The Financial System and Banking Sector in Turkey

October 2009, Istanbul

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The Financial System and Banking Sector in Turkey*

1. Impacts of Recent Developments on the Turkish Economy and the Sector

1.1. Economic Performance

The recent global developments led to a rapid contraction in the world economy and financial markets and deceleration in trade volume.

Starting from the last quarter of 2008 in particular, the global issues have had considerable reflections in Turkey, whose foreign trade volume reached 50 percent of its gross domestic product.

Both domestic demand and external demand decreased. Output and income declined. External financing became more limited. The unemployment rate increased. In the public sector, the budget deficit expanded and the public sector borrowing requirement increased.

On the other hand, interest and inflation rates have fallen.

Selected Economic Variables (percentage)

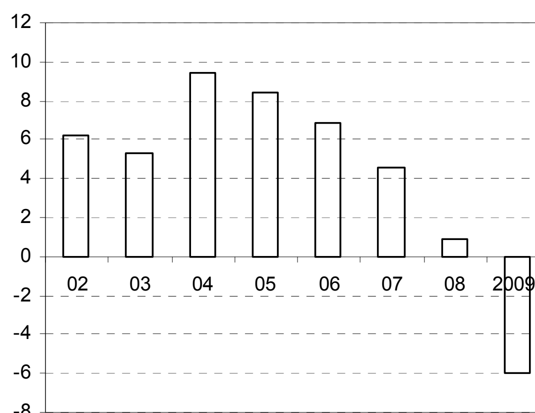
	Dec. 2008	June 2009	Dec. 2009****	Dec. 2010****	Dec. 2009****
Growth*	-1.1	-6.5	-6.0	3.5	4.0
Inflation**	10.1	5.3	5.9	5.3	4.9
Unemployment rate	13.6	13.0	14.8	14.6	14.2
Budget deficit***/gdp	1.8	5.3	6.6	4.9	4.0
Current account/gdp	-5.6	-3.3	-1.8	-2.8	-3.3

* Annual gdp change in real terms.
** Annual change in Consumer Price Index, as of August 2009.
*** Central Government Budget.
****Program by the Government.

The economy has contracted rapidly: Gross domestic product (gdp) in real terms fell by 6.2 percent in the last quarter of 2008 and by 10.6 percent in the first half of 2009 compared with the same period of the previous year.

** The Banks Association of Turkey-www.tbb.org*

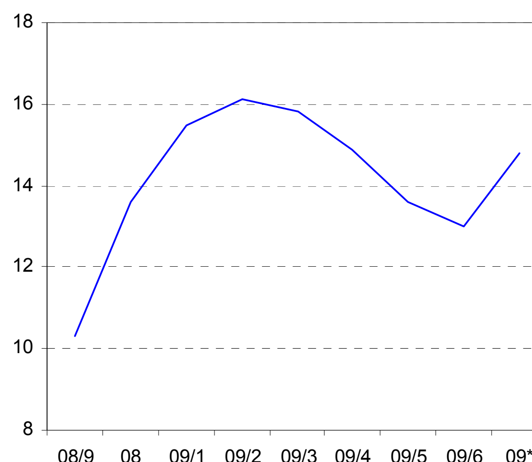
Gdp Growth (percentage change in real terms)



* Program by the Government.

Unemployment rate has increased: The unemployment rate, which was 10.3 percent in September 2008, increased to 16.1 percent in February 2009. Partly due to the effect of the tax reductions implemented in certain sectors, the unemployment rate began to fall and realized at 13 percent in June 2009.

Unemployment Rate (percentage)

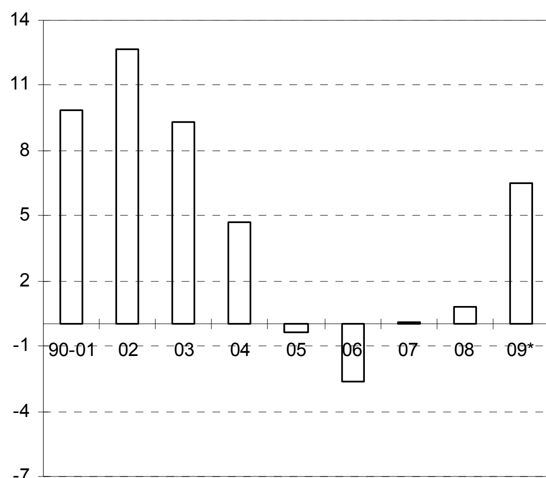


*Program by the Government.

The current account deficit has narrowed down: The ratio of the current account deficit to gdp decreased from 5.6 percent at the end of 2008 to 3.3 percent as of June 2009.

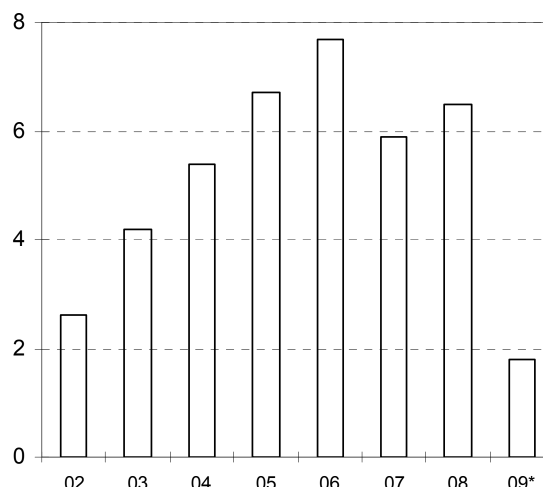
The budget deficit has increased: The ratio of the budget deficit to gdp was around 5.3 percent in the first half of 2009. It is expected to be 6.6 percent at the end of the year.

Public Sector Borrowing Requirement/Gdp (percentage)



* Program by the Government.

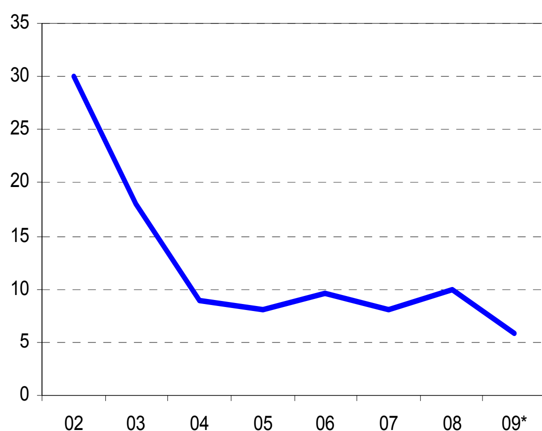
Current Account Deficit/Gdp (percentage)



* Program by the Government.

Inflation and interest rates have fallen: Consumer inflation declined to 5.3 percent as of August 2009. It is expected to be around 5 percent at the end of the year. The Central Bank short-term interest rates decreased to 7.25 percent, down by 10.5 percentage points compared with the last quarter of 2008. Market interest rates also decreased in line with the interest rate policy of the Central Bank.

Inflation (annual percentage change)



* Program by the Government.

External trade volume has declined: The annual volume of external trade was USD 348 billion as of September 2008 and dropped to USD 258 billion as of June 2009.

In the same period, the current account deficit decreased from USD 47 billion to USD 20 billion. Capital inflows turned from USD 48 billion into an outflow of USD 2 billion.

1.2. Measures adopted in Turkey

A series of measures were adopted by the authorities and organizations to ease the negative effects of the global crisis on Turkey.

Within this framework the Central Bank took the following measures:

- resumed its activities as an intermediary in the foreign exchange deposit market until the removal of uncertainties in international markets (9 October 2008);

- raised its transaction limits by twofold to USD 10.8 billion (23 October 2008) and extended the lending maturity to 1 month from 1 week in the foreign exchange deposit market (21 November 2008);

- adopted a strategy to use foreign exchange reserves to primarily support the foreign exchange liquidity need of the banking system. The reserve requirement ratio was unchanged at 6 percent in TL liabilities, but it was lowered to 9 percent from 11 percent in foreign exchange liabilities (28 November 2008). With this measure, the Bank provided an additional liquidity of USD 2.5 billion to the banking system;

- increased the exports rediscount credit limit by USD 500 million to USD 1 billion in order to contain the effects of the global crisis on industry sectors. Additionally, the rules and principles applicable to the exports rediscount loan limit were rearranged for rendering the use of these loans easier.

Therefore, the condition that sets forth assignment of the reserves for letters of credit to the Central Bank was repealed.

The Banking Regulation and Supervision Agency (BRSA), on the other hand, adopted certain measures aimed at preserving the financial strength of banks and containing the effects of abrupt changes in the financial asset prices on banks' capital adequacies. For this purpose, BRSA:

- required banks to get permission for distribution of the 2008 earnings;

- allowed banks to reclassify the securities in their balance sheet from trading portfolio to investment portfolio for once only;

- allowed banks to restructure the loans apparently posing no problems in order to ensure smooth functioning of the loan relations between banks and non-financial institutions.

The Government sought authorization from the Parliament for increasing and determining for a period of two years the deposit insurance coverage, which was TL 50,000. This amendment allowed for the Treasury's direct guarantee on the deposits insured as the Savings Deposit Insurance Fund's (SDIF) own resources would not be sufficient to cover an unlimited insurance on deposits for which the SDIF was authorized under the current law.

Additionally, the Finance Ministry introduced tax advantages for sectors. Accordingly, payment of the tax dues which became payable before 1 September 2008 was decided to be deferred to December 2008 and with 18 installments.

With a law the real and legal person owing funds and other precious assets abroad as of 1 October 2008 were allowed to bring and register such funds and assets in Turkey by paying 2 percent tax.

Similarly, it was also decided that current income and corporate taxpayers should be able to register their existing securities and real properties inside Turkey which were not registered as of 1 October 2008 through payment of 5 percent tax.

Additional measures were continued to be implemented also by various organizations in the first months of 2009 as the global volatility continued to affect the markets. Within this framework:

"The Law No. 5834 About Omission of the Past Records for Unpaid Checks and Protested Promissory Notes, and Credit and Credit Card Debts", known as the law for the amnesty of records allowed the deletion of the real and legal persons' past records kept at the Central Bank for their unpaid checks, protested promissory notes, and credit card debts and other credit debts ensuring that such sums are totally paid before or within 6 months after its effective date or restructured and totally paid.

The Government introduced a new package of measures including implementations in the crisis environment for companies, employees and the retired people; the term for the "short term employment compensation" implemented over Unemployment Fund was extended to 6 months from 3 months, and the sum of compensation was raised by 50 percent. It was adopted that no seizure could be levied on retirement wages, and effective term of the incentives for 49 provinces was extended by 1 more year.

The Government announced the following measures on 13 March 2009 in order to ease the effects of the global financial crisis. Accordingly, it was adopted that:

- consumption tax applied to durable goods and automobiles to be lowered for a period of 3 months,

- value added tax (Vat) applied to real estates to be lowered to 8 percent from 18 percent for a period of 3 months,

- an additional subsidy of TL 75 million to be extended to SMEs,

- resource utilization support fund to be cut by 5 percentage points,

- capital of Eximbank to be increased,

- discounted night tariff for pricing the use off electricity in industry sector that applied to weekdays only to be extended to cover also weekends and other public holidays.

Within the framework of other measures package announced on 25 March 2009 the Government reduced the rate of Vat received from the sale of offices and other workplaces to 8 percent, the public fee in real estate purchases to 0.5 percent from 1.5 percent, the rate of Vat imposed on furniture, certain industrial and work machines used particularly by SMEs, information technology products and office furniture to 8 percent from 18 percent to be effective for a period of three months.

The content of the Vat reduction to 8 percent from 18 percent as adopted by the Government

as effective until 30 June 2009 has been widened by addition of some side products. Certain side products in automotive industry and some types of furniture are among such products listed by the new regulation announced on 14 April 2009.

"The Central Bank Regulation on the Liquidity Support Facility" governing the principles and procedures set forth for the utilization of Icredit facilities as stipulated in subparagraph (c) of the paragraph (I) of Article 40 of the Central Bank Law was published. Accordingly, the loans will be available:

- as advance payments, with one month maturities for a maximum one year period,
- at the lending rate set for the intraday transactions carried out at the Interbank Money Market; bearing in mind the principle that interest rates applicable to credits of this nature are higher than those applicable to normal open market transactions of the central banks,
- against collaterals accepted at the Interbank Money Market,
- being limited to the amount twice as much as the equity capital of the applying bank.

The Central Bank cut its interest rates and extended the maturity in foreign exchange deposit market in order to prevent a possible foreign exchange squeeze in the financial market. Accordingly, lending rate was reduced to 5.5 percent from 7.0 percent for USD, and to 6.5 percent from 9.0 percent for euro. The maturity of interbank transactions was extended to 3 months from 1 month.

1.3. Reflections of Global Developments on the Banking Sector

The global developments have also affected the banking sector in Turkey, although to a rather limited extent in comparison with many other countries.

The reasons behind the relatively limited negative effects on the banking system are a high capital adequacy ratio, a high asset quality, low currency and liquidity risks thanks to successful risk management and effective public supervision, and good management of the interest, counterparty and maturity risks.

The measures taken by the Central Bank and BRSA against the increase in global financial risks helped the banking sector to maintain healthy functioning.

Due to global developments, the external borrowing possibilities for banks became more limited, the cost of external borrowing increased, and currency liquidity management become more important. Demand for banking services sharply decreased as a result of the contraction in economic activity. Demand for TL deposits continued to grow in real terms, while foreign currency deposits followed a fluctuating course. Deposits remained short-term for the most part.

Selected Balance-Sheet Items (TL million)

				Sept. 2008-July 2009	
	Sept. 2008	Dec. 2008	July 2009	Difference (TL million)	Change (%)
L. assets	85.965	104.803	98.962	12.997	15
Securities	178.358	193.964	225.185	46.827	26
Loans	343.201	349.967	348.157	4.956	1
Npl's (net)	1.907	2.416	3.382	1.475	77
Npl's (gross)	10.871	13.044	18.348	7.477	69
Per. assets	19.131	19.095	20.071	940	5
Other assets	10.838	11.966	38.077	8.528	29
Total	656.204	706.949	730.452	74.248	11
Deposits	400.895	435.554	451.768	50.873	13
-TL	266.764	283.158	295.699	28.935	11
-Fx	134.131	152.397	156.069	21.938	16
Non-deposit funds	129.224	137.914	129.949	725	1
Equity	79.564	82.618	96.323	16.759	21
Other liabil.	37.726	41.074	52.412	5.891	13
Total	656.204	706.949	730.452	74.248	11

Source: BRSA

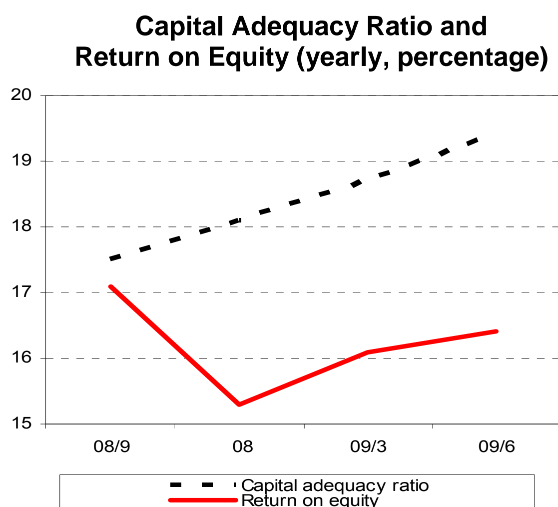
Banks were rather conservative in lending due to increased risks and the slowdown in loan demand as well as the rising demand for funds from the Government. The ratio of loans to gdp remained the same at 37 percent and the ratio of loans to deposits fell to 76 percent, down by 8 percentage points. The share of loans in total assets decreased by 5 percentage points and dropped to 47 percent. Compared with the end of 2008, corporate loans increased more slowly than consumer loans.

Credit risk increased as the ratio of non-performing loans to total loans (gross) was 3.1 percent in the third quarter of 2008 and rose to 5.2 percent in July 2009. Special provisions were set aside at the rate of 80 percent for non-performing loans.

In addition there has been an increase in the share of government securities in the total assets. The share of the securities portfolio in the total assets increased by 4 percentage points to 30 percent on the year-end.

In the period when the global developments began to affect the banking system, the currency risk of banks remained very limited.

The interest risk was higher due to a maturity mismatch caused by long term assets against short term liabilities. However, the rapidly falling interest rates had a positive effect on the interest margin. Meanwhile, banks rapidly introduced measures to limit their operating costs. As a result, the profit volume increased and profitability recorded a growth, albeit slight.



Shareholders' equity has continued to strengthen due to capital raises as well as the increase in the profit volume. As of July 2009, excluding subordinated loans, shareholders' equity rose by 17 percent to TL 96.3 billion and by 21 percent to USD 66 billion in comparison with the end of 2008. The capital adequacy ratio increased by 1.3 percentage points in comparison with the year-end and reached 19.4 percent as of June 2009.

Number of Branches and Employees

	Branches			Employees		
	2002	**2008**	**2009/6**	**2002**	**2008**	**2009/6**
Deposit banks	6,087	8,741	8,799	118,329	166,325	165,959
State-owned	2,019	2,416	2,458	40,159	43,333	43,689
Private	3,659	4,290	4,309	66,869	82,158	82,080
Fund	203	1	1	5,886	267	266
Foreign	206	2,034	2,031	5,416	40,567	39,924
Dev. and inv. b.	19	49	52	4,942	5,273	5,296
Total	6,106	8,790	8,851	123,271	171,598	171,255

Source: The Banks Association of Turkey

As of June 2009 the number of branches, which was 8,489 as of September 2008, increased to 8,851. The number of employees increased from 170,425 to 171,255.

2. The Financial System

In Turkey, the financial sector is yet at the stage of growth. It is small and shallow when compared with the financial sectors of developed countries.

It is estimated that the ratio of financial assets, consisting of bank assets, shares and public and private borrowing instruments, to gdp was 150 percent for Turkey, 246 percent for developing countries and 421 percent for the world in 2007.

The banking system has a major share in the financial sector. In recent years, non-bank financial institutions have grown in number and size. The financial services sector in Turkey includes banks and insurance companies and non-bank financial institutions such as factoring companies, leasing companies, consumer financing companies, pension companies, intermediary institutions, investment funds, investment partnerships and real estate investment partnerships.

At the end of 2008, the rate of total assets to gdp was 78 percent for the banking sector, 2.6 percent for the insurance sector, and 2.5 percent for mutual investment funds.

In the financial system, there is not a single authority responsible for supervision and inspection. The supervision and inspection of banks and leasing and factoring institutions in Turkey is performed by the Banking Regulation and Supervision Authority (bddk.org.tr). Banks are subject to regulation and supervision by the Capital Market Authority for their capital market operations.

2.1. The Banking Sector

Generally, following the crises in 2001 and the restructuring process, the banking sector showed a rapid growth performance in 2002-2008 period. The total assets rose from USD 130 billion to USD 465 billion, their ratio to gdp from 57 percent to 77 percent. The numbers of branches and staff rapidly increased.

In this period, the financial structure of the sector also became stronger. The shareholders' equity of the sector increased from USD 16 billion to USD 54 billion and its free equity from USD 3 billion to USD 40 billion. The capital adequacy ratio which was 18 percent as of December 2008, continued to grow and reached 19.4 percent in the first half of 2009.

In addition, the risk management systems improved and public supervision became more effective in this period. The positive developments recorded by the banking system in 2002-2008 period have several reasons, including the favorable domestic and international economic situation and the change in the risk management conception. Another important reason is the success of the "Banking Restructuring Program".

Box1. Restructuring of the Banking Sector in Turkey

The restructuring process in the banking system was first started with the disinflation programme as of end of 1999 and followed by the extensive "Banking Restructuring Program in 2001. The initial efforts were directed toward making extensive amendments in the Banking Law. The Banking Regulation and Supervision Authority (BRSA) was established as a regulatory and financial authority with administrational and financial autonomy in banking sector. Duties and authorities regarding the supervision and regulation of banks which were previously shared by the Treasury and the Central Bank in the past were transferred to BRSA which started its operations in August 2000. In this period, an unlimited guarantee was introduced for savings deposits.

i) Solving the financial problems of the banks under Savings Deposit Insurance Fund (SDIF) control: The first pillar of the banking restructuring process was to seek solutions for banks facing financial problems. At the end of 1999, five commercial banks with such problems were taken under SDIF control, and the banking licenses of two development and investment banks were cancelled. The Treasury Undersecretariat issued special series of bonds, the Central Bank advances were used, and resources were transferred from SDIF for reinforcing the financial structures and restructuring of 20 banks under SDIF control during the period of 1996-2003. In the same period, the banking licences of 8 banks were revoked and they were liquidated. Sum of the resources transferred to banks owned by SDIF, including the debt principal repayments and interest payments made for and in the account of them, rose to a total of USD 28.2 billion (TL 40 billion) as of the end of July 2003. Some of the banks under SDIF control were sold while the others were merged under Birleşik Fon Bankası A.Ş. (United Fund Bank), which had been established under SDIF ownership.

ii) Restructuring of the state-owned banks: As a second pillar of restructuring process, considerable public resources were transferred to strengthen the capital structures of the state-owned banks, whose financial structures were considerably deteriorated as a result of delays in the repayment of loans used by the Treasury for budget financing, inefficient use of their resources due to political interventions, and management weaknesses. In this framework, a total of USD 21.9 billion (TL 28.7 billion) as of the end of 2001 was transferred to the state-owned banks, including capital support and settlement of the "duty losses", which had reached 50 percent of their balance-sheets at the end of 2000. The efforts were accelerated towards the operational restructuring of the state-owned banks, which were reinforced through mergers between each other and which were planned to be privatized in the end.

iii) Strengthening the capital of private banks: In addition to the negative effects of the crisis, the problems of private banks were further deepened due to provisioning for non-performing loans and the abrupt limiting in the loan supplies to the market by the state-owned banks during the process of their restructuring and meeting the capital adequacy requirements. Therefore, at the third stage of banking restructuring, a program was adopted for reinforcement of the equity capital of private banks which provided that a three-party audit should be made before extending capital support to and reinforce the equity capital of private banks whose asset quality was deteriorated and equity capital rapidly melted down. Under this programme, audits were based on the rules of inflation accounting, different from previous periods. The capital requirements of the banking sector remained at a limited level due to positive approaches in cash capital increases, re-regulation of provisions for nonperforming loans, and assessment of market risks in considering the sector reports prepared after the audits. One bank was transferred to the SDIF due to shortage of capital. The total cost of restructuring in the private sector was USD 7.9 billion, with USD 5.2 billion was met by the SDIF and USD 2.7 billion by the private sector banks. Besides, regulations were adopted for establishing mechanisms that would accelerate the solution of bad assets.

iv) Legislative measures: One of the main objectives of the restructuring in the banking system has been to enact the legal and institutional regulations for improvement of supervision and audit systems, changing the risk taking and risk-management processes and methods and enhancement of the corporate infrastructure. As a result of the measures implemented by the BRSA, the banking legislation was considerably aligned with international regulations, best practices and particularly the EU directives. International regulations were considered in adopting the regulations which aimed to increase the transparency of balance sheets of banks, ensure compliance with international accounting standards and strengthen the financial structure of banks. In this framework, Turkey had started works in 2002 for incorporating the infrastructural elements of new Basel Capital Accord (Basel-II).

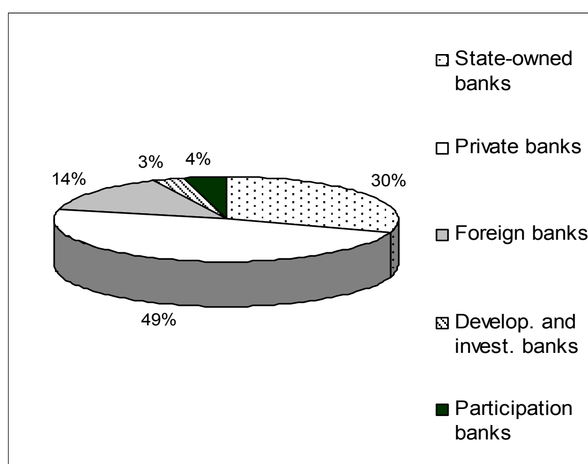
v) The Financial Restructuring Programme: The crisis in the economy in 2001 gave rise also to an environment of uncertainty for non-bank sectors. In the real sector, many firms reduced their activities and investments, and many others faced with insolvency problems. The ratio of non-performing loans to total loans (before provisioning) in the banking sector increased to 29.5 percent at the end of 2001. A program for restructuring the companies' debt to the financial sector, known as the "*Istanbul Approach*", was introduced in June 2002 for a period of three years. The purpose of the programme was identified as to make it possible for the manufacturing companies - which were in financial distress and which could continue their activities only if they were restructured - to work in a productive way, to increase employment and capacity utilization in the economy, to provide order, health and transparency to the balance sheets of the companies both in real sector and in financial sector through performing these regulations, and thereby to increase tax collections. A total of 331 companies, comprised of 219 big companies (35 groups) and 112 Sme's, were included to the Program. Of these companies, the Restructuring Agreement was signed with 221 big companies (30 groups) and 101 Sme's, making up a total of 322 companies. Total sum of the restructured loans reached USD 6.02 billion.

2.1.1 General Information

As of July 2009, there are 49 banks operating in the Turkish banking sector, with 32 of them commercial banks, 13 development and investment banks and 4 participation banks. The commercial banks do not have participation accounts and the participation banks are not licensed to accept deposits. The development and investment banks are not allowed to issue deposit and participation certificates.

The commercial banks and the development and investment banks are members of the Banks Association of Turkey (www.tbb.org.tr) while the participation banks are members of the Participation Banks Association of Turkey (www.tkbb.org.tr).

Distribution of Total Assets by Groups (percentage)



According to BRSA data, the commercial banks and the development and investment banks have a total share of 96 percent in the sector assets while the participation banks have a share of 4 percent as of July 2009. The shares of the private commercial banks, the state-owned and the Fund-controlled banks and the foreign banks are, respectively, 49 percent, 30 percent and 14 percent.

There are 24 commercial, development and investment banks in which a majority of shares, excluding public shares, are held by residents abroad or which have entered into strategic partnership agreements with residents abroad. The controlling shareholders in those banks are resident in the USA (3), France (3), the Netherlands (2), Belgium (2), Germany (2), Greece, Portugal, Luxembourg, Iran, Pakistan, Israel, Bahrain, the United Kingdom, Saudi Arabia, Italy, Kazakhstan and Libya.

2.1.2. Balance-Sheet Items in July 2009

The total assets of the commercial, development and investment banks was TL 730 billion (USD 497 billion) as of July 2009. The ratio of the total assets to gdp was 79 percent as of June 2009.

A 29 percent of the total assets and 33 percent of the total liabilities are in foreign currency. The short position within the balance-sheet was USD 22 billion. The foreign currency net overall position, which includes off-balance-sheet operations, yielded a surplus of USD 583 million.

The liquid assets were TL 99 billion (USD 67 billion). Of the liquid assets, which form 14 percent of the total assets, 59 percent are in foreign currency and 41 percent in TL.

The loan stock was at the level of TL 348 billion (USD 237 billion) and accounts for 48 percent of the total assets. Of the loans, 33 percent were consumer and 67 percent corporate. The ratio of housing loans to the total loans was 11 percent.

The ratio of non-performing loans to total loans was around 5.3 percent. Provisions were set aside for 82 percent of the non-performing loans. The ratio of non-performing housing loans was 2.1 percent, well below the average.

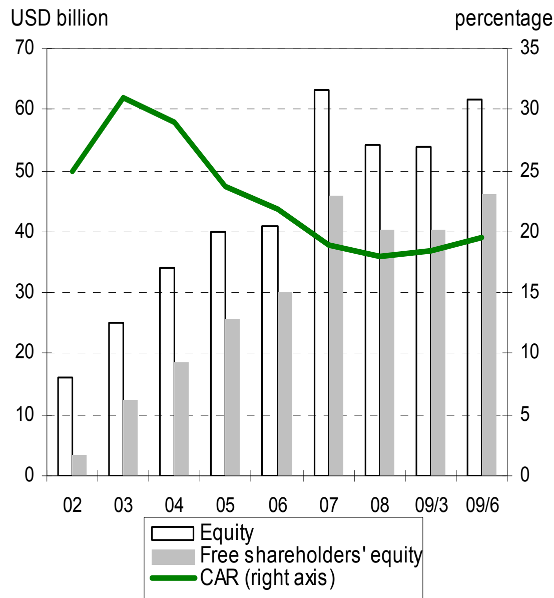
Of the deposits, which are the most important resource for the banking sector and constitute 62 percent of the total liabilities, 65 percent were in TL and 35 percent in foreign currency. Savings and commercial deposits are the largest deposit items. The average maturity of deposits is 2.2 months for TL deposits, 2.7 months for foreign currency deposits, and 2.4 months in general.

The non-deposit resources, which constituted 18 percent of the total liabilities were TL 130 billion (USD 88 billion) as of July 2009. The two most important items among the non-deposit resources are the loans received from banks abroad and the funds raised through repo transactions.

The sharholders' equity was TL 96 billion (USD 66 billion) and the free shareholders' equity was TL 73 billion (USD 50 billion) as of July 2009. The capital adequacy ratio stood at 20 percent.

The total profit volume of the commercial banks and the development and investment banks increased by 35 percent in the first seven months of 2009 on the same period of last year and reached TL 12.3 billion (USD 8.4 billion).

Equity, Free Shareholders' Equity and Capital Adequacy Ratio



The most important factors that contributed to maintaining profitability in the period under consideration were the steady growth of shareholders' equity, the lower operating costs and the maturity mismatch between assets and liabilities.

Profitability was positively affected by the average maturity of total assets being longer than the average maturity of total liabilities in an environment where interest rates were falling.

According to the data of the Interbank Card Centre, there were a total of 43.9 million credit cards and 61.6 million bank cards as of June 2009. The numbers of POS and ATM machines in the same period were, respectively, 1,682,778 and 22,833.

The number of internet banking active customers increased to 5.6 million people as of June 2009. Of these customers, 89 percent are retail and 11 percent corporate. The volume of transactions performed via internet banking reached TL 225 billion (USD 148 billion).