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10 Years and Growing

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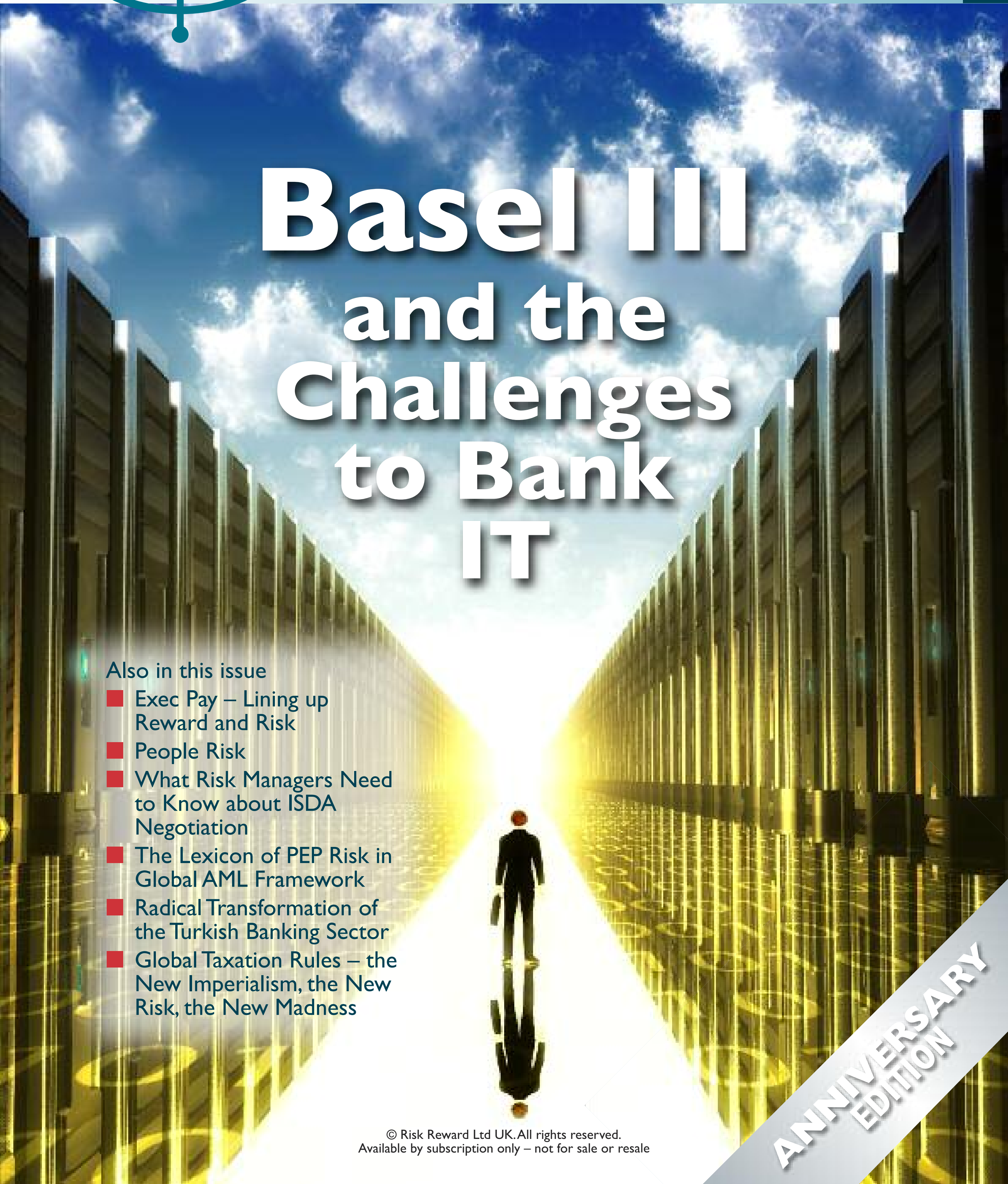

Basel III and the Challenges to Bank IT

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ANNIVERSARY EDITION

Radical Transformation of the Turkish Banking Sector

Dr Botan Berker is a banker and risk management specialist, and CEO at Merit Risk, Istanbul, Turkey and former managing director of Fitch Ratings. In this article she takes a critical review of the more than ten years of dramatic change within the Turkish banking system and holds it up as a reference to paths which other markets may follow.

The Turkish economy had suffered a long lasting high inflation period since the late 1970s which resulted in distortions of the several aspects of economic activities, mostly of the intermediary institutions such as banks. There had been several attempts of the government with the support of the International Monetary Fund (IMF) to tackle the vulnerabilities of the public finances that continuously fed into the inflationary dynamics. However, despite to several relatively milder crises during 80s and 90s it was not up until the year 2001 that the economy really hit the wall and all of the problems of the banking sector became visible by all and a radical change became a requisite?

During the late 1990s Turkish banking sector could be characterised as an overly banked system with small institutions that lacked institutional ownership thus partly owned by some individuals somewhat distant to any corporate governance guidelines. Moreover the banking system was deemed to be highly profitable with respect to the banking systems of other OECD countries due to the fact that banks were overly investing in high yielding Turkish government papers which seriously exposed them to market risk. Furthermore Turkish banks were able to earn large returns by maintaining net open foreign exchange positions. They were funding themselves through lower cost foreign exchange markets and lending in Turkish lira to capture the high risk premium on government debt. The real interest rates on Turkish government securities were around twenty percent and the open position of the banks were more than one hundred percent of their equity in most cases. The lack of prudent supervision played a significant role in alleviating the systemic weaknesses.

The Turkish government had launched a disinflation program in late 1999 and adopted a crawling peg exchange rate system incorporating an exit strategy to the peg in almost two years. This exchange rate system led to underestimation of currency risk by the banking sector. Eventually the accumulated weakness in public finances coupled with an extraordinary mismanagement, the economy collapsed. The immediate consequence was to switch to a free float of Turkish lira which had devalued sharply leaving the banks to realise their losses stemming from their exposures to a very serious currency risk.

With the economic activity coming to a halt and the ongoing IMF Standby program being suspended the Turkish government had approached the IMF to resume and enhance the programme. By May 2001 the Standby Programme for Turkey at an amount of 19 billion USD had been approved by the fund incorporating structural policies aimed at correcting the distortions in banking.

At the heart of the programme was the provision for a fully functioning, newly established independent Banking Regulatory and Supervisory Agency (BRSA). The BRSA stepped in and changed the rules of the game immediately.

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As a starting point to maintain adequate capital the supervisor asked for the triple audit of all the banks which had been reduced in number following the consolidation. Following the audit process that more accurately reflected the banks' financial conditions a recapitalisation scheme for the sector has been introduced and the capital base has been strengthened. Since 2001 the Turkish Banks' regulatory capital ratio had been set as 12% minimum if they wanted to open any new branches. All cash dividend distributions have been suspended until the capital adequacy ratios had been restored and maintained. In order to enhance the transparency administrative and regulatory steps have been taken to improve the reporting required by the banks. The state banks that had the legacy of distorting the markets, have been restructured and their relative advantages have been wiped off to provide a level playing field for all the banks.

Private banks, especially those with common owners, were encouraged to merge. Tax laws were further revised to make mergers of banks and their subsidiaries tax neutral. Loan loss provisioning rules have been strengthened. An enhanced monitoring system for the liquidity position and interest rates in all banks has been introduced to make sure that unviable banks are not allowed to engage in unsound practices and that corrective actions are taken early. To address the problem of connected lending, a regulation defining related parties for purposes of limits on banks' exposures to owners and other parties has been introduced. A capital charge on foreign exchange exposures has been introduced in line with the new market risk regulations. Accounting standards for banks were brought in line with international standards which included bringing all repurchase agreements on to the banks' balance sheets. Furthermore there has been some renewals on the foreclosure and bankruptcy laws.

The Turkish regulator had addressed the issue of quality and quantity of capital at an early date. Besides the requirement of 12 percent regulatory capital they urged the banks to reduce permanent assets through outright sale and/or conversion to interest bearing assets.

A risk management structure had an area of great importance for the regulator and it introduced the required model to the system with immediate effect. Accordingly banks had to establish an audit unit, an internal control unit and a risk management unit which should be carrying out their functions independently of other bank activities.

Separately each bank had to establish an Executive Risk Committee to prepare management strategies and policies.

As a critical part of the internal control function, the bank's operations had to be functionally separated from each other (i.e. separation of banking and trading, separation of marketing and credit review). In order to comply with these requirements banks had installed state-of-the art technology information systems. Risk Management units started to function independently and the head of the unit became responsible to a Board director in charge of risk management. Over the years the system proved effective which had closely been supervised by the BRSA through conducting on-site and off-site supervision.

The banking sector showed a rapid growth performance during 2002-2008 periods and had an asset growth of 258 percent up from USD 130 billion to USD 465 billion.

The Turkish banks have encountered the global financial crisis in a relatively comfortable position with high capital adequacy ratios, low NPLs, strong funding base mainly through deposits and a well-established risk management culture. During 2009 when the economy contracted due to the decline in external and domestic demand the banking sector had been affected mildly as shown in the increase in impaired loan ratio from 3.3 and 3.4 at the end of 2007 and 2008 respectively to 5 percent by the end of 2009. That ratio had come down to 2.7 by the third quarter of 2011. At the end of 2010 the Turkish banking sector had 49 banks. Its assets stood at USD 653.9 billion with an average regulatory capital ratio of 19 percent and return on assets and equity at 2.4 percent and 18 percent respectively.

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