

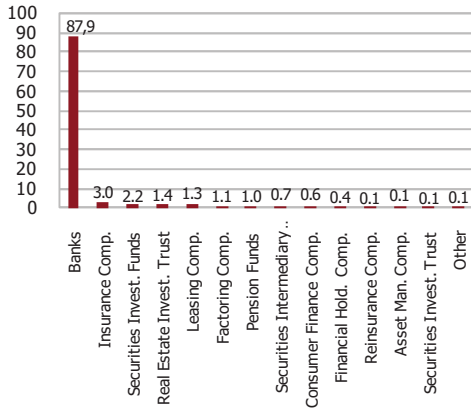
III. RISKS AND DEVELOPMENTS IN THE BANKING SECTOR

While the effects of the global financial crisis are lingering in international financial markets, the Turkish banking sector continues to stand strong. The annual rate of increase in credits remains at reasonable levels for financial stability, owing to the rebalancing between the domestic and foreign demand on the back of a flexible monetary policy, tight fiscal policy and other measures taken in Turkey. Loans, which are mostly extended in medium and long term maturities and denominated in Turkish lira, are mainly financed by deposits; and the surge in legal reserves due to undistributed profits of banks, in addition to the increase in FX deposits and securities issued by banks in the first quarter of 2012 are noteworthy. Moreover, banks do not have difficulty providing sources from international financial markets. Although the profitability performance of the banking sector declined slightly in line with developments in national and global financial markets in 2011, it resumed its upward trend in the first quarter of 2012. The Turkish banking sector, which remains strong in terms of asset quality, is expected to display a limited decline in its capital adequacy ratio on the back of the implementation of the Basel-II/2.5 from the second half of 2012. The banking sector remains robust in terms of capital adequacy ratio, compared to many developed and developing economies.

The Turkish financial sector, which is predominantly composed of the banking sector, continued to grow in 2011 as well. The balance sheet of the Turkish financial sector grew by 20.3 percent compared to end-2010 and reached TL 1,385 billion by the end of 2011 while its ratio to GDP became 106.9 percent (Chart III.1).

The largest share in the financial sector belongs to the banking sector at 87.9 percent, accompanied by a 0.5 percentage point increase in the mentioned period. In December 2011, total assets of the banking sector increased by 21 percent in nominal terms and by 9.5 percent in real terms compared to end-2010 and reached to TL 1,218 billion. Thus, the ratio of the sector's balance sheet size to GDP, which was 91.6 percent at end-2010, rose to 94 percent at end-2011. In March 2012, the asset size of the sector became TL 1,229 billion (Chart III.2). The ratio of the Turkish banking sector's assets to GDP, which was below the EU27 average of 350 percent as of 2010, indicates the sector's growth potential (Table III.1).

Chart III.1. Balance Sheet Size of the Financial Sector (%)^{1,2}

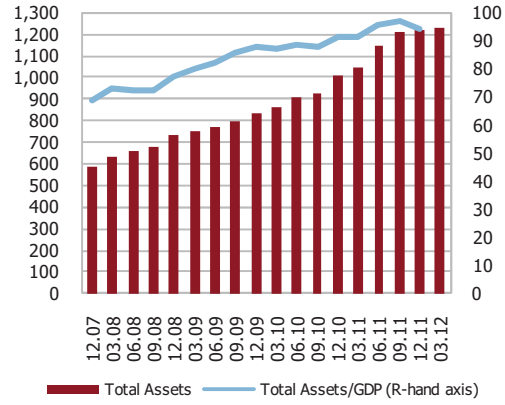


Source: BRSA –CBRT, ACMIIT, CMB, AIRCT

(1) Data for Real Estate Invest. Trust and Venture-Capital Trust belong to September 2011 period; data for Portfolio Man. Comp. and Securities Invest. trust belong to October 2011 period.

(2) "Other" item includes the data of Credit Guarantee Fund, Venture-Capital Trust and Portfolio Management Comp.

Chart III.2. Development of the Banking Sector (Billion TL, %)

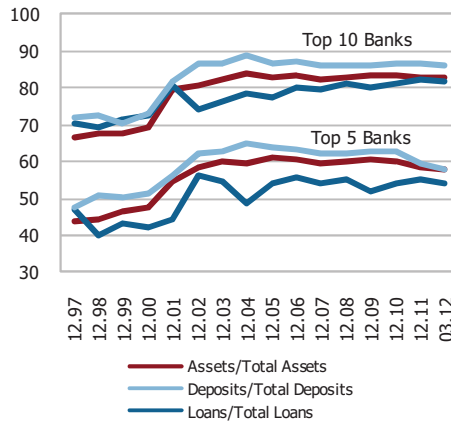


Source: BRSA –CBRT, TURKSTAT

As of March 2012, among the 48 banks operating in the Turkish banking sector, the share of the first 5 banks with respect to asset size was 57.7 percent while that of the first 10 banks was 83.1 percent. Meanwhile, an item-by-item analysis suggests that while concentration is more on deposits, it is lower on credits (Chart III.3). Compared to EU countries, Turkey ranks in the middle based on the share of the first 5 banks in total assets as of end-2010 (Table III.1)

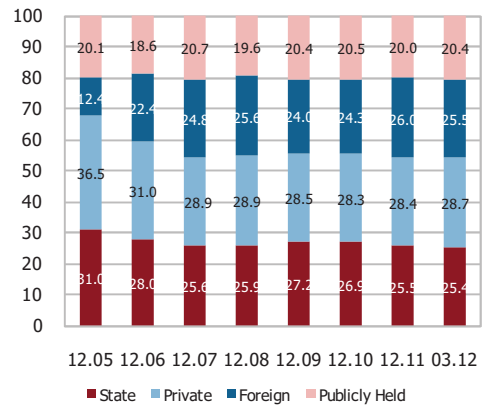
Based on their share in paid-up capital, the share of foreign shareholders in asset size was realized as 25.5 percent in March 2012. Meanwhile, according to data of the Central Registry Agency, when the share of foreign participation in publicly held shares, which accounts for 17.1 percent, are included as well, the share of foreign participation in the banking sector reaches to 42.6 percent (Chart III.4). The 2010 average figure for foreign share in the EU banking sector is 25.4 percent. The same figure for the Turkish banking sector is below that of many Eastern and Central European countries (Table III.1).

Chart III.3. Concentration of the Turkish Banking Sector (%)



Source: BRSA –CBRT

Chart III.4. Composition of Banking Sector Assets by Structure of Ownership (%)¹



Source: BRSA –CBRT

(1) For publicly held shares no distinction has been made between domestic and foreign investors.

By the end of 2011, the ratio of deposits to GDP, which signifies the developments in depth and intermediary functions of the banking sector, was 54 percent, while the ratio of loans to GDP and deposits increased to 54 and 101 percent, respectively. The said ratios stand at 132 percent, 190 percent and 143 percent, respectively, in EU27. Turkey ranks quite below the EU averages in terms of the number of banks in the banking sector (Table III.1).

Table III.1. Comparison of the Selected Financial Indicators with EU Countries ¹

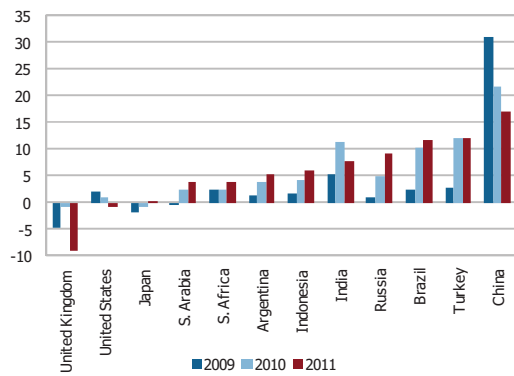
Countries	Total Assets / GDP (%)	Deposits / GDP (%)	Loans / GDP (%)	Loans / Deposits (%)	Total Assets / No. of Credit Institutions (Million Euro)	Share of Top 5 Credit Institutions (%)	No. of Credit Institutions	Foreign Shares in the Banking Sector (%)
Luxembourg	2038	741	1369	185	5,620	31	146	88.1
Germany	319	118	164	138	4,094	33	1,929	11.5
Austria	395	174	278	160	1,450	36	780	16.9
Italy	178	73	124	170	3,554	39	778	17.3
United Kingdom	597	197	237	120	27,166	43	375	42.8
Poland	85	51	59	115	425	43	706	68.0
Spain	362	191	257	134	11,299	44	337	8.7
France	330	126	186	147	9,308	47	686	11.9
Romania	66	36	42	117	1,948	53	42	81.9
Hungary	123	65	88	135	634	55	189	58.1
Bulgaria	105	67	83	124	1,256	55	30	85.6
Ireland	756	165	382	232	2,412	57	489	43.8
Slovenia	156	75	121	162	2,207	59	25	27.1
Latvia	162	86	130	151	746	60	39	71.5
Czech Republic	108	77	68	87	2,944	62	55	94.5
Denmark	387	97	265	272	5,667	64	161	23.7
Greece	217	113	159	141	7,953	71	62	20.8
Portugal	308	134	226	169	3,323	71	160	23.6
Malta	827	316	551	174	1,947	71	26	34.6
Slovak Republic	82	58	56	98	1,863	72	29	100.0
Belgium	324	150	199	133	10,856	75	106	58.6
Lithuania	93	51	74	147	294	79	87	79.8
Finland	258	77	107	140	1,372	84	338	71.6
Netherlands	460	216	328	152	9,336	84	290	12.7
Estonia	215	114	161	141	1,707	92	18	61.2
EU-27 Av.	350	132	190	143	5,228	-	304	25.4
Turkey - 2010	92	56	50	88	10,026	60	49	24.3
Turkey - 2011	94	54	54	101	10,381	58	48	26.0

Source: BRSA-CBRT, Eurostat, ECB

(1) The figures of EU countries are as of 2010

Due to lingering vulnerabilities in global financial markets, credit growth lost pace in many countries. In line with developments in local and global financial markets, while the ratio of credit growth to GDP continued to narrow in the USA, the UK and Japan as well in 2011, the said ratio hovered at high levels, albeit with less pace in emerging economies (Chart III.5, Chart III.6).

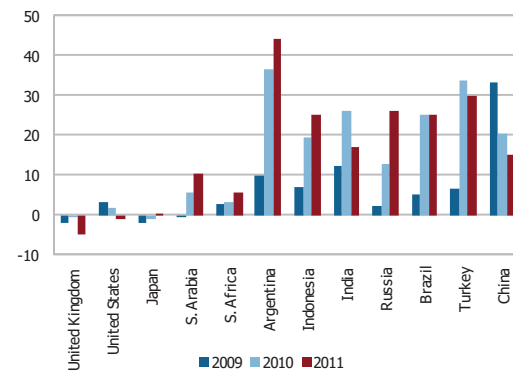
Chart III.5. Credit Growth / GDP (%)¹



Source: IMF, IFS

(1) Latest data from the IMF-FSI database have been used, most of which are end-2011 figures.

Chart III.6. Annual Change in Credits (%)¹

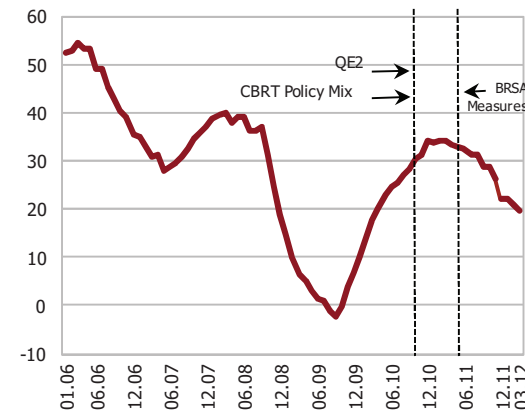


Source: IMF, IFS

(1) Latest data from the IMF-FSI database have been used, most of which are end-2011 figures.

On the back of the flexible monetary policy, tight fiscal policy and other measures taken by the authorities, credit growth has reached reasonable levels for financial stability in Turkey. Due to lingering vulnerabilities related to the global economy and precautionary measures taken by the Turkish authorities, the annual rate of increase in credits, adjusted for exchange rate effect became 22 percent at end-2011. Parallel to the rebalancing process between domestic and foreign demand, credit growth is expected to maintain its moderate course in 2012 as well (Chart III.7). In tandem with the deceleration in the rate of increase in credits in the second half of 2011, the ongoing decline in the ratio of credit growth to GDP continued, too (Chart III.8).

Chart III.7. Annual Growth in Credits (% , Excluding NPLs)^{1,2}

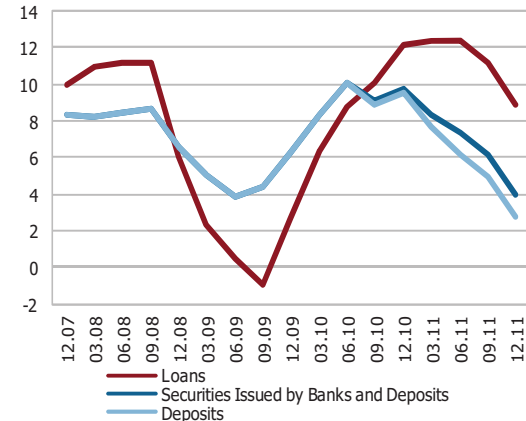


Source: BRSA –CBRT

(1) The basket value used to adjust for exchange rate effect is composed of 70 percent USD and 30 percent Euro. The average basket rate of December 2007 – March 2012 has been used to adjust for exchange rate effect and FX-indexed credits are included in FX credits.

(2) QE2 refers to the second round of quantitative easing introduced by the FED in November 2010.

Chart III.8. Credit and Deposit Growth/GDP (% , Excluding NPLs)¹



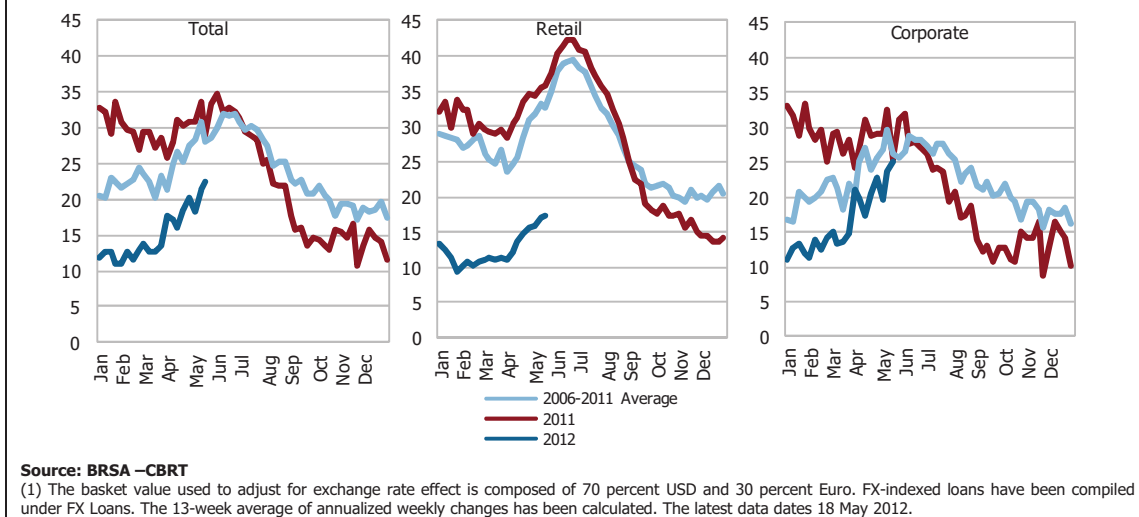
Source: BRSA –CBRT, TURKSTAT

(1) The basket value used to adjust for exchange rate effect is composed of foreign exchange buying rate of 70 percent USD and 30 percent Euro for credits; 60 percent USD and 40 percent Euro for deposits. The average basket rate of December 2007 – March 2012 has been used to adjust for exchange rate effect and FX-indexed credits are included in FX credits.

While consumer loans displayed a limited increase, as desired, credit growth was mainly driven by corporate loans. Although the rate of increase in credits hovered below the previous five years averages and previous year's rate on the back of measures taken to control the credit growth rate and the tight monetary policy, the said rate has increased slightly in the recent period due to seasonal changes. The annualized growth rate of total loans adjusted for exchange rate effect stood as 22.4 percent by mid-May 2012. The increase in corporate loans accelerated on the

back of the implementation of export rediscount credits that has gained pace recently, in addition to the financing need such as stock enhancement, working capital and the restructuring of debts. Thus, the annualized rate of increase in corporate loans adjusted for exchange rate effect became 25.1 percent by mid-May 2012. The annualized growth rate of retail loans became 17.4 percent in the same period (Chart III.9).

Chart III.9. Development of Loans Adjusted for Exchange Rate Effect (%)¹



The contribution of consumer loans to loan growth has declined significantly. In the first quarter of 2012, total loans, corporate loans and retail loans, all adjusted for exchange rate effect, increased by 4.5 percent, 5.4 percent and 2.7 percent, respectively, compared to end-2011 (Chart III.10). In March 2012, the annual growth rate of credits became 12.2 percent in real terms, of which 2.4 points came from SME loans; 5.7 points from other corporate loans and 2.7 points from consumer loans (Chart III.11). The contribution of primarily consumer loans to growth decreased faster than that of other loan types on the back of the measures taken by the BRSA in June 2011.

Chart III.10. Development of Loans by Type (Excluding NPLs, Billion TL, Annual %)¹

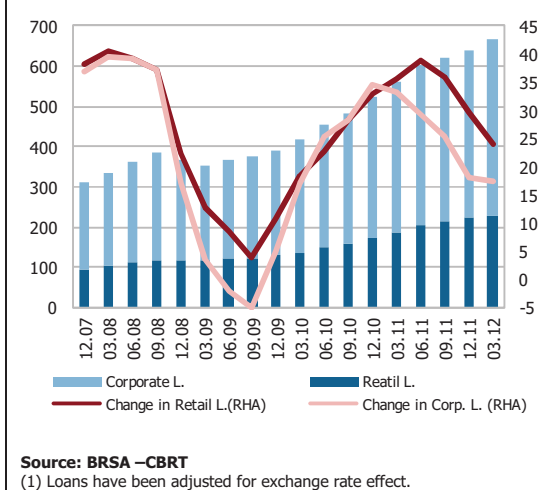
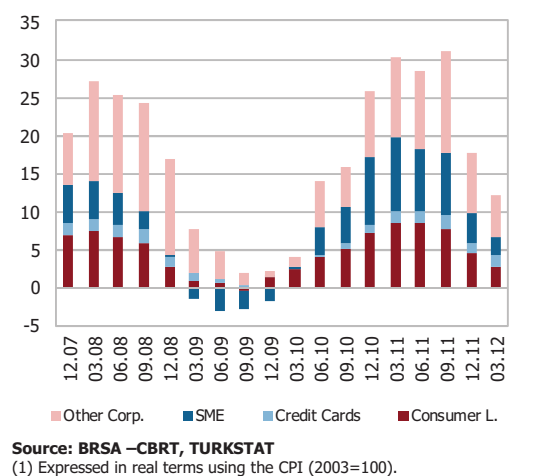


Chart III.11. Contribution of Types of Loans to Credit Growth (% Contribution, Excluding NPLs)¹



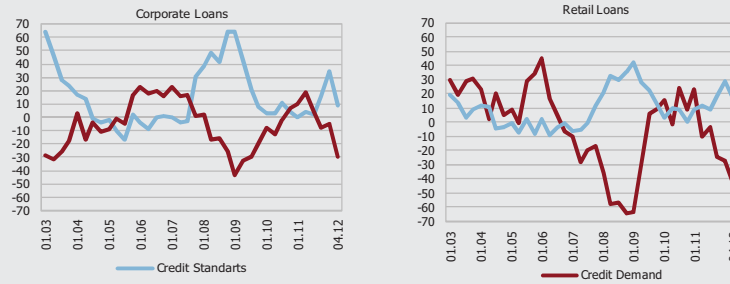
Box III.1. Surveys on Banks' Loans

Lending surveys are widely used by several central banks in order to evaluate supply and demand conditions in the credit market. In this context, lending surveys published by the Fed, the ECB and the CBRT mark the directions of and reasons for changes in credit standards and credit demand in USA, Europe and Turkey, and provide information regarding the nature of perceptions related to the credit market.

According to "The Euro Area Bank Lending Survey", published by the ECB, the tightening of standards on credits extended to the private sector, which started to rise again from the second half of 2011, eased significantly in the first quarter of 2012. This development was mainly attributed to the improvement in expectations on the overall economic activity, banks' liquidity positions and financing costs. The improvement in expectations on the overall economic activity in addition to the financing costs was instrumental in the loosening of tight standards on retail loans.

Although the standards were eased to some extent in the first quarter of 2012, the decline in the private sector's credit demand gained pace. While the decline in the demand for corporate loans was driven mainly by the decrease in the financing need with respect to fixed investments, the decline in the demand for retail loans was driven by the diminishing trend in consumer confidence and negative expectations regarding real estate sector.

Chart 1. Credit Standards and Credit Demand in the Euro Area (Percent)^{1,2}

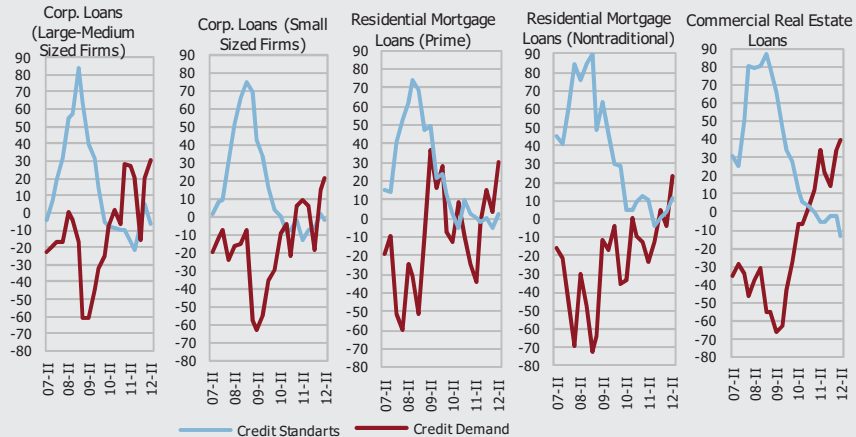


Source: ECB Bank Lending Survey, April 2012

- 1) A negative value in credit standards indicates an easing in standards, whereas a positive value in credit demand indicates an increase in credit demand.
- 2) The demand for retail loans is related to housing loans.

According to the results of the lending survey prepared by the Fed in relation to the credit market indicate that while banks have recently eased their credit standards, credit demand has increased. While increased competitive pressure in the sector and positive expectations related to the economic outlook were influential in the easing of standards on corporate loans, the financing need arising from stock enhancement, fixed investments and mergers/acquisitions along with the decrease in non-bank resources was instrumental in the surge of credit demand. While the recent period has witnessed an easing in standards on housing loans for purchase of premises by firms, it has seen a tightening in standards on real estate loans for households. Meanwhile, the increase in demand for housing loans prevails.

Chart 2. Credit Standards and Credit Demand in the USA (Percent)¹



Source: Fed, Senior Bank Loan Officer Survey on Bank Lending Practices

- 1) A negative value in credit standards indicates an easing in standards, whereas a positive value in credit demand indicates an increase in credit demand.

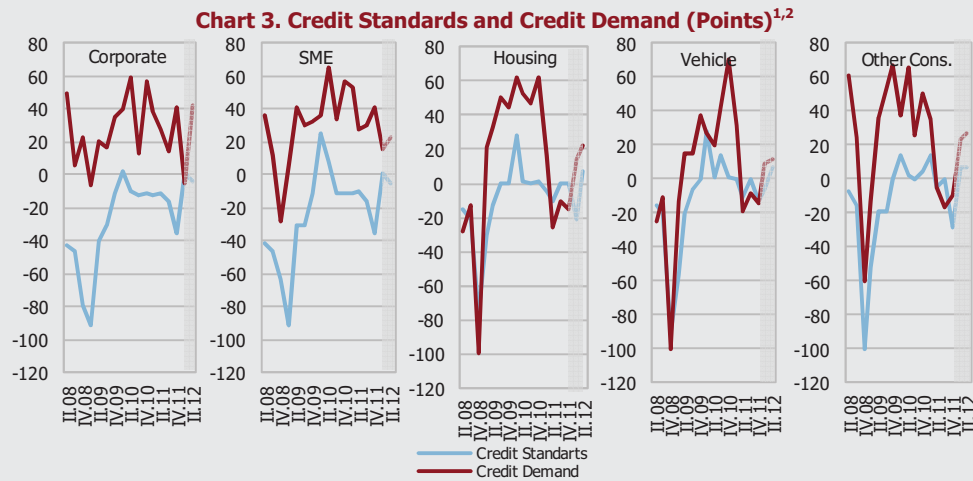
Turkey also experience developments similar to those in US credit markets. According to the CBRT Banks' Loans Tendency Survey, while the tightening trend in standards on corporate loans had continued since the second quarter of 2010, this was replaced by a slight easing in the first quarter of 2012. While financing costs, competitive pressure and risks on collaterals continued to put pressure on standards, the improvement in risk perceptions on economic activity became influential in easing this pressure. Nevertheless, the tightening trend in short-term credits continued in this period as well.

The demand for corporate loans, primarily those extended to large enterprises on long-term maturities, contracted in the first quarter of 2012. In the meantime, the demand for SME loans showed a slight increase. While financing need arising from stock enhancement, working capital along with the financing need related to restructuring of debts boosted the demand for credit, enterprises tended to meet their financing needs through internal finance and this development became the main driver in the decrease in credit demand.

Considering retail loans, tightening in housing and vehicle loans continued due to the deterioration of expectations regarding the real estate sector and deterioration of expectations related to the economic activity, respectively. The standards on other consumer loans were eased due to the competitive pressure of other banks.

The demand for retail loans that started to decline in the second quarter of 2011 began to rise in response to higher consumer confidence and financing need in the first quarter of 2012.

As of the second quarter of 2012, banks expect a tightening in standards on corporate loans and an easing in standards on consumer loans whereas expectations regarding credit demand are on an upward trend in terms of both corporate loans and retail loans.

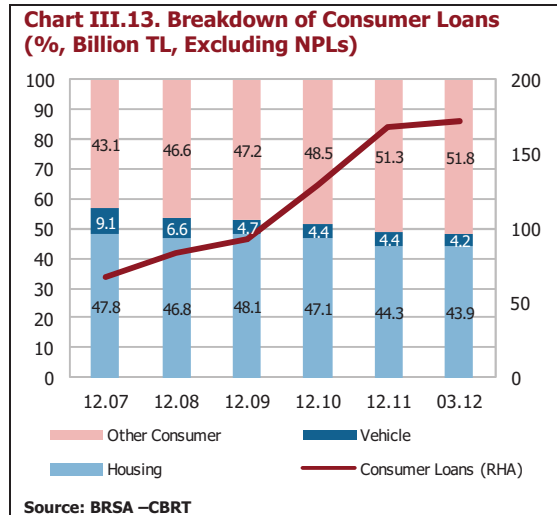
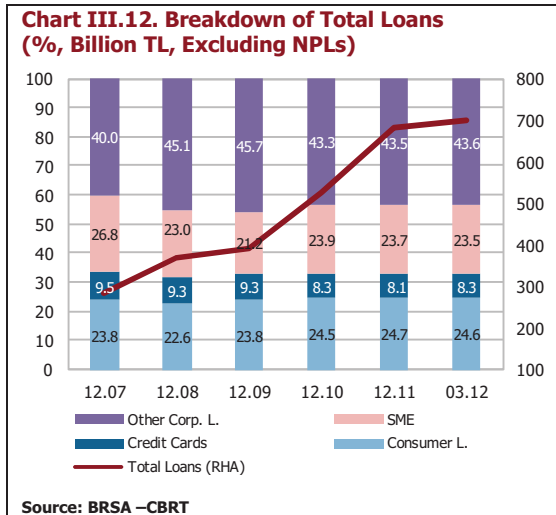


Source: CBRT Banks' Loans Tendency Survey

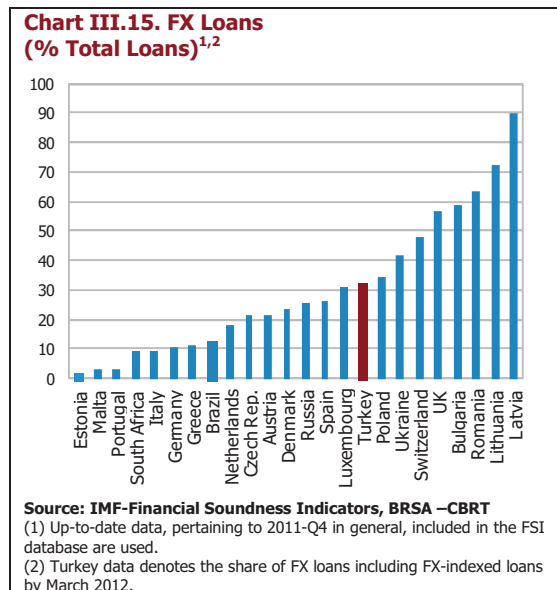
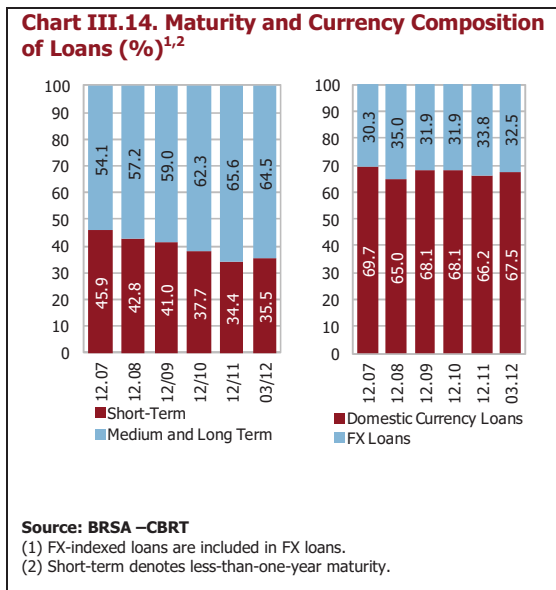
1) Data pertaining to the second quarter of 2012 is composed of expectations for the next three months.

2) Negative value in credit standards indicates a tightening in standards, whereas positive value in credit demand indicates an increase.

No significant change was observed in the distribution of credits by type in the first quarter of 2012. Although the rate of increase in other consumer loans lost ground on the back of measures taken related to these loans, it materialized above that of housing and vehicle loans; therefore, the share of other consumer loans in total consumer loans exhibited an increase by 0.5 points (Chart III.12, Chart III.13).

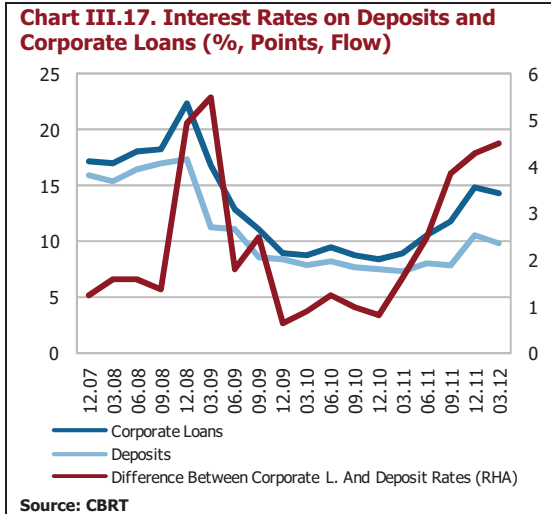
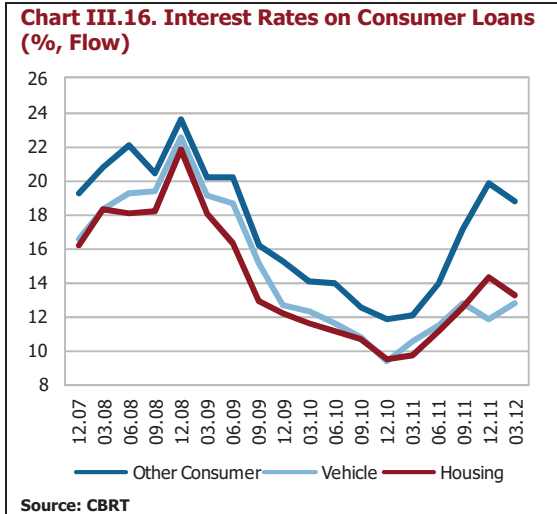


Credits are predominantly in medium and long-term maturities and denominated in Turkish lira, which is considered to be a favorable development in terms of the management of credit risk. It is noteworthy that the change observed in the share of FX-loans since the last quarter of 2011 has been driven by the volatility in exchange rates. In fact, adjusted for exchange rate effect, no significant change is observed in the currency composition of credits. A limited decline was observed in the share of medium and long-term credits in the same period (Chart III.14). The share of FX-denominated loans in the loan portfolio of the Turkish banking system was realized at mean values when compared to other countries (Chart III.15).

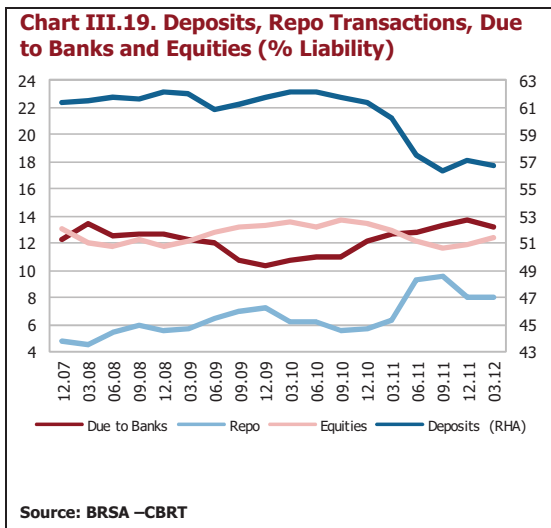
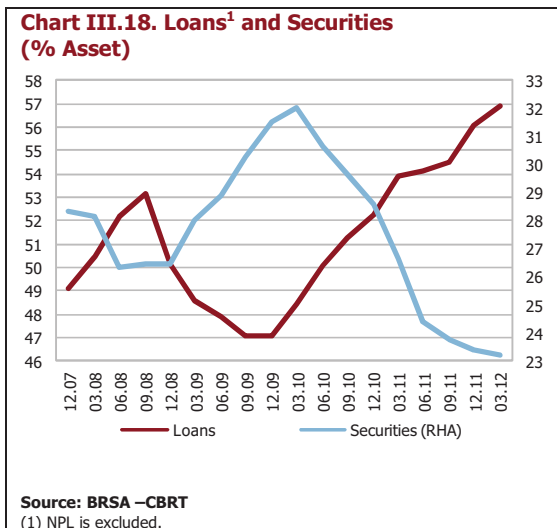


Interest rates on loans are relatively high on the back of the tight monetary policy framework. Throughout 2011, interest rates on loans generally followed an upward trend in line with increasing costs owing to measures taken to bring the credit growth rate to reasonable levels and increased uncertainty in global financial markets. On the other hand, in the first quarter of 2012, interest rates on loans other than vehicle loans declined albeit moderately. By March 2012, interest rates on housing loans materialized as 13.2 percent; while those on other consumer loans and vehicle loans became 18.7 percent and 12.8 percent, respectively (Chart III.16). In the same period, interest rates on corporate loans and deposits became 14.4 percent and 9.9 percent, respectively. As interest

rates on deposits declined more than those on corporate loans, the interest rate margin lost pace, yet still continued to hover around high levels (Chart III.17).

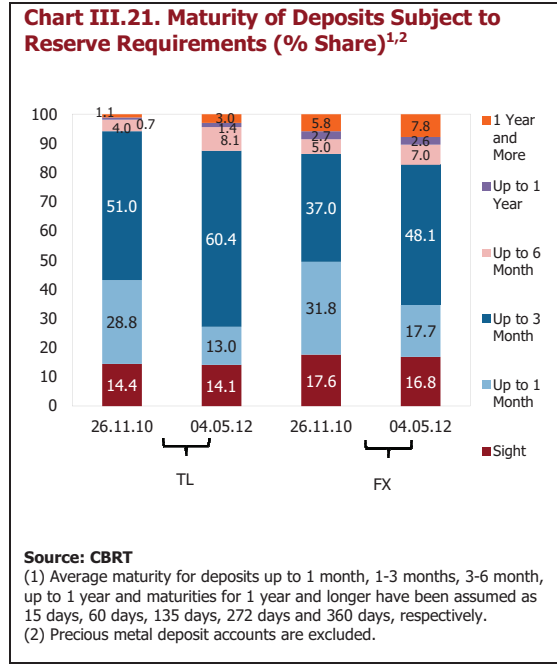
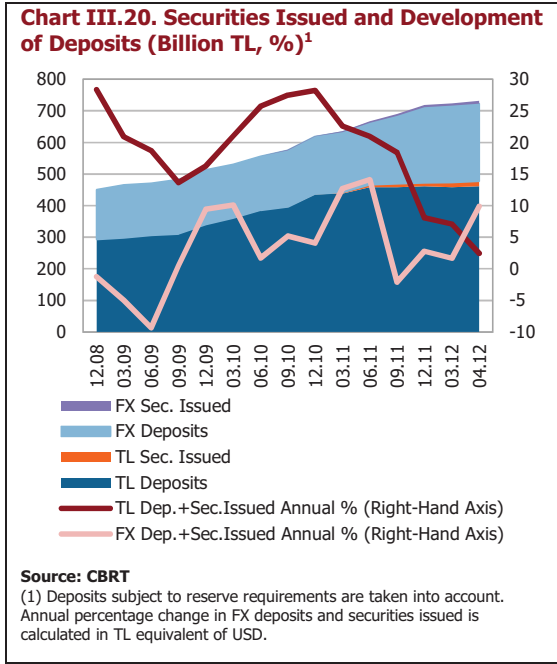


Although banks have used deposits as the main source of finance, they have continued to employ alternative sources in the recent period. Although the share of loans in total assets increased by 0.8 points as of March 2012 compared to end-2011, the share of total deposits in resources declined by 0.5 points despite the increase in FX deposits. In this period, banks increased their funding from securities issued and continued to cover other financing needs mostly with funds from repo transactions and through due to banks abroad. In the first quarter of 2012, due to increased financing costs, banks tended to provide finance from their internal sources (Chart III.18 and Chart III.19). While the fixed asset revaluation fund and securities increment value fund contributed positively to the increase in the share of equities compared to year-end on records, the main contribution came from the portion of profit of the period transferred to legal reserves.

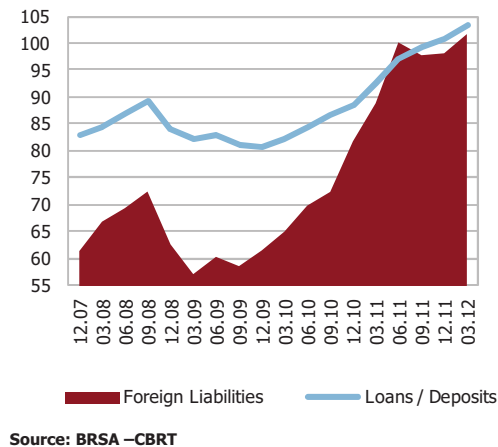
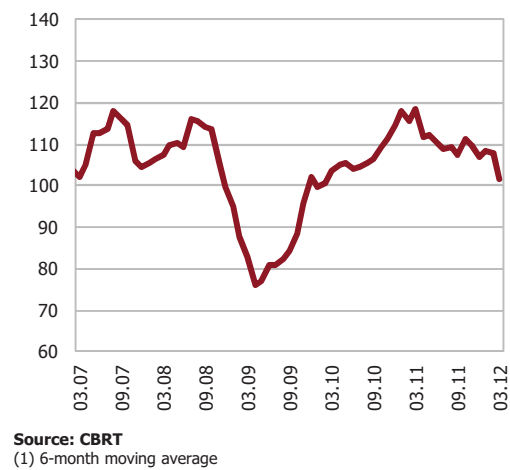


The rate of increase in the Turkish lira deposits/participation funds subject to reserve requirements started to decelerate from the second half of 2011. The deceleration in the growth rate of Turkish lira deposits is attributed to banks' increased use of alternative financing sources, such as bonds and bills, and the increase in precious metal deposit accounts on the back of the CBRT's facility that allowed banks to hold reserve requirements as standard gold. The increase in

FX deposits and FX participation funds, subject to reserve requirements, has continued with decreasing pace since the end of 2011 (Chart III.20). Meanwhile, during the period following the differentiation of required reserve ratios according to maturity structure at the end of 2010, the maturity of deposits extended significantly. Thus, by April 2012, while the share of deposits/participation funds of up to one-month maturity decreased, the share of deposits mostly consisting of maturities up to three months increased (Chart III.21). In this period, the average maturity of Turkish lira deposits became 62.7 days and the weighted average maturity of FX deposits and participation funds became 76.3 days.

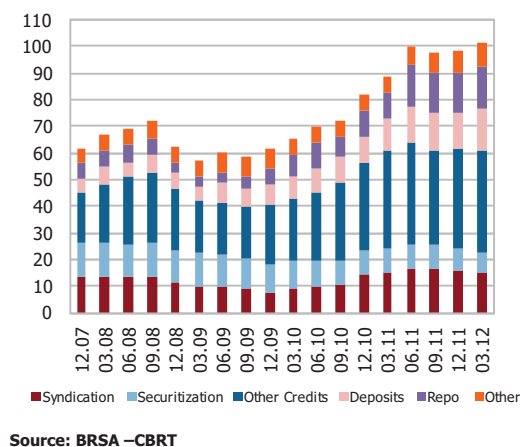
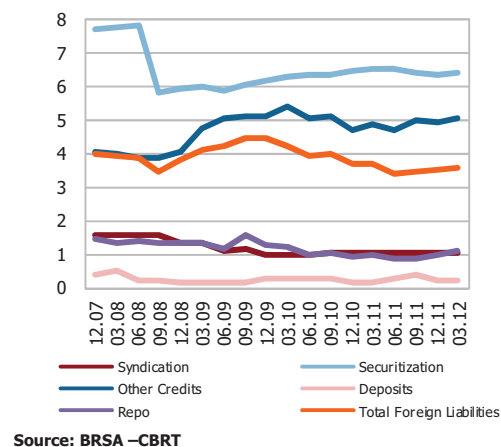


Banks have no difficulty obtaining funds from abroad. As of March 2012, 14.7 percent of total assets pertaining to the banking sector were funded by foreign liabilities and total foreign liabilities of banks surged by 3.6 percent compared to year-end to become USD 101.8 billion (Chart III.22). However, by early 2012-Q2, unfavorable developments in some European economies disrupted the improvement in perceptions related to global economy, as a result of which, capital flows towards emerging economies became more volatile. Therefore, it is considered that in 2012, the increase in the cost of syndication and securitization credits might continue and international money and capital markets might be affected adversely if European banks downsize their balance sheets due to the Euro area sovereign debt crisis. On the other hand, considering its strong structure and indebtedness to countries that have been relatively less affected by the downsizing of balance sheets, the Turkish banking system is likely to maintain its current indebtedness levels if real sector demand remains strong.

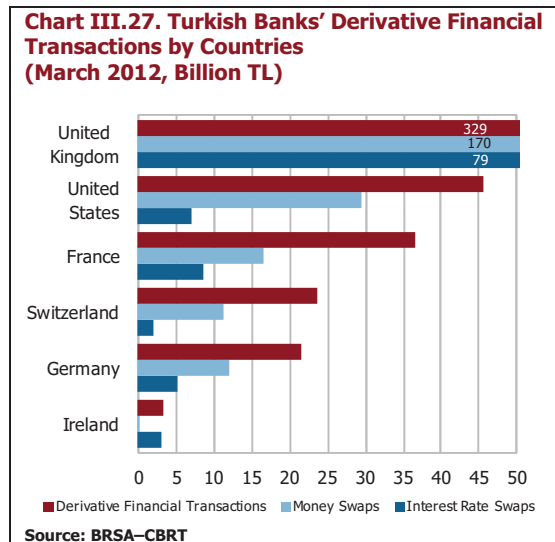
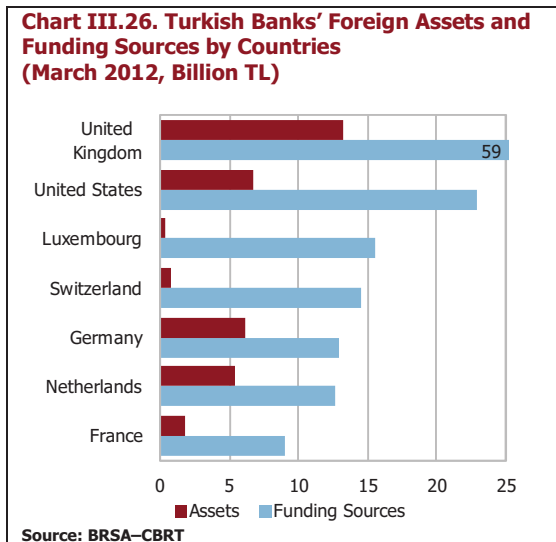
Chart III.22. Foreign Liabilities and Ratio of Loans/Deposits (Billion USD, %)**Chart III.23. External Debt Rollover Ratio of Banks (%)¹**

In 2012, banks are not expected to have problems paying syndication and securitization credits. The banks' external debt rollover ratio has been hovering above 100 percent since end-2009 (Chart III.23). By March 2012, the sum of syndication and securitization credits was USD 22.8 billion, occupying a share of 22.4 percent in foreign liabilities and 3.7 percent in total funding sources (Chart III.24). The amount of syndication and securitization credits to mature till the end of 2012 is USD 10.5 billion. It is considered that the facility provided to banks for borrowing from the CBRT Foreign Exchange Deposit Market and their FX and gold assets held for Turkish lira reserve requirements are sufficient enough to cover their syndication and securitization credits should the need arise.

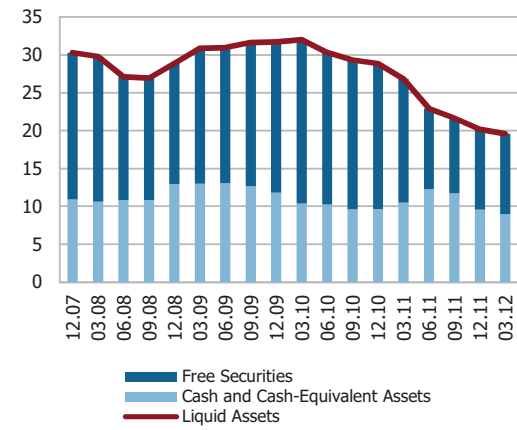
The long-term maturity structure of funds obtained by the banking sector from abroad contributes to the extension of the maturity of liabilities. The weighted average maturity of foreign liabilities followed a stable trend over the past one year and became 3.6 as of March 2012. In the same period, the average maturity of syndication credits, which makes up 14.6 percent of foreign liabilities, was 1 year and the average maturity of securitization credits, which makes up 7.7 percent of foreign liabilities, was 6.4 years (Chart III.25).

Chart III.24. Composition of Foreign Liabilities (Billion USD)**Chart III.25. Average Maturity of Foreign Liabilities (Years)**

An analysis of the share of foreign countries in total assets and funding sources reveals that the Turkish banking system is a net payer. As of March 2012, 4.2 percent of the total assets of banks in Turkey were composed of investments abroad and 19.4 percent of total funding sources were composed of foreign funding. On-balance sheet transactions carried out with foreign countries are mostly composed of interbank operations. The share of investments in EU countries in total assets is 2.8 percent, while the share of funds provided from these countries in total funding sources is 12.1 percent. The United Kingdom, which has the largest share among these countries, has a share of 1.1 percent in total assets and 5.5 percent in foreign funding sources (Chart III.26). Among derivative financial transactions carried out with foreign countries, money swaps and interest rate swaps have the largest share. When the breakdown of derivative financial transactions of the banking sector is evaluated on a country basis, it is observed that the total share of foreign countries is 77.7 percent and the United Kingdom has the largest share with 51.8 percent (Chart III.27). The share of PIIGS countries consisting of Portugal, Ireland, Italy, Greece and Spain is negligibly low with respect to breakdown of assets, funding sources and off-balance sheet transactions.



With the provision of the facility of maintaining Turkish lira reserve requirements as gold and foreign exchange, the banking system was affected positively through cost and liquidity channels and the banks' liquidity needs and borrowings from the CBRT decreased. By March 2012, the ratio of liquid assets to total assets declined by 0.6 points compared to end-2011 and became 19.6 percent. This development is mainly attributable to the decrease in cash and cash-equivalent assets due to the maintenance of a portion of Turkish lira required reserves as gold and foreign exchange at blocked accounts since 28 October 2011 and to reductions in required reserve ratios (Chart III.28). Despite the decline in the share of liquid assets to total assets, the total liquidity adequacy ratios of the banking sector, computed in accordance with the Regulation on the Measurement and Assessment of Liquidity Adequacy of Banks, still remains well above the legal ratio of 100 percent (Chart III.29).

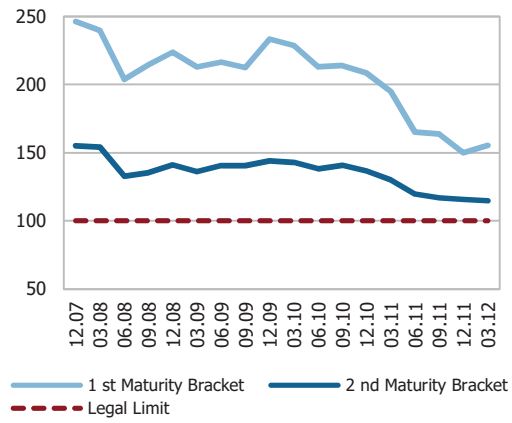
Chart III.28. Liquid Assets (% Asset)^{1,2}

Source: BRSA-CBRT

(1) Cash and cash equivalent assets=Cash+ CBRT + Money Markets + Banks + Reverse Repo

(2) Free Securities = Government securities that are not used as collateral or for repo

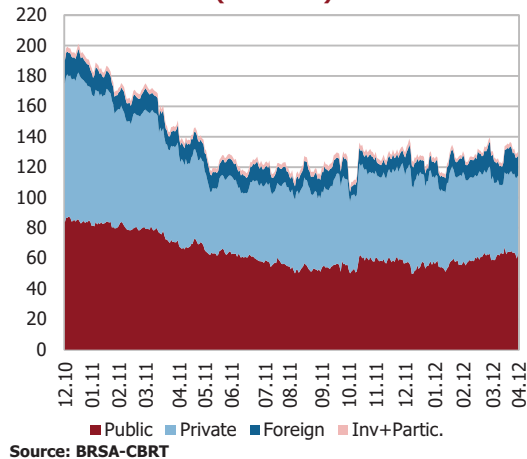
Chart III.29. Total Liquidity Adequacy Ratio



Source: BRSA-CBRT

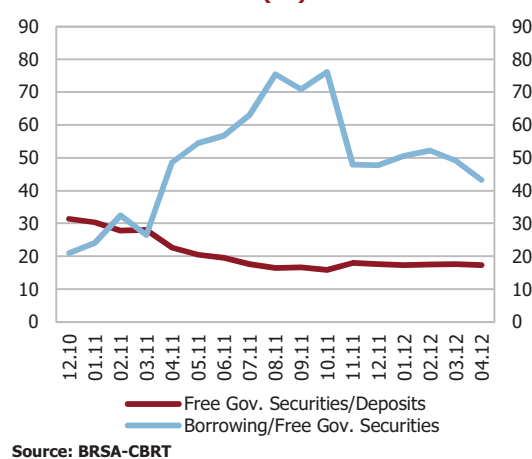
Free securities, which are considered by the CBRT eligible collateral to meet the liquidity needs of banks in case of a temporary liquidity shortage, and the ratio of these securities to deposits have recently followed a relatively flat trend, while the ratio of borrowing from the ISE and Interbank money markets to government securities has started to decline. Free securities, which had reached TL 190.2 billion by the end of 2010, started to decline after this period, followed by a flat course from mid-2011 and became TL 128.5 billion. Meanwhile, the ratio of borrowing from the ISE and Interbank money markets to government securities, which displayed an upward trend by October 2011, assumed a downward trend from early 2012 and materialized at 43.3 percent in April. The ratio of free government securities that can be used by banks in case of a liquidity shortage to deposits followed a horizontal course and became 17 percent in April 2012 (Chart III.30, Chart III.31).

Chart III.30. Total Securities Eligible By the CBRT As Collateral (Billion TL)



Source: BRSA-CBRT

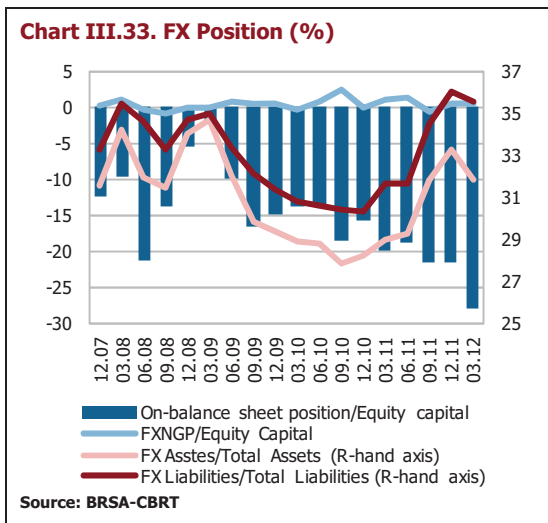
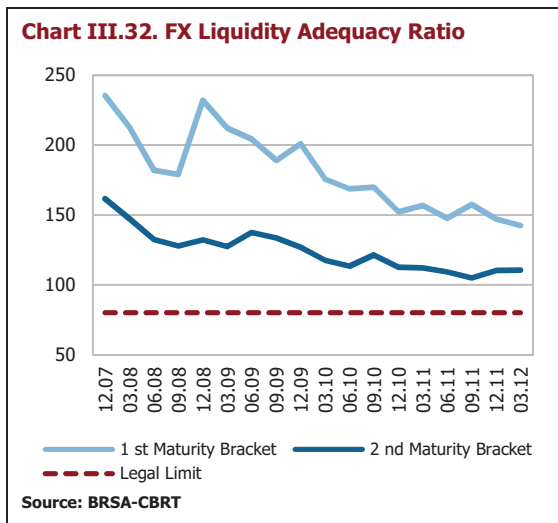
Chart III.31. The Ratio of Total Free Government Securities to Liabilities (%)



Source: BRSA-CBRT

Although banks' on-balance sheet short positions are on the rise due to their propensity to create Turkish lira sources through swaps, their foreign exchange net general positions and liquidity ratios remain within legal limits as they counter-balance the short positions with off-balance sheet transactions. Concerning FX liquidity adequacy

ratios, while the downward trend in the 1st maturity bracket observed since 2009 continues, the 2nd maturity bracket has followed a steady course since 2011 (Chart III.32). By March 2012, the ratio of FX assets, including those indexed to foreign exchange, to total assets was 31.8 percent and the ratio of FX liabilities to total liabilities was 35.5 percent. The on-balance sheet short position, which is closed by off-balance sheet transactions mostly composed of swap transactions, has continued to increase since early 2012. As a matter of fact, Turkish lira borrowing swaps continued to rise in 2012 reaching USD 38.8 billion and foreign exchange borrowing swaps remained flat materializing as USD 12.9 billion in March. As of March 2012, the ratio of foreign exchange net general position to total equity capital was 0.5 percent (Chart III.33).



Box III.2. Short-Term Liquidity Measures of The Central Bank of the Republic of Turkey

In order to prevent any deterioration in medium-term inflation expectations and inflation outlook that might arise from the excessive depreciation of the Turkish lira, base effects from unprocessed food prices and adjustments in administered prices in the last quarter of 2011, the Monetary Policy Committee (the Committee) took the necessary action in October and widened the interest rate corridor by increasing the lending rate significantly; hence adopted a strong tightening in the monetary policy. At its meeting of 23 November 2011, the Committee decided to closely monitor the impact of measures taken on credit, domestic demand and inflation expectations and to adjust the amount of Turkish lira funding via one-week repo auctions on both sides, if needed. Additionally, the Central Bank decided to inform the public on a regular basis regarding the planned amount of funding provided via one-week repo auctions in order to facilitate banks' liquidity management and to assist them with the estimation of their total funding cost. In this framework, the lower limit of the outstanding amount of funding (one-week repo funding amount) for any day throughout the following maintenance period started to be announced on Reuters "CBTF" page bi-weekly every Friday morning at 9:30, from 25 November 2011.

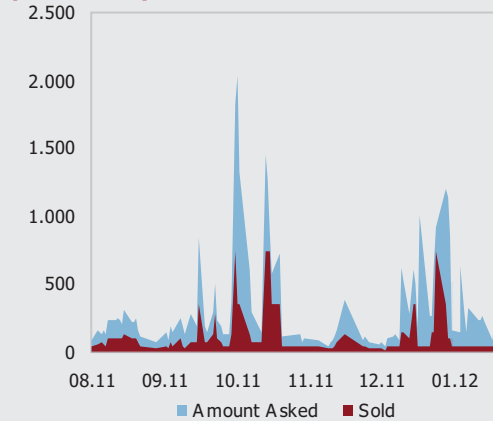
In addition to these measures, the Central Bank started to hold one-month (4 weeks) repo auctions every Friday from 30 December 2011, in traditional auction method in order to balance the effects of global economic developments on the Turkish economy and to contribute to a more effective distribution of liquidity.

Furthermore, at its meeting of 24 January 2012, the Committee decided to announce the lower and upper limits of one-week repo auctions to be held in quantity auction method during the period between two Committee meetings and the upper limit of one-month repo auctions to be held in traditional auction method as a complementary action to assist banks in predicting their funding costs.

Meanwhile, regarding the foreign exchange selling auctions run in line with the strategy formulated at the Committee meeting of 4 August 2011, and upon CBRT's regulation dated 29 November 2011, the total maximum amount of foreign exchange that could be sold for the next two working days via selling auctions started to be announced on Reuters page "CBTQ" at 15:00 on each working day. Within this scope, the total maximum selling amount was determined as USD 100 million for 29 November and 30 November 2011. From 27 December 2011, it was decided that the maximum amount that could be sold at the daily selling auctions would continue to be announced as USD 1,350 million and that the total maximum amount that could be sold for the following two working days would continue to be announced as USD 1,700 million for the term until the next Monetary Policy Committee meeting. However, except in extraordinary circumstances deemed necessary for price stability and financial stability the CBRT also decided to meet only up to USD 50 million of received offers. It was decided that effective from 30 December 2011, the CBRT would continue to hold auctions on the days of a direct intervention in the foreign exchange market by the Bank before the auction time. Due to speculative price formation in exchange rates, the CBRT directly intervened in the market through selling auctions on 18 October, 30 December 2011 and on 2-3-4 January 2012.

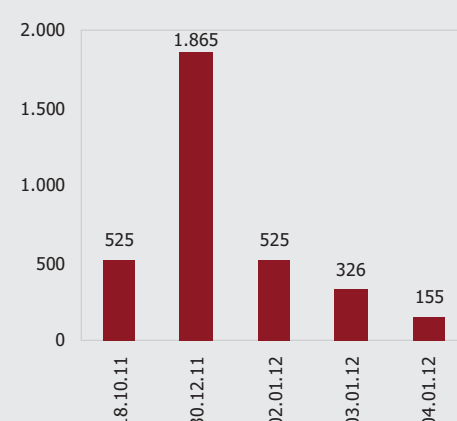
Furthermore, the CBRT initiated implementation of intraday foreign exchange selling auctions as necessary from 6 January 2012, set the daily auction selling amount as USD 50 million for each auction and decided to meet the full amount of offers received up to the auction amount. At the Committee meeting of 24 January 2012, it was indicated that considering the ongoing improvement in current account dynamics and the sudden swings in global conditions, intraday foreign exchange selling auctions would be more effective and more consistent with monetary policy objectives, compared to the regular foreign exchange selling auctions. It was therefore decided to suspend regular foreign exchange selling auctions as of 25 January 2012; yet to hold intraday foreign exchange selling auctions within the framework stipulated in the "Press Release on Intraday Foreign Exchange Selling Auctions" dated 6 January 2012 and to set the maximum daily amount to be sold via intraday auctions as USD 500 million until the next Committee meeting.

Chart 3. FX Selling Auctions Against TL (Million USD)



Source: CBRT

Chart 4. Direct FX Selling Interventions Against TL (Million USD)



Source: CBRT

Meanwhile, with the press release of 27 December 2011, the maturity of foreign exchange deposits that the banks could borrow from the CBRT within their borrowing limits in the Foreign Exchange Deposit Market was raised from 1 week to 1 month, effective as of 2 January 2012.

The press release of 2 January 2012 provided explanations regarding the monetary policy to be implemented by the CBRT on exceptional days. Accordingly, it was stated that under the assumption that end-2011 inflation would materialize above 10 percent, the CBRT introduced an additional monetary tightening from 29 December 2011 to contain the second round effects, and that the liquidity funded to the market at the policy rate might be reduced temporarily below the lower bound announced for normal trading days. It was also indicated that unsterilized (effective) foreign exchange sales and direct interventions might also be used as a complementary instrument when necessary.

At the Committee meeting of 21 February, considering recent expansionary monetary policy decisions around

the globe, it was decided to cut the upper limit of the interest rate corridor. Accordingly, the overnight lending rate was cut from 12.5 percent to 11.5 percent, and the interest rate on borrowing facilities provided for primary dealers via repo transactions within the scope of open market operations was reduced from 12 percent to 11 percent. In the context of the late liquidity window, the overnight lending rate applicable between 16:00 and 17:00 hours at the Interbank Money Market was cut from 15.5 percent to 14.5 percent.

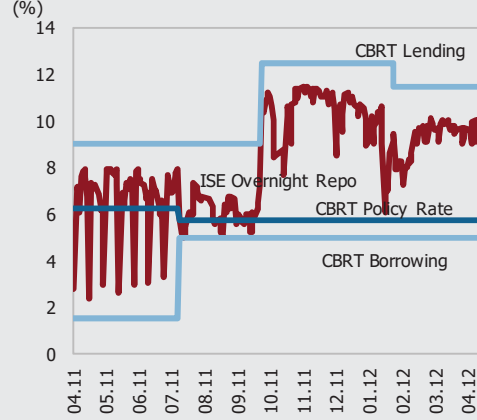
Chart 5. CBRT Weighted Average Funding Cost¹ (%)



Source: CBRT

(1) CBRT weighted average funding cost is the weighted average cost of outstanding funds provided by the CBRT through Interbank Money Market (providing deposits) and Open Market Operations (ISE repo, primary dealer repo, weekly repo via quantity auction, weekly repo via traditional auction, monthly repo). Simple interests have been used in calculation.

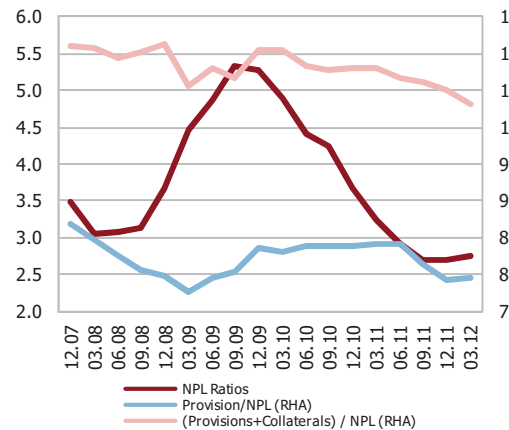
Chart 6. CBRT and Secondary Market Interest Rates (%)



Source: CBRT

The non-performing loan (NPL) ratio maintains its historical low levels. NPL ratio remained steady in the first quarter of 2012 and became 2.7 percent in March. The continuance of the improvement in NPL ratio for loans extended to micro-sized enterprises and housing loans is noteworthy. Considering the provisions set aside for NPLs along with collaterals received for loans, it is observed that the sector is strong enough to cover the credit risk it is exposed to (Chart III.34 and Table III.2).

Chart III.34 Non-Performing Loans (NPL) (%)



Source: BRSA –CBRT

Table III.2. NPL Ratios (%)

	2010	2011	03.12
Total Loans	3.7	2.7	2.7
Corporate	3.4	2.6	2.6
-SME Loans	4.5	3.1	3.2
--Micro	6.7	4.3	4.0
--Small	4.1	2.9	3.1
--Medium	2.8	2.2	2.5
-Other Corp. L.	2.8	2.3	2.3
Retail Loans	4.1	2.9	3.0
-Consumer	2.7	1.9	1.9
Loans			
--Housing	1.4	0.9	0.8
--Vehicle	6.0	3.3	3.4
--Other	3.7	2.6	2.7
-Credit Cards	8.0	5.9	5.9

Source: BRSA –CBRT

Although there is no database regarding the total number of cheques used in Turkey, cheques submitted to the Interbank Cheque Clearing Houses Center (ICH) are considered to be a significant indicator. The ratio of bad cheques presented to the ICH to the total amount of cheques started to

increase in the second half of 2011 (Chart III.35). When default rates are analyzed by sectors, it is observed that the on-going improvement since 2011 continued in March 2012 as well (Table III.3).

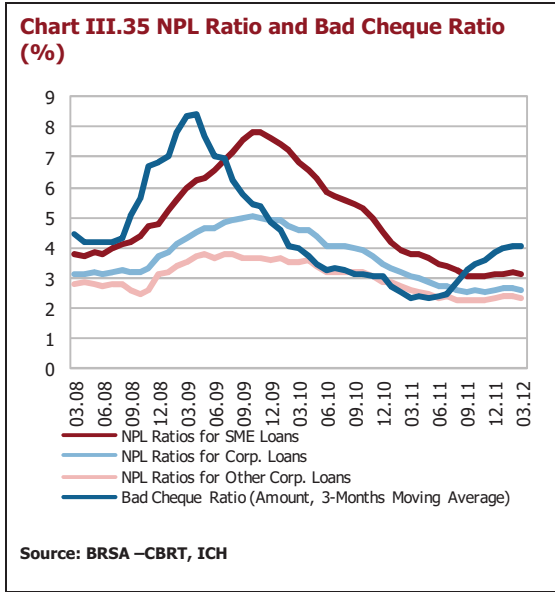


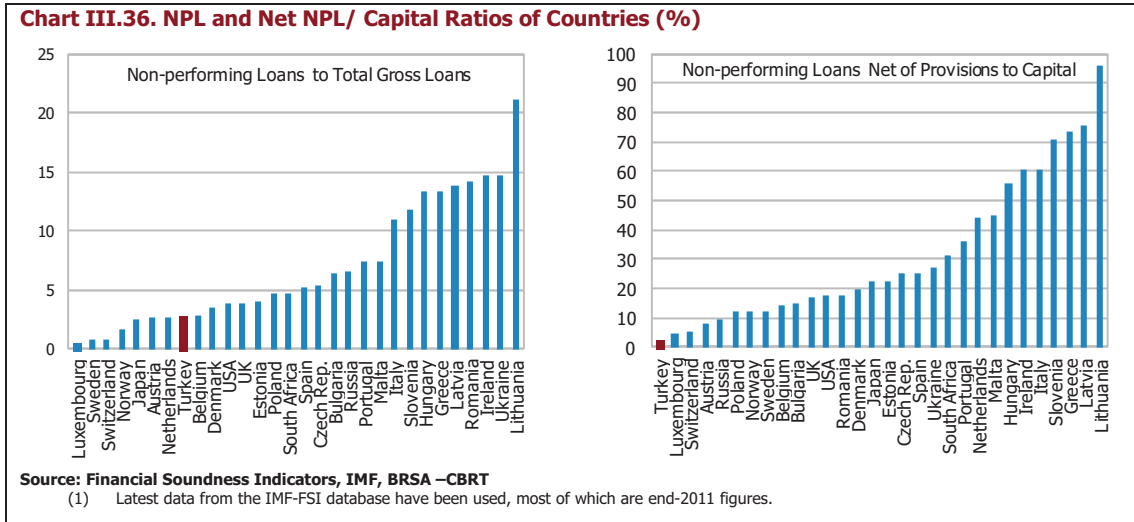
Table III.3. Default Rates by Sectors¹

	2009	2010	2011	03.12
Agriculture,Hunting,Wood Product Industry	19.7	17	10.8	10.9
Food, Beverage and Tobacco Industry	13.4	12.2	9.8	9.7
Textile and Textile Product Industry	15.5	14.5	12	11.7
Main Metal Industry	9.9	8.6	6.8	6.5
Machine and Equipment Industry	8.6	7.5	6.4	6.2
Electric, Gas and Water Resources	7.5	7.5	5.5	5.3
Construction	10.2	9.5	7.6	7.3
Wholesale Trade and Brokerage	11.8	21.3	11.3	10.9
Hotels and Restaurants	11.1	10.3	8	7.8
Transportation, Storage and Communication	9	8.2	5.3	5.1
First 10 Sectors	13.2	16.8	10.5	10.2

Source: BRSA –CBRT

(1) The default rate has been calculated as the ratio of the number of firms that have non-performing loans to the total number of firms that have performing and non-performing loans.

Due to the problems in the banking systems of some European countries and persisting global uncertainties, NPL ratios of these countries remain quite high compared to the Turkish banking system. Because of a general tendency of deceleration in the extension of loans due to the deleveraging process and contraction of financing facilities of these countries as well as economic underperformance, the NPL ratios of many countries hover around high levels. Compared to other developed and developing economies, the Turkish banking system shines with its strong asset quality (Chart III.36).

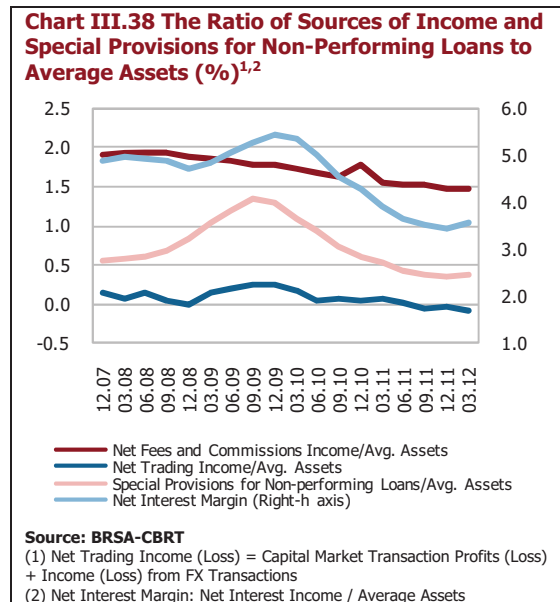
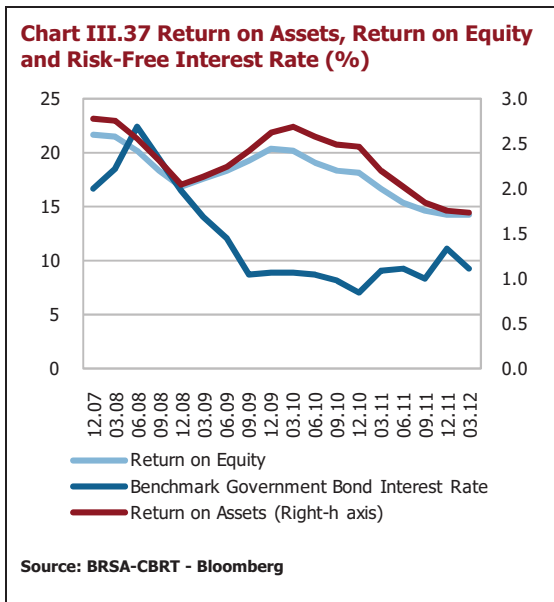


The net profit of the banking sector that declined in 2011 increased year-on-year in the first quarter of 2012. The net profit of the banking sector decreased by 10.3 percent year-on-year at end 2011 and became TL 19.8 billion. In the same period, despite the favorable effect of the decline in special provisions for non-performing loans as well as the increase in net fees and commissions income and net interest income, the surge in net non-interest expenses affected profitability adversely. The increase in non-interest expenses was due to the fact that operational

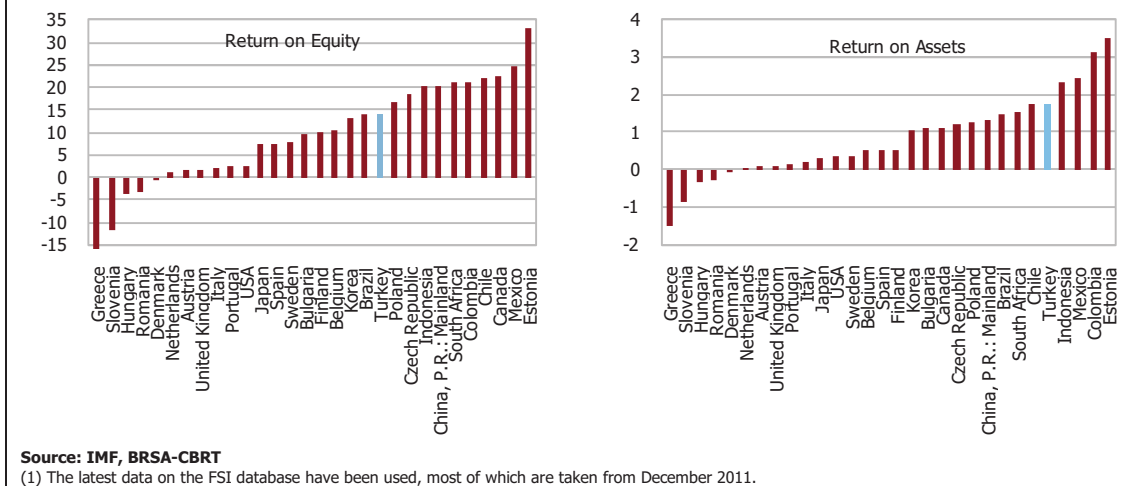
costs and general provisions increased and net trading income turned into losses arising from losses from FX transactions.

Meanwhile, by March 2012, the net profit increased to TL 6 billion on the back of a year-on-year increase by 9.7 percent. This increase was mainly attributable to the surge in net interest income. The non-interest expenses that rose due to the surge in operational costs and profit from capital market transactions turned into losses stemming from derivative financial instruments and the increase in special provisions for non-performing loans became factors that reduced the net profit.

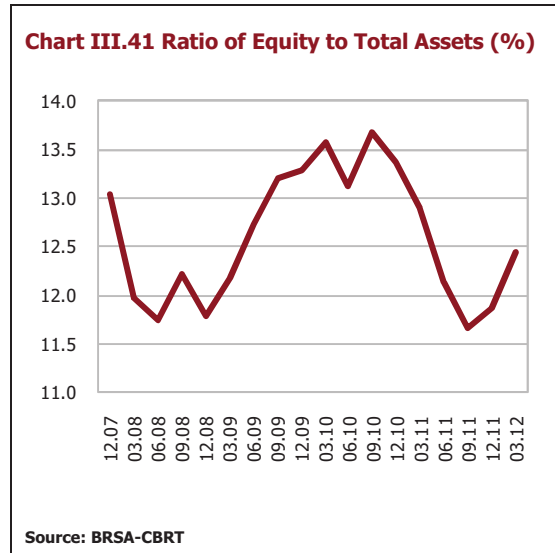
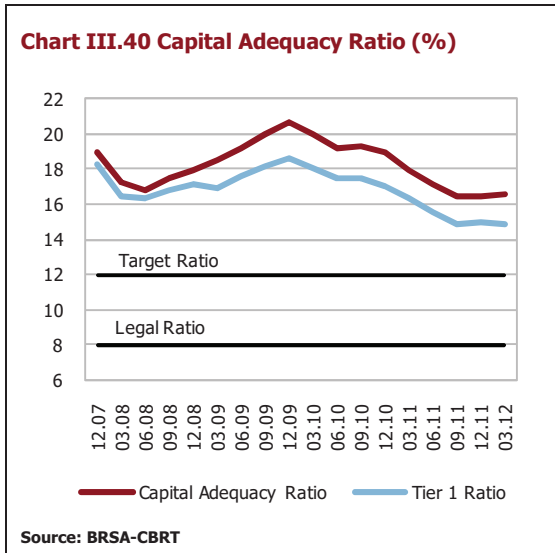
The sector's return on assets and return on equity became 1.7 percent and 14.3 percent, respectively, by the end of 2011 and remained almost unchanged in March 2012. However, it is noteworthy that despite the decline in return on equity, the return received is above the alternative risk-free rate of return (Chart III.37). The net interest margin, which was 3.5 percent by the end of 2011, increased by 0.1 points and reached 3.6 percent on the back of the increase in net interest income in March 2012 (Chart III.38).



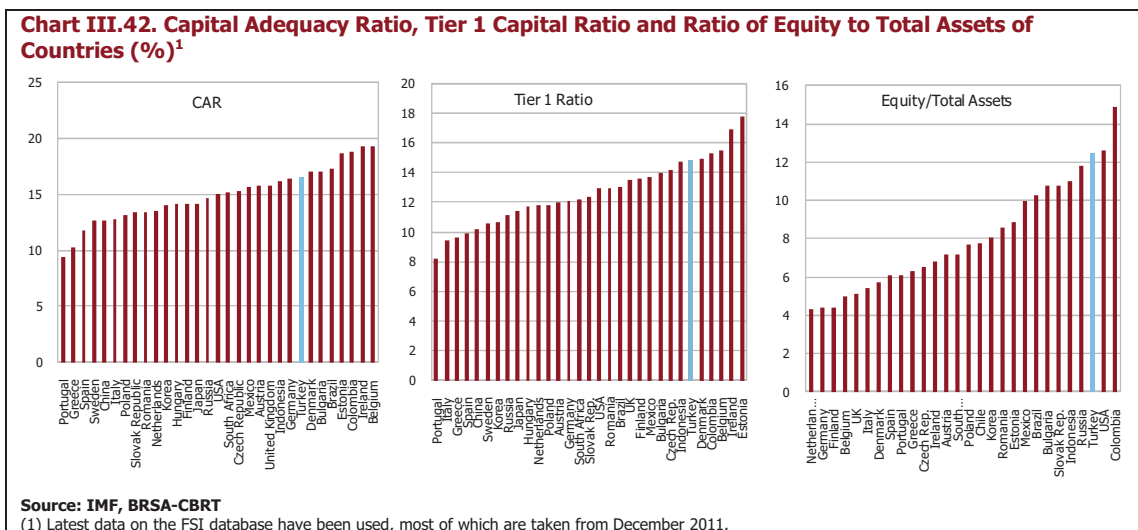
Although profitability performance indicators of the banking sector indicate a downward trend by year-end, they are still high compared to other countries. The return on equity and return on assets of the Turkish banking sector are well above the ratios of other countries (Chart III.39).

Chart III.39. Return on Equity and Return on Assets of Countries (Annual, %)¹

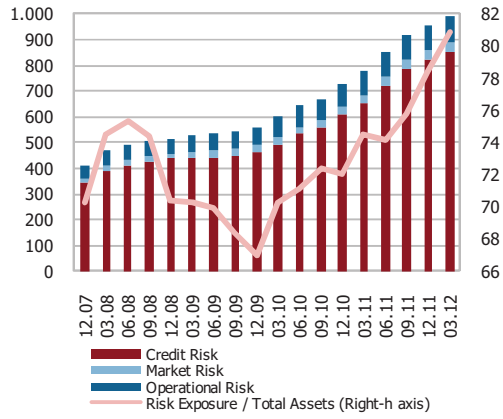
The capital adequacy ratio of the banking sector that had been in decline since early 2011, displayed a moderate increase by the end of the year. The capital adequacy ratio is well above the legal limit of 8 percent and target ratio of 12 percent. As of March 2012, the capital adequacy ratio of the sector increased by 0.1 percent compared to the year-end ratio of 16.5 percent and became 16.6 percent. The limited increase in the capital adequacy ratio of the sector was mainly driven by the improvement in profitability performance and the deceleration in credit growth rate (Chart III.40). In the meantime, the ratio of Tier 1 capital within own funds was approximately 90 percent as of March 2012, which denotes the quality of the own funds components of the sector. In fact, by end-2011 and March 2012, the Tier 1 capital ratio materialized quite high, at 14.9 percent. Moreover, the ratio of equity to assets was on the rise, becoming 11.9 percent at end-2011 and 12.5 percent in March 2012 (Chart III.41). The improvement in profitability performance of the sector and the increase in the securities increment value fund have a positive impact on the equity capital structure of the banking sector. In addition, the ongoing implementation imposing restrictions on banks in the distribution of profits, introduced by the BRSA, contributed to the formation of a significant amount of legal reserves, which also adds to the positive impact. Meanwhile, if the increase in the profitability performance of the sector and the deceleration in the growth rate of credits continue, the rise in the sector's CAR is expected to continue as well. However, with the transition to Basel II by July 2012, the capital adequacy ratio of the sector is expected to decrease slightly (Box III.3).



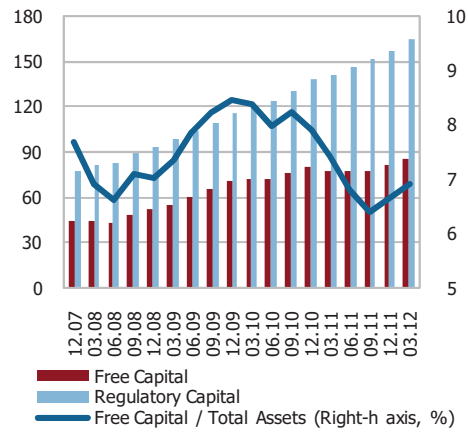
The Turkish banking sector has a high capital adequacy ratio. Compared to other countries, Turkey is one of the countries that enjoy high ratios with regard to the capital adequacy ratio, Tier 1 capital ratio, and the ratio of equity to total assets (Chart III.42).



The rise in the share of total risk exposure of the banking sector in total assets continues. By the end of 2011, mainly due to the credit risk, the said ratio increased by 2.6 points to 78.4 percent compared to September and stood at 80.8 percent in March 2012 (Chart III.43). In the same periods, the ratio of free capital to total assets surged to become 6.6 percent and 6.9 percent, consecutively (Chart III.44). This surge was mainly driven by the soar in equities and the decline in the rise of risk-weighted assets due to credits.

Chart III.43. Composition of Total Risk Exposure (Billion TL, %)

Source: BRSA-CBRT

Chart III.44. Developments in Free Capital (Billion TL, %)

Source: BRSA-CBRT

Box III.3. Basel II, Basel 2.5 and Basel III Regulations**Basel II**

The one-year period, which is called parallel run period in Turkey, implying the simultaneous implementation of Basel-I and II will end in July 2012 and by this time Turkey will become fully qualified to implement Basel II. Of the regulations known as Basel II draft regulations, the Draft Regulation on Measurement and Evaluation of Capital Adequacy of Banks (the Draft Regulation) along with its annexes and draft communiqués were published by the BRSA.

An announcement made by the BRSA indicates that according to the parallel reporting to the BRSA by banks, the CAR of the sector is expected to decrease by 1.2 points in view of March 2012 data. Despite this decrease, the capital adequacy ratio of the sector does not fall below the legal and target limits.

As it is known, while assets are risk-weighted based on the criteria of OECD-membership pursuant to Basel I regulations, their risk weights are determined according to credit ratings pursuant to the standardized approach in Basel II. In this framework, for instance, according to Basel I, exposures to central governments, central banks and public institutions fulfilling certain criteria are subject to a risk-weighting of 0 percent or 100 percent based on a breakdown of OECD members/non-members; according to the Basel II standardized approach, exposures to central governments and central banks are subject to a risk-weighting as per sovereign ratings. However, at national discretion, a lower risk weight within the 0-100 risk weight interval may be applied to banks' exposures to their sovereign and central bank of incorporation denominated in domestic currency and funded in that currency. Therefore, while 100 percent risk weight will be applied to claims on sovereigns denominated in foreign currency due to Turkey's current rating, according to national practices, TL-denominated exposures to Turkish Treasury and Central Bank can be subject to 0 percent risk weight on condition of being funded in terms of TL.

Under the current approach;

- Housing loans classified within the 50 percent risk weight will be classified within 35 percent risk weight according to the Basel II standard approach.
- For exposures to corporates, loans with cash collaterals and mortgage-backed guarantees are subject to 0 percent and 50 percent risk weight, respectively; while for other loans, a 100 percent risk weight is applied. Whereas in Basel II, certain risk weights are specified according to the rating of the firm for these exposures.
- Retail exposures and exposures to SMEs are subject to a risk weight of 100 percent; however the risk weights of these receivables might decrease further if they are credit-protected receivables. Whereas in Basel II, the said exposures are classified within the 75 percent risk weight.

Basel 2.5

Studies related to the incorporation of the regulatory recommendations known as Basel 2.5 (Enhancements to the Basel Framework and Revisions to the Basel II Market Risk Framework, 2009) to the Basel II Regulation Drafts, currently implemented as a part of the parallel run period in Turkey, are carried out by the BRSA.

Basel 2.5 regulations, which were put into implementation in July 2009, cover amendments made to securitization and the trading book. The majority of the losses incurred by banks upon the breakout of the global financial crisis by mid 2007 stemmed from the trading book. One of the most important reasons for this was that the amendments made to Basel I in 1996, related to the inclusion of market risk in calculation of capital adequacy, did not capture some key risks. Therefore, the Basel Committee decided to supplement the current value-at-risk-based trading book framework with an incremental risk capital charge (IRC), which included default risk as well as migration risk, for unsecured credit products.

In addition, calculation of a stressed value-at-risk requirement was introduced. Losses in banks' trading books during the financial crisis were significantly higher than the minimum capital requirements envisaged by Basel II for market risk. Currently, the most recent 12-month observation period is taken into account while calculating the value-at-risk. Additionally, with the amendment made, calculation of a stressed value-at-risk is intended, where inputs of the value-at-risk model is measured by calibrating historical data pertaining to a significant financial stress period of 12 months. Furthermore, it was decided to increase the specific risk weight of 4 percent for liquid and well-diversified security portfolios to 8 percent.

In addition to the changes in the trading book, it was aimed to strengthen the securitization approach set out in Basel II. In this respect, within the internal ratings-based approach, risk weights related to re-securitization were raised so as to reflect the risks borne by the said items. Furthermore, specific risk measurement related to securitization was introduced.

Basel III

The global crisis has revealed that the capital of the majority of banks in developing countries is not of a desired quantity and quality. As a first step to finding a solution to this problem, items included in Tier 1 capital, which have a high level of loss coverage capacity, were named common equity to boost the quality and transparency of the capital. With Basel III, the minimum common equity ratio (Common Equity /Risk-Weighted Assets) will be gradually increased from 2 percent to 4.5 percent during the period from 2013 to 2015.

In addition to legal capital adequacy ratios, there are initiatives to develop approaches that will help alleviate the adverse effects of procyclicality through capital buffers, envisaged to be created by banks. It is aimed that banks should guard themselves against the adverse effects of financial distress and economic contractions by using these capital buffers and thus continue to function effectively. The "capital conservation buffer" introduced by Basel III, will gradually be added to the common equity, Tier 1 Capital and total capital. The said ratio is planned to be increased progressively from 2016 to 2019, ultimately reaching 2.5 percent in 2019. Moreover, introducing an additional capital requirement of 1 – 2.5 points is envisaged for banks with international systemic importance, based on the risk they bear. Currently, the FSB and Basel Committee are conducting similar studies for banks with local systemic importance.

High levels of indebtedness in financial system are also considered to be one of the main reasons for the global crisis. In this context, formulating a leverage ratio that will support the Basel II framework and that will be compulsory is envisaged. The said ratio will be computed by dividing Tier 1 Capital (Principal Capital) by total sum of off-balance sheet items (taken into account with certain conversion ratios) and assets (Tier 1 Capital /Assets + Off-Balance-Sheet Items). A minimum leverage ratio of 3 percent is planned to be tested during the parallel run period until the first half of 2017. The said leverage ratio will be finalized in view of the results of the Quantitative Impact Studies (QIS) as well as the parallel run, and will be effective as of 1 January 2018.

Within the framework of enhancing banks' resilience against systemic liquidity shocks and strengthening their liquidity risk management processes, Basel III regulations have set out the calculation of a Liquidity Coverage Ratio and a Net Stable Funding Ratio. The Liquidity Coverage Ratio, which will be calculated by dividing a bank's liquid

assets by its net cash outflows occurring over a 30-day horizon, is required to be a minimum of 100 percent. The net cash outflow is the difference between cash outflows occurring in 30 days and cash inflows occurring in 30 days.

The Net Stable Funding Ratio is calculated by dividing the amount of "available stable funding" by the amount of "required stable funding" and should be a minimum of 100 percent. The "available stable funding" will be determined according to the maturity and quality of items in banks' liabilities, including their Tier 1 and Tier 2 Capital; while the "required stable funding" will be calculated by taking account of items included in banks' assets at differing ratios based on their maturities and qualities.

For the Liquidity Coverage Ratio, the period from 2011 to early 2015 and for the Net Stable Funding Ratio, the period from 2012 to early 2018 have been set as observation periods. It has been indicated that minimum standards for the said ratios will be announced following the observation periods.

In addition to the high level of the capital adequacy ratio in Turkey, own funds that are composed mainly of paid-up capital and retained earnings, both of which have high loss coverage capacity, suggest that the Turkish Banking sector will not have difficulty in adapting to Basel III regulations. Studies initiated in relation to Basel III in Turkey are planned to be incorporated into the national legislation and implemented by the BRSA in line with the timetable determined by the Basel Committee.

Scenario analyses, which test the resilience of the banking sector to shocks coming from credit and market movements, show that the sector has the capacity to absorb shocks. According to the scenario analysis applied, even when exchange rates, Eurobond returns, interest rates and NPLs are exposed to maximum shocks simultaneously, the capital adequacy ratio materializes at the legal ratio (Table III.4, Chart III.45).

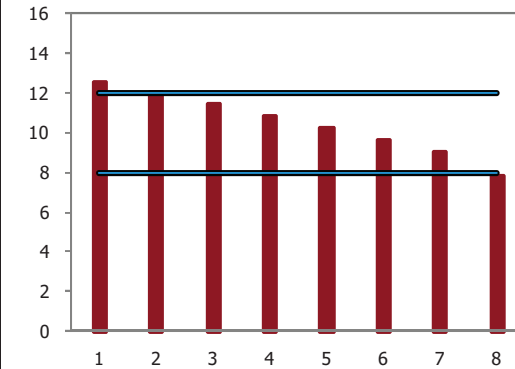
Table III.4 Scenarios Applied¹

Scenario	FX Rate (% increase)	Eurobond (% decrease)	Interest Rate (point increase) ²	NPL (point increase)
1	30.0	5.0	10.0	3.0
2	31.5	5.3	10.5	4.0
3	33.0	5.5	11.0	5.0
4	34.5	5.8	11.5	6.0
5	36.0	6.0	12.0	7.0
6	37.5	6.3	12.5	8.0
7	39.0	6.5	13.0	9.0
8	40.5	6.8	13.5	11.0

Source: CBRT

(1) In scenario analysis, taking into account also past crises, shocks are applied to risk factors simultaneously.
(2) It refers to the Turkish Lira interest rate shock. The FX interest rate shock is about 1/3 of that applied to Turkish lira interest rate. In the shocks applied to commercial portfolios, impairment is about 17 percent on sectoral basis. Effective Eurobond shocks are three times the table figures.

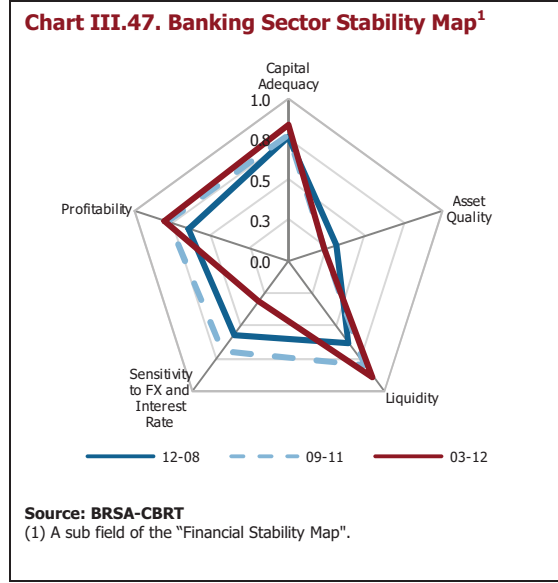
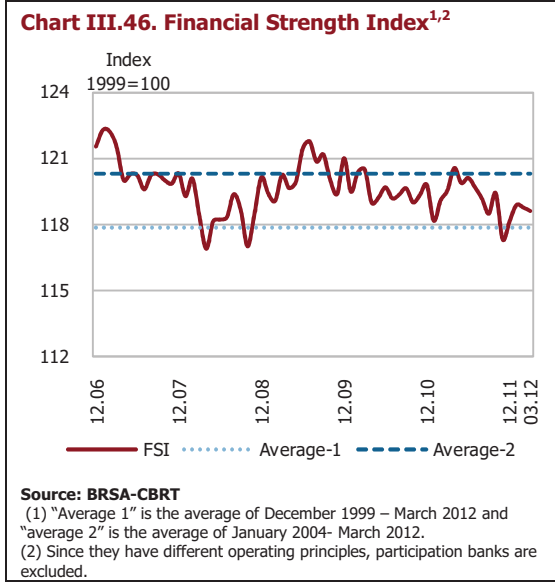
Chart III.45 Results of Scenario Analysis



Source: CBRT

Banking sector indicators suggest that the sector broadly presents a favorable outlook. The asset quality of the sector improved compared to that of the crisis period and followed a relatively flat trend during the past 6 months compared to the previous reporting period. Non-performing loans increased in this period; however, the NPL ratio pursued a horizontal course compared to September 2011 on the back of the increase in performing loans. Nevertheless, profitability ratios assumed an upward trend owing to the improvement in the sector's net interest

income. Additionally capital adequacy ratio is on the rise owing to the improvement in the sector's profitability performance and the slowdown in the credit growth rate. Although the on-balance sheet FX short position has been on an upward trend since end-2011, it is counter-balanced by the off-balance sheet long position; hence the FX net general position maintains its low level. The banking sector's liquidity adequacy ratios for the 1st and 2nd maturity brackets are above the legal limit both in terms of total amount and in foreign exchange; yet, an increase is observed particularly in non-core funding. Due to all these changes, the financial strength index(FSI) became 118.6 in March 2012 and the sector remains strong (Chart III.46, Chart III.47).



Owing to global economic slowdown, tight monetary and fiscal policy and other measures taken by the authorities, credit growth is expected to continue at reasonable levels for financial stability. Despite increased uncertainty in global financial markets, the Turkish banking system does not experience difficulty in obtaining funds from abroad. The profitability performance of banks has followed a horizontal path and capital adequacy ratios remain high. In fact, despite the expected decrease in the sector's CAR during the period of transition to Basel II/2.5, it is expected that profitability performance will maintain its current levels and the sector will maintain its strong capital structure.