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BASEL II'S POSSILE AFFECTS ON TURKISH BANKIGN SYSTEM

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Abstract
This paper examines the Basel II-III and Turkish Banking System together with the economic developments in Turkey. And, Sandard&Poor's important role in ratings so I thought it should be taken into consideration seriously. As Banks across the globe need to comply with Basel guidelines. The benefits are huge but the challenges are many: multi-jurisdictional compliance, multiple risks, multiple approaches, stress testing, business intelligence, transparency, scalability, auditability, data, resources and the list goes on…
Key words: ***Capital adequacy, BICRA Score, Basel II-III, risk-weighted credit, rating, Banks, Central Bank.***

1. INTRODUCTION

The Turkish banking system entered a new phase in July 2012 when it finalized its adoption of Basel II, the Basel Committee on Banking Supervision's regulations. It was the 22nd out of 27 Basel member countries to do so. In their interim statements as of Sept. 30 this year, banks have for the first time published their capital adequacy ratios (CARS) as per Basel II, which regulates how much capital a bank should set aside as a proportion of its assets.

As The Standard & Poor's Ratings Services believes this adds another link in the chain of developments that the Turkish banking regulator has accomplished since 2001. As well as implementing more stringent capital ratios, it has been believed the main benefits of Basel II will also be a more structured approach to capital management and stress testing, as embedded in the second pillar the accord, as well as enhanced transparency, as stipulated under Pillar III.

While these are going on in Turkish Banking System, Turkey becomes one of the world's fastest growing economies (see table 1). Thus, this development affects the Turkish Banking System positevelly as well.

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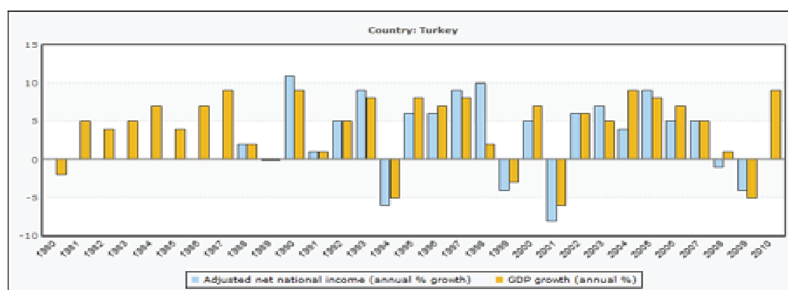
Table 1 GDP growth in Turkey, 1980-2010



2. OVERVIEW

The Turkish banking industry's recent adoption of Basel II regulation will improve its risk governance. The impact of the new regulation on banks' capital adequacy ratios has been limited by various adaptations of the rules by the Turkish regulator. The banking system's average CAR was 16.5% on Sept. 30, 2012, which was comfortably above the 12% target minimum CAR set by the regulator. The move to Basel II has no impact on S&P’s ratings on Turkish banks because we use S&P’s own methodology to assess banks' capital adequacies. · S&P doesn't expect that the forthcoming transition to Basel III will pose difficulties for banks given their currently supportive capital levels and composition.

Like many other countries, Turkey has used some discretion in implementing Basel II. Some of its adaptations have helped to minimize the impact of the migration to Basel II on banks' regulatory CARs, which measure a bank's capital as a percentage of its risk-weighted credit, market, and operational exposures. As a result, the banking system's average CAR remained at 16.5% on Sept. 30, 2012, unchanged from the ratio reported on June 30, 2012, before Basel II implementation. This is also comfortably above the 12% target minimum CAR set by Turkey's Banking Regulation and Supervision Agency (BRSA). There are two chief reasons for this. First, and the most importantly, under Turkey's own version of Basel I, Turkish banks had already included operational risks (the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events) in their regulatory calculation of CAR as stipulated in Basel II ahead of the migration to the second Basel accord. This prevented what otherwise would be a more than 1.5 percentage-point decrease in the systemwide average CAR. Second, under its own version of Basel II, the BRSA has opted for zero risk-weighting for the foreign currency reserves held with the Central Bank of Turkey (CBT), which saved about one percentage point for the system as a whole. The CBT nevertheless opted for a much higher risk weight for longer term retail loans so as to curb banks' retail lending appetites, which has negatively affected leading players in retail banking. Turkey's adoption of Basel II and its impact on banks' regulatory CARs, doesn't affect S&P’s ratings on Turkish banks.

This is because S&P use their risk-adjusted capital framework (RACF) methodology to measure banks' capital adequacy rather than banks' reported regulatory ratios. The RACF, introduced in April 2009, aims to provide a globally consistent measure that is independent of variations in national regulations, Basel II methodologies, and banks' internal risk measurement systems (for further details see "Bank Capital Methodology And Assumptions," published Dec. 06, 2010, on RatingsDriect on the Global Credit Portal). According to S&P's methodology, the capitalization of large rated Turkish banks compares relatively well with international peers: S&P project RAC ratios of large rated Turkish banks will stay between 7.5% and 9.5% over the coming 12-18 months versus our estimated average RAC ratio for banks in the EU, which was 6.8% as of Sept. 30, 2011, or 7.4% for the largest 100 banks in the world we publicly rate (for further details see "Bank Ratings Incorporate Expectations For Improving Capital Assessments Globally," published on Feb. 29, 2012 on RatingsDirect).

Turkey's Basel II implementation comes at a time when banking systems around the world are already preparing for the third Basel accord (Basel III), which aims to further strengthen bank capital requirements and introduce more regulatory requirements on bank liquidity and bank leverage. S&P understands that the Turkish regulator has a plan in place for this, and aims to implement it in a timespan similar to the other 27 Basel members. Although it is uncertain when the BRSA will require its banks to meet the proposed capital standards, we don't anticipate that rated Turkish banks will experience material difficulty in transitioning to Basel III given the currently supportive levels and composition of their capital.

3. BASEL II SHOULD FOSTER BETTER RISK GOVERNANCE

Turkish banks' implementation of Basel II will increase the consistency of reported regulatory CARs with those of international peers to some extent. Prior to adapting to the new regulatory regime, reported CARs of Turkish banks were difficult to compare, even with countries' banking systems that also had Basel I in place. This is because, unlike other banking systems appyling Basel I, the risk-weighted assets (RWA) component in Turkish capital reporting also included capital charges for operational risks. For example, it included zero-risk weighting of sovereign exposures to OECD member countries, including Turkey as per requirements of the first Basel accord. Even with the implementation of Basel II, it has been believed some discrepancies remain in Turkish reporting of CARs as a result of national differences the country has built into the system.

Yet, aside from regulating banks' minimum capital requirements, we think the most positive aspect of Basel II over the longer term will come from the other two pillars of the accord, relating to an improved supervisory review process and enhanced disclosure to achieve more discipline in the market. S&P believes Basel II implementation will help the regulator foster a better risk governance culture in the sector. In particular, we think the requirement that banks perform a compre-

hensive review of their risk profiles as well as some stress testing before setting up their own capital target under the control of supervisors will positively affect risk profiles. We also understand that some rated Turkish banks have been working on IRB approaches and have been collecting internal operational loss data. Even if it takes some time for the regulator and Turkish banks to implement these advanced methodologies, the qualitative impact on enterprise risk management frameworks and internal capital adequacy assessments will be felt much earlier, in S&P's view. It has been also expected systemwide transparency to further improve when banks start publishing disclosures under Pillar III.

4. OPERATIONAL RISK REPORTING HAS MINIMIZED THE IMPACT OF BASEL II

The Turkish banking system has used some national discretion in its Basel II regulations that should in our view ease the transition to the new regulatory regime. First, Turkish banks face no extra burden arising from the operational risk component that is included in regulatory CARs under Basel II. This is because the Turkish system already included this component in its Basel I regulations, even though it was not a requirement of Basel I. According to the figures published by regulator BRSA, operational risk capital charges for the Turkish banking system amounted to Turkish lira (TRY)101 billion ($56 billion) or about 10% of their total risk-weighted assets (RWA) as of June 2012. This compares with the total amount of admissible capital of TRY171.2 billion as of the same date, corresponding to about 1.7 percentage points that was already included in regulatory CARs before the transition to Basel II. A second national variation that the BRSA built into its implementation of Basel II and that has provided some capital relief to banks under the new regulations was the decision to apply zero risk weightings on foreign currency reserves held with the central bank. On June 30, 2012, total reserves of Turkish banks held with the central bank amounted to TRY64 billion. Had the BRSA required banks to apply 100% risk weighting for these reserves (as is the case under core Basel II regulation and as is the case for the foreign currency debt of the Turkish treasury), regulatory CAR for the system would have dropped by about one percentage point. We note, though, that given that the systemwide CAR stood at 16.5% on Sept. 30, 2012, such a one-percentage-point decrease would only have brought the systemwide regulatory CAR down to 15.5%, which is still comfortably above BRSA's target ratio of 12%.

The BRSA did, however, opt to increase risk weights for the longer term portion of retail receivables. Accordingly, the risk-weight for general-purpose loans with more than one-year maturity and credit card receivables with more than six months maturity is determined as 150%. If the maturity of these two asset classes exceeds one year and two years, respectively, the risk weight increases to 200%. This rule to a large extent offsets the benefits from the zero risk weight on reserves held in foreign currency for those banks with businesses skewed more toward reta-

il banking. We believe this demonstrates the regulator's commitment to curbing the increased risk appetite of banks in their retail lending.

5. NEW REGULATORY RATIOS HAVE NO RATING IMPACT

Since April 2009, Standard & Poor's has used its own methodology for calculating banks' RAC ratios. Regulatory CARs imposed under the Basel accord would therefore only affect our assessment if we believed that a bank was close to breaching the minimum regulatory CAR required by the local authorities. When this is not the case, our assessment of capitalization is mostly based on our projected RAC ratio. This allows us to eliminate the discrepancies that reported regulatory CARs exhibit among banking systems across the world. The risk weights we employ to determine RAC ratios rely on our Banking Industry Country Risk Assessment (BICRA) criteria (see "Banking Industry Country Risk Assessment Methodology And Assumptions," published Nov. 9, 2011). A BICRA signals the systemwide risk for individual financial institutions of operating in a particular banking industry. We assess that risk on a scale from '1' to '10', ranging from the lowest-risk banking industries (group 1) to the highest-risk banking industries (group 10). Accordingly, the risk weights for financial institutions are a function of BICRA scores. In the case of Turkey-which has a BICRA score in Group '5'-we put a risk weight of 47.5% on receivables of banks from other Turkish banks. In determining risk weights for the corporate sector and retail banking exposures, we look at the economic risk score-also on a scale from '1' to '10', which constitutes one component of the overall BICRA score. For these asset classes, our economic risk score of '6' therefore determines the risk weights when obligors are domiciled in Turkey. For example, a corporate risk exposure receives 161% risk weight as per our methodology, which is much higher than that recommended by Basel II's standardized approach (see table 2).

Table 2 Risk Weightings on Turkish Bank Capital Under S&P's RACF versus Turkey's Basel II Rules

%	*S&P's RACF (for banks with BICRA econmic risk score of '6')*	*Basel II As Per BRSA (standardized approach)*
Foreign currency Turkish sovereign debt	79	100
Reserves held with the central bank in foreign curency	79	0
Local currency Turkish sovereign debt	47	0
Corporate receivables	161	100
SME retail	121	75
Unsecured retail receivables	121	75

Credit card receivables depending on the maturity	153	200
Prime residential mortgages	54	50

RACF--Riks-adjusted capital framework. **SME**--small and midzsize enterprises. **BRSA**--Turkish Banking Regulation and Supervision Agency.

6. LARGE RATED TURKISH BANKS ARE ADEQUATELY CAPITALIZED

It has been seen that the S&P's project that the RAC ratios for the five large Turkish banks that their rate will remain between 7.5%-9.5% over the next 12-18 months. This compares relatively well with international peers (for further details see: "Despite Significant Progress, Capital Is Still A Rating Weakness For Large Global Banks," published Jan. 18, 2011). S&P's projections are based on the following assumptions for these Turkish banks:

– Annual loan growth in the range of 15%-17% in 2012 and 2013;

– Stable net interest margins varying between 3.5%-4.0%; and

– A stable cost of risk, varying between 1.0% and 1.3%, as measured with the ratio of new loan-loss provisions to average customer loans.

A key factor supporting the capitalization of Turkish banks (such as İş Bankası, Ak Bank, Garanti Bankası) is their strong profitability, as demonstrated by a ratio of three-year-average core earnings to average assets of above 1.5% for the five rated banks between 2008 and 2011. When coupled with the banks' conservative dividend payout policies, this not only provides a strong buffer against expected losses, but also translates to a strong internal capital generation.

The resilience of earnings in the system was tested in 2009 when the Turkish economy experienced a sharp contraction. This led the cost of risk to surge above 3% for all rated banks. However, banks remained profitable in this period and recovered most of their losses in 2010 and 2011 when problem loan collections exceeded new nonperforming loan formation. For some banks, the cost of risk even fell into negative territory. Yet, following normalization in 2012, it has been increasing again to about 1.0%, which we project as a normal credit loss level in the benign part of the cycle.

7. THE NEXT CHALLENGE: BASEL III

The deadlines set by the Basel Committee for new capital standards in Basel III are approaching and it has been understood that Turkey is working on a draft regulation. According to the latest progress report by the Basel Committee in October 2012, only eight of the 27 member jurisdictions have so far issued final plans for Basel III regulations: Australia, China, Hong Kong, India, Japan, Saudi Arabia, Singapore, and Switzerland.

8. CONCLUSION

It has been estimated that it is too early commenting on the likely impact of the third Basel accord on Turkish banks, regarding the new liquidity standards--namely the liquidity coverage ratio and net stable funding ratio. Regarding new capital standards, however, S&P doesn't anticipate rated Turkish banks will experience any difficulty in meeting the requirements. This reflects the good quality of the banks' existing capital base, mostly composed of common equity and retained earnings. Furthermore, banks have limited exposure to the activities that are most affected by Basel III, such as trading books or insurance operations. The impact of Basel III implementation on Turkish banks' current double-digit Tier-1 capital ratios should therefore be moderate.

And, as the Turkish economy grows the Banks' mobility increases and the application capasity of Basel III is going to get more easier.

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