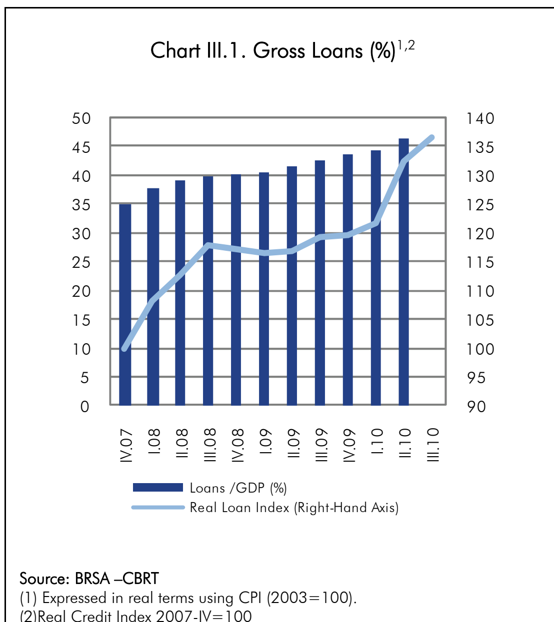
III. DEVELOPMENTS IN THE BANKING SECTOR AND RISKS

During the global crisis, the credit growth rate, especially that of Small and Medium-Sized Enterprises (SME) loans, slowed down, investments on government securities by banks increased, non-performing loan (NPL) ratios went up and financing abroad declined. In this period, the decline in interest rates parallel to the CBRT policy rate cuts resulted in the increase of the net interest margin for the banking sector due to the maturity mismatch in their balance sheets and therefore their profitability increased. However, soaring NPLs became a factor that limited this development. Though the share of loans on the balance sheet decreased, the rise of investments into government securities and the improved profitability performance, led to an increase in the capital adequacy ratio.

While exiting the crisis, as a result of the recovery in economic activity and low interest rates, the increase in all types of loans, especially SME loans, accelerated and NPL ratios declined. While the banking sector's external financing facilities improved, investment in government securities slowed down. Despite improvements in the credit quality, along with the narrowing net interest margin, profitability performance indictors entered a downside trend. Meanwhile, the capital adequacy ratio, still being above the minimum requirement and target ratios, experienced a limited decrease due to the rapid increase in loans, With the domestic and foreign demand separation in the economy in relation to rapid credit expansion and the increase in the current account deficit accruing together, this might raise concerns about financial stability in the coming periods. On the other hand, preserving effective risk management in the increased competitive environment and active credit market is a major important issue.

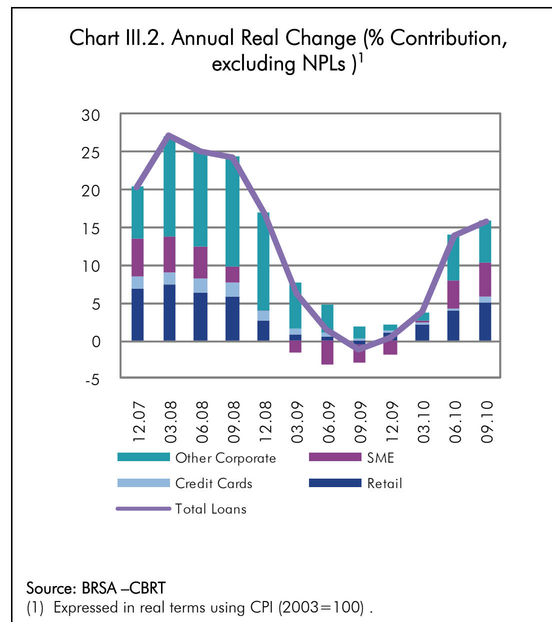
As a result of the recovery in economic activity, a significant rebound has been observed in credit volume. Gross real credits following a horizontal course during the crisis period, exhibited a rapid increase commencing from the second quarter of 2010. The rate of gross credits to national income, increased to 46.4 percent as of June 2010 (Chart III.1). The share of credits in total assets increased to 51.3 percent as of September 2010 and the real annual growth rate accelerated to 15.8 percent. It is noticeable that SME loans, which were affected the most by the global crisis and decreased in real terms, contributed to credit growth with other corporate and retail loans during the exit process of the crisis. Of the annual 15.8 percent real increase in credits, 5.1 points originates from consumer loans, 4.6 points from SME loans and 5.4 points from other corporate loans (Chart III.2).

Chart III.1. Gross Loans (%)[1,2]



Source: BRSA –CBRT
(1) Expressed in real terms using CPI (2003=100).
(2)Real Credit Index 2007-IV=100

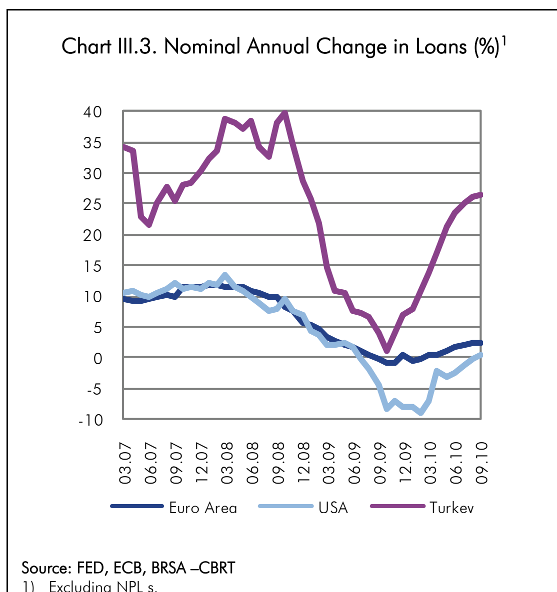
Chart III.2. Annual Real Change (% Contribution, excluding NPLs)[1]



Source: BRSA –CBRT
(1) Expressed in real terms using CPI (2003=100) .

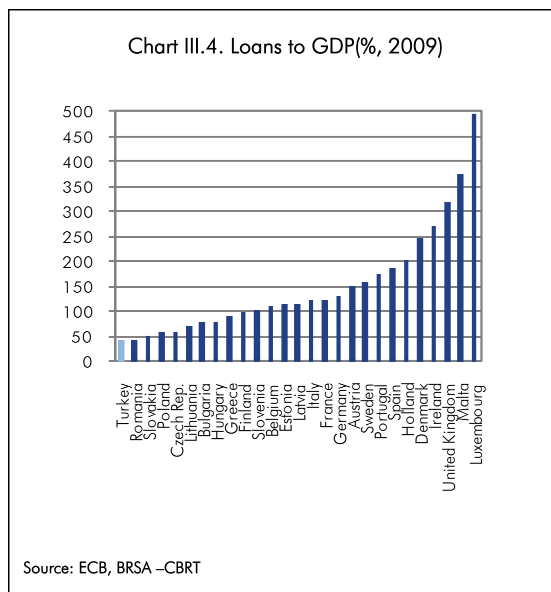
Turkey decouples from developed countries in terms of credit growth. In developed countries, banking sector problems still persist and there is not any noticeable improvement in the credit volume. As of September 2010, annual credit growth in the euro area became 2.4 percent, 0.6 percent in the USA and 26.5 percent in Turkey (Chart III.3). Meanwhile, despite the fast recovery in credit growth, the rate of bank loans to national income in Turkey is still low compared to other countries. This situation has enabled Turkey to be relatively less affected by the crisis and also indicates the existence of growth potential (Chart III.4).

Chart III.3. Nominal Annual Change in Loans (%)[1]



Source: FED, ECB, BRSA –CBRT
1) Excluding NPL s.

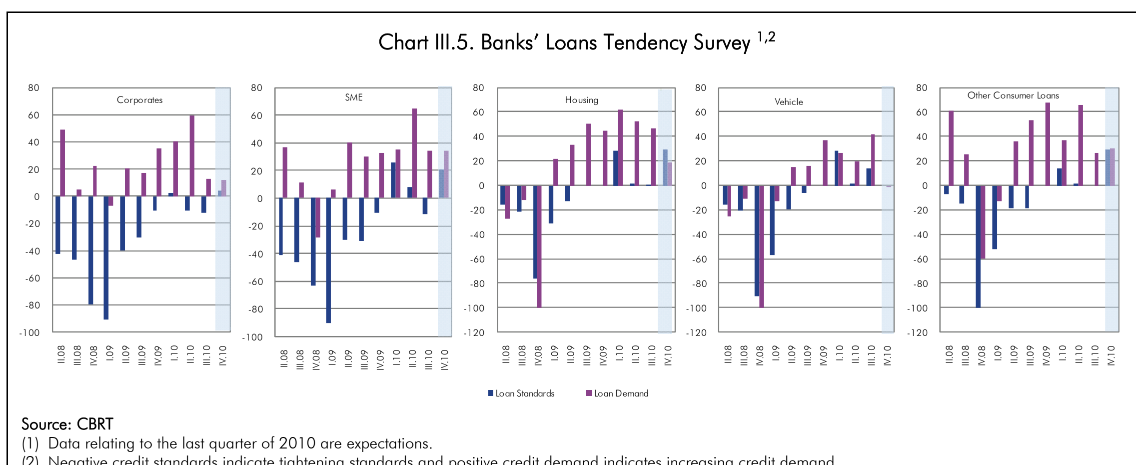
Chart III.4. Loans to GDP(%, 2009)



Source: ECB, BRSA –CBRT

Credit realizations mostly reflect demand dynamics. The results of the Banks' Loans Tendency Survey suggest that contrary to the expectations that banks would not change the standards for small and medium sized enterprises and large enterprises and standards for the short and medium term credits would be loosened in the July-September 2010 period; the expected loosening was not realized in all types of credits. In fact, banks starting to loosen the standards applied to retail loans, during the first quarter of 2010 while they did not change standards much during the second and third quarters. Along with this, credit demands of both enterprises and households, despite the state of loosening during the third quarter of 2010, continued to increase throughout the year. The increase in consumer confidence affected the demand of retail loans positively. It is observed that firms, which had applied for loans to roll over their existing debts during the crisis, recently started to apply for investment purposes (Chart III.5).

Chart III.5. Banks' Loans Tendency Survey [1,2]



Source: CBRT
(1) Data relating to the last quarter of 2010 are expectations.
(2) Negative credit standards indicate tightening standards and positive credit demand indicates increasing credit demand.

The historically low-levels of credit interests and the spread between corporate loans and deposits indicate a decline in the tightening loan supply. The interest rate for vehicle loans decreased to an annual rate of 10.8 percent, for housing loans to 10.7 percent, for other consumer loans to 12.6 percent and for corporate loans to 8.7 percent. The spread between the interest rates of corporate loans and deposits is at historically low levels (Chart III.6 and Chart III.7).

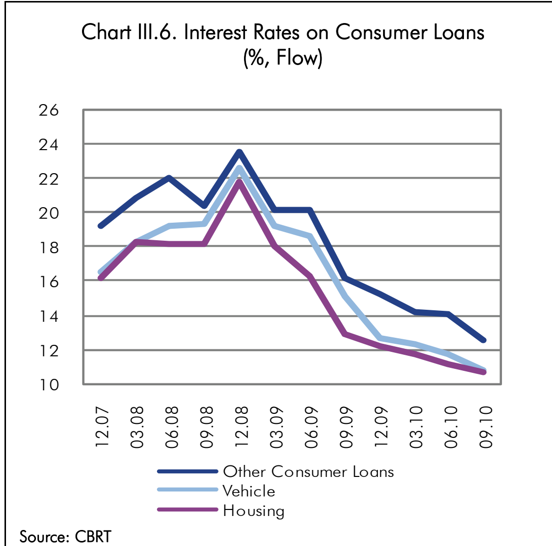


Chart III.6. Interest Rates on Consumer Loans (%, Flow)

Source: CBRT

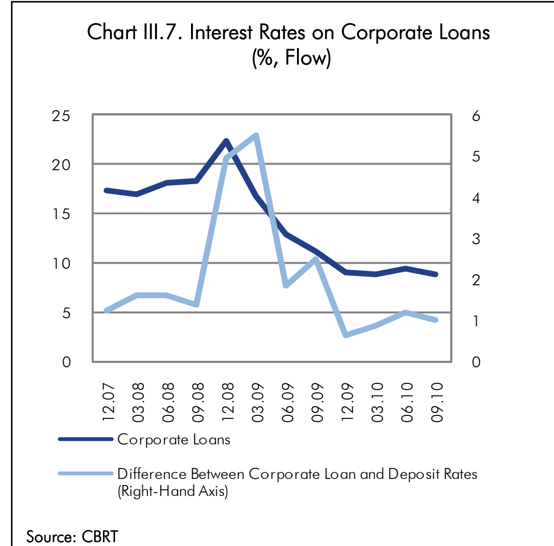


Chart III.7. Interest Rates on Corporate Loans (%, Flow)

Source: CBRT

The share of SME loans and consumer loans in the loan portfolio is increasing. The share of consumer loans and SME loans *increased by 1,8 points and was realized as 56.1 percent as of September 2010 compared to the end of 2009* (Chart III.8). This is considered to be positive for diversification of the credit portfolio. When the sub-items of consumer loans, which mostly consist of housing and other consumer loans is analyzed, the increase in the share of other consumer loans is noticeable (Chart III.9). The Undersecretariat of Treasury was authorized by a Council of Ministers Decision to transfer cash funds of up to TL 1 billion and/or issue private placement domestic government bonds for institutions who are granting credit guarantees to meet the financing requirements of *SME's*. During the January –October 2010 period, a guarantee totaling TL 216.1 million was granted. Along with this support, a target is set to issue credit to a total of 3 billion TL to the firms that bear the burden of interest only at the rate of ¼ based on the rate of interest of 0.94 percent by using the resources of KOSGEB. Of this amount, it is planned that a portion totaling 1.5 billion TL is to be allotted for scale-indexed growth credit support and the other half as export credit support. Upon the start of the application process from 23 November 2010, in a rather short period of time, SME's showed great interest in scale- indexed credit support and a request totaling TL 2,93 billion was received. In the upcoming period, it is expected that these incentives will support the increase in loans extended *to SME's. On the other hand, as per Article 45 of the CBRT Law, the limit for using export re discount credits set aside for the private sector through Eximbank was increased to USD 2.5 billion in April 2009 and credit conditions were eased. Accordingly, the amount of USD 1.4 billion was realized in 2009*. In the first 11 months of 2010, *these* credits, totaling USD 1.1 billion, were mainly allotted to firms engaged in activities in sectors of manufacture of base metal and fabricated metal production, machinery and equipment and textile and textile products.

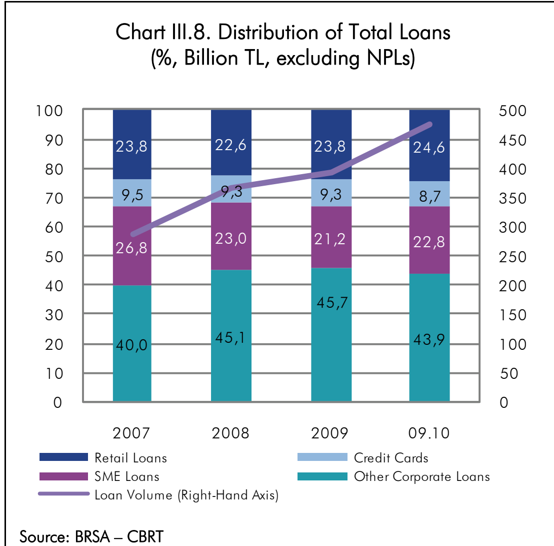


Chart III.8. Distribution of Total Loans (%, Billion TL, excluding NPLs)

Source: BRSA – CBRT

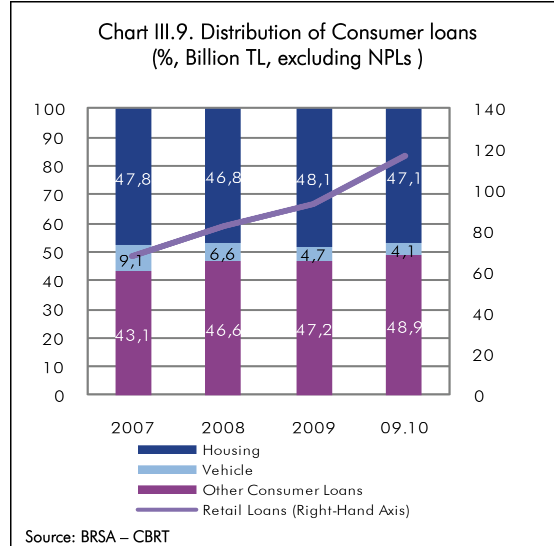


Chart III.9. Distribution of Consumer loans (%, Billion TL, excluding NPLs)

Source: BRSA – CBRT

Credits are mostly extended in TL and their maturities are becoming longer. As of September 2010, including FX-indexed loans, the share of FX denominated loans in total loans became 30.5 percent and due to the faster increase in the share of TL loans and the appreciation of TL, the share of FX denominated loans in total loans has declined (Chart III.10). On the other hand, the share of short-term loans in total loans decreased by 1 point as of September of 2010 compared to the previous year and was realized as 40.1 percent. The extension of loan maturities is favorable for parties utilizing credits; however, for the banking sector, with respect to lowering the risk of maturity mismatch, it is also important to extend the maturities of liabilities (Chart III.11).

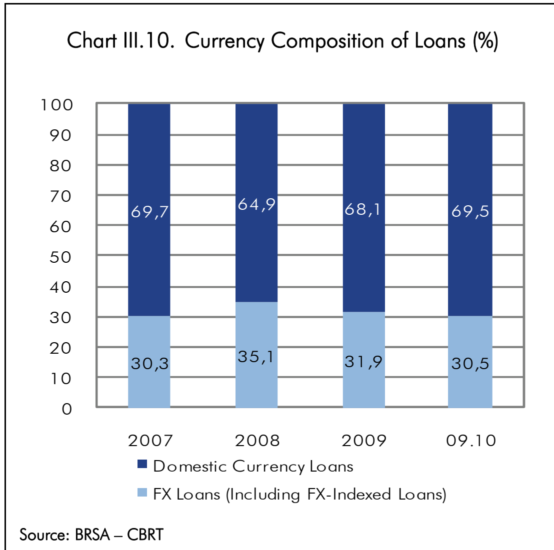


Chart III.10. Currency Composition of Loans (%)

Source: BRSA – CBRT

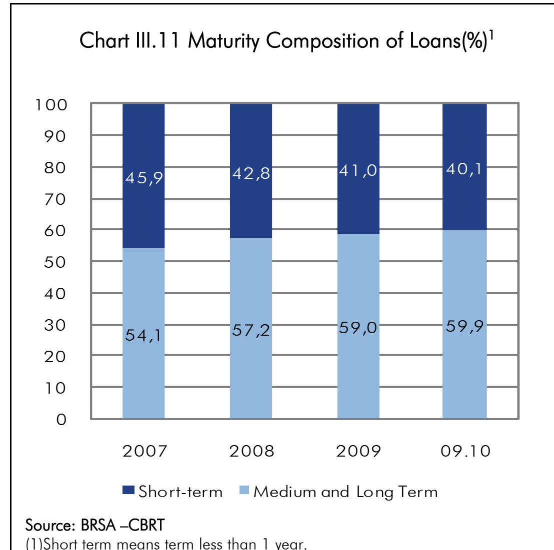
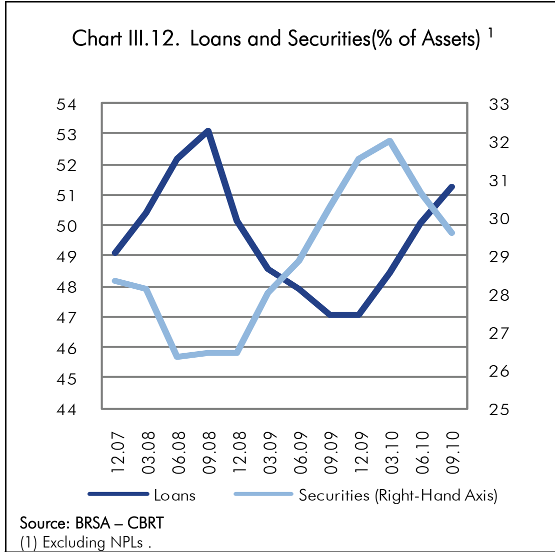


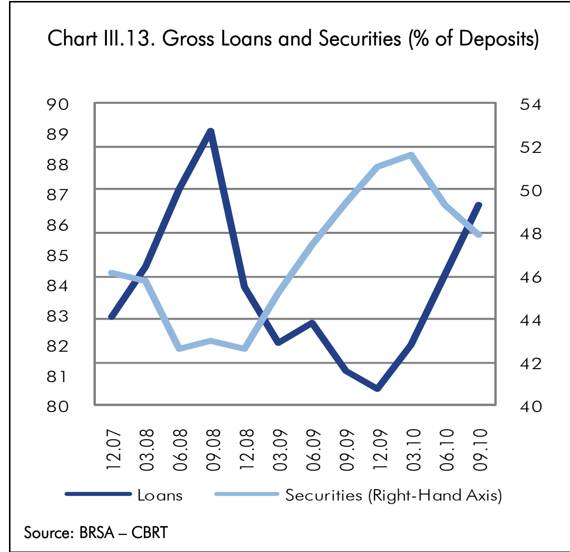
Chart III.11 Maturity Composition of Loans(%)[1]

Source: BRSA –CBRT

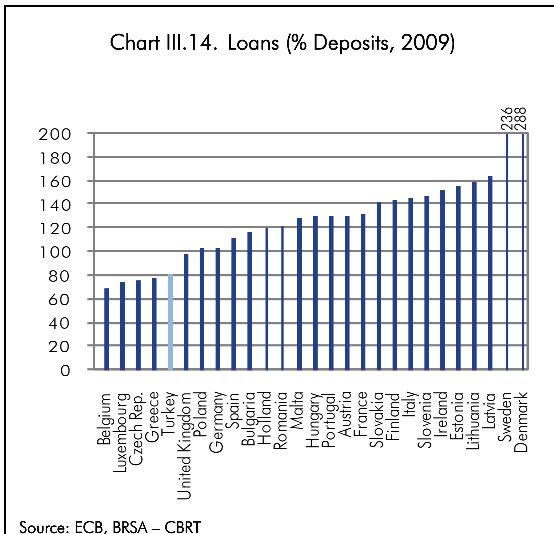
(1)Short term means term less than 1 year.

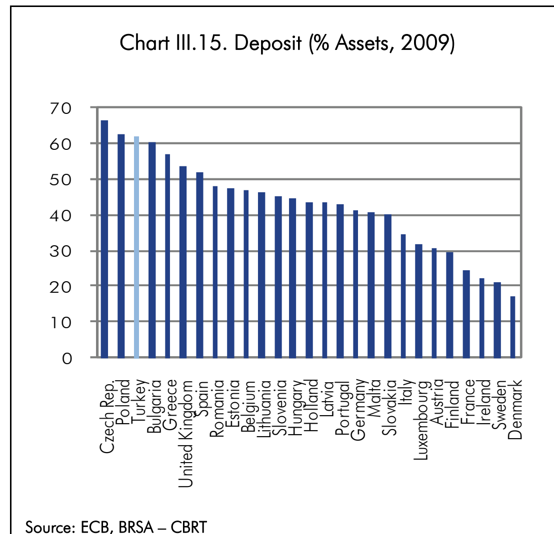
Parallel to the credit growth, loan to deposits ratio increased whereas the share of securities, the weight of which increased during the crisis, decreased within the total assets. As the share of credits in the total assets increased by 4.2 points as of September 2010 compared to year-end figures of the previous year and reached 51.3 percent, the share of securities decreased by 1.9 points to 29.6 percent (Chart III.12). The loan to deposits ratio increased to 86.7 percent, yet it could not achieve its pre-crisis level (Chart III.13).





Compared to other countries, loans in Turkey are funded with stable resources and they mainly consist of deposits. Compared to non-deposit resources, deposits are considered as a more stable source of funds. Due to this, a loan to deposits ratio below 100 percent shows that liquidity risk depending on refunding is low. Contrary to the deposit dominating funding structure in Turkey, in the European Union the loan to deposits ratio is 113.3 percent and the rate of deposits to total assets is 40.1 percent (Chart III.14 and Chart III.15).





Liabilities mainly consist of deposits but the increase in banks' liabilities abroad was also effective in the acceleration of the loan to deposits ratio. The loan to deposit ratio sharply decreased during the crisis period, while the banks' external borrowing facilities followed a stagnant course. The decline in the external liabilities of banks during the crisis period was driven both by the decrease in banks' demands for foreign credits and the banks' willingness to downsize their balance sheets due to financial problems. Parallel to the mitigation of the crisis, a rebound in the external borrowing markets started to occur. By September 2010, the total amount of external liabilities of the banking sector was USD 72.5 Billon and 11.3 percent of the total assets were funded by external liabilities (Chart III.16 and Chart III.17).

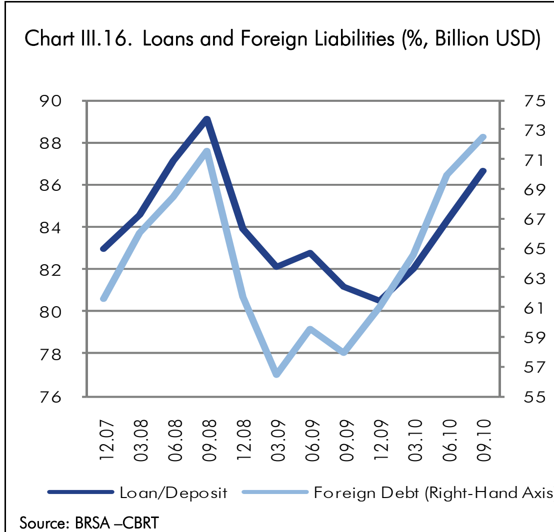


Chart III.16. Loans and Foreign Liabilities (%, Billion USD)

Source: BRSA –CBRT

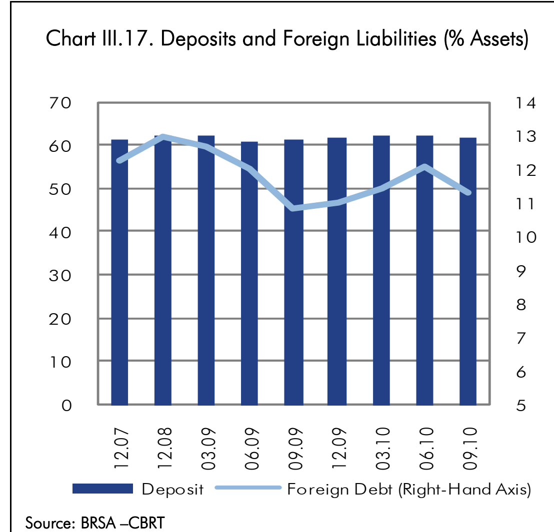


Chart III.17. Deposits and Foreign Liabilities (% Assets)

Source: BRSA –CBRT

Recovery in the external borrowing market and the increase in diversification of resources other than deposits have contributed to the maturity extension of liabilities. Along with the recovery in the external borrowing market, the total amount of syndication and securitization credits of the banks, which was 19.9 billion USD as of September 2010, showed an increase of USD 2 billion according to year-end figures of 2009 (Chart III.18). The increase of syndication credits continues with more favorable conditions and terms during the last quarter of 2010. However, the deposits that form the weighted portion of the liabilities have an average maturity of 1.7 months as of September 2010 (Chart III.19). As a measure to strengthen financial stability, the Central Bank of the Republic of Turkey may differentiate the required reserve rates applied to Turkish Lira deposits according to maturities with the aim of extending maturity of deposits. Meanwhile, the granting of permission by the BRSA to issue domestic bonds in TL is seen as a positive step that will contribute to maturity extension in the upcoming period.

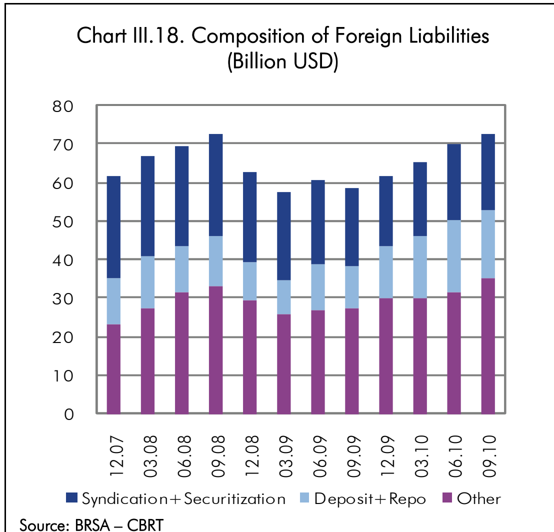


Chart III.18. Composition of Foreign Liabilities (Billion USD)

Source: BRSA – CBRT

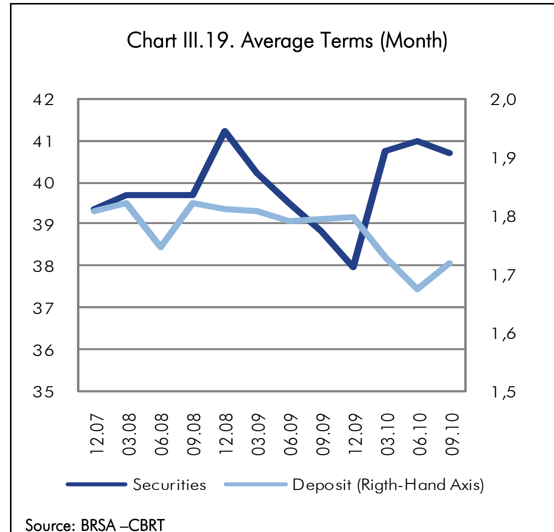


Chart III.19. Average Terms (Month)

Source: BRSA –CBRT

With the increase in credits, the tendency of banks to remain liquid is decreasing; however, it is observed that the liquidity ratios of the sector are above the minimum requirement. Along with the increasing tendency to extend credits, the share of liquid assets on the balance sheet has gone down slightly. As of September 2010, the ratio of liquid assets to total assets decreased by 2.8 points compared to end-2009 and was realized as 29.4 percent. The decrease in cash and cash equivalent assets was influential on the decline in the ratio of liquid assets to total assets (Chart III.20). Despite the

decline in the share of liquid assets on the balance sheet, 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 remain above the legal ratios (Chart III.21).

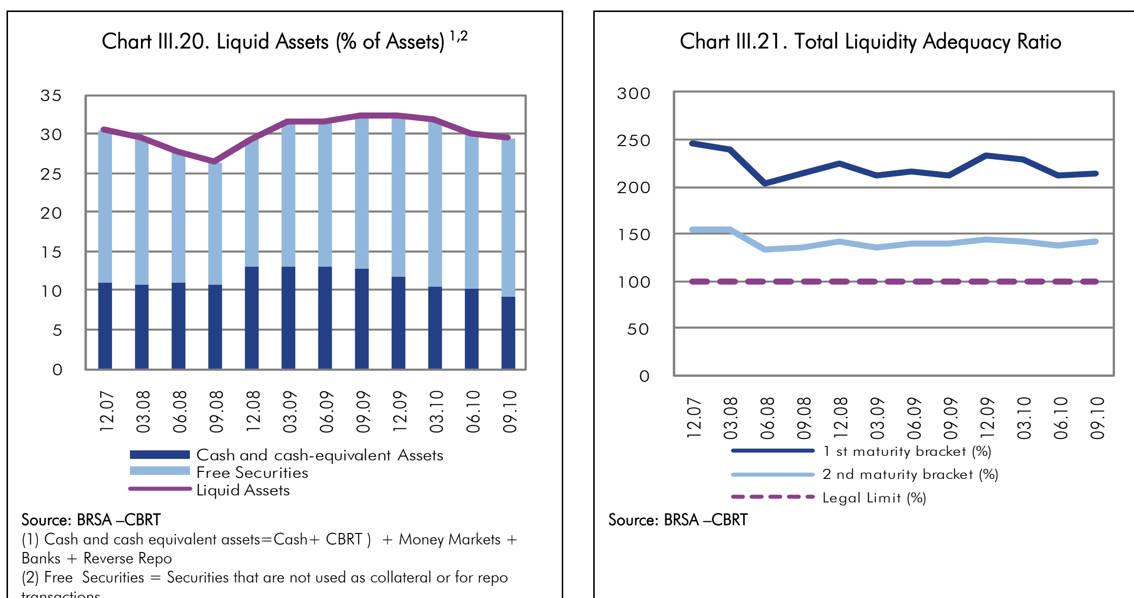


Chart III.20. Liquid Assets (% of Assets) [1,2]

Source: BRSA –CBRT
(1) Cash and cash equivalent assets=Cash+ CBRT) + Money Markets + Banks + Reverse Repo
(2) Free Securities = Securities that are not used as collateral or for repo transactions

Chart III.21. Total Liquidity Adequacy Ratio

Source: BRSA –CBRT

The measures taken by the CBRT regarding foreign exchange and Turkish Lira markets during the crisis period are gradually being lifted; thereby increasing the importance of effective liquidity management by banks. Considering the normalization in the money and credit markets, at its meeting held on April 13, 2010, the Monetary Policy Committee decided to gradually remove the liquidity measures applied during the crisis period. Within the framework of the exit strategy, the amount of liquidity provided, which was in excess of market needs during the crisis period, has gradually started to be decreased and technical interest rate adjustments have been made. The CBRT started to determine the amount of funding via repo auctions to ensure that, at the end of the day, there is less excess liquidity in the market and has tightened the amount of liquidity withdrawn in the Istanbul Stock Exchange (ISE) Repo-Reverse Repo Market and at the Interbank Money Market within the CBRT. The interest rate for one-week repo transactions, which currently stands at 7 percent, has been determined as the policy rate and the auctions have started to be held as quantity tenders with fixed interest rates. As a step in the technical interest rate adjustment process, while the interest rate for the weekly repo auction has been kept unchanged, the overnight interest rates have been reduced and 3-month repo auctions were ceased. The Monetary Policy Committee, at its meeting held on November 11, 2010, decided to reduce the interest rates for overnight borrowing by an additional 400 basis points, thereby increasing the difference between lending and borrowing rates. Furthermore, the required reserves ratios were brought to pre-crisis levels in line with the exit strategy.

The amount of GDDS that can be accepted as collateral for banks borrowing from the CBRT is able to meet the probable withdrawal of significant amounts of deposits in case of a stress-scenario. In the scenario analyses, deposit withdrawals are combined with value losses in free government securities that are not used as collateral or for repo transactions. The analysis results reveal that when the maximum shock is applied, free GDDS can meet deposit withdrawals (Table III.1).

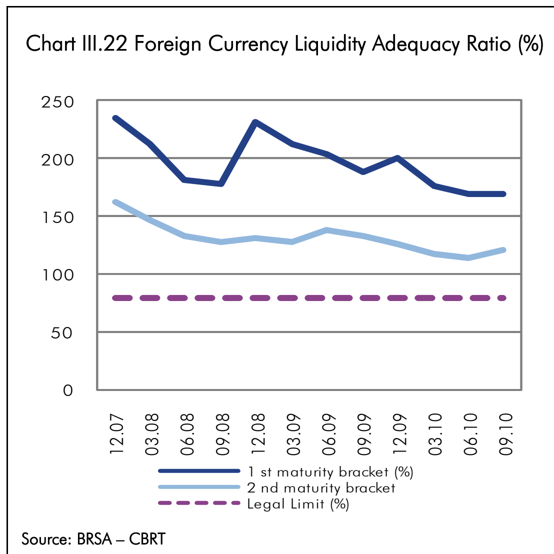
Table III.1. Liquidity Scenario Analysis (%)

DEPOSIT WITHDRAWALS/FREE GDDS (%)		DEPOSIT WITHDRAWALS			
		5%	10%	15%	20%
VALUE LOSS OF FREE GDDS	5%	16.1	32.2	48.4	64.5
	10%	17.0	34.0	51.0	68.1
	15%	18.0	36.0	54.0	72.1
	20%	19.1	38.3	57.4	76.6

Source: BRSA- CBRT

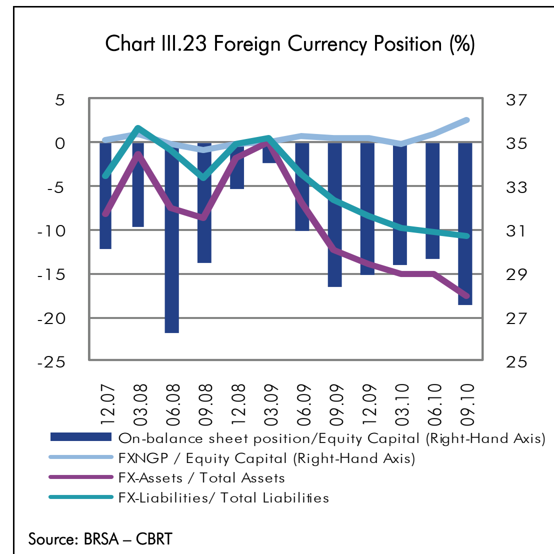
The foreign exchange liquidity ratio is above the legal ratio, the foreign exchange position is balanced and the share of foreign exchange assets and liabilities on the balance sheet is falling. The foreign currency liquidity adequacy ratio is above 80 percent, which is the minimum legal ratio (Chart III.22). It is noteworthy that the weight of FX assets and FX liabilities on the balance sheet is at historically low levels. As of September 2010, including those indexed to foreign exchange, the ratio of FX assets to total assets is 28 percent, the ratio of FX liabilities to total liabilities is 30.8 percent. The on-balance sheet short position, which is closed with off-balance sheet transactions consisting mostly of swap transactions rose as of September 2010. In the same period, while the ratio of on-balance sheet short position to own funds was 18.5 percent, the ratio of the foreign currency net general position computed by taking off-balance sheet transactions into consideration to own funds was realized as 2.7 percent (Chart III.23). Within the scope of exit strategies, similar to the measures taken in the Turkish lira markets, the CBRT is diminishing the measures taken towards foreign exchange liquidity gradually. Considering the recent improvements in international liquidity conditions and the rise in the foreign exchange liquidity of the banking sector, the intermediation function of the CBRT in the Foreign Exchange and Banknotes Market Foreign Exchange Deposit Market was ceased as of 15 October 2010. On the other hand, the CBRT continues to hold foreign exchange buying auctions to accumulate reserves in periods in which foreign exchange supply is higher than its demand.

Chart III.22 Foreign Currency Liquidity Adequacy Ratio (%)



Source: BRSA – CBRT

Chart III.23 Foreign Currency Position (%)



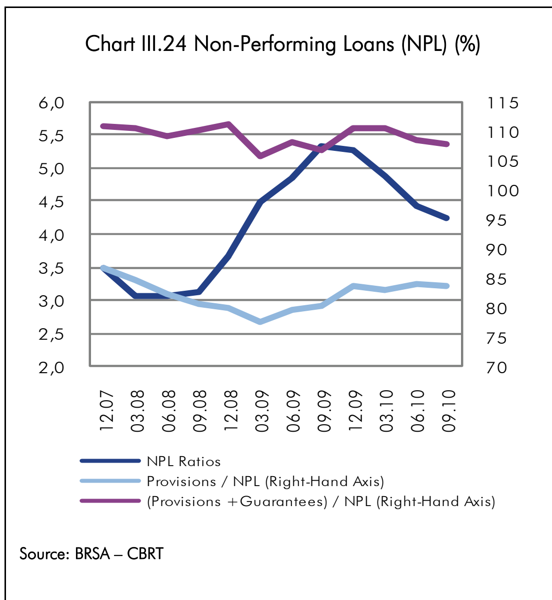
Source: BRSA – CBRT

In Turkey, the liquidity ratio for the second maturity bracket is similar to the Liquidity Coverage Ratio within the framework of Basel III and it is considered that the banking sector will easily adopt the new international arrangements. In parallel to the lessons derived from the global crisis, the Basel Committee has developed two types of global liquidity ratios for the liquidity arrangements of cross-border banks. According to the first ratio called the Liquidity Coverage Ratio-LCR, within a specified scenario, banks have to maintain liquid assets to meet liquidity needs that may arise within a period of

30 days. In order to support the liquidity coverage ratio, to address structural liquidity mismatches and to keep core funding above a certain level, the Committee is working on developing a second ratio called the Net Stable Funding Ratio–NSFR. According to this ratio, the ratio of the available amount of stable funding of a bank to the required amount of stable funding must be greater than 100 percent. The timetable is determined for both ratios; it has been decided to commence reporting for information purposes beginning 1 January 2012, and the ratios will move to minimum standards as of 1 January 2015 and 1 January 2018 for LCR and NSFR, respectively (Special Topic IV.6).

The quality of the credit portfolio improved and the ratio of non-performing loans for all credit types decreased. As of September 2010, the ratio of non-performing loans (NPL) to the total amount of credits decreased by 1.9 points compared to the end of the last year and was realized as 4.3 percent. The fall in the NPL ratio is attributable to the rise in credits as well as deductions from the portfolio upon collection, sale or deletion of these loans (NPL) from assets. The NPL ratio revealed a tendency to decline for all types of loans, however the fall in the NPL ratio was the most rapid for SME loans. The coverage ratio is high and reached 83.8 percent as of September 2010. The total value of provisions and the portion of collateral to be considered exceed the amount of non-performing loans. The high coverage ratio and decreasing NPL ratio show that indicators of credit risk are improving. (Chart III.24 and Table III.2).

Chart III.24 Non-Performing Loans (NPL) (%)



Source: BRSA – CBRT

Table III.2 NPL Ratios by Credit Types (%)

	2008	2009	09.10
Total loans	3,7	5,3	4,3
Corporate Loans	3,7	4,9	4,0
-- SME Loans	4,8	7,6	5,5
--Other Corp. L.	3,1	3,6	3,2
Retail loans	3,7	6,0	4,8
-Consumer loans	2,4	4,1	3,2
--Housing	1,3	2,1	1,6
--Vehicle	6,0	10,3	7,6
--Other	3,0	5,5	4,3
-Credit cards	6,5	10,4	9,1

Source: BRSA – CBRT

The fall in the NPL ratio is attributable to the recovery in loans as well as to the fall in unemployment rates and economic growth. Improvements in the economy have a positive effect on loan re-payment performance. There is a close relationship between the NPL ratio for corporate loans and economic growth. In periods of increasing production and growth, the NPL ratio for corporate loans decreases (Chart III.25). The NPL ratio for retail loans bears a close relationship with the unemployment rate. In periods of falling unemployment rate, the re-payment capacity of households improves and the NPL ratio decreases (Chart III.26).

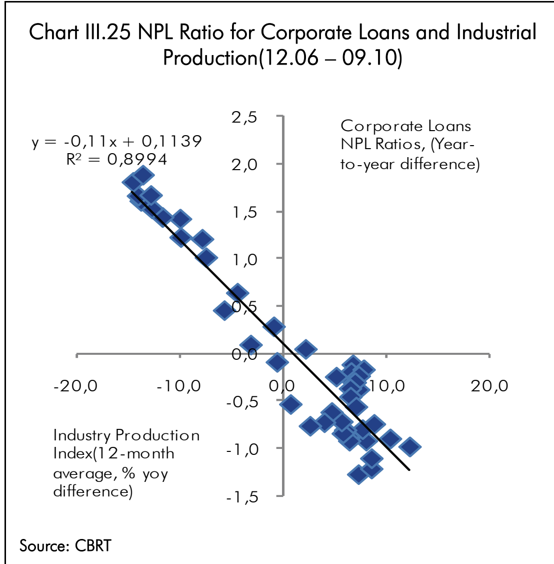


Chart III.25 NPL Ratio for Corporate Loans and Industrial Production(12.06 – 09.10)

Source: CBRT

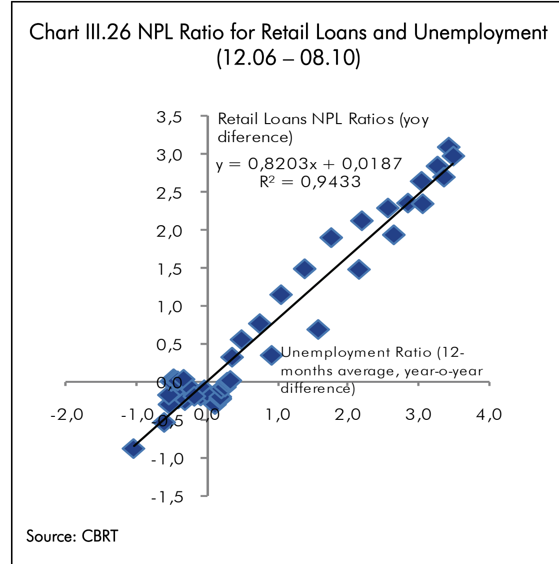


Chart III.26 NPL Ratio for Retail Loans and Unemployment (12.06 – 08.10)

Source: CBRT

When compared to selected countries, it is observed that the NPL ratio of the banking sector is at reasonable levels. The NPL ratio in EU countries is 4.2 percent and the coverage ratio is 50.5 percent as of end-2009. As a result, the ratio of net NPLs to own funds was realized as 21.7 percent. Although the NPL ratio in Turkey is close to the EU average, due to the high coverage ratio, NPLs are not a major threat to own funds. (Chart III.27 and Chart III.28).

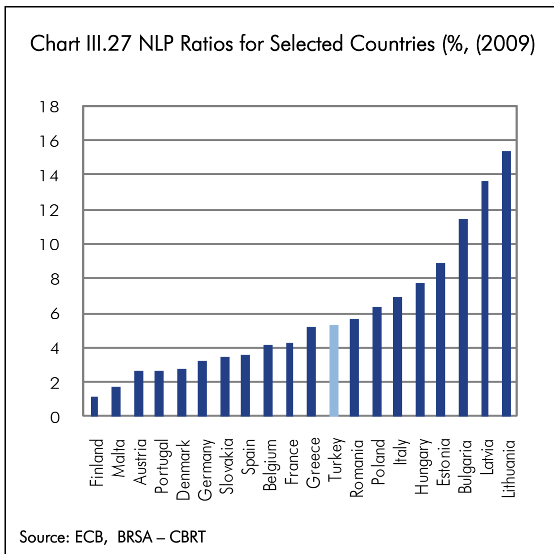


Chart III.27 NLP Ratios for Selected Countries (%, (2009)

Source: ECB, BRSA – CBRT

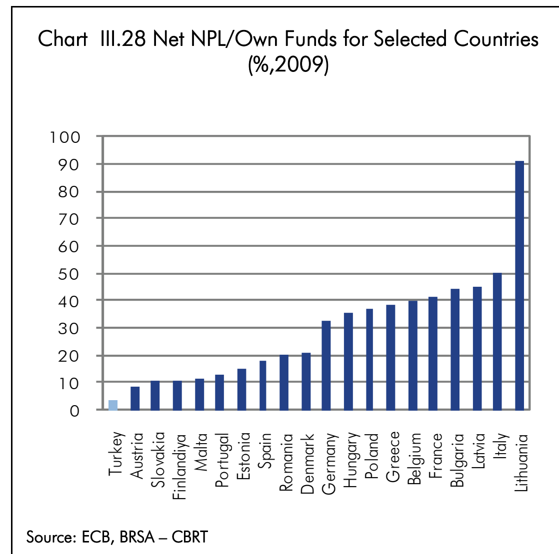


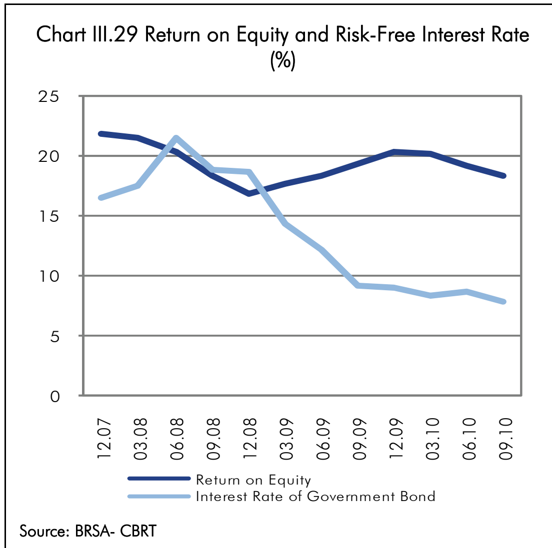
Chart III.28 Net NPL/Own Funds for Selected Countries (%,2009)

Source: ECB, BRSA – CBRT

Despite the ongoing strong profitability of the banking sector and improvements in the quality of loans, the indicators of profitability performance have shown a tendency to decline. During the first nine months of 2010, the net profit of the banking sector was realized as 16.9 billion TL with a year-on-year increase of 7.4 percent. The rise in net profits of the banking sector is mainly attributable to the fall in loan loss provision expenses. It can be observed that profits before tax and provisions decreased by 8.5 percent year-on-year and profitability performance indicators assumed a declining trend. As of September 2010, the return on equity deceased by 2 points compared to the previous year-end figures and went down to 18.3 percent. Despite the fall in the return on equity, it is observed that, the return received is above the alternative risk-free rate of return (Chart III.29). The fall in the return on equity, is attributable to the decline in the return on assets due to the contraction in the net interest margin. As of September 2010, the return on assets dropped by 0.1 points compared to the end of the last year and was realized as 2.5 percent, while the net interest margin, with a contraction of 0.9 points, went down

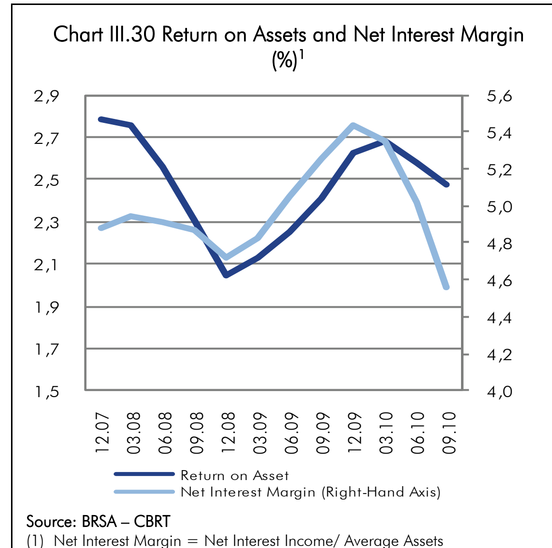
to 4.6 percent (Chart III.30). During the crisis, as a result of the maturity mismatch, the fall in interest rates led to a positive effect on the net interest margins and profitability of the sector. In the post-crisis period, the fall in interest margins is attributable to the competitive prices applied to loans and deposits.

Chart III.29 Return on Equity and Risk-Free Interest Rate (%)



Source: BRSA- CBRT

Chart III.30 Return on Assets and Net Interest Margin (%)[1]

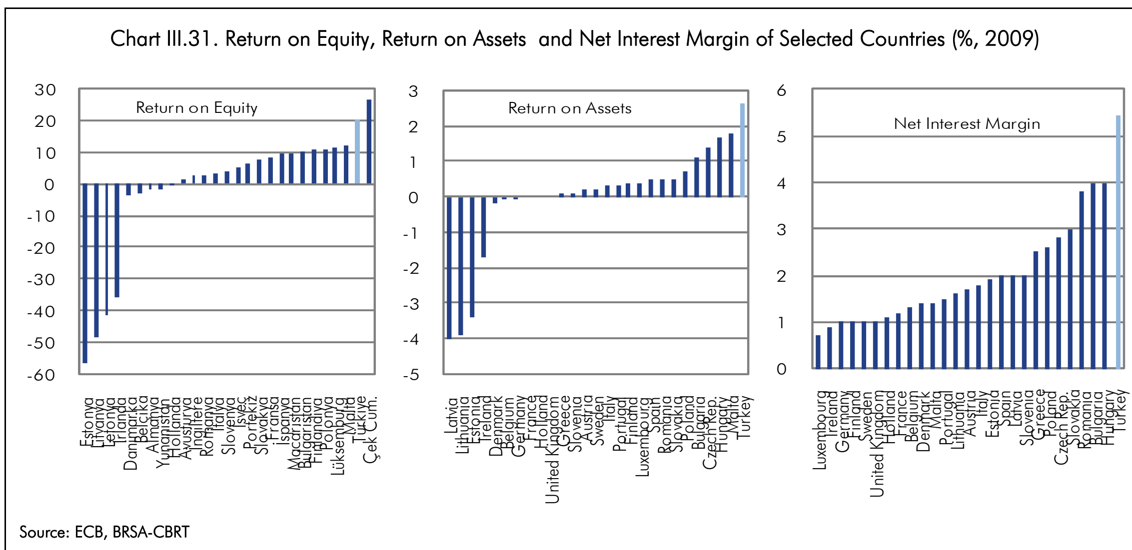


Source: BRSA – CBRT

(1) Net Interest Margin = Net Interest Income/ Average Assets

Profitability indicators of the banking sector are above those of other countries. It is observed that the return on equity, return on assets and the net interest margins of the banking sector of Turkey are rather high compared to those prevailing in EU member countries. In EU countries, return on equity was 3.8 percent, return on assets was 0.2 percent and the net interest margin was 1.7 percent in 2009 (Chart III.31).

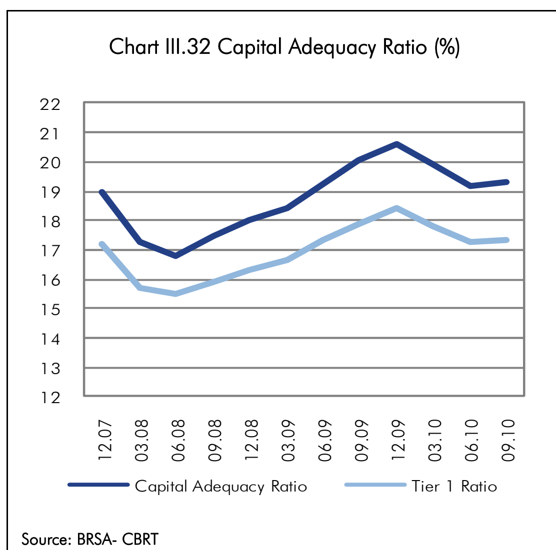
Chart III.31. Return on Equity, Return on Assets and Net Interest Margin of Selected Countries (%, 2009)

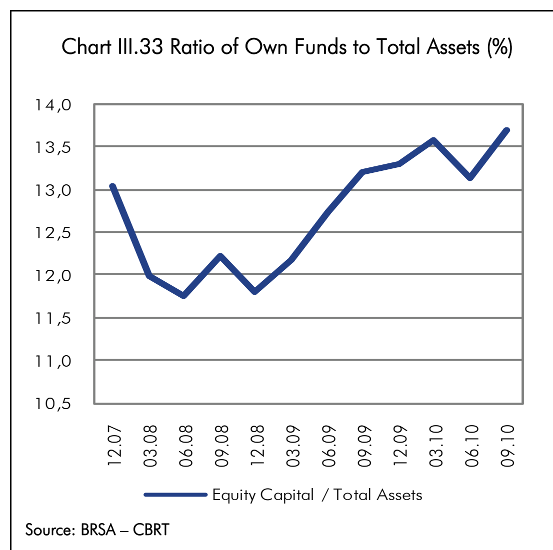


Source: ECB, BRSA-CBRT

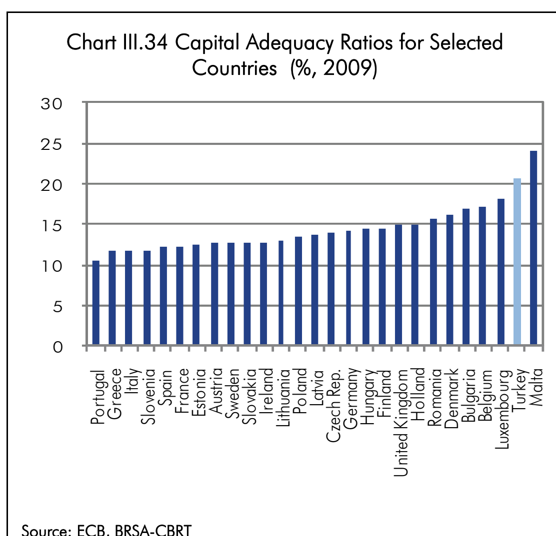
While the decrease in the leverage ratio still continues, the rapid growth in loans has led the capital adequacy ratio, which assumed an upward trend in the crisis period, to decrease. The capital adequacy ratio, which fell to 19.3 percent as of September 2010, with a decrease of 1.3 points compared to the previous year-end figure, is still well above the legal and target ratios (Chart III.32). Besides this, it is noticeable that the loss absorption capacity and the quality of regulatory capital is high. As of September 2010, the Tier 1 ratio has been realized as 17.4 percent, only 1.9 points below the capital adequacy ratio. At the same time, it is noteworthy that the Tier 1 capital is mainly composed of paid-in capital and retained earnings and the share of senior subordinated debt within Tier 1 capital is only 0.1 percent. Despite the decrease in the capital adequacy ratio, it is observed that the leverage

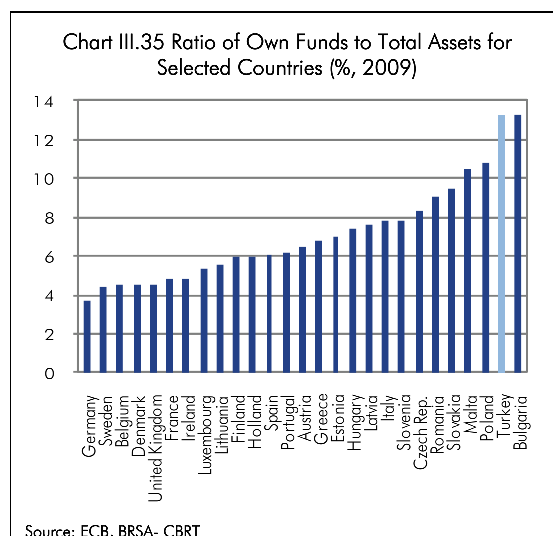
ratio of banks declined. The ratio of own funds to total assets increased by 0.3 points and reached 13.6 percent (Chart III.33).





Compared to other countries, the Turkish banking sector operates with a high capital adequacy ratio and low leverage ratio. When compared with EU countries, it can be observed that the banking sector has adequate capital and a low leverage ratio. Turkey is among the countries with the highest capital adequacy ratio and highest own funds to total assets ratio for the banking sector. In EU countries, the share of own funds on the balance sheet is 4 percent on average and the capital adequacy ratio is 13.2 percent (Chart III.34 and Chart III.35).





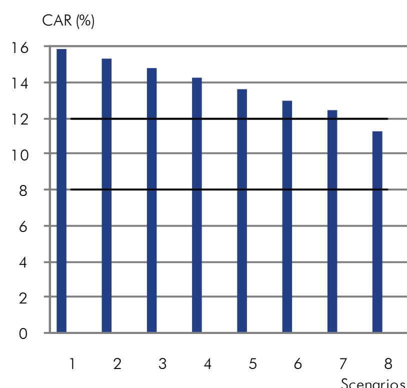
Scenario analysis, which tests the durability of the banking sector to shocks originating from credit and market movements, also shows that the sector has the capacity to absorb shocks. According to the scenario analysis, when maximum shocks are applied to the exchange rate, Eurobond returns, interest rates and NPLs simultaneously, the capital adequacy ratio of the sector decreases by 8.1 points; but still remains above the 8 percent legal ratio (Table III.3 and Chart III.36).

Table III.3 Scenarios Applied[1]

Scenario	Exchange Rate (% increase)	Eurobond (% loss of value)	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 consideration the past crises, shocks are applied to the risk factors simultaneously.
(2)It is the Turkish Lira interest rate shock. The shock of foreign currency interest rate is about 1/3 of the one applied to Turkish Lira interest rate shock.

Chart III.36 Results of Scenario Analysis



Source: CBRT

Along with the high capital adequacy ratio, the fact that own funds are mainly composed of paid-in capital and retained earnings with a high loss absorption capacity indicates that the Turkish banking sector will not experience difficulties adapting to Basel III regulations. According to Basel III regulations, while the minimum capital adequacy ratio was kept at 8 percent, the minimum core Tier 1 (composed of paid-in capital and retained earnings) ratio was raised from 2 percent to 4.5 percent and Tier 1 ratios were raised from 4 percent to 6 percent in order to improve the quality of capital. At the same time, a conservation buffer of 2.5 percent is applied to these ratios and hence a drop in the capital adequacy ratio below the minimum requirement during crisis periods is prevented. Along with the conservation buffer, the core Tier I capital ratio increases to 7 percent, Tier 1 capital ratio increases to 8.5 percent and the capital adequacy ratio increases to 10.5 percent. It is expected that a long period of time will be required to meet these minimum ratios and it is planned that regulations will be fully implemented in 2019. On the other hand, the Basel Committee decided to support the risk-based capital adequacy ratio with a leverage ratio, which is not risk-based and is calculated by dividing Tier 1 capital with on-and-off balance sheet assets. The ratio, which is expected to be around 3 percent, will be finalized after the testing phase and it is thought that it will be effected in 2018 (Special Topic IV.6).

When indicators pertaining to the soundness of the banking system are analyzed from a macro point of view, it is observed that the banking system is generally sound. From the crisis to the recovery stage, the ratio of non-performing loans has decreased on the back of recovery in economic activity and the low level of interest rates. While foreign borrowing opportunities of the banking sector have improved, the share of government securities on the balance sheet has decreased. Despite the improvement in loan quality, along with the contraction in the net interest margin, profitability performance indicators assumed a downward trend, and despite still being above the minimum and target ratios, the capital adequacy ratios fell due to the rapid rise in loans. In line with all these developments, the index has recently been following a low course (Chart III.37 and Chart III.38).

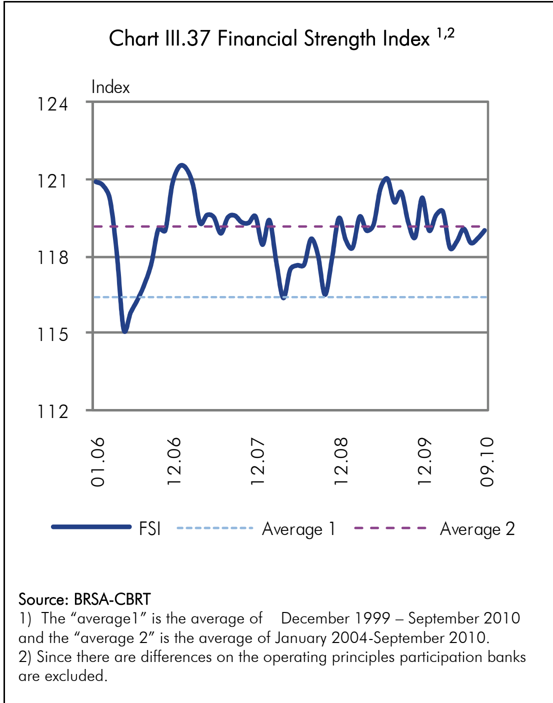


Chart III.37 Financial Strength Index [1,2]

Source: BRSA-CBRT
1) The "average1" is the average of December 1999 – September 2010 and the "average 2" is the average of January 2004-September 2010.
2) Since there are differences on the operating principles participation banks are excluded.

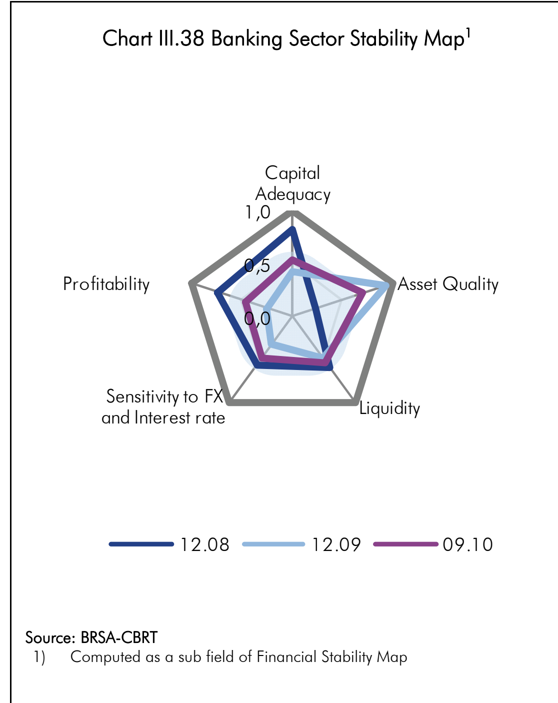


Chart III.38 Banking Sector Stability Map[1]

Source: BRSA-CBRT
1) Computed as a sub field of Financial Stability Map

Credit growth is an indicator that should be monitored closely for financial stability in the forthcoming period. Despite the increase in loans, the historical data do not yet indicate excessive loan growth. The average real rate of increase of loans in the banking sector during the 2003-2009 period was 23.9 percent. As of September 2010, the year-on- year real increase in loans was 15.8 percent, which is below average. The loan to deposit ratio, which was 89.7 percent in August 2008 prior to the global crisis, is still below the pre-crisis level, at 83.8 percent in September 2010. As of the second quarter of 2010, the loans to GDP ratio stands at 44.4 percent, and the annual rate of increase is 4.9 points. The ratio of loans to GDP increased on average by 4.2 points annually between 2003 and 2009. Although the increase in the loan to GDP ratio is above the average, it is observed that increases of 8.1 percent and 7.4 percent in the second quarter of 2006 and in the first quarter of 2008 were experienced respectively. In this respect, it is considered that the increase in loans does not currently indicate excessive loan growth (Chart III.39 and Chart III.40).

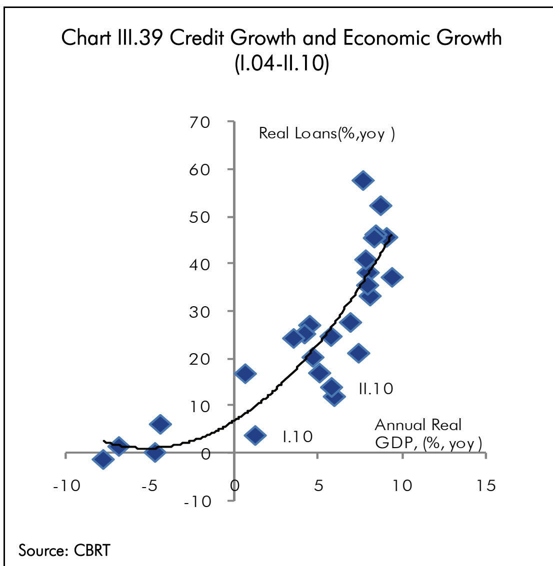


Chart III.39 Credit Growth and Economic Growth (I.04-II.10)

Source: CBRT

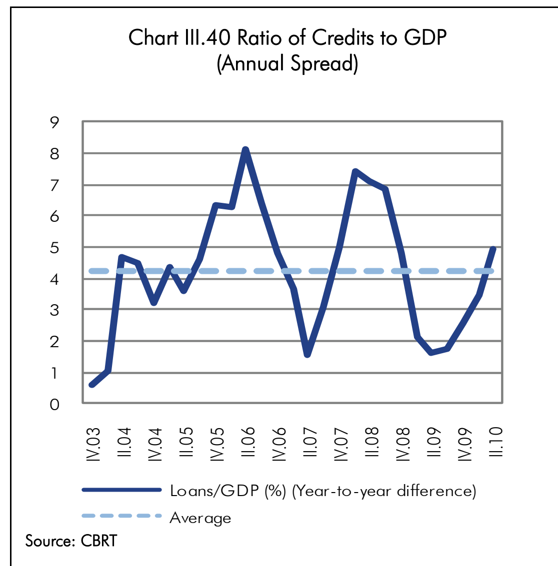
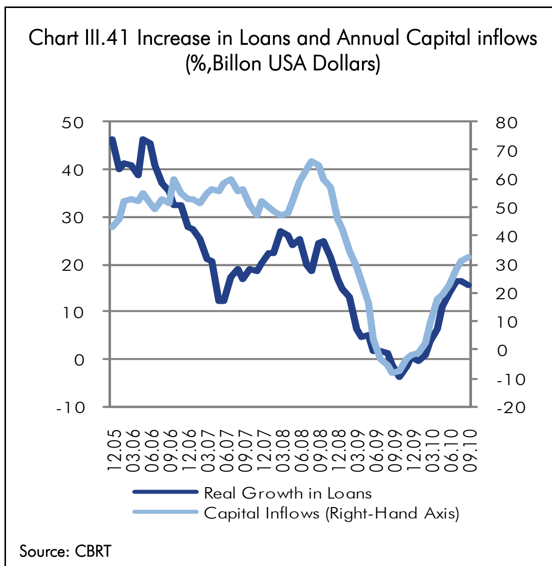


Chart III.40 Ratio of Credits to GDP (Annual Spread)

Source: CBRT

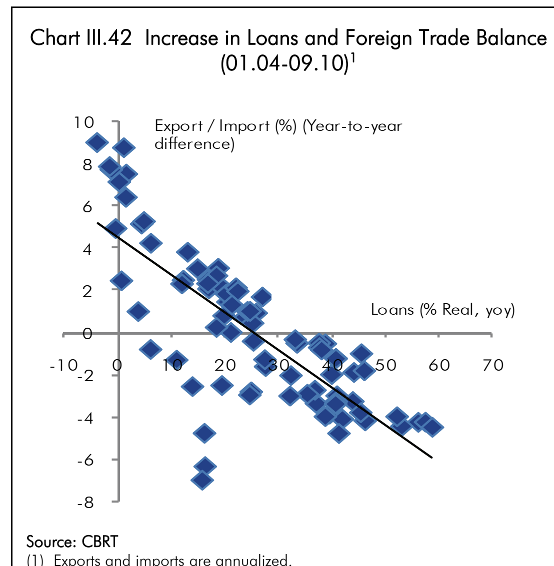
Currently, although no excessive loan growth is observed, the increase in domestic demand, which accelerated on the back of loan growth and capital inflows, may potentially lead to economic instabilities such as foreign trade and current account deficits. Loan growth and foreign capital inflows were experienced during the recovery from the global crisis. In October 2009, the annual net foreign capital inflows decreased to USD 3.8 billion, while loans contracted by 3.8 percent year-on-year in real terms. As of September 2010, real loan growth increased to 15.8 percent and foreign capital inflows increased to USD 32.6 billon (Chart III.41). Growth driven by domestic demand, fuelled by the increase of loans and capital inflows, results in the widening of foreign trade and current account deficits, and exacerbates the vulnerability of the economy (Chart III.42). If capital inflows continue and global growth does not accelerate in the upcoming period, the differentiation between domestic and foreign demand might become more apparent. With a view to limiting risks in this regard, additional policy tools other than short-term interest rates are required. In this context, if differentiation between domestic and foreign demand occurs along with rapid loan growth and deterioration in the current account deficit - thus leading to concerns over financial stability - the CBRT might use alternative instruments, such as required reserves and liquidity management, while formulating monetary policy.

Chart III.41 Increase in Loans and Annual Capital inflows (%,Billon USA Dollars)



Source: CBRT

Chart III.42 Increase in Loans and Foreign Trade Balance (01.04-09.10)[1]



Source: CBRT
(1) Exports and imports are annualized.

Due to contraction of interest margins and increased competition, it is important for banks to maintain effective risk management in their lending processes in the upcoming period. The banks' intention to compensate the negative effect of a lower interest margin on profitability with credit growth, as well as increased competition in the credit market may lead to the under-pricing of credit risks. In such a case, implementing effective risk management is important to sustain the improvement in the asset quality of the sector.