



**BANKING REGULATION AND
SUPERVISION AGENCY**

**REASONS FOR THE TAKE-OVER OF
PAMUKBANK BY THE SAVINGS
DEPOSIT INSURANCE FUND**

Information Report

June 27, 2002

1. GENERAL INFORMATION ON PAMUKBANK

Pamukbank was acquired by Çukurova Group in 1973. Its partnership structure and upper management details as of December 2001 are provided in tables 1 and 2.

Shareholders	Paid-Up Capital	% Share
Avor İnş. Gıda Teks. Kim. A.Ş.	151,9	32,3
Çukurova Holding A.Ş.	122,2	26,0
Endüstri Holding A.Ş.	52,2	11,1
Sınai ve Mali Yat. Holding A.Ş.	50,0	10,6
Çukurova İth. ve İhr. A.Ş.	46,6	9,9
Çukurova Dış Tic. A.Ş.	42,3	9,0
Other	4,9	1,0
Total	470,0	100,0

Table 2: Upper Management

Chairman of the Board of Directors	Mehmet Emin Karamehmet
Vice-Chairman of the Board of Directors	Osman Berkmen
Member of the Board of Directors	Sezer Bilgili
Member of the Board of Directors	Fikret Aktekin
Member of the Board of Directors	Halit Soydan
General Manager	Orhan Emirdağ

Pamukbank holds 5,5% of total assets, 12,7% of total loans and 6,2% of total deposits of the Turkish banking sector. However, the share of its loans in the sectoral total decreases to 3,9% when group exposures are left out. **Apparently, the balance sheet size of Pamukbank shrinks remarkably,**

and hence does the bank's share in the banking sector, when group exposures are excluded.

Upon the completion of audits, total assets of the bank was calculated as TL 6.3 quadrillion as of December 2001. Of the bank's total loan portfolio amounting TL 5,5 quadrillion, an important part was transferred to follow-up accounts and its rediscounts (accumulated unpaid interest outstanding balance) amounting TL 2.9 quadrillion were cancelled. Provisions have been set aside, by also taking the collaterals into account, for the remaining amount as stipulated by the regulation on provisions. **The bank's period loss as of December 2001 was determined as TL 4 quadrillion, and the resource required to reach the standard CAR as TL 3 quadrillion.** Some items of the corrected balance sheet as of December 2001 are provided in Table 3.

Table 3: Selected Balance Sheet Items (December 2001)

	TL Trillion	% Share
Selected Assets		
Banks	493	7,9
Securities Portfolio	436	7,0
Loans	1.665	26,5
Loans Under Follow-Up (Gross Loans under Follow-Up less Provisions)	874	13,9
Interest Income Accruals and Rediscounts	680	10,8
Subsidiaries + Affiliates+ Fixed Securities	968	15,4
Fixed Assets	272	4,3
Selected Liabilities		
Deposits	7.429	118,4
Credits Received	510	8,1
Total Own Funds	-2.288	-36,5
Balance Sheet Size	6.273	100,0
Period Loss	-4.024	--

2. EVOLUTION OF THE BANK'S FINANCIAL STRUCTURE

Due to asset-liability maturity mismatch, liquidity shortage, own fund insufficiency and deteriorated financial status, the bank was subjected to Article 64⁽¹⁾ of the ex-Banks' Act No. 3182 upon the approval dated April 4th, 1989 of the Office of the State Ministry. Under the scope of the Banks' Act No. 3182, required reserves were paid back to the bank and penal interests incurred due to unholding of required reserves were cancelled several times in the past. However, with the enforcement of the Act No. 4389, such practices lost their legal grounds and were thereby terminated.

The status of the bank had worsened due to speculations during the economic crisis of 1994. In that period, the bank's exposures to the Group paved the way to a freezing of its assets which, in turn, created a strong liquidity pressure on the bank. Ultimately, the bank had to bear large resource costs during the said crisis period. In the periods of increasing resource costs, the most important measure to be taken by a bank having a good degree of asset quality is to liquidate its high-cost resources. However, in the case of Pamukbank, the low quality of assets due to the group exposures made the implementation of such a measure almost impossible and efforts to keep those high-cost resources led to an ever-increasing loss.

The most important problem of the bank has been non-performing group loans. Loans extended to the group firms were not collected at their maturities and the maturities were repeatedly subjected to extensions.

⁽¹⁾ Article 64 corresponds to Article 14 of the new Banks' Act as amended by Act No. 4672.

Instead of accruing and collecting interest concerning these loans, the bank practiced accumulating unpaid interest (interest rediscount) only and kept accounting of these loans' foreign exchange evaluations and interest rediscounts under the sub-accounts of loans item and the transitory accounts within other assets item, in violation of the Uniform Accounting Plan and Instructions. Through the income created this way, the bank was shown to have a balance sheet with profit. Furthermore, the group loans extended before June 23rd, 1999 were classified, by reference to the provisional article of the Banks' Act, as performing loans, thereby violating the Regulation on Provisions, and the own funds item of the bank were inflated by not setting aside necessary provisions.

Differences observed between the bank's declarations and the Sworn Bank Auditors' reports have been due to the evaluation of group risks. Within the scope of related legislations, several written and oral warnings since April 19th, 1989 were forwarded to the bank management, asking for the necessary measures to be taken so as to solve the financial problems primarily arising from exposures to the group. Additionally, several talks were held with the bank management on the basis of the instructions given. In all these, the bank management was provided with the necessary incentives so as to enable them to implement their resolution plans. However, despite the sufficiently long time period offered, the bank management did not take a serious action towards eliminating the group risks or bringing them into line with the limits stipulated by the related legislation. Nor, was there any attempt to utilize some important opportunities when existed. Instructions given to the bank by the

supervision authority are provided in detail in section 3 of the present report.

The bank's group exposures amounting TL 3.8 quadrillion as of December 2001 constituted 69% of its total loan portfolio and 40,5% of its total assets. Sectoral composition of cash loans extended to the group is given in table 4.

Table 4: Sectoral Composition of Cash Loans Extended to the Group

Sector	TL Trillion	%
Industry and Construction	3.127	82,0
Services Sector	261	6,9
Trade	155	4,1
Technology	117	3,1
Banking and Finance	95	2,5
Tourism	30	0,8
Media	28	0,7
Total	3.813	100,0

Due to loans which remained uncollected over the years, and hence eventually turned into a kind of capital extended to firms, the bulk of the bank's assets portrayed a frozen character and generated no income at all. The group loans adversely affected the bank's financial status and distorted the balance between incomes and expenses. The evolution of group exposures on a yearly basis is given in Table 5.

Table 5: Distribution of Group Loans (TL Billion)

Years	In-Cash Group Loans				Total Loan Portfolio		Total Assets	
	Principal Rediscount (*)		Total		TL	%	TL	%
	TL	TL	TL	\$ Million				
1995	47.263	15.501	62.764	1.055	87.803	71,5	170.046	36,9
1996	28.630	108.932	137.562	1.280	210.874	65,2	343.479	40,1
1997	28.630	210.321	238.951	1.160	488.896	48,9	788.976	30,3
1998	113.901	519.181	633.082	2.007	995.810	63,6	1.597.349	39,6
1999	167.510	983.359	1.150.869	2.365	1.878.270	61,3	3.262.599	35,3
2000	350.843	1.407.647	1.758.490	2.662	2.761.279	63,7	4.672.904	37,6
2001	923.107	2.887.936	3.813.373	2.667	5.525.874	69,0	9.407.996	40,5

(*) Accumulated unpaid interest outstanding balance

Of TL 1.7 quadrillion non-group loans as of December 2001, an important part constituted the loan extended to Fiskobirlik. As of end-2001, the outstanding Fiskobirlik loan balance reached to TL 592,4 trillion (\$ 414 mn) with TL 1,1 trillion as principal and the remaining TL 591 trillion as unpaid accumulated interest outstanding balance (interest rediscounts). Interest income rediscounts of this loan has been recorded under sub-accounts of the loans item instead of interest income accruals and rediscounts.

The bank had extended Fiskobirlik a loan of TL 10 bn in 1989 and a further loan of TL 6,5 bn in 1990, which add up to TL 16,5 bn. Notwithstanding the failure of Fiskobirlik to repay these loans at their maturities, the bank continued to charge and accumulate interest on the loans. In 1999, it was stipulated by law⁽²⁾ that a part of Fiskobirlik loan, to be determined upon an evaluation of Fiskobirlik's losses due to its hazelnut purchases during the season of 1989, be undertaken by the Treasury through issuing special government bonds and that principles of this

⁽²⁾ Article 44, paragraph E of Year 2000 Budget Law with No. 4494 and dated 28.12.1999, which came into force with its publication in Official Gazette Repeated Edition No. 23922 and dated 30.12.1999.

procedure be set by the Council of Ministers. In consequence, the bank was informed in writing by the Treasury on 22.12.2000 that the Fiskobirlik's total debt of TL 52 trillion (found upon accumulating interest on a *CPI based inflation rate + %10* basis) was decided to be undertaken by the Treasury. However, the bank notified the Treasury in writing on 26.01.2001 that the said amount was far less than the amount calculated by the bank and hence was not acceptable.

The bank calculated unpaid accumulated interest outstanding balance for the Fiskobirlik loan by adding a spread to the funding cost on a quarterly basis. The interest calculation method used by the Bank was different from those used by the Treasury. However, an important point to be noted here is the fact that, the Fiskobirlik loan amount recorded in the Bank's (not the Treasury's) accounts was used in the calculation of capital need of the Bank by the BRSA, and hence no correction whatsoever was made on the said records. By doing so, any amendment on an issue which has been under legal dispute was avoided. Therefore, the claim that the bank's capital adequacy problem was due to receivables from Fiskobirlik has no ground.

The sum of loans extended to companies, excluding Fiskobirlik and the Group companies, amounts to TL 1,1 quadrillion, the bulk of which belongs to companies operating in industry and construction sectors. Sectoral distribution of these loans, which constitute 2,5% of the banking sector's total loans, is provided in table 6.

Due to TL-based placements of the funds raised through FX deposits and FX loans, the bank was in FX short position and thereby incurred large amounts of foreign exchange losses. Subsequently, the bank brought its FX net general position to capital base ratio into line with the regulatory standards by eliminating its open position (USD 1,3 bn as of December 2001) through fictitious forward FX purchase transactions.

Table 6: Sectoral Distribution of the Bank’s Non-Group Loans

Sector	TL Trillion	%
Fiskobirlik	592,4	35,6
Industry and Construction	271,8	16,3
Trade	172,2	10,3
Textile	136,7	8,2
Tourism	47,0	2,8
Banking and Finance	29,0	1,7
Media	26,0	1,6
Technology	9,0	0,5
Service Sector	6,9	0,4
Other	374,2	22,5
Total	1.665,3	100,0

The bank prepared its financial statements by adding accumulated unpaid interest sums (interest rediscounts) to the group loans at end-periods in the amounts sufficient to eliminate term losses and create seemingly reasonable profit figures. Upon the Agency’s inspections, it was found out that the bank had not been able to realize the collections of the principal and interest amounts of the group loans for years. Also found was the creation of an income stream through a procedure of applying rediscount to these loans, adding the resultant to the loan principal and re-

applying the rediscount to the overall sum. In consequence, it was determined that through the methods stated above, the bank's financial statements were presented to be in profit notwithstanding the large and growing real losses incurred.

The bank has had high Group and FX risks, low quality assets, insufficient own funds and low liquidity. Hence, its financial structure was highly distorted. **The Group used the funds of the Bank for its own purposes, to the extent of endangering the bank's safe functioning.**

Although having been under the coverage of close monitoring since 1989, having received numerous directives to improve its financial structure and having benefited from the state support available within the framework of the legislation, Pamukbank has failed in taking sufficient measures to strengthen its financial structure with due care, and the measures taken were not successful in reducing the group loans, which have been the foremost problem of the bank.

3. INSTRUCTIONS GIVEN TO THE BANK BY THE SUPERVISORY AUTHORITY AND THEIR AFTERMATH

The practice of close monitoring of the bank was continued within the scope of Article 14 of the new Banks' Act No. 4389 upon its entry into force. Since there was no change in either the main problems or the bank's approach towards these problems, the instructions given to the bank, by reference to Article 64 of the present Banks' Act No. 4389, concentrated on certain measures. These were, resolving the non-performing group loans, eliminating the own funds deficit and clearing the open position risk

which was particularly effective in the increase of the bank's operational losses.

According to the remarks made by Sworn Bank Auditors in their reports, the nature of problems faced by the Bank remained the same, and these problems even worsened in recent periods.

On the other hand, the bank, which has been under close monitoring for a long time, made its most important attempt in 2000 towards taking the instructed measures to resolve the problems and improve its financial status. These were as follows.

a) A partial repayment in the amount of USD 160 mn of the group loans and a capital injection of TL 90,6 trillion to the bank were realized through using some of the income generated from the public offering of Turkcell Iletisim in the stock exchange in the second half of 2000. However, the fact that group loans amounted to almost USD 2,5 bn nullified the significance of said injections. In this period, although instructed to increase the portion of shares offered to the public and realize the repayment of group loans in larger amounts, the bank's shareholder did not make an attempt to do so.

b) Various guarantees were taken from the group firms and bank shareholders so as to collateralize the group loans. As a matter of fact, all of these collaterals were taken into account by the Agency in the calculation of the bank's capital adequacy as stipulated by the related legislation.

However, the group loan repayments and the capital increases realized had not been sufficient to improve the financial structure of Pamukbank and resolve its chronic problems. Furthermore, losses of Pamukbank was continuing to increase due to effects of the recent crises, the bank's open positions, and increasing costs.

On the other hand, the majority shareholder made a decision on 17.05.2001 that foresaw Pamukbank's acquisition by Yapi Kredi Bank, which also belonged to the same group. This decision was welcomed by the BRSA and the bank was requested to inform the Agency of the developments especially about the intended merger. However, it was stated by the bank that the realization of the decision depended on incentives to be provided for mergers and acquisitions of banks. In order to encourage mergers and acquisitions in the banking sector, new regulatory changes were introduced and subsequently the bank was requested to accelerate preparations for the merger.

In the plans presented to the Agency, the remark that completion of the merger successfully depended on the resolution of group loans was also shared by the bank, along with the majority shareholder group and the international consultant firm that was contracted for carrying out the merger preparations. However, the plan concerning the resolution of group loans through the sale of group assets was not realized over the course of time left behind. Besides, the value of collaterals belonging to the group loans had already decreased due to adverse developments in the markets,

which thereby increased the loan loss provisions, and hence the losses of the bank.

By means of a written instruction of the Agency dated 19.11.2001, the bank was requested to meet the minimum capital adequacy ratio within six months. Finally, through a letter of the Agency dated 27.12.2001, the bank was requested to prepare a plan with a reasonable time schedule for the resolution of group loans. The following instructions, which had been given to the bank previously, were also reiterated in the letter.

- ✓ Guaranteeing the existing group risks through getting the suretyships of natural persons included in the group and resolution of these risks within a pre-determined time schedule,
- ✓ Realizing an in-cash capital increase to fully cover the deficit in the own funds item, or finding a new partner who will provide additional cash inflow,
- ✓ Taking measures to reduce funding costs,
- ✓ Disposal of all subsidiaries and immovables held under the assets item in a cash income generating manner, taking all expenditures under tight control and not opening any further branches,
- ✓ Initiating the follow-up procedure for non-performing loans, classifying the loans in compliance with the regulation on provisions, and setting aside the required provisions,

- ✓ Bringing open position to a level compliant with the regulatory limits.

However, the capital increases requested from the bank was not realized. As regards the latest capital increase realized, it did not provide any positive contribution to the financial structure of the bank for it was fully covered by internal resources.

Meanwhile, the “Banking Sector Restructuring Program” was put into implementation on 15.05.2001 so as to ensure a sound environment for banks and provide permanent solutions to the problems in the banking sector aggravated by the recent crises. Within the scope of this program, various measures, as announced to the public, for ensuring a sound banking system were taken. In order to fully resolve the problems in the banking system, Provisional Article 4 was added to Banks’ Act No. 4389 by the Act No. 4743. Accordingly, capital contribution by the SDIF, within the pre-specified conditions, to those banks which found to be in short of capital upon a triple-audit process was stipulated. The aim of this process, currently in progress, is to determine the financial status of banks and ensure the transparency of their balance sheets.

The issue of lending to those banks in need of capital by the SDIF, subject to pledging of valuable assets owned by the shareholders, was brought into the agenda of the Grand National Assembly of Turkey. Although the issue was accepted to be included in the provisional Article 4 of the Banks’ Act by the Plan and Budget Commission, it was excluded by the General

Assembly. Thus, the present legislation stipulates that banks' capital shortages may not be covered by recourse to state resources, even with the condition of pledging of shareholders' assets.

Within the framework of the Provisional Article 4 of the Banks' Act, Pamukbank's capital adequacy standard ratio (which should be minimum 8%) was calculated as -36.97 % by the first independent auditor and as -42.96 % by the second independent auditor upon the audits they performed on the Bank. Following a re-evaluation by taking into account both the evaluations of the afore-mentioned audits and the assessments of Sworn Bank Auditors, this ratio has been determined as -46.15 %. As of December 2001, the term loss of the bank amounted to TL 4 quadrillion and the bank's resource need to reach 8 % capital adequacy ratio was calculated as TL 3 quadrillion.

Deteriorated financial status of the bank has also been apparent from the audit results. As stated before, in calculating the bank's capital adequacy ratio, accumulated unpaid interest on receivables from Fiskobirlik was not cancelled and no provision has been set aside for these receivables.

While carrying on with the process summarized above, the Agency also continued its concern with the plans regarding the acquisition of Pamukbank by Yapı Kredi Bank. Along these lines, it was stated in various letters submitted to our Agency by the bank that the merger process would take further time due to the adverse effects of the September 11 events on the markets.

Although preparatory works regarding the merger of these two banks had been continuing since the beginning of 2001, and even it was declared by the bank in its first plan submitted to the Agency that the process was to be finalized by 30.06.2002, the projection comprising basic assumptions regarding the merger was submitted to our Agency on 17.06.2002. **In spite of several written requests made concerning the merger, a Board of Directors decision for the merger was not made on the grounds that Yapi Kredi Bank was a publicly listed bank and that such a decision would affect the value of the bank's shares. In the end, the decision under question was made on 10.06.2002 (very shortly before the Agency's commencement of notifying the banks about their capital adequacy levels) and announced to the public without taking the required permissions.**

Nevertheless, the merger proposal was evaluated with utmost care; applicability of it was discussed by taking into account all possible assumptions and the likely impact of the merger on Yapi Kredi Bank's financial structure was deeply evaluated.

As international experience suggests, **for the success of mergers and acquisitions, the resultant company's (bank's) financial stance must not deteriorate and it should be able to continue its activities in a sound way.** As the majority shareholder group agreed on, the resolution of group loans constituted the most important issue in the submitted plan. Nevertheless, there was not a realistic approach towards the resolution of group loans in the plan. Indeed, the resolution plan was based on the basic

assumption that these loans are to be resolved in a 7 or 8- year period under the coverage of the Law on Restructuring the Debts to Financial Sector. **Upon evaluating the submitted resolution plan, it was assessed that, the resolution depended in most part on external factors, did not have realistic projections and would take an unforeseeable period of time to realize. It was also assessed that prolonging the solution of problems within the resultant (post-merger) bank would accelerate the growth rate of the loss, given the increase to occur in the bank's scale after the merger. It was therefore concluded that the realization of intended merger would seriously damage the healthy financial structure of Yapi Kredi Bank and lead to large losses.**

Given that Yapi Kredi Bank and some other firms owned by the group are quoted in both Istanbul Stock Exchange and international markets and that any problem that might be faced by Yapi Kredi Bank would seriously affect domestic and foreign small investors, depositors, banking sector and hence the overall economy, the proposal of Pamukbank's acquisition by Yapi Kredi Bank was not found to be a solution to the bank's problems. It was then concluded that circumstances as set forth in sub-paragraphs 3 and 4 of Article 14 of the Banks' Act had come true for the bank. Accordingly, within the principal stipulations of the present legislation, Pamukbank's take-over by the Savings Deposit Insurance Fund was decided by the Board.

4. CONCLUSION

The transfer of Pamukbank to the Savings Deposit Insurance Fund has been based on objective results obtained from detailed examinations on the financial structure of the Bank. The problems resulting from non-performing group loans were not resolved by the bank. Furthermore, the group risks of the bank increased over time, due to the group's new investments in different fields, and eventually became unmanageable.

Prior to the transfer stage, the bank had been under close monitoring and supervision for a long period of time and its management were given various instructions towards the solution of the bank's financial problems. Although sufficient flexibility was shown as regards the time limitations, the bank failed to act with due care on the issue of eliminating the group risks or bringing them at least into regulatory limits.

All of the measures taken in the banking field by the BRSA aim at strengthening the banking sector and maintaining its reliability. As it is known, a sound banking system is the *sine qua non* condition for a sound economy. Prior to the transfer stage, possible effects of such an operation on the banking sector, depositors, investors, other institutions, and the bank's employees were discussed in detail and, it was concluded that the bank could not carry out its activities in a sound way if the prevailing shareholder structure were maintained.

It is not possible for a banking system containing distressed banks to function efficiently. It was foreseen that upon the implementation of the

merger plan, Pamukbank's problems would also spread over to Yapi Kredi Bank within a short period of time. Pamukbank has been taken over by the SDIF on the basis of the fact that a bank which will turn out to be "very large in scale but troubled" after the merger is more hazardous than otherwise to the general stability of the banking sector. It is believed that the Turkish economy will be positively affected from these decisions in the medium and long-term.