

THE TURKISH BANKING SECTOR AT THE THIRD QUARTER AND THE END OF 1997

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Since the beginning of the 1980s, Turkey has been trying to open out onto the world and integrate her economy with those of other countries; thus she has been increasingly affected by the global economy which itself is undergoing rapid change in the form of what is called globalisation. In the early 1980s, Turkey carried out economic reforms and turned towards a free market system, in a way that would serve as a useful example for many countries with transition economies and developing countries. An important facet of these economic reforms was the financial reforms that were introduced in the 1980s.

The main aim of financial reforms is to ensure the mobilisation and effective use of domestic and foreign investments for rapid and sustainable economic growth and development. The basis of these reforms is the "financial deregulation and liberalisation" carried out for this purpose. By financial deregulation, the required legal framework was set up, and the existing regulations were improved. By financial liberalisation, regular markets were allowed to set the prices of foreign exchange, interest and other financial assets. The introduction of freedom of movement for capital and the amendments to the foreign exchange regulations accelerated the internationalisation of the financial markets. New, regulated markets and exchanges were established and the issue of numerous new financial instruments was made possible.

The process of financial reform in Turkey is completing its second decade. In the course of the past decade, the depth of the financial markets has multiplied by approximately 1.5 and reached almost 65 % of national income. Moreover, when compared with her neighbouring countries, Turkey possesses the most fully developed financial markets, and has the potential to become a regional financial center. In spite of the political instabilities of the past three years, the financial markets have maintained their internal stability and enabled the provision of the required funds for the rapid economic expansion of the past three successive years and for the financing of high levels of public deficit.

Parallel with the process of financial reform experienced in Turkey, international markets have undergone similar developments. Financial deregulation, softening of foreign exchange regulations, freedom of capital movement, internationalisation of domestic markets and freedom of provision of financial services have formed a global financial market working 24 hours a day, made up of markets linked together with the support of information technology.

These rapid developments in the global markets have also brought certain risks. Thus the financial crisis experienced by the Asian-Pacific region in 1997 affected the financial and real markets globally. Therefore, an impact on Turkish Economy was obvious. But, the effect on the Turkish Banking Sector was significantly minimal.

In the light of all mentioned above, Turkish banking sector-one of the largest and profitable sectors of the Turkish economy-displayed a fairly strong growth performance during 1996 and 1997. Total assets rose 21 % in 1996 and 9 % in the first nine months of 1997 to reach \$91 billion, while net earnings surged 37 % and 142 % respectively, reaching to \$ 2.8 billion. Meanwhile, assets represented 63 % of GNP in the year ended September 1997, which compares with 52 % in 1995. Rapid rise in credit demand, due to continuing robust economic growth as well as rising government borrowing, has been the main driving force behind the growth of the banking sector.

With reactivation of Anadolu Bank, Denizbank and Etibank through privatisation, the number of banks operating in Turkey in 1997 rose by 3, and reached a total of 72, of which 59 are commercial banks while the remaining 13 are investment banks. There are 8 state owned banks, of which 5 are commercial and 3 are investment banks. There are 8 state owned banks, of which 5 are commercial and 3 are investment banks. Public sector banks, though much fewer in number, represented 41 % of total banking assets as of September 1997, against 55 % by the domestic private sector banks, and the remaining 4 % by the foreign banks operating in Turkey. Contrary to the low number of state banks, the state-its self-puts an important pressure to the banking sector. This creates a conflict between implementation and liberalisation process promised by politicians.

The trend towards liberalisation and unification that started in the 1980s accelerated in the 1990s. The funding necessary for the public sector of the domestic financial markets, for the financing of the balance of payments deficit and for the funding of the economic expansion was obtained from both domestic and external financial markets. As well as developed countries, many developing participated in this process.

The attractions of international capital movements have encouraged many countries to liberalise their foreign exchange regulations and to reform their financial markets. On the other hand, these movements of capital tend to pave the way to major financial and economic crisis on domestic financial markets and indeed sometimes can even threaten international financial systems. Some examples of such cases are the financial crises experienced during the 1990s in Mexico, Asia-Pacific and Russia.

In Turkey, the reforming and liberalisation of the financial markets started in the early 1980s. Reforms that were intended at mobilising domestic investments have included the creation of new financial institutions, the establishment of new regulated financial markets and the issuing of new borrowing and investment instruments.

The financial reforms brought with them acceleration in the expansion of the financial markets. This development is reflected in the depth of the financial

markets, the development and respective shares of the financial sectors, and the development of financial instruments and financial funds. The depth of financial markets in Turkey increased especially after 1990. Nevertheless, when compared with international development indicators, it is clear that it has not yet achieved the levels required. In spite of the rapid and real expansion of the financial markets, the public sector's levels of borrowing mean that it continues to exert a significant pressure on the markets in 1998. In parallel with the economic expansion, the ratio of flows of financial funds to GNP has passed the 50 % line for the first time, reaching 53.8 %.

TABLE 1 : Size Of Financial System (Ratios To GNP)

Years	Total Financial Assets Central Bank	exc.	M2Y
1990	33.0		23.5
1991	37.1		24.6
1992	43.1		25.7
1993	47.2		26.2
1994	50.8		29.1
1995	54.9		34.6
1996	58.7		36.4
1997	63.7		37.1

Source: Turkish Banking Association; Central Bank of Turkey

The total balance sheet size of financial institutions has been rising steadily in real terms. Total assets, which increased 102 % in 1995 and 116 % in 1996, expanded by 110 % in 1997 and reached TL 32,451 trillion in 1997. An examination of the share of financial institutions' figures in the market sector totals reveals that the banking sector continues to dominate. While its 58.8 % share in 1993 fell to 54.3 % in 1994, the banking sector increased its share in the following three years, reaching 59.7 % 1997 year end.

TABLE 2 : Shares Of Balance Sheet Of Financial Institutions In Total Aggregate Balance Sheet (%)

INSTITUTIONS	1993	1994	1995	1996	1997
The Central Bank	16.61	20.93	20.12	17.32	14.45
Banks	58.79	54.24	55.05	57.91	59.72
Special Finance Houses	0.97	1.18	1.18	1.25	1.43
Insurance Companies	1.06	1.16	1.16	1.24	1.28
Leasing	1.15	1.29	1.47	1.44	1.47
Stock Exchange	21.42	21.20	20.84	20.84	21.65
Total	100.00	100.00	100.00	100.00	100.00

Source: Turkish Banking Association; Central Bank of Turkey.

Only 14 banks are currently listed on the ISE, where Akbank, Garanti Bank, İş Bank and Yapı Kredi Bank shares are the largest and most actively traded financial stocks. As of 1996, while assets of ISE-listed banks represented 63 % of total private banks and 34 % of total banking sector, net income generated by this group accounted for 70 % of the former and 58 % of the latter.

Deposits being a major underlying source of growth, Turkish banks have been putting special emphasis on private banking in a move to attract the savings of small and mid-size investors. New branches have been set up in emerging industrial regions in Anatolia, especially by the private banks. As a result, the number of branch offices of private sector banks rose by 229 to 3,429 in 1996, whereas total branch offices rose by 201 to 6,442.

Many banks invested heavily in automation systems, offering a wide-range of financial services and products extended through ATM networks and the internet. In return, both the quality and the range of services offered by the Turkish banks improved dramatically, leading to rising fee and commission income in the case of banks with a wide branch network.

Indeed, credit card business has been on a fast growth track in recent years as the number of credit cards issued reached 4.7 billion in 1997 from 1.5 billion in 1994, rising by 48 % each year on average. The total amount of credit card transactions displayed an even faster growth pattern and increased by 65 % annually, coming close to \$5 billion from \$ 1.1 billion in the respective period.

Besides the core banking activities, banks have been invariably and deeply involved in financing the public sector deficit, thus enjoying substantial returns on government paper. The total amount of T-Bills and G-Bonds held in the banks investment portfolio rose by 54 % to \$ 22 billion in 1997, representing 74 % of the total T-Bill and G-Bond stock. Meanwhile, banks increasingly resorted to repo agreements in order to finance the rapidly growing investment in public debt instruments.

Consequently, 60 % of such investments, amounting to \$ 12.9 billion, were financed through repo agreements in 1997. As most repo agreements carried notably short maturities ranging from overnight to one week due to prevailing political and economic uncertainties, banks have been compelled to assume a substantial maturity mismatch.

Furthermore, as the pace of devaluation of the Turkish Lira lagged behind the level of inflation in the recent past, the Turkish banking community found it extremely profitable to borrow in foreign currency with a view to invest in government securities.

This situation led to the steady growth of the short foreign exchange position of the banking sector after 1994, rising to an estimated \$ 5 billion in September 1997 from \$ 2.5 billion in 1996.

Another issue that has not been settled so far is the deposits safety net, i.e., the cover guaranteed by Government in case of banks failure. Since April 1994, all deposits (including fx deposits) by individual investors, excluding corporations, are under Treasury's full coverage. With this commitment, public confidence in the banking system was significantly enhanced in the aftermath of

the 1994 crisis, while capitally sound, risk averse banks suffered from unfair competition. Elimination of the safety net and the introduction of a new system, rating banks according to the strength of their capital structure and investment practice, is currently being considered whereby a deposit insurance premium will be imposed in line with the risk rating of each bank.

One major obstacle lying ahead of growth in the banking sector is the inadequate size of the Turkish financial system relative to the magnitude of the economy. As of June 1997, M2, representing total TL deposits and currency in circulation, amounted to nearly 19 % of GNP, whereas M2R, that is M2 plus repo agreements, and M2RY, M2R plus fx deposits, reached, respectively, 27 % and 45 % only. Indeed, the latter ratio stands at around 70 % of GNP in developed economies.

In addition to the inadequacy of the financial system, Government's heavy borrowing requirement due to large fiscal deficits created a crowding out effect, restricting loanable funds to private sector, from 1990 onwards. Indeed, the ratio of T-Bill and G-bond stock to M2Y reached 55 % in 1997 from 28z % in 1990. At first glance, the crowding out effect does not affect the banking sector performance in a negative way with respect to earnings, yet driving it away from the core activity of corporate lending. On the contrary, they enjoy assuming virtually zero credit risk at hefty margins. However, in the long run, the crowding out effect prevents the economy from moving into a sustainable growth pattern.

The future of the turkish banking sector depends particularly on the level of inflation and fiscal deficits. Should inflation slow down and Government's reliance on domestic funds diminish, banks will be able to serve a wider range of customer base through a more varied range of products. However, the transition period may prove costly to some small banks which rely almost solely on high returns on government paper.

A characteristic feature of the Turkish banking sector is the high level of concentration. Indeed, 46 % of total assets belonged to five banks in 1996, which, a same time, disposed of 45 % of total loans and 52 % of total deposits. This situation does not follow, however, when it comes to net income as the 5 largest banks, in terms of asset size, represented only 27 % of total net income. This is due to the fact that 3 of the 5 largest banks are state-owned, which are under-capitalised, over-staffed, and slow in decision making. Likewise, state-owned banks represented 45 % of total assets in 1996, but generated only 14 % of net sectoral income. Conversely, private sector banks represented 53 % of total assets and generated 84 % of total net income.

Historically, state-owned banks were established to accomplish a specific mission: Ziraat Bank lends on soft terms to agricultural enterprises, Emlak Bank finances and builds housing, and turk Eximbank provides export financing. Available evidence suggest that public sector banks have serious asset quality problems because they are driven mainly by political concern rather than profit maximisation.

Assets of the banking sector grew at a much faster pace than the growth in the Turkish economy both in 1996 and 1997. total assets rose by 21 % to \$ 83.3 billion in 1996 from \$ 68.9 billion the year before. Commercial banks accounted

for 94 % of the total assets, increasing by % 23 to \$ 78.3 billion, whereas the assets of investment banks dropped by 1 % to \$ billion, mainly due to problems encountered by the Türkiye Kalkınma Bankası, a state-owned investment bank.

Private sector banks displayed a more resilient nature in the after math of the 1994 financial crisis, as assets of this group banks rose 38 % in 1995 and 22 % in 1996 to \$ 44 billion. Growth in public banks assets on the other hand, lagged behind with growth rates of 26 % and 23 % respectively, reaching \$ 32 billion.

TABLE 3 : Banking Sector Assets (USD Million)

	1993	1994	1995	1996	1997-30
Total	68.982	52.252	68.946	83.337	90.735
Commercial banks	63.824	47.966	63.869	78.300	85.805
Public	26.619	20.717	26.003	31.896	32.935
Private	35.058	25.969	35.872	43.917	49.036
Foreign	2.146	1.280	1.994	2.487	3.834
Investment banks	5.159	4.286	5.078	5.037	4.930
Public	3.663	3.171	3.902	3.786	3.770
Private	1.495	1.116	1.176	1.251	1.160

Converted at year-end USD/TL parity

1997 has also been another growth year with total assets rising 9 % to \$ 90.7 billion in the first nine months of the year when GNP growth in dollar terms remained at 4 %. Assets of the banking sector represented 63 % of GNP which compares with 52 % in 1995 and 41 % in 1991. İSE-listed banks outperformed the sector in terms of asset growth in 1997, as total assets of this group rose 13 % to \$ 30.9 billion the first nine months of the year.

TABLE 4 : Degree Of Concentration In Banking Sector (%)

	Assets		Loans		Deposits	
	1996	1995	1996	1995	1996	1995
Largest 5 Banks	46.4	47.8	45.5	50.0	52.4	52.8
Largest 10 Banks	68.6	71.1	71.9	75.4	71.7	73.0
Largest 15 Banks	77.6	80.5	80.0	83.5	81.6	83.2
Largest 20 Banks	84.9	86.1	85.7	89.2	90.7	88.2
Largest 25 Banks	89.9	90.8	90.5	93.0	93.7	91.3
Largest 30 Banks	93.0	94.3	94.6	96.2	95.8	94.6

Private sector banks consist of large retail banks, such as Akbank, İş Bank, Garanti Bank and Yapı Kredi Bank, owned in most cases by industrial conglomerates, and medium or small size banks, owned by families, which generally specialise in foreigntrade and investment banking activities. Demirbank, Finansbank and Türk Ekonomi Bank are the prominent examples of this group.

The composition of the assets of the banking sector shows slight changes over the recent years. As of September 1997, liquid assets and loan portfolio constituted 74 % of total assets. Liquid assets consisted mainly of cash and marketable securities portfolio was the dominating item with 39 % of total. As a result of high real returns on government borrowing, growth in banks' investments in government paper has been substantial in 1996.

According to Central Bank figures, banks' investments in government debt securities rose by 80 % in 1996 to reach \$ 7.8 billion, excluding the repo portfolios. While this was taken as a deviation from core banking activities, it significantly enhanced banks' net income. It may appear as if banks' government paper portfolio remained almost unchanged in the first nine months of 1997. This was not the case, however, as the amount of such investments rose by 54 % to reach \$ 22 billion in 1997 from \$ 14 billion the year before. Indeed, in order to finance this rapid rise, banks increasingly resorted to repo agreements, and the share of repo financing in T-Bill and G-bond investments rose to 58 % in September 1997 from 45 % in December 1996. As repo agreements constitute an off-balance sheet item, banks' government paper investments remained unchanged in the first nine months of 1997. In actual fact, the share of government paper investments, financed either through repo agreements or directly, measured 23 % of total assets in September 1997 against 17 % in 1996.

In line with rapidly growing economic activity, banks' loan portfolio also displayed a substantial growth performance, expanding by 23 % to \$ 36 billion in 1996, and by 9 % in the first nine months of 1997. As the depreciation of TL remained below inflation in 1996, both banks and borrowers found dealing in fx terms increasingly attractive. Hence, the currency composition of the loan portfolio changed in favor of fx loans, bringing their share in total to 49 % in 1996 from 45 % in 1994, which later declined to 48 % as of September 1997.

35 % of total loan portfolio belonged to public sector banks in 1996, while private banks took a 53 % share. Dominance of private banks in loan generation enhanced in 1997, as the share of this group of banks in total loan portfolio rose to 58 % as of September 1997 while that of public sector banks dropped to 31 %. Available evidence suggest that the maturity structure of banks' loan portfolio prevailing political and economic uncertainties. Spot credit facilities in which loans are extended on an overnight basis and rolled over as long as necessary has become very popular.

Fixed assets of the banking sector remained unchanged in recent years at around 5 % of total assets. There is, at present, a certain tendency, initiated by a government decree, to sell off participations, especially those in nono-financial sector so as to strengthen the bank's capital base. Indeed, in broad terms the decree allows for tax exemption of capital gains accruing from the sale of participations up to the end of 1998. As a result, share of participations portfolio in total assets declined to 0.4 % in September 1997, from 1.8 % in 1994 and 3.2 % in 1990.

Deposits continued to be the major source of funding of the banking system, rising by 30 % to \$ 37 billion in 1996, which., however, remained unchanged as of september 1997. 26 % of total deposits are in non-interest

bearing and 74 % in interest bearing accounts. TL sight deposits constitute the cheapest source of funding with an annual interest of 10 %, while fx sight deposits obviously bear the cost of TL depreciation. In a move to enlarge their non-interest bearing resources, banks introduced new products such as the collection of utility bills and similar periodic payments in particular to government agencies, and started up cash management departments. As a result, TL sight deposits made up 14 % of total deposits in 1996, up from 11 % the year before, while the share of total sight deposits in total deposits remained unchanged at 26 % ISE-listed banks are particularly successful in collecting cheap TL sight deposits, as the share of such deposits in total sight deposits is 36 %, exceeding considerably the sectoral level.

Public sector banks benefited from the fact that most government agencies and State Economic Enterprises are not allowed to keep their funds in private banks and in interest bearing accounts in some cases. Thus, the share of deposits in total assets were higher at public banks as 79 % against 70 % attained by private banks. As a result, public banks were able to raise a larger share of cheap sight deposits, without much effort, as the share of such deposits in total assets were 21 % vs. 9 % realised by private banks. On the contrary, private sector banks attracted 56 % of deposits against 41 % share of public sector banks. Non-deposit resources constitute the second largest funding source of the banking system. Accounting for 17 % of total liabilities and equity in both 1996 and 1995. The main item in this category has been foreign borrowings, mostly syndicated loans, making up 46 % of total non-deposit resources in 1996. The degree of foreign financing was much higher for private sector banks with 69 % against 17 % in public sector banks that remained almost unchanged in the first nine months of 1997.

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