OVERVIEW

The decisive implementation of the economic program supported by tight fiscal and monetary policies, which aims to ensure a balance in macroeconomic indicators and attain a stable growth rate, together with the European Union integration process and developments in international markets had favorable consequences. In this framework, 2005 was completed with the achievement of material improvements in macro balances, a high growth rate, a significant fall in the inflation rate and stability in money and capital markets.

Positive developments in public finance continued in 2005. The management of public debt was easier as a result of the fall in the roll over ratio, net external debt stock and interest rates, along with increasing maturities. The Treasury's sensitivity to interest rate risk has increased to a certain extent since the share of Turkish Lira denominated floating interest rate Government Domestic Debt Securities (GDDS) in the domestic debt composition increased. On the other hand, the share of foreign exchange and foreign exchange indexed GDDS declined, which diminished the Treasury's sensitivity to foreign exchange risk. It is crucial to maintain fiscal discipline and meet the primary surplus target in 2006 for the permanence of financial stability.

It can be observed that the ratio of household liabilities to total household financial assets follows an increasing trend. There was a significant rise in household debt and interest payments due to rising consumer loans, especially housing loans, which were financed by funds that emerged as a result of the reversal of public sector crowding out effect. In order to ensure financial stability, it is very important to closely monitor the risks that might arise from fluctuations in asset prices due to increasing household indebtedness.

The source of economic growth was mainly the increase in productivity and therefore the effects on employment were limited. Nevertheless, as the growth in 2005 is mainly attributable to private final goods demand and capital accumulation, it is expected that growth will have a positive effect on employment in the coming periods.

The declining credit costs in a low inflation environment increased real sector companies' access to loans and played an important role in rising investment expenditures. The rising profitability of firms and strengthening of their financial conditions are regarded positively in terms of the credit risk that might be reflected upon banks. On the other hand, the open positions of the companies, which use foreign exchange loans but can not generate foreign exchange income is an important risk factor. Therefore, it is crucial for firms to effectively use foreign exchange risk management techniques as well as İzmir Turkish Derivatives Exchange facilities.

The inadequacy of domestic savings to meet investments leads inevitably to high current account deficit in our country, which is experiencing high growth. The sustainability of the deficit on the other hand, is directly related to the quality of funding. The fact that the growth in the current account deficit in 2005 was mostly financed by long-term capital inflows and direct investments is regarded as a positive development. In recent periods, the rising uncertainty regarding global interest rates as a result of the change in the interest rate policies of Japan, the USA and the European Central Bank have led to some capital outflows from emerging markets. However, the negative effects of the outflows are reduced by strengthened macroeconomic fundamentals, a stronger financial system, tight monetary and fiscal policies, the shock absorbing function of the flexible exchange rate regime, falling short-term external debt to international reserves ratio and strong commitment to the implementation of the economic program.

Foreign capital inflows to the banking sector, which constitutes 87 percent of the Turkish financial system and which is made up of 51 banks including 4 participation banks, accelerated in 2005. According to finalized share transfers, 12.4 percent of banking sector assets belong to foreign shareholders as of 2005. On the other hand, when the unfinalized share sales, which are going through legal process are included, the aforementioned share increases above 16 percent.

In 2005, banking sector assets grew and the share of assets and liabilities denominated in domestic currency increased. The increase in assets in favor of loans continues, which indicates that the banking sector has again started to focus on its main function.

The significant rise in credit volume leads to higher credit risk. However, as supported by the scenario analyses, the high amount of capital banks hold in excess of the minimum capital requirement, strengthens the positive expectations that expansion in the loan market will continue in the coming periods. Within this context, it is essential that banks continue improving their methods of credit risk management.

The falling non-performing loans ratio in 2005 is mainly attributable to rapid credit expansion. Nevertheless, the high provisioning policy of the sector is regarded as a positive development. It is expected that banks will put more emphasis on risk management issues in the process of adapting to Basel II. On the other hand, careful monitoring of classification and provisioning policies is crucial, taking into consideration the possibility of loosened loan extention policies in the face of increasing competition and economic cycles.

Retail loans, with an increasing share in the loan portfolio, are regarded as less risky since they are higly diversified and backed by strong collateral. Nevertheless, it is very important to closely monitor the rapid rise in these loans, since they are mostly fixed rate, long term loans and the value of collateral may fall during recessionary periods. Moreover, the preparation of regulations, which will enable consumer loans currently at a fixed rate to be extended as floating rate loans, will not only ease banks' management of interest rate risk but will also be beneficial to the household sector in a low inflation environment.

Another issue regarding retail loans is the fact that credit cards, which are basically a means of payment, have become the means of access to loans. As can be seen in other country examples, banks set their credit card interest rates higher than those for consumer loans. Therefore, it is crucial to make credit card holders in need of short-term loans conscious of the advantage of meeting their needs through consumer loans instead of credit cards.

The on balance sheet open positions of banks have increased as a result of the rapid increase in loans obtained from abroad due to rising credibility in the recent periods. However, the flexible exchange rate regime increased banks' sensitivity to foreign exchange risk and led banks to increase their off-balance sheet long positions using derivative transactions. As a result, banks' foreign exchange net open positions were limited.

The sensitivity of the banking sector to maturity mismatch and interest rate risk increased in 2005 compared to the previous year since the maturity of liabilities continued to be short while the maturity of assets became longer.

The scenario analyses regarding market risk reveal that sector losses will remain low in case of rising exchange rates. On the other hand, an upward shock in the interest rate will cause larger losses, however the banking sector capital structure is strong enough to meet possible losses.

The ratio of liquid assets to total assets decreased in 2005 due to the ongoing upward trend in loans. Nevertheless, despite the short maturity structure of deposits, the high amount of core deposits in time and saving deposits, the low concentration in deposits and the high amount of assets that can be accepted as collateral by the Central Bank in case of providing liquidity are risk-reducing factors for liquidity management.

By year-end 2005, the net profit of the Turkish banking sector decreased compared to the previous year. However, this is mainly due to high losses incurred by a private bank in 2005. As a matter of fact, it can be seen that when this bank is excluded, the profitability of the sector follows a favorable course. On the other hand, it is our opinion that the banking sector will face a challenging period, especially in terms of profitability performance, in an environment of low inflation and high competition. Moreover, the creation of income and asset diversity and well management of loan expansion will contribute to banks' profitability, which will have, in the long term, positive consequences for financial stability.

At end-2005, the capital adequacy ratio of the banking sector was 24.2 percent, well above the minimum requirements. This high ratio is mainly attributable to the large Government Debt Securities portfolio held by banks, which is regarded risk free in the calculation of the capital adequacy ratio. The scenario analyses regarding credit and market risk reveal that the sector's capital is adequate to meet potential capital needs.

Basel II, which is announced by the Banking Regulation and Supervision Agency (BRSA) to come into effect in Turkey by January 2008, is expected to be implemented by more than 100 countries around the world. Taking into consideration the effects of Basel II on the financial system, it is crucial for both the banking sector and corporate sector companies to carry out the necessary initiatives for adoption and complete the arrangements to improve their corporate governance structures.

The enactment of Banking Law No. 5411, which aims to establish confidence and stability in financial markets, ensure competition, complete financial liberalization, implement efficient and risk based supervision and integrate the banking sector with international markets, and within the scope of this Law the authorization of the BRSA for the regulation and supervision of leasing, factoring and finance companies and the improvements in the legal infrastructure achieved by the Bank Cards and Credit Cards Law are considered as positive developments.

The implementation of the aforementioned legislation regarding the financial sector and the effective fulfillment of the regulation and supervision function by the BRSA are seen as important factors contributing to financial stability.

In conclusion, the level of the Financial Strength Index, which can be considered as an indicator of the strength of the banking sector and which is enhanced compared to the previous report by the addition of the interest rate risk sub-index, reached its peak by the end of 2005 and continues this trend in 2006, despite the relative decline in interest rate risk, capital adequacy and profitability sub-indices. This index, despite fluctuations from time to time, indicates that, parallel to the positive macroeconomic developments, the financial markets have become more predictable and stable.