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LESSONS FROM THE CRISIS – TURKISH BANKING CRISIS OF 2000-2001

Case studies

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Abstract

In the past two decades or so the Turkish banking system has experienced many changes especially with the liberalization of the financial markets, financial inovations, inovations in the information technology and the increase in the number of financial transactions. With consolidations, competition has grown among banks and they are now competing for smaller profit margins. With all these changes, there has also been a change in the type of risks to which banks are now exposed.

If the banking system in Turkey is following the right path as the authorities in Turkey claim then how did the country get into the grip of the banking crisis of 2000-2001? What went wrong and why bank loans turned into bad debts must be examined.

The Turkish Experience resulting from the financial crisis of 2000-2001 shows that the country has learned the lesson. The financial crisis of 2008 hadn't an impact so great in Turkey compared with other countries.

1. Introduction

The banking system in Turkey has made several structural changes over the period of time and also changes in the products and the services they offer, and they have tried to keep its banks abreast of what is going on in the world. Liberalization within the financial sector of Turkey has attracted both domestic and foreign investors and has shown that the banking system in Turkey is potentially profitable.

The Turkish banking system is not a new one: its roots go back into the 19 th century. It has played a major role in the Turkish financial system throughout the years especially in the last two decades. With its liberalization in the 1980s Turkey has become one of the most developed emerging markets. The high volatility inherited by Turkish markets generates high risk and therefore provides high returns to the investors.

2. Financial crisis in Turkey

The financial crisis of 2000 -2001 held in Turkey is said to be the responsibility of politicians and not the financial bureaucrats. The clash between the president and the prime minister over the war against the corrupt politicians, and the criminal investigation launched into the collapse 10 private banks under government administration, resulted in the loss of investors' confidence in the main objective of the government. This brought the Turkey's much-needed economic and political overhaul to an untimely end. Consequently, banks refused to lend to one another in the overhaul to one another in the overnight market. For a few days, the interbank rates rose to 2000 percent, which, if it had lasted for longer, would have ruined each and every bank in Turkey.

The loss in investors' confidence especially with the foreign investors taking the money out of Turkish treasury bills and the stock market, resulted in billions going out of the country, seriously damaging the central banks' reserves position. As a result interest rates soared and the stock market fell losing 18% of its value alone in one day (21 st February). Considering these conditions the government had no choice other than to float its currency and abandon the „crawling peg" that it had maintained against the basket of currencies that comprised the dollar and the Euro and which had allowed the currency to fluctuate at around 15%. With all this in view, the IMF (International Monetary Fund) sent its team to Turkey to discuss the situation and formulate a plan to overcome such a crisis. As a condition of its loan, the IMF insisted that the government should clean up the banking sector and speed up privatization to attrect foreign investment once again. But soon the IMF loans were suspended because the IMF belived that Turkish government had failed to deliver its promise of banking reform. (Bordo& Landon-Lane, 2010)

In response to the suspension of funding from the IMF, the goverment took control of some weak banks and more than half of the banking sector is owned by the state.

However, it is not an easy task as some 80 banks in Turkey have been identified as having been involved in corruption and are therefore also incompetent.

One point of view about the IMF's suggested reforms is that they may actually have put the Turkish economy at a grater risk, as many of the Turkish banks earn profits by investing in guvernment bonds and by exploiting the high interest ratest than are produced by high inflation and economic volatility. When the government reduced its borrowing and because of the price stability in the market yhe yields on the Turkish treasury instruments fell. This is a big saving for the taxpayer but an enormous loss for Turkish banks. (Dooley et al., 2009)

Many private banks in Turkey have also put their business into danger because of the transfer of their resources to those firms owned by their shareholders, one such example is the Iktisat bank, which as a result of the IMF conditionality was taken over by the regulatory authority in consequence of the resources having been transferred to the shareholders. (Carone et al., 2009)

Because of the mismanagement and some structural problems in the Turkish banking system the central bank's any tool to resolve such problems has so far been to increase the interest rates again and again. As results of this easy action less has been done to identify the root causes of such problems which turn into a full-fledged banking crisis. For these some structural changes in the banking system are much needed at the moment. (Krugman, 2009)

3. Risk management in Turkey

With the introduction of new markets and more developed derivates, the Turkish banking system faces some serious problems. In such an environment, risk management should be given more importance. With the increase in dealing with the existing domestic corporate customers, and increased interbank dealing and some investments by the institutional investors, there is much need for some proper risk management system to be put into place, since for such investment one cannot keep up with the manual work for assessing risk management.

What many banks in Turkey are using is an in-house system and spreadsheets to monitor the treasury operations. Such manual work is intensive as with the increase in the number of transactions, amount of investments and with international involvement, it is more prone to human error and such monitoring cannot calculate some of the calculations necessary to assess risk value. Also the complexity of markets, and the volatility introduced by the Asian and Russian crisis and more recently the possible contagion effect of Argentina, all require banks to be much more aware of the potential risk today than they were to be in the past, when they had to deal only with some domestic customers and the number of transactions was smaller. (Danthine& Gavazzi, 1999)

In the past, market movements were fairly predictable and the market knew how much devaluation or what interest rates would be, but in today's world everything is more complicated. The market itself is international and there is increased uncertainty because of the instruments out there to be traded that have been introduced in the markets.

Bank in Turkey need more of an integrated system that deals with front, middle and back office. They also need a system that could be used not only today but also in the future as with the rapid developments in the market the system should look after the banks in the long run. One such example is of the Ottoman Bank which with affiliation to the Software Company Trema, is using a risk management system called Finance KIT for its treasury operations. This system has so far been running successfully, and the bank has also created a new department called "Risk management and financial control". The main job of this department is to take necessary actions for implementing worldwide risk management techniques and models, and to put them into practice. These steps by the Ottoman Bank have been fruitful and the bank is now running its operation smoothly.

Turkish authorities looking at the market conditions and the possible banking crisis, introduced a law in 1999 starting that all banks have to establish proper risk management, risk and control and internal audits systems, dedicated to manage the market risk, credit risk and operational risk. These types of laws can help in reducing the risk that banks can become exposed to as each and every bank will have its own internal monitoring system and any bank that takes high risk will quickly take some remedial action in order to offset the damage. This will also increase the competition among the banks, as those banks with a sophisticated risk management system in place will make fewer losses and will increase their profits where as banks that take high risks might end up having liquidity problems. (Bhattacharya, 2002)

How banks in Turkey have dealt with the implications of the reforms and risk management will now be considered.

The environment that made banks to function improperly came from macro-economic imbalances, and also the disinflation programmer of the government brought along some additional risks for the banking sector. Not all banks possess the skills to function and to make profits an all sorts of environments. This is the reason why many banks in Turkey after the reforms programmer found it hard to make profits as they lacked experience with real states financing activities and in selecting and monitoring good long-term businesses and projects. During this many banks period preferred to lend within the same conglomerate, which added to the risk. When the banks saw that the opportunities to make profits in the treasury paper were reduced, they turned to consumer lending. The increase in consumer lending brought both macro-economic and banking risk with it. Weak risk assessment in such an environment can be worrying as banks can become exposed to adjustment risks (risk from existing weaknesses and adjustments in an overall macro-economic environment). (Bod, 2009)

The decision made by the Turkish authorities over the deposit insurance in 1994 was also fatal, as it made it easier for the weakest banks to raise funds from the depositors. Some of the low-quality banks angaged themselves in the practice of changing axtra-high deposit rates and lending to over-risky projects as they hoped that it would help them overcome the liquidity/solvency problem. With such cases in mind, the authorities introduced a plan for a gradual reduction in deposit insurance.

So far much of the authorities attention has gone towards the capital base of the banks but less importance has been given to bank's internal risk management system and the priority given by these banks to the risk issues. As mentioned earlier, it is important for banks to have their own risk management system in place for the smooth running of the business and for making profits from its operations. (Bernanke, 2004)

4. Conclusions

Turkish banking crisis could not be resolved within a short span of time, as not only one bank is in trouble but rather the whole banking system that needs to be overhauled. For such a crisis to be resolved, commitment and serious effort are required from the government, supervisory authorities and the bank themselves. One of the causes of the Turkish crisis is corruption within the system. To deal with such a problem, the government needs to take the necessary action to make a separate body that deals with such types of cases and legislation should be passed to punish those involved in such crimes. (Reinhart& Rogoff, 2009b)

Also in today's global village a country with less investment in technology will be left behind. For this reason the Turkish government needs to invest heavily in technology and some new risk management tools have to be introduced. Also, in order to regain foreign investors' confidence, the authorities need to take some sound actions that will deliver results. With speeding up the reforms process the Turkish economy can get back on track quickly. With the continuous process of privatization and foreign investment the government will soon be getting results and can concentrate on some other areas. In this regard the Turkish authorities must follow the IMF reforms package and also the guidelines provides by the World Bank and the Bank of International Settlements. The World Bank groups programme in Turkey is focusing at present on reducing systemic risks and vulnerabilities. Also, it aims to increase productivity, sophistication, and competitiveness in the financial sector, which will bring it up to the state bank restructuring and the reforms needed for the financial sector. (Reinhart& Rogoff, 2009a)

Also, with the importance of its geographical location, Turkey can exploit some more opportunities and can obtain some assistance from the European Union. Once the national currencies in European countries are fully replaced by the Euro, the Turkish currency (lira) will become important for trading in the foreign exchange market as most of the other European currencies will lose their identities.

Another possible solution for banks in crisis is voluntary mergers: a foreign acquisition of a Turkish bank can reinforce the introduction of modern banking practices in Turkey. Also a planned merger between two banks that belong to two competing industrial groups could be an alternative which implies economy wide restructuring in Turkey.

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