

Costs of EU Accession: The Potential Impact On the Turkish Banking Sector

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“Strong Banking Sector, Strong Economy”

Outline

- Structure of the banking sector and the impact of the crisis
- Restructuring strategy and results
 - Restructuring of the state banks
 - Resolution of the SDIF banks
 - Strengthening of the private banks
 - Improving the regulatory and supervisory framework
- A comparison of the Turkish and EU banks
- Foreign bank entry and impact on competition
- Compliance with the EU Banking Legislation



Pre-crisis structural problems

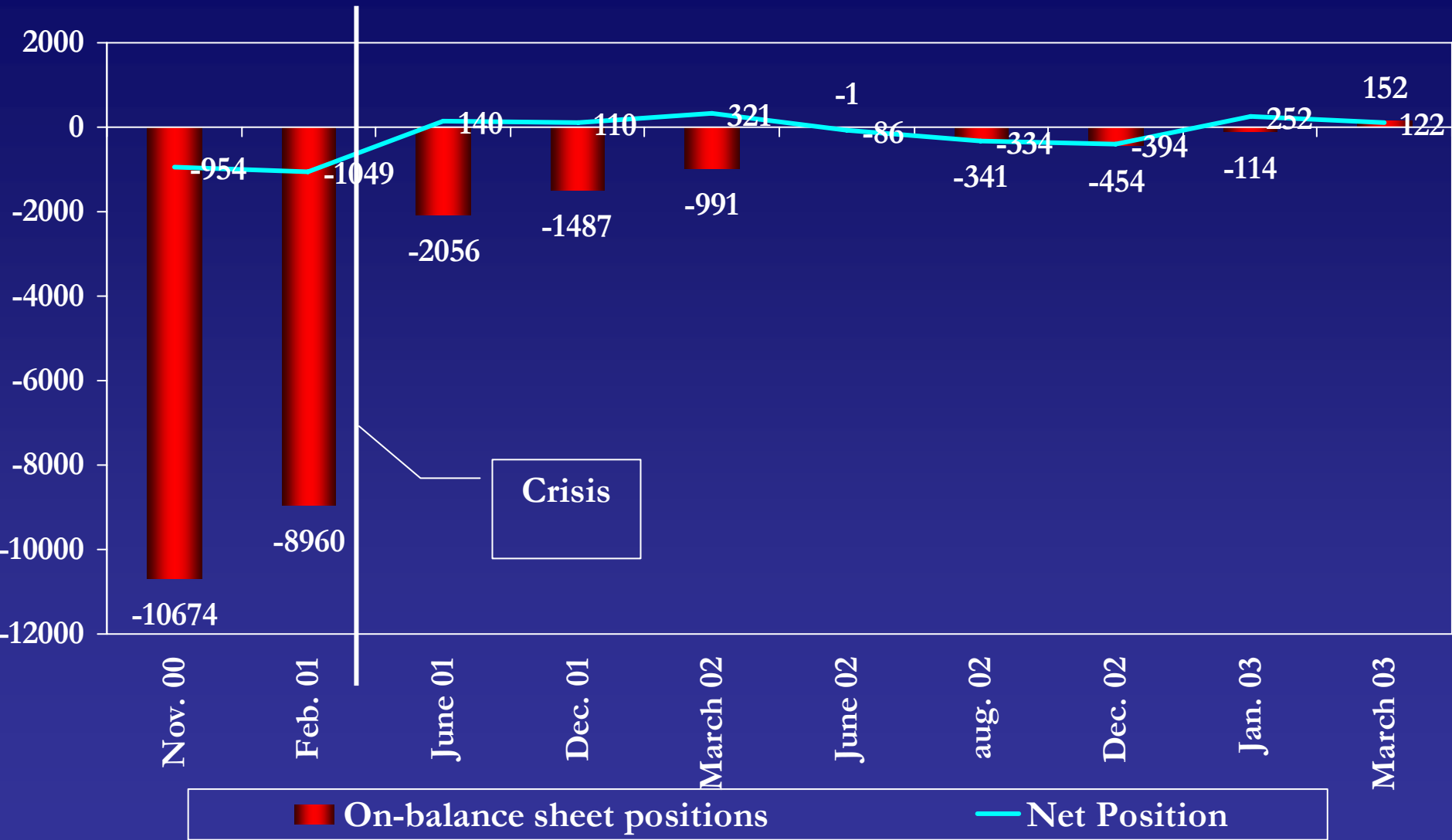
■ Small scale and segmented market structure

	1980	1990	1999	2000
Commercial Banks	31	54	62	61
State	8	7	4	4
Private	19	25	31	28
Foreign	4	22	19	18
SDIF	-	-	8	11
Invest. & Dev. Banks	6	10	19	18
State	4	3	3	3
Private	2	4	13	12
Foreign	-	3	3	3
TOTAL	37	64	81	79

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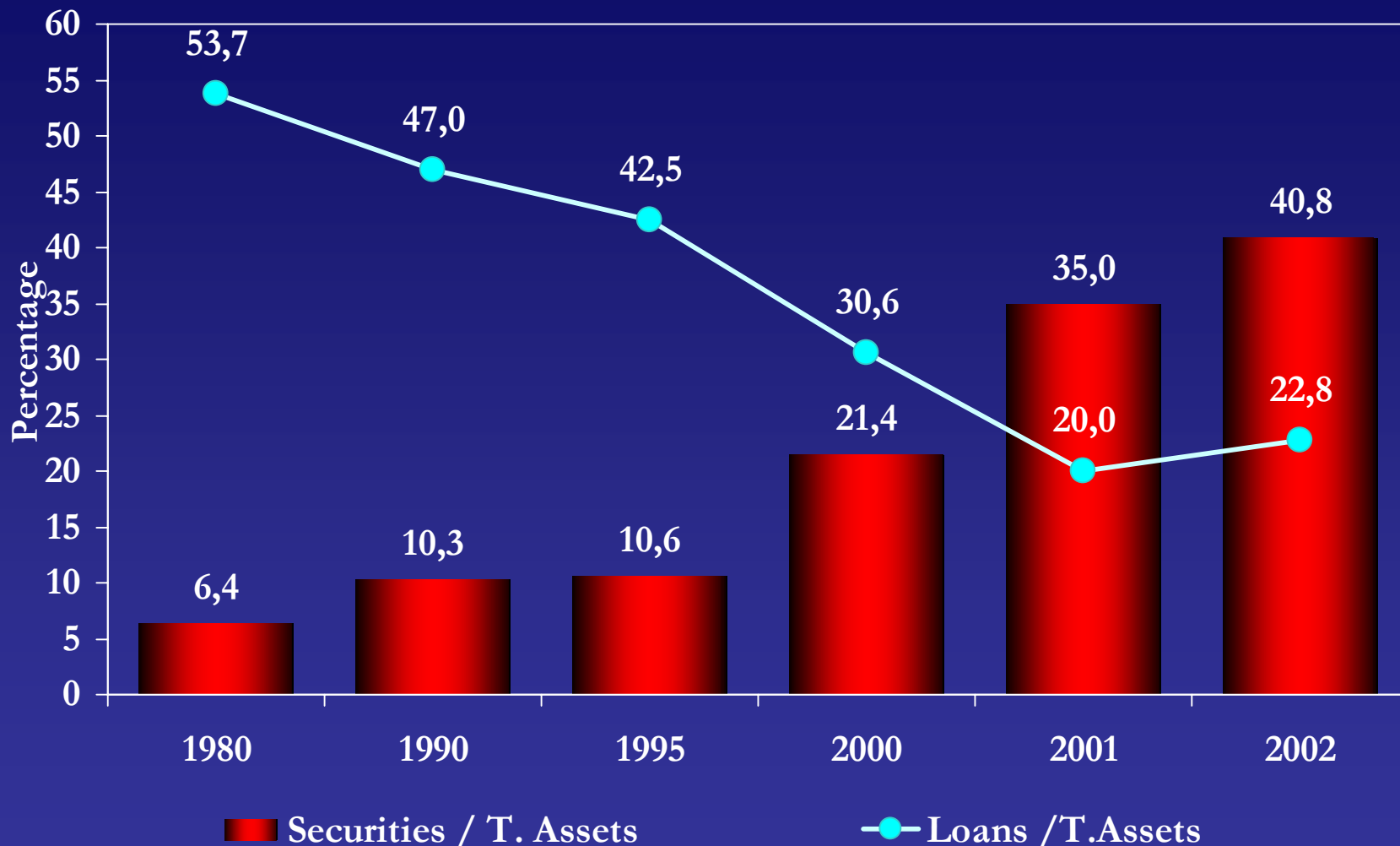


Large FX open positions of private banks



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Crowding out by government



Note: 2001 and 2002 data reflect the results of the three-stage audit process and are inflation-adjusted.

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Summing up: Pre-crisis conditions

- Banks
 - Liquidity problems
 - State banks with over-night liabilities of \$14 billion
 - Large open positions of the private banks
 - Significant share of holdings of government debt
 - Low asset quality
 - Inadequate risk assessment and management systems
 - Lack of good corporate governance
- Operating Environment
 - Major macroeconomic instability
 - High public sector deficit
 - Systemic distortions created by state and weak banks

Banking and Currency Crises

Macroeconomic Shocks

- Sharp **increase** in **interest rates**
- Sharp **depreciation** of the Turkish Lira
- **Contraction** in economic activity



Impact on the Banking Sector

- Maturity mismatch → **funding losses**
- Decline in the value of **securities portfolio**
- Short-positions → **FX losses**
- Asset Quality ↓
- Credit Risk ↑

Result:

Erosion in Capital Base



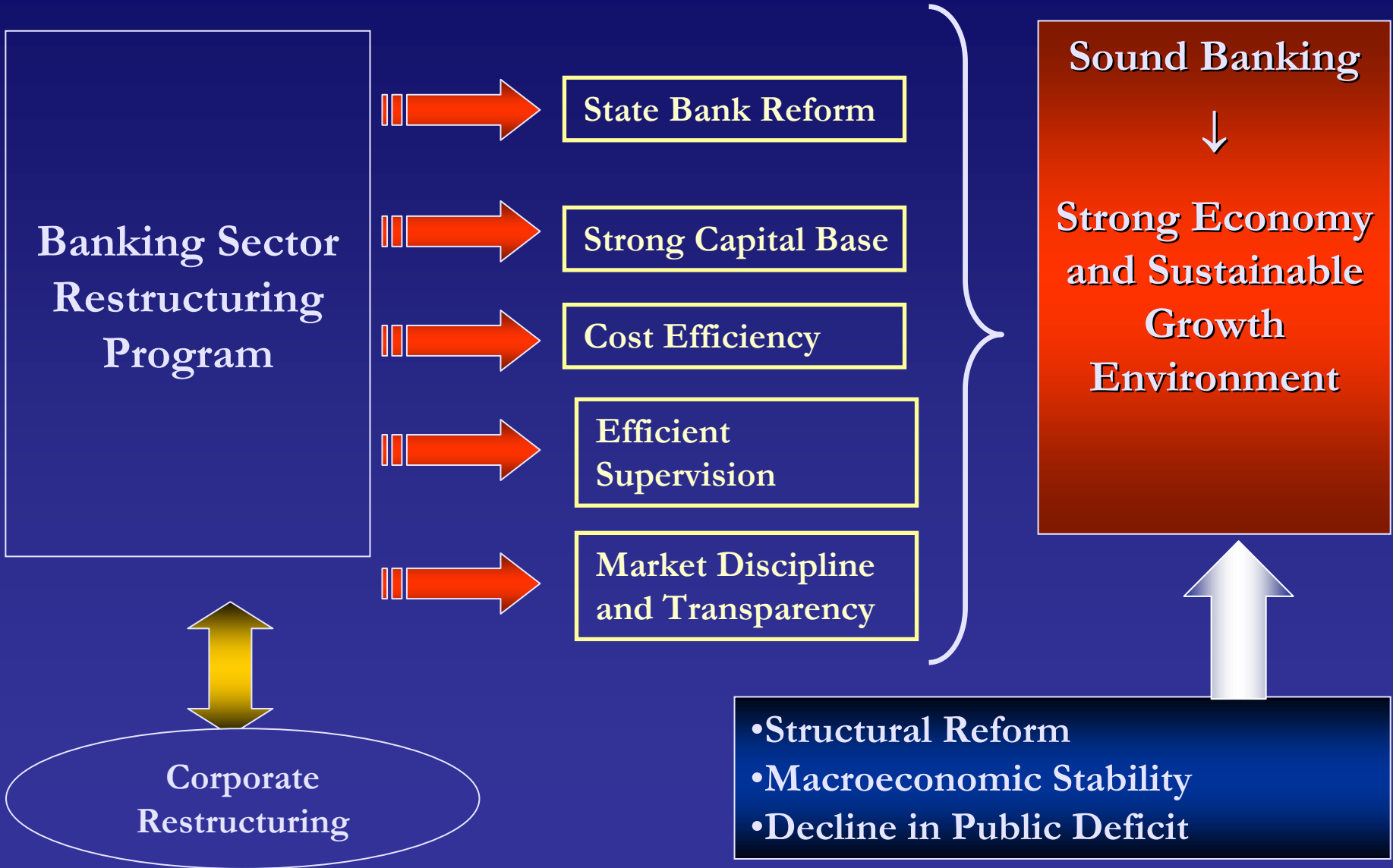
But crises also provide opportunities for major restructuring

- Banking System Restructuring Program
announced on May 15, 2001
- Objective is to **eliminate distortions in the financial sector and adopt regulations to promote an efficient, globally competitive and sound banking sector**
- **4 Main Pillars**
 - **Restructuring of the state banks**
 - **Resolution of the SDIF banks**
 - **Strengthening of the private banks**
 - **Improving the regulatory and supervisory framework**

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Goal: Sound banking-strong economy





Results of operational restructuring

- Consolidation in the banking sector

Number of banks declined from 81 in 1990 to 53 as of April 2003

- Decline in the share of the State and the SDIF banks

During 2000-2002 the share of these banks in total loans and deposits from 34.2% to 18% and 53.3% to 39.3%, respectively.

- Increase in mergers and acquisitions

Total asset size of the mergers and acquisitions that took place in the sector is around \$26.5 billion

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Results of financial restructuring

- Reduction of financial risks to manageable levels.
- Improved transparency
- Improved profitability

In 2002 private banks generated a profit of \$1.5 billion, state banks generated a profit of \$646 million

- Strengthened capital structure

CAR rose to 27.1% in December 2002 from 9.3% in December 2000.



Improving the regulatory and supervisory framework

Moving towards international standards

- **Regulations on capital**
- **Regulations on risk management**
- **Regulations on credit and subsidiaries' limits and loan loss provisioning**
- **Accounting standards and independent auditing**
- **Regulations on facilitating mergers and acquisitions**
- **Regulations on special finance houses**
- **MoUs with other countries supervisory authorities**



Turkey is not the first nor the last country to experience a financial crisis

Country	Crisis Period	Total Cost/GDP (%)
Spain	1977-1985	16.8
Japan	1990-	20.0
Indonesia	1997-	50.0
Malaysia	1997-	20.5
S. Korea	1997-	26.5
Mexico	1995	20.0
Argentina	1980-82	55.3
Brazil	1994-96	15.0-20.0
Turkey	1999-2002	13.7-26.5

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The initial fiscal costs of the Turkish crisis have been high

	BillionUSD	Ratio to GDP (%)
State Banks Duty Losses	19.0	12.8
Capital Support to State Banks	2.9	2.0
Resolution of SDIF banks	21.7	14.9
-Public Resources	17.0	11.7
-Private Resources	4.7	3.2

In addition, private banks **raised \$2.4 billion of capital from own resources.**

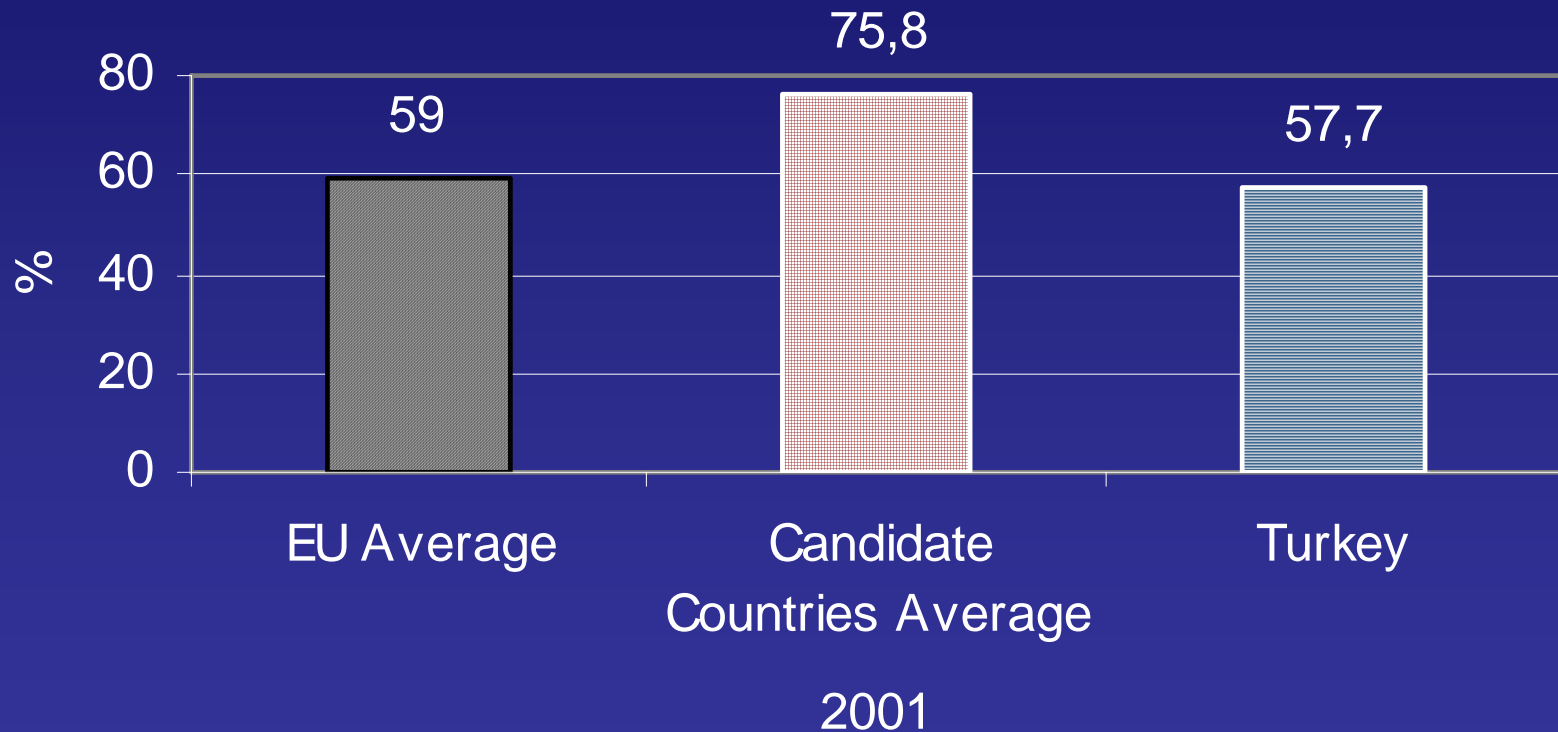
Thus, much of the costs of adopting international standards have already been borne. Annualized costs of \$4bn have been incurred which can be thought of harmonization costs.

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Turkish banks have similar concentration ratios to EU average

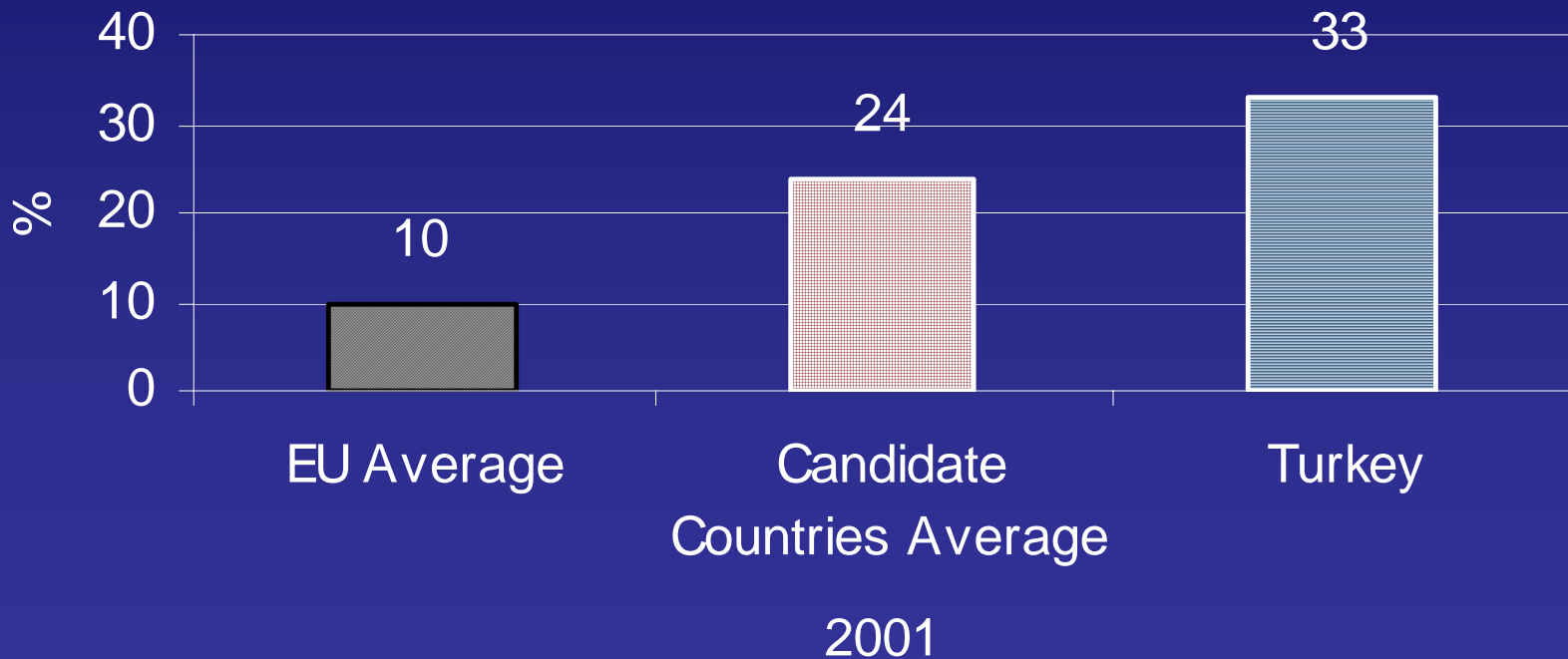
Graph 1: Concentration Ratio of 5 Largest Banks (%)



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While the share of the state banks remain very high in Turkey

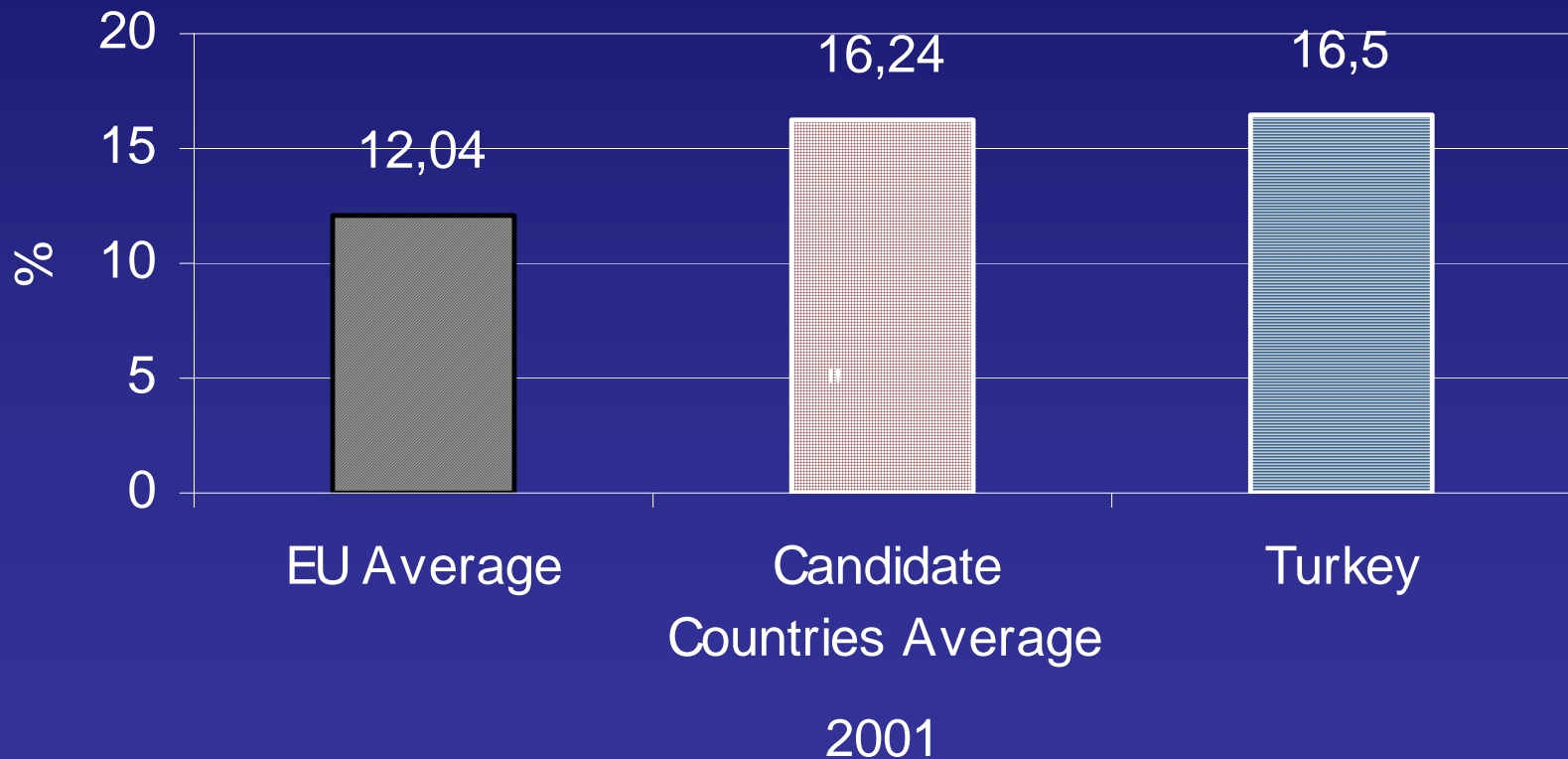
Graph 2: Public Share (%)



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Although capital adequacy is high, free capital remains limited

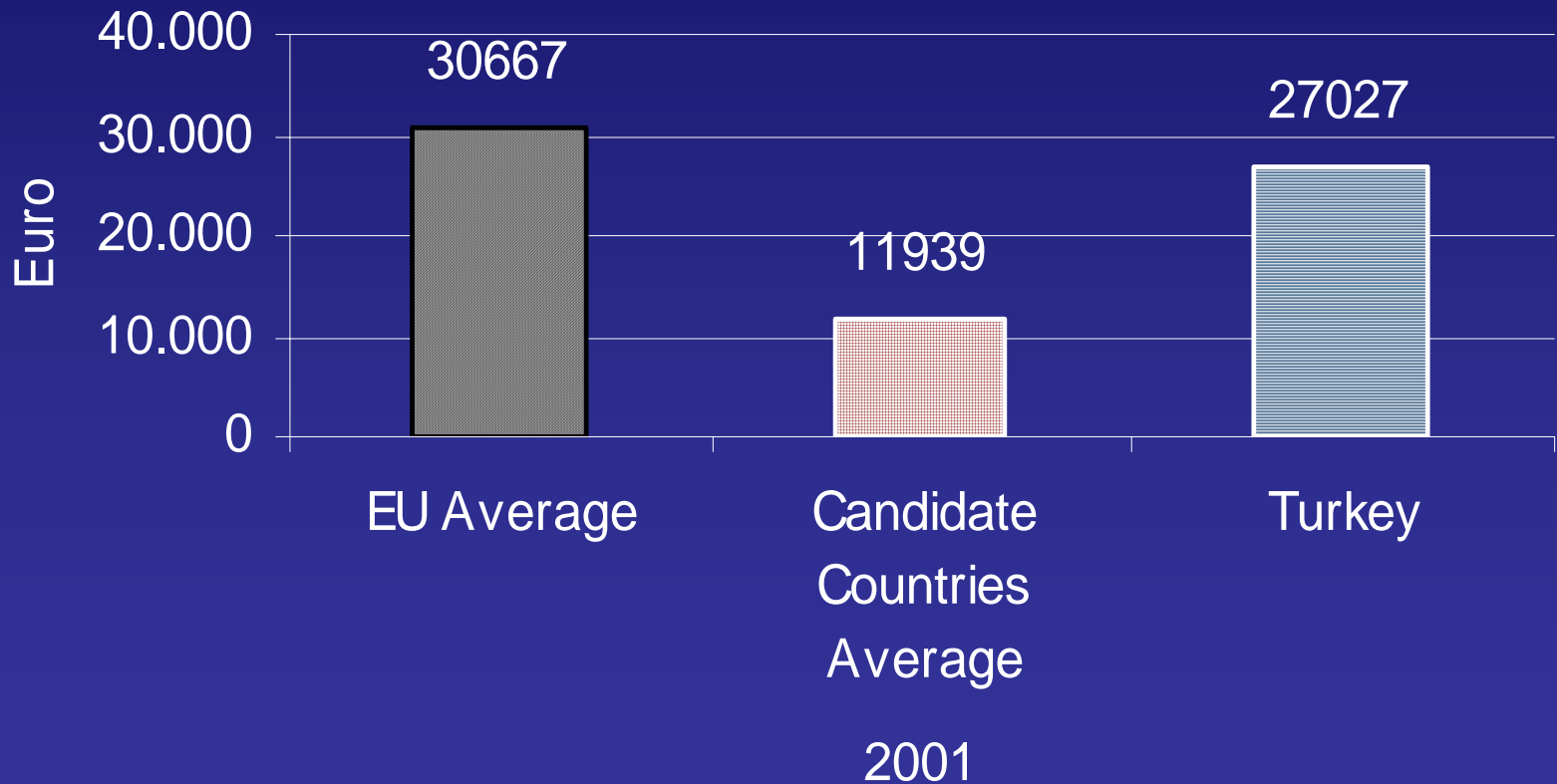
Graph 3: CAR



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Blanket guarantee introduced during the crisis in Turkey

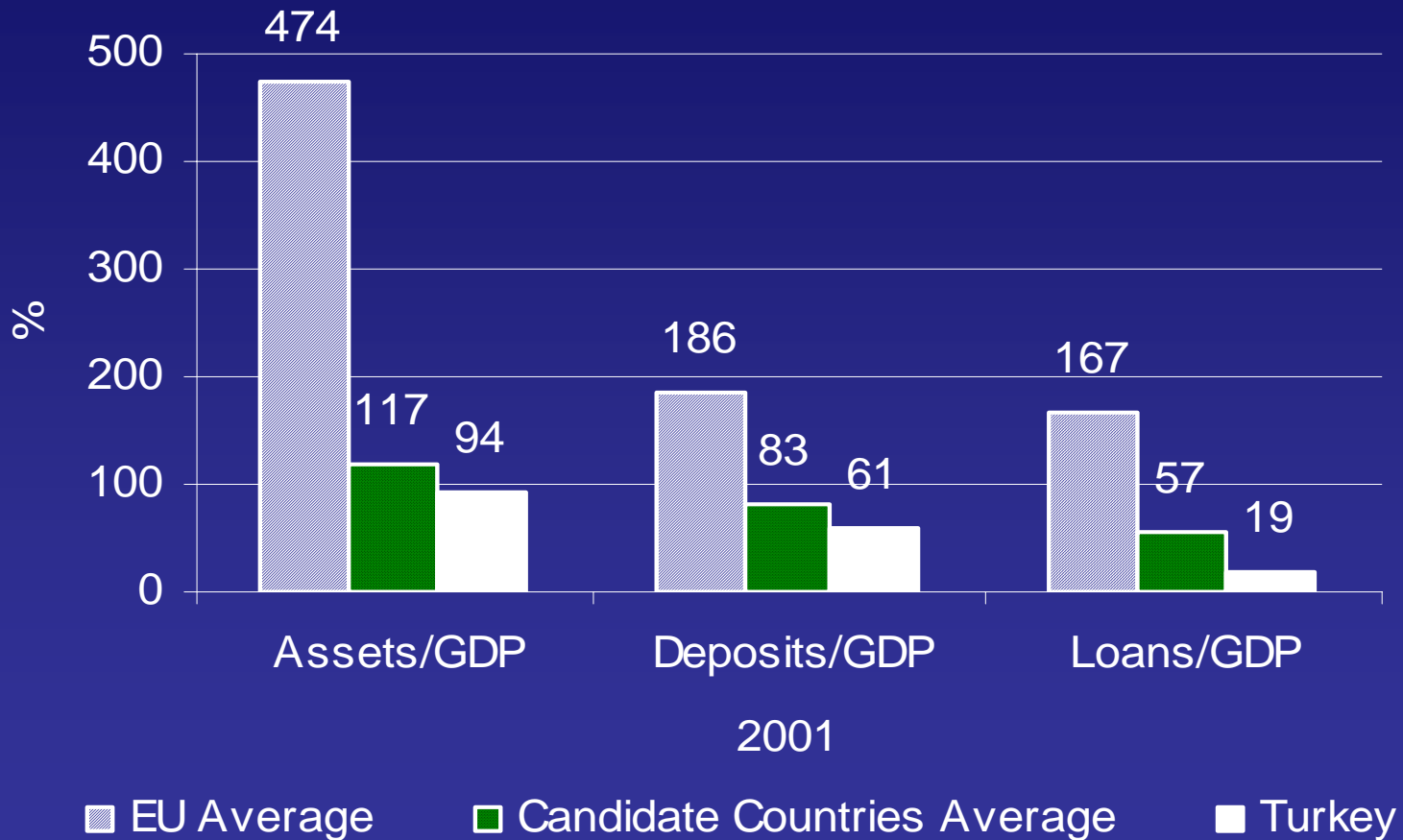
Graph 4: Deposit Insurance



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Low financial intermediation by Turkish banks

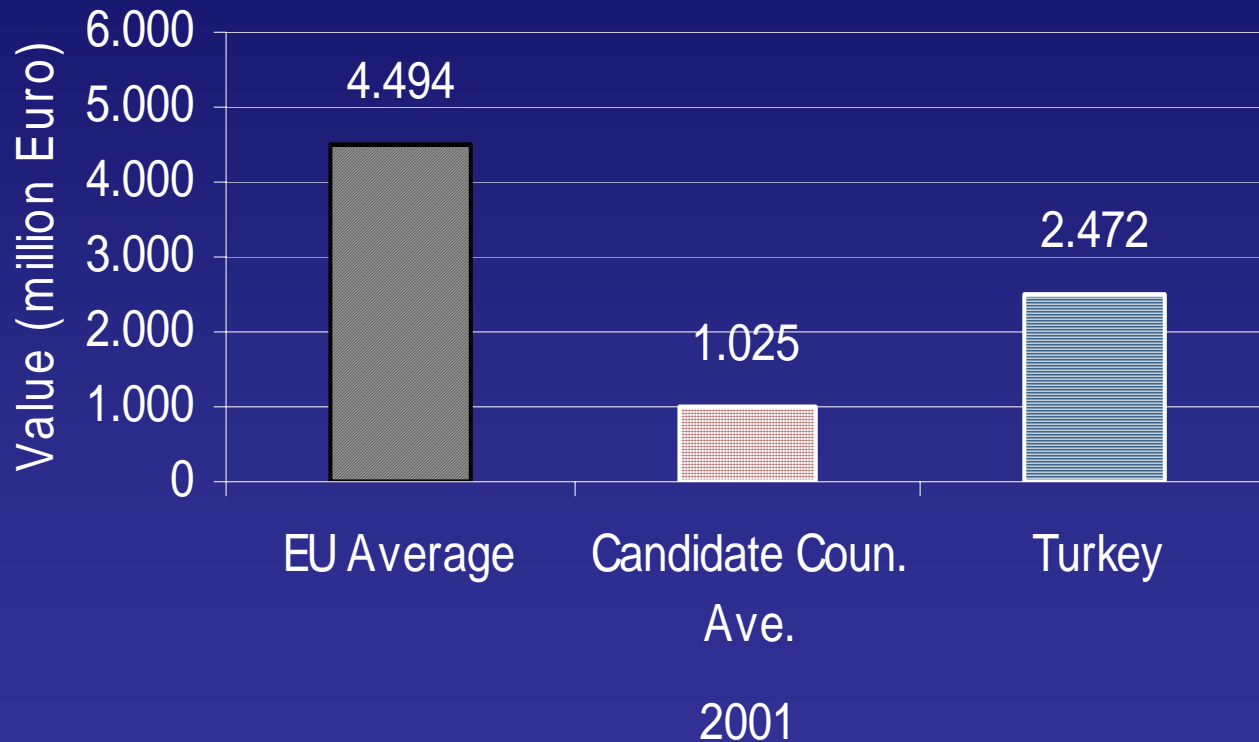
Graph 8: Financial intermediation indicators



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Size of the banking sector is small

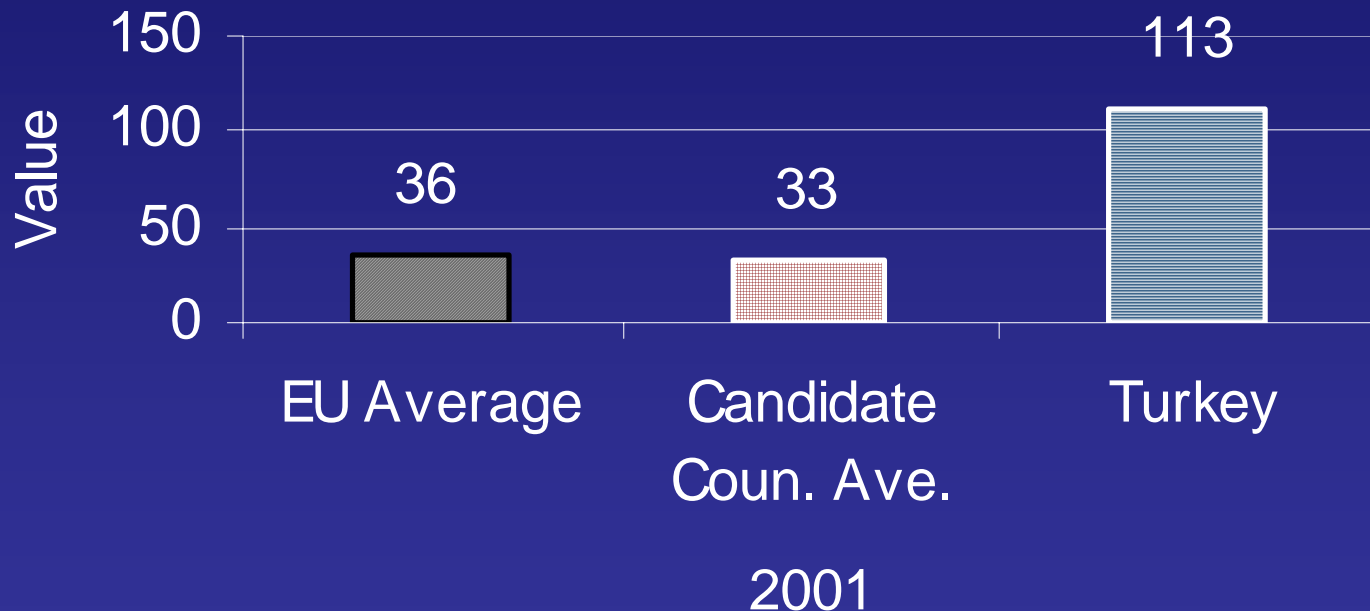
Graph 5: Average Bank Size (Total Assets / # of banks)



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Over-branched banking network

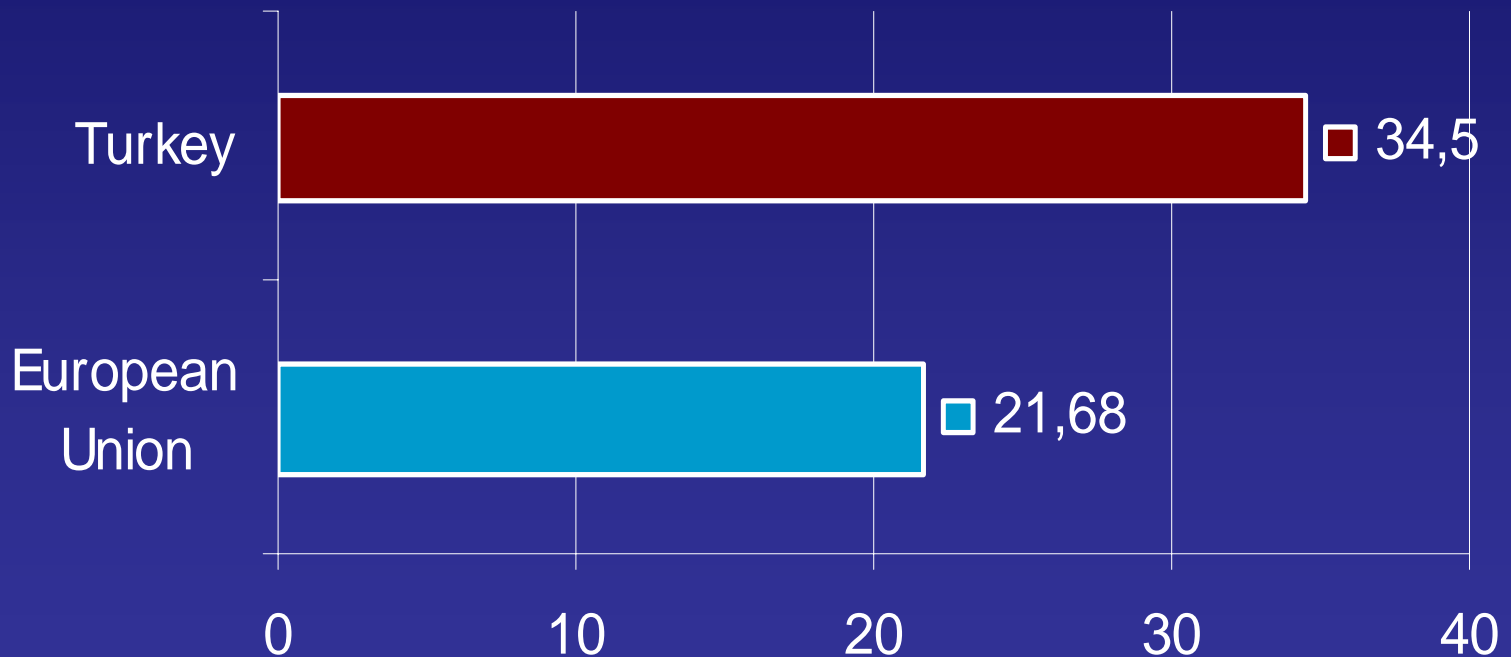
Graph 6: Number of Branches per Bank



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Government crowding-out

Graph 16: Debt Securities / Total Assets



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Literature on foreign bank entry

Features that attract foreign banks:

- liberalization of financial markets
- degree of economic integration between host and parent countries
- support of the client base (“follow the client”) (Konopielko,1999; Clarke *at al*, 2001).
- profit opportunities, low taxes (Claessens *et al.*, 2001; Clarke *at al*, 2001)
- fewer regulatory restrictions for investment (Clarke *at al*, 2001).

Expected benefits of foreign bank entry

Claessens *et al.*, 2001; Konopielko, 1999

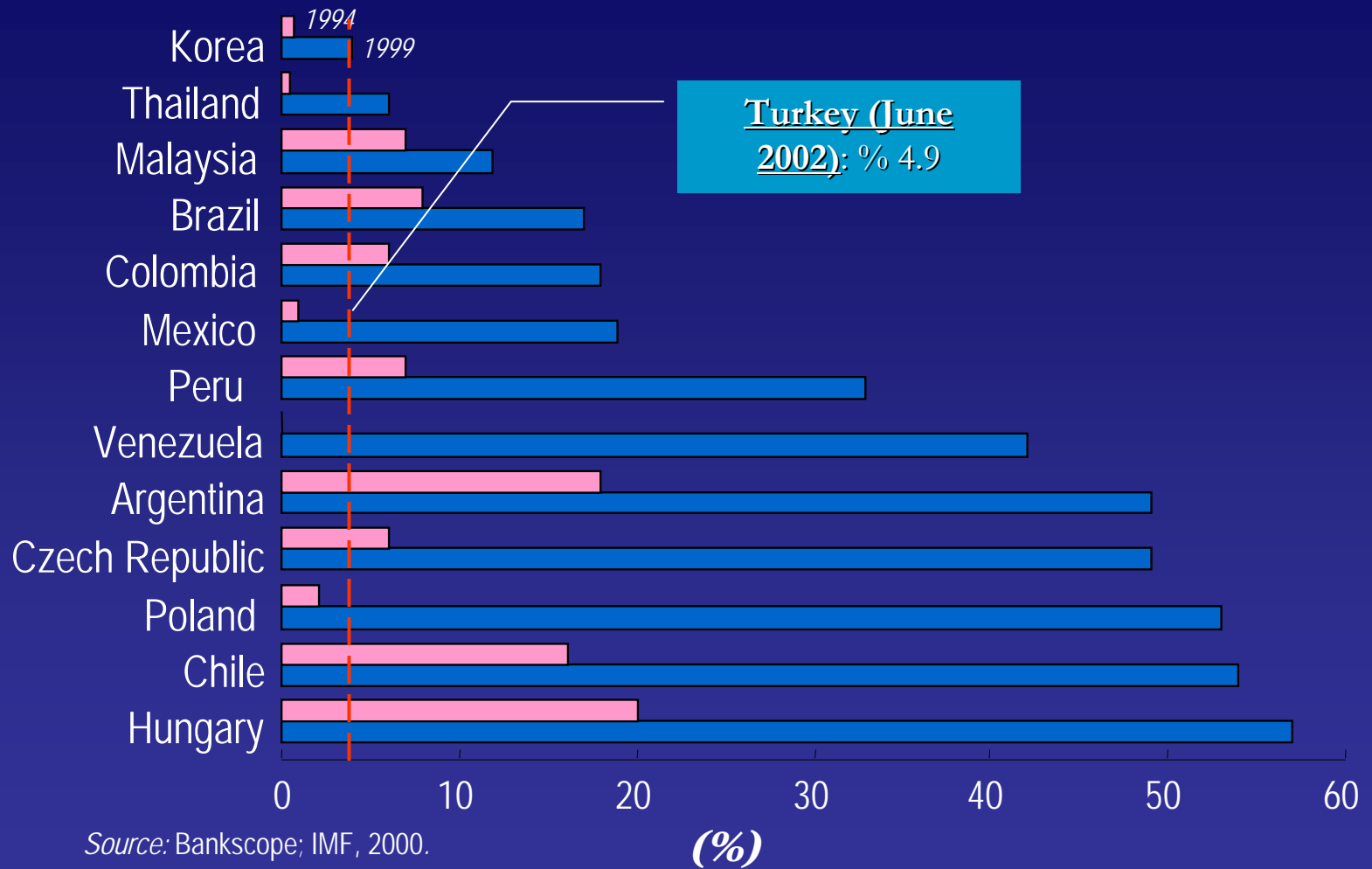
- increase in efficiency and better resource allocation
- increase in competition
- broad application of modern banking technology
- increased access to international capital markets
- stimulate development of supervisory and regulatory practices

Potential disadvantages of foreign bank entry

Crystal *et al* (2002) and Stiglitz (1993)

- difficulties to compete with large international banks
- lower access to financial services by domestics as foreign banks generally serve to multinational firms
- less sensitivity to host country's government policies
- vulnerability to economic conditions in the home country

Market share of foreign banks



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Turkish experience

Despite...

- a long history of liberalization policies and practices
- advanced technological facilities
- qualified human capital in banking sector

...foreign bank presence has been limited due to:

- persistent macroeconomic instability (high and volatile inflation)
- low volume of foreign direct investment
- delays in taking necessary steps for financial sector reforms

Recent increased interest

- Increased interest in the aftermath of the bank restructuring program

Unicredito 49% of Kocbank shares

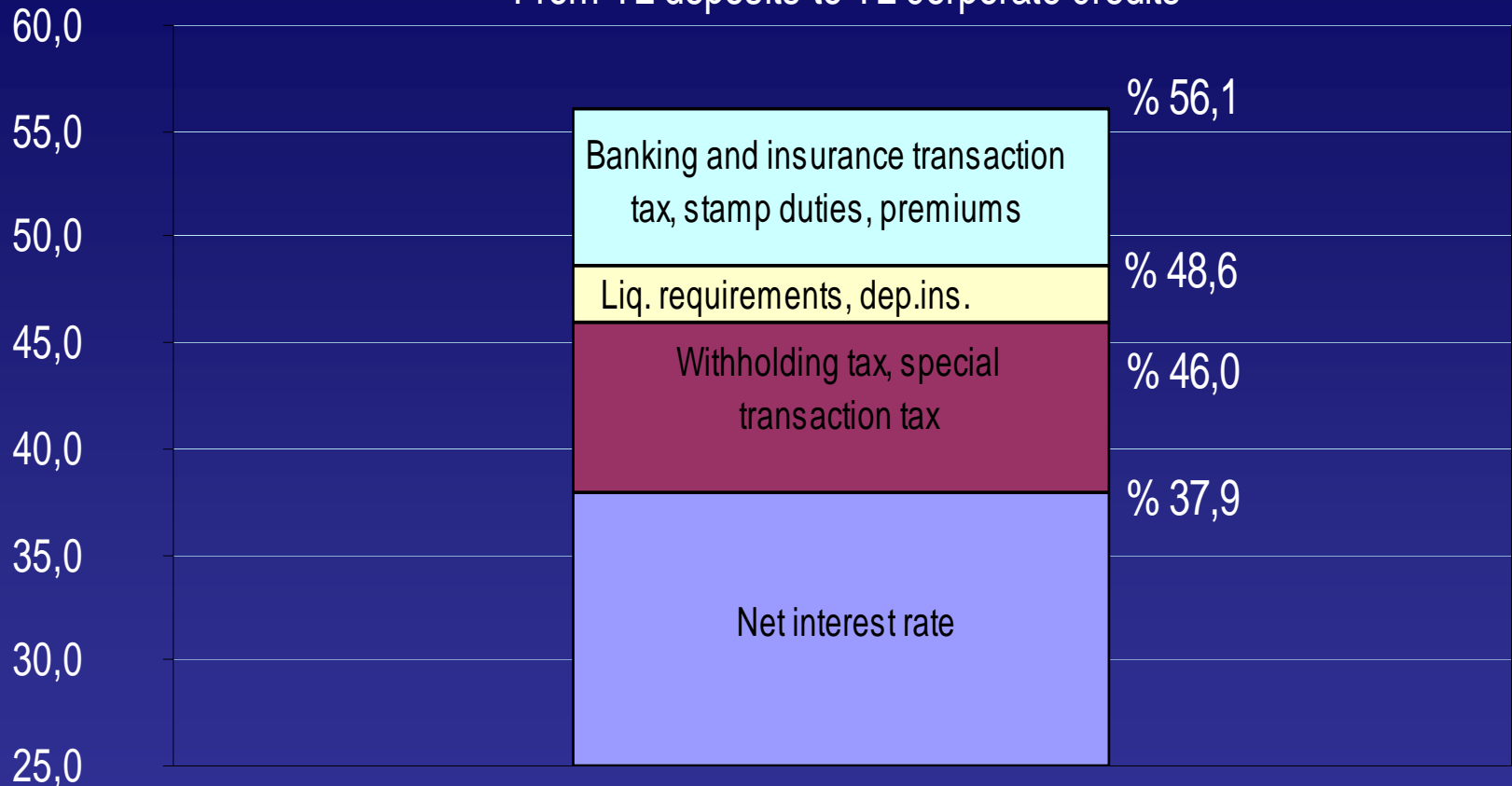
HSBC acquired Demirbank

- However further measures are necessary to attract foreign investors



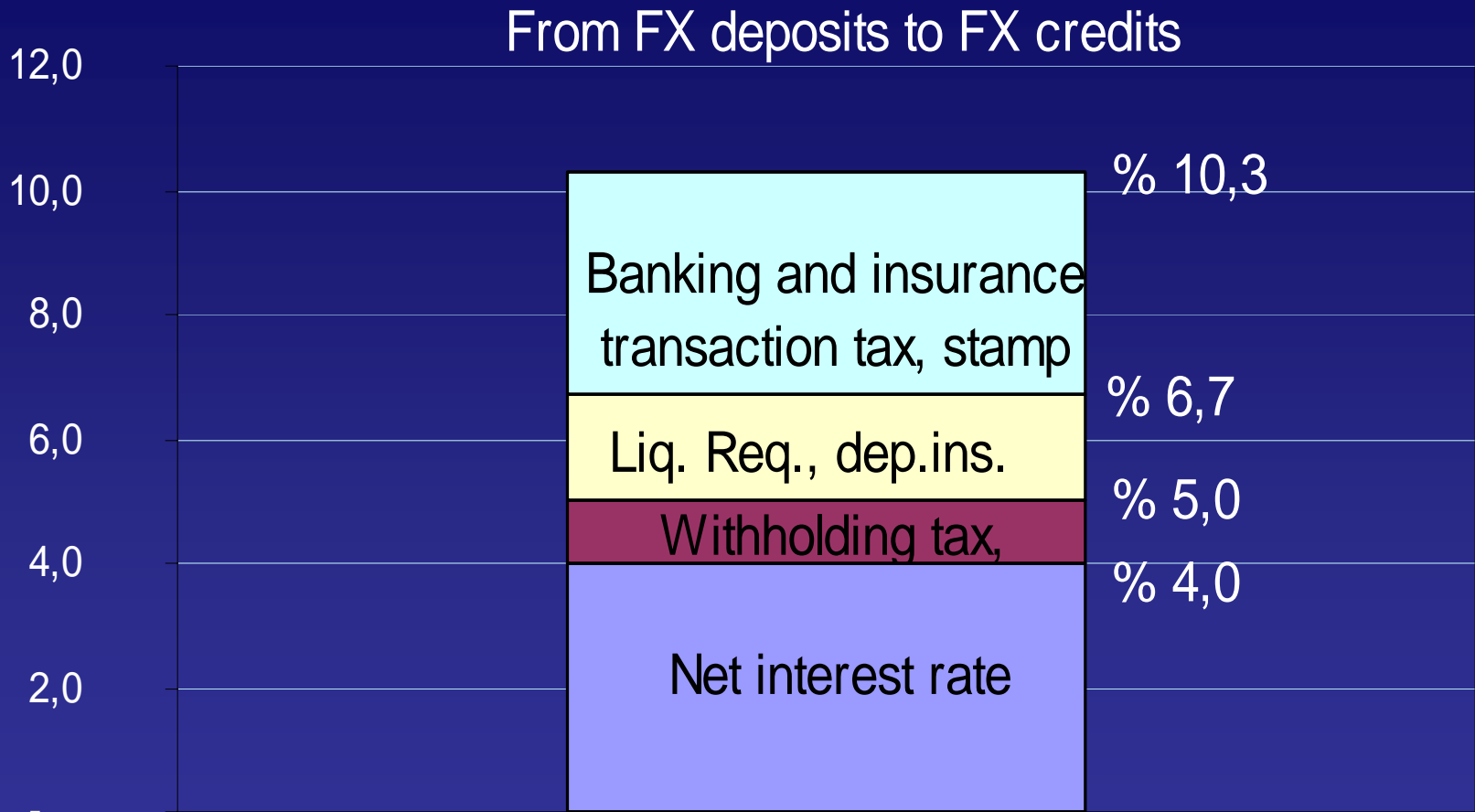
Need to reduce intermediation costs

From TL deposits to TL corporate credits



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Need to reduce intermediation costs





Need to overhaul blanket guarantee

- BRSA/SDIF is working on a deposit insurance scheme
 - Elimination of blanket guarantee
 - Adoption of a limited guarantee scheme in accordance with EU standards (20,000 Euro) with a one-year transition period
 - Redefining protection coverage in favor of domestic currency.
 - Transition to a risk based premium structure in which risk is fairly priced.
 - Application of co-insurance in order to limit potential claims on the insurance system.



Quantitative Impact Study (QIS)

	Date of exercise	No. of banks participating	No. of countries participating	Scope
QIS 1	Autumn 2000	78	10	Standardised Foundation Advanced
QIS 2	Summer 2001	138	25	Standardised Foundation Advanced
QIS 2.5	Autumn 2001	37	12	Foundation
QIS 3	Autumn 2002	Almost 300	Almost 50	Standardised Foundation Advanced All portfolios including securitisation

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Summary QIS-2 Results

	Standardised		IRB Foundation		IRB Advanced	
	Credit	Overall	Credit	Overall	Credit	Overall
G10 Group 1	6%	18%	14%	24%	-5%	5%
Group 2	1%	13%				
EU Group 1	6%	18%	10%	20%	-1%	9%
Group 2	-1%	11%				
Other (non-G10, non-EU)	5%	17%				

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