



CENTRAL BANK OF THE REPUBLIC OF TURKEY



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FOREWORD

In this fourth issue of the Financial Stability Report, as in previous reports, macroeconomic developments affecting the financial system are analyzed, and the risks borne by the banking sector, which constitutes the largest portion of the financial system, are assessed through stress tests and scenario analyses.

It is pleasing that modern risk management tools keep gaining ground in Turkey. This progress, in fact, played a significant role in limiting the negative impacts of the turbulences experienced during May and June 2006.

In the period ahead, the course of international risk factors maintains its importance. These factors, on the other hand, depend largely on the interest rate decisions of central banks in developed countries and global liquidity conditions. The magnitude of the impact of potential turbulences will closely depend on domestic risk perceptions and risk management, as well as decisive implementation of sound economic policies. Therefore, together with the maintenance of monetary and fiscal discipline, it is of vital importance that economic agents should improve their risk awareness and take necessary measures.

In this perspective, I believe the assessments provided in this Report will be beneficial to all economic agents.



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OVERVIEW

The fluctuations that took place in May-June of 2006 have been an important experience indicating the resilience of both the Turkish economy and financial institutions. The structural reforms that have been implemented and the timely and effective monetary policy decisions have limited the impact of the global liquidity shock on the economy and institutions.

Despite the slowdown in the consumption expenditure during the second half of the year, the gross domestic product has grown beyond the expectations in year 2006 due to strong external demand. Additionally, the contribution of net exports to growth has been positive for the first time in the last five years. The trend observed in the second half of the year 2006 is expected to continue in the first quarter of 2007.

The high current account deficit, which has occurred as a result of rapid growth, increasing raw material prices and decreasing private sector savings in recent years, has mainly been financed by long-term investments throughout 2006. Considering a possible unfavorable shift in global liquidity conditions for developing countries, it is necessary to closely monitor the current account deficit. However, the continued strength of external demand and the decline in domestic demand together with the increase in estimated private sector savings, strengthen the expectations towards the decline in the ratio of the current account deficit to GDP.

In 2006, the high primary surplus continued to be attained and the ratio of public net debt stock to GNP fell. The share of the New Turkish lira denominated floating rate government debt securities in domestic public debt stock has been declining and this highlights the Treasury's decreasing vulnerability to interest rate risk. Moreover, inflation indexed bonds issued by the Treasury in February and May 2007 are expected to contribute to the deepening of the markets. On the other hand, in the first four months of 2007, budget realizations remained within the targets due to the increased contribution of non-tax income. Therefore, since 2007 is an election year, the implementation of tight fiscal policies remains to be of significance.

Although the household indebtedness ratio continued to increase in 2006, it is still below the Euro Area average. Since retail loans have fixed rates, the upward movement of interest rates during the second half of the year did not increase the household's interest burden on its total debt. On the other hand, the mortgage system, which was established in 2007 and which will become operative following the completion of the secondary legislations, is expected to further increase household liabilities in parallel to the declining interest rates. During this process, it is important that households consider their current and future income, the maturity structure, the level and type of interest rates while deciding to use a housing loan and, similarly that mortgage institutions act prudently.

There has been an increase in foreign exchange indexed consumer loans although their share in total consumer loans remained unchanged. Considering the fact that the depreciation of the Turkish currency would increase the debt burden of the household sector, it is obvious that households, which do not have foreign currency income, should avoid borrowing in foreign currency.

In 2006, the leverage ratio of firms has increased and their profitability has improved. In addition, the continued high level of the ratio of shareholders equity to total assets underlines the strong debt repayment capacity of firms. High current ratio of firms indicates that liquidity risk is manageable and considering their financial structure, firms are able to meet their short-term obligations.

Although the foreign exchange open positions of firms started to decline in the second half of the year, they increased significantly as of year-end 2006, compared to the previous year. Since a depreciation of the New Turkish lira would increase the default risk of debtors, the foreign exchange risk of firms might turn into credit risk for banks. For this reason, it is necessary for firms to improve their foreign exchange risk management capacity and for banks to act prudently in lending to firms with high open positions and no FX earnings, in order to refrain from credit risk.

Despite fluctuations in the financial markets, the banking sector maintained its growth trend in 2006; its asset size to GDP ratio has risen and the interest of foreign investors in the Turkish banking sector has continued.

In 2006, although the credit volume of the banking sector increased, its pace of growth declined. This slowdown stemmed from the continued high level of interest rates in the second half of the year. The increase in consumer credits in 2006 is mainly a consequence of the rising housing loans as in the previous year as well as the increase in other consumer loans. In 2007, the rise in other consumer loans has become more apparent, while the decline in vehicle loans has continued. This increase in other consumer loans is likely to be stemming from the consumers' tendency to use loans of this kind to pay back their credit card obligations.

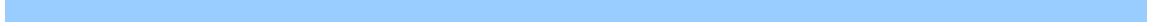
In 2006, while the amount of non-performing loans kept increasing, the non-performing loan ratio followed a horizontal trend due to the increase in loans and this trend has also continued in 2007. Even though the trend of the non-performing loan ratio and the high provisioning policy are considered positive for credit risk, the ratio of provisions to loans is declining.

As of year-end 2006, net profit of the banking sector and thus, the return on assets and the return on equity increased. The capital adequacy ratio, which has declined compared to year 2005 due to the increase in risk-weighted assets stemming mainly from credit expansion, is still above the regulatory and target ratios.

According to the results of scenario analyses, the current capital structure of the banking sector is estimated to be capable of absorbing the losses which might arise as a result of possible shocks.

The Financial Strength Index, which is considered to be an indicator of the strength of the banking sector, exhibited a limited decline in May 2006 due to fluctuations in the financial markets. Following this, it started to increase in June, reaching its previous year's level as of year-end 2006.

As for future outlook, global liquidity and credit conditions and investment preferences of international funds emerge as factors that might affect the Turkish financial markets. Within this framework, the decisive implementation of the current economic program, process regarding convergence to the EU and the continuation of structural reforms maintain their significance in terms of financial stability.



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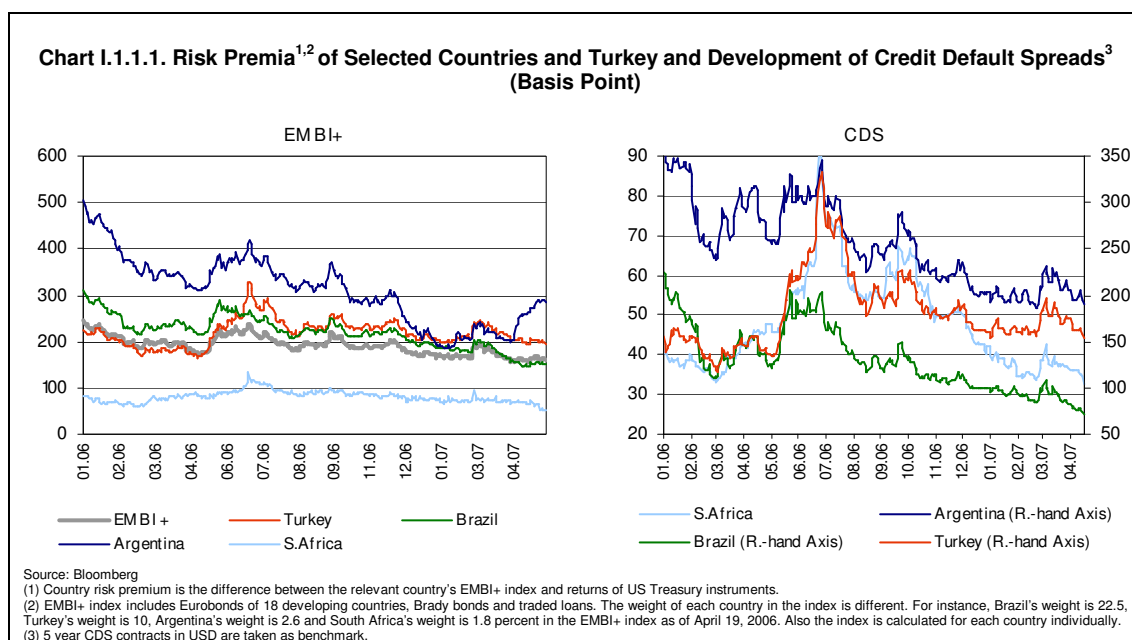
I. MACROECONOMIC DEVELOPMENTS

Complementary to its primary goal of maintaining price stability, the Central Bank, in cooperation with other related authorities, is responsible for monitoring financial markets and taking the necessary measures in order to safeguard financial stability. Considering the importance of macroeconomic developments for financial stability, both international and domestic developments are analyzed in this chapter.

I.1. External Sector

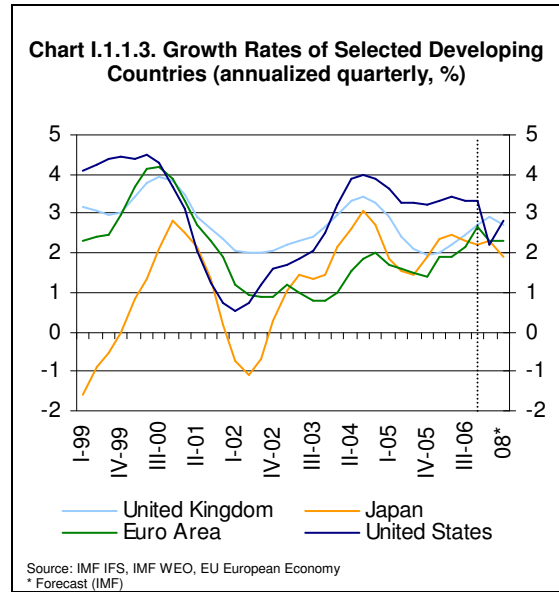
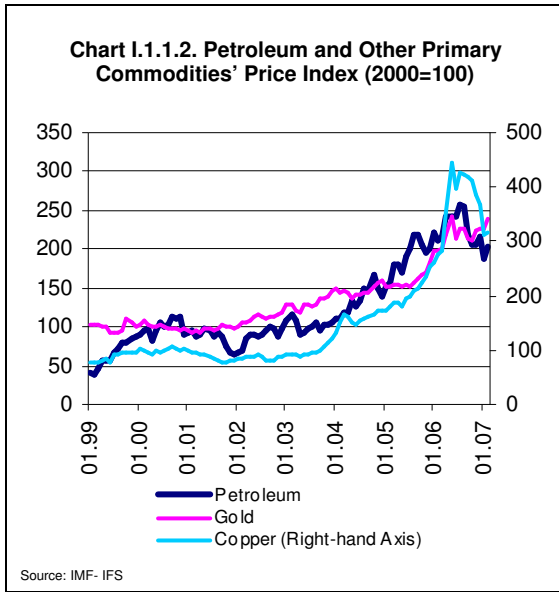
I.1.1. International Developments

Previous issues of this report emphasized the importance of sudden changes in global liquidity conditions and risk appetites of investors on financial stability. A shift in international capital flows parallel to changes in investor expectations may have unfavorable effects on developing countries, depending on the liquidity and depth of national financial markets.

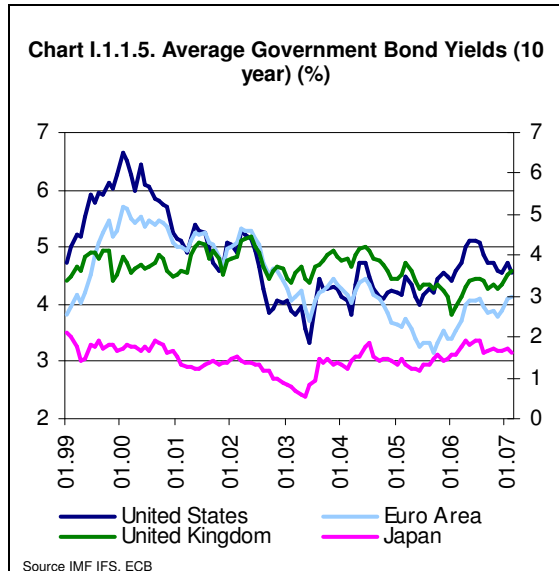
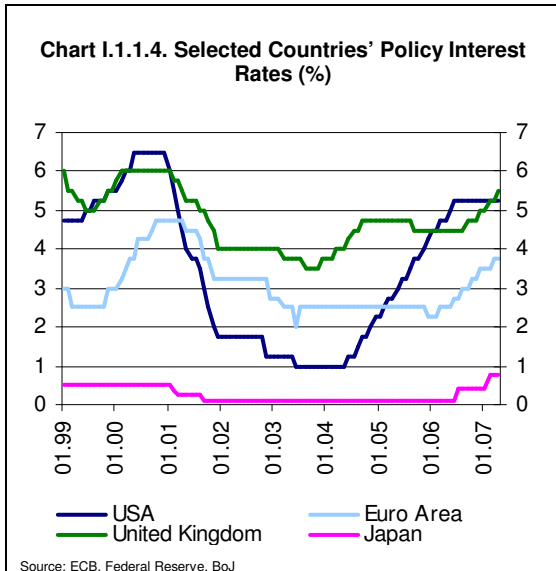


Indeed, the drop in the Shanghai stock exchange in February 2007, concerns about the sluggishness of growth in the United States, announcements by the IMF of possible threats to the global economy posed by low interest rates in Japan, expectations that the European Central Bank would raise key interest rates, the tension arising from Iran's nuclear projects and the increase in oil prices consequently disturbed the global economy, and led to a fall in asset prices and a hike in the volatility of interest and exchange rates. The efforts of carry-traders, who borrow funds at a lower cost from financial markets in Japan and invest these funds in high-yield financial instruments in other countries, to close their positions rapidly with the

expectation of an appreciation of the Japanese Yen, adversely affected developing countries, including Turkey, and increased the risk premium on these countries (Chart I.1.1.1).

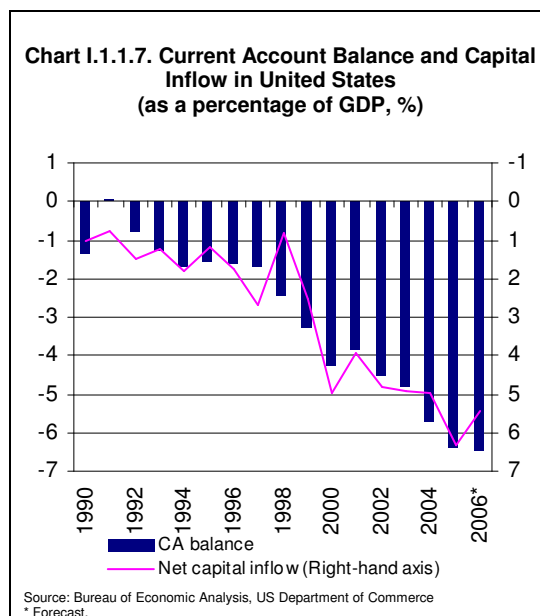
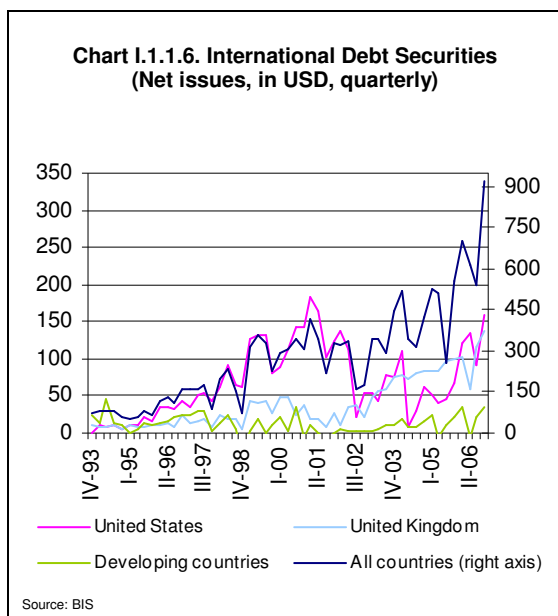


Rapid growth in China, deterioration in growth performance and tensions following defaults in the sub-prime mortgage market in the United States, along with high oil and other primary commodity prices have all contributed to the increase in global risks. The rise in energy prices might both deteriorate growth and inflation performances and widen the current account deficits of energy importing countries. However, as in 2006, strong global growth performance is expected to continue in 2007. Therefore, the expected slowdown in growth rates in the United States, the Euro Area and Japan is anticipated to be rather limited in 2007 and 2008 (Chart I.1.1.3).



Strong growth and increasing primary commodity prices, especially oil prices, ample liquidity and high asset prices force developed countries to either maintain or tighten their current monetary policy stances. As a matter of fact, in the first quarter of 2007, policy interest rates increased in Japan, the Euro Area and the United Kingdom (Chart I.1.1.4).

Despite the recent increases in key policy rates of developed countries, long-term interest rates have not increased at the same pace (Chart I.1.1.5). This might be the result of high credibility of central banks in developed countries regarding price stability, which in turn positively impacts the medium and long-term inflationary expectations. Besides, investment in bonds by private equity, hedge funds and pension funds also play a role in curbing the increase in the long-term interest rates.



Due to strong global loan supply, net bill and bond issues in international markets have increased. Parallel to the movement of global debt markets, debt securities issued by developing countries also rapidly increased in the second half of 2006 (Chart I.1.1.6).

On the other hand, imbalances in the global economy prevail. The United States continues to finance its increasing current account deficit with the savings surplus supplied by developing and oil exporting countries (Chart I.1.1.7). Accordingly, the stability of the flow of funds to the United States and the share of USD denominated assets in the foreign reserves of developing countries are important for the sustainability of the current account deficit in the United States.

There is an increase in the volume of transactions, which aim to earn profits by directing funds borrowed at low interest rates such as Japanese Yen or Swiss Francs to developing countries. Such profits, to some extent, shape the hedge fund activities¹. These transactions result in increasing global risks. Due to the low interest rates in Japan, international investors have borrowed in Japanese Yen and transferred these funds to high yield financial instrument markets, these developments have led to a depreciation of the Japanese Yen and a rise in asset prices in almost all markets. It should be noted that the decline in the value of the Japanese Yen could move towards an equilibrium point, and this process could have an impact on all global markets, especially emerging markets.

¹ BIS Quarterly Review, March 2007 and ECB Financial Stability Review, December 2006.

To conclude, global risk factors for Turkey depend mainly on the monetary policy decisions of central banks of developed countries and the direction of international capital flows. Besides, possible price increases in primary commodities due to the current conjuncture in global politics might have direct and indirect adverse effects on the Turkish economy.

I.1.2. Balance of Payments

The high current account deficit, which has arisen due to increased private sector investments of recent years, rapid economic growth, increase in prices of primary commodities and decline in private sector savings, was mainly financed by long-term investments in 2006. Considering the possibility of a change in global liquidity conditions against developing countries, it is necessary to monitor the current account deficit closely.

Table I.1.2.1. Balance of Payments (Billion USD)

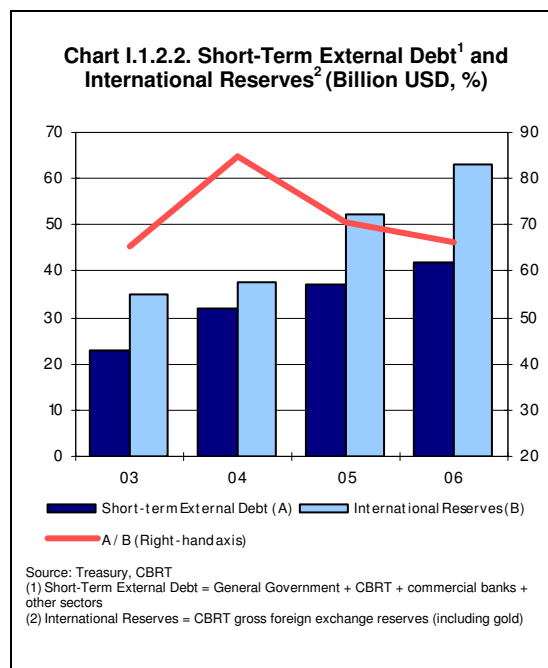
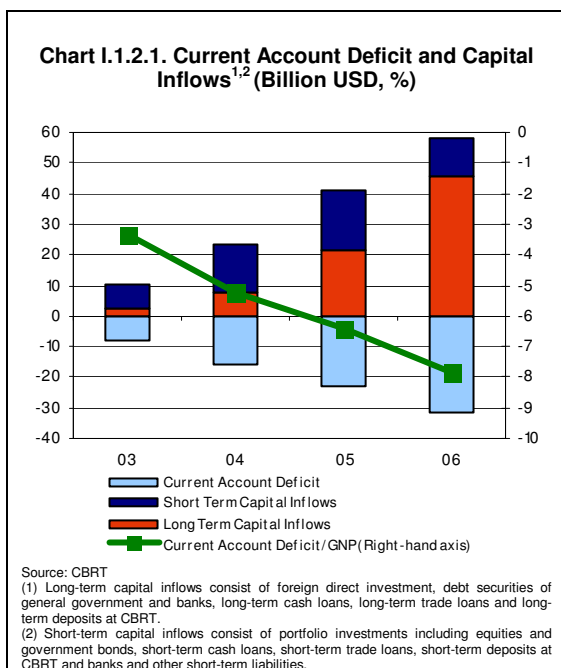
	2004	2005	2006	03.07 ¹
CURRENT ACCOUNT	-15.6	-22.6	-31.8	-32.1
Foreign Trade Balance	-23.9	-33.2	-39.8	-39.7
Exports (f.o.b) (Including gold)	67.0	76.9	91.8	96.7
Imports (f.o.b) (Including gold)	-90.9	-110.1	-131.6	-136.4
Coverage Ratio (%)	73.7	69.9	69.8	70.9
Balance of Services	12.8	15.3	13.4	13.4
Balance of Investment Income	-5.6	-5.8	-6.6	-7.0
Current Transfers	1.1	1.5	1.7	1.7
CAPITAL & FINANCIAL ACCOUNT	13.4	20.5	34.9	32.9
Direct Investments	2.0	8.7	19.2	25.8
Portfolio Investments	8.0	13.4	7.4	8.0
Other Investments	4.2	16.2	14.5	4.5
Reserve Assets	-0.8	-17.8	-6.1	-5.4
NET ERRORS & OMISSIONS	2.2	2.1	-3.2	-0.8

Source: CBRT
(1) April 2006 – March 2007 period is covered.

The current account deficit rose to 32.4 billion USD in January 2007, from 31.8 billion USD as of end of 2006. However, in February 2007, the 12-month current account deficit started to decrease and reached 32.1 billion USD as of March 2007 (Table I.1.2.1).

Exports (including gold) on an annual basis reached a record level of 96.7 billion USD as of March 2007. On the other hand, due to the strong YTL, the dependence of increased industrial production on the import of intermediate goods and the recent rise in energy prices, imports have continued to rise. However, the ratio of exports to imports rose to 70.9 percent as of March 2007, as exports grew faster than imports (Table I.1.2.1).

As of March 2007, the share of foreign direct investments in capital and finance account increased, while other items in this account have lost their share due to the decrease in short-term loans that banks received from abroad and the increase in banks' FX foreign assets (Table I.1.2.1).



Short-term portfolio investments, which had an important role in the financing of the current account deficit in previous years decreased in 2006, while foreign direct investments and long-term loans received by banks and firms increased. Long-term capital inflows equivalent to one and a half fold of annual current account deficit were realized by the end of 2006 (Chart I.1.2.1).

The ratio of short-term debt to international reserves, one of the indicators of the external debt service, decreased from 70.8 percent as of end of 2005 to 66.4 percent in 2006, due to the greater increase in the Central Bank's international reserves (Chart I.1.2.2).

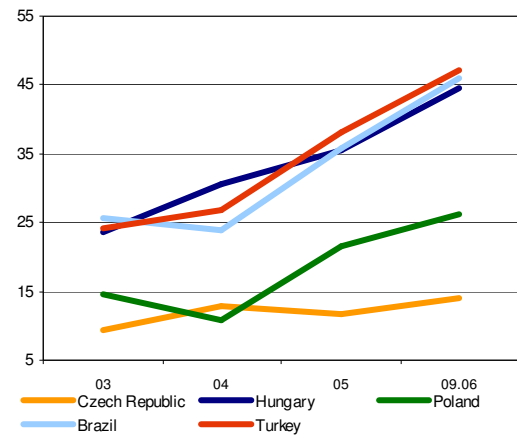
Table I.1.2.2. Parties Financing The Current Account Deficit (Billion USD)¹

	2004	2005	2006	03.07
Current Account	-15.6	-22.6	-31.8	-32.1
Financial Account	13.4	20.5	34.9	32.9
General Government (Including CBRT and CBRT reserves)	2.4	-16.5	-2.9	0.1
Private Sector (Including Banks)	11.0	37.0	37.8	32.8
Net Errors and Omissions	2.2	2.1	-3.2	-0.8

Source: CBRT
 (1) Annualized data is used.

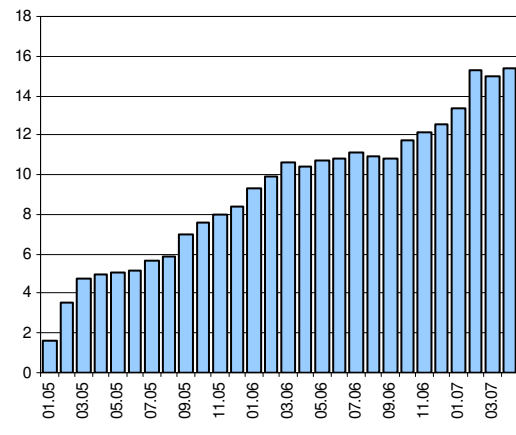
The current account deficit has, to a large extent, been financed by long-term funds from the private sector, including banks (Table I.1.2.2).

Chart I.1.2.3. Net Receivables of International Banks from Selected Countries (Billion USD)¹



Source: BIS
(1) Figures for September 2006 are provisional.

Chart I.1.2.4. Net YTL-Denominated Bonds Issued by Foreigners (Billion YTL)



Source: CBRT

Despite the recent global turbulence, funds that were provided by banks reporting to the Bank for International Settlement (BIS) to developing countries also continued to increase in 2006. The net receivables of international banks from Turkey rose to 47.1 billion USD as of September 2006 (Chart I.1.2.3).

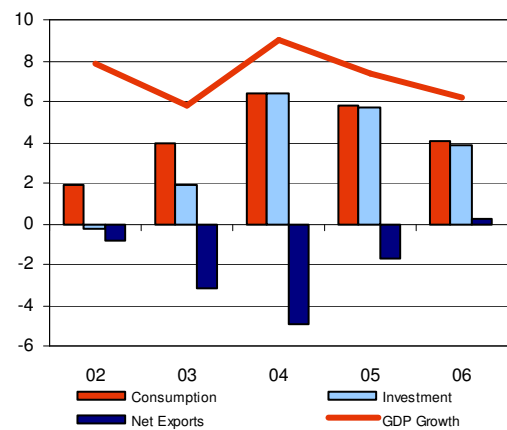
The net volume of YTL denominated bonds issued by foreigners increased from 8.4 billion USD as of end-2005 to 12.6 billion USD as of end-2006, and to 15.4 billion USD by April 2007 (Chart I.1.2.4). This indicates that the positive expectations of foreigners keep increasing towards Turkey.

I.2. Growth and Inflation

I.2.1. Growth

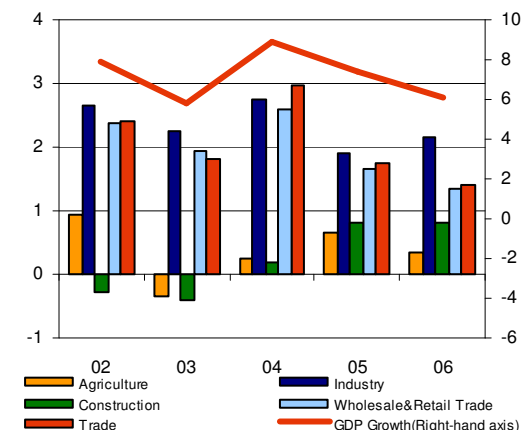
The growth rate slowed down in the second half of 2006 as a result of the May-June fluctuations.

Chart I.2.1.1. Growth Rate and Its Composition (%)¹



Source: TURKSTAT
(1) Net Exports = Exports - Imports

Chart I.2.1.2. Contribution of Sectors to Growth (%)



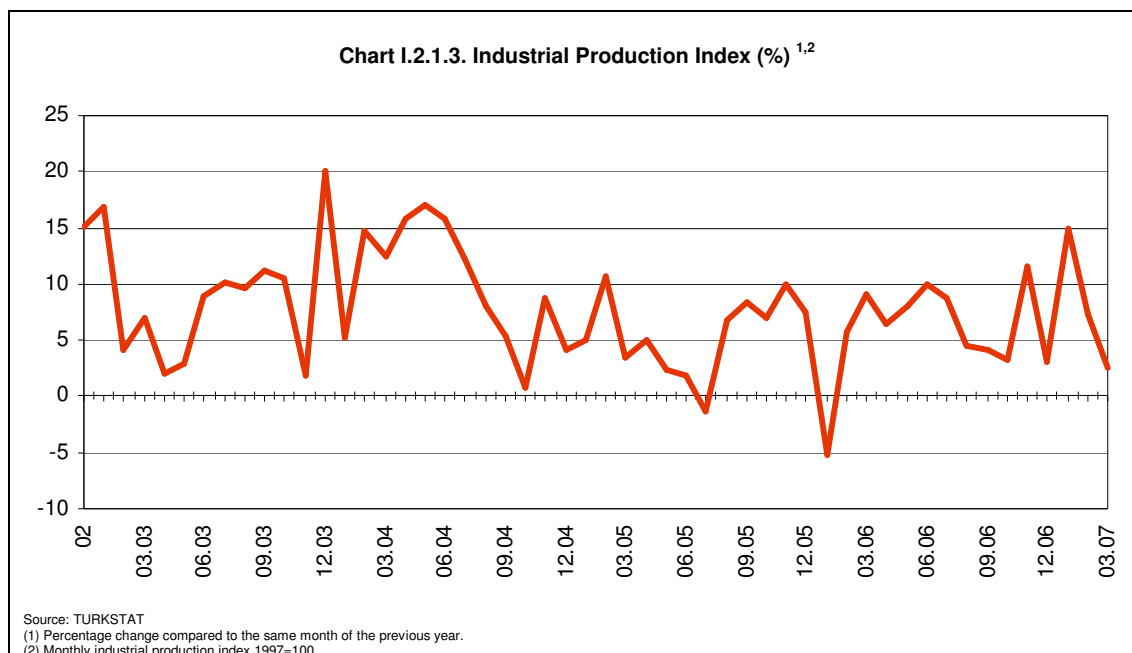
Source: TURKSTAT

In second half of 2006, the gross domestic product (GDP) grew by 6.1 percent, which is above the expectations, as foreign demand continued to be strong - contrary to the sluggishness in consumption and investment expenditures. In addition, the contribution of exports to GDP became positive for the first time in five years (Chart I.2.1.1).

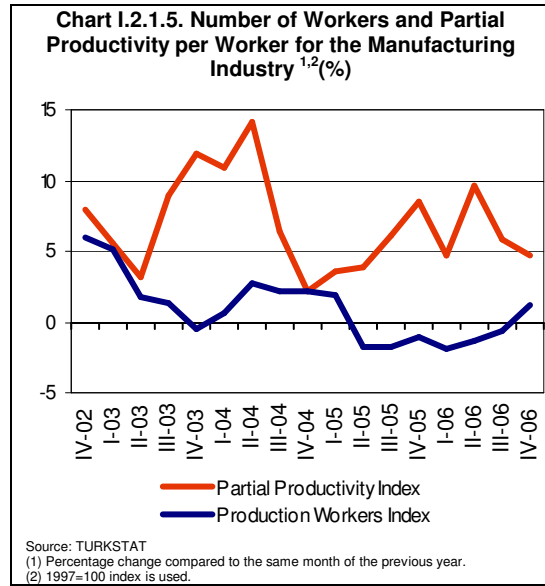
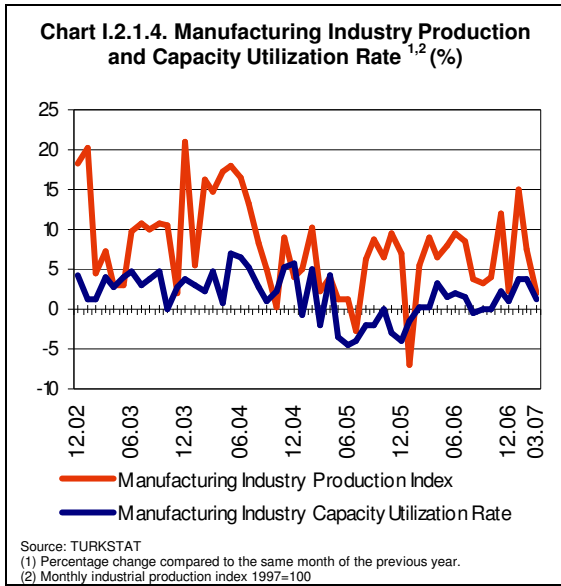
Being the major component of the GDP, the rate of increase in private consumption expenditures, whose contribution to the GDP declined to 3.4 percent in 2006, was 5.2 percent in spite of a severe slowdown in the second half of the year (Chart I.2.1.1). The annual rate of increase in public consumption expenditures stood at 9.6 percent, although it was realized as 0.7 percent for the last quarter, due to tight budgetary discipline. The slowdown in the economic growth rate mainly stemmed from the sluggishness in private consumption expenditures as the major component of GDP.

Regarding the composition of investment expenditures, the contribution of private investment expenditures to the GDP slowed down in the last quarter and decreased annually to 3.9 percent (Chart I.2.1.1). On the other hand, public investment expenditures declined by 0.2 percent in 2006, while it had increased by 25.9 percent in 2005.

Analyzing the contribution of sectors to GDP, the growth rate of agricultural production has been noted to decrease from 5.6 percent in 2005, to 2.9 percent in 2006 due to supply side factors. As one of the driving forces behind economic growth, industrial production increased by 7.4 percent in 2006, especially due to the growth of manufacturing, and electricity, gas and water sectors. Besides, growing annually by 19.4 percent in 2006, the construction sector's strong contribution to GDP continued. The growth rate of wholesale and retail trade sectors became 6.5 percent on an annual basis due to its decline in the second half of 2006.



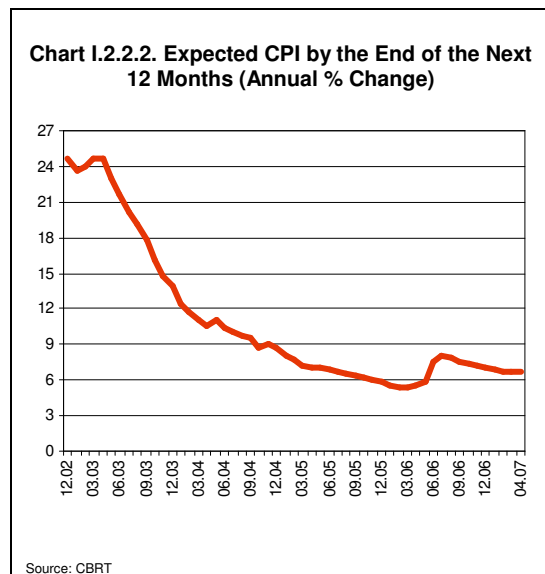
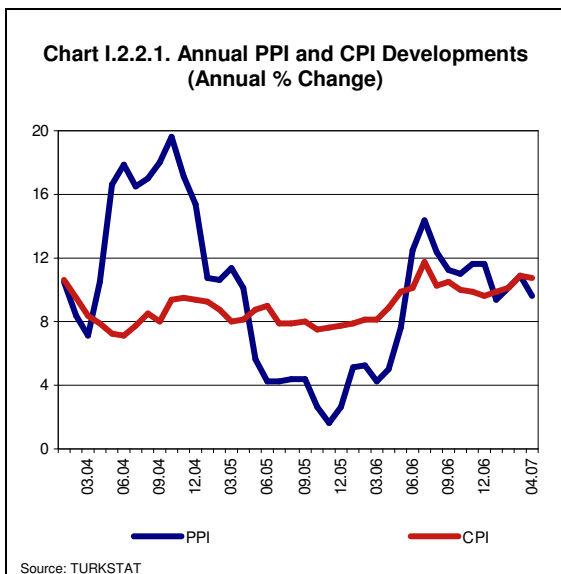
The industrial production growth rate was realized as 5.8 percent in 2006. Although it declined to 2.6 percent in March 2007, the industrial production growth rate was 7.8 percent in the first quarter of 2007 and is expected to strengthen GDP growth in first quarter of 2007 (Chart I.2.1.3).



Manufacturing industry production, the share of which is 86.9 percent in the industrial production index, increased annually by 5.5 percent in 2006 and by 7.6 percent in the first quarter of 2007. Despite the limited increase of 2.1 percent in March, its high level in the first quarter was due to large increases in the months of January and February (Chart I.2.1.4). Analyzing composition of production by subsectors in March 2007, the average growth in sectors of coke, refined petroleum products, non-metallic mineral products, furniture and publishing and printing and reproduction became negative, whereas the average growth rate in sectors of machinery and equipment, fabricated metal products (except machinery and equipment), and tobacco products slowed down. In addition, contrary to the slowdown in the decline of growth of textile production, the degree of contraction in the sectors of wearing apparel and radio, TV, communication equipment has continued to increase.

The partial productivity per worker for the manufacturing industry continued to grow but its growth rate declined compared to the same period of the previous year (Chart I.2.1.5).

I.2.2. Inflation



The annual change in the Consumer Price Index (CPI) rose from 7.7 percent in December 2005, to 9.7 percent in December 2006, as a result of a series of supply-side shocks and fluctuations in the financial markets. Due to the continued high pace rise in unprocessed food prices, the increase in the prices of tobacco products due to the rearrangement of taxes on these products and the fact that the impact of monetary tightening on inflation is currently unclear as well as the lagged, but also diminishing effect of the change in exchange rates, inflation expectations and realizations remained above the target. Hence, as of March 2007, the annual change in the CPI was realized as 10.9 percent (Chart I.2.2.1). On the other hand, the annual change in the CPI declined to 10.7 percent in April 2007 due to the slowdown in durable goods and services inflation in spite of the hike in wearing apparel prices.

Although the annual Producer Prices Index (PPI), which was 11.6 percent in December 2006, increased in the first quarter of 2007, due especially to increased energy prices, it decreased to 9.7 percent in April 2007 due to the decline in durable and capital goods' prices (Chart I.2.2.1).

The full-fledged inflation targeting regime was put into implementation at the beginning of 2006 and inflation targets were set as 5 percent for 2005 and 4 percent for the period of 2007-2009. In 2006, there was an upsurge in inflationary expectations since the annual inflation rate was significantly above the target. The fact that the medium-term inflation expectations are still well above the inflation target as of April 2007 represents a risk factor for the pricing behaviors in the economy (Chart I.2.2.2).

I.3. Public Finance

To reduce the share of public debt stock in national income and close the public deficit permanently in order to safeguard macroeconomic stability, a high primary surplus was also targeted in 2006.

Table I.3.1. Consolidated Government Sector Primary Surplus Targets and Realizations (Billion YTL)

	2004	2005	2006
Primary Surplus Target (Including SEEs)	26.2	30.4	34.5
Primary Surplus Realization (Including SEEs)	27.8	28.3	36.2
Realization / Target (%)	106.0	93.0	105.0

Source: Treasury

Parallel to the fact that public revenues increased at a higher pace than public expenditures, the primary surplus was realized above the Programme target (Table I.3.1). This strengthened the expectations that macroeconomic stability would gain ground and the public financing requirement would decline.

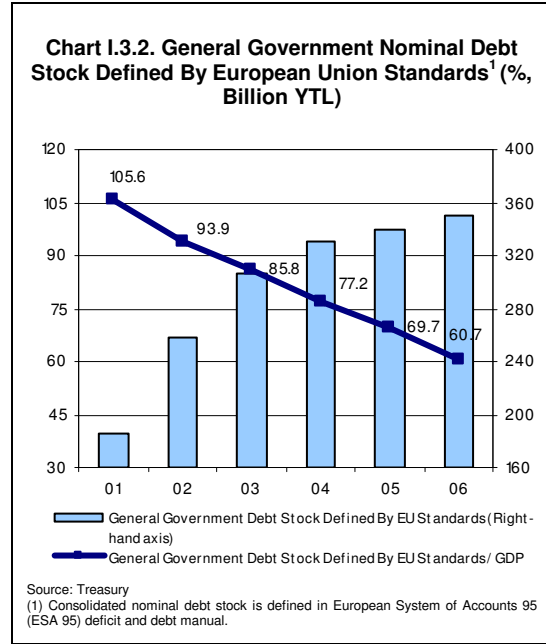
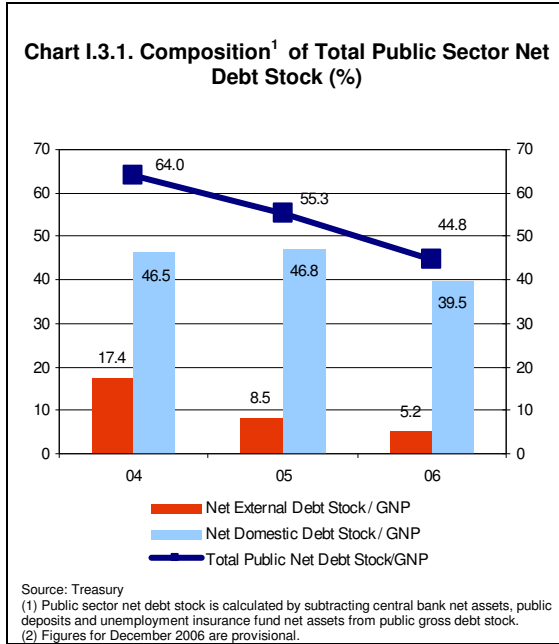
Table I.3.2. Central Government Budget Performance (Billion YTL)

	January- April 2006	January- April 2007	Change (%)	2007 Budget Target	Realization / Budget Target (%)
Expenditures	54.5	65.8	20.7	205.0	32.1
Non-Interest Expenditures	39.1	46.8	19.7	152.0	30.8
Revenues	50.5	60.4	19.6	188.2	32.1
The coverage ratio of revenues to expenditures (%)	92.7	91.8	-	91.8	-

Source: Ministry of Finance

As of April 2007, central government revenues increased by 19.6 percent due to the sale of Turkish Telecom, amounting to 5.8 billion New Turkish liras, whereas primary expenditures increased by 19.7 percent. Besides, as a result of high interest rates, the increase in total expenditures was 20.7 percent compared to the same month of previous year (Table I.3.2).

From January-April 2007, the ratio of revenues to expenditures was realized close to the level of the previous year due to the increase in the non-tax revenues that outpaced the rapid increase in expenditures (Table I.3.2). In the first fourth months of 2007, the budget deficit reached 32 percent of the year-end target.



The ratio of total public sector net debt stock to GNP continued to decline (Chart I.3.1). Increases in central bank net assets, public deposits and unemployment insurance fund net assets led to the above-mentioned decline in the ratio of the total public sector net debt stock to GNP in 2006. Besides, the general government nominal debt stock to GNP, as defined by the EU, continued to decrease (Chart I.3.2).

Chart I.3.3. Composition of Domestic Debt Stock (%)

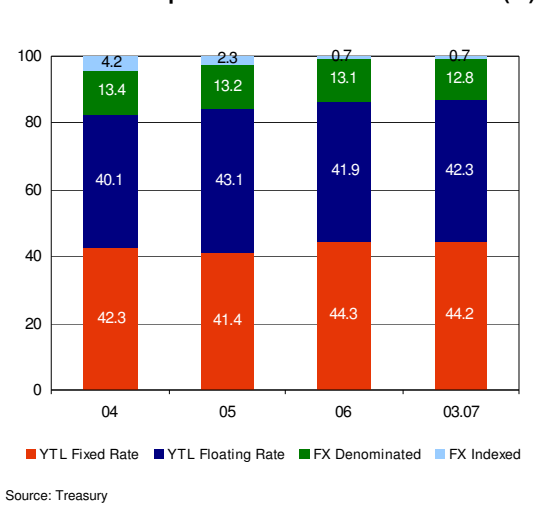
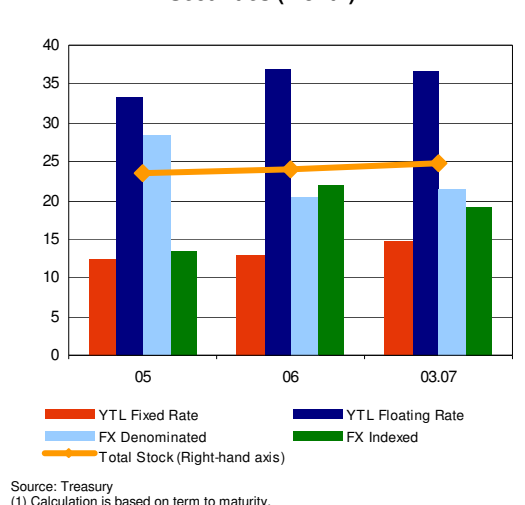


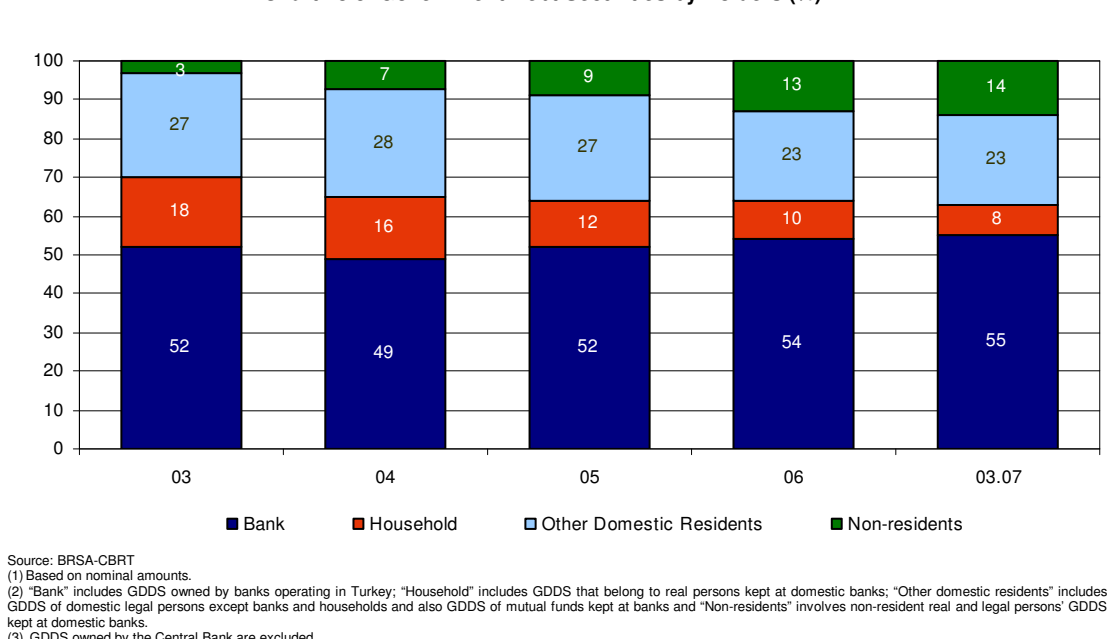
Chart I.3.4. Maturity Structure of Government Debt Securities (Month)¹



Regarding the composition of domestic debt stock, during 2005-2006 the share of debt stock, which is sensitive to the foreign exchange rate (FX denominated and FX indexed) declined and this trend also continued in March 2007. On the other hand, the fact that the weight of floating-rate government domestic debt securities (GDDS) in domestic debt stock prevails indicates that Treasury continues to be vulnerable to interest rate risk as of March 2007 (Chart I.3.3). However, this vulnerability is expected to decline as the Treasury gives more weight to inflation-indexed bonds, which were first issued in February 2007.

The average maturity of GDDS increased to 24.9 months as of March 2007. In the period between December 2006-March 2007, the term to maturity of New Turkish Lira denominated floating rate instruments, which account for the majority of domestic debt stock, decreased, whereas the term to maturity of both New Turkish Lira denominated fixed rate instruments and FX denominated instruments increased (Chart I.3.4).

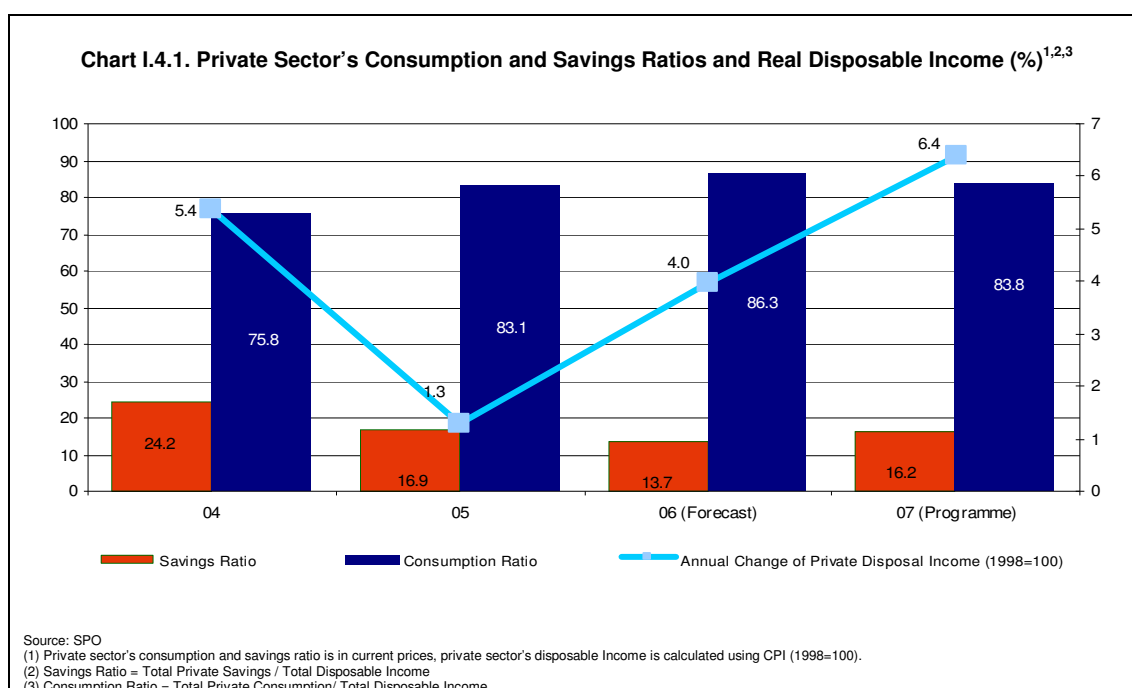
Chart I.3.5. Government Debt Securities by Holders (%)^{1,2,3}



A large part of the total GDDS are owned by banks operating in Turkey, and thus these securities constitute a major part of the assets of the banking sector. In March 2007, the share of the government securities owned by non-residents reached to 14 percent, partially due to the exemption of foreign investors from withholding tax as of July 2006 (Chart I.3.5).

I.4. Private Sector Developments

Monetary tightening, which has been implemented to cope with the unfavorable effects of financial fluctuations experienced in financial markets in the May-June 2006 period, caused domestic demand to decrease as expected and the growth rate of private final consumption expenditures slowed down in 2006.



According to the 2007 programme, it is expected that the growth rate of disposable income, which was 4 percent in 2006 in real terms, will be 6.4 percent in 2007. The increasing share of private sector consumption in disposable income since 2004 is estimated to decrease to 83.8 percent in 2007 (Chart 1.4.1).

Table I.4.1. Private Consumption Expenditures (Annual Change, %)

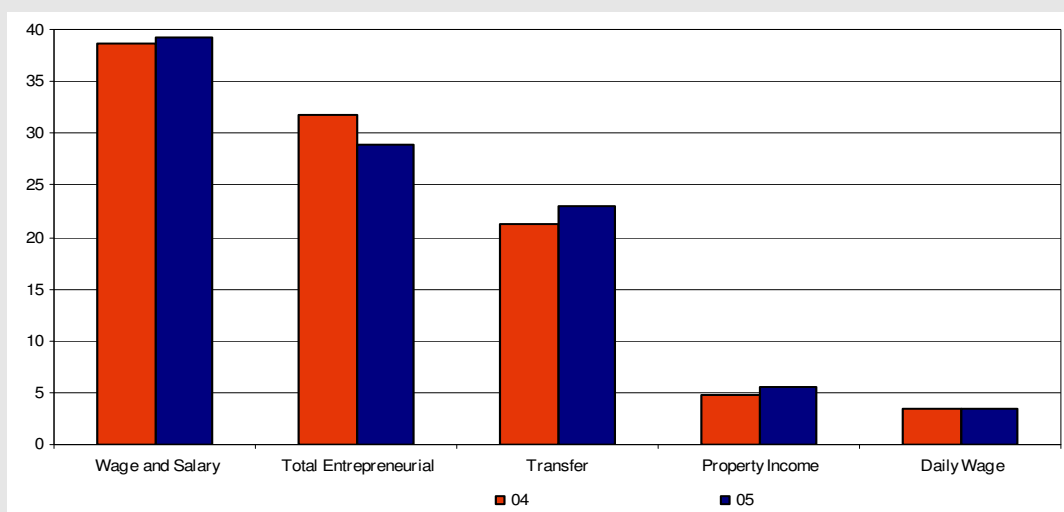
	01	02	03	04	05	06
Private Consumption Expenditures	-9.2	2.1	6.6	10.1	8.8	5.2
Durable Goods	-30.4	2.1	24.0	29.7	15.0	2.9
Services	-9.3	8.5	7.5	9.3	7.8	5.0
Food and Beverages	-3.6	1.1	4.1	2.8	8.2	3.1
Semi-Durable and Non-Durable Goods	-9.0	3.0	2.1	18.8	12.9	15.8

Source: TURSTAT

As a result of the decreased domestic demand due to the tight monetary policy implemented since June 2006, the growth rate of durable goods, services and food consumption decreased, compared to the end of the previous year. On the other hand, the growth rate of semi-durable and non-durable goods consumption increased (Table I.4.1).

I.4.1. Household

Box I.4.1.1. Distribution of the Annual Household Disposable Income (%)



Source: TURSTAT, 2005 Household Budget Survey

Household disposable income is defined as the sum of the total real payments to production factors (wage, interest, income, rent) and one-sided transfers from the Government, private entrepreneurs or the external sector (except retained earnings) minus indirect taxes and one-sided transfers of households to the Government (Pension Fund and Social Security Institution cutoff etc.).

In 2005, the share of the wage and salary and daily wage income in disposable income did not change dramatically and was realized as 42.5 percent. However, the share of entrepreneur¹ income decreased by 3 points and stood at 28.8. Furthermore, unrequited one-sided transfers from the Government, private entrepreneurs and from abroad rose by about 2 points and increased to 23 percent. Additionally, rental income from real estate and property income from securities increased by 0.8 points and was realized as 5.6 percent.

¹ Composed of individuals working for their own account or as employees in agriculture, manufacturing, construction trade and service sectors.

Table I.4.1.1. Household Disposable Income, Indebtedness and Interest Payments (Million YTL)^{1,2,3}

	03	04	05	06
Household Interest Payments	3,983	7,245	10,264	12,175
Household Debt	13,442	28,259	49,979	73,656
Household Disposable Income	180,305	218,752	255,640	289,743
Interest Payments / Disposable Income (%)	2.2	3.3	4.0	4.2
Debt / Disposable Income (%)	7.5	12.9	19.6	25.4

Source: BRSA-CBRT, TURKSTAT

(1) Household debt consists of gross consumer credits and credit card balances extended by banks (excluding participation banks for 2003 and 2004) and consumer finance companies.

(2) Household disposable income for 2006 is calculated by using private sector disposable income for 2005 and private sector disposable income estimation for 2006, under the assumption that the 2005 ratio of household disposable income to private sector disposable income has not changed.

(3) Household Interest Payments include interest and profit-loss sharing contribution paid to banks (excluding Participation Banks in 2003 and 2004) and consumer finance companies.

The household indebtedness ratio continued to rise in 2006. Moreover, the ratio of household interest payments to disposable income displayed a limited rise and was realized as 4.2 percent as of year-end 2006 (Table I.4.1.1). The reason for the limited increase in interest payments is mostly due to fixed rate consumer loans.

Box I.4.1.2. Reference Indexes for Mortgage and Variable Interest Rate Housing Credit Agreements

With "Law No: 5582 Amending the Laws Related to Housing Finance", which was published in the Official Gazette, dated March 6, 2007, the Mortgage system, also known by the public as the "system that will enable the purchase of a house in the same way as renting", became valid. The main characteristic of this regulation is that it gives longer maturity funding opportunities to banks and other authorized entities by issuing mortgage securities.

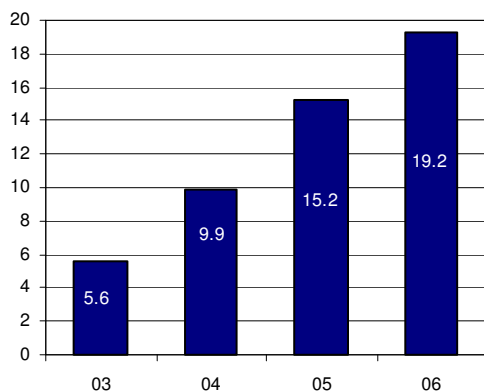
With this law, house financing is defined as "extending credit to consumers with the aim of purchasing houses, renting houses via financial leasing and extending credits secured with real estate". Unless any application is made to the contrary by June 6, 2007, all housing credits, which were used before the enactment of the law, will be governed by this law. In this framework, credits that are used for refinancing purposes will also be covered by the house financing system. Credit costs were decreased by the exemption of credits covered by this Law from Banking and Insurance Transactions Tax (BITT). Furthermore, fixed rate credit users might be charged a penalty of a maximum of 2 percent in case of early full repayment.

This Law also specifies that variable rate credits along with fixed rate can be extended to consumers and reference interest rates and indexes to be used in variable interest rate housing credit contracts will be determined by the CBRT.

In this framework, the Consumer Price Index (CPI), announced by TURKSTAT, was determined as the reference index for variable interest rate housing credit contracts. This Central Bank Communique was published in the Official Gazette No:26513 dated May 5, 2007 and will become operative from June 1, 2007. According to this Communique, when variable interest rate contracts are initially set or interest rate modifications are made at periods indicated in the contracts, the annual change in the CPI which is published by TURKSTAT two months prior to that, shall be used.

As it is known, the interest rate for fixed rate housing credits does not change during the term and consumers are not influenced by any changes. On the other hand, there could be upward and downward movements in the interest rates of variable rate housing credits during the term due to the movement of the CPI and the installment payments of debtors may change accordingly.

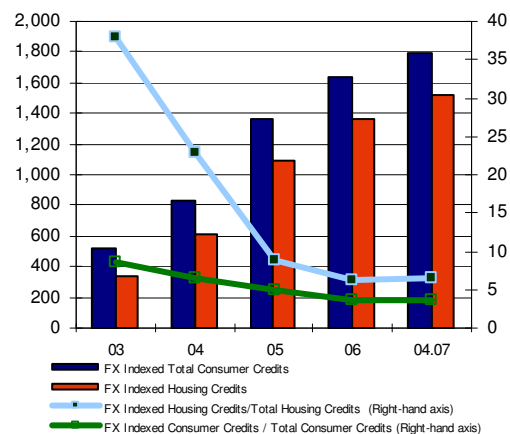
Chart I.4.1.1. Retail Loans to Private Final Consumption Expenditures¹ (% Share)



Source: CBRT, TURKSTAT

(1) Retail loans are composed of gross consumer credits and credit card balances extended by banks (excluding participation banks for 2003 and 2004) and consumer finance companies to real persons.

Chart I.4.1.2. FX Denominated Total Consumer Credits and FX Denominated Housing Credits (Million YTL, %)



Source: CBRT

Ratio of retail loans to private final consumption expenditures kept increasing in 2006 (Chart I.4.1.1).

While FX indexed consumer loans maintain their increase, their share in total consumer loans stands at its lowest level (Chart I.4.1.2).

Table I.4.1.2. Number of Non-Performing Consumer Loans and Credit Card Holders¹

	2005	03.06	2006	03.07
Non-Performing Credit Card Holders	148,117	82,017	211,565	74,316
Non-Performing Consumer Loans	15,127	6,895	25,806	12,649

Source: CBRT

(1) It indicates the number of credit card and consumer credit debtors in the NPL accounts of banks. According to the implementation initiated by the Bank effective from 2000, the records whose "paid notice" is sent by banks are erased from the Registry of non-performing loans after three calendar years and those whose "paid notice" is not sent are removed after five calendar years. Therefore, the number of records for previous periods may vary due to removal of three or five year old records.

The upsurge in household indebtedness caused the number of defaults to increase (Table 1.4.1.2).

Table I.4.1.3. Composition of Household Financial Assets (Billion YTL)^{1,2}

	2004	2005	2006	04.07
YTL Deposits	63.5	90.4	113.6	122.1
FX Deposits	61.3	59.8	75.0	81.7
FX Deposits (Billion USD)	45.3	44.5	53.4	60.0
Currency in Circulation	12.4	18.3	24.7	21.9
Domestic Debt+Eurobond	39.1	32.6	28.2	24.8
Stocks	12.3	15.7	15.8	15.0
Repos	1.6	1.5	2.0	2.0
Private Pension Funds	0.3	1.2	2.9	3.3
Total Assets	190.5	219.5	262.3	270.8

Source: CBRT, CMB

(1) YTL and FX deposits include participation funds
(2) Figures for April 2007 are provisional.

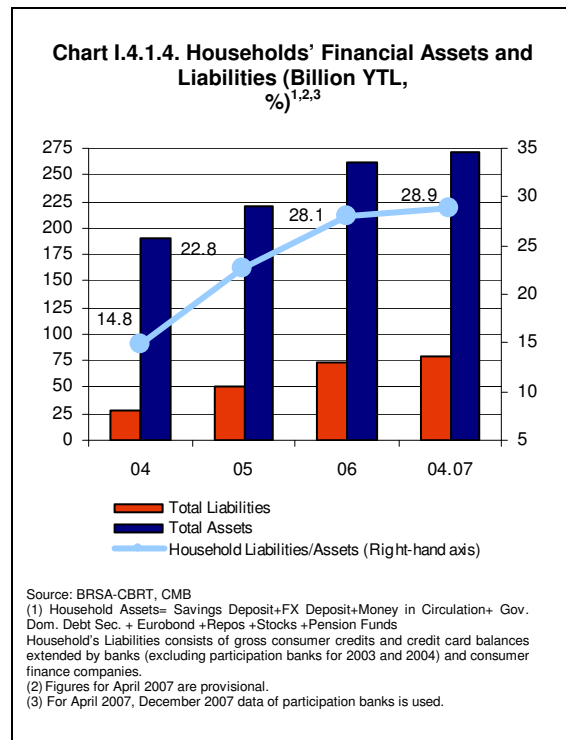
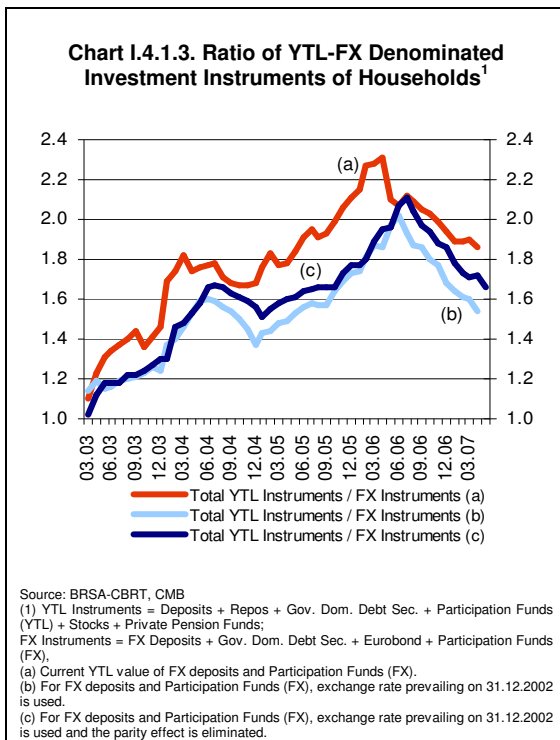
Household financial assets increased by 19.5 percent compared to the previous year-end and was realized as 262.3 billion New Turkish liras by year-end 2006. The aforementioned increase has been maintained in 2007. As of April 2007, 75.3 percent of household financial

assets is composed of deposits and 9.2 percent is composed of government domestic debt securities and Eurobonds (Table I.4.1.3).

Household FX deposits, which have displayed a decreasing trend since 2005, tended to increase by the year 2006. This rise in 2006 particularly started in July and it is thought that this tendency is due to savers' changing risk perceptions.

Another important development in household financial assets is the decrease in the GDDS and Eurobond portfolio since 2004. After the financial fluctuations of the May-June period in 2006, the tendency of households to invest in FX deposits rather than investing in GDDS is thought to be effective in the observed decrease.

Despite its low level in household financial assets, the most remarkable development is the high increase in pension funds. Total amount of pension funds, which was 1.2 billion New Turkish liras as of 2005, increased by 142 percent and was realized as 2.9 billion New Turkish liras by year-end 2006. This interest in the private pension fund system is expected to create a positive impact on the economy in the long run.



Parallel to the changes in the risk perceptions of savers, YTL and FX distribution of the households' financial instruments recently changed in favor of FX (Chart I.4.1.3).

The ratio of household liabilities to financial assets has increased rapidly in recent years due to the increase in retail loans. This ratio was 22.8 percent at year-end 2005 and although a slowdown took place in the growth rate of retail loans since the second half of 2006, the said ratio increased to 28.1 percent as of 2006 (Chart I.4.1.4).

In conclusion, the repayment and consumption capacity of households should be monitored closely due to the rise in household indebtedness and the increasing tendency to

finance consumption expenditures with credits. Moreover, while the ratio of the FX indexed household debt to total consumer credits remains steady, it is thought that holding FX debt without FX income causes exchange rate risk and it is necessary for households to avoid it.

Box I.4.1.3. Housing Credits and Income Distribution

Parallel to economic developments in recent years, the increased demand for real estate has caused movement in the housing market and an increase in housing credits. Moreover, with new regulations, banks and other authorised entities are allowed to issue marketable securities in return for housing credits, and thus their funding opportunities are enhanced via the secondary market. However, housing credit demand will be the determining factor here. The household housing credit demand, on the other hand, depends on current disposable income, future income expectations, interest rates on housing credits, interest rate alternatives (variable – fixed rate), the maturity structure of the credit and real estate prices. In this framework, the following analysis was made with the aim of analyzing households' credit borrowing capacity.

Table 1. Housing Credits and Minimum Disposable Income (2006)

Average Amount of Housing Credits	47 Thousand YTL
Average Maturity	70 Months
Interest Rate (Monthly)	1.5 %
Yearly Payment Amount ¹	13 Thousand YTL

Source: CBRT, BRSA
(1) Commission, fees and taxes are not included.

According to recent data, the average maturity of housing credits is six years, the monthly interest rate is 1.5 percent and the average amount is 47 thousand New Turkish liras. The annual payment of these credits amounts to 13 thousand New Turkish liras, excluding commissions, fees and taxes (Table 1). With a prudential approach, based on the assumption that households will spend 30 percent of their annual income on housing credit payments, it is calculated that consumers have to earn an annual income of 43.5 thousand New Turkish liras to utilize such a credit.

Table 2. Household Disposable Income¹ (YTL)

Household Groups (by 10 % groups)	Income Distribution (%)	Disposable Income (Thousand)	Average Disposable Income Per Household	
	2005	2005	2005	2006
1	2.2	5,588,983	3,185	3,518
2	3.9	9,878,838	5,629	6,219
3	5.0	12,729,005	7,253	8,013
4	6.1	15,588,980	8,883	9,813
5	7.3	18,577,358	10,586	11,694
6	8.6	21,901,753	12,480	13,787
7	10.2	26,092,702	14,868	16,425
8	12.4	31,687,149	18,056	19,947
9	15.8	40,352,624	22,994	25,401
10	28.7	73,242,359	41,736	46,105
Total 100 %	100	255,639,751		

Source: TURSTAT, SPO, CBRT, CMB

(1) Household disposable income for 2006 is calculated by using, private sector disposable income for 2005 and private sector disposable income estimation of the 2006 Programme, under the assumption that the 2005 ratio of household disposable income to private sector disposable income has not changed. Moreover, it is assumed that the rise in the speed of increase of the number of households in 2006 will be the same as in 2005 (2.6 percent) and the income distribution of 2005 will remain the same.

According to the latest income distribution data, it is seen that only the first 10 percent of

households, those which take the biggest share from the income distribution shall be able to use the aforementioned credit (Table 2). According to different maturities and interest rates, yearly payments and the required yearly income for these payments are calculated for a housing credit of 50 thousand New Turkish liras and shown below.

Table 3. Yearly Housing Credit Payments and Minimum Required Disposable Income^{1,2} (YTL)

Monthly Interest Rate	0.5%		0.75%		1%		1.5%	
	Yearly Payment	Yearly Income	Yearly Payment	Yearly Income	Yearly Payment	Yearly Income	Yearly Payment	Yearly Income
10 Years	6,661	22,182	7,601	22,310	8,608	28,665	10,811	36,002
20 Years	4,299	14,314	5,398	17,977	6,607	22,000	9,260	30,835
30 Years	3,597	11,979	4,828	16,076	6,172	20,552	9,043	30,112

(1) Calculated according to a 50.000 YTL housing credit and non-interest costs are not taken into consideration.

(2) It is assumed that households can set aside maximum 30 percent of their income for housing credit payments.

In the table below, those income groups, which can use a 50 thousand New Turkish lira housing credit according to various maturities and interest rates and in line with the current income distribution, are shown with the (√) sign (Table 4).

Table 4. Housing Credit Usage Capacity by Income Deciles^{1,2} (YTL)

Income Decile	Monthly Interest Rate	0.5%	0.75%	1%	1.5%
		5th highest 10 %	10 Years 20 Years 30 Years	√	
4th highest 10 %	10 Years	√			
	20 Years	√			
	30 Years	√	√		
3rd highest 10 %	10 Years	√	√		
	20 Years	√	√		
	30 Years	√	√		
2nd highest 10 %	10 Years	√	√	√	
	20 Years	√	√	√	
	30 Years	√	√	√	
1st highest 10 %	10 Years	√	√	√	√
	20 Years	√	√	√	√
	30 Years	√	√	√	√

(1) Calculated according to a 50.000 YTL housing credit and non-interest costs are not taken into consideration.

(2) It is assumed that households can set aside maximum 30 percent of their income for housing credit payments.

When the payment capacity of households related to housing credits for various interest rates and maturities is analyzed, the number of households who can use housing credits is 1.8 million, under prevailing conditions as of 2006. If interest rates diminish to 0.5 percent monthly and the maturity extends to 30 years, the figure in question can increase to 9 million (Table 3).

I.4.2. Corporate Sector

In this section, the financial analysis of companies listed on the Istanbul Stock Exchange (ISE) and the foreign exchange positions of non-banking sector are examined.

I.4.2.1. Financial Analysis of Companies

As it is known, the most comprehensive data set concerning the corporate sector is Company Accounts, which is published by the Bank and used in our former reports. However, since this data set is published once a year, it becomes necessary to find an alternative and to update the data set to use in the financial analysis of the corporate sector. Therefore, in this

volume of the report, the financial statements of 190² companies, which have been continuously traded on the ISE between 2004-2006 and can be consolidated, but which are not financial entities or are not a subsidiary of any financial entity, are analyzed. Of these 190 companies, 148 are manufacturing companies.

However, companies listed on the ISE are large companies, which have high export opportunities and many funding alternatives other than banking credits, such as capital markets and their shareholders equity is relatively stronger. Therefore, it should be taken into consideration that these companies' financial indicators can differ from the indicators of the whole corporate sector. Moreover, when the data of companies listed on the ISE is distributed according to subsectors, it should be noted that some concentrations occur within specific sectors and thus sectoral advantages/disadvantages may be reflected in the ratios.

Table I.4.2.1.1. Financial Ratios of Selected ISE Companies (%)

	All Companies			Manufacturing Industry Companies		
	2004	2005	2006	2004	2005	2006
Selected Financial Structure Ratios						
Leverage Ratio	44.9	46.5	49.0	41.7	44.6	48.2
Equity ¹ /Total Assets	52.0	50.6	48.4	55.9	53.2	49.8
Equity ¹ /Total Debt	116.0	108.9	98.7	134.1	119.1	103.2
Short -Term Liabilities /Total Assets	29.4	29.9	31.5	29.9	30.8	32.7
Long -Term Liabilities /Total Assets	15.4	16.6	17.5	11.8	13.8	15.5
Financial Debts / Total Liabilities	29.5	33.1	33.0	31.7	34.7	37.9
Profitability Ratios						
Net Income / Equity (ROE)	8.9	10.8	13.9	7.8	9.4	13.5
Net Income / Total Assets (ROA)	4.7	5.5	6.7	4.4	5.0	6.7
Liquidity Ratios						
Current Ratio	148.1	145.2	145.5	158.1	153.7	149.9
Cash Ratio	40.7	35.4	35.7	36.3	27.8	26.3
Short-term Receivables / Total Assets	12.4	14.3	14.8	14.5	17.1	17.7

Source : ISE

(1) "Minority Interests" of the companies which prepare consolidated financial tables according to the full consolidation method are not included in equity.

Similar to the previous year, the share of equity on the balance sheet decreased and debt utilization to finance production increased as of 2006. As a matter of fact, the leverage ratios of all the examined corporations increased at the end of 2005. A similar tendency exists for manufacturing industry companies (Table I.4.2.1.1). On the other hand in 2006, the ratio of equity to total assets is still larger than the leverage ratio, indicating a high repayment capacity.

In 2006, total net income of all the companies examined increased by 44.9 compared to the previous year. On the other hand, while 124 companies, which declared profits in 2005, constituted 84.3 percent of total assets of the companies examined, the number of companies declaring a profit decreased to 119, but they gained 90 percent of the total assets in 2006.

The profitability ratios of those companies examined improved and their return on equity (ROE) increased to 13.9 percent in 2006. A similar tendency exists for manufacturing companies. Moreover, an important increase was observed in the return on assets (ROA) and it was realized as 6.7 percent for both groups in 2006 (Table I.4.2.1.1).

² Different from the Section I.4.2.2.2 on FX position of the Companies listed on the ISE, since 3 companies do not have data for 2004, the analysis is made using the data of 190 companies.

As a liquidity indicator, while the current ratio showed a limited increase for all companies analyzed in 2006, it diminished for manufacturing companies. However, the relatively high current ratios of both the “all sectors” and the manufacturing industry sector suggest that liquidity risks are manageable and companies are in a good financial position to meet their short-term obligations even in case of a sudden halt in access to credit. The cash ratio, which shows how efficiently companies use their working capital, decreased to 26.3 percent for manufacturing companies in 2006 due to the fall in the marketable securities of these companies since 2004, in contrast to all companies examined (Table I.4.2.1.1).

I.4.2.2. Foreign Exchange Position of the Corporate Sector

Foreign exchange positions of companies cannot be calculated by using their balance sheets, since financial statements are prepared in terms of Turkish currency, without any distinction regarding currency composition. However, in order to get a general idea of the exchange rate risk of companies, the foreign exchange position of the sector, which excludes households and banks, may be approximately calculated by using data compiled from balance of payments statistics and various statistical reports sent to the CBRT, the database of the Treasury, and “Locational Banking Statistics” published by the Bank for International Settlements (BIS). On the other hand, FX positions of non-financial companies whose stocks are traded on the ISE are calculated by using footnotes of their disclosed financial statements. In that respect, the FX risks of those companies which constitute an important part of the sector and their credit risk for banks stemming from cash loans are examined. Analyses and assessments regarding the FX risk of the corporate sector are based on a macro perspective. For this reason, considering that some companies have a short position while others have a long position, it should be noted that corporate sector vulnerability to exchange rate risk should be evaluated on a company basis.

I.4.2.2.1. Foreign Exchange Position of the Non-Banking Sector

Table I.4.2.2.1.1. FX Assets and Liabilities of the Sector Except Households and Banks (Million USD)

	12.05	03.06	06.06	09.06	12.06	Change Jun.06-2005 (%)	Change 2005-2006 (%)
ASSETS	49,633	52,977	53,946	57,563	67,101	24.4	35.2
A. Deposits	34,170	37,115	37,598	41,303	49,322	31.2	44.3
- Domestic Banks ⁽¹⁾	15,916	17,929	17,486	18,656	22,626	29.4	42.2
- Foreign Banks	18,254	19,186	20,112	22,647	26,696	32.7	46.2
B. Securities	1,686	1,661	1,536	1,576	1,747	13.7	3.6
- Domestic Issuance	261	268	168	207	225	33.9	-13.8
- Foreign Issuance	1,425	1,393	1,368	1,369	1,522	11.3	6.8
C. Export Receivables	6,721	7,092	7,688	7,454	8,575	11.5	27.6
D. Foreign Direct Invest. To Abroad	7,056	7,109	7,124	7,230	7,457	4.7	5.7
LIABILITIES	77,074	87,405	95,747	98,109	104,125	8.8	35.1
A. Cash Loans	60,794	71,887	78,142	80,936	85,904	9.9	41.3
- Domestic ^(1,2)	21,581	22,743	25,068	24,766	25,677	2.4	19.0
- Foreign	39,213	49,144	53,074	56,170	60,227	13.5	53.6
Medium and Long-term	38,025	47,912	51,801	54,748	58,831	13.6	54.7
B. Import Payables	10,674	10,951	12,913	12,859	13,028	0.9	22.1
C. Protocolized Receivables of SDIF	5,606	4,567	4,692	4,314	5,193	10.7	-7.4
NET POSITION	-27,441	-34,428	-41,801	-40,546	-37,024	-11.4	34.9

Source: BRSA-CBRT, Treasury, SDIF, BIS

(1) Participation funds and funds-extended by participation banks are included.

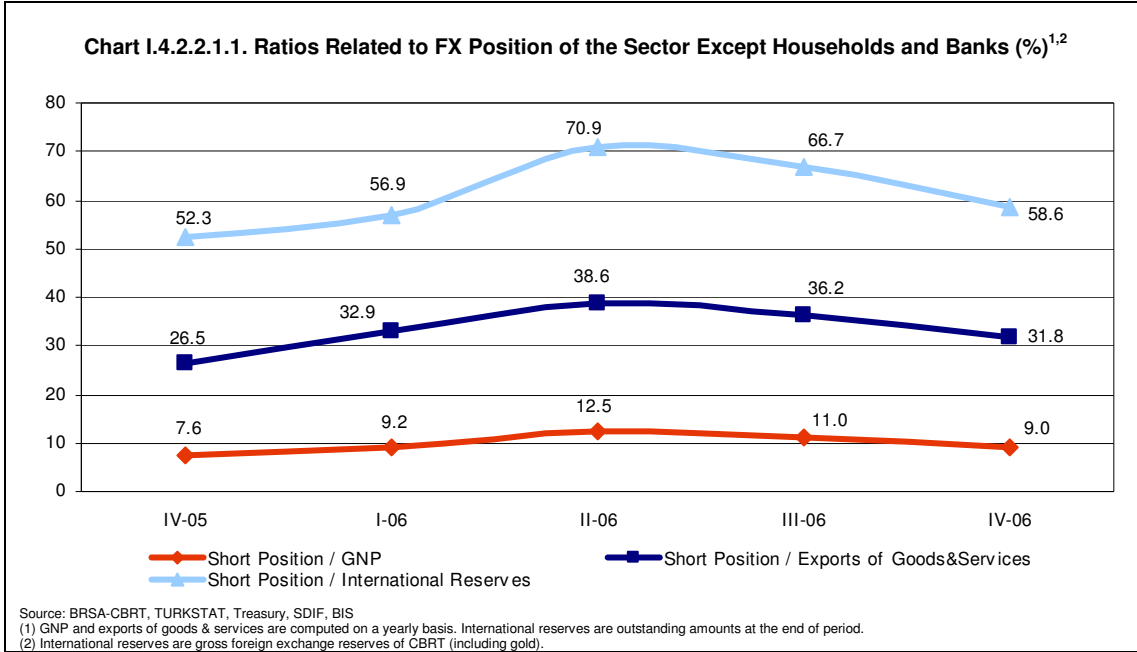
(2) FX indexed loans are included.

Box I.4.2.2.1.1. Foreign Exchange Position Data of the Non-Banking Sector

Data on the FX Assets and Liabilities of the Non-Banking Sector table is different from the previous report due to the update of data. There may be important changes in the “due from foreign banks” account especially due to the fact that especially the data compiled from the Locational Banking Statistics prepared by the BIS is published with a 6-month lag. In fact, the net short position of September 2006, which was 43 billion USD in the previous report, is calculated as 40.5 billion USD in this volume of the report.

On the other hand, the “due from foreign banks” data is provisional as of December 2006, as the data for the fourth quarter of 2006 was published by the BIS in April 2007 and will be finalized in June 2007.

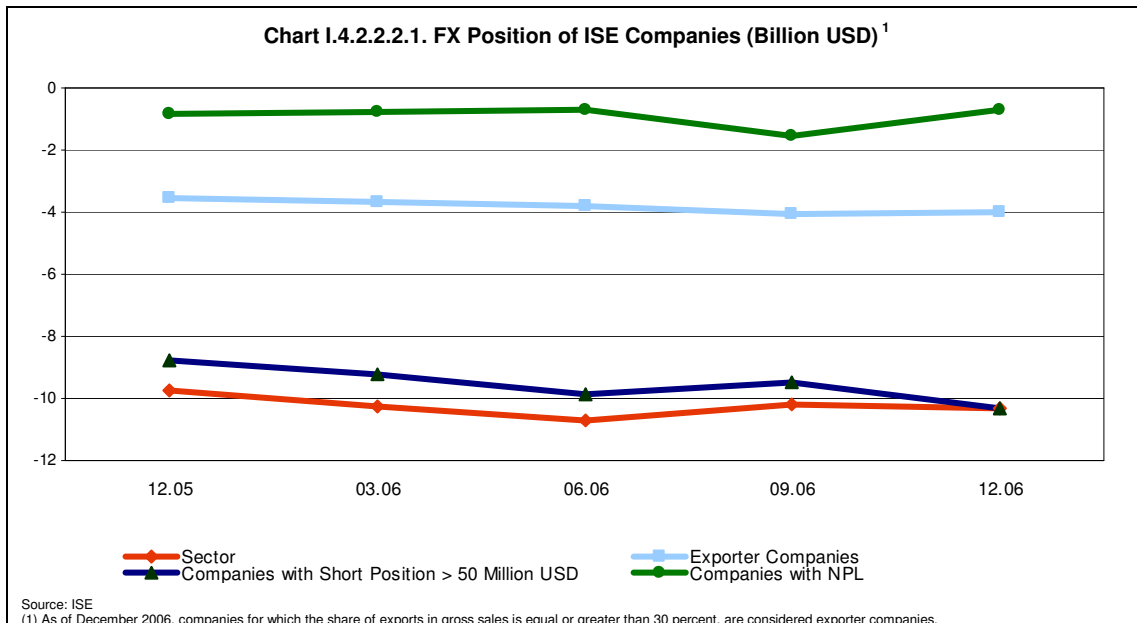
The net short position of the non-banking sector increased by 35 percent and was realized as 37 billion USD by year-end 2006, compared to year-end 2005. By June, the net short position reached its maximum level for 2006, however following the fluctuations in May, it tended to decrease in the second half of the year due to the higher increase in FX assets (especially deposits) compared to the increase in liabilities (Table I.4.2.2.1.1).



The rapid increases in the ratios of the non-banking sector's short position to GNP, exports and international reserves in the first half of 2006, started to display a declining trend in the second half of the year in connection with the decline in net short position (Chart I.4.2.2.1.1).

I.4.2.2.2. Foreign Exchange Position of the Companies Listed on the ISE

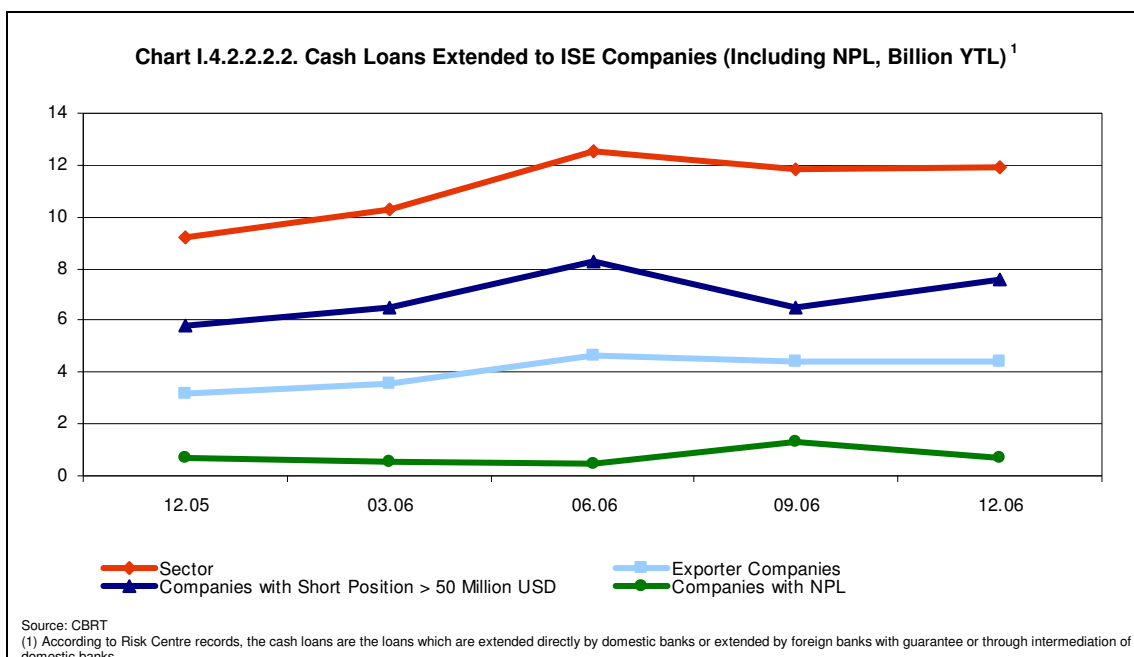
In this section, the FX positions and bank loans of non-financial companies listed on the ISE are examined. In the analyses, of the companies whose financial statements are published by the ISE as of 2006, 193 companies that disclose their FX positions in footnotes to the balance sheet and that have no financial institutions in their consolidated financial statements are taken into consideration.



The short position of the companies examined, which was 9.7 billion USD as of 2005, increased in the first half of 2006 and was realized as 10.7 billion USD by June, decreasing to

10.3 billion USD by December. Of this short position, 99 percent is held by 39 companies whose short position is more than 50 million USD. Furthermore, 128 non-exporting companies constitute 61 percent of the total short position and their short position is 6.3 million USD (Chart I.4.2.2.2.1).

On the other hand, of the 193 companies analyzed, 130 have a short position equivalent to 11.7 billion USD and the remaining 63 companies have a long position of 1.4 billion USD as of year-end 2006. The number of companies, which have a short position, decreased by 13 in June 2006 and 10 of these are non-exporting companies.

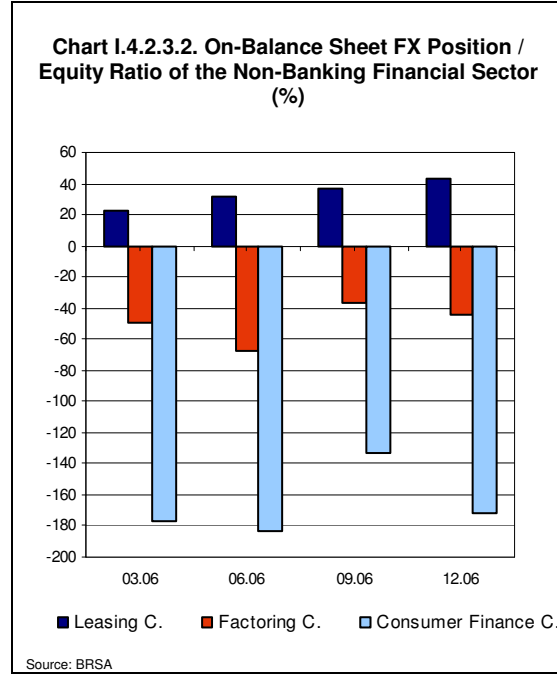
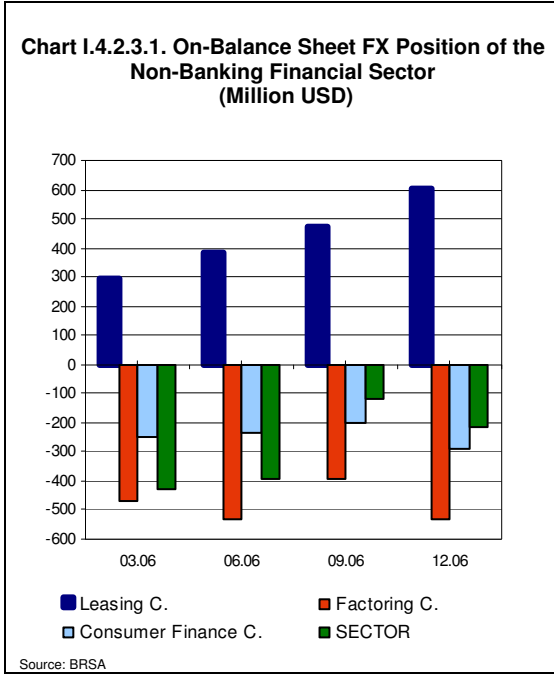


In the analyses, the increase observed in loans in the first half of 2006 was due to the depreciation of the Turkish currency. Total credits of these companies was 11.9 billion New Turkish Liras including NPLs and 17 companies were observed to have NPLs (Chart I.4.2.2.2.2).

Although companies' short positions tended to diminish after June 2006, it is essential for companies to use derivatives in order to hedge the FX risk resulting from sudden exchange rate movements and for banks to avoid credit risk by acting prudently in lending to companies which hold high short positions and do not have FX income.

I.4.2.3. Foreign Exchange Position of the Non-Banking Financial Sector

In this section, the FX on-balance sheet positions of leasing, factoring and consumer finance companies, which have a 3.3 percent share in the Turkish finance sector and maintain a close relationship to the corporate sector as well as the banking sector due to the nature of their activities, are examined.



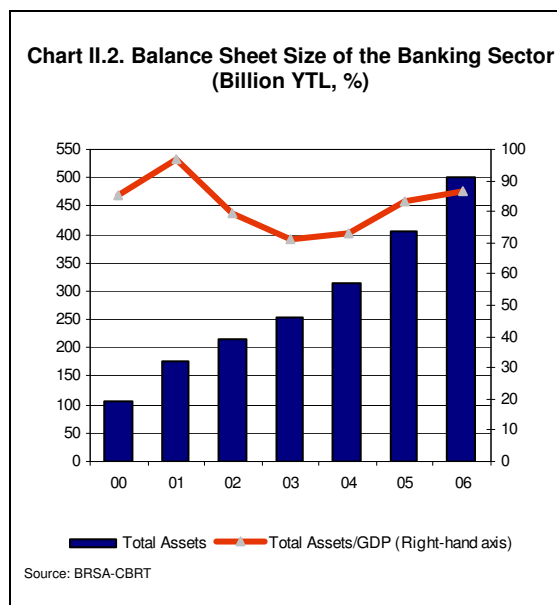
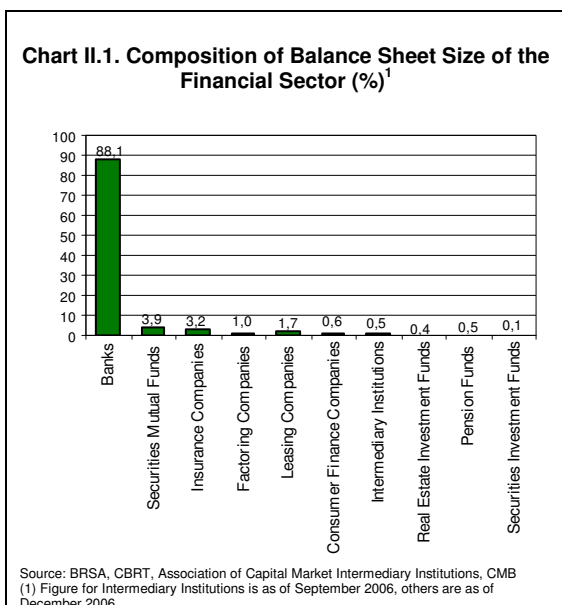
The FX on balance sheet position of the non-banking financial sector displayed a decreasing trend in 2006 and was realized as 215 million USD in December (Chart I.4.2.3.1).

The high level of FX obligations was a determining factor on the on-balance sheet short position of factoring and consumer finance companies. On the other hand, the on-balance sheet position of leasing companies has a surplus due to the fact that an important part of the leasing receivables is in FX (Chart I.4.2.3.1).

Factoring companies' FX on-balance sheet open position to equity ratio tended to decline because of the fact that the increase in equity was more than that in open position. As a result of intensive funding by debt, the on-balance sheet position to equity ratio of consumer finance companies, which have good borrowing opportunities from abroad, was realized rather high (Chart I.4.2.3.2).

II. STRUCTURE OF THE FINANCIAL SECTOR

The Turkish financial sector has continued to demonstrate stable growth in 2006, despite the fluctuation period of May-June. Furthermore, the interest of foreign investors in the banking sector has continued to increase in this period.



The total asset size of the financial sector increased by 20 percent as of year-end 2006, compared to the previous year-end and reached 567 billion New Turkish Liras. About 88 percent of total financial sector assets are composed of bank assets (Chart II.1).

Even though pension funds have a small share in the financial sector, the increase in these funds is remarkable. The portfolio value of pension funds increased by 142 percent in 2006.

II.1. Banking Sector

The Turkish banking sector consists of deposit banks, development and investment banks and participation banks that operate according to profit/loss sharing principles. The data of participation banks are included in the assessments of this section.

As of year-end 2006, the number of banks in the sector decreased to 50 as a result of the merger of Yapı Kredi Bankası and Koçbank and the number of personnel increased by 12,196 compared to the previous year-end and reached 150,853.

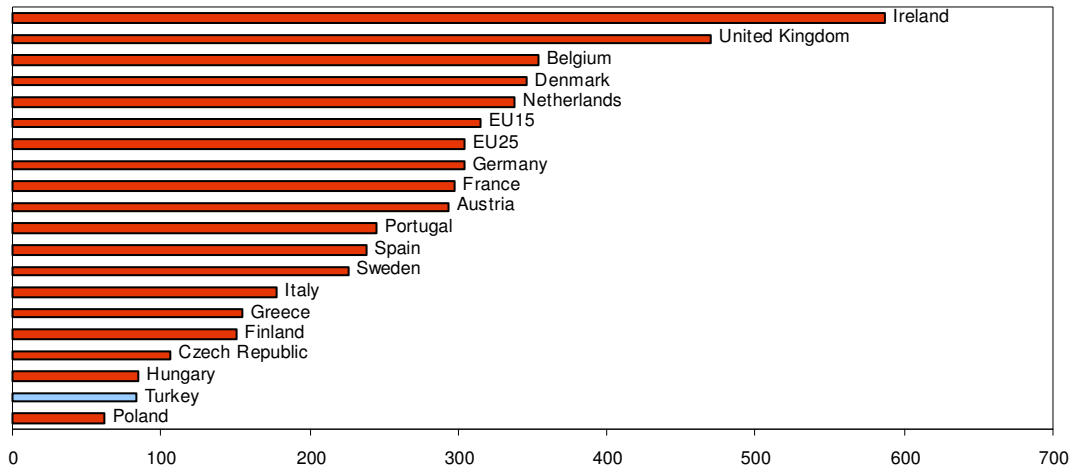
The asset concentration ratio of the largest five banks is 61 percent and the largest 10 banks is 84 percent as of year-end 2006. These ratios have not changed significantly when compared to the previous year-end.

As of year-end 2006, the total asset size of the banking sector increased by 12 percent on a real basis compared to the previous year-end and reached 500 billion New Turkish Liras,

while in USD terms, it increased by 17 percent and reached 303.3 billion from 355.5 billion USD.

The asset size of the Turkish banking sector to GDP ratio, which was realized as 83.5 percent by year-end 2005, reached 86.7 percent as of year-end 2006 (Chart II.2). This indicates that the Turkish banking sector has been growing more rapidly than the GDP, which has been increasing continuously for the last 20 quarters.

Chart II.1.1. Comparison of the Turkish Banking Sector Asset Size/GDP Ratio with Selected EU Countries (%)¹



Source: TURKSTAT, BRSA-CBRT, ECB Report – 2006
(1) All figures are as of 2005. The Turkish Banking Sector Asset Size/GDP Ratio is 87 percent in 2006.

The asset size of the Turkish banking sector to GDP ratio is less than all EU countries except Poland (Chart II.1.1). This indicates the growth potential of the Turkish banking sector.

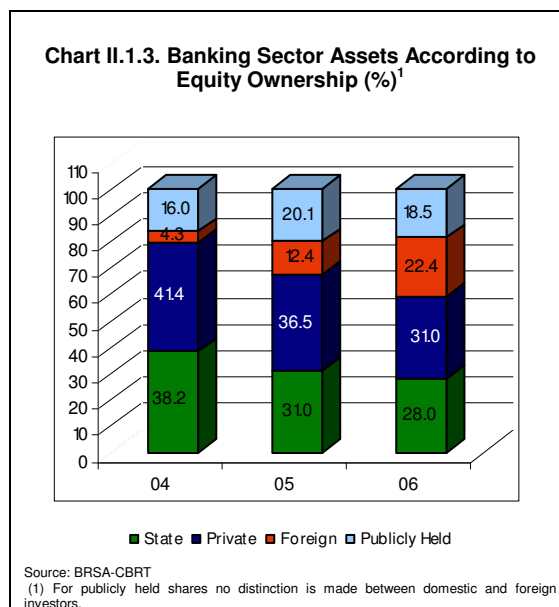
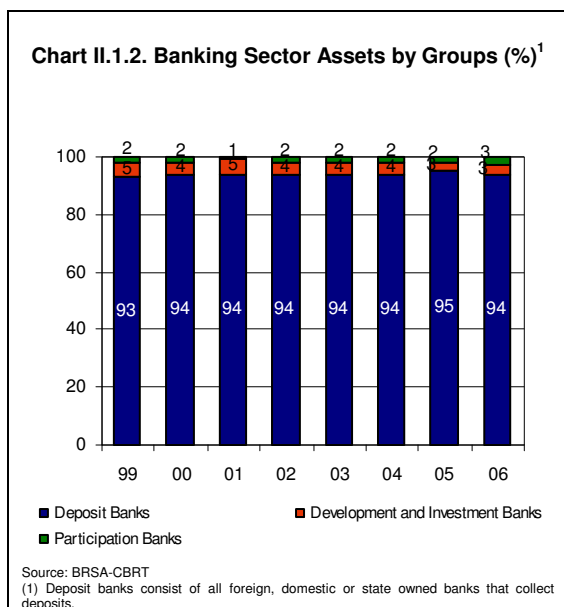
Table II.1.1. Comparison of Selected Balance Sheet Items with Selected EU Countries^{1,2}

Countries	Deposits / GDP (%)	Loans / GDP (%)	Loans / Deposits (%)	Loans / Total Assets (%)	Total Assets / Number of Banks (Million Euro)
Belgium	154	122	79	34	10,553
Denmark	69	184	269	53	3,665
Germany	115	135	117	44	3,268
Greece	104	84	81	54	4,533
Spain	118	141	120	59	6,180
France	80	99	125	33	5,960
Ireland	143	208	146	35	12,076
Italy	60	90	151	51	3,168
Luxemburg	818	494	60	18	5,112
Holland	136	189	139	56	4,234
Austria	101	134	132	45	819
Portugal	110	142	129	58	1,937
Finland	55	76	138	50	646
Sweden	53	120	225	53	3,266
UK	138	156	113	33	20,801
EU15 Ave.	106	130	123	41	4,554
EU25 Ave. ³	104	126	121	41	3,787
Turkey 2005	52	32	63	39	5,026
Turkey 2006	53	38	71	44	5,397

Source: BRSA-CBRT, ECB Report – 2006
(1) Figures for EU countries are as of 2005. The figures of "credit institutions" for EU member countries are used, for Turkey, the figures of "banks" are used.
(2) For Turkey, deposits include participation funds and loans include funds extended by participation banks.
(3) EU-25 averages are taken into account since the data of Bulgaria and Romania, EU members since 2007, are not included in the ECB Report – 2006.

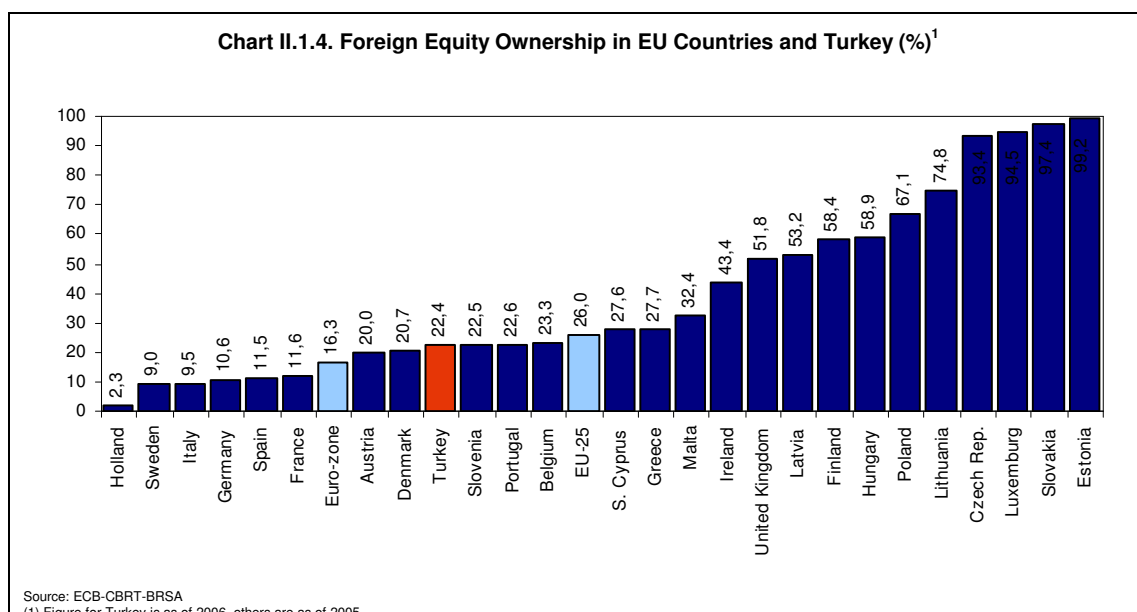
Even though deposits and loans to GDP, and loans to deposits ratios, which show the financial depth and intermediation level of the banking sector, have all demonstrated a

significant increase when compared to the previous year, they remain under the average of the EU countries (Table II.1.1).



Of the 50 banks operating in the Turkish banking sector, 33 are deposit banks, 13 are development and investment banks, 4 are participation banks. The Turkish banking sector is mainly based on deposit banking (Chart II.1.2).

As a result of the increasing interest of foreign investors in the Turkish banking sector in 2006, the share of foreigners reached 22.4 percent of the total assets of the banking sector as of year-end 2006, including those banks whose share transfer process was finalized in April 2007 (Chart II.1.3). On the other hand, according to data of the Central Registry Agency, the share of the foreigners in publicly held shares was 16.4 percent with respect to total assets of the sector for the same period. When these shares are added, the share of foreigners becomes 38.8 percent. Despite the fluctuations of the May-June period, the increasing interest of foreigners in the banking sector indicates that positive expectations are maintained.



Regarding the share of foreign equity, it is observed that the average of the EU-25 is 26 percent and those countries that joined the Union in the last period remain above the average of the EU-25. As of September 2006, according to the legally finalized acquisitions and mergers by foreigners, Turkey is slightly above the average of Euro zone countries (EU-15) but under the average of the EU-25 (Chart II.1.4).

Table II.1.2. Comparison with EU Member Countries¹

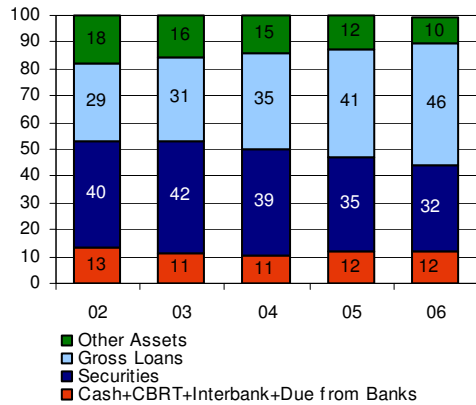
Countries	The Share of the Largest 5 Credit Institutions (%)	Number of Credit Institutions	Total Number of Branches	Total Number of Personnel	Personnel per Branch	Branch per Credit Institution	Banking Sector Personnel to Total Population (%)
Belgium	85	100	4,564	69,481	15	46	0.7
Denmark	66	197	2,114	47,579	23	11	0.9
Germany	22	2,089	44,044	705,000	16	21	0.9
Greece	66	62	3,576	61,295	17	58	0.6
Spain	42	348	41,979	252,829	6	121	0.6
France	54	854	27,075	429,347	16	32	0.7
Ireland	46	78	910	37,702	41	12	0.9
Italy	27	792	31,498	335,910	11	40	0.6
Luxemburg	31	155	246	23,224	94	2	5.1
Netherlands	85	401	3,748	118,032	31	9	0.7
Austria	45	880	4,300	75,303	18	5	0.9
Portugal	69	186	5,427	53,989	10	29	0.5
Finland	83	363	1,616	25,182	16	4	0.5
Sweden	57	200	1,910	39,237	21	10	0.4
UK	36	400	13,694	482,888	35	34	0.8
EU15	54	474	12,447	183,800	15	26	0.7
EU25	60	347	8,050	122,164	15	23	0.7
Turkey 2005	61	51	6,564	138,657	21	129	0.2
Turkey 2006	61	50	7,302	150,853	21	146	0.2

Source: BRSA-CBRT, Eurostat, ECB Report – 2006

(1) Figures for EU member countries are as of 2005. 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 figures for Turkey contain participation banks.

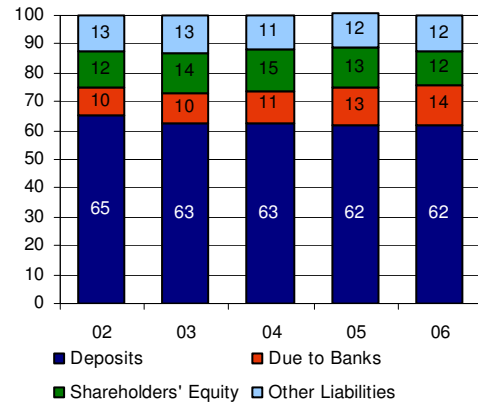
The number of banks and branches in the Turkish banking sector is under the average of EU countries, but the number of personnel is higher than the average of EU-25 countries and lower than the average of EU-15 countries. The number of personnel employed in the banking sector to total population is lower than all EU countries. However, the branch per bank is higher than EU countries as a result of intensive branch banking in Turkey. The number of personnel per branch is higher than the average of EU countries. It is observed that the banking sector concentration is higher than the average of EU countries (Table II.1.2).

Chart II.1.5. Asset Structure of the Banking Sector (%)



Source: BRSA-CBRT

Chart II.1.6. Liability Structure of the Banking Sector (%)



Source: BRSA-CBRT

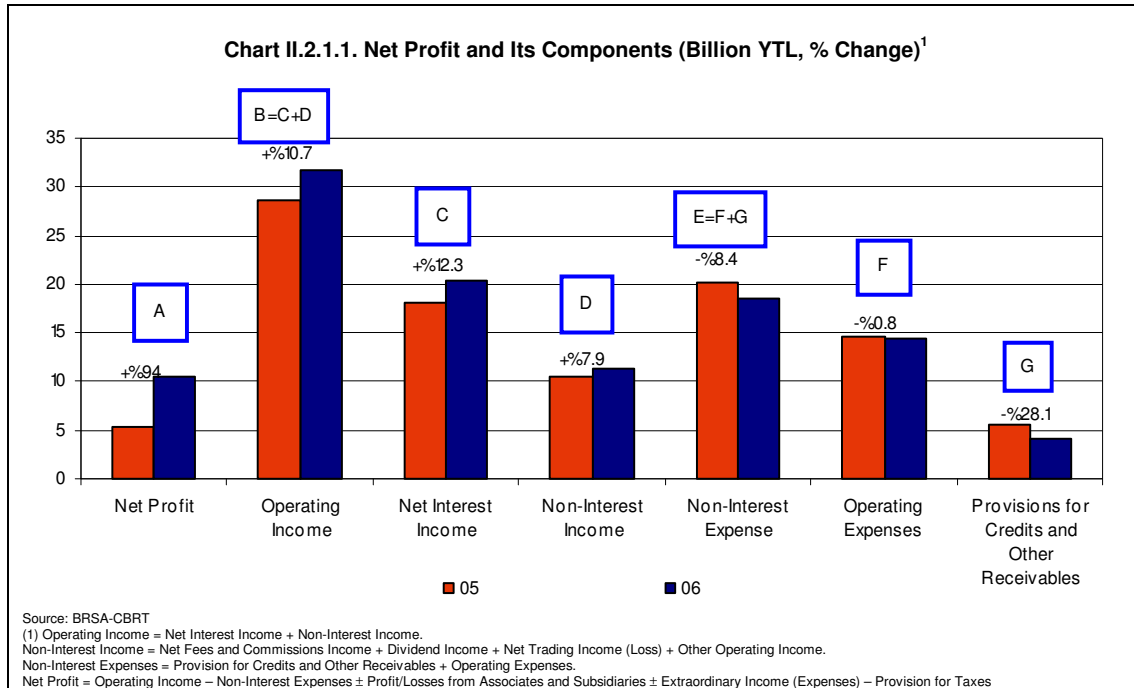
The share of loan portfolio as the largest asset item continued to increase in 2006 and reached 46 percent as of year-end 2006 from 41 percent as of the previous year-end (Chart II.1.5).

In 2006, the share of shareholders' equity in total liabilities decreased by 1 percent compared to year-end 2005 and stood at 12 percent. The share of deposits in total liabilities remained unchanged and maintained its level at 62 percent (Chart II.1.6).

II.2. Profitability and Capital Adequacy³

II.2.1. Profitability⁴

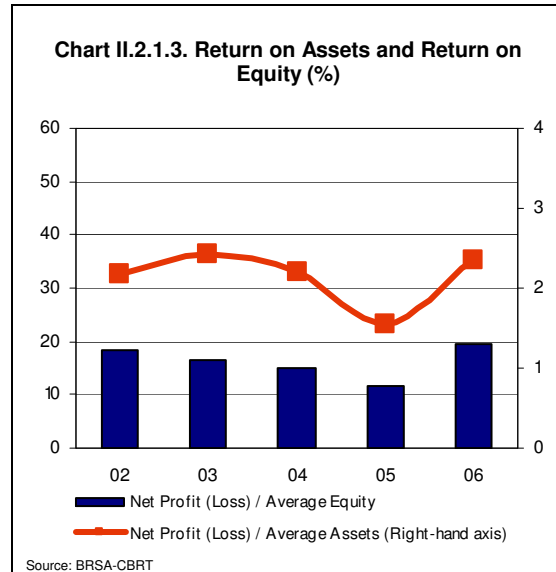
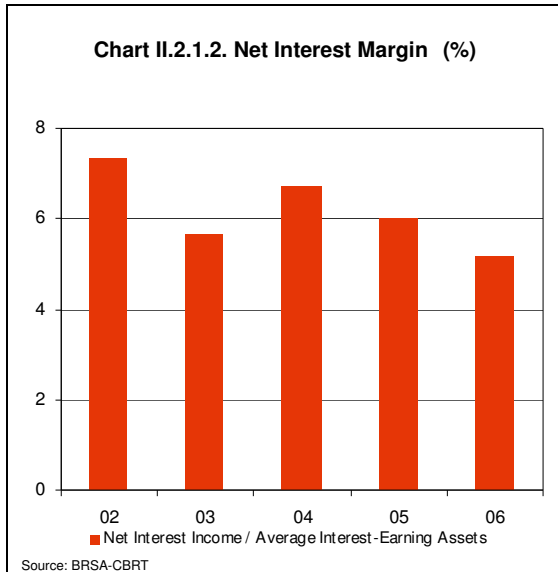
As of year-end 2006, the net profit of the banking sector was realized as 10.6 billion New Turkish Liras, increasing by 94 percent on an annual basis. The fact that one bank, which incurred a high amount of net loss by year-end 2005, made a profit this year, was also effective in the increase in the profit and improved profitability performance of the banking sector.



As of year-end 2006, the increase in the operating income and the decrease in the provisions for loans and other receivables are the determinants of the rise in the profit of the banking sector. It is seen that besides the increase in net interest income, the 17.9 percentage increase in net fees and commissions income as a component of non-interest income, contributed to the increase in operating income. On the other hand, the ratio of operating income to operating expenses increased to 219.9 percent in 2006. The increase in this ratio and net fees and commissions income is evaluated positively in terms of profitability (Chart II.2.1.1).

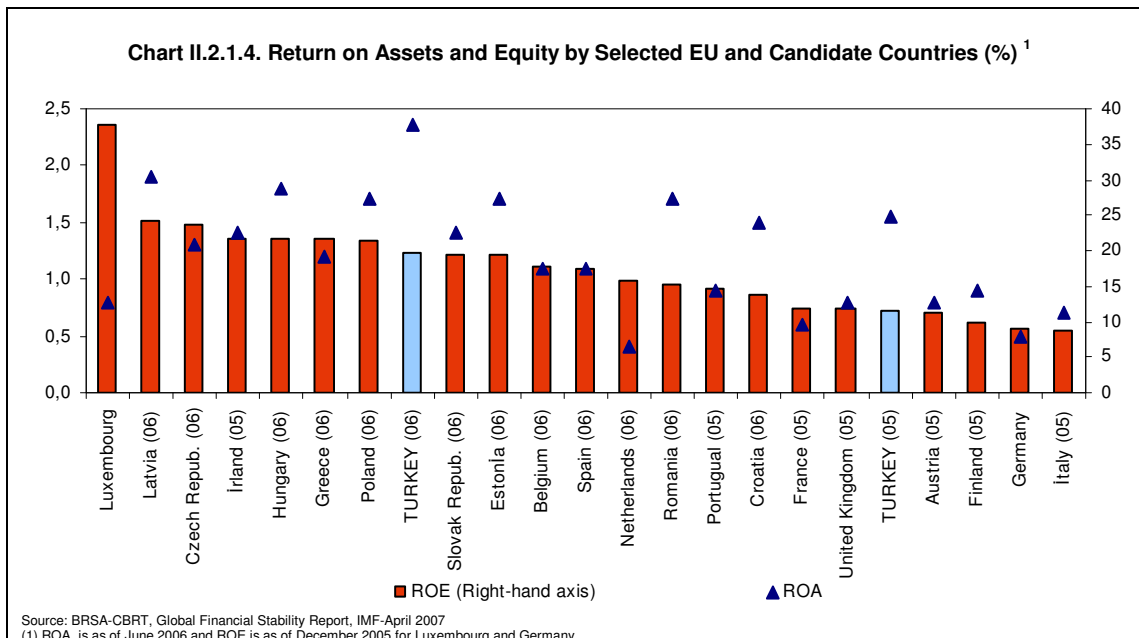
³ Participation banks are excluded in this section due to their different operating principles.

⁴ The SDIF bank is excluded.

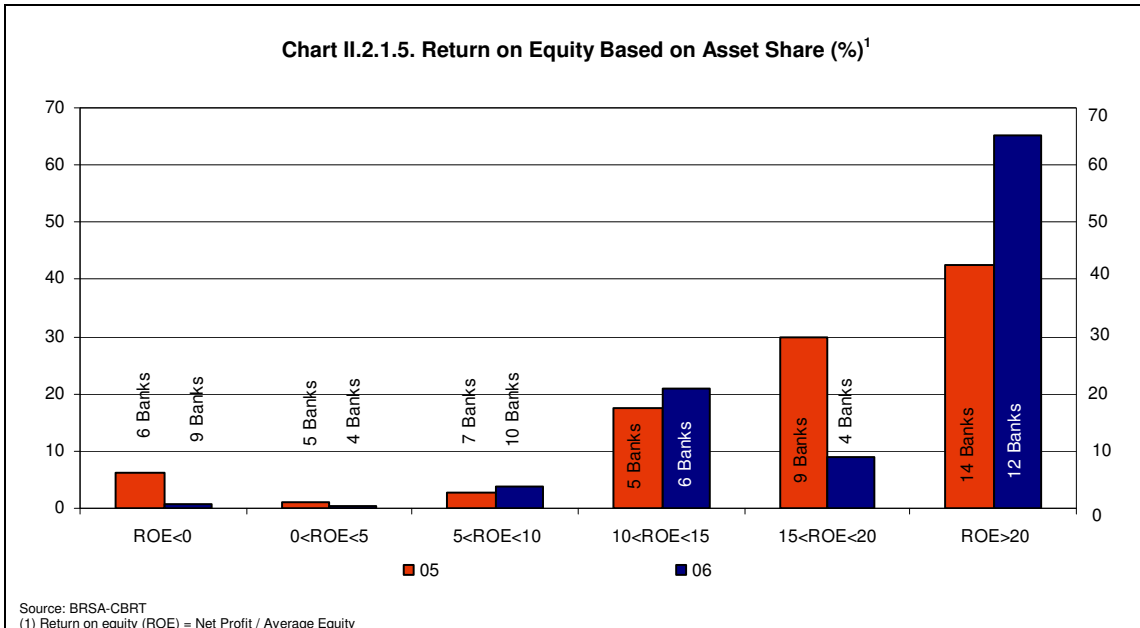


The decreasing trend of the net interest margin, which is the ratio of net interest income to average interest-earning assets, continued in 2006 (Chart II.2.1.2). The decrease in the net interest margin stemmed from the declining trend of interest rates until June 2006. After that period, despite the increase in interest rates, the margin maintained the same level as a result of the strong growth in fixed-rate consumer loans, essentially housing loans, as well as those fixed-rate securities purchased before June.

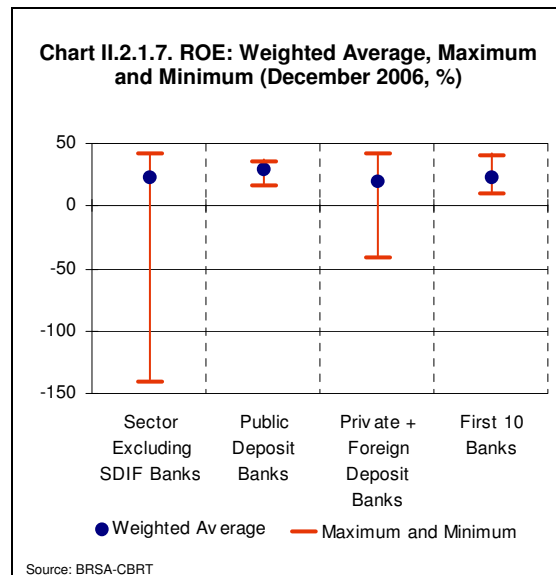
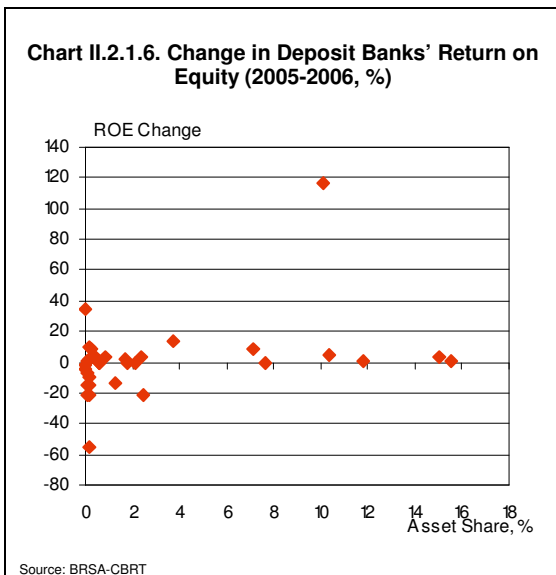
As of year-end 2006, the return on assets and return on equity of the banking sector were realized as 2.3 percent and 19.5 percent, respectively. Both of these figures showed a significant increase compared to year-end 2005 (Chart II.2.1.3).



When compared with selected EU and candidate countries, the Turkish banking system has a higher performance especially with regard to the return on assets. On the other hand, the lower return on equity stems from the low level of financial leverage in the Turkish banking sector (Chart II.2.1.4).



As of year-end 2006, while the number of banks with a return on equity over 20 percent has decreased, the asset share of those banks has increased. The number of banks that incurred losses increased from 6 to 9, but their asset share remained very low in the sector (Chart II.2.1.5).

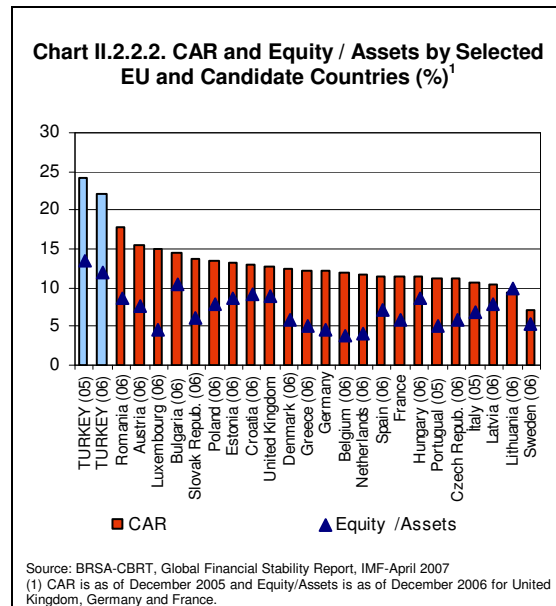
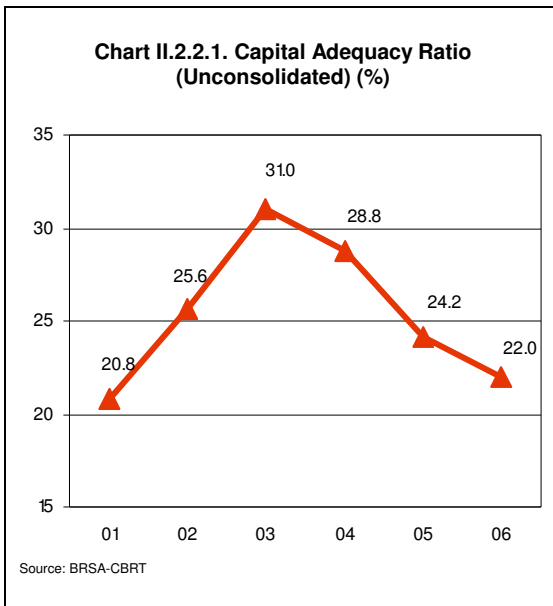


As of the end of 2006, compared to the previous year, it is seen that the change in return on equity is more significant in small banks. The change in return on equity of the banks with a share exceeding 6 percent of total assets is limited, except a bank, which incurred a net loss the previous year and made a profit in 2006 (Chart II.2.1.6).

As of year-end 2006, the value range for the return on equity is narrow for the largest 10 banks and public deposit banks. The broader range for private and foreign deposit banks is due to the small banks (Chart II.2.1.7).

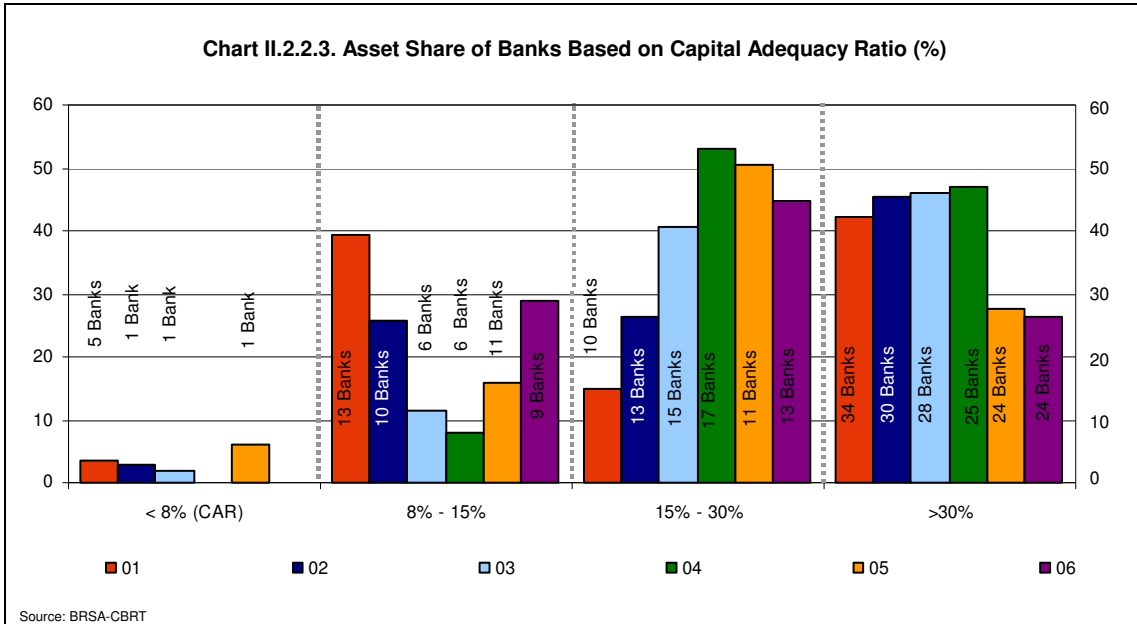
II.2.2. Capital Adequacy

Although the unconsolidated capital adequacy ratio (CAR) of the banking sector, which is the ratio of own funds to risk weighted assets, has a declining trend, it was realized well above both the minimum requirement of 8 percent and the target ratio of 12 percent for all periods under review.

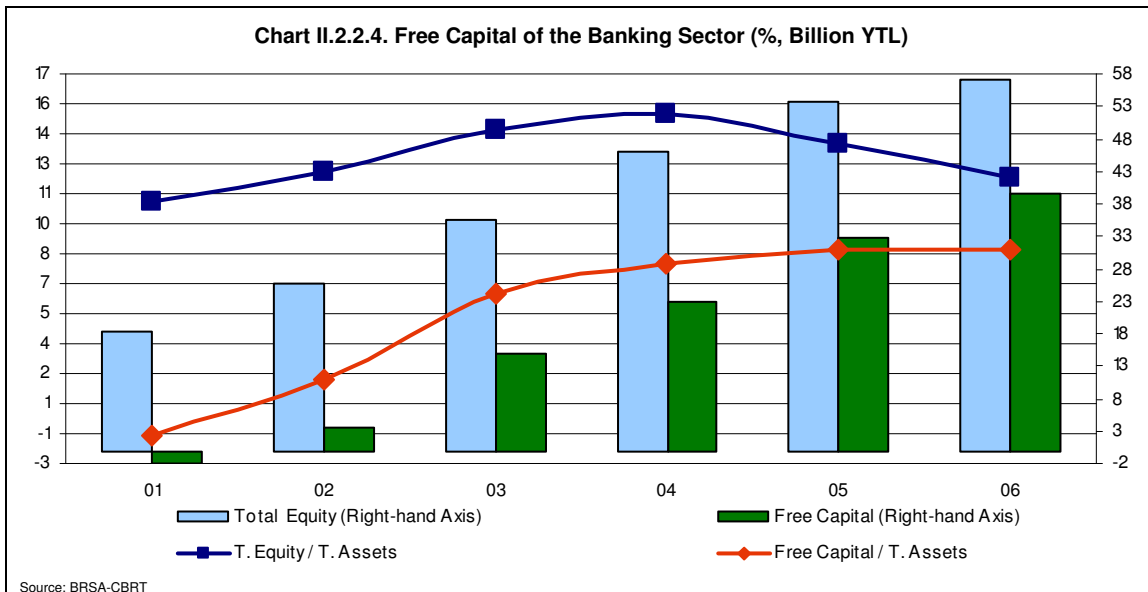


The CAR of the banking sector decreased by 2.2 points with respect to end of previous year and was realized as 22 percent as of year-end 2006 (Chart II.2.2.1). Since own funds grew by 23 percent while the risk weighted assets increased by 35 percent, the ratio of the sector fell as of year-end 2006. While the increase in net profit was effective in the increase in own funds, the increase in risk weighted assets was due to the loan growth in the 100 percent risk-weighted assets category.

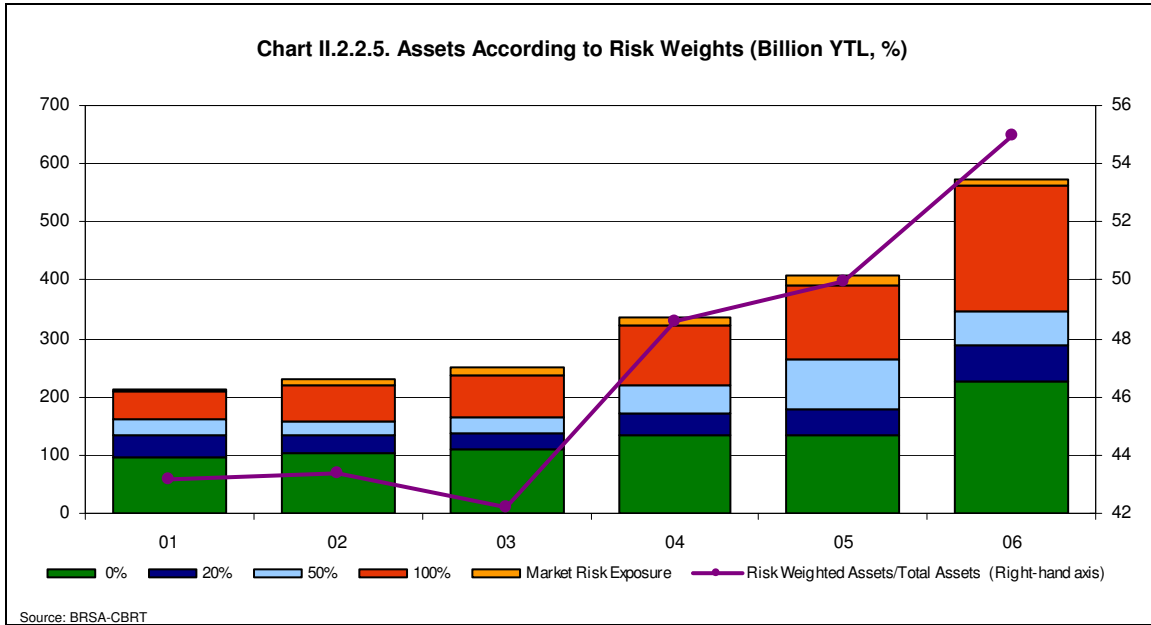
It is observed that the capital adequacy and equity to total assets ratios for the Turkish banking sector have the highest values when compared to EU and candidate countries. While the acceptance of the large portfolio of Government Debt Securities as risk free in the calculation of the capital adequacy ratio causes the CAR to maintain a high level, the low levels of financial leverage gives rise to a high equity to total assets ratio (Chart II.2.2.2).



While the capital adequacy ratios of 35 banks in the sector, which hold 78 percent of the sector assets, exceeded 15 percent by year-end 2005, the capital adequacy ratios of 37 banks, which hold 71 percent of the sector assets, exceeded 15 percent as of year-end 2006 (Chart II.2.2.3).



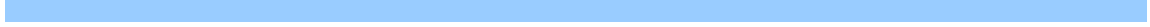
Since free capital and total assets have displayed the same level of increase in the last year, no change is observed in the free capital to total assets ratio. Although the equity to total assets ratio has a declining trend, it is still high when compared to EU countries (Chart II.2.2.4).



As of year-end 2006, the share of 100 percent risk weighted assets increased to 38 percent from 32 percent due to the increase in loans (Chart II.2.2.5).

The increase of 100 percent risk weighted assets was also influenced by the change of the risk category of the “commitments on credit card spending limits”, from 50 percent to 100 percent, according to “The Regulation on Measurement and Assessment of Capital Adequacy of Banks”, which has been put into effect on November 1, 2006. On the other hand, as the “securities available for sale” are taken into account within the context of credit risk instead of market risk as of year-end 2006, the share of zero percent risk weighted assets increased from 32 to 40 percent and the amount of market risk exposure decreased from 4 percent to 2 percent (Chart II.2.2.5).

As of year-end 2006, since the total risk weighted assets had increased more, the ratio of risk weighted assets to total assets had increased to 55 percent from 50 percent, compared to year-end 2005.



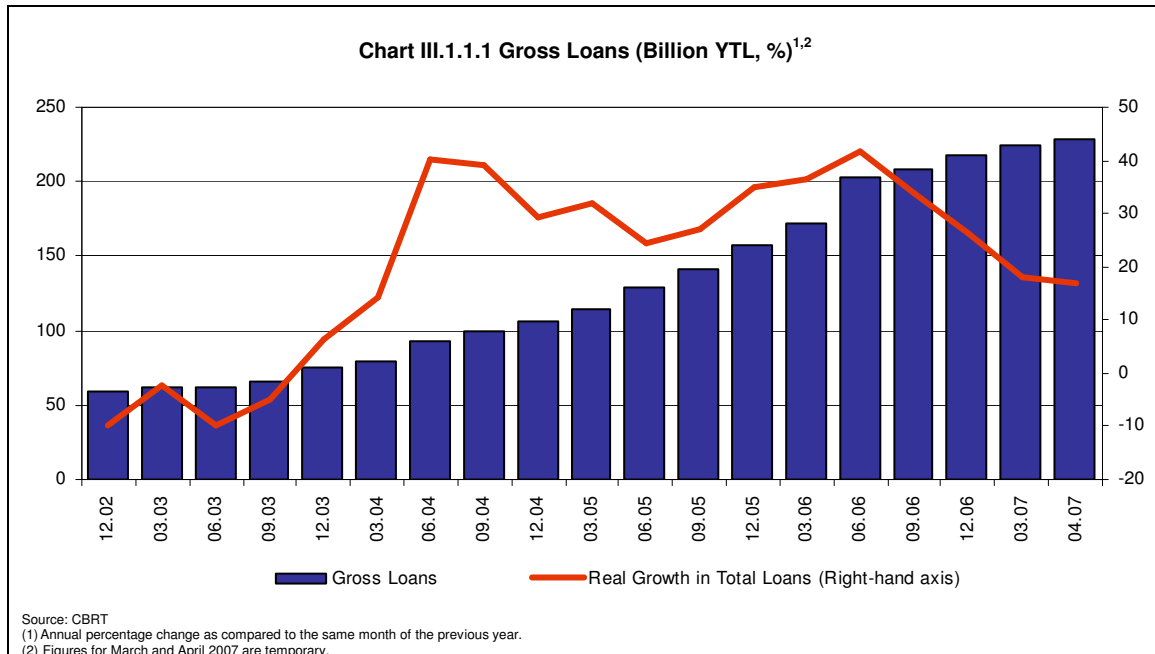
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III. BANKING SECTOR RISKS

Participation Banks, which have the same legal status as traditional banks but different operating principles, are excluded from the risk analyses of this section.

III.1. Credit Risk and Scenario Analysis

III.1.1. Credit Portfolio



Banking sector credit volume reached 217.8 billion New Turkish Liras with an increase of 26.2 percent as of the year-end 2006, compared to the end of the previous year. The slowdown in the growth of the gross credit⁵ volume compared to previous years, stemmed from interest rates, which increased following fluctuations in the financial markets in the second quarter of the year. According to provisional data, the slowdown in growth also continued in the first four months of 2007 (Chart III.1.1.1).

⁵ Gross Loans= Total Loans + Gross NPL

Table III.1.1.1. Some Selected Credit Ratios (Million YTL, %) ^{1,2}

	2002	2003	2004	2005	2006	04.07
First 5 Banks						
Total Gross Loans	32,540	40,888	56,620	87,889	127,494	132,310
Share in Total Gross Loans	55	55	54	56	59	61
NPLs / Total Gross Loans	15	11	5	4	4	4
Loans / Deposits	38	42	48	55	80	79
First 10 Banks						
Total Gross Loans	46,028	58,000	83,965	127,913	183,154	191,316
Share in Total Gross Loans	77	77	79	81	84	88
NPLs / Total Gross Loans	20	12	6	5	4	4
Loans / Deposits	40	43	49	59	69	69
Sector						
Total Gross Loans	59,411	74,850	105,698	157,440	217,846	228,855
NPLs / Total Gross Loans	18	12	6	5	4	4
Loans / Deposits	43	48	55	65	73	73

Source: BRSA-CBRT

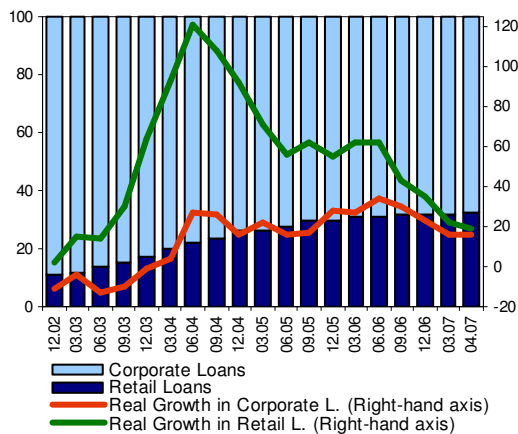
(1) The first 5 and 10 banks have been taken into consideration according to their gross loans.

(2) Figures for April 2007 are temporary.

While the share in total loans of both the first five and ten banks which extended the majority of loans, increased, the NPL ratios of the first ten banks and the sector as a whole declined as of year-end 2006. The fast growth in the Loans to Deposits ratio of the first five banks is due to the fact that a state-owned bank, which was in this group at the end of 2005 and held 20 percent of deposits, stayed out of this group by year-end 2006. While the share of the first five and ten banks in total loans continued to increase, the NPL ratios did not change as of April, 2007 (Table III.1.1.1).

While the loans to deposits ratio of the sector, which reached 73 percent at the end of 2006, its peak for the last five years, indicates a positive development for the intermediation function of banks, the improvement in the NPL ratio in recent years is regarded favorable for credit risk (Table III.1.1.1).

Chart III.1.1.2. Gross Loans by Borrowers and Real Annual Growth Rates (%) ^{1,2,3}



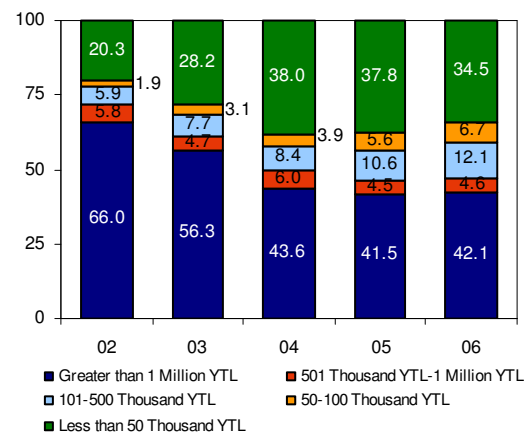
Source: BRSA-CBRT

(1) They were brought to real terms by using CPI (1994=100).

(2) Annual percentage change as compared to the same month of the previous year.

(3) Figures for March and April 2007 are temporary.

Chart III.1.1.3. Loan Distribution by Size (Excluding NPLs, %)

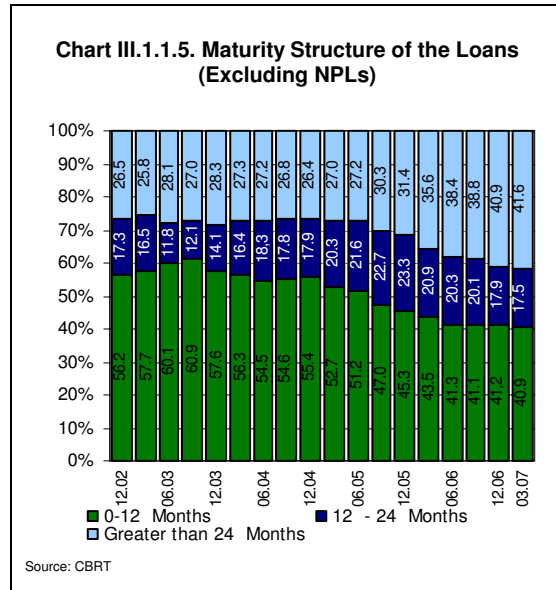
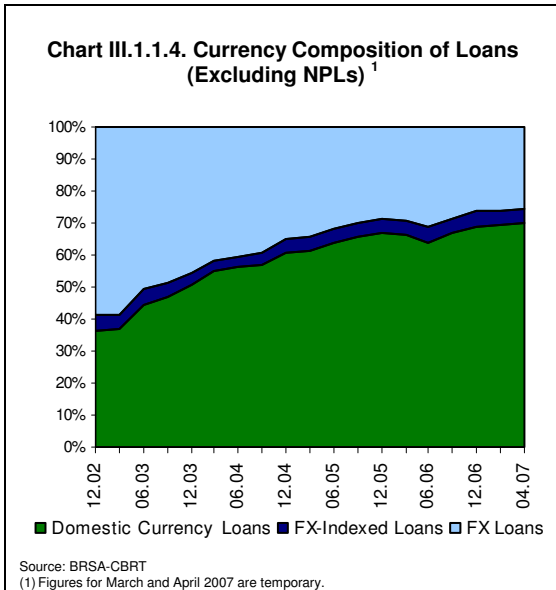


Source: BRSA-CBRT

The tightening of financing conditions after the financial fluctuation in the second quarter of 2006 particularly influenced retail loans and its growth rate of 55.4 percent in 2005 decreased to 34.6 percent in 2006; however, the slowdown in the growth rate of corporate loans remained

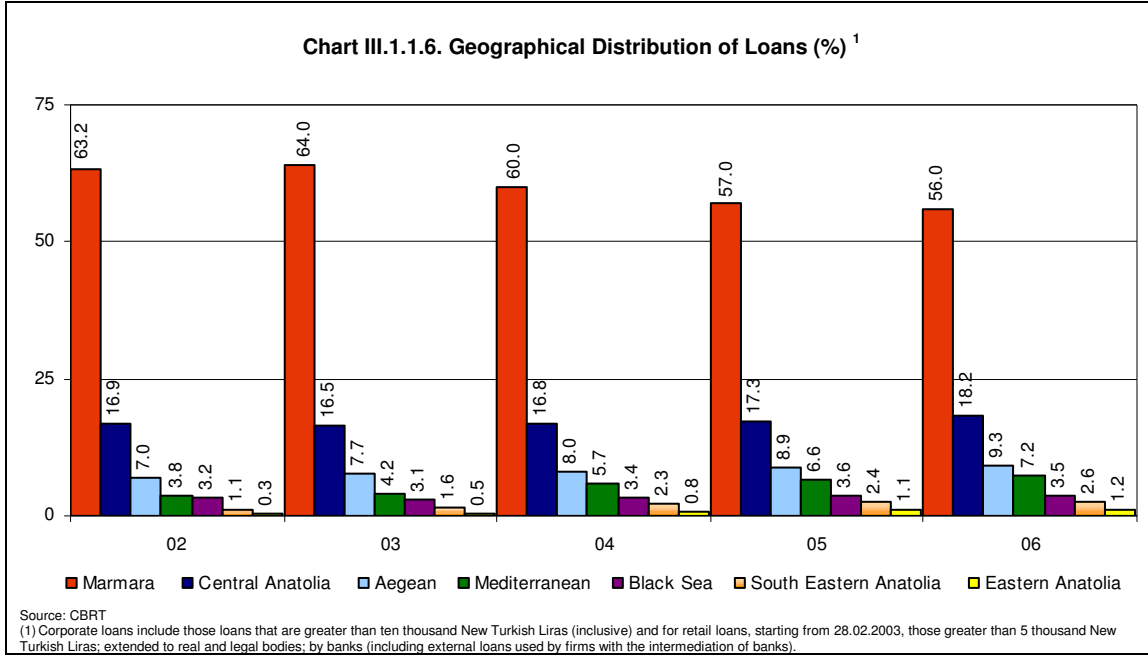
limited. The share of corporate loans in total loans declined in 2006. The slowdown in real growth rates of retail and corporate loans continued in the first four months of 2007 due to maintenance of high levels of interest rates compared to the first half of 2006 (Chart III.1.1.2).

While there is a decrease in the share of loans less than 50,000 New Turkish Liras, there is an increase in the share of other groups as of year-end 2006, compared to the end of the previous year (Chart III.1.1.3). Since the number of customers utilizing loans greater than one million New Turkish Liras is less than other groups, the increase in this group is perceived as a factor that increases credit risk.

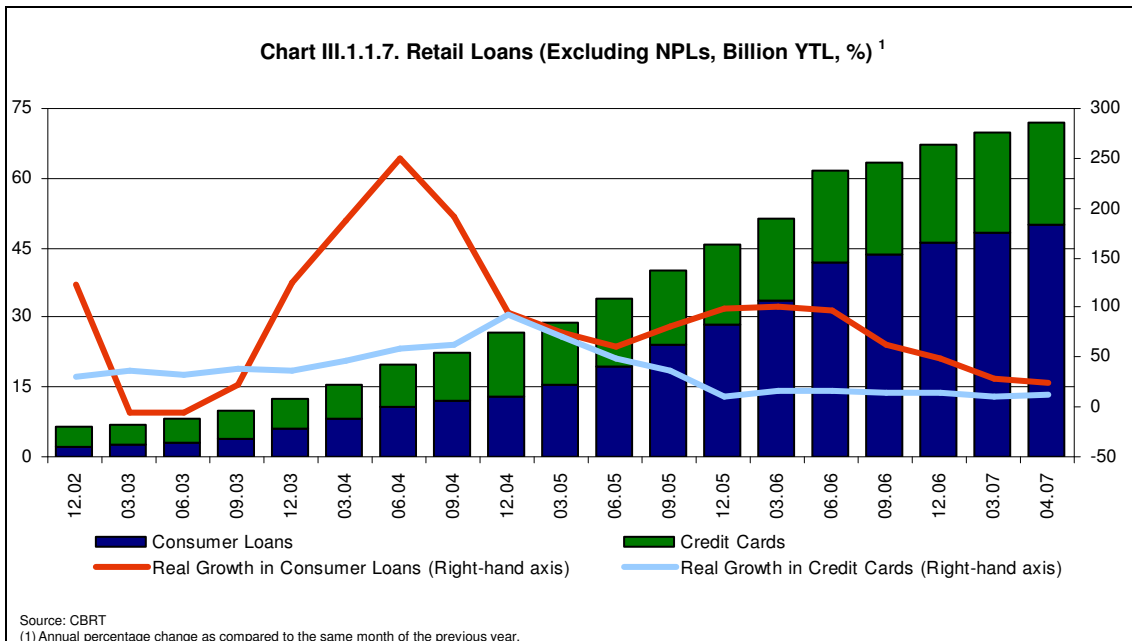


The share of domestic currency loans in total loans extended by banks showed fluctuations in 2006, but after the achievement of stability in FX rates, it increased to 69.1 percent as of year-end 2006, and further increased to 69.9 percent as of April, 2007 (Chart III.1.1.4). While approximately all of retail loans are used in YTL, it is clear that FX loans are mainly used by corporates, which makes them more vulnerable to changes in FX rates.

On the other hand, maturities were extended in 2006 and this trend continued in 2007 (Chart III.1.1.5). Consumer loans are the dominant factor in the increase in loans with a maturity of longer than 24 months.



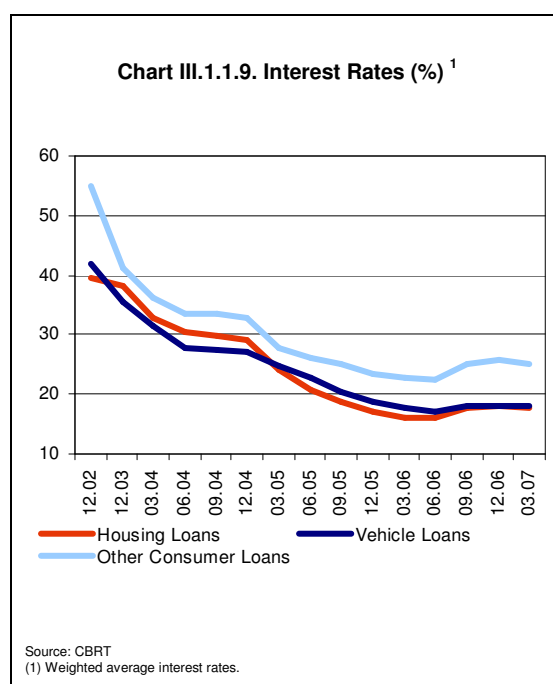
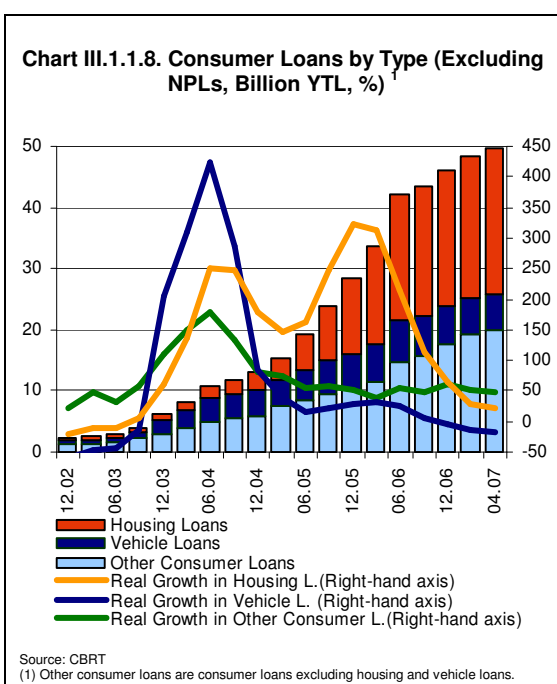
The geographical concentration of loans has decreased since 2004 and it is observed that particularly the share of the Marmara Region in total loans decreased, while the share of other regions except the Black Sea Region increased in 2006 (Chart III.1.1.6). This change occurred due to the increase in loans extended to consumers and small firms.



In 2006, the slowdown in total loans was more evident in consumer loans. The real growth rate of 99.3 percent in 2005, decreased to 47.8 percent in 2006 and it continued to decline in the first four months of 2007 (Chart III.1.1.7).

Credit cards⁶ reached 21.2 billion New Turkish Liras as of year-end 2006, with a 13.5 percent increase in real terms, compared to the end of the previous year. However, the annual real growth rate decreased to 11.6 percent in April 2007 (Chart III.1.1.7).

With regard to the results of the Bank Loans Tendency Survey⁷ of January-March 2007; banks expect regulations on retail loans to be eased and thus the demand for all types of retail loans will increase for the period of April-June 2007. The Consumer Confidence Index⁸ of April 2007 reveals similar results. In fact, according to this index, it is expected that probability of buying durable goods will increase in the next period. However, in the election process and due to tight monetary policy, it is thought that high levels of interest rates will continue to limit credit demand in the next period and no briskness in consumer loans is expected in the short-term.



Although a slowdown is observed in the growth of housing loans, which is the most important item in the expansion of consumer credits, due to the rise in interest rates in the second half of 2006, its share in total consumer credits continued to increase (Chart III.1.1.9). Since June 2006, the real growth rate of other consumer loans has displayed an upward trend and this has increased faster than housing loans in the first four months of 2007. The tendency of households to borrow other consumer loans to close their credit card obligations was also effective in this case. The amount of vehicle loans has been declining since the beginning of 2007 (Chart III.1.1.8).

⁶ Refers to the balance in the cash loans item, until the credit card spendings and cash withdrawals are paid back to the bank.

⁷ CBRT, Bank Loans Tendency Survey, May 1, 2007.

⁸ TURKSTAT-CBRT, Consumer Confidence Index, April 2007, Volume 79.

Table III.1.1.2. Shares of Housing Loans in Total Loans and in GDP for Selected Countries (%)

	Housing Loans / Total Loans				Housing Loans / GDP			
	2002	2003	2004	2005	2002	2003	2004	2005
Belgium	22.8	25.0	26.5	26.1	24.4	26.6	27.9	31.8
Czech Republic	12.0	15.3	20.5	23.8	4.5	6.0	7.9	9.9
Estonia	18.6	21.6	25.4	32.4	7.9	11.7	16.6	24.7
Greece	22.2	24.0	25.8	28.1	14.8	17.1	19.6	23.7
Ireland	22.2	26.5	28.2	28.4	33.8	39.5	49.6	59.1
Latvia	11.2	16.2	21.1	25.1	4.0	7.3	11.8	19.4
Lithuania	11.1	14.2	18.3	21.3	1.9	3.4	5.5	9.1
Hungary	13.8	19.5	21.1	19.8	5.3	8.4	10.2	10.3
Poland	11.3	14.5	15.8	17	3.4	4.5	5.3	5.4
Portugal	35.5	35.8	36.5	38	48.5	49	49.7	53.9
Slovenia	4.9	5.3	5.9	8.1	1.9	2.3	2.8	5.0
EU25	30.0	32.5	33.6	34.3	34.1	37.6	39.5	43.2
Turkey ¹	0.9	1.3	2.7	7.8	0.2	0.2	0.6	2.5

Source: EU Banking Structures, October 2006.

(1) Housing Loans/ Total Loans ratio for Turkey is 10,6% and Housing Loans/GDP ratio is 3,8% at the end of 2006.

Despite the fast growth in housing loans in recent years, the share of these loans in total loans and in the GDP was below the average of selected EU countries and the EU-25 average, as of year-end 2005 (Table III.1.1.2). This share is expected to increase with new housing loans by banks which will have a new financing opportunity after the enactment of the secondary regulations required for full implementation of the mortgage system.

Table III.1.1.3. Sectoral Composition of Corporate Loans (%)^{1,2}

	Gross Loans			FX Loans / Total Loans		
	2004	2005	2006	2004	2005	2006
1 Wholesale and Ret. Trade, Brokerage, Repair of Mot. Veh	15.4	19.1	22.7	43.8	38.2	37.5
2 Transport, Storage and Communication	5.4	5.7	7.8	79.5	68.8	54.7
3 Textile and Textile Product Industry	11.6	9.3	7.1	75.3	70.5	66.7
4 Construction	6.0	6.5	6.4	65.3	59.5	50.3
5 Industry of Tobacco, Beverages and Food	7.2	7.3	5.5	51.4	47.9	46.2
6 Manufacture of Basic Metals and Fabricated Metal Prod.	5.4	5.4	5.4	76.5	73.9	73.5
7 Sources of Electricity, Gas and Water	5.0	3.8	5.1	95.6	96.0	93.4
8 Agriculture, Hunting and Forestry	5.2	4.7	4.6	22.3	19.5	17.3
9 Manufacture of Machinery and Equipment	3.3	3.1	3.6	66.6	60.2	45.9
10 Hotels and Restaurants (Tourism)	2.8	3.0	3.3	81.8	77.6	75.8
First 10 Sector	67.2	68.0	71.5	62.5	55.8	51.7

Source: CBRT

(1) Loans are compiled based on bank reportings under the scope of Central Bank Law No:1211, Article:44. They include those loans that are greater than ten thousand New Turkish Liras (inclusive); extended to real and legal bodies; by banks (including external loans used by firms with the intermediation of banks). They are inclusive of accrued interest and exclusive of non-cash loans. Therefore, they differ from the figures in the balance sheet-based analysis.

(2) Excluding Financial Intermediation.

According to Central Bank Risk Center data, the share of the first ten sectors in total corporate loans increased from 68 percent as of year-end 2005 to 71.5 percent as of year-end 2006, indicating an increase in sectoral concentration. As of year-end 2006, the sector with the largest share in total corporate loans is still the “Wholesale and Retail Trade, Commissions and Motor Vehicles Services”, with a total share of 22.7 percent share. The shares in total corporate loans of the “Textile and Textile Products Industry”, “Food, Beverages and Tobacco Industry”, “Construction” and “Agriculture, Hunting and Forestry” sectors, decreased compared to year-end 2005. On the other hand, the share of FX loans in the total loans used by corporates decreased for all selected sectors as of year-end 2006 (Table III.1.1.3).

III.1.2. Non-Performing Loans

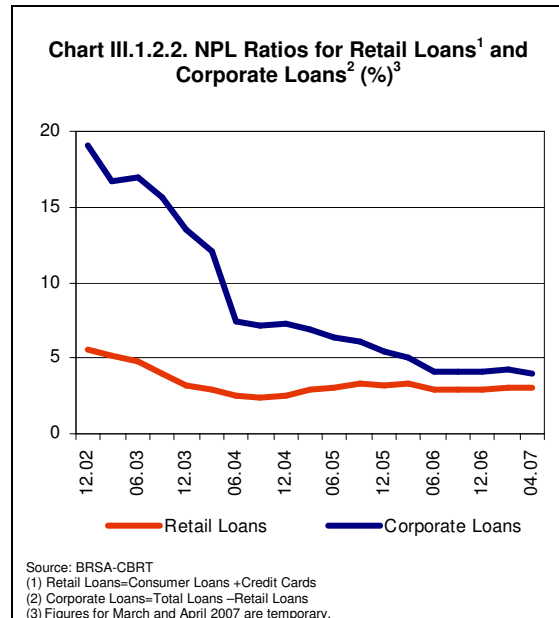
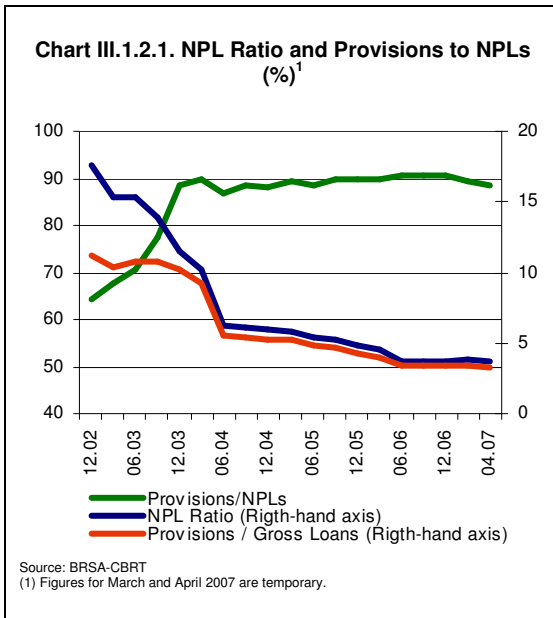
Non-performing loans increased by 9.2 percent in 2006 compared to the end of the previous year and reached 8.2 billion New Turkish Liras. The aforementioned amount rose to 8.4 billion New Turkish Lira as of April 2007 according to provisional data.

Table III.1.2.1. Total NPLs (Million YTL)¹

	2002	2003	2004	2005	03.06	06.06	09.06	12.06
Loans and Other Receivables with Limited Collectibility	1,207	924	595	813	878	823	961	1,149
Doubtful Loans and Other Receivables	2,596	2,296	415	775	790	842	902	820
Loans and Other Receivables Classified As Loss	6,626	5,409	5,342	5,907	6,025	5,920	5,910	6,212
Total NPLs	10,430	8,629	6,353	7,495	7,692	7,585	7,773	8,182

Source: BRSA-CBRT
(1) Excluding İller Bank.

Regarding the distribution of non-performing loans, in 2006, the share of loans and other receivables classified as loss maintains its dominance in the total non-performing loans. It is also remarkable that loans and other receivables with limited collectibility and loans and other receivables classified as loss increased starting from the third quarter of 2006 (Table III.1.2.1).



The limited decline in the NPL ratio⁹ despite the upward trend in NPLs in 2006 resulted from the greater rate of increase in the credit volume in this period (Chart III.1.2.1). Provisions to the credits ratio decreased despite the continued high provisioning policy for NPLs (Chart III.1.2.1). On the other hand, the banking sector maintains approximately 0.8 percent general provisions for standard and closely monitored cash loans in 2006.

Regarding the development of non-performing loans by economic units, the NPL ratios for both the retail loans and corporate loans decreased in 2006. As of April 2007, the NPL ratio for corporate loans continued to decrease, whereas for retail loans it increased slightly (Chart III.1.2.2). It is also expected that the Anatolian Approach that was initiated as of 2006 will have a positive impact on NPL ratios for corporate loans.

⁹ Non-Performing Loan Ratio = Gross Non-Performing Loans / Gross Loans

Box III.1.2.1. Anatolian Approach

“Law No.5569 on Restructuring of the Debts of Small and Medium Scale Enterprises (SMEs) to Financial Sector”, which is more comprehensive than “Law No:4743 on the Restructuring of Debts to Financial Sector and Amendments to Some Laws” dated January 31, 2002 and which is known as the Anatolian Approach by the general public, was published in the Official Gazette dated December 30, 2006 and numbered 26392. Law No.5569 is aimed at restoring the contribution to the economy of small and medium scale enterprises, which were excluded from the Istanbul Approach, producing commodities and services capable of adding value and having a financial bottleneck that requires restructuring to continue activities, and hence increasing employment by this way.

According to Law No.5569, SMEs are defined as enterprises which employ less than 250 employees annually or whose annual net sales revenue or asset size do not exceed 25 million New Turkish Liras and their loans, which were granted prior to October 31, 2006 and were transferred to the frozen or doubtful receivables accounts of banks or other financial institutions (leasing, factoring, consumer finance and asset management companies and Credit Guarantee Fund Management) will be restructured under certain conditions and time limits that will be determined by the framework agreements of financial restructuring.

The measures to be taken by the agreements of financial restructuring are; extending the maturities of the loans; renewing the loans of enterprises (except for SDIF and Emlak Bankasi under liquidation); granting additional new loans to enterprises (except SDIF and Emlak Bankasi under liquidation); deducting or forgoing principal and/or original interest and/or default interest or dividends; converting fully or partially into a subsidiary (excluding Ziraat Bankasi, Halk Bankasi, Emlak Bankasi under liquidation and SDIF banks), to transfer in return for a certain amount of cash, in kind or by means of collection; liquidating fully or partially against belongings of indebted or third persons; engaging in protocols with other banks.

With Law No.5569, unpaid debts on utilities, taxes and insurance premiums of SMEs that were due by October 31, 2006, shall also be suspended for up to 24 months by applying the legal interest rate and without seeking any guarantee and the application should be filed within 2 months from the contract date.

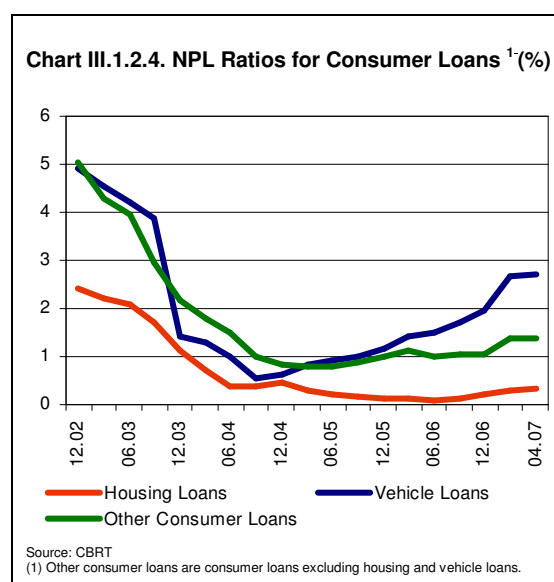
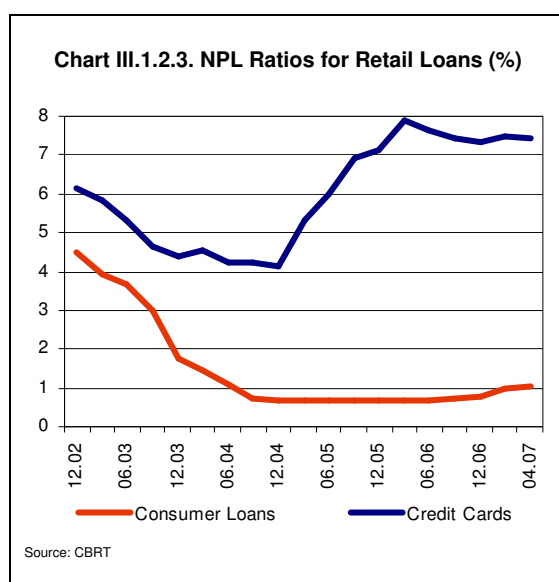
The Framework Agreement prepared by the Banks Association of Turkey was published on March 20, 2007, following the publication of the secondary regulation dated January 31, 2007 regarding Law No.5569. As of April 3, 2007, the Framework Agreement, which was signed by 9 deposit banks, 3 participation banks, 3 development and investment banks and 7 non-bank financial institutions was approved by the BRSA Decision No:2155 dated April 4, 2007. Commencing on the approval date of agreements, it is necessary for the participating financial institutions and SMEs under scope to sign the agreements of financial restructuring within 2 years.

Table III.1.2.2. NPL Ratios and Provisions to NPLs for Selected Countries (%)

	NPL Ratio					Provisions / NPLs				
	2003	2004	2005	2006	Last Data	2003	2004	2005	2006	Last Data
Argentina	17.7	10.3	5.0	3.4	November	79.2	102.9	124.6	128.5	March
Brazil	4.8	3.8	4.4	-	December	144.6	162.1	145.5	-	December
Bulgaria	3.2	2.0	2.2	2.2	December	50.0	48.5	45.3	47.6	September
Czech Republic	4.9	4.1	4.3	4.1	September	76.7	69.4	63.2	62.2	September
Croatia	5.2	4.6	4.0	3.5	December	60.6	60.1	58.2	55.5	June
Hungary	3.0	2.9	2.7	2.7	September	47.3	51.3	54.4	-	December
Latvia	1.4	1.1	0.7	0.5	June	89.4	99.1	98.8	110.0	June
Lithuania	3.0	2.3	0.6	1.1	December	-	-	-	-	
Poland	10.4	9.2	7.7	6.6	June	53.4	61.3	61.6	57.8	September
Romania	8.3	8.1	8.3	8.4	September	-	45.6	45.6	47.1	September
Russia	5.0	3.8	3.2	2.7	September	118.0	139.5	156.3	159.3	September
Slovakia	3.7	2.6	5.0	3.7	August	85.8	86.4	85.1	99.0	September
Ukraine	28.3	30.0	19.6	17.8	December	22.3	21.0	25.0	23.1	December
France	4.0	3.7	3.3	3.2	June	57.7	57.6	59.7	58.7	June
Germany	5.3	5.1	4.1	4.0	June	-	-	-	-	
Greece	5.1	5.4	5.5	5.5	June	49.9	51.4	61.9	60.9	June
Italy	6.7	6.6	5.3	-	December	-	-	-	-	
United Kingdom	2.5	1.9	1.0	-	December	71.2	64.5	56.1	-	December
USA	1.1	0.8	0.7	0.7	September	140.4	168.1	155.0	148.4	September
Turkey	11.5	6.0	4.8	3.8	December	88.6	88.1	89.8	90.8	December

Source: IMF Global Financial Stability Report, April 2007, BRSA-CBRT

As of 2006, the NPL ratio in Turkey was below certain countries such as the Czech Republic, Poland, Romania, the Ukraine, Greece and Germany; whereas provisions to the NPLs ratio was higher than that of most selected countries except Argentina, Latvia, Russia, the Slovak Republic and the USA (Table III.1.2.2).



The NPL ratio for credit cards, which had reached its peak level with 7.9 percent as of March 2006, started to decrease after this period. On the other hand, the NPL ratio for consumer credits displayed an increasing trend in the second half of 2006 and this limited increase stemmed from vehicle loans (Chart III.1.2.3, Chart III.1.2.4).

Despite this increase in the NPL ratio for consumer loans, the wider customer base and easier cash convertibility of collaterals of such loans, limit the credit risk for banks.

Table III.1.2.3. NPL Ratios for Some Selected Sectors (%)¹

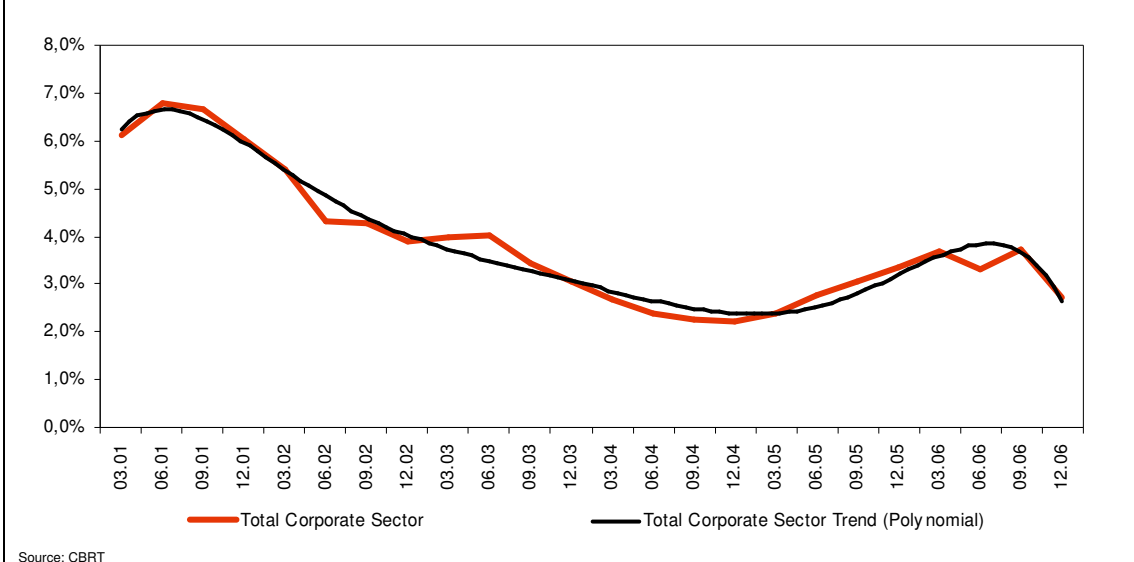
	2002	2003	2004	2005	2006
1 Wholesale and Ret. Trade, Brokerage, Repair of Mot. Veh	26.1	15.5	5.2	3.9	2.3
2 Transport, Storage and Communication	7.3	3.6	2.1	3.4	1.3
3 Textile and Textile Product Industry	18.8	12.5	8.1	10.0	11.2
4 Construction	11.9	7.0	4.9	4.3	4.0
5 Industry of Tobacco, Beverages and Food	15.7	10.6	5.9	3.8	3.8
6 Manufacture of Basic Metals and Fabricated Metal Prod.	16.1	9.3	4.1	2.7	0.9
7 Sources of Electricity, Gas and Water	0.3	0.2	0.3	0.2	0.2
8 Agriculture, Hunting and Forestry	8.7	6.3	4.7	3.4	3.1
9 Manufacture of Machinery and Equipment	12.5	9.7	4.4	5.0	2.1
10 Hotels and Restaurants (Tourism)	17.9	13.1	5.9	3.1	2.4

Source: CBRT

(1) Loans are compiled based on bank reportings under the scope of Central Bank Law No:1211, Article:44. They include those loans that are greater than ten thousand New Turkish Liras (inclusive); extended to real and legal bodies; by banks (including external loans used by firms with the intermediation of banks). They are inclusive of accrued interest and exclusive of non-cash loans. Therefore, they differ from the NPL figures in the balance sheet-based analysis.

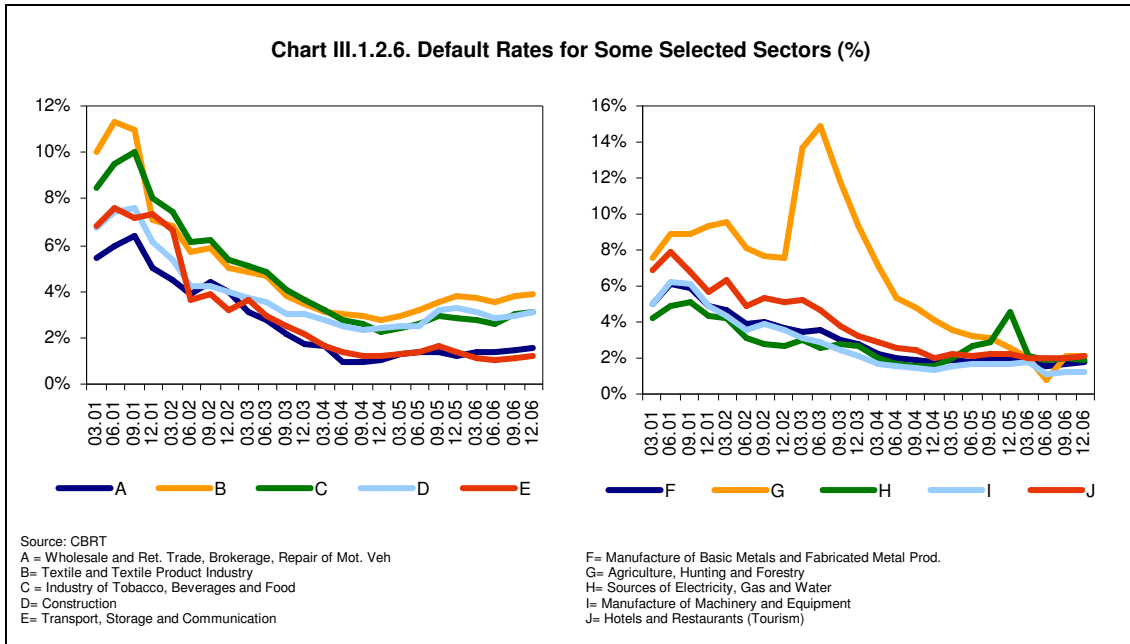
According to the Central Bank Risk Center data, as of year-end 2006, the NPL ratio for “Textile and Textile Products” increased compared to the previous year-end and the NPL ratios for “Electricity, Gas and Water resources” and “Food, Beverages and Tobacco Industry” sectors remained the same, while NPL ratios for all other sectors decreased (Table III.1.2.3).

Chart III.1.2.5. Default Rate for Total Corporate Loans (Number, %)



Source: CBRT

For the 29 sectors monitored by the Risk Center, the default rate, which is the ratio of the number of firms in the NPL accounts in the current period to total number of firms using credits, decreased from 3.3 percent as of year-end 2005 to 2.7 percent as of 2006. (Chart III.1.2.5).



Regarding the top ten sectors utilizing most of the credits, the average default rate was 2.6 percent as of the previous year-end, whereas it decreased to 2.2 percent as of year-end 2006. Although its contribution to the manufacturing industry production became negative because of the decline in its production capacity and thus it borrowed less, the highest rate as of year-end 2006 belongs to the “Textile and Textile Products” sector, which has a share of more than 25 percent in total NPLs of the corporate sector (Chart III.1.2.6).

The default rates of the “Wholesale and Retail Trade”, “Food, Beverages and Tobacco Ind.” and “Textile and Textile Products” sectors increased as of year-end 2006, compared to the previous year-end, whereas for all other sectors it decreased (Chart III.1.2.6).

In addition, the default rates of the “Textile and Textile Products”, “Food, Beverages and Tobacco Ind.” and “Construction” sectors are above the sector average as of year-end 2006.

Box III.1.2.2. Correlations Between the Default Rates of Sectors

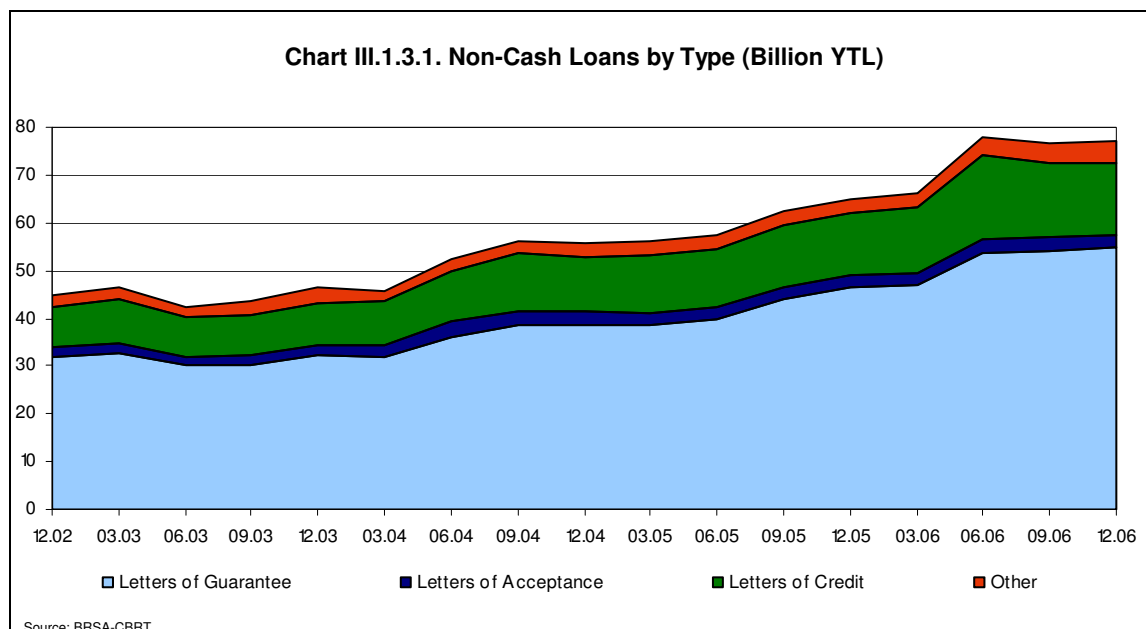
The correlations between the default rates of sectors are calculated in Table 1. Considering the correlation matrix, it is observed that the default rates of sectors are positively correlated and thus it is thought that any negative developments in the macro variables may affect the whole corporate sector credit portfolio more or less in the same way. Hence, despite the downward trend of default rates, as also indicated in financial literature, credit expansion in periods of economic expansion always increases the exposure of the banking sector to credit risk. In this framework, it is thought that the demand of the corporate sector for bank loans, which are the most important financial resources needed in a growing economy, should be met prudently based on sound and effective techniques of analysis. This is one of the leading ways in the effective risk management of the banking sector and in decreasing the fragility of the financial system.

Table 1. Correlation Matrix ¹

		1	2	3	4	5	6	7	8	9	10
1	Wholesale and Ret. Trade, Brokerage, Repair of Mot. Veh	1.00									
2	Transport, Storage and Communication	0.61	1.00								
3	Textile and Textile Product Industry	0.77	0.78	1.00							
4	Construction	0.65	0.88	0.88	1.00						
5	Industry of Tobacco, Beverages and Food	0.38	0.45	0.70	0.69	1.00					
6	Manufacture of Basic Metals and Fabricated Metal Prod.	0.73	0.81	0.93	0.88	0.67	1.00				
7	Sources of Electricity, Gas and Water	0.12	0.15	0.28	0.13	0.25	0.40	1.00			
8	Agriculture, Hunting and Forestry	0.31	0.38	0.55	0.63	0.53	0.57	0.13	1.00		
9	Manufacture of Machinery and Equipment	0.79	0.81	0.90	0.89	0.63	0.92	0.17	0.53	1.00	
10	Hotels and Restaurants (Tourism)	0.67	0.66	0.59	0.53	0.33	0.71	0.51	0.21	0.64	1.00

Source: CBRT
(1) The trend is eliminated by using HP filter.

III.1.3. Non-Cash Loans



The ratio of off-balance sheet liabilities, which include non-cash loans and commitments, to total assets, was 16.3 percent as of year-end 2005 and decreased to 15.9 percent as of year-end 2006. This decrease stemmed from the higher growth rate in total assets (Chart III.1.3.1).

The ratio of non-cash loans, which includes mostly letters of guarantee and letters of credit, to cash loans, was 41.2 percent as of year-end 2005 and decreased to 35.4 percent as

of year-end 2006. The share of foreign currency denominated non-cash loans was 64.4 percent as of year-end 2006.

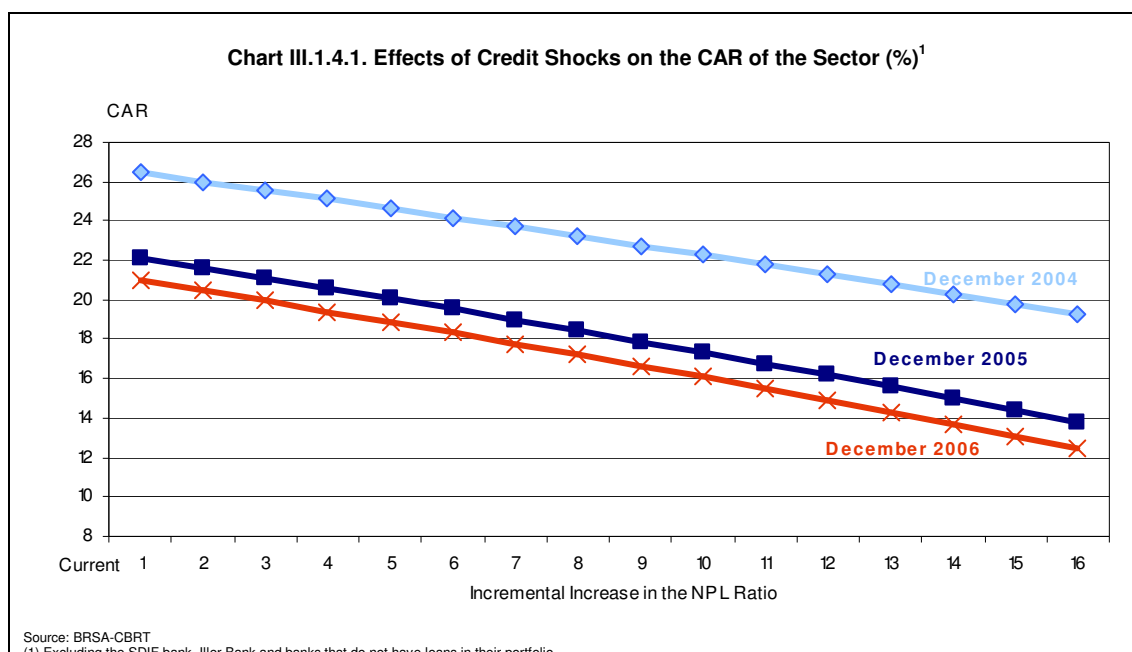
III.1.4. Credit Risk Scenario Analysis

With the aim of assessing the credit risk that the banking sector might be exposed to, analyses were conducted on how the CARs of banks will be affected by an increase in their NPL ratios, as of December 2006.

Within this framework, scenario analyses were conducted under the following assumptions:

- i) The total credit volume of banks remains unchanged.
- ii) NPLs resulting from shocks have the same composition as the existing NPLs of banks. For banks which did not have any NPLs before the shocks, after shock NPLs are classified as “loans and other receivables with limited collectibility”, setting aside a 20 percent provision.
- iii) New NPLs resulting from shocks were accounted for in the 100 percent risk weight category for the calculation of the CARs before such shocks.
- iv) There is no change in the total risk weighted assets and own funds of banks other than the shocks.

Moreover, collateral amounts were not taken into consideration when calculating additional provisions.



The effects of 1-15 points incremental increases of the NPL ratio on the CAR of the banking sector were analyzed¹⁰. While a 15-point increase in the NPL ratio of the banking sector led to a fall of 8.5 points in the CAR of the banking sector as of 2006, this decrease was not so different compared to the effect of the same shock on CAR as of December 2005. Even after the largest shock, the CAR of the banking sector was realized as 12.5 percent as of

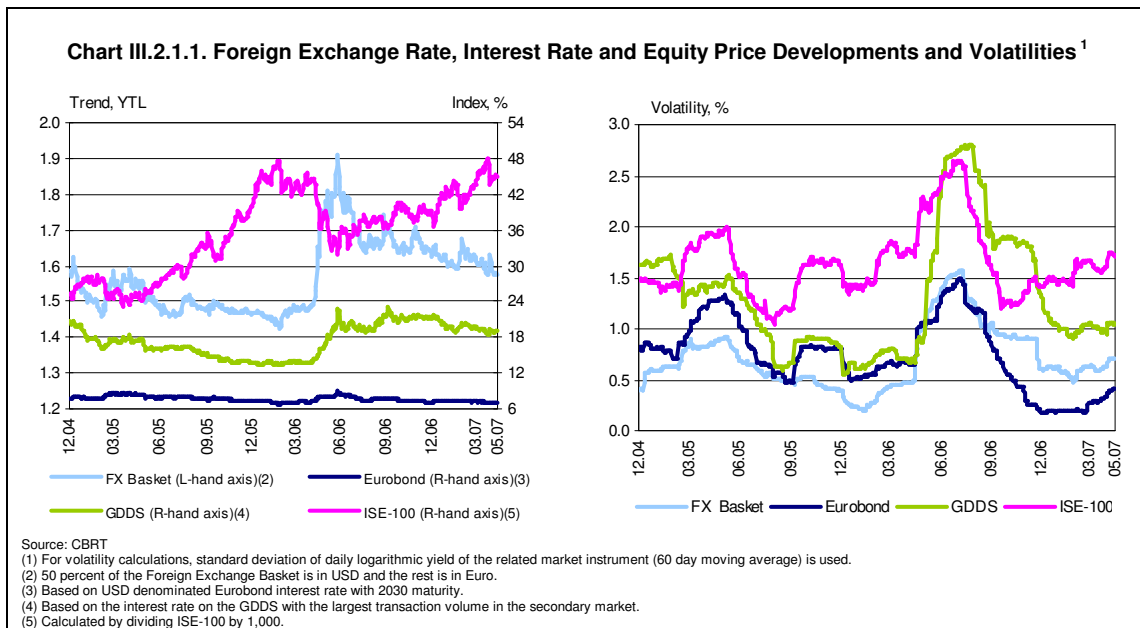
¹⁰ After the non-performing receivable classification of credits and additional provisions, the after-shock CAR is calculated as: (Own funds-Additional Provisions) / (Total Risk Weighted Assets-Additional Provisions) x 100.

December 2006, despite the fact that the starting level of CAR was lower than that of December 2005 (Chart III.1.4.1).

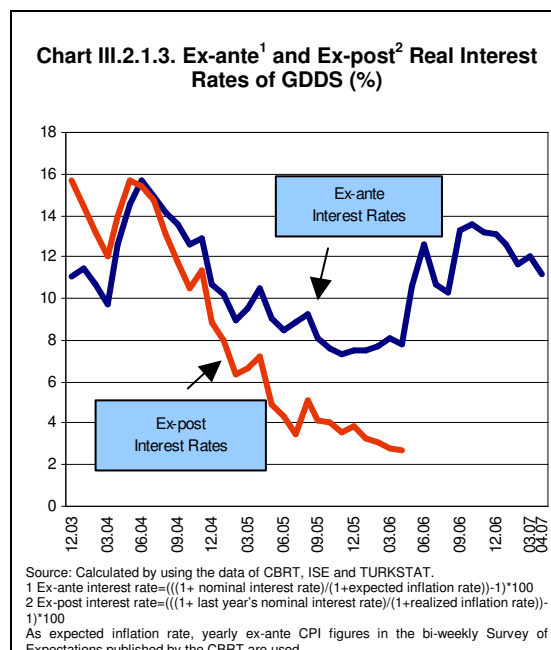
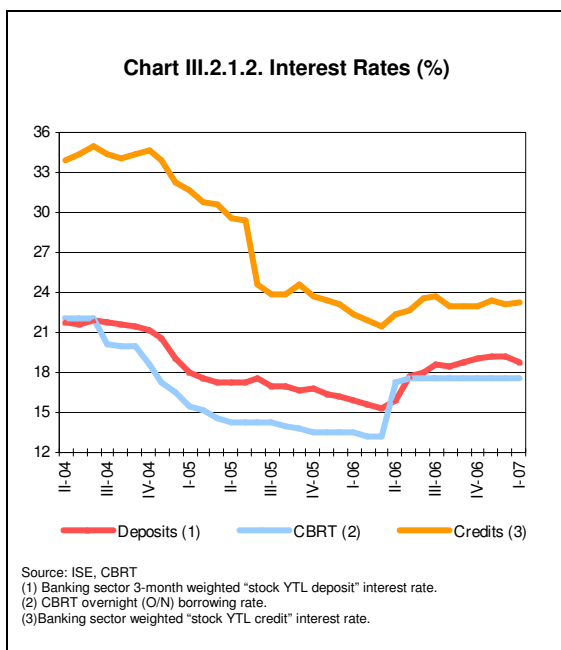
III.2. Market Risk and Scenario Analysis

III.2.1. Market Risk

In this section, along with the analysis of the effects of the developments in interest rate and FX risk on the banks' balance sheets, two hypothetical scenarios based on historical data were designed and their effects were analyzed.

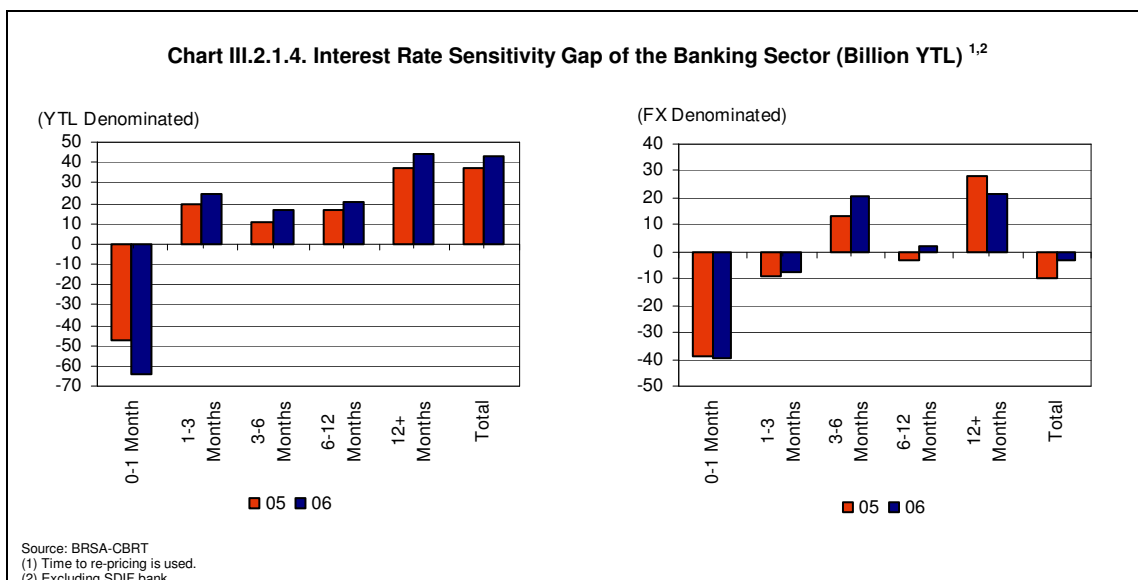


Financial stability in the financial markets has been restored due to the measures taken following the May-June fluctuations. However, the fluctuation in international markets in February 2007 has also had an adverse effect on Turkey, resulting in a depreciation of the YTL and a rapid fall in the ISE index. Despite this fluctuation, interest rates started to decline due to the amelioration in inflation expectations in the first five months of 2007, the increase in global liquidity conditions and increased risk appetite and hence, equity prices increased and YTL appreciated. Nonetheless, the volatility of markets started to exhibit an increasing trend. (Chart III.2.1.1).



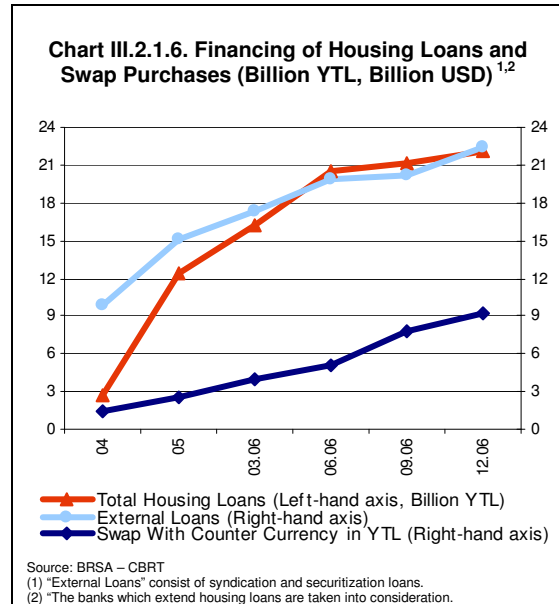
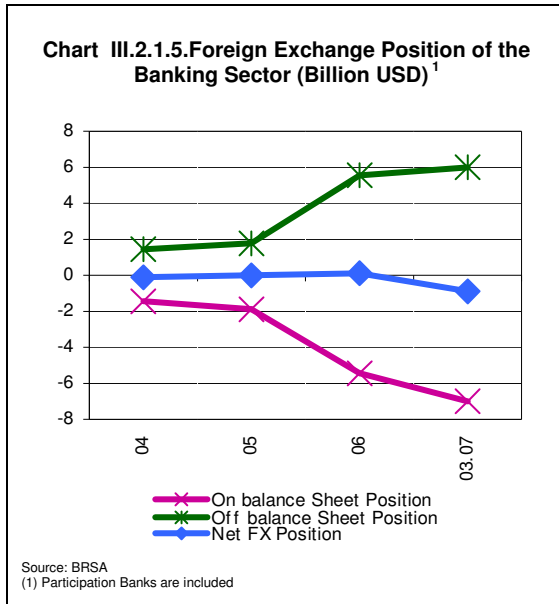
Even though the interest rates of deposits and credits increased in 2006 compared to 2005, the margin decreased. It is thought that the contraction in margin is due to consumer loans which are fixed rated (Chart III.2.1.2).

The ex-ante real interest rate, which used to be 7.6 percent as of year-end 2005, increased to 13.1 percent as of year-end 2006 due to the increase in interest rates. However, the ex-ante real interest rates declined to 11.2 percent as of April 2007, due to the downward trend in raw-material prices in the last period, global liquidity conditions in favor of developing countries and the decline in interest rates beyond inflation expectations. (Chart III.2.1.3).



In terms of time to repricing, the interest rate sensitivity gap of the banking sector both in YTL and FX is concentrated in the 0-1 month maturity bracket as of December 2006, just as in the previous periods. In the December 2005-2006 period, while the YTL denominated interest rate sensitivity gap increased in the 0-1 month maturity bracket, the positive gap in all other brackets increased. This situation indicates a shortening in the maturity structure of banks' liabilities in this period.

In the same period, the FX denominated sensitivity gap in 0-1 month maturity bracket remained nearly the same, whereas the gap in the 6-12 month maturity bracket became positive. In total, the YTL denominated positive gap increased by 2 billion New Turkish Liras, while the FX denominated gap decreased by 5.5 billion New Turkish Liras (Chart III.2.1.4).



The FX net general position (FXNGP) of the banking sector was almost balanced in 2006 and then turned into a short position starting in 2007. On the other hand, parallel to the progress of the off-balance sheet long position, the on balance sheet short position was in the 5-7 billion US dollar range starting from the first quarter of 2006 (Chart III.2.1.5)

Turkish lira credits funded with foreign currency sources used from abroad are the main reason of the short on balance sheet position of the banking sector, especially in 2006. Due to the increasing number of YTL denominated bond issues by foreign institutions since 2005, banks convert part of their long-term FX credits provided from abroad into YTL with swap transactions and lend long-term housing loans without taking any FX risk (Chart III.2.1.6).

The total amount of the selected derivatives with counter currency in YTL (YTL/FX) of the banking sector, which balances its on balance sheet short position with the off balance sheet long position, was almost 14.2 billion USD as of December 2006 and an amount equivalent to 12.5 billion US dollars was realized by financial sector institutions.

III.2.2. Scenario Analyses

III.2.2.1. Interest and Exchange Rate Shocks

In this section, based on the assumption that the interest rate increase and depreciation of YTL shocks occur independently, their individual and total impact on the banking sector are analyzed in two scenarios.

In Scenario A, it is assumed that Turkish Lira depreciates by 30 percent against other currencies, New Turkish Lira and FX interest rates increase by 6 and 5 points, respectively and Eurobond prices decrease by 5 percent.

In Scenario B, it is assumed that Turkish Lira will depreciate by 30 percent, Eurobond prices will decrease by 5 percent and interest rate increases will be twice as much as interest rate fluctuations during the May and June period¹¹.

Table III.2.2.1.1. Interest and FX Rate Increase Scenarios

	SCENARIO A	SCENARIO B
A. Depreciation of YTL	30 percent depreciation of YTL against other currencies	30 percent depreciation of YTL against other currencies
B. Interest Rate Increase-YTL	Re-pricing of YTL interest sensitive assets and liabilities falling in 0-1 and 1-3 month maturity brackets at 6 points higher	Re-pricing of YTL interest sensitive assets and liabilities falling in 0-1, 1-3, 3-6 month maturity brackets at 9, 8, 11 points higher, respectively.
C. Interest Rate Increase-FX	Re-pricing of YTL interest sensitive assets and liabilities falling in 0-1 and 1-3 month maturity brackets at 5 points higher	Re-pricing of YTL interest sensitive assets and liabilities falling in 0-1, 1-3, 3-6 month maturity brackets at 1.1, 0.7, 1.1 points higher, respectively.
D. Trading Portfolio-YTL ¹	6 points increase in market interest rates of YTL denominated fixed income securities in the trading portfolio	Increase in market interest rates of YTL denominated fixed income securities in the trading portfolio by 9, 8, 11 points for the 0-1, 1-3, 3-6 month maturity brackets, respectively.
E. Eurobond Portfolio	Decrease in prices of Eurobonds in the trading portfolio by 5 percent	Decrease in prices of Eurobonds in the trading portfolio by 5 percent

(1) BRSB defines the trading portfolio as "Securities in the trading portfolio" and "Securities available for sale" in accordance with the description of the Basel Committee.

For the calculation of the impact of depreciation scenarios, FXNGP data of banks is used. On the other hand, to calculate the impact of interest rate increase scenario, the re-pricing gap method, which complements the standard method and the implementation of which is recommended by the Basel Committee on Banking Supervision, is utilized. Within this context, the difference between interest rate sensitive assets and liabilities in the "time to re-pricing" maturity brackets of 0-1, 1-3 and 3-6 months are used.

Scenario analyses, which are based on re-pricing gap data, are conducted under the following assumptions:

¹¹ GDDS interest rates are used for the interest rate increase in Scenario B.

- Interest rate sensitivity of the banks' assets and liabilities remain unchanged during the analysis period,
- Demand deposits are not interest rate sensitive,
- There are no new fund inflows or outflows,
- Interest rate increases will last for 3 months under Scenario A and for 6 months under Scenario B.

The loss in value of YTL denominated fixed income securities and Eurobond portfolio stemming from interest rate increases are also calculated.

Table III. 2.2.1.2. Results of Market Risk Scenarios (Million YTL)¹

	Scenario A			Scenario B		
	2004	2005	2006	2004	2005	2006
A. YTL Depreciation						
a. Total	-52	-73	80.4	-52	-73	80.4
Profit (Loss)/Equity (%)	-0.1	-0.2	0.2	-0.1	-0.2	0.2
b. Banks Gaining Profits	293	71	269.7	293	71	269.7
c. Banks Suffering Losses	-345	-143	-189.4	-345	-143	-189.4
Banks Suffering Loss/Equity (%)	-2.1	-0.5	-1.4	-2.1	-0.5	-1.4
B. Interest Rate Increase						
a. YTL	49	8	-172.2	595	483	258.3
b. FX	-248	-352	-290.2	-53	-62	-2
Profit (Loss) due to Interest Rate Increase (a+b)	-198	-345	-462.4	542	421	256.3
Profit (Loss) due to Interest Rate Increase/Equity (%)	-0.5	-0.8	-0.9	1.5	1	0.5
C. YTL Trading Portfolio						
Loss in Value due to Interest Rate Increase	-951	-1,480	-1,549	-1,672	-2,583	-2,701
Loss in Value due to Interest Rate Increase/Equity (%)	-2.6	-3.6	-3	-4.6	-6.3	-5.2
D. Eurobond Portfolio						
Loss in Value	-505	-518	-632	-505	-518	-632
Loss in Value/Equity (%)	-1.4	-1.3	-1.2	-1.4	-1.3	-1.2
E. Total Impact						
Profit/Loss	-1,707	-2,415	-2,563	-1,687	-2,752	-2,997
(Profit/Loss)/Equity (%)	-4.6	-5.9	-5	-4.6	-6.7	-5.9
Current CAR of the Sector (%)	25.6	21.2	19.8	25.6	21.2	19.8
After-Shock CAR of the Sector² (%)	24.4	20	18.8	24.4	19.8	18.6

(1) Excluding SDFI bank, T. Kalkınma Bank, İller Bank and Eximbank.

(2) After-shock profit/loss amounts under the scenarios are assumed to affect only equity but not the risk weighted assets.

III.2.2.1.1. YTL Depreciation

In the depreciation of YTL scenario, the banking sector, which suffered losses as of December 2005 due to its short position, incurred profits as of December 2006 owing to its long position. The amount of losses suffered by banks due to their short positions as of December 2006 increased, compared to December 2005. Due to the increased amount of losses suffered and the low level of shareholders' equity held by those banks that suffered losses, the ratio of such losses to equity also increased. On the other hand, the total amount of profits incurred in the said scenarios, increased between December 2005 and December 2006 (Table III.2.2.1.2).

III.2.2.1.2. Interest Rate Increase and Loss in Value

i) As a result of Scenario A, both the YTL and FX denominated net interest income of the banking sector decreased as of December 2006. Under Scenario B, the YTL denominated net interest income increased, while FX denominated interest income decreased.

The decrease in the net interest income under Scenario A is due to the widening of the gap for the 0-1 month maturity bracket as of December 2006. In Scenario B, while the long position in the 3-6 month maturity bracket led to an increase in income compared to year 2005, the widening of the gap for the 0-1 month maturity bracket had a limiting effect on this increase.

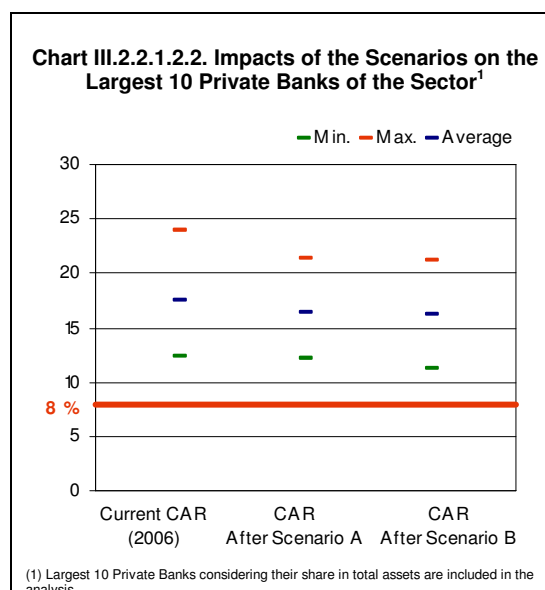
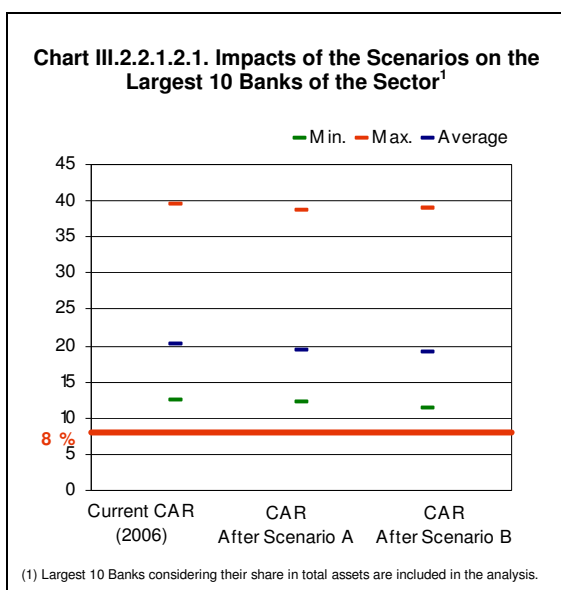
Considering the effects of interest rate increases on FX denominated assets and liabilities, even though there has been a decline in interest income in both Scenario A and B, the decline is lower compared to December 2005.

ii) Although, the loss of value in the discounted New Turkish Lira securities resulting from the interest rate increases rose in both scenarios, the ratio of these losses to shareholders' equity decreased as of December 2006 compared to December 2005.

iii) While the loss of value in the Eurobond portfolio increased in amount, its ratio to shareholders equity decreased due to the strengthened equity structure.

In conclusion, considering the strengthened equity structure of the banking sector in December 2006, the ratio of possible losses arising from shocks to equity declined.

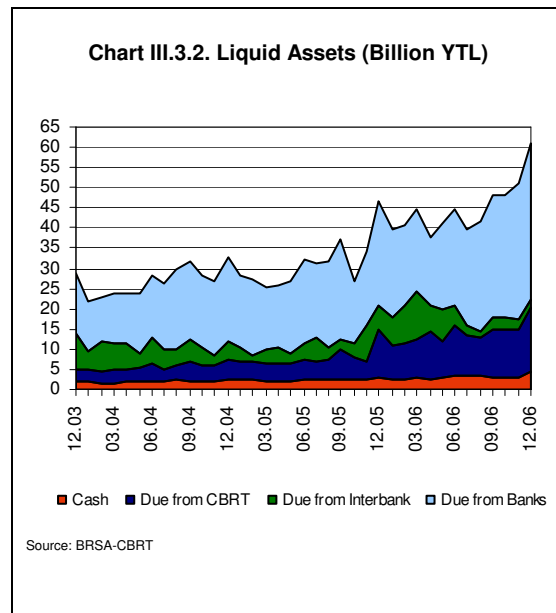
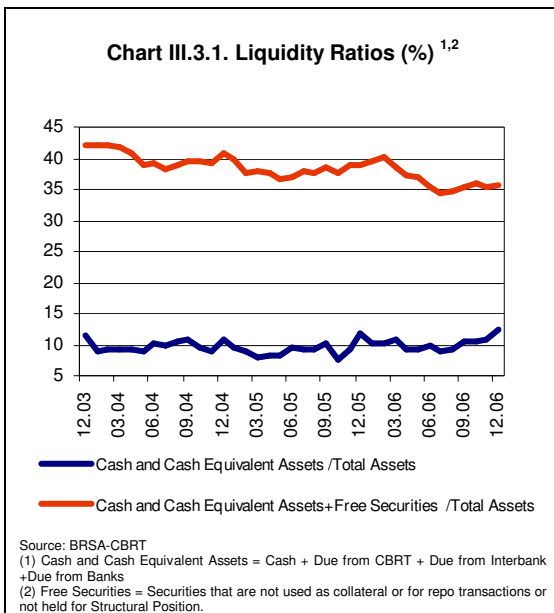
The analysis of the impact of Scenario A and B on the CARs of the largest 10 banks in relation to asset size indicates that the maximum, minimum and average CARs are not affected significantly.



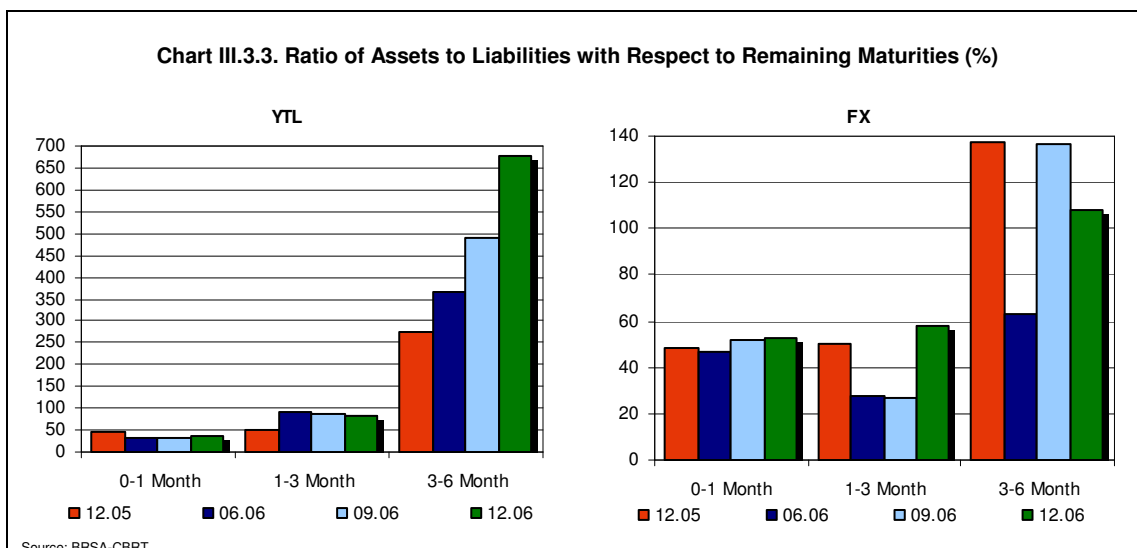
When the market risk shocks of Scenario A are applied to the underlying indicators of the Financial Strength Index, the index decreased from 117.6 to 113.8 by year-end 2006.

III.3. Liquidity Risk

Despite credit expansion, it is remarkable that the liquid assets of the banking sector, consisting of cash and cash equivalent assets, maintained a certain level and display an increasing trend since July 2006. Their share in total assets was realized as 12.5 percent as of December 2006, reaching its peak level for the last three years. However, the ratio becomes 35.8 percent, when the “free” securities that are not used as collateral or for repo transactions are taken into consideration (Chart III.3.1). The decreasing trend in this ratio has stemmed from the fact that the balance sheet structure of banks has changed in favor of loans and the share of the securities portfolio has decreased.

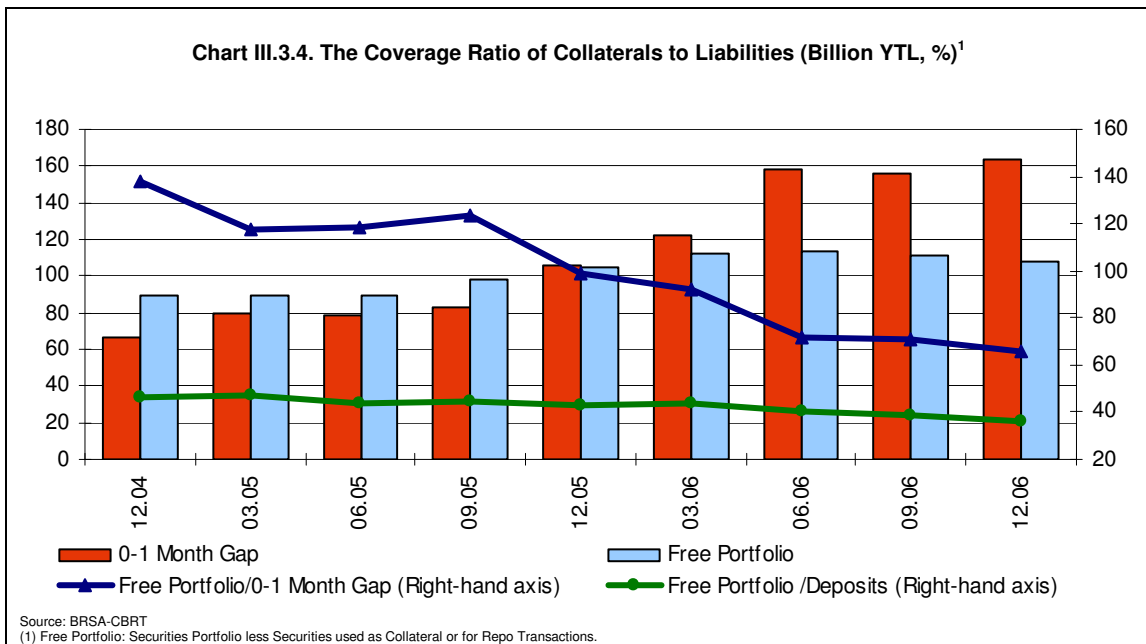


When the distribution of the cash and cash equivalent assets consisting of cash, due from the CBRT, the Interbank and banks, is analyzed, it is observed that the due from banks item has the highest share in liquid assets. The decrease of due from the Interbank item since May 2006 continues. On the other hand, the due from the CBRT maintains its increase (Chart III.3.2).



In the 0-1 month bracket with respect to the remaining maturity, the coverage ratio of assets to liabilities in domestic currency was low due to the short-term nature of liabilities. On the other hand, in the last quarter of 2006, the coverage ratio of assets to liabilities in the 3-6 month maturity bracket with respect to remaining maturity continues to increase due to the increase of assets in this bracket.

In foreign currency, in the 0-1 month and 1-3 month brackets with respect to remaining maturity, the coverage ratio of assets to liabilities increased and was realized above 50 percent, as of December 2006. This increase was due to the increase in assets of this maturity bracket in the last quarter. On the other hand, in the 3-6 month maturity bracket with respect to the remaining maturity, the coverage ratio of assets to liabilities decreased as a result of the increase in liabilities in this maturity bracket (Chart III.3.3).



The ratio of the free securities portfolio, which is among the collaterals to be accepted by the CBRT to provide liquidity in case of a temporary liquidity squeeze, to the difference between assets and liabilities in the 0-1 month maturity bracket was realized over 100 percent until year-end 2005, and thereafter it followed a declining trend until the end of June 2006. After this, it followed a relatively constant course. The ratio of free portfolio to deposits decreased from 43 percent at end-2005 to 36.4 percent at end-2006 (Chart III.3.4).

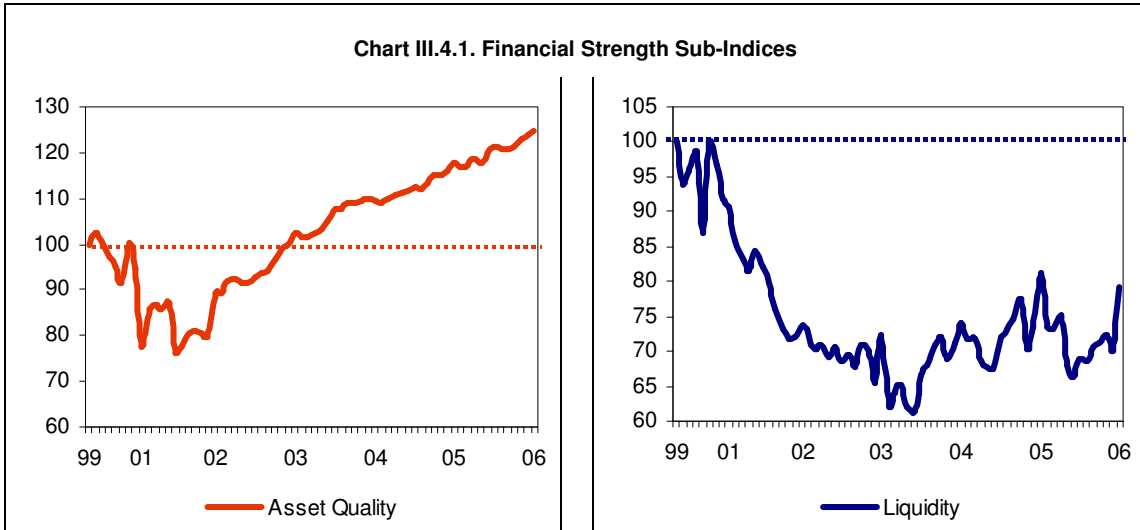
In general, deposits, which are the main source of funds for the Turkish banking sector, are concentrated in the 0-3 month maturity bracket, whereas the securities portfolio and loans are longer term. Despite the short-term nature of deposits, the adverse impact of the maturity mismatch relatively declines since a large proportion of time-savings deposits have core quality.

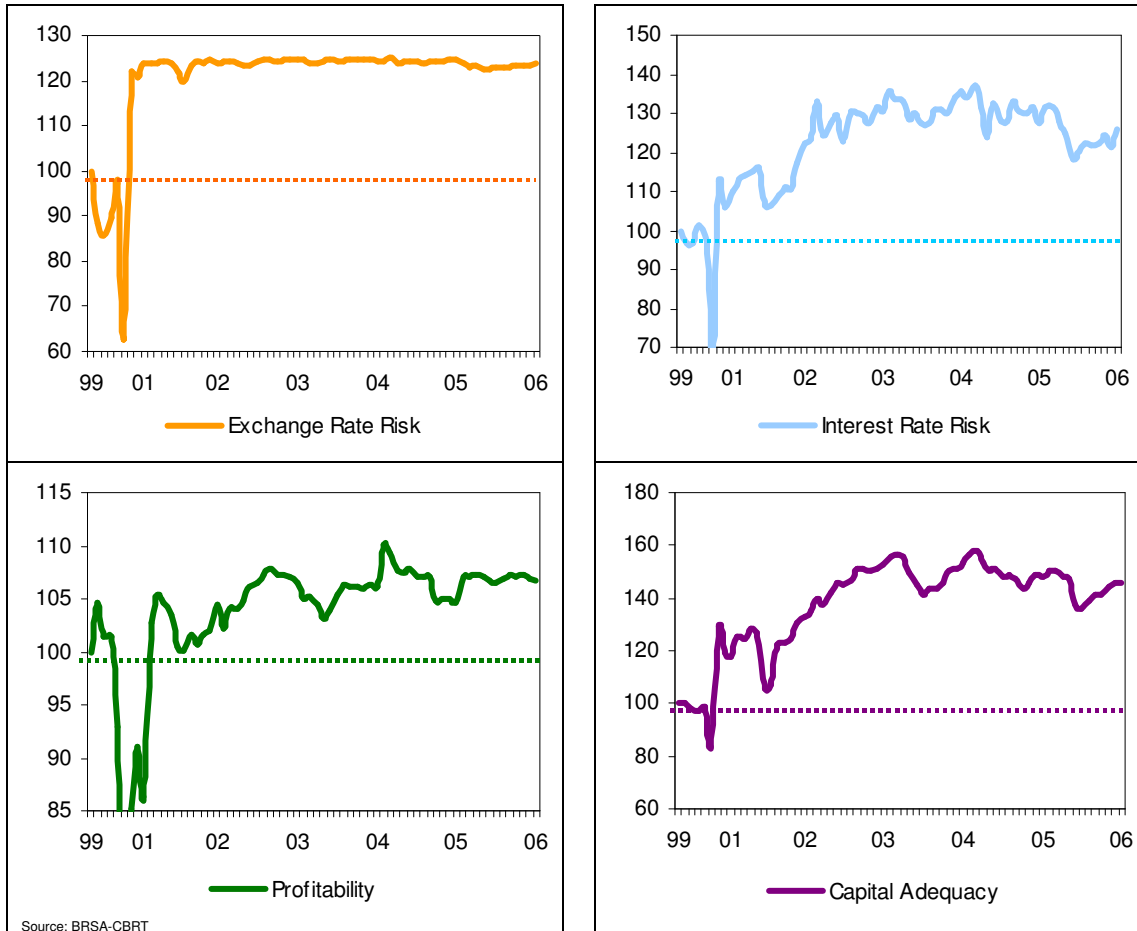
III.4. Financial Strength Index

When compiling the Financial Strength Index (FSI), specific ratios that reflect the risks and fragility of the sector are selected to form an “aggregate indicator”, and the direction of the movement of this index has been used to analyze the strength of the sector. Six sub-indicators are utilized to create the index, which are asset quality, liquidity, exchange rate risk, interest rate risk, profitability and capital adequacy indices (Box III.4.1)

Box III.4.1. Financial Strength Index Variables			
	Financial Strength Indicators	Direction of the Impact	Weights
Asset Quality	Gross Non-Performing Loans / Gross Loans	negative	0.33
	Net NPL / Shareholders Equity	negative	0.33
	Fixed Assets / Total Assets ¹	negative	0.33
Liquidity	Liquid Assets / Total Assets ²	positive	0.40
	Assets with a Maturity up to 3 Months / Liabilities with a Maturity up to 3 Months	positive	0.60
Exchange Rate Risk	On-Balance Sheet FX Position / Own Funds ³	negative	0.50
	FX Net General Position / Own Funds ⁴	negative	0.50
Interest Rate Risk	(Interest Sensitive YTL Assets with a Maturity up to 1 Month – Int. Sensitive YTL Liabilities with a Maturity up to 1 Month) / Equity ⁵	negative	0.50
	(Interest Sensitive FX Assets with a Maturity up to 1 Month – Int. Sensitive FX Liabilities with a maturity up to 1 Month) / Equity ⁵	negative	0.50
Profitability	Net Profit / Total Assets	positive	0.50
	Net Profit / Shareholders Equity	positive	0.50
Capital Adequacy	Free Capital / Total Assets ⁶	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) Own funds is the regulatory capital, and it is different from the equity in the balance sheet. The calculation is in absolute values.
(4) Foreign exchange net open position is the sum of on and off balance sheet foreign currency positions. The calculation is in absolute values.
(5) The calculation is in absolute terms.
(6) Free capital is calculated by deducting fixed assets from equity.





The assessment of the sub-indices that form the FSI is as follows (Chart III.4.1);

i. Asset Quality Index: The asset quality index, which was 117.8 by year-end 2005, continued to increase throughout 2006 due to the decrease in fixed assets to total assets and NPL ratio and was realized as 124.6 by year-end 2006.

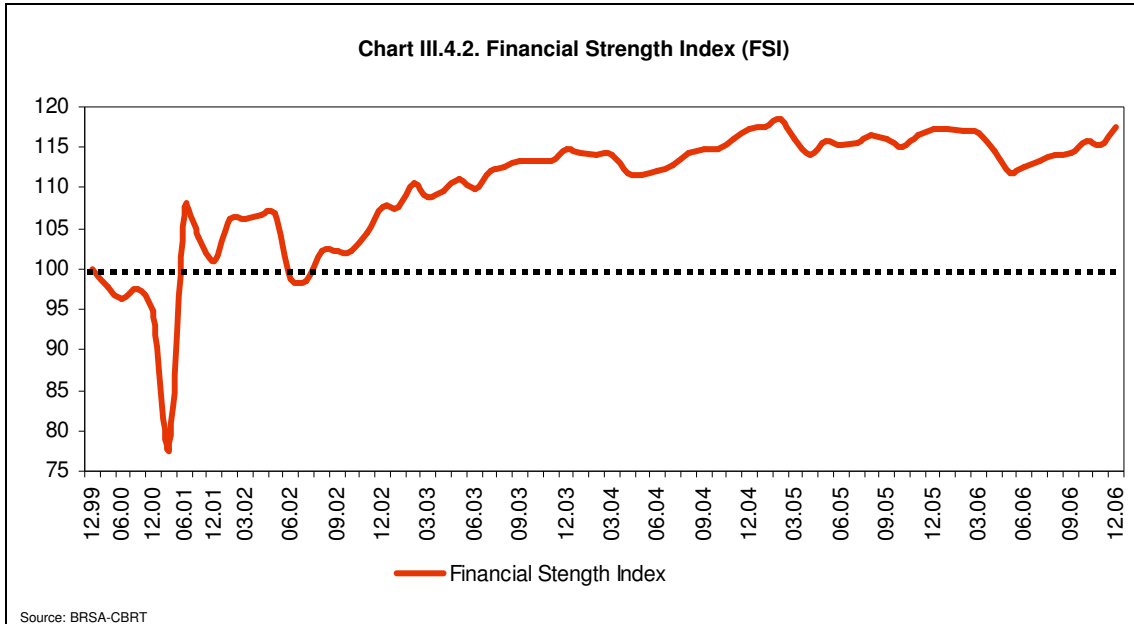
ii. Liquidity Index: The liquidity index dropped to 66.4 in May 2006, and, after a rapid recovery, it increased to 79.2 at end-2006.

iii. Exchange Rate Risk Index: The exchange rate risk index displays a stable trend and was realized as 123.7 by end-2006. The turbulence did not have an important impact on the exchange rate risk index due to the limited open position of the banking sector.

iv. Interest Rate Risk Index: The interest rate risk index, which was 127.6 by year-end 2005, decreased to 125.7 by year-end 2006. This decrease came as a result of the increase in the ratio to shareholders equity of the difference between interest sensitive assets in the maturity bracket up to 1 month and interest sensitive liabilities with the same maturity, which is denominated in YTL.

v. Profitability Index: The said index, which was 104.6 by year-end 2005, increased to 106.7 by year-end 2006 due to the increase in return on assets and return on equity of the banking sector.

vi. **Capital Adequacy Index:** The said index, which was 148.5 by year-end 2005 decreased to 145.5 by year-end 2006, due to the decline in the capital adequacy ratio.



The FSI, which was 117.4 by year-end 2005, decreased to its lowest level to 111.9 as of May 2006, due to the turbulence in financial markets and it recovered after June 2006, reaching 117.6 by year-end 2006 (Chart III.4.2).

IV. PAYMENT SYSTEMS

The smooth operation of payment systems promotes the efficiency and effectiveness of the financial system, therefore it is important for the effective implementation of monetary policy. Besides, the contagion possibility of participants' problems to other parts of the financial system through payment systems, increases the importance of payment systems for financial stability. Hence, central banks give full weight to the determination and prevention of possible risks inherent in payment systems.

This section presents current developments related to the Turkish Interbank Clearing-Real Time Gross Settlement System (TIC-RTGS), which has systemic importance, as well as the Electronic Security Transfer and Settlement System (TIC-ESTS) through which primary market transactions of Turkish Government securities are realized, and the Interbank Clearing House (ICH) since cheque usage still maintains its importance.

Box IV.1. Payment Systems Oversight

The oversight of payment and settlement systems is defined by the Committee on Payment and Settlement Systems, which handles payment systems within the Bank for International Settlements (BIS), as a central bank task principally intended "to promote the smooth functioning of payment systems and to protect the financial system from the possible "domino effects" which may occur when one or more participants in the payment system experience credit or liquidity problems".

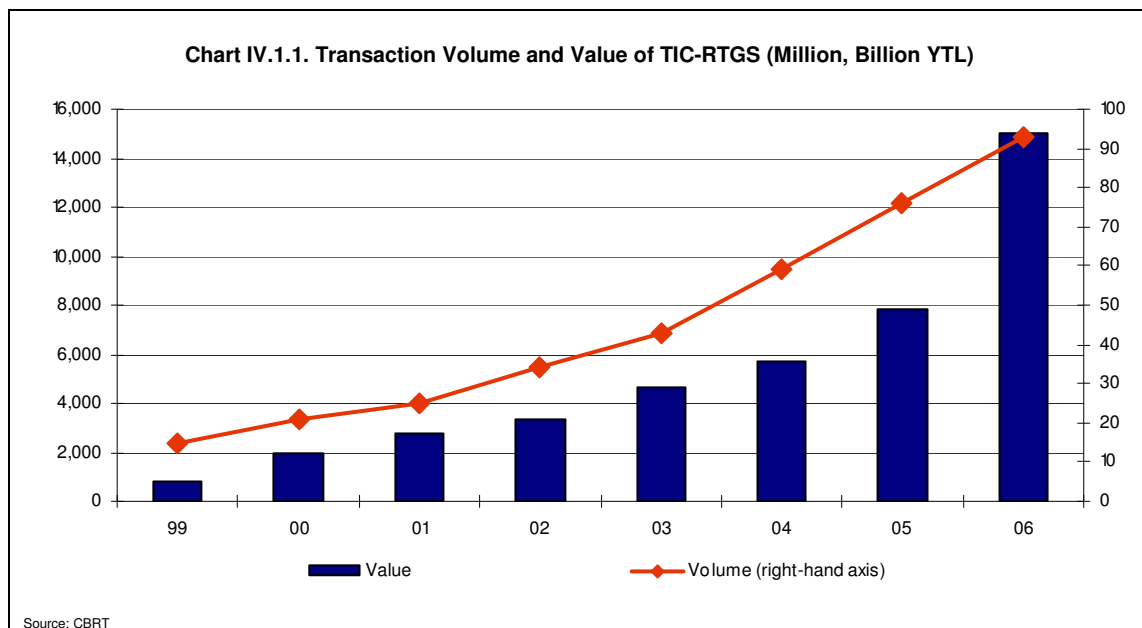
The main aim of central banks regarding payment systems oversight is to enable the safe and efficient functioning of payment systems. Because of this, payment systems should have a solid legal basis which ensures the safe execution of payment transactions, and mechanisms which control the financial and operational risks that might prevent the system from functioning properly. In addition, in order to have an effective and economically efficient system, it is essential that participants can handle transactions easily with minimum cost.

Globally, central banks are furnished with the oversight authority of payment systems via the law. In Turkey, the oversight power of payment systems is provided by the CBRT Law No:1211. Article 4 of the CBRT Law authorizes the CBRT to establish payment and securities transfer and settlement systems and to set forth regulations to ensure the uninterrupted operation and oversight of the existing or future systems. With this authority, the CBRT established TIC-RTGS & ESTS to ensure interbank funds and securities transfer, and based on Law No: 3167 established the Interbank Cheque Clearing Houses Center as a private legal entity to enable the clearing and settlement of cheques. TIC-RTGS & ESTS is operated by the CBRT, however cheque clearing operations are carried out by the ICH under the supervision of the CBRT.

Central banks fulfill their payment systems' oversight task in several ways such as research, assessment and intervention (CPSS Core Principles – January 2001). In the research stage, central banks collect information from statistical data related to payment systems, reports, institutions which operate the system and system participants. Additionally, in this stage, the risks that might arise in the system are determined and scenario analyses are conducted. In the assessment phase, the effectiveness and availability of mechanisms, that will be developed so as to minimize the losses caused by risks, are assessed. In the intervention phase of the oversight operation, the objectives and policies of oversight are publicised and, if necessary, the system principles and working methodology are amended and emergency procedures, which shall enable the completion of an operating day in state of emergency, are prepared.

IV.1. Turkish Interbank Clearing-Real Time Gross Settlement System (TIC-RTGS)

Electronic interbank funds transfer and real time gross settlement of New Turkish Lira payments are realized through the TIC-RTGS, which is owned and operated by the CBRT. The total transaction value of TIC-RTGS reached 26.1 times the annual GNP. In addition, the final settlement of other systems through the TIC-RTGS, as well as its growing usage increases the importance of the system for both financial stability and the Turkish economy.



In 2006, the transaction value of TIC-RTGS increased by 92.4 percent, while the volume of transactions increased by 22.5 percent (Chart IV.1.1).

Table IV.1.1. Real Time Gross Settlement (RTGS) Systems-Country Comparison

Country – Name of Payment System	2001	2002	2003	2004	2005
Belgium (ELLIPS)					
Transaction Volume (Million)	1.8	1.7	1.8	1.8	1.8
Transaction Value (Billion USD)	12,808	12,573	15,307	18,233	21,448
France (TBF)					
Transaction Volume (Million)	3.8	3.8	3.9	4.0	4.3
Transaction Value (Billion USD)	78,364	86,003	108,750	134,697	151,425
Netherlands (TOP)					
Transaction Volume (Million)	4.1	4.8	4.9	5.0	4.7
Transaction Value (Billion USD)	21,665	23,519	29,669	36,878	38,126
Germany (RTGS-Plus)					
Transaction Volume (Million)	23.9	31.9	32.8	34.1	35.8
Transaction Value (Billion USD)	61,501	117,616	145,123	157,005	172,023
Switzerland (SIC)					
Transaction Volume (Million)	161.1	177.0	192.7	209.1	256.4
Transaction Value (Billion USD)	26,905	28,767	33,202	33,762	32,956
TARGET					
Transaction Volume (Million)	53.7	64.5	66.8	69.4	76.3
Transaction Value (Billion USD)	294,315	373,434	478,474	558,091	613,614
CLS					
Transaction Volume (Million)	-	1.7	19.3	32.6	47.9
Transaction Value (Billion USD)	-	23,790	220,574	379,506	545,838
Turkey (TIC-RTGS)					
Transaction Volume (Million)	25.5	33.9	43.0	58.7	76.4
Transaction Value (Billion USD)	2,446	2,214	3,122	3,986	5,806

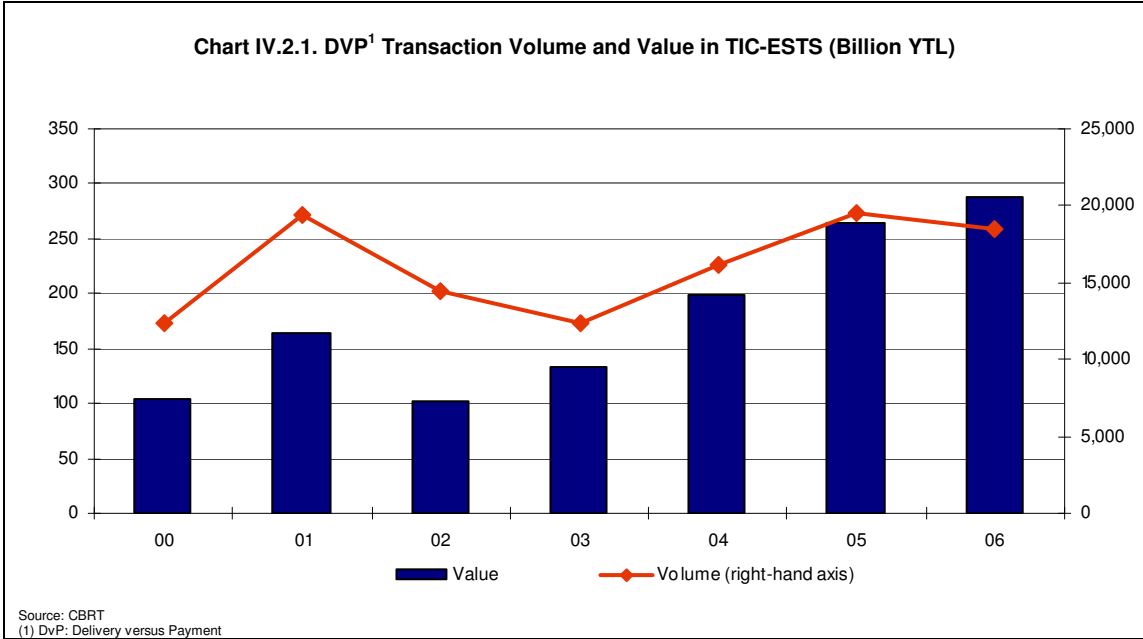
Source: BIS, CBRT

Since no upper and lower limit is defined for the amounts of payment messages, TIC-RTGS, which has 48 participant banks, also allows households and firms to make wide use of the system. Therefore, the volume of transactions in TIC-RTGS is higher than those of many developed European countries, except Switzerland (Table IV.1.1).

The volume and value of transactions of Continuous Linked Settlement (CLS) system, which ensures the final and irrevocable settlement of cross border foreign exchange transactions, continues to increase substantially. The CLS system operates according to the “payment versus payment” principle in order to avoid credit risk. Parallel to international developments, the membership of Turkish currency to this system may be placed on the agenda.

IV.2. Electronic Securities Transfer and Settlement System (TIC-ESTS)

TIC-ESTS, works in an integrated manner with TIC-RTGS to provide electronic, dematerialized and real time transfer and settlement of Turkish government securities among banks with the “Delivery versus Payment” (DvP) principle. The CBRT is both the owner and operator of TIC-ESTS.

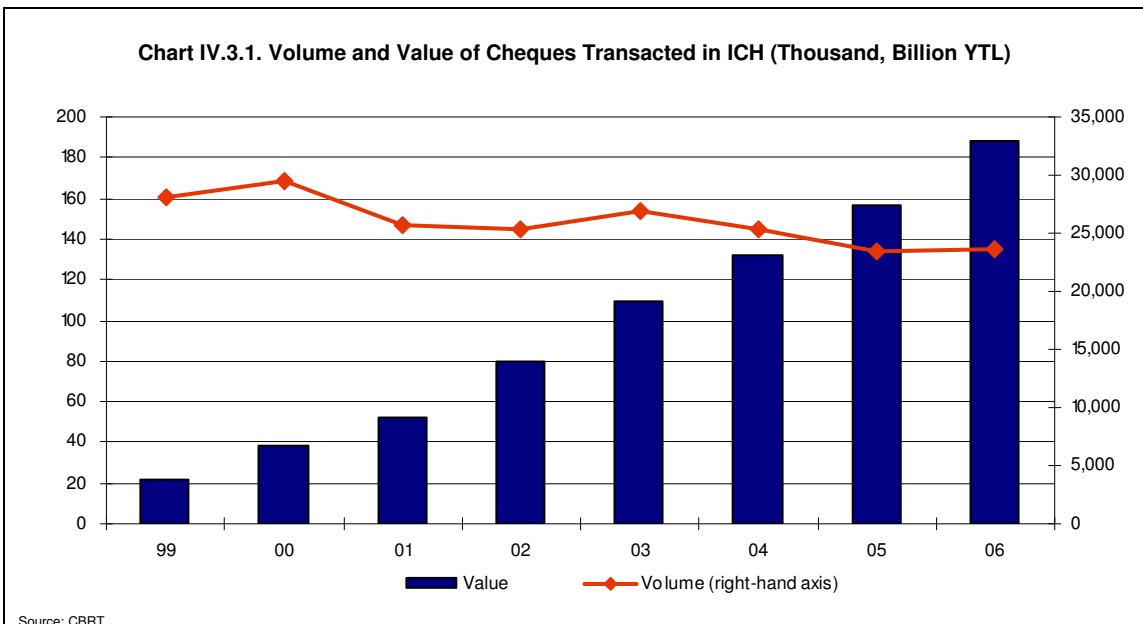


In 2006, the number of DvP transactions in TIC-ESTS decreased by 5.9 percent, while transaction value increased by 9.2 percent compared to the end of the previous year (Chart IV.2.1).

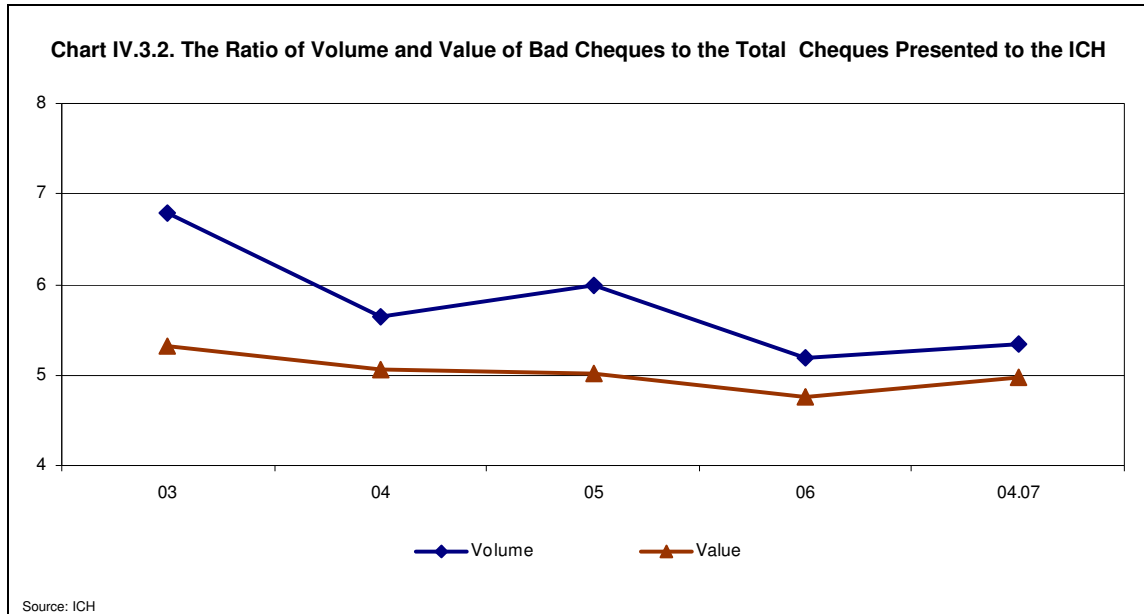
IV.3. Cheque Clearing System

The Interbank Clearing Houses Center, which is established as a legal entity and subject to the provisions of Private Law, provides clearing of cheques and operates under the oversight of the CBRT.

As of year-end 2006, while 9 out of 41 banks participated only in the interbank cheque clearing operations by presenting cheques physically, 32 banks also participated in the operations without physical presentation.



In 2006, the number of cheques, which were subject to the cheque clearing process increased by 0.2 percent compared to 2005, amounting to 23,558 thousand. In the given period, the value of cheques reached 188.3 billion New Turkish Liras, increasing by 20.5 percent. As of the first quarter of 2007, the number of cheques increased by 5.7 percent, amounting to 6,012 thousand, and the value of cheques increased by 21.8 percent, reaching 49.0 billion New Turkish Liras, compared to the same period of 2006 (Chart IV.3.1).



Bad cheques in total cheques presented to ICH is around 5-6 percent and has not changed significantly for years (Chart IV.3.2).

In the cheque clearing system, after the completion of the provision process, participants' debit and credit positions are determined by multilateral netting.

Table IV.3.1. Cheque Clearing System-Netting Ratio

	2003	2004	2005	2006
Netting Ratio (%)	70.42	71.92	71.96	74.79
Transaction Value (Billion TRY)	109.5	131.9	156.2	188.3
Liquidity Saving (Billion TRY)	77.1	94.8	112.4	140.8

Source: CBRT

Since the cheque clearing system operates according to the multilateral netting method, the liquidity requirements of participants derived from cheque transactions is decreasing. The netting ratio of transactions realised through the cheque clearing system increased at end-2006 compared to the previous year. In 2006, thanks to the multilateral netting method, liquidity requirements of participants related to cheque transactions decreased by 140.8 billion New Turkish Liras (Table IV.3.1).

IV.4. Payment Systems Risks

The likelihood of the dispersion of problems derived from system participants to the financial system as a whole via payment systems has increased the importance of payment systems risks. Risks emerging from payment systems can be mainly classified as credit risk, liquidity risk and operational risk.

IV.4.1. Credit Risk

Credit risk is defined as the situation in which participants of payment systems can not meet their obligations either on the due date or subsequently. Problems assessed within the context of credit risk cover the cases in which a participant has permanent and serious problems. The major difference between credit and liquidity risks within the payment systems aspect is that credit risk covers permanent problems while liquidity risk covers temporary ones.

In order to be able to observe the progress of credit risk that participants in the payment system are faced with, their activities, financial statements and capital structures must be regularly monitored. For this purpose, information between the BRSA and the CBRT is regularly exchanged.

In TIC-RTGS, the Real Time Gross Settlement (RTGS) system is used. As is the case in its world implementation, in the TIC-RTGS system, payment orders are realized only if there are sufficient funds in participants' TIC-RTGS accounts at the CBRT. Hence, there is no credit risk deriving from the default in TIC-RTGS.

In TIC-ESTS, transactions are mainly realized according to DvP principles. Since the settlement of delivery and transfer takes place simultaneously, there is no credit risk in these transactions.

The cheque clearing system carries credit risk since there is a possibility that participants cannot fulfill their obligations arising from netting transaction results. In order to eliminate credit risk, the CBRT has the authority to ban failed participants which disrupt settlement, from the system and to finalize netting transactions in the cheque clearing system without the cheques of these participants.

IV.4.2. Liquidity Risk

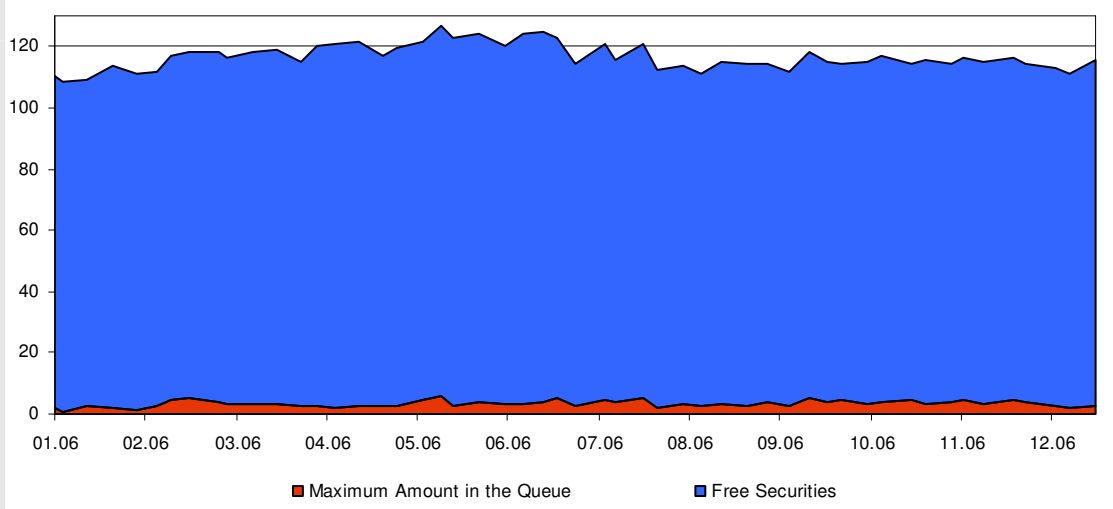
Liquidity risk represents the situation in which a participant cannot fulfill its obligations on the maturity date since it has a temporary liquidity shortage, although it is able to fulfill its obligations in the future. The intraday credit facility, provided to banks by the CBRT, decreases the liquidity risk of payment systems.

Nonetheless, in TIC-RTGS-ESTS systems, there are some features such as adhoc query, queuing of payments and fund management to ensure participants manage their liquidity needs effectively. In the cheque clearing system, participants learn the amount of their obligations which they must fulfill for realization of settlement the previous day when netting transactions finish. This method enables participants to manage their liquidity positions more effectively in cheque clearing transactions.

Box IV.4.2.1. Comparison of Total Amount of Queued Payment Messages at the TIC-RTGS Center with Participants' Free Securities

Banks, which are authorized to carry out transactions in the markets at the CBRT, can obtain liquidity from the CBRT within their limits or from the late liquidity window without any limit against collateral. Considering these facilities, it is examined that if participants cannot fulfill their obligations in the TIC-RTGS system, how much of their obligation can be covered by their free securities. For this purpose, the days on which the total amount of the queued payment messages reached the highest level in a week are chosen, and of these chosen days, the queued payment messages of participant banks are compared with their free securities; which can be used as collateral to get liquidity from the CBRT in case of a temporary liquidity shortage.

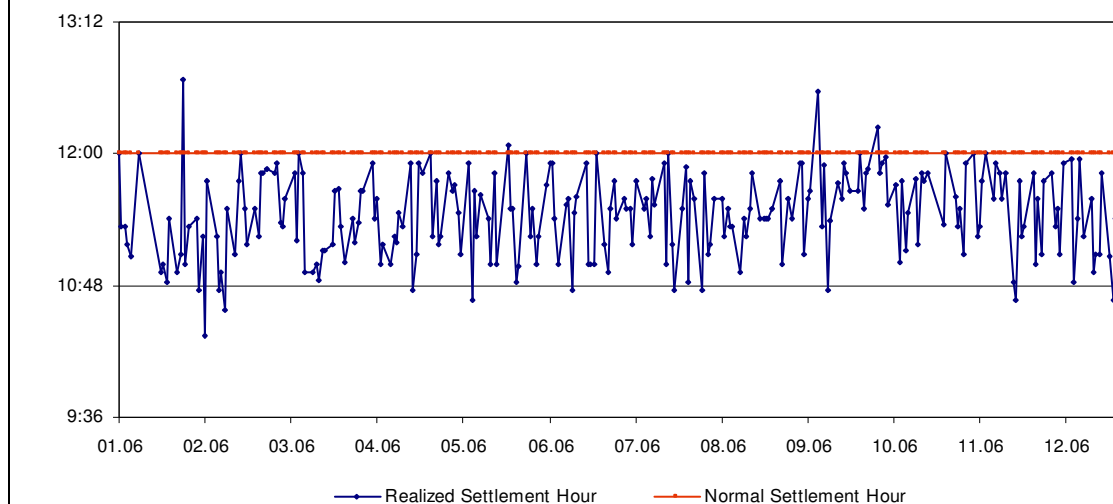
Chart 1. Value of Queued Payments–Participants Free Securities (Government Bonds)¹ (Billion YTL)



Source: CBRT
 (1) Free Securities= Securities that are not used as collateral or for repo transactions.

As a result of the analysis, the participants' high level of free securities reduces the liquidity risk arising from the TIC-RTGS system (Chart 1).

Chart IV.4.2.1. Settlement Hours of Cheque Clearing System– 2006



Source: CBRT

In the cheque clearing system, debtor participants that become debtors as a consequence of netting transactions at the end of the day are required to fulfill their obligations on the next day by 12 noon. In 2006, settlement was delayed four times in the cheque clearing system, as participants performed their obligations later than the due time, for a total of 95 minutes (Chart IV.4.2.1). On the other hand, it should be noted that in the cheque clearing system in 2006, the average settlement time was realized at 11:27 a.m.

IV.4.3. Operational Risk

The probability of problems stemming from the operation of the system due to human errors, software-hardware deficiencies, faults or other problems in communication systems is assessed as an operational risk.

TIC-RTGS and TIC-ESTS, which work in an integrated manner, are designed to minimize possible operational problems caused by the system. In case problems cannot be solved or take a long time to solve, the TIC-RTGS-ESTS system is backed up with a Disaster Center in order to provide operational continuity.

In case of a possible breakdown in the TIC-RTGS-ESTS Center, after the decision has been made to use the backup system, it takes at the latest 5 minutes to start with the backup center system. Backup operation of the system is performed simultaneously. While transferring to the backup system, no messages are lost.

The availability ratio, which shows accessibility of the participants to the system during working hours, in other words, the continuity of services, was 99.98 percent on average in 2006 for TIC-RTGS and TIC-ESTS systems (Table IV.4.3.1).

Table IV.4.3.1. Availability Ratios of Payment Systems (2006)

	CHAPS Euro (England)	TARGET	Viber (Hungary)	TIC-RTGS (Turkey)
Availability Ratios (%)	99.96	99.87	99.77	99.98

Source: Bank of England, ECB, Magyar Nemzeti Bank, CBRT

In order to minimize the operational risk deriving from the system, new electronic cheque clearing software started to be used in September 2006, system technology was renewed and a preferential line was installed in the circuit of the cheque clearing system.

In the cheque clearing system, data sent by participants reach the servers in Ankara Interbank Cheque Clearing House, and in one minute at the latest, the same data is also relayed to the servers in İstanbul ICH. Consequently, data is backed up one by one in both Ankara and İstanbul ICHs. In case of any interruption in the Ankara lines or if any other problem occurs with the Ankara servers, all data sent by participants are directed to the İstanbul clearing house. If any problem occurs, the backup system starts to operate automatically, and it is not necessary to make any manual intervention of the system because the preferential line becomes operational.

In addition to these measures, the backup of data is done simultaneously in the Ankara and İstanbul data servers so as to minimize the effects of operational problems in the cheque clearing system.

Box IV.4.3.1. Impact of Operational Failures on Cheque Clearing System

In this scenario, in order to measure the impact of operational problems of participants on the cheque clearing system, the situation is analyzed in which a bank with the highest transaction volume cannot connect to the cheque clearing system all day through due to problems emerging for various reasons in its data lines. Although participants have the opportunity to connect to the system via other alternative channels, within the context of the scenario it is assumed that these alternative ways are not available.

Despite the probability of the scenario occurring is very low, it is thought that this analysis would be useful to measure the potential effects of the problems that participants experience on the system.

With the realization of this scenario as of October 2, 2006, when the highest transaction volume was reached in the cheque clearing system in 2006, the number of cheques which are subject to clearing in ICH, will decrease by 24.4 percent, amounting to 471,705, the value of cheques will be 2,316 million New Turkish Liras with a 21.9 percent decrease, and 152 thousand cheques will not be able to be processed.

In such a case, two participants which are net creditors under normal conditions, become net debtors. The amount of liabilities of the first two participants whose liabilities increase the most, will increase by 181.6 percent and 145.4 percent, respectively. Their liquidity requirement will increase by approximately 14 million New Turkish Liras compared to normal circumstances.

It is determined that in the likelihood of this scenario, borrowing opportunities from both the CBRT and financial markets are sufficient for participant banks which need additional liquidity arising from new conditions.

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ABBREVIATIONS

BIS	: Bank for International Settlements
BOJ	: Bank of Japan
BRSA	: Banking Regulation and Supervision Agency
BITT	: Banking and Insurance Transactions Tax
CAR	: Capital Adequacy Ratio
CBRT	: Central Bank of the Republic of Turkey
CDS	: Credit Default Swap
CLS:	: Continuous Link Settlement
CMB	: Capital Markets Board
CPI	: Consumer Price Index
CPSS	: Committee on Payment and Settlement Systems
DvP	: Delivery versus Payment
ECB	: European Central Bank
ELLIPS	: Electronic Large-value Interbank Payments System (Belgium)
EMBI	: Emerging Market Bond Index
EU	: European Union
FSI	: Financial Strength Index
FX	: Foreign Exchange
FXNGP	: Foreign Exchange Net General Position
GDDS	: Government Domestic Debt Security
GDP	: Gross Domestic Product
GNP	: Gross National Product
ICH	: Interbank Cheque Clearing Houses Center
IMF	: International Monetary Fund
ISE	: Istanbul Stock Exchange
NPL	: Non Performing Loans
PPI	: Producer Price Index
ROA	: Return on Assets
ROE	: Return on Equity
SDIF	: Savings Deposits Insurance Fund
SIC	: Swiss Interbank Clearing
SME	: Small and Medium Sized Enterprises
SPO	: State Planning Organization
TARGET	: Trans-European Automated Real Time Gross Settlement System
TBF	: Transferts Banque de France
TIC-ESTS	: Turkish Interbank Clearing-Electronic Security Transfer System
TIC-RTGS	: Turkish Interbank Clearing-Real Time Gross Settlement System
TOP	: RTGS System operated by DNB
TURKSTAT	: Turkish Statistical Institute
USD	: US dollars
YTL	: New Turkish Lira