Central Bank of the Republic Of Turkey

FINANCIAL STABILITY AND BANKING REGULATION IN TURKEY

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Esteemed Governors and Distinguished Guests,

It is a great pleasure to be here in Luxembourg to address such a distinguished audience. I would like to thank the Central Bank of Luxembourg for organizing this special event. First I want to share my experiences on the financial stability and banking regulatory developments in Turkey. Then I will present my views on the future of the global financial architecture.

At the outset, let me touch upon the ongoing global financial crisis briefly. In September 2008, the global economy has plunged into the deepest crisis we have witnessed since the Great depression upon the bankruptcy of Lehman Brothers. Just a few months later, almost all economies around the world were in the midst of a full-blown recession due to the massive spillover effects of the liquidity problems and credit crunch.

The sharp increase in risk perceptions resulted in a significant deterioration in short-term credit and money markets - leading to a major liquidity squeeze. Liquidity problems, coupled with solvency crisis, have tested the resilience of the global financial system. Major financial institutions reported huge losses, reputable institutions announced their bankruptcy or rescued by other market participants and governments. Multi-trillion dollars worth of rescue packages were put into effect to prevent a complete meltdown in financial markets.

The global turmoil coupled with credit crunch triggered by the sub-prime meltdown has revealed fundamental weaknesses in the operation, supervision and regulation of the global financial system. In retrospect, it is clear that accommodative monetary policies implemented in developed economies played a major role in the build up of current crisis. Risks were hidden in the system but accumulated continuously, thanks to access to cheap money and use of excess leverage in complex financial instruments. Many thought that the use of such instruments would eliminate the risk factor in their portfolios. But unfortunately, the result was just the opposite. Risks were just mounting up for a massive implosion.

Nonetheless, thanks to the coordinated measures taken by governments and central banks, fears of system wide collapse have dissipated. Recent data displays

some signs of recovery in the economic activity and normalization in the global financial markets. However, there are still some risks involved in the global financial system, especially in the Western Banking system. New bout of risk aversion may deteriorate the already fragile banks' balance sheets and feed into the overall banking system. Moreover, as IMF highlighted, not all anticipated write-downs were realized, which in turn imply further potential erosion in the capital structure of the banking system.

It remains to be seen whether recent improvements in the leading indicators will translate into a long lasting and durable recovery, since part of the rebound reflects the impact of the fiscal stimulus packages. Extraordinary policy measures taken since the last quarter of 2008 make it harder to interpret the underlying trends and put us in a cautious stance in extrapolating past patterns into the future.

Esteemed Participants,

At this point let me turn your attention to the developments in Turkey. Turkish economy, which grew for 27 quarters in a row, experienced severe contraction during the last quarter of 2008 and the first half of 2009. The higher share of cyclically sensitive exports, firms' dependence on external financing, and elevated level of production capacity were the factors that exacerbated the severity of the contraction.

Turkey used to be one of the emerging economies with historically high volatility and particular sensitivity to global risk perceptions throughout the 90s. However, this time the impacts of the crisis have remained relatively limited. Sound financial system, low level of household indebtedness and assertive monetary policy stance were the main factors that prevented an outright depression in Turkey.

Our financial system proved to be resilient during the crisis relative to many other emerging economies. Unlike most of its peers, the Turkish banking system did not require any rescue packages or other forms of government support throughout the crisis. In retrospect, the restructuring plans along with the regulatory and supervisory reforms were already put into effect in the wake of 2001 crisis. Banking sector-restructuring efforts, at the cost of imposing a heavy burden on the public budget, enhanced our banking system's resilience to shocks. In some sense, we had already gone through in

2001 what the world has been experiencing today. These regulations have provided our banks with high level of capital adequacy, liquidity and deposit to loan ratios with mild leverage. Balance sheets free of toxic assets and significantly low levels of FX short positions supported the resilience of Turkish banks. In short, the banking sector restructuring program in Turkey paved the way for reaching financial stability and the formation of a sound financial sector.

From a broader perspective, restructuring of the Turkish banking system in the post-2001 period was not a story in itself. On the contrary, there was an array of other provisions that made economic agents to adopt new behavioral norms. Among these, the maintenance of ambitious primary surplus targets should be mentioned first. This not only put fiscal accounts on more rational grounds, but also triggered the banks to resume their traditional role in the economy, -financial intermediary-.

The fundamental change in the monetary policy framework also deserves special attention. The Central Bank of Turkey started implementing inflation targeting regime and it was given independence with the official mandate of price stability. “Financial stability” was set as an auxiliary objective of the Central Bank and the short-term advance channel from the Central Bank to the Treasury was abolished. These developments, coupled with a successful floatation of the national currency, internalized risks to the markets. Potential adverse selection and moral hazard problems, hence, could be effectively avoided. I believe all these helped the banking system and the financial markets as a whole to maintain a resilient and healthy structure.

As of today, the capital adequacy ratio (CAR) of our banking system is close to 20 percent. In the first nine months of this year, the banking sector profit was up more than 30 percent from the same period of last year. Non-performing loans (NPL) constitute about 6 percent of total loans, up 3 percentage points since last September 2008. According to sensitivity analysis conducted by the Central Bank, even if the NPL ratio increases by 15 percentage points to 21 percent, the CAR would remain well above the target limit 12 percent. In this sense, we are confident that Turkey’s well-capitalized and sound financial system is capable of supporting the economic activity along the recovery.

Dear Guests,

In addition to the sound structure of the financial system, low level of household indebtedness relative to other emerging economies was another factor that contributed to the resilience of the Turkish economy during the crisis. Monetary tightening implemented by the Central Bank between 2006 and 2008 played a critical role in curbing the lending growth and thus the rise in the household indebtedness. Prudent and preemptive measures taken by the Banking Regulation and Supervision Agency in the last seven years prevented the spread of exchange rate risk among households. The share of foreign currency-denominated loans in the current debt stock of households is rather small compared to other emerging economies, especially those in Central and Eastern Europe. Financial markets seemed to have appropriately appraised these factors, as the risk premium in Turkey deteriorated by a smaller extent during the peak of the crisis.

Parallel to the contraction in the aggregate demand and sharp drop in commodity prices, inflation in Turkey plummeted markedly. With the reversal of global developments fueling inflation in the last quarter of 2008, the Central Bank took prompt action to cut interest rates and adopted a pioneer role among emerging markets. The analysis conducted by the CBT indicates that policy rate cuts totaling 10 percentage points (1000 basis points) have alleviated the severity of the decline in economic activity. In this respect, we focused on containing potential adverse effects of global financial turmoil on the domestic economy without compromising our price stability objective. Additionally, borrowing and lending rate band has been gradually decreased in order to reduce fluctuations in the overnight interest rates. Also, liquidity need of the market in local currency has been provided in a timely fashion and at the required amount.

We used our foreign exchange reserves primarily to support our banking system. We acted as a blind broker in the FX Market between the financial institutions and shouldered the counter party risk to facilitate the flow of FX liquidity in the system. Moreover, the maturity of the foreign exchange deposits borrowed by banks from the Central Bank in the FX Deposit Markets was extended and the lending rates were slashed.

Additional FX liquidity in the amount of USD 2.5 billion was provided to the banking system through a 200 basis points reduction in the FX required reserves ratio. And lastly a couple of weeks ago, the required reserve ratio for Turkish Lira was reduced from 6 percent to 5 percent. By this cutback, a permanent liquidity that is equivalent to approximately TL 3.3 billion has been provided to the banking system.

As a consequence of the measures taken by monetary and fiscal authorities, market interest rates today is below the pre-global crisis level in both nominal and real terms. Having neutral interest rates at lower levels during economic recessions is an expected development in well-functioning economies, but it has never been experienced in Turkey before. This development should be perceived as an indicator of the normalization of the Turkish economy.

Distinguished Participants,

Following the developments in the Turkish economy and the banking system, now I want to continue with my views on the future of the global financial architecture. In order to prevent future crises, we definitely need a reformulation of international standards and rules in order to reform the global regulatory infrastructure. Thanks to the global efforts, lessons derived from the crisis have already started to initiate dramatic changes in the global financial architecture. In the recent G-20 meetings in Pittsburgh and the World Bank-IMF Annual Meetings which took place in Istanbul, member countries confirmed their commitments to the principles of strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets, and reinforcing international cooperation.

In this context the Financial Stability Board (FSB) has been established to address systemic vulnerabilities and to develop and implement strong regulatory and supervisory policies on a global scale. Stronger capital structure, fair compensation schemes, improved accounting standards, revitalizing the securitization markets and broadening supervisory and regulatory base to include shadow banking system are the hot topics for the policy makers.

We strongly support the promotion of the standards that will enhance financial stability through reducing the likelihood of banks getting into difficulties and improving

the resilience of the financial sector. We must lay the foundations for a solid infrastructure to ensure that a global crisis of this scale will never happen again. Crisis prevention should be given utmost importance since the next step would be crisis resolution where the public authorities might have to intervene into the markets. These interventions have become less preferred due to the concerns about long-term outcomes such as creating moral hazard among financial institutions. As an example, a capital surcharge for systemically important banks is an option to tackle systematic risk and limit the market advantages that intermediaries derive from being too-big-to-fail or too-connected-to-fail. But the role of such large institutions in supporting the global economy via presenting the benefits of diversification should not be overlooked. Therefore, it is crucial that the effects of reform should be consistent with market efficiency and avoid rigidities that could impair growth, job creation and financial innovation or increase the cost of financial services for customers.

I think that regulators and supervisors should develop effective risk-based supervision systems and continuously analyze the dynamics in the global financial system cautiously in order to prepare their contingency plans. The ongoing crisis has revealed that preventive measures put in place at the local level are not capable of effectively addressing the global problems. Close collaboration among supervisors and regulators at home and in host countries of financial institutions is critical. Central banks and other regulatory institutions should make their findings public through regular reports to increase the risk awareness in the financial markets. As the Central Bank of Turkey, we publish semiannual financial stability reports for this purpose.

All in all, we all agree on the necessity that global supervisory and regulatory architecture should be sustained all around the world without any black holes like tax havens and countries with lax regulations in order to prevent regulatory arbitrage. All these reforms are easier said than done. So it is yet to be seen whether we will be successful on implementing these measures and achieve our goal of sound and stable global financial system.

In conclusion, central banks and other policy makers should identify the risks to the financial stability and manage the crises in coordination with other related parties. The relative calm in global financial markets in recent months should not lead to

indolence. Cooperation between regulatory institutions should not be only limited to times of financial distress. Policy makers should focus on creating action plans in good times to better cope with problems should they arise.

As I conclude my speech, I would like to extend my gratitude to the Central Bank of Luxembourg for organizing this pleasant event.

Thank you for your attention.