TURKISH BANKING SYSTEM

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First, I would like to thank ATC arranging this gathering in Ankara. I am very pleased to be here today, and I would like to talk about the Turkish Banking System.

Let me begin by recalling that banks are important and serious institutions. They depend on trust. They borrow money from the public and use it. They also perform the function of intermediation of funds. For many centuries they have been institutions that contributed to economic development.

There are a number of generally accepted, long-standing principles that apply to these institutions. The most important are:

- Providing effective supervision over these institutions.

- Maintaining an environment in which they can function efficiently.

- Making risk-taking measures adaptable and applicable.

- Helping to improve the culture of credit.

Most of these responsibilities are assigned to public authorities, although some of them are the responsibility of the banks.

During the last two decades, however, financial developments taking place all over the world have brought many changes in the practice of banking. Innovations in information technology, the liberalization process of financial markets, and a rapid increase in the sheer number of financial transactions have also affected banking. Competition in banking and other sectors increased. The number of kinds of risks has grown, and the varieties of non-financial institutions have multiplied.

All these changes together call for a sounder banking system. They remind us of the fact that sound banking is a continuous process. The importance of risk management in various kinds of situations is well understood. In today's environment, our understanding that a sound and efficiently functioning banking system is a fundamental necessity is once again reinforced.

So what have we in Turkey done to meet these exigencies? The Turkish Banking System is not a recently established one. Turkey has a deep-rooted banking tradition that goes back to the 19th century. During the last two or three decades, the banking sector has played a prominent role in the Turkish financial system, and has made considerable progress, aided to some extent by structural changes, towards making the Turkish economy more financially liberalized. In response to the restructuring of the Turkish economy and to the need to integrate Turkey into the modern world of finance, Turkish banks have made major changes both in their institutional structures, and in the quality of services and products they offer. As a result of the greater freedom of that comes with market-oriented policies and a liberalized financial environment, many entrepreneurs, foreign as well as domestic, have been attracted by the potentially profitable Turkish Banking system.

During the last two decades, the number of banks active in the banking sector grew from 43 to 74. During the same period, the number of foreign banks with subsidiaries or branches in Turkey increased from four to 20. As of November 1998, 60 banks out of 74 are universally commercial banks and the remaining 14 are development and investment banks. Thirty-six of these banks are commercial banks whose majority shares are privately owned; 20 are foreign banks established in Turkey or having branch offices in Turkey; and 14, as noted above, are development and investment banks. As of November 1998, Turkish banks now operate though their 7,062 local branches. More than 165,000 persons are employed in the banking sector. In addition, the Turkish Banking System is aggressively modern, adopting every banking innovation rapidly.

Turkish Banks, operating in parallel with the process of internationalization and globalization, have gone one step further by starting to invest in foreign financial establishments as well. Turkish banks are now able to form joint ventures with foreign banks to open financial subsidiaries and branches abroad. As of November 1998, Turkish banks had 63 financial subsidiaries in 19 different countries, and 26 branches in 10 different countries.

As of November 1998, the size of the consolidated balance sheet of the banking sector was $114 billion. According to our peer group classification by ownership, public and private banks both have significant shares in the sector. As of November 1998, state-owned commercial banks account for 35 percent of the banks in consolidated balance of the sector, worth $40 billion, and private banks account for 54 percent of the balance sheet totaling $62 billion. Mean-while, the share of foreign banks with assets of $7 billion has held steady at around 6 percent.

Despite the recent privatization of two state-owned commercial banks, this class of banks has retained its prominent role in the banking sector. But the influence of Turkey's state-owned banks in the banking sector is less significant compared to the influence of state-owned banks in some EU and OECD countries.

As of November 1998, five major banks, including two of the four state-owned commercial banks, held 44 percent of the total assets of the banking sector. These five banks hold 51 percent of total deposits and accounted for 42 percent of total credit extended in the sector. Total equities of these five banks comprised 48 percent of total equity of the sector. If we say that these banks also own almost half of the total branch network of the sector, we could understand this concentration. However, the total share of the five major banks representing the concentration in the Turkish banking system is smaller than the share representing the concentration in most OECD countries. Again according to 1995 figures, concentration in

Sweden banking system is 86 percent, in Holland 81 percent, in Finland 74 percent, in Belgium 59 percent, in England 57 percent, and in Spain 49 percent. In Turkey the figure is 52 percent, and is slowly but steadily declining.

If we look at the concentration issue from another standpoint, using the data for November 1998, and taking into account the total assets of the sector, 65 percent of the Turkish banking system belongs to the top 10 major banks. If we include the 20 foreign banks and branches having a share of 6 percent, and the 14 development and investment banks having a share of 5 percent, it can be seen that 76 percent of the banking system is consistent with 10 big banks, foreign and investment banks. The remaining 24 percent of the sector belongs to 30 banks. Among these banks, there are banks that are leaders in the sector, functioning properly and effectively. However, some limited number of banks have practical problems which are well known to us. We know all their problems. We monitor them. The existing banking laws and other elements of the legal framework do not give us full authority to address them actively and efficiently. The problem of the state owned banks is occasioned by the state budget, and its solution involves different issues.

Now let me talk about risk management in the Turkish Banking Sector. From the standpoint of risk management, we do have well-developed methods of risk management and for supervising the risks that we undertake.

As I pointed out in my brief remarks on the financial standing of the banking sector, Turkish banks have reached a level of financial and institutional development that should not be underestimated. But despite all the aforementioned positive aspects, there are also various threats to the well being of the Turkish banking sector which I believe are worth mentioning. Turkish banks, like all the other banks in the world, are exposed to credit risk, liquidity risk, interest rate risk, and foreign exchange risk. This is true even in the absence of an environment of global crisis and macroeconomic risks stemming from political uncertainties. These are other issues that merit separate consideration.

I will turn now to financial risks. The most important of these is credit risk, to which Turkish banks pay the most attention to managing. The Turkish Banking Sector has become used to accepting and managing credit risk over the years. A credit culture has been developed in which firms, sectors, regions, and individuals participate. Increased competition in the sector clearly has implications for the risk-taking process, which requires that the banks restudy their credit strategy.

An overall examination of credit risk showed that the banking sector has been able to manage its credit risks by keeping the level of non-performing loans low in spite of an environment of shrinking international financing.

As to liquidity risk, the fact that depositors prefer shorter terms, while investors driven by expectations of high inflation and uncertainty, prefer longer terms, has caused a mismatching of the maturity structures of the assets and liabilities of the banking sector. As a result, banks become more vulnerable to liquidity risk. Financial distress and global financial crisis were the main ingredients of the conjuncture of 1998. Following scattered failures in the emerging financial environment, almost all emerging economies began to be treated as risky, due to growing uncertainty about the near-term outlook for the financial markets. In this situation, international investors became more cautious about investing in the emerging markets and became reluctant to provide them with credit. Turkish banks slowed their disbursements of credit, and preferring to be liquid in the market place. We also checked using different ratios for the liquidity in the system.

Interest Rate Risk is another important for of systemic risk. Since the maturity structure of interest-sensitive liabilities in the Turkish banking system tends to favor the relatively shorter maturity segments, external funds are repriced at shorter intervals than assets. This mismatch in the pricing structure at various periods increases the sensitivity of asset and liabilities to changes in interest rates. Banks manage the degree of interest rate risk to which they are exposed during times of rising interest rates by converting their low interest bearing securities into high interest bearing securities by means of repurchase transactions. Interest rate swaps and some other derivative instruments are also used to hedge interest rate risk.

As to foreign exchange risk, the difference between the Turkish lira interest rate and the nominal depreciation of the Turkish lira is the major reason why the banks place foreign currency funds in Turkish lira funds or other alternative investment opportunities. In Turkey's case, the practice of taking short positions for foreign exchange started in 1985. After facing several difficulties and losses, the Turkish Banking System has become very well informed about foreign exchange risk. Furthermore, we, the Turkish authorities, have reduce the risk by means of a number of regulations.

I can say that all these kinds of risk have been thoroughly monitored by the supervisory authorities, and preventive measures have been put in place before the effects of any problems could damage financial stability. All banks operating in Turkey are subject to the Banking Law, and to Decrees and Communiqués concerning the law. This Law authorizes the Treasury and Central Bank to supervise and regulate banks. Under this regulatory framework, banks must submit yearly, quarterly, and even daily compilations of financial data to the Central Bank and the Treasury. In addition to frequent financial evaluations of banks by off-site examiners, on-site examinations are carried out to confirm the reliability and accuracy of the reported data, and clarify any special issues arising during off-site examinations. The increased volume of foreign exchange transactions, there process of internationalization, and market-determined prices, have all increased the market risk that the banks are exposed to, and this, in turn, has increased the need to introduce risk measures aimed at protecting banks' capital. For this purpose, regulatory studies are jointly conducted by the Central Bank and the Treasury, and commonly accepted risk measures such as limits on net open foreign exchange positions, and capital adequacy ratios, have been introduced in addition to credit limits and other measures consistent with EU standards. Another practice followed to make supervision more effective and obtain and better evaluations of banks' real financial standing is consolidated supervision.

Authorized independent bank auditors play an important role in the bank supervision process. Each bank in the sector must obtain an independent audit report every year. These reports are prepared by authorized independent auditing firms operating in accordance with the commonly accepted international accounting and auditing principles.

Another important feature of the Turkish banking system, and not a new one, is its deposit insurance scheme. It was first introduced in 1933 and redesigned in 1983 with the establishment of the Savings Deposit Insurance Fund. This Fund's main source of income is a premium paid by banks, equal to a certain percentage of their savings deposits. In 1994 a new Decree came into effect and all banks deposits, whether denominated in Turkish lira or foreign currencies, were fully insured by the Fund. This step was necessary at this time, to stop the turmoil in Turkey's financial markets and calm depositors' nerves.

Now, as we all know, the 100 percent coverage may subject both bankers and depositors to moral hazard in the form of willingness to take greater risks to earn higher returns. Depositors may encounter moral hazard when they ignore greater risks associated with their choice of a depository institution which offers them higher rates for their deposits. But even though all the drawbacks of the present system of deposit protection are well known, current conditions in the world financial environment and their effects on the Turkish financial system have prevented us from making the necessary changes in the existing deposit insurance scheme just now. Once we manage to stabilize the macroeconomic environment, we will be able to reduce the 100 percent coverage to internationally acceptable levels.

How a powerful and effective supervision could be implemented for the Turkish banking system was foreseen many years ago. The system in effect during the 1930s had revealed its inadequacies, but the first step was not taken until 1959 with the establishment of the Board of Sworn Bank Auditors. The system was first applied to the Turkish economy under the direction of the Ministry of Finance. The Board recruited many valuable personnel, trained them, and gained the power to supervise the system.

But as I mentioned earlier in connection with the need for additional principles to preserve the soundness of the system, the rapid changes of recent years, their consequences, and events occurring in the international environment, have underlined the importance of effective supervision.

In 1997, the Bank for International Settlement (BIS) enumerated the 25 core principals to be used for banking supervision. The need for such principals was well understood after the financial crises in Asia and Russia.

I may say that, during these events, which have been going on for several years, the majority of the Turkish banking system has taken great advantages to adopt these changes. These banks have succeeded in keeping pace with the era, especially with respect to technological innovations, strategies for risk taking, and management techniques.

Besides these advances, there were some factors that damaged the system. These are:

1) High inflation;

2) High Public Sector Borrowing Requirements;

3) The lack of an efficient legal framework.

In addition, the style of banks' operations and strategies are somewhat different in a high inflation, as opposed to a normal, environment. On the one hand, banks try to sidestep the harmful effects of inflation. On the other hand, they revise their methods of overcoming uncertainty and taking risks. And more important, as the public persists in continuing to borrow, which leads eventually to crowding out, the banks turn to the public sector as a simple method of investment. This causes them to turn away from their basic function of intermediation, so essential for the efficient allocation of resources. A system that finances the public sector loses its power. On the other hand, in an environment like that just described and an economy where capital movements have been liberalized, the soundness of banks is especially important.

How, then, can banking system soundness be attained? There are four means to this end:

1) A more efficient and independent supervision system.

2) Embracing internationally accepted auditing principles.

3) Improving methods for reducing the financial risks taken by the banks.

4) The most important is reducing the internal and external imbalances and preserving market stability by creating a sound macroeconomic environment.

Thus, the most important task for the system belongs to the public. The public authorities have an obligation to prepare the necessary legal regulations immediately and pass them through Parliament. Regulations that are inadequate or not updated only cause problems to accumulate.

For these reasons the new banking law has been prepared and submitted to Parliament. The aims of the Draft Law are basically to strengthen supervision and make it more efficient, and to make sure supervision standards remain in line with international standards. The Draft Law was prepared on the basis of the laws and regulations of the European Union and other accepted international practices, and the □25 Core Principles in Banking Supervision□ promulgated by the Bank for International Settlements. I hope that after the forthcoming election, new government will be able to pass this law from the parliament.

Now I must state clearly that I do not believe there are serious problems in the Turkish Banking System. There are not many that interfere with the system. We, the public authorities, evaluate the real financial standing of banks. We know the reality well. If we find a problem in the system, we can take the necessary actions within the framework of the law. We have the necessary tools to do this.

The Turkish banking sector has existed for 130 years and knows how to manage risks. It has credibility in the international arena. It is sounder than many of the world's national banking sectors. It is dynamic. Its human resources are well trained. Supervision and auditing requires several years of experience. A correct judgment of the system cannot be obtained by focusing on a couple of difficulties in isolation. These facts should not be overlooked.

I thank you for your attention.