Financial Sector Assessment

Turkey

December 2016

Finance and Markets Global Practice

Europe and Central Asia Regional Vice Presidency

An IMF and a World Bank team visited Turkey during 6-25 April and 13-29 June 2016 to conduct an assessment under the Financial Sector Assessment Program (FSAP).[[1]](#footnote-2)

**Contents**

Overall Assessment and Main Recommendations 4

I. Macrofinancial Outlook 6

II. Banking and Corporate Sectors and Households Finances 7

III. Vulnerabilities 9

IV. Policies to enhance resilience, integrity, and financial sector effectiveness 10

A. Regulatory and Supervisory Framework 10

B. Financial Market Infrastructure and its Oversight 11

C. Oversight and Management of Systemic Risks 12

D. Managing Systemic Liquidity 13

E. Financial Safety Nets, Bank Resolution, and Crisis Management Arrangements 14

F. Financial Integrity 15

V. Broadening markets and services 17

A. Developing and Deepening Turkish Capital Markets 17

B. Promoting Financial Inclusion 20

C. Islamic finance 21

D. Retail Payment and Systems 23

E. Enhancing Credit Reporting Systems 24

Annex I. Financial System Profile and Recent Trends 26

Annex II. Risk Assessment Matrix 40

Annex III. Previous FSAP Recommendations 42

**Glossary**

|  |  |
| --- | --- |
| AAOIFI | Accounting and Auditing Organization of Islamic Financial Institutions |
| AML/CFT | Anti-Money Laundering and Countering Financing of Terrorism |
| ARA | Assessment of Reserve Adequacy |
| BAT | Banks Association of Turkey |
| BCP  BIST | Basel Core Principles for Effective Banking Supervision  Istanbul Stock Exchange |
| BL | Banking Law |
| BRSA | Banking Regulation and Supervision Agency |
| BRSB  CAD | Banking Regulation and Supervision Board  Current Account Deficit |
| CAR | Capital Adequacy Ratio |
| CBRT | Central Bank of the Republic of Turkey |
| CCP | Central Counter Party |
| CMB | Capital Markets Board |
| CMG | Crisis Management Group |
| CoM | Council of Ministers |
| CRS | Credit Reporting System |
| CSD | Central Securities Depository |
| EBITDA | Earnings Before Interest, Taxes, Depreciation and Amortization |
| ECA | Europe and Central Asia |
| EFT | Electronic Fund Transfer |
| ELA | Emergency Liquidity Assistance |
| ERM | Enterprise Risk Management |
| ESTS | Electronic Securities Transfer System |
| FATF  FMI | Financial Action Task Force  Financial Market Infrastructure |
| FSC | Financial Stability Committee |
| GIR | Gross International Reserves |
| ICAAP | Internal Capital Adequacy Assessment Process |
| ICP | Insurance Core Principles |
| ICR | Interest Coverage Ratio |
| IIFCB | Interest-Free Finance Coordination Board |
| IFSB | Islamic Financial Services Board |
| IMF | International Monetary Fund |
| IOSCO  IPO | International Organization of Securities Commissions  Initial Public Offering |
| IRB | Internal Ratings-Based |
| KKB | Credit Bureau |
| KYC | Know Your Customer |
| LCR | Liquidity Coverage Ratio |
| MASAK | Financial Crimes Investigation Board |
| MKK | Central Registry Agency of Turkey |
| MOF | Ministry of Finance |
| MSME | Micro, Small and Medium Enterprises |
| NFC | Non-Financial Corporate |
| NIR  NPLs | Net International Reserves  Non-Performing Loans |
| NPS | National Payments System |
| NRA | National Risk Assessment |
| PPP | Public-Private Partnership |
| RAM | Risk Assessment Matrix |
| ROM | Reserve Options Mechanism |
| SDIF | Savings Deposit Insurance Fund |
| SIFI | Systemically-Important Financial Institution |
| SME  SOE | Small- and/or Medium-Sized Enterprise  State-Owned Enterprise |
| SRAG | Systemic Risk Assessment Group |
| TEBC | Turkish Execution and Bankruptcy Code |
| TL | Turkish Lira |
| TR | Trade Repository |
| UNSCR | United Nations Security Council Resolution |
| WB | World Bank |

# Overall Assessment and Main Recommendations

**The fundamental challenges confronting the Turkish financial system are to reduce dependence on external and foreign currency financing and to increase the maturity and diversity of funding instruments on which banks and firms depend.** The long-standing shortfall of national savings to finance domestic investment, persistent elevated inflation, and bouts of exchange rate volatility have boosted reliance on foreign currency financing from international capital markets and have also incentivized households and firms to place their own savings in short term deposits, as well as in foreign currency. These deep-seated challenges underpin current heightened financial stability risks from several potential sources -—tighter or more volatile global funding conditions, weaker euro area growth, geo-political tensions and loss of market confidence in domestic policies. Balance-sheet fragilities could amplify their impact.

**This combination of vulnerabilities underscores the importance of a strong financial system oversight and policy framework.** The oversight and management of systemic risks has been strengthened significantly since the previous FSAP. However, further steps are recommended to raise the effectiveness of financial supervision; strengthen systemic risk identification and the coordination of macroprudential policies; lower systemic liquidity risks; and address current gaps in crisis management arrangements. Assessments against international standards spotlighted areas where further enhancements to the supervision of banks, insurance companies and FMIs.

**Development of capital markets would alleviate duration mismatches of banks and corporates, lowering reliance on foreign currency and supporting growth.** This is particularly important given the vulnerabilities associated with the short term nature of funding in lira and foreign currency, as well as the very high dependence on bank finance. The domestic market is developing but important challenges hamper longer-term financing. Policies to support the consolidation of an interest rate derivatives market and stimulate liquidity in government and corporate bond markets could facilitate hedging against interest rate fluctuations and enhance demand for capital market products. Improvements in issuance regulations, disclosure and governance standards could help strengthen and reinforce investor confidence. On the demand side, efforts to stimulate savings should continue and authorities could assess current limitations for more effective allocation of capital by different types of investors.

**Financial inclusion challenges relate to the gender gap, lack of savings, and limited access to finance in under-served regions**. Islamic finance is an emerging and rapidly growing market and could serve as a catalyst for enhancing financial inclusion but issues related to the regulatory and governance frameworks, capacity, financial awareness, and literacy should be addressed**.** Further inclusion could be achieved by better targeting under-served segments, strengthening public/private sector coordination; enhancing the Monitoring and Evaluation framework; ensuring a level playing field between banks and non-banks;and fine-tuning the design of payment mechanisms for government payments.

**Table 1. Turkey 2016 FSAP– Key Recommendations and Time Frame [[2]](#footnote-3)**

|  |
| --- |
| **Policies Addressing Resilience, Integrity and Financial Sector Effectiveness** |
| ***Banking Supervision***  Revise legislation to further strengthen BRSA independence. (MT)  Deepen and broaden the risk assessment nature of banking inspections and follow up. (MT)  Strengthen corporate governance rules and enforcement. (MT)  Evaluate and revise the definition of credit classifications and strengthen enforcement. (ST) |
| ***Insurance Supervision***  Improve independence, governance and accountability of supervisor; increase resources for internal control functions; integrate offsite, onsite and enforcement activities; develop risk based, group supervision. (ST/MT) |
| ***Financial Market Infrastructure***  Improve risk management of EFT/ESTS liquidity and FMI interlinkages. (ST/MT) |
| ***Systemic Risk Oversight***  Strengthen macroprudential measures to lower foreign exchange risk in the economy (I)  Strengthen FSC’s governance/powers, provide explicit financial stability objective to all members, and limit CoM role. (ST)  Develop procedures for improved systemic risk assessment and coordination of macroprudential policies; agree to table policy proposals for ex ante FSC discussion and request formal responses to recommendations. (ST/MT)  Base choice of policy tools on integrated assessment of systemic risk and cost-benefit analysis of alternative options. (ST)  Strengthen transparency (including publishing an Annual Report). (ST) |
| ***Managing Systemic Liquidity***  Orient liquidity provision towards a single key policy rate. (I)  Increase net reserves such that gross reserves are within the range of 100-150 percent of the Assessment of Reserves Adequacy (ARA) metric. (MT)  Improve ELA capacity; redefine CBRT FX lending facility as ELA and increase conditionality. (ST) |
| ***Financial Crisis Management***  Strengthen recovery and resolution planning and enhance resolution powers by: (i) Strengthening the Banking Law; (ii) Developing guidance. (MT)  Strengthen domestic and cross-border coordination arrangements. (ST) |
| ***AML-CFT***  Determine reason for low ML conviction rates and plan to address them. (MT)  Introduce customer due diligence requirements for politically exposed persons. (ST)  Ensure compliance with requirements of the UNSCR, and strengthen border controls on currency transportation. (MT) |

|  |
| --- |
| **Broadening markets and services** |
| ***Developing / deepening capital markets***  Support and promote BIST overnight repo futures and introduce an organized call market. (ST)  Strengthen issuance regulations and disclosure of corporate bonds. (I)  Enhance governance standards and launch special segment for firms listed in BIST. (MT) |
| ***Islamic Finance***  Enhance regulatory and governance framework; build capacity, financial awareness and literacy. (ST/MT) |
| ***Promoting Financial Inclusion***  Target underserved segments, enhance public/private sector coordination and M&E framework. (ST/MT)  Ensure level playing field between banks and non-banks. (MT)  Improve oversight of CRS, retail payment services and design of electronic instruments for government payments. (ST/MT) |

# Macrofinancial Outlook

1. **The Turkish economy has slowed down considerably following strong performance in 2015 (Figure 1).** Turkey has experienced serious domestic and external shocks which, together with increasing private indebtedness, have contributed to weaker business confidence, lower private investment demand and tourism revenues, and a tightening of credit standards. As a result, economic growth is projected to decline to 2.7 percent this year. In the medium-term the economy is expected to recover gradually.
2. **External vulnerabilities remain elevated.** Notwithstanding a favorable external financing requirement in 2016, external imbalances remain significant, reflecting the persistent wedge between private domestic demand and structurally low savings. The economy’s external position is weaker than the level consistent with medium-term fundamentals. The current account deficit is projected to deteriorate to 4.5 percent of GDP in 2016, and, at 60 percent of GDP, the external debt burden is high, with gross annual financing needs over one quarter of GDP. Foreign exchange (FX) reserves are low compared to external debt and the foreign currency refinancing needs of banks and non-financial corporates. Gross international reserves (GIR) are below the IMF ARA metric.
3. **Risks to the outlook are tilted to the downside.** On the upside, the fiscal position is strong, and the recent agreements to open new EU accession chapters could be supportive for reforms. Downside risks relate to the large annual external financing need, against the backdrop of low net international reserves. The growth outlook in key export markets remains tepid, and the lowering of the sovereign credit rating below investment grade implies potentially greater adverse impact on Turkey of shocks in global funding markets. These factors increase the risk of a large and protracted capital flow reversal given weaknesses in banks’ and NFCs’ balance-sheets in an environment of heightened global and regional uncertainties.

# Banking and Corporate Sectors and Households Finances

1. **Banks, at over 90 percent of the financial system by asset ownership, are vital to financial stability in Turkey (Figure 2).** Non-bank financial institutions are small by peer emerging market levels and capital market intermediation remains insignificant. The financial system at 118 percent of 2015 GDP by assets, has been growing significantly faster than GDP since 2008. The banking system is of average size relative to peer emerging markets but the proportion of credit financed by non-deposit channels is larger (Figure 3, panels A—B). Concentration is not significant and market share is equally distributed among private domestic, foreign-owned, and state-owned banks. Acquisition-based entry by foreign banks in recent years has led to a substantial increase in their asset ownership share (Figure 3; panels C—D).
2. **The business models of the 10 largest banks appear to have converged significantly over the last five years, increasing systemic exposure to adverse common shocks**. On the asset side, banks have substituted away from securities into lending with increasing foreign currency (FX) and non-financial corporate (NFC) exposures (*Figure 4; panels A-C*)*.* Partly in response to macroprudential measures, credit growth has shifted from retail towards corporate and SMEs since 2012 and this segment now constitutes over 75 percent of the loan book. Lending in FX has risen strongly although two-thirds of credit exposures remain in TL. Most funding is raised at very short maturities and more than half in FX *(Figure 4; panels D-F).* Elevated inflation, exchange rate volatility and the absence of a term premium offered by banks, incentivize holding of savings (households) and reserves (NFCs) at short maturities and in FX. Systemic risk measures reveal elevated common vulnerability of banks to adverse shocks during episodes of global market disruption and periods of geopolitical uncertainty(*Figure 5*). Large FX positions generated by banks’ funding strategy are closed through derivatives transacted with foreign counterparties *(Figure 6; panels A-B).* Liquidity risk management has become more challenging *(Figure 6; panels C-F).* High TL loan (term and risk) premia have incentivized rising maturity transformation and increasing balance-sheet maturity mismatches as banks have moved out of government securities and into private credit. Returns have declined significantly over the past five years and asset quality pressures appear to be rising *(Figure 7).* Reported asset quality has held steady over this period with NPLs standing at between 2½ and 3 percent of gross lending since end-2011. Even as reported NPLs remained low, there has been a sharp increase in restructured credits held by banks, from around one percent to 3 percent of gross loans between 2011 and 2015, giving cause for concern.
3. **Banks’ capital buffers remain high but have been falling over the medium term** **(Figure 7C).** In part, this reflects falling returns and in part, the rapid balance-sheet expansion towards riskier loans and away from sovereign securities. Rising asset quality challenges represent, therefore, a material risk factor given that estimated cost of equity demanded by investors is higher than bank returns, implying that it could be challenging for banks to raise capital if required.
4. **The NFC sector is a key financial counterparty of Turkish banks**. NFC liabilities have grown sharply since the global financial crisis from 30 percent of GDP in 2007 to over 60 percent in 2015 with a significant portion of borrowing being in FX (45 percent of financial debt). The lion’s share of financial debt, at about 83 percent, is from Turkish banks. NFC FX assets, while substantial, are significantly lower than FX liabilities, covering less than 40 percent of FX liabilities. NFCs run a negative net FX position of $188 billion as of March 2016, although their short-term FX position is closed.
5. **The NFC sector faces a number of challenges, most significantly, the runaway growth in leverage, particularly in FX, the corresponding boost in interest expenses, falling earnings and an unsettled outlook (Figure 8)**. On the expense side, higher leverage and interest burdens have left firms more vulnerable to funding and FX shocks. On the earnings front, TL depreciation has failed to lift exporters’ revenues due to weak external demand. Diverging interest rates between the U.S. and Europe has squeezed profits further (given that exporters tend to earn in euros and service debt in U.S. dollars). These challenges extend to (unlisted) SMEs. Leverage has risen sharply since 2009 including in FX while the SME sector’s profitability has steadily deteriorated since 2011, diminishing resilience to shocks. Bankruptcies have been rising, the current market view of credit quality is dim, and the knock-on impact of NFC distress on banks is likely to be significant.
6. **Household credit remains an important component of bank lending, although there are restrictions preventing lending to households in FX**. While analysis indicates that there is some degree of exuberance in the housing market, there is no evidence of a household debt overhang (given that household debt-to-GDP and financial net worth have held steady). Yet, debt-to-disposable income was rising until recently and loan losses on retail (mainly credit card) loans were higher by over 40 percent in 2015 relative to 2011. In this context, the authorities’ recent decisions to ease macroprudential policies on household lending to support demand comes at a time when risks to financial stability are elevated.

# Vulnerabilities

1. **Structural and cyclical factors combine to increase the vulnerability of the Turkish financial system to common adverse shocks**. Structural factors include the high proportion of wealth and debt held in foreign currency and at short maturities, the dependence on cross-border financing, and the convergence in major banks’ business models. Cyclical factors include growing corporate leverage, an apparently weak underbelly of mid-sized companies below the largest firms, rising corporate-bank and (contingent) corporate-sovereign exposures, and deterioration in banks’ asset quality at a time when returns are below the cost of equity.
2. **Stress tests show that large existing capital buffers appear to render banks resilient in the face of a severe, adverse economic shock, provided it is of sufficiently short duration**. But a protracted recession would generate large capital shortfalls. Under these stress scenarios[[3]](#footnote-4), liquidity risks may add significantly to pressure on solvency, which would push up capital needs even further. Under the stress scenarios, mid-to-large sized NFCs face significant difficulties in servicing their debt burdens because of higher interest expenses implied by rising cost of funds and TL depreciation and a recession induced decrease in earnings.[[4]](#footnote-5)

# Policies to enhance resilience, integrity, and financial sector effectiveness

## Regulatory and Supervisory Framework

1. **Since the previous FSAP in 2011, the authorities have made significant efforts to further strengthen banking regulation and the supervisory process**. Turkey has built a good foundation for banking supervision. The Banking Law (BL) provides a broadly appropriate supervision framework with clear responsibilities and necessary supervisory powers. The established methodology for banking supervision is comprehensive and grounded on extensive databases and on regulation largely in compliance with international standards. The Basel Core Principles assessment highlights the significant strengthening of the framework. However, the assessment also emphasizes the need to reinforce implementation.
2. **Several important elements of the framework potentially limit the BRSA’s operational and organizational independence as well as its mandate.** The BL establishes the BRSA’s general independence and a clear mandate. However, legal parameters and other arrangements which can compromise independence remain in place, including issues within the BRSA board appointments process and the ability of the relevant minister to take action against the BRSA. Moreover, the BRSA’s twin objectives of financial sector stability and financial sector development require prioritization to prevent potential conflict. Financial stability should be assigned the primary role.
3. **Further enhancement of the supervisory process would raise the effectiveness of banking supervision**. The current process is skewed towards validation of compliance processes and constrains active, more forceful supervisory judgments and decisions. The risk management framework is centered in the ICAAP process which needs further development. The framework for credit classification and provisioning requires strengthening, particularly in the areas of asset classification definitions and the supervisory credit review process.
4. **The regulation and supervision of insurance has been significantly enhanced during the past five years**. In particular, the efficiency of information reporting, insurer monitoring and supervision have increased, solvency ratios have been strengthened, and reserving and investment practices have been improved.
5. **Notwithstanding this welcome progress, much work remains to close the gap between current practices and international standards**. The Insurance Core Principles (ICP) assessment includes main findings and recommendations. Among the most relevant ones, first, options should be explored to improve the independence, governance and accountability of the insurance supervision authority, as well as to integrate offsite, onsite and enforcement activities within a single supervisory organization. Completing the development of a risk-based approach and a group wide supervisory framework remain important priorities. The supervisory authorities are also encouraged to take action to strengthen corporate governance requirements, as well as to ensure that key internal control functions are established and have appropriate independence and resources.

## Financial Market Infrastructure and its Oversight

1. **The National Payments System (NPS) in Turkey is well developed, safe and efficient: yet there are opportunities for improvement.** The EFT and ESTS, owned and operated by the CBRT, and, the responsibilities of authorities with respect to FMIs, were assessed against the CPMI-IOSCO Principles of Financial Markets Infrastructures. The assessment also took into account the interlinkages of the EFT and ESTS with the other FMIs in Turkey: Takasbank and MKK. The legal framework has been significantly enhanced in recent years and institutional arrangements are clear and well organized. However, some improvement opportunities include: i) fine tuning the legal framework (with respect to addressing some legal ambiguities in respect to protection of customer's assets in Takasbank); ii) further strengthening the governance framework considering system-wide performance indicators; iii) addressing risk management framework in a more integral way considering risks among FMIs; iv) exploring and implementing liquidity mechanisms to address concentration of payments at the end of the day; v) fine tuning default management, operational risk management and implementing effective monitoring arrangements for tiered participation; and vi) introducing some efficiency measures in the infrastructure for government securities.
2. **CBRT, CMB and BRSA are the authorities with responsibility for specific elements of the Turkish NPS. CBRT has regulatory and oversight responsibility for payment and securities settlement systems.** CMB has responsibility for safe and efficient functioning of the capital markets and is responsible for the Central Securities Depositories (CSDs), Central Counterparties (CCPs) and Trade Repositories (TRs). The BRSA is responsible for regulation of payment instruments and also regulation and supervision of non-bank e-money and payment institutions. The authorities’ scope and powers related to regulation, supervision and oversight of the NPS are adequate. The CMB however has not established dedicated organization arrangements and allocated dedicated resources for its oversight activities. Also the regulatory and oversight framework for Trade Repositories (TRs), which are in the purview of the CMB, is still in process of development. CBRT should consider a clear articulation of criteria for PFMI application in the proposed oversight framework and CMB should finalize regulatory framework for TRs and dedicate more resources for FMI oversight.

## Oversight and Management of Systemic Risks

1. **Turkey has made significant progress in developing a macroprudential policy framework in recent years.** The FSC brings together the heads of the five agencies with financial sector oversight responsibilities, to support the identification and management of systemic risks. The FSC is primarily an oversight and discussion body, as operational responsibilities are retained by the member agencies. Current arrangements have provided considerable benefits. These have supported information sharing across the FSC member agencies and improved the focus and attention on addressing systemic risks.
2. **Strengthening governance, powers and disclosure would increase the effectiveness of the FSC**. Several steps may be envisaged. Although some would require changes in legal frameworks, many of the proposals could be implemented by agreement among the member agencies on internal processes and protocols. First, enhanced governance, including restricting the role of the Council of Ministers to crisis resolution decisions beyond the mandates of the member agencies, would strengthen the independence of FSC members and enhance the ex ante policy-making role of the FSC. Similarly, institutionalizing stronger operational arrangements, including agreeing a commitment among the members to table policy proposals for discussion by the Committee at the formulation stage and including a formal mechanism for member agencies to follow up on its recommendations and provide a response to the Committee on decisions subsequently taken, would enhance proactive policy making, while retaining individual agency responsibility. Strengthening the analytical support available to the FSC and SRAG through an integrated and enhanced Secretariat would also help the quality of the discussions and recommendations. Finally, a more structured communication strategy, including publishing periodical information such as an Annual Report to relevant stakeholders outlining FSC risk assessment, activities, and decisions, would strengthen public recognition of the FSC role, enhance accountability on how the Committee is fulfilling its legal mandate, and also help the Turkish authorities collectively to demonstrate firm oversight and control of systemic risks. A published Protocol or Charter on the responsibilities and organizational practices of the FSC would also support this process.
3. **There are notable improvements to the systemic risk assessment capability in Turkey since the last FSAP**. The FSC (and the SRAG), promote a collaborative approach to systemic risk assessment by enabling each member to bring to the table their respective risk analyses as well as joint analysis. To strengthen the collective review, the SRAG has recently developed the first version of a heat map, as a collaborative tool to support the assessment of systemic risk. The FSC should build on this welcome progress to foster further improvements and support a more integrated and holistic assessment of systemic risks and their on-going monitoring.
4. **The choice of the policy tools should be better informed by the (proposed) integrated assessment of systemic risk and by cost-benefit considerations of alternative options.** Some of the policy tools deployed in the past combine both monetary policy and macroprudential objectives which raise questions of their appropriateness in achieving each policy goal. It also raises questions on whether monetary policy was used instead of macroprudential policy and vice versa. Usage of macroprudential tools should be confined to systemic risk. A systematic review of the costs and benefits of potential options by the FSC at the risk identification and policy formulation stage would help strengthen policy coordination and effectiveness

## Managing Systemic Liquidity

1. **The CBRT’s liquidity provision framework raises three key questions relevant to financial stability.** First, to what extent does the CBRT’s monetary policy implementation framework support the development of the domestic money and capital markets to push against the extensive reliance on FX funding? Secondly, how robust is the CBRT’s capacity to manage the FX liquidity risks in the system? And thirdly, is the CBRT’s ELA framework sufficiently robust to buffer the system in the event of a systemic crisis?
2. **The CBRT could provide a more secure backdrop for the Lira markets to flourish by focusing interest rate tools on inflation, applying those tools more transparently and predictably, and making liquidity more readily available at its key policy rate**. These practices would enhance the CBRT’s credibility, encouraging investors to participate in the unsecured or longer term TL markets that are lacking[[5]](#footnote-6).
3. **The CBRT has limited capacity to manage FX liquidity pressures and needs to build it.** Net FX reserves are relatively low and need to be rebuilt such that CBRT FX reserves are within the standard ARA metric range. Moreover, much of the CBRT’s gross reserves are funded by the reserve requirements of banks which may need access to those funds in the event of stress. Other significant contingent claims on the CBRT’s reserves such as FX auctions, FX sales to the state energy company and the large FX lending facility limit its flexibility to respond to a systemic crisis. Eliminating regular FX auctions and sales would increase flexibility while fostering FX market development and liquidity. [[6]](#footnote-7)
4. **The CBRT’s ELA function should be enhanced.** Some operations such as the FX lending facility should be considered ELA and separated from standard operations. This would give the CBRT additional flexibility in a crisis and bolster incentives for banks to self-insure against FX liquidity risks. Horizon scanning processes for identifying potential ELA needs should be enhanced and regular tests of procedures undertaken. An expanded range of ELA collateral should be introduced (including accepting bank loans) and prepositioned to facilitate its use.

## Financial Safety Nets, Bank Resolution, and Crisis Management Arrangements

1. **Turkey has a number of the elements in place for effective financial safety nets, recovery and resolution frameworks, and crisis management arrangements**. There is a reasonably clear institutional framework for recovery and resolution, with specific tasks allocated to the supervisory agency, resolution authority, central bank and the Treasury, as well as structures to facilitate domestic coordination. The laws applicable to bank recovery and resolution also contain many essential provisions, including corrective action powers, triggers for entry into resolution and a broad range of resolution powers.
2. **The deposit insurance arrangements in Turkey are well developed**. SDIF has many of the powers required to make payouts to insured depositors and has developed systems and controls to achieve this in a relatively short period. The deposit insurance limit of TL100,000 per depositor per bank provides full coverage to over 95 percent of natural person depositors. The deposit insurance fund is financed on an ex ante basis and as of June 2016 represented over six percent of insured deposits – relatively high by international standards. As recognized by the SDIF, there is a need to strengthen the purchase and assumption implementation arrangements and to develop the capacity to complete deposit insurance payments within, ultimately, a target period of 7 days.
3. **As the authorities have recognized, there are still many shortcomings in the financial safety net arrangements, particularly having regard to the new international standards introduced after the global crisis**. The authorities are currently initiating reforms to address a number of these, including proposals for strengthening the BL and developing policy in relation to recovery planning, resolvability assessments and resolution planning.
4. **Legal changes should be accompanied by a strengthening of institutional arrangements for crisis management**. Additional clarification of the objectives of each agency would be beneficial, ensuring that each supports effective crisis management and financial stability. There is also merit to reconsidering the roles of the BRSA and SDIF in the process of entry into resolution.
5. **Coordination mechanisms among the agencies should also be enhanced**. In particular, there would be considerable benefit from establishing a standing working group under the FSC, comprising all member agencies, which would be tasked to coordinate the development of crisis management strategies and options, including policies on recovery planning, resolvability assessments and resolution planning. Arrangements would also be buttressed by the development of a published FSC crisis management MOU setting out the objectives and principles of bank resolution, the responsibilities of each agency, and the processes for crisis management coordination.
6. **The case for the establishment of a new systemic resolution funding mechanism should be considered**. It is recommended that the authorities consider a range of resolution funding mechanisms, and the costs and benefits of each, as well as providing legal clarity on the application of the mechanism.
7. **Cross-border recovery and resolution arrangements should also be bolstered**. Currently, there are no crisis management MOUs in place between the SDIF and its foreign counterparts. SDIF is not involved in any CMGs and has not established CMGs for systemically important banks domiciled in Turkey. Given the importance of foreign banks in Turkey, it is suggested that the agencies establish crisis management MOUs with the foreign authorities (home and host) of systemic importance to Turkey and that they establish or seek involvement in CMGs where practicable.

## Financial Integrity

1. **Turkey is confronted with significant ML/TF risks, but has taken important steps to strengthen the AML/CFT regime.** The country faces serious threats from illegal activities of criminal and terrorist organizations (e.g., ISIL) as well as corruption. Turkey is particularly vulnerable to ML/TF activities owing to its importance as a regional financial center and strategic location.
2. **In response, the authorities have adopted a multi-dimensional approach to combating ML/TF that underscores enhanced domestic cooperation.** The legal framework was amended to adequately criminalize money laundering and establish mechanisms to freeze terrorist assets. A national risk assessment (NRA) is underway to better understand ML/TF risks, and is expected to be completed before Turkey’s next mutual evaluation by the FATF in 2019.
3. **The authorities are encouraged to build on this progress and further strengthen implementation of the AML/CFT regime**. The authorities should, as a priority, determine the reasons for the relatively low ML conviction rate, and develop strategies to address any shortcomings. Prompt completion of the NRA will assist in formulating risk-based responses to ML/TF threats and prioritizing resolution of vulnerabilities. The legal framework needs to be aligned with international standards, including customer due diligence requirements for politically exposed persons, criminalization of the financing of FTFs and the evidentiary standard for domestic designations. Controls over the cross-border transportation of currency should be enhanced (including by increasing fines and sanctions). The authorities also need to ensure that the freezing of assets of designated persons and organizations are conducted without delay.

# Broadening markets and services

## Developing and Deepening Turkish Capital Markets

1. **The development of capital markets could enhance longer-term financing in local currency, supporting growth and financial stability**. Deeper capital markets could help alleviate FX exposures and duration mismatches of banks and corporates. They could also serve as an important complement to bank based financing to support investments, while expanding the pool of assets and instruments available for different types of investors.
2. **Turkey’s domestic capital markets reached greater level of development in recent years, but important challenges remain to be addressed**[[7]](#footnote-8). The domestic yield curve spans up to 10 years and the volume of corporate debt issuances grew from TL 6.8 billion to TL 115 billion between 2010 and 2015. These developments were supported by a solid market infrastructure; improvements in the regulatory framework[[8]](#footnote-9); and the recent growth of pension funds. However, corporate debt issuance is dominated by banks (85 percent of total volume) with maturities only up to 6 months for bank bonds, and below 3 years for bonds issued by NFCs. Lack of hedging tools, such as IRS, constrains the ability of issuers and investors to manage risks of interest rate fluctuations. Liquidity of government debt markets is also decreasing, affected by international trends, a reduction in government borrowing requirements and the participation of a higher share of buy-and-hold investors (e.g. public funds). Investor confidence has been affected, in part due to vulnerabilities in the corporate sector, increased use of bankruptcy protection applications, and poor performance of IPOs. Initiatives to support SME financing via capital markets have achieved only modest results, and despite recent growth, the institutional investor base is still small, far from its potential.
3. **The plan to create a new money market in BIST is a step in the right direction**. Authorities have devised an ambitious plan[[9]](#footnote-10) to launch a new money market for longer tenors, initially 1 and 3 months. TAKASBANK will act as Central Counter Party (CCP) to reduce risks and to mitigate concerns about KYC compliance. If successful, the initiative will provide reliable references for hedging and structuring longer-term contracts.
4. **The recently launched overnight repo futures could be one of the most powerful products to unlock the development of the Turkish bond market.** The product has the advantage of being priced on the BIST overnight repo rate that is considered liquid and reliable by market participants. However, success on the development of a liquid futures market will depend on actions to: i) safeguard future liquidity of the underlying BIST repo rate; ii) increase the availability of sizeable and liquid instruments (e.g. government bonds) maturing at dates coinciding to the maturity dates of futures contracts; and iii) to increase the range of investors that are allowed to participate in the market.
5. **The UoT is implementing measures to sustain the liquidity of the government bond yield curve.** The Treasury promotes liquidity by concentrating outstanding debt on benchmark instruments that reach approximately TL12 billion in volume and by enforcing bid and ask quoting requirements by a group of thirteen primary dealers for selected instruments. Recently, the Treasury strengthened its actions to support secondary market liquidity by enforcing lower bid-ask spreads and introducing buybacks of off-the-run securities.
6. **The introduction of an organized call market could complement existing market-making arrangements and enhance liquidity for a wider scope of securities**. In call markets buy and sell orders are collected and processed in predetermined intervals (e.g. once a day). The mechanism is especially relevant to enhance liquidity and facilitate valuation of instruments that are not frequently traded and quoted by market-makers. BIST’s prominent role in the bond market and solid infrastructure bodes well for the implementation of an organized call market. Calls could be conducted for a broad range of instruments including off-the-run government bonds and corporate bonds.
7. **Corporate TL Eurobonds could be an important first step to attract foreign investors to local currency corporate debt in larger volumes and longer maturities**. Foreign investors are usually more comfortable to initially tap Euroclearable instruments, under an international jurisdiction (e.g. London Law). As local currency corporate bonds consolidate as an asset class with the participation of foreign investors, it becomes easier to increase issuances in the domestic market. A few corporate TL Eurobonds have already been issued, but the market still lacks volume and solid benchmarks that could help pave the way for a deeper market. In this regard issuance of sovereign TL Eurobond could be one of the alternatives to enhance demand and facilitate pricing of non-sovereign local currency Eurobonds. This alternative faces the challenge of potentially increasing fragmentation of government debt instruments in a context of reduced funding needs and secondary market liquidity. However, careful analysis could be done on how to mitigate such effects while assessing the broader benefits that could arise from enhancing long-term financing in local currency for non-sovereign borrowers.
8. **Measures to help restore investor confidence in corporate bond markets are being assessed and should be implemented**. The CMB is attentive to implement changes in regulation to enhance investor protection in the corporate bond market. This is a critical task to support the market. The work is being conducted in consultation with the Capital Markets Association and other stakeholders and will involve changes to strengthen financial reporting standards and disclosure for material events. In this manner, new amendments to Communiqués on Debt Securities and Material Events Disclosure are expected to be in force in the near future.
9. **Higher standards of governance could be implemented for companies in BIST, including the potential creation of a special segment for companies that meet such criteria**. Investors globally are increasingly sensitive to differentiate companies based on their standards of governance. The current governance requirements at BIST are considered insufficient to reward firms with higher standards. The creation of a segment for these firms would help investors identify who they are and impose positive peer pressure on other companies. Stock exchanges of developed and developing countries[[10]](#footnote-11) have introduced improvements in their premium segments to strengthen the corporate governance aiming to enhance blue chip stock attractiveness.
10. **Several initiatives to enhance financial inclusion of SMEs via capital markets[[11]](#footnote-12) are under way**. Accessing capital markets as an alternative to bank financing is a major challenge for SMEs internationally. Turkey’s bank-centric model and the relatively underdeveloped stage of capital markets make the challenge even harder. Important regulatory developments and incentives including for the promotion of business angel investors have been enacted. BIST has launched IPO campaigns and promoted listings of SMEs, launching the Emerging Companies Market (ECM) and offering a variety of incentives. On the fixed income market, a promising project is at advanced stage to set up a venture capital fund whose portfolio will include debt issued by around 50 different SMEs[[12]](#footnote-13). In addition to these initiatives, authorities should continue efforts to enhance financial literacy, strengthen corporate governance, and expand the availability of structured fixed-income instruments.
11. **On the demand side, authorities should take integrated actions for effective and prudent participation of different segments of investors in capital markets, while continuing to adopt policies to stimulate savings**. The government has been pro-active in introducing reforms and incentives to enhance savings[[13]](#footnote-14). While these reforms are essential, the role that different segments of investors could play in support of capital market development (e.g. mutual funds, public funds) is not being fully exploited. In some cases, regulatory restrictions and current practices may be having unintended consequences, among others: (i) captive demand of buy and hold investors reducing liquidity of government bonds and availability of collateral; and (ii) in the development of a derivatives markets.

## Promoting Financial Inclusion

1. **Turkey compares favorably with its peers in Europe and Central Asia (ECA) and the BRICS in terms of bank account penetration, supported by an innovative, dynamic, and vibrant retail payments system.** According to Global Findex 2014, account penetration for individuals stands at 57 percent, higher than the average for other ECA economies (44 percent) but lower than is observed in BRICS (67 percent). Electronic payments have grown dramatically in recent years, though cash remains the dominant medium for retail payments. Turkey outperforms ECA and BRICS in terms of use of credit and ATM cards. Micro, Small and Medium Enterprises (MSMEs) have benefited from a long period of macro financial stability and nearly 80 percent of these firms report having a checking or savings account—slightly behind the average for other ECA economies (88 percent). About 40 percent of Turkish firms have a loan from a financial institution, slightly higher than the average for ECA (37 percent) or BRICS (36 percent).
2. **Despite Turkey’s recent achievements in the financial inclusion arena, a number of challenges exist - especially those related to the gender gap; lack of savings; and limited access to finance for young firms, new entrepreneurs and MSMEs in underserved regions**. The main gaps in financial inclusion of individuals are: i) gender dimension[[14]](#footnote-15); ii) concerns about trust in formal financial institutions (emanating from past financial crises)—materializing most visibly in individuals’ saving and borrowing patterns; and iii) low financial capabilities. Regarding MSMEs, the main underlying concern constraining access to finance is lack of long-term finance and limited availability of alternative financial instruments
3. **The FSAP has looked into the implementation of the financial inclusion strategy and has undertaken a focused analysis on three important areas: (i) capital markets as an alternative to bank financing for SMEs; (ii) Islamic finance as a vehicle for improving financial inclusion; and (iii) strengthening financial infrastructure**. The financial inclusion strategy could benefit from systematic data collection through demand-supply side surveys. Enhancing the monitoring and evaluation framework with measurable targets could increase the strategy effectiveness. As Turkey’s financial sector is so heavily bank based, strengthening the non-bank financial sector including leasing, factoring, and microfinance and ensuring a level playing field between the banking sector and non-bank financial sector is critical. For microfinance sector, lack of a dedicated legal framework is a crucial factor limiting its development. To ensure the growth potential of factoring and leasing sectors, aligning regulation and tax implementation vis-à-vis the banking sector is critical.

## Islamic finance

1. **Islamic finance or participation finance as referred in Turkey is an emerging and rapidly growing market with a history of more than three decades**. Key drivers of high growth are increased demand, recognition, and active support by the policy makers. In terms of CAGR from 2010-2014, Turkey ranked 3rd in global Islamic finance markets with a 25 percent growth rate.
2. **Development of participation finance in Turkey has strategic significance for the financial sector deepening and inclusion for several reasons**:

* ***Could serve as a catalyst for enhancing access to finance***. This is particularly important for the population in non-urban parts of the country who voluntarily avoid engaging in financial activities due to non-compliance with their religious beliefs.
* ***Could promote financial deepening and diversification especially in the area of capital markets and insurance***. Development of Islamic capital markets, insurance, and non-banking institution could provide alternative sources of financing and diversification opportunities especially for SMEs and long-term financing sector.
* ***Is part of Turkey’s initiative to develop the Istanbul International Financial Center Program, with the aim of bolstering Istanbul's status as a regional and international financial center***. Turkey would like to become a leader in Islamic finance given its strategic location and political standing with Islamic countries.

1. **Turkey’s participation finance sector has still relatively less market share when compared with countries such as Bahrain, Malaysia, Pakistan, and Saudi Arabia**. Participation banks’ growth is constrained due to several factors which require adequate interventions and policy response. There is strong commitment from policy-makers and stakeholders to further develop the sector. The recently established high level Interest-Free Finance Coordination Board is a step in the right direction along with a strategic plan as part of The 10th Development Plan. Key challenges faced by the participation banks are: (i) absence of a specific regulatory framework; (ii) capital constraints for further growth; (iii) lack of clarity in Shariah governance practices; (iv) shortage of liquid investable securities; and (v) limited innovation for retail and corporate sector on both sides of the balance sheet.
2. **Development of Islamic capital markets is a priority but the market faces challenges**. For the Sukuk (Islamic bonds) market, low appetite for structured and securitized products, challenges to maintain a liquid yield curve, limited availability of long-term financing, and the absence of an adequate Shariah-governance framework are key impediments for further growth.
3. **Key recommendations for the sector are** to: (i) enhance the regulatory framework for participation banks and support consideration of international standards such as recommended by the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) as additional sources of good practice and, at the same time, ensure that regulatory structure offers sufficient protection for less-sophisticated participants (investment account holders), and more emphasis is placed on investor education to ensure that the participants are clear about the risks involved.; (ii) develop and implement governance framework for Shariah-certification and audit of Islamic products and services; (ii) innovate and introduce new products to cater the retail, corporate, and SME sectors on both sides of the balance sheet; (iv) Turkish Treasury to consider issuing Shariah-compliant T-Bills to provide liquid assets to participation banks and asset managers[[15]](#footnote-16); (v) Participation banks to become more competitive in terms of pricing and service of quality; (vi) develop the market for local as well as foreign currency denominated Sukuk; (vii) develop human resources competent and qualified in Islamic finance; and finally, (viii) increase financial awareness and literacy of Islamic products and services to strengthen the trust of the customers.

## Retail Payment and Systems

1. **As a result of improvements in the NPS (see section on FMIs), Turkey is well positioned to achieve further advancements toward promoting financial inclusion and achieving the goal of universal access to transaction accounts**. Turkey’s strong performance is attributable, at least in part, to: i) its robust enabling environment; ii) payment product design features that are attractive to both payees and payers; and iii) the widespread usage of electronic payment of wages and salaries by public and private sector employers. Some of the other important factors that work to Turkey’s advantage include the high average debit card ownership[[16]](#footnote-17), a high total number of access points, a national payments switch, and an innovation oriented supply side. Turkey’s relative success with respect to access to and usage of transaction accounts may offer valuable lessons for other countries that are striving to advance financial inclusion.
2. **However, there are some aspects of payments systems of relevance for financial inclusion that merit attention and/or further analysis**. In specific terms, given the importance of payment system oversight to achieving policy objectives, it would be useful for CBRT and the BRSA to monitor the implementation and effectiveness of the NPS oversight framework. This is particularly relevant with regard to the customer experience and confidence, and the maintenance of competitive market conditions. Similarly, more information on customer recourse and dispute resolution mechanisms would be useful. In addition, further analysis of the strengths and weaknesses of the Government’s benefit payment programs with respect to expanding access and usage of transaction services could facilitate greater leveraging of those programs to advance financial inclusion. Turkey has a huge disparity in account ownership by gender. The gender disparity appears to be very closely related to the sizable gap in transaction account ownership by employment status. Further, like elsewhere, the regional and rural/urban divide in the distribution and availability of points of access has yet to be effectively addressed. Use of agent-based models in rural areas, potentially in conjunction with the card payments infrastructure and the cashback features already available in some locations presents a promising alternative. Finally, with the entry of e-money providers and payment institutions and the expanding scale of Postal Telegraph Corporation’s (PTT) payment services offerings, their level of access to the national payments system will need to be assessed to ensure fair and transparent access to payments infrastructure.

## Enhancing Credit Reporting Systems

1. **The credit reporting system (CRS) underwent comprehensive reform between 2011 and 2013 enhancing its potential role in promoting financial inclusion**. The CRS is supported by two main entities – BAT-Risk Center and KKB. A credit registry, as allowed under the BL, was operated by CBRT for several years. It was transferred in 2013 to the Bank Association of Turkey (BAT), called the BAT-Risk Center. The BAT-Risk Center in turn delegated the operational activities to the KKB which include data management and processing and development of data and reports. In addition, the KKB functions as a credit bureau under the provisions allowed by Article 73 of the BL. Prior to the reform, CBRT’s Risk Center collected both positive and negative information from individuals’ and enterprises and provided information on periodic (monthly) basis. However, after the reforms made since 2011, besides improving the quality and horizon of data available, coverage of provider financial institutions has been expanded, the variety of information has been enriched, and the efficiency of access to data has improved significantly. KKB has also diversified its products and offers a broad set of value added services.
2. **Some additional improvements in the CRS legal framework could support financial inclusion**. They include: i) developing a more comprehensive regulation that clearly states the role of the existing CRS as a service provider to the creditors including how this information should be treated in cross-border situations; ii) clarifying the role that private sector service providers play in the establishment of CRS, their requirements and obligations; iii) evaluating the recently adopted data protection law and its impact in the CRS activities; and iv) clearly establishing guidance regarding the consumer consent. Lastly, there is scope to strengthen the legal framework to facilitate participation of nonfinancial institutions in the CRS, including the collateral registry, social security institution, Ministry of Finance, and companies from telecommunication and utility sector. This can be especially useful in promoting responsible financial inclusion for both individuals and SMEs.
3. **Another key area for improvement is the development of the oversight function**. Although the BRSA is able to conduct examinations of the BAT-risk center and KKB, there is limited oversight framework and policy objectives are inadequately defined. However, there are some supervisory tools such as audit and regulation issued by BRSA. While concepts of oversight and collaboration between all relevant CRS participants are not defined in law, they are defined in the regulations of BAT-RC published in 2012. Moreover, both authorities have their members in the BAT-Risk Center’s Board, and have a right to say in the decision making mechanism. However, the roles of CBRT and BRSA should be defined more clearly. In addition, CBRT is an active member of World Bank- International Committee on Credit Reporting (ICCR) since 2011 which collaborates with overseers and institutions at international level. However, there is scope to develop provisions related to collaboration between overseers of credit reporting in Turkey and other jurisdictions with significant presence of Turkish banks and populace.

# Annex I. Financial System Profile and Recent Trends

|  |
| --- |
| **Table 1. Turkey: Selected Economic Indicators, 2014–21** |
|  |

|  |
| --- |
| **Table 2. Turkey: Financial Soundness Indicators, 2010–16**  (In percent) |
| Sources: IMF staff calculation based on Table 7 if not noted otherwise.  1 Current year data are annualized using 12-month rolling sums.  2 Net of NPL provisions.  3 Core liabilities include deposits and shareholders' equity.  4 Proxied by T1 Capital over last 2-month average balance sheet assets and average off-balance sheets exposures (> 3 percent).  5 Including FX-indexed assets and liabilities.  6 Non-FX adjusted.  7 Net income as a share of last 12-month average assets or equity.  8 Other non-interest income added to expenses when <0. |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Figure 1. Turkey: The Macro Context** | | | | |
| A. External imbalances are high despite output at potential |  | | B. Reflecting a wedge between investment and savings | |
|  | |  | |  |
| C. Financed in part by elevated and rising corporate FX debt | |  | | D. The current account is persistently in deficit |
|  | |  | |  |
| E. Recent portfolio flow reversals are cause for concern | |  | | F. As international reserves have been falling. |
|  | |  | |  |
| Sources: CBRT, Haver, and Fund staff estimates.  Notes: NIIP = net international investment position; S-I Gap = Investment (% of GDP) — Savings (% of GDP); CA Bal = current account balance; FDI = foreign direct investment; FA Bal = financial account balance; NEO = net errors and omissions; KA Bal = capital account balance; (A) Output gap in percent of potential GDP; NIIP in percent of GDP; (B) in percent of GDP for all series; (C) in percent of GDP; nonfinancial corporates FX net debt data before January 2014 is linearly interpolated; (D) in percent of GDP for all series, except oil which is 12 month average of Europe Brent spot price (fob) in U.S. dollars; current account is annualized with 12 month rolling sum; all series are non-seasonally adjusted; (E) non-seasonally adjusted data that is annualized with 12 months rolling sum; (F) non-seasonally adjusted data that is annualized as 12 months rolling sum; negative NEO and Reserves = financing. | | | | |

|  |  |  |
| --- | --- | --- |
| **Figure 2. Turkey: A Bank Dominated Financial Sector** | | |
| A. Turkey’s financial sector has grown faster than GDP since the crisis |  | B. And is of average size relative to peer markets |
|  |  |  |
| C. It is dominated by banks |  | D. The pension sector is small even by peer market standards |
|  |  |  |
| E. As are the life insurance |  | F. And non-life insurance sectors |
|  |  |  |
| Sources: EDSS, WEO, IMF FSI Annex, and World Bank FiinStats.  Notes: (A)-(B) Financial sector assets-to-GDP; (C) Assets-to-total financial sector assets; (D) Pension fund assets-to-GDP; (E) Life insurance premiums-to-GDP; (F) Non-life insurance premiums-to-GDP. | | |

|  |  |  |
| --- | --- | --- |
| **Figure 3. Turkey: Banking Sector Profile** | | |
| A. Turkey’s banks are larger than peer average when measured by credit intermediated |  | B. …. but of average size when measured by domestic deposits |
|  |  |  |
| C. Concentration in the banking industry is low relative to peers |  | D. State-owned, foreign-owned and private domestic banks hold roughly the same quantity of banking assets |
|  |  |  |
| Sources: World Bank FiinStats and BBSA. | | |

|  |  |  |
| --- | --- | --- |
| **Figure 4. Turkey: Bank Business Model Convergence** | | |
|  |  |  |
|  |  |  |
|  |  |  |
| Sources: BRSA, The Bank Association of Turkey, and Fund staff estimates. | | |

|  |  |  |
| --- | --- | --- |
| **Figure 5. Turkey: Bank Measures of Systemic Risk and Spillover Networks** | | |
| *Market-based capital shortfalls are high in distress periods* |  | *and distress in one bank can spill over easily to others.* |
|  |  |  |
| *This is confirmed by high intra-banking sector spillovers…* |  | *likely reflecting commonalities in banks’ business models.* |
|  |  |  |
| *This results in centrality rankings, revealing which banks have the most significant spillover links with other entities.* | | |
|  | | |
| Source: New York University V-Lab, Bloomberg, L.P., Moody's KMV, and Staff Computations.  Note: SRISK is the capital shortfall measure from V-Lab and measures banks' market-based capital needs following a 40 percent drop in stock prices. CoVaR denotes conditional value at-risk, inferred from a set of 9 banks' stock prices. Spillover analysis is performed on firm's one-year default probabilities from Moody's. Eigenvector centrality is a proxy for systemic risk and indicates how much a firm contributes to, or receives spillovers from other firms. | | |

|  |  |  |
| --- | --- | --- |
| **Figure 6. Turkey: Banks’ FX and Liquidity Risks** | | |
|  |  |  |
|  |  |  |
|  |  |  |
| Sources: CBRT, BBSA, and Fund staff estimates.  Notes: NOP = net open position; short-term liability = of (residual) maturity less than 12 months; medium-to-long term liability = of (residual) maturity greater than 12 months. | | |

|  |  |  |
| --- | --- | --- |
| **Figure 7. Turkey: Banks’ Returns, Asset Quality, and Solvency** | | |
|  |  |  |
|  |  |  |
|  |  |  |
| Sources: BRSA, The Banks Association of Turkey, PDP, and Fund staff estimates.  Notes: CAR = capital adequacy ratio; Core CAR = total core CAR; Hotels = hotels and restaurants; Finance = financial intermediation; Trade = wholesale and retail trade; Households = individual credit; NPL = non performing loans. | | |

|  |  |  |
| --- | --- | --- |
| **Figure 8. Turkey: Corporate Sector Risks and Vulnerabilities** | | |
|  |  |  |
|  |  |  |
|  |  |  |

|  |
| --- |
| **Figure 9. Turkey: Summary Results of Solvency Stress Tests of Major Banks** |
|  |

|  |
| --- |
| **Figure 10. Turkey: Results of the Liquidity Stress Tests of Major Banks** |
|  |

|  |  |  |
| --- | --- | --- |
| **Figure 11. Turkey: Funding Liquidity-Solvency Feedback in Solvency Stress Tests** | | |
| *Liquidity stress can add to solvency pressure…* |  | *and adversely affects banks’ profitability for some time.* |
|  |  |  |
| *The impact is persistent…* |  | *and is significant relative to GDP in 2016* |
|  |  |  |
| Source: FSAP calculations, based on BRSA supervisory banking data.  Note: Specific refers to funding shocks (interest rate shocks to liabilties) imposed on the three weakest banks in 2016, and spilling over to the three most connected banks, based on the results from the spillover analysis. Market-wide refers to a generalized funding shock affecting all banks in 2016 and 2017. Results shown are for the economic risk based approach to solvency stress testing. | | |

|  |  |  |
| --- | --- | --- |
| **Figure 12. Turkey: Corporate Sector Stress Test Analysis** | | |
|  |  |  |
|  |  |  |
|  |  |  |

# Annex II. Risk Assessment Matrix

| **Source of Risks** | | **Likelihood** | **Time Horizon** | **Impact** | **Policy Response** |
| --- | --- | --- | --- | --- | --- |
| **Global** | **Economic fallout from political fragmentation:**   * **Rise in populism and nationalism in large economies** could slow down or even reverse policy coordination and collaboration; international trade liberalization; financial, and labor flows; and lead to unsustainable policies, weighing on global growth and exacerbating financial market volatility. * **Protracted uncertainty associated with negotiating post-Brexit arrangements** could weigh on confidence and investment more than expected—most prominently in the UK and the rest of Europe with possible knock-on effects elsewhere. Increased barriers could also dampen the longer-run economic performance of affected countries more than expected. * **Heightened risk of fragmentation/security dislocation in part of the Middle East, Africa, and Europe,** leading to a sharp rise in migrant flows, with negative global spillovers. | **High**  **Medium**  **High** | **Short to**  **Medium Term**  **Short to**  **Medium Term**  **Short**  **Term** | **Low**  **Medium**  **Medium** | * Preemptively increase FX reserves through sterilized intervention. * Medium term: Improve competitiveness through structural reform. * Reduce energy dependence by developing additional domestic generation capacity. |
| **Tighter or more volatile global financial conditions:**   * **Sharp rise in risk premia with flight to safety:** Investors withdraw from specific risk asset classes as they reassess underlying economic and financial risks in large economies, or respond to unanticipated Fed tightening, and increases in U.S. term premia, with poor market liquidity amplifying volatility. Safe haven currencies—especially the US dollar—surge creates balance sheet strains for FX debtors. * **Reduced financial services by global/regional banks ("de-risking"):** Further loss of correspondent banking services significantly curtails cross-border payments, trade finance, and remittances in emerging and developing economies. | **Medium**  **High** | **Short Term**  **Medium Term** | **High**  **Medium** | * Tighten monetary policy * To the extent the NIR level allows, use FX reserves to smooth volatility in disorderly market conditions. * In case a recession ensues, consider loosening the fiscal stance. Publish a fiscal risk statement to guide policies. * Strengthen bank and NFC balance-sheets through restrictions on the structure of liabilities and higher risk weights or provisioning on lending to NFCs in FX. |
| **Weaker-than-expected global growth:**   * **Significant China slowdown and its spillovers:** Key near term risks are a loss of investor confidence, disorderly corporate defaults, a sharp fall in asset prices, and a quicker fading of the stimulus impact. Weak domestic demand further suppresses commodity prices, roils global financial markets, and reduces global growth (Likelihood: low in short-term, medium thereafter). * **Significant slowdown in other large EMs/frontier economies.** Turning of the credit cycle and fallout from excess household and corporate (FX) leverage as investors withdraw from EM corporate debt, generating disorderly deleveraging, with potential spillbacks to advanced economies. * **Structurally weak growth in key advanced and emerging economies:** Weak demand, low productivity growth, and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to lower medium-term path of potential growth (the Euro area, Japan, and the United States) and exacerbating legacy financial imbalances especially among banks (the Euro area) (high likelihood). Tighter financial conditions and insufficient reforms undermine medium-term growth in emerging markets (medium likelihood). | **Low/**  **Medium**  **Medium**  **High/**  **Medium** | **Short to**  **Medium Term**  **Short Term**  **Medium Term** | **Medium**  **Medium**  **Medium** | * Medium term: Diversify export destinations, increase high value-added exports, and improve competitiveness, thus boosting exports. * Strengthen bank and NFC balance-sheets through restrictions on the structure of liabilities and higher risk weights or provisioning on lending to NFCs in FX. |
| **Persistently lower energy prices,** triggered by supply factors reversing more gradually than expected. | **Low** | **Medium Term** | **Low** |  |
| **Domestic** | **Loose domestic policies leading to:**   * High inflation and a deteriorating fiscal position, eroding confidence and leading to re‑dollarization. This could occur if the government tries to spur growth through demand management, rather than long-term structural reform. | **Medium** | **Short to**  **Medium Term** | **High** | * Short-run: Tighten monetary policy and normalize the framework. Tightening above and beyond what was originally called for might be necessary. * Medium term: Tighten fiscal policy to bring it back into line with the medium-term program. Prioritize expenditure compression. |
| **Private debt overhang weigh on domestic demand**   * The slowdown in private sector credit growth can further weighs on the real economy leading a vicious deleveraging disorderly cycle, ending with a recession. | **Medium** | **Short to**  **Medium Term** | **High** | * Short-run: Allow fiscal automatic stabilizers to run their course. Re‑evaluate the need for monetary and discretionary fiscal tightening, depending on the strength and speed of the moderating effect of private deleveraging on inflation and the current account deficit. * Strengthen bank and NFC balance-sheets through restrictions on the structure of liabilities and higher risk weights or provisioning on lending to NFCs in FX. * A robust debt‑restructuring framework needs to be put in place. |
| 1 The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff’s subjective assessment of the risks surrounding the baseline (“low” is meant to indicate a probability below 10 percent, “medium” a probability between 10 and 30 percent, and “high” a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. “Short term” and “medium term” are meant to indicate that the risk could materialize within 1 year and 3 years, respectively. | | | | | |

# Annex III. Previous FSAP Recommendations

The table below presents the follow-up actions to key recommendations of the 2011 FSAP[[17]](#footnote-18).

|  |  |
| --- | --- |
| **Recommendations** | **Progress** |
| ***Overall financial sector oversight*** | |
| Consider further prudential action to ensure strong capital positions and stability of funding. | The BRSA has adopted the various components of Basel II, 2.5 and III according to the framework established by the Basel Committee. |
| Ensure data are available to assess the risk from unhedged corporate net short FX positions and take corrective action as necessary. | Partly implemented |
| Consider further measures to address the risk of worsening lending standards in the consumer and SME segments. | Partly implemented |
| Develop an approach to risk identification that combines the monitoring of key indicators with qualitative information. Better leverage the expert resources of the BRSA and CBRT by jointly developing databases and modeling frameworks for financial stability analysis. | Partly implemented |
| ***Macro-prudential policy framework*** | |
| Ensure appropriate communication and accountability of the FSC and strengthen its powers through primary legislation. | Partly implemented |
| Consider separating macroprudential policy and crisis management arrangements and ensuring a leading role of the CBRT in systemic risk monitoring and prevention. | Partly implemented |
| ***Micro-prudential regulation and supervision banking*** | |
| Review and revise key aspects of the supervisory and regulatory framework to bring it fully into line with the Basel framework, especially as regards the supervision of key risks and the definition of capital. | Implemented |
| Implement consolidated banking supervision and enhance the coverage of risks emanating from non- banking entities in the group. | Partly implemented |
| Revise the Banking Law to enhance the operational and organizational autonomy of the BRSA for banking supervision. | Not implemented |
| ***Micro-prudential regulation and supervision-insurance*** | |
| Reform the current insurance regulation and supervision processes by making them more transparent, consultative, and accountable to the industry. | Partly implemented |
| Improve the “early warning” system for the required solvency margin. | Implemented |
| Transfer the responsibilities for insurance regulation and supervision to an independent integrated insurance supervisory body. | Not implemented |

|  |  |
| --- | --- |
| **Recommendations** | **Progress** |
| ***Anti-money laundering (AML) / Combating the financing of terrorism (CFT) regime*** | |
| Adopt a new Law on Combating the Financing of Terrorism (CFT) to address the deficiencies identified by the FATF. | Implemented |
| Strengthen and integrate the institutional supervisory framework for AML/CFT to include participation of sector supervisors within the monitoring, selection, planning and coordination of AML/CFT activities. | Implemented |
| Establish a definition for Politically Exposed Persons (PEP) and requirements for reporting entities in line with the FATF standard. | Not implemented |

1. The team was led by Nigel Jenkinson, (IMF) and Mario Guadamillas (WB) and included Jay Surti (IMF) and Anderson Silva (WB) as Deputy Mission Chiefs, Laura Ard, Subika Farazi, Jose Antonio Gragnani, Michael Grist, Zamir Iqbal, Damodaran Krishnamurti, Harish Natarajan, and Kevin Mark Stephenson (all WB); as well as Jefferson Alvares, Jana Bricco, Ryan Davis, Kelly Eckhold, Caio Ferreira, Gregorio Impavido, Richard Lalonde, Jonathan Pampolina, Narayan Suryakumar, and Nico Valckx (all IMF); and Geof Mortlock and Anand Sinha (IMF experts). [↑](#footnote-ref-2)
2. (I) = immediate; (ST) = short-term (within one year); (MT) = medium-term (beyond one year). [↑](#footnote-ref-3)
3. The macro-financial scenarios are guided by the country risk assessment of Turkey and analyze the performance of the banking and NFC sectors under a baseline and two adverse stress scenarios. The baseline scenario assumes stable GDP growth of around 3½ percent with a zero output gap, high credit growth, FX depreciation, and persistently high current account deficits. An adverse scenario assumes a short period of sharp contraction in output with a corresponding loss of access to international capital markets of the order of severity experienced in 2008-09. It may result from a period of volatile global financial conditions with weaker than expected growth in the euro area, and would result in high inflation, capital outflows, increases in interest rates, and stronger FX depreciation, prompting moderate balance-sheet strains for banks and NFCs. A severely adverse scenario assumes a prolonged loss of market access by Turkey that may be triggered by a larger and more prolonged deterioration of the factors generating the adverse scenario. This would be associated with a deep recession, wherein GDP would suffer a significantly larger cumulative and more persistent decline, capital outflows would be higher, and market and credit disruptions more severe and protracted than under the adverse scenario [↑](#footnote-ref-4)
4. For details of stress test results see graphs in Annex I. [↑](#footnote-ref-5)
5. Most of these recommendations are consistent with the CBRT’s reform plans announced in its 2015 “Roadmap”. See <http://www.tcmb.gov.tr/wps/wcm/connect/TCMB+EN/TCMB+EN/Main+Menu/Announcements/Press+Releases/2015/CBRTRoadMap2015> [↑](#footnote-ref-6)
6. The CBRT has not offered to sell any FX via auction since 27 April 2016 but has not formally cancelled daily auctions. [↑](#footnote-ref-7)
7. Many of these limitations are closely linked to the issues discussed in the vulnerabilities and systemic liquidity sections, such as short-term maturities, FX exposure and lack of a clear reference rate on money markets. [↑](#footnote-ref-8)
8. A new Capital Markets Law was launched in 2012 followed by a series of secondary regulations. [↑](#footnote-ref-9)
9. The initiative is the result of solid collaboration among several stakeholders including the UoT, CBRT, CMB, BIST and TAKASBANK. [↑](#footnote-ref-10)
10. For instance, London Stock Exchange launched the Premium segment in 2010 and BM&FBovespa (Brazil) is currently discussing new improvements with companies listed in *Novo Mercado* (premium segment). [↑](#footnote-ref-11)
11. Three other areas of financial inclusion are covered in the next section: (i) implementing the financial inclusion strategy; (ii) Islamic finance as a vehicle for improving financial inclusion; and (iii) strengthening financial infrastructure. [↑](#footnote-ref-12)
12. Turkey Credit Guarantee Fund (KGF) and the European Investment Fund will provide around a 70 percent guarantee on the portfolio. [↑](#footnote-ref-13)
13. For example, matching, since 2013, 25 percent of individual contributions in the pension system. An ambitious reform to introduce auto-enrollment is under advanced stage of discussion. [↑](#footnote-ref-14)
14. The gap between Turkish men and women in terms of having an account, though showing improvement in recent years is still among the widest in the world. [↑](#footnote-ref-15)
15. While the Turkish Treasury does not issue conventional T-Bills, partly with the intent to crowd in corporate issuers in the short-end of the yield curve, the introduction of Shariah-compliant T-Bills would be relatively more important. due to the current scarcity of high quality Islamic instruments that could be issued regularly and support liquidity management market participants. [↑](#footnote-ref-16)
16. Turkey has a robust infrastructure for debit cards with all banks being able to issue debit cards and high proportion of bank accounts with linked debit cards. In many countries, not all bank accounts have linked debit cards as some banks do not issue debit cards because of their limited automation, etc. This makes the product offerings unattractive and necessitating wide reach of bank branches. In the case of Turkey, nearly all bank accounts have linked debit cards, this indicates ability to scale up access without needing physical presence. [↑](#footnote-ref-17)
17. See the FSB Peer Review for Turkey 2015 for additional information provided by the Turkish authorities, and the Detailed Assessment Reports and Technical Notes for additional details. [↑](#footnote-ref-18)