

Contents

1. Introduction.....	1
2. Crisis and recovery	2
2.1 In search of macroeconomic stability	2
2.2 The rehabilitation programme and evolution of the regulatory structure	5
2.3 The present structure.....	7
3. Overview of the financial solidity of banks in 2003	9
3.1 A general assessment	9
3.2 ISE-listed banks: A closer look at the financial indicators	13
4. Obstacles to sound banking	14
4.1 Macroeconomic instability.....	15
4.2 The large share of state-owned banks	16
4.3 State of the loan portfolio and limits to growth potential	17
4.3.1 Non-performing loans and the status of the loan portfolio	17
4.3.2 Looking forward: Growth potential of the loan portfolio	19
4.4 Heavy taxation of the sector.....	20
5. Efficiency, productivity and competitiveness	21
5.1 Measuring efficiency through illustrative indicators	22
5.2 An overall productivity assessment: The McKinsey study	23
5.3 Sectoral competitiveness.....	23
5.4 Why has foreign bank presence been limited in Turkey?	24
6. Overall assessment and policy recommendations	25
Bibliography	28
Annex 1 The Imar Bank Scandal and the Regulatory Framework	30
Annex 2 Survey Questionnaire.....	31
Annex 3 EU Commission Reports on Financial Sector Development in Turkey	32

The Turkish Banking Sector Challenges and Outlook in Transition to EU Membership

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1. Introduction

The Turkish banking sector (TBS) went through major consolidation during 1999-2003 in the aftermath of a failed disinflation programme (December 1999–February 2001), a devastating financial crisis and a renewed IMF programme that brought about the recovery. In early 2004, relative macroeconomic stability appeared to have been achieved, and having gone through the worst, the sector appeared set for the next phase of consolidation and growth. At this interesting juncture, this paper explores the readiness of the TBS for integration into the European Union. The issue is addressed from four different angles. First, we review the present structure and health of the sector, including the state of the regulatory framework, providing a comparative perspective with the larger EU accession countries (section 2). One broad conclusion that follows is that the sector has gone through much rehabilitation and recovery already, and painful as it was, the banking environment is now much improved and has a first-class regulatory framework.

Second, we look at the sector's financial indicators in 2003, with a view to gauging its readiness to adapt to a more challenging banking environment (section 3). Banks were very profitable in 2003, but this profitability was largely based on the large share of Treasury-bill holdings in banks' portfolios and a spectacular, but arguably one-off rally in yields, while the contribution of true banking activities to profits remained low. Third, we look at the present obstacles to good banking, based in part on interviews with a number of senior bank executives, to identify the most critical issues that hinder progress in the sector (section 4). Until recently, the sector suffered from chronic macroeconomic instability, heavy taxation and a weak loan portfolio. There are promising signs that we may be in the early stages of a much more stable macro-environment and reducing taxation of the sector seems to be a priority in the IMF/World Bank programme. Yet macro-stability is tenuous, reducing financial taxes will likely proceed slowly and steps to clean up the bad loan portfolio appear to have stalled. Moreover, state banks' dominant share in the sector, combined with a seeming lack of willingness toward their privatisation, creates a major obstacle to enhancing efficiency in the sector.

In section 5, we explore issues of efficiency in banking. Admittedly, this is a very wide and technical area that goes beyond the scope of this paper. Thus we look at a few broad indicators of efficiency, highlight key findings of a comprehensive productivity study by the consulting group McKinsey on retail banking and share anecdotal evidence on the competitiveness of Turkish banks.

In section 6, we summarise our findings to assess whether the TBS is ready for EU accession. We conclude that the TBS is already at the level of comparator countries such as Poland or Greece before they joined the EU. There is still scope for important improvements, however, for which we make a number of policy suggestions. Though in principle the country has some ten years to prepare for actual membership, carrying out these reforms swiftly would help Turkey to grow faster and catch up with EU averages sooner.

* This paper benefited from the comments of participants in a workshop held in Brussels in May 2004. We would like to thank Ozlem Derici for able assistance with some of the calculations and charts in the paper.

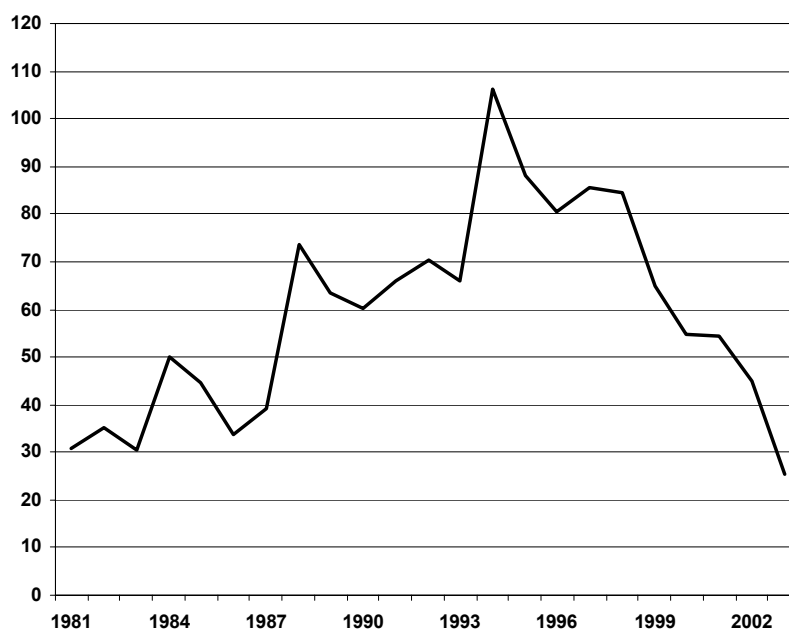
2. Crisis and recovery

A broad review of the restructuring, consolidation and recovery process that the sector underwent in the past three years is critical to understanding the current state of play as well as the way forward for the sector. In what follows, we provide a brief background on the context in which Turkey started banking sector reform, an overview of the rehabilitation programme that followed the 2001 crisis and a snapshot picture of the current structure of the sector, compared with larger European Union accession countries.

2.1 In search of macroeconomic stability

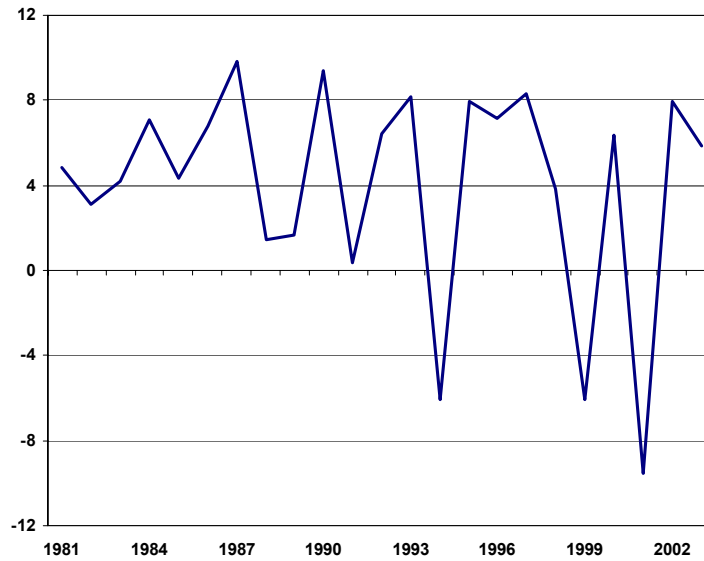
At the onset of the disinflation programme in late 1999, the TBS had several weaknesses, centring on some sort of a 'live and let live' game between the Treasury (the major borrower with an ever-growing deficit) and the banks (the main lenders, thanks to a lucrative 'carry trade' based on the maintenance of large, open foreign-exchange positions). In the late 1990s, any observer of the Turkish economy would have agreed that the sector was marred by several deep-seated problems: a politicised regulatory structure and weak enforcement; pervasive connected-lending practices; several lemons that had survived thanks to T-bill carry trade and deposit insurance; cash-starved state banks; and inadequate capital for the risk exposure of most banks. Clearly Turkey's chronic macroeconomic instability lied at the heart of these problems. Inflation ratcheted up slowly to above 80%, while growth remained extremely volatile (Figures 1 and 2).¹

Figure 1. Trends in inflation over the past two decades



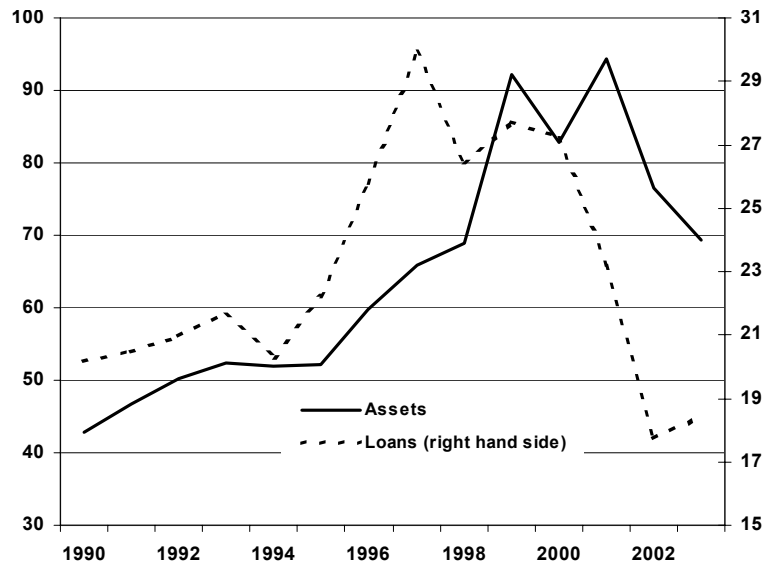
¹ The latter averaged 4% over 1981-2002, which was respectable, but the standard deviation was 5.

Figure 2. Trends in growth over the past two decades



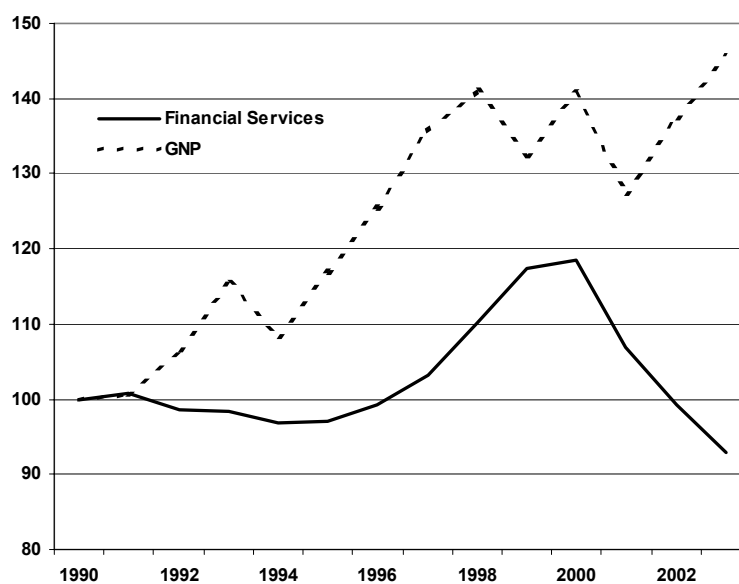
Financial intermediation, measured by the ratios of assets and loans to gross national product (GNP), increased quite significantly through the mid-1990s, but then stalled thereafter and experienced a major setback during the crisis years of 2001-02 (Figure 3). Financial intermediation, particularly as measured by the private loans-to-GNP ratio, increased strongly until 1997 to reach 30% before declining to less than 20% in 2001-02. Value-added growth in the financial sector stayed well below the economy's already weak growth rate as a whole and since 2002 has been below the level of 1990 (Figure 4).²

Figure 3. Banking sector assets and credit to the private sector (% of GNP)



² See section 4 for a brief overview of the academic literature regarding the link between financial development (or good finance) and growth, along with a suggestive thought exercise on Turkey.

Figure 4. GNP versus financial services (value-added; 1990 = 100)



The December 1999 IMF-supported disinflation programme sought to address Turkey's chronic macroeconomic instability, including a growing public debt problem, at a time when the situation had become largely unsustainable. The programme aimed at reducing inflation using an exchange-rate anchor. But it sought to balance risks associated with programmes based on exchange rates by incorporating an 'exit strategy' to the peg (which entailed widening of the band 18 months into the programme) and supporting it by an ambitious package of structural reforms and a sizeable fiscal adjustment. As for the banking sector, the programme strategy was to reform the sector *gradually*, with above-normal profits in the first year of the programme used for partial recapitalisation of the sector. At the heart of this transformation was a new Banking Act, which called for the establishment of an independent Banking Regulatory and Supervisory Agency (BRSA) to take over the supervisory and regulatory functions from the Treasury.

But risks were badly aggravated in due course, and the programme came under attack in November 2000 and collapsed a few months later, with the lira left to float in February. As banking sector excesses played a significant role in bringing about the demise of the programme, the sector was in a very weak financial position in the aftermath of the crisis. The collapse subsequently led to a forced consolidation and a massive injection of public funds into the TBS. The cost of restructuring amounted to over \$50 billion or some 35% of 2001 GNP, including a relatively small amount of funds injected by the private sector itself (Table 1). As the table shows, the restructuring cost to the Treasury of state banks as well as banks taken over by the Savings and Deposits Insurance Fund (SDIF) made up the lion's share of these costs, each at around 15% of GNP.³ On the other hand, the cost of recapitalisation operations to the private sector, including a small sum met from the SDIF's own resources, was a relatively small chunk of the total restructuring costs (some 6.4% of GNP).

³ To clarify, the SDIF met a small chunk of the costs from its own resources, i.e. through premiums paid by the banking sector that had accumulated at the SDIF over time, but the remainder was met through securities on loan to the SDIF in return for 'IOUs' and future collections. The SDIF has recently been separated from the BRSA, with a view to stepping up collection efforts. Thus far, the SDIF has managed to collect about \$2 billion and there is occasionally talk of SDIF's debt to the Treasury being written off.

Table 1. The cost of the banking sector crisis

	US \$ bn	% of GDP
<i>Cost to the Treasury</i>	43.7	29.5
Restructuring of state banks	21.9	14.8
‘Duty losses’	19.0	12.8
Recapitalisation	2.9	2.0
For private banks transferred to the SDIF	21.8	14.7
<i>Cost to the private sector</i>	9.5	6.4
Cost borne by the SDIF	6.7	4.5
Capital injection by shareholders	2.8	1.9
Total	53.2	35.9

Source: BRSA (2003b); Table 12 of the report was modified to include \$6 billion of Imar Bank-related losses.

These figures make the Turkish banking crisis one of the most costly in recent history. The good news is that this painful process of collapse and recovery has led to two major improvements: the sector has now become much leaner and the regulatory structure became almost fully aligned with international standards.

2.2 The rehabilitation programme and evolution of the regulatory structure

The May 2001 Rehabilitation Programme, formulated and executed by the BRSA in consultation with the IMF/World Bank, took a four-prong approach to banking rehabilitation: it sought to restructure state banks, resolve banks taken over by the SDIF, strengthen the financial structure of private banks and further improve the regulatory and supervisory framework.⁴ Although state bank restructuring was completed in the early phases of the programme and the modification of the regulatory structure advanced broadly on schedule – slowly upgrading the system to international standards – progress as regards the strengthening of private banks and resolution of SDIF banks was relatively slow.

The BRSA opted for restructuring and the sale of banks taken over by the SDIF rather than outright liquidation (other than Imar Bank) because of multiple concerns (e.g., to avoid bank runs, to minimise interest and exchange-rate volatility, and to ensure debt sustainability) (BRSA, 2003b). This in turn contributed to substantial slowing down of the process. As for private banks, the BRSA’s approach was completely passive in the first year of the programme, leaving the recovery in bank assets largely to the resumption of economic growth and capital strengthening to injections by shareholders or voluntary mergers. In late 2001, a prolonged recession and continued decline in credit forced the BRSA to become more proactive by officially undertaking a recap operation in June 2002. Around the same time, the BRSA formulated and launched the legal framework to enable smooth functioning of two non-performing loan (NPL) workout mechanisms – the so-called ‘Istanbul Approach’ and the establishment of the Asset Management Corporation (AMC). Even then, however, there has been limited success: the recap operation provided an opportunity for an in-depth penetration into private bank balance sheets and greatly enhanced transparency, but the actual capital injections needed,

⁴ Through regular reports the BRSA kept the public informed about the banking sector restructuring process, hence we provide only a brief overview here. On the approach taken, see various IMF letters of intent and BRSA presentations, as well as Akcay (2003) and World Bank (2003). The BRSA’s approach followed the insights of the economic literature on crisis resolution – see Gray & Holle (1996 and 1997), Dziobek & Pazarbasioglu (1997) and Tang et al. (2000).

somewhat surprisingly, turned out to be much smaller than envisaged, while non-performing loan rescue mechanisms continue to operate very slowly (see Box 3 in section 4 below).⁵

Yet, in the aftermath of a crisis-ridden period, it is perhaps fair to argue that Turkey has largely paid its dues and the restructuring programme was broadly successful in cleaning up the banking environment from its previous excesses and weaknesses. By early 2004, 21 domestic private banks had been taken over (19 of these between the onset of the disinflation programme in late 1999 and mid-2003) and the number of domestic private commercial banks in the system had declined to 18. Moreover, the capital base of the remaining private banks had largely been replenished, and the state banks had been operationally restructured under new management and ceased to be a major source of 'liquidity risk' for the markets. Indications are that the remaining 'contingent liabilities' in the sector are unlikely to exceed 5% of GNP – a manageable level compared to the overall cost of the crisis.⁶ Perhaps most importantly, the regulatory framework had already gone through several amendments, broadly coming to par with EU standards (Box 1). Although the recent 'Imar Bank' episode dealt a serious blow to the credibility of the regulatory framework in general and to that of the BRSA in particular, the scale of the 'fraud' suggests that it was more than just a simple case of regulatory oversight and its implications for the existing regulatory framework should hence be assessed carefully (see Annex 1).

Box 1. Key changes effected in the regulatory structure, from 1999 to the present

The reform of the regulatory structure picked up in the run-up to the 1999 disinflation programme. In June 1999, a new Banking Act was passed (No. 4389), which, among others, called for the establishment of a new autonomous banking agency (the BRSA) and the resumption of its operations in September 2000. This was a welcome step given that, while the regulatory framework needed much improvement (especially with regard to connected-lending practices, transparency and consolidated accounts, etc.), the key problem had been the lack of enforcement rather than the regulatory framework as such. After some haggling over the selection of board members, the coalition government managed to put together a board in late July 2000 and appointed the head of the BRSA in August. Inevitably though, the financial crisis of 2001 shifted the focus of the newly born BRSA from supervision to restructuring and rehabilitation. Over a course of three years, the following key changes were effected in the regulatory system.

Main amendments to the banking law. The Banking Act was fully revised in June 1999 and went through several amendments thereafter (a total of seven, including the latest draft law that seeks to further strengthen rules for bank ownership). Several of the amendments sought to strengthen the BRSA and accelerate asset collection. One of the major amendments was implemented to proceed with the recap by passing a provisional article (Art. 4) as a part of comprehensive legislation (the Law on Financial Sector Restructuring, No. 4743). This legislation defined, among other things, a broad framework for corporate debt restructuring and allowed for the establishment of an AMC. The latest round of amendments, which are expected to be legislated by the end of November this year according to the IMF programme, seeks to bring the legal framework more closely in line with EU standards. As explained in the latest letter of intent (see July 2004), the law focuses on strengthening the legal framework in the following areas: (i) "fit and proper" criteria for bank owners; (ii) on-site inspections; (iii) lending to related parties; (iv) legal protection for BRSA and SDIF board members and staff for actions taken in good faith during the course of their duties; and (v) delineating the responsibilities of BRSA and SDIF respectively and providing for their effective coordination.

Capital adequacy. To bring the practice in line with international standards, the capital adequacy ratio calculation was expanded to include capital charges for market risks on a solo basis and monitoring of internal control and risk-management systems starting 1 January 2002, and on a consolidated basis from 1 July 2002.

⁵ The recap plan had three phases that extended through the end of June 2002, from the completion of three separate audits on the basis of December 2001 balance sheets to the injection of public funds. The two audits were conducted by the banks' own auditors and an externally designated auditor for each bank, respectively, and the final audit was essentially a judgment call by the BRSA.

⁶ At the time of writing, it appeared that the Treasury would issue securities of another 0.5% of GNP or so to enable the merger of Pamukbank, one of the two banks remaining under SDIF management, and Halkbank, the smaller of the two state banks.

Capital adequacy ratios are now calculated every quarter, with on- and off-balance sheet risks incorporated in the calculation.

Foreign exchange (F/X) exposure of banks. To limit F/X exposure further, the ratio was brought to +/- 20% of bank equity on a consolidated basis as of 1 January 2002. To identify structured finance products and to minimise risks, the BRSA established a new committee and a new set of rules.

Connected-lending practices. New regulations introduced the concept of a 'risk group' and defined the shareholders of a bank and its participations as belonging to the same risk group. Replacing the narrow definition of the previous period, which had led to much abuse of connected lending, this concept led to increased transparency of the connected-lending practices. The amount of exposure a bank can take with each risk group was reduced from 75% of the bank's net worth to 25%. In order to comply with this drastic restriction in connected lending, banks were allowed an adjustment period, whereby the ratio would gradually decline from 75% to 25% by 2007. These limits are being monitored by the BRSA and the relevant information is included in the audited financial statements, which are made public.

Limits on participations in non-financial sectors. In the past, conglomerates used their bank to finance their other businesses, frequently in industries unrelated to finance. New regulations limit the amount that banks can invest in other businesses. Banks can now invest only 15% of their net in a non-financial subsidiary and the sum of such participations cannot exceed 60% of net worth. The TBS is allowed a transition period until 2009 to comply with this rule.

Loan-loss reserves and provisioning. The regulations for loan-loss treatment and provision requirements, which are fully consistent with EU standards, were introduced and became effective as of July 2001. The new regulations require a detailed classification of all loans and other receivables from borrowers into five categories: standard, watch-list, limited collection possibility, doubtful collection possibility and write-off. Any loans that have a deterioration of credit or collateral quality, or in any case a non-payment of principal or interest on the due date should be moved out of the 'standard' category. If the non-payment period exceeds 180 days, the loan is progressively re-classified into the last three categories, which are considered 'non-performing' categories that prompt provisioning requirements. Loan provisioning starts at 20% and all loans with a non-payment period of one year must be fully provisioned. The classification of one loan into a non-performing category requires the classification of all loans to the same borrower into non-performing categories, hence providing a strong disincentive for the connected-lending practices of the past. In addition to these special provisions, there are general provisions at the rate of five per 1000 of total loans outstanding and one per 1000 of all contingent liabilities. The provisioning regulations outlined above have been fully operational since January 2002, with the termination of a transition period.

Risk-management practices. To promote internal control and risk-measurement systems, a new practice that requires a well-defined structure and organisation for risk measurement and control has been set forth. The setting up of internal systems for banks is now underway and implementation is expected in 2005.

Accounting and audit practices. To fully adopt the international framework, a new set of accounting policies was announced. Implementation of the full set began in July 2002, after completing the design of the internal systems of the banks. Consolidated reporting requires incorporating the offshore subsidiaries of domestic banks. The switch to inflation accounting was achieved as of January 2003. To establish standards for specifications of external audit and auditors, a new set of rules and practices were announced. External audits are now required to include examinations of the loan portfolio and market risks as well as of internal control and risk-management systems (effective January 2002). Offshore banks that are related to Turkish banks are now covered by BRSA audits.

Non-bank financial institutions. Regulation and supervision of non-bank financial institutions will be transferred from the Treasury to the BRSA by January 1, 2005.

2.3 The present structure

Where does the TBS now stand in terms of size, market structure, asset and liability composition in comparison with five of the EU accession countries from the Central and Eastern European countries (henceforth the CEEC-5)?⁷ With 21 private banks having been taken over or outright dissolved by the

⁷ The EU accession countries used for comparisons in this section include the Czech Republic, Hungary, Poland, Slovakia and Slovenia.

SDIF, the number of private banks is now much reduced and it is hard to talk of the TBS as being ‘over-banked’ (see Table 2). Moreover, compared to the size of the economy, the TBS is still relatively small: total assets stood at some 60% of GDP at the end of 2003, which is less than EU averages. Meanwhile, total assets of *private* banks only stood at 40% of GDP, which is not much smaller than the ratio in the CEEC-5.

Table 2. Number of banks and asset sizes

	Czech Rep.	Poland	Slovakia	Slovenia	Hungary	Turkey
Number of commercial banks	42	75	21	25	33	14
Total bank assets (as a % of GDP)	181	65	96	79	65	60

Sources: Wagner & Iakova (2001) for the CEEC-5 (for 2000) and the Banks Association for Turkey (for 2003).

As for concentration, the industry is dominated by seven large banks (three state-owned banks and four private ones), which account for 75% of the sector. The share of the five largest banks – a common indicator of concentration – stands at some 60% (as of September, 2003), which is higher than the EU average of 50% and lower than the average of EU accession countries of 75% (Pazarbasioglu, 2003). This is a fair ratio in that the level of competition in the sector is sufficiently high to prevent the development of a monopolistic service provider with a price-setting capability, but also, the sector is not too fragmented to preclude reaping the benefit of economies of scale.

The structure of the TBS differs from the banking sectors of the CEEC-5 in two important aspects. First, the share of state-owned banks in the CEEC-5 has declined rapidly in the past decade to 5% in Hungary and 23% in Poland, with no state banks remaining in the Czech Republic. In Turkey, the two state-owned banks, Ziraat Bank (the Agricultural Bank, which has a public mission to lend to farmers) and Halk Bank (which has a public mission to lend to small- and medium-sized enterprises [SMEs]) together account for 27% of the Turkish banking sector (year-end 2002 figures, in terms of total assets). If Vakifbank (a special-status bank owned by foundations) is included, this rises even further to 34%. Second, the CEEC-5 has relied on foreign strategic ownership: in Poland and Hungary, for instance, foreign-owned banks account for 77% of the banking assets and in the Czech Republic for 94%, while in Turkey the ratio is only 5%.⁸

In terms of the ratio of deposits to GDP, Turkey compares evenly to EU accession countries and to some of the EU members (e.g., Italy) (Table 3). But in terms of the composition of assets, Turkey appears to differ significantly from EU members and the CEEC-5. One of the most striking differences is Turkey’s low private-sector-loans-to-GDP ratio (at some 18%), which is lower than in EU countries (both incumbent and accession), and the high share of government securities in total assets (some 44%). As of December 2003, the private-sector-loans-to-GDP ratio had recovered (25%), and the ratio of government securities in total assets had declined (42.8%).

Table 3. Deposit and loan levels

	Germany	France	Spain	Italy	Greece	Czech	Poland	Hungary	Turkey
Deposits/GDP	95.5	64.8	81.0	52.5	56.0	64.5	34.4	38.7	50.0
Loans/GDP	121.0	88.1	106.0	62.7	52.0	41.3	25.2	28.9	17.8

Sources: Pazarbasioglu (2003) and EIB data; figures for EU and candidate countries are for 2000 and 2001; for Turkey these are end-2002 (BRSA figures).

⁸ In Turkey there are a large number of licensed, foreign-owned banks: 13 of the 37 commercial banks are either fully-owned subsidiaries or branches of foreign banks. Their operations are, however, mostly limited to a single branch and to corporate banking. Only three of them – Kocbank, (where Credito Italiano has a 50% stake), HSBC and Citibank – have a multi-branch retail presence. A fourth one, Bank Europa (a subsidiary of Banco Comercial Portugues), has started to build a network.

The picture improves somewhat when we break down these figures into private and state-owned banks (Table 4). The share of government securities in the total assets of state banks is significantly higher than for private banks (60% versus the sector average of 42.5%), with private banks generally doing a better job in channelling private savings into private credit. The position of Halkbank, the smaller of the two state banks, is particularly noteworthy in that, despite a mandate to primarily lend to SMEs, the bank appears to fail badly in performing this function, with 80% of its assets placed in government securities.

Table 4. The public versus private asset allocation of the TBS, end 2002 (%)

	State	Private	Total
Loans/total assets	14.4	33.2	27.7
Government securities/total assets	60.0	35.5	42.5

Source: Turkish Banks Association.

There is also a significant difference in the composition of deposits by denomination. Turkish individuals and corporates can open sight and savings deposits in foreign currencies as well as in Turkish lira. The share of foreign currency deposits is close to half at 45% in early 2004. While state banks have 42% of total deposits versus the private banks' share of 53%, this ratio is almost reversed in TL deposits. State banks have 57% of Turkish lira deposits and private banks have 40%. Private banks have 70% of foreign currency deposits.

3. Overview of the financial solidity of banks in 2003

The past two years, especially 2003, have been good for the sector, helping it to recoup some of the losses from the 2001 crisis. What has been the key source of this profitability? Can it last? In this section, we briefly explore these questions. After sharing a few observations on the sector as a whole, we take a somewhat more detailed look at the financial indicators of the banks listed on the Istanbul stock exchange (ISE). In a nutshell, we come up with two broad, and admittedly simple, observations: notwithstanding the sharp improvement in profitability, it is unlikely to last, and though capital adequacy ratios look healthy, the free capital of the sector is quite low. These indications, in turn, suggest that although 2003 was a successful year for the TBS, the sector is not necessarily well-positioned for a more challenging banking environment.

3.1 A general assessment

Real assets of the sector remained broadly stable in 2003 (reflecting the impact of real appreciation on the relatively large share [some 45%] of F/X-linked assets and deposits in the balance sheets), but profitability remained high (Tables 5 and 6).

After a TL 2.4 quadrillion (some \$1.5 billion) in net earnings (before tax) in 2002, the sector managed to generate another TL 5.7 quadrillion (some \$4 billion) last year – a 100% growth in real terms. As Table 5 indicates, 'trading activities', i.e., gains associated with the rally in interest and exchange rates, appear to be the main driver of this profitability, with TL 6.7 quadrillion net trading gains out of some TL 8 quadrillion of net income before tax. But this is not very surprising. Real interest rates on government borrowing were high during most of the period, but have declined sharply since the end of the Iraqi war (Figure 5), thereby allowing banks to record hefty profits on a marked-to-market basis. Combined with the large share of securities in bank portfolios noted in the earlier section, the rally in yields led to significantly higher profits than in earlier years (Figure 6).

Table 5. Selected items from the balance sheet of the banking sector

	2003	2002
Total assets (in quad TL)	249.7	212.7
(12-month real growth; %)	-6.3	-13.5
(% of total)		
SDIF	2.8	4.4
Public banks	33.3	31.9
Private banks	57.0	56.2
Foreign banks	2.8	3.1
Investment and Development banks	4.1	4.4
Loans (% of assets)	26.2	23.1
(% of total)		
Public banks	18.5	15.5
Private banks	70.0	69.5
Nonperforming loans (as a % of gross loans)	3.6	7.6
Public banks	6.6	15.6
Private banks	2.7	4.6
Securities portfolio (% of total assets)	42.7	40.5
(% of total)		
Public banks	44.8	45.6
Private banks	48.3	46.2
Deposits (% of total)		
Public banks	38.6	35.1
Private banks	56.9	58.4
Net earnings (as a % of total assets)	2.3	1.1
(% of total)		
Public banks	31.5	44.8
Private banks	51.4	103.1
Open F/X positions (gross; \$ billion)	0.0	-0.6
o/w: private banks	-0.4	-0.5
Capital adequacy ratio (%)		
Total	30.9	26.1
Public banks	56.3	48.3
Private banks	23.5	19.6
Foreign banks	36.2	32.6

Sources: BRSA and authors' calculations.

Table 6. Selected income statement items

	2000	2001	2002	2003
Net earnings	-2.8	-11.9	2.4	5.7
Net interest income (after provisions)	2.6	9.1	9.2	8.6
Interest income	22.6	58.2	44.4	39.3
Loans	7.6	15.4	10.4	10.5
Banks	2.9	8.6	1.5	0.9
Securities	4.2	20.4	27.5	23.2
Other interest expense	7.9	13.8	5.0	4.7
Interest expenses	18.0	39.9	31.6	28.0
Deposits	11.3	30.1	26.3	23.2
Other	6.7	9.8	5.3	4.8
Provisions (past-due and unexpected loan losses)	2.1	9.2	3.6	2.6
Net non-interest income	-4.7	-20.0	-5.7	-0.5
Non-interest income	3.3	5.5	7.7	7.2
Non-interest expenditure	6.3	11.0	12.1	12.7
Specific non-interest income	-1.7	-14.5	-1.2	5.0
Net trading gains	-1.7	-11.0	0.9	6.7
Net capital market transactions	0.3	-1.2	3.3	5.1
Net F/X transactions	-2.0	-9.7	-2.4	1.6
Net income from extraordinary transactions	0.0	-3.6	0.0	0.1
Net income from net monetary polistion	0.0	0.0	-2.1	-1.8
Net income before tax	-2.1	-10.9	3.5	8.1
Tax	0.7	1.0	1.2	2.5

Sources: BRSA and authors' calculations.

Figure 5. Real interest rates (% compounded)*

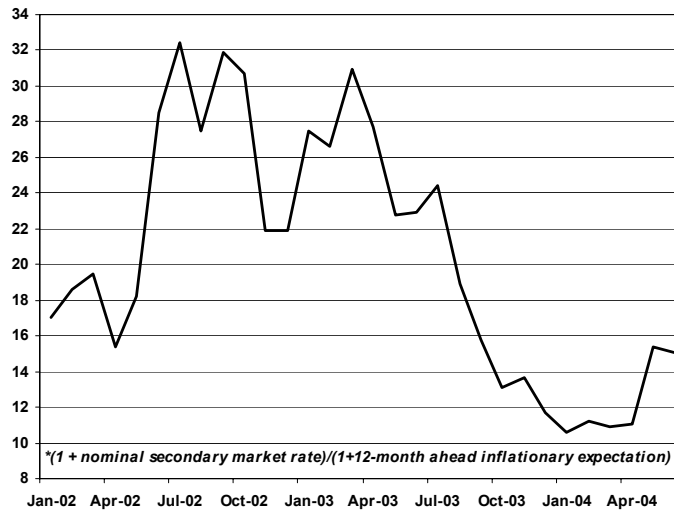
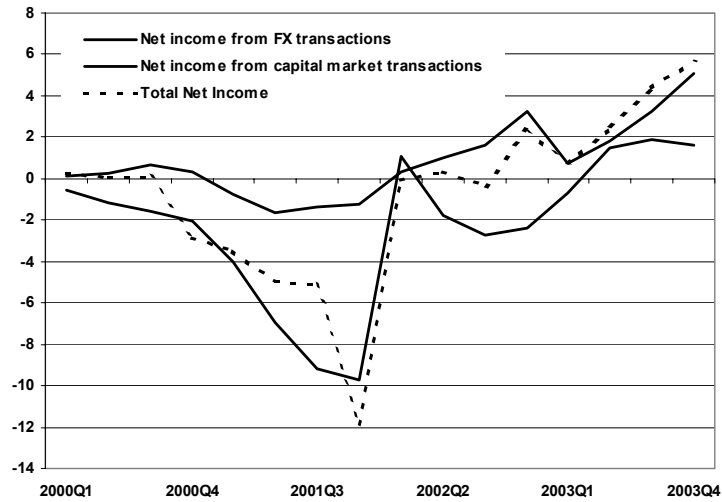
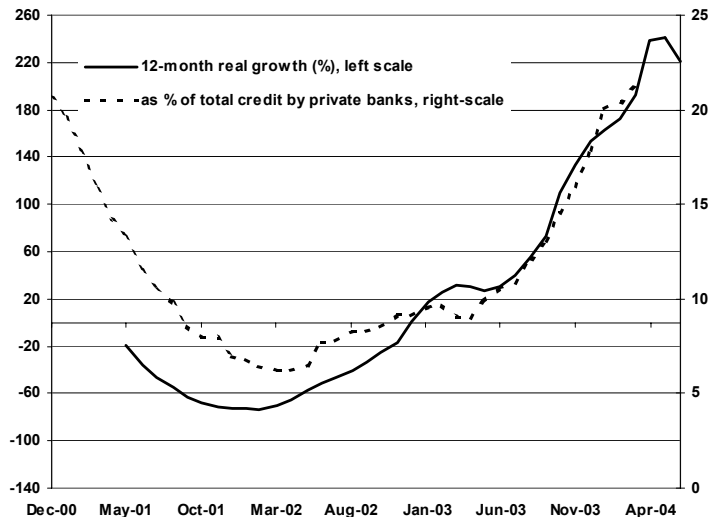


Figure 6. Net trading gains (TL quadrillion)



Clearly though, it seems that it is no longer possible to achieve this level of profitability from investing in government securities. Macroeconomic stability appears to have been relatively restored with real rates having come down to some 12% and banks being forced to change their asset composition toward loans, as revealed by the sharp growth in consumer loans (Figure 7). With macroeconomic stability gaining ground, real rates should decline further, but gains comparable to last year are arguably one-off. (In fact, real rates have slightly risen again since April, attesting to a volatile year that the sector will have to live through.)

Figure 7. Consumer credit by private banks



As for the capital adequacy of the sector, there is clearly a significant improvement since the May 2001 rehabilitation programme and the sector appears to be very well-capitalised (see Table 5). Taking private banks, for instance, the capital adequacy ratio (CAR) has improved further from 19.6% in 2002 to 23.5% last year, which is much higher than the CAR for leading banks in Europe and North America. Obviously, this reflects the large share of government securities (with a zero risk-weighting) in bank assets and a change in the composition of bank assets in favour of loans to the private sector (with a 100% risk weight) would lower CARs. For example, if private banks increased their loan share

from 33% to 50% of total assets (offset by a reduction in government securities) the CAR would decline from 23% to 15%. This is a substantial drop, but nevertheless still in line with the CARs of leading international banks. Should such a dramatic change in the asset composition occur as assets expand, banks will need additional capital. Improved earnings contribute to increased reserves and, combined with a much-improved balance-sheet quality, make it easier to raise fresh capital from the market.

3.2 ISE-listed banks: A closer look at the financial indicators

A closer look at the ISE-listed banks' financial indicators provides a better picture. After all, these nine banks, which include the 'Top-4' and make up 85% of private bank assets (Tables 7 through 9), are those that have the highest chance of adapting to a more challenging environment.

Table 7. ISE banks' balance sheet items

	Assets as a % of		Loans as a % of		Securities as a % of		Deposits as a % of		Equity as a % of		Net earnings as a % of	
	2003	TBS	2003	TBS	2003	TBS	2003	TBS	2003	TBS	2003	TBS
Akbank	29.5	20.7	8.7	19.0	14.1	27.4	19.1	21.7	5.0	24.1	1.3	45.4
Iş Bankası	31.1	21.8	8.6	18.7	11.8	23.0	19.6	22.2	5.6	26.8	0.4	14.5
Garanti Bankası	22.4	15.7	6.9	15.0	9.5	18.5	14.4	16.3	2.5	11.7	0.3	10.3
Yapı Kredi	20.9	14.7	8.0	17.4	5.1	9.8	13.4	15.2	3.5	16.8	0.2	5.6
Diş Bank	5.2	3.7	2.0	4.4	1.4	2.8	2.7	3.1	0.9	4.2	0.2	5.9
Finansbank	5.7	4.0	2.6	5.7	1.7	3.3	3.6	4.1	0.8	3.7	0.2	5.2
TEB	2.8	2.0	1.2	2.5	0.1	0.2	2.0	2.2	0.3	1.6	0.1	1.7
Şekerbank	2.5	1.8	0.7	1.6	1.1	2.2	2.1	2.3	0.2	0.8	0.1	2.0
Tekstilbank	1.2	0.8	0.5	1.1	0.1	0.3	0.7	0.8	0.1	0.6	0.0	0.2
TBS (private)	142.3	85.3	45.8	85.7	51.5	87.4	88.2	88.0	20.9	90.4	2.9	90.9

Sources: Istanbul Stock Exchange and authors' calculations.

Table 8. Selected items from income statements of ISE-listed banks (2003) (in trillions of TL)

	Ak	Is	Garanti	YKB	Dis	Finans	TEB	Seker	Tekstil	Total
Net earnings	1,325	423	302	162	172	153	51	59	6	2,653
Interest revenues	3,736	3,665	2,101	2,498	620	754	325	417	149	14,264
o/w: Credits	977	1,601	1,074	1,520	279	403	178	210	92	6,334
Money market transactions	311	48	9	11	79	7	87	0	0	553
Securities	2,354	1,848	886	853	206	313	24	178	49	6,710
Interest expenses	2,003	2,570	2,045	2,567	382	470	188	350	113	10,688
Net interest income	1,733	1,095	56	-69	238	285	137	67	35	3,576
Net trading gains	1,726	900	713	480	137	155	53	106	21	4,292
Net capital market transactions gains	1,349	670	558	451	152	0	41	64	27	3,312
Net F/X transactions gains	378	230	155	29	-15	155	11	42	-6	980
Net earnings as % of TBS (private banks)	45.4	14.5	10.3	5.6	5.9	5.2	1.7	2.0	0.2	90.9

Sources: Istanbul Stock Exchange and authors' calculations.

Table 9. Performance of ISE-listed banks 2002-03

	ROA (%)		ROE (%)		NPL ratio (%)		Free capital (quad. TL)		Loans/deposits	
	2003	2002	2003	2002	2003	2002	2003	2002	2003	2002
Akbank	4.5	2.8	26.3	21.1	0.0	0.0	4.1	2.8	0.5	0.4
İş Bankası	1.4	0.5	7.5	2.9	0.0	9.6	0.3	-0.5	0.4	0.4
Garanti Bankası	1.3	0.6	12.3	7.3	0.0	0.0	-0.6	-1.1	0.5	0.4
Yapı Kredi	0.8	5.9	4.6	40.2	2.3	3.5	-0.5	-1.0	0.6	0.5
Diş Bank	3.3	2.1	19.6	14.4	1.2	0.6	0.5	0.2	0.7	0.6
Finansbank	2.7	3.8	19.9	35.2	0.0	3.9	0.3	0.0	0.7	0.5
TEB	1.8	0.8	15.6	7.2	0.7	0.6	0.1	0.1	0.6	0.5
Şekerbank	2.3	0.5	33.4	10.0	18.4	23.8	-0.1	-0.1	0.4	0.3
Tekstilbank	0.5	5.4	5.4	61.8	0.5	2.8	0.0	0.0	0.7	0.4

Sources: Istanbul Stock Exchange and authors' calculations.

As for return on assets (ROA), with the exception of one bank that has been suffering from a large non-performing loan ratio in its balance sheet, the banks have acceptable ratios. In the transition economies of Central and Eastern Europe, only so-called 'green field' foreign banks and privatised banks tend to have ROA ratios greater than 1% (foreign banks have 2.2% and privatised banks have 1.7%) (Bonin et al., 2004). Return on equity is quite high for Akbank and Finansbank, and is acceptable for other banks, especially in light of the fact that these are inflation-adjusted figures. The problem however is that when ratios are calculated excluding the trading gains of 2003, which are unlikely to be repeated in the future, both ratios decline. This decline is especially dramatic for Yapı Kredi and Finansbank.

Another not so favourable piece of news concerns 'free capital', which would appear very important in Turkey's volatile financial environment. We calculated free capital for illustrative purposes by deducting NPLs net of provisions, subsidiaries, participations and fixed assets (land, buildings, etc.) from total equity (there is no standard definition of free capital). As Table 9 above shows, only Akbank has significant free capital; İşbank has negligible free capital and Garanti and Yapı Kredi have negative free capital.

4. Obstacles to sound banking

Despite a much-improved regulatory framework and a leaner environment, a 'take off' in the sector nevertheless seems hindered by a number of complicating factors. These factors can be classified into four broad categories, which include (roughly in order of importance) macroeconomic stability, the dominant role of state banks, the status of the loan portfolios and heavy taxation of the sector.⁹ A fifth problem that has adversely affected the soundness of the sector – the 'blanket deposit guarantee' – is now terminated, with the coverage having been reduced to EU-comparable levels as of July this year.¹⁰

⁹ These factors were partly identified through interviews with a number of bank executives. See Annex 2 for the questionnaire used in these interviews. For an evaluation by the EU of the progress achieved by the TBS and remaining pitfalls see Annex 3 and European Commission (2001, 2002 and 2003).

¹⁰ Before we move to other factors, a brief historical background on the deposit guarantee system may be helpful. The blanket deposit guarantee has been around for ten years and caused much 'moral hazard' on the part of depositors and distortion in the sector, but at the same time it may have helped to prevent wide-scale 'bank runs' – a phenomenon never observed in Turkey despite the many financial crises the country underwent. The blanket state guarantee was first introduced to ward off the 1994 currency crisis. Though the initial plan was to phase out the unlimited guarantee once the situation normalised, the temporary policy turned into a permanent

4.1 Macroeconomic instability

As we have noted in section 2, chronic macroeconomic instability and the resulting high real interest rates are possibly among the key factors that curtailed the development of financial intermediation in Turkey. High real interest rates could discourage financial intermediation at least in two ways, through what one could call ‘direct’ and ‘indirect’ channels: the direct channel would work as high and volatile real interest rates discourage both demand for credit (through uncertainty) and its supply (through crowding out). The indirect channel would work through diverting talent away from productive and core banking activities to Treasury operations. Any observer of the Turkish economy would agree that the 1990s were profoundly characterised by these tendencies, with low growth, poor income distribution and a large informal economy keeping the economy far below its potential. In light of recent academic research, which appears to have established a strong connection between good finance and general economic growth, one could argue that strong financial intermediation is not only key to economic growth going forward, but was also a contributor to Turkey’s unimpressive growth rate in recent years (see Box 2).

Box 2. Financial sector development and growth

During the last 15 years the economic literature has both theoretically and empirically been able to demonstrate a strong relationship between economic growth and financial sector development. In King & Levine (1993), four financial indicators are added to a standard modern growth model. The control variables are initial income, initial secondary school enrolment, the ratio of trade to GDP, the ratio of government spending to GDP and average inflation. The four financial indicators are financial depth (broad money/GDP), the importance of banks relative to the central bank (the ratio of deposit-money banks’ domestic assets to deposit-money banks’ domestic assets plus central-bank domestic assets), the share of credit to the non-financial private sector in total credit and the ratio of credit to the non-financial private sector to GDP. They used a large sample of 80 developing and developed countries.

For the long period (1960-90) examined by King & Levine (1993), higher per capital growth is associated with higher levels of financial development, that is, the indicators tend to rise with higher economic growth. Their regressions not only find statistically significant contemporaneous correlations between all four financial indicators and per capita growth, capital accumulation and a measure of total factor productivity (TFP) growth, but also find significant correlations between initial levels of financial development and subsequent economic growth, capital accumulation and TFP growth. In the cross-sectional study by Levine, Loayza & Beck (2000), the causality between financial development and economic growth was analysed. The results support the hypothesis that economic growth is at least partly explained by the effect of the exogenous components of financial development. (See also IMF, 2004, for a nice overview of this literature, as well as Demetriades & Andrianova, 2003).

In a study of Russia, Beck (2004) applied these results and simulated the loss in economic growth owing to an underdeveloped financial sector. He simulated three scenarios: first, what would have happened to growth if the financial sector had been able to maintain its progress until 1998 beyond that date? Second, what would have happened to growth if Russia had been able to bring its financial sector development to the average level achieved in Hungary and Poland? And third, what would have happened if Russia had been able to bring its financial sector development to the level achieved by the top performers in the King & Levine sample? The

one. The moral hazard this created is generally considered to be the main reason why many private banks, which ended up at the SDIF, took those risks. In July 2000, as part of the disinflation program, the coalition government started to phase out the blanket guarantee, by lowering the ceiling to TL100 billion (more than US \$150,000 at the prevailing exchange rate). The blanket guarantee was re-introduced six months later in December 2000 during the liquidity crisis. During the collapse of Imar Bank in July 2003, the BRSA said it would adhere to the blanket guarantee, but that it would reduce the coverage to deposits that are below TL 50,000 billion (around €30,000) by July 2004, which was executed as planned. This ceiling is broadly in line with the deposit guarantee in EU countries, whereby the level of deposit protection varies between €20,000 and €60,000, but is a bit high for Turkey, given that its average income per capita is about one-fifth of that in the EU. The ceiling covers over 90% of the accounts by the number of accounts, but only about 60% by the size of accounts.

results are suggestive. Under the first scenario the Russian growth rate during 1998–2002 (in the absence of a crisis) would have been 1 percentage point higher every year. Under the second scenario (Russia reaches average Polish and Hungarian financial development by 2002), the growth rate would have been higher by 6.9 to 8.1 percentage points. The third simulation, which is admittedly unrealistic, suggests a 52-61 percentage point higher average annual growth rate.

If we take the fourth indicator for Turkey, that is, the ratio of credit to the non-financial private sector/GDP, which stood in 2003 at 18% and compares to an average of Poland and Hungary of 30%, we can repeat the exercise by asking what would happen to real growth in Turkey if this ratio was increased by 10 percentage points to come close to the level in Hungary and Poland? As the relationship is non-linear (variables are in log) the very low starting point of Turkey will have a much larger impact than, say, a 10 percentage point improvement for Hungary or Poland. With a growth coefficient of 0.028, the King & Levine results suggest that Turkey's growth rate would improve by 2 percentage points annually on average. Although not very precise, this is a strongly suggestive result. There are not many other policy options that can promise such an impact on growth.

Turkey's growth over the last few decades was unimpressive for a developing country that is supposed to catch up. The financial literature suggests that an underdeveloped financial sector is partly the result of overall economic development and partly the cause of volatile and modest average growth. In this view financial reforms are urgently needed and, even if resistance has to be overcome, this effort is worth the trouble. (See BRSA, 2003, which puts forward the conjecture that Turkey should be able to grow faster as financial taxation declines and with it deepening in the sector increases).

4.2 The large share of state-owned banks

As noted in section 2, state-owned banks make up a large segment of the Turkish banking sector (about 42% of total deposits and some 20% of total loans). Although such high ratios are observed in advanced EU countries such as Germany, no accession country has a state bank share close to Turkey's.

State banks were the main contributor to the latest crisis. Subsequent to the crisis, the state banks (Ziraat, Halk and Emlak) have gone through successful operational restructuring as part of the banking sector reform programme (e.g., the merger of Emlak with Ziraat and the appointment of a joint management board; the downsizing of branches and employment; and the passing of legislation preventing 'duty losses'). But now the next phase of reform is marred by uncertainties, and the government (at least until now) has provided mixed signals regarding its intentions.¹¹ One reason could be that Turkey privatised a number of state banks in the mid-1990s, but experience has not been particularly encouraging as most of these banks were among the first to be taken over by the SDIF during the crises years (e.g., Sumerbank).

Regardless of the government's intentions and fair concerns regarding the privatisations of state banks, the presence of these banks adversely affects the smooth functioning of the banking sector in a number of ways. For one thing, following the imposition of a ceiling on the government guarantee on deposits, state banks continue to be perceived as having an 'implicit' blanket guarantee. This may lead to a migration of deposits, especially large TL deposits from private to state banks,¹² putting private banks – no matter how financially sound – at a competitive disadvantage.

Second, though state banks have arguably a few strengths (such as the franchise with SMEs and farmers or loyal depositors), weaknesses such as infrastructure, staff quality and ability to compete

¹¹ Numerous examples of these mixed signals can be found in the local press. Another interesting issue is the recent attempts by the Turkish post office to obtain approval from the BRSA to offer banking services, which appear to contradict the broader objective of reducing the role of the public sector in banking.

¹² As of 20 February, state banks had 42% of all deposits, but 57% of TL deposits and only 24% of foreign currency deposits. They have only 21% of total loans, so loan migration and certain products (F/X deposits) are unlikely to pose a problem.

with private banks in terms of service quality and innovation seem to overpower the strengths by far.¹³ Consequently, there is currently discussion on the possible strategy for state banks and the government's intentions. Banking sources (mainly representing private banks) sound pessimistic that state banks can be privatised – and they propose instead that state banks be reduced in size and stick to their original public functions. This strategy, in their view, would prevent the state banks from distorting the market. In order to continue with their function of agricultural- and SME-lending, they need not continue as universal banks with a deposit-taking license. The counter argument to privatisation, expressed by the current management of Ziraat and Halk, asserts that no potential buyers would be interested in the state banks as they are and therefore they must first improve their results as commercial banks and then be put up for sale. The recent forays of these banks into consumer products, especially into the credit card business should be interpreted in this context.

Finally, state banks hold a monopoly on banking with state enterprises and foundations in Turkey, which are barred from opening an account with private banks and can only bank with state banks. This practice gives state banks a complete monopoly on the cash management of state enterprises and foundations. Arguably, the practice also deprives this captive customer base from using the more advanced financial products offered by private and foreign banks. In addition, according to industry sources, state banks have also continued the habit of bidding up interest rates on TL deposits (offering higher rates than large private banks) to maintain their market share. These two factors partly explain their dominance in Turkish lira deposits.

4.3 State of the loan portfolio and limits to growth potential

With regard to the loan portfolio, the banking system appears to be faced with two key problems. First, although the problem is much smaller than in the comparator countries that went through similar financial crises, there are aspects of the non-performing loans in Turkey that still have to be tackled. They still make up a relatively sizeable portion of the loan portfolio and hamper growth. Second, regardless of the NPL problem, the growth potential of the loan portfolio appears limited in the very near term, which emerges as a key obstacle to growth and profitability, and enhances macroeconomic risks.

4.3.1 Non-performing loans and the status of the loan portfolio

Immediately after the 2001 crisis, the BRSA had to cope with three types of NPL problems, which had almost reached one-third of the total loan portfolio (Table 10): the connected-lending practices of numerous private banks that became insolvent and were taken over by the SDIF; the NPLs of state-owned banks, which had to be fully provisioned for using public funds; and the better-managed private banks, which saw an increase in NPLs as a result of the deteriorating economy and hence needed some sort of a debt-workout mechanism.

As the total loan portfolio was relatively small compared to both total assets and GDP, NPL growth was not the major source of the banking crisis as was the case, for instance, in Asian economies during 1997-98 crisis. Nevertheless, NPLs accounted for close to half of the restructuring costs. The problem had been concentrated in two segments of the sector: private banks transferred to the SDIF and state-owned banks. The former was mainly owing to connected lending to the controlling shareholders of the banks.¹⁴ The portion of this restructuring cost from non-performing loans extended to companies

¹³ In fact, McKinsey (2003) finds that state banks are a key drag on productivity in the sector (see p. 212).

¹⁴ Connected lending has traditionally been a major problem of the TBS. Prior to the 2001 crisis, the problem had been aggravated by both the weak enforcement of the regulations and by legal loopholes, which allowed the controlling shareholders to lend to their non-financial businesses without exceeding the legal lending limits. Treasury auditors had been aware of the over-lending to subsidiaries or affiliated companies. Some bank shareholders infamously invested in new ventures where the only lender was the owner's bank. In addition, shareholders used cross-holdings, relatives and friends, etc. to further their interests. By the late 1990s, the problem had reached proportions that constituted a systemic risk to the sector as a whole.

controlled by the majority shareholders of these banks was \$11 billion. (Of this amount, \$9 billion was lent directly from the bank to the shareholders and another \$2 billion came from other banks that ended up with the SDIF, collateralised by the owner's bank). The problem of NPLs in state banks was mainly the result of politically motivated lending. Both had little to do with the drastic contraction of the economy in 2001. The private NPL portfolio rose to 28% of total loans in 2001, a very high figure by international standards.

Table 10. NPL ratio and provisions in the Turkish banking sector

	NPL ratio (%)			Provision/NPL (%)		
	Dec-01	Dec-02	Dec-03	Dec-01	Dec-02	Dec-03
State banks	37.3	37.4	26.2	62.7	73.9	97.6
Private banks	27.6	8.9	6.5	31.5	53.0	80
Foreign banks	5.5	4.9	4.3	75.6	77.7	78.5
Investment banks	10.7	4.0	3.5	82.3	64.2	90.3
SDIF banks	67.3	69.4	53.8	55.9	60.5	75.4
Total	29.3	17.6	11.5	47.1	64.2	88.5

Sources: BRSA Annual Report 2003 and authors' calculations.

The restructuring programme tackled the state and SDIF banks. There has not been a significant improvement in the NPL portfolio of state banks, but with the help of recapitalisation, they are now well provisioned. Prior to the restructuring, state banks had mainly been financing the Treasury and commercial loans had not been a substantial part of their activity. The bulk of lending consisted of politically motivated lending to companies or groups, which did not and could not have access to private-sector credit, because of their low level of creditworthiness.

Asset collections from former owners, or more generally, asset resolutions have gone fairly slowly until now, but there has been some progress of late. First, the SDIF has signed long-term repayment agreements with controlling shareholders of a number of banks for a total of about \$3.5 billion.¹⁵ Second, to improve enforcement SDIF was separated from BRSA, as of January this year (see Box 3). Finally, SDIF started to auction bad loans of banks taken over, as part of the IMF programme.

Box 3. Whither the 'Istanbul Approach'?

For resolution of the NPLs of private banks, the Bank Association of Turkey, with the approval and support of the BRSA, initiated the Financial Restructuring Framework Agreements to work out the corporate debt problem. The platform was named the 'Istanbul Approach' (after the London Approach of the 1970s, where banks and corporates gathered under the auspices of the Bank of England). Initially, progress was slow largely reflecting difficulties in pulling banks with conflicting interests around a unified framework, but eventually 25 banks and 17 non-bank financial institutions signed the agreement. The initial understanding was that private banks, in return for restructuring their creditors' debt, would be able to remove the NPLs from their balance sheets and international institutions would provide some of the financing required. The plan did not quite develop in this direction. In general, results have been mixed, the key problem being that the Istanbul Approach essentially evolved into a platform of *postponing* rather than *restructuring* debt. That the private banks have not received any support also contributed to this outcome, and they now carry the restructured loans on their balance sheet. (They have only been provided an exemption from provisioning requirements for loans restructured within the Istanbul Approach.)

¹⁵ Excluding the latest Cukurova deal, signed in early August 2004. Banking Law changed to take legal action to seize personal assets of SDIF banks' former shareholders. The first implementation was the seizure of the assets of The Uzan family in February 2004, while most SDIF banks were provided with a gradual compliance plan. As explained in Box I above, the latest round of revisions to the Banking Act that are underway, are seeking to tighten rules for bank ownership further.

The total loans brought under the Istanbul Approach platform for ‘restructuring’ as of October 2003 (BRSA, 2003b) is provided in the table below:

<i>Debt restructuring within the Istanbul Approach</i>		
	Number of debtors	Total restructured debt (\$ million)
Large corporates	20	4,561
SMEs	69	555
Total	89	5,116

In another attempt to tackle the NPL problem, asset management companies, which would take over the bad loans of the TBS, could develop as another method. Despite legislation and regulations being finalised in 2002, no asset management companies have been established yet.

In summary, the NPL problems of the TBS, after provisioning and after two years of high growth, have come down to manageable levels. Private banks’ NPL/loan ratio in August 2003 stood at 9.4%, with more than half provisioned for. We can assume that NPLs no longer pose a threat to the stability of the system. Nevertheless, they are high enough to discourage lending and act as a brake to further loan growth. (A coordination committee that was to be established under the Treasury to facilitate and monitor the corporate debt restructuring process as well as identify and propose the removal of impediments never took off.)

4.3.2 Looking forward: Growth potential of the loan portfolio

The credit demand in Turkey is derived from three segments: large corporates, SMEs and consumers. The TBS currently faces different problems in profitably expanding in all three segments. Large corporates have never experienced any problems in terms of access to credit. In the completely liberalised financial environment of the Turkish economy, not only domestic banks, but also foreign banks (with or without a local presence) have been willing to lend to Turkish corporates with good credit standing. In other words, lending to corporates has been a ‘borrower’s market’. Consequently, spreads in this segment have reportedly declined to breakeven levels, with the implication that, short of a pick up in growth, there seems to be little room for further loan growth in this fiercely competitive segment.

The SMEs on the other hand have been notoriously underserved, which seems to be explained by a combination of demand and supply-side factors. Even for Halkbank, which is the state bank with the designated mission of lending to SMEs, the loans/total assets ratio is less than 10% (2002 figures). One reason is that SMEs have not enjoyed a comfortable relationship with private banks, which in the past have tried to expand into SMEs as a target market-segment. During the extremely volatile macroeconomic environment in the last decade, however, at the very first sign of a liquidity problem, banks either called in SME loans before maturity or increased interest rates on the existing loans drastically. This practice was repeated in 1994, 1999 and 2001, and created a problem of trust between SMEs and private banks, which subsequently started counting on equity finance for expansion. Under the current more stable macro-environment, the trust between the SMEs and the TBS is likely to be restored, but this will take time.

On the supply side, banks face a problem of evaluating SME creditworthiness and overcoming the asymmetric information problem faced by all banks in dealing with SMEs. In many sectors where SMEs dominate, non-registered transactions are the norm and the actual activity level of the prospective borrower is rarely reflected on the financial statements. This makes it difficult to make valid credit decisions about SMEs. This problem is especially great for foreign banks, which have to comply with their global credit practices.¹⁶ In more developed markets most of the lending to SMEs is

¹⁶ A key drawback for SMEs would appear to be ‘being informal’.

secured by mortgages and pledges on property (merchandise, machinery, trucks, cars, ships, etc.) or revenue streams. To boost lending to SMEs, the legal instruments first need to be created.

Given these problems with lending to enterprises, be it blue chip or SME, the third segment, retail lending, becomes the only possible loan growth area. One problem though is that this is a relatively new area for the TBS, the first one of which ended in tears. The first consumer-lending boom in recent history took place in 2000, which ended in the 2001 crisis. Banks started to lend again to consumers in late 2003 and total consumer loans (including car and house loans) tripled, restoring its share in total loans to the pre-crisis levels of 15%. Although growth is still slow, little is known about the effectiveness of growth in this area.

At the end of 2003 there were 2.5 million consumer loan contracts outstanding. In a country with an estimated 15 million households, this figure may indicate that there is a lot of room for growth. Yet industry sources assert that this represents the bankable population of Turkey at the moment. The remaining majority of the population does not demand banking products, including loans. The reasons frequently cited are low levels of per capita income in the lower income levels, unequal distribution of income, the relatively recent history of urbanisation and low levels of education. At any rate, in a country with a notorious current account deficit owing to an insufficient level of domestic savings, a strong growth of consumer lending would not be desirable, at least as long as the government still runs a sizeable deficit. Should consumer lending develop strongly the government may even wish to curb it with a tax.

A further constraint on the supply of loans is the method of calculating capital adequacy ratios in line with the original Basle criteria. The current criteria assign a zero risk-weighting to sovereign debt instruments, whereas loans to the private sector have a positive risk-weighting. If the composition of assets were to change towards a larger share of loans, this would lower the capital adequacy ratios automatically.

4.4 Heavy taxation of the sector

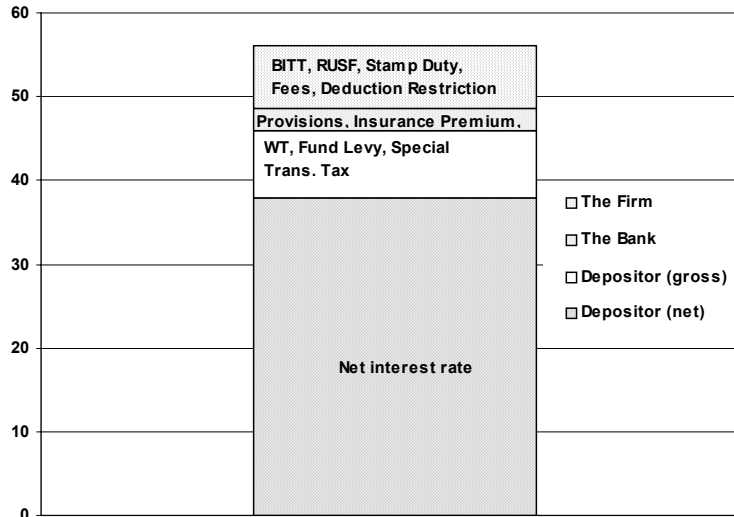
The heavy taxation of the financial sector has received much attention in the past two years. A working group has been formed at the BRSA, with a view to analysing the problem and formulating recommendations. The large business association, TUSIAD, and the Banks Association also formulated their proposals in this connection. In a comprehensive and carefully prepared report, BRSA shows that for 2002, various taxes and fees on financial intermediation (including reserve requirements) raised the cost of TL-credit by over 50% (Figure 8) and about as much for foreign-exchange denominated loans.¹⁷ The study finds that some 85% of these costs are passed on to the consumer.

Heavy taxation, like all excessive taxation, causes two problems: it creates a form of 'financial repression' by way of overburdening the sector and impeding its growth; it also causes the migration of financial intermediation abroad in a liberalised capital account. Evidence of the latter is two fold – the high level of non-financial private sector external debt (\$27.5 billion at the end of 2003) and the ratio of credits extended through foreign branches and subsidiaries of local banks to total credit, which stands at some 40%. In other words, the TBS has reacted to heavy taxation with the migration of both deposits and loans to subsidiaries or branches abroad. Almost every Turkish private bank worth its name has established a subsidiary bank in Europe, with the Netherlands as the favoured location. As of the end of 2002, 40% of all loans by Turkish banks had been booked offshore, mainly to companies domiciled in Turkey. International branches and affiliates accounted for 22% of total assets and 16% of deposits. The asset and liability migration initially created a supervision problem as the international subsidiaries were outside the jurisdiction of Turkish regulatory authorities. This problem

¹⁷ Figure 8 was reproduced from a BRSA study. It builds up the cost of numerous taxes and fees from the net interest stage (paid to depositor) to the lending phase, including (net) required reserves – i.e., required reserves held by banks, adjusted for the remuneration they receive at money market rates.

has now been solved by the BRSA auditing the international subsidiaries and branches along with the production of financial statements, consolidating these subsidiaries. Nevertheless, the burden continues on the TBS in the sense of allocating capital and resources to these subsidiaries.¹⁸

Figure 8. From TL deposit to commercial credit (%)



5. Efficiency, productivity and competitiveness

In this section, we take up a fourth angle in assessing the readiness of the TBS for EU integration, and explore issues of productivity, efficiency and competitiveness. Admittedly, this is a very broad and data-demanding area, and a thorough examination goes beyond the scope of this paper.¹⁹ Instead, we do three things: we look at a few broad indicators of efficiency, summarise the findings of a comprehensive productivity study by the consulting group McKinsey on retail banking and share some anecdotal evidence on the competitiveness of Turkish banks in the current environment.

We conclude that the record is somewhat mixed. Despite weak ‘financial intermediation’ and excessive reliance on government securities, Turkish private banks come across as relatively advanced as retail franchises.²⁰ They have made large investments in IT infrastructure and exploited the efficiency gains offered by alternative distribution channels. Internet-based and telephone banking have become standard options, with an increasing proportion of transactions moving to these channels from the traditional branch network. Most of the banking executives we interviewed were of the opinion that private Turkish banks are as advanced as any bank in the EU with regard to retail banking, and that given the skilled resources they employ, they were capable of developing and maintaining this level of service. This would appear to be an important asset as Turkey prepares to enter a common market for financial services, as called for by the EU’s Second Banking Directive.

¹⁸ In 2002, fiscal revenue from this taxation amounted to about 3% of GDP; meanwhile, with declining interest rates, total fiscal revenue from the financial sector appeared to have been halved in 2003, and simulations suggest that it would have dropped to about 0.5% of GDP should the interest rate declined to European levels of around 10%. Tax “rate” would decline as well, although still remain significant at almost 40% even at 10% interest rate.

¹⁹ The terms ‘efficiency’ and ‘productivity’ for our purposes are very close to each other – essentially, *productivity* is a measure of economic *efficiency*, which shows how effectively economic inputs are converted into output. On the other hand, competitiveness is, by definition, a relative position, but arguably it also boils down to productivity/efficiency.

²⁰ State banks suffer from low-skilled human resources, an underutilised IT infrastructure and a lethargic service level, typical of many state-owned enterprises.

But all is not well. As a McKinsey study shows, the sector seems to suffer from low levels of productivity compared with both the benchmark country (the US) and its own potential, while our simple, illustrative indicators suggest that efficiency gains in the sector are a recent phenomenon. Moreover, anecdotal evidence suggests that Turkish banks are already suffering from competition, with heavy taxation being a major drawback.

5.1 Measuring efficiency through illustrative indicators

There is little doubt that compared with the 1990s, the TBS is now much leaner in terms of standard efficiency measures such as deposits and assets per employee and per branch. Perhaps the most striking statistic is that, despite the tripling in both deposits and assets in the 1990-2003 period, the total numbers of employees and branches are now lower than they were at the beginning of the last decade (Table 11). Specifically, the sector employed 154,000 staff in 6,500 branches in 1990; it now employs 123,000 staff in 6,000 branches. The numbers peaked in 2000 with 170,000 staff and 7,800 branches, then declined rapidly. The productivity gains were achieved in the post-crisis 2001-03 period during which personnel numbers declined by 28% and branch numbers by 24%.

Table 11. Efficiency indicators

	1990	1995	1999	2000	2001	2002	2003
Deposits (\$ billion)	32.5	43.5	89.1	101.6	81.2	86.9	111.2
Assets (\$ billion)	58.1	67.0	133.2	154.6	115.3	129.8	178.8
Deposits/assets (%)	56	65	67	66	70	67	62
Deposits/branch (\$ million)	5.0	7.0	11.6	13.0	11.7	14.2	18.6
Deposits/employee (\$ million)	0.2	0.3	0.5	0.6	0.6	0.7	0.9
Employee/branch	23.5	23.2	22.6	21.7	19.9	20.2	20.7
Assets/employee (\$ thousand)	377	463	766	907	839	1,053	1,451
Assets/branch (\$ thousand)	8,859	10,739	17,320	19,724	16,692	21,259	29,967

Sources: TBA, BRSA and authors' calculations.

In terms of branch density, Turkey has nine branches for every 100,000 persons (a common measure of branch density). Among the EU members, Germany has 60 branches and the UK, Finland and Sweden have less than 25. Among the new members Poland has 6 and Hungary has 11. Employees per branch now stand at 21 and assets per branch at about \$30 million. Assets per employee, which were less than \$400,000 in 1990, are now nearly \$1.5 million. In Poland assets per employee are \$0.8 million and in Hungary these total \$1.5 million. Contrary to what may be expected, the productivity figures of state banks are in line with those of private banks, possibly reflecting the favourable impact of restructuring during 2001-02.

The improvement in the productivity figures of the sector was mainly the result of restructuring of state banks and the liquidation of the SDIF banks. The survivors also improved their productivity through an emphasis on alternative delivery channels. No data are available, but industry sources assert that nearly half of all the transactions of large private banks take place through telephone and online banking. In terms of non-interest costs, Turkey's four largest banks compare favourably with the transition economies. Their 'non-interest cost/total asset' ratio ranged between 3.4% and 4.6% in 2003. For the transition economies, the ratio ranged between 10% for green field foreign banks (the lowest) and 18% for state banks (the highest).

In terms of the most common measure of bank efficiency, the operating cost-income ratio, three of the four largest Turkish banks had a good ratio, in the 30-70% range. The EU average is 61%. Only Yapı Kredi, with a 95% ratio, appears to be 'inefficient' by this criterion. Given that 2003 was a year when

one-off trading results had a big impact on bank earnings, one alternative is to normalise by excluding trading gains. Then, only Akbank and Isbank appear to fall in the acceptable range of efficiency.

Under conditions of high interest-rate volatility, the stability of a bank's earnings depends to a large extent on the income from commissions and fees for the banking services they provide. Historically, with the high interest margin earned from investments in government securities, Turkish banks have subsidised other banking business by offering zero-fee transactions to gain market share. This practice has been discontinued and fees and commissions have started to contribute to the 'bottom line'. The weighted average (i.e., weighted with assets) commission was 1.4% in 2003. This was in line with ratios in transition economies, from a low of 1.3% for state banks to 1.9% for privatised banks. The bulk of commission income is from the consumer business, mainly from credit cards and asset management fees.

5.2 An overall productivity assessment: The McKinsey study

Measuring productivity, defined essentially as output per unit of input(s), is clearly a difficult exercise in the absence of homogenous inputs and outputs, requiring a clear methodology and much data gathering. Luckily, as part of a recent comprehensive study on Turkish productivity, the consulting group McKinsey examines the productivity levels in the retail-banking sector as one of the 13 sectors (McKinsey, 2003).²¹ The study concludes that Turkey has a long way to go in terms of matching the productivity level of the benchmark country (the US) as well as its own potential. Specifically, it finds that labour productivity in the TBS is only 42% of the benchmark US case, and some 46 percentage points below its own potential (which the study calculates is 88% of the US).

The study takes a production function approach to the calculation of labour productivity, whereby three main categories – payment transactions, deposit accounts and loans – are considered as physical outputs and their relevant employment figures as inputs.²² The analysis finds the "organization of functions and tasks" (OFT) in the "payment transactions" category, as the biggest operational contributor to the productivity gap (see Exhibit 4 on p. 199 in McKinsey, 2003). (Other contributors to the productivity gap include capital intensity/technology, scale, capacity utilisation and customer demographics and behaviour, with relatively smaller contributions from these categories except perhaps for customer demographics and behaviour.) This, in turn, is explained by a payment mix dominated by labour intensive, branch-level transactions, with the latter accounting for 46% of all payment transactions (compared to 3% in the US and 7% in the Netherlands). Although OFT-related weaknesses are common to all banks, the study finds that state banks have two additional challenges: the infrastructure for 'alternative delivery channels', and branch design and practices. In fact, low productivity levels in state banks explain 21 percentage points of the 46 percentage point gap between the TBS's current and potential productivity levels. Just aligning their operational efficiency with that of private banks, the study finds, would improve overall productivity by 8 percentage points.

The analysis comes up with three recommendations for policy-makers (two related to state banks alone). One is relevant for the entire banking sector – the introduction of productivity-related performance measures into state banks; the other two involve removing state banks' unfair advantages by levelling the playing field and creating the enabling legislation that encompasses the promotion of alternative delivery channels and improves efficiency in loan application processes.

5.3 Sectoral competitiveness

The TBS is clearly at a competitive disadvantage vis-à-vis international banks in meeting the demands of large Turkish corporates, especially in terms of capital market products. The frequent crises and the

²¹ This is by far the most comprehensive productivity study on Turkey that we are aware of, whereby the standard McKinsey Global Institute methodology is employed to measure productivity.

²² See the appendix to the McKinsey (2003) chapter on p. 219 for an exact description of the methodology used on the measurement of labour productivity.

short-term outlook of the TBS developed under the volatile macro-conditions of the past decade left only a few tools in their arsenal. Under an open capital account, large Turkish corporates with increasingly international businesses have turned to foreign banks and started using financial products that were not available to them locally. Anecdotal evidence abounds that Turkish corporates give only their most ‘mundane businesses’ to the TBS. On the other hand, a wide spectrum of more sophisticated tasks with higher profit margins, ranging from Vestel’s asset-backed bond issue in international markets to Eregli Demir Celik’s long-term investment finance syndicated loan, were all arranged by foreign banks.

Local banks have so far managed to serve the other two segments of the customer base, the SMEs and consumers. The decade-old experience of the only foreign bank to venture into the local consumer business suggests that local knowledge still counts in the Turkish market. Their credit card, otherwise a valuable global brand, has under-performed in the market.

5.4 Why has foreign bank presence been limited in Turkey?

In the new EU member states foreign banks have been the carriers of new technological and *savoir faire* transfers. Why have foreign banks shunned Turkey? The entry of foreign banks into Turkey began with the financial liberalisation in the 1980s. All legal barriers to entry were gradually removed and the Treasury has traditionally been accommodating in granting licenses, be it to open a single branch or register as a full-fledged, incorporated bank in Turkey. A number of foreign banks – commercial banks with a deposit-taking license and investment banks – operate in Turkey at present, but most of them with only one branch in Istanbul. As documented in section 2, foreign banks make up some 5% of the sector’s assets, which is very low compared to CEE-5.

Why has this been the case? The question is interesting, given that, as noted above, legislation is not an obstacle to foreign bank ownership and is arguably more liberal than in many countries that have received more foreign direct investment into their financial sectors.

First, it needs to be recognised that the Central European experience is quite unique. When these countries opened up, they had no history of commercial banking and the most efficient option of quickly transforming their banking system was indeed to invite foreign banks as strategic investors. Second, in Central Europe geography also helped. The ‘gravity model’ not only is pertinent for trade flows, but also for foreign investment (Gros & Steinherr, 2004). It is doubtful that Austrian banks, for example, would wish to have the same presence in Turkey as in neighbouring countries. Third, even in well-banked EU countries the share of foreign banks is less than in Turkey: in 1999, the share of foreign banks was 3.3% in Austria, 7.1% in Finland, 9.8% in France, 4.3% in Germany, 6.8% in Italy, 7.7% in the Netherlands, 10.5% in Portugal and 11.7 % in Spain (Dermine, 2003, p. 48).

Some bank executives we interviewed argued that with the fully liberalised financial regulations of Turkey, a foreign bank that wants to do business with local corporates can do so with one branch, while others can do a lot with only one representative office.²³ Although it is not possible to support it with figures, it is a well-known fact that foreign banks lend a lot more to Turkish corporates than it appears on the balance sheet of their Turkish operations.²⁴ There really is no incentive to expand the balance sheet in Turkey and add ‘currency risk’ in addition to the country risk they have already assumed. The question then becomes: Why are foreign banks not willing to expand business by entering the retail sector, i.e., lending to SMEs and individuals?

²³ This is very similar in nature to what McKinsey calls the “FDI paradox”, i.e., the tendency of foreign participants to have a presence in Turkey but refrain from intense involvement and expansion (see p. 46 in McKinsey, 2003).

²⁴ External debt numbers show a high level of private sector indebtedness, which provides some indirect evidence for this, but a good chunk of this debt, as also noted above, may well be Turkish wealth abroad being recycled into Turkey to avoid several disadvantages, including tax-related ones.

The answer to that question can only be speculative. Until recently, there were barriers other than physical legislative ones. In other words, chronic macro-instability and corrupt banking practices with heavy reliance on T-bill holdings resulted in inflated valuations that acted as a natural barrier to entry. Potential foreign acquirers felt unsure about their ability to sustain high levels of profitability in this environment through ‘operational excellence’ alone (McKinsey, 2003). This appears to have now changed, with Turkey becoming relatively more stable.

However, it also needs to be recognised that the Turkish political and business establishment has not been eager to face foreign competition in domestic markets they carved up for themselves. Legal uncertainties, family ownership of banks, the tradition of having portfolios of industrial holdings and the exposure of banks to the debts of their parent groups, have made acquisition of banks in Turkey less attractive.

Once a track-record of macro stability is established, and certainly when EU accession becomes a concrete vision of the future, foreign bank entries will naturally follow. At any rate, the TBS will go inevitably through a significant consolidation in the next few years. In that connection, able management of this process by the BRSA would appear to be the most critical policy challenge looking forward. A good opportunity is provided by the more than 25 banks under administration. Once restructured some of them could be put up for sale to foreign banks. An encouraging example is the acquisition of the assets of Demirbank by HSBC.

6. Overall assessment and policy recommendations

We have evaluated the TBS along several axes in this report, and our main conclusions and policy suggestions may be summarised as follows:

- First and most importantly, the macroeconomic environment will have to improve further. Macroeconomic stability, defined as single-digit inflation and sound public finances, is essential to a healthy and growth-supportive banking sector. Turkey has made major strides in this regard in the past few years, but the job is not finished yet. Single-digit inflation needs to be sustained, and public finances have some way to go before both budget deficits and public debt as a percentage of GNP are brought fully under control. Maintenance of macro-stability is essential, as without it all other achievements would be at risk. Macro-stability is particularly important given the recent removal of the blanket deposit guarantee.

Also, from a macro-perspective, to support the development of the financial sector, authorities would be well advised to significantly reduce reserve requirements as well as other taxes on financial intermediation in line with general EU practice (ECB, 2003) or remunerate banks at market rates, i.e., fix the rate on Treasury bills to reduce the implicit tax on financial intermediation. As is well known, as banks manage to shift this tax onto borrowers, it acts as a drag on borrowing, hence on financial intermediation and investment. This is true for multitude of taxes and fees that suffocate the financial sector in Turkey.²⁵ Reduction of taxes on financial intermediation has driven large borrowers and depositors abroad. One goal of reduced taxation would be to repatriate these operations and to level the playing field for entry into the European banking market.

The new regulations introduced reporting on a consolidated basis. This is important as Turkish banks have a strong presence abroad through branches and subsidiaries. The new Turkish rules are compatible with the EU Second Banking Directive that makes home authorities responsible for solvency of foreign branches whereas host authorities are responsible for subsidiaries. (For liquidity rules and management host authorities are in charge).

²⁵ Clearly though, these have to be achieved without endangering the fiscal and monetary policy goals of the programme.

Turkey has capital account convertibility that Greece, Portugal and Spain had not yet achieved when they became members of the EU. The capital market is still very underdeveloped as it has been in those comparator countries and as is the case in the new member countries. This is a disadvantage for modern banking – that is, the unbundling of financial services – but rather typical for the present state of development. In the future greater attention needs to be addressed to the development of financial markets for which the regulatory environment of the EU is very demanding. The decision to transfer oversight of financial markets as of 1 January 2005 from the treasury to BRSA, underlines the government’s readiness to disentangle from its, for the Turkish economy, unhappy involvement in financial sectors.

- Second, the regulatory framework and supervision appears to be in good shape. Great progress has been achieved after the recent crisis and the present system is close to EU standards and an independent regulator exists. Of particular note, in this connection, is the fact that Turkey has an independent central bank since May 2001, and inflation accounting has been introduced as of the beginning of 2004. Of course, the new system is not yet fully tested but the new structure combined with a more stable macroeconomic outlook is sure to provide grounds for much greater stability and efficiency.
- Third, the banking system is already open to the outside world. Foreign banks are formally welcomed and there are no capital controls. The fact that foreign banks are not assuming a very important role in TBS is less the result of a “protective policy” than the result of strong competition that makes it difficult for foreign banks to capture easily market shares. In the past macroeconomic instability was certainly also a deterrent. However, as the failed acquisition of a controlling share of GarantiBank by Bank Intesa (Italy) demonstrates, Turkish and EU valuation standards still diverge in areas such as non-performing loans. Turkish authorities would send a convincing signal about changed priorities to international markets if they invited foreign banks to compete for acquisition of the banks presently in administration and restructuring. One of the pillars of the EU banking framework is mutual recognition of banking licenses. This is a much more distant consideration as Turkey cannot yet be part of the single passport rule (implying that a bank licensed in any member country can operate in all others without national approval) which is based on reciprocity.
- Fourth, financial development – as measured by the degree of financial intermediation – is still lagging as it is in the new member countries taken as comparators. In 2003, the deposits-to-GDP ratio was 50% in Turkey, favourably comparing to 35% in Poland or 39% in Hungary, but the loans-to-GDP ratio was 25%, as it was in Poland and short of the 29% in Hungary. As we explained in the main text, financial development will strongly benefit from macro-stability.
- Fifth, for reasons of distorting the playing field and efficiency, government ownership is often considered a negative factor. In Turkey, state banks account for close to 40% of deposits and little more than 20% of loans. This compares unfavourably to most new member countries, yet it should be recalled that in Germany, for example, public sector banks hold more than 50% of the market. The question is whether the privatisation of state banks should be a policy priority. In the past state banks were extremely politicised and badly run, and this danger still exists. Then again, the public sector banks have specific missions, such as lending to the agricultural sector or to SMEs, and private banks may not be able to fully fill these vacuums. It may therefore not only be difficult to privatise these state banks but even somewhat undesirable from a public policy viewpoint. The alternative would appear to be to avoid distorting the playing field and ensure that state banks pursue and stick to their targets. This would require a discontinuation of their privileges, such as the restriction that state and foundation funds be exclusively deposited with state banks. Even better, they should be transformed into ‘narrow’ banks that cannot receive deposits at all and must refinance in the market. This would correct the present anomaly of their strong role in deposit collection, of which only one-fourth is used for loans, thereby depriving private banks of deposits. As argued in section 4, this would give a boost to the development of domestic money and capital markets.

Although state ownership is not an obstacle to acceptance in the European banking family, state subsidies may run foul of EU competition rules. This does not seem, however, to be a problem in Turkey, as subsidies are specific to sectors which receive particular treatment in the EU as well. There are no institutions comparable to the German Landesbanken, which have had problems with EU competition rules.

- Sixth, as in most countries, part of the TBS is inefficient, but some banks are very efficient. A study of the efficiency of European banks by Wagenvoort & Schure (1999), shows that the average of banks in some EU countries deviates as much as 60% from the ‘optimal-cost curve’ (i.e., they suffer from a so-called ‘x-inefficiency’). By that standard, Turkey is not an outlier in the European sample. As for intermediation margins, there are no readily available data on Turkey that could be used for comparison with EU countries and a bare look at the margins could be somewhat misleading owing to several factors (e.g., interest-rate volatility or heavy taxation in the financial sector), but the margins look high nevertheless: for instance, for consumer loans, the margin was over 6 percentage points until recently – well above EU averages.²⁶ In summary though, it is hard to argue that the TBS is notably less efficient than some of its European competitors.
- Finally, is the TBS able to meet, by 2007, the Basle II standards? In this paper we have shown that in 2003 most of the private banks had very high capital ratios. The concern is that Basle II, which attributes higher capital coverage for risky assets, including government debt, will present a difficult challenge for Turkish banks. It needs to be recognised, however, that Basle II also presents considerable advantages to the banking sector in a country such as Turkey. In particular, Basle II has eliminated the ‘sovereign floor’. This implies that banks can now be rated higher than their government, with a minimum of 20% remaining. Turkish government debt is rated B+ so that banks have to risk-weight the holding of Turkish government paper or credits with 100%. Yet this only applies to banks outside of Turkey. *It is at national discretion to set the risk-weights for national debt in national currency held by banks incorporated in the country.* This implies that the Turkish authorities can maintain these risk weights at 0%. Banks would then prefer to hold government debt in national rather than foreign currency. As the large majority of securities held by banks are government securities, at least for those denominated in Turkish lira, there would be no change in capital requirements. The only additional requirement would be capital backing for operational risk. Hence, despite the reluctance of the banking sector in accepting Basle II, with an unchanged asset structure the impact will be anything but dramatic.

By contrast, if the asset structure changes significantly before 2007, then Turkish banks will need more capital. As is to be hoped and expected, the share of credits to the private sector will increase at the expense of a lower share of government securities. If in addition (as is again to be hoped), Turkey embarks on a path of strong growth, then bank lending will not only produce a reallocation of a constant balance sheet but generate growing bank assets to be backed by more equity. If all goes well, the higher the growth achieved the more bank capital will be needed. But, in such an environment of improved systemic confidence, greater macro-stability and more robust growth, it should not be difficult to find the required equity.

Of course, not all banks will do well. This is the message of competition. Some already start with weaker financial indicators and others will fall prey to unwise position-taking. If, therefore, there are weaker banks that have difficulties with respect to Basle II it may be better to find a way out rather than closing them. In order to avoid limiting the growth of the sector and overburdening the deposit insurance scheme, one could proceed as follows. In many countries there are different classes of banks. This may be the case because international banks are the only ones that have to adopt Basle II; the US serves as another example, where regulatory authorities are different for various classes of banks. In no country are specialised investment banks part of the banking

²⁶ Consumer loans were made at interest rates close to 40% while savings deposits fetched less than 23% interest.

franchise and hence the monetary system. In the literature, Bryan (1998) has proposed splitting up banks and applying regulation and deposit insurance only to 'deposit banks', i.e. banks that collect deposits and invest these receipts in liquid money-market instruments (Gros & Steinherr, 1995, Bisignano, 1997 and Pierce, 1997). In Turkey one could apply this concept in the following manner. There could be two classes of banks – let's call them A-class and B-class banks. A-class banks would be under the rule of Basle II, part of the domestic payments system and enjoy deposit insurance. B-class banks would have none of that. They would have to pay higher deposit rates, and in order to generate a profit take more risk in lending to SMEs. If a B-class bank fails, there will be no bailout. It is a firm like any other. They would not put at risk the payments or the deposit insurance scheme. The moral hazard in banking would be much reduced. Depositors would have a wider choice and could obtain higher returns by accepting a higher risk. This choice has value in a country where the capital market does not offer the range of products available in mature financial markets and where savers still lack financial sophistication. Of course, every bank would have to indicate clearly on its entry and its stationary whether it is an A-class or a B-class bank. Perhaps the name 'bank' would be reserved for A-class banks. And B-class banks could be called 'finance corporations' or something similar (Gros & Steinherr, 2004).

What is the bottom line then, regarding our main question? Is the TBS prepared for EU integration? Our conclusion is that in 2003 the TBS already compared well with the comparator countries and the banking sector is anything but an obstacle for EU membership. Of course, important improvements are still possible and there are some ten years to achieve that. In fact, an important point to keep in mind when analysing this question is exactly that: Turkey is still at least some ten years away from actual EU membership. Even then, in comparison with the new member countries or Greece, Portugal or Spain some ten years before their entry into the EU, the TBS appears very well placed, and clearly better than Poland was in 1994 – perhaps the most relevant comparator country. Yet, there is no room for complacency, and the Turkish authorities would be well advised to execute suggested reforms as quickly as possible given the critical role that the financial sector plays in the growth process. In that connection, much will depend on maintaining macro-stability and this, not the state of the banking sector, is a key question for the future development of the Turkish economy.

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Annex 1

The Imar Bank Scandal and the Regulatory Framework

The collapse of Imar Bank as such was not a major surprise to close watchers of the TBS but the financial damage that resulted and the way it took place was truly shocking. The takeover as such was not a big surprise because Imar Bank had been on the Treasury's watch-list – the regulatory authority before the BRSA was established – for almost ten years, as its loan portfolio, characterised by an exceptional connected-lending practice, consisted mainly of (direct and indirect) loans to companies owned by the Uzan Group. Once the BRSA was established, the new authority requested that Imar Bank shareholders re-capitalise the bank and reduce exposure to the Uzan Group. As no action was taken on either front, BRSA appointed a board member with veto powers in July 2001 and another representative was appointed to the board in December 2001. In 2002, during the May recap programme, the bank reduced its risk to Uzan Group companies; shareholders injected capital into Imar bank and the BRSA decided to withdraw the board member with veto powers in August 2002. With a BRSA representative still on the board, the problem seemed resolved and a takeover was avoided.

The bank was hit again in June 2003 when the charters of the two regional power companies, which provided the bulk of the cash flow of the Uzan companies, were revoked by the Electricity Regulatory Board. This news led to a run on the bank and liquidity problems resulted. The board members of Imar Bank refused to cooperate with the BRSA and resigned their posts in late June. Meanwhile, the BRSA had only four board members and could not take a decision because a decision required at least five members. Upon the appointment by the government of the fifth member, the BRSA cancelled the deposit-taking license of Imar Bank and declared that all personal deposits were under government guarantee.

The true and shocking scale of the problem emerged during the reconciliation carried out by the BRSA to finalise the amounts due to depositors. The most recent reports of Imar Bank to the BRSA, as late as late June 2003, had showed a total deposit amount of TL 750 trillion (around \$0.5 billion). The investigation of depositors' documents, however, revealed that this amount was actually TL 8.1 quadrillion (more than \$5 billion). The bank had also converted some offshore deposits (not covered by government guarantee) and sold Treasury bills to the public even though it did not have a license to do so. The bank maintained a double-accounting system throughout, where true information would exist at the branch level but the headquarters would falsify it and then report to the BRSA.

In its essence, the Imar Bank case appeared to be a special case of skilled financial banditry, and as such should not be seen as a failure of banking supervision. These oversights also remain a general problem by international norms (e.g., Parmalat) and indicate a significant failure of information-sharing among various government agencies, i.e., BRSA and others (such as the Capital Markets Board, Central Bank and Ministry of Finance).

Annex 2 Survey Questionnaire

Key challenges and structure

What do you see as the three overriding problems/issues faced by the Turkish banking sector today? Please describe each one of them briefly.

How do you see the sector's structure evolving in the next three years? Specifically, do you think consolidation is over in the banking sector? If not, could the second wave of consolidation be as disorderly as the first wave?

Do you think the banking sector is adequately capitalised?

Competition

Do you see state banks as a major competitor in general? In deposits? In loans? Please elaborate briefly.

Why do you think the share of foreign banks has been small in the TBS? Do you see foreign entry increasing dramatically, as it has been in some of the EU accession countries (e.g., Poland)?

Do you think the TBS is ready for free competition from the banking sectors of the EU countries, as called for in the EU's Second Banking Directive?

Financial indicators, asset composition, profitability

How do you envisage the asset composition of your balance sheet evolving in three-years time? Could you please give us a description as to how your balance sheet will look in terms of percentages?

How do you see your profits evolving in the next three years? Could you give us a description of its composition?

Regulation and restructuring programme

What are your thoughts on the regulatory environment in Turkey today (e.g., is it on par with international standards? What do you see as key strengths and weaknesses?)

What are the implications of the envisaged reduction in deposit coverage to TL 50 billion by July 2004? Is TL 50 billion an appropriate level for Turkey?

How ready are you for risk-based supervision?

How do you see the performance of the BRSA's banking rehab programme launched in May 2001? Where do you see its major strengths? Weaknesses?

Annex 3

EU Commission Reports on Financial Sector Development in Turkey

This annex reproduces sections pertaining to the financial sector from the three most recent EU regular progress reports (see European Commission, 2001, 2002 and 2003).

2001 Regular Report

The financial sector is still under restructuring and does not channel sufficient financial resources to productive investment. The financial sector mainly consists of the banking sector. During the 1990s this sector expanded rapidly, benefiting from generous state insurance for savings and deposits, and strong public sector credit demand. As a result of political interference in the banking sector, chronically high inflation, weak legislation and insufficient surveillance, the Turkish banking sector accumulated substantial structural weaknesses. The banking sector consists of about 70 institutions. The four main state controlled banks account for about 30% of the sector's assets and for nearly 35% of the deposits. The privatisation of those state banks is overdue. Another 30% of the sector's assets are controlled by the 4 largest private banks. About 10% of the assets are owned by 18 non-operative banks, which have been transferred into the custody of the Savings and Deposit Insurance Fund (SDIF). The share of government securities in private bank assets is relatively high at about 25%. Bank lending accounts for about 23% of GDP and is highly concentrated in the public sector and related group companies. As a result, only 0.1% of all borrowers account for nearly 40% of the total loan value. Stock market capitalisation is at about 20% of GDP. After the financial crisis, the share of non-performing loans in total loans rose to 18%, mainly due to the sharp rise of non-performing loans of state controlled banks, in particular of the banks under the administration of the Savings and Deposit Insurance Fund.

Progress in addressing the weakness of the financial sector has been achieved. The state controlled banks have been re-capitalised and their short-term exposure has been substantially reduced. Private banks have been obliged to improve their capital adequacy ratios and to adhere to international reporting and prudential standards. Non-viable private banks have been put under the administration of the SDIF, where they are in the process of being restructured and reorganised. The banking regulations have been further strengthened. The establishment of the Banking Surveillance and Regulatory Agency (BRSA) in 2000 has significantly improved banking surveillance and the adherence to prudential rules. However, the consolidation process is far from being completed. So far, only the smallest state-controlled bank, *Emlak bankasi*, has been dissolved. The two largest state banks, the agricultural bank, *Ziraat bankasi*, and a bank providing credits to SME's, *Halk bankasi*, have been put under joint professional management and will be prepared for privatisation. Another state controlled bank, *Vakif bankasi*, is planned to be privatised soon. Some of the non-viable banks have been merged with the *Sümerbank*, which is supposed to be sold soon to *Oyakbank*, belonging to a support fund of the military staff. So far, one smaller bank, the *Bank Ekspres*, and the 9th biggest bank in Turkey, the *Demirbank*, have been sold.

2002 Regular Report

The financial sector is still in the process of consolidation and does not yet channel sufficient savings towards productive investment. During the 1990s, the banking sector expanded rapidly, benefiting from high public-sector financing requirements and loose financial market regulations and supervision. Banking sector deposits rose from around 45% of GDP in 1997 to about 62% of GDP in 2001, while banking sector assets rose from around 80% to close to 100% of GDP. At the same time, domestic credit to the private sector remained at a relatively low level of about 20% of GDP. The Turkish banking sector is dominated by 3 state-dominated banks, accounting for nearly 30% of total assets, and a few big private banks, accounting for another third of the sector's assets. Many of the important private banks are part of family-owned enterprise groups, the so-called 'conglomerates'. As a result of complex ownership structures, compliance with prudential and transparency standards is difficult to assess. Their lending inside the enterprise group is not always in line with market principles or prudential standards. The difference between lending and borrowing rates has been high, pointing to inefficiencies in the sector. In addition, the overall profitability of the banking sector has declined markedly during recent years.

A major banking crisis erupted in 2000-2001. During 2000, increasing tensions in the financial markets revealed major systemic weaknesses. Profitability declined as a result of the December 1999 programme's success in reducing interest rates and public-sector borrowing requirements. Furthermore,

tight conditions on the overnight money market posed major difficulties to banking institutions, which had specialised in refinancing medium-term credit on the overnight market. In particular state banks had been very exposed to this kind of activity, forcing them to roll-over on a daily basis up to 4% of GDP. Unexpected liquidity bottlenecks in November 2000 and February 2001 drove these overexposed banks close to bankruptcy. The authorities had to intervene and switch to a less strict monetary policy and give up the crawling peg exchange rate regime. The sharp depreciation of the currency after the floating eroded the capital base of some overexposed institutions.

In order to address the banking sector's weaknesses, a major financial effort was necessary to restructure the financing profile of the troubled banks and to strengthen the sector's capital base. Furthermore, increased priority has been devoted to faster alignment of prudential regulations with international standards. Banking surveillance has been strengthened. Political interference with the lending of state banks to specific sectors, such as agriculture and SMEs, was reduced last year. So far, 19 non-viable banks, accounting for about 15% of the sector's total assets, have had to be transferred to the custody of the Savings Deposit Insurance Funds, reducing the number of operating banks to 57. The costs of bailing out the banking sector have led to a sharp increase in the public-sector debt ratio. As a result of improved transparency regulations and the economic recession, the share of non-performing loans in the banking sector's loan portfolio rose from 2.3% in 1997 to 12.9% in 2001. In order to alleviate the bad-loan issue, the government is supporting corporate debt restructuring through the so-called 'Istanbul Approach'. Furthermore, the authorities are restructuring the state banks and preparing them for privatisation. One important step in this process has been the elimination of political interference in the management of the banks and the reduction in the number of branches. The privatisation of the state-dominated *Vaquif* bank is scheduled to be completed by the end of 2002. The other two state-dominated banks are supposed to be privatised as soon as possible. The recent transfer of one major private bank into the custody of the SDIF not only indicates that the cleaning-up process in the banking sector is still continuing, but also underlines the authorities' determination in proceeding with the sector's consolidation.

2003 Regular Report

The banking sector has been strengthened, but the restructuring and consolidation process is not yet completed. Turkish banking sector assets amounted to slightly more than 70% of GDP. Bank lending to the private sector has declined in recent years to about 17% of GDP, while the share of securities has increased to about 30% of GDP. About 90% of the security portfolio consists of government securities. The banking sector currently includes some 50 banks, but in fact is dominated by two state banks, amounting to about one-third of the total sector's assets, and a few private banks. In order to prepare the state banks for privatisation, political interference has been reduced and the number of branches has been decreased. However, so far, no privatisation has taken place. The legal framework for mergers and acquisitions has been amended with a view to accelerating consolidation in the banking sector. During the last year, the process of improving the shock resilience of the banking sector has continued. In order to strengthen banking sector surveillance, the independent Banking Regulatory and Surveillance Agency (BRSA) was established in autumn 2000. During the last year, the competence of the BRSA has been enhanced and stricter prudential standards have been implemented. However, the efficiency of banking sector supervision is sometimes impeded by insufficient human resources and the slow speed of legal proceedings. The capital base of the banking sector has been strengthened and systemic weaknesses, such as a high exposure to foreign exchange risks, have been addressed. Most of the non-viable banks, which have been transferred under the administration of the public Savings and Deposit Insurance Fund (SDIF), have been dissolved. In July, the BRSA withdrew the banking licence of a smaller private bank and transferred it under SDIF administration. However, the dispute around the closure of one bank belonging to one of the influential conglomerates proves the need to further strengthen and clarify the legal and institutional framework dealing with banking sector surveillance. The main source of banking income is highly concentrated on interest earnings from government securities, which account for about 50% of total income. As a result of highly profitable and low risk bearing public sector borrowing, credit provision to the private sector has been particularly low. The recapitalisation of state banks, the elimination of non-viable banks and restructuring support in the form of the 'Istanbul Approach' has helped to improve the sector's capitalisation. Nevertheless, the assets of many banks are still vulnerable to a deterioration of their loan portfolio. Profitability of the banking sector improved after the 2001 crisis. Since autumn 2002, domestic currency lending spreads have remained at around 11%, while foreign exchange lending spreads have declined from 4.7% in September 2002 to 3.6% in April 2003.

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