



BANKING REGULATION AND SUPERVISION AGENCY

BANK CAPITAL STRENGTHENING PROGRAM

Progress Report

21 June 2002

INDEX

1. INTRODUCTION	2
2. AUDIT AND ASSESSMENT PHASE OF THE BANK CAPITAL STRENGTHENING PROGRAM	3
3. RESULTS OF THE AUDITING AND ASSESSMENT PHASE	8
3.1 Asset Structure	9
3.1.1 Classification of Loans	10
3.1.2 Collateral Valuation and Loan Loss Provisions	12
3.1.3 Subsidiaries, Affiliates and Fixed Assets	13
3.2 Liability Structure	14
3.2.1 Own Funds	15
3.2.2 Profit- Loss	16
3.3 Off-Balance Sheet Transactions	16
3.4 Capital Adequacy Ratio (CAR)	17
4. CONCLUSION	21

1. Introduction

The “Banking Sector Restructuring Program” has been initiated by the Banking Regulation and Supervision Agency (BRSA) as of 15.05.2001 to bring forth permanent solutions to the problems of the banking sector and to promote the necessary operating environment for a sound banking system. Within the framework of the Act No. 4743 published on 31.01.2002, this Program has been reinforced through additional instruments and the legal framework for a potential state recapitalization of privately-owned banks has been established.

The following were the guiding principles utilized in the design of the “Bank Capital Strengthening Program.”

- ✓ The process shall be subject to clear and objective rules,
- ✓ Equal and fair treatment of all banks,
- ✓ Transparency of the process and adequate public disclosure at each stage,
- ✓ Incentives for banks’ shareholders to increase capital,
- ✓ Encouraging merger and acquisitions,
- ✓ Limiting costs of restructuring through prompt intervention and limited/controlled provision of state funds,
- ✓ Avoidance of any moral hazard effects through provisions of guarantees and safeguards for the public funds injected.

With the completion of the “audit and assessment phase” of the Program, the financial status of the banks has been established. In the second phase, which is in progress, banks are to increase their capital through their own resources. For those banks that have insufficient but above a certain level of capital, provision of support from public resources may be considered in the final stage.

In accordance with the transparency principle, the results of “audit and assessment phase” were announced to the public on 13.06.2002. In the announcement, developments regarding 24 of the 27 banks under the scope of the program have been stated. Due to the fact that the BRSA’s evaluation of the proposal by Çukurova Group regarding the acquisition of Pamukbank by Yapi Kredi Bank was not finalized and that Milli Aydın Bank has been taken over by the Savings Deposit Insurance Fund (SDIF), the banks in question have been excluded from the announcement.

On 19.06.2002, the BRSA announced to the public that the plan and feasibility report regarding the acquisition of Pamukbank, which had negative capital adequacy, by Yapi Kredi Bank was not found viable and Pamukbank was taken over by the SDIF.

This report aims to provide detailed information to the public about the results of the “audit and assessment phase” of the “Bank Capital Strengthening Program”. The evaluations set out in the report comprise 25 banks as Pamukbank and Milli Aydın Bank have been taken over by the SDIF.

2. Audit and Assessment Phase of the Bank Capital Strengthening Program

The recapitalization program consists of three phases as summarized in Figure 1.

A three-stage audit procedure has been utilized in order to establish a realistic financial status of each bank. First audit was conducted by the independent audit company appointed by the bank. A second audit by a different independent audit company was conducted to ensure that the first audit was done according to agreed-upon principles. A third and final audit was conducted by the Sworn Bank Auditors of the BRSA. This multi-phase auditing procedure is applied so as to minimize conflicts and increase reliability.

In order to ensure standardization in the audit process, the principles and detailed procedures to be followed by the banks and independent audit institutions have been published. The “Help Desk” established within the BRSA provided technical support to the independent auditors regarding the procedures in order to ensure the consistency of the audit process.

Standard reports prepared on a bank basis resulting from the three-phase audit have been subject to BRSA’s own evaluations. A “working group” for each bank has been established on a bank basis under the coordination of an upper committee.

In order to determine the capital needs in a realistic manner, a dynamic approach has been adopted, and positive as well as negative developments

after 31.12.2001 which have affected the financial position of a bank have been taken into consideration. Meetings have been held with banks regarding the evaluations of the BRSA. Finally, the capital needs of the banks under the scope of the program were announced to the public on 13.06.2002 and 19.06.2002.

The BRSA announcement dated 13.06.2002 covered the developments of 24 banks. Due to the fact that the proposal by the Çukurova Group regarding the acquisition of Pamukbank by Yapi Kredi Bank was being evaluated by the BRSA, the announcement did not include information about these two banks.

The assessment of the BRSA on the acquisition proposal has been finalized as of 19.06.2002. The following decisions were made:

- The proposal of Pamukbank's acquisition by Yapi Kredi Bank would damage the financial structure of Yapi Kredi Bank given the capital need of Pamukbank, which is assessed as close to \$ 2 bn as of 2001 year-end, and thus the plan and feasibility reports submitted were found inapplicable.
- Pamukbank did not take the measures instructed by the BRSA in accordance with paragraphs (1) and (2) of the Article 14 of the Banks' Act and that even if it were to take these measures at the current period, there is no possibility to strengthen its financial structure.
- The total of Pamukbank's liabilities exceeds the total value of its assets.
- The continuation of its banking activities would threaten depositors' rights as well as the safety and soundness of the financial system.

Thus, it was decided that the shareholder rights (except dividend rights) and management and supervision of Pamukbank be transferred to the Savings Deposit Insurance Fund in accordance with Article 14 paragraphs (3) and (4) along with the provisional Article 4 of the Banks' Act No. 4389.

PAMUKBANK

Pamukbank, the seventh biggest bank of the Turkish Banking Sector, accounts for 5.5 percent of the total assets, 12.7 percent of the total loans and 6.2 percent of the deposits of the Turkish Banking Sector. Based on the audit results, the total assets of the bank amounted to TL 6.3 quadrillion (\$4 bn) as of December 2001. The loan portfolio of the bank amounted to TL 5.5 quadrillion (\$3.5 bn) of which TL 4.2 quadrillion (\$2.7 bn) has been classified as non-performing after the audit and the rediscounts (accumulated unpaid interest outstanding balance) have been cancelled and provisions have been set aside for the remaining amount.

As a result of the audits, it has been determined that the bank has incurred large amounts of losses and that these losses have been growing in time due to the fact that principal and interest on group loans were not collected and that income was generated through charging accumulated unpaid interests on these non-performing loans.

Main indicators of the bank as of December 2001 are provided below.

	(Trillion TL)	(Mn \$)*
<i>Total Assets</i>	6.273	4.096
<i>Loans</i>	1.264	825
<i>Non-performing Loans</i>	1.224	799
<i>Provisions Set Aside</i>	349	228
<i>Non-performing Loans (net)</i>	874	570
<i>Deposits</i>	7.429	4.851
<i>Own-Funds</i>	-2.288	-1.494
<i>Capital Adequacy Standard Ratio (%)</i>	-46.2	-46.2
<i>Capital Need to reach %8</i>	2.963	1.935

As apparent from these indicators, the fact that the own funds took negative values led to extremely high levels of resource needs. In determining the capital adequacy of the bank, no correction procedure has been made regarding the receivables from Fiskobirlik (The Union of Agricultural Cooperatives for the Sale of Hazelnut) due to the fact that the legal conflict concerning the receivables from Fiskobirlik has not yet been settled.

There has not been any operation towards liquidation of Pamukbank which has been transferred to the Savings Deposit Insurance Fund as of 18.06.2002. Closing its branches or lowering the number of the personnel is not being considered in the short-term. The necessary support will be provided to Pamukbank and it will continue to perform all its banking activities and meet its commitments under the ownership of the SDIF. The sale process of Pamukbank by the SDIF will be initiated as soon as possible.

() The CBRT F/X purchase rate as of 21.06.2002 has been used in the conversions.*

YAPI KREDI BANK

The proposal of Çukurova Group for the acquisition of Pamukbank by Yapi Kredi Bank has not been found feasible and viable due to the high capital needs of Pamukbank. The adverse impact on the financial structure of Yapi Kredi Bank- which does not have a capital adequacy problem- as well as on the rights of the other shareholders has been taken into account during the decision-making process.

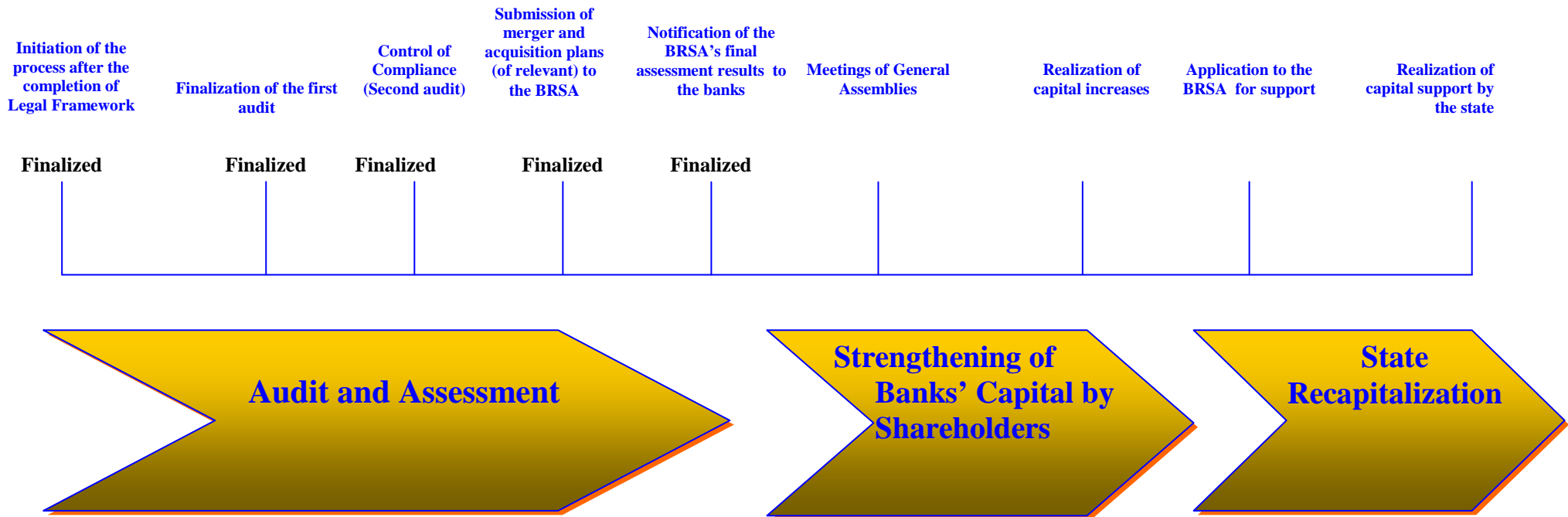
The capital adequacy ratio of Yapi Kredi Bank exceeds the minimum required level as of end-2001 and it has been concluded that the bank is not in need of capital. The capital adequacy ratio of Yapi Kredi Bank has been determined as 10.2% as of 31.12.2001. Loans extended to the group have been evaluated prudently and the provisions necessary have been set aside in the calculation of the ratio.

*However, upon the acquisition of Pamukbank by the SDIF, the shareholders of the bank are declared as unfit to meet the requirements to be a shareholder in accordance with the Banks' Act. The shareholders rights (except dividend rights) of these Çukurova Group members that hold directly or indirectly more than 10% at Yapi Kredi Bank have been transferred to the SDIF. In other words, **Yapi Kredi Bank will continue to perform its activities under the ownership of the existing shareholders** and the SDIF will exercise rights (except dividend rights) of these shareholders that lost the fit and proper criteria required by the Banks' Act. Within this framework, two new members have been appointed to replace the positions of the ex-members of the Board of Directors who have lost their qualifications to be a director.*

This application will continue until the stake in question is transferred to persons who meet the eligibility criteria stated in the Banks' Act. Technology firms of Çukurova Group will not be affected from this application in any way.

In the case that the negotiations are completed in a constructive way, the provisions set aside for group loans may be reversed, which would then lead to a higher capital adequacy ratio of the bank.

Figure 1: Phases of Bank Capital Strengthening Program



3. Results of the Audit and Assessment Phase¹

The capital needs of the 25 banks within the scope of the recapitalization program have been determined as TL 1.3 quadrillion (\$866 mn) during the evaluation phase. Following this, discussions have been carried out with banks, and a TL 1.1 quadrillion (\$720 mn) of the capital need has been covered as a result of the measures taken by the banks and other positive developments.

The main measures include a cash capital injection of TL 162 trillion (\$ 106mn) and a loan collection of TL 738 trillion (\$482mn) where TL 468 trillion (\$305mn) part of this amount consists of the collection of non-performing loans extended to majority shareholders. As these collections are related to non-performing loans, it is obvious that claims such as “The program forces the banks to attain the capital adequacy and therefore calls back active loans” have no ground. The 14% decrease in exchange rate risk due to banks closing their balance sheet open positions during the December 2001 - May 2002 period has reduced the capital requirements for market risk by TL 72 trillion (\$ 47mn). Together with the above-mentioned measures, the increase in the value of government papers in the securities portfolio by TL 130 trillion (\$85mn) has been an important development that reduced capital needs.

As a result of all these developments, the additional capital needs of the banks have been calculated as TL 224 trillion (\$ 146mn) and this has been announced to the public on June 13th, 2002 as the outcome of the “audit and assessment phase”. The capital need is to be covered by the banks, however, if necessary SDIF contribution may then be given a consideration.

¹ The CBRT F/X purchase rate as of 21.06.2002 has been used in the conversions.

TABLE 1: SUMMARY RESULTS OF AUDIT AND ASSESSMENT PHASE

	(Trillion TL)	(Million \$) (*)
Total Capital Need (I)	1.326	866
Measures Taken by Banks (II)	972	635
Cash Capital Increase	162	106
Correction of the Provisions Set Aside Previously Due to Collection of Non-Performing Loans (Cash)	738	482
-From Group Credits	468	306
-Other	270	176
Decrease in Capital Need Due to the Change in the Market Risk	72	47
Positive Developments in year 2002 (III)	130	85
Valuation of Securities	130	85
Remaining Capital Need (I-II-III)	224	146

(*) Based on the CBRT F/X purchase rate as of 21.06.2002.

3.1 Asset Structure

Prior to the audit phase of the bank recapitalization program, the asset size of the 25 banks within the scope of the program have been declared as TL 105.7 quadrillion (\$ 69bn).

Upon the completion of the audit and evaluation process, the asset size of the banks in subject has been determined as TL 102.1 quadrillion (\$ 66bn). Detailed information on asset composition is given in Table 2.

TABLE 2: CHANGE IN ASSET STRUCTURE (*) (Trillion TL)

	DECEMBER 2001	
	Pre-Audit	Post-Audit
Cash+ Banks+ Interbank Money Market Transactions + CBRT	20.829	19.777
Securities Portfolio + Fixed Securities	28.546	28.344
Loans	29.182	24.032
Non-Performing Loans (Net)	1.246	5.238
Non-Performing Loans (Gross)	2.334	7.821
Special Provision for Loans	1.088	2.583
Subsidiaries, Affiliates and Fixed Assets	11.468	10.942
Other assets	14.423	13.785
-Interest and Income Accruals and Rediscounts	6.701	6.014
Total	105.692	102.119

(*) The inflation accounting is applied on the values.

3.1.1 Classification of Loans

The analysis of the asset structure of the 25 banks reveals important revisions in loans and non-performing loans items.

In order to classify the loans in compliance with the regulations, within the framework of prudentiality principle, at least **75% of cash and non-cash loans of the bank's corporate loan portfolio including loans extended to 200 big customers have been analyzed.** In addition, all loans extended to the group that the bank belongs have been analyzed. While analyzing group loans, the emphasis was given to current performance and the payment capacity of the group firms.

Cross-checks on loan classification have been made through analyzing the risks of the debtors in each bank. Particular attention was paid to check whether or not there were banks systematically showing lower credit risks for the same companies. A comprehensive data set on individual firm basis has been prepared to determine with due care whether or not the loans appear in the appropriate category through comparisons among bank declarations, first and second audit results, sworn bank auditor reports and the SDIF and public bank loan portfolios.

The receivables of banks, especially in foreign subsidiary accounts, which are classified as current receivables, have been closely examined to ensure that these are free deposits. **It was determined that about TL 589 trillion (\$384 mn) of these deposits were actually non-performing loans provided to related parties.** Necessary provisions and corrections have been made by reclassifying these assets as a decrease in the "banks" item and an increase in non-performing loans item.

Finally, to ensure that loan classification has been made adequately, **accrued but not earned interest and income on non-performing loans has been written-off. Extensive work has been carried out to ensure adequate loan loss provisioning and appropriate collateral valuation.**

TABLE 3: CLASSIFICATION OF LOANS (Trillion TL)

	Pre-Audit	Post-Audit
Loans (I, II)	29.182	24.032
Non-Performing Loans (III, IV, V)	2.334	7.821
Provisions	1.088	2.583
Non-Performing Loans (Net)	1.246	5.238
Ratio of Transformation to Non-Performing Loans (*)	%7	%25

(*) Non-Performing Loans (Gross) / Loans+ Non-Performing Loans (Gross)

After the audit and assessment phase, **receivables classified as performing loans under the first and second group have been decreased from TL 29.2 quadrillion (\$ 19.1bn) to TL 24 quadrillion (\$ 15.7bn).**

The careful analysis of the loan portfolio indicated that the ratio of non-performing loans classified under group III, IV and V, which has been calculated at the level of 7% of total loans before the audit and assessment phase increased to 25% of total loans. The distribution of non-performing loans is shown in Table 4 and Figure 2.

TABLE 4: DISTRIBUTION OF NON-PERFORMING LOANS (Trillion TL)

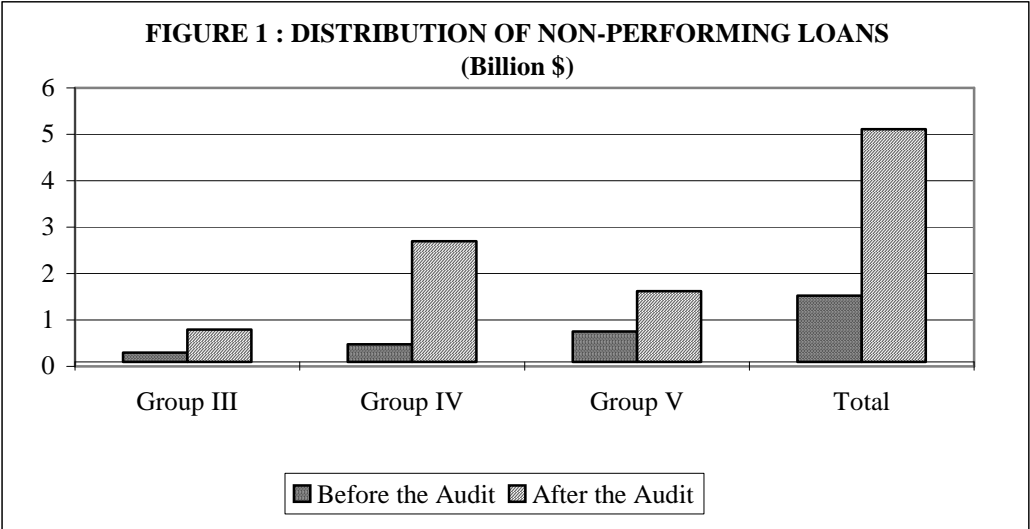
	Pre-Audit	% Share	Post-Audit	% Share
III. Limited Collection Possibility	455	20	1.217	16
IV. Doubtful Receivables	728	31	4.126	52
V. Loss	1.151	49	2.478	32
Total	2.334	100	7.821	100

The banks have TL 10 quadrillion (\$ 6.5bn) of collateral backing TL 7.8 quadrillion (\$ 5.1bn) non-performing receivables. However, based on the prudentiality principle within the scope of the Regulation on Provisions, the TL 5.2 quadrillion (\$ 3.4bn) of the collateral value has been accepted, and the banks have been requested to set aside an additional TL 2.5 quadrillion (\$1.6bn) in loan loss provisions.

The effects of the economic crises on bank balance sheets have been exposed in a transparent way and loan loss provisions have been reserved in a conservative and prudent manner. Such a prudent approach will help

banks cover potential losses that may occur in the future. Another factor that will protect the banks from future losses is the fact that the value of the collaterals has been carefully analyzed and evaluated conservatively.

With the continuation of the economic recovery, payments on non-performing loans are expected to improve, leading to a reversal of loan loss provisions for non-performing loans and hence to an increase in bank profits. Voluntary debt restructuring in the context of the “Istanbul Approach” and operation of asset management companies are expected to further support banks’ efforts in debt resolution.



(*) The CBRT F/X purchase rate as of 21.06.2002 has been used in the conversions.

3.1.2 Collateral Valuation and Loan Loss Provisions

The characteristics of the collaterals accepted by the banks for the loans they have extended have been examined and an analysis has been carried out to determine the current values of the collaterals by utilizing the reports prepared by experts or real estate valuation agencies. The current values have been compared with the book values and the necessary provisions have been set aside by taking the lowest of the current and the book value in the valuation of collaterals. The changes in the amount of collaterals resulting from the evaluations are as stated below.

TABLE 5: CLASSIFICATION OF COLLATERALS (*)

	Pre-Audit (Trillion TL)	Pre-Audit (%)	Post-Audit (Trillion TL)	Post-Audit (%)
I. Group	1.567	4,4	1.621	5,3
II. Group	13.971	39,0	13.236	43,6
III. Group	18.256	51,0	13.616	44,8
IV. Group	1.993	5,6	1.912	6,3
TOTAL	35.786	100,0	30.385	100,0

(*) The gross amount of collaterals are shown. The net collateral value is found by multiplying the gross collateral value by the collateral group coefficient.

As a result of the audit and assessment process, there has been a change in provision amounts in parallel with the reclassification of the loans. This is due to the fact that when extending loans, Turkish banks traditionally rely on collateral to secure the return of credit rather than taking into account project assessment and the expected re-payment capacity. Hence, the increase in non-performing loans did not translate into a one-to-one increase in loan loss provisions due to the high collateral values for such loans on the provisions to the same extent.

3.1.3 Subsidiaries, Affiliates and Fixed Assets

While inflation accounting was planned to apply to the whole banking sector starting from July 2002, it has been decided to reflect the inflation effects to the 2001 year-end financial statements of the banks covered by the “Bank Capital Strengthening Program” in order to determine their real financial status.

Within this framework, **non-monetary items such as subsidiaries, affiliates, fixed assets and depreciation, have been subjected to correction** in full accordance with the international standards. Monetary items and items valued by their current values such as foreign currency, precious metals, and stocks have been excluded from this correction. In cases where the corrected values were higher than the current values, the current values have been taken into account for the sake of prudence. Therefore, **hidden reserves and/or hidden losses have been exposed and the factors preventing the observation of the real financial status of banks have been removed.**

TABLE 6: NON-MONETARY ASSETS (*) (Trillion TL)

	DECEMBER 2001		
	Pre-Audit (Without Inflation Accounting)	Post-Audit (With Inflation Accounting)	Difference
Fixed Assets	2.304	5.570	3.266
Affiliates and Subsidiaries (Turkish Lira)	3.080	4.317	1.237
Total	5.384	9.887	4.503
Total Assets	100.994	102.119	
Non-Monetary Assets / Total Assets (%)	5,0	9,6	

(*) Total of subsidiaries, affiliates and fixed assets is different from the totals stated at Table 2 because Table 6 covers only the TL denominated non-monetary assets.

The date of inclusion of non-monetary assets to bank portfolios and the weight of the items in question in asset side directly affect the net monetary position profit/loss after correction. There have been some criticisms that the practice of inflation accounting is used as a means to allow some banks to meet the minimum required capital adequacy ratio.

However, the share of items subject to inflation accounting in total assets of 25 banks is only at the level of 5 % before correction. After inflation accounting, the non-monetary items to total assets ratio has increased to 9.6 %.

For 22 of 25 banks covered by the “Bank Capital Strengthening Program”, the non-monetary items to total assets ratio is below the average. Given the fact that the CAR of three banks, whose non-monetary assets are above the weighted average and which hold 77% of the difference arisen from the correction procedure, have been found to be well above the minimum level even without the application of inflation accounting procedure. Thus, the claims that capital needs of banks decreased due to inflation accounting have no grounds. Effects of the application of inflation accounting on capital adequacy have been examined in detail under Section 3.4 below.

3.2 Liability Structure

Changes occurred in the liabilities structure of the banks under the scope of program after the “audit and assessment phase” are summarized in Table 7.

TABLE 7: CHANGE IN THE LIABILITY STRUCTURE
(Trillion TL)

	DECEMBER 2001	
	Pre-Audit	Post-Inflation
Deposit	72.751	72.752
Interbank Money Market	711	711
Credits Received	12.677	12.677
Other Liabilities	5.511	5.403
Own Funds +Profit	14.042	10.574
Total	105.692	102.119

The application of inflation accounting has impact only on the own funds item of the liabilities.

3.2.1 Own Funds

Changes occurred in banks' own fund items under the scope of "Bank Capital Strengthening Program" are given in Table 8.

TABLE 8: EVOLUTION OF THE OWN FUND ITEMS (Trillion TL)

	DECEMBER 2001		
	Pre-Audit (Without Inflation Accounting)	Pre-Audit (With Inflation Accounting)	Post-Audit (With Inflation Accounting)
Paid-up Capital	5.248	5.248	5.248
Reserves	957	957	957
Revaluation Funds	2.168	18	474
Capital Reserve	0	12.643	13.564
Valuation Differences	0	1.143	973
Term Profit-Loss	1.155	-2.130	-4.111
Previous Years Profit-Loss	85	-3.837	-6.530
Total	9.613	14.042	10.574

The effect of the practice of inflation accounting over own funds can be summarized as follows. Application of correction procedure to paid-up capital and reserves items effectively leads to creation of a capital reserve amount. However, given that this amount is also reflected as "loss" on the profit/loss items of the current and previous terms, the net effect of the correction procedure on own funds is zero (0).

The correction of non-monetary assets such as participations, subsidiaries and fixed assets positively affects the current and previous periods' profits through the profit/loss item.

Through the revision of both income statements and balance sheet items on the basis of inflation accounting, a reliable calculation of current term profits and losses have been established.

As a result, the own funds of the 25 banks increased by TL 4,429 trillion (\$ 2.9bn) due to the application of inflation accounting. **However, this amount has been reduced to TL 961 trillion (\$ 627mn) upon the corrections made in accordance with the evaluations of the BRSA.**

3.2.2 Profit/ Loss

Inflation correction performed on non-monetary assets creates two opposite effects. While exerting a positive effect on the current and previous periods' profits, it, on the other hand, leads to the realization of substantial losses due to the corrections made to paid-up capital and reserves items.

Following the application of inflation accounting procedure and appropriate classification of loans, the banks covered by the program have declared a total loss of TL 10,6 quadrillion (\$ 6.9bn) for current and previous terms in their year-end balance sheets of 2001.

Two important remarks are in order at this point. First, the fact that a significant part of the stated losses is engendered by a *once-only stock correction* should be kept in mind. Second, these losses must be compared neither with the profit/loss figures of previous year balance sheets nor with balance sheets of other banks which are not applying inflation accounting.

3.3 Off- Balance Sheet Transactions

During the audit process particular emphasis has been placed on the evaluation of the off-balance sheet transactions of banks. Forward transactions and option contracts, as well as structured financial products in general, have been subjected to careful inspection in order to verify their

correctness. Along these lines, “core characteristics” of the transactions rather than their “legislative structure” has been considered as an evaluation criterion. By reference to the principle of ability-to-pay some of the transactions have been cancelled while provisions have been set aside for some others. The changes occurred in the off-balance sheet items of banks as a consequence are summarized in Table 9.

**TABLE 9: THE CHANGE OF OFF-BALANCE SHEET LIABILITIES
(Trillion TL)**

	DECEMBER 2001	
	Pre-Audit	Post-Audit
Guarantees and Suretyships	27.752	27.752
Commitments	6.730	7.862
Transactions Related to Foreign Exchange and Interest Rates	28.275	25.105
Total	62.757	60.720

3.4 Capital Adequacy Ratio (CAR)

As a result of the audits and evaluations, the own funds subject to capital adequacy increased from \$ 4.9bn (TL 7.6 quadrillion) to \$ 5.3bn (TL 8.1 quadrillion) after the application of inflation accounting and required corrections. The breakdown of capital and the impact from inflation accounting is provided in Table 10.

After the audit process, risk weighted assets which were \$ 35bn (TL 53.8 quadrillion) before the correction procedure increased to \$ 36bn (TL 55 quadrillion). Taking into account the subsidiaries and the fixed assets (that positively affect the profitability because of indexation to inflation) with a 100% risk weight in the calculation of risk adjusted assets has been effective in this outcome. Additionally, commencement of the practice of taking into account the amounts subject to market risk in the calculation of CAR as of end-2001 (instead of 2002 as planned previously) for the banks covered by the program has been another contributing factor to the increase in the adjusted assets¹.

¹ Taking into account market risk in the CAR calculation has been stipulated by the Regulation published on 31 January 2002. Accordingly, market risk will be taken into account as of 1 February 2002 for the CARs to be calculated on a solo basis, and as of 1 July 2002 for those to be calculated on a consolidated basis.

TABLE 10: CAPITAL ADEQUACY RATIO**(TL, Trillion)**

	DECEMBER 2001		
	Before the Audit (Without Inflation Accounting)	Before the Audit (With Inflation Accounting)	After the Audit (With Inflation Accounting)
I. CORE CAPITAL	7.445	12.623	9.128
- Paid-up Capital	5.248	5.248	5.248
- Reserves	950	2.848	3.775
- Capital Reserve due to Inflation Correction	0	10.726	10.719
- Profit/Loss	1.240	-5.967	-10.641
II. SUPPLEMENTARY CAPITAL	2.473	2.451	1.739
- General Loan Provision	115	886	213
- Revaluation Funds	1047	64	492
- Subordinated Loans	3	8	8
- Securities Value Increase Fund	1.121	1160	955
- Free Provision	187	333	71
III. THIRD TIER CAPITAL	0	0	0
IV. CAPITAL SUBJECT TO THE RATIO(*)	9.890	14.579	10.858
V. VALUES REDUCED FROM THE CAPITAL	2.242	2.851	2.731
VI. OWN FUNDS (IV-V)	7.648	11.728	8.128
VII. RISK WEIGHTED ASSETS	53.796	54.999	54.977
- 0 % Risk-weighted	0	0	0
- 20 % Risk-weighted	6.260	4.112	3.737
- 50 % Risk-weighted	6.722	6.390	6.028
- 100 % Risk-weighted	34.288	37.971	37.308
- Amount subject to market risk	6.526	6.526	7.904
CAPITAL ADEQUACY RATIO (VI / VII)	14.2	21.3	14.8
TIER 2 CAPITAL / TIER 1 CAPITAL	33.2	19.1	19.0
TIER 1 CAPITAL / RISK WEIGHTED ASSETS	13.8	23.3	16.6

(*) Capital subject to the ratio may differ from the total of core capital, supplementary capital and third tier capital, due to the related Regulation's stipulation on the composition of core and supplementary capital.

As a result, the capital adequacy ratio of the 25 banks covered by the program was calculated as 14.8 % compared to the pre-inflation adjusted level of 14.2 %.

After the announcements of the results of the audit phase much criticism has been made regarding the calculation of the capital adequacy of the banks. These criticisms include the following:

- The minimum CAR set as 8 % and 9 % (the latter to apply in the case of tier-2 capital support of the SDIF) is insufficient due to the high market risk in Turkey,
- The calculation method of CAR has been changed to enable banks to meet the required capital adequacy levels, and,
- Inflation accounting fictitiously reduces banks' capital needs.

It must be made clear at the outset that a very conservative and prudent approach has been adopted in calculating the capital adequacy of the banks within the framework of the “Bank Capital Strengthening Program”. Accordingly, the lowest one of the CARs calculated on solo and consolidated basis were taken into account in the determination of the capital adequacy of the banks covered by the program.

A regulatory amendment was made on 14.09.2001 stipulating that loans extended to majority shareholders are not to be deducted from the capital base and hence from own funds. The BRSA made such an amendment in line with international standards. Accordingly, all related party exposures (including loans, subsidiaries and participations) are to be classified as “credits” and are subject to strict limits. This change was made long before the adoption of the Bank Capital Strengthening Program and is fully in line with international best practice.

The criticism —that the minimum CAR set as 8 % is insufficient due to prevalence of high market risk in Turkey— seems to ignore the fact that the market risk *is taken into account* within the framework of the program. Indeed, as a result of the audits and assessments carried out, it has been found that for 25 banks, the market risk taken into account in the calculation of the CAR amounts to TL 7.9 quadrillion (\$ 5.2bn). If the market risk were not taken into account, the CAR would have been 17.2 %, instead of 14.8 %. Taking into account market risk in the calculations has resulted in an additional capital liability of TL 632 trillion (\$ 412mn) for the program banks.

The average CAR of 14.8 % for the banks covered by the program is clearly well above the standard ratio. Furthermore, of the CARs of 25 banks, 7 were between the range of 10 % - 20 %, while 11 were above 20 %.

It is also important to emphasize that although the banks are allowed to keep equal amounts of core and supplementary capital, the supplementary capital of banks included in the program constitutes only 19 % of their core capital.

Since 1990, international standards require the application of inflation accounting in countries with high inflation rates. Given that Turkey has been experiencing chronic and high inflation since the 1980's, preparatory work towards the application of inflation accounting was initiated, albeit with a delay, and is about to be finalized. Accordingly, the Capital Market Board and the Ministry of Finance plan to apply inflation accounting as of the beginning of 2003, whereas the BRSA foresees the implementation of inflation accounting by all banks as of July 1st, 2002. However, in order to determine the true financial status of banks included in the program, it has been decided to apply inflation accounting on financial statements dated December 31, 2001 of these banks. The BRSA strongly supports the view that financial statements prepared by inflation accounting should be used as a basis for taxation.

To summarize, inflation accounting has not been used as an instrument to reduce banks' capital need in a fictitious way. In contrast, it has been applied to financial statements dated December 31, 2001 in order to determine the banks' need for capital in a correct manner. There has not been a single bank, of which the CAR was initially below 8 % and exceeded this ratio upon the application of inflation accounting. Furthermore, banks included in the program had to announce high amounts of losses due to inflation accounting. It would be misleading to compare these losses with these banks' previous year non-inflation accounted balance sheets or with profit and loss figures of banks that do not apply inflation accounting. It should be kept in mind that an important part of the losses in question is due to a stock correction applied on a one-time basis. A better approach would be to take into consideration "own funds" and "financial statements" as a whole when making evaluations about, and judgment for, the banking sector in Turkey.

4. Conclusion

Experiences of countries facing banking crises show clearly that, it is vital to determine the financial status of banks through reliable methods, in the most correct way, and in the shortest time period possible in order to ensure success and minimize social costs.

Taking into account this fact, the “audit and assessment” phase of the “Bank Capital Strengthening Program” has been successfully completed through close cooperation with banks and independent audit institutions.

The most concrete evidence of the success achieved in the audit and assessment phase is the fact that incentives have been created on banks’ majority shareholders to increase the capital adequacy of their banks.

The audit and assessment phase carried out within the framework of the program will not only increase the chances of success of “The Bank Capital Strengthening Program”, but also bring about positive long-term effects on the Turkish banking system. First of all, the transparency of the banking sector has increased. Announcements made by the BRSA regarding aggregate figures and the bank-specific information to be provided by banks after their general assemblies will provide a platform for sharing of reliable information, including group risks, open positions and in-kind credit risks. This way, true financial stance of the Turkish banks will have been clearly demonstrated, eventually leading to the elimination of market participants’ doubts over the banks to a great extent. Secondly, with the success of the audit and assessment phase, the ability of the public authority to design and apply sound policies towards the establishment of a healthy and efficient banking sector has been improved.

A capital adequacy ratio of 8 % is a globally accepted criterion to evaluate the soundness of a banking system. Nevertheless, this figure is not set as the sufficient target to be aimed for and rather reflects the minimum ratio to be attained. In order for the Turkish banking system to carry out its activities in a healthy manner and be globally competitive through creating confidence in international markets, aiming for a higher than 8 % CAR would certainly be natural. Upon the evaluations carried out, it has been determined that the sector’s average CAR is 14.8 %, which clearly is well above the

minimum ratio. In the coming days, the BRSA will make every effort to further strengthen the sector's capital adequacy and its maintenance at higher levels. Prompt action based on early warning systems will be key to maintain a sound banking system and the BRSA will continue to fulfill its supervision role with utmost care.

It should be noted that the Capital Strengthening Program is only one of the elements of the restructuring program aimed at ensuring safe and sustainable functioning of the banking system. The audit and assessment phase, as well as the on-going capital increases realized in relation with the results obtained at this phase, will allow for the attainment of a certain degree of transparency and level of capital in the sector. Going forward, priority will be given to the following issues on the BRSA's agenda. Implementation of measures to increase banks' profitability and thus to maintain sufficient capital adequacy, close monitoring of the operational restructuring of banks, encouraging mergers and acquisitions, and continuing to take necessary actions on the part of related institutions with a view to reduce intermediation costs.

Despite the fact that a significant part of the "Banking Sector Restructuring Program" has been completed, the BRSA believes that the implementation of above measures and thus the establishment of an appropriate environment will be a key determinant of the timing of the withdrawal of the blanket guarantee. Once such an environment is established, the BRSA, with adequate advance notice, will seek to bring the deposit guarantee in line with international standards.