A comparative analysis of the Turkish Banking Sector with the European Union while completing the Customs Union and in the process of full EC accession

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Abstract

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This study aims determining the competitive position of Turkish banking sector and suggesting strategies to be and remain competitive against the European Internal Market. A brief history of the Turkish Banking Sector is provided to enable assessment of the development of the banking sector in Turkey. The affect of foreign banks in the domestic sector is analyzed. The Internal market, the harmonization process in EC and its effects on EC countries as well as on third countries to the community are discussed in detail to estimate the implications for the Turkish Banking Sector. The effects of the recent entry to the Customs Union with the European Union is analyzed in terms of its indirect consequences on the banking sector.

The liberalization and deregulation in Turkish banking sector is given and the importance of legislative unification and enhancing the competitive power of the sector is stressed.

The issues that need to be highlighted when comparing Turkish Banking Sector against its EC counterparts are firstly the order of different scale in terms of assets and equity, secondly, high profitability, high operating costs and low

productivity, and thirdly the oligopolistic structure in the sector.

Altough currently suffering from the structural problems in the economy, Turkish banking is on the way of integration to international markets and in the process of enhancing the competitiveness against foreign banks.

Kısa Özet

Tam Üyelik Sürecinde ve Gümrük Birliğine Girildiği Sırada, Türk Bankacılık Sektörünün, Topluluk Bankacılık Sektörü ile Karşılaştırmalı Analizi

Hazırlayan
Ümit Altınay

Bu çalışma Türk bankacılık sektörünün rekabet yapısını belirlemek ve Avrupa Birliği karşısında rekabet gücünün geliştirilmesi ve korunması için stratejik tavsiyeler sunabilmek amacı ile hazırlanmıştır. Çalışmada, Türk bankacılık tarihi, bankacılık sisteminin geçmişi ve değişikliklere uyumu hakkında fikir sahibi olabilmek için incelenmiş, yabancı sermayeli bankaların sektöre etkisi araştırılmıştır. Avrupa birliği, birlik içindeki servis sektörünün ve sermaye dolaşımının serbestleştirilmesi ve uyum süreci ile bu konulardaki gelişmelerin üye ülkelere etkileri üzerinde durulmuştur. Bu birleşmenin üçüncü ülkelere etkileri de, Türk bankacılık sektörüne olası etkilerini analiz etmede faydalı olması açısından analiz edilmiştir. Türkiye'nin 1995 başından itibaren Avrupa Birliği ile gümrük birliğine girişinin üretim sektörü üzerine doğrudan etkileri ile bankacılık sektörüne dolaylı etkisi incelenmiştir.

Türkiye'de 1980 sonrasında gerçekleştirilen serbestleştirme ve uluslararasılaşma reformları ve 1992 den sonra avrupa finans sektörünün uyumlaştırılmasının tamamlanmasından sonra bu çerçevede yeniden gözden geçirilen yasal düzenlemeler ile avrupa topluluğunun finans sektörünü düzenleyen kavram ve kurallarına uyumluluk büyük ölçüde

sağlanmıştır. Bu konuda uyumla ilgili küçük farklılıklar halen devam etmektedir ancak ciddi değildir.

Türk bankacılık sektörünü, avrupadaki rakipleri ile karşılaştırırken ve avrupadaki sürecin Türkiye üzerine etkileri incelenirken yasal düzenlemelerdeki farklılıklar ve uyum gereklerinden çok, Türk bankalarının avrupalı rakipleri ile rekabet edebilecek duruma getirilmesi için alınması gerekli önlemleri ve strateji gereksinimleri üzerinde durulmalıdır. Bu açıdan bakıldığında, Türk bankacılık sektörünün avrupa ya göre sermaye ve aktif yapılarından anlaşılacağı gibi ölçek farkının bulunduğu, karlılık ve operasyon giderlerinin avrupaya göre yüksek, ve verimliliğinin düşük olduğu ve halen oligopolistic yapısını devam ettirdiği gözlenmektedir.

Şu anda, ekenomideki yapısal sorunların etkisindeki sektörümüz, uluslararası pazarlar ile entegrasyon ve rekabet gücünü artırmaya yönelik bir sürecin içindedir.

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1. Introduction

The roots of the internal market goes back to 1957 to the Treaty of Rome. (European Community, 1984) One of the objective was to create the internal market and the other one was to coordinate the economic policies of the governments. The goal was to create a stable competition system with the unrestricted movement of capital, goods and workers.

The Internal Market of EC is composed of a population of 338 million, GNP of 5,4 trillion US dollar, with which it will become comparable to dominant economies like US and Japanese.

Without considering the dynamics of unification, only savings that will result in abolishing the limitations on movements, is expected to be 5% of the GNP of the community as a whole.

The realization of EC will have considerable effects on the financial sector especially in the banking sector.

The percentage of financial services in the economies of the member countries both in terms of value added and in terms of worker population is increasing although the percentages vary between member states.(Gurlesel 1993) For example, value added in France is 4.3%, In UK is 10%, and in Luxembourg it is 14.9%. The value added has increased as a percentage to GNP however it is low in community member states when compared to US and Japan. When compared with other markets 1/3 of the financial transactions are made by EC banks. 75% of the financial assets are banks assets in EC. To complete the unification in financial system, European Monetary Union should be established, European Monetary system should be executed efficiently, and ECU should be used in a larger extent in member countries. To unify the monetary policies of the member states, European Central Bank should come into effect. In Maastricht Treaty all these issues are discussed and signed, which dictates to form the Communities Central Bank in 1998 and to complete the monetary unification in 1999. However, if the measures are taken before and the necessary improvements are accomplished the central bank may be formed in 1997. These decisions will directly affect the banking sectors because they define the environment in which the member states banks are operating. There are a number of directives aimed at de-regulation of member country rules and regulating uniformly the banking sector at the community level.

On the other side, Turkish Banking Sector has experienced certain reforms in 1980s, however there are some structural problems and there are a number of problems originating from the deficiencies in the economy. Although Turkey is a third country to the community, the unification steps should be taken as Turkey has applied for membership to the community. In the process of de-regulation and unification to communities requirements, Turkey should also take into account the developments in the global banking industry and other international norms. Again the strategies against the community should be unifying the legal conditions on the one hand and enhancing the competitive position of the domestic sector on the other. While determining strategies the dominance of banking sector in domestic financial sector should be considered. The comparison should be made against the member states that whether the Turkish banking sector have the same instruments, institutions and markets. Also the issue that Istanbul may become a finance and business center in Europe should not be forgotten.

In this study first, the history, the liberalization period and current position of Turkish banking sector is described, the effect of foreign banks in the domestic sector is analyzed, the conditions of establishing offices or branches in Turkey is given and the limitations on their activities are listed. Turkish Banks' activities in foreign countries are also taken into consideration. The harmonization process in the EC is explained, the effect of unification in EC to financial sectors of member states and to third countries are analyzed and Turkey is evaluated against the EC member countries in terms of financial ratios and structures. The possible indirect effect of customs union on Turkish Banking sector is analyzed. The problems of the Turkish Banking Sector are described, and strategies are suggested to enhance the competitiveness of the sector.

2. Banking In Turkey

2.1. *History*

The development of banking can be divided into five periods. These periods are the development stages which are seen different from each other from functional and methodological point of view.

2.1.1. First Period (Before 1847)

Before 1847 the only institutions operating on money were bankers. In Ottoman Empire, the bankers and specialists(sarrafs) used to exchange money, give change, lend money, buy and sell bills of exchange.

Specialists were Jews, Armenians and Laventans (Easterns). These were specialists who use other people's money, collect money, make payments, and lend money on behalf of rich people and people from the state.

In 1842, two commissions were formed by specialists having the names "Anadolu" and "Rumeli" companies and the income of the empire used to be gathered and brought to the Treasury and distributed by these commissions.

The specialists who go in important money business were lately called "bankers" and from those, the ones who are powerful enough to lend money and who were settled in Galata are called "Galata Bankers". Briefly the operations similar to bank operations were carried out by specialists or bankers in this period.

2.1.2. Second Period (1847-1875)

When the value of the first printed paper money in 1840 started to fall down, this affected in great deal, the exchange prices. For a solution to this, in 1845, the government made a two-year contract with the major players of Galata-Bankers. And these, with the permission of the government and to control current exchange rate values, founded the Bank of Constantinople. However, the exchange rate speculations of the specialists and the Bank of Constantinople couldn't be avoided and it followed the close down of the bank after 3 years. The government considered the advantage of controlling the exchange rate by a financial institution and after the Kırım war, with the increasing need an English proposal was accepted to establish the Ottoman Bank having its headquarters in London in 1856. The business center would be in Istanbul and except Egypt it would have branches all around the country. In the next seven years, after its foundation as a private bank, the Ottoman bank turned into a bank which was favored and had a private permission, and within three years a few other banks were founded. These were formed in order to get advantage from money and exchange rate speculations and find cash with high interests for the Ottoman government as government budget deficits are not closed for years. Union Financiere with Türkiye Bankası, Societe Generale de L'empire Ottoman, The Ottoman Financial Association, Credit General Ottoman are examples of these banks. Meanwhile, the

Ottoman Bank which had the name "Ottoman Imperial Bank" in 1863, was given the permission to issue banknote until 1875. In 1868, the first national savings institution "Emekli Sandığı" was founded. Ziraat Bankasi was also founded in 1863 but its main functioning started in the third period after 1875.

2.1.3. Third Period (1875-1908)

In the period which started with the stopping of payments in 1875 until the foundation of the "Duyunu Umumiye İdaresi" in 1882 and reserving certain parts of state income to government debts, the financial situation was not good. After 1882, European investors started again to show interest in Turkey, foreign banks started opening up branches in Ottoman Empire, also new banks were established by foreign and local capital. Ziraat Bankasi also started its functions in this period in 1888. Beside the foreign banks, the other local banks founded in this period are mainly Midilli Bankası(1891) and Selanik Bankası(1888). But the only bank with dominant domestic capital was Ziraat Bankası.

2.1.4. Fourth Period (1908-1923)

Turkiye Milli Bankası was founded as an Ottoman joint stock company in 1909, Turkiye Ticaret ve Sanayi Bankası with foreign and local capital in 1910 however both of them failed to succeed and closed in 4-5 years. A number of regional banks in Anatolia were established in this period to name some of them, Istanbul Bankası (1911), Konya Iktisadi Milli Bankası (1912), Adapazarı Islami Ticaret Bankası in 1913 (changed name as Adapazarı Turk Ticaret Bankası and in 1937 Türk Ticaret Bankası), Karaman Milli Bankası in 1913, Milli Aydın Bankası in 1914, Akşehir Bankası in 1916. The most important success is achieved by the Itibati Milli Bankası (Credit National Ottoman) that was founded in 1917 which operated nationally and in 1927 merged with Türkiye Iş Bankası.

2.1.5. Fifth Period (1923-1980)

In this period, the banks were meant to assist in economic recovery of the country both for infrastructural investments and for the construction of the industry. Since private capital accumulation was totally inadequate, major state contribution in financing new banks was regarded as necessary.

During the decade between 1923-1932, the Central Bank of Turkey and a number of important banks were established like Türkiye Iş Bankası (1924), Türkiye Sanayii ve Maadin Bankası (1925), Emlak ve Eytam Bankası (1926), Türkiye Imar Bankası(1928). Also a number of local banks were established in Anatolia. During the next 12 years between 1933 and 1945 five large state owned banks were established in order to assist in diversifying national focus on new areas of economic activity like Halk Bankası(1938), Etibank, Sümerbank, Vakıflar Bankası and private banks like Iller Bankası and Esnaf Bankası.

1945-1960 period, on the other hand is best characterized by the establishment and rapid development of private retail banks, with a sharp increase in branch banking and in credit institutions to meet different demands like Akbank(1948), Demirbank, Pamukbank(1955), Sekerbank(1953), Garanti Bankasi(1946), Yapi Kredi Bankasi(1944).

The period 1960-1980 in Turkey is defined as the planning era. During this time specialty banking was emphasized in addition to continued growth in branch banking. The continued prevalence of expansive branch banking in Turkey owes its survival until early 80s to the relative importance banks attached to deposits since negative interest rate policies were in effect nationally and governmentally. Particularly after 70s, holding companies entered the field of branch banking and this resulted in an oligopolistic structure in the Turkish banking sector based on a wide network of branches.

2.1.6. Sixth Period (1980+) and Liberalization in Turkish Banking Sector

Until the 80s Turkish Banking existed in a state of isolation from the rest of the world. It was with the implementation of liberal economic policies in early 80s that Turkey's banks began their own transformation towards liberalization, deregulation and globalization. The most pronounced aspect of this liberalization process was in the domain of organizational structures. Again, until that time, capital markets in Turkey were limited in scope and had not yet developed sufficiently.

Again it was during this period that Turkish banks achieved an impressive progress to catch up with the rest of the world in the areas of technology such as EDP, automation, networking and telecommunications as well as in diversifying their financial products and services and obtaining state of the art quality in these areas. However, it is early to claim that the process of transformation has been completed.

Liberalization, restructuring and deregulation measures imposed on the Turkish economy in the 80s forced Turkey's banks to face a much more competitive and open market environment. To this challenge, Turkish banks responded successfully by diversifying their products and services and by adopting many of the state-of-the-art techniques. In addition to these, the entire sector underwent a series of institutional and structural reforms. The main components of the financial liberalization programme were liberalization of the exchange rate mechanism, freeing of interest rates, institutional reforms, reforms on capital markets and movements of capital and monetary reforms.

Interest rates for deposits and loans were determined by government offices up until the 80s.(Erk, 1994) With a national turn towards liberalization, first step towards deregulation of the Turkish financial system was to free all interest rates. In July 1980, ceilings on interest rates were abolished. Deregulation of interest rates resulted in a sharp rise in nominal rates from 30% to 50% on banks deposits and hence real rates became positive in 1981. In 1982 interest rates continued to rise rapidly. However lack of regulations on financial institutions with respect to these recent developments led to an early collapse in the financial system. Therefore from 1983 onwards the Central bank was authorized to determine upper limits on deposit rates on the basis of fluctuations in the inflation rate and other economic developments. At the present Turkish banks is said to effectively employ rational decision making and determine their own interest rates in total freedom. Freeing of interest rates, in spite of government guarantee of deposits, introduced certain competition to the banking sector and encouraged banks to come up with creative solutions in better serving their customers. New products and services were introduced and a service charge tradition was initiated.

The Turkish lira was devalued by 33% in Jan 1980, and from 1981 onwards a flexible exchange rate policy were adapted to maintain an unchanged real effective exchange rate through daily changes in the nominal rate.

In 1981 the Capital Market Board was established to implement the new Capital Market Law and to supervise all institutions operating in the securities market. However, the Istanbul Stock Exchange (ISE) became inactive from 1982 to 1985 due to the damaging effects of the financial crisis. The ISE re-opened in 1985 after the financial sector recovered.

In Jan 1983, a new banking law was introduced with extended provisions on capital requirements, contingency reserves for non-performing loans, a new deposit insurance scheme, unified accounting and reporting standards, and a requirement for external auditing (Yaşar, 1992). A number of important measures were taken in order to diversify the financial institutions operating in Turkey. In that respect, foreign banks were allowed to operate in domestic market from 1981 onwards. Citibank and American Express were the first foreign banks to open branch offices in Turkey in 1981. In addition, in 1985 Special Finance Houses were allowed to operate according to Islamic banking practices and three of these finance houses were established. Nevertheless, due to important restrictions imposed on the local activities of foreign banks, the impact of foreign entry on the competitiveness of the banking sector remained insignificant. Reforms were made up in personal and corporate income tax to promote security ownership. New financial assets were introduced with different risk return combinations. New financial institutions were formed. The number of commercial banks increased from 38 to 56. New financial institutions were started to operate in primary and secondary markets. The treasury started to issue T-bills and bonds through weekly auctions. The Turkish interbank market was established in 1986 to meet the short term liquidity requirements by banks and to put excess liquidity into work. Almost 99% of all the transactions are overnight transactions. Also foreign currency interbank market(1988), gold market(1989) are in operations, and central bank is highly active in open market operations.

During the 80s Turkish banks turned to international money markets and incurred foreign currency obligations. While this new opening had positive effects on the banks profits, it also presented new issues and risks for the sector. Exchange rate movements posed the most obvious risks. Banks with expanding foreign currency items in their balance sheets become more sensitive to exchange rate movements. Moreover, in order to minimize the negative effects of changes in interest rates, banks began to monitor and coordinate reciprocally the time structure of their assets and liabilities. Enhanced competition among banks, both for resources as well as for placements, resulted in a search for different modalities in credits, in a change in the composition of services offered by banks and in a turn towards competition by means of improved service quality independent of the size of deposits and credits.

In summary the trends in the banking sector after 80s were the following (Akguc, 1990) :

- increase in the number of foreign banks from 4 to 20
- stopping and gradually reduction in the branch network (6087 in 1994 as compared to 6587 in 1991)
- increase in the number of small private banks
- increase in the percentage share of the public banks in credits and savings potential
- decrease in mergers and acquisitions of the private banks, increase in number of banks
- decrease in the percentage of credits in total assets
- increase in the level of bad debts, unreturned credits

- change in the sectoral distribution of the credits and the decrease of the share of the industrial sectors in the credits given
- fast increase in the level of foreign exchange based resources and foreign credits
- change in the structure of deposits from sight to term deposits
- decrease in the share of the recourses of central bank in Banks Balance sheets
- increase in the paid-in capital of the banks

Official emphasis on systematic identification of the compatibility among various balance sheet items, and its consequences experienced by the sector have resulted in greater movements in items which had been dormant and regarded as insignificant until that time, the composition of bank balance sheets thus become much more diverse and this forced banks to use better judgment in asset and liability management.

Profit margins in the entire sector were reduced as a result of positive interest rate policies and banks turned to balance sheet management with greater interest (Aydoğan and Çapoğlu, 1990). Treasury management become high priority, hedging techniques received greater attention. It was during this same period in the 80s that banks turned away from traditional growth and expansion policies and more towards conservative policies that increased their profitability and raised quality of their assets, and towards a restructuring of their balance sheets. In order to contain risks which were increasing, a limited and selective loan policy was implemented. Loans to commercial customers were restricted in order to minimize the negative effects of nonperforming loans on asset performance (ROA) and placements were steered towards non-credit areas. Individual banking especially individual credits gained high importance to aid risk management by diversification of risk and the demand for individual credits in the form of direct credits, loans for building houses, house development and renovation loans and loans to buy cars received a considerable demand. Containment and reduction of the balance sheet became an important issue and off-balance sheet transactions gained in significance.

Chronological Developments after 1980

1980 Interest Rate were liberated and banks made acquaint of positive interest rates

1982 Capital Market Board was formed

1985 Banks Act number 3182 went into effect and introduced the international control and supervision system and international banking standards system, and standardized accounting system, introduced independent auditing for balance sheets, established a deposit insurance fund, and introduced a more realistic provisions application for non-performing loans

The Interbank Market was established

Permission was given to Turkish residents to possess foreign exchange and open FX accounts.

1986 Istanbul Stock Market was reorganized as ISE

1987 the Central Bank began open market transactions

1988 a currency market was established, deposit interest rates were liberated

1989 foreign exchange transactions and capital movements were liberated

1990 the convertibility of the TL was announced, residents abroad were given permission to invest in securities and open TL and FX deposit accounts in Turkey.

The Central bank promoted and launched its monetary programme aimed at increasing predictability and reducing uncertainties in financial market

1992-EFT system become operational

2.1.7. Turkish Banking In the Beginning of the Decade

At the beginning of 90s custom tariffs and various funds on imports have been lowered, thereby importation of consumer goods has been promoted. Meanwhile, keeping the devaluation rate lower than that of the prevailing inflation rate has led to an increase in the short-term foreign exchange borrowings on the banks part.

The war in the GULF, coupled with serious declines in export volume and an expected lower inflow of touristic revenues led bankers to a devaluation expectation in the beginning of 1991. As expected, January and February 1991 foreign exchange rates climbed significantly, which led the banks to keep long on foreign exchange. With the beginning of March 1991, the Central Bank of Turkey had freed the TL deposit rates that the banks offered to their depositors, as well as withdrawn from TL O/N quotation in the interbank, with the expectation of dampening the pressure on the foreign exchange. The expectations have materialized soon enough. Foreign exchange rates vis a vis TL have fallen but O/N interest rates, which were steady at round 69% passed the 100% mark to reach 180% levels on certain days. Banks with a small TL deposit base, which fund themselves through the inter-bank, have suffered an intolerably fast increase in funding costs. Meanwhile deposit rates, which were around 56%, started climbing to 70% and over for one-year deposits, pulling up the credit rates to 90% and above. Meanwhile Turkish inflation was becoming an epidemic phenomenon encouraging inventory build-up and discouraging new productive investments.

2.2. Current Situation : The Turkish banking sector

The Turkish banking system had 70 members as the beginning of 1994. However banking licenses of 3 banks are canceled within the year 1994, therefore the number of banks has decreased to 67, 35 of which are national commercial banks, 20 are foreign banks or branches, 12 are investment and development banks. Of 67, 9 are state owned banks except the Central Bank. There are also 4 special finance institutions operating under Islamic Principles under the permission of the Council of Ministers namely Al Baraka Turk Özel Finans Kurumu, Anadolu Finansman, Faisal Finans and Kuveyt Turk Evkaf Finans Kurumu.

Before 1994 after the reserve and liquidity requirements banks were allowed to place 49% of demand deposits in TL and 57.5% of time deposits in TL which was a considerable burden on banks and a negative point in terms of financial efficiency. However, the liquidity ratios were revised in order to make deposits more attractive, to increase the amount of available funds and to decrease the cost of funds in the short-term. Therefore, reserve requirements on TL deposits were reduced and liquidity ratios were abandoned in 1994. However, certain non-deposit liabilities are subjected to liquidity requirements for the first time. By this change (as the government begin paying enormous interest rates to liquid assets) the term and sight deposits in TL have 8% reserve requirement and NO liquidity requirement therefore 92% of all the funds collected in TL can be placed on credits and 90% of the funds collected in FX can be loaned. For non-deposit liabilities a liquidity requirement of 8% for the amount in TL and 9% for the amount in FX is established for the first time in 1994.

Table 1 - Reserve Requirements and liquidity ratios before and after 1994

	Reserve Requirements		Liquidity Ratios	
	Previous	94	Previous	94
TL deposits			35	-
Demand deposits	16	8		
Time deposits	7.5	8		
Foreign Exchange			-	-
Demand deposits	11.5	10		
Time deposits	9.5	10		
TL part			-	-
Demand deposits	8	-		
Time deposits	3	-		
Non-Deposit liabilities				
TL	-	-	-	8
Foreign Exchange	-	-	-	9
Banks in Turkey 1994, Banks Association of Turkey				

In 1994 total assets of Turkish banking, excluding the Central Bank, increased by 93% compared to previous year and reached 2,018 trillion TL at current prices but fell 28% in US dollar terms to $ 52,186 million. This increase was 107% for state owned banks, 81% for private national commercial banks, 55% for foreign owned banks, 55% for investment and development banks. However in USD terms the total assets is shrunk by 28% with respect to the previous year.

Total loans extended by banks fell by 31% to 20 billion US dollar. In addition loans as a percentage of total assets continued to decrease and declined from 42% to 39%. The decrease in the current assets was a striking change on the assets side. The sudden increases in interest and exchange rates caused a decrease in the value of securities during the crisis period. Nonperforming loans increased from 3% to 4%. The amount of total non-performing loans was 844 million US dollar while provisions were 468 million US dollar. The equity participation's decreased by 29% and fixed assets by 18%. The ratio of equity participation's to total assets remained almost unchanged around 1.7% and the ratio of fixed assets to total assets increased from 4.9% to 5.5%. The share of foreign currency assets in the total was up to 45% in 1994 from 38% in the previous year. The basic reason behind this was the intention of banks to limit their balance sheet risks due to short term uncertainties and sharp price fluctuations. As a matter of fact, at the beginning of 1994 the banking sector had a short position of 5 billion US dollars but they tried to close it during the year. As of the end of the year, total short positions came down to 860 million US dollar.

In 1994 total deposits declined by 13% to 33 billion US dollar. However reduction in balance sheet size was even greater than that and, therefore the share in total funds increased from 52% to 63%, whereas the share of non deposit liabilities decreased from 26% to 18%. The share of foreign exchange deposits to total deposits continued to increase and reached 52% from 39%. On the other hand the trend was in the favor of time deposits. The share of time deposits in total deposits rose from 70% to 73%, and TL deposits rose from 61 to 72%. Meanwhile the maturity structure of deposits concentrated on less than 6 months. In detail 12% of total time deposits had a maturity of 1 month, 36% a maturity of 3 months and 12% a maturity of 6 months. This caused an interest rate risk in addition to FX risk in the sector. During 94, non-deposit liabilities reduced by 53% and amounted to 9 billion USD due to mainly repayment of short-term external debt.

One of the most remarkable development in the liability side was the rapid decrease in shareholders equity, excluding 1994s net profit, total equity of the sector has reduced considerably. and the shareholders equity has reduced by 33% to $3.2 billion. Equity/Total assets ratio has reduced to 6.2% from 6.6%. Including the profit of 1994 total equity / total assets ratio has reduced down to 8.4% from 9.3% of the previous years ratio.

Total profit increased by only 17% in TL terms which compared to 150% inflation rate means a decrease of 53.2% with respect to the previous year. Also in dollar terms it decreased by 56% to reach $855 million. ROE dropped down to 34% from 55% and ROA decreased down to 2.2% from 3.4% of the previous year. The most significant factor contributing to poor profit performance in 1994 was the decrease in interest income which is the most important income item, and increase in interest expenditures. As a matter of fact, the interest income declined by 7% while interest expenditures increased by 3% in dollar terms. At the same time, the commissions and other income shrank in real terms and the foreign exchange losses continued to increase due to the rapid depreciation of TL.

Before the crisis in 1994, banks were maintaining large funds in government bonds and had large debts in foreign currency to increase profitability while exchange rates were kept under pressure for years, which resulted in deepening crisis when the interest rates rise and TL is devalued. However, in spite of the crisis, in 1994 The Turkish Banking Sector has paid net foreign debt of over $7 Billion.

Table 2 - Selected Balance Sheet Items of Turkish Banking Sector (billion $)

	89	90	91	92	93	94
Total Assets	45.795	56.725	56.739	62.214	70.835	52.186
FX assets	11.301	12.943	16.180	19.346	26.118	
Total Credit	19.329	26.420	24.527	26.067	28.549	20.416
FX credit	4.570	5.332	6.947	6.924	7.991	
Total Deposits	26.684	32.125	32.455	34.369	36.020	32.960
TL deposits	20.691	24.688	22.210	22.034	22.422	15.886
FX deposits	6.560	8.374	10.696	13.373	17.674	17.074
FX accounts	5.993	7.436	10.245	12.335	13.598	
Non-deposit funds	8.935	11.806	11.075	13.883	19.605	9.151
external credit	1.995	4.085	4.203	6.618	9.662	
FX funds	10.577	14.967	17.320	22.615	31.297	
Exchange position	724	-2.025	-1.140	-3.179	-4.964	-860
Equity	3.114	3.996	3.915	4.219	4.741	3.234
Profits	771	1.296	1.325	1.523	1.933	1.145

Banks Dialogue 93,94 (for years until 1994)
Banks in Turkey 1994 Banks Association of Turkey (1994 column)

Table 3. Comparison between 1993-1994 (amounts in million $)

	1994	% change
Total Assets	52.186	-28
Current Assets	20.498	-32
Loans	20.416	-32
Non-performing Loans	833	-10
Equity Particip.	905	-29
Fixed assets	2.882	-18
Other Assets	7.117	-2
FX position	-860	-82
Deposits	32.960	-13
TL	15.886	-30
FX Deposits	17.074	-15
Non Deposit Liab.	9.151	-52
Other Liab.	5.697	-34
Equity	3.234	-33
Interest Income	13.670	-7
Interest Expenses	9.083	3
Fees and Commissions	546	-21
FX profit (loss)	-1.887	13(loss)
Non interest Income	1.782	7
Non Interest Expense	3.999	-9
EBT	1.157	-51
Provisions for taxes	303	-22
Net profit	855	-56
Banks in 1994, Banks Association of Turkey		
Central Bank		

2.3. Foreign Banks

Financial liberalization in developing countries has been widely advocated during the past decade and financial sector deregulation has been a major element in the general shift towards a more open and market-orientated economic strategy adopted by many Third World countries in compliance with the conditionally attached to World Bank and IMF structural adjustment lending.

With the implementation of the financial liberalization programme in 80, previous restrictions on the entry of foreign banks were removed, and there was a significant increase in the number of foreign-owned banks in Turkey. The entry of foreign banks was expected to induce an improvement in the efficiency performance of the domestic banking sector.

At the end of 94 there were 20 foreign institutions operating in Turkey, their presence itself a mark of how things have changed in the financial sector, with the liberal economic policies. Foreign banks make up (20 / 67 = 30% as of the end of 94) almost one third of the total number of banks in Turkey - although their share of the market is still only about (60 trillion / 2.000 trillion in terms of total assets) 3%. Many prominent American and European names are there as well as smaller outfits, particularly from around the Middle East. Among 20, 9 of them are foreign capital banks established in Turkey, 11 of them are branches of multinational banks.As in many other developing countries, the foreign banks in Turkey have a small market share in total banking activities, and the percentage of total bank deposits and credits accounted by the foreign banks remain very low. (14 trillion / 789 trillion = 1.77% of total credits and 24 trillion / 1,275 trillion = 1.88% of deposits as of the end of 1994). The foreign banks appear to be more profitable than the local banks. (6.7 trillion / 44 trillion = 15% of net income as of 1994) This is largely due to a number of advantages that the foreign banks have over the domestic banks. For example, foreign banks have negligible bad debt since they only work with the multinational corporations and large domestic holding policies; they are exempt from local preferential lending policies; they have the flexibility of borrowing from the local market or international markets wherever the borrowing rate is lower (during the late 80s high domestic interest rates and low depreciation rate of the Turkish lira encouraged banks to borrow from abroad and lend in the domestic market. They have low operating costs due to small size of their networks and number of offices; and they have the advantages of having highly qualified staff and advanced technology. The chief cause of irritation is the lending limits foreign banks face because of the capital provisions they must comply with. A banks loan-book in Turkey cannot be more than two folds of its own funds. It cannot lend more than 10% of its equity to one company, or more than 25% in one transaction. These provisions are meant as a default protection. But as foreign bank branches have a relatively small capital base -and local laws don't take into account the guarantee of the parent bank overseas- foreign bankers complain that their lending ability is unnecessarily and unfairly restricted, especially as their main business is trade finance.

For foreign banks, there are increased opportunities in fee-generating areas, such as privatization issues and mergers & acquisitions as foreign investment increases and local businesses prepares to cope with the approaching single market within the EC (Argın, 1993 ; Gürlesel, 1993).

Table 4 - Productivity and profitability comparison of private and public commercial domestic banks

	public	private	foreign
Assets per worker	10840M	16550M	26086
credits per worker	4000	6283	6444
equity over assets	6.7	7.4	8.2
return on assets	0.67	2.99	11.1
Banks in Turkey 1994, Turkish Banks Association			

The establishment of foreign banks in Turkey required the permission of the Board of Ministers, according to banking Act 3182, articles 6,7,8,9, applicants are required to meet the following conditions in order to be eligible to open branch offices in Turkey;

- to have the status of an incorporated company,
- to bring into Turkey a minimum paid in capital
- to ensure that directors or deputy directors of the branch offices in Turkey are Turkish nationals or resident in Turkey and not have been barred from operation in their home country
- and if the country of origin of a foreign bank applies a rule that is resulting in a restriction or a

limitation then Turkish authorities may wish to apply the same restriction or limitation on activities of foreign banks in Turkey originating in the country of concern, even the permission of banking may be taken back.

In Turkey, the major objectives in exposing domestic banks to foreign competition were to increase the diversification and quality of domestic financial services and to increase the efficiency of financial intermediation of banks.

2.3.1. Modernization in the Banking Sector

In Turkey, the quality of banking services was low until 80s. This was due to the traditional and uncompetitive market structure of the sector. Less than 10% of the employees were university graduates, financial products were very limited, and the banking system was not computerized. From 1980 onwards this picture has changed. Liberalization of the sector and the entry of the foreign banks resulted in a substantial change in banking operations in a way that improved the speed and quality of financial services. Foreign banks and internationalization introduced new products and brought computerized banking system and market orientated management philosophy into the domestic banking sector. Banks in Turkey responded to these changes quickly by computerizing their operations and by becoming affiliated to the SWIFT (Society for worldwide Interbank Financial TeleCommunication) Network; and by introducing new financial products such as consumer credits, credit cards, leasing, and factoring (Erdem, 1993). The following indications of modern management methods have been widely adopted as a result of the foreign banks presence in the market and internationalization. These changes can be summarized in three broad groups : Planning, Credit evaluation and marketing; and recruitment.

2.3.1.1. Planning

Until recently, there was no formal budgeting and planning and heavy reliance was placed on on-the-spot decision making process. The projection of the forthcoming year's performance based on past recorded accounting results, appears to have been the main management tool in banking until the 80s. However, the use of the various budgeting and planning techniques by foreign banks in Turkey encouraged domestic banks to adopt modern planning techniques, budgeting, financial analysis and modern management information tools in order to evaluate their performance.

2.3.1.2. Credit Evaluation and marketing

During the pre-80 period in Turkey, decision makers relied mainly on information obtained from their personal knowledge and on the information provided by the intelligence units on the reputation of the borrower and previous experiences with the borrower, instead of actively searching for information and conducting financial analysis about their potential borrowers. Again, the challenge created by foreign banks induced traditional Turkish banks to reorganize their structure and adopt more sophisticated methods in credit evaluation. Banks became aware of the importance of accurate and reliable information in their lending. Therefore, for the first time they adopted a systematic approach to gather information. Furthermore, it is seen that the lending criteria of banks has changed significantly. For the pre-80 period the most important lending criterion were the reputation of the firm, prior relationship with the firm and capital structure of the firm in the order of importance. This ranking changed to structure of the firm, riskiness of the sector that the potential borrowers are operating in, and finally the productivity of the firm in the order of importance. These changes indicate a significant improvement in banks credit evaluation and hence credit allocation since the financial position, riskiness and the productivity of the borrowers are taken into account.

On the other hand, foreign banks brought new marketing strategies into domestic market. Traditional Turkish banking was based on collecting deposits with a profit margin to the borrowers who were actively searching loans from banks. However, foreign banks introduced the practice of marketing strategies and first established their marketing departments. Therefore, domestic banks were stimulated to develop their own marketing strategies by employing young professionals, conducting market research and identifying a number of well established firms as their potential clients. Before financial liberalization there was also a heavy reliance on central decision making at the head office whereas branch offices were merely acting passively. However, it appears that domestic banks have begun to move their marketing activities from head offices to branch offices, making the branch managers more aware of their responsibilities.

2.3.1.3. Recruitment

The impact of foreign banks on domestic banking has also been felt in banks recruitment strategies. The banks began to employ the best university graduates who speak foreign languages with attractive salaries. Therefore, a striking trend that appears in the employment statistics is the shift towards university graduates where the ratio of employees in the banking sector with university or further education doubled from around 10% in 80 to 20% in 89, to 27% in 1994.

These developments in planning, credit evaluation, marketing and recruitment indicate that not only advanced technology and new products but also a market-oriented management philosophy were adopted by Turkish banking. Thus the necessary conditions for an improvement in the efficiency and quality of banking services in Turkey were put in place during the post-liberalization period. These changes also positively affected efficiency in credit allocation since banks began to undertake market research and to collect systematic information about potential borrowers.

2.3.2. Efficiency In Financial Intermediation : Effect of liberalization & foreign banks

There are a number of different concepts of efficiency which can be used to evaluate the financial system. From the perspective of economic growth and development, functional efficiency in financial intermediation is considered. In general, functional efficiency is measured by the cost and profit margins of financial institutions. A high financial intermediation cost refers to a wider spread between net return to savers and gross cost to borrowers. This indicates an inefficiency in financial intermediation, because high intermediation costs reduce the amount of resource mobilization through the financial sector. In addition to intermediation cost, high profit margins of financial institutions indicate a wider spread between borrowing and landing rates which unnecessarily increases the cost of borrowing and discourages investment. (Also the taxes applied on borrowed funds decreases the efficiency of financial intermediation as there is 5% tax over the loans and 6% additional funds over taxes.)

According to the McKinnon-Show financial liberalization theories, in financially repressed countries where foreign bank entry is forbidden, the market structure is uncompetitive and financial institutions operate inefficiently with high costs and profits (Tezer, 1992). However, under perfect competition there would be no monopoly in the banking sector. Therefore, it is argued that exposing banks to foreign competition will decrease the concentration ratio of domestic banks and reduce their excess profits and costs. Empirical research has shown that banks in countries that excluded foreign banks tend to have higher gross earnings, higher operating costs and higher profit margins, as percentage of their total assets.

However in the case of Turkey, empirical results suggest that these benefits have not been realized. The cost efficiency of domestic commercial banks did not improve in the post-liberalization period. At the same time, profitability increased. These findings suggest that the domestic firms were able to capture the productivity gains, which arose from the adoption of new technology and practices introduced by the foreign banks in the form of increased profits. In the absence of effective competition, the domestic banks were not pressured into improving their cost-efficiency performance.

These results are consistent with the economic reasoning relating to deregulation and competition policy. The entry of foreign firms is unlikely to have a significant impact on the economic performance of domestic institutions. If the market remains oligopolistic and segmented. The foreign banks activities were restricted and limits placed on the number of branches they could open. Consequently, the foreign banks accounted for a small share of banking transactions, and the existing oligopolistic and highly concentrated market structure was largely unaffected.

To study the impact of foreign bank operations on the efficiency of financial intermediation in Turkey, the gross margin, operating expenses and net margins of private commercial banks for the pre and post 1980 periods are compared (Tezer, 1992). Private commercial banks are selected in order to eliminate the effect of preferential loans extended by development banks and state commercial banks.

Table 5 - Consolidated income accounts of domestic private commercial banks in Turkey, 1970-1989 as % to total assets

	70	71	72	73	74	75	76	77	78	79
Interest Income	6.2	6.7	6.8	6.6	6.8	7.2	7.5	6.9	6.7	7.2
Interest expense	2.7	3.1	3.3	3.0	3.1	3.4	3.6	3.5	3.4	4.0
interest margin	3.5	3.6	3.4	3.6	3.7	3.8	3.8	3.5	3.4	3.1
other income	6.0	2.5	2.6	2.4	2.4	2.6	2.4	2.7	2.9	3.2
gross margin	9.5	6.0	6.0	5.9	6.1	6.4	6.3	6.2	6.3	6.3
operating cost	4.6	4.8	4.67	4.7	4.9	5.1	5.0	5.3	5.5	6.0
net margin	4.9	1.2	1.5	1.3	1.2	1.3	1.3	1.0	0.8	0.4

	80	81	82	83	84	85	86	87	88	89
Interest Income	11.4	17.0	18.9	18.4	23.4	24	23	20	22	23
Interest expense	5.2	13.4	18.4	17.1	20.7	22	20	15	17	20
interest margin	5.2	3.6	0.6	1.4	2.7	2.0	2.5	4.7	4.9	2.7
other income	4.6	5.2	6.5	5.2	5.4	6.4	5.1	4.1	5.0	3.8
gross margin	9.9	8.8	7.2	6.6	8	8.3	7.8	8.8	9.9	6.5
operating cost	8.6	6.7	5.6	4.9	5.0	5.7	5.0	4.6	6.1	6.0
net margin	1.3	2.1	1.6	1.6	3.0	2.7	2.6	4.2	3.8	0.5

Source : Publications of Banks Association of Turkey

It is seen that the pre-1980 period domestic private commercial banks' operating costs, gross earning margins, and profit margins were almost constant as a proportion of their average total assets, at around 6%, 5% and 1% respectively. On the other hand, during the post-1980 period domestic private commercial banks' cost and profit margins have fluctuated sharply through 1980-1989. Also note that, during this period cost and profit margins never fell to the 1970-1979 levels.

Taking the simple arithmetical averages for each period separately, we find that the operating cost, on average, rose from 5.04% to 5.82% of total average assets in the pre-liberalization period. However, the mean difference of the operating cost between these two periods is not statistically significant at 95% significance level although it is close to be significant. This result indicates that the operating costs of domestic banks in Turkey are still at the same levels of the pre-1980 period, which is substantially higher than the operating cost ratio of the banks in OECD countries -that for the OECD group countries, operating cost is calculated as 2.8% of total assets in 1977, and 2.3% of total assets during the period 1977-1981. In contrast, the average profit margin rose from 0.86% in the pre-1989 period to 2.04% in the post-1980 period, the average gross margin rose from 6.50% to 8.15% and the average net margin rose from 1.49 to 2.28% during the same period.. Except for the average net margin, the mean differences of these figures are all statistically significant, indicating an increase in the profit margins of domestic banks in Turkey in the post-liberalization period. In other words, larger proportions of financial assets were captured as profits by the banking sector. This is contrary to the expectation that foreign bank entry would increase competition and eliminate monopolistic profits. Evidence in support of this argument is presented above for Turkey, which demonstrates that the foreign bank entry did not significantly reduce the concentration ratio of the domestic banking sector. The share of the three largest commercial banks in total deposits remained above 50% until 1988 (40% in 1994), this ratio is even higher for the private domestic commercial banks as it remained above 70% until 1987(47% in 1994). These findings show that, in Turkey, the impact of foreign bank entry on the domestic banking structure was negligible with regard to the market structure and efficiency. Turkish banking has maintained its oligopolistic make-up, wherein nine large banks control 72% of total assets, 75% of all deposits, 62% of all credits and enjoy 66% of all profits as of the end of 1994.

2.4. Structural Problems in the Economy that is facing the banks

Main problems which the banking sector is facing are the instability of the national economy, high input costs, unfair competition, inadequacies in the legal infrastructure vis a vis new products and techniques in banking. Even tough free market mechanisms have been activated and considerable advances have been made by the Turkish economy towards opening up to the world outside, stable growth and development have not been attained. Widening gap in public deficits and chronically high inflation rates have had the effect of increasing interest rate and exchange rate risks.

Today, Turkey is experiencing an excessive demand for money, originating from SEEs borrowing requirements which result in chronic public sector deficits (Gürlesel, 1993). Total supply of funds has failed to grow as a result of input costs. Restricting public investment based on the public deficit can only be successful if private sector investments are strongly supported and encouraged in order to counter high population growth trends in the country. However, the Turkish financial sector offers only very little in terms of medium to long term investment loans with payment structures which are in line with the cash generating capacities of such projects. These types of investment loans are essential in private sector investments and has to grow. Even tough the Central Bank has ceased to meet such needs by its previously popular rediscount credit facilities after 1989 this facility has not been instituted enough since that time. Due to increasing public deficit, government bonds are issued and put on the market with ever increasing volume and speed and a high interest rate response by banks become inevitable due to the lack of depth and width in financial markets. Public debt stock reached $25 billion of domestic funds and $65 billion of foreign funds as of the end of 1994(the Undersecretary of Treasury).

State banks in Turkey used to be synonymous with crippling portfolios of bad debts, tangled balance sheets and political complications (Berksoy, 1994). Since the mid 80s, that image has changed to some extent, but serious deficiencies remain particularly in non-performing loans.

The eight commercial state banks still account for more than 50% of the business volume in the banking industry, as of the end of 1994 extending 380 trillion out of the total 789 trillion credits (48%), however they accounted for 9.9 trillion out of the total 14.1 trillion (70% as of 94) in non-performing loans in the banking system. Most of the state banks problems have come from non-cash credits in the form of commitments or guarantees to rescue operations or otherwise. Non-cash credits carry negligible commissions, so defaults has negatively affected assets too.

Because all deposits are subjected to various compulsory reserve requirements and indirect taxes which in practice were to leave only 50% of the funds collected free for the bank to use in placements creates an appreciable gap between the deposit interest rates and the actual cost of the fund of the bank, the latter being far bigger. While reserve requirements are meant to regulate and stabilize the market, these have been lately employed to meet the ever increasing financial need of the government. The pressures exerted by the public sector in this fashion can only be alleviated if reserve requirements are reduced to EC levels. (In 1994 the reserve requirements were reduced and liquidity requirements were abolished). The requirements on deposits should be considered together with the inflation rate to find the cost of the requirements as it reduces the purchasing power of the money deposited in the central bank without interest.

Table 6 - Reserve requirements on term deposits and inflation rates (1991)

Country	%reserve req.	%inflation
Belgium	0	2,8
Denmark	0	2,3
Germany	6-12	4,2
Greece	7.5	17,8
Spain	18.5	5,5
France	5-0	3,1
Ireland	10	-
Italy	25	-
Luxemburg	0	2,6
Holland	0	4,9
Portugal	15	9,6
United Kingdom	0.5	4,5
Turkey	7.5 (1995=8)	65 (Dec94=149,6)

Can Fuat Gurlesel, 1993, Turkish Banks Association Publications The internal market and Turkish Banking Sector, problems and proposals for solutions

2.4.1. Inflation

High inflation poses several threats to banking. That, which appears as nominal increases in profits may in reality be reductions and shrinkages (Çilli, 1994). Net worth may be reduced in real terms. Inflationary conditions, increase the cost of loans, reduces the possibility of finding low-risk placements. Problematic credits increase in numbers, nonperforming loans and defaults hamper liquidity and increase the cost of resources.

Inflation effects the sector directly and reduces the competence of the sector as it depreciates the purchasing power of the assets. Banks preferred to move the assets and liabilities to be denominated in foreign exchange to prevent from the inflation which introduced the exchange rate risk. Secondly against inflation the banks reduced the maturities of credits which finally with fluctuating exchange rates (following the inflation) resulted in spot credits.

Secondly there is the interest rate risk as it is accepted that the nominal interest rate is composed of inflation expectations and real exchange rates proposed. As inflation rate is uncertain and high there is the interest rate risk exposed on the time difference between the loans and deposits. Banks make use of hedging techniques, planning and mainly and actually reducing the terms of credits to cope with this. (The interest rate expenses / total expenses for 1991,92,93 was 52.3, 57.6, 59.0% respectively but in 1994 this ratio has reduced to 38% by the crisis)

Third effect of inflation is in the increasing cost of unused TL funds in the operating costs of the banks. Banks if they do not put reserves for needed funds (which are unused for some time) need to borrow at very high rates in the interbank market increasing the short term interest rate fluctuations in the interbank market and decreasing the smooth operations of the markets.

Also the inflation clears the profits and reduces the equity as the profitability of the banks remain below the inflation levels (Erk, Füsinoğlu and Çabuk, 1990).

2.4.2. Capital Adequacy Issues

Capital strength is a sensitive topic among many Turkish banks. 15 years ago, when the Treasury imposed capital adequacy requirements for the first time in Turkey, some banks struggled for more than two years before they could reach the targets laid down. Even so the sector lags behind international banking norms and much of the new capital coming into the sector has gone not to existing banks but to new enterprises.

A variety of factors lies behind the situation. Most company owners in Turkey, including bankers, have until recently generally preferred the cream-off profits from their banks for immediate use rather than plough-back funds. Several of the best-known banks are linked to industrial groups which continue to use them (despite legislation imposing strict ceilings on intergroup lending) to transfer funds into other subsidiaries.

In a consistently inflationary environment, banks have also been tempted to keep their capital in real estate, which consistently keeps ahead of inflation, rather than risk holding it in liquid form. It is also arguable that the high levels of required reserves before 1994 which the commercial banks forced to deposit with the Central Bank, impose an obvious brake on their profitability and reduce their ability to recapitalise themselves.

Equity stakes in industrial ventures, another popular way of holding capital, has more risks than real estate. It was to cope with this situation, that in Nov 89, the Treasury issued a long-awaited Communique on Capital Adequacy, laying down targets for the years between 89 and 92. By the end of 89, all Turkish banks had to have a risk/asset ratio along BIS of 5.5%. This was 2.5% below the internationally agreed minimum laid down by BIS. In the following years the ratio was to be increased step by step. And currently the ratio that should be maintained under the Basle definition is 8% which is totally compliant with the community standards.

Considering Total Equity / Total Assets ratio without risk adjustments, for example, for Tütüncüler Bankası the ratio is 3.2% as of 1994, most of the banks are between 6% and 7% as of 1994 according to the information collected from the Bank Dialogue Turkey and the Banks Association of Turkey.

The revaluation funds as they imply non-cash increases in equity portion of the balance sheets, by increasing the total amount of resources that can be lent increases the risk of the banks as they do not imply a debt paying capability. Together these items created capital inadequacy problems for the banks. As the percent of revaluation funds to equity increases the long term debt paying capability and reliability of the banks will vanish. (revaluation fund / equity as of the end of 1994 is 30%). If this 30% is excluded, the remaining funds of $2.67 billion appear drastically inadequate against $52.186 billion total assets and $16 billion non-cash liabilities and obligations. Therefore, equity funds have to be reinforced and strengthened, profit distribution policies reviewed and paid in capital increased by means of fresh cash injections.

3. The harmonization process in the EC banking sector

3.1. *The EEC Treaty of Rome and the Banking Sector (1957)*

The treaty sets out to create a single Community wide market based on the principle of freedom of movement for goods, persons, services and capital. Freedom of movement of individuals basically means that nationals of a member State and by extension, companies registered in that member state are entitled to take up end pursue an occupation or business activities in other member states. Freedom of movement for services entitles individuals, companies or firms to provide services in a member state other than the one in which they are established.

Both of these freedoms affect the service sector in that persons may provide services in a member state other than their own either directly or through branches or subsidiaries.

Although a customs union was soon established (1 July 1968), many administrative barriers which limited freedom to provide services and freedom of establishment still remained in place as a result of national regulations governing the banking, insurance, transport and the professions or as a result of more general measures dealing for example with capital movements, standards, public contracts and frontier formalities.

The EEC Treaty of Rome doesn't contain a specific EEC sectorial policy for banks as, for example, for agriculture and transport. Policies in the banking sector must comply with the general principles of the Treaty which are; free movement of goods, persons, services and capital, and must respect general rules stemming from horizontal policies such as competition policy, economic policy, social or taxation policies.

However, some provisions of the Treaty are crucially important in achieving the objective of a "Common Market" in the banking sector as in particular the rights on the basic freedoms; the freedom to establish, to provide services and the free flow of capital movements. These freedoms form part of the Treaty's Second part on the foundations of the community. There are two types of rules; those abolishing any restrictions based on nationality or location on the one hand, and those defining certain objectives and indicating the communitarian means to implement these objectives on the other hand.

The first set of rules in the articles 52,59, 60 of the EEC Treaty provide that there is no discrimination of natural and legal persons within the EEC. These provisions are in accordance with the decisions of the European Court of Justice directly applicable throughout the whole community. This implies in the banking sector that all credit institutions from a member State which exercise banking activities in another member state could not be subject to stricter rules or conditions other than those imposed on credit institutions of the latter member state.

These are personal rights for which legal proceedings may be taken before the court. The only exceptions mentioned in the articles 55 and 56 concern public order and public interest and there is a very restrictive interpretation given by the Court. **In conclusion, in the case Turkey would become a full EC member, already the EEC treaty of 1957 provided for that banks from other member states has to be accepted under the same conditions as Turkish banks.**

The second set of rules under articles 52 to 73 of the Treaty defines certain objectives like the objective to ease persons to take up and pursue activities as self employed persons, and these articles confer on Community institutions the competence to adopt Community measures in order to achieve these objectives. Typical examples are the articles 54 to 57 on which all harmonization measures of the Community in the banking sector are based.

There are only two places in the Treaty in which the banks have got explicit consideration and mentioning :

- Article 61 states that the liberalization of banking services is to be done step by step with the liberalization of capital movements.

- Article 57 states that the coordination of national laws, regulations and administrative provisions at Community level should be decided by unanimity of the member states in banking sector.

3.2. EC banking law harmonization until the Mid 80s

It was not before ten years after the signature of the EEC treaty in 68 that a group of highly qualified experts from the original signatory member states started to elaborate a comparative study on the legal systems in banking in the 6 member states. This led to the drafting proposal for a directive in the early 70s which was supposed to become the future EEC banking Act. It dealt in a very comprehensive way with all the important aspects and problems on the banking legislation and prudential supervision.

However, this proposal failed to be accepted by the member states in particular the new ones - Denmark, Ireland and UK-. The EEC provisions were too far reaching countries like the UK which had barely any banking legislation.

After this failure with a comprehensive EEC banking Act, it was necessary to proceed step by step and to propose the bits and pieces of the comprehensive approach. It was only in 1977 that the so called "First Banking Coordination Directive" was decided, which was the First Council Directive of 12 DEC 77 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions which still is a very important piece of legislation for the EC banking sector.

There was the first harmonization of basic licensing requirements in the first banking coordination directive which apply to all EC credit institutions. These comprise

- The need to possess separate and adequate minimum own funds
- that there are at least two persons in each credit institutions who effectively direct the business and who have a good reputation and are sufficiently experienced to perform duties
- a programme of operations setting out the types of business envisaged and the structural organization of the credit institutions.

These basic licensing criteria sound very simple and evident, but several member states had none at that time.

A very important feature of the directive was that national authorities could no longer reject the authorization of a bank with the argument that there is no economic need for further credit institutions. Wide discretionary powers which certain banking supervisory authorities exercised for the licensing of banks, notably those coming from other member states had been eliminated thereby.

The First Directive contained only rudimentary attempts for rules regarding the supervision of the pursuit of the banking business. It provided for the calculation of observation ratios with a view to monitor solvency and liquidity of EC credit institutions in order to ensure that savings were protected. **As a consequence already since 1980 the Community had started to calculate and examine on a trial basis three types of ratios in order to monitor the ratio of solvency, the liquidity and the profitability of the EC credit companies.**

A further improvement of the first council directive on banking activity of 77 was the establishment of an EC banking Advisory Committee which is composed of high ranking representatives from the banking supervisory authorities in member states to assist the Commission in the preparation of new proposals in the banking field and ensuring proper implementation of community legislation.

Although the 77 Directive proposed the fundamental principle of home country control as an ultimate objective, it was only in 83 that this concept was further developed by requiring the home supervisory authorities to be ultimately responsible for the operations of a credit institution's subsidiaries throughout the community. The ultimate aim of this 83 directive on supervision on a consolidated basis was to establish the principle and to enable the supervisory authorities of a parent bank to get a basis for a sound overall judgment on the financial situation of that parent and the group altogether.

3.3. White Paper (1985)

The costs and disadvantages associated with the existence of separate national markets were being perpetuated by the remaining internal obstacles to trade. The commission published a White Paper on completing the internal market which listed 282 proposals for laws together with a timetable for their implementation. The White Paper was approved by the Heads of the State or government. One of the innovations of the White Paper was the emphasis (15% of the measures proposed) placed on liberalizing the provision of services on the basis of mutual recognition of national regulations following on from the prior harmonization of basic principles where necessary.

Single European Act (1 July 1987) amended the EEC treaty, confirmed that the objective of completing an area without frontiers by 92 and the timetable set out in 85 White Paper (Yuceer, 1989). It adapted the Community's decision making procedures and increased the scope for qualified majority (as opposed to unanimous) voting in the Council. It has facilitated adoption of the measures envisaged in the White Paper.

According to the Cecchini Report, the economic advantages of the single market legalized by the Single European Act estimates 200 Billion ECU savings and an employment opportunity for 5 million new employees. Price Waterhouse expects conditionally 11 to 33 Billion in ECU savings for customers from the unification of the financial market and the creation of the European Financial Area due to reduced prices by the competition.

3.4. Freedom To Provide Banking Services : Second Directive

In order to ensure freedom of establishment for and freedom to provide banking services with a view to establishment of a single market and to achieve mutual recognition of authorizations for credit institutions and of prudential rules in order to pave the way for the granting of a single banking license recognized throughout the community and for the application of the principle of consolidated supervision by the member state of origin, the 2nd Council directive 89/646/EEC of 15 DEC 89 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of credit institutions and amending directive 77/780/EEC entered into force.

The contents of the 2nd directive are:

- Definitions of the terms "credit institution", "authorisation","branch","qualifying holding", "subsidiary", "solvency ratio" etc.

- The competent authorities may not grant authorization where initial capital is less than ECU 5 Million. However, member states are free to grant authorization to particular categories of credit institution (co-operatives, building societies etc.) whose initial capital is not less than ECU 1M.

- The competent authorities may not grant authorization for the taking-up of the business of credit institutions until they have been informed of the identities of the shareholders or members that have qualifying holdings and of the amounts of those holdings. They must refuse authorization if they are not satisfied as to the suitability of the mentioned shareholders or members.

- **Introduction of a single banking license.** This will allow a branch of an institution authorized in another member state to be opened without authorization from the host member state and the need for separate endowment capital.

- There must be prior consultation between the local authorities and the authorities of the country of origin on the authorization of a credit institution which is a subsidiary of a credit institution authorized in another member state or as a subsidiary of the parent undertaking of a credit institution authorized in another member state or controlled by the same persons, whether natural or legal.

3.4.1. Relations with Third countries

a. Member states are to inform the Commission of any authorization they grant to a direct or indirect subsidiary of a parent undertaking which is governed by the laws of a third country and of any holding acquired by such a parent undertaking in a community credit institution such that the latter would become its subsidiary

b. member states are to inform the commission of any general difficulties encountered by their credit institutions in establishing themselves or carrying banking activities in a third country; the commission is to draw up periodically a report examining the treatment accorded to community credit institutions in third countries and to transmit it to the council;

c. where the commission find that a third country is not granting community credit institutions effective market access comparable to that granted by the community to credit institutions from that third country, it may ask the Council for the appropriate mandate for negotiation with a view to obtaining comparable competitive opportunities for community credit institutions.

- harmonization of the conditions relating to the pursuit of banking activities, maintenance of initial capital, control powers in respect of the acquisition of qualifying holdings in credit institutions, existence of sound administrative and accounting procedures and adequate internal control mechanisms.

- prohibition on credit institutions investing more than 15% of their own funds in an undertaking which is neither a credit institution nor a financial institution nor an undertaking carrying on an activity which is an extension of, or ancillary to, banking. Prohibition on such investments cumulatively exceeding 60% of a credit institutions with holdings exceeding the limits on the date of entry into force of the directive have 10 years from that date in which to reduce those holdings.

- requirement that credit companies have a fixed establishment in the host country, introduction of the principle of the home country control.

- allocation of supervisory functions between home country and host country authorities. The home country has responsibility for overall solvency while the host country supervises liquidity if branches on its territory. Exchanges of information and coordination in cases where the institution ceases to comply with one of the authorization conditions.

- the directive requires that credit institutions have a fixed establishment in the host countries and lists the core banking activities which can be performed in any member state through branches or direct services.

The services are,

- current checking A/C's
- retail deposits
- money market deposits / loans
- eurocurrency deposits
- offshore banking
- foreign exchange
- traveler's cheques
- hire purchase / consumer finance
- credit cards
- house mortgage
- factories, export credits
- leasing

- venture capital
- business loans
- international renting
- investment in stock market
- loan guarantee
- investment and corporate advice
- life insurance
- accident insurance - motor
- employers liability
- reinsurance
- investment fund management
- unit trust management
- pension services
- securities underwriting etc.
- securities broking
- money broking
- bullion and commodity trading

In summary, The single market has been a reality in banking since 1 Jan 93, when the second banking directive entered into force (European Comission, 1994). This directive confirms the principle of the single license allowing banks and other credit institutions to offer services throughout the community and establishes a list of the banking services that can be provided on the basis of such a license. It also lays down the minimum capital required for establishing a bank and rules on the supervision of internal management and the auditing of accounts.

The main characteristics of the single market in banking are,

- essential harmonization in all member states of the laws and practices governing access to banking activity, the capital required to cover both credit and market risks, the solvency ratio, the prevention of overlending to individual borrowers, the form and content of the annual and consolidated accounts published by banks, and the obligation to observe the various requirements of banking supervision on a consolidated basis;

- home-country control through coordination between national supervisory authorities, authorities in the country in which it has its registered office;

- mutual recognition by the national supervisory authorities of the rules and regulations in the countries of origin of the banks operating in their territory;

The granting of licenses to subsidiaries of banks with registered offices outside the community, will, in principle, be left to the discretion of the member state concerned within the framework of the international agreements entered into by the community. However, member states may be required to suspend authorization in respect of subsidiaries set up by banks with registered offices in countries which do not grant national treatment or effective market access to community banks wishing to establish themselves on their territory. Such suspension is intended to enable the Commission to negotiate an agreement with the third country concerned on the removal of the obstacles in question. However, once authorized, a subsidiary of a bank with its registered office in a third country will enjoy the same rights within the community as have been granted to Community banks.

To ensure that all banks and other credit institutions in the Community can compete on an equal footing and to prevent registered offices being transferred to countries where supervision is less strict, the measures supplementing the 2nd directive detailed below have been adopted.

3.4.2. Annual Accounts of banks and other financial institutions

In order to harmonize the format and the contents of the annual accounts of banks and other financial institutions 86/635/EEC of 8 DEC 86 on the annual accounts and consolidated accounts of banks and other financial institutions came into effect, and its entry into force with the latest date for banks is determined as the financial year beginning on 1 Jan 93 .

3.4.3. Large Exposures

Recommendation 87/62 counsels the monitoring and control of "large exposure". This occurs where a large proportion of the loans of a bank is committed to a single client or a group of related clients. Large exposure means 15% or more of own funds.

3.4.4. Deposit Guarantee Scheme

Recommendation 87/63 lays down harmonized minimum requirements for deposit guarantee schemes by all member states to provide protection of the depositor in the event of the credit institution becoming bankrupt. Recommendation 90/109 suggests transparency of banking conditions in cross border financial transactions.

3.4.5. Mortgage Credits

There are also recommendations on Mortgage Credits (to remove obstacles to the provision of such credit and to improve the cooperation between supervising authorities in member states) and on winding-up of credit institutions with the object of establishing mutual recognition of the national systems in this field, on consumer credits, electronic payments (87/598) and banking transactions.

3.4.6. Accounting documents of branches of foreign credit and financial institutions

In order to remove the need for branches of foreign banks and other financial institutions having their head office in another member state or in a non-member country to publish separate annual accounts, so that they are treated in the same way as branches of domestic financial institutions, the Council directive 89/117/EEC of 13 Feb. 89 on the obligations of branches established in a member state of credit institutions and financial institutions having their head offices outside that member state regarding the publication of annual accounting documents, came into effect beginning 1 Jan 93. The directive applies to all EC branches of banks and other financial institutions which had their head offices outside a member state where the branch is established. The directive abolishes present requirements of members to publish separate branch accounts at that time. The annual accounts, consolidated accounts, annual report etc. must be published and audited as required by the law of the member state in which the head office is located. The same applies for companies having their head offices in a non-member country.

3.4.7. Own Funds

The size of equity is an important criterion for the regulatory authorities in calculating the solvency of credit institutions and other prudential measures. Standardization of these calculations throughout the community is essential for mutual recognition of home-country control. The Council directive 89/229/EEC of 17 APR 89 lays down the common standards. It divides the own funds into core capital and supplementary capital like revaluation reserves, securities of indeterminate duration, hidden reserves etc. which can not exceed 100% of the core capital. Core capital includes common stock valued at par, perpetual preferred stock, surplus, minority interest in consolidated subsidiaries and retained earnings minus treasury stock and goodwill. Supplemental capital includes limited life preferred stock and related surplus, loan-loss reserves, perpetual debt, mandatory convertible securities and subordinated debt with an original maturity of not less than 5 years. Again member countries are free to apply stricker rules.

3.4.8. Solvency Ratios

In order to contribute to the harmonization of prudential supervision and to strengthen solvency standards among the community credit institutions, thereby protecting both depositors and investors as well as maintaining banking stability, the council directive 89/647/EEC of 18 DEC 89 on a solvency ratio for credit institutions came into effect. Solvency ratio is considered as the indicator of capital adequacy against the risk undertook by the banks. The ratio proposed by the commission applies to credit institutions defined in directive 77/780/EEC. The own funds of each credit institution are expressed as a proportion of the risk adjusted value of its assets and off-balance-sheet items. Weighting vary from 0% for such low risk items as claims on EC member state's central governments and central banks to 100% for such high risk items as those representing claims on the non-bank sector. Off balance sheet items are assigned credit conversion factors and before being multiplied by the risk weight they are multiplied by this factor and added to the risk weighted assets. The effective weight is the product of the credit conversion factor and the risk weight. The prescribed minimum ratio for own funds / risk adjusted assets, is 8% and this limit may be increased by the member states for their countries. After 1 Jan 93, credit institutions will be required to maintain **at all times** a ratio of at least 8%.

3.4.9. Money Laundering

In order to eliminate the dangers associated with the laundering of the proceeds of criminal activities, the council directive 91/308/EEC of 10 June 91 in prevention of use of the financial system for the purpose of money laundering came into effect. According to the directive, credit and financial institutions must require identification of all their customers by means of supporting evidence not only for opening accounts, even for any transaction involving a sum amounting to ECU 15000 or more.

3.5. *The effect on the Turkish Banking System from the legal perspective*

The legal principles which govern the banking system in Turkey are based upon the Banking Code 3182 which was passed in its most recent form on 25 APR 85 and went into effect on 2 May 85. Foreign banks established abroad which are present or intend to be engaged in activities in Turkey by means of opening branches are also subject to the provisions of this Code. A comparison of the Turkish law with the relevant EC directives reveals the following similarities and differences.

Article 51 of Law 3182 provides that, banks are required to make use of a Uniform Statement of Account and standard balance sheets and profit and loss statements prepared by Turkish Banks Association put into effect on Jan 1 87 pursuant to Provisional Article 7 of the banking Law and confirmed by the undersecretary of the treasury and foreign trade.

Article 54 also states that, Banks have to submit their balance sheets and income statements confirmed by the auditors together with the audit reports to the undersecretary of the treasury and foreign trade, the ministry of industry and the central bank of the Turkish republic within one month since the date of the board of directors meeting. Balance sheets must be published in the Official Gazette and also in a national newspaper.

Article 56 provides that banks have to prepare summaries of quarterly accounts in accordance with the principles and specimen determined by the undersecretary of the treasury and foreign trade by the end of the months March, June, September and December. Quarterly account summaries are sent to the ministry of industry and commerce and to the central bank.

Thus the Turkish Banks Association and the Undersecretary of the Treasury and Foreign Trade are able to fulfill the requirements of EC directives 86/635 by using the powers laid down in the above provisions.

The equity capital of banks in Turkey is defined in Article 3 of Law 3182. It states that the equity capital is the sum of the paid-in capital and capital set aside as reserve. The concept of paid-in-capital and the reserved funds are defined in the 6th and 7th paragraphs of the same Article. Accordingly "the paid in capital is equal to the amount remaining after subtracting the capital set aside for the branches outside Turkey and the loss stated in the balance sheet and not compensated by the reserve funds". In consequence the definition of the equity capital in Turkish Law should be changed completely and adapted to the EC standards.

There are very significant differences between the basic principles of the 2nd Banking Directive and the Turkish Laws. For that reason it will be unavoidable to change the Turkish banking Laws in the case of becoming a member of the EC.

According to the EC Directive, subject to certain exceptions, the foundation capital of a bank must be minimum 5 million ECU and the equity capital during its operations must not be below this amount. In Turkey the capital required for the establishment of a bank excluding the capital reserved for each branch other than the headquarters may be increased under the Article 78 of Law 3182 without any necessity for a change in the Law.

However, the rule which says the capital during the bank's operations cannot fall below the foundation capital must be added to Turkish Laws thus Law 3182 must be amended by Turkish Parliament.

According to the current Turkish Banking Law (Article 38 and subsequent of Law 3182) the solvency of the banks is protected by determining certain ratios between the cash loans that the banks can give, bonds and similar assets that they can buy, the letters of credit that they can give, the total loans that they can provide to their clients, the funds that they can invest in real estates and the bank's equity capital (Treasury, 1995). Article 56(3) of Law 3182, states that "the Undersecretary of the Treasury and Foreign Trade has the authority to determine the solvency ratios in relation to the financial status and use of the capital, and to determine the methods and principles for the publication of those ratios as required. Banks have to keep up with the determined ratios. Depending on this Article, the Undersecretary of the Treasury and Foreign Trade has determined the method of calculating the solvency ratio (capital base/risk weighted ratio) by the official bulletin no.6 and decided this ratio to be 8%. The solvency ratio determined above does not correspond to the EC Directive. However by the official bulletin no 8 (1 APR 93) of the Treasury, the capital nominator and risk weighted assets denominator of the Basle ratio is accepted as it is in calculating the capital adequacy ratio for the banks operating in Turkey and harmonization with EC in that respect in completed.

Article 50 provides that banks are not permitted to trade in real estate for commercial gain. They may not acquire immovable properties in any way other than those they need in order to conduct their banking activities and which comply with decisions adopted by the Turkish Central Bank in this regard.

There are significant differences between the EC Directive and the current Turkish Laws and, the laws and regulations governing the re-organization and the liquidation of credit institutions. However certain steps has been taken on these issues.

The merger of a bank with one or more banks and the take over of a bank's obligations, claims and the deposits by another bank engaged in activities in Turkey are subject to the permission of the Ministry of Industry and Commerce.

Articles 70-72 state that the banks that wish to wind up their activities are obliged to publish this in at least two newspapers printed and circulating throughout Turkey, to provide written notification to all their depositors and other creditors of this fact, and to return any and all outstanding account balances and borrowings within two months. All claims whose owner's cannot be found are turned over to the Central Bank of the Republic of Turkey. The Ministry has the authority to have bankruptcy or dissolution proceedings audited through chartered banking accountants and their assistants.

The meaning of large exposures is defined as 15% of the paid in capital in EC directives however according to Turkish banking Law exposures that are above 25% or 40% are accepted as large exposures and up to 75% of the capital amount may be granted to a single group. Credits with large amounts is 20 times the equity with respect to Turkish Banking Act but it is 8 times according to community directives. Again the risk weight for non-cash loans is 20% or 40% with respect to domestic Laws, however the Basle Committee (Cookee report) matches 100% for this kind of loans.

The independent financial institutions established in EC countries before 1993 were allowed to do banking in EC with no restrictions. This permission is not valid for branches of third country banks. By 1993, the rule of reciprocity is operational as the permissions & restrictions for foreign banks in 3rd countries will be valid for the countries institutions that want to do banking in EC. This led to a run up to 92 flow to establish banks in EC & Turkish groups although were very late established a number of banks in EC countries. In 90&92 3 banks in Germany and 1 in France are established. It should be stressed that the rules of reciprocity will have serious effects on Turkish laws in the near future.

As of 1993 the rule of reciprocity and mutual recognition for foreign banks operations in Turkey is applicable and Turkish authorities are able to apply any restriction on operations of Turkish banks subsidiaries or branches in a foreign country to the branches or banks with foreign capital established in Turkey and originating from the country of consideration.

3.6. A Brief Review of the Turkey-EEC Relations

Turkey has shown a close interest in the European Community since its foundation on 1 Jan 1958 based on the Treaty of Rome (Kabaalioğlu, 1985). As a consequence of this interest, Turkey and the EEC under article 238 of the Treaty of Rome, signed an Association Agreement (also called the Ankara Agreement) on 12 September 1963, which took effect on 1 DEC 64. This Association Agreement provided for the setting up of a customs union after a preparatory stage, and envisaged Turkey's possible adhesion to the EEC in the final stage, after the completion of the customs union. The timetable for realization of the customs union was set out in the Additional Protocol (signed in 1970 and officially entering into force in January 1973) which laid down the provisions carried out in the transitional period (Ceyhan, 1988). Nevertheless, The community's obligations took effect as of 1 Sep 71 by means of an interim agreement. While the Association Agreement and the additional protocol were signed between Turkey on the one side and the six founding members on the other, three new members namely the UK, Ireland and Denmark joined the EC in 1973 were included in the Turkey-EEC Association by the signing of a supplementary protocol which came into force on 1 Jan 74. In addition as the other new members entered the community the supplementary protocols were signed again with new members.

In the meantime without waiting for the completion of the customs union, Turkey logged her formal application for membership in the community on 14 April 87. The council of ministers of the EC asked the EC commission to prepare a report on the feasibility of this membership from economic, social and political standpoints. The council of ministers is empowered to decide unanimously as to whether to start the full membership negotiations regardless of the fact that the Opinion of the commission which is expected to be finalized in two to three years after the application, views this membership positively or negatively. Furthermore under the SEA (Single European Act) the European Parliament's assent on the basis of a simple majority is also required for the membership negotiations to commence.

In sum, it can be said that the Turkey-EC Relations have a dual legal feature at present, comprising the implementation of the Association arrangements in the transitional period on the one hand, and the community's handling of the relations with Turkey as a candidate country on the other.

Apart from that, the importance of the Turkey-EC relations lies not only in Turkey's goal of taking part in economic and political integration process taking place in EC, but also in that the EC is Turkey's largest trading partner accounting for a share of more than 45% of Turkey's exports and around 40% of imports (Bolat, 1989). The progressive completion of the Internal market by 1992 makes Turkey's achieving closer links with the community vital for the purpose of maintaining and increasing our share in the EC market.

Under the Additional Protocol which set up the customs union between two sides, Turkey and the Community undertook to abolish customs duties, quantitative restrictions and measures having an equivalent effect on the bilateral external trade of their industrial products. With respect to the imports of industrial products from the community countries, Turkey undertook to remove custom duties and measures having equivalent effects progressively in two transition periods of 12 and 22 years, varying from one product group to another. Furthermore Turkey was also required to reduce her custom duties considerably in accordance with the 12 year and 22 year lists in order to adopt her tariff system to the Common External Tariff system of the Community progressively. Turkey will be completing the unification to the customs union as of 1 Jan 95 and the entry to the customs union is approved by the community. Financial assistance, participation in joint attempts in the field of R&D, the adaptation of legislation on the competition policy of the community aiming fair competition among undertakings, control of mergers, abolition of monopolies and ensuring non-distortion of competition due to state aids will be followed by the agreement for the customs union.

4. The EC Banking Sector

4.1. Current Situation

On the eve of the integration of the European banking markets, the common tendency is towards a strengthening of efficiency, diversification and size through mergers, takeovers and, to a lesser extent, cooperation agreements with suitable associates. On the other hand, the necessity to effect a strictly internal recasting of banks organizational structures, both from the geographical and sectorial aspects, appears to be less widespread. Taking the EC in its entirety, the trend is towards privatization of state-owned or state-controlled banks. This is the case in France, where the nationalization process of 1982, after suffering a reversal at the end of the 1980s, now records a status quo, as well as in other countries where state control of banks goes back slightly further in time. Where the public sector is the owner, it tends to be concentrated on specialist sectors and, in particular, on institutions offering long-term investment finance.

Table 7 Top Ten Community Credit Institutions by Assets

	Country	Assets (Billion) ECU)	World Rank
Credit Agricole	F	181.3	8
Banque Nationale de Paris	F	166.6	12
Credit Lyonnais	F	160.1	14
Barclays Bank	UK	151.3	16
Deutsche Bank	D	151.0	17
National Westminister Bank	UK	144.4	19
Societe Generale	F	127.1	23
Groupe Ecureuil	F	123.2	26
Dresdner Bank	D	109.7	27
Compaigne Financiere de Paribas	F	102.8	28

The Banker 1989

Table 8 Top Ten Community Credit Institutions by Published Capital And Reserves

	Country	Assets (Billion) ECU)	World Rank
Credit Agricole	F	16.5	4
Barclays Bank	UK	15.0	7
National Westminister Bank	UK	13.7	8
Deutsche Bank	D	11.9	9
Compaigne Financiere de Paribas	F	11.1	12
Banque de Nationale de Paris	F	8.7	17
Credit Lyonnais	F	7.8	22
Societe Generale	F	7.7	24
Dresdner Bank	D	7.6	26
Rabobank	NL	7.4	27

The Banker 1989

4.1.1. Structure Of The EC Banking Sector

There are certain differences in structures of the banking sectors in member states. Therefore the process of unification is expected to be long and competitive in banking sector especially in terms of financial centers namely London, Paris and Frankfurt.

France and the Federal Republic of Germany together account for almost two thirds of the total number of the credit institutions of the Community, a direct consequence of their important public and mutual banking business. In the Federal Republic of Germany and Italy the number of cooperative banks is very high. In the United Kingdom, foreign establishments represent 60% of the market. Banks assets in EC amount to almost 20% of the total assets in the community.

According to statistics set up by "The Banker" journal, of the 1000 top global banks classified according to their assets, 440 are credit institutions in the Community.

Declared capital and reserves are another criterion for evaluation. These are the basic factors proposed by the Commission for determining the solvency of banks. This situations is slightly modified when assets are used to set up a classification of the international banks.

Traditionally, banking in Europe is identified as Continent Europe Banking, however countries like UK and

Ireland are more known as implementing Anglo Saxon type of banking.

The shared characteristics is providing capital market services, acting as insurance agencies, giving real estate services beside the core deposit and credit operations. Banks also involve in industry and acquire subsidiaries. Specialty banking is active especially where the public enterprises are involved which increases the weight of the public share in the sector.

Except the countries said to implement Anglo Saxon type of banking, the banks activities were directed toward their internal markets but internationalization become important in the last 15 years. In UK and Ireland and other countries involved in Anglo Saxon banking, the banking sector has been and is totally open to international competition and private banks dominates the sector. Commercial banks do not involve in capital market operations and industrial partnerships but merchant banks close that gap.

Table 9 Market Concentration & Shares on foreign institutions % of total assets

	Market Share absorbed by the largest 4 banks	market share absorbed by foreign institutions
Belgium	42	46
Denmark	47	1
Deutschland	15	4
Greece	64	
Spain	21	11
France	42	16
Ireland	74	11
Italy	25	3
Luxembourg	24	91
Netherlands	69	10
Portugal	57	3
UK	27	60

OECD European Banks 1991

4.1.2. Banking groups in EC

Discussing the banking groups it should not be forgotten that the tendency is towards abolishing the differences between the products and services offered and increasing the competition between the groups also.

A. Commercial Banks : Most of them provide universal banking services but also the merchant banks are cited under this category. Where merchant banks mainly involve in financing the industry, act as intermediaries in issuing bonds and stocks for the industrial corporations, portfolio management, act as intermediaries in mergers and acquisitions. Mainly the universal banks are providing the whole range of banking services and the banks under this category are represented in the community by the European Banking Federation.

B. Savings Banks : (represented in the community by the Savings Bank Group of the EC) mainly collect deposits and grant loans with respectively low volumes considering the commercial banks, their activities are regional and local.

C. Cooperative banks : are rural and focused on financing the agriculture business, mainly dealing with small and middle scaled customers, similar to savings banks as they are not usually international and more regional and local. But there are some very large banks in this category namely the Credit Agricole a French bank is the largest bank in the community.

D. Financial Specialty Institutions : focused on mortgage financing but under separate groups. Represented in the community by a number of different authorities namely European Community Mortgage Federation, European Federation of Building Societies, European Federation of Finance House Associations.

4.1.3. Mortgage Credit

The role of credit institutions in the financing of residential and non-residential property building constitutes one of the most important contributions to investment within the economy of the Community. In Denmark, France and the U.K., the market is dominated by specialist mortgage credit institutions. In the U.K., the commercial banks have considerably increased their market share by granting second mortgages and the building societies have only recently regained 50% of their market by granting second hand mortgages. This sector is, at the present time, characterized by a low level of cross-border activity.

4.1.4. Structural Changes, Mergers And Amalgamations

It is generally expected that the banking sector in Europe will undergo important structural changes during the next ten years, which should lead to increased concentration of the sector (Revell, 1991).

The concentrations movements work in different ways depending upon the nature of the internal markets (Revell, 1987).

In France, as the markets are occupied by a small number of large networks (retail) and by a variety of specialist investment banks, not many merger or takeover operations have taken place. At national level, the only notable developments have concerned savings institutions and mutual banks, which are gradually reducing the number of their affiliated members. These are therefore "intranetwork" mergers. From the point of view of international development, the big institutions are generally proceeding to create foreign subsidiaries (French banks today are those which have the most branches outside the national territory) or buy alliance with foreign enterprises.

In the United Kingdom, the big banks (except possibly for Barclays Bank) are in the process of gradually shrinking their networks of retail bank outlets in Europe (S.Brothers, 1991). The low stock market value of the credit institutions makes them very vulnerable to takeovers from foreign investors.

In Spain, merger operations mainly concern savings institutions, and take place at regional levels. The biggest merger recorded up to the present in Europe was that carried out by the Banco de Bilbao with the Banco de Vizcaya.

In Italy, a regulatory framework compels limitation of development of numerous small and medium sized banks. Here again merger mechanisms appear at regional level, and the big banks are endeavoring to consolidate their position on the national market.

The most spectacular merger operations have taken place in the Netherlands and Denmark. These, in the case of both countries, are mergers between big banks. In the Netherlands, of the five leading banks, four have merged two-by-two (NMB-Postbank, ABN-Amro). A similar situation has appeared in Denmark as a result of the merger between SDS Privatbanken and Andelsbanken.

It can therefore be noted that the European strategies of a majority of banks consists mainly of protecting themselves against the risk of eruption on their market of large foreign establishments, as well as against takeover threats.

One country is an exception in this area : the Federal Republic of Germany This situation in fact results from certain peculiarities of the German market. With relatively little centralization, this market is occupied by some commercial banks, state banks, cooperative banks and large-sized savings institutions. The latter two control the major part of retail business. Although very regional, the Sparkassen (savings institutions) are, in fact, very profitable universal banks, which do not seem to want to merge with each other, and which are not very vulnerable to takeover threats. nevertheless, with a weak capital structure and no competition in their market, they show little development. On the other hand, the big commercial banks (Deutsche Bank, Commerzbank, Dresdner Bank), since it is difficult for them to extend on the retail market and since the profitability of their traditional activities shows a reducing trend, have adapted aggressive policies of cross-border growth.

These international developments, however, only concern the biggest institutions, which are the only ones with the necessary capital to carry out such strategies (Solomon, 1991). The small countries of the EC, whose financial markets were still hampered by strict protective regulations (Greece, Portugal), are the countries to experience difficulties in adapting themselves. Since their national banks are not competitive, these countries have, until 1993, restricted the access of foreign banks to their market.

The reason for different types of banks to go for merging or acquisitions can be analyzed as following :

For universal banks doing retail banking, acquiring a bank with a customer base & established ready to use distribution channels is the best way to open to enter new markets.

- Corporate banks prefer merging & takeovers mainly to increase their capital base and reach capital and assets that will enable them to handle increasing transaction volumes (Gurlesel, 1993). Generally large banks merge in that manner and become larger and stronger.

- When the merger possibilities are analyzed the following complications should be considered.

There are certain limitations for cross border operations, for example in Italy, France & Germany banks are usually publicly owned or are cooperative banks in most cases. It is impossible to get involve with that kind of relation with these public banks.

- Takeovers of private banks give rise to the notion of nationalism and result in increasing controls and limitations.

- Goodwill is increasing the buyout value of the banks much above their book value. Other financial institutions that are sellable are usually suffering some financial problems & weak & need re-organization. One of the other factor against takeovers or mergers is the changing structural differences between sectors for the investment, mortgage, cooperative and commercial banks.

4.1.5. Cross-border Activities

The statistics for evaluating the degree of commitment of banks outside their home country boundaries are supplied by the Bank for International Settlement. These statistics, unfortunately, make no distinction between intra-group operations and operations with the outside countries. From the strictly analytical point of view, it is current practice not to consider intra-group transactions, since these can be regarded as an internal movement of funds rather than a basis of real activity.

In the nine countries of the Community (excluding Portugal, Greece and Ireland), the consolidated volume of cross-border business of the banks established in their domestic base country is very small in volume with respect to the domestic sector in total. The only exceptions are the U.K. and Luxembourg, which accommodate a great many foreign banks. Retail outlets of foreign banks constitute the majority of the banking institutions in the U.K., whereas in Luxembourg, subsidiary establishments of foreign banks are more usual.

Although incomplete, the statistics clearly show that the international activities of the banks in the Community is basically carried out by the commercial banks. Other credit institutions are at present increasingly carrying out cross-border activities. This is particularly the case with Danish mortgage banks in the F.R.G and in the U.K., or with building societies, U.K. mortgage credit institutions in Spain.

Table 10 - Cross Border Banking Operations of EC member states

Country	Billion ECU	1988 %
Belgium	85.9	2.3
Denmark	27.2	0.7
Germany	288.3	7.7
Spain	34.2	0.9
France	317.3	8.4
Italy	163.0	4.3
Luxemburg	18.4	0.5
Holland	104.3	2.8
United Kingdom	211.2	5.6
AT(9)	1249.8	33.3
Total World	3756.4	100.0

BIS, International Banking Development, 1988
Statistical Annex

Table 11 - Operations of non-domestic banks in member states

Country	Billion ECU	1988 %
Belgium	147.0	3.2
Denmark	19.4	0.4
Germany	243.7	5.3
Spain	24.7	0.5
France	303.5	6.6
Ireland	7.7	0.2
Italy	57.4	1.3
Luxemburg	207.9	4.6
Holland	136.7	3.0
United Kingdom	838.7	18.4
AT(9)	1986.7	43.5
Total World	4566.1	100.0

BIS, International Banking Development, 1988
Statistical Annex

The cross border operations of the banks established in the member states constituted 30-35% of the international activities in the world and the operations of the 3rd country banks in EC member countries was 43.5% of the international activities in the world.

4.2. *Impacts Of Financial Integration For EC Member Countries*

The expectations in the process and after the implementation of the harmonization process in the EC are the following :

- Free capital movements and different taxing schemes on financial investments between countries is the first important consideration. This will let capital and savings move to the states which apply lower taxes and may result in new limitations in movements of capital. Also this will have considerable effects on monetary policies applied in member states as they lose control over their money base.

Table 12 - Taxes on Financial Instruments in EC countries

Country	On deposits		On dividends	
	Domestic	Foreign	Domestic	Foreign
Belgium	25	25	25	25
Denmark	0	0	30	30
France	**	0-30	0	25
Germany	0***	0***	25	25
Ireland	0-35	0-35	0	0
Italy	12.5-30	12-30	10	32
Luxembourg	0	0	15	15
Netherland	0*	0	25	25
UK	25	25	0	0
Greece	***	49	42-53	42-53
Portugal	30	30	12	12
Spain	20	20	20	20

Arthur Andersen, 1991, World Financial Markets

- reduction of public shares in the sector
- reduction of government intervention in the sector
- increasing competition between intra and inter country banking institutions

- reduction in the prices of products and services offered

Table 13 - Potential and estimated price decreases in financial services in EC Countries

Country	% potential	estimated %
Belgium	23	6-16
Germany	25	5-15
Spain	34	16-26
France	24	7-17
Italy	28	9-19
Luxemburg	17	3-13
Holland	9	0-9
United Kingdom	13	2-12

Price Waterhouse, European Commission 1988

- developing strategies for cross border operations
- competition among the financial centers and international money markets like London, Paris and Frankfurt.
- mergers and acquisitions
- diversification and developments in products and services provided
- strengthening the financial structure of individual banks, meeting capital adequacy requirements, reducing operating expenses, technological developments, electronic banking, EFT and electronic data transfer.

The Commission of the European Communities had launched a comprehensive research project on "The Cost of Non-Europe". One of recently published studies deals with "The Cost of Non-Europe in Financial Services". It gives a qualitative and quantitative assessment of the impact of financial integration and liberalization for the present Member States of the EC. Some of the relevant findings are summarized below.

4.2.1. Integration, Liberalization and Costs of Finance

A general expectation is that the transformation of the presently segregated national financial and capital markets into a single European market will improve the efficiency of the financial institutions and lead to a reduction in the costs of finance for entrepreneurs. The various reasons given for this expectation can be reduced to two basic factors of distinct character. If a bank provides finance to an entrepreneur, the bank provides a bundle of capital plus banking services. Thus, the interest charged respecting the costs of finance comprise two different components; the cost of capital, and the cost of services. Though there are, in practice, interrelations between components, it is useful to separate their determinants.

a. Costs of Capital

Banks have to pay a price for funds which they utilize for financing entrepreneurs. This price is basically the interest rate for deposits. However, the central bank may offer (for political reasons) additional (re)financing possibilities at different interest rates.

Although the degree of competition between financial institutions is not irrelevant for the rate of interest paid to depositors, the basic relation for the determination of the costs of funds with respect to the rate of interest is the macro-economic relation between savings and investment.

b. Costs of Services

Banks act as financial intermediaries. They transform amounts, maturities and risks. This is one (important but invisible) service rendered to entrepreneurs for which banks can claim a remuneration.

There are other services like keeping accounts, transfer of money, overdraft facilities etc. The costs of these services depend on the efficiency of bank operations (which define a minimum charge). But, how much the bank actually charge their customers - either as a separate service fee or as a spread of the lending rate over the deposit rate - depends mainly on the degree of competition in the banking sector. Strong competition will force banks to apply the most efficient techniques and to keep their actual service charges close to thé minimum.

4.2.2. Integration and Competition in Financial Markets

The integration of the financial markets of the EC countries means that presently existing barriers to the establishment and operations of bank branches or subsidiaries of banks from one EC country in another EC country will be removed.

However, the existing barriers result mainly from the fact than foreign banks have to comply with the same procedures as domestic banks which may be more restrictive than in their home country. There is no discrimination against foreign banks in most EC countries.

Although these barriers are non-discriminatory, the integration of the financial markets should lead to a harmonization also of such rules for the establishment and operation of foreign bank branches or subsidiaries. This would reduce the costs of setting up units in other EC countries.

The expectation is that the number of foreign banks in each EC country would increase. This would intensify competition between banks - the expectation is that strong competition will persist in the long run. This does not necessarily require that the number of competing banks will always be as large as in the beginning. But even if the number decrease, the competition in the resulting oligopolistic situation may be at least as strong as it was before. Intensified competition would enforce an improvement in the efficiency of the banking sector and the reduction in the cost of services - and in consequence - of the costs of funds. The quantitative dimension, however, should not be dramatic but quite modest. The impact will be most effective in countries where so far a more discriminating policy against foreign banks has been followed. Spain and Italy are the EC countries where the policy is more restrictive against foreign banks than in the rest of the EC.

4.2.3. Liberalization and Supply of Capital

Of more quantitative relevance are those barriers which are the results of exchange controls and restrictions of capital movements. Without a liberalization of capital movements, foreign banks can take recourse to foreign banking technology and know-how but only to the domestic resources of the host country - factually, however, capital imports are permissible in most countries, the restrictions are for capital outflows -. There are no exchange controls or restrictions on capital movements in Belgium, Germany, Luxembourg, the Netherlands and the United Kingdom. France and Italy are now liberalizing their exchange controls, While restrictions continue to be in force in Greece, Ireland, Portugal and Spain.

Exchange controls with respect to restricted international capital mobility can effectively constrain the international trade in financial services.

If the macro-economic definition of capital movements is applied, then - in a system of flexible exchange rates - capital exports imply a surplus of the current account and the capital imports a deficit. A current account deficit implies that imports of goods and non-factor services fill the resource gap between domestic savings and domestic investment. Thus domestic investment is partially financed by foreign savings. In case of a capital export with respect to current account surplus, domestic savings have not been fully absorbed by domestic investment, and the capital exporting country has financed investments in other parts of the world.

Capital imports increase and capital exports decrease the availability of capital in the domestic economy. If capital movements (especially capital exports) were liberalized, differentials in real interest rates would determine the direction of capital movements (for given country risks and exchange rate expectations).

Countries with higher interest rates would attract foreign capital. The supply of capital would increase, bringing down the domestic interest rate and reducing the inflow of capital.

Countries with higher real interest rates would attract foreign capital. The supply of capital would decrease, bringing up the interest rates and reducing the outflow of capital.

The result of a liberalization of capital movements would be a tendency towards an equalization of real interest rates within the financially integrated area. Capital flows would stop when the interest rates were equalized - as long as different countries practice their national economic policies, one should not expect a total equalization of interest rates because the perception of the equality of the economic policy is an important factor for the assessment of the "country risk", which probably will differ between EC countries. Real interest rates would differ accordingly -.It is expected that a liberalization of capital movements would facilitate a more efficient utilization of a given volume of savings of the EC countries so that the real interest rate would not only be unified but also reduced as compared to its present average level.

4.3. Autonomous Monetary Policies in an Integrated Market

Real interest rates are determined by nominal interest rate and the rate of inflation; for international comparisons, the (present and expected) exchange rate has also be taken into consideration.

The member countries of the European Monetary System (which so far does not include Greece, Spain, Portugal and the United Kingdom) have agreed upon a system of fixed exchange rates. Even before 1993 when capital movements were not fully liberalized, the room for autonomous monetary policy was limited, but with a fully integrated and liberalized capital market, it ceases to exist.

Suppose country A wants to stimulate its domestic employment by a policy of "easy money". It may pursue a policy of monetary expansion to achieve lower interest rates (Bolat, 1989).

The lower nominal interest rates will attract borrowers from other EC countries while deposits will flow out of this country.

The foreign borrowers have received the loans in A currency. They will converts these amounts into their national currencies. If the fixed exchange rates are to be maintained, the central banks have to intervene in the foreign exchange markets. They have to buy A currency against other EC currencies. This means a contraction of the effective quantity of A currency in circulation.

The increasing credit demand, the decreasing deposits and the reduction of the A currency in circulation will tend to bring the interest rate in A back in line with the average of the Community. Thus, A's monetary policy did not become effective.

In a fully integrated and liberalized capital market with fixed exchange rates between the currencies of the participating countries, there is no room for autonomous monetary policies (including fiscal policies with monetary effects like financing budget deficits through central bank credits). On the contrary, there is a strong need for a coordination and harmonization of economic policies in order to guarantee a smooth functioning of the EMSs. But one has to realize that there is no guarantee that all national governments will always prefer the smooth functioning of the EMS to an autonomous policy. If the priorities are reserved, inflation differentials may continue to exist or will emerge again so that adaptations of the EMS parities become inevitable.

4.4. Impacts of EC Financial Integration for Countries Outside the EC

Although there are some preferential treatments for residents of EC Member States, the integration and liberalization efforts of the EC in the financial market do not actively discriminate against non-EC countries. In general the same regulations and rules must be observed when a foreign bank wants to establish a branch or a subsidiary in an EC country irrespective of whether the applicant is from an EC or a non-EC country. And if capital movements are liberalized, it is irrelevant whether capital flows in from or out to EC or non-EC countries.

But even a perfectly non-discriminatory integration and liberalization policy in combination with a system of fixed exchange rates may have some adverse effects for countries outside the EC.

4.4.1. Risk and Exchange Rate System

The EMS is formally a system with fixed exchange rates. But since it became effective in 1979, there have been 10 minor and major realignments of the exchange rates. Against this background it would not be very prudent to assume in long term financial transactions that the exchange rates are given and cannot change. If one expects that the past policy will continue in the future, then an exchange rate risk will also remain in an integrated market.

But the integration and liberalization of capital markets may create a strong political pressure on the European governments to strive for economic convergence, i.e. to narrow the differences in the development of economic variables which are of high relevance for exchange rates. A crucial variable is the rate of inflation, which has been reduced substantially in all EMS member countries over the past years. If this leads to a uniform development of (low) inflation rates, the exchange rates may become more stable than in past years. If medium or even long-term stability can be expected (not with certainty but with a reasonable probability), the exchange rate risk for international transactions will be reduced to a minimum within the EC and will be substantially lower than for transactions in other currencies.

This implies that if all other conditions remain unchanged, placements of funds or borrowing in third countries outside the EC become less attractive. **If markets are integrated and liberalized, and if the exchange rate risk can be reduced within the EC, there will be more and less risky opportunities for financial transactions within an EC area.** The volume of capital movements within the non-EC area may be reduced, and these banks in non-EC countries which have been engaged in international financial transactions may suffer from this reduction. Though the tendency seems to be clear, it is hardly possible to assess the quantitative dimension of this effect.

4.4.2. Depreciation or Appreciation of Non-EC Currencies

It is assumed that the economic convergence among the EC with respect to EMS member states will lead to more stability and less inflation in the EC. If inflation in non-EC countries or even accelerates, the exchange rates should reflect this inflation differential. But there are at least two problems in this regard.

- It is difficult to predict inflation rates accurately. On the one hand, an inflationary process with such high rates as in Turkey develops its own dynamism; even if the monetary policy does not change, it is hard to forecast how the process will continue. On the other hand, the monetary policy is not usually stable but changes (e.g. from expansion to contradiction); unfortunately, however, these policy changes are hard to predict both with respect to their quantitative dimension and their timing. All this leads to a relatively high exchange rate risk and only a very rough reflection of inflation differentials in the exchange rates if they were freely determined market forces.

- If for many non-EC countries, the exchange rates are not really flexible: the authorities practice a managed floating in one form or another. Non-EC countries do not only deal with the EC but also with other countries, and usually a substantial part of their foreign trade is transacted in US Dollar. The EMS currencies with respect to the ECU are flexible against the US Dollar and, depending on market forces, may depreciate or appreciate.

Depending on the rule for the managed floating (e.g. pegging the currency to the US Dollar), The currency of a non-EC country may depreciate or appreciate against the EMS block. If there is a predictable trend in the movement of the non-EC currency against the ECU this may promote the country's trade or stimulate its capital movements with the EC. But **if there are more or less erratic exchange rate fluctuations instead of a trend, this uncertainty will increase the exchange rate risk.**

4.4.3. Risk Pooling in Integrated Markets

The integration and liberalization of the markets improves the possibilities for portfolio diversification; investors can achieve a better trade-off between risk and return (i.e. a lower risk for a given return or a higher return for a given risk) as compared to a situation where they are restricted to their domestic market only.

But not all investors in EC countries are restricted to domestic assets; important EC member countries like the U.K. and Germany have already removed exchange restrictions and allow their residents to acquire foreign assets or foreigners to purchase domestic assets. Investors in these countries can have recourse to the world market for their portfolio diversification.

If the integration and liberalization within the EC is enacted on a non-discriminatory basis, then investors in all EC countries will have the possibility to acquire foreign financial assets from the world market for their portfolio diversification.

Thus, non-EC members with liberalized capital markets may intensify their trade in financial services and assets with some of the EC countries.

4.5. Competition and Specialization in the Banking Sector

If the integration of the financial markets leads to more cross-border competition among the financial institutions, one can expect that the efficiency of the bank operations will be improved and that some banks can realize gains from more specialization and from an intensified division of labor between (different types of) financial institutions. There may be certain types of transactions especially related to foreign trade with or direct investments in non-EC countries where EC banks compete with non-EC banks. The chances are that the EC banks could improve their competitive position because of the (enforced) increasing efficiency.

But it is also possible that the banks in the non-EC countries could adapt for particular market segments in their countries some of the new improved techniques of EC banks and combine these with their specific knowledge of markets so that they could gain a competitive edge over EC banks in such segments. In the case of Turkey the rapid development of trade finance by Turkish banks in recent years may be quoted as an example for such a process of initial imitation and subsequent improvement in the banking sector. Thus, it seems impossible to come to a definite conclusion as to whether EC or Turkish banks would gain from improved efficiency of banking services in a particular market segment (like foreign trade with or direct investments in Turkey).

4.6. Impacts of EC Financial Integration for Countries Joining the EC: The Case of Turkey

It is assumed that Turkey will become a full member of the EC only after its financial markets have been integrated and capital movements have been liberalized. The respective rules of the EC should also be applied in Turkey. This will have an impact both on the competitive situation in the Turkish banking sector and on capital movements between Turkey and the rest of the EC. The liberalization of the capital markets could severely restrict the scope for an autonomous monetary policy.

4.6.1. Competition in the Banking Sector

If EC banks can penetrate the Turkish market without any restrictions and if financial services can be traded freely, this should lead to intensified competition in the Turkish banking sector. From the study on "The Cost of Non-Europe in Financial Services" by Price Waterhouse which made an attempt to quantify the effects of the present regulations and barriers on integration in the financial markets, some conclusions about the impact of increased competition can be reached. Although this study covers only eight of the present 12 EC Member States, and although comparable figures for Turkey are not available, it would be useful to summarize the methodology and the findings of that study.

For the quantification of the effects of regulation, various approaches have been considered. Three of these approaches are of particular interest here, namely comparisons of; prices for specific products and services; value added/output ratios; and net margins.

a. Comparative Prices

The basic assumption is that in an integrated market, prices for the same products tend to be equalized. If there are marked differences in prices between European countries, This can be due to different competitive advantages, unexploited economies of scale, different market structures, and different regulations. The differences give an indication where competition is most likely and what may be the quantitative results.

These figures, however, must be interpreted with some caution. It must be pointed out that several prices represent margins over wholesale money market rates and not the costs to the consumer of the financial services. But more important, there are conceptional and practical problems with the comparative price approach.

- The conceptional problems arise from the fact that even in full integrated national market, significant price differences exist. Therefore, the integration of the EC markets must not necessarily result in a single price for a particular product in all countries. The price reductions may be less than what may be expected.

- The practical problems are related to the question of comparability of products and to the fact that prices change frequently.

But in spite of these reservations, one can get at least an idea of differences between the national banking system, and the findings from the comparative price analysis can be combined with the results of the following approaches so that errors may be kept within a reasonable margin.

b. Value added/output ratios

The value added of a sector is a measure of the factor income (for labor and capital) generated in that sector. If the value added is related to the output of this sector, this ratio shows how many resources (factor inputs = salaries and profits) are used to produce one unit of the output. A pragmatic measure for the output of banks are loans outstanding (which neither reflects differences in the risk of loans nor considers other non-loan products and services of banks).

The value added/output ratios average shows a wide range from 3% (Netherlands and the U.K.) to 6.3% (Italy)

c. Gross and net margins

International comparisons often use gross and/or net margins - i.e. the gross/net earnings as percentage of total assets - as indicators for the income generating power, for cost efficiency and for the profitability of banks. There are marked differences both in net and gross margins between countries and within one country between different types of banks.

Of course it is impossible to predict exact prices for financial services in an integrated Europe, but the tendency is clear. Prices for comparable products will converge towards a level that is determined by the most efficient financial institutions. There is no guarantee that less efficient institutions would survive in unrestricted competition, and it may well be that the number of banks may decrease substantially in some countries while the banking sector grows rapidly in other countries. Structural and regional adjustments in the banking sector will be inevitable. This adjustment process should have taken place in the present EC countries before Turkey joins the Community. This means that Turkish banks would be confronted with a European banking industry which is more integrated and efficient than it is now. If Turkish banks feel that they could compete with banks from EC countries now, it may be dangerous to extrapolate this into the future with a unified European market for financial services. Turkish banks should be prepared for the worst and should assume that their competitors would be in a position to offer, in

Turkey, all products and financial services at the lowest prices and with the least possible costs.

Probably, many Turkish banks would have to reduce their operating costs substantially. This would be the "straight forward" strategy to adapt to stronger competition. But there may also be more sophisticated responses to the European challenge, namely efforts to develop a specialized know-how and specific products for certain segments of the Turkish or European market where a competitive edge could be gained.

If Turkey joins the EC and has to liberalize capital movements, Turkish residents will get the right to purchase securities (government bonds, equity shares, commercial papers, etc.) abroad. This may well result in a net outflow of capital from Turkey. However, the general expectation in Turkey seems to be that, capital will flow into the country once Turkey has joined the EC. In particular there are great expectations regarding foreign direct investment.

4.6.2. Foreign Direct Investment in Turkey

It is argued that Turkey's accession to the EC would improve its attractiveness for foreign investors and that foreign direct investments would increase substantially. In support of this opinion, the Spanish example is quoted, where the inflow of foreign direct investment has been spectacular in recent years, i.e. after Spain's accession to the EC. Unfortunately, such expectations have only a questionable basis, and the reference to the Spanish example could be misleading if the following less optimistic interpretation holds some truth.

- Spain experienced a fundamental change in economic policy in the Mid 80s. It shifted from inward-orientation and statism to a more liberal and outward-oriented strategy, supplemented by effective structural adjustment policies. Since, 1984 Spain has entered the phase of vigorous expansion of output and employment accompanied by a marked slowdown in inflation. In spite of the decrease in inflation rate, domestic demand has grown rapidly. The business climate has improved substantially, and the capacity expansion and job creating private fixed investments (including foreign investments) has increased drastically. The EC accession contributed to the improvement of the business climate, but this was only a supplementary factor. Turkey, underwent almost the same liberalization in the 80s which was the best time for substantial increase of foreign direct investment but prospects were not so bright as in the case of Spain; there was no comparable boosts of private investments and consumption. Turkey suffered from foreign debt obligations and had used much of (almost all of as of 1994) its international credit standing after debt rescheduling in 3 subsequent years (1978, 1979, 1980). The stabilization policies of 80s brought down inflation only temporarily. In total, the climate for private investors was less favorable in Turkey than it was in Spain.

- The increasing competitive pressure after accession to the EC will not necessarily be conductive to an improvement of the business climate and the growth prospects in Turkey's industry. In 1980s when the government made attempts to revitalize and strengthen the private sector, The Turkish domestic market was protected by high custom duties. This bolstered the profit expectations for foreign direct investments in inward-orientated (import substituting) industries producing mainly for the Turkish market. Therefore, the protection of the domestic market may have induced some inflows of investment from abroad. But after an EC accession and the abolition or reduction of protective tariffs this type of investment may vanish.

4.6.2.1. Capital Movements and Exchange Rates

The decision on direct or portfolio investments abroad depend not only on the return of capital in the national currency of the host; more important is the return in the currency of the investor's home country. Therefore, the expected exchange rates must be taken into account. For given nominal rates of return and inflation differentials, the expected real exchange rates are crucial for the placement decision and also for the direction of capital movements. The more investors in EC expect that the relative exchange rate of the TL will depreciate against their currency the higher must be the difference in the nominal rates of return on capital to make investment in Turkey attractive. The nominal rate of return would increase certainly, with an increase in the rate of inflation but an inflated nominal return will hardly make investments in Turkey more attractive because the accelerated inflation simultaneously affects the real exchange rate. Thus only an increase in the real return and in the marginal productivity of capital could attract more capital when exchange rates expectations are given. But there are good reasons to assume that the marginal productivity of capital cannot be increased at will. Then the monetary and exchange rate policy are mainly responsible for the volume and direction of capital movements.

4.6.2.2. Restriction on Monetary and Exchange Rate Policy

In an integrated and liberalized European financial market, the problem is not only that foreign investors are not willing to place their funds in Turkey if they expect a real depreciation of the TL so that no additional capital will flow in, in addition Turkish investors (including banks and other financial institutions) will make the same calculations and should come to the conclusion that a placement of funds in other EC countries may be advantageous. A net outflow of capital may take place.

During 85-87 the Turkish authorities have followed a policy of stabilizing or depreciating the real effective exchange rate of the TL, however after 87 to 90 the TL is not depreciated to balance the real exchange rate, and in the last 5 years there were considerable fluctuations of the TL exchange rates, therefore foreign investors are reluctant to place funds in Turkey, depreciation could promote exports which is to have positive effects when the large external debt of the country is considered. However after 1989 depreciation slowed down and stayed behind the inflation, and with increasing emission imports has increased and exports are reduced. Although the TL is not devalued strongly the foreign investors preferred, either exporting goods to Turkey or lending the government their funds to close government budget deficits. Turkey's high, accelerating and fluctuating inflation is an obstacle to the sound integration of the Turkish economy into the large European market. During the process of inflation reduction, structural weaknesses will become apparent, and the already high unemployment rate may increase further during a transition period. But these costs must be balanced against potential gains from the exploitation of the development potentials.

5. Evaluation of the Turkish Banking sector against the European Union

Although taking part in EU and becoming a member of the union is a long term objective and the process is long and the results are not obvious, the sensitivity against the possible effects of the union should not be underestimated (Uludağ, Ekren, 1993). Financial unification will increase the competition of foreign banks both in the member countries and in Turkey. Turkish banks that follow an expansion policy and are opening to international markets will be effected more from the ever increasing competition.

Aside the economical relations with the community, the fact that the potential of the citizens living abroad cannot be ignored is proved by the growing existence of the offices of the domestic banks in European countries. Obviously the competition strategy of the banks in the community will have serious outcomes for the Turkish banking system. Being a large and growing market like Italy and Spain, Turkey is in the focused economic region of enormous European banks.

As of 90, the number of foreign banks or branches operating in Turkey was 25 and the establishment of Societe Generale, Credit Lyonnais, Midland bank were very recent. Only Credit Lyonnais is following a pan-European strategy. This means that today big German and British banks did not entered the Turkish market and so far the existence of foreign banks are weak and focused on acting as intermediaries in foreign trade. Most of the (19 out of 26

) foreign banks or branches are established after 1980. In 1994 the number has reduced to 20.

It shouldn't be expected that, the competition of the foreign banks will remain that weak. Although, the banking rate in Turkey is increased by expanding network of branches, the real development of the banking and the financial sector mainly depends on the increase of GDP and the decrease in the level and stability of the inflation rate. A deepening financial sector will be very attractive for foreign banks.

The emerge of the European financial union and the increasing integration against Eastern Europe will definitely have seriously effect Turkey. **To make Istanbul one of the international finance centers should be one of the most important targets of the banks and the government.**

Comparative analysis of the Turkish banking system with foreign systems is necessary to identify the problems and to set the correct policies in the process of international competition and unification. The following issues are the main factors that effect the competitive position of the domestic banking system.

5.1. Inadequacy of financial depth

M2 / GNP, which is affected by the investment preferences of investors, return on bank deposits and capacity of economy in savings begin increasing in 1980 to reach 25.6% in 1990, which then reduced steadily down to 15% as of the end of 1994. A comparison of M3/GNP (M3 to include also the money market instruments and other deposit kinds) with European countries as of 1989 show that the money stock in the financial sector is very low with respect to EC countries.

Especially the differences in the definition of money stock numbers should be considered during this comparison.

The percentage of financial institutions in domestic economy is 3%, whereas in EC the value is 7% and especially in UK it is 12%.

Table 14 - M3/GNP of EC Countries and Turkey

Country	M3/GNP (1989) %
Belgium	82.9
Germany	86.1
Spain	73.8
France	68.5
Italy	75.3
Holland	85
United Kingdom	89.1
Turkey	38

Banks in Turkey 1994, Banks Association of Turkey

5.2. *Being late in banking :*

The number of banks, The number of branches, number of ATMs, number of accounts, very large usage of paper and currency money (paper money / M1) is considered under the density of banking and the activities of financial institutions. The number of ATMs and Point of sales terminals are increasing very rapidly however the numbers today are much behind the european countries. For the point of sale terminals for example France has a base of 200.000 terminals whereas Turkey has 20.000 terminals.

Paper money over M1 was 33% in Belgium, Germany and Spain, 14% in France, Italy, U.K. while is was 43% in Turkey in 1989. This means that the volume of paper and coin currency in use is much greater than EC countries, meaning that the money is circulating out of the banking sector.

Number of accounts is again respectively low as it is 44M/60M = 0.73 (1994) in Turkey and 2.8 in France, 2.4 in U.K. and 1.1 in Holland.

Table 15 - Density of electronic payment instruments

Country	# of ATMs
Germany	30.500
France	20.000
Spain	23.000
UK	19.500
Italy	16.500
Netherland	4.500
Turkey	4.000
Switzerland	3.400

Visa International Turkey

Table 16 - Number of banks in member countries and Turkey

Country	# of banks (in 1989)
Belgium	163
Denmark	281
Germany	4410
Greece	33
Spain	620
France	1978
Ireland	56
Italy	1201
Luxemburg	203
Holland	172
Portugal	261
United Kingdom	660
Turkey	67

Panaroma of EC Industry - 1991, Turkish Banks Association - 1994

Table 17 - Percentage of payment methods with respect to transaction value

Country	Cheque	Credit Card	Paper based credit transfer	electronic funds transfer
Belgium	36	1.2	41.8	12.3
Germany	9.9	0.7	27.4	25.3
France	62.6	-	1.5	15
Italy	49.2	1.2	43.8	3.7
Holland	17.8	0.5	38.2	27
United Kingdom	54.7	12.4	8.7	13.4

Panaroma of EC Industry, 1991

Table 18 - Total and per capita number of accounts

Country	accounts in million	number of accounts / capita
Denmark		
Belgium	10.2	1.0
Germany	60.5	1
France	154.7	2.8
Holland	15.4	1.1
Italy	21.2	0.4
United Kingdom	138.1	2.4
Turkey	39.7 (44 in 1994)	0.6 (0.73)

Bank Profitability Statistical Supplement
Financial Statements of Banks 1981-1989 OECD, 1991

Table 19 - Branch per capita, ATM per capita

Country	population / # of branches	population / # of ATMs
Belgium	1070	NA
Denmark	1610	NA
Germany	2230	2895
Greece	3600	NA
Spain	1290	943
France	2930	3076
Italy	3870	2477
Luxemburg	910	NA
Holland	2220	3656
Portugal	3010	NA
United Kingdom	3500	4711
Turkey	9857	15000

OECD, 1991, Banks Association of Turkey 1994
Banks in Turkey, 1994 & Visa International

5.3. Banks significance in financial sector

Banks account for more than 90% of the **financial sector** in Turkey while they account for around 75% in average in EC. Almost the name financial institution is used as synonyms for banks in Turkey. In financing the private industry sector bank credits account for 95% while the stock exchange or capital market instruments remained very low.

The banking sector in Turkey shows an oligopolistic structure where 40% of the assets belong to the largest 4 banks which is quite similar to union member countries.

Table 20 - The percentage of assets of 4 largest banks to total assets of the banking sector

Country	% (in 1989)
Belgium	42
Denmark	47
Germany	15
Greece	64
Spain	21
France	42
Ireland	74
Italy	25
Luxemburg	24
Holland	69
Portugal	57
United Kingdom	27
Turkey	40 (1994)

Panaroma of EC Industry - 1991, Turkish Banks Association - 1994

5.4. *Significance of Public banks and retail banking :*

Public sector banks and retail banking are very strong in Turkey, however in EC countries specialized institutions share is larger and increasing like mortgage funds, financial leasing companies, insurance companies, financial intermediaries and public sector specialized institutions. In Turkey, the share of public banks in deposits and credits are around 50% especially with the deposits of public institutions like SEEs. Public banks are less profitable than private banks(return on assets is 2.38% for private banks and 1.5% for public banks). Governments intervention to the sector is not limited with the significance of the public sector banks, heavy lending requirement of the government is serious. The percentage of public debts and reserves to total assets is 25-35% in Turkey and Italy, whereas, the rate is 13%, 1.1%, 4% respectively in Germany, UK and France.

Commercial and retail banks are also significant in the sector with 70% share in lendings. However, the expectation in the community is the increase of the share of non-bank specialized institutions. According to Arthur Andersen the market share is 50% for banks, 17% for institutions granting especially in mortgage credits, 17% for financial leasing companies, 5.5% for insurance companies, 5.5% for financial intermediaries and 5% for public institutions in 1996.

5.5. *Asset and Equity capacity and capital adequacy*

In international competition, the importance of scale intensifies the issue of capacity of assets and capital adequacy. Asset structure is determined by the development level of the sector and the economy and the structure of banking activities. In international comparison the power of domestic currency should also be considered.

The scale problem can be understood from the facts that Ziraat Bankası, the largest bank in Turkey by far has been ranked as 138. in Europe in 1991 by The Banker and the Total Assets of the Turkish banking sector is around $50 billion which is 1/4 of a single bank in Germany. Especially after the financial crisis in 1994 the numbers returned to the numbers of 1990s as total assets of the sector reduced to ECU 40 billion. The same holds for the equity if not worse. The total equity of the 5 largest banks indicate that the scale problem is the main issue in unification.

Table 21 - Total assets of EC Countries and Turkey

Country	billion ECU
Belgium	252.8
Denmark	99.3
Germany	1773.8
Greece	39.4
Spain	431.6
France	887.2
Ireland	38.8
Italy	854.5
Luxemburg	238.8
Holland	373.4
Portugal	36.1
United Kingdom	1709.7
Turkey	57.2 (1990), 40 (1994)

Panaroma of EC Industry - 1990, Turkish Banks Association - 1994

Table 22 - Assets and percentage over GNP of banks in EC countries and Turkey (1990)

Country	assets billion ECU	% GNP
Denmark	99.3	168
Germany	1773.8	172
Greece	39.4	49
Spain	431.6	167
France	877.2	201
Holland	373.	185
United Kingdom	1709.7	230
Turkey	57.2 (1994 40)	68

EUROMONEY, Towards a Single Market, 1992

Table 23 - Total equities of the largest five banks

Country	$ billion (1989)
Belgium	6.1
Denmark	5.7
Germany	24.6
Greece	1.7
Spain	14.6
France	37.1
Italy	19.0
Luxemburg	1.5
Holland	15.4
Portugal	2.2
United Kingdom	32.0
Turkey	1.3 (1.6 in 1994)

The Banker, 1990

And the standing is much worse in total for the sector. The free equity has turned to positive only in 1990 and it has returned back to negative in 1994.

Quality of assets is another main consideration in financial positioning of the sector, as bad-debts directly effect the profitability especially in countries like Turkey where the inflation rate is so high, also the low quality of assets, increase the prices of products to cover up the losses and decreases financial efficiency.

Table 24 - Asset Structures of EC member states banking sector & Turkish Banking Sector, 1989

	Cash & Central Bank	Inter bank	Loans	Securitie s	income generating assets	Other
Belgium	0,18	43,4	28,54	23,34	95,28	4,55
Denmark	1,6	16,2	43,09	21,71	81	17,4
France	1,56	45,08	37,07	5,16	87,31	11,13
Germany	2,46	24,49	55,11	15,34	94,94	2,6
Greece	13,48	5,07	33,33	43,26	81,67	4,85
Italy	0,38	8,19	32,11	13,15	53,44	46,18
Luxembourg	0,2	60,23	23,86	7,28	91,37	8,43
Netherland	2,58	25,13	56,49	8,75	90,37	7,05
Portugal	12,81	12,06	37,39	15	64,45	22,74
Spain	9,34	10,26	44,45	21,9	76,61	14,05
U.K.	1,58	17,02	60,81	6,44	84,27	14,15
Turkey	7,66	7,62	39,44	12,9	59,95	32,39

OECD 91 Banks Profitability Supplement
Banks in Turkey 1994 Banks Association of Turkey

Table 25 - Liability Structures of EC member states banking sector & Turkish Banking Sector, 1989

	Equity	Central Bank	Interbank	Deposits	Securities	Other
Belgium	3,39		57,94	28,77	4,5	5,4
Denmark	8,72	1,87	25,64	46,79		16,97
France	2,84		47,02	32,55	7,34	10,25
Germany	3,82	4,41	22,87	52,79	12,46	3,64
Greece	2,87	0,09	1,01	92,33		3,69
Italy	6,34	0,37	9,04	45,03		39,24
Luxembourg	3,2		49,97	38,48	3,19	5,17
Netherland	4,37	0,55	22,26	47,63	15,55	9,65
Portugal	10,32	0,3	4,9	73,2	0,89	10,38
Spain	8,78	3,33	9,85	66,83	1,72	9,49
U.K.	4,89			86,99	3,63	4,49
Turkey	4,62	3,23	4,02	60,34	0,41	27,38
Turkey(94)	5,25	3,35	1,3	63,75	0,3	26,05

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The percentage of reserves for bad-debts to assets is compared to EC countries which indicated that first U.K. reserved the most out of its assets as 1,44% in 1989 however this was due erasing the credits in South American countries and the 2nd was Turkey with 0,86% in 1989 and 0,7 in 1994, the other countries were below 0,5. The legal actions against bad-debts should be more efficient and clear to reduce the stock of bad-debts and defaults.

Table 26 - Allowances for bad debts as percentage to total assets

Country	
Denmark	0.73
Germany	0.45
Greece	0.36
Spain	0.42
France	0.48
Italy	0.49
United Kingdom	1.44
Turkey	0.86

Bank Profitability Statistical Supplement
Financial Statements of Banks 1981-1989 OECD, 1991

For **capital adequacy,** the ratio of financial independence (Equity / Total Assets) was 8.4% and financial risk ratio (equity / cash and non-cash credits) was 5.9 in 1994. Of course these numbers should be corrected for risk weights in Cookes definitions and off balance sheet transactions. However some EC countries have also small values for these ratios. However the ratios for Turkey will reduce by 30% if revaluation funds are excluded.

Table 27 - Basle ratio of capital adequacy

Country	
Belgium	8.0
Denmark	8.7
Germany	over 8.0
Greece	2.87
Spain	8.78
France	7.5
Italy	7.5
Luxemburg	3.20
Holland	over 8.0
United Kingdom	8.9
Turkey	4.62

Financial Times

With risk weighted assets and consideration of off-balance sheet items, the Cooke's ratio shows that Turkish banking sector is in a very disadvantageous position and has to increase its equity to be competitive with respect to EC countries. The numbers are above 8% for Belgium (8,0), Germany, Holland, U.K. (8,9), Denmark (8,7) and Spain (8,78), 7,5 for France and Italy, and 4,62 for Turkey as of 1989.

The percentage of credits granted to deposits collected is 65.3% in Turkey however it is 96% in EC average which means that there has been high legal requirements on the deposits collected and this burden resulted in less efficient placements. However the percentage of deposits to total liabilities was 60.3% with respect to 47% in EC average indicating that Turkish banks were doing deposit banking until recently, they moved a little to fee generating activities in recent years.

In order for the banks that do not meet the Cooke's capital adequacy ratio of risk weighted assets to equity, there are several alternatives. One of them is that shareholders may put fresh money. However, it is too unrealistic, therefore banks have to finance themselves where profitability of the banks become important, however as the banks in EC have less margins and it is expected that the profit margins to reduce in the domestic sector also profits will be inadequate to close equity gaps. Finally the most realistic and practical way to generate equity is to sell valuable non income generating fixed assets and shares in subsidiaries in non banking sectors in their portfolio and to add the outcome to their equity.

One more feasible alternative is mergers and acquisitions. 3 public banks have merged in late 80s to form larger banks to provide enhancements in balance sheets of some of the banks, however these mergers did not provide improvements on reducing expenses or increasing profitability nor in enhancing balance sheets instead balance sheets of the large banks get worse.

Also as holding groups capitalize more than one bank in their group, because the banks are specialized in different areas, mergers will not result in better performances and savings to a large extent.

5.6. *Comparison of efficiency, operating costs, profitability and productivity*

5.6.1. Efficiency

The indicator of operating efficiency is the margin between the deposit rates and credit rates quotations which has been traditionally high in Turkish market. The increase in profit margin of the banks is explained by high operating expenses and profits. Also the elasticity of the demand for credits, the inflation rate and the competition affects the margins but the margins are relatively quite high with respect to EC countries where in Turkey margins are 15-20% and in EC countries like in Belgium it is 5.6%, in France 4.3%, in Spain 10.7% and in England 2.5%.

5.6.2. Operating costs

Percentage of operating costs to total assets is considered for comparison which resulted in the fact that the operating costs are very high for Turkey exactly the highest when compared to EC countries. Operating costs in Turkey has increased after 1980 steadily by the increase in personnel expenses and technological investments. As technology investments are unavoidable it can be expected that the increase will continue.

Table 28 - Operating expenses over total assets

Country	%
Belgium	1.19
Denmark	2.10
Germany	1.75
Greece	2.39
Spain	3.11
France	1.67
Italy	2.79
Luxemburg	0.47
Holland	1.89
Portugal	2.3
United Kingdom	3.46
Turkey	3.81

OECD, 1991, Banks Association of Turkey 1994

Table 29 - Income before taxes over Operating expenses

Country	%
Belgium	1.52
Denmark	1.54
Germany	1.55
Greece	1.30
Spain	1.63
France	1.55
Italy	1.59
Luxemburg	2.44
Holland	1.53
Portugal	2.14
United Kingdom	1.53
Turkey	1.94

OECD, 1991, Banks Association of Turkey 1994

Table 30 - Personnel expenses over total assets

Country	%
Belgium	0.83
Denmark	1.31
Germany	1.11
Greece	1.87
Spain	2.09
France	1.02
Italy	1.98
Luxemburg	0.25
Holland	1.10
Portugal	1.49
United Kingdom	2.01
Turkey	3.06

OECD, 1991, Banks Association of Turkey 1994

5.6.3. Profitability

When the net income before taxes over total assets are compared, it is obvious that Turkey has the highest profitability among the EC countries. It was 2.38 in 1991 and it has reduced to 2.75% in 1994 and after taxes the number is 2.2 by the end of 1994. This number is less than 1% in more than half of the EC countries. The trend for EC is the reduction in profitability and margins. The other measures for profitability are the ROE which has been 63.4% in 1991 in Turkey and 25.8% in EC (36% in 1994 in Turkey), net interest income / Total assets was 3% in Turkey and 1.9% in EC.

Table 31 - The return on assets before taxes in EC Countries and Turkey

Country	%
Belgium	0.15
Denmark	0.27
Germany	0.50
Greece	0.37
Spain	1.38
France	0.37
Italy	1.14
Luxemburg	0.31
Holland	0.63
Portugal	1.02
United Kingdom	1.52
Turkey	2.38 (2.75 in 1994)

OECD, 1991, Banks Association of Turkey 1994

Table 32 - Gross margins in EC Countries and Turkey

Country	gross margin
Belgium	1.32
Denmark	2.54
Germany	2.01
Greece	1.19
Spain	4.20
France	2.03
Italy	3.30
Luxemburg	0.82
Holland	2.01
Portugal	4.12
United Kingdom	3.22
Turkey	3.76

OECD, 1991, Banks Association of Turkey 1994

However, while measuring the profitability of the banks by ROA (return on assets) the inflation should not be forgotten. ROE has been 36% before taxes in 1994 however when 150% inflation is taken into account this means it was between -30% and -40% in reality. This means that Turkish banks have losses which is eating up their equity, which also makes t very difficult to increase capital adequacy ratios. However the ROE of large banks in EC ranges from 5% to 20%. (24.6% for Deutsche Bank in 1990)

Table 33 - Inflation Rates in EC & Turkey

Country	Inflation
Denmark	2,3
Belgium	2,8
Germany	4,2
Greece	17,8
Luxemburg	2,6
Spain	5,5
France	3,1
Holland	4,9
Portugal	9,6
United Kingdom	4,5
Turkey	65 (149,6 in 1994)

The Economist : Internet

Table 34 - Income & Expense Structures and profitability of banking sectors of EC member states & Turkish Banking Sector, 1989

	Interest Income	Interest Expense.	Net difference	Non interest income	gross income	operating expenses	net income
Belgium	9,9	8,58	1,32	0,5	1,81	1,19	0,62
Denmark	8,59	6,05	2,54	0,71	3,24	2,1	1,14
France	8,84	6,82	2,03	0,55	2,58	1,67	0,9
Germany	6,77	4,76	2,01	0,69	2,71	1,75	0,96
Greece	13,22	12,02	1,19	1,93	3,12	2,39	0,73
Italy	8,49	5,19	3,3	1,14	4,44	2,79	1,65
Luxembourg	9	8,18	0,82	0,32	1,15	0,47	0,68
Netherland	10,05	8,04	2,01	0,88	2,89	1,89	1
Portugal	12,31	8,19	4,12	0,8	4,92	2,3	2,61
Spain	10,46	6,26	4,2	0,86	5,06	3,11	1,94
U.K.	12,36	9,14	3,22	2,08	5,3	3,46	1,84
Turkey	25,54	21,78	3,76	3,64	7,39	3,81	3,58

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Table 34 Con'd - Income & Expense Structures and profitability of banking sectors of EC member states & Turkish Banking Sector, 1989

	Allowances	NIBT	Taxes	Net income after taxes
Belgium	0,43	0,19	0,09	0,1
Denmark	0,86	0,27	0,05	0,22
France	0,54	0,37	0,1	0,27
Germany	0,46	0,5	0,28	0,22
Greece	0,36	0,37	0,05	0,32
Italy	0,51	1,14	0,39	0,75
Luxembourg	0,37	0,31	0,1	0,21
Netherland	0,37	0,63	0,15	0,48
Portugal	1,59	1,02	0,24	0,78
Spain	0,57	1,38	0,39	0,99
U.K.	1,73	0,11	0,1	0,01
Turkey	1,21	2,38	0,52	1,86

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5.6.4. Productivity

Total assets per personnel is considered mainly for comparison instead of profitability per personnel and ratios regarding the branches. With respect to assets per personnel Turkey is in the last rank when compared with EC countries. Luxembourg has 30 times more assets per personnel than Turkey, Sweden, Austria, Belgium, Portugal and France are in the range of 6 times, Holland, Norway are 4 times, U.K., Denmark and Greece are 2 times more in assets per personnel. This means that personnel productivity is low with respect to EC countries. The reality of low personnel and branch productivity can be explained by relatively low wages, competition in non-price issues, and the employment policies of public banks.

Branch productivity is very low ,(Total assets / # of branches) (6.2 in Turkey and 56.8 in EC average), personnel per branch is again high (22.9 in Turkey, 17.4 in EC in 1989), personnel expenses over operating expenses is high (80.3% in Turkey and 51.5% in EC in 1990)

Table 35 - Number and density of personnel

Country	# branches	# personnel	personnel / branch
Belgium	3618	51600	14
Denmark	3059	54000	18
Germany	39601		
Greece	799	29700	37
Spain	16819	155700	9
France	20998	360348	17
Italy	10564	240300	23
Luxemburg	295	15200	51
Holland	7412	111800	15
Portugal	1741	58100	33
United Kingdom	12789	399300	31
Turkey	6087	146248	24

OECD, 1991, Banks Association of Turkey 1994
Banks in Turkey, 1994

Table 36. Income, Assets and Loans per personnel of banking sectors of EC member states & Turkish Banking Sector, 1989

	NIBT	Assets	Loans
Belgium	13.085	6.755.880	1.926.470
Denmark	17.937	3.020.000	1.301.414
France	17.476	5.044.545	1.870.335
Greece	3.353	983.745	327.335
Italy	32.567	3.336.350	1.071.135
Luxembourg	66.073	21.935.295	5.232.355
Netherland	23.915	4.244.726	2.397.845
Portugal	11.569	1.222.710	457.223
Spain	30.429	2.367.245	1.052.192
U.K.	25.072	19.977.368	12.170.243
Turkey	5.330	275.475	108.115

OECD 91 Banks Profitability Supplement
Banks in Turkey 1994 Banks Association of Turkey

5.7. Opening to international finance markets

Altough there has been a great increase in the number of foreign banks in Turkey after 1980, this development did not result by a serious external competition. As the domestic economy is opened to international markets and foreign trade increased, these entries have slowed down with stronger competition by domestic banks in spacialized or corporate banking activities. As percentage to the number of banks 34% of the banks are foreign investment, however, they have 3.5% share in credits and 2.4% in deposits which does not imply a considerable foreign competition when compared to other countries. Especially UK and Luxembourg are the countries attracting the largest number of foreign banks with their developed securities market. The percentage of number of foreign banks in UK is 60% and in Luxembourg 91%. The reason for this is high profitability, the availability of financial products and the easiness of entry for foreign banks to these markets.

An obstacle facing Turkish banks to enter international finance markets and acquire subsidiaries or to act in partnerships is the low level of equity. Especially, the joined ventures with French, American and German banks in foreign countries is very positive for the domestic banking sector.

Table 37. Assets and liabilities in FX / Total Assets

Country	Assets in FX / Total Assets	Liabilities in FX / Total Assets
Denmark	30.6	36.5
Belgium	50.7	61.4
Germany	16.4	9.6
Greece	M.D	M.D
Luxemburg	88.4	81.4
Spain	4.8	7.5
France	15.5	M.D
Holland	31.6	26.2
Portugal	6.8	4.5
United Kingdom	M.D	M.D
Turkey	7.9	4.5

Bank Profitability Statistical Supplement Financial Statements of Banks 1981-1989 OECD, 1991

Table 38. FX deposits / Total Deposits : EC and Turkey

Country	FX deposits / Deposits (1989)
France	2,7
Spain	4,3
Netherland	4,5
Germany	6,5
United Kingdom	14,2
Turkey	24(49,8 in 1994)

Dolarization & money substitution (not internationalization for Turkey)
Banks Association of Turkey

Table 39. Turkish Banking in EC

	Branches	Other	Banks
Denmark			
Belgium		2	
Germany	9	50	2
Switzerland			1
Luxemburg	1		
Ireland			1
France		2	5
Holland	1	5	3
Portugal			
United Kingdom	2	3	1
Turkey			

Banks Association of Turkey 1994

The transactions in foreign exchange were 60% of the deposits in 1994, the term structure of FX position indicates that credits granted are long term and deposits were short term. Aside the interest rate and liquidity risk involved, the increase in the volume of FX denominated liabilities in total deposits have serious effects on balance of payments. This has serious implications since the deposits in FX belong 92% to Turkish residents whereas most of them belong to non-residents in EC.

5.8. *Information Technology and Re-engineering*

With the enormous investments made on the telecommunications network mainly between 1983 and 1989, the use of telecommunications in the sector has increased. The infrastructure was one of the most technologically advanced while entering the 90s, and the demand of the financial sector for telecommunications was a fact, so beginning in 1985 and onward the use of technology in the banks begin increasing exponentially, although the first heavy investments on technology started by the 1980s. By the introduction of ATMs, some of the activities in the branches has moved to ATMs and an important amount of overhead is moved to the ATMs. This resulted in questioning some of the branches because ATMs were satisfactory in some locations and the profitability of the branches has reduced substantially when branch banking become unrealistic, as a result banks began closing branches and investing on ATMs. For example Yapı Kredi Bank decreased the number of branches from 668 to 370 in 3 years beginning 1989. Then they started to open feasible branches in time while the number of ATMs increased from 100 to 500 in the same period. However the number of branches and the number of ATMs (4000 as of 1995) are very low with respect to EC countries. For Example France with same population as Turkey has 20.000 ATMs which is 5 fold of Turkey. Also the indicators of other variables like the number of POS terminals, the number of debit and credit cards, although increased very rapidly and still is increasing are very low when compared to EC countries. BKM is established to facilitate in clearing of domestic electronic transactions. There are a number of technologically developed banks in Turkey which can easily compete with the banks in EC, however the total figures are far below the EC averages. For example the percentage of electronic transactions to the total number of financial transactions is 60% in Yapi Kredi and this number is far (53% EC average) higher than EC average. But if we look at the number of accounts for example in Spain, each and every individual has a bank account while in Turkey this number is 0.6 accounts per person. Again for example the number of POS terminals in France is 400.000 however the number is 18.000 in Turkey. The operating costs for financial transactions in Turkey is quite high with respect to EC countries.

5.8.1. Automation in Central offices

As the product range is diversified and the new products are started to be offered, a computerized solution for automation needs is developed and when entered the middle of 1990s there were so interrelated but exclusive systems in the technology departments that a certain need for unification of the systems become a reality. A number of small projects and systems have been developed to meet the needs of localized processes and to reduce the operating costs by automating some parts of the processing. Also with simple reporting mechanisms the upper management and the logistics departments are made aware of the consolidated positions. However, these systems were although centralized in sharing the processing power of the mainframes, were very distributed in that consolidating the information become a serious problem. For example large banks doing individual banking can not follow the customers as customers having a range of products from the bank, they just follow customer numbers for, for instance a credit card and the customer number for a consumer credit but there is no defined way to know that both of them are the same customer in most of the EDP departments. This was because the technology departments of the banks started and worked as EDP departments not as Information Technology departments lacking the connections and business logic in developing central systems.

As the importance of technology departments increased and the banks become unable to operate without the information systems, the CEOs of banks begin to consider the technology departments more, and when focused on technology they realize that especially for banks operate heavily in individual banking a serious bottleneck is knocking their doors which is the information processing. There was a certain need for changing the product based systems to process based systems who see the customer on one end and the service provider on the other. This customer focus will also effect the customer databases to focus on customers rather than on individual products. This also effect the cost management techniques as when you see the customer in one hand, you can apply the necessary pricing techniques keeping in mind what customer gets as service and what are the costs incurred in the process of providing the service. Consolidated supervision of the activities in banks also result in better decision support systems helping the upper management improve the efficiency in their decision making process.

5.8.2. Customer Focus and Informatıon Technology

As the needs grow and the importance of the IT on bank activities become vital, the banks begin investing enormous amounts on restructuring and started re-engineering programmes recently, for example Yapı Kredi is investing 500 million US dollar in 3 years to Information Technology. Banks also have to create Technology Architecture Management Teams to follow technology and apply it in their banks, of course a co-operation of these teams under an Interbank Technology Development Institution will result in certain reductions in costs for both research and development and implementation of new technologies.

The unprecedendent need for information processing requirements of the banks to enable core banking business activities resulted in focusing on technology departments and the recent trends are,

- Increasing the efficiency of electronic processes and reducing operating costs
- Move from product oriented systems to process oriented systems
- Consolidated management information systems
- Consolidated decision support systems
- Customer focused systems automating customer focused processes
- segmentation of customers to various distribution channels
- training the personnel in the banks
- technology politics

- purchasing and customization vs. in-house development
- outsourcing
- electronic banking
- technology
    - moving to client server technologies
    - reduction in the importance of central processing, increase in distributed systems
- personnel
    - workgroups and teamworks
    - knowledge sharing
- environment

- products
    - expert systems
    - ATMs and EFTPOS terminals
    - mag stripe cards, memory cards and chip cards
    - home banking and IVRs
    - interactive videos
    - phone banking
    - EDI, Swift and transaction switching

Also the software crisis resulted in bottlenecks for the banks in software development activities with currently used technologies. (in mainframes generally COBOL and PL-1 is used with DB2 as the database system) And in the analysis phase currently no methodology or tool is used to help to increase the productivity and to standardize the analyses made. Lower and Upper CASE tools should be employed and the methodologies should be adopted to companies. But these enhancements should also be considered together with the re-structuring of technology departments because the necessary skills of individuals in new processes will be different and the roles of individuals will have to be negotiated considering their skills and their training requirements also new methodologies dictate new procedures and the participation of the banks specialists in projects. Project management and costing issues are main issues in re-structuring.

Research and developments committees should be very careful in targeting the new innovations in international financial markets to Turkey, because of some structural differences (.i.e inflation), some of the products have difficulties in penetrating the market. For example the banks invested a serious amount of money and time in increasing debit transactions in EFTPOS(Electronic Funds Transfer at the Point of Sale) terminals by developing on-line authorization systems through BKM(Bankalararasi Kart Merkezi), however, more than a year has passed over and the percentage of debit card transactions has never been more than 0.1% of total transactions in EFTPOS terminals. The same may hold for the electronic purse.

5.9. Effect of the customs union on banking sector

One effect of the customs union in Turkish Banking sector is that the banking sector will be indirectly effected from the direct effects on the manufacturing industry (Akgüç, 1994). The increased competition and different competence levels of different sectors in Turkey should be closely followed as successful competitive firms will make investments partly by borrowing from banks while some sectors will be incompetitive and unable to pay their debts (Imre, 1995). Increase in bad debts may further decrease the profitability of the banks, if loan decisions are not analyzed seriously. So, **the loans granted will move to the competitive sectors and the customer profile of the banks would change.**

Trade finance transactions will increase therefore banks specialized in this area will benefit and others via increasing international connections have to strengthen their competence level on this area.

In manufacturing industry, mergers and acquisitions of private firms with EC firms and joint ventures are expected.

Public banks will move to specialty banking to grant credits to for example agriculture financing, foreign trade financing, financing middle and small range firms etc.

To enjoy economies of scale, especially between small and middle scaled banks mergers and acquisitions may take place.

The product ranges of banks will diversify to include forwards as instruments for those investors that need to hedge their positions against fluctuations on exchange and interest rates, financial futures and options to increase the efficiency of the markets.

Reduction in reserve and liquidity requirements is foreseen and become actual in 1994.

6. Conclusion

The banking system in Turkey started with foreign capital, then came the public banks with specific aims, and with the foundation of the Republic of Turkey, the private banks came into scene. Important changes have taken place in the sector from 1980 onwards by the liberalization programme, and the internationalization of the banking activities paved the way towards the integration of Turkish banking system into the European Banking system. When competitiveness of the Turkish banking sector to EC is considered, it should be stated that the national banking in Turkey is one of the most open sectors to outside competition. There is no critical differences in legal grounds between EU and Turkish banking secror and the discrepancies are being harmonized in time, moreover the problems are such that, they can be resolved even after EC accession.

Table 40 - Strengths and weaknesses of Turkish banking sector against foreign banks in domestic market and in EU

Strengths	**Weaknesses**
investment on technology	low capacity of assets
installed branch network	capital inadequacy
ready customer base	high operating expenses
qualified personel	high profitability
harmonized legal conditions	short term and expansive liabilities
experience on re-structuring and crisis management	high level of bad debts and low quality of assets
low wages and salaries	inefficiency of financial intermediation
diversified product range and importance given to quality	low level of productivity
reduction of reserve and liquidity requirements	Irrational public banks with a big share in the sector
electronic banking	economic infrastructure and instability : high interest rate and exchange rate risks
universal banking	oligopolistic sector structure
following international standarts and institutions	low banking rate and inadequacy of financial depth in markets
studies to increase efficiency and control costs	high level and continous inflation
	low-level of competition due to foreign banks up to now
	inadequate international activities
	cost of adapting new information technologies

For the foreign banks who want to access retail customers, huge technological investment is a must, altough these kinds of banks may leverage the know-how and techology of the parent company, they have to make serious adaptations to their software base and they have to invest huge amounts on hardware to effectively reach and serve the individual customer. Turkish banks, especially after 1980s invested large sums in technology and now have a base of customized and used hardware and software base. The developments in the west on the applications depending on on-line technology are also new. The main difficulty on that subject was the inefficiency of communication network. Parallel to the recent developments on this area, the banks rapidly started to apply on-line technology and has been successful on this.

Installed branch networks and ready customer base are very important for the domestic banking sector, especially after the rationalization of branches. Each foreign bank has to install its customer base in time.

Especially in recent years the quality of the personnel employed in the sector has increased substantially and now it is an advantage for the domestic banking sector. Management is especially experienced on crisis management as the 1994 economic crisis is overcomed and re-structuring as it can be seen from the rationalization of branches.

Diversified product range and supply of modern services is an advantage.

With the reduction of reserve and liquidity requirements efficiency in financial intermediation is supposed to increase as the percentage of money that can be lent to deposits collected increases.

Opportunities & Threats

Ready customer base allows cross marketing opportunities for domestic banks by selling new products to customer who already has a relationship with the bank.

The oligopolistic structure of the sector result in less competition and high ability of determination for big banks. Moreover, there are examples of more than one bank owned by a holding group, which results in higher level of concentration. Basically, domestic banks are operating with high operating expenses, are less efficient in using the resources and are less productive when compared to community banks however resulting from low level of competition the profitability is much higher and with the Customs Union or total accession to EU, domestic banks are expected to face more competition of foreign banks and the profitability will decrease. It may be fatal for the banks with inadequate capital.

For the foreign banks who want to operate in Turkey, acquisition of Turkish banks with low market value and an installed base of branches, technological infrastructure and human potential may be a threat.

Banks in Turkey began providing technology supported services at the end of 1980s, because of the developments in information technology they have to replace in parts their technological infrastructure which is very costly. The same holds for banks who want to provide new banking technologies but the key here is almost with the same level of importance with the technological base is the sufficient and qualified personnel requirement. Even the branch personnel have to have suggestions on products to be offered by the bank.

Wages and salaries are expected to increase with the increasing competition due to foreign banks, in the banking sector which has high personel expenses, with the increase of personel expenses, total operating expenses will tend to increase

Especially public banks are operating irrationally with very high operating expenses and irrational personel policies. To adapt to competition flexibility in decreasing personel shuold be possible and beurocracy should be less, especially government should not be able to be effective in the decision making process of public banks.

Small size and respectively low assets limits the operations that Turkish banks can carry in international markets.

Strategies to enhance competitive power of the sector

Major general trends in the internal market are further diversification of products and services and gaining profits out of innovations which will have demands with low price elasticity, intensified competition in the community level, utilization of technology, new distribution channels, new competitors, and finally changes in customer preferences.

It seems that, the unification process in EC will not lead to discrimination against non-member countries or markets rather it would help in globalization of financial sectors. For the Turkish Banks who were not following a globalization strategy until recently, an efficient strategy of opening to international markets should be implemented.

Liberalization in financial sector has been experienced after 1980 and especially big companies and banks have developed their international activities. Cross border operations in retail banking may be effective in long term because of the inherent characteristics regarding the cost of branch network and the nature of bank-customer relationship. However, the internal market is coming with intensified competition especially on services focused on medium sized firms and high-end customers. These effects have already motivated the restructuring operations and created stronger banks through merger activities in member states.

Strategies for the Turkish banking sector are divided into three categorically, namely governmental, sectoral and individual bank level strategies.

Governmental Strategies

- **Economic Stability** : After 1980 with the deregulation's and liberalization's in the sector a modern banking infrastructure was built. Reforms executed by the Central Bank and liberalization policies opened the sector to international competition and the competition in the sector has increased.

With the leading of the Central Bank and the Banks Association, technological infrastructure is modernized and via entering SWIFT and building the EFT system certain milestones.

The last step in re-structuring process is about the capital market. In that step, anti-inflationist and consistent financial policies and co-operation among relevant institutions (namely the Treasury, the Central Bank, the Capital Market Board and the Banks Association) is important. Because it is experienced that without reducing the inflation levels and establishing a financial discipline on the markets and abolishing the need for reel devaluation, financial deregulation and liberalization of capital movements results in destabilization of the economy. On the other hand, the solution of these problems may only be possible with the cooperation of all parties involved and political decisiveness.

The real problems of the Turkish banking system is the crowding out of the financial sector due to heavy government intervention, high funding requirements of the SEEs, unfair competition of state banks and failure to eliminate it and the inflation. Especially without preventing the high level of inflation, liberalization and deregulation in financial and capital markets have no chance to succeed in monetary policies and result in dolarization (Kazgan, 1994). This means that enhancing the competitiveness of the financial market against EC, puts certain responsibility on the government also. Dolarization resulted in high interest-inflation-devaluation-public deficits and debts cycle. Also it has created serious problems related to balance of payments as US dollar is being used as a means of exchange and the TL is not trusted anymore unless enormously high interests are paid to TL deposits. To overcome these difficulties the government need certain re-structuring in SEEs and government offices.

In the case of realization of EMU, monetary pressure over Turkey will increase, considering that the Central Banks in EMU will be autonomous, measures against the autonomy of the Central Bank should be applied.

- **The Banking Model** : The next area that needs a nation-wide cooperation is on determining the long term strategies on national and international activities of the domestic banking system. The cooperation between the public authorities, banks and industrial and commercial companies will provide the sector with a long term vision.

Banks should support small and medium scaled firms on financing, consulting and management techniques and join the activities on electronic data interchange (EDI) and fund transfer.

Big banks should undertake the auto control responsibilities in the sector to increase the reliability and efficiency of the sector. So that the public control will move to the areas like the financial strength of individual banks etc.

- Strategic Cooperation with foreign banks through joint ventures and with other domestic banks to reach to the scale that will let the Turkish banks be competitive in international markets is beneficial.

- International finance center : To reduce the dependency to foreign finance centers and to attract foreign capital, it is vital to develop the qualifications of Istanbul (considering the richness of infrastructure) as a finance center. To achieve this free entry to foreign banks should be granted, liberalization policies should be in conformance to international banking norms, and financial innovations should be introduced .

- Financial depth : To minimize the leakages from the banking system, payment of wages and salaries through bank accounts should be widened, all the payments to the public authorities should be encouraged to be transferred with cheque, card or bank accounts. To increase the use of cheques the data bank and risk management and control mechanism under the control of the central bank should be further developed.

Corporate investors should be gained by the financial system. Retiring through more rational funds should be promoted to convert the Social Security institutions to large investors and thus provide the banking sector with long term funds that will enhance the financial depth and further the stability of the sector.

- Competition Policy : The price agreements and domination of markets by cooperating banks should be discouraged. The weight of the public banks in the sector should be reduced with privatization. Capital of banks should be shared by a wide base composing the management's, personnel and corporations.

The small scale of equity of Turkish banks against large community banks give importance to considerations regarding the open competitive model. The costs should be reduced and reserve and liquidity requirements should be reduced to community levels close to 5%.

Sectoral Strategies

- Control of technology costs with the development of electronic banking should be considered on the sectoral base.

- Cooperation with international banking institutions, becoming knowledgeable on the markets and opening to international environment should be promoted.

- The relationship with the industrial and commercial sectors should be emphasized, security and efficiency considerations in payment systems should be focused on.

- The development and diversification of products and services should be supported on sectoral base.

Banks Strategies

The strategies against the international markets will be based on the specific goals and capabilities of individual banks.

- In Turkey, the commercial banks will remain to be universal banks. Medium scaled development and investment banks may develop regional policies. Specialized banks, through competing on price and quality, may follow high value-added areas, and commercial banks with diversification of products and rationalization of the distribution channels will compete through customer segmentation.

- technology costs will be determinant as the requirements for electronic banking, searching and focusing on new customer segments become obligatory.

- Rationalization of the branch network, increasing the productivity of personnel, support of small branch structures are crucial.

- Directed services to specific customer segments, product differentiation and developing banks images with increasing quality and price competition should be implemented.

- The centralization in terms of removing all of the back office processes from the personnel facing the customers and decentralization in terms of empowering the personnel facing the customer is the most important consideration in increasing the efficiency of operations, speeding up the processes and reducing the costs. However the empowerment of front end personnel requires intensive customer focused data to be feeded to them which in reality requires perfectly designed and implemented information technology systems. Enhancing the decision making process should be implemented through re-engineering of banking processes mainly the payments, product management systems, capital markets, risk management and accounting.

Basic **limitations** of the research originated from the fact that, comparative ratio analysis employed in the reserch has two important weaknesses. First, there is no common acceptance on the ratios to be considered in such an analysis. Second, for the reason of the fact that there is no standart on the definitions and data provided by the countries investigated, data that is edited and corrected to remove the disrepancies, by specialized institutions is used which has resulted in non-up-to-date data to be used.

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