U. M. OGUBUNKA

BANKING SECTOR REFORMS AND BANK CONSOLIDATION: THE EXPERIENCE OF TURKEY

By
U. M. OGUBUNKA, Ph.D*

1.0 Introduction

Countries reform their banking sectors for a number of reasons, including structural, capitalization and ownership issues. Consequently, the objectives of the reforms can hardly be the same in all countries.

Indeed, the scope of such programmes and the strategies adopted in the execution vary from one country to another. Expectedly therefore, the results of banking reform programmes differ for a number of factors.

However, the banking reform programme of one country may provide some good lessons for others, especially those intending to, or are already engaged in such exercise. The lessons may assist in guiding policies and guidelines as well as ensuring that the reform goals are achieved with little or no negative consequences. It is on this basis that this paper presents an overview of the banking reform in the Turkish Republic and the lessons Nigeria could learn from it.

To facilitate a clearer understanding, the paper is structured into seven sections. The next section following this introduction identifies some of the key features of Turkish banking system pre-reform era of 2001, section three deals on the drivers of banking reform in the country. Section four reviews some of the actions taken in implementing the programme while section five and six respectively, discusses the results and lessons from the banking reforms in Turkey. A brief conclusion in section seven ends the paper.

2.0 The Features of Banking in Turkey

Orthodox banking in the Turkish Republic can be traced to about 1847 when representatives of foreign banks ventured into the country to provide credits to Ottoman Empire whose financial resources had deteriorated following the Crimean War. In 1856, the Ottoman Bank (Osmauh Bankasi) which served as the Central Bank until the 1930s was established, with its head office in London. The first set of national banks, about 24 of them, was established from 1908 to 1923.

2.1 Institutional Developments (Growth)

Since then, banking institutions and activities have grown in Turkey. In 1998, two years before the 2000 banking crisis which gave rise to the banking restructuring/reforms that started about 2001, Turkey had about 75 banks. Fifty (50) of them

*U. M. Ogubunka, Ph.D, FCIB is the Director, Consultancy, Training & Research, CIBN

were commercial, fifteen (15) were development and investment and the rest were foreign banks. However, at the end of 2001, the number of banks had reduced to 61 with 46 of them engaged in commercial banking. The commercial banks operate as universal banks with a broad range of financial services and products. They are however, not permitted to engage in leasing and trading in goods or immovables for commercial purposes

2.2 Classification by Type of Service and Size.

Providers of banking services in Turkey are classified into two main sub-sets – deposit accepting (commercial banks) and non-depository banks. As the names imply, deposit accepting banks are permitted to receive deposits from the public. The non-depository banks are not allowed by law to receive deposits from the public. They are essentially development and investment banks.

Another feature of the banking system in Turkey is that banking institutions fall into large, medium and small sizes. The large-scale banks have nation-wide branch networks while medium and small-scale banks concentrate mainly in highly populated cities.

2.3 Ownership Structure

Ownership of banks in Turkey falls into three groups – state, private and foreign. The foreign banks are of two categories – those established in Turkey with foreign capital resources and branches of foreign banks in the country. Foreign banks are subject to banking laws and regulations in Turkey like their local counterparts.

It is necessary to also observe that, according to Chhibber (2001), state-owned banks accounted for a large share (40%) of the banking market in Turkey. Consequently, their activities impacted greatly on the banking system.

2.4 Regulatory Authorities of the Turkish Banking system

Banks in Turkey are governed under the general provisions of the Turkish Commercial Code, Banks Act and various tax laws. They are also subject to special provisions by the Banking Regulation and Supervision Agency (BRSA) which is an autonomous regulatory and supervisory agency for banks. The Central Bank of Turkey does not engage in supervision of banks, unlike its Nigerian counterpart – the Central Bank of Nigeria. BRSA's job is to "safeguard the rights and benefits of depositors and create proper environment in which banks and financial institutions can operate with market discipline, in a healthy, efficient and global competitive manner, thus contributing to the achievement of long-run economic growth and stability of the country".

3.0 Drivers of Turkey's Banking Restructuring

3.1 Overview of the Economic Liberalisation of 1980s

The objective of Turkey's economic liberalization in the 1980s was to integrate the country's economy with world markets. The strategy to achieve this was hinged on moving towards a free market economy. The economic liberalization of the 1980s, led to many changes in the banking system. These changes include the liberalization of interest and foreign exchange rates, entry of new banks including foreign ones,

venturing abroad by Turkish banks through the opening of overseas branches and establishment of the inter-bank money market by the Central Bank of Turkey to regulate banking system liquidity. There was also the establishment of special finance institutions, especially Islamic banking institutions, within the period.

Noble as the policy and strategy were, however, some of the results that followed affected the economy and the banking system adversely due to poor implementation and sequencing of the liberalisation. For instance, interest rates skyrocketed to over 100%. Inflation and unemployment rates worsened. Illiquidity of state-owned banks which accounted for a large percentage of the market negatively affected the banking system; the level of savings became low due to low levels of income. There was also low demand for financial assets due to high cost of intermediation.

3.1.1 Major Problems of the Banking System Before 2001

These problems, among others resulted to weaknesses in the banking system, especially poor financial conditions of the state-owned banks. Indeed, some of the banks became distressed and were transferred to the Savings Deposit Insurance Fund (SDIF). The banks which were supposed to be the hub and catalysts of economic activities could no longer support the economy. The real sector could not borrow money at prevailing cut-throat interest rates to enhance growth in the economy. There was general decline in the level of economic activities. Turkey's banking ran into murky waters in the early 2000s. To redress these problems the banking restructuring and reforms became necessary in Turkey.

3.2 The Pillars of Turkish Banking Sector Restructuring Programme

The banking reforms or restructuring in the Turkey Republic was anchored on four pillars. These were:

3.2.1 Restructuring of the state-owned Banks.

As stated earlier, state-owned banks accounted for sizeable percentage of the banking market in Turkey. Unfortunately, they were not only inefficient; their financial conditions were also very weak. Indeed, their excess liquidity needs affected the entire banking system negatively. There was the need for their reform and restructuring to reduce the level of financial risk they induced in the banking system.

3.2.2 Resolution of SDIF Banks

As a result of the crisis in both the economy and the banking sector, some banks had financial problems that warranted their transfer to the Savings Deposit Insurance Fund (SDIF) for resolution. From 1997 – 2003, 21 banks featured in the portfolio of SDIF needing remedial attention.

3.2.3 Strengthening of Private Banks.

The number and impact of private banks were increasing in the Turkish economy. The free market economy adopted in the 1980s also signalled increasing private sector participation. The private banks were expected to play significant roles in supporting the real sector growth. To be able to meet this challenge they needed to be strengthened, especially in terms of increased capitalization.

3.2.4 Strengthening of the Regulatory and Supervisory Frameworks

In order to ensure the success of the reform exercise, the need for strengthening the regulatory and supervisory bodies was identified. Strengthening them would also provide the principles and procedures for the entire programme such that it could be properly managed, monitored and supervised towards the intended objectives.

4.0 Implementation of the Banking Restructuring Programme in Turkey

A number of steps (including the following) were taken by the appropriate agencies of the Turkish government to carry out the banking sector restructuring programme, which commenced in 2001.

4.1 Resolution of State-Owned Banks

As earlier pointed out, financial status of state-owned banks was very poor, especially because they sustained significant losses due to duty losses. To stop the state from charging state-owned banks with new financial responsibilities without making prior budget allocation, the Law No. 4603 of November 25, 2000 was enacted. Furthermore, on April 30, 2001, the Council of Ministers decided that existing duty losses suffered by state banks should be cancelled. That decision ensured that such losses were completely wiped-off through the introduction of cash and bills. Similarly, the short-term liabilities of state banks to the Central Bank of Turkey were significantly reduced while others were brought to zero. With regard to strengthening the capital position of these banks, cash and securities were introduced into them.

It is also noteworthy that inefficient and non-profitable branches were closed down and a sizeable number of employees were disengaged. Furthermore, independent auditing firm was hired for external auditing of state owned banks. The restructuring of state banks also saw the transfer of Emlak Bank to Ziraat Bank as at July 6, 2001. All these actions were taken to ensure a healthy banking system with less risks.

4.2 Resolution of SDIF Banks

The SDIF, being the deposit insurer, took over some distressed banks that had significant financial problems. These distressed banks were resolved using some good mix of resolution options.

Some of the distress resolution measures include mergers, sales and closures. For instance, Egebank, Yurtbank, T. Tutunculer Bank (Yasarbank), Bank Kapital and Ulusal Bank were merged with Sumerbank. On the other hand, Bank Ekspres and Demirbank were sold while Turk Ticaret Bank was closed down.

Some other measures taken to redeem the Banks were provision of deposit and capital supports to the banks by SDIF; their overnight obligations, except those with the Central Bank, were eliminated; their short-term liabilities with the Central Bank were significantly reduced; bad assets were transferred to SDIF Collection Department. As in the case of state banks, a Joint Management Board was put in place to restructure the banks operationally. Ultimately, their number of branches

and employees was reduced.

4.3 Strengthening of Private Banks

The Banking Regulation and Supervision Agency (BRSA) which was created, courtesy of the Banks Act No. 4389 of 1999 developed the "Regulation on the Principles and Procedures of Banking Sector Recapitalisation Scheme" . The objective of the regulation "is to lay down the principles and procedures for the recapitalisation scheme designed for private owned deposit-taking banks incorporated in Turkey with the ultimate aim to establish a sound and transparent banking system".

In accordance with Article 4 of Banks Act No 4389, the regulation provided for: the details of the general assembly to be held by banks; procedures regarding an increase or decrease of the banks' capital; the measures that need to be taken based on assessments of the Banking Regulation and Supervision Agency; the transfer period of shares which are subject to the capital increase; the issuance of convertible bonds and triggers for the conversion of these bonds into shares; the sale of banks' shares taken over by the Savings Deposit Insurance Fund (SDIF) and the conversion of subordinated debts to capital.

It should be noted that the regulation does not affect banks taken over by SDIF, public owned banks, special finance institutions, development and investment banks and branches of foreign banks operating in Turkey.

According to the regulation, capital enhancement by banks in Turkey was not generalized and no specific amount was imposed on all banks. On the contrary, banks were required to maintain 8% capital adequacy ratio. The ones that were required to recapitalise were those whose capital adequacy ratio was below 8%.

For banks to know their positions, the BRSA, after an evaluation of a bank, was expected to notify the Bank's Board of Directors on the following areas:

(i) the financial statements of the bank audited according to the criteria and procedures defined in the Regulation on the Principles and Procedures for Special Audit along with the report of the independent auditing institution on the financial statement;
(ii) the determined capital adequacy ratio;
(iii) the required amount of capital to reach the 8% capital adequacy ratio, that is, if the ratio is below 8%;
(iv) the need to increase capital or to issue subordinated debts; and
(v) any other measures that need to be taken.

What this means is that banks in Turkey are audited and evaluated for, essentially capital adequacy. Only those that are below the internationally accepted 8% level are mandatorily required to increase their capitalization.

Another significant revelation from the regulation is that banks which are unable to meet the required minimum capital adequacy ratio from their legal reserves and attempting to increase the capital adequacy may apply to BRSA to participate in the banking sector recapitalisation scheme.

The Agency can:
(a) inject capital to reach the tier one capital ratio. The capital injection by the Fund cannot

exceed the contribution of the shareholders. The Fund would pay net book value for the shares.
(b) provide subordinated debts in the form of 7-year convertible bond to reach capital adequacy ratio of 9%.

The regulation also provides for mergers and acquisitions. In Article 24 it provides that "private commercial banks with an asset market share below 1% (as of September 2001) can apply for Tier one capital contribution by the Fund, provided that they meet this threshold through mergers and acquisitions. Banks with an asset market share below 1% should apply to the Board for pre-approval for mergers and acquisitions, until April 2002". There was however, no provisions as to how mergers and acquisitions would be undertaken, perhaps because the issue of merger and acquisition was not a must for the banks.

As may be appreciated, the above provisions opened reasonable windows for private banks in financial difficulties to resolve their problems.

4.4 Strengthening of the Regulatory And Supervisory Framework

According to Banks Association of Turkey (2005), strengthening the regulatory and supervisory system during the banking reforms manifested in decisions and measures taken in the areas of: foreign exchange exposures, capital adequacy, internal control and risk management, lending limits, conditions to be met by bank owners, bank ownership control in transfer of shares, consolidated and cross-border supervision of banks, accounting standards for financial disclosure purposes, prudential reporting and loan loss provisioning.

In addition, the SDIF which used to be an appendage of BRSA gained autonomy (Act No 5020 of 2003); savings deposit insurance coverage which used to be 100% was reduced to 50 billion TL (50,000 new Turkish Lira) to decrease the moral hazard effect; risk-based, as opposed to rule-based supervision, was initiated.

The Restructuring of Debts to the Financial Sector Law No 4743 was enacted in 2002, that is, a few years following the enactment of Regulation on the Principles and Procedures of Banking Sector Recapitalisation Scheme, Banks Act No 4389 in 1999. To encourage mergers, some legal changes were enacted in June 2001 under Regulation on Bank Mergers and Transfer.

Similarly, tax incentives were given and the Central Bank put in place a monitoring system to access weekly data on deposit interest rates being applied by banks. As a way of reducing transaction cost and to encourage banks to mobilize deposits, the Central Bank commenced the payment of interest on banks' required reserves in lira deposits.

5.0 Some Positive Results of Bank Restructuring and Consolidation in Turkey

Some of the outcomes of the banking sector reforms in Turkey have been outstanding and are highlighted hereunder:

- The number of banks have decreased from 75 in 2000 to 48 in 2004, that is about 36%

- Of the 21 distressed banks transferred to SDIF

for resolution, 13 (62%) have been merged, 5 (24%) sold and 2 (10%) closed as at December 31, 2004. The only one remaining is Bayindirbank, which is a bridge bank put in place to handle distressed banks.

- The number of bank branches have reduced from 6908 (2001) to 6106 (2004). That means that about 12% of bank branches were closed;

- Total number of bank employees declined by 14,246 persons or about 10%, from 137,495 (2001) to 123,249 (2003) before increasing to 127,163 (2004).

- It is important to note that while about 41% of the bank employees in 2001 worked in state-owned commercial banks, 47% worked in privately owned commercial banks. However, by 2004, the ratio changed to 31% for state-owned commercial banks and 60% for privately owned commercial banks.

- Non-performing credits (gross) declined from 13,886 YTLM (2001) to 6,301 (2004), that is by about 55%; a substantial improvement in the quality of banks' assets;

- In terms of profitability, returns on assets improved from –5.7 (2001) to 2.1 (2004) while returns on average equity rose to 13.8 (2004) from –58.4 (2001). The state-owned banks that hitherto made losses have started making profit.

- Besides the above developments, other results of the reform exercise showed in the:
- Improvement in the liquidity position of banks, hence reduced liquidity risk;
- Enhanced capitalization of banks resulting, for instance, in the capital adequacy ratio of 28.2% for private banks as at end of 2004.
- Reducing interest rates;
- Stabilizing foreign exchange rate and reduction in foreign exchange exposures;
- Declined dominance of state-owned banks in the system;
- Increasing relevance and contribution of privately owned banks
- Reduction in financial risks in the banking sector
- Narrowing of margins and increasing competition
- Evident growth in the banking sector

- Total cost of the restructuring programme was about US$47.2 billion with about $39.3 billion or 83% from the public purse while $7.9 billion or 17% from the private banks.

6.0 Lessons from Turkey's Banking Sector Reforms for Nigeria

Turkey's experience in banking sector restructuring and consolidation, no doubt provides some lessons to other countries that are either considering similar exercise or have already embarked on one. This includes Nigeria that commenced banking reforms mid 2004.

Perhaps, the first lesson is that Turkey's restructuring was, from the on-set, properly focused to address weaknesses observed in the banking sector. It chose four targets for the exercise viz, state-owned banks, private-owned banks, distressed banks and strengthening the regulatory and supervisory framework. With that type of compartmentalization, it was easy to have focus, determine necessary actions to be taken and measure the outcomes.

The second lesson is that although there was need

for banks' recapitalistion, only banks with capital adequacy ratio below 8% were mandatorily required to bring same within line. Consequently, there was no universal requirement for all banks to increase capital by a common amount irrespective of their capital adequacy ratio. This is in line with best practice.

Again, despite the reforms, the structure of banking institutions largely remains the same with banks of large, medium and small sizes co-existing.

It is equally noteworthy that the government ensured that its banks were strengthened by cancelling existing duty losses suffered by the banks, enhancing their capital through the introduction of cash and securities and limiting its financial requirements from the banks to prior budgetary allocations. There was also introduction of guidelines, laws and regulations as well as tax incentives to support the reforms and motivate operators. Indeed, the government gave explicit support to ensure the success of the programme. A clear evidence is the huge cost of the programme that was borne by public treasury.

Another important lesson is that there was no compulsion on banks to consolidate via mergers and acquisitions or indeed any other form of arrangement. Banks were at liberty to chose whether or not to merge, acquire or be acquired. That is one of the beauties of private sector freedom.

To ameliorate the liquidation of many banks, and the consequent negative impact, a bridge bank, Bayindirbank, was incorporated to take on banks with less chances of survival and prepare them for acquisition, merger, sale or closure. This accounted for the low rate of casualties – only 2 banks were closed – and that gave confidence to the banking public.

There is no doubt that the opportunity created for the transfer of bad loans in banks to a department of SDIF for management needs to be mentioned because it helped in the reform process. This arrangement was made despite the plans to establish Asset Management Company (AMC). And a further lesson is that the rules guiding the establishment of AMCs made it possible for private sector participation.

Finally, it is noteworthy that the Central Bank of Turkey is not directly involved in the supervision of banks. This role, which is being played by the Banking Regulation and Supervision Agency (BRSA) makes it possible for the Central Bank to concentrate on its core functions.

7.0 Conclusion

The banking reform that started in 2001 in the Turkish Republic appears to have addressed most of the identified problems that motivated it. Thus, it brought about enhanced capital and capital adequacy ratios and significant improvement in banks' liquidity. Indeed, it also culminated into a consolidated banking sector with reduction in the number of banks and bank branches as well as the dominance of state-owned banks in the economy.

Evidences following the exercise further point to banks' profitability looking upward and minimization of financial risks in the economy. Furthermore, with interest and exchange rates reduction and moderation, the real

sector operators have once again, resorted to banks for investment funds, thus, generating and improving employment and productivity.

The foregoing therefore, suggest that the pay-off from the reform justifies the exercise. However, as has always been the experience, the seeming end of one reform produces new challenges that may necessitate further reforms. Thus, as the Turkish Banking sector stabilizes and perhaps grows, it is imperative that it should prepare for new reforms to meet challenges in the global banking market. This is particularly true with regard to its capacity for mega businesses and the privatization of state-owned banks, three of which were still in existence as at end of 2004.

References

Banks Association of Turkey (2005). "Financial Sector and Banking System in Turkey", *A Report of BAT.*

Banking Regulation and Supervision Agency (2005). "Banking in Turkey"

Central Bank of the Republic of Turkey. Annex 1: Developments in Structural Reforms, Monetary Policy Report.

Chhibber Ajay (2001). "Bank Restructuring in Emerging Markets: An Institutional Perspective".

Yardim Dilek (2003). "Banking Sector in Turkey", a paper presented at the 24th Annual Conference on U.S. – Turkis