NEW BASEL ACCORD
AND
ITS MACROECONOMIC IMPLICATIONS
ON TURKEY

Distinguished participants,

Ladies and gentlemen,

Before I start out, I would like to thank the Central Bank for organizing this conference and for their kind invitation.

Since Mr. Başçı has covered the implications of Basel II on central bank policies, I will focus more on the likely impact of Basel II on banking, public finance and real sector.

I would like to start with a very brief overview of recent history and description of the issues and then move to my comments on Turkey.

Under the fast track integration of markets during the last two decades, the need to achieve financial stability intensified the efforts for adoption of a set of common rules regulating financial systems across the globe.

The Basel accords, which served as the main guideline for the financial sector stability, continued to evolve in line with financial market needs and innovative advances in the sector.

Though we had the rules in place in the 1990s, many countries including Turkey could not escape financial crises with devastating impacts on the real sector and wide spread contagion in other countries. In many of these cases, main factors

to blame were the weak financial systems and poorly managed and supervised banks.

This painful experience resonated in the global financial community.

While the rules of Basel I were common practice for more than a decade, it became apparent that they needed a thorough review to enhance better functioning of the financial system.

Basel II has been shaped after years of intense efforts to introduce new rules not only on capital structure but also on supervisory process and market discipline.

Three mutually reinforcing pillars of Basel II 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.

The third pillar brings market discipline through improved disclosure, enhanced transparency and strengthened corporate governance.

Thus, the third pillar will enable the markets to reward banks that take a responsible approach and penalize those that do not.

Dear participants,

Now, I would like to touch upon the impact of the new framework on the Turkish economy, in the context of banking, public finance and real sector.

Turkish banking sector will feel the immediate effect of Basel II on capital adequacy ratios, given the proposed changes in the risk weights of assets.

But, 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 point to be raised 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.

We have made substantial progress in this area by the introduction of “Regulation on Internal Control and Risk Management Systems of Banks” in February 2001.

The compliance of Turkish banks with International Accounting Standards has been completed to a great extent.

Banks have also furthered their efforts to establish consolidated risk management systems.

From a macro policy perspective, it is particularly encouraging to see the regulatory environment of banking sector being increasingly harmonized with the internationally accepted standards.

The advanced risk measurement requirement of Basel II will impose additional costs to the banks for investment in information technologies, human capital and organizational restructuring.

I would like to underline the fact that Turkish banking sector has been very conscious of this requirement and has been heavily investing in this area.

I am sure Mr Şirin, Vice Chairman of BRSA and Mr. Özince, General Manager of İşbank will share their reflections on this issue with us later today.

Transition to Basel II will make the need for consolidation in the banking sector more pronounced, while laying the ground for more integration with the international financial system.

We have been observing very encouraging developments in this front.

With entrenched macroeconomic stability and European Union perspective, mergers and acquisitions in the banking sector are gaining further momentum.

We strongly believe that improved supervision (through Pillar 2) and enhanced market discipline (through Pillar 3) will further strengthen investor confidence in the Turkish financial system and help attract more funds into the sector in the years ahead.

These positive developments will ensure the convergence of the Turkish banking sector to the EU standards more smoothly and make the transition to Basel II less costly.

All in all, it is fair to say that Turkey has accomplished a structural transformation of the banking sector. We are determined to implement further structural reforms on our way to full integration with the EU. The new banking act is a reflection of our policy to bring the regulation and supervision of the financial sector more in line with the EU standards.

Distinguished guests,

The new accord will also have implications for the public finance strategy.

With the introduction of Basel II, the international capital flows will be more dependent on the credit rating of countries.

In assessing the likely impact on Turkey, we should keep in mind that in allocating their funds, international banks already rely more on country ratings rather

than OECD membership. In other words, the new accord will only institutionalize what has been the current practice.

On the other hand, since the risk weights of FX denominated government bonds will be 100 percent whereas those of domestic currency denominated bonds might be between 0 to 100 percent under the national discretion, the composition of borrowing will be tilted towards domestic currency.

At this point, I would like to draw your attention to recent trends in Turkish financial markets.

With increased confidence in economic outlook, substantial decline in inflation and currency reform, there has been a very strong demand on YTL based assets by both national and international financial institutions.

In fact, issuances of debt instruments in YTL terms by foreigners including Austrian Treasury, World Bank and EIB have reached around 4[1] billion dollars since December 2004.

Similarly, the share of YTL instruments in total financial assets has increased to around 70 percent as of May 2005 from around 50 percent at the end of 2002.

These are clear indicators of confidence in the Turkish economy and in national currency, which obviously will help Treasury to better cope with the challenges of transition to Basel II.

Moreover, as Turkey's credit rating improves over time, risk weights of FX denominated bonds will decline substantially.

[1] With the currency rate of YTL / $ as of May 16, 2005.

In fact, Turkey's credit rating has been raised 4 times during the last 2.5 years. Our credit rating was upgraded to BB- for the first time in ten years.

We are committed to continue with our comprehensive economic reform program and the EU accession process which we believe will eventually help to raise Turkey's credit ratings to investment grade.

Distinguished participants,

Let me now touch upon the impact of the change on the real sector.

Under Basel II, strengths and weaknesses of companies will be more closely analyzed and credit conditions will be strictly based on credit ratings given by banks or rating agencies.

This in turn will bring tough challenges particularly for small and medium sized enterprises.

In the new framework, SMEs will have to improve their accounting standards, to operate in a more transparent way and to enhance their governance.

In addition, they have to increase the level of risk awareness and improve risk management practices throughout their organizations.

SMEs will also need to take appropriate actions to improve their capital bases.

To meet these challenges, SMEs will need to improve their product qualities and strengthen their role in the supply chain of the economy.

Investments in information technology and human capital, use of risk hedging methods, and implementation of advanced international accounting standards will occupy the agenda of the real sector in the coming years.

Distinguished guests,

Overriding importance of financial stability in the Turkish economy is better recognized now.

A successful transition to Basel II will definitely contribute to financial stability through improved risk culture, strengthened regulatory and supervisory framework, and enhanced transparency.

The experience with the new Accord will serve as a public good for all. I am sure, initial adjustment costs will be outweighed by the future gains.

Let me remind you that Basel II will lay the ground for Capital Requirements Directive of EU. As Turkey moves along in harmonizing with the EU and adopts "Acquis Communitarie", Basel II needs to be incorporated into our system. In this regard, making a successful transition to Basel II becomes more imminent for us.

I believe, now is a good time for Turkey to accelerate the process and build on the good progress so far. In fact now, we are in a good position to leverage the favorable factors such as improved resilience of the banking sector and the strengthened economic fundamentals to ease Turkey's transition to Basel II.

As I conclude my remarks, I would like to point out three issues to be tackled with.

For the public sector, the challenge is to continue with prudent fiscal and monetary policies.

The task for the financial sector is not to be complacent and to be responsive to the changing environment.

As for the real sector companies, the challenge is to realign their operations and practices in accordance with the higher standards required under the new framework.

I strongly believe that the Turkish private sector will, once again, prove its ability to adapt to the changing conditions very quickly and will transform these challenges into opportunities.

I, once again, thank the Central Bank for this very important event and thank you all for your kind attention.