EBS/01/69
Supplement 1
Correction 1

CONFIDENTIAL

June 14, 2001

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Turkey—Sixth and Seventh Reviews Under the Stand-By Arrangement—Foreign Exchange Exposures in the Banking Sector**

The following corrections have been made in EBS/01/69, Supplement 1 (5/10/01):

Page 3, para. 8, last two lines and top line of page 4: Item (c) deleted and subsequent items (d) and (e) changed to (c) and (d).

Corrected pages are attached.

Att: (2)

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structures that are not specifically covered by the reporting requirement. Banks claim that they have actual foreign exchange exposures in excess of the prudential limits and that they have profited from these exposures (because of the high interest rates on TL assets compared to the rates on foreign exchange liabilities) even when taking account of the losses from the recent devaluation. Again, the SBAs refute these claims. In fact, with regard to the 13 commercial banks taken over by the SDIF in the last few years, 9 of them used such financial structures. However, the structures were detected by the SBA before these banks were taken over and they failed primarily for other reasons. No further structures where found in the audits of these banks after their takeover. This increases the mission's confidence that the SBAs find reporting abuses in banks when they exist.

4. **Three important questions need to be answered:** (a) what are banks' foreign currency exposures and are they excessive?; (b) have banks suffered financially from their foreign exchange exposures, whatever they actually are?; and (c) is the regulatory regime adequate?

5. **With regard to the first question, it seems unlikely that banks' foreign currency exposures are dramatically different than reported by them to the BRSA/Central Bank of Turkey** (CBT) and are certainly substantially less than those reported by the press and foreign bank analysts. Except for the SDIF banks, the reported exposures are reasonable given the risks and expected return. Nonetheless, some banks insist that they have larger exposures than they report. While supervision seems good, those banks that are determined to hide larger exposures are probably able to do so—at least for a while.

6. **With regard to the second question, the large interest rate spread between foreign currency liabilities and TL assets implies that banks made money on average from their exposures even after deducting the devaluation losses experienced so far, no matter what size their exposure.** By late April the TL/U.S. dollar rate had depreciated by almost 45 percent. Whether banks' exposures will prove profitable in the end depends on what the real depreciation ultimately is in relation to the interest rate spreads that were gained.

7. **With regard to the third question, it would be a supervisory concern if regulations were inadequate and poorly monitored.** But regulations and supervision are adequate. A new market risk regulation, which becomes effective January 1, 2002, provides an appropriate and adequate tool for containing and monitoring foreign exchange exposures in relation to capital. The risk of non-performance of a forward foreign exchange purchase or calling a foreign currency guarantee is a credit risk. These risks should be limited by the over all credit exposure to individual or related counterparties.

8. **The mission recommended that:** (a) the BRSA refute market claims that exposures are larger than reported and provide information on an ongoing basis to clarify the situation; (b) review and improve accounting and reporting standards, especially with regard to off balance sheet items; ~~(c) the government temporarily take a larger share of the foreign currency risk by issuing more foreign currency (or indexed) debt so that banks can reduce~~

~~theirs without undue pressure on the exchange rate;~~ (~~d~~c) the 20 percent of capital limit be waived for banks with adequate risk-management systems that adopt the capital charge required under the new market risk regulation in line with best international practices; and (~~e~~d) the implementation of the new regulation be brought forward on a voluntary, bank-by-bank basis.

I. Introduction

9. Because the interest differential between foreign currencies and TL has been so large (in relation to the announced rate of depreciation), questions have been raised as to whether banks (and perhaps also the wider economy) have exposed themselves to an excessive amount of exchange rate risk and whether their exposure has resulted in serious loss of capital from the recent devaluation. There is a market perception that banks are significantly overexposed and have incurred heavy losses as a result. The validity of this perception has very immediate implications for the condition of the banking sector following the floating of the TL in February and the policies needed to deal with it.

10. An MAE mission investigated this question in visits to Turkey in February and March (with further follow up in April). Over the two visits, the mission met with BRSA officials, in particular the SBAs, and six commercial banks (large, small, and foreign). More generally, the mission was also concerned whether existing regulations are adequate and whether foreign currency exposures imply a major vulnerability for the banking system.

11. After summarizing the regulatory framework, the Section III examines the data on foreign exchange exposures submitted by banks to the CBT and the BRSA. It then examines misunderstandings and claims in the market with regard to the size of these exposures. Section III provides the mission's assessment of the answers to these questions and Section IV sets out its recommendations.

II. Size and Regulation of Open Positions

A. Regulatory Framework

12. Prudential regulations limit banks' exposures to exchange rate risk to 20 percent of their capital (i.e., the excess of foreign currency liabilities over foreign currency assets, both on and off the balance sheet, must be less than 20 percent of capital). This limit applies to each bank individually (including its branches abroad) and when its balance sheet is consolidated with the assets and liabilities of its financial subsidiaries. There is also an older style regulation on the ratio of foreign exchange assets and liabilities (see Table 1).[3]

[3] It should be noted that prudential regulations prior to the establishment of the BRSA in August 2000 were issued by the Treasury in its capacity as supervisory authority for banks.