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RECENT BANKING REFORMS IN SELECTED OIC COUNTRIES

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The banking sector in Indonesia, Malaysia, Turkey and Kazakhstan was severely affected by the financial crises that those countries experienced in the last decade. The macroeconomic instability caused by the said crises showed that a sound banking sector is a prerequisite for a stable financial system and a pivotal factor for sustainable economic growth and development. The reforms undertaken by those countries since the crises have focused on rehabilitating the banking sector, which led to a significant improvement in its performance. The reforms in those countries increased prudential regulations aimed at finding lasting solutions to the reoccurrence of such crises. This paper discusses the recent banking reforms in each country and investigates that sector's performance by analysing some relevant indicators.

1. INTRODUCTION

It is difficult for a country to attain economic development at the desired levels without a sound banking sector. In many developing countries, including some of the OIC members, weaknesses in the banking sector have led to serious problems in the financial markets and economies. International institutions such as the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) play an important role in setting parameters and standards for the banking sector which include common international practices aimed at promoting the sector and enhancing its efficiency. Recently, banking reforms in many countries have focused on the efficiency of the banking sector through following guidelines based on the recommendations and policies made by international organisations, including the two mentioned above. International financial standards have become a common practice in the global marketplace. Any country that aspires to sustainable economic

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and social development must adhere to those standards if it is to attract capital and keep it within its borders.

In the case of the OIC countries, some have successfully implemented international rules and regulations pertaining to the banking sector. Yet, more efforts are still required by some others in order to achieve an adequate level of progress in this direction. This paper aims to give an overview of the recent banking reforms in Indonesia, Malaysia, Turkey and Kazakhstan and investigates the performance of the banking sector in each of them. In fact, each of those countries faces its own challenges as its banking sector is affected by different factors and reasons. In the case of Indonesia and Malaysia, for instance, the Asian crises of 1997/1998 had a profound adverse impact not just on them but on the whole region as well. Kazakhstan adopted international standards after its independence in 1991. However, in 1998, the Russian crises negatively affected the whole region's banking sectors, particularly in the Newly Independent Countries (NIS) in Central Asia, which became vulnerable to external shocks. In Turkey, several crises occurred, the most recent being in 2001, which severely impacted the banking sector. However, the banking system has recently been undergoing rapid changes as a result of the banking reform programme adopted by the Government in 2001.

The paper is organised as follows: Section 2 discusses the developments that led to the weakening of the banking system in Indonesia following the Asian crisis and the progress made so far in restructuring the banking sector. Section 3 investigates the steps taken in the banking sector reform process in Malaysia and the recent developments in the sector. Section 4 discusses the recent banking restructuring efforts in the Turkish banking sector and analyses its performance over the recent years. Section 5 reviews the reforms made and the current restructuring efforts in the banking sector of Kazakhstan. Section 6 concludes the paper.

2. INDONESIA

2.1. The Banking Sector and the Initial Response to the Crisis

Following the implementation of extensive bank reforms in October 1988, the banking industry grew rapidly in terms of number of commercial banks as well as total assets (Batunanggar, p.4).

Accordingly, the number of banks increased from 111 in 1989 to 240 in 1994 (Table 1). In 1997, as it experienced a financial crisis, Indonesia's banking sector suffered the most damage. Measures taken prior to 1997 were not enough to restore confidence in the banking system which deteriorated as a result of weak corporate governance, poor management, large exposure to foreign currency loans and high Non-Performing Loans (NPL) (state banks) in the 1990s prior to the 1997 Asian financial crises.

Table 1: Number of Banks

	1989	1991	1992	1993	1994	1995	1997
Commercial banks	**111**	**192**	**208**	**234**	**240**	**240**	**222**
State banks		7	7	7	7	7	7
Regional development banks		27	27	27	27	27	27
Private banks		129	144	161	166	165	144
Joint & foreign banks		10	10	10	10	10	44

Source: Bank Indonesia, http://www.bi.go.id.

Following the crisis, the government embarked on a new programme in November 1997 and, in the same month, Bank Indonesia (BI) bailed out systematically several important banks. It was hoped that closing these insolvent banks would demonstrate commitment to prudential regulations, boost confidence in the banking system and end the shift of deposits to state and foreign banks. However, such initial efforts to deal with the banking crisis actually deepened it as closing these banks did not bring about the desired effects.

Up to December 1997, BI's funds support to banks to prevent insolvency accounted for 10.1 percent of GDP (Batunanggar, p.9). Deposit outflows continued throughout December 1997, financed largely by BI liquidity support (Scott, 2002, p.10). Faced with the threat of a collapse in its banking system in early 1998, Indonesia signed the second agreement with the IMF on 15 January 1998. Consequently, on 27 January 1998, the government issued a blanket guarantee to prevent a further slide and maintain public confidence in the banking system. The blanket guarantee covered all commercial banks' liabilities (rupiah and foreign currency), including both depositors and creditors[1].

[1] The replacement of the blanket guarantee with a financial safety net began in April 2005.

The Indonesian Bank Restructuring Agency (IBRA) was established on 26 January 1998 to execute the operations of the blanket guarantee, take over and rehabilitate ailing banks and manage the non-performing assets of those banks (Siregar R. Y., p.10). The IBRA was assigned to restructure the banks taken over by BI and recover and manage their assets through a specialised Asset Management Unit (AMU). Most of the banks' liabilities were transferred to state banks while their assets were transferred to the state-owned IBRA which functioned for 5 years until February 2004.

The IBRA managed to act swiftly in accelerating the sale of these assets. However, despite these restructuring efforts, by the end of 1998, little progress was achieved to improve the deteriorating economy. The large-scale defaults by corporate borrowers and a general loss of confidence in the banking system resulted in too many bank insolvencies. It became apparent that closing the banks was not an ideal solution to restore the Indonesian banking system.

2.2. Banking and Corporate Restructuring in the Post-crisis Period

As part of its programme to restore health to the banks, the Indonesian government recapitalised insolvent banks and merged or closed the rest of them (Fane and McLeod, 2001, p.3-4). Before the recapitalisation programme was initiated, at the onset of the crises in late 1997, the government increased the minimum Capital Adequacy Ratio (CAR) from 8 percent to 9 percent (Fane and McLeod, 2001, p.4). Although it was scheduled to be increased incrementally to 12 percent over the following 4 years, it was instead reduced to 4 percent in February 1999 to reduce the amount of new equity needed to recapitalise the banks and with the understanding that it would increase later on. During the said period, the government also temporarily lowered the capital requirements of banks in order to facilitate its banking restructuring.

All the 7 state banks were recapitalised and 4 of them merged to form Bank Mandiri which became the largest bank in Indonesia with deposits accounting for 30 percent of the total deposits in the banking system (Fane and McLeod, 2001, p.4).

By using the 'fit and proper' test that categorises banks according to their CAR, the government planned to recapitalise 80 percent of the required fund for banks, which were weak but proved to be viable through the review of the rehabilitation programmes. For this purpose, IBRA had the BI liquidity support in the form of equity capital or subordinated loans (Nam, 1999, p.28). The banks scheduled for recapitalisation included some of the largest private banks, including the relatively healthy Bank International Indonesia (BII), Bank Bali and Bank Lippo.

AMU was set up under the IBRA with the purpose of identifying unsound banks, re-capitalising banks that have inadequate capital, and purchasing NPLs from state banks as well as closed or restructured banks. During 2003, IBRA sold approximately USD 22 billion of NPLs (PricewaterhouseCoopers, p.7). In total, IBRA recovered USD 8.3 billion from a total nominal amount of approximately USD 29 billion of bad loans transferred to it. This represented a recovery rate of around 29 percent.

Moreover, the Jakarta Initiative Task Force (JITF) was established in September 1998 as a state-funded agency to resolve corporate credits from foreign banks. Similar to the IBRA, its mandate was to restructure the failed banking system, as many loans turned bad following the rupiah's massive depreciation. Initially, 182 firms applied for help under the Jakarta Initiative. By end-1999, however, JITF debt workout agreements reached only USD 1.3 billion. Although applications did not increase much until its operations ended in December 2003, significant progress was made during the time span of JITF. In 2002, the JITF met its target for debt restructurings, and by end of the year, the cumulative total for JITF-mediated debt reaching the Memorandum of Understanding (MOU) stage amounted to USD 18.9 billion, representing the debt of 86 companies (IMF, 2003, p.9). Having handed over a total of 102 cases worth USD 26.9 billion in debts, the JITF managed to restructure 96 cases worth USD 20.5 billion, or close to 80 percent of the total value (Wijaksana, 2003, p.1).

In December 2003, the Sorak Consortium acquired a 51 percent stake in BII from IBRA (BII, 2003, p.14). The sale of Bank Lippo took place shortly after the completion of the majority divestment of the bank in early 2004, which was postponed earlier due to unacceptable low bids. A state-owned asset management company, PT Perusahaan

Pengelola Aset (PPA) was established to sell those remaining NPLs and equity stakes.

Today, banks are still the dominant institutions of the financial sector in Indonesia. Most corporations own banks that play an important role in the development and economic recovery of the country's corporate sector. On the other hand, following the crisis, and to strengthen the financial sector, BI made encouraging strides in risk-based supervision and the upgrading of banking regulations in line with international standards and introduced new asset classification rules. Furthermore, recent management changes at top state-owned banks, which continued to be the main source of fragility in the financial system, are expected to help improve governance.

A business plan for Bank Mandiri was devised in 2004. As the irregularities at BNI surfaced, serious control weaknesses were revealed in the bank's operations. As a result, more emphasis was given to internal controls along with management changes to address these weaknesses.

2.3. Progress and Future Prospects

So far, banking restructuring efforts had the combined effect of reducing the number of banks in the system. At the end of 1999, that number amounted to 164 compared to 133 at the end of 2004 (Table 2). That drop resulted from the suspension of 38 private banks and the closure of 2 joint-venture banks (BI, 1999, p.67-68). It also resulted from the mergers of 4 state banks, 2 private national banks and two commercial banks (formerly joint-venture banks) together with the establishment of 2 new state banks. In 2000, the falling trend in the number of commercial banks continued with the merger of 9 taken over banks with Bank Danamon, the closure of 3 private domestic banks and the merger of 2 joint-venture banks (BI, 2000, p.102). In the period 2002-2003, the number of banks declined from 141 to 138 because 3 banks were closed, 2 private banks were merged and 1 foreign bank was set up. More recently, in 2004, 2 banks were closed, 1 bank undertook self-liquidation and 3 banks merged, which brought the number to 133.

Table 2: Number of Banks, 1998-2004

	1998	1999	2000	2001	2002	2003	2004
Commercial banks	**208**	**164**	**151**	**145**	**141**	**138**	**133**
State banks	7	5	5	5	5	5	5
Regional development banks	27	27	26	26	26	26	26
Private banks	130	92	81	80	77	72	72
Joint & foreign banks	44	40	39	34	34	31	31

Source: Bank Indonesia, http://www.bi.go.id.

The banking sector showed signs of improvement following the restructuring of banks after the crisis. In the period 1998-1999, significant achievements were made with respect to improving NPL, increasing CAR and the banks' intermediary function. In recent years, further progress was achieved in improving NPL. Net NPL as a percentage of total loans fell from 5.8 percent in 2000 to 2.1 percent in 2002 before increasing slightly to 2.8 percent in 2004. Loan loss reserves as a percentage of compromised assets recorded 43.4 percent in 2003 compared to 36.1 percent in 2000 (Table 3). On the other hand, CAR turned positive in the period 1999-2000 and reached 23.8 percent in 2004. After falling from 72.4 percent in 1998 to 26.2 percent in 1999, loan to deposit ratio steadily increased to 43.2 percent in 2003 (Table 3). In 2004, the intermediary functions of the banks showed a descending trend.

Table 3: Leading Banking Indicators (%)

	1998	1999	2000	2001	2002	2003	2004
Loan to Deposit Ratio (LDR)	72.4	26.2	33.2	33.0	38.4	43.2	40.1
CAR	-15.7	-8.1	12.5	20.5	23.0	19.3	23.8
NPL-gross (% of total loans)	48.6	32.8	18.8	12.1	8.1	8.2	8.2
NPL-net (% of total loans)	34.7	7.3	5.8	3.6	2.1	3.0	2.8
Loan-loss reserves/compromised assets			36.1	35.5	35.9	43.4	42.9

Source: http://www.bi.go.id and Global Financial Stability Report (GSFR).
Note: 2004: June.

On the other hand, the divestment of state banks played a key role in enhancing the efficiency of state-owed enterprises and exposing them to greater competition. In this context, it constitutes an integral component of the government's privatisation programme aimed at reducing concentration in the financial sector. The whole process of divestment of 71 percent of Bank Permata's shares was completed as PPA divested 20 percent of its shares in December 2004 after receiving the proceeds of the sale of 51 percent of Bank Permata's shares from the IBRA (PPA

Web Site). As a result, all banks taken over during the crisis were returned to private ownership (IMF, 2005d, p.2). The government also divested part of its remaining shares in Bank Danamon and Bank Niaga in late 2004 which reduced its share in those banks.

The Indonesian Banking Architecture (API) was introduced in early 2004 with a view to enhancing the soundness and strength of the national banking industry. As part of API, BI is about to launch a programme to increase the banks' capital and foster greater consolidation in the sector. Thus, more attention has been given to ensuring that mergers in the sector lead to creating sound and strong banks later on. Further progress is likely to take place as BI continues to implement its strategies in this direction. Eventually, the consolidation process will prepare the banks for the challenges of the new century, which require meeting international standards as prescribed by the leading international financial institutions.

3. MALAYSIA

3.1. Banking Reform Initiatives in the Aftermath of the Crisis

In 1997, although the banking system had only a little foreign currency exposure, a massive accumulation of outstanding domestic credits in the system with a heavy exposure to the property sector pushed the financial sector to crises. Non-performing loans (NPLs) also increased significantly in the same period. Following the crisis, reform initiatives started in 1998 with the establishment of three institutions, namely Danaharta, Danamodal and the Corporate Debt Restructuring Committee (CDRC). In addition to these bad debt carving out and recapitalisation schemes, Bank Malaysia Negara (BNM), the central bank, embarked on an ambitious programme for finance companies and banks which aimed at reducing the number of banks with a view to improving their competitiveness. The banking merger programme, which was announced by the BNM on 29 July 1999, consolidated the country's existing financial institutions into 10 banking groups. The first round of bank consolidation was initiated in 2000 when BNM imposed a USD 526 million capitalisation requirement on banks.

Danaharta was established in June 1998 to purchase NPL from banking institutions and maximise the recovery value of those assets.

Financial institutions seeking recapitalisation from Danaharta were required to sell their NPL in excess of 10 percent of total loans to this institution as a precondition. By mid-1999, Danaharta acquired almost 40 percent of all NPL in the banking sector.

Most of the NPLs belonged to companies involved in construction, property development and share financing sectors: property sector (29.9 percent), purchase of shares (16.9 percent), financing, insurance and business services (15 percent) and manufacturing (13.1 percent) (ASLAM, 2004, p.88). About 67.1 percent of them were in the form of restructured loans, of which 21.2 percent had more than one-year maturity and 11.7 percent below one year. The major borrowers were private limited companies (59 percent), followed by quoted companies (15 percent), non-residents (19 percent) and residents (7 percent). With regard to collateral, property constituted about 47 percent, shares 20 percent and unsecured portfolios 37 percent.

The money recouped amounted to about 5 percent of the total NPL property portfolio (ASLAM, 2004, pp. 88-89). Danaharta had problems selling off the other 95 percent of its property holdings because these properties were being tendered at prices that were considered unattractive. In some cases, the properties belonged to uncooperative borrowers, making the sale difficult, as Danaharta did not have physical control of the properties. The third method that Danharta used to raise funds was by issuing bonds in exchange for NPLs. Danaharta issued 15 government-guaranteed bonds between 20 November 1998 and 31 March 2000. The maturity dates of two of those bonds were in 2003, 10 in 2004 and 3 in 2005. Since the Danaharta bonds, the majority of which are believed to be held by the EPF and banks, are zero-coupon bonds, interest payments need not be made to the financial institutions that hold them.

At the end of 2000, less than USD 10 billion of loans or assets were restructured or disposed of with an average recovery rate of 74 percent. In this context, loans acquired and managed by Danaharta within the resolution process included various workout processes such as loan structuring, settlement and special administration for viable loans, and sales of collateral and businesses, foreclosures, liquidation, and special administration via a bid process for non-viable ones.

Danamodal was established in 1998 to recapitalise poorly capitalised institutions whose capital adequacy ratio fell below 9 percent. It injected a total of USD 1.6 billion into ten banking institutions which increased the banking system's Risk Weighted Capital Ratio (RWCR). By December 2001, Danamodal's capital injection into 10 financial institutions (5 commercial banks, 2 merchant banks and 3 finance companies) was initially in the form of 7.5 percent Exchangeable Subordinated Capital Loans (ESCLs), which were formalised through conditional agreements (ASLAM, 2004, p.90).

On the other hand, at the end of 2000, applications received and accepted by the CDRC amounted to USD 10 billion. Of these, 42 applications (including those with the assistance of Danaharta), with a value of USD 7.2 billion (almost 70 percent of debt accepted by the CDRC) were resolved while 21 others, accounting for nearly 20 percent of the debts, were withdrawn or rejected (Table 4). By the end of 2001, the CDRC resolved 33 cases, 20 of which were investment holding companies, 7 were in property and construction, 5 in finance and services and 1 in manufacturing (ASLAM, 2004, p.86). The Committee resolved 11 cases in the year 2001 (BNM, 2001, p.110). During its four years of operation, which ended on 15 August 2002, the CDRC successfully resolved 48 cases (BNM, 2002, p.115).

Table 4: Progress of CDRC Cases, End of Period (Accumulative)

	1998	1999	2000	2001	2002
Applications Received	36	66	75	75	87
Withdrawn/Rejected Cases	-	15	21	21	28
Transferred to Danahart	-	8	9	9	11
Total Cases Resolved	2	15	33	44	48
Cases Outstanding	34	28	12	1	0

Source: http://www.bnm.gov.my and BNM annual reports 2001 and 2002.
Note: In 1999, 2 cases were resolved with the assistance of Danaharta.

By 2001, important initiatives were taken in Malaysia to enhance the soundness of the financial system in addition to the establishment of Danaharta, Danamodal and the CDRC and the completion of the merger programme. The BNM required banks to establish internal systems to manage risks, including cross-border transactions. Moreover, the BNM's move towards risk-based and consolidated supervision contributed to the efforts to enhance the soundness of the financial system. Risk-based supervision allowed the BNM to focus its resources on the most critical areas in the individual institutions as well as on the satisfaction of risk areas across the financial sector. These financial innovations were expected to play an important role as the merger programme was completed with the new banking groups becoming larger, more complex and engaging in more varied activities (IMF, 2001, p.80).

In March 2001, the Financial Sector Master Plan (FSMP) was launched with a view to helping the development of the financial sector over a period of 10 years by implementing 119 recommendations through a change programme. Over a three-stage period, the first of which ended in 2004, the FSMP envisages to increase competitiveness in the financial sector. Overall, these efforts are intended to create a more resilient and competitive financial sector, including banks.

3.2. Recent Progress and Future Prospects

Measures taken to rehabilitate the banking sector in the post-crisis period increased incentives for the banks to merge. As a result, the number of depository banks fell from 89 in 1996 to 80 in 1998. At the end of 2004, the depository financial institutions amounted to 39 (Table 5). Out of these, 23 were commercial banks, 6 finance companies and 10 merchant banks. Compared to 1996, the number of commercial banks and finance companies fell sharply whereas no significant decline in the number of merchant banks took place in the said period.

Table 5: Number of Depository Banks, 1996-2004

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Commercial banks	37	35	35	33	31	25	24	23	23
Finance companies	40	39	33	23	20	12	11	11	6
Merchant banks	12	12	12	12	12	10	10	10	10
Total	**89**	**86**	**80**	**68**	**62**	**47**	**45**	**44**	**39**

Source: Bank Malaysia Negara, http://www.bnm.gov.my.
Note: Excluding Islamic banks.

Compared to the initial years of the reform programme, Malaysia's banking soundness improved greatly as clearly indicated by the primary indicators in the sector. Malaysia benefited from a well-developed legal and institutional framework and made a considerable progress, as measured by the NPL to total loans ratio and the capital ratios. The RWCR in the banking system increased from 12.5 percent in 2000 to

13.2 percent in 2002 (Table 6). In 2003 and 2004, that ratio accounted for 13.8 percent and 14.3 percent, respectively.

Table 6: Capital Ratios (%), 1997-2004

Risk-Weighted Capital Ratio (RWCR)								
	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Banking system	10.5	11.8	12.5	12.5	13.0	13.2	13.8	14.3
Commercial banks	10.3	11.7	12.8	12.3	12.8	13.2	14.0	14.3
Finance companies	10.3	11.1	10.8	11.5	12.1	12.0	11.6	10.5
Merchant banks	13.3	15.2	14.5	17.1	19.6	19.0	19.2	22.9
Capital Adequacy Ratio (CAR)								
Banking system	9.1	8.7	10.1	10.7	11.1	11.1	11.1	11.3
Commercial banks	9.0	8.9	10.6	10.8	11.0	11.2	11.3	11.3
Finance companies	8.5	7.2	7.3	8.8	9.8	9.1	8.9	7.5
Merchant banks	11.4	11.3	12.1	14.6	16.3	16.8	17.2	20.4

Source: Bank Malaysia Negara, http://www.bnm.gov.my.

The Capital Adequacy Ratio (CAR) in the banking system increased from 8.7 percent in 1998 to 11.1 percent in 2001, but did not change much since then (Table 6). During the period 1997-2004, both RWCR and CAR were above the international standard level of 8 percent[2]. Further increases in those levels during the period 2003-2004 confirm the banks' commitment to become more competitive to face the challenges of the 21st century. However, in 2004, the CAR of finance institutions was below 8 percent (Table 6). In contrast, their RWCR remained above that level although it fell by 1.1 percent to 10.5 percent in the same year.

Table 7: Loan to Deposit Ratio (%), 1997-2004

	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Commercial banks	91.9	92.9	83.8	83.6	88.1	87.0	82.1	81.2
Finance companies	95.5	87.8	82.5	90.6	109.2	111.5	116.2	123.9
Merchant banks	87.4	84.3	72.9	70.1	57.6	51.3	37.6	33.0

Source: Bank Malaysia Negara, http://www.bnm.gov.my.

On the other hand, the loan to deposit ratio was highest in finance companies in 2004 with 123.9 percent (Table 7). In contrast, the same ratio in the commercial and merchant banks accounted for 81.2 percent and 33 percent respectively. It is observed from Table 7 that the intermediary function of finance companies was significantly recovered in the period 2001-2004, whereas it weakened in the commercial and merchant banks in the said period.

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[2] Basel I requirement.

It is also observed from Table 8 that the banking system's ratio of NPL to total loans declined in the period 2001-2004, while the ratio of total provisions to NPL increased substantially in the same period. This shows the rapid progress made in disposing of NPLs in the system in recent years.

Table 8: Non-Performing Loans (% of Total Loans) and Total Provisions (% of NPL) *, 1996-2004

Non-Performing Loans (% of Total Loans)									
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Banking system	3.7	4.1	8.1	6.4	6.3	8.1	7.5	6.8	5.9
Commercial banks	3.6	3.2	6.7	5.5	5.4	7.4	6.9	6.4	5.5
Finance companies	4.7	6.5	11.7	8.6	8.5	8.5	7.6	7.2	7.7
Merchant banks	1.7	3.5	10.8	12.3	11.7	21.7	20.9	17.9	16.8
Total Provisions (% of NPL)									
Banking system	96.6	151.4	148.8	206.1	199.2	188.7	214.3	213.1	224.4
Commercial banks	98.4	254.7	163.1	199.6	206.5	191.2	230.6	211.0	233.8
Finance companies	88.2	132.8	125.0	236.5	186.2	181.6	180.0	221.0	171.1
Merchant banks	156.9	226.7	139.6	163.5	182.3	187.7	170.1	207.4	223.6

Source: Bank Malaysia Negara, http://www.bnm.gov.my.

* The ratios in the table are based on a 6-month classification for the period 1998-2004.

In 2004, total provisions as a percentage of NPL were highest in commercial banks (Table 8). Moreover, it is observed from Table 8 that provisioning increased substantially in the period 2003-2004.

However, despite the greater performance exhibited by the banks in 2004 compared to previous years and the continued commitment to reform, a full recovery has not yet been achieved. Consequently, as these banks will face international competitiveness, they need to ensure that capacity building measures are fully met as prescribed in the first phase of the FSMP. This will strengthen the capability of those banks to promote economic growth through their operations.

4. TURKEY

4.1. Restructuring of the Banking Sector

As a result of the liberalisation policies of the banking sector undertaken by the Turkish government during the 1980s, the number of commercial banks (depository banks) in Turkey increased from 31 in 1980 to 54 in

1990 (Table 9). Despite these positive achievements, the economic and financial crises in 1994 and 2001, which occurred as a result of a currency and liquidity crisis, revealed that the banking sector was highly fragile. The Banking Regulation and Supervisory Agency (BRSA), which was established in 1999 with the aim of increasing the efficiency of surveillance and supervision over banks, introduced the "Banking Sector Restructuring Programme" in May 2001 to address the weaknesses in the sector. Recapitalising the banking sector, resolving non-performing loans (NPL), limiting foreign exchange open positions of the banks and encouraging bank mergers were the main components of the programme. The programme also aimed at improving the regulatory and supervisory framework and competition in the sector. Consequently, with the implementation of this programme, the number of banks started to decline in the aftermath of the crisis. In the period 2001-2004, the total number of commercial banks fell from 46 to 35 (Table 9).

Table 9: Total Number of Commercial Banks

	1980	1990	1997	1999	2000	2001	2002	2003	2004
Total Commercial	**31**	**54**	**59**	**62**	**61**	**46**	**40**	**36**	**35**
State-owned banks	8	7	4	4	4	3	3	3	3
Private banks	19	25	38	31	28	22	20	18	18
SDIF* banks	-	-		8	11	6	2	2	1
Foreign banks	4	22	17	19	18	15	15	13	13

Source: BAT 2000, 2003 and 2005.
(*) The Savings Deposit Insurance Fund.

The "Banking Sector Restructuring Programme" aims at the financial and operational restructuring of state banks with the ultimate goal of privatisation. Prior to the crisis in 2001, the financial conditions of the state banks had deteriorated due to mounting duty losses, which became a major source of public deficit. Those losses increased from 8.5 percent of GDP to 11.5 percent of GDP in the two-year period of 1999-2000. At the end of 2000, duty losses of state banks arising from subsidised lending amounted to USD 21 billion or 50 percent of the balance sheet (OECD, 2001, p.7). With the Council of Ministers' decision dated 30 April 2001, the decrees on the outstanding duty losses of state banks were annulled and completely eliminated as of the end of June by extending cash and bills. Overall, capital injections as well as the increased share of Treasury papers that carry zero risk weight contributed to the strengthening of the capital structure and capital adequacy.

As regards their operational restructuring, the management of the state banks (Ziraat, Halk and Emlak) was transferred to a newly appointed Joint Board of Directors, which was granted the authority of restructuring and preparing them for privatisation. The banking licence of one of those banks (Emlak) was revoked on 9 July 2001 and its banking assets and liabilities transferred to another state bank (Ziraat). In 2003, the total branches of the state banks and the number of their personnel declined to 1,971 and 37,994 respectively (BAT, 2003, p.1).

During 1997-2004, 21 banks were taken over by the Savings Deposit Insurance Fund (SDIF), all of which were taken by 2003 (Table 10). Those banks were expeditiously resolved through merger, sale or direct liquidation. By the end of 2004, only one bank, namely Imarbank, which was taken over in 2003, remained under the control of the SDIF.

Table 10: Resolution Process of the SDIF Banks

	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**Total**
No. of banks taken over	1	1	6	3	8	1	1	0	21
No. of merged banks	-	-	-	-	7	5		1	13
No. of sold banks	-	-	-	-	3	2		0	5
No. of banks under liquidation process	-	-	-	-	-	1	1	0	2
No. of fund banks	**1**	**2**	**8**	**11**	**9**	**2**	**2**	**1**	**1**

Source: BRSA (2005) and SDIF (2005).

At the end of 2000, the total number of banks taken over by the SDIF increased to 11. In 2001, 8 more banks[3] were taken over by the Fund. In the same year, 5 banks[4] merged with another (Sümerbank), which was sold along with 2 other banks (Demirbank and Sitebank) in 2002. Also in 2001, 2 other banks (Interbank and Esbank) merged with another (Etibank) which, along with 4 other banks, merged with another bank (Bayındır) under the management of the Fund in 2002. In 2004, the number of banks under the control of the Fund was reduced to one, as a bank (Pamukbank) was transferred to a state bank (Halk) which is not managed by the Fund.

With the introduction of the floating exchange rate regime in February 2001, the foreign exchange losses of the SDIF banks significantly increased due to their high open positions. The total public

[3] Ulusal Bank, İktisat Bankası, Bayındırbank, EGS Bank, Kentbank, Tarişbank, Milli Aydın Bankası, Sitebank and Toprakbank.

[4] Bank Kapital, Egebank, Yurtbank, Yaşarbank and Ulusal Bank.

debt stock arising from the state and SDIF banks reached USD 43.6 billion by May 14, 2001. Out of this amount, USD 19 billion were paid by the Treasury with government securities to eliminate duty losses of state banks and USD 2.3 billion were capital injections (cash and non-cash). The remaining USD 21.7 billion were transferred to the SDIF. Out of this amount, USD 17 billion were undertaken by the Treasury and the remaining USD 4.7 billion by the private sector (BRSA, 2003, p.0).

The SDIF banks financed an important portion of their assets through very short-term funds. In order to accelerate their resolution process, the banks under the Fund went through a comprehensive restructuring process. Accordingly, their short-term liabilities were liquidated. The banks taken over by the SDIF were capitalised directly by the government within the restructuring process which began in 2000. The SDIF pays back interest on government securities granted by the Treasury. The foreign exchange, deposit and repo liabilities of the SDIF banks were transferred to the Central Bank of the Republic of Turkey (CBRT), 2 State banks (Halk and Ziraat) and private banks in exchange for government securities, the principal and interest instalment of which accrue on behalf of the SDIF. Thus, although the principal sum of the government securities granted by the Treasury to the SDIF amounts to USD 17.3 billion and despite repayments, the total debt of the SDIF to the Treasury as of 31 July 2003 increased to USD 28.2 billion.

Receivables under follow-up of the SDIF banks were transferred to the Fund's Collection Department to ensure efficiency in their follow-up and collections. Besides, insurance premiums collected from private banks by the SDIF, which make up a considerable portion of the SDIF income, were allocated to finance the resolution of those banks. Accordingly, the intervened banks were taken over by the Fund which became, in effect, a public asset management agency. The SDIF completed its first loan sale with a face value of USD 250 million by the end of June 2003. It[5] intends to complete the bulk of asset recoveries before end-2007 (IMF, 2005e, p.13). The Fund estimates that it will be able to recover about USD 6.2 billion. The SDIF banks showed signs of

[5] The SDIF was transformed into a separate legal entity as BRSA's administrative power on the Fund was revoked on 26 December 2003 by Act No. 5020.

improvement under the bank restructuring programme in the first quarter of 2003 as their CAR turned into positive, reaching 51.1 percent.

On the other hand, the “Banking Sector Restructuring Programme’’ aimed at strengthening the financial structure of private banks. Capital support was extended to private banks within the framework of this Programme under a separate programme known as “Capital Strengthening Programme”. In line with the Programme, important steps were taken toward strengthening the capital base of the private banks with their own resources.

Furthermore, in line with the bank restructuring programme, the Istanbul Approach (IA) was introduced as voluntary corporate restructuring of debts to the financial sector. The implementation of IA started on 24 June 2002 and continued until April 2005. During this period, 329 firms representing USD 6.3 billion in loans benefited from the IA. Out of these, 219 were large firms and 110 represented small and medium enterprises.

4.2. Progress and Future Challenges

Banking sector indicators improved further in the period 2002-2004 indicating that the sector’s performance significantly improved in more recent years. NPL as a percentage of both total loans and provisioning improved significantly in the period 2002-2004 (Table 11). Although RWCR fell sharply in the period 2003-2004, it maintained a level higher than that encountered in 2002. Both RWCR and CAR exhibited highly satisfactory levels in 2004.

Table 11: Leading Banking Statistics

	1998	1999	2000	2001	2002	2003	2004
RWCR		8.2	9.3	20.8	25.1	30.9	26.5
CAR	8.7	5.2	6.1	9.6	11.6	13.6	14.0
LDR		26.2	33.2	33.0	39.6	43.5	52.3
NPL/Total loans	6.7	10.5	11.1	25.2	17.6	11.5	6.1
Provisions/NPL	44.2	61.9	63.1	48.9	64.2	88.5	88.6

Source: GFSR (2005).

The privatisation of state banks remains an important future challenge for the banking industry. In this respect, the sale of two other state banks (Halk and Ziraat) made little progress although important developments took place recently. The merger of the bank taken over in mid-June 2002 (Pamukbank) by the SDIF with a State bank (Halk) on 17 November 2004 is likely to provide momentum in the already delayed privatisation process of the State banks. A comprehensive restructuring plan for Ziraat is being developed with the assistance of international consultants (IMF, 2005c, p.15).

Another remaining challenge is the completion of the resolution process of a bank (İmarbank) that is making little progress. Recent efforts in this direction are likely to bring about the expected progress. Furthermore, the blanket guarantee was lifted on 5 July 2004 and replaced with a limited deposit protection scheme. In line with efforts to join the EU, the Turkish Parliament is currently negotiating and drafting a new banking law which aims at improving and ensuring transparency, corporate governance and risk management in the banking sector.

5. KAZAKHSTAN

5.1. Reform Initiatives in the Aftermath of the 1998 Russian Crisis

Following its independence in 1991, Kazakhstan successfully modernised its financial sector in the 1990s. Between 1995 and 1997, wide-ranging regulatory and accounting changes were introduced and the prudential and supervisory capabilities of the National Bank of Kazakhstan (NBK) were improved (Hoelscher, 1998, p.3). By the end of 1997, an internationally acceptable regulatory and prudential environment was largely in place.

However, following the 1998 Russian crisis, the capital requirements of banks increased and their supervision strengthened, which intensified closures and mergers among banks in Kazakhstan. This process intensified as the Deposit Insurance Fund (DIF), which was introduced in late 1999, prevented banks that did not comply with supervisory regulations from participating in the scheme. As a result, the number of banks fell from 71 in 1998 to 55 in 1999 (Table 12).

Table 12: Number of Commercial Banks, 1991-1999

	1991	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
Total	72	158	204	184	130	101	82	71	55

Source: National Bank of Kazakhstan, http://www.nationalbank.kz.

Since 2000, NBK's responsibility has been broadened by allowing it to cover the licensing and supervision of banks as well as other financial institutions like securities markets, pension funds and insurance. During this period, the share of commercial banks in other banks, private pension funds, insurance, leasing, brokerage and asset management companies showed a growing tendency. As a result, the banking sector was dominated by influential financial-industrial groupings. Additionally, one of the largest three banks (Halyk Savings Bank) was privatised in October 2001.

New rules for risk classification were adopted in late 2002, which set out the criteria for quality assessment of the banks' assets and liabilities. On the other hand, assessment of the internal control and risk management in banks was required by the NBK as part of the 2002 external audit exercise. Consequently, the strengthening of the banking sector continued at a rapid pace in 2002. Another new legislation was passed in 2002, which enabled the NBK to obtain information on the ownership of banks. A financial groups division was also created in the NBK supervision department. Moreover, uniform standards, which are in compliance with the International Accounting Standards (IAS), were introduced for accounting, auditing and reporting.

These measures are likely to play a significant role in developing a sound and transparent banking sector in Kazakhstan over the coming years. The growing trust in banks can help this process move forward as it has already helped the banking sector progress at an increasing rate. Accordingly, banks will rely on building confidence with the public and on the adequate implementation of the unified supervision in order to achieve better results in their overall performance as well as provide better prospects in the financial market and economy.

5.2. Progress in Ongoing Reforms

The ongoing reform process in Kazakhstan is important for increasing confidence in the banking sector as it will strengthen the position of banks and help them play a more significant role in developing the financial market as well as achieving the desired levels of macroeconomic performance.

Efforts to restructure and develop Kazakhstan's financial sector have led to a further consolidation of the banking sector as well as creating a better investment climate in the country. The financial sector has a strong potential for development in Kazakhstan. As more foreign investments are channelled into this market in the coming years, Kazakhstan's economy will flourish and make it a leading market for investment in the region. This will also increase competition among the banks in the country and help them create a more favourable environment to meet the credit needs of their customers through providing cheap loans.

In the period 2000-2004, reform programmes led to the privatisation, re-licensing and merger of banks, all of which contributed to an increased dominance of banks in the financial sector as well as confidence in them. The number of banks fell from 48 to 36 in the said period (Table 13). In 2004, three of the largest banks' (Kazkommertsbank, Bank Turan Alem and Halyk Bank) combined market share accounted for 60 percent of the deposits in the banking system. Additionally, one bank (Eximbank) was privatised in February 2004. In 2004, 15 out of 36 banks were with foreign capital (Table 13). However, the number of these declined compared to the previous year.

Table 13: Number of Commercial Banks and Branches, 2000-2004

Year	**Commercial Banks**					**Branches**
	State and Interstate*	**With Foreign Capital**		**Other**	**Total**	**Total**
		Total	**Subsidiaries**			
2000	2	16	12	30	**48**	418
2001	3	16	11	25	**44**	400
2002	2	17	11	19	**38**	368
2003	3	16	10	17	**36**	355
2004	1	15	10	20	**36**	385

Source: IMF (2005b).

* including Development Bank, which does not accept deposits from the public, and Eximbank.

Loan to deposit ratios increased sharply in the period 1999-2003, while they exceeded 100 percent in 2001 (Table 14). In 2003, this reflects the increased role of the banking sector in lending to the economy in recent years.

Table 14: Selected Banking Indicators (%), 1999-2003

	1999	2000	2001	2002	2003
CAR (Tiers I and II)	28.0	26.0	19.0	17.0	17.0
Tier I		14.0	11.0	9.0	9.0
Loan to Deposit Ratios (LDR)	87.3	95.1	110.1	111.5	133.8

Source: National Bank of Kazakhstan, http://www.nationalbank.kz.

Despite this increase in loan to deposit ratios by over a 100 percent in the period 2001-2003, the banking sector seems to be sufficiently liquid in this period (Table 14). Nonetheless, remarkably high ratios may lead to undesired outcomes for the banks if they are not able to keep the deposit base at the required level at the date of maturity of those loans.

Table 15: Provisioning Rates (%), 1999-2004

	1999	2000	2001	2002	2003	2004
NPL/Total Loans				12.2	13.1	
Loss Loans/Total Loans		2.1	2.1	2.0	2.1	2.9
LLP* to Total Loans	9.5	4.5	4.7	5.5	6.2	7.0

Source: National Bank of Kazakhstan, http://www.nationalbank.kz.
* LLP: Loan loss provisions.

Although the ratio of NPL to total loans increased from 12.2 percent to 13.1 percent in the period 2002-2003, it remains at manageable levels. This is attributed to the ongoing reform process which led to a rapid consolidation of the sector over the past years. In the period 2000-2004, provisioning has increased more than loss loans, reflecting the increased funds of the banks to cover those losses (Table 15). In the period 2000-2004, the CAR did not increase but maintained a level above 8 percent (Table 14).

6. CONCLUSION

The financial crises of the last decade, as witnessed in Indonesia, Malaysia, Turkey and Kazakhstan, renewed the absolute need for a sound banking system which is pivotal to achieve sustainable economic development. Indonesia and Malaysia were severely affected by the 1997 Asian crises. While Indonesia resorted to the IMF assistance in restructuring its economy and banking sector, Malaysia started reforming the banking sector at its own initiative. Lately, Indonesia became more determined to take unilateral measures to restructure its banking sector. Turkey witnessed several crises and although its efforts to continue implementing the IMF guidelines failed at certain times, it made considerable progress in implementing the recent package presented by the IMF in 2001. Turkey's determination to join the EU has also helped this process move forward as efforts are under way for a new bankruptcy law and developing a strategy for the privatisation of state banks which will allow for more competition in the sector and foster economic activity in the country. As a transition country, Kazakhstan has developed into a country with well-established institutions that support the financial market as well as the development of the banking sector. The 1998 Russian crisis affected the economy of the country to a considerable extent. Nevertheless, the banking sector's role in the economy has grown with the initiatives taken based on the recommendations made by the IMF and other leading international financial institutions. Overall, the banking reforms undertaken in the aftermath of financial crises in those countries contributed to the positive developments in the financial markets and later necessitated that those countries adopt international best practices to build a sound banking sector based on international competition and financial innovation.

An important issue concerning the banking sector reform in general is the regulation on blanket guarantee on deposits. This was introduced in different forms in selected countries usually after crises to avoid the collapse of the banking sector. The blanket guarantee introduced in Turkey and Indonesia was effective in avoiding panic and bank failures in general. As this encourages banks to take risks, reducing their coverage is likely to bring better prospects for the banking sector and the economy as a whole in the coming years. The recent initiatives to remove the blanket guarantee in Indonesia and Turkey will increase efficiency in the banking sector and ensure its development. In Kazakhstan, the establishment of the Deposit Insurance Fund helped to restore confidence in the sector after the crisis, whereas in Malaysia reform initiatives started with the establishment of three institutions to rescue its failing banking sector in the aftermath of the crisis. Indonesia and Malaysia have recently embarked on a long-term strategy aimed at strengthening their banking sectors. In the short term, a major challenge would be to address the weaknesses arising from the weak supervision in the sectors of the two countries.

The recent banking reforms in Indonesia, Malaysia, Turkey and Kazakhstan have all led to intensifying mergers among banks. This shows that the banking sector grew rapidly with early liberalisation measures but the lack of financial discipline and supervision left them vulnerable to a crisis and most banks did not have the financial strength to compete in the sector.

In recent years, the Risk Weighted Capital Ratios (RWCR) of Indonesia, Malaysia, Turkey and Kazakhstan were above the minimum Basel requirements of 8 percent. This was due to the recapitalisation of banks as a part of the efforts to restructure the banking sector in those countries. For example, the recapitalisation of banks in Turkey in 2001 contributed significantly to the increase in the Capital Adequacy Ratio (CAR) from 15.3 percent in 2001 to 26.4 percent in 2002. However, although the capitalisation programme in Indonesia provided additional capital to banks and increased their CAR, it was insufficient for the recovery of the intermediation function of the domestic banking system. Yet, efforts to increase the intermediation role of the banking sector in the economy constituted an important objective of the restructuring programme. Although current policies are focused on meeting this objective, lending is still at a low level in this country. Except in Malaysia, the LDR increased in the others in the period 2002-2003. In Indonesia, it was the lowest compared to Kazakhstan, Malaysia and Turkey in 2003. In 2003, the same ratio was more than three times higher in Kazakhstan compared to Indonesia. This shows that future policies require measures to help recapitalise banks to overcome their liquidity problems.

Moreover, the ratio of NPL to total loans fell rapidly in Malaysia and Turkey in the period 2002-2004 owing to the progress achieved in the reform process. In fact, those countries have sufficient provisioning to cover their potential losses. Better prospects in improving the NPL to total loans ratio in Indonesia do not seem far away depending on the progress made in the near-term goals. In Kazakhstan, the ratio of NPL to total loans is higher than in Turkey and Malaysia. However, the provisions set aside to cover the losses in their loans seem to be sufficient. As it exits from its transitional phase and with its current economic potentials, Kazakhstan seems to make considerable progress in lowering its bad debts in the banking system.

In general, although the recent reform process in Kazakhstan, Indonesia, Malaysia and Turkey proved to be successful as it proceeded at a rather faster pace, the greater challenge facing those countries in the near future is to adopt certain international rules which may face legislative obstacles and thus take longer to be developed.

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