Potential insolvency, prudential regulation and supervision in emerging market banking systems: the case of Turkey

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Abstract: The crises in the last two decades underlined the importance of prudential and independent supervision, especially in emerging markets with inadequate legal, judicial and financial infrastructure. The 2000–2001 crises in Turkey showed that ineffective regulation, weak supervision and political interference aggravated the cost of the banking crisis. The aim of this paper is to discuss the efficacy of bank regulations and supervisory practices during the deregulation, pre-crisis and crisis periods in the Turkish banking sector. Turkey, the biggest candidate country in the EU, gives prime importance to the integration and adoption of both EU and international banking regulatory standards.

Keywords: banking supervision and regulation; Turkish banking sector; banking crisis.


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1 Introduction

The global financial system has experienced new regulatory practices as a part of the effort towards liberalisation and globalisation over the past two decades. Financial markets in developed and emerging economies have integrated closely, increasing the possibilities of a widespread cross-border contagion crisis in the global financial system. In the last 30 years, more than 112 systemic banking crises took place in 93 countries, where more than 130 cases were seen among IMF countries (Caprio and Klingebiel, 1997). Financial crises have transformed from ‘country crises’ to ‘systemic crises’, as evidenced by the outbreak of the Asian crises. The Asian crises of 1997–1998 spread from Thailand to the rest of Southeast Asia, to East Asia, Eastern Europe and South America and to the financial centres of the developed countries. In its May 2000 discussion, IMF Executive Directors drew attention to the serious weaknesses in banking supervision in many countries, especially in the areas of risk management, corrective actions and consolidated supervision (IMF and WB, 2002). Recent systemic financial crises that took place in other emerging countries (Ecuador, Mexico, Russia, Turkey and Venezuela) also underlined the need for a set of universal prudent regulatory and supervisory governance in crisis prevention. The findings of several empirical studies about the relationship between an adequate legal and supervisory framework and crises indicate that a high majority of the countries that experienced crises had weak legal and supervisory frameworks, as well as weak enforcement (Ward, 2002). Das and Quintyn (2002) identified the main contributing factors to the depth and size of the systemic crises as weak regulations and supervision, forbearance and political interference in the regulatory and supervisory process.

Debates about the roots of the recent crises, the policy implemented and the reforms that took place afterwards have led to an international collaboration to prevent future crises. Hence, governments of developed and emerging countries together with international institutions such as the IMF, the World Bank and the Bank for International Settlements (BIS) have collaborated in their efforts to strengthen the “international financial architecture”, where the policies depend on crisis prevention, crisis prediction and crisis management (Eichengreen, 1999). The Basel Committee on Banking Supervision of the BIS established a set of 25 basic principles called “Core Principles for Effective Banking Supervision” in 1997 (BIS, 1997). The Basel Core Principles (BCPs) are designed to serve as a basic reference for effective banking supervision and applied by all countries in the supervision of banks in their jurisdictions. The Committee believes that implementation of the BCPs by all countries would be a significant step towards improving financial stability domestically and internationally and provide a good basis for further development of effective supervisory systems. Consequently, the BCPs have also been used by the IMF and the World Bank in the context of the Financial Sector...
Assessment Program to assess countries’ banking supervision systems and practices. Recently, the BCPs were revised to address new issues, insights and gaps in regulation in close collaboration with the IMF, the World Bank and major emerging market supervisors in June 2006 (BIS, 2006).

Parallel with the developments in global banking regulation, many emerging market countries have adopted international standards in banking supervision systems. However, regulation of banking has been more challenging for the candidate countries of the EU. Turkey, due to its current status as a candidate country, faces EU regulatory standards (Treaty Article 105(5)–(6), the Agenda 2000 programme, the Financial Services Action Plan (FSAP)), as well as international standards. Therefore, the aim of this study is to discuss the nature of regulatory environment and the role of the supervisory agency in the process of crisis prevention, crisis prediction and crisis management in Turkey as a specific case of an emerging economy. The choice of the Turkish banking sector as a case study stems from Turkey’s statue among emerging financial markets and its position on the European stage. Turkey is an emerging market that experienced severe banking crises in the last decade, despite its high potential in global banking in terms of state-of-the-art technology, diversity in banking services and integration with the global financial system. In addition, Turkey is the biggest candidate country in EU, giving prime importance to the integration and adoption of EU banking regulatory standards. Deficiencies affecting prudent banking supervision and regulation should be eliminated, and a sound banking environment should be created during the harmonisation process of the EU.

The structural and regulatory developments and the financial crises in the Turkish banking sector (the crises of 1994 and twin crises of 2000 and 2001) have drawn attention to the importance of a prudent regulatory environment and efficient legal mechanisms to prevent bank failures and resolve the financial distress of banks. Recent structural and regulatory changes have raised important questions about the efficacy of supervisory practices. Could the failure of banks be avoided by regulatory agency? Did the taken-over banks have financial characteristics that affect the likelihood of insolvency? Did the regulatory agency take prompt corrective action? Or was it reluctant to close/take-over financially weak banks? Was there political interference in regulatory policy making? Did the legal and judicial process work properly for financially weak banks? Could the regulatory and supervisory agency develop a more prudent and independent system in order to prevent future banking crisis in a post-crisis period? Therefore, it is of interest to examine the regulatory and legal environment in shaping the structure of the Turkish Banking industry over three different periods:

- **the deregulation period**, after the implementation of the Financial Liberalisation Program
- **pre-crisis period**, during the implementation of Banks Acts Nos. 4389 and 4491

The rest of the paper is organised as follows: Section 2 reviews the regulatory and legal environment of the Turkish banking system for the deregulation, pre-crisis and crisis periods. Section 3 discusses the possible sources of banking crises in the context of microeconomic, macroeconomic and system-related issues. Section 4 presents conclusions.
2 Regulatory structure and legal framework of the banking sector

In the last two decades, the global banking system has experienced substantial legislative, technological, structural and financial changes. New banking reforms and regulations were introduced to strengthen the financial structure of banks, to establish a sound and stable financial system and to increase the efficiency of supervision in the banking sector. Paralleling liberalisation and deregulation changes in the global financial system, the Turkish banking industry has undergone major changes since 1980. Among the important structural reforms supported by the government were four main banking sector measures: state bank reform, exit and resolution of insolvent banks, strengthening of the private banks and improving the regulatory and supervisory framework (BRSA, October 2003).

The Turkish banking sector was tightly regulated and protected from foreign competition until mid-1980s. The sole authority in regulation and supervision in Turkey was the Treasury operating under the control of the Ministry of Finance until 1983. The banks had been inspected by the Board of Sworn Bank Auditors (SBA) since 1958. A new Banking Law (the Banks Act No. 3182), which was an important step towards a market-oriented banking system, was enacted in May 1985. Following the new legislation, restrictions on international financial operations and foreign asset holdings were abolished, the rate of entry was increased and ceilings on deposit and lending rates were freed. The supervisory role of the Central Bank increased with the new Bank Act in 1985, and the Board of Sworn Bank Auditors (SBA) was still responsible for inspection of banks, but their authority was extended in accordance with the Article 5(1) of the same Banks Act (BRSA, October 2003).

Although the deregulation policy started in the early 1980s, the first half of the decade continues to reflect the regulation period because of the time lag in the implementation of the new laws. The actual transition from a regulated to a deregulated environment took place in the second half of the 1980s, with the introduction of more active deregulation policies and the establishment of financial infrastructure. Thus, the deregulation period actually covers the years 1988–1997. During this period, financial performances of the banks were monitored by the SBA and their reports were submitted to the Treasury. If the performance of a bank was found unsatisfactory, the bank would be under the surveillance of the Treasury in the context of Article 64 and a board member and/or internal auditor would be appointed by the Treasury. There were 15 banks operating under Article 64 until the end of 1999 (Denizer et al., 2000).

The pre-crisis period, 1998–2000, represents a new era of both expansion and consolidation in the banking sector. In 1997, more than ten new small-scale banks were established and four of the existing state banks were privatised. This period reflects a policy shift towards a more competitive market with a small and fragmented banking structure (Ozkan-Gunay, 2004). On the other hand, these small banks competed with the large banks in terms of price variables such as deposit rates and non-price variables such as advertising, product diversity, technological infrastructure and over-branching. They offer higher interest rates on deposits under full guarantee of deposits, leading to inefficient competition in the deposit market. The high rates of return on government bond investment made possible the survival of many banks, which otherwise would have collapsed. As a result, the Turkish banking industry was over-banked.

The regulatory environment of the banking sector was changed in June 1999. The Banks Act No. 4389 was introduced to strengthen the legal and regulatory environment of the banking sector, and an independent regulatory and supervisory
agency, the Banking Regulation and Supervision Agency (BRSA), was established. The main objective of the BRSA was to eliminate distortions in the financial system and to adopt regulations necessary to promote an efficient, globally competitive and sound banking sector (BRSA, May 2001). Regulations on operations and the supervision of the banking system were harmonised with international norms and especially with the European Union directives and Basel II requirements. The bank resolutions were also granted to the BRSA, and the status of the Agency was strengthened with Bank Act No. 4491, issued in December 1999. The flexibility of the supervisory authority in cases of financial weakness of a bank was enlarged; more objective criteria for strengthening financial structures of banks and changes to speed up decision making were accepted. Personal responsibilities of shareholders and top managers, as well as administrative fines for violation of regulations and judicial fines, were increased (BAT, 2001). At the end of 1999, shortly after the amendments in the Banking Law, five banks that were previously under the surveillance of the Treasury in the context of Article 64 were taken over by the Saving Deposits Insurance Fund (SDIF), which operated under the Turkish Central Bank between 1983 and 2000 and the BRSA between 2000 and 2003 and then became an autonomous institution in 2003.

The Turkish banking sector entered the crisis period (2000–2001) with new legal, structural and institutional changes. It was a period of failures, consolidations, take-overs and mergers. The BRSA was legally fully operational as an independent agency in September of 2000 and took full control of bank supervision by addressing issues such as regulations on risk management and capital adequacy, open positions in foreign exchange and other prudential regulations. On the other hand, the BRSA was still under the political surveillance of the ruling political parties, because the chairman and board members continued to be appointed by the Government. With the enforcement of the new Bank Act No. 4491 and the foundation of the BRSA, inefficient banks were taken over and mergers, cross-border mergers and alliances were encouraged. The year 2001 was a turnaround in the wake of restructuring plans. “The Banking Sector Restructuring Program” was introduced to eliminate distortions in the financial sector and adopt regulations to promote an efficient, globally competitive and sound Turkish banking industry. Among the important structural reforms supported by the government were four main banking sector measures: state bank reform, exit and resolution of insolvent banks, strengthening of the private banks and improving the regulatory and supervisory framework (BRSA, October 2003).

3 Financial performance, prudential supervision and bank closures

Crisis prevention depends on prudential regulation and supervision. The regulatory agency is responsible for creating a sound financial environment by setting the regulatory framework, where the supervisory agency monitors the financial viability of banks and checks compliance with regulations. However, the regulatory and supervisory agency should have appropriate enforcement power, credibility and an autonomous structure in order to be more effective in prudential supervision. Even with a proper regulatory framework, bank failures can not be prevented because risk taking is a natural part of banking transactions. Therefore, prudential supervision is of prime importance in handling financially troubled banks, minimising the cost of banking crises and preventing systemic crisis.
Andrews and Josefsson (2003) identified three underlying causes of problem banks as microeconomic, macroeconomic and system-related causes. Noy (2004) also located inherent microeconomic imperfections facing banks as adverse selection, moral hazard, principal–agent issues and informational asymmetries. Microeconomic causes stem from poor banking practices that lead to losses or fraud. Macroeconomic causes originate from unstable macroeconomic environment of high inflation, interest rates and volatile exchange rate as well as global shocks. System-related factors arise from market distortions from state banks, connected lending, inadequate legal framework and supervision (Andrews and Josefsson, 2003). However, the pressures of banking lobbies and politicians are also important sources of distortions in the Turkish banking.

Introduction of different Banks Acts and the regulatory attempts to rehabilitate the sector could not prevent weak financial performance, bank mismanagement and fraud due to the lack of judicial and supervisory enforcement power in the Turkish banking sector. In addition to the unstable macroeconomic environment, the turbulence of 2000–2001 stemmed from structural weaknesses such as inadequate capital bases, small size and fragmented banking structures (Ozkan-Gunay, 2004); the dominance of inefficient state banks (Ozkan-Gunay, 1998; Mercan and Yolalan, 2000); low asset quality; high exposure to market risk and inadequate internal monitoring. Another important structural weakness was the full deposit insurance introduced during the 1994 crisis to prevent the panic in the banking system. This precaution had the negative effect of shifting the choice criteria of customers. Since all deposits were covered by full guaranty, the financial soundness of the bank ranked at the very bottom as a choice criterion, while interest rates emerged as the major criteria. These weaknesses deteriorated the efficiency of banks and increased the fragility of the banking system (Ozkan-Gunay and Tektas, 2006). Together with microeconomic and macroeconomic causes, the system-related factors discussed below prepared a suitable environment for the twin crises of 2000 and 2001.

3.1 Distortions from state banks

The dominance of the state banks has been an important issue in the Turkish banking sector. Four state banks had a market share of 34%, 27% and 40% in total assets, deposits and loans, respectively, in 2000 (Ozkan-Gunay, 2004). The presence of state banks in the system has been a serious shortcoming of the reform process. Governments use these banks to bypass the budgetary process, as state banks extend credit to favoured sectors or individuals at the will of the government. State banks deliver subsidised credits to certain sectors of the economy and often charge interest rates below their funding costs. Since they are not fully compensated for their subsidised lending, they carry large amounts of non-performing loans (5% of GNP) arising from these transactions (Denizer et al., 2000). Consequently, the financial health of the state banks deteriorated due to accumulation of duty losses and inefficient management (BRSA, July 2002).

3.2 The pressures of banking lobbies and politicians

The protection of weak regulations by politicians and forbearance as a result of political pressures are the two most common strains that undermine the integrity of the supervisory function (Quintyn and Taylor, 2002). Hence, the bank regulatory and supervisory agency should be independent from the political process, and supervisor
intervention for financially weak banks should be on a timely basis. Otherwise supervisory leniency may aggravate the problems of weak banks, making the eventual resolution efforts more difficult and more costly, with the possibility of more widespread crisis. Andrews and Josefsson (2003) pointed out that shareholders should not be compensated for losses when a bank got into difficulty; otherwise, it would encourage other banks to behave less prudently on the expectation that they would receive a similar treatment in case of a problem. Equally, supervisory action should not protect the interest of the bank’s corporate officers. The connection between the government and the political power of banks is often much greater in emerging market countries, thus making it more likely that the latter will be bailed out if they experience difficulties (Mishkin, 2001).

Reluctance to bail out insolvent banks can be due to concerns related to the failure of supervisory authority and a broader loss of confidence in the system, leading to panic or the unwillingness to impose losses on shareholders and depositors because of political concerns. In Turkey, the reluctance of the Treasury to eliminate financially weak banks was due to both political and economic reasons. After the 1994 crisis, the commercial banks became the major customers of government bonds. Thus, many inefficient banks could survive by investing in government securities and the government did not want to lose important customers. On the other hand, the regulatory agency monitored banks through on-site examinations and off-site surveillance activities. If the bank examiner found sufficient financial difficulties, the examiner reported to the Treasury. Troubled banks were subject to close watch (under Article 64) by an appointed board member and an auditor of the Treasury with the approval of the economy minister. These banks were exempted from reserve requirements and tax obligations, and the minister was authorised to take all measures to improve the financial health of the banks. According to Denizer et al.:  

“banks that were put under Article 64 did not have any incentive to improve their condition. In fact, over the years, 15 or so banks have always been under it and removal from the list seems to have been a negotiated process rather than a regulatory decision.” (Denizer et al., 2000)

The existing banking law assigned excessive discretionary powers to the minister in charge, and the removal of weak banks from under Article 64 to the bankruptcy process was completely dependent on the approval of the minister and the cabinet (Denizer et al., 2000). Unfortunately, the close ties of major shareholders to politicians and powerful pressures coming from banking lobbies shaped up the regulatory environment, and many troubled banks survived, creating a problem of moral hazard in the system.

During the privatisation of the state banks after 1997, banking licenses were granted to those in the political circle rather than on the basis of financial competency. Likewise, the regulatory system failed to establish an effective supervision on lending to group companies and on equity holding in closely held companies because of the powerful pressures of banking lobbies. In addition to this, lack of prudential supervision and a healthy jurisdiction system provided an environment favourable for fraud and looting for some major shareholders. It was reported widely in the press that regulations poorly controlled the misuse of deposit insurance, lending limits to affiliates and related third parties (Denizer et al., 2000). Close ties between the major shareholders of the banks and politicians distorted the risk/return perceptions in banks. The problems had been known, reported and documented extensively by the banking department of the Treasury.
The political and regulatory environment communicated the message that stretching the ethical principles and legal rules for the ‘benefit’ of the bank (or the major shareholder) would go undetected and condoned. The structural weaknesses, weak regulatory environment, and financial and political pressure encouraged the exploitation of legal loopholes and grey areas. Consequently, dealing with weak banks in a fragile and highly volatile regulatory environment requires an autonomous, determined and consistent supervisory authority.

3.3 Inadequate legal and judicial system

Inadequacy of the legal system is a very important issue in emerging financial markets, as when property rights, collateral system and bankruptcy procedures are not well defined and implemented. In the Turkish banking system, in addition to structural weaknesses, the lack of prudential supervision and a healthy jurisdiction system provided an environment favourable for fraud and looting for some major shareholders. Between 1999 and 2002, 20 banks were taken over by the BRSA. Major shareholders and top managers of these banks were called to the State Security Court (SSC) with the allegation of violating the Turkish Penal Act and the Turkish Bank Acts. They were accused with allegations of causing bank losses and of not protecting the rights and interests of depositors. This was an important turnaround, giving the message that legal rules for the ‘benefit’ of the major shareholder would not go undetected and condoned any more. Lawsuits were filed against the first four taken-over banks in the SSC, the highest-order court specialising in cases threatening the unity of the country. The other 16 banks, although faced with similar allegations, were not tried in the SSC. At the end of a year, the initial four banks were also transferred to the Penal Courts, when the SSCs were abolished in 2004 during the harmonisation process with the European Union. However, the degrading impact of being subject to SSC trial on the reputation of the banks, stakeholders and the managers is difficult to call off. The number of lawsuits filed against managers and major shareholders of the taken-over banks added up to 157. Sixty-four of these were individual bankruptcy lawsuits against majority shareholders and ex-managers of the transferred banks (BRSA, July 2002). Lawsuits included accusations of fraudulent capital expansion, fiduciary loans, back-to-back lending, connected lending, loans to shell companies and offshore banking (Ozkan-Gunay and Hortacsu, 2004). The common ground in these allegations was the alleged intention of the major shareholder to enhance the personal gain by outsmarting the legal system. Were they the only responsible managers? When the troubled banks were placed on the regulator’s list after the recommendation of the agency’s auditor, they were subject to close watch by an appointed board member and an auditor of the Treasury. Fifteen banks operated under close watch (under Article 64) for a long time. Why did the regulatory agency not take over or close the troubled banks? Why were the representatives of the Treasury in troubled banks not charged with the same allegations as the major shareholders and managers, even though they were authorised signatory officers and shared the same responsibility in banking operations?

Recently, “the banking sector restructuring program”, introduced in May 2001, was a major source of progress in terms of establishing a well-regulated banking sector. With the Banks Act No. 4389, the BRSA, an independent agency, acted to remove the loopholes in the system and strengthen the regulatory and supervisory framework. There is a consensus about the definition of ‘independence’ in the regulation of financial
sector literature. Quintyn and Taylor (2002) identify agency independence in the context of four dimensions: regulatory, supervisory, institutional and budgetary independence, where regulatory and supervisory independence are the core functions and institutional and budgetary independence are essential in supporting the execution of core functions. Barth et al. (2002) defined the independence of supervisory authority as political and institutional independence, where the supervisory authority was independent from lawsuits from banks and other parties. Das and Quintyn (2002) depicted independence as being independent from the political sphere and from supervised entities. Alper and Onis (2003) drew attention to the importance of independence of regulatory authority from short-term political considerations as well as the need of political support to be effective.

The BRSA gained its administrative and financial autonomy with the Banks Act No. 4389 in 1999. Its authority extended with the transfer of power of granting new banking licenses from the Council of Ministers with the Bank Act No. 4491 during the crisis period. But indeed, the BRSA could not prevent the twin crises due to the structural and legislative problems of the banking system that accumulated throughout the years. In the post-crisis period, parallel to the financial and operational restructuring of the banking sector, new legislative and institutional regulations were adopted to strengthen the regulatory and supervisory framework, ensure efficiency and competitiveness in banking sector and facilitate sound banking practices to establish confidence in the sector (BRSA, July 2002). Restructuring of state banks was carried out and privatisation efforts started for four large state banks, but the progress was slow. The deposit insurance system was changed from full coverage to a ceiling of 50,000 NTL (approximately EUR 25,000). A new approach, “Risk Focused Monitoring (RFM)”, in risk management changed monitoring techniques and attitudes towards the determination of risk profile of the bank and competency of the bank in managing risks instead of avoiding the risk-taking behaviour of the banks. Inefficient procedures related to the legal proceedings were removed. Comprehensive amendments and changes were made in the Execution and Bankruptcy Law (BAT, 2004). Eventually, the regulatory and supervisory agency in Turkey became more effective in prudential supervision and regulation with the appropriate enforcement power, credibility and autonomous structure in the post-crisis period.

4 Conclusion

This paper emphasises the impact of prudent regulatory and supervisory policies in emerging financial markets for global financial stability. An adequate financial infrastructure for effective banking supervision, such as the efficacy of the supervisory and regulatory framework, stable macroeconomic policies, a well-developed legal and judicial infrastructure, effective market discipline, procedures of effective resolution of banks and effective safety nets, becomes of prime importance in emerging financial markets like Turkey. Despite the structural and regulatory developments in the Turkish banking sector, the highly volatile regulatory environment was created by introducing several regulations and Bank Acts since 1985. These regulatory attempts to rehabilitate the sector could not prevent the systemic banking crises. Financial deregulation might have prepared a suitable ground for fraud and bank mismanagement in the system, but regulatory governance should have taken the corrective actions promptly. Ineffective regulation, reluctance to enforce regulations, leniency and political interference increased
the fragility of the banking system and aggravated the cost of banking crises. The twin crises of 2000 and 2001 were the worst in modern Turkey’s history, affecting 25% of 81 banks in the sector. Twenty-two banks were taken-over by the Savings and Deposit Insurance Fund (SDIF), leading to an economic loss of approximately 20% of the Gross National Product (GNP). Major shareholders and top managers of the taken over banks were accused of causing bank losses and not protecting the rights and interests of depositors by violating the Turkish Banking Law and the Turkish Criminal Law.

A remarkable progress has been made in creating a well-functioning legislative and regulatory framework, regarding the prudential operation of banks with the banking reforms in the post-crisis period. Moreover, elimination of structural and system-related distortions created a proper environment for the BRSA to maintain confidence, to protect the rights of depositors, to minimise potential risks of the banking system and to enhance banking sector efficiency and competitiveness. Since the regulatory and supervisory agency in Turkey has appropriate enforcement power, credibility and an autonomous structure, it is more effective in prudential supervision.

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