



**BANKING REGULATION AND SUPERVISION  
AGENCY**

**Bank Capital Strengthening  
Program**

February 20, 2002

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# Bank Capital Strengthening Program

## 1. Introduction

Developments in the national and global economies during 2001 have caused a slow down in the recovery of the Turkish banking sector due to negative impacts on assets, own funds' sufficiency, and the quality of the loan portfolios. Accordingly, a need has arisen to strengthen through new legal instruments the existing program aimed at the restructuring of the banking sector. As a consequence thereof, changes have been made in the legal framework to:

- ✓ Allow the formation of asset management companies in order to resolve non-performing assets, and thereby improve the liquidity of assets retained by the banks,
- ✓ Allow efficient functioning of debt restructuring systems to ensure that real sector companies which meet certain criteria, and have lost their financial strength due to the financial crisis, carry on with their activities,
- ✓ Strengthen the capital structures of banks, which have been damaged by the crisis.

The capital support provided to banks is an important component of this process as it allows a macro level intervention in the sector. Indeed, in addition to the existing steps being taken, this additional component allows a comprehensive, fast and once-only intervention in the sector. Thus, it will be possible to put an end to speculation about uncertainties likely to be faced by participants in the economy in the future. Furthermore, the new strengthening strategy will also contribute to breaking the vicious circle of banking sector crisis and real sector crisis, as it will provide interaction between the real sector and the financial sector, opening up a new perspective to the restructuring process.

The main objectives of the strengthening strategy are:

- ✓ Transition to a secure banking system through strengthening of banks' capital,
- ✓ Increasing and maintaining transparency in the Turkish banking system, and
- ✓ Broadening of real sector-oriented credit opportunities.

The recapitalization program is structured to achieve these aims, based on the following principles:

- ✓ Equal and fair treatment of all banks in capital strengthening,
- ✓ Process subject to clear and objective rules with a precise agenda,
- ✓ Avoidance of any moral hazard effects through guarantees obtained for public funds provided,
- ✓ Limiting costs of restructuring through rapid intervention and limited/controlled provision of funds,
- ✓ Transparency of the process and informing the public at each step,
- ✓ Incentives for banks' shareholders to increase capital.

The legal basis of the new recapitalization program set up within the framework of these objectives and principles consists of the regulations below:

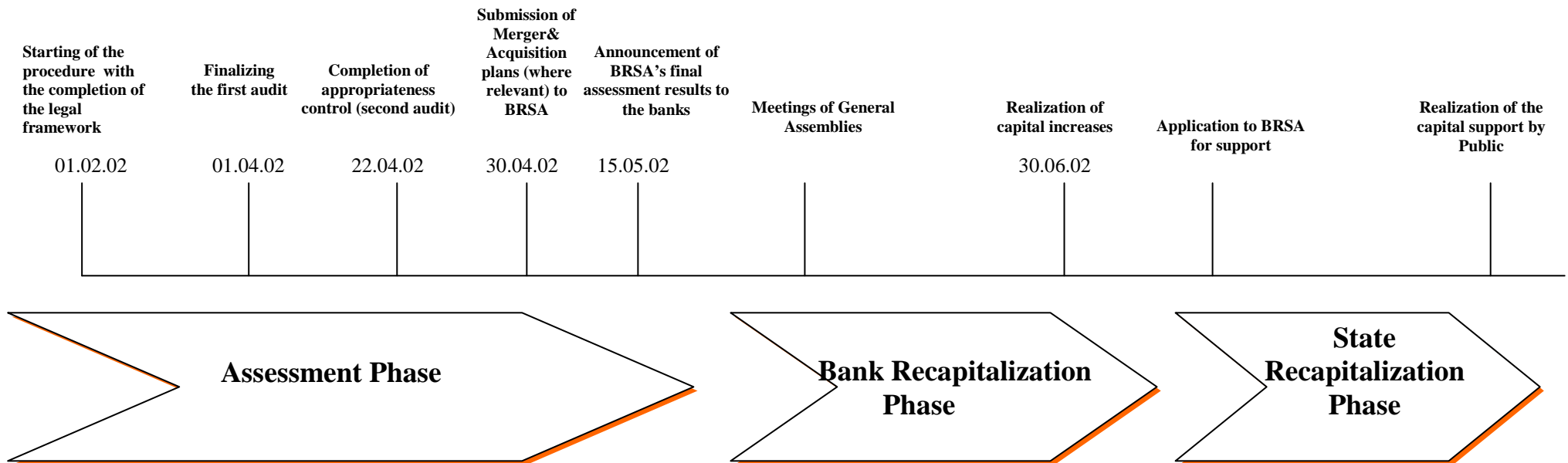
- ✓ Amendment to the Banks' Act through Act No: 4743,
- ✓ Regulation on Principles and Procedures related to the Restructuring of the Banking Sector,
- ✓ Regulation on the Principles and Procedures of Private Independent Audit to be Carried Out According to Provisional Article 4 of the Banks' Act.

## **2. Phases of the Recapitalization Program**

The recapitalization program consists of three phases. These phases are summarized in Diagram 1.

- ✓ Assessment Phase: the financial status of all private commercial banks with new and improved accounting standards is arrived at based on a three-phase audit procedure carried out on a fair and impartial basis, utilizing independent audit institutions.
- ✓ Bank Recapitalization Phase: In case losses cannot be met through reserves, assumption of all the bank's losses by shareholders through the convening of the bank's General Assembly, allowing the bank also to make other decisions necessary, including making a decision regarding cash capital increases.
- ✓ State Recapitalization Phase: Recapitalization of the banks, which may occur if the bank's CAR is positive but below 8 percent, to be achieved through capital participation and/or subordinated debt from public sources with appropriate security and safeguards.

## DIAGRAM 1: Bank Restructuring Program Phases



## 2.1 Assessment Phase

The three-phase-assessment set up to increase the efficiency of the recapitalization program as providing the sector with transparency is one of the most critical steps of the program. This is expected to be achieved by the standards imposed and the principles adopted for the assessments, such as inflation accounting and consolidated reporting, as well as the checks and balances put in place such as the cross control of the first and second audit processes.

In the assessment process a three-phase-audit will be carried out, the first and second phases being performed by independent auditing institutions, and the third and final evaluation being made by the BRSA. The working plan of the assessment phase is given in Diagram 2.

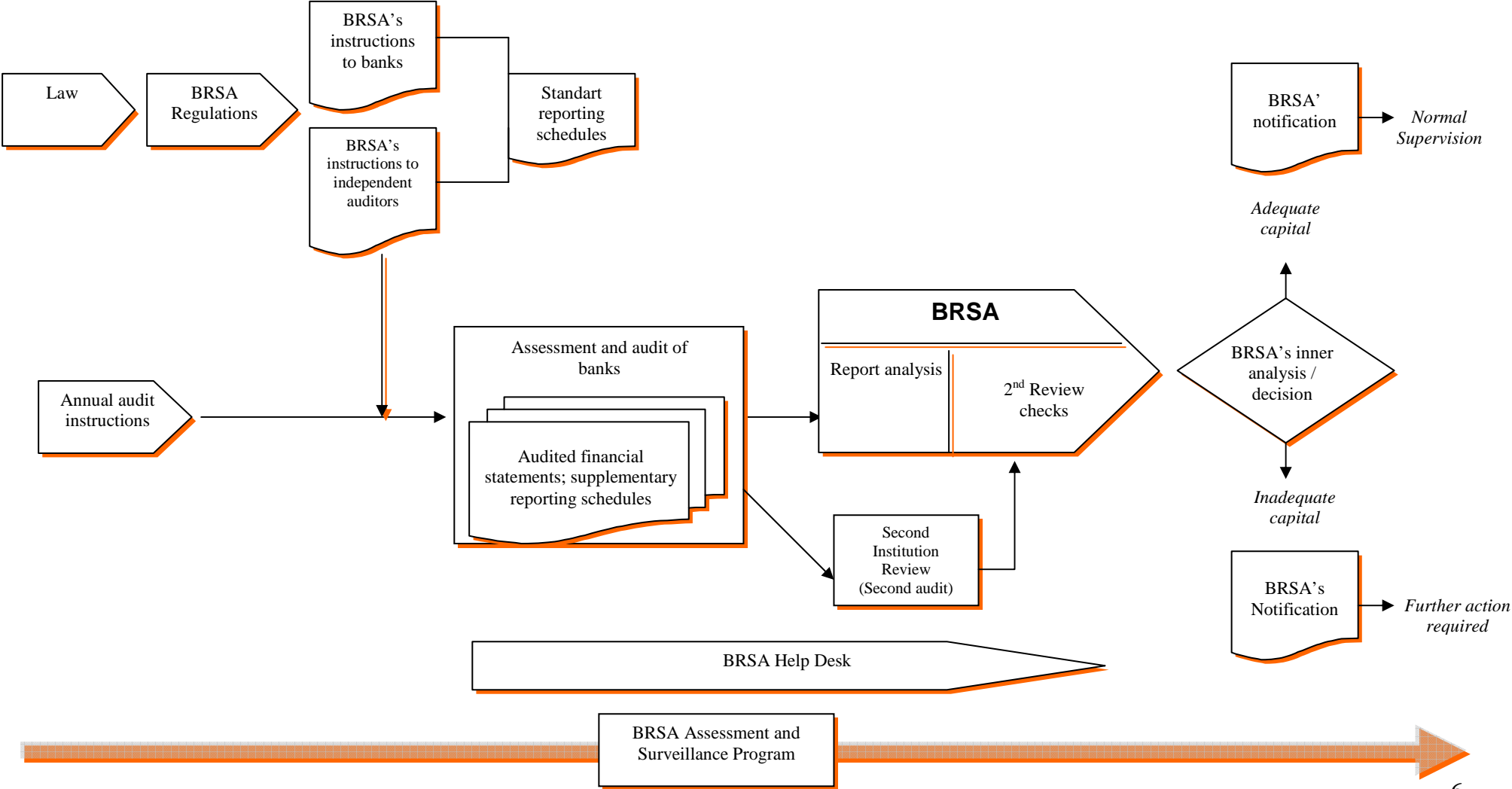
### 2.1.1 First independent audit

Besides financial statements of banks (balance-sheet, income statement, cash flow statement, own funds table and supplements, as well as footnotes thereof) the first audit brings along the obligation for banks to prepare supplementary reporting schedules within the framework of detailed instructions by the BRSA. These supplementary reporting schedules, as well as the instructions for the preparation of these statements are defined in the Annex to the *Regulation on Principles and Procedures related to Private Independent Audits to be Carried Out According to Provisional Article 4 of the Banks' Act*. Instructions for preparing the supplementary reporting schedules and statements are focused on four areas:

- ✓ Capital adequacy,
- ✓ Credit Portfolio and counterpart risk,
- ✓ Risk groups to which the bank belongs,
- ✓ Structured transactions and other income recognition issues.

As detailed in the published regulations, every bank is responsible for preparing basic data for the completion of the reporting statements and supplementary reporting schedules included in the Annex of the regulations. The independent auditing institution that is to carry out the first phase of the audit, must, in addition to auditing the financial statements, examine the supplementary reporting schedules prepared by the banks, and complete specific sections of the report to be filled in by the auditor. Banks retain their responsibilities for consistent and accurate information to be supplied. The independent auditing institution is held responsible for their reporting on whether the bank-prepared schedules are consistent and accurate, and supplying adjustments when they are not.

# DIAGRAM 2: Assessment Phase (February 1 – May 15, 2002)



In preparing the financial statements and the supplementary reporting schedules, the accounting and reporting rules to be taken as a basis are: the specific regulation on the assessment process, BRSA regulations on accounting standards to be applied by banks, BRSA regulations on uniform chart of accounts, and other relevant announcements made by the BRSA and International Accounting Standards (IAS), respectively.

### **2.1.2 Special issues related to the preparation of financial statements**

Special issues related to the preparation of financial statements may be classified under four broad categories:

- ✓ Inflation accounting,
- ✓ Consolidated reporting,
- ✓ Inclusion of material changes to financial statements after December 2001,
- ✓ Special issues related to the assessment.

#### *a) Inflation accounting*

The bank's actual financial status requires that the financial statements be prepared so as to reflect the current purchasing power of the currency. Therefore, the principle of application of inflation accounting is taken as a basis in the preparation of financial statements.

In the restatement (as the assessment is based on different rules than previously required) of financial statements in accordance with the framework of inflation accounting, an indexation adjustment factor calculated based on the wholesale price index will be used. Within this framework, the items subject to a restatement will be balance-sheet items such as depreciation, subsidiaries, affiliated companies, reserved securities (including those that are held for reserve and liquidity requirements) and other share transactions, along with own funds and all income statement items. Monetary items on the balance-sheet and non-monetary items evaluated at their current value are excluded from this restatement (such as FX, precious metals and shares).

In cases where the amounts restated within this framework exceed the current value, the amounts in question will be stated based on their market value by establishing an adequate provision. The profits and losses arising from this restatement will be recorded under the "net currency position profit (loss) account" on the income statement.

*b) Reporting and Auditing on a Consolidated and Bank only Basis*

Banks must prepare consolidated financial statements if the bank is the parent entity and the parent has one or more financial institutions over which the bank has effective control (the “financial group”). The independent audit must be performed on these consolidated financial statements as well as the bank only financial statements. This will allow the depositors, investors and other interested parties to be well informed about the financial position and performance of the financial group.

*c) Taking into account events occurring after the balance-sheet date*

The auditors are not only responsible for the auditing of balance-sheets dated 31.12.2001, but also for taking into consideration the impact on the financial statements of events occurring after the balance sheet date up to 31.03.2002 or up to the date of submission of the financial statements and audit reports to BRSA.

*d) Special issues related to assessment*

As a part of determining the banks’ actual financial status, non-monetary items in the financial statements will be subject to a restatement through the use of inflation accounting, while monetary items will be evaluated within the framework of existing regulations. Notable aspects of these regulations are summarized below.

✓ *Loan portfolio assessment and provisioning*

Taking the bank’s balances classified as standard and closely monitored, the auditor will ensure that the audit coverage achieved from the total of cash and non-cash credits in the commercial loan portfolio and other receivables portfolios is the higher of 75 percent of the combined portfolios by value or the largest 200 customer exposures.

All loans extended to the risk group to which the bank is linked are to be included within the scope of this analysis. Moreover, if one loan becomes a non-performing loan (NPL), then all loans extended to members of that borrower’s risk group will be subject to specific audit.

The valuation of collateral taken by banks in exchange for the loans the banks extend is to be checked by the auditor using either independent expert reports or real estate valuation company reports, depending on the nature of the collateral in question.

✓ *Evaluation of derivative instruments*

Forward and option agreements along with other similar agreements and structured financial products will be checked accordance with criteria stated in the regulation to determine validity. The required adjustments are to be proposed by the auditor for transactions regarded as fictitious. It is of particular importance that the auditor is required to ensure that the accounting policies applied reflect the economic substance of events and transactions and not merely their legal form.

✓ *Accounts which do not have the nature of free deposit accounts*

Banks' deposits, and assets having the nature of deposits, along with FX accounts which have not been found to be free deposit accounts in other banks, both in the country and abroad, will be transferred to the related accounts. This will ensure that the banks comply with the relevant regulations including the provisioning rules for assets, which in substance are illiquid and carry risk.

✓ *Evaluation of swap bonds*

FX denominated securities issued within the framework of the swap operation transacted in June 2001 will be reevaluated through indexation of their yield rate to the swap rate, and through the discount rate obtained by a 1-point reduction from the eurobond interest rate.

When compared with eurobonds, swap bonds have a six month shorter maturity period and their yields vary according to maturities. As the risk premium of eurobonds varies according to maturities, and as there is a declining trend in yields, the discount rate shall be calculated by a reduction based on the eurobond interest rate.

✓ *Evaluation of FX-accounts*

In those cases where the valuation exchange rate to be used in the valuation of FX accounts has not been defined, the rate to be used will be the FX purchasing rate on the date of the banks' balance-sheet. This rate should not differ by more than +/- 2,5 percent from the exchange rate of the CBT on the same date.

*e) First independent audit report*

The audit to be carried out by independent auditing institutions in the first phase of the assessment process is a more comprehensive exercise compared to the ordinary annual audits. In addition to issues the auditors take into account in their ordinary annual audit, the independent auditing institutions must, for this first independent audit, include in their report whether the audit has been carried

out in accordance with the instructions stipulated in the regulation, along with their consideration of events occurring during the period of the audit and their influence on the bank's financial statements. The audit reports prepared in accordance with this framework are to be submitted to the BRSA by the auditors along with consolidated and unconsolidated financial statements including final adjustments and supplementary reporting schedules.

The report to be prepared as a result of the audit carried out will also include the bank's CAR calculated both on a consolidated and unconsolidated basis. In case either of these ratios is below 8 percent, the amount of capital necessary to bring each ratio up to 8 percent will be calculated and reported. In the calculation of the CAR, market risk will be included using the standard method.

The audit report prepared by the first institution is to be submitted to the BRSA no later than 01.04.2002.

### **2.1.3 Control of first audit's compliance with independent audit principles and procedures: second institution review**

The second institution to be designated by the BRSA will check the bank's compliance with the regulations and instructions in preparing the financial statements and completing the supplementary reporting schedules, as well as review the reports of and adjustments raised by the first auditor, ensuring that the audit carried out by the first institution has been in accordance with BRSA's published principles and procedures for independent audits. The second institution will clearly state the deficiencies, mistakes and differences in opinion which it has found in the bank's financial statements and supplementary reporting schedules, as well as in the reports prepared by the first institution, which it deems likely to have an impact on financial statements. The second institution will submit its report to the BRSA within 15 working days from the date on which it has received the bank's financial statements and supplementary reporting schedules and the report prepared by the first institution.

Regulations on the principles and procedures related to the second institution review will be announced separately.

### **2.1.4 Help Desk**

A help desk has been established to provide prompt, appropriate and consistent solutions for the problems that may be faced by the banks or the auditing institutions during the assessment process.

### **2.1.5 Final assessment to be made by the BRSA**

The financial statements and supplementary reporting schedules prepared by the banks and the reports prepared by the independent audit institutions will be compared with the evaluations made for each bank as a result of surveillance and on-site supervision activities by the BRSA. Within this framework, BRSA will consult with the bank and the auditing institutions, as appropriate, and make a final assessment of the bank's financial statements.

Banks' financial statements which are in compliance with the Regulation's provisions based on the assessments made by the two independent audit institutions and by the Agency, and which, based on the independent audit institutions' reports, have a capital adequacy standard ratio under 8 percent, the BRSA will notify the bank of the required capital amount.

### **2.2 Strengthening of Banks' Capital by Shareholders**

The second phase of the recapitalization process starts with BRSA's notification to the banks. This process which may be referred to as the "strengthening of Banks' capital by shareholders" phase comprises the following:

- ✓ convening of ordinary general assemblies by all the banks,
- ✓ the presentation to the shareholders of the actual financial situations of the banks as determined in the first phase assessments, and,
- ✓ for the banks whose capital adequacy standard ratio is under 8 percent, the required recapitalization resolutions to be made by shareholders in an extraordinary general assembly meeting to be held on the same day together with other required resolutions.

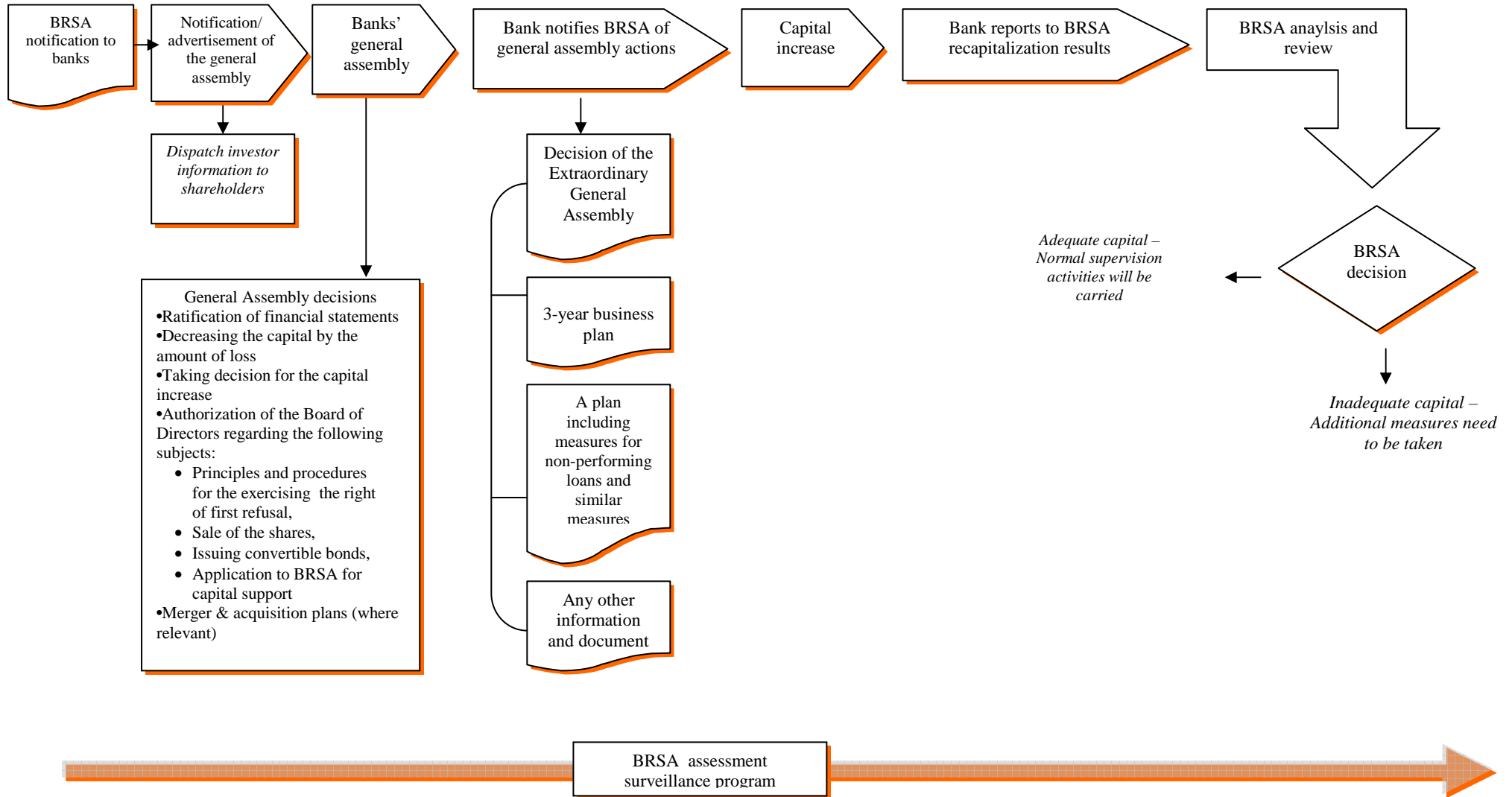
The flow plan concerning the strengthening of Banks' capital by shareholders phase is provided in Diagram 3. The schedule setting out the Phase 2 process is given in Diagram 4.

#### **2.2.1 Consequences on banks of BRSA's notification**

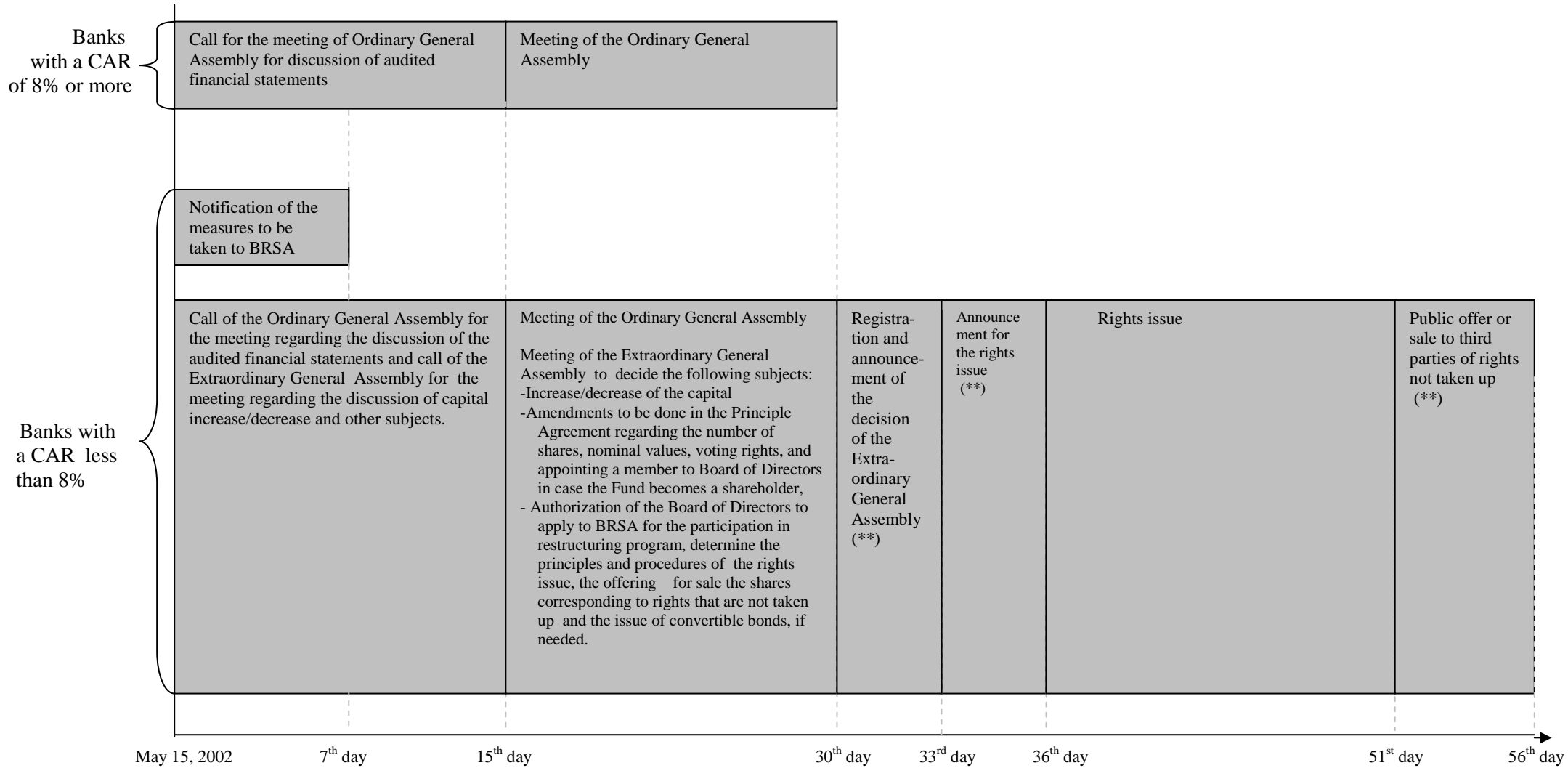
Banks whose capital adequacy standard ratio is 8 percent or more will present to shareholders the bank's balance sheet and profit and loss accounts, as forwarded to them by the BRSA, in accordance with the general provisions of the ordinary general assembly meetings of the banks which have already been postponed.

Banks which are not able to cover their losses with existing reserves, based on the results of the Phase 1 assessments, will be notified by the Agency to increase their capital and to take additional measures.

## DIAGRAM 3: Bank Recapitalization Phase (May 15 – June 30, 2002)



## DIAGRAM 4: Schedule for Bank Recapitalization Process (\*)



(\*) shows the deadlines for the completion of the related activities. (\*\*) in terms of working day.

Starting with the date of receiving the notification, the banks whose capital adequacy standard ratio is under 8 percent will:

- ✓ submit the measures that will be taken to the Agency within seven days
- ✓ convene their ordinary general assemblies within fifteen days in order to ratify their audited financial statements,
- ✓ convene their extraordinary general assemblies within fifteen days in order to decrease/increase capital and to resolve all other issues that need to be ratified according to the Regulation.

Banks whose capital must be increased will come to a decision about capital restructuring requirements and actions in their extraordinary general assemblies. Furthermore, in the extraordinary general assembly meetings, the shareholders must resolve to authorize an irrevocable contractual arrangement enabling the Fund to nominate members to the board of directors in cases where the Fund becomes a shareholder of the bank. Also, the board of directors will need to be authorized by the shareholders regarding the usage of the right of first refusal, the issuance of ordinary share capital for subscription by the Fund together with providing suitable security to the Fund to address risks of moral hazard, and, issuance and sale of convertible subordinated bonds in connection with the restructuring program.

### **2.2.2 Regulations speeding up the capital increase process**

Regulations speeding up the extraordinary general assemblies' meetings, decision procedures and the implementation of decisions are as following:

- ✓ The minimum number of general assembly members required for the meeting to take place has been brought down to 50 percent, and the minimum number of votes required for decision-making has been brought down to a simple majority.
- ✓ The condition that certain decisions be ratified by the preferred shareholders' general assembly has been removed.
- ✓ The announcement period for the extraordinary general assembly has been shortened, and the registration and announcement procedures have been simplified.

### **2.2.3 Informing Public and Investors in Publicly Listed Banks**

While regulations speeding up the capital increase process are being established, keeping the public informed as well as protecting the rights of the minority shareholders have been taken into consideration.

To ensure that the General Assemblies which are to take into consideration the banks' actual financial situations as determined in the first phase assessments, the banks' ordinary general assembly meetings in respect of their activities for the year ended 31 December 2001 have been postponed until the banks receive their respective notification letters from the BRSA. Accordingly, the banks involved in the recapitalization process will not publish their financial statements, which are to be made available according to the Capital Market Act, the Commercial Act and other relevant regulations, will not be published until the General Assembly Meetings mentioned in the Regulation. Each participating bank's interim (first quarter) financial statements will also not be published until these General Assembly Meetings are held.

By waiting for the two-phased independent audit assessments to be completed, together with BRSA surveillance and supervision assessment results will enable the public and, in particular, all investors to obtain recent independently audited and assessed information concerning the financial situation of each of the banks.

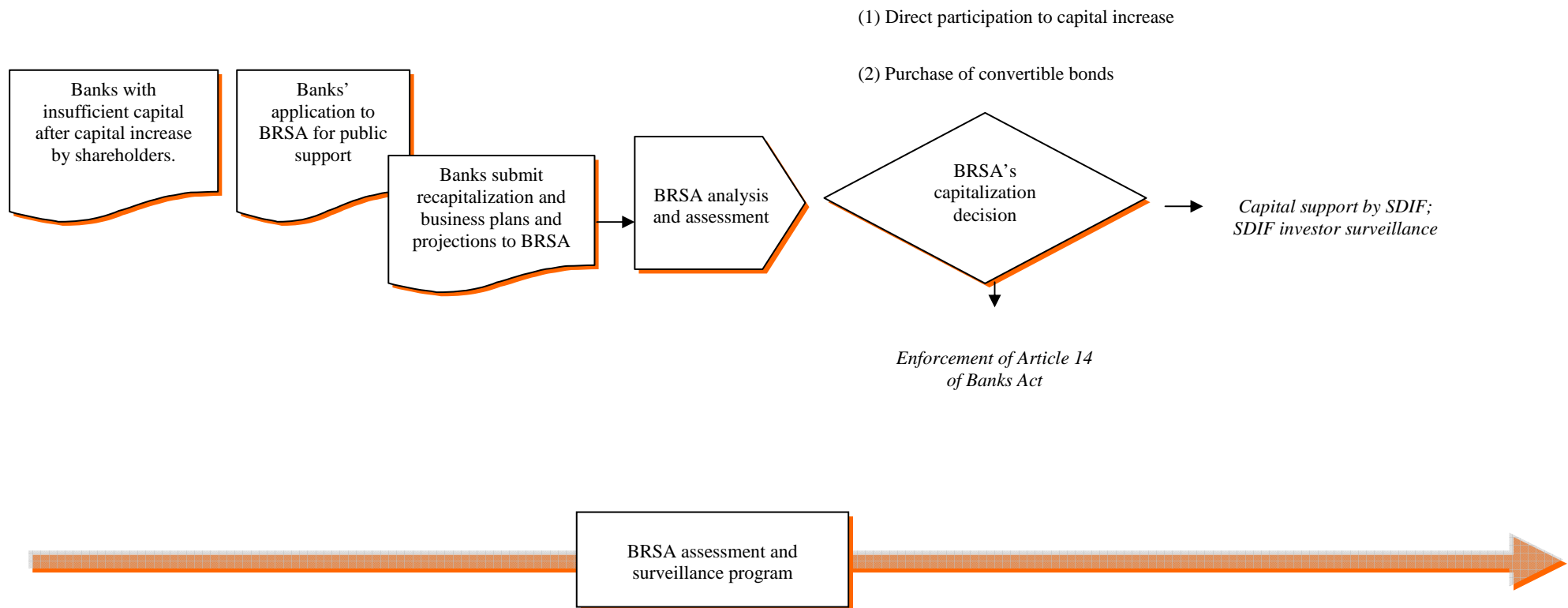
Within the framework of providing investors and the public with relevant and reliable information that is significant in the recapitalization process, the following additional steps are being taken:

- ✓ Minority shareholders with rights for the subscription to additional shares in their banks are to be informed at the end of the first five days of capital increase period, and prior to their subscription deadline, by the ISE (Istanbul Stock Exchange) of the commitments made by the major shareholders regarding their subscription to the capital increase.
- ✓ Banks must provide the public with accurate and sufficient information in accordance with detailed requirements of an information memorandum/prospectus for the rights issue.
- ✓ BRSA will review and approve the offering memorandum or prospectus for the rights issue.

### **2.3 State Recapitalization Phase**

The banks that are not able to bring their capital adequacy ratios to 8 percent, despite the measures taken and the capital increase resulting from decisions taken at by the General Assembly, may participate in the capital support program, which is the third phase of the recapitalization program. This program is summarized in Diagram 5.

## DIAGRAM 5: State Recapitalization Phase (June 30, 2002 and after)



### **2.3.1 Application to the Agency**

The Banks, which want to participate in capital support program, will apply to the BRSA with the following:

- ✓ the decision of extraordinary general assembly to apply,
- ✓ 3-year business plan,
- ✓ a plan including measures to be taken by the bank, such as resolving non-performing loans, to strengthen the asset structure,
- ✓ any other information and documents that the Agency requires.

### **2.3.2 Assessment principles of the Agency**

The Board will decide whether the capital support will be provided or not, the amount and the form of the support, in accordance with the capital increases achieved and all the information submitted, within the context of the request made by the bank.

The Board can decide to take the following actions separately or together;

- ✓ Injection of capital to reach a capital adequacy standard ratio of 5 percent, for banks with capital adequacy ratio greater than 0 percent but less than 5 percent and a market share of at least 1 percent as of September 30, 2001, provided that the proposed contribution of the SDIF does not exceed the positive qualifying contributions made by the shareholders and other participants in the capital increase,
- ✓ Regardless of the bank's market share, provision of subordinated debt in the form of 7-year convertible bonds to reach a capital adequacy standard ratio of 9 percent, to the banks that have a capital adequacy standard ratio of 5 percent or more.

The decision of the Board regarding the provision of the public support will, in the keeping with the transparency principle, be publicized in the Official Gazette within five days, and all transactions regarding the capital support are to be completed within fifteen days.

### **2.3.3 Source of the support**

The capital contribution to the bank by the Fund will take the form of government securities issued at market terms. The amount extended as subordinated debt will take the form of government bonds with a 7-year maturity, and 2-year non-repayment period, and will carry a maximum spread of 5 percent.

### **2.3.4 Measures taken to secure public funds**

In the process of providing capital support, commitments of majority shareholders will be taken in order to secure the public support. Also, additional requirements are stated in the Regulation:

*In case of provision of capital (Tier 1 capital) support:*

- ✓ Banks can not distribute dividend without the prior written approval of the Board,
- ✓ BRSA, for the periods it will decide, will request reports from participating banks concerning compliance with their business plan and may take measures regarding these reports.
- ✓ If the Banks do not take the required measures, despite notification by BRSA of the measures that need to be taken, the provisions of Article No. 14 of Banks Act will be applied.
- ✓ The fraction of the shares of majority shareholders corresponding to amount provided by the Fund will be pledged to the Fund by the majority shareholders in order to secure the capital contribution.
- ✓ The pledged shares cannot be seized, transferred or pledged to third parties; and preliminary seizure or injunction cannot be applied
- ✓ The majority shareholders commit to cover the potential difference between the consideration arising from the sale to third parties of the Fund's shareholding and the costs incurred by the Fund in initially acquiring the shares, through the transfer of the ownership of the pledged shares from the majority shareholders to the Fund.
- ✓ The majority shareholders commit not to transfer to third parties any shares they hold that are not subject to the pledge before the sale of all the Fund's shares in the bank.
- ✓ Majority shareholders can in the first instance buy the Fund's shares by exercising their first right of refusal. The price of these shares cannot be less than the cost incurred by the Fund.

*In case of the provision of the subordinated debt (Tier 2 capital):*

- ✓ Banks cannot distribute dividends without the prior written approval of the Board.
- ✓ The fraction of the bonds which are not paid back at their maturity or any unpaid interest accrued will be converted into shares.
- ✓ In banks whose capital adequacy standard ratio declines below 5 percent over time, the subordinated debt will be converted into shares. In the conversion process, the "recalculated capital" which is loss-deducted capital to arrive at a net asset value per share will

be taken into consideration for the valuation of the conversion price.

- ✓ The lowest one of three alternate values: net asset value per share, the value of shares issued by the bank during the capital support program, and the current market value of shares, will be taken as the basis price for the conversion of the bonds into shares.
- ✓ The general assembly or the board of directors of a bank cannot make a decision that can prevent the exercising of the rights arising from convertible bonds.
- ✓ Banks cannot transfer the government bonds they hold as subordinated debt granted to third parties without the prior written approval of the Agency.

### **3. Exit of the Public Sector from the System**

The public sector policy for support to banks is the result of the extraordinary conditions brought about by the economic crisis, and will be applied temporarily and one time only. It is envisaged that the public support in the bank capital strengthening program will be phased out gradually, by ensuring normalization both in the banking sector and in the economy, more generally.

In this context, shares held by the public sector as a result of capital support may not only be sold to existing shareholders, but also may be sold to third parties. Repayment of subordinated debt prior to maturity is also possible.

#### **3.1 Exit through Share Transfer Agreement to be signed with Majority Shareholders**

Major shareholders of the banks receiving public support retain the right to repurchase the shares held by SDIF in parallel with the improvement on their financial structure. With this aim, a sale contract between SDIF and majority shareholders can be signed during the recapitalization operation, the minimum conditions of which are the following;

- ✓ The selling price is the total amount comprising the nominal value of government bonds issued for the acquisition of the shares, plus the compounded interest including an added 5 percent spread to the interest rate, which is to be determined by the Treasury.
- ✓ The payments will be made in quarterly installments within 18 months.
- ✓ The possession and title of the SDIF held shares shall only be transferred to the majority shareholders upon receipt of the final payment.

- ✓ If the majority shareholders default on the payment schedule, then the agreement would be annulled and the majority shareholders would be repaid only the principal amounts they have paid.

### **3.2 Exit through Sale of Shares to Third Parties**

SDIF's shares can be sold to third parties. If SDIF puts its shares for sale in the 18 months following the recapitalization operation, majority shareholders may exercise their right of first refusal.

- ✓ Shares will be put up for sale by bid, auction or private placement.
- ✓ The announcement of the sale will be published in the Official Gazette.
- ✓ In case of a sale within the first 18 months following the provision of public support, the majority shareholders will be advised of the potential sale and provided with an opportunity to exercise their first right of refusal.
- ✓ Shareholders wishing to make use of their right of first refusal should apply to the BRSA within 15 days following the announcement in the Official Gazette.
- ✓ In this circumstance, the majority shareholders may exercise their right of first refusal by paying the highest of the following alternatives: the cost price, the net book value per share, or the market price. SDIF can sell the shares to third parties if the right of first refusal is not exercised by the majority shareholder.
- ✓ If the selling price to third parties is less than the cost price, then the majority shareholders, through their transfer of the pledged shares to the SDIF, will cover the loss which otherwise would have been borne by the public.

### **3.3 Exit related to Bonds Convertible into Shares**

The public sector will exit its investment in bonds issued by the bank with the repayment by the bank, of the capital and accumulated interest of the sources under the form of subordinated debt on due-date. The subordinated debt can also be paid back before the maturity date by the bank, or sold to the majority shareholders.

- ✓ Banks may, by paying the interest and other costs by cash and with BRSA approval, repurchase the bonds prior to maturity.
- ✓ Unpaid subordinated debt and accumulated but unpaid interest can be converted into shares at BRSA discretion.
- ✓ In a situation where the required capital increase cannot be achieved by the shareholders in a bank where the CAR has

declined below 5 percent, the SDIF will convert the bonds into shares. A new write down of capital will be required to establish the new net asset value per share as at the conversion date.

- ✓ In this conversion transaction, the conversion price will be the lowest of the following: the bank's most recent net asset value per share, the nominal value of the shares or, the market price of the shares.

## **4. Other Issues**

The Bank Capital Strengthening Program targets the restoration of a healthy structure to the sector to ensure efficient financial intermediation. The program encourages mergers and acquisitions in order to increase cost effectiveness and efficiency. Furthermore, in order to encourage banks to resume their intermediation role and to continue lending, the law stipulates that public resources used for capital increase are to be lent to the real sector in accordance with prudent banking practices.

### **4.1 Incentives for Mergers and Acquisitions**

The Capital Strengthening Program encourages small banks to effect commercially justified mergers and acquisitions. Private commercial banks with an asset market share below 1 percent (as of September 2001) may apply for Tier 1 capital contribution by the SDIF, provided that they meet this threshold through approved mergers or acquisitions. Banks with an asset market share below 1 percent should apply to the BRSA for pre-approval of mergers or acquisitions by 30 April 2002.

In performing a merger or acquisition, detailed instructions for banks and first auditing institutions will additionally be defined through a separate regulation and announced to the public as "Detailed Instructions for Banks and Auditors/ Supplementary Reporting Schedules for Mergers and Acquisitions"

### **4.2 Actions to Minimize Credit Crunch**

In order to jump-start the financial intermediation process, banks are to offer to real sector companies outside their group, the amount equivalent to at least 60 percent of the public support (in form of tier-1 capital injection) provided to them by June 30, 2003.

### **4.3 Fulfillment of Tax Liabilities during Recapitalization Period**

The assessment phase of the Banks' Financial Statements dated 31 December 2001 will cause delays in finalizing these financial statements and thus the determination of the provisional tax and corporate tax bases of the

banks. Due to this delay, banks have applied to the Ministry of Finance with a request of counting this delay as a force majeure (extraordinary events beyond ones' control) mentioned in Section 13 of Tax Procedure Law. The Ministry of Finance allows an additional period to the banks for preparing their provisional tax returns due such extraordinary events.

#### **4.4 Accordance with Prudential Regulations during Assessment Phase**

Certain prudential regulations take into account the bank's equity, own funds or other financial measures that will be subject to the assessment process. During the period of the assessment process, the banks are to use their own calculations of these variables in determining the lending limits, capital adequacy ratios and other reporting requirements that are subject to prudential regulations.

The banks need to comply with the prudential regulations based on the bank's revised financial statements within 6 months after the finalization of the assessment results, as notified by the BRSA.

### **5. Conclusion**

The Bank Capital Strengthening Program is to be applied in a transparent fashion, with clear and objective criteria and in accordance with an appropriate timetable to ensure that the program is both effective and rapid. In addition to providing a comprehensive one-time only solution to the lack of capital from a macroeconomic perspective, the program adopts a rigorous approach in dealing with the structural and operational problems that exist in the Turkish banking sector. In order to ensure domestic and international confidence in a recapitalization program that includes use of public funds for the restructuring of banks, the BRSA gives particular importance to the following aspects of the recapitalization program:

- ✓ Effective use of international experience,
- ✓ Transparent and fair assessment,
- ✓ Uniform treatment of all participating banks,
- ✓ Adequate and timely provision of information to the public,
- ✓ Mechanisms to protect minority shareholder rights, and,
- ✓ Mechanisms to ensure an efficient and prudent use of public funds with appropriate incentives and safeguards.

The following benefits are to be obtained from a successful application of the program:

- ✓ Maximize participation by bank owners and shareholders in increasing banks' capital.
- ✓ Minimize the costs of bank restructuring.
- ✓ Create an appropriate environment for viable mergers and acquisitions.
- ✓ Create a transparent and adequately capitalized banking sector and thereby increase confidence in the sector.
- ✓ As banks would be adequately capitalized they would be more willing to participate in corporate loan restructuring agreements and to establish viable asset management companies.
- ✓ A transparent and sound banking system is likely to attract higher participation from local and foreign investors.
- ✓ Create an appropriate environment to gradually phase out the full deposit guarantee mechanism that has historically had a negative effect on market discipline.

The successful implementation of the Bank Capital Strengthening Program, the Istanbul approach on corporate loan restructuring agreements and the establishment of asset management companies will clearly be a challenge for the banking sector, the corporate sector and the regulatory authorities. However, the program also holds the key to overcoming the structural problems of the Turkish banking sector and implementing appropriate accounting standards, leading to a sound and competitive banking sector.