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BANKING SECTOR CRISES AND RELATED NEW REGULATIONS IN TURKEY *

[CRISIS DEL SECTOR BANCARIO TURCO Y LAS NUEVAS REGULACIONES]

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Looking Back: Three Decades of Instability and Crises

Over the past 30 years, Turkey has been governed by 22 governments, while macroeconomic and political instability became a major feature of the country. Populist macroeconomic policies, moral hazard problems, huge public sector deficits, high real interest rates, overvalued Turkish lira, strong currency substitution, large current account deficits, volatile short-term international capital flows, extremely risk-taking behavior of banks, volatile economic growth, and high and persistent inflation resulted in several successive crises in the real and financial sectors in Turkey (see Ertuğrul and Selçuk, 2002).

In Turkey, the financial sector is traditionally dominated by banking activities, and the banking sector experienced several systemic crises since late 1970s, as also shown in Figure 1. In early 1980, in response to a strong balance-of-payments crisis accompanied by a deep recession and accelerated inflation, Turkey abandoned its inward-oriented development strategy and gradually started to introduce free-market based reforms. To liberalize the repressed domestic financial system, many restrictions on domestic and external financial intermediation have been removed, or at least minimized, between 1980 and 1989. The early domestic financial liberalization attempt between 1980 and 1982 failed as a result of (*i*) the strong competition between banks and broker houses in interest rates, and (*ii*) missing regulations towards strengthening the legal fundamentals of banking sector in Turkey. In 1982, five banks, along with many brokerage houses, were liquidated. During the whole liberalization process in the 1980s, however, the number of banks increased from 43 in 1980 to 66 in 1990, while the number of their branches climbed from 5954 to 6560 with an accommodating rise in number of employees from 125312 persons to 154089 persons within the same period (see Figure 2 and 3). As a result, the number of branches per bank decreased from 138 in 1980 to 99 in 1990, with no significant changes in the number of employees per branch (see Figure 2). Meanwhile, between 1980 and 1990, the number of foreign banks in Turkey increased from 4 to 23.

Opening of the Turkish economy to the rest of the world in the 1980s increased certainly the funding options abroad both for the financial system and large corporations. However, it also increased the vulnerability of the domestic economy to external shocks. After 1989, the overvaluation of the Turkish lira and high domestic interest rates on government bonds attracted short-term capital inflows into Turkey.

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The so-called hot-money mechanism, which was driven mainly by external open positions of Turkish banks, created a deep currency and banking crisis in early 1994 because it turned out that this mechanism was not sustainable anymore. Between 1994 and 1999, the number of banks increased from 67 to 81, while number of bank branches climbed from 6087 to 7691 causing an employment rise from 139046 persons to 173988 persons. The 1994 financial crisis resulted in a lower credit rating of Turkey and a general pessimism about the economy, and hence, many small banks found it difficult to raise funds abroad. Therefore, they were forced to increase their branch networks in order to collect more deposits.

Between 1995 and 1997, both the continuing failure of governments in disinflating the economy and the re-emergence of the so-called hot-money policy were accommodated by the repeated excessive risk-taking behavior of the banking sector. Even after the currency and banking crisis of 1994, many (mostly smaller) banks continued to abandon traditional banking activities in favor of using their funds to purchase government securities.

Following the 1994 crisis the government introduced a full deposit insurance system (both for foreign and domestic currency savings accounts), which contributed significantly to arising moral hazard problems in the banking sector, while the government was placing weakened banks on the Treasury's surveillance list for poor financial status and exhibited an unwillingness to close them. The number of listed banks climbed to 15 between 1985 and 1999, and hence, many banks abandoned sound banking practices and their financial conditions started to deteriorate around 1997. By the end of the 1990s, the sole function of the financial system in Turkey was nearly reduced to transferring funds from the domestic and international markets to the Treasury (Denizer *et al*., 2000). During the 1990s, most of the new domestic entry into the banking sector was from large industrial conglomerates founding their own banks, since the poor regulatory structure allowed for large amounts of lending from the banks to in-group companies (Denizer *et al*., 2000, and Damar, 2004). Beside that, illegal activities in the Turkish banking sector also increased in the late 1990s. Meanwhile, the number of state-owned banks in the sector diminished from 12 in 1980 to 8 in 1990, and then to 4 in 1999. In the late 1990s, bad macroeconomic policies of governments, along with excessive risk-taking preferences of banks, reverted the direction of financial liberalization of the 1980s back to the situation in the late 1970s, which was characterized by an "over-branched" and "over-staffed" banking system (Zaim, 1995, and Akçay, 2001).

As a combined result of (*i*) bad investment and production decisions of domestic industrialists, (*ii*) connected lending and (*iii*) illegal activities in the banking sector, the weight of non-performing loans on banks' portfolios significantly increased, especially after 1997. Meanwhile, increasing foreign open positions of banks was an indication of rising exchange-rate risk in the system. In early 1999, the banking system was very fragile to a systemic crisis. In 1999, the *State Deposit Insurance Fund* (SDIF) took over six insolvent banks, using the authority given to it in 1994 when full deposit insurance was introduced.

By December 1999, the government introduced a three-year (2000-2002) disinflation and macroeconomic restructuring program, which was essentially an exchange-rate-based stabilization program supplemented by fiscal adjustment and structural reforms measures involving agricultural reform, pension reform, fiscal measurement and transparency, and tax policy and administration. There were also measures to

strengthen and regulate the banking sector. According to the new banking law, enacted in June 1999, and later modified in December 1999, an independent *Banking Regulation and Supervision Agency* (BRSA) was established.

At the beginning, the 2000-2002 program was quite successful. Interest rates fell sharply below expected levels, inflation significantly slowed down, and production and domestic demand started to increase. Despite the fact that the program achieved some remarkable results in a short period of time, the 2000–2002 program had to be revised in light of the two successive liquidity and exchange-rate crises; first in November 2000, as a result of the extremely risky position of a medium-sized bank with large holdings of government securities in its portfolio, and then in February 2001. The systemic banking crisis of late 2000, hand in hand with a deepening recession, resulted in a sharp currency crisis. The government abandoned the crawling-peg regime under the original plan and floated the Turkish lira in February 2001. Between 2000 and 2002, more than 2 billion persons lost their jobs in Turkey. The decline in employment in the banking sector amounted approximately to 47130 persons, which made 29.3 percent of the number of employees as end of 2000. More than 32000 banking sector employees, which were mostly well-educated and well-paid, become unemployed only in 2001.

From Crisis to Recovery: Banking Sector Restructuring and Rehabilitation

After the banking and currency crises in November 2000 and February 2001, the government initiated a comprehensive *Banking Sector Restructuring and Rehabilitation Program*, which aimed at (*i*) strengthening the private banks, (*ii*) resolution of the banks transferred to SDIF by methods, such as merger, sale and liquidation, (*iii*) operational and financial restructuring of state banks with the ultimate goal of privatization, and (*iv*) developing the legal and institutional framework, which will increase supervision and audit in the sector and make the sector more effective and competitive. Implementation of this restructuring program imposed substantial burden on the economy and public finance, as experienced in other countries. Between 1997 and 2002, the SDIF took over 20 banks with more than 37000 employees and succeeded to create new job places for more than 10000 in their new banks. The number of banks (incl. the banks under the SDIF) declined from 81 in 1999 to 54 in 2002, while the number of bank branches dropped from 7691 to 6106 in the same period. Government officials estimate that Turkey has spent some USD 44 billion (or 30 % of GDP) since 1997 to reform the banking sector, which suffers from inherent structural weaknesses. In February 2003, under the leadership of the BRSA, a coordination committee was formed with representatives of the *Banks Association of Turkey* (BAT), to ensure rapid implementation of *New Capital Adequacy Agreement* (*Basel II*), and capital adequacy arrangements, which are called *CAD-3* under the EU legislation.

Table 1 presents selected banking sector figures, which characterize the developments in the sector between 2001 and 2004. As end of 2004, the number of banks in Turkey is 48, and only one of them is currently under the control of the SDIF. Latest statistics of the BAT indicate now slight increases in the number of employees and branches, with respect to previous year. This improvement is in accordance with the recent development path of the BSF index in Figure 1. Indeed, the Turkish banking sector seems to be recovered from the 2000-2001 financial crisis.

As also stated in the *Letter of Intent* of the Turkish Government to the IMF on July 15, 2004, however, the Government's efforts to strengthen the financial system continue to move ahead across several fronts. The limited deposit guarantee system is put into effect on 5 July 2004. In summer 2004, the Government has completed a comprehensive review of the banking act to bring the legal framework more closely in line with EU standards. As of mid of February 2005, the new draft *Banking Law* seems to be ready to submit to the Turkish Parliament by the Government. The Government is committed to maintain the operational and financial independence of the BRSA and the SDIF in the new banking act and other relevant legislation. Furthermore, the loan portfolio of the banking sector is revised and the non-performing loans (NPLs) are classified in compliance with international standards, and necessary provisions are allocated. Significant progress has been achieved with *Istanbul Approach*, which is a voluntary debt restructuring mechanism of the banks, developed to accelerate settlement of bad loans. As of September 2004, an agreement was reached with 295 out of 327 companies covered under the Approach, and 5.7 billion dollars of debt was restructured, which allowed these companies to continue their economic activities. The ratio of NPLs to the gross loans decreased to 6.3 % in June 2004 from 29.3 % in December 2001 (Republic of Turkey, 2004).

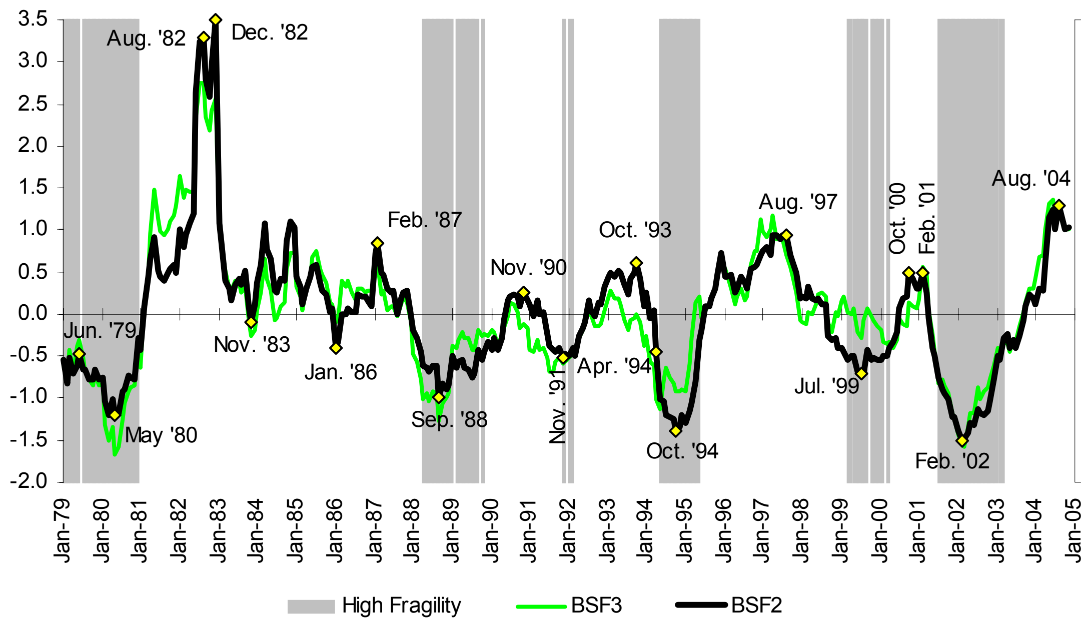
Looking into the Future: EU-Convergence and Banking Sector in Turkey

Last December the EU decided to start accession talks with Turkey on 3rd October 2005. During the accession negotiations, which may last more than ten years, Turkey will experience significant economic and structural changes before joining the EU. She will take over and apply the whole body of EU legislation and standards, the *Acquis Communautaire*, upon accession at the latest.

On December 14, 2004, Mr. *Rodrigo de Rato*, the IMF Managing Director, stated in his press release on Turkey (No. 04/265) that "in the banking sector, the goal over the next three years will be to align Turkey's supervisory framework more closely with EU standards, accelerate resolution of assets held by the Savings Deposit Insurance Fund, and strengthen further the operations of the state banks. A key first step will be the introduction of a new financial services law that will upgrade rules relating to bank owners and managers, licensing, and related party lending, and allow the Banking Regulation and Supervision Agency to coordinate on-site and off-site inspection more effectively."

Recent estimations of Deutsche Bank, moreover, show that the Turkish banking sector in particular stands to benefit from the increasing macroeconomic stability, improving sovereign creditworthiness, higher economic growth, increasing domestic savings and EU-related institutional reforms during the EU-convergence process within the coming 10 to 15 years, and the sector is likely to experience increased consolidation and foreign competition (see Jaeger, 2005). If this scenario becomes true, then, the relatively underdeveloped structure of the banking sector, in which assets and loans represent a mere 70 percent and 20 percent of GDP, respectively, may finally be transformed into a stronger one, as it is needed since more than three decades in Turkey.

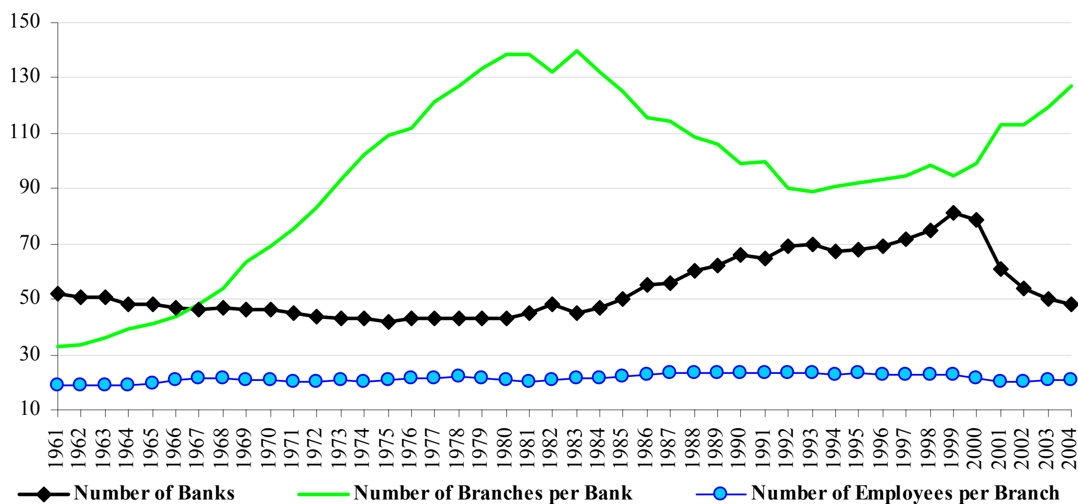
Figure 1: Banking Sector Fragility in Turkey (Jan. 1979 – Nov. 2004)



Data Source: Central Bank of Republic of Turkey, State Institute of Statistics, and the International Monetary Fund; author's own calculations. Methodology: Kibritçioğlu (2003).

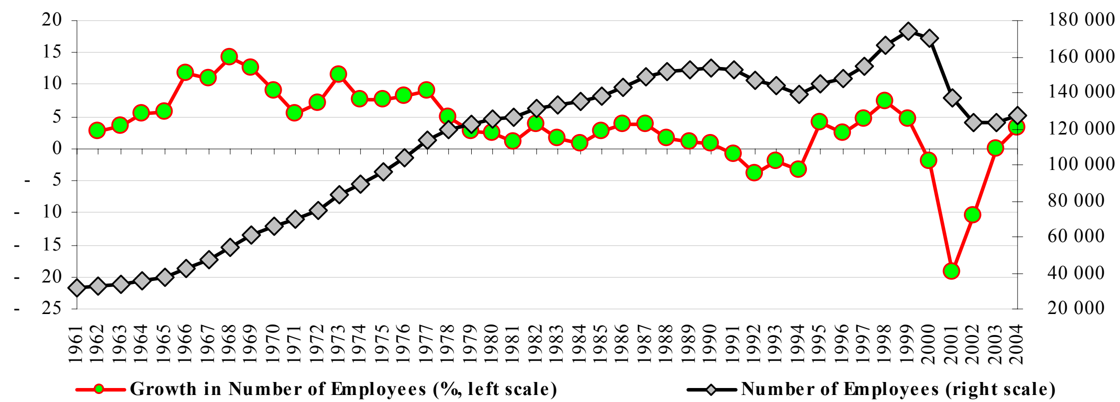
Note: Turkish banking sector experienced several difficulties, as a result of their own excessive risk-taking behavior within the last 25 years. Figure 1 above shows a banking sector fragility (BSF) index developed by Kibritçioğlu (2003). In one version, BSF3, it measures the weighted average of month-to-month real changes in bank claims on the domestic private sector, foreign liabilities of banks, and bank deposits, which are accepted as indicators of credit risk, exchange-rate risk and liquidity risk, respectively. The BSF2 version then excludes changes in bank deposits. The difference between these two versions shows roughly the effect of bank withdrawals, which becomes small if deposit insurance exists. Applied to Turkey, Figure 1 shows an excessive risk-taking behavior prior to each of the banking crises, visible as a peak value of the BSF curve. Then, these periods of excessive risk-taking are followed by sharp falls in the BSF index. The periods in which the index is below –0.5 are entitled as "high-fragility" periods, which are depicted as gray-shaded areas in the figure.

Figure 2: Selected Indicators of the Banking Sector in Turkey (1961 – 2004)



Source: Banks Association of Turkey (BAT); author's own calculations.

Figure 3: Employment in the Turkish Banking Sector (1961 – 2004)



Source: Banks Association of Turkey (BAT); author's own calculations.

Table 1: Characteristics of the Turkish Banking Sector (2001 – 2004)

	Dec. 2001	Dec. 2002	Dec. 2003	June 2004	Dec. 2004
Main Indicators					
Assets (billion USD)	117.7	130.1	178.9	184.9	n.a.
Loans (billion USD)	23.4	30.0	47.4	58.9	n.a.
Deposits (billion USD)	76.6	84.4	111.3	115.1	n.a.
Number of Banks	61	54	50	49	48
Number of Branches	6908	6106	5966	6014	6106
Number of Employees (thousands)	137.5	123.3	123.2	126.3	127.2
Concentration Ratio (%) *	57.7	62.2	63.0	60.0	n.a.
Performance Indicators					
Net Profit (billion USD)	-8.2	1.8	4.0	1.6	n.a.
Return on Assets (%)	-7.0	1.4	2.2	0.9	n.a.
Loans / Deposits Rate (%)	30.5	35.5	42.6	51.2	n.a.
Risks					
Capital Adequacy Ratio (%)	20.8	26.1	30.9	25.4	n.a.
Foreign Exchange Position (billion USD)	-1.6	-0.6	-0.0	-1.1	n.a.
Non-Performing Loans / Gross Loans (%)	29.3	17.6	11.5	6.3	n.a.
Securities Portfolio / Assets (%)	35.0	40.5	42.8	41.5	n.a.
***Memo Item:* GDP (billion USD)**	145.6	184.1	239.8		299.3 **

Source: Banking Regulation and Supervision Agency (BRSA) and Banks Association of Turkey (BAT).
* The share of five largest banks in total assets.
** Estimation for the year of 2004.

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