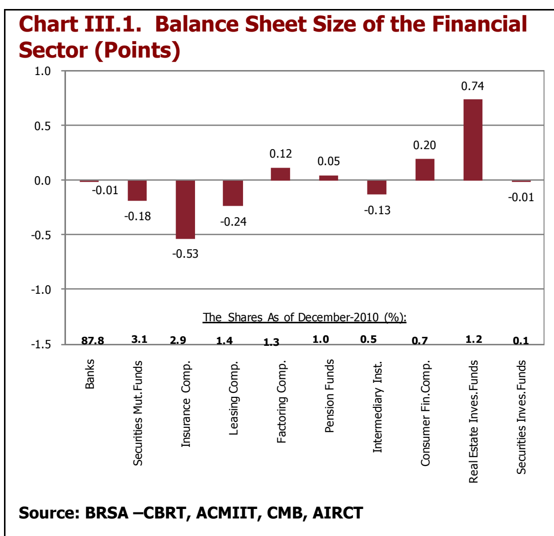
III. RISKS AND DEVELOPMENTS IN THE BANKING SECTOR

Trend of recovery in the economy, reduced risk perception and intense competition in the banking sector have increased credit supply. Increased confidence regarding the economic outlook, improvement in employment conditions and the low level of credit interest rates have boosted the increase in credit demand. The rise in credit volume and current account deficit, along with acceleration of short-term capital inflows has brought into the agenda the risks regarding financial stability. With the new policy mix implemented by the CBRT, it is aimed to bring credit growth to reasonable levels for financial stability and to extend maturities of portfolio investments. The ratio of non-performing loans dropped on the back of increased debt service capacity of corporate sector and households, and the sector's asset quality improved. Although profitability performance of the banking sector trended down due to the decrease in the net interest margin and the capital adequacy ratio declined slightly due to the increase in loans, the banking sector maintains its strong capital and profitability structure.

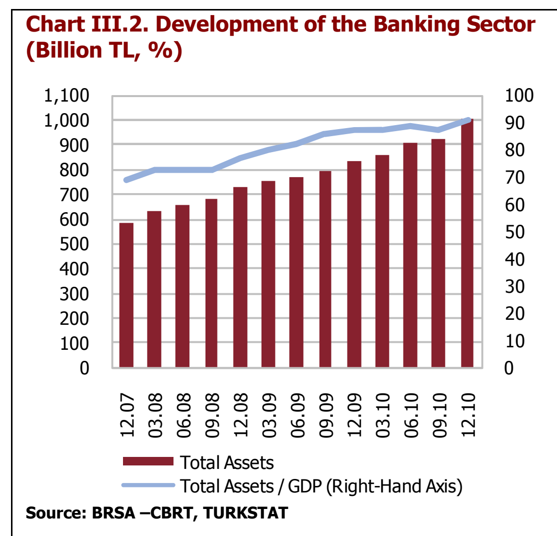
The Turkish financial sector, mostly composed of banking sector, maintains a sound growth path. The balance sheet of the Turkish financial sector that continued to grow in 2010 as well, increased by 25.8 percent compared to 2009 and reached TL 1,146 billion, whereas its ratio to GDP became 103.7 percent. While the share of banks, which accounts for 87.8 percent of sector assets, remained unchanged compared to the same period of the previous year, the shares of real estate investment trusts, consumer financing firms and factoring companies increased, and those of insurance and financial leasing companies and mutual funds decreased (Chart III.1). The total asset size of the banking sector, which weighs the most in the financial sector, rose by 20.7 percent in nominal terms and by 12.3 percent in real terms, to reach TL 1,007 billion in December 2010 compared to end-2009. Thus, the ratio of the banking sector's balance sheet size to GDP rose from 87.6 percent at 2009 to 91 percent at end-2010 (Chart III.2)

Chart III.1. Balance Sheet Size of the Financial Sector (Points)



Source: BRSA –CBRT, ACMIIT, CMB, AIRCT

Chart III.2. Development of the Banking Sector (Billion TL, %)

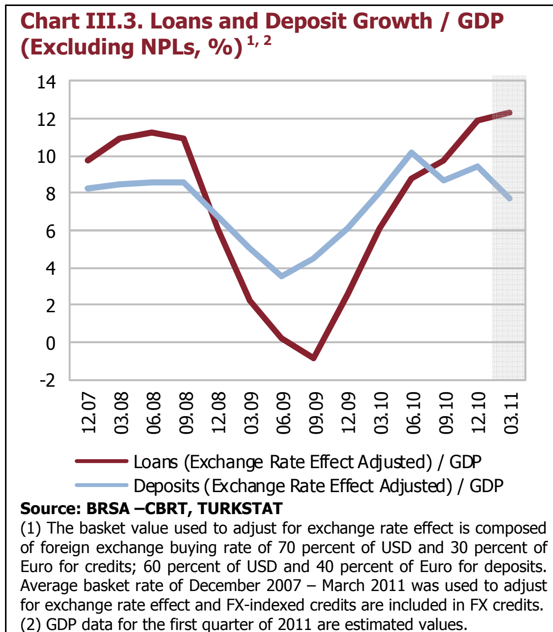


Source: BRSA –CBRT, TURKSTAT

Although the credit growth rate lost pace in the first quarter of 2011, it did not decline below reasonable levels for financial stability. The ratio of credit growth to GDP surpassed the pre-crisis level and became 12.4 percent; however, the ratio of deposit growth to GDP

has declined since the second half of 2010 (Chart III.3). Despite the strong domestic demand on the back of credit growth and capital inflows, global growth couldn't gain impetus; as a result, the divergence between domestic and foreign demand became more apparent, and the widened current account deficit created concerns over financial stability (Chart III.4). In order to ease macro-financial risks, reduce short-term capital inflows and to slow down the credit growth rate, a new policy mix has started to be implemented since November 2010 by using concurrently various policy tools, which are mutually complementary. Factors such as external demand, capital flows and credit expansion might affect the composition of the policy mix in the upcoming period.

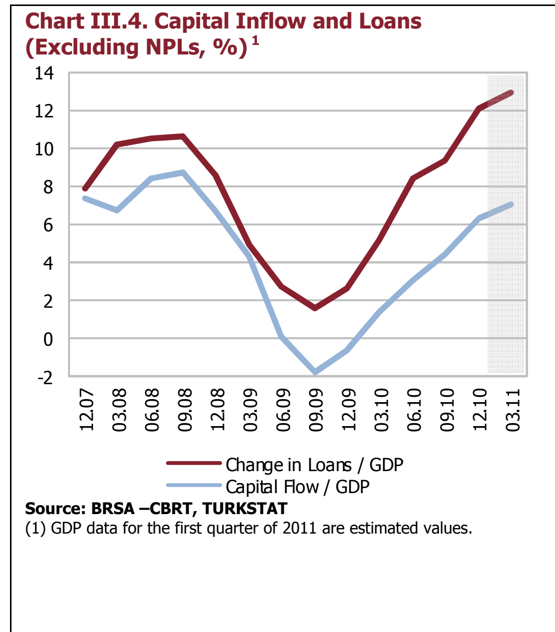
Chart III.3. Loans and Deposit Growth / GDP (Excluding NPLs, %) [1, 2]



Source: BRSA –CBRT, TURKSTAT

(1) The basket value used to adjust for exchange rate effect is composed of foreign exchange buying rate of 70 percent of USD and 30 percent of Euro for credits; 60 percent of USD and 40 percent of Euro for deposits. Average basket rate of December 2007 – March 2011 was used to adjust for exchange rate effect and FX-indexed credits are included in FX credits.
(2) GDP data for the first quarter of 2011 are estimated values.

Chart III.4. Capital Inflow and Loans (Excluding NPLs, %) [1]

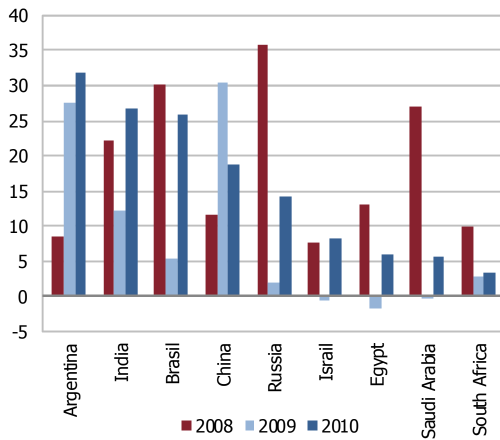


Source: BRSA –CBRT, TURKSTAT

(1) GDP data for the first quarter of 2011 are estimated values.

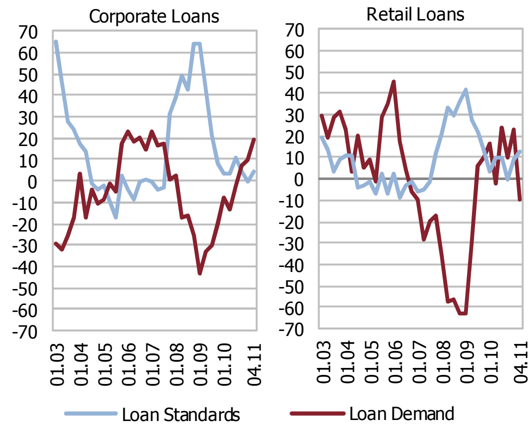
Emerging economies, which also include Turkey, recovered faster than advanced economies. This situation strengthened capital flows to these countries and increased the demand for domestic loans. High growth rates of emerging economies attracted more capital flows to these countries and the credit growth rate recovered on the back of strong domestic demand (Chart III.5). Meanwhile, while risks regarding advanced economies remain important, it is expected that the problems experienced by these countries in management of public debt and their financial systems will persist in the upcoming period and external demand is likely to remain weak. In fact, credit growth rates in the USA, the Euro area and Japan have not yet reached their pre-crisis levels (Chart I.12). In this context, the Euro Area Bank Lending Survey suggests that despite strengthening demand for corporate loans, retail loans remain weak (Chart III.6).

Chart III.5. Credit Developments (%)



Source: IMF, IFS

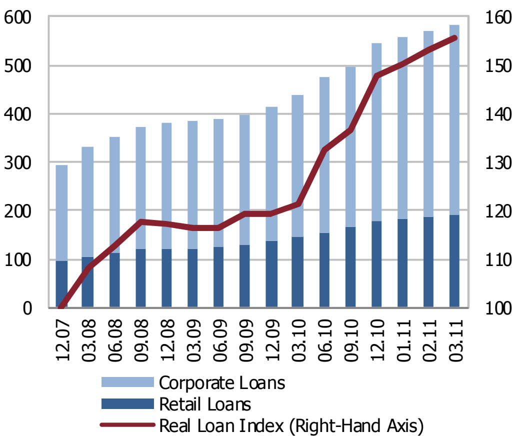
Chart III.6. Credit Standards and Credit Demand in the Euro Area (%)[1,2]



Source: ECB, Euro Area Bank Lending Survey, April 2011
(1) Negative value in credit standards indicates an easing in standards, whereas positive value indicates an increase in credit demand.
(2) Demand for retail loans is related to housing loans.

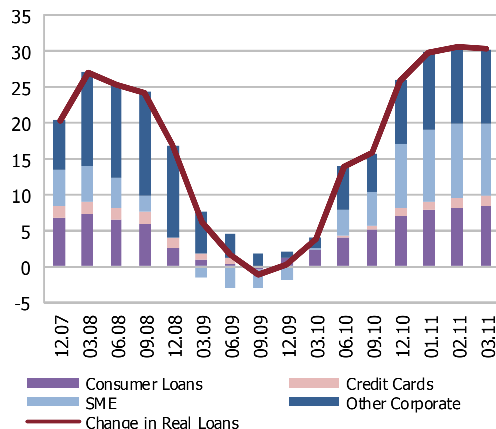
Credit growth rate is expected to slow down in Turkey, especially in the second half of 2011 on the back of measures taken. The credit growth rate, which had accelerated in the last quarter of 2010, started to lose pace, albeit to a moderate extent, in the first quarter of 2011 owing to the effects of policy decisions (Chart III.7). The share of credits in total assets increased to 53.9 percent and the annual real growth rate reached 30.2 percent in March 2011. Small and Medium Size Enterprises (SME) loans, in addition to other corporate and consumer loans were influential in the credit growth during the exit from the crisis. Indeed, the annual real growth rate of credits standing at 30.2 percent is composed of 8.5 points from consumer loans, 9.8 points from SME loans and 10.5 points from other corporate loans. The contribution of credit cards to growth was limited at 1.4 points in this period (Chart III.8).

Chart III.7. Credit Developments (Billion TL, %)[1, 2]



Source: BRSA –CBRT
(1) Real Credit Index 2007-IV=100. In calculating the index, total credits are expressed in real terms using CPI (2003=100).
(2) Including gross NPLs.

Chart III.8. Real Increase in Credits by Type and Their Contribution to Growth (% Contribution, Excluding NPLs)[1]

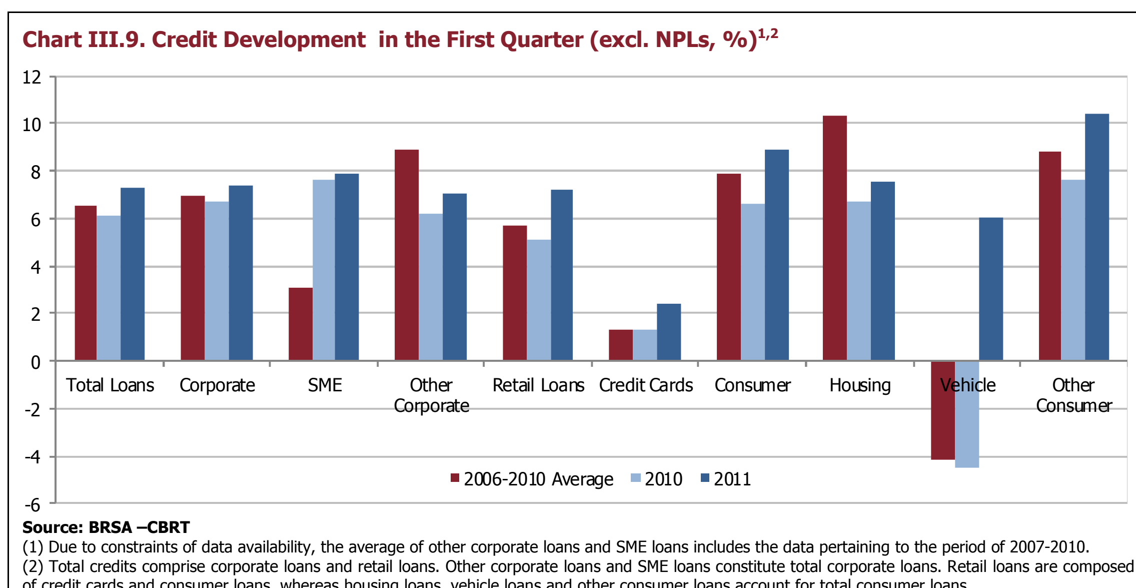


Source: BRSA –CBRT
(1) Expressed in real terms by using CPI (2003=100).

In addition to SME loans that continued to recover in the post-crisis period, the increase of consumer loans, including primarily other consumer and housing loans also accelerated in the first quarter of 2011. While total credits displayed an increase by 7.3 percent, consumer credits were up by 8.9 percent and other consumer loans were up by 10.4 percent in the

first quarter of 2011 compared to end-2010. In the period of 2006-2010, quarterly growth rate of retail loans remained below that of total credits compared to the end of the year, whereas accelerated in 2011 and approached the growth rate of corporate loans. Other consumer and housing loans surged on the back of historically low level of credit interest rates; individuals were able to meet their lagging consumption needs, and they advanced the timing of future demands; banks offered competitive credit products - all of which were instrumental in the above-mentioned development. Vehicle loans that had been on the decline since 2006 accelerated in the last quarter of 2010 and this increase continued in the first quarter of 2011, albeit to a limited extent and supported the surge in retail loans (Chart III.9).

Chart III.9. Credit Development in the First Quarter (excl. NPLs, %)[1,2]



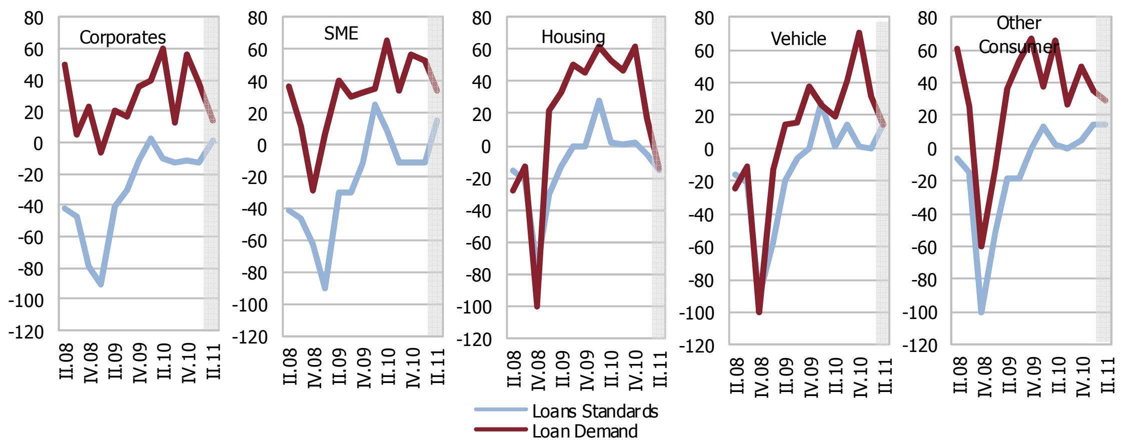
Source: BRSA –CBRT

(1) Due to constraints of data availability, the average of other corporate loans and SME loans includes the data pertaining to the period of 2007-2010.

(2) Total credits comprise corporate loans and retail loans. Other corporate loans and SME loans constitute total corporate loans. Retail loans are composed of credit cards and consumer loans, whereas housing loans, vehicle loans and other consumer loans account for total consumer loans.

In the Turkish credit market, where inter-bank competition is intense, financing needs of firms due to their need of operational capital and stock enhancements, as well as financing needs of individuals due to purchases of durable consumption goods boosted the increase in credit demand. According to the Banks' Loans Tendency Survey, the credit conditions that had been tightened significantly during the crisis period were eased in the first quarter of 2011 due to intensification of competition among banks, except for housing and general corporate loans (Chart III.10). Despite the positive impact of increased competition in the first quarter of 2011, standards applied to corporate loans were tightened on the back of primarily the constraints on capital adequacy as well as increased risk aversion, funding costs and balance sheet constraints. In the coming quarter, it is expected that increased credit demand by corporate on the back of their financing need arising from stock enhancements and operational capital needs will continue, albeit with less pace, While demand for other consumer loans increased on the back of expenditures of durable consumption goods and improved consumer confidence in the first quarter of 2011, competitive pressure became influential in easing the conditions for such loans. In the same period, conditions for housing loans were subjected to tightening on account of the restriction imposed on the loan to value ratio with regard to housing loans and increased profit margin on average loans.

Chart III.10. Bank Loans' Tendency Survey[1,2]



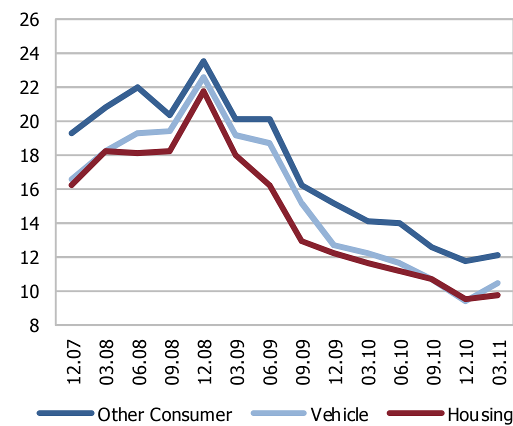
Source: CBRT

(1) Data for the second quarter of 2011 are expectations for the next three months.

(2) Negative value for credit standards indicates tightening of standards whereas positive value for credit demand indicates an increase in the credit demand.

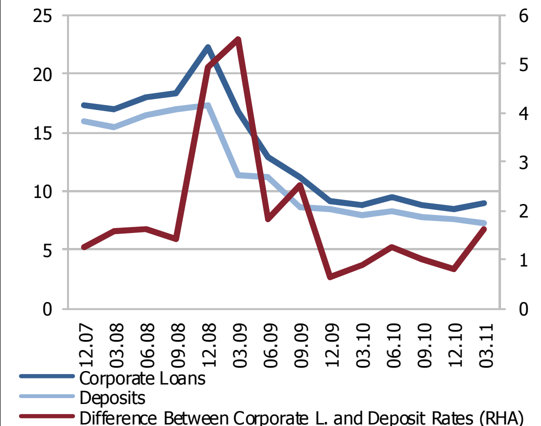
Effects of the measures taken by the CBRT are expected to reflect on credit interest rates with a lag. Credit interest rates have slightly increased since end-2010 and the tightening effects of the policy mix on credit interest rates are expected become more apparent in the upcoming period. In March 2011, the interest rate for vehicle loans was 10.5 percent in annual terms, whereas interest rates for housing loans, other consumer loans and corporate loans became 9.7 percent, 12 percent and 8.9 percent, respectively (Chart III.11). Banks decreased their deposit rates in the first place due to the cost pressure driven by the increase of required reserves within the scope of the policy mix implemented and they increased their interest rates on loans. As a result, the spread between the interest rates of corporate loans and deposits started to rise again in March 2011 (Chart III.12).

Chart III.11. Interest Rates on Consumer Loans (%, Flow)



Source: CBRT

Chart III.12. Interest Rates on Deposits and Corporate Loans (%, Flow)[1]



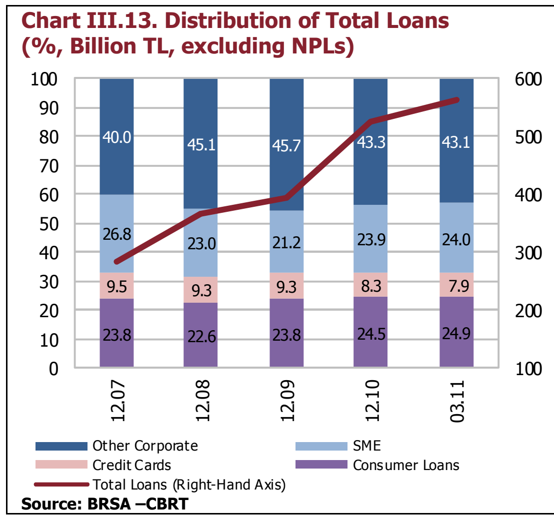
Source: CBRT

While the share of SME loans in the loan portfolio is increasing, that of corporate loans and credit cards are decreasing. Composition of the credit portfolio indicates that the share of consumer loans and SME loans in overall credits are 48.9 percent, showing an increase of 3.9 points compared to end-2009 (Chart III.13). Despite a decline in the share of credit cards in the said period, the increase in the share of other consumer loans is noteworthy. This development is considered to be mainly attributable to the fact that individuals started to meet their cash needs by

using other consumer loans instead of credit card cash advance, which incurs a higher interest rate (Chart II.33).

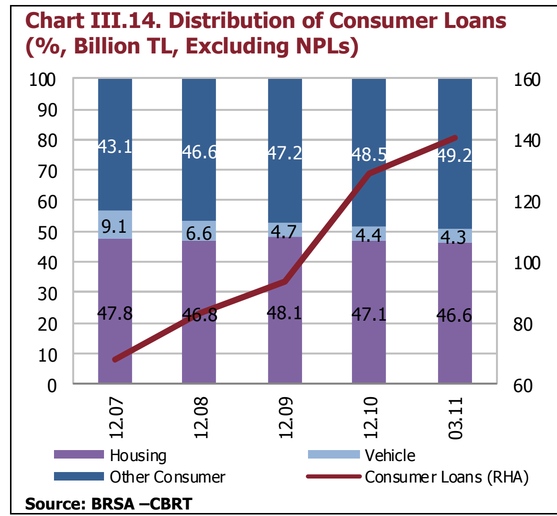
In addition to the measures taken by the CBRT regarding credit growth, the BRSA introduced restrictions on the loan-to-value ratio with regard to housing loans in order to hedge against increased credit risks of the banking sector and to reduce risks related to financial stability. The BRSA decision, published in the Official Gazette No. 27789 dated December 18, 2010, stipulates that in credits to be extended by banks to customers for housing and in consumer credits to be extended under housing collaterals, the amount of the credit will be limited to 75 percent of the value of the real estate subject to collateral and in corporate loans to be extended for commercial real estate purchase, the amount of the credit would be limited to 50 percent of the value of the real estate subject to collateral as of January 1, 2011.

Chart III.13. Distribution of Total Loans (%, Billion TL, excluding NPLs)



Source: BRSA –CBRT

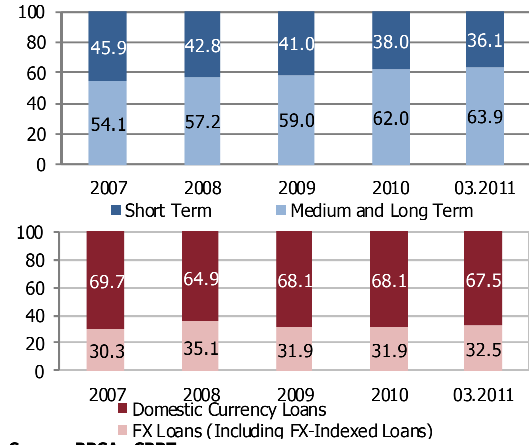
Chart III.14. Distribution of Consumer Loans (%, Billion TL, Excluding NPLs)



Source: BRSA –CBRT

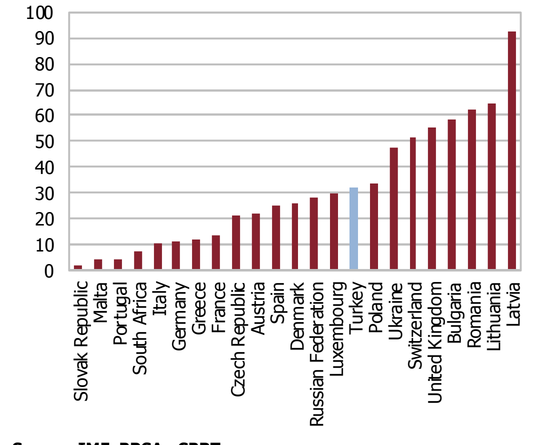
Maturity of credits that are mostly extended in TL becomes longer. Extension of maturities of credits in addition to the extension of maturity of deposits is considered a favorable development for the corporate sector and households. The share of medium and long-term credits increased by 4.9 points in March 2011 compared to end-2009 and became 63.9 percent (Chart III.15). The increase in the share of medium and long-term FX-denominated loans and the decline in the share of short-term TL-denominated loans were instrumental in this development. As of March 2011, the share of FX-denominated loans in total loans increased by 0.6 points compared to end-2010 and reached 32.5 percent on the back of depreciation of TL (Chart III.15). Compared to other countries, the share of FX-denominated loans in the Turkish banking system is close to the EU average (Chart III.16). Extension of the maturity of loans and increased share of TL-denominated loans are favorable developments in terms of financial stability.

Chart III.15. Currency and Maturity Composition of Loans (%)[1,2]



Source: BRSA –CBRT
(1) Short-term means term less than 1 year.
(2) FX-indexed loans are included in FX loans.

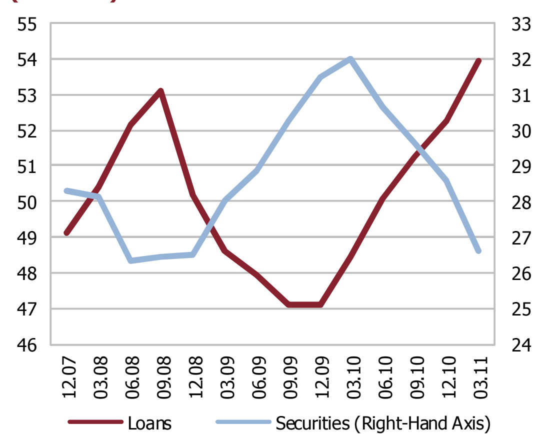
Chart III.16. FX Loans (% Total Loans)[1]



Source: IMF, BRSA –CBRT
(1) Up-to-date data, pertaining to end-2010 in general, included in the FSI database are used.

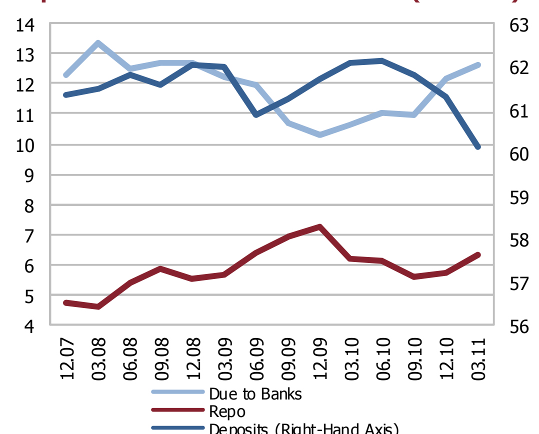
Parallel to the credit growth, the loan to deposits ratio increased whereas the share of banks' short-term sources of finance in total assets increased and that of securities decreased. As of March 2011, the share of loans in the total assets increased by 1.7 points compared to end-2010 figures and reached 53.9 percent; the share of securities, the weight of which had increased during the crisis was down by 2 points to 26.6 percent (Chart III.17). On the liabilities side, the share of deposits, which are the main source of finance for banks, declined to 60.1 percent. In addition to deposits, the main source of finance, the banks financed their needs increasingly through funds provided from increasing repo transactions, external borrowings, issuance of securities and the decline in the securities portfolio (Chart III.18). As the acceleration in credit volume was above the increase of deposits, the loan to deposits ratio increased to 92.7 percent in this period (Chart III.19).

Chart III.17. Loans and Securities (% Asset)[1]



Source: BRSA –CBRT
(1) NPL is excluded.

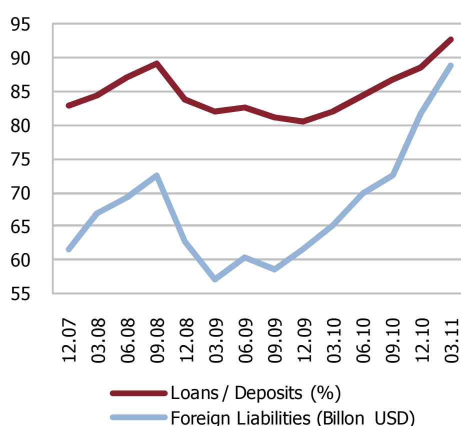
Chart III.18. Funds Obtained from Deposits, Repo Transactions and Due to Banks (% Asset)



Source: BRSA –CBRT

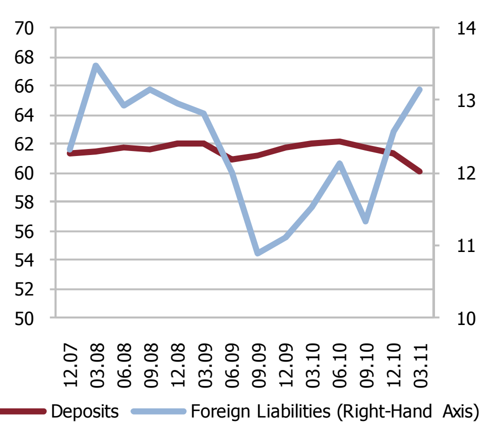
The foreign liabilities of banks are still on the increase. Parallel to the fading effects of the crisis, recovery in the external borrowing market has been underway since end-2009. As of March 2011, total foreign liabilities of the banking sector rose by 8.6 percent to USD 89 billion compared to end-2010 and 13.2 percent of total assets were funded by foreign liabilities (Chart III.19 and Chart III.20).

Chart III.19. Loan / Deposit and Foreign Liabilities (%, Billion USD) [1]



Source: BRSA –CBRT
(1) Excluding NPL

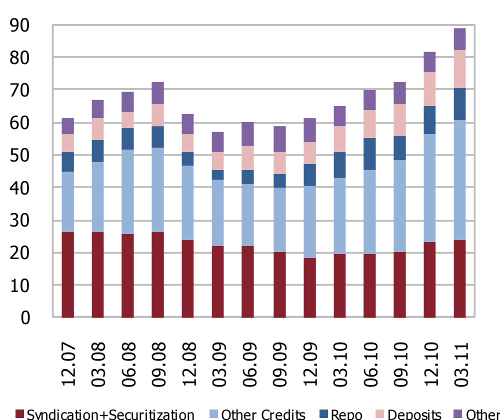
Chart III.20. Deposit and Foreign Liabilities (% Liabilities)



Source: BRSA –CBRT

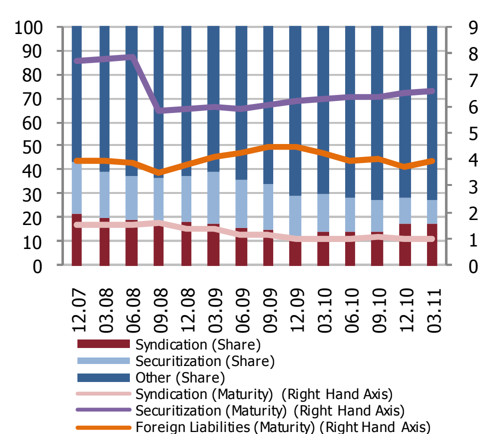
The increase in foreign liabilities of banks has contributed to the maturity extension of liabilities. At end-2010, the total amount of syndication and securitization credits of banks went up by 29.5 percent to USD 23.4 billion on an annual basis and became USD 24.1 billion in March 2011 (Chart III.21). The share of syndication and securitization credits within foreign liabilities; total funding sources and total liabilities is 27.1 percent; 4.1 percent and 3.6 percent, respectively. The weighted average maturity of foreign liabilities became 3.9 years in March 2011 due to the rise in the share of syndication credits. In the same period, the average maturity of syndication credits that represent 17.2 percent of foreign liabilities was 1 year; while that of securitization credits comprising 9.9 percent of foreign liabilities was 6.5 years (Chart III.22). In addition to this, deposit banks, which were allowed to issue foreign bills and bonds only, were permitted to issue domestic bills and bonds in TL by the BRSA. Since the granting of this permission, deposit banks have issued domestic bonds totaling around TL 6.8 billion in nominal terms; and foreign bonds of about TL 5.1 billion in terms of USD[5]. Moreover, banks operating with on-balance sheet short position have been converting their FX resources into TL by swap operations and generating resources for loans. The net TL borrowing swap volume of banks became TL 25 billion in March 2011.

Chart III.21. Composition of Foreign Liabilities (Billion USD)



Source: BRSA –CBRT

Chart III.22. Distribution of Foreign liabilities and Average Maturities (%, Year)

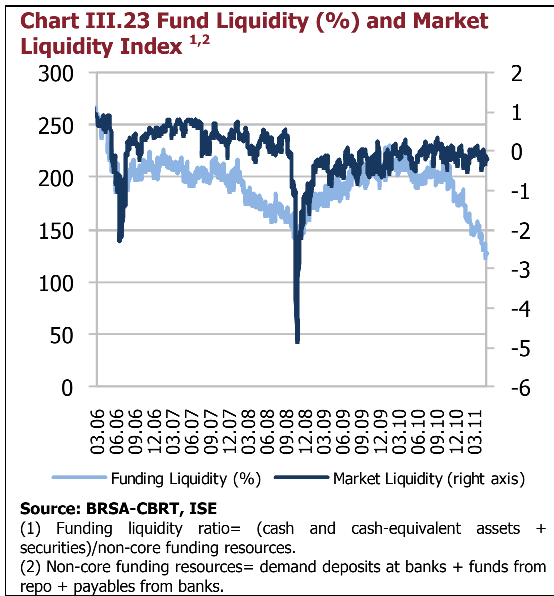


Source: BRSA –CBRT

[5] Please refer to: Special Topic V.7. Bond and Bill Issues of the Banking Sector.

During the crisis, the interaction between market and funding liquidity became more pronounced. The market liquidity index confirms that confidence in the markets continues to exist. The funding liquidity ratio has started to have a decreasing trend as of the last quarter of 2010 (Chart III. 23). This decline was attributable to the decline in securities and the increase in non-core funding resources, and in this scope especially the increasing trend in payables to foreign banks, which are currently at low levels (Chart III.24). The rise in capital flows towards developing countries and the external funding opportunities of banks under eligible conditions are significant factors in this development. Despite the rise in non-core resources, the sensitivity of the banking sector against the wholesale funding is limited as deposits are significant resources in funding and constitute around 60 percent of total liabilities. Nevertheless, non-core funding resources of banks equal about 19 percent of the total balance sheet size. Adding the issues of securities to this, the share totals 20 percent.

Chart III.23 Fund Liquidity (%) and Market Liquidity Index [1,2]

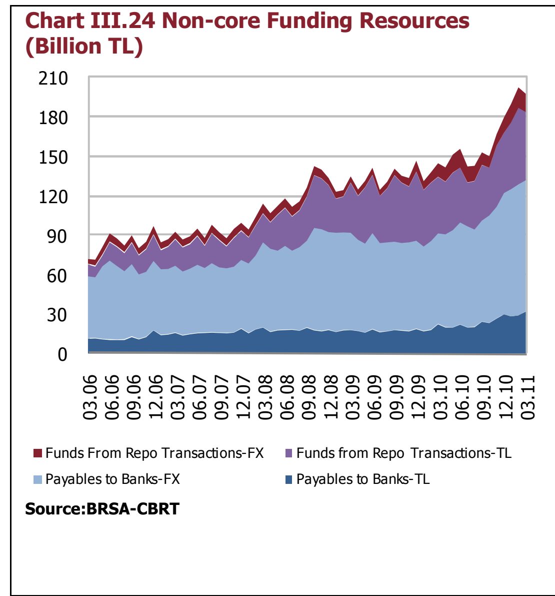


Source: BRSA-CBRT, ISE

(1) Funding liquidity ratio= (cash and cash-equivalent assets + securities)/non-core funding resources.

(2) Non-core funding resources= demand deposits at banks + funds from repo + payables from banks.

Chart III.24 Non-core Funding Resources (Billion TL)



Source:BRSA-CBRT

In line with the recovery in the Turkish economy, the credit supply increased and the tendency to remain liquid went down. Besides, liquidity ratios have trended downwards since the start of 2010. Banks met their liquidity requirements, which rose due to their required reserve liabilities by borrowing from the Central Bank via repo auctions; and cut down on their government securities portfolios to support credit growth as of the second quarter of 2010.

By March 2011, the ratio of liquid assets to total assets went down by 2.1 points to 26.8 percent compared to the figures of 2010. The decline in free government securities as opposed to the increase in cash and cash-equivalent assets was influential in this (Chart III.25).

While the ratio of liquid assets to total assets decreased, the total liquidity adequacy ratios of the banking sector, computed in accordance with the Regulation on the Measurement and Assessment of Liquidity Adequacy of Banks still remain above 100 percent, which is the legal ratio. (Chart III.26).

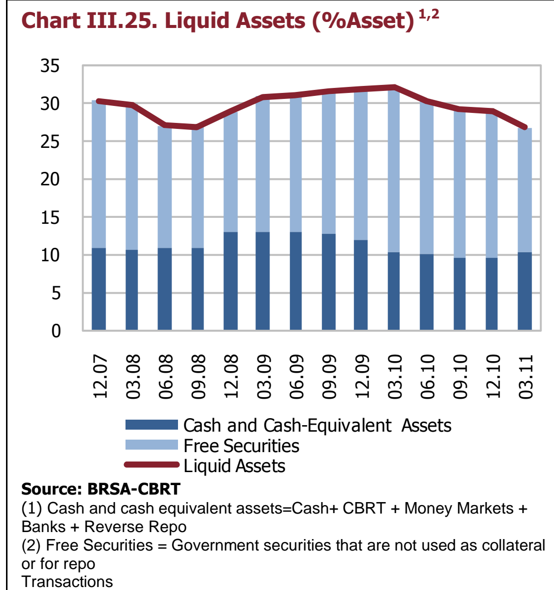


Chart III.25. Liquid Assets (%Asset) [1,2]

Source: BRSA-CBRT

(1) Cash and cash equivalent assets=Cash+ CBRT + Money Markets + Banks + Reverse Repo

(2) Free Securities = Government securities that are not used as collateral or for repo Transactions

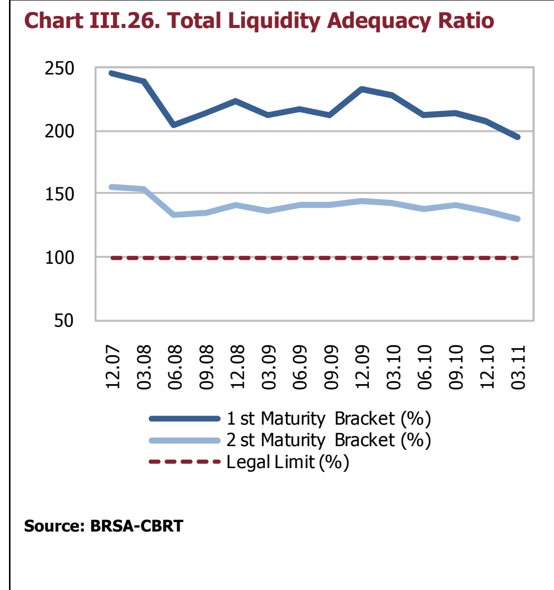


Chart III.26. Total Liquidity Adequacy Ratio

Source: BRSA-CBRT

Stress testing results indicate that banks' liquidity ratios remain above legal limits after the given shocks. For the banks' asset side, haircuts and the liability side the run-off rates are simulated. Results of the liquidity stress tests assert that under severe but feasible shocks banks' liquidity ratios for the 2nd maturity bracket remains above the legal ratio. While total liquidity ratio in the said maturity bracket was 130 percent in March 2011, the fact that 95 percent of the simulated ratios remained above the legal limit highlights banks' sound liquidity conditions (Chart III.27).

Table III.1 Assumptions

Haircuts %	
Securities	20
Consumer Loans	15
Runoff Rates %	
Deposits	25
Noncore funding	100

Source: CBRT

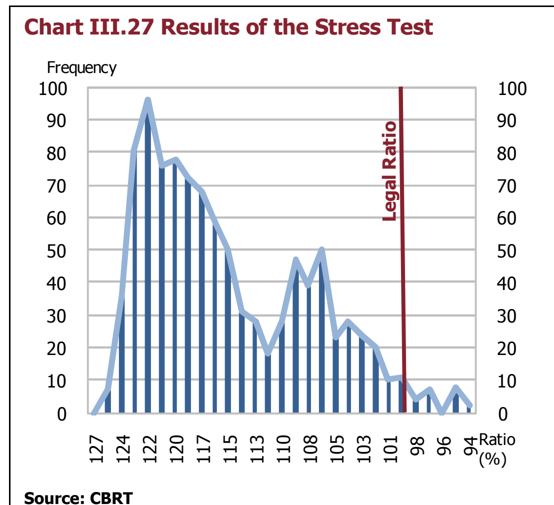


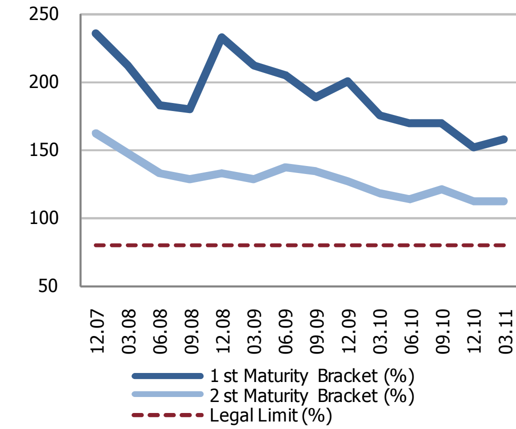
Chart III.27 Results of the Stress Test

Source: CBRT

The foreign exchange liquidity ratio is above the legal ratio, the foreign exchange position is balanced and the share of foreign exchange assets and liabilities on the balance sheet is on the increase. The foreign currency liquidity adequacy ratio, having dropped in 2010 in parallel to global developments, followed a horizontal course in the first quarter of 2011, remaining above 80 percent, which is the minimum legal ratio (Chart III.28). It is noteworthy that the weight of FX assets and FX liabilities on the balance sheet is on an increasing trend. As of March 2011, including those indexed to foreign exchange, the ratio of FX assets to total assets is 29 percent, the ratio of FX liabilities to total liabilities is 31.6 percent. The on-balance sheet short position, which

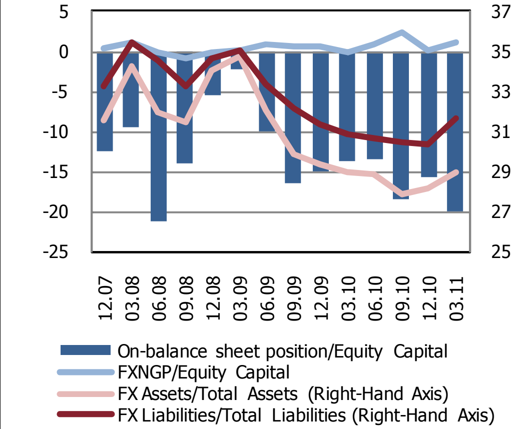
is closed with off-balance sheet transactions consisting mostly of swap transactions increased from USD 13.8 billion at end-2010 to USD 18.2 billion in March 2011. As of March 2011, while the ratio of on-balance sheet short position to own funds was 19.9 percent, the ratio of the foreign currency net general position computed by taking off-balance sheet transactions into consideration to own funds realized as 1.1 percent (Chart III.29).

Chart III.28. Foreign Currency Liquidity Adequacy Ratio



Source: BRSA-CBRT

Chart III.29. Foreign Currency Position (%)



Source: BRSA-CBRT

Box III.1. Liquidity Measures taken by the Central Bank of Turkey

The current economic climate necessitating the monetary policy to consider financial stability along with price stability, required the utilization of a broader set of monetary policy instruments, hence a policy mix consisting of instruments such as policy rates, reserve requirement ratios and liquidity management facilities has started to be applied. In this context, the lower policy rate, wider interest corridor and higher reserve requirement ratios has been assessed to be the expedient policy mix for financial stability and price stability. The Monetary Policy Committee, at its meeting held on December 16, 2010 decided to reduce the interest rate for one-week repo transactions, which has been determined as the policy rate, to 6.5 percent, and the overnight borrowing rate to 1.5 percent. The Committee at its meeting held on January 20, 2011 decided to reduce the interest rate for one-week repo transactions to 6.25 percent. On the other hand, the synchronous rise in the current account deficit and credits and the rise in the share of short term sources in financing the said deficit rose concerns about financial stability, henceforth the policy interest rate was decreased and the interest corridor widened to decrease short term capital inflows, while the required reserve ratios were increased in order to slowdown credit expansion. Moreover, the TL required reserve ratio was differentiated according to the maturity of deposits/participation accounts starting from 07.01.2011 liability period in order to lengthen the maturity of banking sector resources, reduce maturity mismatch and contribute to financial stability. Then, starting from 04.02.2011 and 01.04.2011 liability periods, TL required reserve ratios were increased for sight deposits, deposits/participation accounts up to 1-month and up to 3-month maturity and other liabilities in order to strengthen financial stability. Also the FX required reserve ratio was differentiated according to the maturity of liabilities and FX and TL required reserve ratios were increased for liabilities with shorter maturities. Therefore, liquidity amounting to approximately 38 billion TL and 1.6 billion USD has been withdrawn from the market.

Table 1. Development of Required Reserve Ratios

TL

DATE OF ENFORCEMENT	DATE OF MAINTENANCE	CHANGE (% POINT)	RATIO (%)	ESTIMATED LIQUIDITY WITHDRAWAL (Billion TL)
02.10.2009	16.10.2009	-1	5	-3.3
01.10.2010	15.10.2010	0.5	5.5	'2.1 *
12.11.2010	26.11.2010	0.5	6	2.1
07.01.2011	21.01.2011**	1.4	7.4	7.6
04.02.2011	18.02.2011	2	9.4	9.8
01.04.2011	15.04.2011	3.8	13.2	19.1
29.04.2011	13.05.2011	0.1	13.3	1.5

FX

DATE OF ENFORCEMENT	DATE OF MAINTENANCE	CHANGE (% POINT)	RATIO (%)	ESTIMATED LIQUIDITY WITHDRAWAL (Billion TL)
28.11.2008	12.12.2008	-2	9	-2.5
30.04.2010	14.05.2010	0.5	9.5	0.7
06.08.2010	20.08.2010	0.5	10	0.7
01.10.2010	15.10.2010	1	11	1.5
07.01.2011	21.01.2011	- ***	11	0.2
29.04.2011	13.05.2011**	0.8	11.8	1.4

Source: CBRT

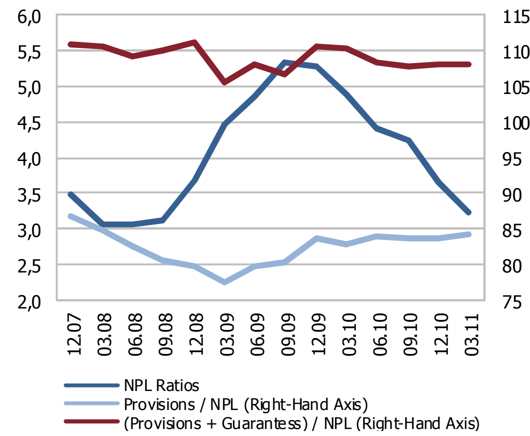
*** Remuneration on TL required reserves has been terminated with an effect of 1.1 billion TL annually.**

**** From this date ratio is calculated as a weighted average of required reserve ratios of corresponding maturity groups.**

***** Effect of expanding reserve requirement base to include repo transactions.**

On account of the credit expansion and the increase in debt service capacity, asset quality improved and the NPL ratio went down. Besides the increase in credits, collection of NPLs, their deletion from assets and their elimination from the portfolio due to sales, the ratio of NPL's to total credits dropped to 3.2 percent by March 2011. Considering the collaterals received for loans besides the provisions set aside for NPLs, the credit risk indicators of the sector appear strong (Chart III.30 and Table III.2).

Chart III.30 Non-Performing Loans (NPLs) (%)



Source: BRSA–CBRT

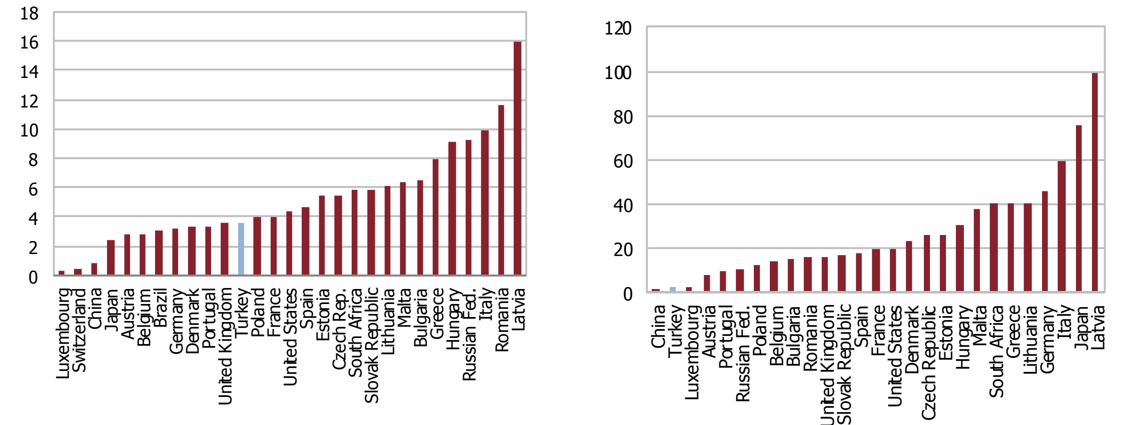
Table III.2 NPL Ratio (%)

	2009	2010	03.11
Total Loans	5.3	3.7	3.2
Corporate	4.9	3.4	3.0
-SME Loans	7.6	4.5	3.8
-Other Corporate Loans	3.6	2.8	2.6
Retail Loans	6.0	4.1	3.7
-Consumer Loans	4.1	2.7	2.3
--Housing	2.1	1.4	1.2
--Vehicle	10.3	6.0	4.9
--Other Consumer	5.5	3.7	3.1
-Credit Cards	10.4	8.0	7.7

Source: BRSA–CBRT

Compared to other countries, the Turkish banking sector performs better with regard to NPLs. The relatively slow recovery in economic activity in advanced economies and the troubles experienced in the financial systems of some EU countries led the ratio of NPLs to remain high in these countries (Chart III.31).

Chart III.31 Ratio of NPLs and Net NPL / Own Funds of Selected Countries (%)[1]



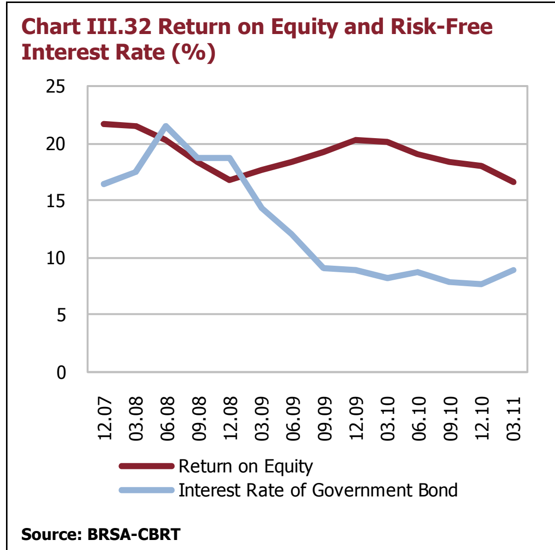
Source: IMF, BRSA–CBRT

(1) The latest data are used most of which pertain to end-2010.

Although profitability performance of the banking sector has exhibited a downward trend since the second half of 2010, it is considered that the profitability of the sector will not be as low as foreseen by the market for the rest of the year as a result of price adjustments. As of end-2010, the net profit of the banking sector went up by 9.6 percent compared to the end of last year and amounted to TL 22.1 billion. As of March 2011, according to the annualized data, the net profit decreased by 3.8 percent compared to year-end figures of 2010 and fell to TL 21.3 billion. This was attributable to the decrease in net interest income despite the decline in loan loss provision expenses. Although the return on equity went down by 1.3 points to 16.7 percent by March 2011 compared to end-2010 figures, the return received remained above the alternative risk-free rate of return (Chart III.32). In the same period, due to the contraction in net interest margin, parallel to the return on equity, the return on assets went down as well. As of March 2011, return on assets dropped by 0.2 points compared to the end of last year and was realized as 2.2 percent; while the net

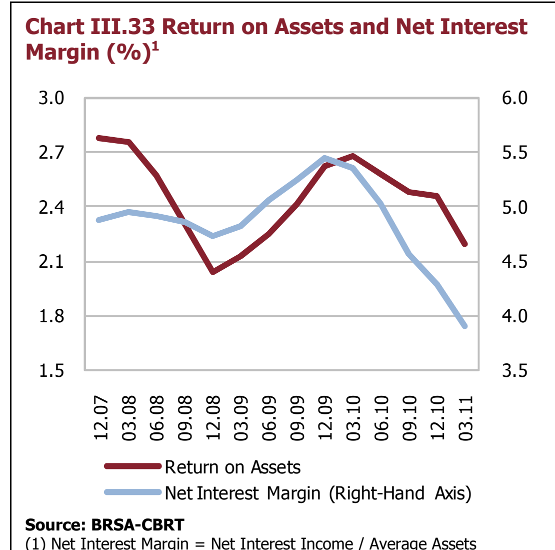
interest margin, with a contraction of 0.4 point went down to 3.9 (Chart III.33). Meanwhile, it is expected that the contraction in the net interest margin will not linger on at the same speed; the pace of decline in the profitability in the first quarter of the year will decelerate in the rest of the year and the profitability will follow a more constant course.

Chart III.32 Return on Equity and Risk-Free Interest Rate (%)



Source: BRSA-CBRT

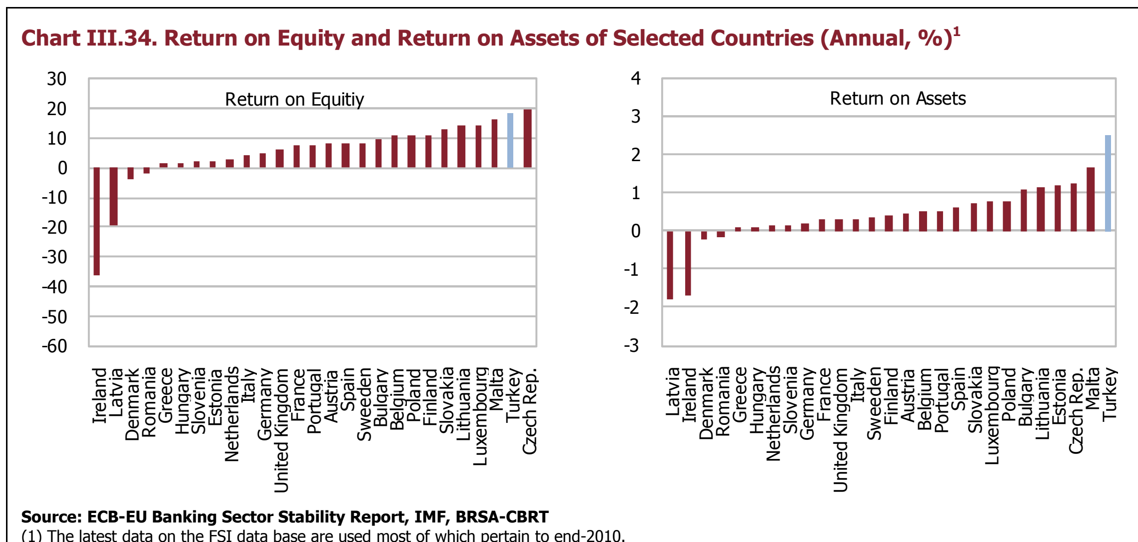
Chart III.33 Return on Assets and Net Interest Margin (%)[1]



Source: BRSA-CBRT
(1) Net Interest Margin = Net Interest Income / Average Assets

Despite the downward trend of profitability indicators of the banking sector, they are still above those of other countries. The return on equity and return on assets of the Turkish banking sector are remarkably higher than those of EU member countries (Chart III.34).

Chart III.34. Return on Equity and Return on Assets of Selected Countries (Annual, %)[1]



Source: ECB-EU Banking Sector Stability Report, IMF, BRSA-CBRT
(1) The latest data on the FSI data base are used most of which pertain to end-2010.

The ongoing rise in risk-weighted assets in line with the continuing increase in loans and recalculation of the exposure stemming from operational risk in the New Year led to a decrease in the capital adequacy ratio. The capital adequacy ratio, which went down by 1 point to 18 percent in March 2011 compared to end-2010, had greatly surpassed the legal and target ratios (Chart III.35). The share of Tier I capital within own funds maintains its approximate level of 90 percent, which indicates that own funds consist of elements with high quality. As a matter of fact, by March 2011, the Tier 1 capital ratio realized at 16.4 percent, which was only 1.6 points below the total capital adequacy ratio. In the same period, the ratio of own funds to total assets fell by 0.5 point to

12.9 percent compared to previous year-end figures (Chart III.36). This development was driven by the rise in assets, which went beyond that of own funds.

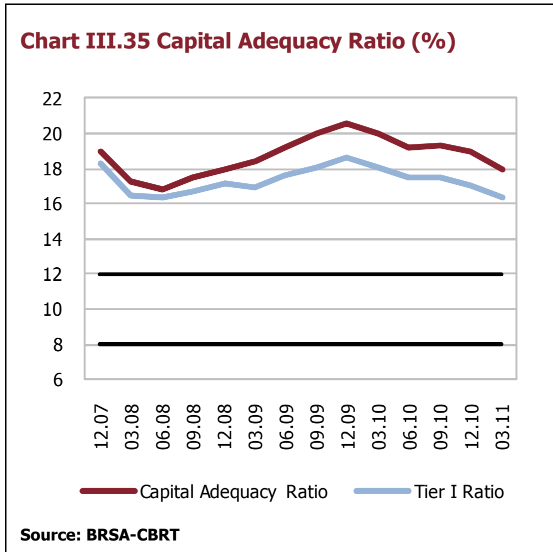


Chart III.35 Capital Adequacy Ratio (%)

Source: BRSA-CBRT

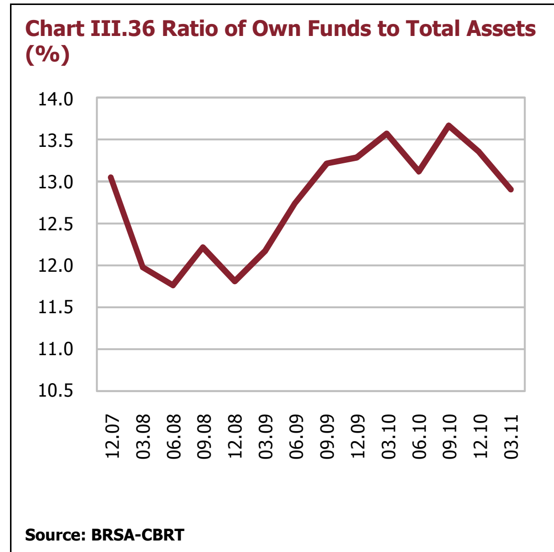


Chart III.36 Ratio of Own Funds to Total Assets (%)

Source: BRSA-CBRT

The banking sector operates with a high capital adequacy ratio and low leverage ratios. When compared with other countries, the banking sector has higher capital and a low debt ratio. The Turkish banking sector is among those with the highest ratios with regard to both capital adequacy ratio and the ratio of own funds to total assets (Chart III.37 and Chart III.38).

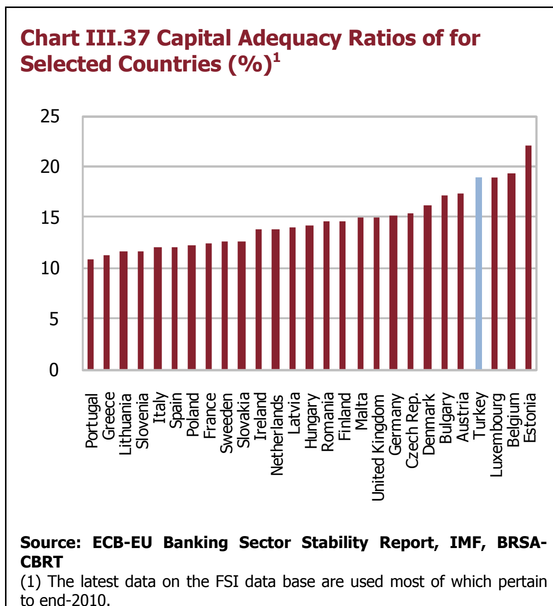


Chart III.37 Capital Adequacy Ratios of for Selected Countries (%)[1]

Source: ECB-EU Banking Sector Stability Report, IMF, BRSA-CBRT

(1) The latest data on the FSI data base are used most of which pertain to end-2010.

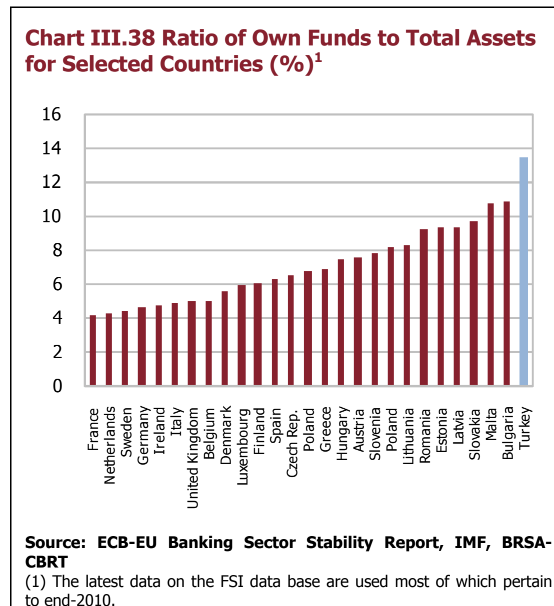


Chart III.38 Ratio of Own Funds to Total Assets for Selected Countries (%)[1]

Source: ECB-EU Banking Sector Stability Report, IMF, BRSA-CBRT

(1) The latest data on the FSI data base are used most of which pertain to end-2010.

The share of total risk exposure of the banking sector within total assets has an increasing trend parallel to the developments in loans. By March 2011, the said ratio went up by 2.5 points to 74.5 percent compared to the previous year-end figures (Chart III.39). Meanwhile, the ratio of free capital, calculated by deducting capital requirement from the regulatory capital, to total assets, dropped by 0.5 point to 7.4 percent in the same period (Chart III.40).

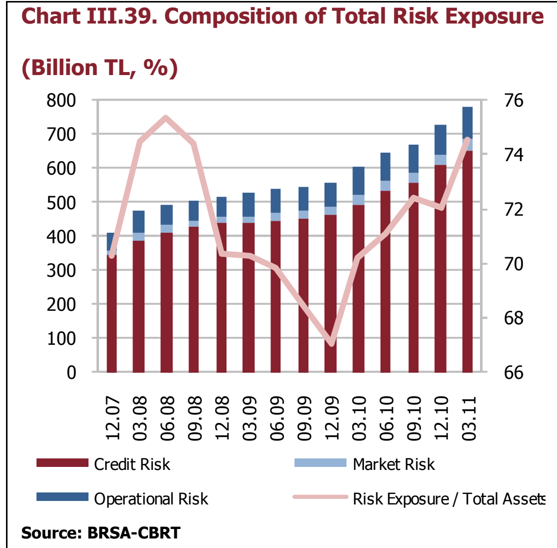


Chart III.39. Composition of Total Risk Exposure (Billion TL, %)

Source: BRSA-CBRT

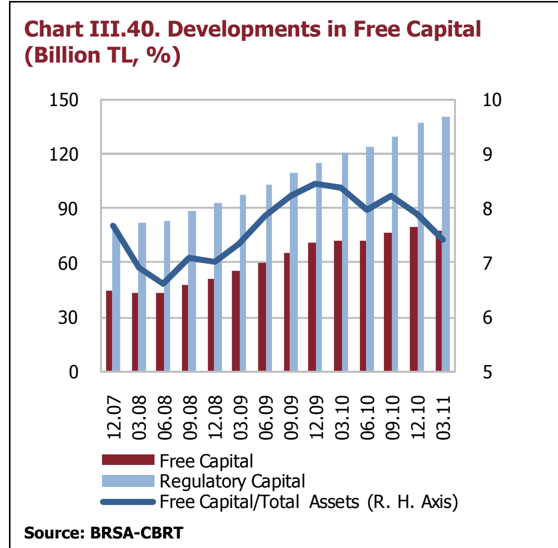


Chart III.40. Developments in Free Capital (Billion TL, %)

Source: BRSA-CBRT

Scenario analysis, which tests the resilience of the banking sector to shocks originating from credit and market movements, shows that the sector has the capacity to absorb shocks[6]. According to the scenario analysis, when maximum shocks are applied to the exchange rate, Eurobond returns, interest rates and NPLs simultaneously, the capital adequacy ratio of the sector decreases by 9.1 points; but still remains close to the 8 percent legal ratio (Table III.3 and Chart III.41).

Table III.3 Scenarios Applied[1]

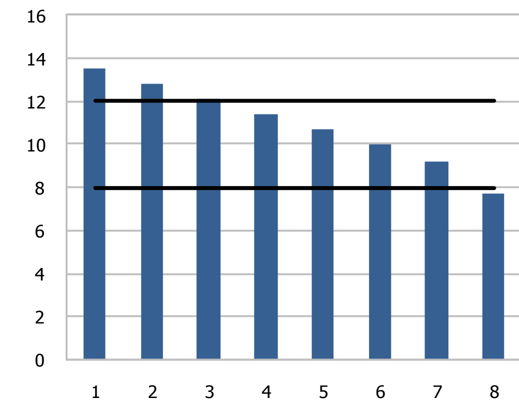
Scenario	Exchange Rate (% increase)	Eurobond (% loss of value)	Interest Rate (point increase)[2]	NPL (point increase)
1	30.0	5.0	10.0	3.0
2	31.5	5.3	10.5	4.0
3	33.0	5.5	11.0	5.0
4	34.5	5.8	11.5	6.0
5	36.0	6.0	12.0	7.0
6	37.5	6.3	12.5	8.0
7	39.0	6.5	13.0	9.0
8	40.5	6.8	13.5	11.0

Source: CBRT

(1) In scenario analysis, taking into consideration the past crises, shocks are applied to the risk factors simultaneously.

(2) It is the Turkish Lira interest rate shock. The shock of foreign currency interest rate is about 1/3 of the one applied to Turkish Lira interest rate shock.

Chart III.41 Results of Scenario Analysis



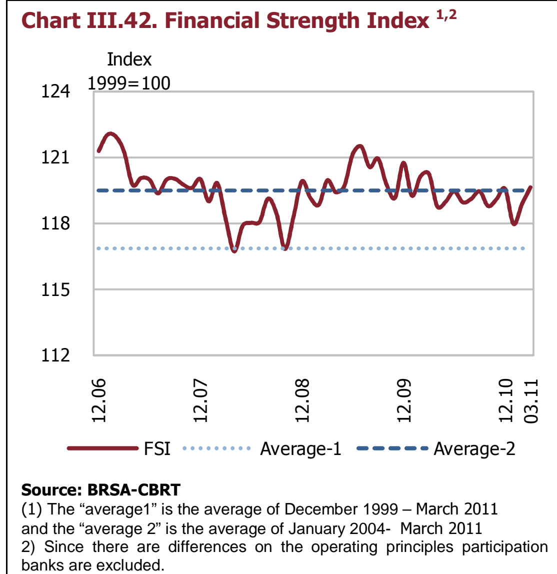
Source: CBRT

Indicators regarding the banking sector highlight the financial strength of the system. The improvement in lending conditions, the low level of interest rates and the increasing repayment capacity of borrowers led to a decline in the ratio of bad loans. While the foreign liabilities of the banking sector kept increasing, the share of public securities on the balance sheet decreased. Despite the improvement in credit quality, the rise in interests and non-interest incomes lagged far behind that in expenses. This led profitability performance indicators to trend downwards while maintaining their sound structure. Meanwhile, the capital adequacy ratio maintains its high level above

[6] Please refer to: Special Topic V.2. Stress Test Approach.

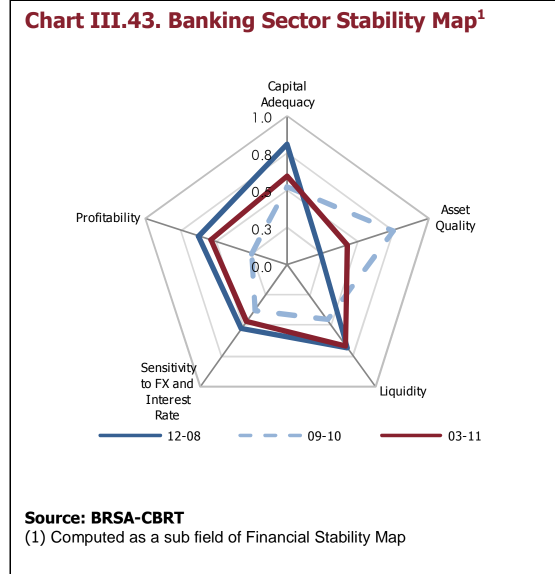
the minimum and target ratios although experiencing a limited decrease due to the rise in loans. Despite the trend of decrease in liquidity ratios due to the decline in securities coupled with the rise in repo and borrowings from foreign banks, these ratios are still above the legal requirements. On the back of these developments, the financial strength index reached the average of the January 2004-March 2011 period (Chart III.42 and Chart III.43).

Chart III.42. Financial Strength Index [1,2]



Source: BRSA-CBRT
(1) The "average1" is the average of December 1999 – March 2011 and the "average 2" is the average of January 2004- March 2011
2) Since there are differences on the operating principles participation banks are excluded.

Chart III.43. Banking Sector Stability Map[1]



Source: BRSA-CBRT
(1) Computed as a sub field of Financial Stability Map

In the forthcoming period, the rate of increase in credits is expected to decelerate owing to the lagged effect of the measures taken in line with the policy mix. Under current conditions, where the decoupling between domestic and foreign demand became more pronounced and particularly consumer loans accelerated, the increasing current account deficit escalated risks pertaining to financial stability. In this scope, foreign demand, the course of capital inflows and credit developments will be significant in setting up the content of the policy mix. Meanwhile, besides those taken by CBRT, measures that should be taken by other institutions to ensure financial stability are essential. The robust activity in the credit market and the increasingly competitive environment of banks should preserve their active risk management in lending procedures.