

FINANCIAL SECTOR ASSESSMENT

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BASED ON THE JOINT IMF-WORLD BANK FINANCIAL SECTOR ASSESSMENT PROGRAM

A joint International Monetary Fund-World Bank team conducted an assessment of Turkey's financial system in connection with the Financial Sector Assessment Program (FSAP) through missions in April, August-September 2006 and March, 2007.¹ The main objectives of the FSAP were to assist the authorities in assessing potential vulnerabilities in Turkey's financial system, and to identify priority areas for financial sector development.

This report provides a summary of the main findings of the assessment and the policy priorities identified.

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Glossary

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
ATM	Automated Teller Machine
BRSA	Banking Regulation and Supervision Agency
BCP	Basel Core Principles for Effective Bank Supervision
BKM	Bank Card Center
CAR	Capital Adequacy Ratio
CBRT	Central Bank of the Republic of Turkey
CPSS	Committee on Payments and Settlement Systems
EU	European Union
FSI	Financial Soundness Indicators
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
ISE	Istanbul Stock Exchange
KKB	Credit Bureau of Turkey
MOU	Memorandum of Understanding
NBFIs	Nonbank Financial Intermediaries
NPLs	Nonperforming loans
SDIF	Savings Deposit Insurance Fund
SMEs	Small and Medium Enterprises
TOKI	Housing Administration of Turkey
YTL	New Turkish lira

I. OVERALL ASSESSMENT

1. **Turkey's economy and financial system have improved substantially since the 2001 crisis.** Growth rebounded quickly from the crisis and averaged over seven percent per year in 2003-2006 (Annex Table 1). Inflation has been reduced to less than ten percent per year. The banking sector has been developing and provides greater access and more financial products; its capital ratios are high and nonperforming loans (NPLs) are low relative to loans. The capital market is once again providing investable resources; the private pension system created in 2003 is growing; and financial regulation and supervision have improved. Foreign direct investment increased sharply in 2005 and 2006, reaching nearly five percent of GDP in 2006, including flows into the capital of financial institutions. Gross international reserves have roughly tripled since the crisis and now exceed US\$65 billion.

2. **Notwithstanding the government's strong commitment to sound macroeconomic policies, macroeconomic risks still exist.** The current account deficit in 2006 was nearly 8 percent of GDP. Much of the financing of the current account deficit has come from strong foreign investment, but a significant portion has been potentially volatile financial flows. Despite strong fiscal performance, the public sector's gross debt was still about 65 percent of GDP at the end of 2006. About 75 percent was domestic debt, over half of which was linked to foreign exchange or had a floating interest rate. Moreover, the legacy of past volatility hinders financial development. Saving has risen only slowly, deposit maturities are still limited, and the share of foreign currency deposits, though lower than in 2002, remains over 35 percent. Turkey suffered more than most countries in the May/June 2006 "turbulence" in emerging markets. The Central Bank (CBRT) responded by raising interest rates sharply and, with the revival of international investors' interest in emerging markets, a quick recovery occurred. Reflecting these issues, the economy remains vulnerable to declines in global liquidity and investor sentiment.

3. **Turkey is engaged in accession talks with the European Union (EU) and is integrating further into the world economy.** These processes will require a strong financial sector and strong financial regulation and supervision, as well as sound corporate governance. While considerable progress has been made in these areas, continuing efforts will be needed.

A. Banking Sector Resiliency and Vulnerabilities

4. **The Turkish banking system is much stronger than in the past, but it faces various challenges and vulnerabilities that deserve close monitoring.** Regarding risks in banking, interest rate risk is an issue because of a duration mismatch between deposits relative to banks' holdings of government securities and some of the housing loans. Exchange rate risk is less of an issue because banks have only a small net foreign exchange position and hedges are generally considered to be with strong institutions. Banks' direct credit risk on lending in foreign exchange is reduced by restrictions against such loans to nonexporters, although this rule does not apply to foreign-exchange indexed loans. Large corporations have relatively high foreign-exchange liabilities often to foreign lenders. In the banking system, NPL ratios have fallen. Bank capitalization ratios have risen substantially since the crisis, although they declined somewhat recently because of rapid loan growth and large dividend payouts by some banks, including the state banks.

5. **Another set of issues relates to the possible risks of new activities and the rapid credit expansion involving new borrowers.** The rapid credit growth in the recovery from the 2002 crisis may have increased risks in the banks, especially as they entered new activities and faced increased competitive pressures in some market segments, such as housing loans. As banks sought to increase their market share and attractiveness to foreign buyers, profitability and conditionality on some types of loans declined. The slowing of credit growth after June 2006, in the context of higher interest rates, has given the banks time to improve their approaches to their new activities.

6. **Improved risk-assessment is spreading, with the entry of foreign banks complementing activities by domestic banks and BRSA in this area.** The Mortgage Law, passed during the FSAP process, will provide a sounder basis for mortgage lending and a framework for securitization. This securitization will allow banks to transfer risks on mortgages to capital market investors, especially as standard mortgage contracts develop and titling improves.

B. Financial sector regulation, supervision and infrastructure

7. **Bank regulation and supervision has improved and was strengthened by the 2005 Banking Law, the accompanying regulations and, recently, the increased capital adequacy and provisioning requirements.** The Banking Law and the adoption of associated regulations in 2006 represent major improvements in regulation. The challenge now is to fully implement them. Further improvements in supervision would be desirable in the areas of BRSA independence, loan evaluation, loan loss provisions, on- and off-site supervision, consolidated supervision and surveillance of conglomerates, remedial measures that require banks to correct deficiencies uncovered by supervision, and arrangements to supervise foreign banks operating in Turkey in cooperation with the supervisors in their home countries. Banking supervision also will need to keep pace with the rapid changes in banking, such as new banking activities and risk modeling. During the FSAP process, the BRSA raised bank capital adequacy requirements to twelve percent for banks seeking new branches and doubled general provision requirements, to one percent.

8. **Improvements have been made in procedures for the exit of failing banks, but further enhancements are needed.** The authorities will need to be prepared for any further bank exits as the sector consolidates and handle them smoothly to maintain confidence. The BRSA has extensive enforcement powers, but it may face challenges in exercising those powers in a decisive and timely fashion in the absence of pre-set trigger points. The Savings Deposit Insurance Fund (SDIF) now has stronger powers to resolve problem banks, and it protects depositors up to the statutory limit. However, SDIF could be more involved in inter-agency contingency planning, especially during difficult periods. In addition, a bank transferred to SDIF may be kept open for 270 days, or more if deemed necessary, while the authorities seek to resolve it. In this period, depositor withdrawals would have to be fully paid by SDIF, unless the bank was closed. Moreover, some market participants argue that a bank kept open by SDIF is legally a state bank and perceived to have full deposit insurance. Finally, it is not specified that SDIF bank resolutions should take into account the minimization of fiscal cost. Experience worldwide suggests that the lack of specific triggers for action and delays before removing problem banks from the system raise the cost of resolving intervened banks.

9. **Capital market regulation and supervision are broadly satisfactory.** The Capital Markets Board (CMB) is implementing an action plan to improve convergence with European practices. A new Capital Markets Law, drawing on the CMB's twinning arrangement with its German counterpart, is scheduled to be presented in 2008. Extension of the improvements in accounting to smaller firms and strengthening of the regulations regarding large shareholders' market activities and their interactions within financial conglomerates would be desirable.

10. **Regulation and supervision of nonbank intermediaries and financial intermediation are also good.** Both the private pension system for individuals and the payment and security settlement systems are well regulated. The real-time, gross settlement payments system represents a modern approach and infrastructure for payments between financial institutions. The new Insurance Law will strengthen sectoral regulation in areas such as capital, reserves, provisioning, and licensing.

11. **Coordination between the various financial sector regulators will become even more critical as Turkey's financial system becomes broader.** Banks dominate the financial system. Although the nonbank sectors are relatively small they are likely to grow, and bank owned firms have a large presence in some of them, in particular in capital markets.

C. Deepening and Broadening the Financial Sector

12. **The continuation of the government's strong commitment to macroeconomic stability will support financial development and economic growth.** Continued economic stability will gradually increase public confidence in the financial sector and encourage the growth of instruments with longer maturities denominated in new Turkish lira (YTL). Capital markets will benefit, and their growth will reduce the current dominance of banks in the Turkish financial sector. Financial transactions taxes represent a negative incentive on financial development.

13. **The banking sector is shifting toward more intermediation with the private sector, especially consumer lending, and access to finance is improving.** Bank credit to the private sector has grown rapidly in the last three years and now exceeds 30 percent of GDP. Lending to small- and medium-sized enterprises (SMEs) has increased. Banks have also increased their consumer and mortgage lending, as well as the facilities for consumer banking such as branches and ATMs. The new Mortgage Law will help reduce the risks for the banks in granting mortgages, for example by allowing banks to use pre-payment penalties. It will also support securitization of mortgages, which will increase the funding base for mortgages and allow banks to shift risks to the capital market. A good credit information system is widening its coverage. As in many countries, strengthening rural finance remains an issue.

14. **The capital market is growing again, and changes in the status of the Istanbul Stock Exchange (ISE) would support future growth.** The ISE functions well. However, allowing it greater budgetary flexibility and clarifying the supervisory relationship between the CMB and the ISE would be helpful for future growth. In addition, resolving the issues delaying the ISE privatization would help maintain the quality of its operations in the future.

15. **The private pension system for individuals has grown rapidly since it began in 2003; further growth will benefit retirees and capital market development.** Some improvements could be made in the pension system along the lines of allowing greater portfolio diversification, including overseas diversification, and improved governance of pensions that now are linked to economic sectors and individual corporations, as well as integrating these pensions into the existing private pension system for individuals. The government is contemplating changes in these areas.

16. **The legal framework for finance has been substantially improved, most recently with the 2005 Bank Law and the new Mortgage and Insurance Laws; further improvements in the legal framework would support further financial and economic growth.** The new Mortgage Law and the Insurance Law will benefit those sectors and the economy. Regulations for both laws will need to be completed to make them effective. The legal system for collateral has a relatively good reputation, but further reductions in the costs of establishing and foreclosing collateral as well as improving the speed with which the judicial system handles financial cases would support greater access to credit and, more generally, sound credit growth. Improved titling would support and strengthen the growth of mortgage finance. In addition, it may be desirable to examine in general the enterprises' recent experience with the bankruptcy law and make changes as appropriate.

17. **Improvements in transparency and corporate governance would provide a strong stimulus to financial markets.** Despite considerable progress in many areas, a significant agenda remains. Action would help overcome the legacy of past problems in the minds of investors. Corporate ownership is still fairly concentrated, and a high degree of cross-ownership exists, which is often difficult to track. Corporate boards and minority shareholders' rights could be strengthened. Regulatory differences exist with respect to the treatment of large shareholders in capital markets (major shareholders are not legally considered insiders in evaluations of market conduct, although they and board members must issue statements of "significant events") and bank lending (the limits on lending to shareholders are not parallel to general limits on lending, though by law lending to shareholders cannot be on favorable terms). Transparency of the balance sheets of nonlisted companies could be improved further.

18. **The table on the next page summarizes the main FSAP recommendations that are explained in more detail in the text.** "Short term" actions are those that would be desirable to undertake as soon as possible. "Medium term" actions are those that are less time-critical or require a longer lead time, in which case it would be desirable to begin preparations in the short term. The main text also describes the many important government actions that have occurred during the last 12 months.

MAIN RECOMMENDATIONS

Sector	Priority	Recommendation
Short term		
All	High	Complete and implement the regulations associated with the new Mortgage Law and the Insurance Law. In particular, establish prudential norms for mortgage lending, and assign related oversight responsibilities.
Banking	High	Implement the regulations of the new Banking Law promptly. Develop, and implement, a comprehensive plan for the BRSA to supervise banks in line with the new legal and regulatory framework, including their risk management
Banking	High	Review and amend procedures for handling failing banks, and ensure active involvement by relevant agencies, to ensure timely and cost-effective action.
Banking	High	Ensure that domestic-currency loans indexed to foreign currency are subject to constraints similar to those on foreign currency loans.
Corporate governance	High	Review any differences in regulations between major corporate shareholders and other shareholders and remove any residual privileges.
Medium-term		
All	High	Phase out transaction taxes.
Banking	High	Conclude Memoranda of Understanding (MOUs) with foreign supervision counterparties of foreign banks in Turkey.
Banking	High	Continue privatization of state-owned banks.
Banking	Medium	Refine data collection and analysis to meet market developments
Banking	Medium	Review mechanisms to ensure financial independence of supervisory agencies.
Insurance	Medium	Establish mechanisms to generate more reliable data on insurance companies' provisions and capital.
Capital markets	High	Resolve problems regarding privatization of the ISE.
Capital markets	High	Pass the Capital Markets Law in 2008.
Access to finance	Medium	Reduce the costs of creating and realizing collateral.
Access to finance	Medium	Improve credit information system by adding noncredit data.
Housing finance	High	Improve titling of collateral and develop standard mortgage contracts
Housing finance	High	Continue to limit financial activities of government housing agencies.
Pensions	Medium	Gradually relax investment limits and lower caps on fees.
Payments	High	Improve the legal certainty of settlement and the arrangements for unwinding in the check clearing system.
Corporate governance	High	Strengthen minority shareholders' protection and raise board members' accountability.
Corporate governance	High	Further strengthen accounting and auditing, especially in smaller nonfinancial firms.

II. MACROECONOMIC DEVELOPMENTS AND VULNERABILITIES

19. **The Turkish economy has improved substantially since the 2001 crisis** (Annex Table 1). During the crisis, GDP fell and inflation was high. Several private banks were intervened and the state-owned banks received a large recapitalization. Under the government program, supported by the International Monetary Fund and the World Bank and in the context of a favorable international environment for emerging markets, the economy rebounded quickly. Growth in GDP averaged over seven percent per year from 2003-2006 and annual inflation has fallen below ten percent per year.

20. **The large government debt and current account deficit remain important macroeconomic vulnerabilities.** Public sector debt (gross) remains about 65 percent of GDP. About 75 percent is domestic. The risk profile of public sector debt has improved. Nonetheless, its short average maturity and its large foreign currency linked component imply significant exchange rate, interest rate, and roll-over risks. The current account widened to nearly 8 percent of GDP in 2006, in the context of strong growth and investment, lack of savings growth, high oil prices and a trend appreciation of the Turkish lira (YTL) reflecting high capital inflows. Although foreign direct investment (FDI) also has grown sharply, reaching nearly 5 percent of GDP in 2006, the residual reliance on portfolio and short-term inflows makes the economy vulnerable to changes in global liquidity and investor sentiment.

21. **The market turbulence of May-June 2006 highlighted Turkey's exposure to a reversal in market sentiment but also the resiliency of the system.** The emerging market sell-off in this period hit Turkish markets hard. The central bank (CBRT) responded to the shock by raising interest rates and, with the return of confidence in emerging markets, the impact of the turbulence largely passed. Longer-term FDI decisions, particularly in the financial sector, do not seem to have been greatly affected. Nonetheless, domestic interest rates remain high and GDP growth slowed in 2006. The financial turbulence in industrial countries' markets in January 2007 was largely confined to them and did not have a major effect on Turkey.

III. THE FINANCIAL SYSTEM

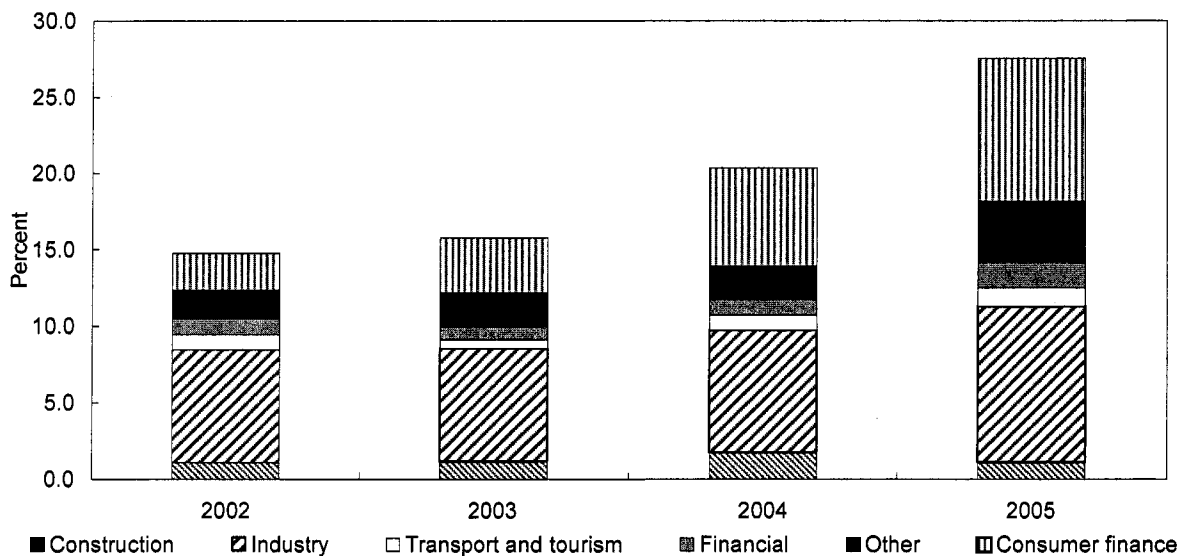
22. **Banks dominate the financial system, and foreign banks' interest in Turkey is growing.** Banks hold about 85 percent of financial sector assets directly and control the majority of nonbank institutions (Annex Table 2). Three major banks are still effectively in the public sector, but two of them have made initial public offerings (IPOs) recently. The state banks face increasing competition from private banks. Foreign banks have recently have been purchasing majority or minority positions in the capital of Turkish banks.²

² Turkey has been attractive to foreign banks because of its growth, the room for deposit growth and expansion of banking services, and the possibility of full entry into the EU. Despite the recent rapid increase in foreign banks, they still have a smaller penetration in Turkey than in Central and Eastern Europe, or the EU-25.

23. **The banks appear fairly strong, but some issues exist.** Broadly speaking, bank capital ratios are high but have declined somewhat recently with the growth of credit and the payout of large dividends by some banks, including state banks. Nonperforming loan ratios are low, but partly this reflects loan growth and the strong economy. Smaller banks show larger deviations from these averages than major banks. In some banks, pension liabilities may reduce capital when the banks fully convert to International Financial Reporting Standards.

24. **With the return of stability and growth, bank credit rose rapidly** (Figure 1).³ Credit to businesses has grown and consumer credit grew even faster, albeit from a low base. Banks rapidly expanded their consumer credit and mortgages both to take advantage of new techniques and economies of scale and to make themselves attractive to potential foreign partners. Since the turbulence of May-June 2006 and the related rise in interest rates, growth of credit, especially mortgage credit, has slowed. Government securities holdings still represented about one-third of banks' assets at the end of 2006 and were especially important in the recapitalized state banks. Sovereign risk correspondingly exists.

Figure 1 Composition of Commercial Credit and Consumer Finance
(Share of GDP)



Source: Turkish authorities, and staff estimates.

25. **Deposit growth also revived after the crisis, but average deposit maturity is still only about three months.** Banks have relied on foreign inflows to finance some of the credit expansion, and these were often hedged;⁴ the banks' net foreign exchange position was

³ The trend rise in deposits and credit began in the mid-1990s, but was interrupted by the 2001 crisis.

⁴ In part because average deposit maturity is very short, banks borrowed longer-term abroad and hedged the loans through swap operations, in order to finance longer-term corporate and housing loans. The swap counterparties appear to be well-known foreign banks. Since the May-June 2006 turbulence, costs of swaps have gone up and credit growth has slowed, reducing the importance of this process.

roughly zero at the end of 2005. The inter-bank market is only moderately active and repurchase operations (repos) are low, in part because of the attraction of the central bank deposit facility, in part because of legal and contractual issues. Transactions taxes discourage domestic intermediation; the authorities plan to remove these taxes as fiscal space develops.⁵

26. Foreign currency deposits and loans have declined in relative but not absolute terms since the crisis, similarly to developments in other countries that have stabilized. The share of foreign currency deposits has declined because YTL deposits have grown faster than foreign currency deposits, and the trend appreciation of the YTL has both reduced the YTL value of foreign currency deposits and created an incentive for a shift to YTL deposits. Foreign currency credits have also declined in relative terms for similar reasons, as well as the growth of consumer credit that is almost always in lira. A large percentage of loans to large corporations remain in foreign currency or indexed to foreign currency. Some of the foreign currency loans are done offshore, with Turkish banks' branches or foreign banks.⁶ Since June 2006, the rise in the share of YTL deposits has reversed to some degree.

27. The government debt market is active and the Treasury has been reducing its risks. The market had an annual turnover of marketable debt of about 4 times relative to the stock of marketable debt outstanding (including the primary dealers' operations) in 2005. Government debt is held largely by banks. It represents the majority of the assets of mutual funds, investment funds and the private pension system. The Treasury has extended the debt's duration and maturity and decreased its reliance on foreign currency-indexed and currency-denominated debt, although much of its debt still has floating rates.

28. The capital market has improved substantially since the crisis. Equity market capitalization rose to 45 percent of GDP in December 2005, compared to 20 percent in 2002, although during 2006 it declined slightly to 41 percent of GDP. Trading reached 1.4 times market capitalization. Listings declined after the 2001 crisis but began to rise again in 2004 and have reached 315 companies, putting Turkey in the middle of emerging equity markets in terms of listings. The majority of institutions that operate in the capital market, in terms of assets, are linked to banks. IPOs have resumed, and the first domestic YTL corporate bond in many years was issued in August 2006. Continued macroeconomic stability is a prerequisite to development of the private capital market.

29. Nonbank financial intermediaries (NBFIs) are growing rapidly, but remain very small compared to banks. The insurance sector, for example, is reviving after having been badly affected by chronic high inflation and the 2001 crisis. The new Insurance Law will contribute substantially to the sector's further development. A system of voluntary individual private pensions was created in October 2003 and many of the largest life insurance companies converted to combination life-pension firms at that point. This pension system has

⁵ These include the Banking Transaction and Insurance Tax, which generates revenue of 0.5 percent of GDP, and the Resource Utilization and Support Fund, which generates revenue of 0.3 percent of GDP.

⁶ Turkish banks' offshore branches represent less than ten percent of their assets and are part of BRSA's consolidated supervision.

grown rapidly, albeit from a small base. Its continued growth would improve incomes for future retirees and support capital market development, as it has in other countries.

A. Financial Soundness

30. **Banks' financial soundness indicators (FSIs) have improved substantially since the crisis** (Annex Table 3). They are currently broadly comparable with those in other emerging markets. On average, Turkish banks' capitalization and provision ratios have risen substantially. At the same time, their NPLs rates have declined substantially since the crisis.⁷ However, NPL rates on credit cards recently began to rise; any impact of the 2006 rise in interest rates on borrowers will only showing up gradually; and the sub-regulations in the new Banking Law may lead to recognition of more problem loans. New risks have come with the growth of consumer and housing loans. Banks and their risk management staff have had to adjust to these new activities. In addition, the competitive pressures in mortgage markets in 2005 led to both declines in lending rates to nearly the cost of funding as well as to loans with higher ratios of loan-to-asset value and higher debt service to income, though these ratios are still less than in other countries. Partly as a result of these developments and the general increase in competition, banks' profitability, which had rebounded after the crisis, began to decline.⁸ In 2006, however, profitability seems to have risen again. Banks have been careful to maintain liquidity buffers and limit their net open foreign currency positions; their hedging counterparties seem to be well-known international institutions. Nonetheless a significant duration mismatch exists, with average maturities of deposits lengthening less than the average maturities of government debt and credits. The major banks' FSIs are similar to the overall averages, but there are larger deviations from the averages among the smaller banks, some of which have low and variable profits.

31. **The market turbulence of May-June 2006 led to a temporary reduction in banks' capitalization and slowed credit expansion in the latter half of 2006.** Some banks experienced accounting falls in capital just after the turbulence as fixed-interest rate government securities were marked-to-market at the lower prices associated with the higher interest rates. These accounting declines in capital were reversed as assets matured and were rolled-over at the new, higher interest rates. Growth in credit to households was slowed by the higher interest rates that have prevailed since mid-2006 and banks have tightened conditions on consumer credit and mortgages. This slowdown has also given the banks a respite to improve their approaches in these new areas. The episode illustrates the risks associated with the duration mismatch in banks but also the banks' resiliency. The turbulence in industrial country equity markets in the first quarter of 2007 had only a marginal impact on Turkey.

⁷ Immediately after the crisis, the decline reflected the substantial loan restructuring was allowed under the "Istanbul approach." The grace periods under this rescheduling are ending, but some banks have already made the necessary provisions against these loans.

⁸ Bank profitability rose after the crisis because of large interest rate spreads, valuation gains, and the improved in loan quality. Comparisons over time of profitability measures are complicated by various idiosyncratic events at individual banks and changes in accounting practices, such as elimination of the allowances for inflation after 2004.

32. **The limited FSIs available for nonbanks are broadly satisfactory.** For example, most insurance companies seem to be reasonably capitalized and report high profits, although the adequacy and appropriateness of reserving policies are difficult to assess, as is the case in most countries.⁹

33. **The corporate sector has been rebuilding its financial strength, but foreign exchange exposure remains a concern in the larger firms** (Annex Table 4). A strong improvement in corporate sector performance has characterized the Turkish economy since 2001. Nonetheless, an analysis of a representative group of 20 large Turkish listed firms reveals relatively large exposures to credit in foreign currency and at short maturities.¹⁰ On the aggregate balance sheet of these companies, 70 percent of liabilities are short-term and 50-60 percent of liabilities have been denominated in foreign currency or are exchange-rate indexed. Of course, these figures reflect these firms' access to credit internally and externally, which is much better than smaller firms' access. More detailed analysis does offer some reassurance. The 20 largest corporations' debt servicing capacity appears strong, as evidenced by a ratio of total liabilities to assets of about 50 percent, debt-equity ratios of 0.9, and an interest coverage ratio of about 5, all strong figures by international standards.

34. **Stress test results indicated that the banking sector as a whole has substantial capital buffers, but some banks are vulnerable to large interest and credit-quality shocks.** Banking profits, and eventually bank capital, appear sensitive to a large rise in interest rates on YTL and domestically-issued non-YTL instruments according to the stress test scenarios. A large deterioration in credit quality would have a substantial impact on profits and, to a lesser extent, on regulatory capital, although most large banks would seem able to absorb these losses without falling below the required minimum CAR. Liquidity risk appears to be small, although this hinges crucially on the liquidity of the sovereign bond market should liquidity conditions deteriorate within the banking system. Stress test scenarios suggest that with a sudden stop of capital inflows or a persistent, large increase in oil prices suggest some institutions' profitability could be threatened and, eventually, capital injections would be needed.

B. Financial Sector Regulation, Supervision, and Infrastructure

35. **Turkey has made significant strides in financial regulation and supervision and in financial infrastructure since the crisis.** Major achievements include the 2005 Banking Law, the sub-regulations to the Banking Law issued in October-November 2006, and, earlier, the creation of the BRSA and the SDIF, a new Capital Markets Law (2002), and the sound regulation of the new private pension system for individuals. Regarding payments infrastructure, Turkey is in full observance of almost all of the provisions of the Committee on Payment and Settlement Systems (CPSS) Core Principles for Systemically Important

⁹ In most countries, profitable insurance companies tend to overstate reserves and lower reported profits to save taxes, while struggling companies tend to understate reserves to hide their weakness.

¹⁰ These companies account for 37 percent of the market capitalization of listed nonfinancial companies; their net sales are equivalent to 13 percent of GDP.

Payments Systems and the real-time, gross settlement system for payments between financial institutions is very modern.

36. **A general regulatory/supervisory issue is the need for better coordination among the various financial sector regulators as Turkey's financial system becomes more diverse.** Coordination of regulators will be increasingly important with the intensification of the multiple links among financial intermediaries and the existing links between intermediaries and nonfinancial corporations in Turkey. MOUs exist regarding information-sharing across some of the Turkish regulatory agencies, but stronger implementation is needed. The establishment of the high-level Financial Sector Committee, involving the Treasury, the BRSA, the CBRT and the Capital Market Board (CMB), is a good start, but it should meet more frequently and be used more intensively during times of pressure on the financial system. Creation of subcommittees to take technical work forward with more frequent interactions would be a useful improvement, as would formalization of the schedules and the agenda for the committee and its subcommittees.

C. The Bank Regulatory and Supervisory Framework

37. **Turkey has made impressive progress in bringing its bank regulatory and supervisory framework in line with international practice.** The Banking Law and the sub-regulations issued in October-November 2006 were major steps, as noted. However, full implementation of the regulations will take time. During the FSAP process the authorities had already taken steps to improve supervisory practice. The BRSA now prepares an annual supervisory cycle for each bank, and is developing capacity to conduct information systems and technology audits.

38. **The authorities have raised the capital adequacy requirement (CAR) to twelve percent for banks that wish to open new branches and doubled general provisions on new loans to one percent.**¹¹ A desirable next step would be to introduce a specific provision requirement on "special mention" loans.¹²

39. **The Basel Core Principles (BCP) assessment indicates a number of strengths but also some issues.** Further improvements in supervision would be desirable in such areas as the independence of the BRSA in its budget¹³ and its ability to set regulations; forward-looking loan evaluation; and large exposures, consolidated supervision and surveillance of conglomerates. Supervision of cross-border banking also deserves more attention, particularly given the growth of foreign bank interest in Turkey. Informal procedures allow international cooperation, but more formal relationships and MOUs would be desirable with

¹¹ The 12 percent CAR already existed for banks with offshore branches. For other banks, the CAR is 8 percent. The forthcoming introduction of Basel II will establish a framework for supplemental capital requirements.

¹² Currently, loans that exhibit weaknesses, such as cases when the debtor faces negative trends in payment capability or substantial financial risks but is performing, are termed "special mention" and require no specific provisions.

¹³ Banks and leasing, factoring, and consumer finance institutions pay fees for supervision but the revenue need not accrue to the BRSA.

supervisors in the home countries of foreign banks operating in Turkey, or countries in which Turkish banks have branches.

40. **In addition, major challenges similar to those facing supervisors worldwide face the BRSA.** These include ensuring that supervisory practice keeps pace with the rapid changes in banking, information use improves, new types of information are gathered on new developments in the financial system, and information is appropriately shared with other regulators. The BRSA needs to ensure that it maintains the capacity to evaluate the increasingly complex risk management procedures and risk models used by banks. The demands on its capacity in this area will increase as banks adopt more sophisticated models, motivated by both market forces and the introduction of Basel II (Box 1).

Box 1 Implementation of Basel II

The Turkish authorities plan to implement Basel II as of January 2008, with the model-based approaches to be implemented one year later. The authorities will also take this opportunity to implement VaR models for the valuation of market risk.

The implementation of Basel II will affect banks' capital adequacy ratios and incentives. Using the Basel II risk weights of residential mortgages and other consumer credits will reduce the capital needed for the retail portfolio. This reduction may prompt expanded lending in these areas. Additional capital will be needed to cover significant investments in commercial interests. Banks have already begun to divest these investments to reduce their capital costs. If the authorities choose to impose some risk weight on claims on the public sector, then capital requirements could increase on average, and the spread between bond yields and lending rates could decrease. Attention to capital allocation on maturity mismatches may also be desirable. Generally speaking, the authorities may wish to make use of the flexibility afforded under Pillar II to address those risk factors that are especially relevant to Turkish banking.

D. Bank Intervention and Resolution and Deposit Insurance

41. **The Turkish authorities have made substantial efforts to establish a more effective banking sector safety net and crisis management.** However, some areas require further strengthening to ensure that bank intervention and resolution are expeditious and efficient, and have no systemic effects. Good procedures are needed, if only to handle any exit of banks that might develop as the sector evolves. Experience worldwide suggests that slow resolution of weak banks increase the costs of resolutions.

42. **The BRSA has legal authority and capacity to identify unsafe and unsound practices in banks and request corrective actions by these banks.** During the 2001 crisis, delays in the resolution of several weak banks, in part reflecting a lack of mandatory triggers, increased the ultimate cost of bank resolution to the government. The BRSA needs to further build its reputation for rigorous correction of deficiencies uncovered during supervision. To this end, it would be valuable to define explicit criteria for timely and graduated action, and to ensure good coordination between the BRSA and the SDIF.

43. **The Banking Law specifies that the BRSA may transfer a failing bank, either open or closed, to the SDIF, but the process for such transfers should be improved.** For

example, the decision process for making such transfers could be made more specific, based on well specified criteria and more agile. Good cooperation with SDIF prior to any transfer will be essential.

44. **The SDIF is responsible for deposit insurance and for dealing with failing banks and their assets once they receive them from BRSA.** Limited deposit insurance, managed by the SDIF, replaced the blanket deposit guarantee in 2004. The further development of procedures to ensure a fast repayment process of insured deposits would be desirable. Once confidence in the banking system has built up further, the government may wish to review the level of insurance.

45. **SDIF has the option to keep a failing bank open, but the current procedures may end up increasing the costs to the government of bank resolution.** The SDIF can ask BRSA to revoke a transferred bank's license, but it can also keep the bank open to seek its rehabilitation, sale, or resolution for up to 270 days (with a possible 90 day extension) without a clearly-specified rationale. Keeping the bank open without a clearly-specified rationale or solution could create a flight of the depositors, who would have to be paid in full by SDIF. Moreover, market perceptions are that if a weak bank were to be kept operating under the SDIF, and later closed, its depositors would be protected in full, since the bank would have become a state bank. Thus keeping a bank open under the SDIF may effectively generate a blanket guarantee for the bank, potentially leading to large costs to the government. To address these weaknesses, regulatory measures should be adopted to ensure that a transferred bank would remain open only in specified, limited cases – for instance, if an investor is at hand or if extraordinary circumstances exist under which the closure of the bank could clearly put the stability of the whole banking sector at risk. International practice suggests that bank resolution agencies should make explicit the objective of finding a solution that minimizes the cost to public funds and maintains the smooth functioning of the system. The efficient resolution of even small banks is important to maintain confidence.

46. **The capacity of the judicial branch to interfere in, and even reverse, withdrawals of bank licenses and liquidation processes remains an issue.**¹⁴ The banking authorities' decision to withdraw a bank's license and undertake its liquidation should be a definitive and irreversible administrative process.

E. Anti-money laundering and combating the financing of terrorism (AML/CFT)

47. **The government recently passed a number of key laws relating to AML/CFT; the Financial Action Task Force noted progress in its recent assessment.** A new money laundering offence was introduced in June 2005, and the stand-alone terrorist financing offence was introduced in July 2006. The new AML law (Law 5549 of October 2006) provides, among other things, for a new and more comprehensive system for disclosures of cross-border movements of cash and monetary instruments to be implemented in the near future. Nonetheless, the new legislation has not been in place long enough to fully demonstrate its effectiveness. As a result:

¹⁴ Past experience with legal challenges to supervisory action justify this concern.

- the number of suspicious transaction reports and convictions for money laundering is relatively low, and confiscation measures have also not yet produced substantial results;
- preventive measures requiring financial institutions to undertake customer identification and certain other measures do not fully meet the FATF standards for ongoing customer due diligence (CDD), identification of the beneficial owner, and CDD for high-risk customers and operations;
- a comprehensive AML/CFT obligations statement is needed for the Designated Non Financial Businesses and Professions in order to comply with the FATF standards; and
- although the framework for international co-operation is adequate, some limitations in the coverage of the money laundering and terrorist financing offences could provide a technical limitation to such assistance.

F. Nonbanking Regulation, Supervision, and Infrastructure

48. **The CMB has strong supervisory powers to monitor market institutions and market practice. It has achieved a high degree of compliance with the International Organization of Securities Commissions (IOSCO) principles.** In 2005, the CMB approved and began implementing a well-designed Action Plan. It is harmonizing regulations with the EU over the next two years under a twinning arrangement with the German financial regulator. Major amendments to the Capital Markets Law are expected to be submitted to parliament in 2008. Infrastructure for settlements in the capital market and its regulation are excellent according to the IOSCO and CPSS-IOSCO Securities Settlement assessments, as is the infrastructure in the government debt market.

49. **Key capital market regulatory issues relate to the treatment of large shareholders and the improvement corporate governance.** Currently, large shareholders are legally excluded from treatment as “insiders” for purposes of regulating market conduct, although they must file declarations of “significant events” and their actions are tracked by the CMB. The CMB has initiated major efforts to improve corporate governance. Nonetheless, improvements in corporate governance in publicly owned corporations, for example in the quality and independence of their boards, and in securities market firms that are often linked to banks, remain an issue. Another issue is improving the current system for valuing illiquid assets in the balance sheets of mutual funds and pension funds in order to ensure better comparisons of investment performance.

50. **The insurance regulatory framework has been improved in recent years.** An early warning system introduced in 1997 has been used to identify financially weak companies and undertake intervention actions. Several weak insurance companies have been forced to exit the market by regulatory action – through license suspension, termination, liquidation, or bankruptcy. Legal challenges to interventions have been largely rejected by the administrative courts. More recently, a regulation on risk-based capital requirements has been adopted and insurance companies have been obliged to establish internal control systems and to constitute reserves. Most insurance companies now seem to be reasonably well capitalized and report high profits, although the adequacy and appropriateness of

reserving policies remains difficult to determine, as is the case worldwide.¹⁵ In this regard, new rules have been adopted on technical reserves, and further regulations are in preparation.

51. **The new Insurance Law will further strengthen the sector.** The law will strengthen regulations in areas such as minimum capital; reserves and provisions; fit and proper requirements; licensing; and changes in control. Regulations for the law will need to be drafted and implemented in the future. Steps have been taken to introduce full EU solvency requirements and a close approximation to IFRS accounting. Regulatory matters that still need improvement include conglomerate supervision; market conduct; and coordination between licensing, offsite supervision, onsite inspections and enforcement. It will also be critical to improve data on the insurance firms further; the new Insurance Monitoring System is a good initiative in this area.

52. **The system of private pensions for individuals is supported by a strong regulatory framework and effective supervision.** In the combined pension-life insurance companies, the assets of the pension funds are completely segregated from the life insurance business. The Central Register Agency keeps the records of all dematerialized securities and provides safe custody. The creation of the Pension Monitoring Center, a computerized system that is jointly-owned by Treasury and the pension companies has enhanced supervision.¹⁶

53. **Nonetheless, some regulatory changes should be considered as the system grows.** In particular, it would be desirable to compile and publish analytical data on the size, role and performance of existing pension schemes of “first pillar” substitutes and the various supplementary occupational pension schemes. Over time, the current supervisory focus on rule compliance can be replaced by an emphasis on internal control systems and ex-post assessments of good conduct. The investment limits could be gradually relaxed and the existing caps on fees lowered.

IV. FINANCIAL SECTOR DEVELOPMENT ISSUES

54. **Further financial deepening and broadening will increase access to financial services, raise the efficiency of investment allocation, and ultimately enhance growth and stability.** Private credit from banks has grown since the 1990s, rebounding to a much higher level than before the 2001 crisis. Nonetheless, a comparison of the Turkish financial system with those of other emerging market countries suggests that considerable scope exists for further financial deepening (Figure 2). Similarly, while the equity market has recovered but it remains in the middle of the larger countries in the emerging market group in terms of listings and market capitalization. Future deepening and broadening of the financial system

¹⁵ Reported profits of insurance companies are affected by reserving policies. In most countries, profitable companies tend to overstate reserves to save taxes, while struggling companies tend to understate reserves to hide weakness. Detailed actuarial audits, following standardized methodologies, are needed to verify the correctness of reserving policies.

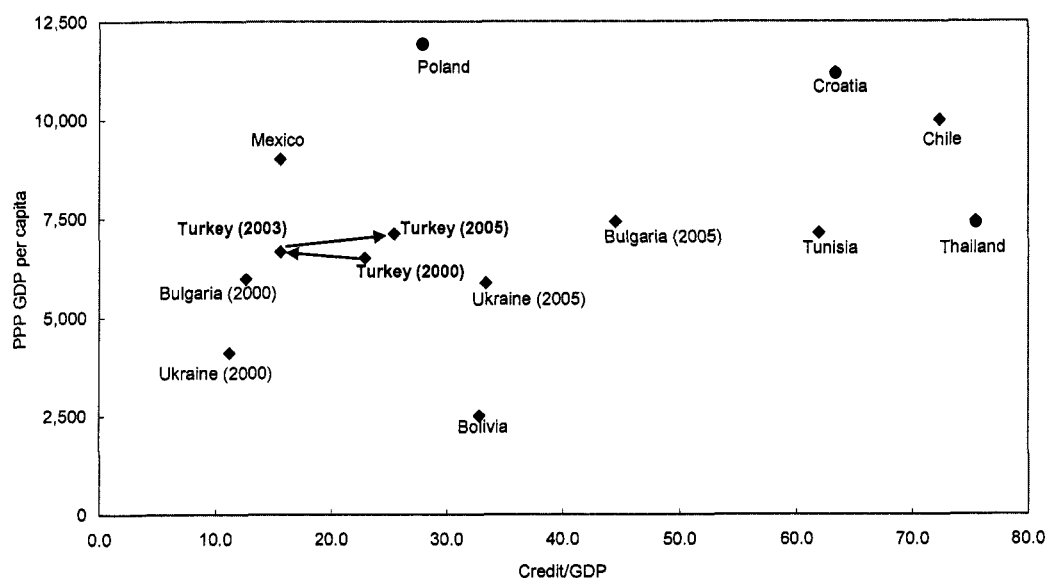
¹⁶ System-wide data are available on the website of the monitoring center within three business days.

will depend, first of all, on the government's maintenance of its current strong commitment to macroeconomic stability.

A. The Banking Sector

55. **The banking system is in transition from a focus on financing the government and a few major enterprises to a focus on greater intermediation with the private sector.** In 2004 and 2005, bank credit grew substantially to firms and, especially, to consumers. (Figures 1 and 2). While banks' government debt holdings remain large, their share in bank assets has declined. Banks have focused on consumer banking – more branches, ATMs and credit – to take advantage of new techniques and economies of scale in the use of credit information systems and credit scoring. The growth in the consumer segment is mainly due to the activities of the large private and foreign banks. Although credit growth slowed with the higher interest rates and tighter credit conditions that have prevailed since the turbulence of May-June 2006, the banks' focus on consumer banking continues.

Figure 2. Private Credit and Income per Capita
(GDP per capita in US\$ purchasing power parity, all observations for 2005 except as noted)



Source: IFS, World Bank, and staff estimates.

56. **The increase in foreign banks' participation in capital of the banking sector will have numerous positive effects.** For example, foreign banks have brought new risk assessment technology, which is spreading through the system, which will complement the efforts that the BRSA has made in this area. Foreign banks also bring new capital, permitting an expansion of lending.

57. **State banks still have a substantial portion of Turkish bank assets but have been limited in their new lending.** Much of their assets continue to be government debt – they have a much higher proportion of government debt than private banks – as a legacy of the large volume of nonmarketable recapitalization bonds they received. Although the proportion of loans in the state banks' portfolio has risen, these bonds have limited the rise in lending, as have the state banks' recent large dividend payouts.

58. **State banks are being put on a more commercial footing and are in the IPO process; privatization will enhance these banks contribution to development.** State banks are losing their privileged access to public sector deposits and the higher-than-market rates paid on their recapitalization bonds. Their lending, particularly agricultural lending, has been put on a full commercial footing by law. The foundation-owned bank recently made an IPO that will help it move more into the mainstream with respect to bank corporate governance.¹⁷

B. Housing finance

59. **Mortgage lending grew rapidly in 2004 and 2005 but slowed in 2006.** Mortgage lending is concentrated in the larger private banks, which tend to have more sophisticated analyses of the risks and which are developing this capacity further during the current slowdown in this lending. Mortgages are still only four percent of bank assets, leaving substantial room for sound growth as the framework for mortgages is developed.

60. **The recently-passed Mortgage Law will substantially improve the framework for mortgage loans.**¹⁸ The law will allow mortgages to carry floating interest rates and prepayment penalties. It will also facilitate mortgage securitization, thereby allowing risks to be transferred out of the banks to others who are willing to take them, and increasing the funding for mortgages. The law also provides for the establishment of mortgage finance companies that can raise nondeposit funds and intermediate the securitization process.

61. **Securitization will nonetheless take time to develop.** Only mortgages with good titles and standard contracts will be attractive for securitizations at reasonable interest rates. Thus, the development of mortgage securitization will depend on the speed with which better titles and standard contracts develop.

62. **The government will need to continue to monitor the operations of the Government Housing Administration (TOKI) carefully.** TOKI constructs and sells homes, mainly to families in the lower 40 percent of the income distribution but also to higher income families. While TOKI's current activity is restricted to rolling-over funds from the repayment of existing housing loans, it can issue bonds and mortgage-backed securities, which could allow it to expand its operations. It also is planning to establish a mortgage finance company. TOKI contributes significantly to the supply of housing in Turkey, but it should not be allowed to dominate the mortgage market or crowd out private lenders.

C. Securities Markets and Corporate Governance

63. **Security market development will depend on sustained macroeconomic stability and further microeconomic and regulatory changes.** Participation remains low, despite improvements in macroeconomic stability, regulation, market-related information, market conduct, market infrastructure and corporate governance. Investors probably are deterred by

¹⁷ In May 2007, one of the state-owned banks completed a public offering of 25 percent of its share capital.

¹⁸ The CMB is developing the supporting regulations to make the law effective.

long memories of deficiencies in these areas. The choice of capital market products is narrow and government securities are by far the principle fixed income instrument.

64. **The government and the CMB have attempted to improve information quality.** However, companies – particularly nonlisted companies – still often need to improve their accounting practices to reach CMB standards, which in most areas reflect international practice. Also, investors remain concerned about possible inter-company transactions that might not be well disclosed, despite the improved consolidation of accounts. In a related area, identifying the ownership and locus of decision-making in corporations is often difficult, despite the CMB's attempts to increase transparency.

65. **Potential investors may also be concerned by the legal exemption of large shareholders from CMB rules on insider trading and the degree of protection for minority shareholders.** Although large shareholders and board members must disclose "significant events," these disclosures may leave room for interpretation and be delayed slightly compared to transactions. Moreover, large shareholders are not subject to penalties for insider trading – most countries use disclosure of significant events as a complement, not a substitute, for penalties on insider trading. In addition, effective penalties are in general often low, as it is often difficult to successfully prosecute complicated insider trading in the clogged judicial system. Furthermore, market participants cite concerns that minority shareholders still have difficulty in identifying controlling shareholders and being protected from their actions.

66. **The CMB and other regulators need to continue to support improved financial reporting and corporate transparency and apply regulatory and civil penalties as warranted.** Although the authorities have set standards in these areas, implementation needs improvement, particularly for companies that have the potential to be listed. Strengthening corporate boards could help improve corporate governance.

67. **The proposed new Commercial Code, or amendments to the existing code, could address some of the issues of corporate governance.** These issues include: silence on the consequences of noncompliance or violation of the laws provisions on corporate governance; the low level of accountability of board members; lack of presumption of due diligence on the part of board; the lack of fit and proper criteria for board members other than level of education; the inability of mutual funds to exercise voting rights related to equity shares they hold; and the narrow interpretation of minority shareholders' protection.

68. **Market development could also be stimulated by encouraging greater competition between mutual funds and by improving the money market.** For example, banks could be required to allow easy transfer of their depositors' funds to mutual funds and other market intermediaries that are not connected to the bank, in order to increase competition. The development of the money market is limited by issues of the standardization of repo contracts and the legal framework, as well as by the attractiveness of the CBRT's depository facility to banks.

69. **The status of the Istanbul Stock Exchange (ISE) as an autonomous government agency could create regulatory issues and limit its future ability to provide low cost services.** The government needs to ensure that: (i) governance of the ISE allows it to remain

competitive and cost-effective; (ii) sufficient capital is available for investment in technology and related areas; and (iii) the regulatory function remains strong – the possibility exists for some overlap between the CMB and the ISE. Issues surrounding the privatization of ISE need to be resolved soon. Otherwise, it may be difficult to keep pace with technological improvements and maintain its current good performance.

D. The Insurance Sector and the Voluntary Private Pension System for Individuals

70. **The insurance sector exhibits some structural strengths but is less developed than comparator companies.** Premiums paid per capita, one measure of sectoral size are less than in comparator countries. The taming of inflation promises to be an impetus to the sector's growth. The new Law will enhance the sector's growth potential and its ability to provide sound service the public. Following the crisis there was a substantial shake-out of the smaller, weaker companies. Many of the remaining domestic companies are now affiliates of banks. In addition, interest in the Turkish market has grown among foreign companies with global operations. As a result, further consolidation may occur. Other than compulsory third-party motor liability, most lines of nonlife business operate with low loss-claim ratios and produce positive results that are further enhanced by investment income on accumulated reserves. The new computerized network on insurance policies, motor accidents and motor claims promises to lower costs and improve information availability and efficiency.

71. **A voluntary private pension system for individuals began in October 2003 and has grown rapidly.** The system's assets reached nearly YTL 2.7 billion in December 2006 (nearly 0.5 percent of GDP); it has almost one million participants. Contributions and investment returns benefit from modest tax incentives and withdrawals are less heavily taxed if they occur after the contributor reaches retirement age. As mentioned above, ten of the eleven providers are combination life insurance-pension companies which were large life insurance firms that added pensions business when the system began. Smaller companies have been deterred from converting by the high capital requirement imposed on pension business and the need for expensive, on-line computerized systems.

72. **Further improvements in the pension sector would contribute to improved pensions for the public and development of the financial system and the economy.** Greater portfolio diversification, including greater offshore diversification, would reduce risks to participants. Allowing the existing company- and sector-based systems to shift into the private pension system for individuals would improve pension regulation, supervision, and transferability and increase coverage of the voluntary system substantially. In addition, pension vesting arrangements in the company- and sector-pension systems could be improved. The government is considering reforms along these lines.

73. **Development of the private pension system for individuals could be further enhanced by some additional changes.** The growth of the system would benefit from campaigns to build confidence in its integrity, stability, efficiency and fairness. Such campaigns could also underscore the potential benefits from long-duration assets and structured products for retirement saving purposes and encourage the selection of pension companies (and mutual funds) with low operating fees. Increasing the availability of analytical reports that assess the overall performance of the system and provide detailed comparative data on investment returns and operating fees would be a crucial part of such a

campaign. In order to clarify costs, operations of the pension-life companies could be segregated, in addition to the current segregation of assets. Lowering the caps on operating fees could be considered as continued growth of pension assets generates economies of scale. Annuity regulation will need to be streamlined as demand for annuities increases with the maturing of the pension system. Finally, better analytical data would be desirable on the size, role and performance of pension schemes that are first pillar substitutes and remain as corporate or sectoral pension schemes.

E. Access to Financial Services and Credit Information

74. Access to finance is growing with stabilization and the banks' recovery from the 2001 crisis. Turkey rated reasonably well in terms of the number of deposit accounts (1,114 per 1000 people in 2003/4), relative to comparators such as Bulgaria and Romania, although Turkey's branch penetration was low.¹⁹ The recent emphasis on consumer banking should improve these figures, particularly in urban areas – branches increased 5 percent in the first six months of 2006 alone and the number of ATMs is growing.

75. Credit access is improving, except in rural areas. Small-scale credits come mainly from banks, especially the state banks. There are almost no microfinance institutions, reflecting the legal requirements for bank-like institutions. Consumer lending – credit cards and housing loans – now accounts for over 20 percent of bank lending, compared to only 8 percent in 2002. Within commercial lending, small and medium enterprises account for about 50 percent of the total, compared to 48 percent in 2002. However, agricultural lending has fallen to only 5 percent of bank lending, reflecting the post-crisis fall in agricultural lending by the state banks and the Agricultural Credit Cooperatives that traditionally depended on the state banks for subsidized funding. The passage of the long-pending law on Micro-Finance Institutions would provide an enabling framework to encourage microfinance institutions.

76. Increasing agricultural credit in a sustainable manner remains a difficult issue in Turkey, as it is in many countries. After the crisis, the large volume of nonperforming agricultural loans in the state institutions was written off and replaced by government debt. New lending by these institutions was put on a commercial basis. State institutions still account for about 90 percent of agricultural lending. The government policy of using commercial rates eventually will help to bring in new lenders, although rural borrowers are accustomed to low rates. A related problem in attracting new lenders to the sector is their wariness that new government decrees might unilaterally reduce debtors' obligations at their expense, despite the government's announcements that this will not occur. Although reductions in debtors' obligations help those particular debtors, they tend to reduce the access to credit for some time afterward. Other issues are the rural population's limited participation in the formal economy, making it difficult to obtain information on their potential creditworthiness. Improved titling would help lending, although many lenders are deterred by the general complexities of foreclosing on agricultural land. Weather and catastrophic insurance would reduce the risks of rural lending. Improvements in the agricultural

¹⁹ T. Beck, A. Demirguc-Kunt and M. Martinez Peria, "Reaching Out: Access to and Use of Banking Services Across Countries" World Bank Policy Research Paper, #3754.

cooperatives' governance, transparency and accountability would make them more attractive as a way to channel bank loans to farmers.

77. Leasing improves access by reducing collateral problems, and the leasing industry has grown rapidly. Leasing firms raise their funds from banks, which are prohibited from engaging directly in leasing. Since 2000, leasing has tripled in dollar terms, to over US\$ 4 billion in leases. The average lease is about US\$ 100,000 and 75 percent of leases are for machinery and equipment. Changes in taxation could be considered to facilitate new types of leasing, such as operational leases.

78. Credit information is a key factor in access to credit by households and small and medium enterprises (SMEs). The Credit Bureau of Turkey (KKB) generally performs well.²⁰ It provides both positive and negative information on consumer credits and shares information among commercial banks, participation banks and consumer finance companies. The principal issues with its operations are the weaknesses of the processes by which consumers can challenge ratings. The government plans to make some improvements in this area through regulations that have given the BRSA authority to regulate the KKB. The KKB could also expand its sources of information beyond debt service to financial intermediaries. For example, the KKB could include data from utility companies. This expansion of data would help those outside the financial system gain a reputation for prompt repayment and qualify for bank loans. Regarding SMEs, the Credit Registry already provides data, and KKB plans to expand its operations to SMEs soon. Including data from leasing and credit cooperatives, as well as the tax authorities, would be desirable.

F. Legal Issues

79. Titling and the costs of creating and executing collateral represent issues in expanding access. The Turkish Cadastre and Registration General Directorate could improve titling by modernizing land titling and registration systems, completing the real estate cadastre, automating cadastral offices, and developing a property valuation system. Costs for creating collateral, including taxes, fees, and registration seem high relative to other countries in the region.²¹ Creditors are penalized by heavy taxes on collection and are prohibited from reaching a mutually acceptable solution with defaulting borrowers by legal restrictions.²² These issues are likely to become more important with the growth of mortgage lending.

80. The delays in execution of collateral and bankruptcy proceedings as well as in reaching decisions in complex financial cases are a problem for the financial system. The Turkish judicial system is generally well-regarded and seems as efficient as those in most comparable countries, but improvements would support Turkey's financial development and increase its attraction to international investors. The Ministry of Justice has

²⁰ See World Bank, *Doing Business Indicators*, various years.

²¹ Ibid.

²² Article 873/2 of the Civil Code, the Lex Commissaria prohibition.

been attempting to speed-up the process of collateral execution, but court congestion, lack of judges and inefficient process and case management remain hindrances, suggesting the need for expansion of court capacity. A perennial problem is the limited expertise of the judiciary regarding complicated financial matters.

81. **Bankruptcy proceedings represent a further set of issues.** A new bankruptcy law was put into effect in 2003. It included the possibility of suspending bankruptcy proceedings in cases where companies might emerge from bankruptcy (similar to U.S. Chapter 11 Bankruptcy proceedings). However, some market participants have complained that difficulties have emerged in both the determination of the eligibility of an applicant for this procedure, and the management of the assets while the applicant is under this protection. Also, concerns have been expressed about a lack of understanding of the law in the corporate world. The authorities are encouraged to investigate these concerns, and on this basis possibly amend the law or issue new regulations.

ANNEX TABLES

Table 1 Selected Economic Indicators, 2001–06
(In percent except where indicated)

	2001	2002	2003	2004	2005	2006	
GNP (US\$ billions)	144.0	182.7	238.5	301.5	361.9	401.4	...
GNP per capital (in US\$)	2,140	2,671	3,431	4,271	5,054	5,534	...
Population (in millions)	67.3	68.4	69.5	70.6	71.6	72.6	
GNP (Turkish lira billions)	176.5	275.0	356.7	428.9	486.4	575.8	
Nominal GNP growth rate	40.5	55.8	29.7	20.3	13.4	18.4	
Real GNP growth rate	-9.5	7.9	5.9	9.9	7.6	6.0	
CPI (12-month, end-of period)	68.5	29.7	18.4	9.4	7.7	9.7	
Savings/GDP	19.3	20.7	19.6	20.6	18.5	15.6	
Investment/GDP	16.9	21.5	23.0	25.8	24.8	23.5	
Public sector primary balance/GDP	5.5	5.1	6.2	7.2	6.8	6.6	
Public sector overall balance/GDP	-17.1	-12.5	-9.1	-4.6	-1.2	-0.8	
Public sector net debt/GDP	90.4	78.4	70.3	64.0	55.3	44.8	
of which: domestic	52.9	46.3	48.4	46.5	46.8	37.5	
Nominal growth of M2Y broad money	87.5	25.4	13.0	22.1	24.5	24.1	
Real broad money growth 1/	11.2	-3.3	-4.6	11.7	15.3	13.5	
Real credit to the private sector growth 1/	-27.5	-16.5	20.1	28.5	33.6	25.1	...
Base money/GDP	4.4	3.8	4.2	4.7	6.7	7.3	
Broad money/GDP	60.4	48.6	42.3	43.0	47.2	50.7	
Lira broad money/GDP	26.8	22.5	23.2	25.3	31.5	32.9	
Private credit/GDP	21.9	15.3	16.7	21.0	26.7	31.7	...
Average nominal treasury bill interest rate	93.6	64.6	45.1	24.7	16.2	18.1	...
Average nominal deposit rate (eop)	54.3	39.3	23.5	17.3	13.7
Average nominal lending rate (eop)	74.3	56.0	42.7	34.8	23.5
External current account balance/GDP	2.4	-0.8	-3.4	-5.2	-6.3	-7.9	
Net foreign direct investment/GDP	1.9	0.5	0.5	0.7	2.4	4.8	
Gross external debt/GDP	93.1	77.3	56.4	50.1	46.7	50.5	
Gross official reserves (US\$ billions)	19.8	28.1	35.2	37.6	52.2	63.3	
REER appreciation (CPI based, period average)	-17.6	11.4	8.9	5.1	11.5	0.4	...
Exchange rate (YTL/US\$, eop)	1.45	1.64	1.40	1.34	1.35	1.41	...

Sources: Data provided by the Turkish authorities; and IMF staff estimates and projections.

1/ Deflated by the CPI.