RECENT DEVELOPMENTS IN BANKING

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and
Its Likely Prospects For The Year 2000"
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Thank you very much, Mr. Chairman. In fact I have two separate thanks to express. I have been invited several times to various seminars and gatherings organized jointly with the Akdenet by the Foundation of Economic Research, on whose Board I have always been proud to serve. The quality of these meetings has always been extremely high. For this reason, my first "thank you" goes to the Foundation of Economic Research and Akdenet for inviting me to this gathering. My second expression of thanks is for the title of today's seminar, which indeed has an exotic flavor. It is unquestionably a good idea to perform a "SWOT" analysis covering Strengths, Weaknesses, Opportunities, and Threats, a technique now widely used in the industrial sector, and see how it might be adapted for the financial and banking sectors. Accordingly I would like to thank our sponsors for having organized a meeting that will illuminate the shape of the banking sector after the year 2000.

Today, I will discuss three points. First, since the object of our analysis is to be the banking sector, it may not be out of place to remind you of some of that sector's realities. Second, when we come to elaborate on the SWOT analysis, I would like to dwell on recent progress in the international banking system, especially now that the Asian crisis has brought banking issues to the forefront. And third, I want to briefly evaluate the probable advantages that Turkey's new Banking Act will bring to this kind of analysis.

As we very well know, banking has now become a global activity and a global issue.

From the global standpoint, the principle of "big is strong and small is beautiful" is no longer valid. Some figures have been provided just today on the size of Turkey's banking system. At first glance, they may seem frightening, since they seem to indicate that the size of our banking system is quite small. These figures force us to acknowledge that the total assets of the Turkish banks that are among the top 1000 banks in the world are smaller than the assets of a single Japanese bank.

But since at the global level, balances are extremely sensitive, the sheer size of a bank or a banking system is not all that important. More important than the size of a bank or banking system is its compliance with the rules of the globalized environment, the extent of its risk-taking, and the techniques it uses to deal with risk. I am therefore not altogether surprised to see that the Turkish banking system's size of $114 billion gives it only a tiny place in the worldwide banking system.

A better way of evaluating our banking system in the global system is to measure its ability to comply with the internationally accepted banking rules.

Second, Turkey must absolutely have a sound and efficient banking system to enable it to implement an unyielding macro-economic policy. In light of recent developments, international financial institutions and rating agencies have begun to give a country's banking sector a major place in their analyses, and to act accordingly. For example, during the 1970s and 1980s the International Monetary Fund would have given little attention to countries' banking systems. Their reports highlighted many matters and hardly anything about the banking sector was even mentioned. Now, however, the banking system seems to be the first priority in their examination.

Other truths have emerged since the Asian crisis. Formerly, in evaluating banks we used to look only at the assets and liabilities on their balance sheets. This too is no longer the case. Banking supervision now extends to capture "off-balance sheet" items as well as formally acknowledged assets and liabilities. I recently read an article about South Africa's foreign exchange reserves, which amounted to $6 billion.

But a look at the South African central bank's off-balance sheet operations revealed that the actual level of its reserves had been reduced to -$17 billion as a result of forward operations by the central bank. It was only by examining the off-balance sheet items that the loss in reserves could be detected. This is why examinations now look not only at banks' "on-balance sheet" items, but also at all "off-balance sheet" items.

Another feature of globalization is its dynamic nature. The banking sector and its arrangements must absolutely be able to deal with this dynamism, which will require permanent changes in the way banking is carried on.

Second, I need to describe the recent advances that have taken place in the international banking system and their implications for the analysis of banking practices. These new developments are the result of the Asian crisis which erupted in September 1997. There are four main issues to be addressed. The first has to do with changes in the way risk is managed. A second concerns improving market discipline and ensuring that it penetrates the banking system. The third is finding better ways of supervising high risk enterprises such as hedge funds. And the fourth is to ensure that the examination of individual banks includes analysis of its consolidated balance sheet, taking account of its transactions with both foreign and domestic financial institutions, instead analyzing only the bank's own in-house balance sheet.

The first of these four issues, the handling of risk, requires first that the need for managing risk is recognized and that measures for doing so are in place, and then proceed to determine their strengths and weaknesses. A method called "stress testing" has recently been developed for evaluating risk management. Supervisory institutions are looking onto how efficiently these stress tests are being implemented in banks. What does "stress test" mean? Suppose you have accepted a risk which has now begun to fluctuate or has under stress mostly for exogenous reasons. For example, suppose you have extended credit to an institution which later finds itself in financial difficulties for any reason. At this point the questions are, will the credit you have extend survive the exogenous threat? And how can you get your money back? Similar questions arise for countries and governments. How is the financial position of an economic agent, a government, or a sovereign state affected when a risk it has taken threatens to materialize? I understand that advanced computer techniques are being developed for modeling such situations. I am not aware that any such stress tests are available in the Turkish banking system. I have not yet seen any example of it. But I am sure such techniques will be widely used in time to come.

Another important aspect of risk management is client selection. When a client is to be selected or a risk accepted, it has now become important that the risk analysis be performed and the decision made by autonomous agencies specializing in these activities. A modern risk management system must therefore include autonomous, impartial agencies that can base risk decisions on the analysis of facts and figures. Why am I repeating all this? Because the world banking system now attaches a great deal of importance to risk management and to the matters I just mentioned. Let me especially underline once more that stress tests are becoming increasingly important.

The second issue being addressed internationally is promoting market discipline. Greater market discipline requires that market participants have full access to correct and transparent information. Getting this information into the hands of interested parties is extremely important. Market participants who have accurate and timely information can make much better decisions, but if the information is incorrect, incomplete, or late, problems will emerge. The information needed to enable the marketplace to regulate itself should include financial performance, transparent and complete balance sheet, and the risk management system in use, examining how risks are taken, and what the risk mapping looks like. Markets generally recognize five fundamental categories of risk: exchange rate risk, interest rate risk, maturity risk, credit risk, and liquidity risk. The information on which the risk analysis is based serves the cause of market discipline as well. This requires accurate accounting records, compliance with internationally accepted rules, and good management performance on the part of a bank.

The third issue now receiving close attention at the international level is stronger monitoring of especially risky institutions. It will be recalled that a U.S. hedge fund named Long-Term Capital Management (LCTM) went bankrupt unexpectedly. The Federal Reserve Board acted immediately by urging banks to join the private sector in bailing out this hedge fund, which they did. This operation was recognized as an extremely important event in the history of finance. I personally encountered the managers of this fund during a meeting. Two of the senior managers were the economists Mr. Robert Merton and Mr. Myson Scholes, who had been awarded the 1997 Nobel Prize in economics. The words of such persons naturally carry a lot of weight. They had not only put forward the theory of "option" and won the Nobel Prize, but had developed some new financial techniques. They left their careers as economists and set up their hedge fund. Enjoying great confidence on the part of everyone, they managed their fund in a way calculated to ensure permanent high returns by increasing their exposure. LTCM had successfully created the impression that it could not collapse by reason of any of the five major categories of risk--exchange rate risk, interest rate risk, maturity risk, credit risk, or liquidity risk. And it did not. LCTM went out of business because of a quite different risk. This experience has profoundly influenced world financial circles and world financial literature, and made the investment strategies and accounting practices of hedge funds and the modalities of their control important objects of scrutiny. The fact that in Turkey we do not have any institutions like hedge funds may presently be counted among our strengths. But we will have to make arrangements to accommodate the probability of their eventual establishment.

The fourth and last point is the need for access to consolidated balance sheets reflecting all financial holdings. In fact, the financial statement of an institution performing many different kinds of functions and services must be analyzed as a whole. Once such a consolidated balance sheet has been prepared, the financial institution's figures, in particular its capital adequacy, can be meaningfully assessed, and the institution evaluated accordingly.

I will not describe these new approaches in the conduct of international financial business in detail. But I do believe that the SWOT analyses must focus on these four points first in order to provide a clear picture of the Turkish banking system. There are, of course, some loopholes and gaps in our system; but I am confident that we will manage to eliminate them in time and earn a prominent place in the international banking system.

Now let me refer to the implications for the Turkish banking system of the new Banking Act approved by Parliament in June. First, it must be understood that the new Banking Act has four general objectives, as follows: first, to close the legal loopholes just mentioned; second, to bring our supervisory regulations up to international standards; third, to assign the task of bank supervision to an independent agency; and fourth, to establish uniform procedures for the founding and operation of banks.

Although it was relatively long ago--in 1994--that the Constitutional Court annulled some important provisions of the Banking Act, creating gaps and loopholes, various political uncertainties have prevented us from obtaining remedial legislation until quite recently.

Indeed, the loopholes in the Banking Act have been one of the most pressing issues I have had to deal with during my three-and-a-half years as Governor of the Central Bank. For the first few years we pretended there were no loopholes, but the gaps made themselves felt when some banks got into financial difficulties last winter. At that point the amendments in the Banking Act became a high priority, and it was enacted into law soon after the general elections.

This was extremely important. As you will appreciate, the interval was indeed a difficult period to live through. We were forced to act according to provisions that had, in fact, been annulled by the Constitutional Court, but fortunately this is no longer the case.

What points received our closest attention when the Law was being drafted? You will recall that I have mentioned several new rules and innovations recently introduced into international banking, especially in the area of bank supervision.

To lead international progress in this area, a committee of central banks and banking supervisors from several countries was established, under the leadership of the Bank for International Settlement (BIS). Almost all of the proposals that emerged from this "Basle Committee" have been adopted by the banking systems of many countries, even though their acceptance is strictly voluntary. Of course, a country that rejects these internationally accepted rules will be considered to be a country with a backward banking system or inadequate supervision. For this reason, the 25 Core Principles for Effective Banking Supervision drawn up by the BIS in 1997 have been incorporated into the amendments to the Banking Act. In addition, the directives of the European Union have been included in the Banking Act.

We wanted our revision of the Banking Act to incorporate internationally accepted rules regarding the banking system and bank supervision. To help us do this we asked the International Monetary Fund to come and examine the provisions of the Banking Act one by one in consultation with our colleagues. In the end they concluded that Turkey is in compliance with the majority of international requirements, and recognized while some of the BIS's 25 core principles are not yet implemented, this can easily be done once the Independent Banking Supervision Agency become operational. Turkey's intention of adhering to the 25 BIS standards has been reported to the world. This is indeed an important step forward for the future of Turkish banking, because there are still many countries in the world that have not yet decided to apply the 25 core principles.

The third fundamental change under the new Banking Act will be to assign the task of banking supervision to an independent agency. I will not go into detail here, since I have often explained this step and its importance on similar occasions. Suffice it to say that an independent system of bank supervision has become one of the basic requirements of our era. In former times, central banks, ministries of finance, or treasuries were willing to take responsibility for bank supervision. But experience has shown that banks are best supervised by an independent supervisory agency. Here it should be noted that an extremely important point is how one defines "independent." It is a fact that no plausible definition for "independence in such supervisory mechanisms" has yet been given. For a central bank the definition of "independence" turns out to be quite simple. The concept of "central bank independence" involves both powers and accountability. What is accountability for a central bank? It must be transparent enough to ensure that all the steps taken in the pursuit of monetary policy are clear to the public. What are the powers of a central bank? A central bank must have the power to decide independently how to use its monetary policy tools, and how to act in order to achieve price stability. A central bank is rarely required to behave independently in setting its goals. But independence in the use of tools, the most important being short-term interest rates, has turned out to be the most important element for ensuring the independence of the central bank's conduct of monetary policies.

However, there is another important aspect of independence. Independence must be exercised with caution, taking care to ensure that the actions of the independent central banks are coordinated with other official institutions and ministries. If the central bank's actions conflict with those of other government agencies, its *"independence"* will quickly become *"isolation."* Coordination is extremely important if a central bank is to become really independent.

In exchange for its independence, a central bank must accept certain obligations, of which the most important are transparency, accountability, and objectivity. The obligation of transparency poses difficulties for an institution charged with banking supervision. The data and information which banks are obliged to disclose to bank examiners, on which the work of the supervisory agencies is based, are important and sensitive. They cannot be subjected to the rule of transparency. Unless strict and absolute confidentiality is observed, there can be no banking supervision. The elements of accountability, which is a second obligation imposed by independence, are defined in several different parts of the Banking Act.

The "independent banking supervision agency" envisaged by the new Banking Act is vested with extensive powers. It will supervise banks, obtain the clearest possible picture of their activities and condition, make comments, and seek prompt solutions if problems are found. If a bank is already in good condition, the bank supervision agency will see what can be done to improve it. In addition the agency will coordinate with other involved institutions in devising measures to make the banking system work more effectively.

Indeed, the most vital aspect of the bank supervisory agency's work is that it, like the central bank itself, must take care to cooperate with all related institutions and ministries. If it does not, the like the central bank will see its independence turn into isolation. Germany and England provide good examples of such cooperation. I personally think England may be the best model.

There, coordinated action is considered very important. The "Financial Services Authority" (FSA) acts alongside the Bank of England and the Treasury. The deputy governor of the Bank of England is a member of the FSA board, and the chairman of FSA is a member of the Bank of England's board. The English version of independence seems ideally designed and highly professional in its operation.

Let me pause to make a special point here. In Turkey, when we speak of independence, two things are generally misunderstood. First, it is mistakenly assumed that an "independent" institution can do whatever it wishes. This is perfectly wrong. Independence means no such thing. There are laws and rules governing the operation of all agencies; and as noted earlier, independence carries with it the obligations of transparency and accountability. A third requirement is objectivity. For this reason we may ask, "Is this supposedly independent institution subject to political influence? Does it behave politically or not?" At present, it seems to me that public opinion has some questions on this point. I believe that those who raise these questions will be reassured in time by our practice. If the rules are objectively designed, and if all these functions are carried out in cooperation with the concerned ministries, the Treasury and the Central Bank, then there cannot be any political influence. Should politicians demand something that is contrary to independence, such demands can be refused. All of us will see future developments and their repercussions. I am confident that independence will characterize the actions of the banking supervision agency. We will all be able to monitor the degree of its independence, and we intervene if there is any wrongdoing.

I would like to emphasize once more that there is a fine line between independence and loneliness. I know this very well from my own experiences as Governor of the Central Bank. The slightest differences must be regulated skillfully. Otherwise we risk finding ourselves isolated in spite of all our efforts to become independent.

Before concluding my remarks, I want to revisit a last point concerning the Banking Act. Several items were added to the Banking Act in order to close loopholes in the system. I started my career 32 years ago as an Assistant Sworn Bank Auditor. My job was related to the supervision of banks. Since then, there have been radical changes in the way banking supervision is conducted. Worldwide, banking supervision practices are generally centered on two methods: the management of risk, and compliance with banking rules. Turkey's supervisory system has always been based on compliance with banking rules. We have not been able to establish a system based on risk management.

In Turkey, supervisory reports on individual banks generally inform us about the quality of their observance of banking laws and regulations. But in fact the worldwide trend in the banking supervision is gradually placing more emphasis on risk management. I hope that our new institutions can develop a banking supervisory system that can measure the risks being taken, of course without neglecting compliance with the rules. A banking supervisory system based on risk management will determine and assess the risks taken by banks, which will provide a basis for judging the soundness of the banking system as a whole.

And now let me point out once more that three vital needs are revealed when the Turkish banking system is analyzed from the standpoint of Strengths, Weaknesses, Opportunities, and Threats. These three urgent needs are to achieve effective supervision, to adapt internationally accepted working rules to the Turkish banking sector, and to pursue sound macroeconomic policies, which is essential to the soundness of a country's banking system. These fundamental needs are important not just for Turkey's banking system, but also for its economy as a whole. I hope we will be able to succeed.

Thank you all for listening.