



**BANKING REGULATION AND SUPERVISION AGENCY**

**TOWARDS A SOUND TURKISH BANKING  
SECTOR**

**May 15, 2001**

## CONTENTS

<b>I.GENERAL OVERVIEW OF THE TURKISH BANKING SECTOR</b>	<b>2</b>
<b>Banking Sector Developments</b>	<b>2</b>
<b>November 2000 and February 2001 Crises and the Impact on the Banking Sector</b>	<b>6</b>
<b>II. MAIN GOALS AND STRATEGY OF THE BANKING REGULATION AND SUPERVISION AGENCY</b>	<b>9</b>
<b>III. BANKING SECTOR RESTRUCTURING AND REHABILITATION PROGRAM</b>	<b>11</b>
<b>Strengthening the Financial and Operational Structure of the Banking Sector</b>	<b>11</b>
State Banks	11
Banks under Management of the Savings Deposit Insurance Fund (SDIF)	13
Private Banks	16
<b>Strengthening Legal and Institutional Framework</b>	<b>17</b>
<b><u>ANNEX:</u> BANKING SECTOR RESTRUCTURING PROGRAM: IMPLEMENTATION SCHEDULE</b>	<b>20</b>

## TOWARDS A SOUND TURKISH BANKING SECTOR

### I. General Overview of the Turkish Banking Sector

#### Banking Sector Developments

1. In Turkey, a majority of financial flows go through the banking sector. Although there has been an increase in the size and number of non-bank financial institutions in recent years, the banking sector accounts for about 75% of the assets of the total financial sector assets. The importance of the banking sector is even greater as most of the non-bank financial institutions are subsidiaries of banks.
2. The Turkish financial sector has gone through a major structural change as a result of the financial liberalisation program that started in the early 1980s. The abolition of directed credit policies, liberalisation of deposit and credit interest rates and liberal exchange rate policies as well as the adoption of international best standard banking regulations have accelerated the structural transformation of the Turkish banking sector.
3. Since 1980s the Turkish banking sector experienced a significant expansion and development in the number of banks, employment in the sector, diversification of services and the technological infrastructure.
  - The number of banks increased from 43 in 1980 to 66 in 1990 and to 79 by the end of 2000. 5 banks under the management of the Saving Deposit Insurance Fund (SDIF) were merged under Sumerbank bringing the number of banks to 74 by mid-May 2001.

#### Turkish Banking Sector ( December 2000)

	Total Assets (USDmn)	Share in sector (%)	Total loans (USDmn)	Share in sector (%)	Total deposits (USDmn)	Share in sector (%)	Net worth (USDmn)
State	53,151	34.2	13,727	27.0	41,095	40.3	1,450
Private	73,588	47.4	27,753	54.5	44,349	43.5	8,056
-5 largest banks	50,530	32.6	20,490	40.2	30,102	29.5	7,265
-Other	23,058	14.8	7,263	14.3	14,247	14.0	791
Foreign	8,403	5.4	1,438	2.8	3,300	3.3	547
SDIF banks	13,192	8.5	3,311	6.5	13,141	12.9	-3,263
<b>Deposit Money Banks Total</b>	<b>148,335</b>	<b>95.6</b>	<b>46,230</b>	<b>90.8</b>	<b>101,884</b>	<b>100.0</b>	<b>6,790</b>
Development & Investment	6,902	4.4	4,701	9.2	0	0	1,362
<b>Sector Total</b>	<b>155,237</b>	<b>100.0</b>	<b>50,931</b>	<b>100.0</b>	<b>101,884</b>	<b>100.0</b>	<b>8,152</b>

Source: The Banks Association of Turkey

- Of these 74 banks, 56 banks are deposit money banks and 18 are investment and development banks. Of the 56 deposit money banks, 4 are state banks, 26 are private domestic banks, 18 are private foreign banks and 8 are under the SDIF.
- As of December 2000, the 26 private domestic banks accounted for about 47% of total assets of the banking sector with the largest 10 banks accounting for 40% of total assets.

- Total employment in the banking sector has increased from 125 thousand in 1980 to 154,000 in 1990 and to 170,000 in 2000. Banking sector employment has been contracting in the aftermath of the November 2000 and February 2001 crises.
- The number of foreign banks increased from 4 in 1980 to 18 in 2000. However, foreign banks' share in total banking sector assets increased from 3.7% in 1992 to 5.4% in 2000; a very low figure compared to similar emerging market countries.
- The share of state banks in banking sector total assets have decreased from 45% in 1980s and 1990s to 34% in 2000.
- During the last decade, the Turkish banking sector has made advances in terms of technology infrastructure with a sharp increase in the number of ATMs, use of on-line banking services, use of Electronic Funds Transfer and SWIFT systems. Banking services have also expanded and bank card and credit card use has increased rapidly. Credit card use increased from 1 million in 1992 to 13.6 million in March 2001.

#### **Banking Sector: Selected Indicators**

	<b>1980</b>	<b>1990</b>	<b>1994</b>	<b>1999</b>	<b>2000</b>
Number of Banks	43	66	67	81	79
Number of Branches	5,954	6,560	6,087	7,691	7,837
Number of On-Line Branches	..	..	..	6,938	7,523
Number of ATMs	..	3,209	4,023	9,939	11,991
Number of POS	..	..	16,135	188,957	299,950
Personnel Employed	125,312	154,089	139,046	173,988	170,401
Credit Card Use (in thousands)	..	..	1,564	10,045	13,408
Bank Card Use (in thousands)	..	..	10,469	24,107	29,560
Credit Card Volume (USD mn)	..	..	1,273	12,410	16,413

Source: The Banks Association of Turkey, BRSA.

4. There has been important financial developments regarding bank balance sheets since 1980s.
  - Total assets of the banking sector increased from USD20.8bn (28.6% of GNP) in 1980 to USD58.2bn (38.2% of GNP) in 1990 and to USD155bn (76.9% of GNP) in 2000.
  - Deposit mobilization also increased sharply with saving deposits increasing from USD4.3bn in 1980 to USD64.4bn in 2000. In particular, there has been a marked increase in foreign currency deposits since mid-1980s with the share of foreign currency deposits in total saving deposits increasing to 58.6% in 2000. Since the mid-1990s there has been a marked increase in repo operations of non-bank clients reaching a figure as large as 15% of saving deposits by end-2000.
  - Banks' off-balance sheet operations also expanded sharply during most of 1990s as a result of the increase in repo operations and foreign exchange hedging instruments. The ratio of off-balance sheet operations to total assets increased from 41.4% in 1992 to 100.8% at end-2000.

**Banking Sector: Financial Indicators**

USDmn unless stated otherwise	1980	1990	1994	1999	2000
Total Assets	20,785	58,171	52,552	133,533	155,237
Total Credits	11,168	27,342	20,559	40,206	50,931
Securities Portfolio	1,339	5,997	5,955	22,955	17,848
Total Deposits	10,188	32,564	33,191	89,361	101,884
Savings Deposits	4,288	19,343	24,190	58,807	64,352
-TL	4,288	11,914	8,612	24,701	26,628
-FX	..	7,429	15,578	34,106	37,724
Non-deposit funding	1,289	11,760	9,019	22,934	29,435
-Foreign banks	..	3,460	2,675	12,073	16,284
Networth+Profits	1,147	5,903	4,409	7,840	11,367
Total Assets/GNP (%)	28.6	38.2	40.3	71.7	76.9
Total Credits/GNP (%)	15.4	17.9	15.8	21.6	25.2
Securities Portfolio/GNP (%)	1.8	3.9	4.6	12.3	8.8
Savings Deposits /GNP (%)	5.9	12.7	18.5	31.6	31.9
State Bank Assets/Total Sector Assets (%)	44.1	44.6	39.6	34.9	34.2
Off-balance Sheet Operations/ Total Assets (%)	..	..	49.5	103.5	100.8

Source: The Banks Association of Turkey, BRSA.

5. The banking sector legislation and regulations have been designed in line with international best practice. In particular, the Banking Law (No. 4398) effective as of June 1999, delegates Banking Regulation and Supervision Agency (BRSA) as the independent authority to regulate and supervise the banking sector. BRSA has started to operate in August 2000.
6. Despite all these positive developments, the Turkish banking sector has moved away from traditional banking activities. The share of loans in total assets of the banking sector declined from 47% in 1990 to about 33% in 2000. The ratio of loans to deposits decreased from 84% in 1990 to 51% in 2000. The credit to GNP ratio is about 25%; lowest among the emerging market countries.
7. The following factors have contributed to the decline in the financial intermediation function of the banking sector:
  - **Macroeconomic Instability:** The high and volatile inflation rates of 1990s, the boom-bust cycles of economic growth and the fragility of external capital inflows all contributed to the uncertainties and led to a domination of “short-term” behaviour of economic agents. The confidence in the Turkish lira also deteriorated leading to an extensive currency substitution. As a result, the maturity of bank funding sources have shortened substantially and the share of foreign currency liabilities in total liabilities have increased sharply.
  - **High Public Sector Deficit:** The increase in public sector deficit and its financing with high real interest rates from the domestic financial markets led to a sharp decline in the allocation of resources to the real sector. The arbitrage opportunities due to the high domestic real interest rates made it attractive for banking sector to borrow abroad and

finance public sector deficits leading to an increase in foreign exchange open position of the banking sector. As a result, the share of government securities in deposit money banks' total assets increased from 10% in 1990 to about 23% in 1999.

- ***Systemic Distortions Created by the State Banks:*** The financial health of the state banks deteriorated rapidly as a result of the accumulation of duty losses and inefficient management. The illiquid state banks covered their financing needs from the markets borrowing at very high rates and at short maturities. This led to an increase in interest rates and created an uneven playing field for the other banks in the sector. As a result, the state banks became unable to fulfill their banking functions; although state banks account for 40% of total deposits their share in total loans is only 26%.
- ***Inadequate Risk Assessment and Management Systems:*** Although the banking sector became more exposed to liquidity, interest rate and foreign exchange risks, the banks' risk assessment and management systems were not developed adequately. The lack of independent and effective supervision and regulation and the existence of deposit insurance also contributed to the weaknesses in risk management.

8. As a result of all these developments, the Turkish banking system as a whole has been subject to the following structural weaknesses:

- Inadequate capital base
- Small and fragmented banking structure
- Dominance of state banks in total banking sector
- Weak asset quality (concentrated credits, group banking and concentrated risks, mismatch between loans and provisions)
- Extreme exposure and fragility towards market risk (maturity mismatch, FX open position)
- Inadequate internal control systems, risk management and corporate governance
- Lack of transparency

9. The Turkish banking sector was severely tested in the aftermath of the 1994 financial crisis—the Turkish lira depreciated by more than 50% and interest rates rose sharply. The banks that carried a significant short position in foreign exchange position and mismatch of maturities had to incur large losses and faced liquidity problems as a result of a major run on deposits. Three small banks were put on liquidation process in April 1994, which triggered further deposit withdrawals. The government had to introduce 100 percent guarantee to savings deposits and provide liquidity support to the banks that were facing difficulty. However, except for three small banks that were liquidated, the banking sector proved to be resilient and a banking crisis was avoided. These developments highlight the fact that the Turkish banking sector is highly segmented, with a group of efficient and profitable banks at the core and other smaller banks at the margin. The banking sector recovered

rapidly from the 1994 financial crisis and posted an average annual growth rate of 18% in the post-1995 period. However, the East Asia and Russian crises of 1997-98 and the two devastating earthquakes of 1999 had a negative impact on the Turkish economy and the banking sector.

### **November 2000 and February 2001 Crises and the Impact on the Banking Sector**

10. Turkey adopted a comprehensive disinflation program at the beginning of 2000. The main pillars of the program were tight fiscal and monetary policies, ambitious structural reforms and the use of a pre-determined exchange rate path as a nominal anchor. Monetary policy was conducted under a currency board type arrangement with liquidity expansion being strictly linked to foreign currency inflows.
11. The disinflation program had a major impact on banks' balance sheets. First and foremost, with the initial sharp decline in market interest rates and the expectation of further fall in these rates, the banks also reduced deposit and lending rates. The banks also increased their exposure to fixed rate treasury securities during this period. On the other hand, the pre-announced exchange rate path and the real appreciation of the Turkish lira meant lower cost of funding for foreign currency liabilities. As a result, a number of banks borrowed in short-term foreign currency terms and lent in longer term Turkish lira terms. This led to a sharp increase in maturity mismatch and foreign currency open position of the private banks.
12. The composition of the asset structure of the banking sector changed significantly during 2000 with an increase in the share of loans and a decline in liquid assets. Especially consumer credits four folded during 2000. Unlike the change in the currency composition of deposits (towards an increase in foreign currency deposits) the currency composition of loans increased in favor of the Turkish lira. As a result of these changes, the exposure of the banking sector to liquidity, interest rate and exchange rate risks increased during 2000.
13. The delay in the privatization of Turk Telecom, adverse international capital market conditions and the heavy financing needs of Turkey as well as the sharply widening current account led to a general loss of credibility of the disinflation program. The outflow of foreign funds from Turkey and the sharp increase in treasury bill rates led to financing difficulties by some private and state banks. The subsequent November 2000 crisis led to a significant erosion of the capital base of the banking sector and revealed further the fragility of the system. In particular, the financial health of the state and SDIF banks that relied heavily on overnight funding deteriorated sharply.
14. The rapid announcement of the additional USD7.5bn under the Supplementary Reserve Facility of the IMF in December 2000 could only calm the market for a limited period. The escalating political uncertainties and the loss of credibility of the exchange rate regime and finally the abolition of the

exchange rate peg in February 2001 further hit the already weak banking sector.

15. In sum, the banks were hit by three main shocks:

- Sharp increase in funding costs due to the increase in interest rates and maturity mismatch.
- Capital losses due to a sharp mark-to-market decline in the value of government securities holdings
- Capital losses due to a sharp change in foreign exchange rate and open foreign currency position

16. Furthermore, it is possible that there would be further deterioration in asset quality as a result of the contraction in the real sector and the subsequent deterioration in the repayment capacity of borrowers.

<b>Banking Sector Foreign Currency Net Open Position and Developments in Domestic Debt Securities Portfolio</b>						
The gross foreign currency open position (excluding future contracts) of the banking sector declined from USD18.2bn in September 2000 to USD12.2bn in March 2001. The net foreign currency open position (including future contracts) declined from USD874mn to USD479mn during the same period. As of March 2001, the private domestic banks' gross foreign currency open position was USD6.2bn while the net foreign currency open position stood at USD429mn.						
A significant part of the banking sector open position is due to the exposures of the SDIF banks while the state banks carry a very marginal open position. The open position exposure of the SDIF banks is reduced to regulatory requirements as a result of issuance of foreign currency denominated papers to these banks by the Turkish Treasury (this operation was concluded on May 14, 2001).						
<b>Banking Sector Net Foreign Currency Open Position Developments (USDmn)</b>						
	January 2000		September 2000		March 2001	
	(1)	(2)	(1)	(2)	(1)	(2)
State Banks	-177	-191	-1	-22	-66	-25
Private Domestic Banks	-6,061	-773	-9,637	-847	-6,185	-429
SDIF Banks	-5,345	-2,684	-6,271	-4,910	-4,552	-4,670
Foreign Banks	-1,201	-60	-2,112	-78	-1,131	4
Development and Investment Banks	-2	91	-168	33	-226	-29
<b>Total</b>	<b>-12,786</b>	<b>-3,617</b>	<b>-18,189</b>	<b>-5,824</b>	<b>-12,160</b>	<b>-5,149</b>
<b>Total (Excluding SDIF Banks)</b>	<b>-7,441</b>	<b>-933</b>	<b>-11,918</b>	<b>-914</b>	<b>-7,608</b>	<b>-479</b>
(1) Gross Foreign Currency Open Position (Excluding Future Contracts) (2) Net Foreign Currency Open Position (Including Future Contracts); the regulations limit net foreign currency open position to 20% of capital.						
The market value of the banks' domestic securities portfolio has declined sharply as a result of the increase in secondary market interest rates during the crisis period. However, since the second half of March the secondary market rates have been on a declining trend, limiting the mark-to-market losses of the banks' securities holdings. The replacement of the securities held by the State and SDIF banks with floating rate securities and foreign currency denominated papers will limit the market losses of these banks.						
<b>Development in Banks' Domestic Debt Stock Portfolio (TL trillion) *</b>						
	December 1999		September 2000		December 2000	
	Total Dom. Securities Portfolio	Share in total assets (%)	Total Dom. Securities Portfolio	Share in total assets (%)	Total Dom. Securities Portfolio	Share in total assets (%)
State banks	4,490	17,8	7,151	22,4	7,977	22,3
Private domestic banks	8,202	26,5	9,074	20,3	9,621	20,0
Foreign banks	1,866	36,2	2,219	34,8	2,053	29,8
SDIF banks	4,075	55,4	5,249	60,7	8,018	90,5
Development & Investment banks	235	6,88	423	10,1	391	8,4
<b>Total</b>	<b>18,868</b>	<b>26,2</b>	<b>24,115</b>	<b>25,1</b>	<b>28,060</b>	<b>26,9</b>
Source: BRSA						
* Securities portfolio is the sum total of on balance sheet securities holdings and the securities underlying the repo operations.						

17. The government adopted a new program “Transition to a Strong Economy” in order to eliminate the confidence crisis and the financial instability. The strategy is strongly based on market-orientation and openness to the world economy. An important pillar of the program consists of a renewed effort to eliminate structural weaknesses that had not been fully tackled by the 2000 program, particularly by strengthening governance and good economic management. The key elements in the area of banking include: a deep financial restructuring of state and SDIF banks; measures to facilitate the participation of private capital in the strengthening of the private banking system; and, a further improvement of banking regulation and supervision. In this context, the underlying strategy of the BRSA towards establishing a sound banking sector and the action plan for the restructuring of the banking sector are outlined in the next two sections.

## II. Main Goals and Strategy of the Banking Regulation and Supervision Agency

18. The **mission** of the Banking Regulation and Supervision Agency is to create the proper environment in which banks and financial institutions can operate with market discipline, and in a healthy, efficient and globally competitive manner. The creation of a sound banking system is key to achieve long-run economic growth and stability of the country.
19. In order to fulfill its mission BRSA will establish, implement and develop the necessary regulatory and supervisory framework. In this framework, the main goals of the BRSA are:
- *To enhance banking sector efficiency and competitiveness*– elimination of distortions created by the state banks; strengthening of the banks’ capital base; reduction of the banks’ intermediation costs; minimization of group banking and non-financial activities.
  - *To maintain confidence in the banking sector* – in accordance with market discipline and “self responsibility” principle, to design the proper regulation for public awareness; making adequate, understandable and accurate information accessible to the markets in a timely manner; promoting international best standards in accounting and reporting systems; providing a transparent environment in which information on risks is clear and accessible for all parties.
  - *To minimize the potential risks to the economy from the banking sector* – prevention of all kinds of transactions and practices that can jeopardize the smooth and safe operation of the banks; developing early warning and prompt correction systems to prevent individual problems from causing systemic risk.
  - *To enhance the soundness of the banking sector* - enhancing the flexibility of the sector against risks; giving importance to the improvement of corporate governance; developing internal control and risk management systems; taking market risk into account in calculation of capital adequacy; improving the BRSA’s capacity for risk-focused and consolidated supervision and control.
  - *To protect the rights of the depositors* - establishing a balance between the adverse effects of deposit insurance, such as erosion in market discipline and increase in moral hazard, and the need to protect the rights of depositors.
20. In order to fulfill these goals the main values that the BRSA needs to establish are the following:
- *Cost Effectiveness*: Regulatory and supervisory practices shall be carried out regarding cost/benefit approach; and regulation and supervision activities shall be conducted in order to promote competitiveness of the banking sector.

- *Approach Based on Internal Accountability:* Even if regulatory and supervisory function is carried out at optimum, this function cannot go beyond being a secondary means for ensuring soundness and efficiency of the banking sector. The primary means is market discipline. An approach, which emphasizes internal accountability, such as improvement of internal control mechanisms and use of independent auditing/rating institutions shall be adopted.
- *Impartiality:* The BRSA shall equally treat all institutions that operate in its scope, and fulfill its responsibilities with care and impartiality.
- *Responsiveness:* The BRSA shall adapt itself to policies and practices necessitated by the developments in national and international financial system in a rapid and effective manner, and work with other public institutions in harmony.
- *Participation:* During the formulation of regulations and direction of practices, importance shall be given to the participation of banks, customers and the professional associations in the sector and academicians; communication channels shall be kept open.
- *Transparency and Accountability:* In order to make the BRSA operate in a transparent manner public and the relevant public agencies shall be informed about the operations and operation results.
- *Consumer Focus:* Besides the service for financial institutions, a service approach focused on consumer demand and needs shall be placed in the structure of the BRSA. For this purpose, a “consumer relations unit” shall be established within the BRSA; and a “consumer affairs page” shall be maintained on the BRSA’s Internet site. With these two services, the BRSA shall make the consumers conscious of financial services, and it shall review its regulations and policies in the light of suggestions and complaints from the consumers.
- *International Cooperation:* The Agency shall be in a close cooperation with foreign regulatory and supervisory agencies and international organizations in order to follow rapid change and developments in financial markets, to achieve an effective supervision on banks on a consolidated basis, and to get information relating to potential investors in the sector.
- *Expertise and Efficient Organizational Structure:* In order to develop the expertise necessitated by changes in financial sector, the BRSA will give importance to employment of personnel with analytical capability and professionalism, and review its organization structure in accordance with the developments in financial activities and information technology.
- *Performance Assessment:* The BRSA shall conduct public opinion surveys, effectiveness surveys and employee surveys in order to assess public opinion about the performance of the BRSA.

### III. Banking Sector Restructuring and Rehabilitation Program

21. The main goal of the Banking Sector Restructuring and Rehabilitation Program is to eliminate the distortions in the financial sector and to adopt regulations to promote an efficient, competitive and sound banking sector. The strategy under this program rests on four main pillars: the financial and operational restructuring of state banks, the resolution of SDIF banks, the strengthening of private banking; and, the strengthening of the legal and regulatory environment.

#### Strengthening the Financial and Operational Structure of the Banking Sector

##### *State Banks*

22. The overnight exposure of the state banks reached unprecedented proportions exposing these banks to interest rate and liquidity shocks. The sharp increase in interest rates during the November 2000 and February 2001 crises, amplified the funding needs of the state banks and thus the losses incurred by these banks.
23. The first step to restructure the state banks was to adopt a program to eliminate the short term funding needs of these banks. The Treasury provided floating rate notes (TL23 quadrillion) thus securitized the losses incurred by banks (the duty losses). The securitization operation provides interest income (yielding cash receipts) and allows the banks to borrow directly from the Central Bank using the securities as collateral. The latter eliminates the need to borrow heavily from the markets at very high rates.

#### **Securities Issued for the Duty Losses of the State Banks (\*)**

(Trillion TL.)	Ziraat	Halk	Emlak	Total
<b>2000 Year End</b>	<b>2,034</b>	<b>863</b>	-	<b>2,897</b>
2001 January	2,333	2,167	-	4,500
February	-	1,000	-	1,000
March	550	1,750	-	2,300
April	4,500	1,750	-	6,250
May	4,730	4,130	45	8,905
<b>2001 Total</b>	<b>12,113</b>	<b>10,797</b>	<b>45</b>	<b>22,955</b>
<b>TOTAL</b>	<b>14,148</b>	<b>11,659</b>	<b>45</b>	<b>25,852</b>

Source: Undersecretariat of Treasury

(\*)USD750 million securities denominated in foreign currencies were converted by the CBRT exchange rate of the issuing day, January 3, 2001.

24. The state banks' overnight liabilities to the markets have declined from USD8.4bn on March 16 2001 to USD1.1bn by May 4 2001. The Central Bank of Turkey (CBRT) provides liquidity to the state banks by acquiring these securities through repurchase agreements. The bulk of these repos will be converted to outright purchases by end-June 2001.
25. The securities given to the state banks by the Treasury not only limits the overnight funding needs of these banks but also allows these banks to reach regulatory capital adequacy ratio. The Treasury paid 326 trillion TL in cash to strengthen the capital base of State Banks.

26. This securitization operation has three important implications. First, in practice this means that the government will no longer finance its deficit through the state banks. Second, the securitization operation shifts the management of short term borrowing from the state banks to the CBRT. The CBRT is in a better position to manage this funding need at lower rates and longer maturities (the CBRT will continue to withdraw the liquidity with reverse repos). Thus as a result, public debt finances will be put on a much more transparent and efficiently serviced structure. Finally, as the CBRT converts the repos to outright purchases (buying back the securities given to the state banks) the balance sheet of the state banks will contract by the same amount. This consolidation will allow a more rapid corporatization and privatization of the state banks as well as increase deposit mobilization by private banks.
27. Simultaneously with the financial restructuring of the state banks important measures are also being taken in order to allow for an operational restructuring of these banks.
- The state banks will no longer be forced to run duty losses. In the future, any support provided via the state banks will be budgeted and will not lead to a loss by the state banks.
  - The management of the two largest state banks, Ziraat and Halk, is strengthened through the establishment of a common and politically independent governing board, reporting to the Treasury. The new management will apply commercial criteria to operations and pricing policies that ensure profitability. The board will also formulate plans for the privatization of these banks; the banks are to be privatized within three years.
  - The banking license of Emlak Bank will be withdrawn and its liabilities and remaining assets will be transferred to Ziraat Bank by end-May 2001.
  - The privatization process of Vakifbank will be resumed as soon as market conditions allow.
  - To reduce the operating costs of state banks the inefficient branches of these state banks will be closed and timely retirement will be encouraged.
  - Once financial restructuring is completed, the state banks will be required to fully comply with all BRSA regulations applicable to commercial banks. The Treasury will start monitoring closely their cash flow, profitability and liquidity.
  - The implementation of these reforms will be overseen by independent external auditors in each bank, to be appointed in May 2001.

***Banks under Management of the Savings Deposit Insurance Fund (SDIF)***

28. The number of banks under SDIF increased from 2 at end-1998 to 8 in 1999 and to 11 by end-2000. Five banks (Bank Kapital, Egebank, Yurtbank, Yaşarbank and Ulusal Bank) have been merged under Sumerbank. As of mid-May 2001, there are 8 banks managed by the SDIF. Except Demirbank, the management of the SDIF banks have been put under a joint board of management.

**Banks Under the SDIF Administration**

<b>Name of the Bank</b>	<b>Date of Transfer</b>
T. Ticaret Bank	November 6, 1997
Bank Ekspres	December 12, 1998
Interbank	January 7, 1999
Egebank	December 22, 1999
Yurtbank	December 22, 1999
Sümerbank	December 22, 1999
Esbank	December 22, 1999
Yaşarbank	December 22, 1999
Etibank	October 27, 2000
Bank Kapital	October 27, 2000
Demirbank	December 6, 2000
Ulusal Bank	February 27, 2001
İktisat Bank	March 15, 2001

Source: BRSA.

29. As of April 30 2001 the total assets of the SDIF banks are USD11.4bn and total liabilities are USD16bn. Total deposits in the SDIF banks are USD11.7bn.

**Consolidated Balance Sheet of the SDIF Banks**

(April 30, 2001) (Billion USD)

<b>Total Assets</b>	<b>11.4</b>
-Securities Portfolio	2.8
-Credits	2.0
-Non-Performing Loans (Net)	0.4
-Non-Collaterals	0.7
-Collaterals	1.5
-Requirements	1.8
-Subsidiary Assets	3.9
-Other Assets	2.3
<b>Total Liabilities</b>	<b>16.0</b>
-Deposits	11.7
-Interbank Funds	1.4
-Fund Borrowed	1.0
-Other Liabilities	1.9
<b>Shareholders' Equity</b>	<b>-4.6</b>
-Paid in Capital	0.6
-Reserves	5.2
-Loss	-10.6
-Other	0.2

Source: BRSA.

30. As of May 14, 2001 the Turkish Treasury issued USD8,007mn FX denominated securities and TL 8,529 trillion in domestic currency to the SDIF. In total TL 16,3 quadrillion of securities have been supplied to SDIF by the Treasury

### Securities Issued to SDIF by the Treasury

	Foreign Exchange		TL	TOTAL
	Million	TL Equivalent	Trillion TL.	Trillion TL.
	USD	(Trillion TL.)(* )		
<b>2000 Year End</b>	<b>2,687</b>	<b>1,825</b>	<b>2,037</b>	<b>3,862</b>
January 2001	261	250	-	250
February	-	-	-	-
March	559	531	1,493	2,024
April	-	-	774	774
May	4,500	5,154	4,225	9,380
<b>Total 2001</b>	<b>5,320</b>	<b>5,935</b>	<b>6,492</b>	<b>12,428</b>
<b>TOTAL</b>	<b>8,007</b>	<b>7,760</b>	<b>8,529</b>	<b>16,290</b>

Source: BRSA, Undersecretariat of Treasury

(\*) Calculated according to the exchange rate of CBRT on the day of issuance.

31. The SDIF transferred TL8,529 trillion of domestic currency denominated securities and 7,011 million USD worth of foreign exchange denominated securities to the banks under its administration in exchange for their losses. The SDIF also received cash advance from Central Bank using Treasury securities as collateral and placed TL750 trillion as deposits in SDIF banks. Furthermore, the SDIF transferred TL734.8 trillion of capital and TL684.2 trillion of deposits to these banks from its own resources.

### Resources Transferred to SDIF Banks

	Trillion TL.	Million USD (1)	Million USD (2)
<b>Securitization of losses</b>			
-FX Denominated	7,010 <sup>(1)</sup>	7,011	7,011
-TL Denominated	8,529	8,869	7,447
<b>Deposits</b>			
-From SDIF Resources	684	1,626	597
-From CBRT Advance	750	996	996
<b>Cash transfer from SDIF for recapitalisation</b>	735	1,760	642
<b>Total</b>	<b>17,708</b>	<b>20,262</b>	<b>16,693</b>

Source: BRSA, Undersecretariat of Treasury

(1) Calculated using the exchange rate on the date of issuance

(2) Calculated using the exchange rate on May10, 2001.

32. As implemented for the state banks, a program is underway for the SDIF banks to reduce overnight borrowing liabilities. In this framework, the overnight borrowing amount of SDIF banks from the market and sources other than the Central Bank declined from USD5.2bn on March 16th to USD0.9bn as of May 4, 2001.

33. Uniform deposit rates for all SDIF banks are being determined on a daily basis by the management and treasuries of the SDIF banks in consultation with CBRT.

34. Important steps are being taken regarding operational restructuring of the SDIF banks. In this framework;

- Between the date of transfer to SDIF and May 7, 2001, the number of branches and total personnel of these banks were reduced by 25 percent and 32.6 percent, respectively.

#### Number of Personnel and Branches of the SDIF Banks

Name of the Bank	Number of Branches		Personnel	
	At transfer date to SDIF	As of May 7 2001	At transfer date to SDIF	As of May 7 2001
Bank Ekspres	25	26	721	618
Demirbank	198	202	4,241	3,896
Esbank	94	77	2,363	1,764
Etibank	151	151	2,076	1,972
İktisat Bank	62	62	1,305	1,257
İnterbank	38	41	1,732	1,282
Sümerbank (*)	401	138	9,357	3,953
T. Ticaret Bank.	274	238	4,790	3,180
<b>Total</b>	<b>1,243</b>	<b>935</b>	<b>26,585</b>	<b>17,922</b>

Source: BRSA.

(\*) Egebank, Bank Kapital, Yurtbank, Yaşarbank and Ulusal Bank, merged under Sümerbank.

- Significant savings were made in the operational and personnel costs of the SDIF banks. As of April 2001, personnel expenditures and operational expenditures were cut by 50.8 percent and 66.9 percent, respectively, in USD terms.
- 30 financial and non-financial subsidiaries of the merged Sümerbank have been listed for sale as of April 3, 2001. The sale is to be completed by end- June 2001.
- Sale process of vehicles and movable properties (assets) has been started.

35. Below is a summary of the resolution strategy for the SDIF banks:

- Unless sold by end-May 2001, Türk Ticaret Bank, İnterbank, Esbank, and Etibank will be merged under a second transition bank. The total number of personnel and branches shall be rationalized.
- Bad assets of the SDIF banks shall be transferred to collection department of the SDIF by end-July 2001.
- The two transition banks will be put up for sale by end- July 2001. If not sold, these banks will be liquidated by end-December 2001, their assets will be transferred to the SDIF collection department and their liabilities will be paid off.
- The sale of Demirbank still continues, and offer submission deadline is extended until June 18, 2001.

- Negotiations are still continuing for the sale of Bank Ekspres and are likely to be completed by May 31, 2001.
- The sale process for Iktisat Bank is expected to start, likely during May 2001, after the completion of its acquisition balance sheet.

### Public Sector Debt from Recapitalization of Banks

The public sector debt stock originating from state and SDIF banks was around TL22 quadrillion as of December 2000. Of this amount, TL3.9 quadrillion accounts for bonds issued for SDIF banks, and TL18.2 quadrillion for the duty losses of the state banks. As of December 2000, only TL2.9 quadrillion of the state banks' duty losses was securitised and the remainder was carried on these banks' balance sheets as non-cash receiving frozen assets (claims on Turkish Treasury), leading to a significant liquidity problem for the state banks.

Due to the negative impact of the two recent crises and the already existing stock problem, these banks' losses grew significantly in 2001. In order to strengthen the financial position of the state and SDIF banks and to eliminate the state banks' duty losses the Turkish Treasury provided TL21.7 quadrillion of resources to these banks. As a result, the public debt stock stemming from state and SDIF banks reached TL43.6 quadrillion by May 14, 2001. (See table below for details).

#### Public Sector Debt from Recapitalization of State and SDIF Banks (Trillion TL.)

	Stock as of December 2000 (1)	Provided between Jan. 1- May 14, 2001 (2)	Stock as of May 14, 2001 (1)+(2)
SDIF Banks	3,862	12,428	16,290
Restructuring of Emlak Bank *	-	669	669
Capital to Halk Bank		900	900
Duty Losses of the State Banks	18,093	7,714	25,807
-Securitized	2,897	22,910	25,807
-Non-Securitized	15,196	-15,196	0
<b>Total</b>	<b>21,955</b>	<b>21,712</b>	<b>43,666</b>

Source: BRSA, Undersecretariat of Treasury.

\* TL 45 trillion of the TL 669 trillion was given to compensate for duty losses.

### Private Banks

36. The private banks also incurred significant losses in the aftermath of the November 2000 and February 2001 crises which led to a general loss of confidence in the financial sector. With the strict implementation of the "Banking Sector Restructuring Program" and "Program for Transition to a Strong Economy", the confidence in the financial markets is expected to be restored in the near future.
37. The rehabilitation of the state and SDIF banks will significantly reduce the pressure on interest rates and provide a level playing field for the banking sector. As the securities given to the state and SDIF banks for recapitalisation purposes are retired, these banks' asset size will decline and thus their weight in the financial sector will decline. As a result, the private banks will be able to mobilize larger volume of domestic deposits and at lower costs.
38. The key will be the strengthening of the banks' net worth and balance sheet structure. The BRSA, the Treasury and the Central Bank are working together

to identify measures to eliminate the distortions that adversely affect the banking sector.

39. The specific measures that have been taken in order to promote the soundness of the private banks include the following.

- The BRSA has introduced an enhanced monitoring system for the liquidity position and interest rates in all banks to make sure that unviable banks are not allowed to engage in unsound practices and that prompt corrective action is taken.
- BRSA has conducted a series of extensive discussions with individual private banks to identify their specific problems, the impact of the crisis and to formulate solutions.
- Based on these discussions, BRSA has received, on an individual bank basis, comprehensive Letters of Commitment regarding the bank's business plan, projections and if necessary the restructuring/rehabilitation strategy. The BRSA will actively follow up on the implementation of such plans through time-bound commitment letters. Relevant action will be taken against the banks that do not fulfill the performance criteria identified in the Letters of Commitment.
- The Letters of Commitment, which differ across banks depending on each bank's financial condition, incorporate the implementation plan for a combination of the below listed measures within a specified time table:
  - Capital injection
  - Utilization of subordinated debt
  - Mergers and acquisitions
  - Rationalization of branches and personnel
  - Cost reduction
  - Restructuring of concentrated credits
  - Sale of subsidiaries and real estate
  - Sale of partial or all of shares to foreign and domestic partners
- BRSA has required banks to include profits as capital. By end-April 2001 the private banks committed to a capital injection of TL 1.4 quadrillion; some of this injection has already taken place.
- Prompt action will be taken against any bank that becomes insolvent.

### **Strengthening Legal and Institutional Framework**

40. In coordination with the financial and operational restructuring of the banking sector, legislative amendments and institutional changes are being adopted. These efforts aim to promote efficiency and competition in the banking sector, facilitate sound banking practices and thus establish confidence in the sector.

41. Some of the legislative changes have been incorporated to the amendments to the Banking Law. In this context;

- The legal amendment defining “consolidated own funds” is introduced to allow consolidation of related parties lending and make the regulation fully consistent with EU standards.
- Banks’ non-financial subsidiaries are limited to 15% of total net worth and the total sum of all such subsidiaries are limited to 60% of total net worth with a transition period until 2009.
- Forward contracts, option contracts and other similar derivative type operations will be included under the definition of “credit” to limit the overall exposure to individual and related counterparties.
- Corporate tax deductibility of specific provisions is clarified.
- The collection ability and procedure of the SDIF banks is improved by the changes made in the Banks Act.

42. The BRSA will introduce the following regulations and take prompt actions to strengthen supervisory infrastructure:

-Communiqué on the “Accounting Practices” will be published on July 31, 2001 and will be effective as of January 1, 2002. The communiqué will aim to cover the inclusion of repo transactions on balance sheets and full adoption of international accounting standards.

-In order to prevent loan concentration, direct and connected lending will be amalgamated in the calculation of lending limit to a group.

-The establishment of Banks’ Internal Control and Risk Management System, which is scheduled to be effective as of January 1, 2002, will be closely monitored.

-Banks will be obliged to take into account market risks in the calculation of capital charges on an individual basis by January 1, 2002, and on a consolidated basis by July 1, 2002.

-Banks will be encouraged to utilize independent external audit in assessing their internal control and risk management systems as well as loan and trading portfolios.

-Off-shore banks owned by Turkish entities will be supervised in cooperation with the host country supervisory agency.

-Turkish banks’ foreign branches will be subject to on site supervision.

43. To promote efficiency and competition in the banking sector, joint work is being conducted with the relevant authorities in the areas of:
- Review of the withholding tax rates and reserve requirements in order to encourage long term savings,
  - Extension of tax advantages, as defined in law 4605, to facilitate the merger of banks' subsidiaries,
  - The removal of the requirement of the two year holding period for property and subsidiaries to be eligible for corporate tax exemption and reduction of withholding tax on exempted income generated from the sales of these properties and subsidiaries.

## Annex

### Banking Sector Restructuring Program: Implementation Schedule

#### I. Financial and Operational Restructuring of Banks

Measures and Regulations	Timing	Explanation
<b>A. State Banks</b>		
Elimination of state banks' overnight liabilities to the parties other than the Central Bank of Turkey (CBRT)	End of May 2001	State Banks' overnight liabilities to the parties other than the CBRT, which was USD 8.4 billion on March 16, 2001, has been reduced to USD 1.1 billion. as of May 4, 2001.
Limiting the stock of repurchase agreements of state banks (including SDIF banks) with the CBRT to TL 7 quadrillion	End of May 2001	
Elimination of duty losses and their accrued interests	May 2001	As of May 2, 2001 all duty losses have been securitised For this purpose, the Treasury has issued TL 25,9 quadrillion non-cash bonds in total, of which TL 23 quadrillion has been issued in 2001.
Preventing generation of new duty losses	May 2001	97 previously issued cabinet decrees relating to the current duty losses have been abolished. A draft bill for the elimination of current duty losses based on legislative arrangements has been prepared and consigned to the Prime Ministry by the Treasury.
Allocating the sufficient appropriation within the budget for subsidies through state banks		TL 400 trillion has been allocated within the 2001 Budget.
Appointment of a joint board of management consisting of professional managers for the state banks,	April 2001	The joint board of management has been appointed in April 2001. This board has authority to prepare Ziraat and Halk Banks for privatization within three years.
Setting an upper limit for deposit rates offered by state banks		Deposit rates are being uniformly determined below market interest rates for Treasury securities.
Strengthening capital structure of state banks	May 2001	In 2001, for the purpose of recapitalization Ziraat Bank, Halk Bank and Emlak Bank have been paid TL 217.6 trillion, TL 67.2 trillion and TL 40.8 trillion, respectively. Furthermore, Treasury issued special bonds in an amount of TL 624 trillion and TL 900 trillion for Emlak and Halkbank respectively for the recapitalization purposes.

<b>Measures and Regulations</b>	<b>Timing</b>	<b>Explanation</b>
Withdrawal of Emlak Bank's license, and transfer of its liabilities and remaining assets to Ziraat Bank	End of May 2001	
Privatization of Vakıf Bank		Privatization procedures shall be resumed as soon as the market conditions allow.
Downsizing of inefficient branches, and elimination of overstaff by providing retirement incentives		
<b>B. SDIF Banks</b>		
Establishment of joint management for the SDIF Banks	April 2001	All SDIF Banks excluding Demirbank have been put under the joint board of management.
Merger of some SDIF Banks under Sumerbank	January and May 2001	Egebank, Yurtbank, Yaşarbank and Bank Kapital in January 2001, and Ulusal Bank in May 2001, have been merged under Sumerbank.
Merger of Türk Ticaret Bank, İnterbank, Esbank and Etibank under a second bridge bank	May 31, 2001	
Rationalization of the number of branches and staff		The number of branches of the SDIF banks, which was 1,243 on the date of take over, has been reduced to 935 as of May 7, 2001. At the same period the number of staff has been lowered from 26,585 to 17,922. As of April 2001, compared to one month prior to the take over date, personnel and operating expenses have been reduced by 50.8% and 66.9% respectively .
Sale of financial and non-financial subsidiaries, vehicles and movable assets		30 financial and non-financial subsidiaries of the merged Sumerbank have been listed for sale on April 3, 2001. The sale of excess vehicles and movable assets of Sumerbank has also been initiated.
Elimination of SDIF banks' overnight liabilities to the parties other than the Central Bank of Turkey (CBRT)	End of May 2001	SDIF banks' overnight liabilities to the parties other than the CBRT, which was USD5.2 billion. on March 16, 2001, has been reduced to USD 0.8 billion. as of May 4, 2001.
Limiting the stock of repurchase agreements of SDIF banks (including state banks) with the CBRT to TL 7 quadrillion	End of May 2001	
Setting an upper limit for deposit rates offered by SDIF banks		Deposit rates are uniformly determined below market interest rates for Treasury securities.

Measures and Regulations	Timing	Explanation
<b>B. SDIF Banks (Continued)</b>		
Recapitalization and strengthening the financial position of SDIF banks	May 2001	TL 16.3 trillion Treasury special issued bonds has been issued for the SDIF banks. In addition, TL 1.4 quadrillion has been provided to these banks in the form of deposit and capital from the SDIF's own sources.
Transferring the bad assets of SDIF banks to the collection department of SDIF	July 31, 2001	
Initiating sale of Sumerbank and the second bridge bank	July 31, 2001	
Resolution of the two bridge banks	December 31, 2001	In case two bridge banks cannot be sold, merging the bank(s) with one of the solvent banks or putting them into liquidation by honoring all liabilities and transferring good assets to the collection department of the SDIF
Sale of Demirbank		The bid deadline has been extended to June 18, 2001
Sale of Bank Ekspres	May 31, 2001	
Sale of İktisat Bank		The sale of İktisat Bank will be initiated within May 2001 after completion of its acquisition balance sheet.
Establishing the infrastructure to accelerate collections of the SDIF banks' non-performing loans and legal proceedings		Necessary arrangements on the Banking Law have been already done.
<b>C. Private Banks</b>		
Preparation of recapitalization and restructuring plans by the private banks	End of April 2001	The Commitment Letters, which cover recapitalization, subordinated debt, and restructuring strategies, have been received from the private banks.
Ensuring capital injection	2001	The BRSA has required banks to add their profits to their capital. The banks have applied to the BRSA to increase their capital by TL 1.437 trillion as of April 2001.
The implementation of performance criteria set out in the Commitment Letters	2001	The observance of the performance criteria will be strictly enforced.

## Banking Sector Restructuring Program: Implementation Schedule

### II. Legal and Institutional Arrangements

Measures and Regulations	Timing	Explanation
<b>A. Strengthening the Supervisory Framework</b>		
Defining consolidated own funds consistent with the EU Directives	May 2001	With the change in Banking Law, “consolidated own funds” is defined, and it is ensured that this definition is used in calculation of consolidated credit limits and standard ratios.
Limiting the banks’ subsidiaries in non-financial institutions	May 2001	Banks’ non-financial subsidiaries are limited to 15% of total net worth and the total sum of all such subsidiaries are limited to 60% of total net worth with a transition period until 2009.
Broadening the definition of credit, and inclusion of forwards, options and other similar derivatives into the definition of credit	May 2001	Necessary arrangements in Banking Law have been done.
Clarifying the deductibility of loan loss provisioning in calculation of corporate income tax base	May 2001	Necessary arrangements in Banking Law have been done.
Ensuring transparency in financial statements and that all transactions are properly recorded	July 31, 2001	The Regulation of Accounting Practices shall be issued by end-July 2001 and will be effective as of January 1, 2002.
Inclusion of repo transactions on balance sheet	January 1, 2002	To be included in the context of The Regulation of Accounting Practices.
Adopting the basic principles of International Accounting Standards together with the Standard No: 39 including valuation and classification of financial tools and the financial transactions against risk	January 1, 2002	To be included in the context of The Regulation of Accounting Practices.
Adoption of connected lending regulation	June 30, 2001	The regulation covers organizational structure of banks; lending principles and procedures; definitions of indirect shareholding, indirect credit and indirect participation, and the principles and ratios of non-cash credits taken into account in calculation of credit limits.

Measures and Regulations	Timing	Explanation
<b>A. Strengthening Supervisory Framework (Continued)</b>		
The revision of the establishment and operation principles for independent auditing firms	September 2001	
Monitoring the establishment process of internal control and risk management systems	January 1, 2002	The related regulation will be effective on January 1, 2002.
Incorporation of the market risks on consolidated basis in the calculation of capital adequacy ratio	2002	Banks will be obliged to take into account market risks in capital adequacy calculations on an individual basis by January 1, 2002, and on a consolidated basis by July 1, 2002.
Encouraging banks to give importance to internal and external supervision, and ensuring examinations on internal control and risk management systems and lending portfolio and market risks during independent supervision activities		
Close monitoring of the off-shore banks established by Turkish banks or their dominant shareholders		BRSA does sign agreements and cooperate with other countries' supervisory agencies.
Ensuring on-site supervision of branches in foreign countries		
<b>B. Other Measures to Enhance Efficiency and Competitive Power of the Sector</b>		
Review of the withholding income tax rates and reserve requirement practices to promote long term savings		BRSA does conduct some efforts in cooperation with the relevant institutions.
Eliminating the remaining obstacles for merger and acquisitions		Ministry of Finance have been requested that the tax advantages in Law No: 4605 apply also to merger of bank subsidiaries.
Promoting the increase in own funds		The removal of the requirement of two year holding period for property and subsidiaries to be eligible for corporate tax exemption shall be abolished. In addition, the withholding tax rate on income generated from property and subsidiary sales will be reduced. Ministry of Finance has been requested to start procedures for these arrangements.