Can Financial Regulations Strengthen Financial Stability in Developing Countries? : The Case of Turkey

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Abstract
The type of prudential regulations commonly used in developing economies aims directly to control of financial aggregates, such as liquidity expansion and credit growth, namely capital requirements with risk categories used in industrial countries. The results achieved in the last two decades have clearly indicated, contrary to policy intentions, the very limited usefulness of those policies in helping those countries to contain the risks involved with more liberalized financial systems; especially in episodes of sudden reversal of capital flows.

In the case of Turkey, the new liberal economic policy began to be implemented in January 1980, which aimed at integration with world markets by establishing a free market economy. As a reflection of this policy, the 1980s witnessed continuous legal, structural and institutional changes and developments in the Turkish banking sector. During these years, Turkey experienced two very severe financial crisis one in early 1994 and the other one in early 2001. In mid-1994, Turkey adopted an IMF based stand-by agreement, and managed to calm the severe economic crises. However, macroeconomic instability continued until the late 1990s. In December 1999, Turkey signed a three-year standby agreement with IMF. This program had failed due mainly to a major banking sector crisis and Turkey has started another stabilization program backed by IMF which is still being implemented in Turkey. With this new program, an extensive streamlining plan, Banking Sector Restructuring Program was started and announced to the public in May 2001.

The aim of this paper is to evaluate the effectiveness of financial regulations adopted in Turkey in achieving financial stability throughout the liberalization process. In this framework, in the light of developments in the Turkish economy the recommendations of the Basel Committee in terms of liquidity and capital requirements are assessed, especially in controlling the adverse impact of volatile short run capital flows on the financial systems of developing countries.
Key words: Financial regulation, Financial stability
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CONTENT

I. Introduction

The recent wave of financial globalization since the mid-1980s has been marked by an increase in capital flows among industrial countries and, more notably, between industrial and developing countries. While these capital flows have been associated with high growth rates in some developing countries, a number of countries have experienced periodic collapse in growth rates and significant financial crises over the same period, crises that have exacted a serious toll in terms of macroeconomic and social costs. Existing institutions and arrangements were widely seen as inadequate for dealing with very large and extremely volatile capital flows, in which an important part of the volatility was caused by large imperfections in the financial markets themselves. As a result, an intense debate has emerged in both academic and policy circles on the effectiveness of financial regulation policies and the usefulness of those policies in helping developing economies to contain the risks involved with more liberalized financial systems; especially in episodes of sudden reversal of capital flows.

Globalization has started to show its effects on Turkish economy in the form of structural adjustments and legislative regulations in early 1980s, especially after the January 24th decisions. In this context, transition to free market economy, opening to foreign markets, export-led growth, reducing the weight of public sector in the economy, privatization, liberalization of the financial system, facilitating to enter the banking sector, developing non-banking financial institutions, utilization of flexible interest and exchange rates, lifting restrictions in foreign currency and free flow of capital or at least alleviating these restrictions, allowing those living in Turkey to open foreign exchange accounts (FX deposits), establishing a capital market, re-organizing the body of Istanbul Stock Exchange and activating it, encouraging both foreign and local investments, funding public expenses heavily with debt due to loss of public revenue because of tax incentives and discounts could be regarded as the effects of globalization over economy.

During the liberalization period, Turkey experienced two very severe financial crisis one in early 1994 and the other one in early 2001. In mid-1994, Turkey adopted an IMF based stand-by agreement, and managed to calm the severe economic crises. However, macroeconomic instability continued until the late 1990s. In December 1999, Turkey signed a three-year standby agreement with IMF. This program had failed due mainly to a major banking sector crisis and Turkey has started another stabilization program backed by IMF which is still being implemented in Turkey. With this new program, an extensive streamlining plan, Banking Sector Restructuring Program was started and announced to the public in May 2001.

The main purpose of this paper is to evaluate the effectiveness of financial regulations adopted in developing countries, mainly in Turkey in achieving financial stability throughout the liberalization process. To this aim, the second section reviews the basic characteristics of financial markets and commonly applied financial regulatory policies in developing countries with reference to special problems related to regulation in those countries. The third section analyses the financial developments in Turkey. In this section, in the light of developments in the Turkish economy the recommendations of the Basel Committee in terms of liquidity and capital requirements are assessed. The focus is on the regulation of banks, as these are the dominant financial institutions in Turkey. The fourth section discusses the approaches for increasing the effectiveness of prudential regulations in developing countries especially in controlling the adverse impact of volatile short run capital flows on the financial systems of those countries. The adequacy of commonly used regulatory tools in reducing the adverse effects of capital flow volatility on domestic financial markets is also discussed. The final section provides the conclusions.

II. Financial Liberalization, Financial Instability and Regulation in Developing Countries

Since the collapse of the Bretton Woods system increased global capital mobility has been accompanied by greater frequency of financial crises in both developed and developing countries. The episodes of financial instability and crisis in industrial countries include the banking and real estate crises in the United States lasting more than a decade from the late 1970s, the major slumps in the global stock market in 1987 and 1989, several episodes of extreme instability in the currency markets of industrial countries of which an outstanding instance was the currency crisis of the European Monetary System (EMS) in 1992, and the instability in Japanese financial markets that started with the bursting of the bubble in the early 1990s, whilst those in developing countries include the Southern Cone crisis of the late 1970s and early 1980s, the debt crisis of the 1980s, the Mexican crisis of 1994-1995, the East Asian crisis beginning in 1997, the Russian crisis of 1998, and a number of other more limited currency and banking crises.[1]

Those episodes showed that as financial markets are liberalized, sound financial regulation and supervision are needed to protect the stability of the financial system. However, most developing countries have yet to create robust prudential systems which can protect their banking systems from

[1] Further details concerning those crises can be found in UNCTAD (1998) Part One, Annex to chap. III.

the increased risk of systemic crisis following financial liberalization. Although many countries have adopted regulatory reforms, these measures have often not been properly or fully implemented. There have also been problems associated with the application of a prudential regulatory model which has largely been designed in developed countries, to the conditions prevailing in developing countries where legal and accounting systems are weak, there are often acute shortages of skilled personnel to undertake supervision, and regulators are vulnerable to political interference.

a) *Features of Financial Markets in Developing Countries*

Financial markets in developing countries differ in several important ways from developed countries. Mainly,

- In developed countries, investors have access to a wide range of investment options offering a wide spectrum of tradeoffs between risk and return. At one end of the spectrum would be savings accounts and certificates of deposit (CDs). At the other end would be things such as futures, futures options, emerging market funds, etc. In developing countries, investment possibilities are limited and, in turn, possibilities for trading off risk and expected return are also limited. This is especially true in rural areas lacking access to urban banking and other financial facilities.
- In developed countries, transaction costs are generally a small percentage of the value of investments and borrowings. In developing countries, where transactions tend to be much smaller in size, transaction costs can be a high percentage of the value of the transaction.
- In developed countries, information on investment and borrowing options is widely available at low cost. In developing countries, information is relatively costly. Basic information is often lacking on alternative investment possibilities and rates of return to alternative investments.
- In developed countries, lenders can diversify their portfolios at relatively low cost. In developing countries, portfolio diversification is relatively costly. In rural areas, for example, bad weather or other adversities can affect a large number of borrowers at the same time. Portfolio diversification in this setting requires other, non-rural investments.
- In developed countries, markets are well integrated in spatial terms. In developing countries, markets are often not spatially integrated. To one degree or another, rural financial markets are often spatially isolated from each other and from urban financial markets.
- In most developed countries, the financial services sector is highly competitive. In developing countries, competition is often limited. Due to economies of scale, the market will often only support a small number of financial services providers. In addition, government regulations often

limit entry into this sector.

Considering those general differences, the relative shallowness of financial systems in developing countries suggests that investors' confidence that financial assets will yield a positive and stable rate of return over an extended period of time has remained weak. Investors' concerns are reflected in the high degree of volatility in the ratio of deposits to GDP that persisted in developing countries during the 1990s (Rojas-Suares; 2005).

For the developing countries another indicator of financial strength, the share of government claims in bank assets is also quite important because, one of the objectives of financial liberalization and reforms was to reduce the massive transfer of resources from the private financial sector to the public sector, which in the 1970s and early 1980s had served to finance large fiscal deficits. Yet, while in most of the developing countries experiencing financial liberalization governments significantly reduced their interference in direct allocation of credit, a number of governments continued financing their deficits with resources from the domestic banking system. Whereas in the 1980s this was achieved by direct lending to governments or high reserve requirements, since the mid-1990s governments issued large amounts of debt that was purchased by banks and by the general public. Indeed, it is interesting to note that in addition to bank deposits, government paper constitutes the other major source of liquidity in developing countries. Because of the absence liquid private capital markets, investors in most of the developing countries largely hold their financial wealth in bank deposits and government paper.

Consequently, due to the different level of development of financial markets there are important differences between industrial and developing countries in the nature and effects of financial instability and crises. Experience shows that in developing countries reversal of external capital flows and sharp declines in the currency often threaten domestic financial stability. The differences between developing and developed countries stem from a number of factors (Akyüz,Cornford ;1999) .
Basically,

- The size of developing-country financial markets is small, so that entry or exit of even medium-size investors from industrial countries is capable of causing considerable price fluctuations, even though their placements in these markets account for a small percentage of their total portfolios.

- Differences in the net foreign asset position and the currency denomination of external debt play a crucial role. The vulnerability of developing countries is greater because of their typically higher net external indebtedness and higher shares of their external debt denominated in foreign currencies. The vulnerability of the domestic financial system is increased further when external debt is owed by the private sector rather than by sovereign governments.

b) Commonly Applied Financial Regulatory Policies in Developing Countries

During the past two decades many developing countries have sought to liberalize their financial systems. As financial markets are liberalized, sound financial regulation and supervision are needed to protect the stability of the financial system. The developing countries began to implement major reforms to their prudential systems in the 1980s and early 1990s. These reforms were in many cases stimulated by the financial crises which had occurred in the 1980s and/or were part of broader programmes of financial sector reforms funded by loans from the World Bank or other multilateral agencies. Conditionalities related to bank regulation and supervision featured prominently in World Bank financial sector adjustment loans, with a higher probability of inclusion than interest rate deregulation, bank privatization or directed credit reforms (Cull; 1997).

Prudential reforms followed a broadly similar pattern, although the details and scope of the reforms varied between countries. An industrial country (in particular the US) model of regulation and supervision has been adopted by most of the developing countries. The Basle Committee's Core Principles for Effective Banking Supervision, drawn up in 1997, sets out the basic framework of this model (IMF, 1998). The model involves a set of detailed prudential regulations, set out in the banking law (e.g. minimum requirements for capital to risk assets, restrictions on banks' asset portfolios including restrictions on large loan exposures and insider lending, auditing requirements, etc.), with supervision undertaken directly by a public agency. Supervision entails on-site inspections and off-site monitoring of banks based around the CAMELS (Capital adequecy, Asset quality, Management ability, Earnings record, Liquidity and Sensitivity to interest rate variations) principles (Sheng; 1996). Supervisors aim to inspect banks at regular intervals and banks are required to submit regular financial reports to the supervisors. Some, but not all of the developing countries have also adopted some type of deposit insurance (Kyei; 1995). Prudential reforms have also included considerable institutional strengthening, albeit from very low levels of institutional capacity in many cases. Staffing levels have been expanded, training provided for supervisors, and technical advisors provided to supervisory authorities.

However, most of the developing countries have yet to continue the process of creating robust prudential systems which can protect their banking systems from the increased risk of systemic crisis following financial liberalization. Especially, there are problems associated with the application of a prudential regulatory model which has largely been designed in developed countries, to the conditions prevailing in the developing countries where legal and accounting systems are weak, there are often acute shortages of skilled personnel to undertake supervision, and regulators are vulnerable to political interference.

c) Some Special Problems Related To Financial Regulation In Developing Countries

The type of prudential regulations commonly used in developing economies; with underdeveloped and fragile financial institutions is usually based on the idea that traditional precepts of financial regulation are more effective, such as to impose effective ratio controls on capital, large exposures, and liquidity, to prevent connected lending and to limit political influence on management decisions; in other words to apply CAMELS through its steps. But, there are special problems and difficulties with financial regulation in developing countries. Therefore, supervisors must take into account these issues and there is need access to forward-looking macroeconomic analysis to determine where financial stress may occur.

The basic problems related to financial regulation in developing countries can be analyzed in two main headings (Goodhart *et. al.*; 1999 p:100-104).

a) The banking system

b) The economic infrastructure

The banking system; The commercial banks are the heart of the financial system in developing countries, yet the main types of commercial banks present in those countries generally each have some deficiencies.

A taxonomy for the commercial banks in developing countries would be:

-*Transformed state banks*; Transformed state banks (TSBs) will previously have made loans to favored state-owned enterprises (SOEs). After the reforms and in the transition, the more decentralized, market system causes the SOEs to become loss making, so the TSBs become weighed down with the burden of bad debts from existing loans. In some countries the TSBs are rendered effectively insolvent. Just as the (loss-making) SOEs are of ten difficult, or impossible, to liquidate (or to sell, since they have a negative present discounted value), and are thus effectively on a soft-budget constraint, so too are the TSBs, on which the SOEs are reliant, effectively on a soft-budget constraint.

- *Banks linked with industrial groups*; Because both capital and entrepreneurial skills are in relatively short supply in emerging countries, the readiest source of both may be existing industrial groups. The problem. however, is that much of the incentive to establish banks linked with industrial groups is to channel the resultant deposits back into the founding industrial groups. While this process can foster growth, connected lending not only causes conflicts of interest but also can become a serious source of weakness during periods of economic difficulty.
- *Foreign banks in countries with an existing domestic banking sector and dominant international banks*;
- *Specialized banks and Co-operatives*; Specialized banks are usually created directly by governments, and include development banks, export-import banks specially established to finance certain economic (e.g. agriculture) or geographic sectors or certain (und er- privileged) groups. They are frequently kept outside the jurisdiction of the supervisors, at least until they become insolvent. In some countries they have become a serious source of instability in financial markets, first because they are under pressure to grant political loans that cannot be recovered, and, second, because of poor management. A major unresolved question is how supervisors in emerging economies can deal with those kind financial institutions, or indeed with those private financial institutions in which government has a significant shareholding.

On the other hand both TSBs and banks established by industrial groups are likely to focus their lending on large enterprises. SMEs and agriculture are of ten badly served, and co-operative banks emerge to fill the void. But, co-operatives are frequently small and undercapitalized, and their managers are short on banking skills. Authorities are of ten required to encourage the development of a central umbrella institution for the co- operatives, to provide a source of liquidity, banking skills, and in some cases of capital as well.

The economic infrastructure; In developing countries not only is the banking system likely to have shortcomings, but also the economic infrastructure in which the banks have to operate is likely to be more difficult. The economy may be may be subject to greater volatility. Financial markets are usually less liquid and more volatile than in developed countries.

In other words, most of the developing economies are much more volatile than industrial economies in real economic growth, inflation, nominal and real exchange rates, equity prices and real interest rates. In this environment, bank supervisors find themselves reacting to the consequences of the volatility rather than proactively reducing volatility. Sharp fluctuations in any or all of these variables can have an effect on the balance sheets of even the most sound banks. For example, sharp appreciation in real exchange rates can force exporters into default, even if a bank maintains a currency-neutral stance on its own balance sheet. Sharp increases in real short-term interest rates can cause even a borrower who has a healthy business to default.

III. Financial Development in Turkey

The Turkish economy was reformed and became more outward looking with the structural adjustment program launched in the 1980's. As a reflection of this policy, the 1980s witnessed continuous legal, structural and institutional changes to liberalize the repressed domestic financial system. During the liberalization process, between 1980 and 1989, many restrictions on domestic and external financial intermediation have been removed, or at least minimized.

The main aim of these reforms was to increase the efficiency of the financial system by fostering competition among banks. In this context, interest and foreign exchange rates were liberalized, new entrants to the banking system were permitted and foreign banks were encouraged to operate in Turkey. Turkish banks intensified their business relations abroad either by purchasing banks in foreign countries or by opening branches and representative offices. The liberalization of foreign exchange regulations increased the foreign exchange transactions in the banks. The Interbank Money Market, which is administrated by the Central Bank, was established in 1986 with the purpose of regulating liquidity in the banking system. A uniform accounting plan and accounting principles as well as a standard reporting system were adopted in the same year. In 1987, the application of external auditing of the banks in accordance with internationally accepted accounting principles was started. In addition, legal and institutional arrangements were introduced to foster the development of the capital market. As a result, banks began to provide additional services such as consultancy and trading in securities, underwriting fund management, establishing mutual funds and financial consultation.

a) Banking Sector Restructuring and Prudential Regulation in Turkey

Banks in Turkey have the status of joint-stock companies and are subject to the Banks Act and general controls under the provisions of the Turkish Commercial Code and of various tax laws. The Banks Act No.4389, which brought substantial differences, was issued on June 23rd, 1999. Prior to the changes in the Banks Act, the Undersecretariat of the Treasury and the Central Bank had been the two main regulatory and supervisory bodies in the banking sector. With the new Act, the *Banking Regulation and Supervision Agency* (BRSA) was formed, which had financial and administrative autonomy. The

BRSA exercises its supervisory authority on a direct and ongoing basis through the Board of Sworn Bank Auditors who is responsible for on-site examination of the banks in terms of legal considerations and financial soundness. Additionally, the banks' financial statements are audited by external auditors in accordance with internationally accepted accounting principles. Banks are also examined by their own auditors, who are required to submit quarterly reports to the BRSA.

With the establishment of the BRSA, *the Savings Deposits Insurance Fund* (SDIF), which had been under the authority of the Central Bank, began to operate under the administration of the BRSA.[2] The decision-making body of the Agency is the Banking Regulation and Supervision Board (BRSB), which is appointed by the Council of Ministers and consists of seven members. Following the appointment of the members of the Board, the Agency commenced its operations as of August 31, 2000.

After the banking and currency crises in November 2000 and February 2001, the government initiated a comprehensive *Banking Sector Restructuring and Rehabilitation Program*, which aimed at;

- Strengthening the private banks,
- Resolution of the banks transferred to SDIF by methods, such as merger, sale and liquidation,
- Operational and financial restructuring of state banks with the ultimate goal of privatization,
- Developing the legal and institutional framework which will increase supervision and audit in the sector and make the sector more effective and competitive.

Implementation of this restructuring program imposed substantial burden on the economy and public finance, as experienced in other countries. Between 1997 and 2002, the SDIF took over 20 banks with more than 37000 employees and succeeded to create new job places for more than 10000 in their new banks. The number of banks (incl. the banks under the SDIF) declined from 81 in 1999 to 54 in 2002. It is estimated that Turkey has spent some USD 44 billion (or 30 % of GDP) since 1997 to reform the banking sector, which suffers from inherent structural weaknesses (Kibritçioğlu; 2005).

In this general framework the Government's efforts to strengthen the financial system continue to move ahead across several fronts. In February 2003, under the leadership of the BRSA, a coordination committee was formed with representatives of the BAT, to ensure rapid implementation of *New*

[2] However, with the enactment of Act No. 5020 on December 26, 2003, the management of the SDIF was separated from the management of the BRSA.

Capital Adequacy Agreement (Basel II), and capital adequacy arrangements, which are called *CAD-3* under the EU legislation.

During 2003 and 2005, several improvements have been realized in terms of regulative and legislative framework of the Turkish banking system;

- SDIF has been separated from the administration of the BRSA and it's legislative framework has been renewed for the collection non performing loans from the debtors of SDIF banks,
- In July 2004, savings deposit insurance was limited to 50 Thousand New Turkish Lira (YTL), which is expected to decrease the moral hazard effect,
- Risk based deposit insurance system has been settled,
- In order to increase intermediation costs, stamp duties and charges on loans were removed, deposit insurance premiums were decreased considerably and special transaction taxes on deposits were lifted. Furthermore the government has eliminated the Resource Utilization Fund on commercial loans,
- Accounting standards has been brought mostly in lines with International Accounting Standards,
- The new banking act (No. 5411) and a new law on credit cards became into force in 2005,
- The loan portfolio of the banking sector is revised and the nonperforming loans are classified in compliance with international standards, and necessary provisions are allocated. Significant progress has been achieved with *Istanbul Approach*, which is a voluntary debt restructuring mechanism of the banks, developed to accelerate settlement of bad loans.

Thus, the supervisory system has been further strengthened by legislative arrangements and a number of decisions taken in accordance with the standards of the prudential regulation exercised by the international banking community and in general covered the following banking related areas:

- 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.

b) Financial Liberalization, Banking Crises in Turkey

The early domestic financial liberalization attempt between 1980 and 1982 failed as a result of (*i*) the strong competition between banks and broker houses in interest rates, and (*ii*) missing regulations towards strengthening the legal fundamentals of banking sector in Turkey. In 1982, five banks, along with many brokerage houses, were liquidated. During the whole liberalization process in the 1980s, however, the number of banks increased from 43 in 1980 to 66 in 1990, while the number of their branches climbed from 5954 to 6560 with an accommodating rise in number of employees. Meanwhile, during same period, the number of foreign banks in Turkey increased from 4 to 23 (Kibritçioğlu; 2005).

After 1989, the overvaluation of the Turkish lira and high domestic interest rates on government bonds attracted short-term capital inflows into Turkey. This mechanism, which was driven mainly by external open positions of Turkish banks, created a deep currency and banking crisis in early 1994 because it turned out that this mechanism was not sustainable anymore. The 1994 financial crisis resulted in a lower credit rating of Turkey and a general pessimism about the economy, and hence, many small banks found it difficult to raise funds abroad. Therefore, they were forced to increase their branch networks in order to collect more deposits. Between 1995 and 1997, both the continuing failure of governments in disinflating the economy and the re-emergence of short-term capital inflows to Turkey were accommodated by the repeated excessive risk-taking behavior of the banking sector.

Also, even after the currency and banking crisis of 1994, many - mostly smaller - banks continued to abandon traditional banking activities in favor of using their funds to purchase government securities. Following the 1994 crisis the government introduced a full deposit insurance system (both for foreign and domestic currency savings accounts), which contributed significantly to arising moral hazard problems in the banking sector, while the government was placing weakened banks on the Treasury's surveillance list for poor financial status and exhibited an unwillingness to close them. The number of listed banks climbed to 15 between 1985 and 1999, and hence, many banks abandoned sound banking practices and their financial conditions started to deteriorate around 1997. By the end of the 1990s, the sole function of the financial system in Turkey was nearly reduced to transferring funds from the domestic and international markets to the Treasury (Denizer *et al*., 2000). During the 1990s, most of the new domestic entry into the banking sector was from large industrial conglomerates founding their own banks, since the poor regulatory structure allowed for large amounts of lending from the banks to in-group companies (Denizer *et al*., 2000). Beside that, illegal activities in the Turkish banking sector also increased in the late 1990s. Meanwhile, the number of state-owned banks in the sector diminished from 12 in 1980 to 8 in 1990, and then to 4 in 1999. In the late 1990s, insufficient macroeconomic policies of governments, along with excessive risk-taking preferences of banks, diverted the direction of financial liberalization of the 1980s back to the situation in the late 1970s, which was characterized by an "over-branched" and "over-staffed" banking system (Akçay, 2001).

As a result of; inefficient investment and production decisions of domestic industrialists connected lending and illegal activities in the banking sector, the weight of non-performing loans on banks' portfolios significantly increased, especially after 1997. Meanwhile, increasing foreign open positions of banks was an indication of rising exchange-rate risk in the system. In early 1999, the banking system was very fragile to a systemic crisis. In 1999, the deposit insurance fund SDIF took over six insolvent banks, using the authority given to it in 1994 when full deposit insurance was introduced. By December 1999, the government introduced a three-year (2000-2002) disinflation and macroeconomic restructuring program, which was essentially an exchange-rate based stabilization program supplemented by fiscal adjustment and structural reforms measures along with measures to strengthen and regulate the banking sector. As mentioned in the previous heading, according to the banking law enacted in 1999 an independent regulation and supervision agency BRSA was established. Although the implemented program produced some remarkable results at the beginning, the 2000–2002 program had to be revised in light of the two successive liquidity and exchange-rate crises; first in November 2000, as a result of the extremely risky position of a medium-sized bank with large holdings of government securities in its portfolio, and then in February 2001. The systemic banking crisis of late 2000, hand in hand with a deepening recession, resulted in a sharp currency crisis. The government abandoned the crawling-peg regime under the original plan and floated the Turkish lira in February short-term capital inflows into Turkey 2001. Meanwhile, Turkey has started another stabilization program backed by IMF which is still being implemented in Turkey.

c) Basel II and Implications on Turkey

As indicated above, during the financial liberalization process like many of the developing countries

Turkey could not escape financial crises with devastating impacts on the real sector. The occurrence of banking crises during the 1990s underlines the fact that that many countries have yet to build robust prudential systems which can protect their banking systems from systemic crises. Thus, while the rules of Basel I were common practice for more than a decade, it became apparent that those practices needed a thorough review to enhance better functioning of the financial system.

In this framework, Basel II has been shaped to introduce new rules not only on capital structure but also on supervisory process and market discipline. There are three mutually reinforcing pillars of Basel II which aim to provide a better framework for safeguarding the stability of national and international banking systems. The first pillar, defining a new capital requirement ratio creates immediate incentives for banks to improve risk analysis of their assets. The second pillar strengthens the power of the supervisory authority in evaluating a bank's assessment of its risks and in enforcing measures for poor risk management and for inadequate capital allocation and the third pillar brings market discipline through improved disclosure, enhanced transparency and strengthened corporate governance.

The impact of the new framework on the Turkish banking sector will be the immediate effect on capital adequacy ratios, given the proposed changes in the risk weights of assets. But in this respect, studies indicate that the impact of the new rules on the capital adequacy ratio at consolidated level in the banking sector will remain limited. In fact, Quantitative Impact Study conducted by the Banking Regulation and Supervision Agency shows that even though banks' capital adequacy declines to some extent under Basel II, this is not considered to be significant because of prevailing high capital adequacy ratio of Turkish Banking Sector. More specifically, the results of the study indicate that the consolidated capital adequacy ratio of 23 banks currently standing at 28.8 percent will decline to 16.9 percent under Basel II. The basic reasons for this decline are the high capital obligations for FX denominated Treasury papers and operational risk factor taken into account in the calculations under the new framework.

Another important point with respect to banking is the funding cost. As the OECD club rule in the current framework will be replaced by the credit rating rule under Basel II, Turkish Banks' cost of funding from international markets is likely to be affected.

Basel II will also have certain implications for strengthening the risk management practices of the banks. In this area Turkey introduced *Regulation on Internal Control and Risk Management Systems* *of Banks* in February 2001 and the compliance of Turkish banks with International Accounting Standards has been completed to a great extent. Although regulatory environment of the banking sector is increasingly harmonized with the internationally accepted standards, especially the advanced risk measurement requirement of Basel II will impose additional costs to the Turkish banks for investment in information technologies, human capital and organizational restructuring.

IV. Prudential Policies in Developing Countries

This section focuses on weaknesses of prudential regulation practices of developing countries in dealing with the risks resulting from liberalized financial systems facing high external capital volatility.

a) Alternative Approaches for making Prudential Systems More Effective in Developing Countries

The wave of currency and banking crises that began in East Asia, and then spread to many other emerging markets, generated a broad consensus that fundamental reforms were required in the international financial system. Existing institutions and arrangements were widely seen as inadequate for dealing with very large and extremely volatile capital flows, in which an important part of the volatility was caused by large imperfections in the financial markets themselves. Thus, the continuing incidence of financial instability and crises in industrial countries suggests that regulatory and supervisory reform is unlikely to provide fail-safe protection in this area.

Basically in the developing countries the weaknesses include loopholes in the prudential regulations, shortages of skilled supervisors, and regulatory forbearance. Furthermore, there are difficulties in applying the developed country model of regulation, which relies heavily on accurate financial information, highly skilled technicians and an impartial bureaucracy, in an environment characterized by weak accounting and legal frameworks, acute shortages of skilled personnel and pervasive political interference in public administration.

In this general framework the limits to the effectiveness of regulation and supervision have various sources. Firstly, financial regulation is constantly struggling to keep up with financial innovation, and in this struggle it is not always successful. There is a danger that new practices or transactions not yet adequately covered by the regulatory framework may prove a source of financial instability. But perhaps the most fundamental determinant of the limits of regulation and supervision is the susceptibility of most of banks' assets to changes in their quality resulting from changes in economic conditions. No private-sector loan or other asset on a bank's balance sheet should be classified generically as "good". However reasonable the original managerial decision to make a loan and however justified its initial classification as low-risk by banking supervisors, the loan is vulnerable to the possibility of an eventual deterioration in its status. So long as cycles of financial boom and bust are features of the economic system, so also will be unforeseeable deteriorations in the status of many bank assets. During such cycles risks take time to build up and become widely evident. Consequences of such boom-bust cycles can be described in terms of the concept, "latent concentration risk", as used in recent literature on credit risk (Caouette, 1998: 91, 240).

In light of the experience of the developing countries and because of the difficulties in obtaining desirable results from traditional regulatory policies, it is argued that policies that attempt to *"price developing countries risk right"* may prove quite beneficial for strengthening financial sectors in these countries. The "pricing-risk-right" approach to regulation works by taking the particular financial features of countries into account in order to provide incentives for avoiding excessive risk-taking activities by financial institutions. In the case of industrial countries, the new Basel II proposal is based on this philosophy. The issue for developing countries is the identification of policies that would be able to provide the right incentives. Because the degree of development matters, policy recommendations for the least developed countries need to differ from the most financially advanced developing countries.

Based on a simple classification of countries into two groups according to their degree of financial development, the "pricing-risk-right" approach suggests that the following policy recommendations might be effective. For the first group, the financially least developed group, where traditional regulations, such as reserve requirements and *any* capital standards are largely ineffective, it is obvious that sustainable policies consist in removing the constraints to the effectiveness of prudential regulations. That is:

- The implementation of appropriate accounting, reporting and judicial frameworks, that would prevent the evasion of reserve requirements,
- Development of markets that validate the accounting capital ratios.

Those policy reforms, however, often take a significant amount of time to implement. In the *transition* to a more comprehensive reform, the "pricing-risk-right approach" suggests that it is still possible to identify and develop some indicators of banking problems that help to reveal the true riskiness of banks. For example, deposit markets have often been identified as markets that work in many developing countries in the sense that they have been able to provide effective early-warning signals about the relative strength of banks (Rojas-Suarez; 2001).

Policy recommendation are quite different for the second group of developing countries, namely those with a sufficient degree of financial development to allow traditional prudential regulatory policies to be meaningful, but where their particular features such as limited access to international capital markets imply that strict application of industrial-country regulation, such as the Basel Accord, may be of limited effectiveness. In this group of countries, the recommendations advanced for less financially developed countries have to a large extent already been implemented. Following the "pricing-risk-right" approach, reserve requirements does not seem to be a desirable tool not only because it loses it effectiveness as alternative sources of liquidity develop in the domestic markets, but also because it does not discriminate between different levels of bank quality. The main recommendation for this group of countries is to design a *transitional* capital standard that appropriately reflects the risk of banks' assets because Basel (I or II) does not fit the bill in the short-run (Rojas-Suarez; 2005).

b) Areas of Possible Concern with Basel II

In the Basel II accord internationally active and/or large banks can choose between either using ratings provided by external agencies or their internal rating systems as a basis for classifying the credit risk of a particular loan and for calculating the regulatory capital requirement. The adoption of either of these two approaches in industrial countries may exacerbate the already high volatility of capital flows to the developing countries. There are two reasons. First, international banks adopting the internal rating based (IRB) approach will have a much larger discretion to assess the risks involved in lending to clients in developing countries, in contrast to current practices in which all loans to non-OECD corporations and governments carry a 100% risk weight. Therefore, in the event that an underestimated (overestimated) risk from a credit to the region materializes, international banks will quickly reverse (increase) the flows to micro-manage capital requirements, thus widening the swing in economic cycles. The adverse effect to the stability of capital flows to the developing will be even higher if loans come from international banks adopting the standardized approach. In this case, risk weights will be assigned according to the credit assessment of rating agencies, which already have a track record of lowering ratings to developing markets after the emergence of problems in these countries.

From the structural point of view, the main concern with Basel II is with respect to the use of external ratings in the process of determining the required amount of capital. Such a scheme is likely to create a huge demand for new ratings by companies in developing countries. The New Accord will thus generate a new demand for ratings because companies borrowing money from a bank will have a strong incentive to obtain a favorable rating in order to lower the capital requirement for the bank and, thereby, be charged a lower interest rate on the loan. Since, this new and huge demand for ratings cannot be satisfied by existing rating agencies, supervisors will have to license a large group of new rating agencies in a relatively short period of time.

V. Concluding Remarks

Maintaining financial stability in global banking and financial markets continues to be an important objective of regulators, bankers, and other market participants, particularly because of the negative impact that financial instability has on economies as a whole.

The Turkish economy was reformed and became more outward looking with the structural adjustment program launched in the 1980's. The main objectives of this program can be summarized as: i) minimizing state intervention; ii) establishing a free market economy iii) integrating the economy with the global economic system.

In the light of the Turkish experience this paper argues that traditional prudential regulatory policies used in industrial countries have had limited effectiveness in controlling the adverse impacts of capital account volatility on financial systems in developing countries. The main reason for this disappointing result is that, by not taking into account the particular characteristics of financial markets in developing countries, these regulations cannot effectively control excessive risk taking by financial institutions.

In general, important features that distinguish financial markets in developing countries from those in industrial countries are the predominance of assets with short maturity and high volatility as well as the large concentration of financial and real assets. These features significantly decrease the effectiveness of traditional prudential regulatory instruments.

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