sector total assets is 57 percent in 2004. The three state banks¹² maintain a significant share of 35 percent. The share of 13 deposit banks fully owned by foreigners is 3.4 percent. The share of private banks in the sector rose to

The share of state, private and foreign banks was realized as 35 percent, 57 percent and 3.4 percent respectively as of the end of 2004.

¹² Although it is shown as a state bank, the status of Vakıfbank is not clear. It is in the privatization process and it will become a private bank when its shares, currently under the control of the Genel Directorate of Foundations, are offered to the public.

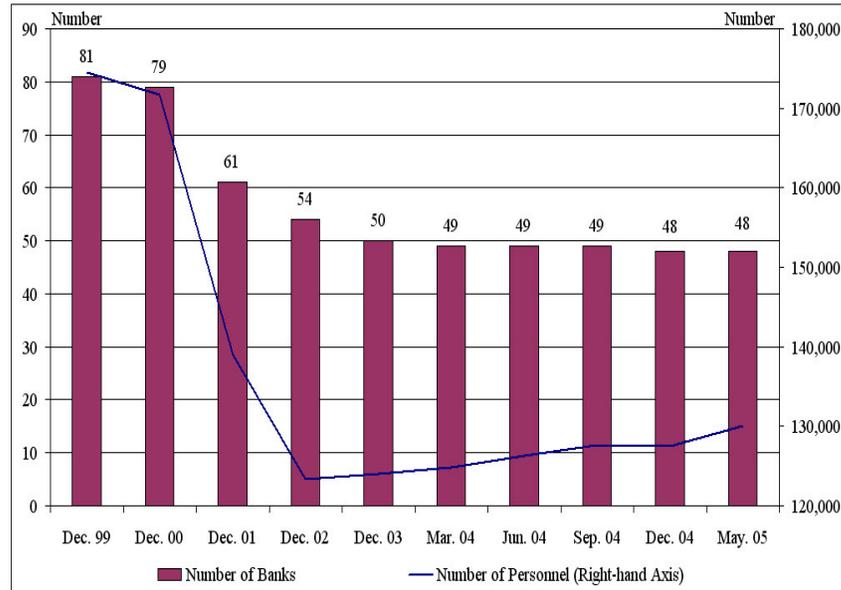
58 percent in May 2005, whereas the share of state banks has decreased to 33 percent and the share of foreign banks have been 4.1 percent.

Box.II.1.1.1.Development of the Share of Foreign Banks in the Turkish Banking Sector Assets

According to the total balance sheet size, the share of 13 foreign deposit banks in the Turkish banking sector is 4.1 percent as of May 2005. On the other hand, if the shares of Taib Yatırım Bank and Calyon Bank, which are in the development and investment banks group, and the banks which are in the private banks group but have foreign participation such as Turkish Bank, Tekfenbank, Finansbank, Koçbank and Türkiye Ekonomi Bank are included, the share of foreign banks in the sector rises to 6.7 percent. Stability in the Turkish economy and banking sector after 2003 has positively affected the interest of foreign investors in the Turkish banking sector. When sales negotiations on some banks with foreign investors are considered, the share of foreign banks is also expected to rise in the future.

The share of development and investment banks in the sector was 4 percent in 2004. While the share of SDIF banks went up to 8 percent in the previous years, it declined to 0.6 percent as of May 2005 and the number of banks also decreased from 20 to one, after sales, mergers or liquidation (Chart II.1.1.3).

**Chart II.1.1.4
Number of Banks and Personnel**



Source: BRSA-CBRT

The diminishing number of banks and personnel has stemmed from the crises of 2000 and 2001. The comparison between 1999 and 2003 as the before and after crises periods, indicates that as a result of sales,

mergers and liquidations, the number of banks decreased from 81 in 1999 to 50 in 2003 and the number of personnel declined from 174,442 to 124,030 (Chart II.1.1.4).

The number of banks further decreased to 48 after the acquisition of one private and one foreign bank and the number of personnel and branches further increased in 2004, mainly due to private banks.

At the end of May 2005, the number of banks has not changed, but the total personnel increased by 2,495 when compared to end 2004 and was realized as 130,031.

While the number of banks operating in the banking sector decreased to 48, the number of branches and personnel increased in 2004.

Table II.1.1.2. Comparison with EU15 ¹

	The share of the largest 5 credit institutions	Number of credit institutions	Total Number of Branches	Total Number of Personnel	Personnel Per Branch	Branch Per Credit Institutions	Proportion of Banking Sector Personnel Number to Total Population
Belgium	83	108	4,989	73,553	15	46	0.04
Denmark	67	203	2,118	45,994	22	10	0.05
Germany	22	2,225	47,351	725,550	15	21	0.05
Greece	67	59	3,300	61,074	19	56	0.04
Spain	44	348	39,762	243,460	6	114	0.04
France	47	939	25,789	420,291	16	27	0.04
Ireland	44	80	924	35,658	39	12	0.05
Italy	27	801	30,502	337,689	11	38	0.04
Luxemburg	32	172	269	22,513	84	2	0.07
Holland	84	481	3,671	119,857	33	8	0.05
Austria	44	814	4,395	73,308	17	5	0.05
Portugal	63	200	5,440	53,931	10	27	0.05
Finland	81	366	1,252	26,668	21	3	0.05
Sweden	54	222	2,061	39,456	19	9	0.05
United Kingdom	33	426	14,186	495,173	35	33	0.05
EU15 Average	53	496	12,401	184,945	15	25	0.04
Turkey							
Dec.03	60	50	6,062	124,030	20	121	0.03
Dec.04	60	48	6,152	124,141	20	128	0.03

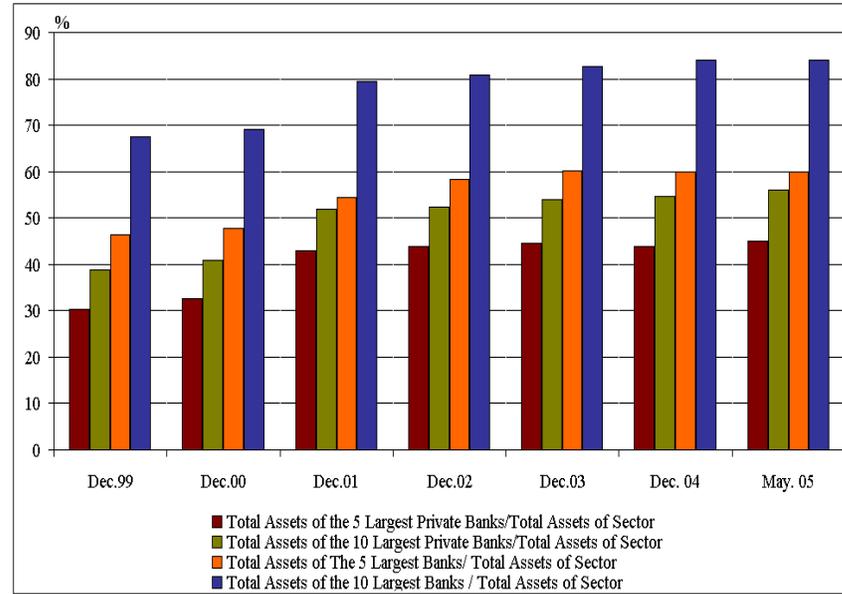
Source: BRSA-CBRT, Eurostat, ECB Report 2004

¹ Data for EU countries is as of 2003. In EU countries, the definition of "credit institution" may differ and non-bank financial institutions may be included in the definition of credit institutions in some cases. The data for Turkey contains only banks.

When we compare the Turkish banking sector with the EU15, it is observed that the number of branches, banks and personnel of the Turkish banking sector is under the average of the EU15. This situation stems from the smaller size of the Turkish banking sector when compared to EU15 countries, as well as the difference in definition of

credit institutions in Turkey and the EU. The proportion of the number of personnel of the Turkish banking sector to the population is lower than both the average of the EU15 and all its members. As a result of intense branch banking in Turkey, the branch number per bank is higher than the EU15. Moreover, the number of personnel per branch is close to the EU15 average (Table II.1.1.2).

Chart II.1.1.5
Concentration in the Banking Sector by Asset Size

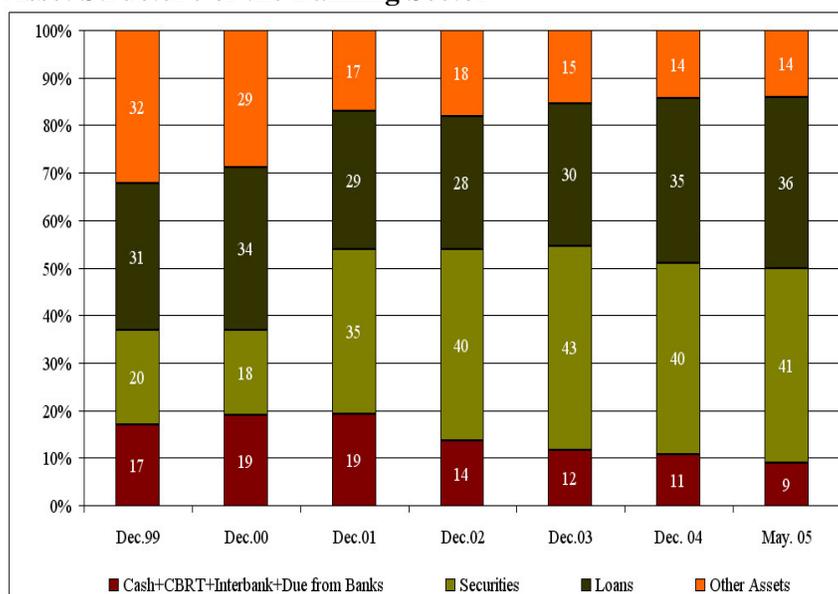


Source: BRSA-CBRT

When the asset size concentration of the Turkish banking sector is compared with the EU15, it is observed that the total asset size of the largest five banks is higher than the average of the EU15 in addition to some other developed countries (Table II.1.1.2).

When the share of the total asset size of the largest ten banks is considered, it can be seen that the ratio was 69 percent in 2000, whereas in 2004 it increased to 84 percent. On the other hand, the share of the largest ten private banks rose from 41 percent to 55 percent in the same period. As of May 2005, these figures did not change significantly (Chart II.1.1.5).

Chart II.1.1.6
Asset Structure of the Banking Sector



Source: BRSA-CBRT

Decreased political instability and uncertainty in 2002, the gradual increase of economic stability and positive expectations in 2003 and 2004, have all contributed to the restructuring of assets by the banking sector. As a result of increased confidence in the sector both internally and externally, and improvements in sources of funding, the banking sector has tended to increase its investments by decreasing its liquid assets, especially those in domestic currency. At the end of May 2005, the share of liquid assets of the sector in total assets declined by two percent compared to the previous year-end and was realized as 9 percent (Chart II.1.1.6).

Compared to the previous year-end, as of May 2005, while the share of securities and loan portfolio in the total assets increased by one percent, the share of liquid assets decreased by two percent.

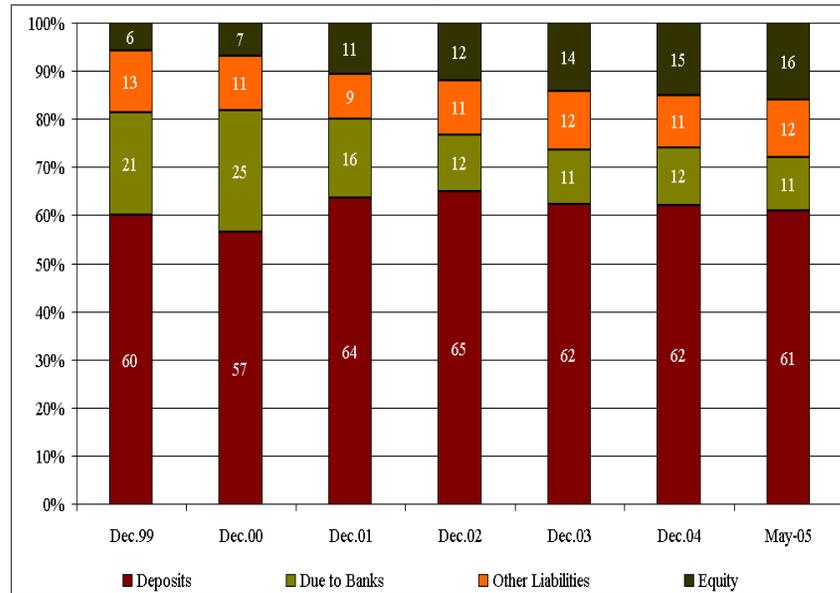
After the crises period, the share of the securities portfolio in total assets decreased by three percent at the end of 2004, when compared to 2003, and was realized as 40 percent. During the restructuring process of the banking sector after the crises period, due to the transfer of domestic debt securities, especially to state banks, and as a result of the banks' assessment of these securities as less risky and more profitable, the share of domestic debt securities in the securities portfolio has increased significantly. As of May 2005, the share of the securities in total assets was 41 percent (Chart II.1.1.6).

In line with the favorable economic developments in 2004, the credit volume of the banking sector has increased.

The credit volume of the banking sector started to enlarge in 2003 as a result of the strengthened financial condition. In line with the positive developments in macroeconomic indicators and positive expectations of the market, the share of the loan portfolio in total assets, which was 30 percent in 2003, increased to 35 percent in 2004 and reached 36 percent at the end of May 2005. Greater emphasis by banks on private banking services, hence the increase in credit cards and consumer credits played a significant role in increasing credit volume (Chart II.1.1.6).

The restructuring process of the banking sector caused a significant decline in other assets (assets other than cash-equivalents, securities and loans). While 32 percent of the total banking sector assets consisted of other assets in 1999, it decreased to 14 percent in 2004 and it remained the same in May 2005. The share of other assets in total assets was high in 1999 since duty loses of state banks were included in other assets (Chart II.1.1.6).

**Chart II.1.1.7
Liability Structure of the Banking Sector**



Source: BRSA-CBRT

As of May 2005, while the share of deposits and due to banks in total liabilities decreased by 1 percent, the share of other liabilities increased by 1 percent when compared to the end of 2004.

The share of equity in the total liabilities is 15 percent in 2004. The share of deposits in total liabilities is 62 percent and amounts to 191.1 billion New Turkish liras. With the effects of the positive developments in the economy and increased confidence in the domestic currency in 2004, the share of domestic currency denominated deposits in total

deposits increased by 4 percent when compared to the previous year and went up to 55 percent, while the share of foreign currency denominated deposits decreased to 45 percent. As of May 2005, the share of deposits in total liabilities is 61 percent (Chart II.1.1.7).

The share of due to banks in total liabilities reached 25 percent in 2000 and began to decline after the end of 2001. Following this it went down further to 11 percent in 2003 and stood at 12 percent in 2004. At the end of May 2005, the share of due to banks in total liabilities decreased again by one percent (Chart II.1.1.7).

The amount of equity, which was 45.9 billion New Turkish liras in 2004, increased by 29 percent compared to 2003 and its share in total liabilities rose from 14 percent to 15 percent. The increase in both paid-up capital and profit for the period affected the rise in the share of equity. As of May 2005, the share of equity in total assets rose to 16 percent (Chart II.1.1.7).

II.1.2.Special Finance Institutions

Box.II.1.2.1.Special Finance Institutions

Special Finance Institutions (SFI) are not authorized to collect deposits but they collect funds by special current accounts and profit and loss participation accounts, and they distribute these funds raised by way of financial leasing, financial support for production, profit and loss participation, trade financing transactions. Though the first SFI was established in Turkey in 1984, today their number and share in the system is very limited. Five SFIs are operating in Turkey and they are subject to Banks Act No: 4389, but these institutions are not required to be a bank. The BRSA is the authorized institution for their supervision and regulation and since 2004 they have their own uniform chart of accounts.

Table II.1.2.1
Number of Branches and Personnel of SFIs

	Dec.02	Jun.03	Dec.03	Jun.04	Dec.04	Apr.05
Number of Institutions	5	5	5	5	5	5
Number of Branches	148	166	189	220	255	259
Number of Personnel	2,530	2,966	3,502	4,145	4,790	5,213

Source: BRSA-CBRT

Special Finance Institutions operated with 189 branches and 3,502 personnel at the end of 2003, whereas their branches increased to 255 and personnel to 4,790 at the end of 2004. As of April 2005, the figures were 259 and 5,213, respectively (Table II.1.2.1).

Table II.1.2.2
Selected Balance Sheet Items of SFIs

Million YTL	Dec.02	Jun.03	Dec.03	Jun.04	Dec.04	Apr.05
Funds-Extended	2,101	2,457	3,138	4,215	4,901	5,674
Due from Banks	547	274	530	506	685	679
Non-Performing Loans(Net)	245	192	124	97	112	113
Fixed Assets	501	680	722	587	548	164
Funds Raised	3,206	3,205	4,111	5,048	5,992	6,559
Equity	400	521	672	771	956	659
Off Balance Sheet Liabilities	799	1,004	1,446	2,192	3,094	3,726
Total Assets	3,962	4,193	5,252	6,323	7,383	7,727

Source: BRSA-CBRT

About 73 percent of the total asset size of the special finance institutions consists of funds-extended.

Total asset size of special finance institutions which was 5.3 billion New Turkish liras at the end of 2003, increased by 40.6 percent and was realized as 7.4 billion New Turkish liras in December 2004. 54 percent of the total assets and 40 percent of the total liabilities of the special finance institutions was denominated in domestic currency as of December 2004. As of April 2005, when compared to year-end 2004, there is no change in total asset size and 73 percent of the total assets and 45 percent of the total liabilities are denominated in domestic currency.

The share of funds-extended in total assets was 59.7 percent and the share of fixed assets was 13.7 percent at the end of December 2003. It is observed that the share of funds-extended in total assets increased but the share of fixed assets declined in December 2004. This tendency continued in April 2005 and the share of funds-extended was realized as 73 percent and the share of fixed assets was just 2 percent (Table II.1.2.2).

The fixed assets of special finance institutions was 548 million New Turkish liras at the end of 2004, but this amount declined to 163 million New Turkish liras by March 2005 due to the Uniform Chart of Accounts for Special Finance Institutions coming into force by the BRSA on 1.1.2005. According to the Chart, assets used for financial leasing have been accounted as funds-extended, beginning from 2005.

The gross non-performing loans of special finance institutions, which was 315.7 million New Turkish Liras at the end of 2003, increased by 7.6 percent and was realized as 340 million New Turkish liras in December 2004. The amount rose by 5.2 percent and was realized as 357 million Turkish liras in April 2005.

The main source of funds for special finance institutions, other than equity, come from current accounts and participation accounts which are mostly held in foreign currency.

Table II.1.2.3
Funds Raised by Special Finance Institutions

Million YTL	Special Current Accounts			Special Project Accounts			Participation Accounts		
	YTL	FX	Total	YTL	FX	Total	YTL	FX	Total
December 2002	149	503	652	3	98	101	268	2,181	2,449
June 2003	147	500	647	2	100	102	425	2,031	2,456
December 2003	277	665	942	3	112	115	848	2,207	3,055
June 2004	371	634	1,005	3	219	222	1,607	2,215	3,822
December 2004	476	822	1,298	3	91	94	1,796	2,817	4,613
April 2005	577	777	1,354	0	11	11	2,283	2,911	5,194

Source: BRSA-CBRT

The amount of funds raised, which was 4.1 billion New Turkish liras at the end of December 2003, increased by 45.8 percent and reached 6 billion New Turkish liras in December 2004 and 6.6 billion New Turkish liras in April 2005. The share of participation accounts in funds raised was 80.4 percent and the rest came from current accounts as of April 2005.

Table II.1.2.4.
Equity of Special Finance Institutions

Million YTL	Dec.02	Dec.03	Mar.04	Dec.04	Apr.05
Total Equity	400	672	726	956	659
Paid-Up Capital	286	420	425	723	806
Reserve Funds	11	12	17	72	118
Revaluation Fund of Fixed Assets	123	202	219	4	4
Profit/Loss of the Period	17	75	32	102	56
Previous Year Losses or Profits	-38	-37	33	56	-324

Source: BRSA-CBRT

While equity was 672 million New Turkish liras at the end of December 2003, it increased by 42.3 percent and was realized as 956 million New Turkish liras at the end of 2004. Following this, it declined by 31 percent and was realized as 659 million New Turkish liras in April 2005. This fluctuating trend of equity stems from the “loss of the previous year”. According to the Accounting Regulation for special finance institutions and its related communiqués, the differences that stem from the application of new accounting rules will be accounted for in the previous year profit / loss account. Therefore, the application of the above-mentioned regulation has affected the increase in the previous year losses account.

Special Finance Institutions continued to increase their profitability performance in 2004. While their profit was 74.5 million New Turkish liras at the end of 2003, it increased by 36.8 percent and reached 102 million New Turkish liras in December 2004. In the period between March 2004-2005, the profitability of these institutions increased by 48.6 percent and was realized as 48 million New Turkish liras in March 2005.

II.1.3. Insurance, Reinsurance and Private Pension Companies

Box II.1.3.1. Insurance, Reinsurance and Private Pension Companies

As of December 2004, there are 44 insurance, eleven private pension and three reinsurance companies in the insurance sector.

The authorized institution for the supervision and regulation of the insurance sector is the Insurance General Directorate under the Undersecretariat of Treasury, according to Insurance Law No: 7397

Regarding the premiums written, the share of the largest ten companies was 64.4 percent and the share of the largest 20 companies was 84.8 percent in the insurance sector. The concentration in the sector is high because the capital of some insurance, private pension and reinsurance companies belongs to the same group.

As of December 2004, the asset size of the insurance sector is 2.9 percent of the assets of the financial sector. In analyzing the consolidated balance sheet of the insurance, reinsurance and private pension companies, it is observed that total assets of the sector was 5.8 billion New Turkish Liras in 2002, 8.1 billion New Turkish Liras in 2003. This figure increased by 29.9 percent in 2004 and was realized as 10.6 billion Turkish liras. Furthermore, the share of securities in total assets continues to increase (Table II.1.3.1).

Table II.1.3.1

Selected Asset Items of Insurance, Private Pension and Reinsurance Companies

Million YTL	2001	2002	2003	2004
Cash Like Assets	628.1	679.4	875.3	956.9
Securities	2,168.4	2,983.0	4,389.8	5,771.2
Receivables	962.5	1,461.8	1,611.5	2,706.1
Fixed Assets	449.1	569.0	978.4	832.8
Other Assets	169.5	148.4	268.2	287.4
Total Assets	4,377.5	5,841.5	8,123.2	10,554.5

Source: Treasury- Insurance Supervision Board

The share of the securities portfolio in total assets increased to 54.7 percent in 2004, while it was 54.1 percent in 2003. 92.3 percent of the securities portfolio is composed of government bonds and treasury bills and one percent of it is equities. The share of the receivables to total assets was 19.7 percent in 2003 and reached 22.3 percent in 2004.

Table II.1.3.2

Selected Liability Items of Insurance, Private Pension and Reinsurance Companies

Million YTL	2001	2002	2003	2004
Liabilities	3,117.7	4,212.2	5,888.9	7,891.3
Equity	771.2	1,257.3	1,763.1	2,083.2
Other Assets	173.2	64.4	171.7	208.7
Previous Year Loses/Profits	-46.5	-63.4	-90.7	-138.1
Loses/Profits of the Period	315.4	307.6	299.6	371.2
Total Liabilities	4,377.5	5,841.5	8,123.2	10,554.5

Source: Treasury- Insurance Supervision Board

It is observed that the consolidated equity of the insurance sector was 1.3 billion New Turkish liras in 2002, 1.8 billion New Turkish liras in 2003. In 2004, it increased by 15.4 percent and was realized as 2.1 billion New Turkish liras. The share of equity in total assets was 21.7 percent in 2003 and 19.7 percent in 2004 (Table II.1.3.2).

Table II.1.3.3

Revenues and Expenses for Insurance, Private Pension and Reinsurance Companies

Million YTL	2002	2003	2004
Total Income	9,929.2	12,827.1	16,753.8
Income	9,110.3	11,866.9	15,799.1
Financial Income	818.9	960.2	954.7
Total Expenses	9,621.7	12,527.6	16,382.5
Expenses	8,657.8	11,520.5	15,173.2
Financial Expenses	963.9	1,007.1	1,209.3
Profit/Loss Of the Period	307.5	299.5	371.3

Source: Treasury- Insurance Supervision Board

The current period profit of the sector was 299.5 million New Turkish liras in 2003 and rose to 371.3 New Turkish liras in 2004. About 20 percent of the companies closed the year 2004 with a loss. The Return on Assets of companies was 3.7 percent in 2003 and declined to 3.5 percent in 2004. In the same periods, the Return on Equity for the sector was 17 percent and 17.8 percent, respectively.

Insurance companies operate in the fields of fire, transportation, accident, traffic, machinery assembling, agriculture, health, life and private pension. The number of direct premiums written increased by 32.6 percent in 2004 and was realized as 6.6 billion New Turkish liras. Accident insurance has the highest share in all other fields according to the number of premiums written. The share of accident insurance excluding traffic insurance was 33.9 percent in 2004.

Table II.1.3.4
Insurance Services According to Premiums Written¹

Insurance Fields					
%	2000	2001	2002	2003	2004
Fire	14,41	17,59	17,90	16,51	15,28
Transportation	3,96	4,29	4,37	3,90	3,91
Accident	48,46	43,77	42,63	33,77	33,90
Traffic	0,00	0,00	0,00	10,30	14,23
Machinery Assembling	3,78	4,82	5,02	4,16	3,90
Agriculture	0,36	0,34	0,42	0,41	0,44
Health	10,64	10,85	11,26	10,30	9,87
Life	18,38	18,35	18,41	20,66	18,47
Total	100,00	100,00	100,00	100,00	100,00
Domestic Direct Premium Written (Million YTL)	1.775,0	2.503,8	3.631,3	4.971,2	6.596,7

Source: Treasury- Insurance Supervision Board

¹ Data doesn't include private pensions

The share of domestic direct premiums written in the GDP was 1.4 percent in 2003 and 1.5 percent in 2004, on the other hand premiums written per individual was 69.4 New Turkish liras in 2003, increasing to 90.5 New Turkish liras in 2004.

Box II.1.3.2. Private Pension Companies

The private pension system started to operate from 27.10.2002, according to Law No: 4632, on Private Pension Savings and the Investment System dated 7.4.2001. There are eleven companies in the system and ten of them deal with life and private pensions and one of them deals only with pensions.

Number of system participants is 337,897 and total amount of the fund is 287.9 million New Turkish liras as of December 2004.

II.1.4.Consumer Finance Companies

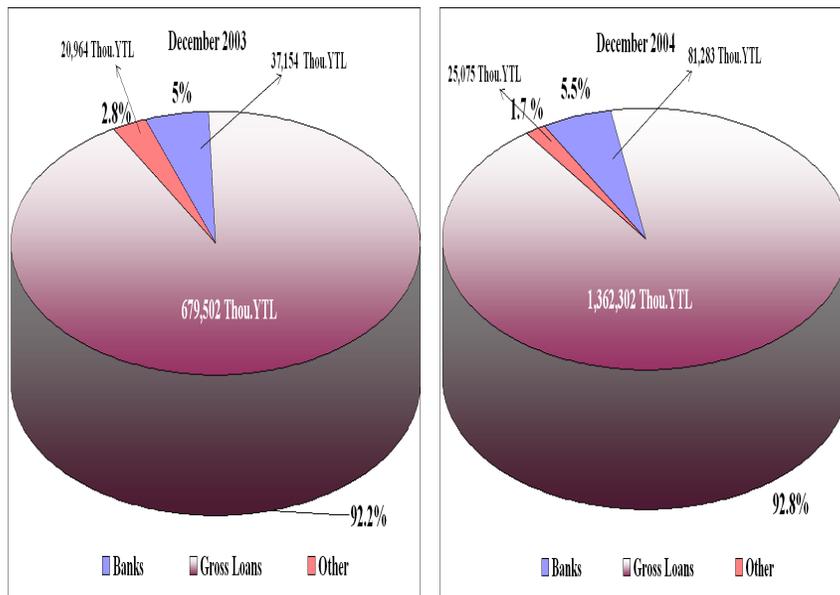
BoxII.1.4.1.Other Financial Institutions

Financial Leasing Companies; are the companies with the ownership of the investment commodity but the right of using it is given to lessee for a specified term and agreed leasing payments. The ownership rights are transferred to the lessee at the end of the specified term. These companies provide leasing rights of a commodity instead of buying it, therefore the operating capital of the company can be used for other priorities. Thus, leasing companies have an important role in increasing profitability and efficiency.

Factoring Companies; offer a package of financing, guarantee and collection services of a financial product by being assigned a firms receivables that will arise from sales of goods and services based on invoice documents.

Consumer Finance Companies; are involved in lending to consumers for financing purchases of commodities and services, in line with the Decree Law on Lending Transactions.

Chart II.1.4.1
Asset Structure of Consumer Finance Companies



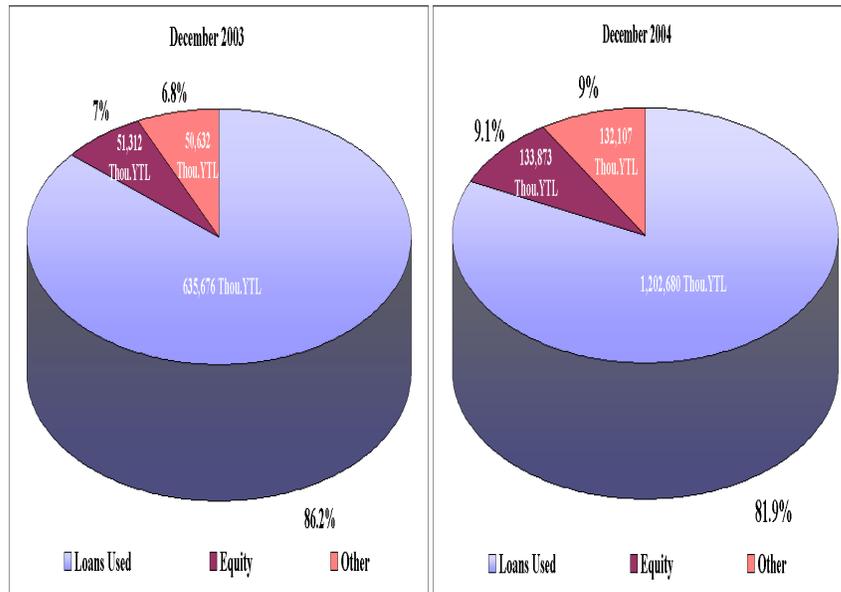
Source: CBRT

The total asset size of consumer finance companies increased by 99.1 percent and reached 1.469 million New Turkish liras in 2004, compared to the previous year. In analyzing the asset structure of these companies, it is observed that their loan portfolio has a 92.8 percent weight in total assets (Chart II.1.4.1). In the first five months of 2005, the asset size of companies increased by 17.3 percent and was realized as

1.723 million New Turkish liras. Although it is still a significant figure, the share of gross loans declined to 92.3 percent as a result of the increase in due from banks.

Almost all of the medium and long-term credit portfolio (74.3 percent of total loans) is composed of automobile and other motor vehicle credits in 2004. Two-thirds of gross loans are composed of retail credits. As of May 2005, the above-mentioned tendencies have not changed.

Chart II.1.4.2
Liability Structure of Consumer Finance Companies



Source: CBRT

In analyzing the liability structure of consumer finance companies, it is observed that the share of credits used has declined but its importance continues (Chart II.1.4.2). Of these credits, 71.8 percent was obtained from banks and the rest from other institutions. Most of the credits obtained from banks are from banks abroad. The share of credits used has remained the same in May 2005 but the share of credits obtained from other institutions increased to 36.6 percent. As of May 2005, 84.3 percent of credits obtained from banks comes from banks abroad.

II.2.BANKING SECTOR RISKS

II.2.1.CREDIT RISK

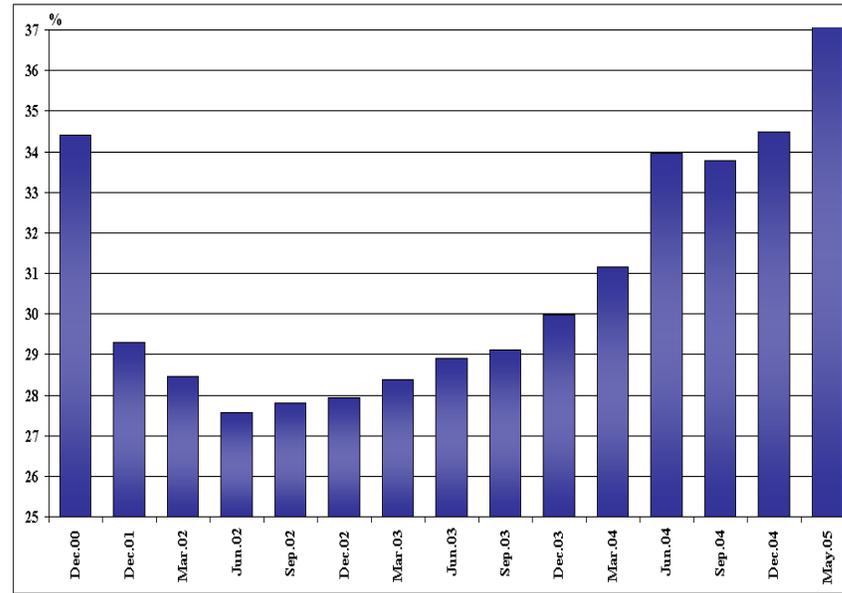
II.2.1.1.Developments in the Credit Portfolio

II.2.1.1.1.General Structure

After the crises experienced in 2000 and 2001, regarding the banking sector's asset structure, there has been an expansion of liquid assets and securities and a significant shrinkage of loans. As mentioned in Part II.1.1, after the crises, for banks that prefer to stay liquid in an environment of increasing uncertainty, domestic and foreign funding opportunities diminished and funding costs increased. Furthermore, difficulties in the collection of loans and the deterioration of some banks' equity as a result of the realization of risks that they were exposed to, led to the reduction in the banks' credit supply limits. Some banks invested in government bonds, which are less risky and create higher yields considering the risk weights set by the capital adequacy regulation. Additionally, the decrease in credit demand caused by the rapid shrinking of the economy has been influential in the reduction of the amount of loans extended.

After the crises in 2000 and 2001, the amount of loans extended has shrunk significantly.

Chart II.2.1.1.1.1
Share of Gross Loans in Total Assets



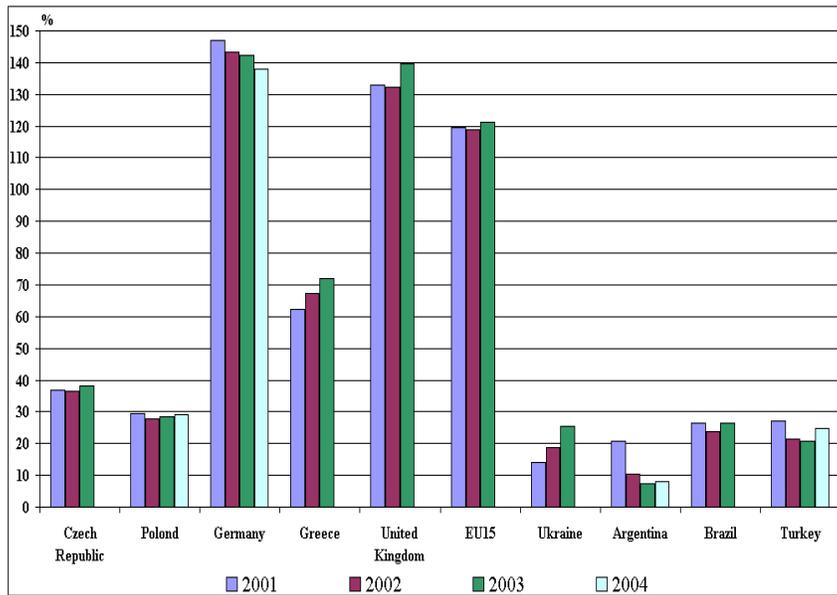
Source: BRSA-CBRT

During the year 2004, credit volume increased rapidly.

Several factors have influenced the credit volume to follow an increasing trend from 2003, including the determined course in implementing the economic program and increased political stability, as well as improvements in macroeconomic indicators and expectations, the stability of foreign exchange and interest rates and especially the restructuring of loans under the scope of the İstanbul Approach. In particular, as of the third quarter of the year 2003, with the realization of deferred demand for credit, this trend has become more apparent. In fact, the share of gross loans in total assets¹³ which used to be 27.9 percent by the end of 2002, rose to 30 percent by the end of 2003, and to 34.5 percent by the end of 2004. This was especially due to the increase in retail loans. The aforementioned rise continued during 2005 and the share of gross loans in total assets reached 37.9 percent as of May 2005 (Chart II.2.1.1.1.1).

¹³ Gross Loans = Total Loans + Gross NPL

Chart II.2.1.1.1.2
Loans to GDP Ratios of Selected Countries

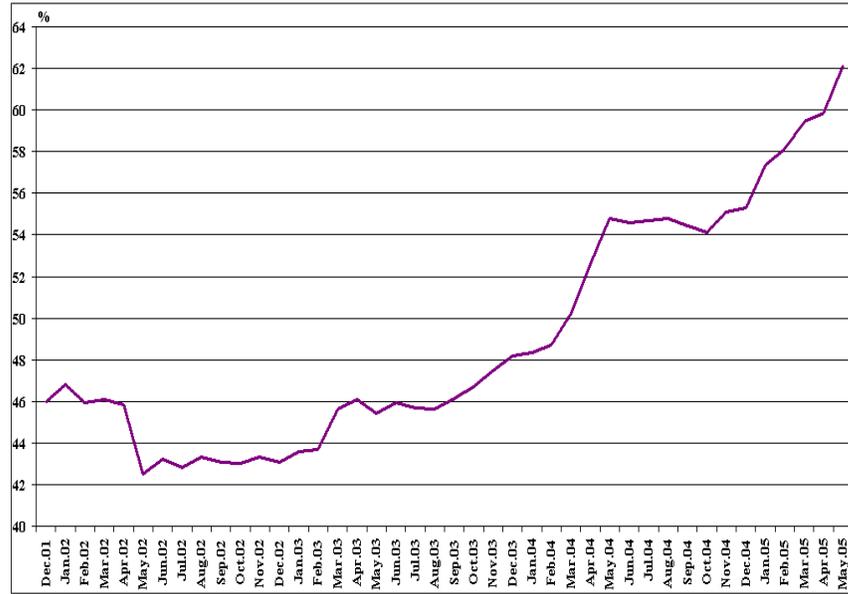


Source: CBRT, EuroStat, ECB Report on Banking Structure - January 2005 and National Central Banks

The chronic inflation experienced since the 1990s and the high borrowing requirement of the Government caused by high public deficits, have led to the withdrawal of domestic funds by the Government, an increase in investment costs and, therefore, a low loans to GDP ratio. Even though this ratio showed an increasing trend caused by the expansion of loans beginning from the year 2003, it is still low compared to the loans extended by banks to the GDP ratio of other selected countries, except Argentina (Chart II.2.1.1.1.2). However, as a result of the decreasing public deficit, declining interest rates along with price stability and financial deepening, it is expected that the ratio of loans to GDP will increase more in the following years.

Despite the significant increase in credit volume in 2004, loans to GDP ratio is still low .

Chart II.2.1.1.3
Loans/Deposits Ratio

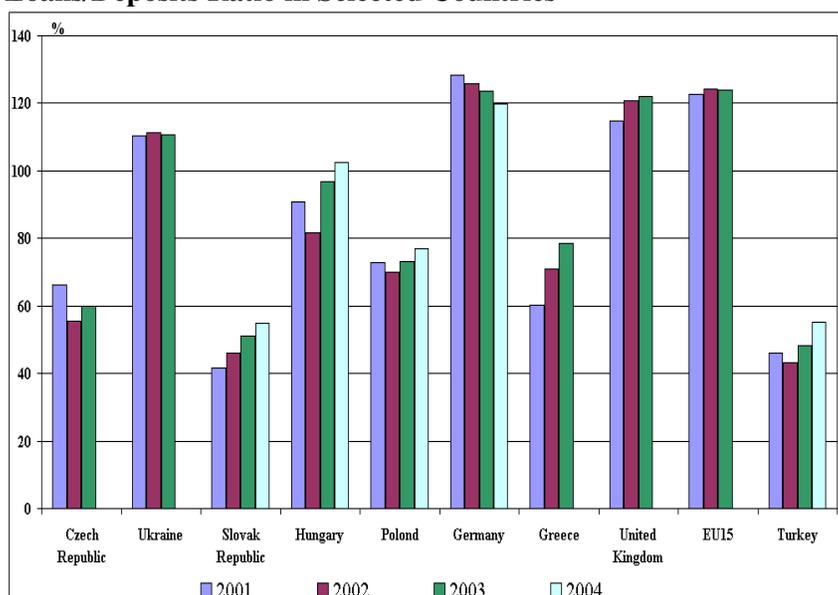


Source: BRSA-CBRT

Loans/Deposit ratio has an increasing trend since 2003.

As a result of the decrease in credits in the years 2001-2002 and rise in total deposits, the Loans/Deposits ratio, which is an important indicator of the transformation of savings into investments in the economy, has been significantly low. In fact, the ratio, which stood at 46 percent by year-end 2001, decreased to 43.2 percent in 2002 and was realized as 48.2 percent as of year-end 2003. The Loans/Deposits ratio, which showed a rapidly increasing trend, especially in the last quarter of 2003, rose to 55.3 percent by the end of 2004 and to 62.1 percent by the end of May 2005 (Chart II.2.1.1.3).

Chart II.2.1.1.1.4
Loans/Deposits Ratio in Selected Countries



Source: CBRT, EuroStat, ECB Report on Banking Structure - January 2005 and National Central Banks

The Loans/Deposits ratio is observed to be low compared to the EU15 average and to the ratios of the selected countries (Chart II.2.1.1.1.4).

Table II.2.1.1.1.1
Bank Concentrations of Some Selected Credit Ratios ¹

Million YTL - %	Dec.01			Dec.02			Dec.03			Dec.04			May.05		
	Top 5 Banks	Top 10 Banks	Sector	Top 5 Banks	Top 10 Banks	Sector	Top 5 Banks	Top 10 Banks	Sector	Top 5 Banks	Top 10 Banks	Sector	Top 5 Banks	Top 10 Banks	Sector
Total Gross Loans	27,572	41,076	50,788	32,540	46,028	59,411	40,888	58,000	74,850	56,620	83,965	105,698	67,201	98,371	123,050
Share in Total Gross Loans	54.3	80.9	100.0	54.8	77.5	100.0	54.6	77.5	100.0	53.6	79.4	100.0	54.6	79.9	100.0
NPLs / Total Gross Loans	26.7	25.5	25.2	15.2	20.3	17.6	11.4	12.3	11.5	5.0	6.5	6.0	4.7	5.9	5.6
Loans / Deposits	45.6	45.5	46.0	37.9	39.6	43.1	42.0	42.9	48.2	47.8	49.5	55.3	54.5	55.7	62.1

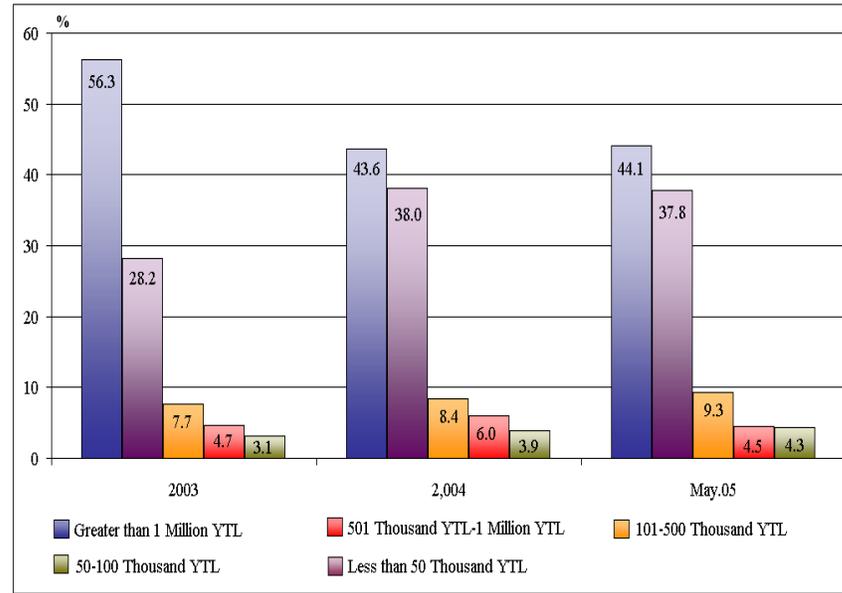
Source : BRSA-CBRT

¹ First 5 and 10 banks according to their total gross credits have been taken into consideration.

In May 2005, the shares of the first five and ten banks, which extended the majority of loans continued to be high. However, improvements in the NPL ratios of those banks, is considered to be a positive development from a credit risk point of view (Table II.2.1.1.1.1).

Bank concentration of loans is at high levels.

Chart II.2.1.1.1.5
Cash Loans by Size

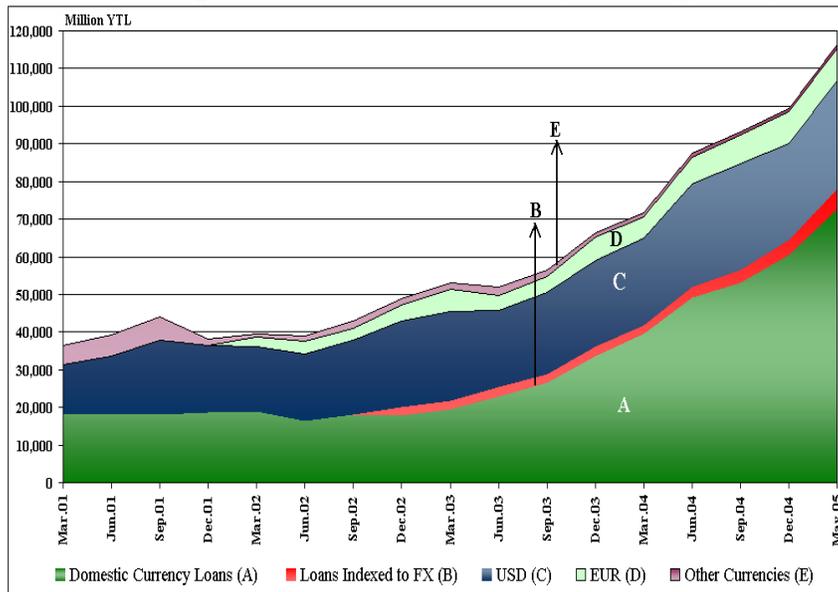


Source: BRSA-CBRT

The share of large exposures in total loans decreased as a result of the increase in consumer loans and credit cards.

When the distribution of loans according to size is analyzed, it is observed that the share of loans greater than one million New Turkish lira decreased from 56.3 percent at the end of 2003 to 43.6 percent at the end of 2004. On the other hand, contrary to the fall in the share of large exposures, the share of loans of less than 50 thousand New Turkish lira increased from 28.2 percent at the end of 2003 to 38 percent at the end of 2004. This came as a result of the rise in consumer loans and credit cards. As of May 2005, the aforementioned distribution stayed almost the same (Chart II.2.1.1.1.5). It is our opinion that the decrease in the concentration of credits is a positive development from a credit risk point of view and indicates a broader customer base.

Chart II.2.1.1.1.6
Currency Composition of Loans Extended (Excluding NPLs)

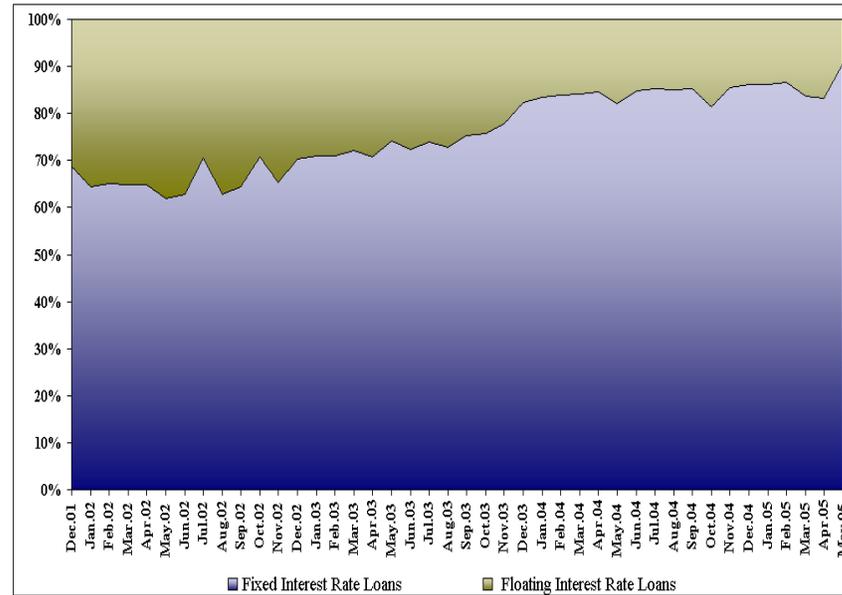


Source: BRSA-CBRT

It is observed that the share of domestic currency loans in total loans is increasing. In fact, the share of domestic currency loans which was 48.8 percent at the end of 2001, rose to 54.6 percent by year-end 2003 and 64.8 by year-end 2004. As of May 2005, the share of domestic currency loans was realized as 67.1 percent while the share of foreign currency loans became 32.9 percent (Chart II.2.1.1.1.6). The fact that almost all retail loans are in domestic currency can be considered as one of the causes of this rise in the share of domestic currency loans.

The share of domestic currency loans in total loans is increasing.

Chart II.2.1.1.1.7
Fixed and Floating Interest Rate Loans (Excl. NPL)¹



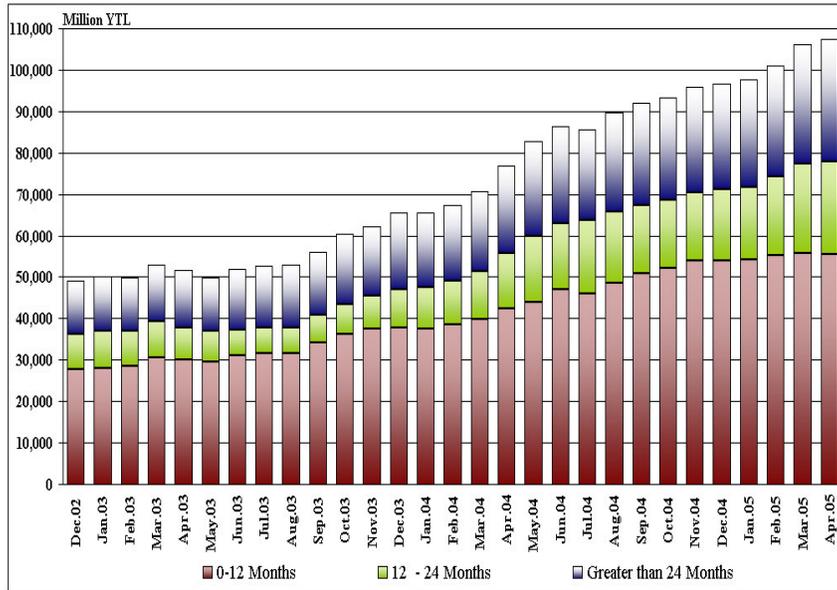
Source: BRSA-CBRT

¹ Excluding İller Bankası

The rise in domestic currency loans, which mainly stemmed from consumer loans, had a positive effect on credit risk. However, the fact that the rates on consumer loans are fixed, led to an increase in the amount of fixed rate loans. In fact, at the end of 2002, the share of fixed rate loans increased from 70.2 to 86.2 percent as of year end 2004 and to 90.8 as of May 2005, as a consequence of the increase in consumer loans and fall in interest rates (Chart II.2.1.1.1.7). This situation emphasizes the importance of the management of interest rate risk that the credit portfolio of the banking sector is exposed to. Within this framework, it is our opinion that new arrangements for enhancing floating-rate consumer loans along with fixed-rate ones would be beneficial to mitigate the interest risk resulting from them.

Chart II.2.1.1.8

Maturity Structure of the Total Credit Portfolio of the Banking Sector (Excluding NPLs)

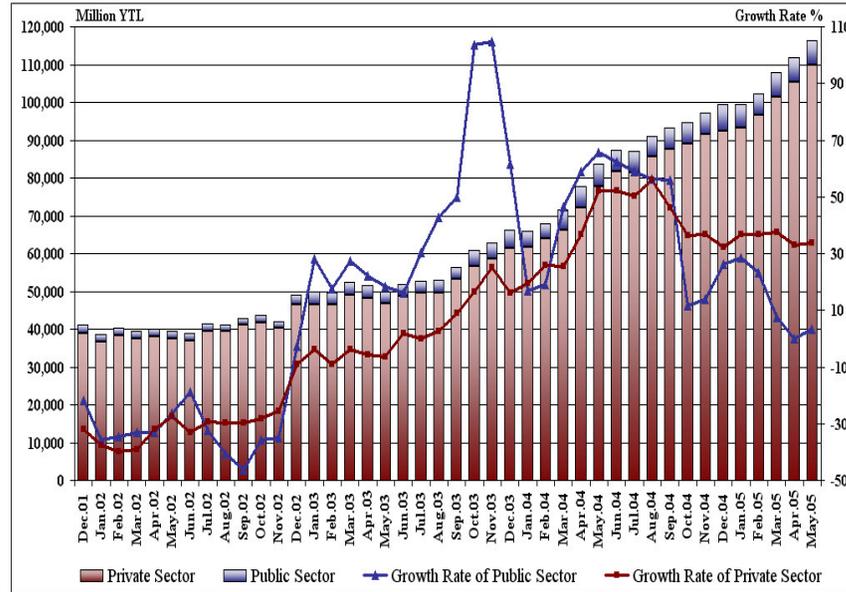


Source: CBRT

When the development of the original maturities of the loans extended by the banking sector is analyzed, it is seen that even though majority of total loans are short-term loans (0-12 months), the share of such loans in total loans is falling. The share of short-term loans, excluding non-performing loans, which was 64 percent at the end of 2001, decreased to 57.6 percent as of year end 2003, 55.7 percent as of year end 2004 and to 51.8 percent as of April 2005 (Chart II.2.1.1.8). This rise in the share of long-term loans has especially stemmed from consumer loans with a maturity of longer than one year.

There exists a rise in the share of long term loans stemming from the increase in consumer loans.

Chart II.2.1.1.1.9
Loans Extended to the Public¹ and Private Sector



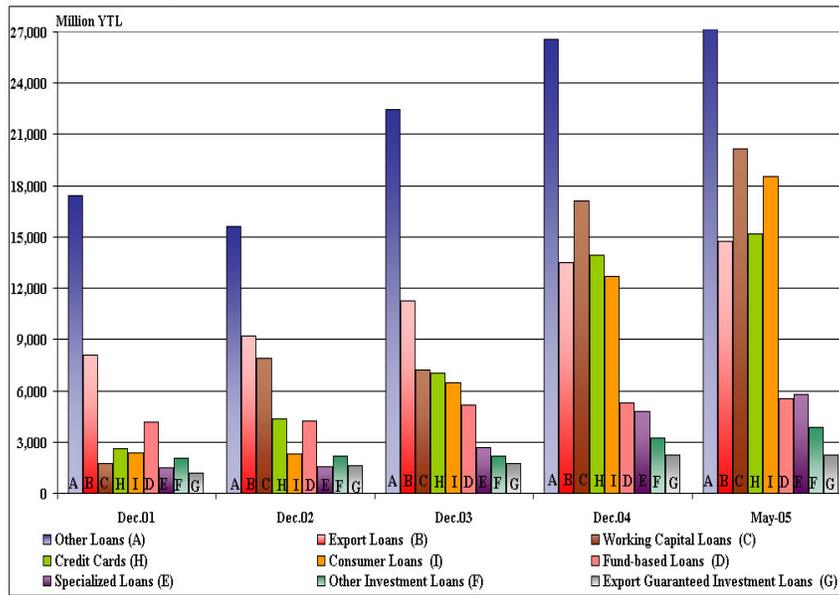
Source: BRSA-CBRT

¹ Public sector loans are composed of loans extended to central and local governments and to non-financial public enterprises.

The majority of loans are loans extended to the private sector by deposit banks.

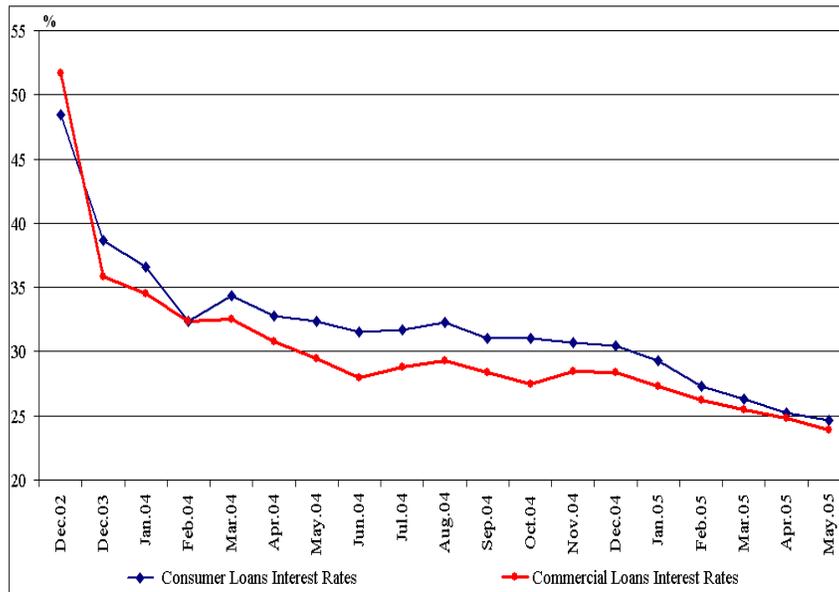
Regarding the public-private sector distribution of loans extended, more than 90 percent of total loans are extended to the private sector in every period, and this ratio rose to 95 percent in 2004. In the meantime, the share of loans extended to the public sector, which are composed of loans extended to central and local governments and to non-financial public enterprises, is around five percent (Chart II.2.1.1.1.9).

Chart II.2.1.1.10
Loans by Type (Excluding NPLs)



Source: BRSA-CBRT

Chart II.2.1.1.11
Interest Rates on Consumer and Commercial Loans^{1,2}



Source: CBRT

¹ Weighted average interest rates.

² Interest rates for domestic currency loans.

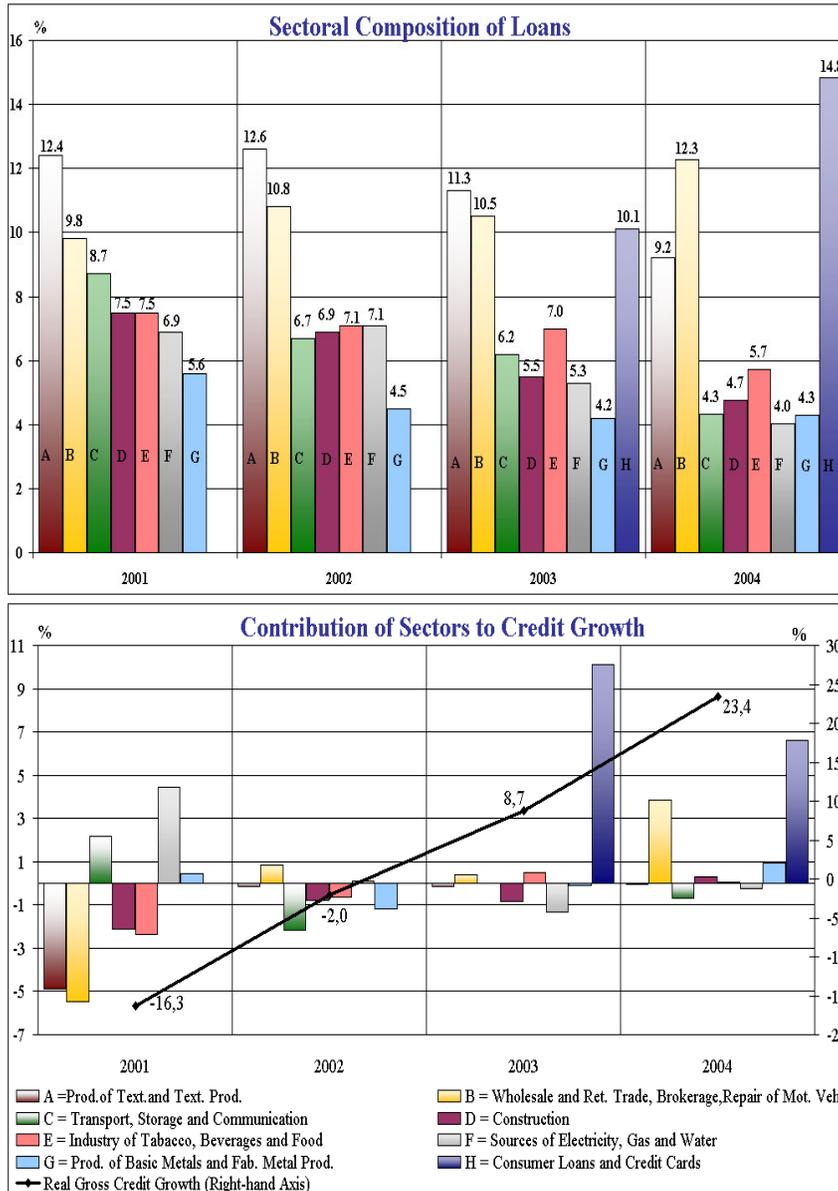
A hectic pace of growth is observed in retail loans and working capital loans.

Regarding loans by type, there is a significant increase in retail loans (composed of consumer loans and credit cards) and working capital loans during the 2002-2004 period (Chart II.2.1.1.1.10). The increase in retail loans is a consequence of the realization of deferred consumption due to the low interest rates achieved in the stable financial system (Chart II.2.1.1.1.11). As a matter of fact, during the aforementioned period, the share of retail loans increased from 15.1 percent to 26.8 percent with a growth of 259.5 percent in retail loans and the share of working capital loans increased from 16 percent to 17.2 percent with a growth of 117.9 percent. As of May 2005, the share of retail loans rose to 29 percent with no significant change in working capital loans.

Additionally, the rate of increase in export and export-guaranteed investment loans, which have the maximum share in total loans, remained below the rate of increase in retail and working capital loans and exhibited a drop in share from 22.6 percent to 15.8 percent as of end 2004. This trend continued in 2005 and as of May 2005 this share decreased to 14.6 percent.

Chart II.2.1.1.12

Sectoral Composition of Loans and Contributions of Sectors to Credit Growth^{1,2,3}



Source: CBRT-Risk Center

¹ Contributions of sectors to credit growth is the ratio of the change in loan amounts compared to the previous year for each sector to gross credit.

² Corporate loans include; starting from 01.01.2002, those loans that are greater than ten thousand new Turkish Liras (inclusive) (seven thousand new Turkish Liras for 2001) and for retail loans, starting from 28.02.2003 (initial date of monitoring by the Risk Center), those loans greater than five thousand New Turkish Liras; extended to real and legal persons with a tax ID; by banks and special finance houses (including external credits used by companies with the intermediation of banks and SFHs). Therefore, it does differ from the figures in the balance sheet-based analysis.

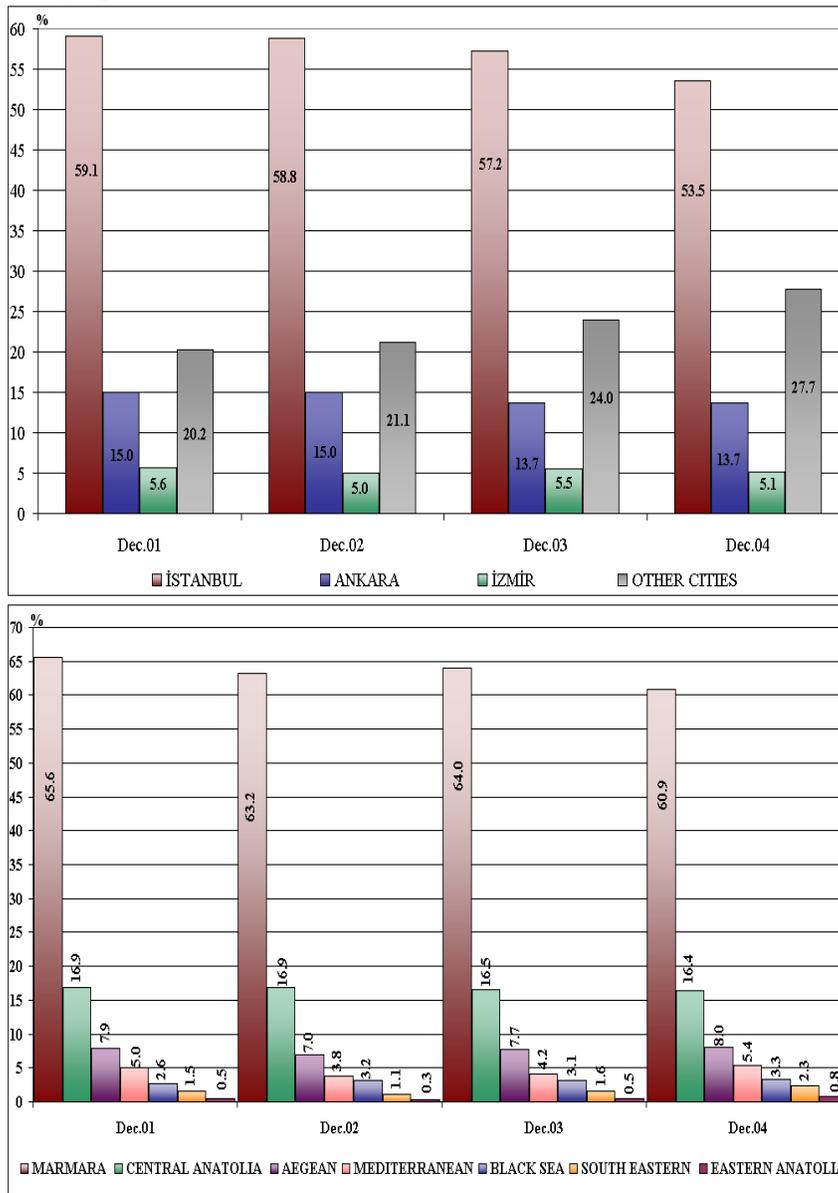
³ Since the monitoring process for retail loans and credit cards by the Risk Center was initiated as of 28.02.2003, column "H" which denotes those loans does not appear in the chart for the years 2001 and 2002.

Concentration by sectors has a tendency to decrease.

According to Central Bank Risk Center data for loan concentrations by sectors, the share of eight sectors indicated in Chart.II.2.1.1.1.12, which was 60.1 percent at the end of 2003, dropped to 59.4 percent by year-end 2004 and rose to 60.9 percent in May 2005. However, excluding retail loans and credit cards, the share of the remaining seven sectors decreased from 50 percent to 44.6 percent by year-end 2004 and to 44.4 percent by May 2005. This trend shows that the increase in the total of these eight sectors mainly stems from the increase in retail loans and credit cards. In addition, during the 2001-2004 period, among those seven sectors "Wholesale and Retail Trade, Commission, Motor Vehicle Services" is the only one with an increasing share.

In 2004, retail loans and credit cards had the largest share with 14.8 percent, which continued to rise in 2005 and rose to 16.5 percent by May 2005. The fact that retail loans have the most diversified customer base, the collateral of consumer loans (especially automobile and housing loans) is much easier to make liquid compared to other types of loans and their risk coverage is higher, are all considered favorable from a credit risk point of view. On the other hand, it is necessary to closely monitor the potential effects of the increase in credit volume on the balance of payments and inflation targeting, as well as the types of financing that banks use to fund those types of loans.

Chart II.2.1.1.13
Geographical Distribution of Loans¹



Source: CBRT-Risk Center

¹ Corporate loans include; starting from 01.01.2002, those loans that are greater than ten thousand new Turkish Liras (inclusive) (seven thousand new Turkish Liras for 2001) and for retail loans, starting from 28.02.2003 (the initial date of monitoring by Risk Center), those loans greater than five thousand New Turkish Liras; extended to real and legal persons with a tax ID; by banks and special finance houses (including external credits used by companies with the intermediation of banks and SFHs). Therefore, it differs from the loan and non-performing loan figures in the balance sheet-based analysis.

Regarding the geographical distribution of loans, more industrialized regions naturally have a higher share in total loans. However, these dropped slightly during the 2001-2004 period. Especially the share of the Marmara Region, which has the highest contribution to the GDP, fell from 65.6 percent in December 2001 to 64 percent by the

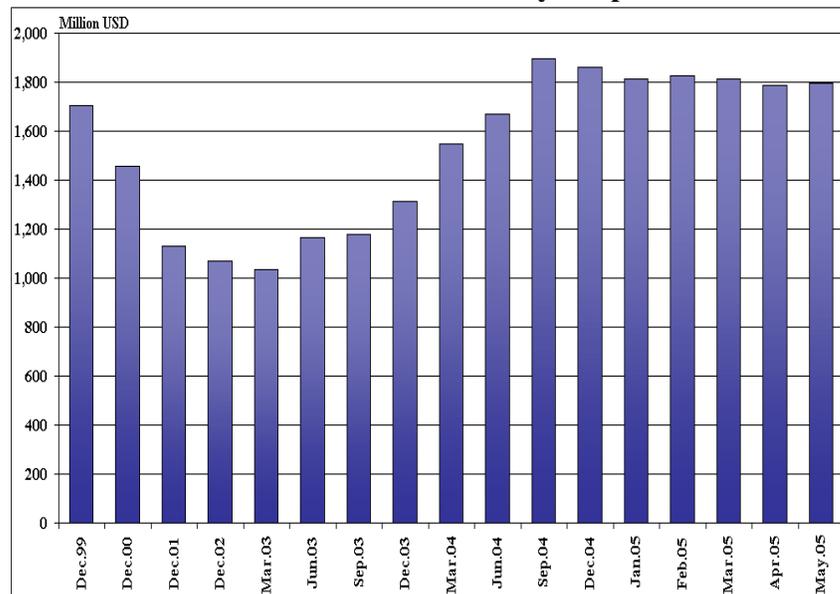
60 percent of the total loans are used by highly industrialized Marmara Region.

end of 2003 and to 60.9 percent by the end of 2004. The opposite trend is observed in the South Eastern Region, with an increasing share from 1.5 percent to 2.3 percent; also in the Black Sea Region with an increasing share from 2.6 percent to 3.3 percent (Chart II.2.1.1.1.13). The distribution of loans by geographical regions is considered as evidence of the beginning of a shift in loans from developed regions to SMEs operating in less developed regions, as a result of the drop in interest rates and inflation, and is believed to have a positive effect on investment, employment and production.

The same trend continued during the first five months of 2005 and stemming from the fall in the shares of the two big cities; İstanbul and Ankara, the share of the Marmara Region dropped to 59 percent and that of the Central Anatolia region to 16.3 percent as of May 2005. In the meantime, the share of the Mediterranean Region rose to 6.2 percent, the Aegean Region to 8.6 percent, the Black Sea Region to 3.5 percent, the Eastern Anatolia Region to 1 percent and the Southern Anatolia Region to 2.4 percent.

Chart II.2.1.1.1.14
Bank-Guaranteed External Loans Used by Corporates¹

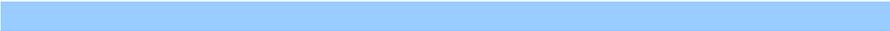
Starting from the first quarter of 2003, bank guaranteed external foreign currency loans have been increasing.



Source: CBRT-Risk Center

¹ Stock data

According to Risk Center data, bank-guaranteed external foreign currency loans amounting to 1.7 billion USD used by corporates at the end of year 1999, shrank after the crises of 2000 and 2001 and dropped to



1.1 billion USD as of year-end 2002. However, these loans started to increase again starting from the first quarter of 2003, reached 1.9 billion USD as of year-end 2004 and kept the same level during the first five months of 2005 (Chart II.2.1.1.1.14).

On the other hand, according to Risk Center data, external loans used by corporates without any bank guarantees make up a total of 12.3 billion USD. Considering the distribution of those loans by sectors, the "Electricity, Gas and Water Resources" sector ranks first with a share of 18.7 percent in total intermediated loans. Following that is the "Financial Intermediation" sector with a share of 10.9 percent, the "Wholesale, Retail Trade, Commissions, Motor Veh. Services" sector with a share of 9.5 percent, the "Transportation, Storage and Communication" sector with a share of 7.4 percent, the "Transportation Vehicles Industry" with a share of 7 percent and the "Chemistry and Chemical Products and Synth. Fiber" sector with a share of 5.8 percent. Total external loans without bank guarantees used by corporates operating in those six sectors has a 52 percent share in total external loans. Regarding the distribution of those loans by types of company, they are mostly concentrated in internationally credible, large scale, better institutionalized and internationally active large companies and generally used by the intermediation of foreign banks operating in Turkey.

Those external loans that are used by companies but are not included in the "Loans" item on the balance sheet of the banking sector had a share of 14.2 billion USD as of end of 2004 and was an important source for the funding of the corporate sector. Therefore, when assessing the development of the credit volume, this amount should also be considered.

II.2.1.1.2. Development of Non-Performing Loans

Box II.2.1.1.2.1. Regulation Regarding Non-Performing Loans (NPLs)

According to the BRSA's Regulation on the "Principles and Procedures Related to the Determination of the Loans and Other Receivables for which Provisions Shall be Set Aside by Banks and to the Provisions to be Set Aside¹⁴" published in the Official Gazette No: 24448 dated June 30, 2001, banks in Turkey and their branches abroad should classify and monitor their loans and other receivables in following groups according to their ability to collect and credibility of the borrowers, paying close attention to the criteria and explanations as defined by the Regulation:

- I. Standard Loans and Other Receivables – First Group
- II. Closely Monitored Loans and Other Receivables – Second Group
- III. Loans and Other Receivables with Limited Collectibility – Third Group
- IV. Doubtful Loans and Other Receivables – Fourth Group
- V. Loans and Other Receivables Classified As Loss – Fifth Group

According to the 5th article of the Regulation titled "Non-performing Receivables";

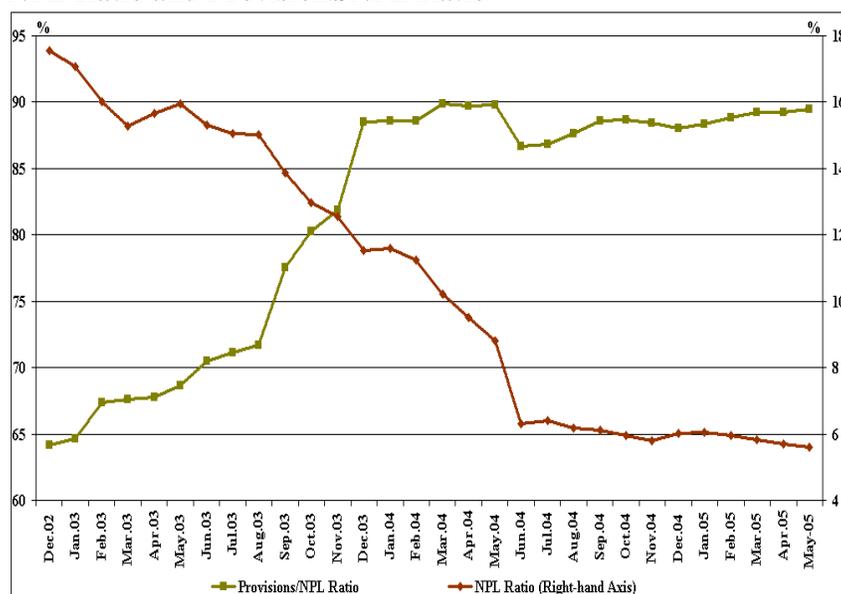
1. All receivables which have been classified in the Third, Fourth and Fifth Groups and the collection of whose principal and interest has been delayed for more than 90 days from the due date are deemed non-performing receivables in the application hereof, regardless of whether the accrued interests and interest alike burdens on the debtor have been added to the principal or whether it has been refinanced.

2. If several loans have been extended to a loan customer by the same bank, and if any one of these loans is considered as a non-performing receivable pursuant to the classification made, all debts of the said loan customer to the bank are classified in the same group as the non-performing receivable. In case the first loan that has become a non-performing receivable is fully repaid, other loans of the loan customer may be evaluated and re-classified under Article 4 of the Regulation.

3. In the case of cash loans, the disbursement of which has resulted in an overdrawn current account and for which there is no record of due date, the related loan is considered as a non-performing loan and classified as such if the interests for the relevant period and related fees have not been paid for a period exceeding 90 days and added to the principal, if the debt is not paid within a period of over 90 days following the account cut off date, if the interests and principal the collection of which has been delayed, is financed by opening another loan to the debtor in a way which is contrary to the provision of article 9 hereof, or if the account limit is exceeded continuously for more than 90 days.

¹⁴ Amended with the Regulation published in the Official Gazette reiterated issue No: 24657 dated 31.01.2002, the Regulation published in the Official Gazette No: 24980 dated 31.12.2002 and the Regulation published in the Official Gazette No: 25692 dated 06.01.2005.

Chart II.2.1.1.2.1
NPL Ratio and Provisions/NPL Ratio



Source: BRSA-CBRT

The “Non-Performing Loans Ratio¹⁵” has followed a decreasing trend since 2002 (Chart II.2.1.1.2.1). The increase in the debt-servicing capacity of the borrowers has played a significant role in this trend. The effects of restructured loans under the “Istanbul Approach” which was put into practice after the crisis (See Box II.2.1.1.2.2), arrangements for enhancing effective risk management by banks and the improvement of banks’ risk perceptions and assessments are among other factors that contribute to this fall in the NPL ratio.

As well as the decrease in the non-performing loans ratio, the increase in provisions maintained by the banking sector for non-performing receivables has also effected the improvement of credit quality since 2002. The Provisions to NPL ratio which used to be 49 percent during 2001, increased to 88.1 percent by the end of 2004 and to 89.5 by May 2005 (Chart II.2.1.1.2.1).

While NPL ratio decreases, Provisions/NPLs ratio increases.

Decreasing NPLs, despite the rise in the credit risk related exposure stemming from the significant expansion in the credit volume in 2004, led to an improvement in the credit quality.

¹⁵ Non-Performing Loan Ratio = Gross Non-Performing Loans / Gross Loans

Table II.2.1.1.2.1
NPL Ratio and Provisions/NPL Ratio for Selected Countries

	2000	2001	2002	2003	2004	Latest
	NPL/ Gross Loans					
Argentina ¹	16,0	19,1	35,6	33,6	27,7	September
Brazil ³	8,4	5,7	5,3	4,4	3,8	September
Bulgaria	17,3	13,1	8,6	7,3	6,7	September
Czech Republic	19,9	13,7	10,6	4,9	4,5	June
Indonesia	12,8	11,4	10,4	8,8	6,6	June
Croatia ³	9,5	7,3	5,9	5,1	4,6	September
İsrael ⁴	6,7	8,1	9,9	10,3	-	
Latvia	4,6	2,8	2,0	1,4	1,4	June
Lithuania ²	11,3	8,3	6,5	3,0	2,1	October
Hungary	3,0	2,7	2,9	2,6	2,7	March
Polond ²	15,5	18,6	22,0	22,2	18,1	June
Russia	7,7	6,2	5,6	5,0	15,0	September
Slovak Republic	13,7	12,3	9,2	6,4	5,4	August
Slovenia	6,5	7,0	7,0	6,5	-	
Thailand	17,7	10,5	15,7	12,9	12,4	June
Ukraine ⁵	29,6	25,1	21,9	28,3	28,0	September
Europe ⁶	3,5	3,4	3,7	3,7	-	
Turkey	11,1	25,2	17,6	11,5	6,0	December
	Provisions / Gross NPL					
Argentina ¹	61,1	66,4	73,8	78,4	80,0	September
Brazil ³	82,1	126,1	143,5	165,6	183,2	September
Bulgaria	65,9	61,7	65,0	52,8	49,1	September
Czech Republic	46,8	60,3	77,5	77,1	76,8	June
Indonesia	36,1	35,5	35,9	43,4	42,9	June
Croatia ³	79,9	71,8	68,1	60,8	61,4	September
İsrael ⁴	55,8	57,1	54,7	53,8	-	
Latvia	74,1	80,4	95,5	98,5	89,2	June
Lithuania ²	34,6	34,2	18,6	21,6	-	October
Hungary	56,4	57,7	51,3	47,7	-	March
Polond ²	40,5	42,6	46,7	47,3	58,0	June
Russia	102,6	108,1	112,5	118,0	35,3	September
Slovak Republic	75,1	79,7	86,1	88,3	89,1	August
Slovenia	101,0	100,5	102,0	101,5	-	
Thailand	47,2	54,9	61,8	72,8	69,0	June
Ukraine ⁵	38,4	39,2	39,6	22,7	20,7	September
Europe ⁶	78,5	88,1	76,9	76,1	-	
Turkey	63,1	49,0	64,2	88,5	88,1	December

Source: IMF Global Financial Stability Report ,2005 - CBRT

¹ Includes banks and other non-bank financial institutions.

² Loans are recorded as Non-Performing when they are 30 days past due.

³ Loans are recorded as Non-Performing when they are 60 days past due.

⁴ Ratios of largest five banking groups.

⁵ The increase in NPLs in 2003 is a consequence of the new legal regulation.

⁶ Includes the largest 50 banks.

The non-performing loan ratio, as a result of the rapid decrease in non-performing loans, though being relatively lower than in Argentina, Poland, Bulgaria, Russia, Ukraine and Thailand, is higher compared to other emerging economies in Europe. On the other hand, provisions to the non-performing loans ratio is recently being increased for Turkey and is higher than other countries (Table II.2.1.1.2.1).

Box II.2.1.1.2.2.İstanbul Approach

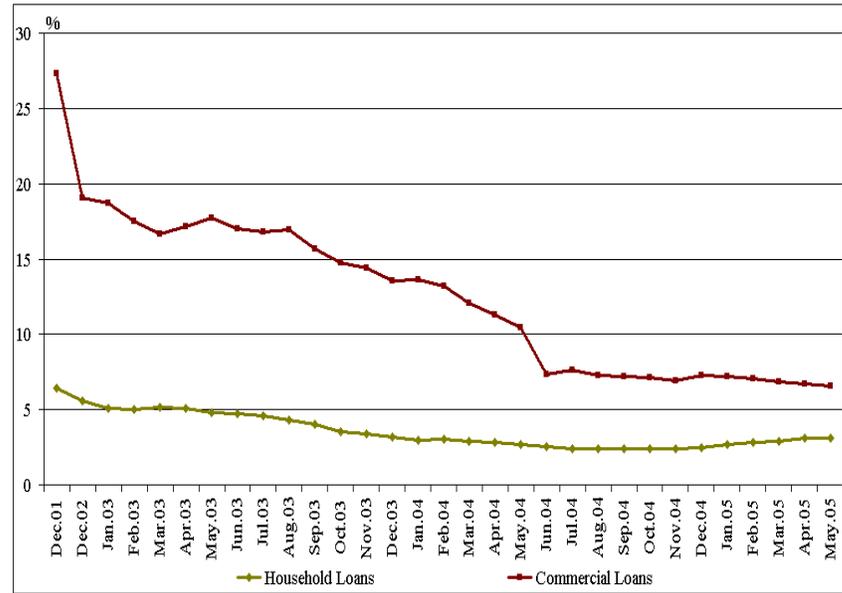
In order for the rehabilitation of the companies that became insolvent due to the crises in November 2000 and February 2001, Law No:4743 dated 31.01.2002 on “Restructuring of Debts to the Financial Sector and Amendments to be made to some Acts” was issued. Based on the aforementioned Law, the “Regulation on Terms related to the Acceptance and Application of the Framework Agreements for Financial Restructuring¹⁶” was issued on 11.04.2002 by the BRSA and the “Financial Restructuring Framework Agreement” which has been prepared by the Turkish Banks’ Association was approved by the BRSA on 04.06.2002.

With the implementation of the restructuring program known as the “Istanbul Approach”, applications of companies that are experiencing temporary liquidity problems have been assessed and loans of those firms that are capable of continuing their activities have been restructured by the banks that they do business with.

Within this framework, according to data from The Turkish Banks’ Association for May 2005, the amount of debts under the scope of the program is 5,373.7 million USD for 221 large firms, 646.9 million USD for 101 small firms with a total restructured debt amounting to 6,020.6 million USD.

¹⁶ Amended by the Regulation published in the Official Gazette No: 24784 dated 13.06.2002 and the Regulation published in the Official Gazette No: 25179 dated 25.07.2003.

Chart II.2.1.1.2.2
NPL Ratios for Household¹ and Commercial² Loans



Source: BRSA-CBRT

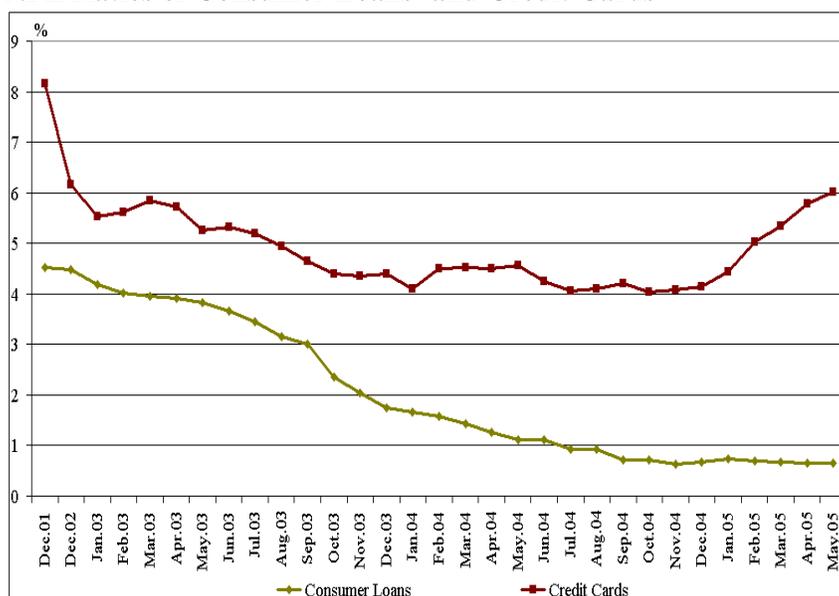
¹ Household Loans = Gross Consumer Loans + Gross Credit Cards

² Commercial Loans= Total Gross Loans - Gross Household Loans

NPL ratio of commercial loans, though being higher compared to that of households, has a decreasing trend.

Regarding the distribution of non-performing loans by economic units, risks that stem from household loans are much less than those of commercial loans (Chart II.2.1.1.2.2). As it has been mentioned in the previous section on loan types, as collaterals of loans extended to households are easier to make liquid and are more diversified considering the customer base, such loans have a lower non-performing loan ratio.

Chart II.2.1.1.2.3
NPL Ratios of Consumer Loans¹ and Credit Cards



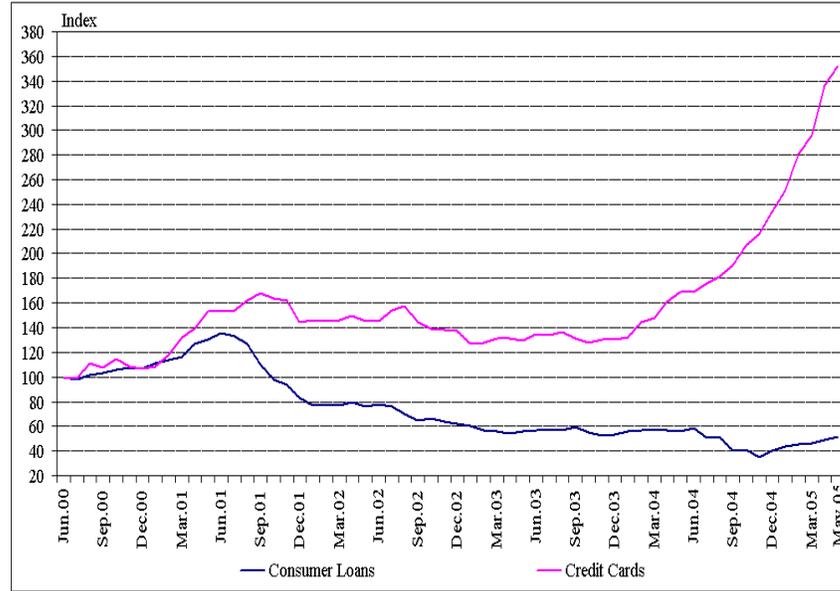
Source: CBRT

¹ Excluding the loans extended by consumer finance companies.

The non-performing loan ratio for consumer loans, which was 1.8 percent at the end of 2003, dropped to 0.7 percent as of year-end 2004. There has been no significant change in the ratio during 2005, and it was recorded as 0.7 percent in May 2005. On the other hand, there has been a continuous increase in non-performing loans for credit cards and the NPL ratio of 4.6 percent for those loans as of year-end 2003 dropped slightly to 4.3 percent as of year-end 2004 and rapidly increased during 2005, rising to 6 percent as of May 2005 (Chart II.2.1.1.2.3).

While NPL ratio for consumer loans remained the same, the ratio for credit cards increased rapidly during the first five months of 2005.

Chart II.2.1.1.2.4
Non-Performing Consumer Loans and Credit Cards Indices¹



Source: CBRT

¹(1994=100) Data which has been expressed in real terms using the CPI, is converted to index values using the base year of June 2000.

Regarding the indices of non-performing loans for consumer loans and credit cards, the index of the NPL for consumer loans has shown a steadily decreasing trend since June 2001, while the index for credit cards restarted to follow an increasing trend since December of 2003. The same trend continues until May 2005 (Chart II.2.1.1.2.4).

Table II.2.1.1.2.2
Distribution of Total NPLs¹

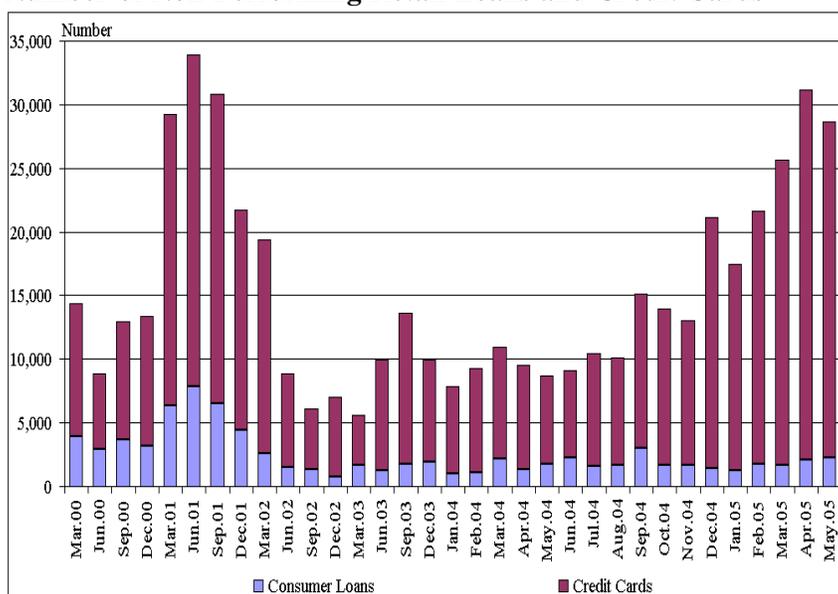
Million YTL	2002	2003	2004	May.05
Loans and Other Receivables with Limited Collectibility	1,207	924	595	680
Doubtful Loans and Other Receivables	2,596	2,296	415	589
Loans and Other Receivables Classified as Loss	6,626	5,409	5,342	5,559
Total NPLs	10,430	8,629	6,353	6,828

Source: BRSA-CBRT

¹ Excluding İller Bankası

“Loans and other receivables classified as loss” have the highest share in non-performing loans (Table II.2.1.1.2.2).

Chart II.2.1.1.2.5
Number of Non-Performing Retail Loans and Credit Cards^{1,2,3,4}



Source: CBRT- Risk Centralization Division

¹ The totals include the number of loans that are not-paid or paid later than the due date.

² For retail loans and credit cards, the minimum declaration limit is 250 YTL. The data are shown on the basis of number of declarations, therefore, one person may have more than one record.

³ The data shows the declarations of non-performing loans for the related month, not the cumulative totals.

⁴ The difference between the number of non-performing retail loans and credit cards and the total number of non-performing loans (Chart II.2.1.1.2.6) results from the differences in declaration limits. Therefore, retail loans and credit cards that are less than five thousand YTL but more than 250 YTL, which appear in this Chart, do not appear in Chart II.2.1.1.2.6 as they are outside the declaration limits.

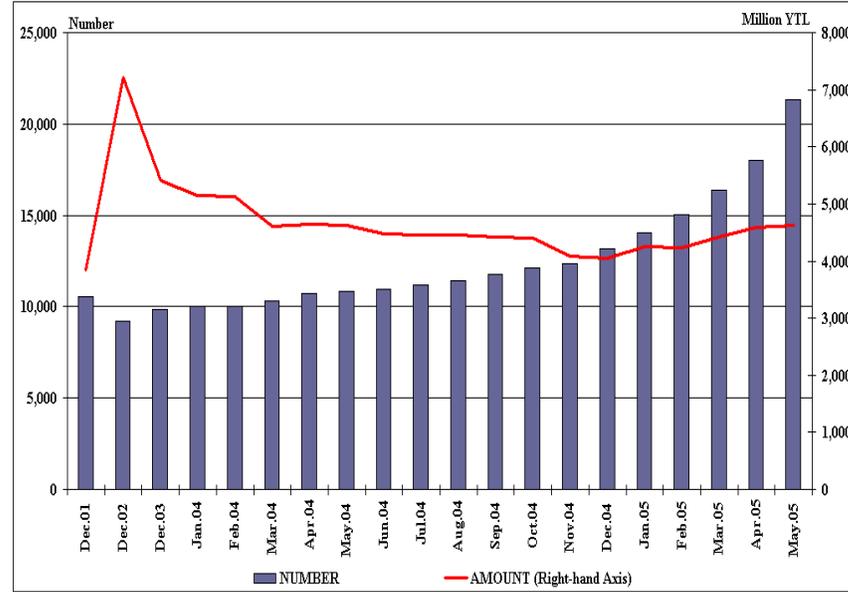
According to non-performing retail loans and non-performing credit cards data obtained from the declarations of banks to the Central Bank, after the crises the number of non-performing loan declarations increased significantly. In the meantime, after the crises period, as a result of the shrinking of the economy, the cost of such loans increased and adversely affected consumer demand, causing sharp falls in the number of non-performing loans after 2002 (Chart II.2.1.1.2.5).

By the year 2004, as a result of the increase in loan demand stemming from the recovery of the economy, the number of non-performing retail loans and credit cards began to follow an increasing trend once again. In fact, the number of such non-performing loans increased from 7,025 as of December 2002 to 9,955 as of December 2003, to 21,112 as of December 2004 and to 28,645 as of May 2005 (Chart II.2.1.1.2.5).

Non-performing credit cards has the highest share in the total number of non-performing retail loans and credit cards. In fact, the share of non-performing credit cards, which was 81 percent as of year end

2003, increased to 93 percent as of the end of 2004 and decreased slightly to 92 percent as of May 2005 (Chart II.2.1.1.2.5).

Chart II.2.1.1.2.6
Total Number and Amount of NPLs^{1,2,3}



Source: CBRT-Risk Center

¹ Corporate loans include; starting from 01.01.2002, those loans that are greater than ten thousand new Turkish Liras (inclusive) (seven thousand new Turkish Liras for 2001) and for retail loans, starting from 28.02.2003 (the initial date of monitoring by Risk Center), those loans greater than five thousand New Turkish Liras; extended to real and legal persons with a tax ID; by banks and special finance houses (including external credits used by companies with the intermediation of banks and SFHs). Therefore, it differs from the non-performing loan figures in the balance sheet based analysis.

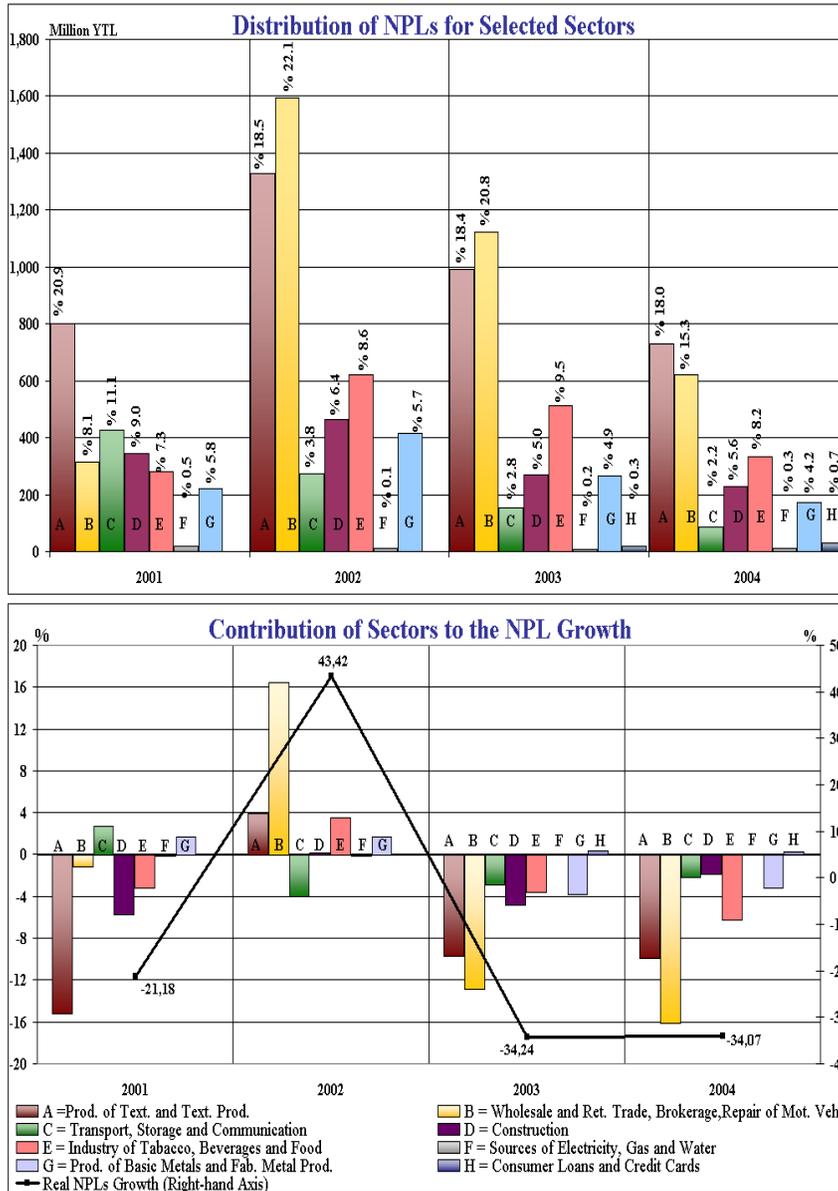
² Stock data is used.

³ The difference between the number of non-performing retail loans and credit cards and the total number of non-performing loans (Chart II.2.1.1.2.5) results from the differences in declaration limits. Therefore, retail loans and credit cards that are less than five thousand YTL but more than 250 YTL which appear in Chart II.2.1.1.2.5, do not appear in this Chart as they are outside the declaration limits.

According to Risk Center data on the number and amount of non-performing loans, as of end of year 2003, 9,876 non performing loans amounting to 5.4 billion New Turkish Liras decreased to 13,166, loans that total 4.1 billion New Turkish Liras as of end of year 2004 and rose to 21,300 loans that total 4.6 billion New Turkish Liras as of May 2005 (Chart II.2.1.1.2.6). The fact that the number of non-performing loans is increasing faster than the amount shows that especially SMEs and households that use loans in smaller amounts, face problems in repayment.

Chart II.2.1.1.2.7

Distribution of NPLs for Selected Sectors and Their Contribution to the NPL Growth^{1,2,3}



Source: CBRT-Risk Centralization Division

¹ The contribution of the sectors to credit growth is calculated as the ratio of the change in each sector to the total gross loans.

² Corporate loans include; starting from 01.01.2002, those loans that are greater than ten thousand new Turkish Liras (inclusive) (seven thousand new Turkish Liras for 2001) and for retail loans, starting from 28.02.2003 (the initial date of monitoring by the Risk Center), those loans greater than five thousand New Turkish Liras; extended to real and legal persons with a tax ID; by banks and special finance houses (including external credits used by companies with the intermediation of banks and SFHs). Therefore, it differs from the non-performing loan figures in the balance sheet based analysis.

³ Since the monitoring process for retail loans and credit cards by the Risk Center has been initiated as of 28.02.2003, column "H" which denotes those loans do not appear in the chart for the years 2001 and 2002.

“Retail Loans and Credit Cards”, the sector with the highest contribution to the rise in the total credit volume in 2004, has a very low effect on the increase in non-performing loans.

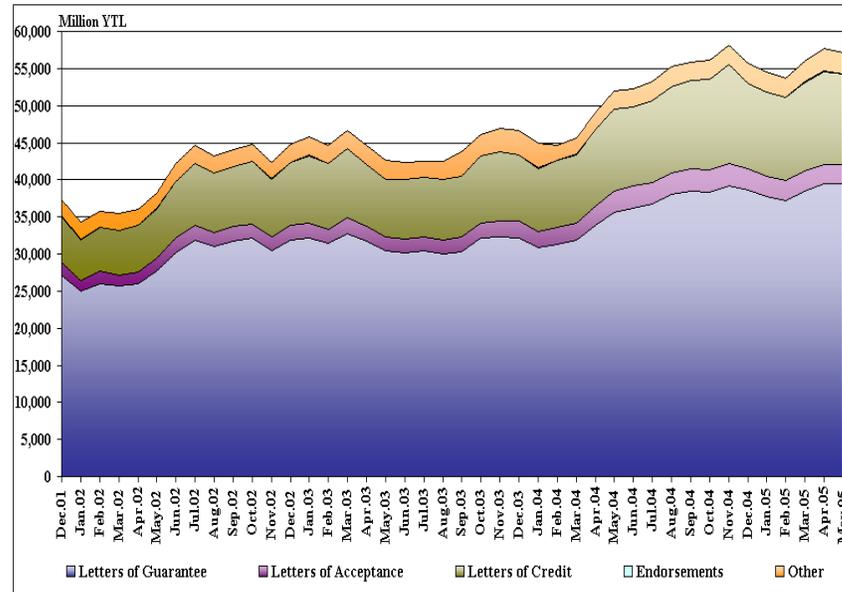
Regarding the distribution of non-performing commercial loans by sectors, “Retail Loans and Credit Cards”, the sector with the highest contribution to the rise in the total credit volume in 2004, has a very low effect on the increase in non-performing loans. Wholesale, Retail Trade, Commissions and Motor Vehicles Services which ranks the second according to both the share in total credit volume and the contribution to sectoral credit growth, has a significant effect in the drop of total non-performing loans. The “Textile and Textile Products” sector, which has an important share in total loans, has a positive effect in the drop of the non-performing loans, despite its low contribution to credit growth in 2004 (Chart II.2.1.1.2.7).

In May 2005, non-performing loans decline by 5.2 percent in real terms stemming from the “Textile and Textile Products Industry”, the “Food, Beverage and Tobacco Products Industry” and the “Metal Main Industry and Processed Materials” sectors.

II.2.1.1.3. Development of Non-Cash Loans

**Chart II.2.1.1.3.1
Non-Cash Loans by Type**

The increase in non-cash loans in 2004 was relatively slower compared to cash loans.



Source: BRSA-CBRT

The ratio of off-balance sheet liabilities, which include banks' non-cash loans and commitments and exclude derivatives, to balance sheet total was 25.9 percent as of the end of 2001. The ratio decreased to 18.4 percent by year-end 2004 and eventually to 17.6 percent as of May 2005. This fall stems mainly from off-balance sheet liabilities growing at a



slower rate than total assets. Although, the share of non-cash loans in foreign currency is higher, the share of domestic currency non-cash loans increased during the period of 2001-2004. However, this increase in non-cash loans was not as large as the increase in cash-loans, therefore, the non-cash loans/cash loans ratio, which was 73.6 percent by the year-end 2001, dropped to 62.3 percent by the year-end 2003, to 52.7 percent by year-end 2004 and to 46.4 percent by May 2005. As of May 2005, letters of guarantee with a share of 69.2 percent and letters of credit with a share of 21.4 percent constitute a large portion of the commitments.

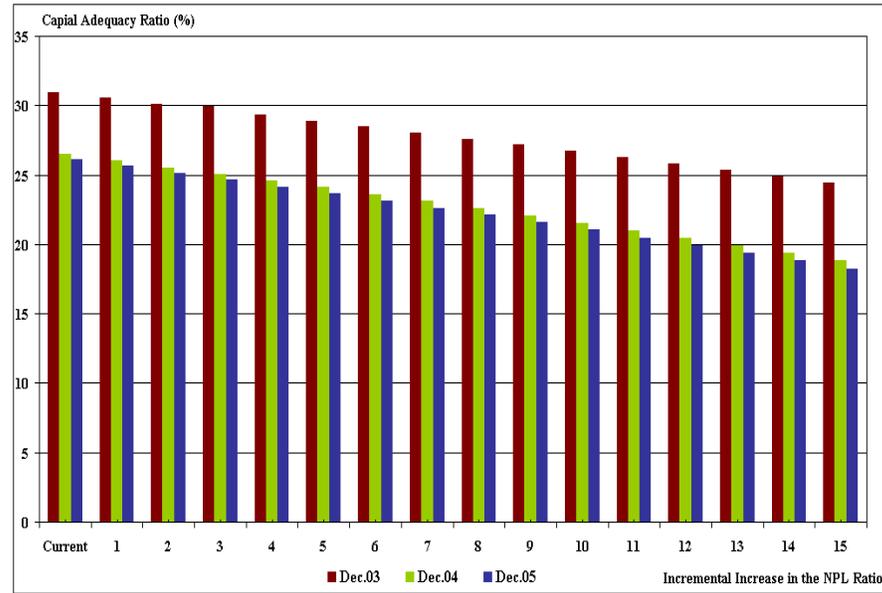
II.2.1.2.Scenario Analysis for Credit Risk

Scenario analysis for credit risk, involves examining the effect of a change in non-performing loans on the capital adequacy ratio of the sector. The various levels of NPLs were derived by implementing shocks to the NPL ratio¹⁷.

In accordance with the current regulations, non-performing loans of the sector are classified in three groups as follows; Loans and Other Receivables with Limited Collectibility, Doubtful Loans and Other Receivables, Loans and Other Receivables Classified As Loss for which banks maintain provisions of 20 percent, 50 percent and 100 percent, respectively. By applying this scenario analysis, it was assumed that, i) the total credit volume of the banking sector does not increase, ii) non-performing loans resulting from shocks have a composition similar to the current non-performing receivables of the sector, iii) new non-performing loans which resulted from shocks are included in the 100 percent risk-weight group for the calculation of the capital adequacy ratio before the shocks, iv) there has been no significant change in the total risk weighted assets and equity of the sector other than the shocks. In the meantime, collateral amounts are not taken into consideration in the calculation of additional provisions.

¹⁷ Non-performing loan ratio is an indicator of what percentage of the total credits are past due.

Chart II.2.1.2.1
Credit Shocks and Results



In the above chart, the capital adequacy ratios of the sector for the years 2003, 2004 and March 2005 are provided reflecting the effect of a one point incremental increase in the NPL ratio of the banking sector¹⁸. With the scenario analysis, as a result of the assumed maximum shock of fifteen points, the capital adequacy ratio of the banking sector¹⁹ dropped by 7.7 points to 18.8 percent. For year end 2003, the same shock led to a drop of 6.5 points in the capital adequacy ratio of the sector to 24.4 percent. For March 2005, a shock of fifteen points decreased the ratio by 7.9 points to 18.2 percent. In 2004 and March 2005, the decline in the capital adequacy ratio as a result of the shocks is larger as a consequence of the increase in the credit portfolio of the sector during these periods. Additionally, considering that the minimum capital adequacy ratio is 8 percent, even after the maximum shock the ratio is still twice its minimum value, which shows that despite the credit growth of the banking sector, the sector's equity are sufficient to cover its credit risk.

¹⁸ After the non-performing receivable classification of the credits and additional provisions that are built, after-shock capital adequacy ratio is calculated as: (Equity-Additional Provisions) / (Total Risk Weighted Assets-Additional Provisions) x 100.

¹⁹ SDIF banks and İller Bankası are not included in the analysis.

II.2.1.3. Conclusions and Expectations Related to Credit Risk

Parallel to the positive improvements in the economy since 2003, there had been significant changes in the asset structure of the banking sector. In general, positive improvements in macroeconomic indicators, on the supply side, induced banks to keep lower levels of liquidity and invest less in securities. Additionally, on the demand side, this led to an increase in investments and consumption that were deferred during crises and developments in inflation and foreign exchange rates that led to a relative increase in the purchasing power of the consumers. Thus, all these developments had positive consequences from a credit point of view. In fact, credit volume, which had an obviously decreasing trend especially after the crises experienced during 2000 and 2001, started to rise starting from the third quarter of 2003 and not only its share in the GDP but also its share in total assets began to follow an increasing trend. Within this framework, the effectiveness of household and corporate sector financing, which are among the most important functions of the banking sector, has increased and the rise in the loans/deposit ratio is a positive indication that banks have been re-gaining their main intermediation function. However, there has not only been an increase in credit volume, but also significant changes in the structure and distribution of credits (See Part II.2.1.1.1 and II.2.1.1.2). The descending trend observed since 2002 in non-performing loans, has continued, regarding the distribution of loans by size and sectors. Furthermore, the concentration has decreased remarkably and the share of domestic currency loans has increased significantly. In addition, it has been observed that the underlying reason for the increase in loans during 2004 is the increase in consumer and working capital loans. This situation played a defining role in the diversification of loans and positively affected credit risk. Also, the fact that consumer loans are provided at a fixed rate has emphasized the importance of management of interest risk. Within this framework, it is our opinion that making new arrangements to enhance floating-rate consumer loans that do not contradict the consumer protection principles will help mitigate the interest rate risk.



Additionally, a slowdown in the credit expansion and continuation of the increase in housing loans is expected in the upcoming periods. This situation has arisen as a consequence of firstly, the fact that most of the deferred consumption spending was realized and, secondly, financial incentives to encourage spending were removed. Regarding loans extended to the corporate sector, considering that along with achieved economic stability, the public sector's borrowing needs through the banking sector will decrease and therefore, banks will be able to extend this excess liquidity as loans. Moreover, possible declines in credit interest rates in the following periods will increase demand by the corporates. However, it is believed that in such an environment, the banks' continued efforts of effective risk management without interruption is a significant point.

Besides, the increase in both industrial production and capacity utilization ratios may lead to an increase in credit demand for financing investment spendings. However, this effect will remain limited because of the increase in foreign borrowing opportunities for large companies and their preference for financing through their equity, thus banks may need to focus more on SMEs in the end. Considering such a change, the main obstacle that needs to be overcome is the fact that the "institutionalization" principles of Basel II have still not been fulfilled by most of the corporate sector.

In conclusion, while the credit risk exposure of banks increased due to the remarkable expansion in credit volume during 2004, effective risk management by banks, the decrease in non-performing loans due to the İstanbul Approach and economic stability along with the improvement in financial conditions of corporates all positively affected the quality of the credit portfolio.

Additionally, as the credit risk scenario analysis supports, the fact that banks have their equity above the minimum required capital, has strengthened the positive expectations regarding the permanence of this dynamic structure of the credit market.

II.2.2.MARKET RISK

II.2.2.1. The Importance of Market Risk and Its Components

Box II.2.2.1.1. Market Risk

Market risk is defined as the risk of losses in on and/or off balance sheet positions arising from movements in market prices. The Basel Committee defines market risk as encompassing price risk, foreign exchange risk (including gold), equity risk, commodity risk and the risk of options. Measuring and applying capital charges for market risk was added to the framework in 1997.

According to the regulation of the BRSA, in calculating market risk, banks compute additional capital requirements for interest rate, foreign exchange rate and equity risks on an unconsolidated basis starting from January 2002 and on a consolidated basis from July 2002 by using the “standard method”. For this calculation;

In interest rate risk; securities in trading portfolios of banks, repo and reverse repo transactions and derivatives;

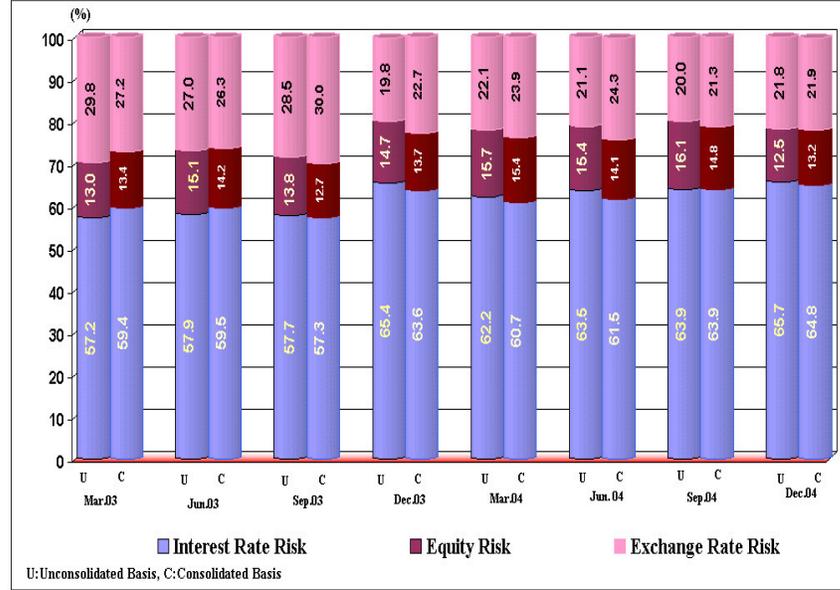
In foreign exchange risk; all on and off balance sheet foreign exchange and foreign exchange indexed assets and liabilities,

In equity risk; the security positions representing a share in capital are taken into account.

According to international implementation, in the calculation of the capital adequacy ratio using the standard method, it is accepted that the weight of credit risk in risk weighted items is around 70 percent, whereas the weight of market and operational risk is around 15 percent, each.

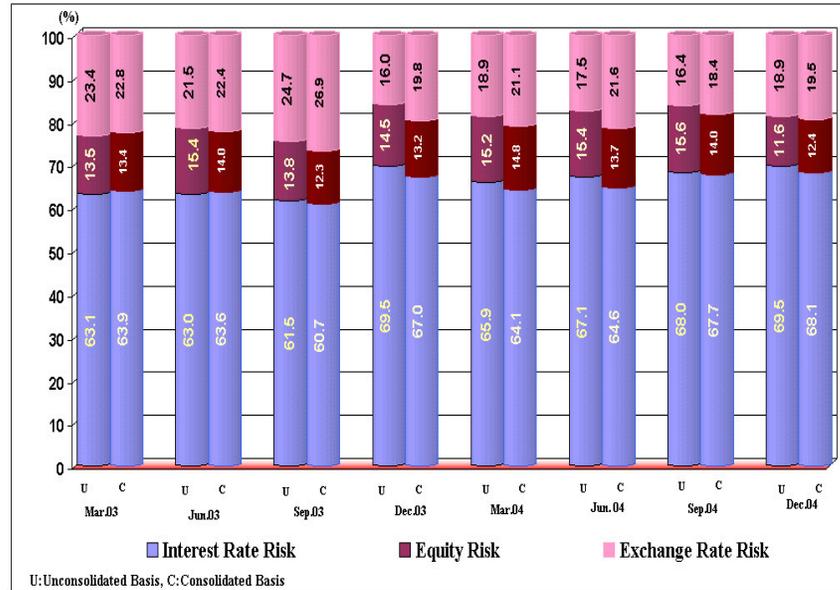
In Turkey, based on the consolidated data of December 2004, the share of market risk in risk weighted items was 10.7 percent for the banking sector and 10.4 percent for deposit banks, and realized as 10.2 percent and 9.9 percent, respectively, based on unconsolidated data. With respect to May 2005 unconsolidated data, these shares did not change significantly and were realized as 10.5 percent and 10.2 percent, respectively.

Chart II.2.2.1.1
Share of Market Risk Components of the Banking Sector in Total Capital Requirement



Source: BRSA

Chart II.2.2.1.2
Share of Market Risk Components of Deposit Banks in Total Capital Requirement



Source: BRSA

While the market risk exposure of the banking sector, based on unconsolidated data, was 14.4 billion New Turkish Liras in December 2003, it increased to 15.2 billion New Turkish Liras at the end of 2004. As of April 2005, since the market risk exposure increased to 17.3 billion

New Turkish Liras, the additional capital requirement was realized as 1.3 billion New Turkish Liras.

In the Turkish banking sector, interest rate risk constitutes the most important part of market risk. As a matter of fact, at the end of 2003, according to the unconsolidated data of banking sector, the share of the capital requirement calculated for interest rate risk in the total market risk related capital requirement was realized as 65.7 percent. In December 2004, the ratio remained the same. For deposit banks, the share of capital requirement for interest rate risk in the total market risk related capital requirement was parallel to the sector level.

In the Turkish Banking Sector interest rate risk constitutes the most important component of market risk.

Following interest rate risk, foreign exchange risk is the second important part of market risk. While the share of capital requirement calculated for foreign exchange risk in the total market risk related capital requirement, based on the unconsolidated data of the banking sector, was 19.8 percent at the end of 2003, it increased to 21.8 percent in December 2004. For deposit banks, it was realized as 16 percent at the end of 2003 on an unconsolidated basis and 18.9 percent in 2004 and it displays the same trend as the sector.

The lowest share in the total capital requirement calculated for market risk pertains to equity positions. While the share of capital requirement calculated for equity risk of the banking sector in the total market risk related capital requirement, based on unconsolidated data at the end of 2003 was 14.7 percent, with a limited decrease, it was realized as 12.5 percent at the end of 2004. For deposit banks, a similar trend to that of the sector is observed and the ratio was realized as 11.6 percent at the end of 2004.

Table II.2.2.1.1
Market Risk Concentration of the First 10 Banks ¹

	Dec.03				Dec.04				Apr. 05	
	Unconsolidated		Consolidated		Unconsolidated		Consolidated		Unconsolidated	
	Share in Deposit Banks	Capital Requirement (%)	Share in Deposit Banks	Capital Requirement (%)	Share in Deposit Banks	Capital Requirement (%)	Share in Deposit Banks	Capital Requirement (%)	Share in Deposit Banks	Capital Requirement (%)
(Million YTL)										
Interest Rate Risk	678	94.7	755	94.2	712	90.9	825	90.4	772	90.4
Exchange Rate Risk	147	88.8	218	92.5	199	93.3	269	87.1	259	95.2
Equity Risk	149	99.9	155	99.6	130	100.0	182	98.0	172	100.0
Total Market Risk Exposure	12,090	93.8	14,011	93.9	12,857	91.3	15,217	86.5	14,808	91.2
Capital Requirement For Market Risk	967	93.8	1,121	93.9	1,029	91.3	1,217	86.5	1,185	91.2
Capital Requirement For Market Risk (Sector)	1,154		1,311		1,218		1,413		1,390	

Source: BRSA

The data of the first ten deposit banks is taken into account, separately for each risk group.

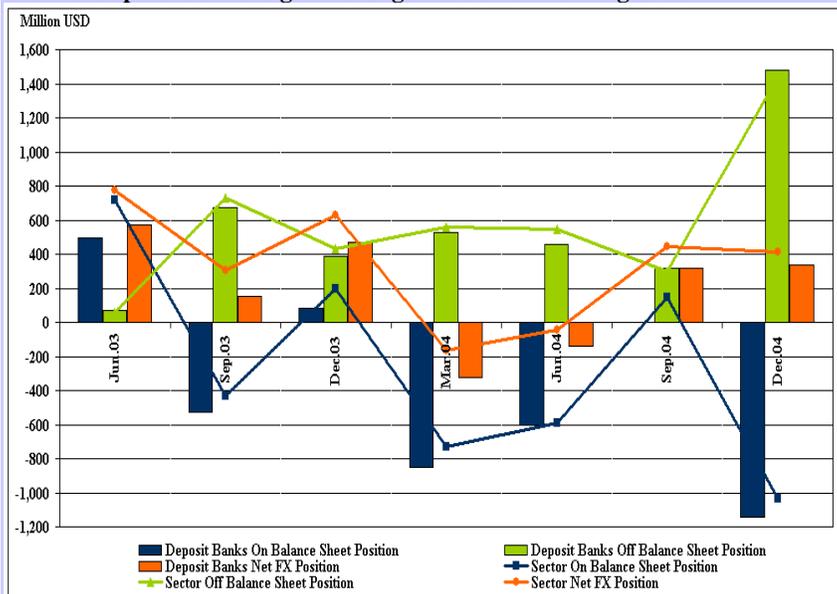
Regarding market risk concentration, the share of the first 10 banks is % 90.

From a market risk perspective and on a consolidated basis, the total market risk exposure of the first ten banks was 14 billion New Turkish liras in December 2003. This amount of exposure is 93.9 percent of the total market risk exposure of deposit banks. In December 2004, the amount of exposure was realized as 15.2 billion New Turkish Liras and the ratio as 86.5 percent. On the other hand, when the total exposure was analysed based on unconsolidated data, it was observed that while the ratio increased in April 2005 relative to 2004, the capital requirement for market risk remained the same (Table II.2.2.1.1).

Box II.2.2.1.2. Exchange Rate Risk

In addition to market risk information, the “Foreign Exchange Net General Position/Capital” standard ratio is among the reportings of banks to the BRSA. This standard ratio is also being monitored by the Central Bank. The ratio is calculated by taking into account the foreign branches and the YTL equivalent of foreign exchange and foreign exchange indexed items on and off balance sheet and by dividing net positions that were calculated as the difference of assets and liabilities to capital. In 1999, the macroeconomic stability programme was adopted based on the foreign exchange peg, and hence, the foreign exchange rate started to be preannounced. The predictability of the foreign exchange rate, generated an opportunity for arbitrage and holding open positions became attractive to banks. The banking sector tended to partially close these open positions after the November 2000 liquidity crisis. However, with the adoption of the floating exchange rate regime after February 2001, foreign exchange rate risk was realised and banks were exposed to a significant amount of foreign exchange losses. In time, banks limited their open positions due to the adoption of the floating exchange rate regime, foreign currency sales of the Central Bank, the “Banking Sector Restructuring Programme” implemented by the BRSA and the swap operation of government bonds by the Treasury .

The Development of Foreign Exchange Position of Banking Sector



Source: BRSA

As a matter of fact, in 2003 and 2004, on balance sheet positions of deposit banks fluctuated between 500 - 1.000 million US Dollars and due to the closing of on balance sheet positions with off balance sheet positions, net general positions converged to equal positions. While the open position of the banking sector in the first six months of 2005 remained at the same level, as long as the floating exchange rate regime and the steady decrease in interest rates continue, it is our opinion that the banking sector will be expected to keep its open position under control.

The continuing downward trend in interest rates has encouraged the Turkish banking sector to prefer short term resources and this has caused the maturity mismatch to continue increasing. Consequently, interest rate risk is still the most important part of market risk due to the high maturity mismatch.

Due to the floating exchange rate regime adopted after the crises, the share of foreign exchange risk in market risk tends to decrease. Hence, since the foreign exchange positions of the banking sector remain in equilibrium, there is no capital requirement stemming from foreign exchange risk.

II.2.2.2. Market Risk Scenario Analysis

In the scenario analysis for market risk, the impact on the banking sector of possible positive and negative shocks in interest rates and foreign exchange rates was examined, excluding SDIF banks. When the impact of foreign exchange shocks to the sector were being calculated, the foreign exchange net general position data of banks were used and by multiplying this with the change in the foreign exchange rate, the profit/loss position was calculated for each bank.

In calculating the impact of interest rate shocks, the repricing method, which is complementary to the standard method and proposed by the Basel Committee, was used. Within this framework, the profit or loss for structural interest rate risk was calculated by multiplying the gap, which is defined as the difference between the interest rate sensitive assets and liabilities within the maturity intervals of 0-1 month and 1-3 month, classified according to the repricing period (sight deposits are not included in liabilities) with the change in interest rate.

In the scenario analysis the following assumptions were made;

- The interest rate sensitivity of assets and liabilities has not changed during the analysis period,
- There is no new funding source,
- The interest rate shock would continue both in one and three month intervals and the rates would return to their pre-shock levels after the interest rate shock.

II.2.2.2.1. Negative Interest and Foreign Exchange Rate Shock Scenarios

Table II.2.2.2.1.1
Scenario Parameters for Negative Interest and Foreign Exchange Rate Shocks

Types of Scenarios	Scenario Inputs		
	Scenario I	Scenario II	Scenario III
A. Currency Shock	The depreciation of YTL against other currencies by 10 percent	The depreciation of YTL against other currencies by 20 percent	The depreciation of YTL against other currencies by 30 percent
B. Interest Rate Shock	The repricing of 0-1 and 1-3 month YTL assets and liabilities 2 points higher	The repricing of 0-1 and 1-3 month YTL assets and liabilities 4 points higher	The repricing of 0-1 and 1-3 month YTL assets and liabilities 6 points higher
	FX The repricing of 0-1 and 1-3 month FX assets and liabilities 1 point higher	The repricing of 0-1 and 1-3 month FX assets and liabilities 3 points higher	The repricing of 0-1 and 1-3 month FX assets and liabilities 5 points higher

Table II.2.2.2.1.2
Negative Interest and Foreign Exchange Rate Shock Results

	Scenario I			Scenario II			Scenario III		
	Dec.03	Dec.04	Mar.05	Dec.03	Dec.04	Mar.05	Dec.03	Dec.04	Mar.05
A. Currency Shock									
a. Sector excluding SDIF Banks	33	-15	-47	67	-29	-95	100	-44	-142
Profit (Loss) / Equity (%)	0.1%	0.0%	-0.1%	0.2%	-0.1%	-0.2%	0.3%	-0.1%	-0.3%
b. Banks Gaining Profits ¹	79	64	72	158	129	143	237	193	215
c. Banks Suffering Losses ²	-46	-79	-119	-91	-158	-238	-137	-238	-357
Banks Suffering Loss / Equity (%)	-0.3%	-0.4%	-0.6%	-0.7%	-0.8%	-1.1%	-1.0%	-1.2%	-1.7%
B. Interest Rate Shock									
i) Sector Excluding SDIF									
(a) Interest Rate Shock (1 Month) YTL	-6	-4	-29	-11	-8	-59	-17	-11	-88
(b) FX	-12	-11	-16	-35	-33	-49	-58	-56	-82
Loss after Shock (a)+(b)	-17	-15	-46	-46	-41	-108	-75	-67	-170
Loss / Equity (%)	0.0%	0.0%	-0.1%	-0.1%	-0.1%	-0.3%	-0.2%	-0.2%	-0.4%
(c) Interest Rate Shock (3 Months) YTL	-45	-55	-90	-90	-109	-180	-135	-164	-269
(d) FX	-57	-50	-63	-171	-151	-189	-285	-251	-316
Loss after Shock (c)+(d)	-102	-105	-153	-261	-260	-369	-421	-415	-585
Loss / Equity (%)	-0.3%	-0.2%	-0.4%	-0.8%	-0.6%	-0.9%	-1.2%	-1.0%	-1.4%

¹ Total profit of banks who benefit from negative shocks

² Total loss of banks who lose with negative shocks

³ Annual average data were used for foreign exchange risk.

II.2.2.2.1.1. Negative Foreign Exchange Rate Shock

According to scenario analysis results, banking sector is sensitive to foreign exchange rate shocks.

According to foreign exchange net general position data of the banking sector, since the sector was in a long position in 2003, it incurred profits from increases in the foreign exchange rate, but in 2004 due to the short FX position, banks have incurred losses whenever there was an increase in foreign exchange rates. In the period January-March 2005, the sector is in a short position and has an increased sensitivity to possible foreign exchange rate shocks.

The ratio of possible losses that banks will incur due to their open positions to capital increased in 2004, compared to 2003. Based on the maximum foreign exchange risk shock, the ratio of the losses of banks with open positions to their capital was 1.7 percent. In general, it is observed that the banking sector avoids holding open positions and the sector is resistant enough against fluctuations in foreign exchange rates even with a significant rate shock (Table II.2.2.2.1.2).

II.2.2.2.1.2. Negative Interest Rate Shock

In the interest rate shocks, as a result of repricing, the losses that banks will incur are limited.

i) When the New Turkish Lira and foreign currency investments and obligations of the banking sector (excluding SDIF banks) are exposed to a one month negative interest rate shock, a decrease in net interest income occurs due to repricing. As of March 2005, such losses increased relative to December 2003 and December 2004. This situation showed that the banking system was increasing its short term open position. When the negative interest rate shock lasted for three months, it was determined that costs would increase due to maturity mismatch and would be higher related to the years 2003 and 2004. On the other hand, when the strong capital structure of the banking sector is considered, it is understood that the impact on capital of such losses would be limited.

Table II.2.2.2.1.2.1
Scenario Parameters for Value Losses of Securities under Negative Interest Rate Shocks

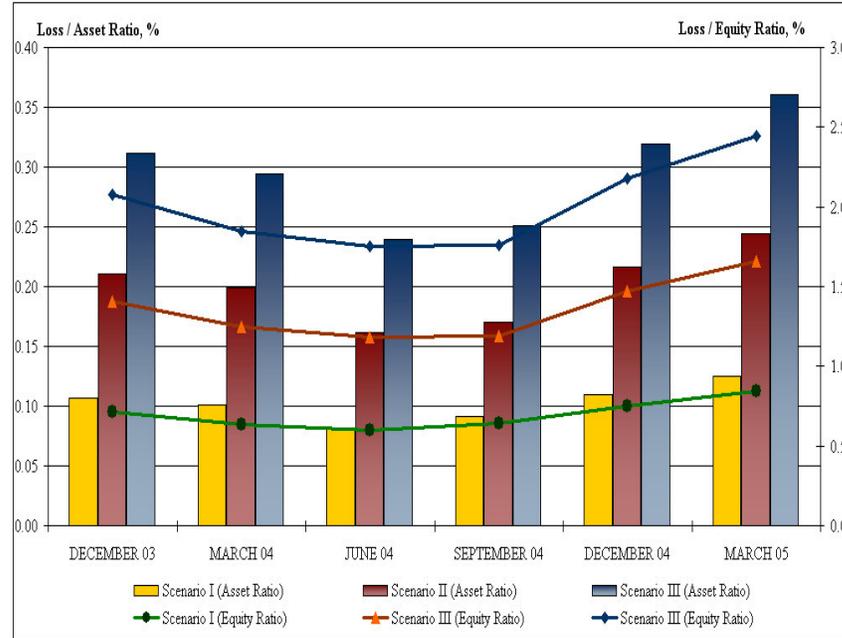
Scenario Inputs		
Scenario I	Scenario II	Scenario III
2 point increase in the market interest rates of YTL denominated fixed income securities in the trading portfolio ¹	4 point increase in the market interest rates of YTL denominated fixed income securities in the trading portfolio ¹	6 point increase in the market interest rates of YTL denominated fixed income securities in the trading portfolio ¹

¹ BRSA defines trading portfolio as “Securities in the trading portfolio “and “ Securities available for sale” in the light of the Basel Committee definition.

ii) Under negative interest rate shocks, in addition to the calculation of losses arising from repricing, the value losses of securities were taken into account. However, since new Turkish Lira securities with floating interest rates are not exposed to interest rate risk and the securities to be held until maturity are revalued by using the internal rate of return, only new Turkish lira securities in the trading portfolio and securities available for sale are used in the scenario analyses. Also, in calculation of value losses, the average days to maturity, nominal value and interest rate are used to calculate the value of the portfolio on related dates and the value after the interest rate shocks and the difference is shown as a value loss (Chart II.2.2.2.1.2.1.)

Chart II.2.2.2.1.2.1

Ratio of the Loss in Value of Discounted YTL Securities to Assets and Equity under Negative Interest Rate Shocks



It is observed that the equity of banks are adequate to cover the loss of value due to interest rate shock.

When the ratio of the losses that would occur on the market value of the discounted new Turkish lira securities under negative interest rate shocks to assets was examined, in the December 2003-June 2004 period, it was observed that the ratio of value losses in the securities after interest rate shocks to total assets decreased, however, the ratio started to increase from June 2004 onwards.

In March 2005, the ratio of loss of value to assets was 0.1 percent in Scenario I (two points shock), 0.3 percent in Scenario II (four points shock) and 0.4 percent in Scenario III (six points shock). The share of loss of value to total assets would be limited even with the highest interest shock.

In the period between December 2003-March 2005, no significant changes were observed in the ratio of the value loss of the discounted new Turkish lira securities under negative interest rate shocks to equity. In March 2005, the ratio of loss of value to equity was 0.9 percent in Scenario I (two points shock), 1.7 percent in Scenario II (in four points shock) and 2.5 percent in Scenario III (six points shock). In short, banks have adequate capital to cover the loss of value even with the highest interest rate shock.

In conclusion, it was understood that the interest rate risk of the banking sector (excluding SDIF banks) has increased since June 2004, however, possible losses in value would still be low. Also, in case the banks do not sell the securities before maturity, it should be taken into account that the losses of value would not be reflected on the balance sheet as loss (Chart II.2.2.2.1.2.1).

II.2.2.2.2. Positive Interest and Foreign Exchange Rate Shock Scenarios

Table II.2.2.2.1
Scenario Parameters for Positive Interest and Foreign Exchange Rate Shocks

Types of Scenarios	Scenario Inputs		
	Scenario I	Scenario II	Scenario III
A. Currency Shock	The appreciation of YTL against other currencies by 10 percent	The appreciation of YTL against other currencies by 20 percent	The appreciation of YTL against other currencies by 30 percent
B. Interest Rate Shock	YTL The repricing of 0-1 and 1-3 month YTL assets and liabilities 2 points lower	The repricing of 0-1 and 1-3 month YTL assets and liabilities 4 points lower	The repricing of 0-1 and 1-3 month YTL assets and liabilities 6 points lower
	FX The repricing of 0-1 and 1-3 month FX assets and liabilities 1 point lower	The repricing of 0-1 and 1-3 month FX assets and liabilities 3 points lower	The repricing of 0-1 and 1-3 month FX assets and liabilities 5 points lower

Table II.2.2.2.2
Positive Interest and Foreign Exchange Rate Shock Results

Million YTL	Scenario I			Scenario II			Scenario III		
	Dec.03	Dec.04	Mar.05	Dec.03	Dec.04	Mar.05	Dec.03	Dec.04	Mar.05
A. Currency Shock									
a. Sector excluding SDIF Banks	-33	15	47	-67	29	95	-100	44	142
Profit (Loss) / Equity (%)	-0.1%	0.0%	0.1%	-0.2%	0.1%	0.2%	-0.3%	0.1%	0.3%
b. Banks Gaining Profits ¹	46	79	119	91	158	238	137	238	357
c. Banks Suffering Losses ²	-79	-64	-72	-158	-129	-143	-237	-193	-215
Banks Gaining Profits / Equity (%)	0.3%	0.4%	0.6%	0.7%	0.8%	1.1%	1.0%	1.2%	1.7%
B. Interest Rate Shock									
i) Sector Excluding SDIF									
(a) Interest Rate Shock (1 Month) YTL	6	4	29	11	8	59	17	11	88
(b) FX	12	11	16	35	33	49	58	56	82
Profit after Shock (a)+(b)	17	15	46	46	41	108	75	67	170
Profit / Equity (%)	0.0%	0.0%	0.1%	0.1%	0.1%	0.3%	0.2%	0.2%	0.4%
(c) Interest Rate Shock (3 Months) YTL	45	55	90	90	109	180	135	164	269
(d) FX	57	50	63	171	151	189	285	251	316
Profit after Shock (c)+(d)	102	105	153	261	260	369	421	415	585
Profit / Equity (%)	0.3%	0.2%	0.4%	0.8%	0.6%	0.9%	1.2%	1.0%	1.4%

¹ Total profit of banks that profit from positive foreign exchange rate shocks

² Total loss of banks that lose from positive foreign exchange rate shocks

³ Annual average data were used for foreign exchange rate risk.

II.2.2.2.1. Positive Foreign Exchange Rate Shock

From the Foreign Exchange Net General Position (FXNGP) data of the banking sector it is observed that since the sector was in a long position in 2003, the possible appreciation of the foreign exchange rate generated a loss, whereas in 2004, since the FXNGP was short, it generated a profit. In the January-March 2005 period, because of the short position of the sector, banks profited in case of a positive foreign exchange rate shock. With the highest positive foreign exchange shock, the ratio of profit of banks that hold short positions to their capital was 1.7 percent. Although, it was observed that the banking sector avoids holding short positions, it can be seen that they would gain profit from a positive foreign exchange shock.

II.2.2.2.2.Positive Interest Rate Shock

When new Turkish lira and foreign exchange investments and obligations of banks are exposed to a one month positive interest rate shock, the net interest income would increase due to repricing. As of March 2005, such profits increased compared to December 2003 and December 2004. This situation indicated that banks increased their short term short positions. If the positive shock lasted three months, the profits would increase further, depending on the maturity mismatch and this would be higher compared to 2003 and 2004.

II.2.2.2.3.Conclusion

According to the scenario analyses with negative foreign exchange shocks, since short positions of banks were at negligible levels, this causes possible losses arising from foreign exchange risk to remain at low levels. Since the short term interest sensitive assets were less than the interest sensitive liabilities, with negative interest rate shocks, net interest income decreases due to repricing. On the other hand, in the framework of assumptions, the market value of securities in the trading portfolio of the banking sector decreases due to interest rate increases. However, the capital is strong enough to cover such losses.

Since the foreign exchange net general position of the banking sector is short and short term interest sensitive assets are less than interest sensitive liabilities, the positive foreign exchange and interest rate shocks would positively affect the profitability of the sector.

II.2.3.LIQUIDITY RISK

Box II.2.3.1. Liquidity Management of the Central Bank of the Republic of Turkey

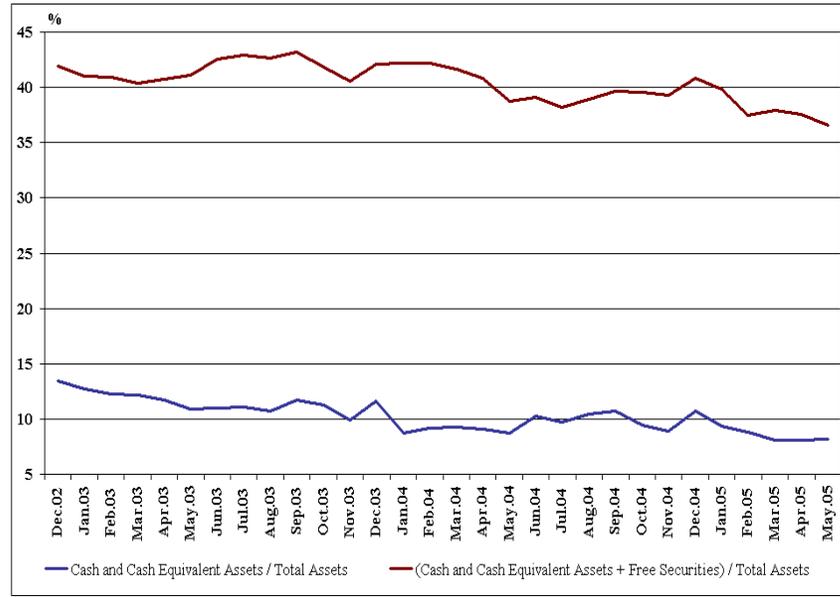
The banks, which are authorized to make transactions in the markets at the CBRT can obtain liquidity from the CBRT as follows:

- i. Banks can borrow at the Interbank Money Market between 10:00-16:00 at the overnight quotations announced by the CBRT, within their existing limits and in exchange for collateral.
- ii. Banks can borrow at the Foreign Exchange Market of the CBRT at the one week foreign exchange deposit quotation announced by the CBRT, within their existing limits and in exchange for collateral.

iii. Within the framework of “the lender of last resort” function of the CBRT, banks can borrow without limit from the Late Liquidity Window at the Interbank Money Market between 16.00-16.30 at the offer quotation of the CBRT in exchange for collateral.

iv. Market maker banks can also obtain funds from the CBRT through overnight and weekly repo transactions between 10.00-12.00 and 13.00-16.00 within their existing limits .

Chart II.2.3.1
Liquidity Ratios^{1,2,3}



Source: BRSA-CBRT

¹ Cash and Cash Equivalent=Cash + Due from CBRT + Due From Interbank + Due From Banks

² Free Securities = Securities that are not used as collateral or for repo transactions or not held for Structural Position.

³ Iller Bank was excluded.

When the ratio of cash and cash equivalent assets to total assets is analyzed; it can be observed that the ratio which was 13.5 percent in 2002, followed a declining trend afterwards, accept for periods of external shocks. Especially, as a result of arranging terms with the European Union on December 17, 2004 regarding a negotiation date, the decline in this ratio accelerated due to positive expectations in the markets and by May 2005 the ratio was realized as 8.2 percent (Chart II.2.3.1).

The ratio of the cash and cash equivalent assets and securities portfolio to total assets showed a moderate decline due to the high share of securities in bank balance sheets. This ratio, which was 41.9 percent

by the end of 2002, decreased to 36.6 percent in May 2005 (Chart II.2.3.1).

The decline in both ratios is attributable to the tendency of banks to extend longer term loans as a result of macroeconomic stability.

Chart II.2.3.2
Ratio of Assets to Liabilities with Respect to Remaining Maturities



The ratio of 0-1 month assets to 0-1 month liabilities, both in domestic and foreign currencies, decreased in March 2005 as compared to December 2004.

Source: BRSA-CBRT

The ratio of zero to one month assets to zero to one month liabilities decreased in March 2005, compared to December 2004, both in domestic and foreign currency. The ratio was realized as 49.7 percent for domestic currency and 36 percent for foreign currency as of March 2004 (Chart II.2.3.2). When compared to developed countries, these figures are low due to the general structure of the Turkish banking system. Deposits, which are the main source of funds for banks are concentrated in zero to three months, whereas government securities and loans, which are the main investment items, are concentrated in more than twelve months. However, it is our opinion that there is no risk in terms of liquidity management since a large proportion of zero to three month deposits consist of core deposits.

Box II.2.3.2.Measures Taken during the Iraq Crisis

The Central Bank takes necessary measures in order to mitigate the fluctuations in the markets stemming from external shocks. In March 2003, a number of measures were taken in order to limit the probable adverse affects on our markets of the military operation, which commenced against Iraq on March 20, 2003. These measures were also aimed at maintaining price and financial stability.

A) Turkish Lira Money Market

It was announced that in case of an additional liquidity need in the markets, the necessary amount would be provided by the CBRT with the following terms and conditions:

i. The interest rate on funds that can be obtained without limit and in exchange for collateral between 16:00-16:30 from the “Late Liquidity Window” at the Interbank Money Market was decreased by five points.

ii. It was announced that if needed, the CBRT could also provide overnight funding in the İstanbul Stock Exchange Repo Market.

B) Foreign Exchange Market

i. The interest rate on one week US dollar deposits that can be obtained within existing limits from FX Markets at the CBRT was decreased by four points.

ii. Necessary measures were taken to meet the probable foreign exchange cash requirements.

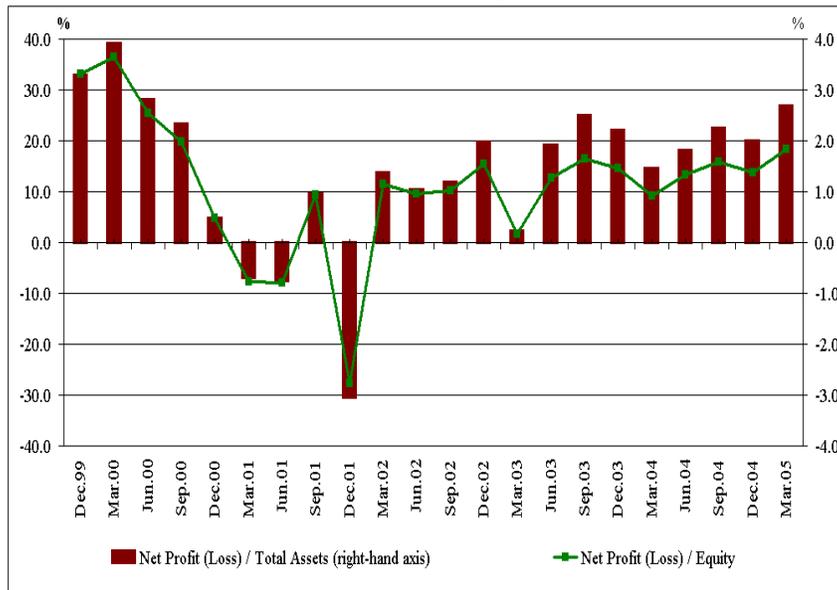
In conclusion, as a result of the expectations that the decline in inflation and interest rates will be permanent, New Turkish Lira and foreign exchange liquidity ratios decreased. However, the fact that a large proportion of securities that are held by the banking sector can be readily used as collateral is positively regarded in terms of liquidity management.

II.2.4.PROFITABILITY AND CAPITAL ADEQUACY

II.2.4.1.Profitability

As of December 2004, total net profit of the banking sector (excluding SDIF banks) increased by 13.6 percent (a decrease of 0.2 percent in real terms) compared to the end of 2003 and reached 6.1 billion New Turkish Liras. In the first quarter of 2005, the net profit of the banking sector was realized as 2.1 billion New Turkish Liras.

Chart II.2.4.1.1
Return on Assets and Return on Equity



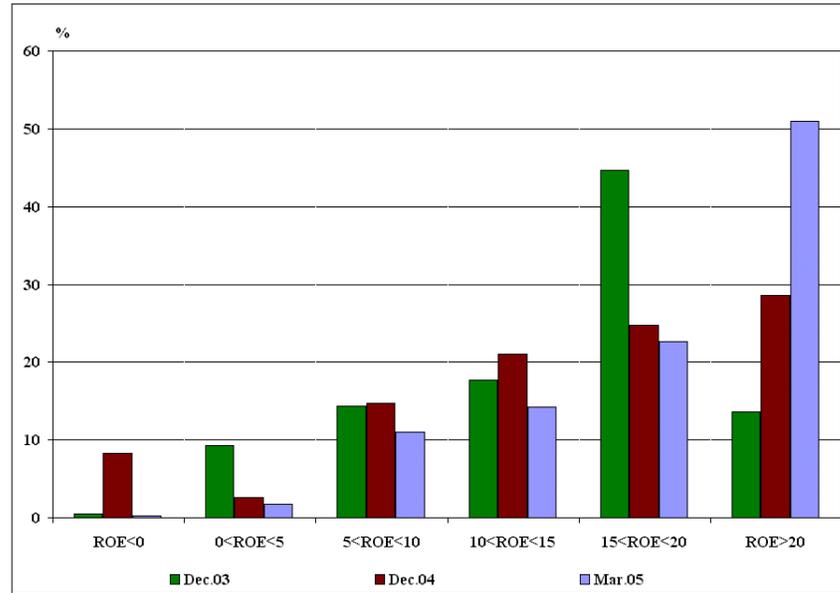
Source: BRSA-CBRT

The return on assets of the banking sector was realized as 2.0 percent, whereas return on equity was observed as 13.6 percent.²⁰ In addition to the return on equity, the return on assets decreased at end-2004. According to the results of the first quarter of 2005, the return on assets and return on equity of the banking sector increased to 2.7 percent and 18.3 percent, respectively. The increase in the first quarter of 2005 was mainly due to the elimination of monetary losses arising from the termination of inflation accounting (See Box II.2.4.1.2).

Both the return on assets and return on equity which had decreased as of 2004, started to increase in the first quarter of 2005.

²⁰ The profitability ratios, which are determined by dividing the income statement data by balance sheet data, are multiplied by 4 (for March), 2 (for June) and 1.33 (for September) in order to annualize data.

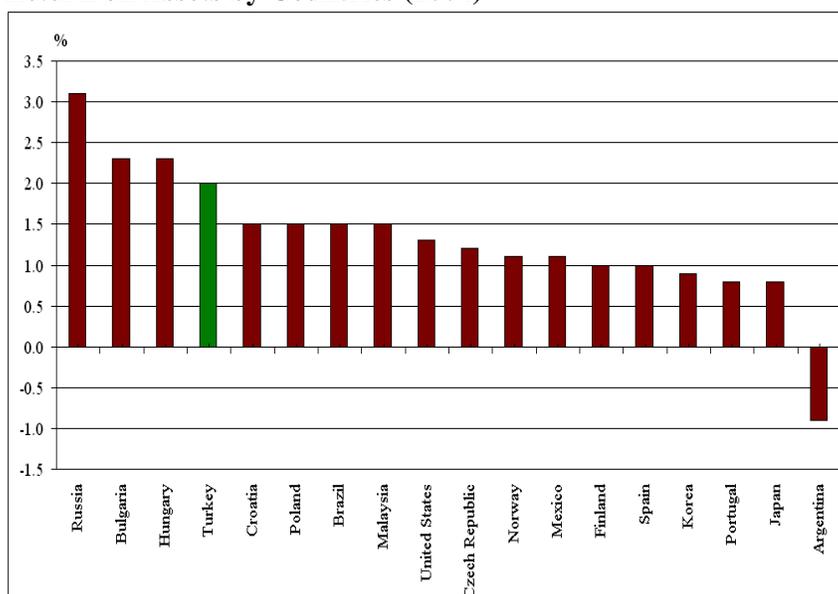
Chart II.2.4.1.2
Distribution of Bank Assets Based on Return On Equity (%)



Source: BRSA-CBRT

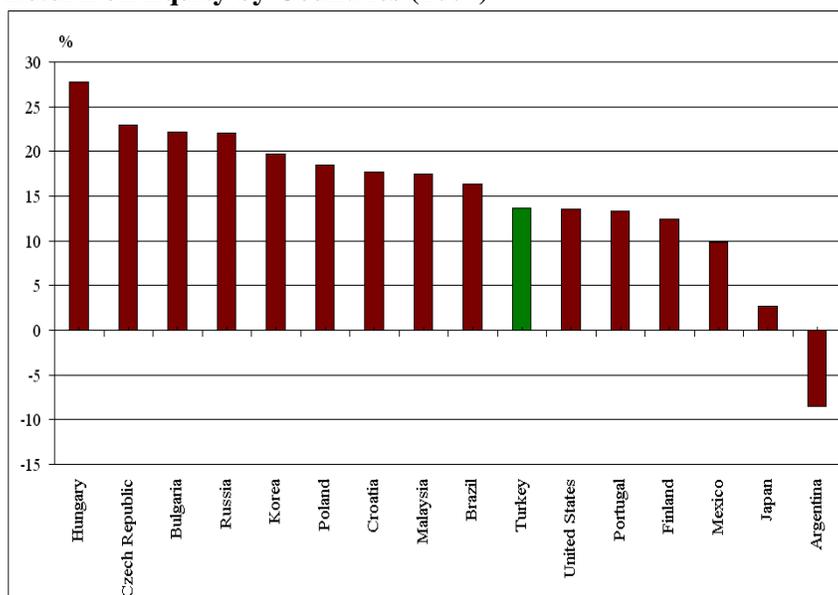
In the period of December 2003-2004, the share of banks, with return on equity over 15 percent, in total banking sector assets, declined from 58 percent to 53 percent, while the asset share of banks within the 5-15 percent range, increased from 32 percent to 36 percent. As of March 2005, the asset share of banks with less than 20 percent return on equity in the total banking sector assets has decreased, whereas the asset share of banks over 20 percent return on equity has reached 51 percent (Chart II.2.4.1.2).

Chart II.2.4.1.3
Return on Assets by Countries (2004)²¹



Source: Global Financial Stability Report, 2005, IMF

Chart II.2.4.1.4
Return on Equity by Countries (2004)



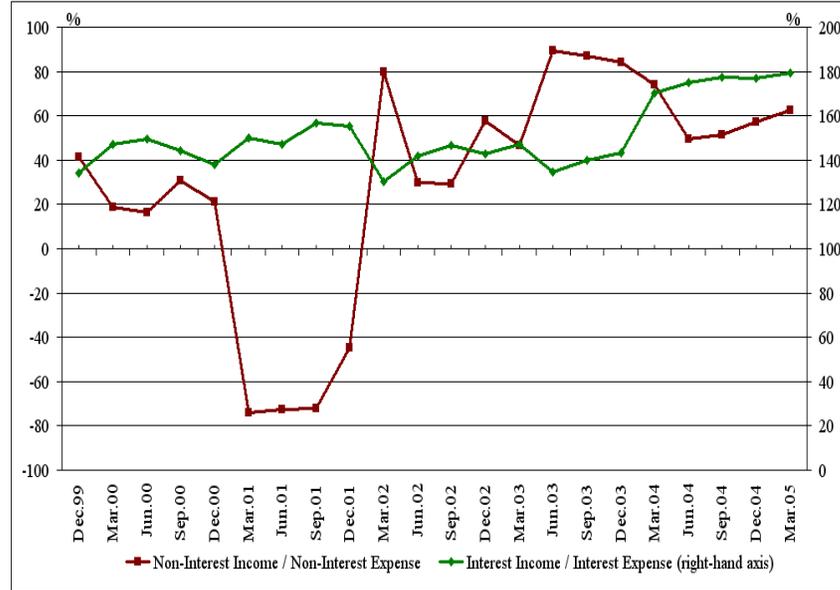
Source: Global Financial Stability Report , 2005, IMF

As of 2004, it is observed that Turkey, among the selected countries, showed a high performance with regard to return on assets. On the other hand, Turkey displays a relatively lower performance for the

²¹ The data for Czech Republic and Hungary are as of March 2004; the data for Poland, Malaysia, Finland, Spain, Korea and Portugal are as of June 2004; the data of the other countries are as of September 2004 and the data for Turkey is as of December 2004.

return on equity when compared with the selected countries due to its low leverage ratio (Chart II.2.4.1.3, II.2.4.1.4).

Chart II.2.4.1.5
Interest and Non-Interest Income-Expenses



Source: BRSA-CBRT

When the income/expense structure of the banking sector is analyzed, the ratio of interest income to interest expenses has increased to 176.7 percent, whereas the ratio of non-interest income to non-interest expenses has declined to 57.8 percent.²² As of March 2005, the ratio of interest income to interest expenses continued increasing and has reached 179.1 percent and the ratio of non-interest income to non-interest expenses was realized as 62.6 percent (Chart II.2.4.1.5).

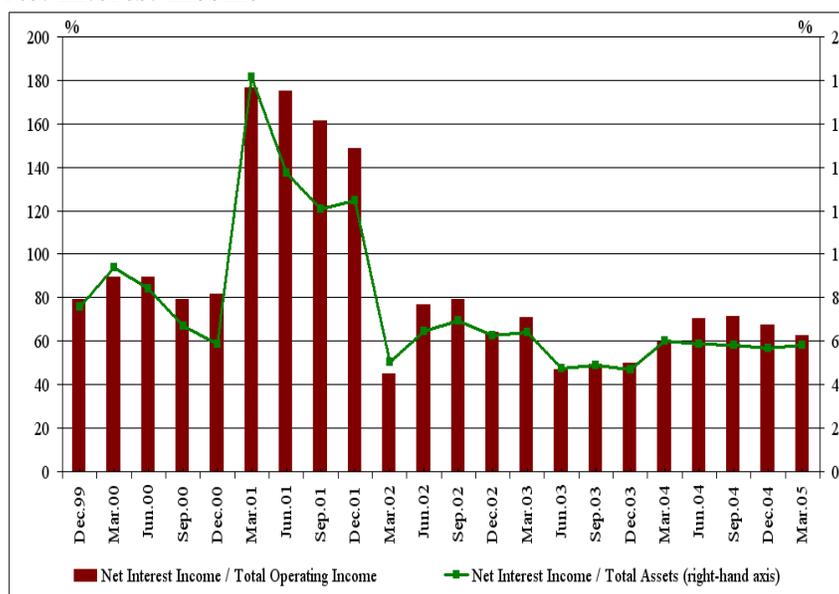
In 2004, the increase in the ratio of interest income to interest expenses is due to the 6 percent increase in interest income as compared to 14 percent decrease in interest expenses. On the other hand, the ratio of non-interest income to non-interest expenses has declined due to the 66 percent decrease in net trading income,²³ 9 percent increase in provisioning expenses and 7 percent increase in operating expenses, despite increased net income from fees and commissions.²⁴

²² Non-interest income consists of net fees and commissions income, dividend income, net trading income and other operating income. Non-interest expenses consist of provision for loan losses or other receivables, and other operating expenses.

²³ Net trading income (loss) consists of profit/loss on trading portfolio and foreign exchange gains/losses.

²⁴ Net fees and commissions income is the sum of fees and commissions received and income from banking activities, whereas fees and commissions paid is deducted from this sum.

Chart II.2.4.1.6
Net Interest Income

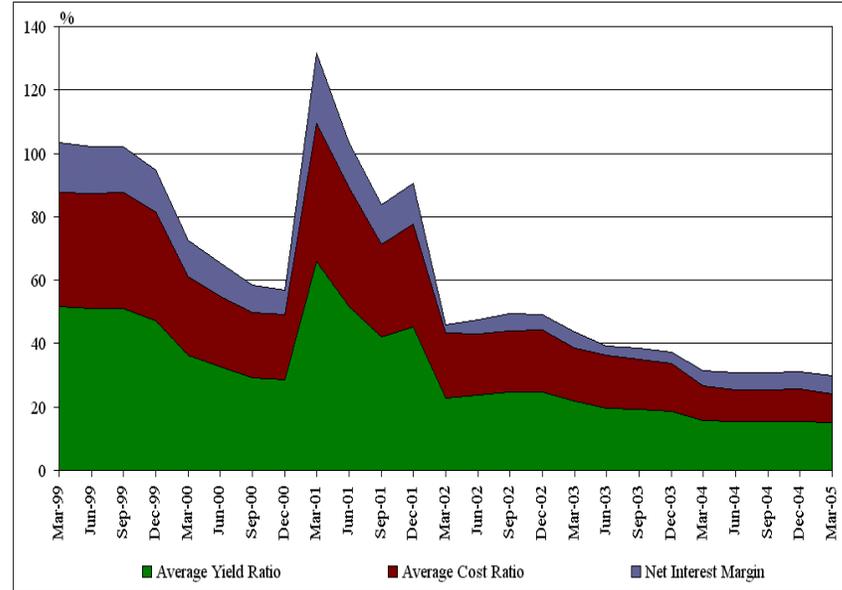


Source: BRSA-CBRT

As of end-2004, the interest income of the banking sector, which amounted to 39.9 billion New Turkish Liras, increased by 6 percent in nominal terms and decreased by 7 percent in real terms, compared to the previous year. On the other hand, the interest expenses decreased by 14 percent to 22.6 billion New Turkish Liras at end-2004, compared to the previous year. As a result of these developments, net interest income reached 17.3 billion New Turkish Liras, the net interest income/total assets ratio increased to 5.7 percent and the share of net interest income in total operating income rose to 67.2 percent. As of March 2005, the banking sector continued preserving its high interest margin, however, the share of non-interest income in total income has increased due to the increase in income from fees and commissions, resulting in a decrease in the share of net interest income in total income to 62.4 percent (Chart II.2.4.1.6). Compared to the previous period, as a result of increased loan activity, interest income on loans has increased despite the reduction in interest rates, whereas interest received from banks, money market transactions and securities portfolio has decreased. As a result of these developments, the share of interest on loans in total interest income reached 39 percent and the share of interest received from the securities portfolio in total interest income decreased to 53 percent. As of March 2005, the share of interest on loans in the total interest income continued growing and reached 45 percent. In the same period, the share of interest received from the securities portfolio was realized as 48 percent.

Moreover, all interest expense items decreased due to the reduction in interest rates. Besides this, the share of interest on deposits in the total interest expenses was realized as 84 percent.

Chart II.2.4.1.7
Average Yield on Assets and Average Cost of Liabilities

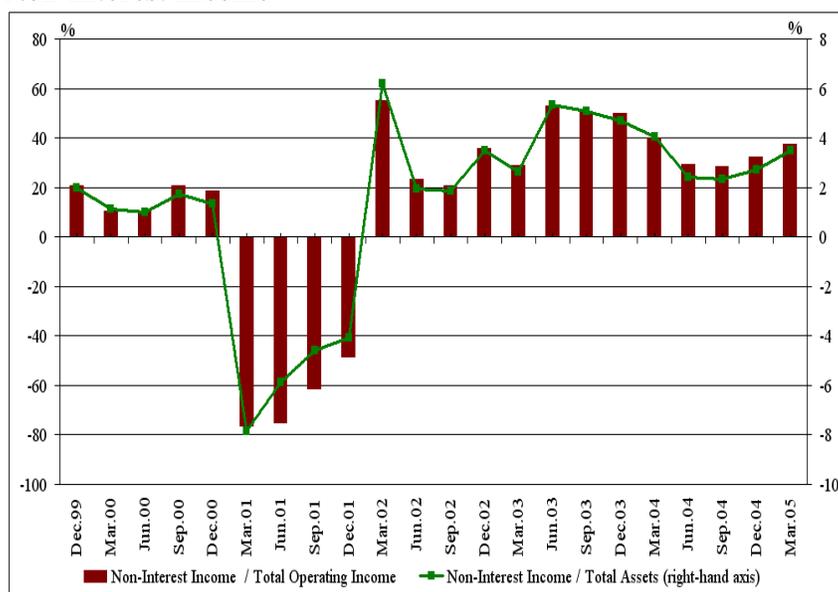


Source: BRSA-CBRT

The fall in interest rates does not have the same impact on the yield of assets and cost of liabilities of banks²⁵. As a matter of fact, since the rate of decrease in the yield on securities and loans was greater than the rate of decrease in the cost of liabilities, there was a rapid fall in the net interest margin in the second quarter of 2003. During 2003, the average yield on loans was especially lower than the cost of deposits. In the first quarter of 2004, the net interest margin began increasing and became stable after that period. This increase was due to the greater rate of decrease in the cost of liabilities than the rate of decrease in the yield on assets. As of March 2005, the net interest margin has increased to 5.8 percent.

²⁵ Total yield is interest income as a percentage of average interest-earning assets and total cost is interest expense as a percentage of average interest bearing liabilities. In order to annualize, the ratios are multiplied by 4, 2 and 1.33 for March, June and September, respectively.

Chart II.2.4.1.8
Non-Interest Income



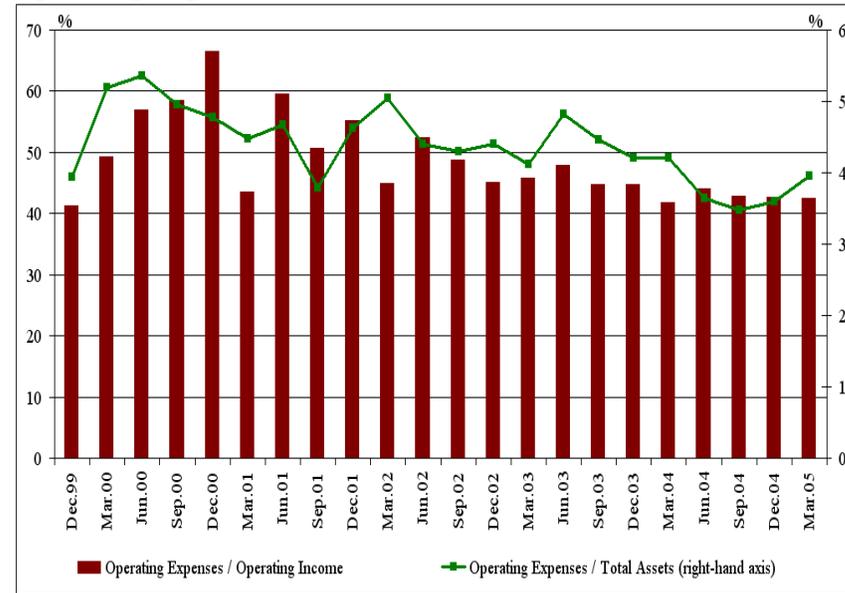
Source: BRSA-CBRT

As of end-2004, non-interest income of the banking sector declined by 26 percent, compared to end-2003 and was realized as 8.5 billion New Turkish Liras. As a result of this development, the ratio of non-interest income to assets and the share of non-interest income in the total operating income declined to 2.8 percent and 32.8 percent, respectively. In the first quarter of 2005, income from fees and commissions and banking activities increased and the ratio of non-interest income to assets reached 3.5 percent. The share of non-interest income in the total operating income rose to 37.6 percent (Chart II.2.4.1.8).

As of December 2004, net fees and commissions income increased both in nominal and real terms. In this period, it is observed that the banking sector was mainly aiming to increase its operating income. In the year under review, net trading income is the main item that constrains the profitability performance of the banking sector. Net trading income decreased by 66 percent in nominal terms because of the decline in the profit on the trading portfolio and foreign exchange gains. As a result of these developments, the share of net fees and commissions income in the total non-interest income rose to 48 percent, whereas the share of net trading income in the total non-interest income declined to 27 percent. Similarly, as of March 2005, the share of net fees and commissions income in the total non-interest income continued increasing and the

share of net trading income in the total non-interest income continued declining. Thus, the aforementioned ratios were realized as 56 percent and 22 percent, respectively.

Chart II.2.4.1.9
Operating Expenses



Source: BRSA-CBRT

As of end-2004 both the provision for loan losses and other receivables and operating expenses declined in real terms. Operating expenses which amounted to 10.9 billion New Turkish Liras decreased by 6 percent in real terms. As a result of this development, the ratio of operating expenses to total assets and the ratio of operating expenses to operating income declined to 3.6 percent and 42.4 percent, respectively. As of March 2005, the ratio of operating expenses to total assets increased to 3.9 percent and the ratio of operating expenses to operating income was maintained at 42.5 percent with a slight increase (Chart II.2.4.1.9). Personnel expenses constitute 44 percent of the total operating expenses, constituting the major item in total operating expenses. In 2004, compared to the previous year, the increase in personnel expenses was realized as 4 percent in real terms and the ratio of fees and commissions income to personnel expenses increased by 18 points, reaching to 88 percent in December 2004. The decline in the gains on treasury operations caused the banking sector to be more sensitive to the developments in operating expenses. As of March 2005, fees and commissions income continued growing and the ratio of fees and commissions income to personnel expenses exceeded 100 percent.

Consequently, in 2004, the net profit of the banking sector, excluding SDIF banks, decreased by 0.2 percent in real terms, compared to the end of the previous year and amounted to 6.1 billion New Turkish Liras. At the same time, both the return on assets and return on equity ratios of the banking sector declined. The negative impact stemming from the decrease in profits on trading portfolio and foreign exchange gains was offset by the increase in net interest income, resulting from the greater decline in the cost of liabilities than the decline in the yield on assets. The net fees and commissions income of the banking sector has increased, whereas operating expenses and provisioning expenses declined in real terms. In the period under review, although the high income from treasury operations of the banking sector declined; the cost of liabilities decreased at a higher rate than the yield on assets, which contained a growing loan portfolio. Additionally, the increase in operating income was greater than the increase in operating expenses. According to the results of the first quarter of 2005, the return on assets and return on equity ratios of the banking sector increased and the sector managed to maintain its net interest margin despite falling interest rates. As the banking sector went back to its core banking functions, fees and commissions income, which is a much more stable source of income, continued growing. However, while the ratio of operating expenses to operating income displayed a slight change, the ratio of provisioning expenses to operating income increased. While the elimination of monetary losses due to giving up inflation accounting did not have an important impact on the return on assets ratio, the other profitability ratios of the banking sector improved due to the termination of this system of accounting.

In low interest-rate environment, banking sector managed to maintain its profitability by focusing on sustainable income sources and operational efficiency.

In the first quarter of 2005, return on equity increased to 18.3 percent. The result of the analysis on the components of return on equity as of March 2005 is as follows:

- i. The improvement in return on equity was as a result of increased return on assets.
- ii. No change occurs in the leverage level.
- iii. Despite the increase in the ratio of operating income to assets, the improvement in the return on assets ratio was especially due to the increase in the profit margin.
- iv. The increase in the ratio of operating income to assets was due to the increase in net fees and commissions income.
- v. Despite the increase in provisioning expenses, the profit margin improved due to the decline in non-operating expenses, which includes net monetary losses.

Box II.2.4.1.2. Termination of Inflation Accounting and Its Impact

With the Banking Regulation and Supervision Board Resolution dated 21.04.2005, No. 1623, the utilization of inflation accounting in the banking system was terminated due to the fact that the indicators implying a high rate of inflation have been eliminated.

In this context, the following conditions will be fulfilled by banks and special finance institutions and will be effective starting from 01.01.2005;

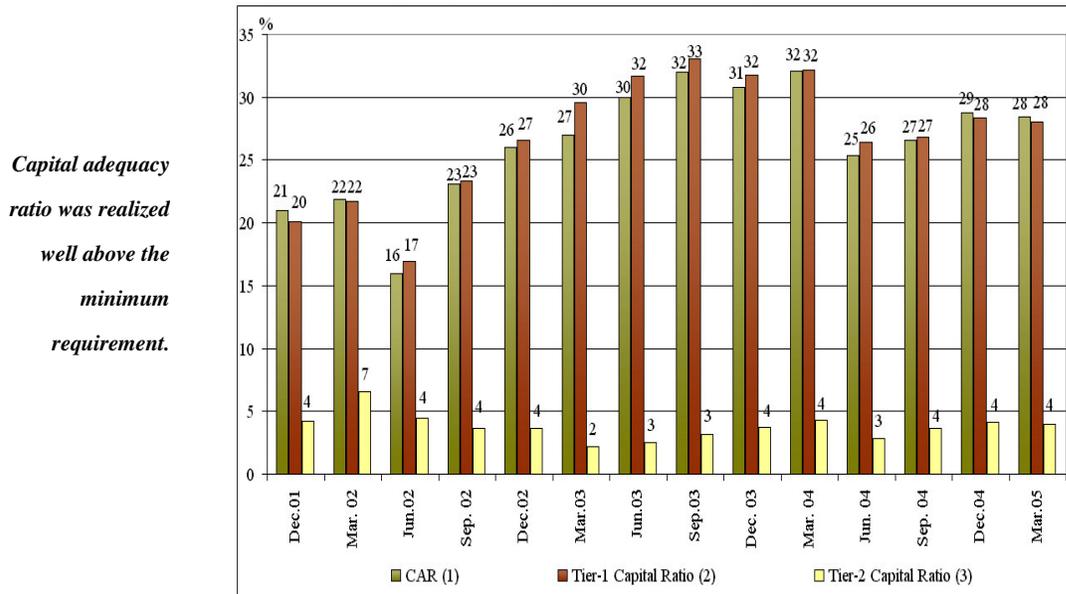
- i. The entries made during 2005 to the Inflation Adjustment of Capital accounts will be cancelled.
- ii. The balances that take place in the Inflation Adjustment of Capital accounts, excluding the Capital Sub-account, will be transferred to the accounts related to the adjustments.
- iii. The Inflation Adjustment of Capital accounts will not be used anymore.
- iv. The balance of Capital Sub-account that takes place among Inflation Adjustment of Capital accounts, will be transferred to Other Reserve Capital Sub-account.

In 2005, the elimination of net monetary position losses resulting from inflation accounting will have a positive impact on the net profit of the banking sector with the termination of following inflation accounting. The banks that have high free capital will benefit most from this change.

II.2.4.2. Capital Adequacy

When the trend of the unconsolidated capital adequacy ratio (CAR) for the Turkish banking sector is analyzed, it is observed that this ratio, which is perceived as an indicator of confidence against potential risks, was realized above the minimum requirement (8 percent) for all the periods under review.

Chart II.2.4.2.1
Capital Adequacy Ratio (Unconsolidated)



Source: BRSA-CBRT

¹ CAR: Capital / Risk Weighted Assets

² Tier-1 Capital Ratio: Tier-1 Capital / Risk Weighted Assets

³ Tier-2 Capital Ratio: Tier-2 Capital / Risk Weighted Assets

The unconsolidated capital adequacy ratio of the banking sector declined from 31 percent at end-2003 to 28.8 percent at end-2004. This decline stemmed from the fact that risk weighted assets increased at a higher rate relative to capital. In the mean time, as of March 2005, the unconsolidated capital adequacy ratio was realized as 28.4 percent and thus, was lower than the figures posted both in March 2004 and December 2004 (Chart II.2.4.2.1). Similarly, the tier-1 capital ratio declined in the period of December 2003-December 2004, resulting from the increase in 100 percent risk weighted assets. It is also observed that tier-1 capital ratio has a greater impact on CAR relative to tier-2 capital ratio. On the contrary, the tier-2 capital ratio has increased in this period. This came as a result of the higher increase in supplementary capital

relative to risk-weighted assets, resulting from the increase in the Marketable Securities Value Increase Fund (MSVIF) (Chart II.2.4.2.1). As of March 2005, while there is no change in the tier-1 capital ratio (28.0 percent) of the banking sector, there is a slight decrease in the tier-2 capital ratio compared to both March 2004 and December 2004. This decline stems from the decrease in MSVIF.

Table II.2.4.2.1
Unconsolidated Capital Adequacy Ratio of Deposit Banks

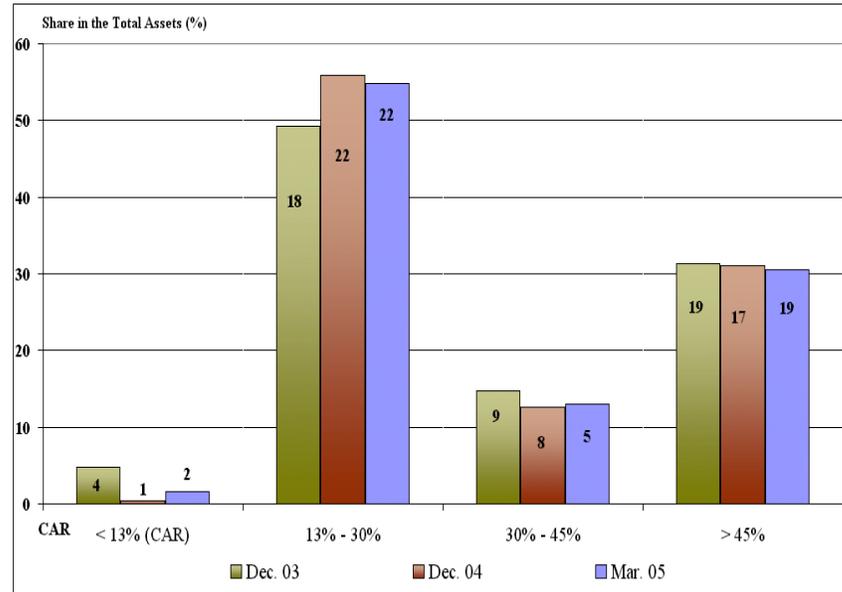
	Dec. 02	Mar. 03	Jun. 03	Sep. 03	Dec. 03	Mar. 04	Jun. 04	Sep. 04	Dec. 04	Mar. 05
Deposit Banks										
Tier-1 Capital Ratio	27.7	30.1	31.8	32.8	31.3	31.4	25.4	25.7	25.3	24.9
Tier-2 Capital Ratio	2.4	1.2	1.9	2.5	3.1	3.8	2.3	3.3	3.7	3.6
CAR	25.1	26.2	28.7	30.5	29.7	30.6	23.7	25.0	25.3	24.9
Banking Sector										
Tier-1 Capital Ratio	26.6	29.6	31.7	33.1	31.8	32.2	26.4	26.8	28.4	28.0
Tier-2 Capital Ratio	3.7	2.2	2.6	3.2	3.7	4.3	2.8	3.6	4.1	4.0
CAR	25.6	27.1	29.6	31.6	31.0	32.1	25.4	26.6	28.8	28.4

Source: BRSA-CBRT

The capital adequacy ratio of the deposit banks group has a determining impact on the ratio of the banking sector and the ratio of this group was realized close to that of the banking sector (Table II.2.4.2.1). The unconsolidated capital adequacy ratio of the deposit banks group declined from 29.7 percent at end-2003 to 25.3 percent at end-2004. This decline stemmed from the fact that risk weighted assets increased at a higher rate relative to capital due to the increase in loans, which are categorized in the 100 percent risk weighted assets. Moreover, the unconsolidated capital adequacy ratio of the deposit banking group was realized as 24.9 percent by March 2005 and this ratio decreased in this period compared to both March 2004 and December 2004, resulting from the increase in risk weighted assets.

Chart II.2.4.2.2

Distribution of Bank Assets and Number of Banks¹ Based on CAR

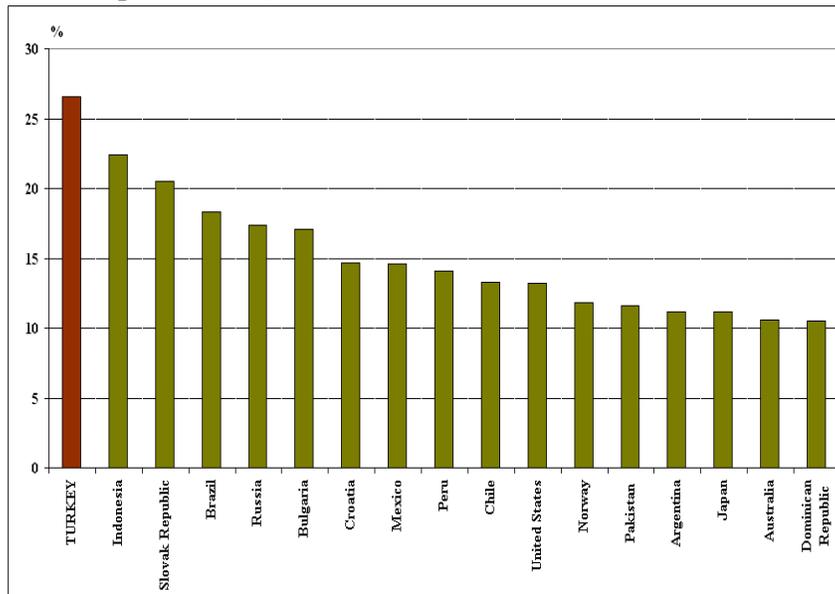


Source: BRSA-CBRT

¹ The numbers within the bars represent the number of banks.

In the period of December 2003-2004, the number and asset share of the banks in the banking sector with capital adequacy ratios over 30 percent has declined. This reflects that the banks began using their capital in a more rational way. On the contrary, the number and share of banks with capital adequacy ratios within the 13-30 percent range increased (Chart II.2.4.2.2). As of March 2005, the asset share of banks with capital adequacy ratios within the 13-30 percent range and over 45 percent decreased by one point, while the asset share of banks with capital adequacy ratios less than 13 percent rose by one point compared to December 2004.

Chart II.2.4.2.3
Comparison of CAR by Selected Countries
(As of September 30, 2004)

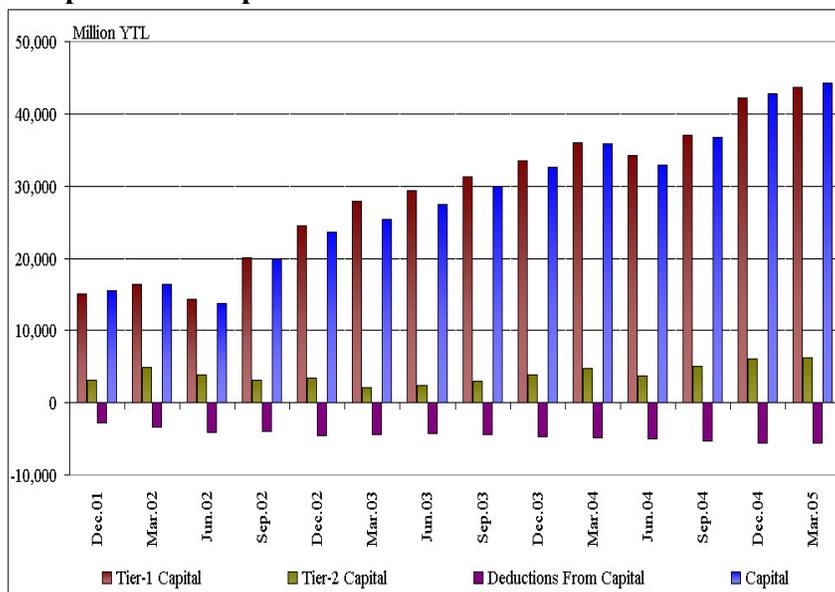


Turkish banking sector has the highest capital adequacy ratio compared to the selected countries.

Source: Global Financial Stability Report, IMF, April 2005

As of the third quarter of 2004, it is observed that the Turkish banking sector has the highest capital adequacy ratio among the selected countries under review, due to the fact that the Turkish banking sector has a high portfolio of Government Debt Securities and these are classified in the zero risk-weighted assets (Chart II.2.4.2.3)

Chart II.2.4.2.4
Components of Capital

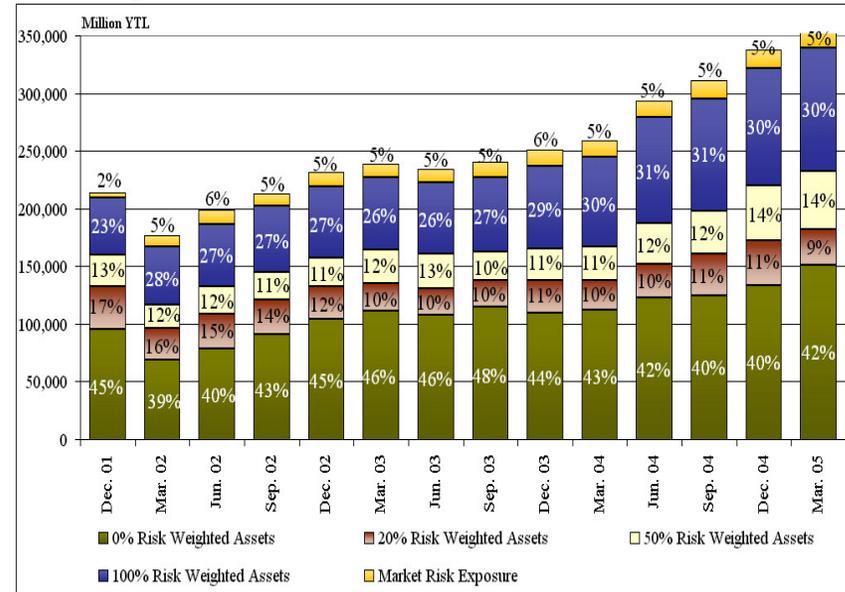


The increase in capital level utilized in the calculation of the capital adequacy ratio was mainly due to the increase in tier 1 capital.

Source: BRSA-CBRT

Analyzing the components of capital (tier-1 capital, tier-2 capital and deductions from capital) utilized in the calculation of the capital adequacy ratio, it is observed that the capital level increased by 31 percent in the period of December 2003-December 2004 due to the increase in tier-1 capital. The same trend was also observed in March 2005, and the amount of capital increased by 3.4 percent compared to December 2004 (Chart IV.2.4.2.4).

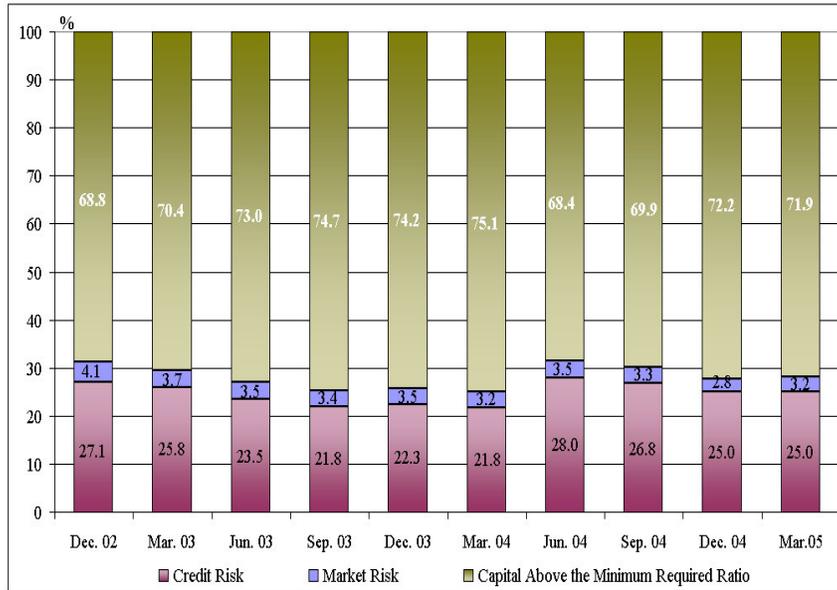
Chart II.2.4.2.5
Risk Weighted Assets



Source: BRSA-CBRT

The classification of Government Debt Securities in the zero-risk weighted assets has had a positive impact on the capital adequacy ratio. In the mean time, as of December 2004, zero risk weighted assets and 100 percent risk weighted assets constitute 40 percent and 30 percent of total risk weighted assets, respectively. The same trend is observed in March 2005, as well (Chart IV.2.4.2.5).

Chart II.2.4.2.6
Distribution of Regulatory Capital Requirement Based on Credit and Market Risk

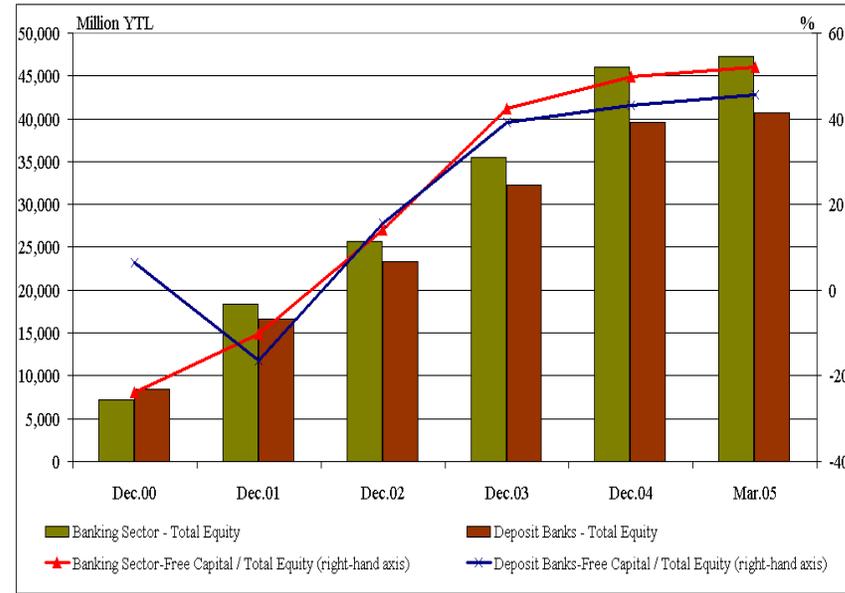


Source: BRSA-CBRT

As of December 2004, the ratio of capital for credit risk to total capital increased by three points compared to end-2003, and reached 25.0 percent. This came as a result of the increased loan activity. Moreover, capital for market risk constitutes 2.8 percent of the total capital. It is observed that the capital of the Turkish banking sector is above the minimum required capital for credit risk and market risk. In addition to this, there has not been a significant change in the aforementioned ratios by March 2005 (Chart II.2.4.2.6).

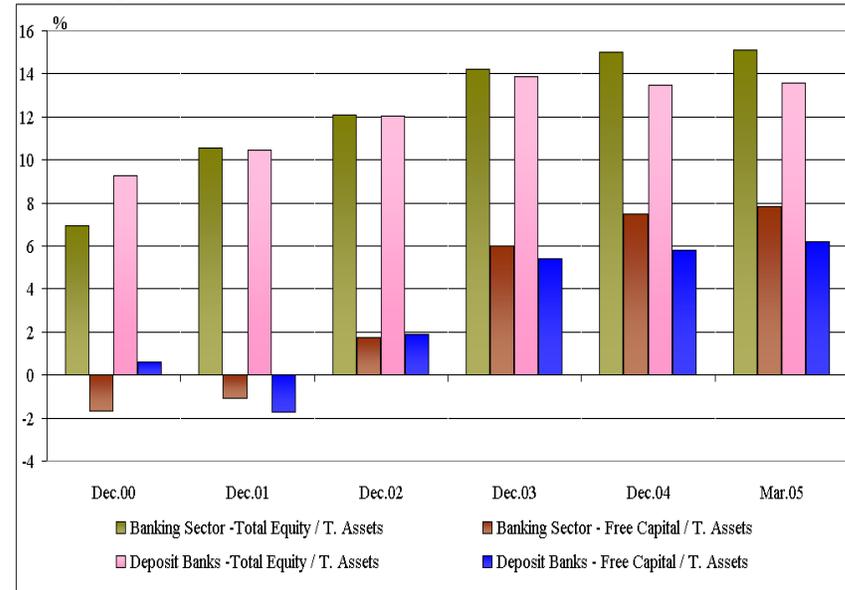
The capital of the Turkish banking sector is above the minimum required capital for credit risk and market risk.

Chart II.2.4.2.7
Capital and Free Capital



Source: BRSA-CBRT

Chart II.2.4.2.8
Total Equity and Free Capital / Total Assets



Source: BRSA-CBRT

Free capital is calculated by deducting fixed assets (including assets to be sold) and net non-performing loans from total equity. Given this definition, the ratio of free capital to total equity increased from 42.3 percent at end-2003 to 49.8 percent at end-2004. Similarly, the ratio of free capital to total assets rose from 6.0 percent at end-2003 to 7.5 percent at end-2004 (Chart 2.4.2.7 and Chart 2.4.2.8). In other words, the



amount of capital that is not allocated to non-earning fixed assets and non-performing loans has increased. This improvement in free capital was due to the increase in equity and the decrease in net non-performing loans. Similarly, as of March 2005, free capital of the banking sector improved further due to the increase in equity and decrease in net non-performing loans and fixed assets (including assets to be sold). At the same time, the ratio of equity to total assets of the deposit banks group declined from 13.9 percent at end-2003 to 13.5 percent at end-2004, resulting from the higher increase in assets relative to the increase in equity.

Consequently, if the observed change in the asset structure of the banking sector persists, the capital adequacy ratios of the banks may decline. Based on the stability and sustainable growth of the Turkish economy, loans and non-interest income are expected to increase and interest received from the securities portfolio is expected to decrease. Qualified and sustainable profitability and capital structure are very important to support growth of the banking sector. The BRSA has determined that its regulations to be put into operation related to Basel II will decrease the capital adequacy ratio of the banking sector but extra capital will not be required by the sector. As the stronger capital structure persists, there will be more opportunities for the restructuring of the banking sector's assets, preserving international competitive advantages and providing healthy banking operations.

II.2.5. Financial Strength Index

In order to determine the financial strength and fragility of the banking sector in general terms and to summarize it in one indicator, an index was formed utilizing selected ratios. Asset quality, liquidity risk, exchange rate risk, profitability and capital adequacy indices are formed by using the selected ratios and then financial strength index is constructed by taking arithmetic average of the indices.

Box II.2.5.1. Financial Strength Indicators

Financial Strength Indicators	Signs of the Ratios in terms of their Effects	
	on the Indices	Weights
Asset Quality	Gross Non-Performing Loans / Gross Loans	negative 0.33
	Net Non-Performing Loans / Equity	negative 0.33
	Fixed Assets / Total Assets ¹	negative 0.33
Liquidity	Liquid Assets / Total Assets ²	positive 0.40
	Asset with a maturity up to 3 months / Liabilities with a maturity up to 3 Months	positive 0.60
Exchange Rate Risk	Absolute Value (On Balance Sheet Foreign Currency Position / Capital) ³	negative 0.50
	Absolute Value (Foreign Currency Net Position / Capital) ⁴	negative 0.50
Profitability	Net Profit / Total Assets	positive 0.50
	Net Profit / Equity	positive 0.50
Capital Adequacy	Free Capital / Total Assets ⁵	positive 0.50
	Capital Adequacy Ratio	positive 0.50

¹ Fixed Assets consist of subsidiaries, assets to be sold, fixed assets and net non performing loans.

² Liquid Assets consist of cash, due from the CBRT, due from money market, due from banks and receivables from reverse repo transactions.

³ Capital is as defined in the CAR and it is different from the equity in balance sheet.

⁴ Foreign exchange net open position is the sum of on-balance sheet foreign currency position and off-balance sheet items.

⁵ Free capital is calculated by deducting fixed assets from equity.

Financial strength indicators used in the calculation of indices reflecting the financial strength of the banking sector and developments of the banking risks are presented in the table above. In choosing these indicators and weights, their capacity to reflect past crises was one of the main concerns.

In the table, the signs of the ratios in terms of their effects on the indices are given. Accordingly, a positive sign signifies that the index will rise due to the increase in the ratio, whereas a negative sign indicates that the index will decline due to the increase in the ratio. The weights in the table indicate the weights given to the ratios when constructing an index for each indicator group. For example; in constructing the capital adequacy index; the standardized value²⁶ of the ratios are multiplied by the determined weights and summed up. Thus, an index is constructed for the capital adequacy indicator group by taking the year 1999 as 100. In each index group, while an increase in the value of an index indicates an improvement, a decrease reflects deterioration. For instance, an increase in the liquidity-risk-index signifies that the liquidity of the banks has improved compared to past periods and liquidity risk has diminished.

²⁶ Data frequency of the ratios in the financial strength indicators are on a monthly basis starting from the end of 1999. In order to standardize, the value of the ratio in each period is subtracted from the average value of the selected period and then the outcome is divided by its standard deviation. At the same time, an adjustment was made to all of the values in order to make the values positive.

Table II.2.5.1
Financial Strength Index

	Asset Quality Index	Liquidity Risk Index	Exchange Rate Risk Index	Profitability Index	Capital Adequacy Index	Financial Strength Index
Dec.99	100.0	100.0	100.0	100.0	100.0	100.0
Dec.00	93.3	88.0	98.2	93.7	99.4	94.5
Dec.01	73.0	91.6	120.8	87.9	111.0	96.9
Mar.02	83.1	84.1	121.0	104.7	116.9	102.0
Jun.02	72.0	83.0	119.9	100.4	100.8	95.2
Sep.02	77.2	74.7	121.6	100.6	113.3	97.5
Dec.02	85.6	74.9	121.2	103.9	122.4	101.6
Mar.03	89.2	72.3	121.2	103.6	126.5	102.5
Jun.03	89.3	69.8	121.5	105.8	133.0	103.9
Sep.03	94.4	72.1	121.6	106.4	137.4	106.4
Dec.03	101.0	73.3	121.9	105.7	138.7	108.1
Mar.04	100.8	66.4	121.0	104.0	141.6	106.8
Jun.04	107.1	67.9	121.4	104.7	131.6	106.6
Sep.04	109.1	73.1	121.9	105.4	135.5	109.0
Dec.04	109.7	75.0	121.5	105.3	142.3	110.8
Mar.05	111.2	69.5	121.3	106.7	143.3	110.4

The evaluation of the risks and financial strength of the banking sector based on the constructed indices, is explained below:

i. The asset quality index signifies an improvement in the asset quality of the banking sector after the past crises. NPL ratios, fixed assets/total assets ratios and net non-performing loans/equity ratios decreased rapidly and this decline has a positive impact on the asset quality of the banking sector. However, strong loan growth in the Turkish economic environment requires a good management of credit risk.

ii. The confident and stable economic environment induced banks to prefer being less liquid and this is reflected in the liquidity risk index. As a matter of fact, a decreasing trend is observed starting from 2002 until the second half of 2004. While the share of liquid assets in the total assets of the banking sector is decreasing, the ratio of assets in the maturity bucket up to three months to liabilities with the same maturity is realized below 50 percent, indicating that the maturity mismatch continues to exist. However, the existence of core deposits and medium and long-term loans used from international institutions are the main factors that decrease the liquidity risk.



iii. Following the crises, the exchange rate risk performance index followed a stable trend with the elimination of FX open positions through swap operations of the Treasury using government debt securities in June 2001. This development strengthens the banking sector against sudden currency fluctuations.

iv. From 1999 to 2001, the banking sector suffered a loss for three years in a row. However, in 2002 and 2003, the banking sector made a satisfactory profit, due mainly to trading gains. In 2004, the accelerating increase in the profitability index came to an end. However, in 2005, the profitability index began accelerating again. This came as a result of the elimination of monetary position losses due to the termination of inflation accounting, which had a positive impact on the net profit of the banking sector. In a low inflation environment, decreased profit margins and increased competition require the banking sector to increase its sustainable income sources under changing macroeconomic conditions by restructuring its balance sheet and continuously improving its operational efficiency.

v. The increase in the capital adequacy index in the last three years indicates that capital structure of the banking sector has been improving and getting stronger compared to the previous years. The strong capital structure strengthens the resilience of the banking sector against possible shocks.

vi. As a result of the improvement in asset quality, the elimination of foreign currency open positions, successful profitability performance and stronger capital structure of the banking sector, the financial strength index reached its highest level for the last five years as of end-2004. As of May 2005, the soundness in the financial structure of the banking sector continues to exist.