A WORLD BANK COUNTRY STUDY

Non-Bank Financial Institutions and Capital Markets in Turkey

25954

April 2003

THE WORLD BANK

A WORLD BANK COUNTRY STUDY

Non-Bank Financial Institutions and Capital Markets in Turkey

THE WORLD BANK
Washington, D.C.

Manufactured in the United States of America
First printing: April 2003

1 2 3 4 05 04 03

World Bank Country Studies are among the many reports originally prepared for internal use as part of the continuing analysis by the Bank of the economic and related conditions of its developing member countries and to facilitate its dialogues with the governments. Some of the reports are published in this series with the least possible delay for the use of governments, and the academic, business, financial, and development communities. The typescript of this paper therefore has not been prepared in accordance with the procedures appropriate to journal printed texts, and the World Bank accepts no responsibility for errors. Some sources cited in this paper may be informal documents that are not readily available.

The findings, interpretations, and conclusions expressed in this paper are entirely those of the author(s) and do not necessarily reflect the views of the Board of Executive Directors of the World Bank or the governments they represent. The World Bank cannot guarantee the accuracy of the data included in this work. The boundaries, colors, denominations, and other information shown on any map in this work do not imply on the part of the World Bank any judgment of the legal status of any territory or the endorsement or acceptance of such boundaries.

ISBN: 0-8213-5527-9
eISBN: 0-8213-5528-7
ISSN: 0253-2123

Library of Congress Cataloging-in-Publication Data has been requested.

CONTENTS

Figures

Boxes

Abstract

This study analyzes the state of development and prospects of future growth of Turkish non-bank financial institutions and capital markets. Currently, credit markets in Turkey are dominated by banking, and capital markets are dominated by Government securities. Longstanding macro-economic instability and inflation have discouraged investment in financial assets and crowded out funding for the private sector. The resulting lack of depth and breadth has made the financial sector vulnerable to shocks resulting in repeated crises, and has reduced its intermediation efficiency. To enhance the financial sector's capacity to support private sector development and economic growth, and to reduce its vulnerability to shocks, non-bank sources of finance should be developed. The report identifies the key policy issues that should be addressed for this purpose. The discussion and policy recommendations are structured around the following leading themes: (i) mobilizing savings; (ii) building an institutional investor base comprising insurance companies, private pension funds and mutual funds; (iii) developing equity, debt and derivative markets; (iv) developing leasing, factoring and venture capital companies; and (v) strengthening confidence in financial markets through improved corporate governance, accounting and auditing standards and practices and financial sector regulation and supervision.

ACKNOWLEDGMENTS

This report was prepared by **Lalit Raina** (Lead Financial Sector Specialist, CFA, CIM) and **Marie-Renée Bakker** (Lead Financial Sector Specialist, CFA) of the Private and Financial Sector Development Department, Europe and Central Asia Region, the World Bank.

Noritaka Akamatsu (Lead Financial Economist), Donald McIsaac (Lead Specialist), John Hegarty (Manager), Sue Rutledge (Senior Private Sector Development Specialist), Gurhan Ozdora (Senior Operations Officer), all of the World Bank, and Tanis MacLaren, Serap Oguz Gonulal, Graham Glenday and Amarjeet Singh (Consultants) all provided input into the report.

Field visits were made in July and December 2001 and June 2002. The report was prepared in close consultation with the Turkish Capital Markets Board and the Undersecretariat of Treasury, who are the main counterparts for the NBFI/Capital Markets Study.

Several other public and private institutions were also consulted, including the Bank Regulation and Supervision Agency, the Ministries of Finance, Industry & Trade and Justice, the Istanbul Stock Exchange, TAKAS Bank, the Association of Insurance and Reinsurance Companies, the Association of Leasing Companies, the Association of Factoring Companies, the Association of Turkish Capital Markets Intermediary Institutions (TSPAKB), the Union of Certified Public Accountants and Sworn Certified Public Accountants (TURMOB) and the Association of Turkish Industrialists and Businessmen (TUSIAD), as well as several Turkish and foreign owned banks, insurance, reinsurance, leasing and factoring companies, pension funds and securities firms.

Acronyms and Abbreviations

A&A ..... Accounting and Auditing
ACWI ..... All Country World Index
BITT ..... Banking and Insurance Transaction Tax
BRSA ..... Bank Regulation and Supervision Agency
CBT ..... Central Bank of Turkey
CCP ..... Central Counter Party
CMB ..... Capital Markets Board
CML ..... Capital Markets Law
CPA ..... Certified Public Accountant
CPI ..... Consumer Price Index
CRI ..... Central Registry Institution
C&S ..... Clearing and Settlement
DB ..... Defined Benefit
DC ..... Defined Contribution
DDI ..... Domestic Direct Investment
EU ..... European Union
FDI ..... Foreign Direct Investment
GAAS ..... Generally Accepted Auditing Standards
GAAP ..... Generally Accepted Accounting Principles
GDI ..... General Directorate of Insurance
GDF ..... General Directorate of Foundations
ICF ..... Investor Compensation Fund
IA ..... Independent Accountant
IAS ..... International Accounting Standards
IAIS ..... International Association of Insurance Supervisors
IASB ..... International Accounting Standards Board
IFAC ..... International Federation of Accountants
IOSCO ..... International Organization of Securities Commissions
IPO ..... Initial Public Offering
ISA ..... International Standards on Auditing
ISE ..... Istanbul Stock Exchange
M&A ..... Mergers and Acquisitions
MSCI ..... Morgan Stanley Capital International
MOF ..... Ministry of Finance
MOIT ..... Ministry of Industry and Trade
MOU ..... Memorandum of Understanding
NBFI ..... Non-Bank Financial Institution
OTC ..... Over the Counter
PC ..... Pension Company
PD ..... Primary Dealer
REIT ..... Real Estate Investment Trust
RUSF ..... Resource Utilization Support Fund
SBA ..... Sworn Bank Auditor
SCPA ..... Sworn Certified Public Accountant
SDIF ..... Savings Deposit Insurance Fund
SMEs ..... Small and Medium Sized Enterprises
SOE ..... State Owned Enterprise
SRO ..... Self Regulatory Organization
SSK ..... Social Security Organization of Workers
TASB ..... Turkish Accounting Standards Board
TB ..... TAKAS Bank (securities clearing and settlement agency)

TCIB . . . . . .Turkish Catastrophe Insurance Board
TCIP . . . . . .Turkish Catastrophe Insurance Pool
TMUDESK . . . . . .Turkish Accounting and Auditing Standards Board
TPL . . . . . .Third Party Liability
TSPAKB . . . . . .Turkish Association of Capital Markets Intermediary Institutions
TURMOB . . . . . .Union of CPAs and Sworn CPAs
TUSIAD . . . . . .Turkish Association of Industrialists and Businessmen
UCITS . . . . . .Undertakings for Collective Investment in Transferable Securities
VAT . . . . . .Value Added Tax
VCC . . . . . .Venture Capital Company
VCIT . . . . . .Venture Capital Investment Trust
WAN . . . . . .Wide Area Network

Currency Equivalents

Currency Unit = Turkish Lira (TL)
US$1 = TL 1,634,501
(as of February 18, 2003)

EXECUTIVE SUMMARY

Turkey's financial services industry is in an early stage of development, with credit markets dominated by banking (accounting for over 85% of financial system assets in 2001), and capital markets dominated by Government securities (accounting for over 90% of trading). Non-bank financial institutions (NBFIs) such as insurance companies, private pension and mutual funds, leasing, factoring and venture capital firms together account for less than 15% of financial system assets and just over 10% of GNP. The equity market has shrunk in recent years and market capitalization accounted for only around 30% of GNP in 2001; it is estimated that this percentage fell further to around 20% in 2002. Corporate debt markets don't exist and organized derivative markets are still in their infancy. Lack of depth and breadth has made the financial services industry vulnerable to shocks resulting in repeated crises, and has reduced its intermediation efficiency to the detriment of private sector growth.

Longstanding macro-economic instability and inflation have discouraged investment in financial assets, and a persistently high Public Sector Borrowing Requirement has crowded out funding for the private sector. The Government's ongoing stabilization and structural reform efforts, however, are improving the prospects for development of the financial services industry. To capitalize on this opportunity, and to ensure that rapid 'catch-up' growth of selected parts of the financial system does not create new vulnerabilities, a series of key policy issues should be addressed. This study identifies these issues and formulates recommendations for addressing them.

The study is organized as follows. Chapter I outlines the advantages of a broad based, diversified financial services industry, lays out the evidence of a clear correlation between financial system development and per capita income, and analyzes the outlook for the financial services industry over the next 3–5 years. Based on historic growth trends, estimated future economic growth and the experiences of other emerging and developed economies, it is argued that NBFI assets have the capacity to more than double to around 16.5% of GNP. While equity and corporate debt markets are likely to take somewhat longer to develop, they are also expected to grow very rapidly

from their current low/zero base. Chapters II–VI focus on the key elements of a strategy for developing NBFIs and capital markets: (i) mobilizing savings; (ii) building an institutional investor base; (iii) broadening, deepening and enhancing the efficiency of securities markets; (iv) developing other non-bank sources of finance; and (v) strengthening confidence in financial markets.

Chapter II (mobilization of savings) describes the extent to which macro-economic uncertainty, chronically high inflation and ill-suited tax policies have driven a significant portion of savings into real estate, gold, mattress money and overseas bank accounts. Key recommendations to redirect savings into the formal financial system include: (i) developing a tax system that creates a more level playing field for all types of investment assets, and that encourages the investment of savings in longer term/risk based instruments; (ii) phasing out, circumstances permitting, the Dresdner accounts at the Central Bank used for mobilizing savings of Turkish citizens living abroad, to allow these savings to be mobilized through the regular financial system; (iii) mobilizing gold deposits into the banking system, (iv) educating the public on investments in financial instruments and their rights in case of financial institution failures; and (v) extending the coverage provided by the newly created Investor Compensation Fund (ICF) to debt instruments, and equalizing the compensation of retail depositors by the Savings Deposit Insurance Fund (SDIF) and retail investors by the ICF once the blanket guarantee currently in place for all bank creditors has been lifted. A targeted public relations campaign should support these measures.

Chapter III (building an institutional investor base) lays out the key issues in developing the insurance, private pension and mutual fund industries. Insurance penetration (premiums as percent of GNP) and density (premiums per capita) are very low in Turkey, at 1.3% of GNP and US$30 respectively (2001). Key recommendations to develop the insurance industry include: (i) upgrading the legal and regulatory framework to EU and IAIS[1] standards; (ii) enhancing the quality and independence of insurance supervision; (iii) addressing the high level of industry fragmentation and the captive agency system; (iv) proactively promoting the use of new types of insurance (e.g., for earthquakes and agriculture); and (v) rationalizing the taxation of both insurance companies and insurance products.

Chapter III also documents the little noticed existence of a multitude of private pension schemes with estimated assets under management of around 2.3% of GNP. Most of these schemes are not properly regulated and supervised, as a result of which some have excessive asset concentrations (e.g., Is Bank's pension fund is over 90 percent invested in Is Bank shares) or inappropriate equity holding structures (e.g., Oyak-the army pension fund-is a financial-industrial conglomerate rather than a portfolio investment vehicle). Key recommendations to develop the private pension fund industry include: (i) further reforming the state social security scheme to create more room for contributions to private pension schemes; (ii) bringing pension fund regulation and supervision up to best practice standards (as outlined by the OECD), and applying these standards to all types of private pension schemes; (iii) creating an integrated, independent private pension fund regulatory structure to replace the current system with multiple agencies having jurisdiction over separate schemes or elements thereof; (iv) reducing the minimum capital requirement for pension companies to the amount required for life insurance companies, to allow the latter to compete with pension companies on a level playing field; and (v) rationalizing and harmonizing the tax regimes applicable to the different types of schemes. The mutual fund industry in Turkey is still very small (around 3% of GNP in 2001) and highly fragmented, with a few players accounting for the majority of assets under management. Key measures to further develop the mutual fund industry include: (i) encouraging fund consolidation; (ii) harmonizing regulations with the UCITS directives of the European Union (EU); (iii) strengthening corporate governance provisions to ensure directors and managers act in the best interest of investors; and (iv) rationalizing taxation.

---

[1] International Association of Insurance Supervisors.

Chapter IV describes the current state of development of the equity, debt and derivatives markets, and points to a large potential for the corporate sector to enhance the use of the equity market as a source of long term investment finance. Key policy recommendations to exploit this potential include: (i) increasing the minimum free-float requirement, including for majority state-owned enterprises (some of which have been exempted from the current already very low 5% minimum free float requirement); (ii) streamlining IPO clearance procedures and abolishing the tax on IPOs; (iii) simplifying and strengthening enforcement of Istanbul Stock Exchange (ISE) listing rules, especially concerning information disclosure; (iv) educating issuers on their ability to maintain control with less than majority ownership; (v) using privatization to deepen equity markets; (vi) developing a market segment on the ISE dedicated to small/new companies; and (vii) reducing the tax burden on equity investments through a tax integration structure that avoids the double taxation of dividend income. The key policy recommendations for developing corporate debt markets are: (i) lengthening of the maturity profile of Government debt, to create room initially for a short term commercial paper market and subsequently a corporate bond market, (ii) establishing a tax level playing field between Government and corporate debt, (iii) developing credit rating, securities registration and disclosure systems, and (iv) further strengthening of creditor rights through upgrading of collateral and bankruptcy legislation. To allow better hedging of risks by financial institutions, investors and issuers (including the Government itself), the Istanbul Futures and Options Exchange should be operationalized and the range of exchange traded instruments should be expanded to include interest rate/Treasury security futures. Capital rules for broker-dealers should provide appropriate credit for risk reduction through use of derivative positions. Investment restrictions for capital market participants should be reviewed to ensure that they do not unnecessarily limit the use of derivatives.

To further enhance the efficiency of market infrastructure institutions and trading systems the following measures should be considered: (i) abolishing the registration fees for off-ISE trades in Government securities; (ii) organizing over-the-counter (OTC) trading in Government securities through an electronic bond trading platform; (iii) developing a strategy for privatization and subsequent demutualization of the ISE; (iv) addressing potential conflicts of interest in the monopolistic nexus of market infrastructure institutions (i.e., ownership linkages between the ISE, Takas Bank (the securities clearing & settlement agency) and the new Central Registry Institution); (v) shortening the time frame for achieving full dematerialization of securities; (vi) creating a National Clearing House to further simplify and reduce the costs of securities registration; (vii) encouraging consolidation of the fragmented securities industry; and (viii) reviewing the role of TSPAKB, the organization of broker-dealers, as a self-regulatory organization.

Chapter V focuses on the current state of development and best ways to further develop the leasing, factoring and venture capital industries—all important sources of finance for small and medium sized enterprises (SMEs). Market penetration of leasing (percent of fixed asset investments financed through leasing) is still low in Turkey at around 3.9% (2001). Key recommendations to develop the leasing industry include: (i) upgrading the leasing law and regulations to allow more modern forms of leasing; (ii) encouraging industry consolidation; and (iii) rationalizing taxation. While export factoring is fairly well developed in Turkey, the overall factoring volume at around 2.5% of GNP (2001) is still low. Key recommendations to develop the factoring industry include: (i) new legislation to separate factoring from money lending; (ii) encouraging industry consolidation, (iii) rationalizing taxation; and (iv) further upgrading creditor rights to allow faster foreclosure on factoring receivables. Export insurance coverage by the Turkish Export-Import Bank for important Turkish export destinations where a local factoring industry does not exist could also be considered. Venture capital is almost non-existent in Turkey, with only one company active at the moment. To develop the venture capital industry, it will be necessary to address the capital markets development issues outlined above, to ensure easy exit for venture capital investments once they mature. Additional policy recommendations for developing the venture capital industry include: (i) allowing institutional investors such as insurance companies, private pension

funds and mutual funds to invest a certain percentage of assets in venture capital companies; (ii) undertaking a study of the most appropriate form of venture capital company and of programs successfully used in other countries to 'seed' the industry; and (iii) putting such a 'seed' program in place in Turkey.

Finally, Chapter VI focuses on ways to strengthen confidence in financial markets, by improving corporate governance, accounting & auditing standards and practices, and financial services industry oversight. In the area of corporate governance, the key recommendations are: (i) faster operationalization of the new Central Registry Institution and modernization of company registers; and (ii) strengthening of the roles of Boards of Directors and general shareholders meetings, and training of directors. The current 'stove pipe' approach to accounting & auditing, where each regulatory agency sets accounting standards and approves auditors for the entities under its jurisdiction, should be replaced with a common, pure IAS accounting platform for all financial institutions and listed/publicly held institutions. Financial sector regulatory agencies should supplement this platform with industry specific prudential reporting requirements as necessary. A Chamber of Auditors tasked with certification and enforcement responsibilities for the use of ISA-based standards should be created to oversee the audit profession.

Chapter VI, while containing specific recommendations for further strengthening of regulation and supervision of capital markets, insurance, and private pension funds, also points to the need to rationalize the atomized oversight structure, where multiple regulatory agencies are responsible for regulating and supervising an increasingly integrated financial services industry dominated by large financial-industrial groups. As a first step, consolidated supervision across traditional industry boundaries should be developed to identify and address risks inherent in such conglomerates. Consideration should also be given to developing a holding company regime for financial and mixed conglomerates. In the longer term, integration of all financial sector regulatory agencies into one common oversight structure may be desirable.

CHAPTER I

IMPORTANCE OF A BROAD BASED FINANCIAL SERVICES INDUSTRY

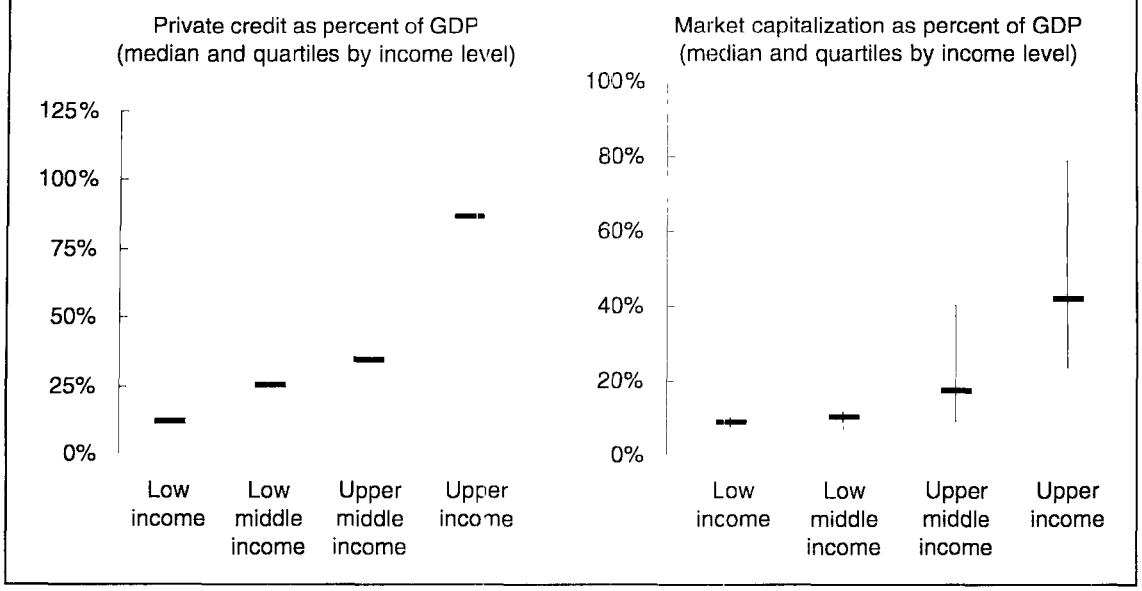
Why is a Broad Based Financial Services Industry Necessary?

Financial Sector Depth and Breadth is Essential for Economic Growth. The experiences of a series of financial crises around the world in recent years in East Asia, Russia, Latin America and Turkey have clearly demonstrated the rather devastating economic consequences of weak financial systems in these countries. Failed financial institutions and extreme macroeconomic volatility have often led to widespread loss of wealth, and negative economic growth in the aftermath of those crises. On the other hand, during stable non-crisis periods, an effective financial infrastructure competently delivering essential services can, and often has, made a large difference to a country's economic development. Deep and broad financial markets have invariably enhanced access to finance for more firms and individuals at acceptable cost, and reduced volatility, distortions and risk by improving transparency, competition and diversity of products and services. Improvements in financial architecture therefore quite often precede and contribute to economic performance in most countries. In all advanced economics, for example, sophisticated financial systems efficiently delivering a broad range of financial services have been a critical pillar in contributing to macroeconomic stability and sustained economic growth and prosperity. Growth in private credit volumes and equity market capitalization as a percent of GDP have consistently been correlated with growth in per capita income (Figure 1). Thus, robust growth and effective functioning of a full service financial system is essential for economic development and prosperity.[1]

There should be a structural balance between bank and non-bank financial intermediation in a financial system—they are both equally important and are complements, not substitutes. Banks, securities markets, and a range of other types of intermediary and ancillary financial firms like

[1] The relationship between finance and economic growth has been explored in detail in the World Bank Publication Finance For Growth by Caprio and Honahan (2001), and applicable research findings have been reproduced here.

FIGURE 1: FINANCIAL DEPTH AND PER CAPITA INCOME



Note: This figure represents the average of available dates in the 1990s for each of 87 countries.

Source: World Bank (Beck, Demirg-Kunt, and Levine (BDL) database).

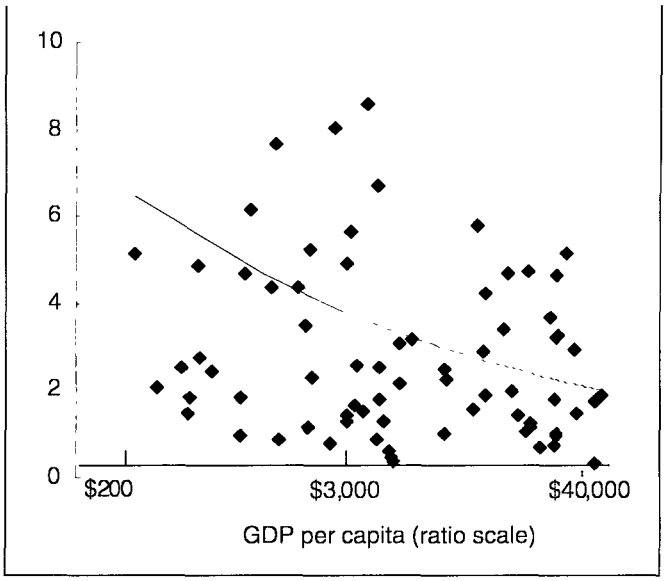
insurance, leasing, factoring and venture capital companies, and mutual and pension funds all contribute to a balanced financial sector able to successfully meet a wide variety of financing needs of individuals, businesses and the public sector. Banks dominate financial systems in most countries, but in some of the most advanced countries the ratio of equity market capitalization to banking system assets is very high, and there is a general tendency for the market-to-bank ratio to increase with the level of development (Figure 2) Firms in successful economies reach a mixture of bank and equity market development that suits their own particular financing needs and institutional structures; the higher the level of income and revenue growth, the more likely that mixture will be weighted toward equity. Development of different segments of the financial system challenges the other segments to innovate, to improve quality and efficiency, and to lower prices. Thus, the correct policy choices should include promoting an appropriate degree of diversity in channels for financing, along with a balanced set of incentives for complementary development of banking and non-bank financial institutions (NBFI) and markets in promoting economic growth.

Development of the securities markets-equity as well as debt-and of leasing, factoring, and venture capital is likely to provide sufficient competition against excess profits in banking. In developing economies with lower per capita income, the banking system is more deeply entrenched than NBFIs and securities markets, and the value of bank assets tends to be a larger multiple of equity market capitalization than in higher income countries (Figure 2).[2] With so much of the borrowings by firms coming from banks, the borrowing cost depends on the operational efficiency and competitiveness of the banking market. In many developing economies, interest rate liberalization, especially if not accompanied by large-scale ownership change and enhanced banking sector com-

[2] High growth economies are most often middle income countries rather than low income ones because successful import-substituting/export-promoting industrialization accelerates economic growth. If an economy has an equity market, its capitalization as an indicator of future income growth grows exponentially at that stage. That is why there tend to be outliers among middle income countries.

petition, has often been associated not only with higher wholesale interest rates, but also with a widening of intermediation spreads-at least partly reflecting increased exercise of market power by banks. One path to lower financing costs through increased competition in financial markets is through the development of securities markets—both debt and equity—and leasing/factoring and venture capital financing.

FIGURE 2: RATIO OF BANK ASSETS TO MARKET CAPITALIZATION AND PER CAPITA GDP



Source: World Bank

NBFIs provide alternative financial services, and therefore improve general system-wide access to finance, facilitate longer term investments, and match funding sources with investments based on appropriate risk-return characteristics. Since banking is financed mostly by depositors and there are limitations to the type and nature of financing risks that banks can easily undertake, bank credit is more appropriate for trade finance, retail consumer finance, short term working capital and medium term investments with clear secured collateral arrangements. However, in cases where the creditworthiness of borrowers cannot be clearly established, or adequate collateral may not be available, or the viability of proposed ventures may be uncertain, leasing,[3] equity and venture capital financing may be the most appropriate mechanism to match financiers to the type of ventures being undertaken. These are also key to ensuring that smaller-scale firms can get access to financing at reasonable cost. Development of such alternative financing vehicles adds to the liquidity and diversity of the financial system, thereby increasing its effectiveness as an engine for economic growth and enhancing the financial system's capacity to absorb shocks.

The growth of contractual/collective savings institutions, like insurance companies, pension funds and mutual funds, widens the range of savings media available to persons of moderate wealth, and provides competition for bank deposits, thereby mobilizing long term funds necessary for the development of equity and corporate debt markets and leasing, factoring and venture capital financial services. By creating a pool of long term capital, they also generate demand for long-term investments (required by life insurance providers and firms selling annuities if they are to match their obligations with assets of comparable maturity), thereby providing a market-based solution to a perceived financing gap and rendering costly and distorting Government financing and subsidy programs unnecessary. Similarly, private pension funds in need of long term, lower risk fixed income securities to match their liabilities are often a positive force for the development of broader and deeper sovereign and corporate bond markets. In fact, the development and strengthening of the capital markets and of managed funds often go hand in hand. In addition, in both mature and emerging markets, contractual savings institutions and collective investment vehicles have

[3] Leasing finances nearly one third of investments in some OECD countries. See also Chapter V: Developing the Leasing Industry.

been central in supporting numerous market-based financial innovations, such as asset-backed securities and the use of structured finance and derivative products, including index-tracking funds and synthetic products that protect investors from market declines. Catastrophic risk bonds placed by insurance companies are yet another example of the financial innovations emerging from this segment, and the process is likely to continue, with an apparent market gap in longevity-based derivatives. The associated learning and human capital formation, as fund managers tool up to employ such techniques, helps to enhance the quality of risk management throughout the economy. Thus, contractual savings institutions expand the range and depth of financial services provided not only to their own policyholders/unit holders and plan participants, but to a much wider range of financial and real sector actors.

Contractual savings institutions, because of their financial strength, can be a significant driver of market reforms in the areas of quantitative and qualitative information disclosures and corporate governance. Mutual funds and pension funds constitute large blocks of significant investors with the muscle to expect and demand comprehensive rules and legislation for improving market integrity, efficiency of trading mechanisms, and corporate governance including better information disclosure to, and protection of, minority shareholders. However, the impact of such block ownership is not usually effective until their equity holdings have reached a critical mass of, say, 20 percent of the market, a level that may take some time to be achieved: in particular, the accumulation of block ownership by pension funds is a gradual process.[4] While the emergence of private pension funds is neither necessary nor sufficient for a well-functioning equity market, it is thus well worth ensuring that the preconditions for contractual savings development are in place. This is true not only for the longer-term benefits that will accrue to pensioners, policyholders, and other customers, but also for the spill-over effects that can result for financial sector development if the pension fund industry is competitive and innovative.

Opening equity markets to foreigners improves efficiency and transparency. For a country that has an active equity market, opening that market to foreign investors is a decisive step that can be expected to influence the level and dynamics of asset pricing. More than thirty sizable stock exchanges in emerging market economies implemented significant liberalization, mostly during the mid-1980s to the mid-1990s. Even though liberalization of capital flows, and increased participation by foreigners increases the possibility of hot portfolio money flows and perception of increased market volatility and instability, the overall results from emerging markets show that equity values in terms of price-earnings ratios have been brought up to the standards prevailing in developed markets over time, thereby lowering the cost of capital, without an undue increase in volatility. Opening up has also accelerated improvements in disclosure and the efficiency of the local equity markets, even though these have lost some of their share of the increased business in the listing and trading of local equities to overseas markets. Similarly, ownership of domestic banks and NBFIs by reputable foreign financial institutions fosters innovation and brings enhanced competition and use of best practice risk management techniques to the domestic financial system, thereby enhancing both its efficiency and safety.

In conclusion therefore, the development of NBFIs and capital markets in parallel to the development of the banking system is vital because it enables:

- Mobilization of savings (for which the outlets would otherwise be much more limited);
- Accelerated economic growth through increased availability of funding and more efficient allocation of capital for productive investment by the private sector; and improved access to alternative sources of finance, including for small and medium sized enterprises (SMEs);

[4] Block pension fund ownership impact also will not happen where the strategy of the funds is to take majority shares in affiliated firms, as is the case for the main pension funds in some countries.

- Better management of systemic financial risk (reducing it through aggregation and enabling it to be carried by those more willing to bear it);
- Development of secondary capital markets, improving price discovery and valuation of financial assets and productive entities, and improving liquidity by facilitating efficient capital entry and exit;
- Better corporate governance and monitoring of managers (so that the funds allocated will be spent as envisaged);
- Building of a financial information and analysis service industry to assist investment management and research.

Outlook for the Turkish Financial Services Industry

Financial Services Industry Overview

In spite of all of the macroeconomic and political instability in Turkey, the financial sector has grown both in absolute terms and as a % of GNP, although the sector is still dominated by banking (Table 1). Total assets of Turkish financial institutions in both absolute US$ terms and as percent of GNP increased during the period 1996-2001 (from US$93.5 billion to US$133.6 billion, and from 50.91 to 91.43% of GNP), and the year-on-year growth rate of financial system assets has been significantly above the year-on-year growth rate of GNP during the past five years (by the same token, the decline in financial sector assets in 2001 when GNP contracted sharply also has been less than the decline in GNP). The growth would have been even higher but for the macroeconomic and banking crises in 2000–2001 causing a severe shrinkage and loss of wealth in the financial sector.

The NBFI segment of the financial system grew from a low base of US$10.3 billion in 1996 to US$14.8 billion in 2001, and as a share of GNP it almost doubled from 5.63% in 1996 to 10.1% in 2001. Within the NBFI segment, except for the recession year 2001, the insurance sector has displayed low but steady growth. The leasing and factoring business has seen ups and downs with the economic cycle, while investment funds riding on the back of the rapid expansion of the Government securities market have been growing fastest. The assets of private pension funds[5] are estimated to have grown rapidly as well, although the 2001 crisis inflicted serious losses on some of these funds.

There are no functioning organized corporate debt securities markets in Turkey. With the predominance of the Government securities markets, and the overwhelming need to continuously finance the Government's borrowing need in increasing volumes, there has been very little incentive or encouragement (even some resistance from the authorities[6]) for prospective issuers of corporate debt. Even on the short end of the maturity spectrum, there is no functioning commercial paper market, as money markets remain dominated by repurchase and reverse repurchase transactions (repo/reverse repo) using Government securities as the primary tradable securities.

Equity market growth has been mixed. Market capitalization has fluctuated over the years with the condition of the economy, but still increased over a six year period as percent of GNP from 16.8%

---

[5] There are several such funds in Turkey, including Oyak, the army pension fund. See Chapter III: Developing the Private Pension Fund Industry for more detail.

[6] Despite the abolition of a rule in place during the mid 1990s prohibiting corporate debt to offer higher interest rates than Government debt, there is some anecdotal evidence that during the past few years regulators have frowned upon prospective issuers of corporate debt, as they would offer competition to Government securities, and thus increase the Government's refinancing cost. In addition, corporate debt remains tax-disadvantaged vis-à-vis Government debt. See for further detail Chapter IV: Developing Corporate Debt Markets.

TABLE 1: OVERVIEW OF THE FINANCIAL SECTOR

(US$ MILLION)	1996	1997	1998	1999	2000	2001
NUMBER OF FINANCIAL INSTITUTIONS	**571**	**711**	**776**	**816**	**884**	**865**
Banks (incl. inv. & dev. banks and special finance houses)	75	78	81	87	85	66
Insurance companies	62	65	68	66	68	68
Leasing, factoring and consumer finance companies	112	169	182	199	215	210
Securities dealers	101	142	143	136	133	130
Investment funds (open & closed end)	138	174	219	245	300	308
Pension funds	83	83	83	83	83	83
TOTAL ASSETS OF FINANCIAL INSTITUTIONS	**93,466**	**104,781**	**131,618**	**149,427**	**174,076**	**133,593**
Banks	83,123	94,417	117,483	133,214	154,582	118,837
NBFI-incl.	10,343	10,364	14,135	16,213	19,494	14,756
– Insurance companies	1,960	2,183	2,860	3,698	4,185	3,023
– Leasing, factoring & consumer finance companies	3,175	3,070	4,944	4,470	6,050	3,442
– Securities dealers	837	568	975	865	1,011	653
– Investment funds (open & closed end)	1,121	1,043	1,606	3,180	3,883	4,273
– Pension funds	3,250	3,500	3,750	4,000	4,365	3,365
PERCENTAGE DISTRIBUTION	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**
Banks	89.17%	89.68%	88.43%	87.98%	87.36%	87.08%
NBFI—incl.	10.83%	10.32%	11.57%	12.02%	12.64%	12.92%
– Insurance companies	2.10%	2.07%	2.15%	2.44%	2.36%	2.21%
– Leasing, factoring & consumer finance companies	3.41%	2.92%	3.72%	2.95%	3.42%	2.52%
– Securities dealers	0.90%	0.54%	0.73%	0.57%	0.57%	0.48%
– Investment funds (open & closed end)	1.20%	0.99%	1.21%	2.10%	2.19%	3.13%
– Pension funds	3.22%	3.80%	3.76%	3.96%	4.10%	4.58%
PERCENT OF GNP	**50.91%**	**54.34%**	**64.35%**	**80.39%**	**86.65%**	**91.43%**
Banks	45.28%	48.97%	57.44%	71.67%	76.95%	81.33%
NBFI—incl.	5.63%	5.37%	6.91%	8.72%	9.70%	10.10%
– Insurance companies	1.07%	1.13%	1.40%	1.99%	2.08%	2.07%
– Leasing, factoring & consumer finance companies	1.73%	1.59%	2.42%	2.40%	3.01%	2.36%
– Securities dealers	0.46%	0.29%	0.48%	0.47%	0.50%	0.45%
– Investment funds (open & closed end)	0.61%	0.54%	0.79%	1.71%	1.93%	2.92%
– Pension funds	1.77%	1.82%	1.83%	2.15%	2.17%	2.30%
EQUITY MARKET CAPITALIZATION	**30,797**	**61,879**	**33,975**	**114,271**	**69,507**	**47,689**
Percent of GNP	16.78%	32.09%	16.61%	61.47%	34.60%	32.64%
MEMO ITEMS						
GNP	183,575	192,821	204,522	185,884	200,887	146,113
Customer deposits of banks	57,165	61,273	77,097	89,361	101,884	80,778
Exchange Rates	107,775	205,245	313,475	541,401	673,384	1,443,039

Notes: (i) Data for pension funds are estimates, since these pension funds are not or only very lightly regulated, and data on their assets under management are not collected on a routine basis. (ii) The US$ equivalent of TL is based on the bid/ask average of CBT year-end TL/US$ exchange rates.

Source: BRSA, CMB, ISE, Undersecretariat of Treasury, World Bank.

to around 20%, despite significant shrinkage during 2000–2002. The market cap figure, however, can be somewhat misleading, since it is based on the full capitalization of all the shares of listed companies, while the free float (traded shares) on average is only around 20%—lower than in most developed and other emerging markets. As a matter of fact, some of the largest companies in Turkey have a much lower free float (2–10%), with several state-owned enterprises being exempted from the current already very low 5% minimum free float requirement set by the ISE, and are giving an upward bias to these market cap figures.[7]

Prominence of Government Debt Securities in the Investment Agenda

However, the growth of the private credit/equity markets and consequent availability of investment capital to the private sector would have been much higher if it had not been significantly affected by the crowding-out effect of the excess level of Government borrowing from the capital markets during the past several years. The public debt (direct Government and Government guaranteed state entities debt) has been consistently growing in Turkey, both in absolute terms and as a percentage of GNP over the last several years, and the level has severely escalated during 2001 in the wake of the macroeconomic and banking crises (Table 2). As a result of this escalating debt in an environment of political uncertainty, macroeconomic instability and chronically high inflation, the Government has consistently paid a high sovereign risk/inflation expectation premium, with real rates of interest on Government securities ranging between 20–40%. Such a high real return on what is often perceived as a risk-free investment has attracted all sources of investment capital to Government securities[8].

As a consequence, the development of the asset base of NBFIs (as well as of banks) has been quite lopsided, both in terms of investment opportunities and risk diversification, because of the preponderance of Government securities in their asset portfolios. While the growth of the size of the financial system as a % of GNP has been quite significant, especially in the sense of mobilization of savings interested in earning a risk-free return, a large part of the growth is simply the result of operating a resource transfer mechanism from the general public to the Government. The growth owes much less to the qualitative and quantitative development of a broad range of financial products and services, especially for the private sector, and would almost certainly have been much higher in the absence of the severe crowding out that has taken place, thus constituting a missed opportunity for Turkey to achieve a higher level of development and economic growth. In this context, it is also important to point out that Turkey's financial system might have been much larger if chronically high inflation and continued macro-economic instability would not have driven a significant portion of private savings into non-financial investment vehicles such as housing, gold and foreign currency. The nature and magnitude of these informal savings are explored in more detail in Chapter II: Mobilizing Savings.

[7] See for further detail Chapter IV: Deepening and Broadening Equity Markets.

[8] See also Chapter IV: Deepening and Broadening Equity Markets, Figure 5 on the efficiency frontier in Turkey.

TABLE 2: PUBLIC SECTOR DEBT

(US$ BILLION)	1996	1997	1998	1999	2000	2001
GNP	183,575	192,821	204,522	185,884	200,887	146,113
Total Net Public Sector Debt	65,21	61,54	75,10	88,66	107,63	115,44
As % of GNP	35.52%	31.92%	36.72%	47.70%	53.58%	79.01%

Source: World Bank

Financial Intermediation to the Private Sector—Cross Country Comparison

With crowding-out of private funding by the Government, one would expect financial intermediation to the private sector to be below that in more developed and comparable emerging market economies where such crowding-out is absent. Credit to the private sector as a % of GDP in Turkey has been rather static over the last five years, and actually declined during 2001. In combination with the equity market, the funding for the private sector has oscillated somewhat over the years, but still remained in an overall up trend having risen from 39.4% of GDP in 1996 to 52.9% in 2001 (Table 3).

TABLE 3: FINANCIAL SECTOR DEPTH—CROSS COUNTRY COMPARISON

(% OF GDP)		1996	1997	1998	1999	2000	2001
Argentina	Private Sector Credit	20.19	21.93	24.15	24.89	23.89	20.84
	Market Cap	16.41	20.22	15.16	29.57	58.4	71.62
	Total Private Funding	**36.60**	**42.15**	**39.31**	**54.46**	**82.29**	**92.46**
Brazil	Private Sector Credit	30.36	30.62	34.12	34.54	35.15	34.66
	Market Cap	28	31.63	20.43	43.05	38.09	37.06
	Total Private Funding	**58.36**	**62.25**	**54.55**	**77.59**	**73.24**	**71.72**
India	Private Sector Credit	23.97	23.91	24.1	26.2	29.04	28.62
	Market Cap	31.96	31.35	25.4	41.46	32.4	23.12
	Total Private Funding	**55.93**	**55.26**	**49.5**	**67.66**	**61.44**	**51.74**
Italy	Private Sector Credit	55.75	56.54	58.94	71.8	77.55	79.82
	Market Cap	20.94	29.54	47.62	61.71	71.54	61.61
	Total Private Funding	**76.69**	**86.08**	**106.56**	**133.51**	**149.09**	**141.43**
Korea	Private Sector Credit	69.69	78.78	87.49	93.61	101	108.03
	Market Cap	26.69	9.66	38.21	97.44	37.18	54.97
	Total Private Funding	**96.38**	**88.44**	**125.7**	**191.05**	**138.18**	**163**
Mexico	Private Sector Credit	18.8	20.12	19.36	16.27	13.04	11.47
	Market Cap	32.06	39.06	21.79	32.06	21.58	20.49
	Total Private Funding	**50.86**	**59.18**	**41.15**	**48.33**	**34.62**	**31.96**
Poland	Private Sector Credit	14.72	16.63	18.81	22.42	24.46	25.28
	Market Cap	5.83	8.43	12.91	19.08	19.85	14.85
	Total Private Funding	**20.55**	**25.06**	**31.72**	**41.5**	**44.31**	**40.13**
South Africa	Private Sector Credit	119.86	116.24	118.62	136.67	138.95	78.85
	Market Cap	168.07	155.95	127.27	199.74	160.21	78
	Total Private Funding	**287.93**	**272.19**	**245.89**	**336.41**	**299.16**	**156.85**
Spain	Private Sector Credit	74.7	79.96	87.31	92.27	101.59	106.67
	Market Cap	39.81	51.81	68.63	71.95	90.27	103.46
	Total Private Funding	**114.51**	**131.77**	**155.94**	**164.22**	**191.86**	**210.13**
Turkey	Private Sector Credit	22.83	26.3	23.1	22.46	23.75	20.58
	Market Cap	16.58	32.29	16.86	61.32	34.96	32.3
	Total Private Funding	**39.41**	**58.59**	**39.96**	**83.78**	**58.71**	**52.88**
United Kingdom	Private Sector Credit	120.66	120.85	120.2	123.46	135.08	140.61
	Market Cap	147.53	151.4	168.34	203.47	182.18	152.85
	Total Private Funding	**268.19**	**272.25**	**288.54**	**326.93**	**317.26**	**293.46**
United States	Private Sector Credit	111.58	120.95	131.44	144.7	144.18	142.72
	Market Cap	109.46	136.97	154.1	180.09	153.54	137.48
	Total Private Funding	**221.04**	**257.92**	**285.54**	**324.79**	**297.72**	**280.2**

Source: World Bank

When compared to the private sector funding characteristics of other countries, however, it is clear that in more advanced economies with higher GDP per capita, financial depth is much greater. Private sector funding at 52.9% of GDP also puts Turkey at the low end of the scale compared with other emerging markets (better than Mexico and Poland, but lagging Argentina (pre-2002 crisis), Brazil, Korea and South Africa). Due to the distortion in Turkish market cap numbers caused by the low free float, in reality it probably ranks even lower. It is likely that without Government crowding-out and the recent crises, Turkey by now would have been higher on the scale and well on its way to duplicate the trend towards rapid financial sector deepening and concomitant higher GDP per capita apparent in more stable economies.

Future NBFI and Capital Market Growth Prospects in Turkey

The Government has embarked on a macroeconomic stabilization program, with the key objectives of reducing inflation and Government debt, and resuming steady economic growth. Since 2001, the Government has been implementing a broad ranging fiscal & monetary stabilization, and financial & public sector structural reform program with the assistance of international financial institutions, with a view to progressively reducing its expenditures and the total public debt burden, bringing inflation down to single digits within three years, and putting GNP growth on a 3–5% steady growth path. The projected economic targets are presented in Table 4 below. The key anticipated developments will be inflation, nominal and real interest rates, and public debt. Over the 2003–2005 period, all of these parameters are likely to be on a declining path, with inflation projected to drop to single digits in 2005 and the public debt reduced by nearly 20% to 73.1% of GNP by end 2005. Coupled with resumed economic growth in Turkey, these developments will gradually reduce the crowding-out effect, lower real rates of interest, and increase the incentives for the private sector to invest in real sector and other financial products and services. Such trends are likely to create a positive environment with economic stability and the right incentives for the growth of capital markets and NBFIs. The likely impact on the financial sector, especially the NBFI and capital markets segments, has been estimated below.

Based on the macroeconomic projections, the likely growth of the financial sector as a percentage of GNP and the growth of NBFIs and capital markets in terms of absolute and relative size have been estimated. Overall financial sector assets in US$ terms have on average grown at a rate of around 12.7% relative to GNP year-on-year over the last five years, irrespective of the ups and downs of the economic cycles. The NBFI segment of the financial sector, however, has grown

TABLE 4: PROJECTED NBFI AND EQUITY MARKET GROWTH BASED ON KEY ECONOMIC INDICATORS

	ACTUAL		PROJECTED			
	2000	2001	2002	2003	2004	2005
GNP Growth Rate	6.3	–9.4	3	5	5	5
CPI Inflation(year-on-year)	39	69	37	20	11	8
Net Public Sector Debt/GNF (%)	53.6	79.0	82.2	75.1	73.1	73.1
GNP (US$ billion)	200.89	146.11	174.71	182.34	211.12	226.99
Financial sector assets as % of GNP	86.65%	91.43%	103.05%	116.14%	130.90%	147.53%
– NBFI Assets as % GNP	9.70%	10.10%	11.42%	12.92%	14.61%	16.53%
– NBFI Assets (US$ billion)	19.5	14.8	19.96	23.56	30.85	37.52
– Equity Market Cap as % of GNP	34.60%	32.64%	19.69%	25.00%	30.00%	35.00%
– Equity Market Cap (US$ billion)	69.5	47.7	34.4	45.6	63.3	79.5

Source: ISE, World Bank, Staff Estimates and Table 1.

at a more rapid rate of around 13.1% relative to GNP (Table 1) These growth rates have been projected forward in Table 4 above using 2001 data for the four year period 2002–2005 to give a near term estimation of the potential increase in NBFI assets. Based on these estimates, as economic growth resumes in Turkey, it is anticipated that NBFI assets are likely to more than double to around US$37.5 billion by end 2005, representing 16.5% of GNP. It is quite possible, however, that NBFI assets will grow faster going forward than they did in the past, as their growth has historically been repressed by persistently high inflation. Once a sustainable reduction in inflation becomes apparent, there may be significantly faster catch-up growth in NBFI assets, especially in the insurance and private pension fund segments. If NBFI assets for example would grow 20% annually relative to GNP, NBFI assets would increase to over US$47.5 billion, equivalent to almost 21% of GNP by end 2005.

It is more difficult to predict the potential growth in equity market capitalization based on the past performance of the market, as both in terms of absolute size and relative to GNP, the market cap is a much more volatile indicator, and can fluctuate wildly year to year. Therefore, based on the trend of higher GNP being positively correlated with a higher market cap relative to GNP and taking into account the low free float, the presence of significant room for expanding listings and historically high price volatility (see in Chapter IV, Section 1: Deepening and Broadening Equity Markets), a conservative estimate of assuming that the market cap will at least return to its pre-crises sustainable trend level of around 35% of GNP over the 2003–2005 period would probably be appropriate. The absolute value of market capitalization is still likely to grow significantly with GNP growth under this assumption, to reach an estimated US$79.5 billion by the end of 2005. The figures of course can be higher if macroeconomic and political stability is achieved early, investment returns on equity quickly become attractive relative to Government debt, and public confidence in financial markets is rapidly restored after the 2000–2001 turbulence. Over the medium term, it is also not unrealistic to assume that a corporate debt market will re-appear (such a market existed and displayed rapid growth in the early 1990s), and reach a level of 5–6% of total Government domestic debt[9] representing US$8–10 billion or around 3.5–4.5% of GNP, potentially raising total private capital market capitalization to around 40% of GNP or more over the next 3–5 years.

The NBFI And Capital Market Development Strategy Going Forward

The above sections have explained the rationale behind the emphasis on focusing the attention of economic policy makers, regulators and market players on development of NBFIs and capital markets, as a key component in accelerating the growth of funding for the private sector, and thereby increasing the level and scope of private sector economic activity in Turkey. It is self evident that there is a critical need to ensure that the most effective legal and regulatory, institutional development and incentive framework for further accelerating the growth in these segments of the financial system is established, as the economy turns for the better and economic stability returns to Turkey on a sustained basis. The key elements of such a framework are listed below and recommended as the building blocks of a comprehensive strategy for this purpose. These are:

- *Mobilizing Savings* effectively from both domestic and foreign investors;
- *Building An Institutional Investor Base,* by promoting the development of the insurance, private pension fund, and mutual fund industry;
- *Developing Securities Markets,* through broadening/deepening and enhancing the efficiency of existing markets and market infrastructure;
- *Developing Other Non-Bank Sources of Finance,* like leasing, factoring and venture capital; and

[9] Representing the average level of such debt in overall debt markets in comparable economies; see Table 18 in Chapter IV: Developing Corporate Debt Markets. Corporate debt market for purposes of this section comprises debt securities issued by financial as well as real sec or entities

- *Strengthening Confidence in Financial Markets* by improving corporate governance, accounting and auditing standards and practices, and further strengthening the regulation and supervision of financial sector activity.

All of the above topics will be discussed in detail in the following sections of this study. The current practice in Turkey has been evaluated both from the perspective of the needs of the Turkish economy and the practices and level of financial sector development in other countries. Based on this evaluation, a set of key recommendations in each area has been provided to form the basis for further discussions and policy decisions.

CHAPTER II

MOBILIZING SAVINGS

Bringing Informal Savings into the Formal Financial System

A large segment of Turkish domestic capital resources has over the years systematically exited the formal financial system, and either gone overseas or underground into a basket of informal savings products. The magnitude of such informal savings is enormous compared to the size of the formal financial system and GNP, and one of the primarily policy goals for the Government in the coming years has to be to facilitate the mobilization of such informal savings into formal investment channels through systemic reforms and attractive incentives. Mobilizing the Domestic Direct Investment (DDI) capacity of Turkish investors[10] is likely to be a critical contributor to both NBFI and capital markets development and economic growth in Turkey, of potential significance even larger than Foreign Direct Investment (FDI). Some of the key factors contributing to the continuing growth of the informal financial sector, the estimated magnitude of the potential DDI resources and the areas for policy and structural reform needed to reverse this trend are discussed below.

Informal Savings Generators

While the lack of attractive capital market investment opportunities, limited development of NBFIs, and the crowding-out effect of excess Government borrowing have all contributed to mobilization of *formal* savings into bank deposits and sovereign debt securities, the main causes for generating *informal* savings have been fear of continued high inflation and the onerous taxation system. The distortions caused by the interactions between inflation and the tax system, and difficulties in the market anticipating inflation given its high variability, have driven savings into inflation hedges and tax shelters such as real estate, foreign exchange-denominated assets, and gold.

[10] This would include capital flight prevented by domestic NBFI/capital markets development, as well as money that went out and comes back as foreign investment inflows.

Housing—Inflation Hedge and Tax Shelter. Private housing has always been considered in Turkey (and in other countries) as a first order of priority for investment of household savings, especially in an inflationary environment. All other forms of investment like stocks, bonds or gold come further down the investment pecking order. The attractiveness of housing as an investment and inflation hedge is further enhanced in Turkey by: (i) weak enforcement of the taxation of rental income, and (ii) the exemption from tax of capital gains on residential property held for more than four years. The net taxable income on rental property is therefore often small or negative. Even though interest income of banks providing housing loans is subject to Resource Utilization Support Fund (RUSF) tax and Banking and Insurance Transaction Tax (BITT), the impact of these distortive taxes is limited because most private financing of homes is arranged outside of the formal financial system through housing cooperatives exempt from the application of such taxes. Thus, as long as residential property is weakly taxed relative to financial investments and provides a hedge against inflation, investment in homes and rental properties will remain a strong competitor for private personal and pension savings products.

Other Tax Biases. Even without the impact of high inflation, however, it is evident that there are many distortions in the tax structure in Turkey that bias savings and investments towards or away from particular investment instruments. For example, there are different tax levels applicable to Government and corporate bonds (favouring the former); and different levels of tax advantages for diverse types of pension schemes (favouring Oyak—the army pension fund—and other existing pension schemes over new third pillar funds). As noted above, tax policies also favour investments in real estate over investments in financial instruments. Double taxation of dividends and capital gains on equity investments are discouraging equity investments; financial leasing is not recognized (and hence discouraged) for tax purposes; and the Resource Utilization Support Fund (RUSF), Banking and Insurance Transaction Tax (BITT) and other transaction taxes, registration fees and stamp duties (e.g., on off-ISE trading in Government securities and Initial Public Offerings-IPOs) unnecessarily raise the costs and reduce the returns on financial intermediation and investments, as well as secondary market liquidity of the financial instruments concerned. Positive tax incentives are also not used in a systematic fashion to encourage the development of institutional investors and longer term sources of risk capital. For example, in the insurance sector all insurance products (non-life, term life and life policies with a savings component) are taxed equally, not allowing taxation to be used as a tool to stimulate long term savings. These and other tax issues are further elaborated in the relevant sections of the report dealing with equity and corporate debt markets, pension funds, insurance, lease finance, venture capital, etc.

Magnitude of the Informal Savings or Potential DDI

Housing. It is estimated that housing investments account for as much as 40% of overall private investments. On a flow basis, given that gross domestic investment has been around 24% of GDP with slightly over 70% thereof accounted for by the private sector, during the last five years around anywhere between US$10–14 billion annually may have been invested in private housing.

Besides real estate (which is rather illiquid) there are other more liquid forms of informal savings, namely: (i) foreign currency deposits held overseas by people of Turkish origin or Turkish citizens; (ii) gold bullion and ornaments held by the general Turkish population and businesses; and (iii) cash money (most likely in foreign exchange) kept under mattresses or in safe deposit boxes. Apart from the large Turkish diaspora overseas, foreign exchange funds are routinely kept by Turkish individuals and businesses abroad, especially in Europe.

Dresdner Accounts. Some of these funds are collected by the Central Bank of Turkey (CBT) through foreign currency accounts offered under an arrangement with Dresdner Bank from Germany, called Dresdner accounts. These accounts collect both short term (1 year or less), and medium

term (2 to 3 year) FX deposits. The total amount in these Dresdner accounts as of January 2003 had reached nearly US$14.6 billion (TL23.9 quadrillion), with almost eighty percent held in medium term funds[11]. The CBT raises these FX resources by offering competitive interest rates, and counts them as part of its official foreign currency reserves. While as such these savings are thus strictly speaking not informal savings, they do not flow into the Turkish economy through regular commercial banking channels. Under stable macroeconomic circumstances in the medium term, it is likely the CBT either would not need to raise these additional FX resources, or would be able to raise them through institutional sources without having to compete overseas for retail deposits with Turkish commercial banks. Therefore, in future with macroeconomic stability in Turkey, these funds could become available as an additional source of potential DDI for the real sector.

Gold. Another potentially large source of wealth that remains outside the formal financial system, and hence unavailable for productive investment, is the stock of gold in private hands in Turkey. It is difficult to estimate the exact magnitude of this stock, and a portion of it may be held for cultural reasons in the form of personal jewellery rather than as an inflation hedge. There is anecdotal evidence, however, that wealthy individuals are holding gold in the form of bullion. Also, the magnitude of net non-monetary gold imports into Turkey (which itself does not produce gold) at US$1–2 billion annually during the last decade[12] provides an indication of the significance of investment in gold. With a gradual reduction of inflation, a rationalized financial sector tax structure, better investment alternatives and greater investor education, and to the extent gold is held to protect savings from inflation, it should be possible over a period of several years to mobilize part of the gold holdings into the formal financial system. In fact, the importance of informal gold holdings has been recognized by the Government with the establishment of the Istanbul Gold Exchange in 1995. This exchange has as one of its explicit objectives to mobilize the informal gold stock into the formal financial system[13]. After rapid growth in trading volume on the exchange during its first few years of operation, however, volume declined steadily thereafter due to heightened macro-economic instability.

Mattress money. It is extremely difficult to estimate the amount of cash in hard currency that is stashed away in safety boxes or hidden at home (so called mattress money). From experience in Russia and elsewhere, the amounts can run into several billion US$. Considering the size of Turkey's population and its preoccupation with gold as a mattress money equivalent, the mattress money amount excluding gold is likely to be at least US$2 billion.

While the total amount of these informal savings cannot be estimated with accuracy, it is conceivable that as a percentage of GDP, they are as high as the formal savings (around 20% of GDP or approximately US$30 billion). Thus, the rewards of a successful program of mobilizing such savings could be potentially very large.

Policy Recommendations for Facilitating Mobilization of DDI

An effort to bring even a fraction of the potential DDI informal savings into the formal savings and investment system with proper incentives will have proportionately a very significant impact on the economy, and the growth of the NBFI and capital markets segments of the financial system. Some of the measures that can facilitate mobilization of such DDI are discussed below.

Taxation. The Government should undertake a comprehensive review of the impact of its tax policies on the financial system, develop a vision for financial system development going forward,

---

[11] Source: Turkish Central Bank website.

[12] Source: Turkish Central Bank website.

[13] See for further details http://www.iab.gov.tr/english/indexen.htm.

and implement a targeted tax strategy that seeks to achieve that vision. Some desirable tax policy changes are already included in a new tax strategy agreed for near term implementation, which seeks to be revenue neutral given the Government's tight fiscal position. These include creation of a pooled basic exemption for all financial income in place of the separate exempt amounts and differential withholding tax rates for different types of financial instruments (such as type A mutual funds, Government bonds, term deposits of different maturities, etc.); declaration of income over the pooled limit; indexation of interest income for instruments with a term over three months; indexation of company interest income and deductions; introduction of provisions to encourage financial leasing; and restructuring of the tax integration system to limit the tax burden on equity investments. Further changes are necessary, however, including to create level playing fields for: (i) all private pension products; (ii) sovereign and corporate debt securities; and (iii) bank finance, leasing and factoring. Also, it will be necessary to specify the tax integration structure for equity income, to introduce separate taxation regimes for different types of insurance products to allow those mobilizing long term savings to be encouraged, and to abolish all transaction taxes[14].

Finally, thought should be given to developing targeted incentives to support financial system development, including through tilting financial intermediation towards longer term maturities and risk-based private sector investments. Given the Government's tight fiscal situation, the tax policy review should take tax revenue considerations into account, to determine the fiscal affordability and sustainability of any proposed changes. Such fiscal considerations are likely to have an impact on the *timing* of implementation of the necessary changes, but should not be allowed to *prevent* implementation, given the critical importance of deepening and broadening financial intermediation to support private sector development and economic growth. In fact, a well-designed tax policy for financial system development is likely to generate additional tax revenues on a stronger private sector tax base, including through bringing informal activity into the formal economy.

Dresdner Accounts. Besides taxation, the Government should discuss with the CBT the feasibility of gradually phasing out the mobilization of retail FX deposits by the CBT in competition with private Turkish banks, thus enabling the channelling of such FX holdings into the commercial banking system, NBFIs and domestic capital markets.

Mobilize Gold Holdings. The Government should develop a strategy for bringing informal gold holdings, to the extent feasible, into the formal financial system. Encouraging trading on the Istanbul Gold Exchange may be one way of doing so. Alternatively, the Government may consider trying to mobilize gold into the banking system as deposits, including possibly through a guarantee mechanism that would back the issuance of gold certificates to depositors redeemable in gold or cash equivalent.

Public Education. Efforts to mobilize informal savings have to be supported by a massive countrywide public education campaign describing the costs and benefits and risks associated with different financial products and services, and why it is in the interest of the saving public to put their savings in the formal financial system (see the section below on Developing an Effective Investor Compensation Scheme for further details on how to arrange such a campaign for domestic investors).

---

[14] Given that the overall tax strategy seeks to maintain tax neutrality, it will be necessary to identify alternative sources of tax revenue to make up for the loss of tax revenue that would result from abolition of the most important transaction tax, the Banking and Insurance Transaction Tax (BITT) which currently raises tax revenue equivalent to 1.5% of GDP.

Attracting Foreign Portfolio Investment

Current Situation

Worldwide, sophisticated investors have recognized that they may increase their returns/decrease their risks on investment by diversifying their holdings across countries. This, coupled with the reduction or elimination of rules limiting investments by pension funds and other institutional investors to their respective domestic markets, has produced a large pool of capital that is available for investment in the portfolio securities of other countries, where the return on investment may warrant the risk taken.

In countries like Turkey where the demand for capital, once macroeconomic stabilization is achieved and economic growth resumes, is likely to exceed the funds available domestically, these international funds can be very important. This is true especially in the initial stages of capital market development when informal savings are still being mobilized into the formal financial system. They do come with risks attached, however, as international investors owe no loyalty to foreign countries and fund flows may reverse very quickly, as seen during the 1990s Asian crises. However, attempts by individual countries to ensure that funds cannot be withdrawn quickly (such as by imposition of capital controls) are likely to ensure that the money never flows into such countries in the first place.

Half of the free float in firms listed on the Istanbul Stock Exchange (ISE) is held by foreigners or through foreign resident accounts.[15] As there are no commercial paper/corporate fixed income markets in Turkey, there is no foreign portfolio investment in traded private debt at the moment. When compared to other countries, the gross inflow of foreign portfolio investment into Turkey is not large. According to IMF International Financial Statistics, gross foreign portfolio inflows in 2000 measured as a percentage of GDP were nearly twice as high in Brazil and South Africa, three and a half times higher in Korea, and thirteen times higher in Spain than in Turkey. While in 2001 inflows fell in all of these countries except Korea, the decline in Turkey was most pronounced, with gross inflows turning negative to the tune of 2.52% of GDP.

In making foreign investment decisions, investors look at all the usual factors for a domestic investment (growth expectations for the company and the industry, quality of management, corporate governance, prior performance of the company and its competitors, size of the public float and liquidity of the instrument, etc.). Additional factors for foreign investments include economic and political stability of the foreign country, tax treatment, legal and accounting standards, foreign exchange controls and risks, infrastructure to support foreign investment such as reliable local custodians and investment advisors/managers, etc. Foreign portfolio investment can thus not only be an important source of additional finance for the private sector, but in an open economy like Turkey's (see below) is also likely to stimulate the development of ancillary capital market development support services, and modernization of accounting and auditing standards and practices and corporate governance arrangements.

Foreign portfolio inflows can be enhanced by the presence of a country's capital market in internationally recognized indices, such as the Morgan Stanley Capital International equity indices[16] against which institutional investors benchmark their performance or on which index funds are based. Where the country is not well known to the investment community, foreign in-

---

[15] It appears that much of this foreign capital belongs to expatriate Turks or Turkish residents who hold assets outside the country.

[16] The participation weights given to various countries in the MSCI indices are determined using a methodology based on a number of factors including the total market capitalization in a country adjusted to reflect the free float available for investment by foreigners and subject to individual minimum size requirement for each company included. Even where there is no change in the local economy, the country's weight in the index may be affected by changes in the performance of other markets. For details, see the MSCI Enhanced Methodology (May 2001) available at www.msci.com.

vestment may also be increased through directed promotional campaigns by the Government and others.

As of end 2002, Turkey represented 0.05% of the MSCI All Country World (Equity) Index. In comparison, the US represented 53.99%, Spain 1.31%, Korea 0.86%, India 0.20%, Mexico 0.31%, Brazil 0.27% and Poland 0.05%.[17]

Turkey has a liberal foreign exchange regime and has eliminated all restrictions on foreign portfolio investment in securities traded on the ISE. Under Turkish tax laws, non-resident individuals and corporations are subject to tax only on income earned in Turkey.[18] However, this may result in double taxation, if their jurisdiction of residence taxes worldwide income and there is no tax treaty between the country of residence and Turkey.

Medium Term Targets and Policy Recommendations

Given the current very low share of Turkey in the MSCI index, there is a risk that Turkey will be removed from the index, and as a result will be in a weaker position to attract foreign portfolio investment inflows going forward. Effective implementation of a strategy to broaden and deepen the existing equity market and to improve accounting and auditing standards and practices and corporate governance arrangements, as described elsewhere in this report, should be pursued to avoid this from happening. In particular, increased market capitalization coupled with higher free float amounts should increase Turkey's presence in the MSCI ACWI, which will in turn enhance foreign investment flows into Turkey, as institutional investors and others match their benchmarks. Turkey should strive to maintain its open capital account regime and lack of restrictions on foreign portfolio investments, to benefit to the maximum extent possible from the positive impact of such enlarged portfolio investment inflows once the economy stabilizes and economic growth resumes.

The Government should ensure that the tax policy for financial products and investors does not hamper foreign portfolio investments. In particular, the Government should ensure that appropriate tax treaties are/remain in place[19] with the Government of any country that is a key source of foreign portfolio investment in Turkey to avoid double taxation of income earned in Turkey by non-residents. In anticipation of EU accession and the integration of Turkish capital markets in EU markets, it is especially important to ensure that tax treaties are in place with all existing and prospective EU member states.

In addition, the Government, in cooperation with the CMB, the ISE, TSPAKB and other interested industry members, should undertake coordinated promotional activities in major centres where internationally active investors are located, such as New York, London, and Hong Kong, to educate these investors about the opportunities in the Turkish market.

Developing an Effective Investor Compensation Scheme

Current Situation

An effective investor compensation scheme directly protects the interests of investors. It also can enhance the confidence of retail investors in the markets, as the cost of the insolvency of their intermediary is reduced.

The 1999 changes to the Capital Markets Law created the Investor Protection Fund (the Fund), the function of which is to protect the interests of clients in the case of insolvency/failure

---

[17] Source: MSCI.

[18] ISE, *Markets and Operations* (May 2002) at p.45.

[19] Turkey currently has tax treaties with 49 countries, including the US, the UK, Germany, France, Italy, Russia, India and China. Among others, no tax treaties are currently in place with Greece, Ireland, Luxemburg, Spain and several EU accession countries, and Switzerland. A full assessment of the context of these treaties is beyond the scope of this study. *Source*: General Directorate of Revenue of the Ministry of Finance.

of their capital markets intermediary. The Fund compensates investors who lose cash or equity securities when the intermediary fails, but does not cover loss of debt instruments. It is also responsible for carrying out a preferential liquidation (called gradual liquidation) of the assets of the failed intermediary for the benefit of its customers. The gradual liquidation process overrides and operates in priority to the normal bankruptcy rules and liquidation processes specified in the bankruptcy law and the Turkish Commercial Code.[20]

Each customer, other than a client who is also a manager, director or relation of the failed intermediary, is covered for losses up to TL17.9 billion (about US$10,950).[21] This amount is lower than the EURO 20,000 amount mandated by the relevant EU Directive. While banks' securities transactions with clients are also covered by the Fund, repo transactions undertaken by banks on behalf of clients currently fall under the protection provided by the temporary blanket guarantee for all bank liabilities instituted after the December 2000 banking crisis. Thus, in case a bank fails, such transactions enjoy 100% protection as long as the blanket guarantee remains in force, favoring repos over other securities.[22] The Fund revenues come from annual risk-based dues paid by intermediaries, administrative fines imposed by the CMB, the ISE and TSPAKB, temporary levies (if imposed) and the return on the Fund's assets.

The Fund was formally created as a legal entity in 2001 and is managed by the new Central Registry Institution (CRI). The CMB supervises the Fund's operations. The Fund has yet to deal with a failure of an intermediary, but it is expecting to face one soon.

Policy Recommendations

To build investor confidence, investors need to be informed about the Fund and its coverage. This could be done directly by the Fund, or in a joint venture with the CMB, ISE or TSPAKB. One fairly simple method used in several jurisdictions[23] involves requiring the participating intermediaries to:

- Include notices in all advertisements and other documents sent to clients that the intermediary is a member of the investor protection scheme;[24] and
- Provide the scheme's coverage brochure to all customers.

As the Fund's experience with insolvencies increases, it may also want to consider publicizing its success in reducing investor losses.

The Government's decision to limit coverage to shares and cash was reportedly designed to encourage ownership of equities. However, it may be a disincentive to the development of a corporate debt market and it isn't entirely clear how the limitation will work in practice[25]. This limitation in coverage has the potential to create inequities in the treatment of investors and may put the confidence-building objective at risk if not carefully handled. Furthermore, the difference in

---

[20] See Capital Markets Law article 46/B. "*In the decision and operations of gradual liquidation, the provisions related to liquidation in the Turkish Commercial Code, the Execution and Bankruptcy Law and the other legislation shall not be applied.*" (paragraph 2). "*If the assets of the failed institution are insufficient to meet the amounts owed to customers, the Fund, with the agreement of the Capital Markets Board, may put the intermediary into bankruptcy.*" (paragraph 10).

[21] This amount will be adjusted each year to reflect inflation.

[22] Once the blanket guarantee is abolished, only retail *depositors* will enjoy protection by the SDIF against bank failure (as the SDIF does not cover banks' retail repo liabilities). All other bank depositors and creditors will no longer enjoy any special protection.

[23] Canada, Australia, UK and US.

[24] This is currently already mandated for the legal agreements broker-dealers enter into with clients; but not yet for marketing brochures and other investment related materials, as well as for broker-dealer websites.

[25] For example, would the cash proceeds of sale of debt securities be covered as cash, or not covered as they were invested in debt?

coverage between bank deposits (currently covered 100% under the blanket guarantee) and cash balances at securities firms treats similar customers in dissimilar ways without a compelling public policy justification for the difference. A better policy would be to extend coverage to all types of capital market instruments held in the trading accounts of customers at all types of intermediaries, and to create equality in the coverage level provided (such equalization to be undertaken once the blanket guarantee that is currently in place for the banking system is lifted).

In preparation for eventual EU accession, Turkey should bring the coverage level of its investor protection scheme in line with the minimum set by the applicable EU Directive. It is recommended, however, that such adjustment be made as late, rather than as early as possible, as Turkey's per capita income is currently still much lower than in the EU, and thus raising the coverage level early on would provide unnecessarily generous protection relative to the prevailing level of per capita income.

Developing an Investor Education Program

One of the key objectives of securities regulation is to protect investors. Regulators seek to protect investors by requiring issuers to disclose all facts necessary for an investor to make an investment decision, regulating certain of the activities of intermediaries and prosecuting market participants who commit fraud or other abuses. In addition, the IOSCO Principles indicate that regulators should play an active role in the education of investors.[26]

While investor education does not replace the substantive regulation of securities markets and intermediaries, it can assist regulators in protecting investors. Investor education may enhance investors' understanding of the role of the regulator, provide investors with the tools to protect themselves against fraud (and other abuses) and to assess the risks associated with particular investments, assist the regulator in the enforcement of the securities laws concerning offerings and sales of securities, and maximize the regulator's limited resources. Educated investors can better choose investments that are the most appropriate for them in light of their individual circumstances.

Many securities regulators and industry associations have established investor education programs, such as the Brazilian Securities and Exchange Commission's Program on Investor Education and Assistance,[27] and have put specific investor education materials on their websites.[28]

Policy Recommendation

At present, both the ISE and the CMB undertake some activities to provide information to investors.[29] However, the retail investor market in Turkey could benefit from a well-planned investor education program.[30] While the financial services industry should take the lead role in sponsoring such a program, the Government should where possible support the industry's effort through supportive public statements and the provision of complementary information concerning its macro-economic policies and sovereign borrowing activities.

---

[26] International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation*, (February, 2002) at section 6.5.

[27] The program is described on their website at www.cvm.gov.br.

[28] See for example the site established by the Australian Securities and Investments Commission at http://fido.asic.gov.au/fido/fido.nsf

[29] The CMB and the ISE currently publish booklets describing securities, collective investment institutions, and rights of investors, and also have dedicated parts of their websites to increasing public awareness in the securities markets. The CMB also holds public meetings in different cities in cooperation with local chambers of commerce. A TV program is being planned.

[30] The optimal investment portfolio (best return for risk assumed) in Turkey consists of a combination of foreign exchange deposits and overnight Government repos (Figure 5). The risk associated with equity investments far outweighs their return. The presence of retail investors in the equity market in Turkey under these conditions shows that there is a need for further educational efforts.

CHAPTER III

BUILDING AN INSTITUTIONAL INVESTOR BASE

Developing the Insurance Industry

Current Situation

Industry Structure. As of end 2001 there were 62 insurance companies operating in Turkey (see Table 5). Composite companies write life insurance as well as health and several other lines of non-life insurance. The trend in insurance markets worldwide is towards greater separation of life insurance from other lines of insurance business, as also mandated by the applicable EU Directive. Many countries will no longer license a company as a composite, but will grandfather existing companies that have been operating as composites. Turkey ceased licensing composite companies in 1994, and since 1998 also has prohibited composite companies from simultaneously writing new policies in both life and non-life lines of business. Existing portfolios, however, are being grand-fathered.

Of the 60 direct writing companies in operation as of end 2001, 2 were majority state-owned, 5 majority foreign owned and the remainder majority domestically privately owned. The market is open to new entrants and there are no limits on ownership of company shares by foreign investors. Table 6 provides a summary of direct domestic premium volumes for major lines of business in recent years, giving an indication of the relative importance of the different lines of business. The figures indicate that the growth in both health and life insurance coverage has been more rapid, relatively speaking, than the growth experienced in other lines of business.

The casualty branch includes several lines of business. The most important of these, for Turkey, as for most under-developed insurance markets, is the insurance of motor vehicles for land transport. What is interesting is that for Turkey, the premiums for motor vehicle third party liability (TPL) insurance are much lower than the premiums for motor vehicle property insurance. In 2001, for example, premium levels for motor vehicle TPL and motor vehicle property insurance were US$187 and US$538 million, respectively. This suggests weak enforcement of the purchase of the mandatory TPL insurance, with reportedly only around 40% of the population complying with the requirement to purchase coverage.

TABLE 5: OVERVIEW OF THE INSURANCE INDUSTRY

(DATA FOR END 2001)	DIRECT WRITING COMPANIES	REINSURANCE COMPANIES
Life, Health, Personal		
Accident (only)	23	—
Composite companies	8	—
Non-life (only)	29	
Total	60	2

Source: General Directorate of Insurance of the Undersecretariat of Treasury.

For the mandatory motor vehicle TPL insurance and earthquake insurance for owners of residential property (also mandatory), premium levels are set by the General Directorate of Insurance (GDI) of the Treasury (which regulates the industry) to prevent abusive pricing. GDI is also determining the minimum insurance coverage level for accident liability of bus operators, liability of transporters and sellers of certain hazardous material, and professional indemnity for insurance brokers. In all other lines of insurance business, insurance companies are free to determine premium and coverage levels. Despite the presence of the aforementioned controls, the difference between premium income and loss payouts (the so-called "technical result") during the past five years has remained positive for all insurance product lines on an aggregate basis, albeit a downward trend is noticeable in some lines of business for structural reasons explained below.

Loss statistics clearly show the impact of the devastating 1999 earthquake (Table 7). In 1999, 14 insurance companies and 1 reinsurance company incurred losses. While only a fraction of the economic losses were insured, the losses had a significant impact on the insurance industry, and the aggregate capitalization level of the industry declined to 24.34% at the end of 1999 from an estimated 26.73% at the end of 1998. Consequences of these losses would include an increase in rates available from reinsurance companies.

On an industry wide basis, there was a recovery as a result of operations during 2000 and the comparable ratio at the end of 2000 was 25.56%. The economic crisis in 2001 however, further eroded the industry's capitalization to 24.82% at the end of 2001. These aggregate numbers mask the dire financial situation of many individual companies, as during 2000 and 2001 11 and 10 insurance companies, respectively, still were making losses, reflecting the presence of structural weaknesses beyond the impact of the 1999 earthquake (see the policy issue section below).

Except for life[31] and accident insurance, a significant portion of insurance business is reinsured domestically or abroad, suggesting many domestic insurance companies act more as insurance brokers than as insurance risk underwriters (Table 8). The following table indicates that results of

[31] In 2001, 96.62% of direct premium production for life insurance was retained domestically.

TABLE 6: INSURANCE SECTOR PREMIUM VOLUMES

(US$ MILLION)	1996	1997	1998	1999	2000	2001	2001 (% share)
Total, of which	1178	1372	1746	1797	2636	2033	100
Fire	198	207	242	288	380	361	18
Transport	119	108	104	80	104	88	4
Casualty	537	647	846	829	1277	877	44
Engineering	55	68	81	70	100	99	5
Health	78	116	171	199	280	221	11
Life	175	216	293	323	484	378	18

Source: General Directorate of Insurance of the Undersecretariat of Treasury.

reinsurance during 2001 were in favour of the direct writing companies.

TABLE 7: INSURANCE SECTOR LOSS RATIOS

(BRANCH)	1998	1999	2000	2001
Fire (incl. earthquake)	56.65%	230.86%	39.60%	65.97%
Transportation	52.93%	67.24%	56.62%	66.81%
Casualty	88.25%	82.99%	66.95%	71.13%
Engineering	53.10%	121.80%	69.05%	206.60%
Agriculture	104.79%	87.78%	36.00%	50.03%
Health	85.10%	86.06%	76.04%	76.66%

Source: Insurance Supervisory Board of the Undersecretariat of Treasury

Milli Re. Milli Reasurans T.A.S. (commonly referred to as Milli Re) is the national reinsurance company. It was set up in 1929 to ensure that local companies could obtain reinsurance on reasonable terms, and to retain premiums paid for reinsurance in the country. The company has served its market well and its management has earned the respect of the local industry. While companies were obliged initially to cede to Milli Re a proportion of all their premiums (on a quota share basis), over time the system has changed as local companies earned the confidence of the major international reinsurance companies and brokers. By the 1990s, mandatory cessions to Milli Re had been substantially reduced as a proportion of business written (to about US$110 million annually on average during the past ten years). The primary exception was the mandatory motor vehicle TPL insurance, where the cession continued to be on a quota share basis. As of January 1, 2002 the requirement for mandatory cession of domestic insurance business to Milli-Re was terminated, although Milli Re will continue to enjoy a right of first refusal on any business to be offered to foreign reinsurers (about US$40 million annually) until end 2006. Thus, except for this segment relating to foreign cessions, Milli Re must now compete for its share of reinsurance business with other reinsurance companies that seek to do business with Turkish insurance companies. In practice, however, Milli Re remains the dominant market player.

Earthquake Insurance. In Turkey, earthquake insurance is mostly provided as an allied peril to fire insurance policies. In the aftermath of the 1999 earthquake, public financing including loans and grants from international donors was required to help restore the buildings and infrastructure that were destroyed. Only a small fraction of the economic loss was insured, and hence the repair burden fell mainly on the Government. In response and to avoid recurrence, the Government decided to explore means whereby greater use could be made of the insurance mechanism to mitigate the risk being borne by public funds. After discussions involving the World Bank and major reinsurance companies, implementation of compulsory earthquake insurance was launched through enactment of decree Law No. 587 on December 27, 1999 and the creation of the Turkish Catastrophe Insurance Board (TCIB) and the Turkish Catastrophe Insurance Pool (TCIP). The program covers all urban residential property, and a simplified insurance policy was designed

TABLE 8: INSURANCE INDUSTRY—RISK SHARING CHARACTERISTICS

(%)	PROPORTION CEDED TO LOCAL RE-INSURERS	PROPORTION CEDED TO FOREIGN RE-INSURERS	RETENTION	CLAIMS PAID BY RE-INSURERS	CLAIMS PAID BY DIRECT WRITING COMPANIES
Fire	26.66	46.60	26.74	75.50	24.50
Casualty	14.46	14.95	70.59	27.70	72.30
Health	8.77	21.70	69.53	34.15	65.85

Source: Insurance Supervisory Board of the Undersecretariat of Treasury.

to be sold to all home-owners (excluding those in villages). This policy provides protection only for those losses caused by earthquake or fire resulting from an earthquake. Coverage is determined as a multiple of a dwelling's surface area in m^2 and unit construction cost, up to a pre-set upper limit which is currently TL28 billion (approximately US$17,140). The TCIP uses a multiple tariff system which reflects the structural risk characteristics of insured dwellings and their location. For example, if a residence is not built in accordance with prescribed codes of construction and is close to an earthquake fault, the insurance premium charged that property is considerably higher than the average premium. With a 2% deductible and no co-insurance requirement, the premium rates are affordable even in the current difficult economic climate.

Local insurance companies are serving as agents for the marketing of the policies. Under an agreement with the Treasury, Milli Re is serving as administrator of the program for five years. However, neither Milli Re nor any of the local companies accept any of the underwriting risk on these policies. That risk is borne by the TCIP. With reinsurance support, most of the risk has been canalized to the international reinsurance markets. The TCIP has established important international reinsurance facilities and is capable of supporting insured losses of up to US$1 billion. If aggregate losses exceed that level, the excess could once again fall on the Government. Although the purchase of earthquake insurance is mandated by decree law, only 23% of buildings were covered as of September 2002. Coverage is expected to increase once the requisite full implementation legislation will be enacted.

Agricultural Insurance. A long-lasting presence of the Government in the agricultural sector has created strong disincentives for farmers to buy agricultural insurance products, and for insurance companies to develop and market such products. As a result, in Turkey the agricultural insurance market is almost non-existent, with the penetration by private hail insurance at under 0.6 percent of the total surface planted. However, an agricultural insurance project envisaging the introduction of new agricultural insurance products was developed in 2002 with the assistance of the World Bank. The implementation of this project is expected to be started in 2003.

Investments. Notable shifts in the investment portfolios of insurance companies (Table 9) have occurred over the last few years, especially out of short term T-bills and into longer term Government bonds, mainly in response to movements in TL interest rates. Short term interest rates dropped especially sharply in the early years of implementation of the IMF-supported macroeconomic stabilization program that was initiated in 1999, leading to a corresponding steepening

TABLE 9: INSURANCE INDUSTRY ASSET ALLOCATION

	1996	1997	1998	1999	2000	2001
Total Bonds & Shares	78.98%	80.87%	73.73%	56.80%	68.99%	66.11%
Treasury bills	64.06%	43.48%	47.29%	19.29%	9.86%	19.89%
Government bonds	3.96%	27.43%	19.33%	32.35%	45.57%	34.29%
Investment Funds	1.34%	2.65%	1.72%	1.58%	3.87%	4.22%
Shares and Non-Government Bonds	5.22%	4.92%	4.63%	1.91%	7.31%	6.03%
Other	4.40%	2.39%	0.76%	1.67%	2.39%	1.68%
Real Estate	10.83%	10.12%	9.18%	6.09%	7.16%	7.66%
Deposit Accounts	7.16%	5.89%	12.67%	32.08%	16.96%	19.36%
Participations	2.97%	3.05%	4.24%	4.87%	6.62%	6.24%
Loans	0.06%	0.07%	0.18%	0.16%	0.27%	0.63%
Grand Total	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

Source: Turkish Association of Insurance and Reinsurance Companies

of the yield curve. The shift may also partially reflect the rapid growth (pre-2001 crisis) of life insurance, which as a longer term liability requires insurance companies to invest in longer term assets. At the same time, there has also been a tendency to make greater use of bank deposits, reflecting the impact of the 1999 earthquake and associated spike in claim payments, but possibly also a desire on the part of investment managers to remain more liquid during severe macro-economic turbulence.

Policy Issues

Low Insurance Penetration/Density. Turkey ranks very low in terms of insurance density and penetration when compared with other countries (Table 10). Premiums as of end 2001 constituted only 1.31% of GDP. Consequently, insurance industry assets are also low, at only US$3 billion or just over 2 of GNP as of the same date. The total number of policies outstanding for all insurance product lines increased from 13.3 million as of end 1997 to 17.4 million as of end 2001; but actually declined sharply in 2001 (by 2.4 million) due to the economic downturn; as a result, on a population of over 65 million people, penetration is very low with premiums per capita only at US$30.1 in 2001, down from US$40.4 in 2000, putting the industry back three years to the level it had reached in 1998.

Numerous factors have contributed to the very low levels of penetration and density seen in Turkey, including chronically high inflation, low per capita income and unfamiliarity with, and lack of understanding of the value of, insurance products, and weaknesses in the policy regime for insurance and in industry oversight (see below); and more recently, also, the economic downturn. The widespread practice of insurance companies to pay claims only with significant delays (especially damaging in highly inflationary circumstances) has also eroded consumer confidence.

Highly Fragmented Market, Excessive Competition and Pressure on Profitability. Deregulation of premium rates in 1990 for most classes of business other than certain compulsory lines, coupled

TABLE 10: CROSS COUNTRY COMPARISON OF PREMIUM VOLUMES, INSURANCE DENSITY AND PENETRATION

(DATA FOR 2001 IN US$ MILLION)	TOTAL PREMIUM	NON-LIFE	LIFE	DENSITY: PREMIUMS PER CAPITA (US$)	PENETRATION: PREMIUMS AS % OF GDP
Argentina	6,986	4,418	2,569	187.0	2.60
Brazil	10,775	8,953	1,882	64.0	2.14
India	11,877	2,459	9,418	11.5	2.71
Italy	68,988	27,506	41,481	1186.4	6.27
Korea	50,537	14,145	36,392	1060.1	12.07
Mexico	11,176	5,893	5,283	112.6	1.81
Poland	5,410	3,529	1,882	140.0	3.07
South Africa	20,297	3,145	17,152	446.3	17.97
Spain	36,441	17,077	19,364	923.9	6.25
Turkey	2,034	1,660	375	30.1	1.31
United Kingdom	218,380	65,664	152,717	3393.8	14.18
United States	904,021	460,608	443,413	3266.0	8.97

Note: Total premium data for Turkey do not exactly match those in Table 6 due to the use of different TL-US$ exchange rates.
Source: SIGMA.

with a liberal licensing regime that allowed the number of companies operating in the market to more than double (from 49 in 1991 to 62 as of end 2001) has resulted in sharp competition over prices, to the point where some premium rates are now inadequate. For example, the premium for fire insurance on property has now been reduced to the point where it is barely sufficient to cover the insurance charge for earthquake protection that the Government has mandated to include in personal policies. In other words, insurers are effectively collecting no premium for other, more conventional perils. As a result, profitability has fallen, with aggregate industry return on assets and return on equity both displaying a noticeably downward trend (from over 12 and 65% in 1997 to just over 7 and 41% in 2001, respectively). Fierce competition among insurers on price, rather than on quality of services offered, if allowed to continue, is likely to result in the de-capitalization of many smaller/weaker companies and concomitant pressure on these companies to either exit or consolidate. The decline in the number of direct-writing companies from 62 as of end 2001 to 60 as of end October 2002 may indicate the beginning of a possible trend towards such consolidation.

Capital shortfalls and Weak Regulation/Enforcement. As a result, and also due to the impact of the 1999 earthquake and the 2001 recession, the capital base of the insurance sector has been eroded. GDI has recognized the problem, and has placed almost one third of all insurance companies under enhanced supervision because of failure to meet solvency margin requirements. During the last two years, seven of the companies under enhanced supervision have also been prohibited from writing new insurance business. The magnitude of the problem may be larger, however, than the enforcement actions taken to date by GDI suggest. While the Turkish solvency margin requirement is in line with the solvency margin requirement specified by the applicable EU Directive,[32] differences in the definition of technical reserves result in overstatement of solvency in Turkey when compared with the EU. In fact, the asset portfolios of several undercapitalized insurance companies may be insufficient to allow their transfer together with policy holder liabilities to other, more healthy insurance companies. There is currently no mechanism to deal with such asset shortfalls. There are also weaknesses in the enforcement of timely processing of claims, compliance with the premium levels wherever these are set by GDI, and the mandatory purchase of motor vehicle TPL and earthquake insurance.

Accounting and Auditing. Currently, GDI in cooperation with the Turkish Association of Insurance and Reinsurance Companies (an industry association with limited self-regulatory responsibility) sets the accounting standards for insurance companies (including for those listed on the ISE[33]). These standards are not in line with IAS, and reduce the reliability of insurance companies' published financial statements, as well as the prudential information GDI receives. As there is no general oversight body for the audit profession, GDI is forced to scrutinize and approve external auditors for insurance companies, rather than being able to rely on such an outside body for this purpose.

Captive Agency System. Insurance policies are sold by insurance companies directly, through banks[34] acting as insurance agents and through independent non-bank agents (of which there were 14,718 as of end 2001). While policies sold through independent agents constitute an immediate liability for the underwriting insurance companies, the former are allowed to collect the

[32] The minimum solvency requirement in Turkey is a function of one year's premiums or net claims paid, whichever produces the higher value. In the EU, the requirement is a function of premiums or gross claims paid, based on experience using a three-year average.

[33] The Capital Markets Law specifically delegates this power from the CMB to GDI. See also the section in Chapter VI on "Strengthening Accounting and Auditing Standards and Practices."

[34] Although banks cannot underwrite insurance policies, they own many of the currently active insurance companies, and all of the largest 8 companies are partially or fully bank-owned. As such, they have no incentives to abuse the agency privilege of keeping premiums, as they do not want to 'kill' their own insurance subsidiaries.

premiums in case of sale of non-life policies,[35] and often deliberately delay their transfer to profit from high short term interest rates, depriving the companies concerned of an important source of income. It is estimated that over the last several years, non-life insurance companies lost between 27-30% of gross premium written as a result, and the loss of premium income also is the reason for the failure of several such companies during the past few years. The capacity of GDI to address this problem is hampered by the cancellation by the Constitutional Court of several articles in the existing insurance law regulating the activities of insurance agents.

New Private Pension Initiative. One of the important developments that will shortly impact the insurance sector is the launch of a new, defined contribution private pension scheme (see also the next section of this Chapter on the Turkish pension system). Participation in this scheme is voluntary and encouraged through tax incentives. The scheme can only be offered by pension companies licensed and supervised by GDI. To qualify as pension companies, life insurance companies (other than composite companies) must cease offering lines of business other than life and personal accident insurance (except for health insurance on a temporary basis for two years, after which they must transfer their health insurance portfolios to other insurance companies) and meet a minimum capital requirement of TL20 trillion (US$12.2 million). Despite the apparent large amount of capital required, several life insurance companies have indicated their plans to invest this sum, and one company has already transferred its health insurance business to another company, to qualify for this new activity. The enabling legislation (Law No. 4632 on the Private Pension Savings and Investment System), as well as the requisite implementing regulations (four so-called by-laws regarding the operation of the system) are in place, and out of eleven life insurance companies that have applied for transformation into pension companies eight have been granted GDI's approval for transformation. Upon receipt of such approval, the companies are obliged to obtain a license to operate in the pension branch in order to initiate their activities; to date, one company was granted such a license.

Medium Term Targets and Policy Recommendations

The insurance industry should, over the next 3–5 years, strive to raise its rate of insurance penetration to 3–4% of GDP from the present low level of 1.31% (2001) allowing insurance sector assets as percent of GNP to double to 4–5%. This would put Turkey at par with other emerging markets and at the low end of large EU member countries, allowing it to better withstand strong cross border competition if and when it enters the EU. To achieve these objectives, several major policy changes are needed.

A new modern insurance law should be enacted, and insurance regulation and supervision should be significantly strengthened.[36] Solvency standards (including the definition of technical reserves) should be brought fully in line with applicable EU and best practice standards and proactively enforced. The new law should also address structural industry weaknesses such as the captive agency system, and require the use of "pure" IAS (rather than national standards) for general financial statement reporting purposes. Once a new Chamber of Auditors is operational, GDI should adjust its licensing arrangements for external auditors for insurance companies to supplement, rather than substitute for, the role of this new oversight body. All undercapitalized companies should be resolved. Where assets on an IAS basis are less than policy holder liabilities, a strategy should be developed to fill such gaps, to allow GDI to arrange transfers of the portfolios of undercapitalized insurance companies to healthy insurance companies as a less disruptive exit mechanism than liquidation. Standards for timely claim processing should also be developed, and adherence encouraged through the introduction of meaningful penalties for non-compliance.

---

[35] Premiums for life insurance policies are paid directly to the life insurance companies.

[36] See Chapter VI, "Strengthening Regulation and Supervision of Insurance" for further detail.

The insurance industry should be rationalized, and its consolidation encouraged, by: (i) ensuring that the minimum capital requirement (currently TL8 trillion or US$4.9 million[37]), remains at that level in US$ or EURO terms, and is proactively enforced; companies not meeting the requirement should be forced to merge with other companies or exit; (ii) extending the tax exemptions granted to banks for mergers in the aftermath of the recent banking crises to insurance company mergers; and (iii) introducing a licensing system for all insurance agents, and mandating direct payment of non-life insurance premiums to the insurers underwriting the risks rather than to agents.

Well-established insurance companies with strong life insurance operations should be permitted to offer the new private pension products without having to increase their capital to TL20 trillion. As companies offering these products would not underwrite investment risk, there is no rationale for a TL20 trillion minimum capital requirement, even though a lower minimum capital requirement may be justified to ensure only serious players capable of making the requisite investment in modern technical infrastructure, development of new marketing and sales strategies and human resources enter the industry. Companies currently still licensed as composites (offering both life and non-life products) under a grand-fathering arrangement should also be permitted to offer the new products, subject to a requirement that they first separate their life and non-life business (and hence cease to be licensed as composites), with their life insurance arms subsequently undergoing transformation into pension companies.

The implementation legislation mandating the compulsory purchase of earthquake coverage by all property owners should be enacted by Parliament and rigorously enforced by GDI. Additionally, to reduce the financial vulnerability of the rural population to variability in crop yields due to adverse weather events, and to reduce fiscal exposure to the agriculture sector, the Government should promote a wider use of innovative insurance products in the agricultural sector in lieu of farm subsidies. Similarly, enforcement of the purchase of mandatory motor vehicle TPL insurance should be stepped up. While the Ministry of Interior has primary responsibility in this area, its efforts should be supported by a proactive outreach effort by GDI. To further develop the health insurance industry, consideration should be given to replacing the current system of budget allocations financing health insurance for civil servants with a system of financing premium payments for private health insurance (that is, a reform of Emekli Sandigi, the state social security system for civil servants; for further details on this system see below).

To allow insurance companies to deepen their investment activity, to better manage maturity transformation and other investment risks, and to restore their profitability and thus their potential to grow, the menu of available investment options should be widened beyond Government paper, bank deposits and real estate. Towards this end, a concerted effort should be made to develop domestic equity and corporate fixed income markets (see Chapter IV, "Developing Securities Markets" for further detail) and to create a primary and secondary mortgage lending industry.[38] The latter would not only be beneficial in promoting home ownership, but would also create a vehicle (for example, mortgage backed securities) that insurance companies in many countries find good quality investments that match their obligations to policy holders.

The tax regime for both insurance *companies* and insurance *products* should be revised. At the company level, investment income is subject to withholding tax, but this tax is not refunded even if the total income of the insurance company is negative. Such refunding should be allowed. Additionally, mandatory reserves (for example, for earthquake insurance) should be allowed to be deducted from corporate income tax as a legitimate business expense. The Banking and Insurance

[37] This requirement was phased in over several years since 1994, with the last year of the phase-in period being 1999.

[38] A discussion of housing finance is outside the scope of this study. It should be noted, though, that once macro-economic stability takes hold, mortgage finance markets are more likely to flourish.

Transaction Tax (BITT) should be abolished (revenue considerations permitting).[39] At the product level, as argued in the section below on development of the private pension industry, the tax treatment for life insurance products should be brought in line with the tax treatment of private pension schemes.[40] Also, the fire insurance tax (another transaction tax) should be abolished.

Finally, a vigorous education campaign should be undertaken, to explain to the public the potential advantages and uses of insurance products. While the Association of Insurance and Reinsurance Companies is best placed to take the lead in organizing such a campaign, the Government should support its drive to do so where possible.

Developing the Private Pension Fund Industry

Current Situation

First Pillar. For the majority of residents of Turkey, the state social security system is the primary source of retirement income security. The state system is run through three public organizations:

- Sosyal Sigortalar Kurumu (SSK): the Social Security Organization of Workers; under Law No. 506 SSK entitles all persons employed under a contract of service to benefits in the event of industrial injury or disease, sickness, maternity, disability, old age and death.
- Bag Kur: the Social Security Organization for the self-employed; covers merchants, artisans and the self employed. Bag Kur has no health facilities of its own and contracts with other public and private service providers, with the scheme operating on a reimbursement basis, subject to co-insurance in respect of drugs.
- Emekli Sandigi: the State Pension Fund for public employees; primarily a pension fund for retired civil servants, but also provides health insurance for retired employees, financed out of general budget allocations. Healthcare costs for active civil servants are covered by specific state budget allocations.

At the time of their establishment, these schemes were designed to operate on a partially funded basis. However, for a number of reasons, including alleged inefficiencies in fund management, their accumulated funds were depleted through the years, and from 1990 onwards the system has been supported on a pay-as-you-go basis. There is a consensus that the social security services provided by the three institutions bring a considerable burden to the public purse, and moreover that they are unsustainable under present circumstances (the annual deficit of the three institutions is currently around 3.5% of GNP). To address these problems, the Government has adopted a two-stage reform strategy for the social security system. In stage I (completed in August 1999) parametric redesign was undertaken for all three social security organisations. The key aspects of the first stage reform, as concerns pensions, are: (i) increasing the minimum retirement age to 58/60 (F/M) for new entrants and 56/58 (F/M) with a transition period for current contributors from 38/43 (F/M); (ii) increasing the minimum contribution period for full old-age pensions for SSK to 7,000 days from 5,000; (iii) extending the reference period to whole working-life for SSK and Bag-Kur, for which the reference period was the last 5 or 10 years depending upon

[39] The Bank and the Government are working on reform of the overall tax policy in Turkey. A new tax strategy is under development that will increase corporate income tax revenue, and this increase should provide room for abolition of the BITT, which is not only distorting insurance product pricing, but also banking, leasing and factoring product pricing. The BITT is an important source of tax revenue at the moment at 1.5% of GDP, however, and therefore cannot be abolished without replacement revenue being generated first.

[40] This doesn't necessarily mean that the tax treatment of both products should be the same. The time period for qualifying for tax benefits in private pension schemes (38 years) is currently almost four times as long as the comparable period for savings-oriented life insurance products (10 years). The tax structure should ideally provide incentives in proportion to the maturity of the savings products invested in.

the income of the contributor and last income step, respectively; (iv) increasing the contribution ceiling for SSK to 3 times from 1.6 times the minimum insured earning in January 2000, to 4 times in April 2000 and to 5 times in April 2001; (v) indexing contribution bases for SSK and Bag-Kur to both real GDP growth rate and percentage change in the CPI; (vi) significant reduction in the replacement rate for old-age and invalidity pensions;[41] and (vii) changing the pension calculation system, and indexing pensions to the CPI. Measures to increase the coverage and compliance rates (new declaration obligations for employers and employees and an increase in the number of inspectors) were also introduced. In stage 2 (ongoing/planned), individual (private) retirement schemes will be introduced (see below), institutional and administrative reforms will be undertaken (including combining the three existing social security organizations under one umbrella, introducing means/income-testing mechanisms, creating a national database, and separating the health and other benefits from the retirement portions of the system), and the system itself will be further restructured.

The state social security system requires pension contributions of 11% from the employer and 9% from the employee (self employed pay 20%) apart from further contributions to health, maternity and work-related injury insurance. This implies a pension contribution of 18% of the gross earnings of the individual depending upon the full package of employer-paid benefits.[42]

First Pillar Substitute, Second Pillar-Type and Existing Third Pillar-Type Funds.[43] When the SSK law (Law No. 506) was enacted, the service sector (e.g. banks, insurance and reinsurance companies, stock exchanges and chambers of commerce) was excluded from participation in SSK, and in response, several entities in this sector created their own defined benefit occupational pension plans for their employees. The provisional Article 20 of Law No. 506 subsequently required these plans to be organized as "vakifs" (non-profit foundations) providing benefits to their members comparable to those of the SSK, and made membership mandatory for employees of their sponsors. There are currently 18 such *first pillar substitute funds.* The total population covered by this type of plan is estimated at around 333,000 (as per the Social Insurance Institution Statistical Yearbook 2000) and estimated assets under management as of end 2001 were around US$750 million.[44] Several of these funds, besides providing pensions, also provide death, disability and health insurance products, as well as loans to their members. If the sponsoring organization of one of these plans falls into bankruptcy,[45] the accounts of the participating employees are transferred to the SSK scheme and SSK takes over their liability to finance their future pension obligations. Hence, there is an effective Government guarantee for these schemes.

There are also two *second pillar-type schemes* in which membership is mandatory, for the armed forces (Oyak) and for the employees of the state-owned coal mining enterprise TTK (Amele Birligi). These schemes operate under separate legislation and combine defined benefit and defined con-

[41] The basic replacement rate for 5,000-contribution-days for SSK was 60%, but it is now 53.9% for 7,000-contribution-days. Similarly, the replacement rate for Bag-Kur was 70% for 25 years of contribution, and it is now 65% for 25 years of contribution. Moreover, the replacement rate for invalidity pensions for both schemes is decreased by 10 percentage points.

[42] Based on contributions of 9.5–15% of earnings made by the employer for health, maternity, work related injury and unemployment. Note that the insured or pensionable earnings are the earnings of a worker excluding the contribution of the employer to pension or other social insurance coverage or any other employee benefits received. Hence, the pension contributions will be considerably less than 18% of the gross earnings of the worker, except in the case of the self-employed.

[43] The use of the terms first, second and third pillar funds does not imply that Turkey has a well-functioning multi-pillar pension system; in fact, the pension schemes described here have largely come about without such a concept consciously underpinning their creation, and suffer from several deficiencies as elaborated in this section.

[44] This estimate was arrived at by visiting several of the funds, and also by using Treasury data for end 2000 of assets under management of these funds.

[45] This in fact happened with some banks taken over by the SDIF after the recent banking crises.

tribution elements. It is estimated that these schemes covered around 209,600 people (Oyak: 190,000; Amele Birligi: 19,600–2000 data) and had assets under management of around US$1.315 billion (Oyak: US$1.3 billion; Amele Birligi: US$15 million) as of end 2001. Oyak also sells insurance products and mortgage loans to its members.

Several of the institutions that run a first pillar substitute fund, as well as the CBT, the police and numerous private sector corporates also run "vakif"-based, third pillar-type funds that provide either defined benefit (DB), defined contribution (DC) or combination DB/DC pensions on a voluntary basis, for purposes of enhancing the benefits available under the state social security system. Based on research done by Treasury's GDI,[46] it is estimated that there are at least 60 such *existing third pillar-type funds*, covering over 400,000 people and managing estimated assets of around US$1.3 billion.[47] It is possible, however, that there are many more such funds (an estimate of as high as 250 has been mentioned), but as the General Directorate of Foundations, to which all "vakifs" report, does not proactively enforce vakif reporting requirements, the true size of this universe is impossible to know with certainty. As is the case for the first pillar substitute funds, several of these funds also provide insurance and lending services to their members. At least one fund (of the police force) is reported to be interested in acquiring a bank to be able to provide its members with basic retail banking services. A schematic overview of all of these schemes can be found in Table 11.

There is no formal system for regulation and supervision of the operations of these schemes and many are believed to invest their funds principally in the shares of their sponsoring organizations (for further details see the section on "Strengthening Regulation and Supervision of Pension Funds" in Chapter VI).

New Third Pillar-Type Funds. To enhance the income security available to retiring workers and to reduce the strain on the public system, the Government as part of its social security system reform program has recently developed a new third pillar-type private pension scheme. The features of this scheme are laid down in Law No. 4632 on the Private Pension Savings and Investment System which came into effect as of October 7, 2001 (see also Table 11).

The purpose of this Law is the regulation and supervision of a new individual pension system that is complementary to Social Security. The system is based on voluntary participation and the fully funded defined contribution principle, and will thus provide participants with ease of portability in the event of their transfer from one employer to another. The expectation is that the retirement savings of individuals will be invested in the private sector, with the assets accumulated under such plans to be managed by private portfolio management companies. The program should provide a means of supplementing income during retirement, while at the same time contributing to economic development by creating long term resources for the economy.

Participants (people aged 18 and above) will enter into a contract with a "pension company" (PC) that will manage the accumulation of pension savings and arrange for payment of benefits. PCs will maintain individual pension account records on behalf of each participant and transfer any contributions collected to a separate and independent pension fund, similar to a trust, that will accumulate the assets on behalf of the participants. Participants will be able to change the composition of investment funds and to switch to another PC. PCs must hire separate portfolio managers (asset management companies) and custodians to manage the pension funds. In its investment activities, the portfolio manager is expected to follow the general fund management strategy established by the PC. Participants become eligible for retirement at age 56, provided

[46] GDI initiated a study on this topic in 2000. 135 funds were randomly selected and asked to fill out a questionnaire identifying their pension, insurance and lending activities and assets/liabilities, 61 of which replied. During 2002, GDI sent questionnaires to 208 funds, and as of October 2002 60 funds had replied.

[47] These estimates were arrived at by visiting several of the funds, and also by using Treasury data for end 2000 of assets under management of 43 of these funds.

TABLE 11: OVERVIEW OF PRIVATE PENSION SCHEMES

	FIRST PILLAR SUBSTITUTE (MANDATORY)	SECOND PILLAR-TYPE SCHEMES (MANDATORY)
No. of Active Funds	18	2
Legal Basis	SSK Law Temporary Art. 20, Law on Vakifs	Fund specific legislation (e.g., Law on Oyak)
Legal Form	Vakifs (non-profit foundations owned by members)	A unique form of non-profit foundation owned by members.
Sponsors	Banks, Insurance and Re-insurance Companies, Exchanges, Chambers of Commerce	Army, State Coal Mining Enterprise TTK (Amele Birligi)
Beneficiaries	Staff and family of sponsors	Army staff and staff of private sector corporates in which Oyak owns more than 50% of capital; state coal mine employees
No. of Beneficiaries	332,870 (as of end 2000)	190,000 (Oyak, as of end 2000) 19,600 (Amele Birligi, as of end 2000)
Type of Pension Benefits Paid	DB (same minimum as SSK) or a mix of DB and DC	mix of DB and DC
Regulator	General Directorate of Foundations (GDF), Ministry of Labour and Social Security	Ministry of Defence (Oyak) Ministry of Labour and Social Security (Amele Birligi)
Accounting Standards	Same as for all vakifs, set by GDF	Same as for private sector corporates, set by Ministry of Finance
Audit Requirements	Annually, general audit only	Annually for general audit, bi-annually for actuarial audit (Oyak)
Disclosure	Only to GDF	Only to the Ministry of Defence, but Oyak intends to disclose general audits to its members. Annually, general audits only (Amele Birligi)
Asset Management Function	In-house	In-house
Asset Allocation Requirements	None, except that GDF must approve real estate transactions	Oyak: Prudent man rule. Amele Birligi: none, but investment is mainly in real estate and bank deposits
Assets under Management (US$ million, end 2001)	±750	Oyak: 1,300. Amele Birligi: 15
Other Activity	PAYG health insurance, disability and term life insurance (similar to SSK)	Disability, term life insurance, mortgage and consumer loans (Oyak)
Failure Resolution Arrangements	When sponsor fails, fund is liquidated and assets & liabilities are transferred to SSK	By court decision, but no specific regulation

Source: Undersecretariat of Treasury, CMB, Oyak, selected banks and Bank staff estimates.

EXISTING THIRD PILLAR-TYPE SCHEMES (VOLUNTARY)	NEW THIRD PILLAR-TYPE SCHEMES (VOLUNTARY)	TOTAL
60+	0	80+
Civil Code, Law on Vakifs	*New Private Pension Fund Law*	
Vakifs	Functions of pension sponsor and portfolio manager are both separate from the actual pension fund	
CBT, Banks, Police Force, Teachers Unions, Private Sector Corporates	Pension companies are licensed by the GDI and must have minimum TL20 trillion capital	
Staff and family of sponsors	Open to all individuals	
400,000+	0	942,470+
DB, DC and hybrid	DC only	
GDF	Pension companies are licensed and regulated by GDI, and pension funds are licensed and regulated by CMB	
Same as for all vakifs, set by GDF	For pension companies set by GDI, and for pension funds set by CMB	
Annually, general audit only	At least annually for pension companies, quarterly for pension funds	
Only to GDF	To GDI, CMB, participants and market	
In-house	To be contracted out to asset management companies licensed by CMB	
None, except that GDF must approve real estate transactions	Set by CMB	
±1,300		±3,365
Disability, term life insurance, death benefits, spousal & children allowance, loans	Pension companies can provide life and individual accident insurance products	
By court decision, but no specific regulation	When pension company fails, assets & liabilities are transferred to another pension company	

that they have been in the system for at least ten years as of the date of entry into the system. A participant who is entitled to retire has the right to request that a certain part or all of his/her accumulated savings in the individual pension account be paid to him/her in a lump sum, or may enter into an annuity contract for the payment of benefits in installments. To create incentives for individuals to commit their savings to these new retirement plans, contributions are tax deductible up to 10% of income within certain caps.[48] Employers can also contribute to the system on behalf of their employees on a tax deductible basis within certain limits. Investment income earned during the accumulation phase is exempt from corporate income tax (at the pension fund level) and personal income tax (at the beneficiary level), but is subject to withholding tax, with the withholding tax rate dependent on the type of investment instrument used. Beyond the first 25% of the benefit payment which will be tax free, withdrawals are treated as capital gains and subject to a withholding tax rate depending on the length of time a beneficiary has participated in the system.[49]

PCs will be licensed and supervised by GDI. To obtain a license, an applicant must be established as a joint stock company and have a nominal capital of at least TL20 trillion (US$12.2 million) and a paid-up capital of at least TL10 trillion (US$6.1 million), the remainder of which is undertaken to be paid within three years. It must also establish at least three pension funds with different portfolio compositions. PCs are subject to annual audits by independent auditing firms. The portfolio managers, custodians and pension funds will, however, be licensed and supervised by the CMB. Pension funds will be subject to annual external audits. The Individual Pension Advisory Board, a coordination committee comprising the Ministries of Labour and Finance, the Treasury, and the CMB is tasked with coordinating the activities of all of the regulatory agencies concerned. Pure, non-composite life insurance companies established after 1996[50] and operating in Turkey prior to the publication of the Act can be transformed into PCs, provided they file an application within five years of the effective date of the Act and fulfill certain conditions. For most non-composite life insurance companies, compliance with these conditions means transferring their health insurance business to another company and raising their capital to TL20 trillion.

While the law is in force and the necessary implementing regulations were issued in February 2002, as yet, only one pension company has been approved for licensing; another eleven companies have applied for transformation into pension companies, and eight have been granted approval by GDI for doing so.

Medium Term Goals

As indicated in Table 1, it is estimated that aggregate pension funds under management in Turkey currently amount to close to US$3.4 billion. In developed countries, pension funds play a very important role as institutional investors. In the United States, for example, it is estimated that over 40% of the outstanding shares in corporations listed on the New York Stock Exchange are held by pension funds. Given that the existing pension funds cover less than 1 million people and the development of a properly regulated third pillar is still in its infancy, there is clearly great capacity

---

[48] The law specifying the tax treatment of individual pensions (Law No 4697) came into effect as of October 7, 2001. Limits are established for aggregate contributions made by and/or on behalf of an individual in a year: (i) for self employed: 10% of annual declared income and less than the total annual minimum wage (currently, TL222 million*12 = TL2,664 million); (ii) for employee individuals: 10% of monthly salary and less than the total annual minimum wage. There is discretion to increase the limits to 20% and double the annual minimum wage. "Salary" for purposes of calculating the applicable taxes are gross wages including contributions to state sponsored social security by the employee and/or employee or the value of other employer-provided benefits.

[49] The regular withholding tax rate on capital gains is 25%. A Decree of the Council of Ministers dated December 21, 2002 specifies the following withholding tax rates for private pension schemes: 5% for payments to participants entitled to retire, 10% for payments to participants who have participated at least 10 years but are not yet entitled to retire, and 15% for payments to participants who have participated less than 10 years.

[50] Composite companies whose life insurance business is being grand-fathered after the coming into force of the 1994 amendment to the insurance law separating life and non-life business do not qualify.

for further development of the pension fund industry as a key institutional investor base component in Turkey.

Looking at the experience in other countries that have developed private pension schemes (Table 12), it is apparent that once reforms have been introduced, growth of assets under management by such schemes is very rapid. It should therefore be possible for Turkey to grow its pension assets under management to around 4–5% of GDP or US$10–12 billion within the next 3-5 years. Such growth will, however, to some extent be dependent on further parametric reform of the pay-as-you-go social security system creating additional room for contributions to private pension schemes, as explained below.

Policy Recommendations

With the evolution of the state social security system and the introduction of a new third pillar-type private pensions scheme, the rationale for the continued existence of the 18 first pillar substitute funds has disappeared. These schemes should thus be transitioned to the state social security system (for the part of their assets funding the payout entitlements under that system) and the new third pillar-type private pension system (for any excess of invested assets over the payout entitlements of the social security system). Their insurance activities should be transitioned to licensed insurance companies.

In many countries that have adopted the multi-pillar approach to reform of the system for retirement income security, careful attention has been paid to the total contribution burden for individuals and their employers for social security, which ideally should not exceed 30–35% of gross wages. If the burden of mandatory contributions to the social security system (pension and health and other insurance combined) is too great, individuals will not have sufficient disposable income to permit contributions to a voluntary third pillar scheme. Recognizing this reality, Governments have sought means to reduce the mandatory required contributions, and thus to free up larger amounts of personal income for contribution to voluntary retirement savings plans. In Turkey, overall combined social security contribution rates for pensions, health and other insurance are 32.5–39% of wages, and hence even with tax incentives, participants may have insufficient income to contribute to the voluntary, new third pillar. Further reforms of the social security

TABLE 12: CROSS COUNTRY COMPARISON—PRIVATE PENSION FUND ASSETS AS % OF GDP

	1996	1997	1998	1999	2000	2001
Argentina	1.96%	3.01%	3.86%	5.93%	7.15%	7.42%
Brazil	9.48%	10.34%	10.42%	13.45%	12.55%	13.16%
Italy	3.2%	2.9%	3.0%	4.2%	4.5%	n/a
Korea	2.9%	1.8%	4.2%	3.3%	2.5%	n/a
Mexico	0.00%	0.15%	1.39%	2.40%	2.96%	4.74%
Poland	—	—	—	0.35%	1.52%	2.75%
South Africa	125.87%	115.29%	115.97%	125.24%	109.08%	n/a
Spain	3.66%	4.26%	5.43%	5.33%	5.87%	6.54%
Turkey	1.77%	1.82%	1.83%	2.15%	2.17%	2.30%
United Kingdom	75.7%	80.9%	80.6%	85.1%	85.0%	n/a
United States	61.2%	67.4%	71.7%	74.7%	69.9%	75.0%

Source: OECD; International Federation of Pension Fund Administrators, Ministry of Labour and Social Policy of Poland, Financial Services Board of South Africa and Bank Staff Estimates (for Turkey).

Note: Ratios for Turkey are based on GNP.

system[51] are therefore necessary to reduce mandatory contribution levels, raising the amounts available for contribution to private schemes. Ideally, such reforms should allow for the early introduction of secondary, mandatory pillar-type schemes,[52] to ensure that any room created for enhanced contributions to retirement savings schemes is indeed used for that purpose and not dissipated in additional consumption. Mandatory secondary pillar-type schemes are also more likely to generate rapid pension industry growth than voluntary third pillar-type schemes.

As noted previously, different rules and different supervisory authorities apply to the various schemes competing for pension savings. It is likely that there is considerable public scepticism concerning savings for retirement through pension funds. This will have to be overcome if there is to be any growth in voluntary participation in the pension industry. Thus, regulatory requirements for pension schemes of all types should be harmonized. There will obviously continue to be differences in the rules for defined contribution versus defined benefit plans. However, there should be similar considerations for investment practices (qualitative and quantitative limits of the investment portfolio), reporting and avoidance of conflicts of interest on the part of pension funds managers (prohibition of any degree of self-dealing, such that investments are made for the sole benefit of the individuals who participate in a plan). A single supervisory agency for pensions should be identified with reporting and oversight responsibilities for pension schemes of all types. This will mean that responsibility for existing schemes, as well as any activities relating to the new third pillar, will have to be transferred to this agency (see also the section on "Strengthening Pension Fund Regulation and Supervision" in Chapter VI). In this context, it is recommended that the Government undertakes a comprehensive study to identify all already existing pensions schemes (in effect, beyond the 60 schemes for which Treasury's GDI has been able to collect information) to ensure that all such schemes are simultaneously brought under the new regulatory regime. Finally, the authorities should steer occupational pension schemes with an interest in providing retail banking services to their members in the direction of creating independent, member based credit unions; as pension funds should limit their activities to portfolio investment and not be in the business of acquiring and managing commercial banks.

The authorities have completed all regulations required for the launch of the new third pillar-type private pension system. However, only one PC has been licensed, and another eight companies that have received GDI permission for transformation into PCs have not yet applied for a license. The authorities should explore the reasons for this delay (possibly the high minimum capital requirement) and take corrective actions as necessary to ensure the scheme is operationalized and reaches a minimum critical mass in the near future.

The TL20 trillion minimum capital requirement for PCs is excessively large given the limited responsibilities to be absorbed by PCs, with assets held in separate trusts and each fund obliged to retain the services of an independent portfolio manager. It is thus likely that the capital amount serves as a barrier to entry limiting the number of players competing in this field, especially life insurance companies which are typically small in Turkey (see the section in this Chapter on "Developing the Insurance Industry"). Therefore, once the third pillar-type system has commenced operation, serious consideration should be given to reducing the minimum capital level to the amount required for new insurance companies (currently TL8 trillion). Thought should also be given to replacing the requirement for the new pension funds to invest at least 30% of their assets in Government securities with modern asset allocation/portfolio management principles, to ensure pension savings are not unnecessarily precluded from flowing into private sector investments consistent with the parameters set by these principles.

---

[51] The Bank's September 15, 2000 Country Economic Memorandum outlines a strategy for such reforms.

[52] It is projected that the reforms recently introduced to the pay-as-you-go social security system will only allow a portion of contributions to be diverted to a new secondary mandatory scheme by 2010, to ensure that the deficit of the pay-as-you-go system remains within manageable limits. Advancing this date will therefore require additional reforms. For further detail, see the above referenced Country Economic Memorandum.

Tax incentives for voluntary third pillar schemes can take many forms and a popular model involves the deductibility of contributions and deferment of any taxes on investment earnings during the accumulation phase, with the application of normal income taxes on any amounts that are later withdrawn by the participant whether at retirement or at any other time (the so-called EET model, see Box 1).

Although the tax treatment of the new third pillar-type scheme in Turkey is of the EET type, the second "E" is not fully exempt, given that investment income is still subject to withholding tax. Such withholding taxes should ideally not be levied on private pension schemes such as the new third pillar-type scheme, to maximize the tax incentive. Also, the "T" is structured in an unusual, possibly unfair and complex way. First, pensions are effectively deferred employment income and as such are treated as additions to personal income when received, and not as capital gains. Second, the application of a final withholding tax to pension payments, rather than including them in personal income, can result in individuals paying a higher marginal tax rate and losing the benefits of life-time tax averaging that the EET system offers. Third, the provision of an exemption for long-term savings behavior undermines the tax base, is probably not cost-effective, and is difficult to administer. Internationally, early withdrawal is usually either restricted to specific circumstances (death, disability, etc.) or discouraged by a penalty tax. The incentive will be ineffective for all current employees within ten years of retirement (they do not qualify), and will be discounted by all persons with more than ten years before retirement. The tax treatment of withdrawals should be adjusted to address these issues.

BOX 1: TAX STRUCTURES FOR PRIVATE PENSION SCHEMES

Pension savings are subject to a range of tax treatment in different countries. Generally, however, the "ideal" tax-assisted pension scheme is structured as "EET". This means that contributions that are limited with respect to a share of employment earnings made by the worker or by the employer on his behalf are treated as tax deductible (the first "E"). These are allowed to accumulate investment income tax-free (the second "E"), and if they are held for some minimum period or beyond some minimum age, they are allowed to be withdrawn subject to payment of income tax (the final "T"). Early withdrawal is blocked or allowed subject to a penalty tax, unless the individual dies or is disabled prior to retirement age.

The attractions of the EET structure are that: (i) the upfront deduction provides an immediate and certain incentive for pension saving, (ii) the tax free accumulation of funds encourages investment in long-term equity and more risky investments, (iii) the deferral of tax until withdrawal in retirement provides a level of long-term income averaging over a life time, and (iv) deferral of taxation until withdrawal for expenditure also removes the problem of indexing the investment income for inflation. The gains from tax averaging come about because the marginal tax rate, when contributions are made, could well exceed the marginal tax rate on pension withdrawals. The major negative aspect of the EET structure is that the Government's tax revenues are at risk until funds are withdrawn from the pension plan—the Government essentially is a joint owner of the pension fund, with a participation equal to the tax rate on the deductible contributions. The risks to the revenues include theft of the funds out of the fund, poor investments not growing the fund, and hence, not growing the tax base over time, and the risk of political pressures to exempt pension payments to the aged or that tax evasion occurs upon withdrawal. Loss of tax on the withdrawals turns the EET structure into EEE, which means neither the employment nor the investment income are taxed. The EET structure effectively turns the tax on the contributed component of employment income into a consumption or expenditure tax, which has no tax on investment income.

The alternative tax structure to assist pension savings is the TEE structure. By contrast with EET, the TEE structure has no tax averaging, no upfront incentives, a smaller fund (the Government's share is already in the Treasury and may or may not be invested), but it still provides the incentive of tax-free accumulation on the private savings component. An EEE structure can be viewed as a double subsidy on investment income, or alternatively that both the employment and investment income are exempt from tax.

Another issue to be addressed concerns the presence of differences in the tax treatment of existing pension schemes and the new third pillar scheme. Currently, participants in first pillar substitute and second pillar funds enjoy EEE status with no limits on the first E, while participants in existing third pillar schemes appear to have ETT status, with employer[53] and employee contributions tax deductible up to the SSK limits, withholding taxes applicable on investment income depending on the type of investment made, and pension benefits exceeding the benefits payable to the highest paid civil servant taxed as employment income. This will not only confuse participants, but may also discourage voluntary participation. There is a need to integrate tax incentives across all tax-assisted pension schemes. Limits should in all cases be imposed/maintained, however, on the first E (not to exceed the limits for pre-tax contributions to the new third pillar-type scheme).

Finally, the tax treatment of life insurance products also is less favorable then for the new third pillar (EET with a 5% contribution limit for the first E, with 10% of the benefit tax-exempt on condition that the beneficiary holds the insurance policy for at least ten years, while the new third pillar enjoys a 10% contribution limit and a 25% benefit exemption). Retirement oriented life insurance products in mature economies typically enjoy less favorable tax treatment than private pension products (TTE rather than EET), because they are mostly supplementing, rather than substituting for, a well-functioning basic pension system. However, in less mature economies where such a well-functioning basic pension system does not yet exist, a case can be made for at least initially maintaining an equal playing field between life insurance and private pension fund products. Turkey clearly falls into this category. Thus, consideration should be given to integrating the tax treatment of life insurance with the tax treatment of pension schemes[54] (by implication, this will require the development of separate tax treatment for life and non-life insurance policies; such a separation does not currently exist). Such integration would encourage long-term savings and investment, allow families to protect themselves against loss of life or disability of the income earner and thereby prevent expansion of the public welfare rolls, and allow faster development of the insurance industry as a key component of an institutional investor base.

Developing the Mutual Fund Industry

Current Situation

As of end 2001, there were 277 open-end and 31 closed-end mutual funds operating in Turkey. The open-ended funds fall into two types differentiated by the investments they are required to hold. Type A funds are required to keep 25% of their assets in equity investments in order to qualify for tax incentives,[55] while Type B funds do not have equivalent requirements. Most of their assets consist of Treasury bills and reverse repos. There are more Type A than Type B funds (162 versus 115), but the Type B funds represent the bulk of the assets (US$405.4 million versus US$3,170.7 million). As of end 2002, only 2.55% of the assets of all open-ended mutual funds were invested in shares, down from a pre-crises high of 21.83% in April 2000. The closed-end funds are investment companies (22 with US$89.8 million in assets), venture capital investment trusts (1 with US$2.7 million in assets) and Real Estate Investment Trusts (REITs-8 with US$604.2 million in assets). The mutual fund market is characterized by a very few large funds (it

[53] It is not clear whether exemption from tax of the employer contribution is legally sanctioned under the income tax law provisions for employment income, or merely the result of weak compliance with, and enforcement of, the income tax law.

[54] As also noted in the section on "Developing the Insurance Industry", this doesn't necessarily mean that the tax treatment of both products should be the same. The time period for qualifying for tax benefits in private pension schemes (38 years) is currently almost four times as long as the comparable period for savings-oriented life insurance products (10 years). The tax structure should ideally provide incentives in proportion to the maturity of the savings products invested in.

[55] I.e., complete exemption from income tax at the individual unit holder level.

is estimated that the 10 largest funds have about 70% of the assets[56]) and a large number of very small funds.[57]

As of end 2001, the assets of the open-ended funds totaled 2.42% of GDP. While this figure is higher than the comparable numbers for Argentina and Poland, it is only a fraction of the levels seen in Brazil, Korea and advanced economies (Table 13).[58] Even with the assets of open-ended funds growing rapidly (almost doubling to close to US$6 billion as of end 2002, representing an estimated 3.46% of GNP), it will take considerable time before they reach developed economy levels as a percent of GDP (see also Figure 3 on next page).

The Capital Markets Law governs the activities of mutual funds and the CMB has published several Communiqués to regulate the different types of entities. Sponsors of open-ended mutual funds are using intermediary institutions which have a portfolio management license from the CMB. The sponsor and the portfolio management company could belong to the same financial or financial-industrial group, though (for example, Is Bank using Is Fund Management as portfolio manager). The sponsors undertake all fund administration, while back office functions are undertaken either by the sponsors or the portfolio managers.[59] For these functions, the funds rely to a significant extent on the high quality, centralized custodial services provided by Takas Bank (which maintains the central depository for equities, and where open-ended mutual funds must deposit all their equity securities as well as cash) and the CBT (which maintains the central depository for Government securities and repos/reverse repos). Closed-end funds are not subject to a requirement to use separate portfolio managers. However, REITs are required to have 1/3rd independ-

[56] Eight banks and their related companies (mostly dealers) sponsor funds managing approximately 90% of the mutual fund assets in Turkey.

[57] These mutual funds vary in size from US$4,000 to slightly over US$33 million. Source: Capital Markets Board *Monthly Bulletin for August 2002.*

[58] Note that the comparison across countries is not exact, as the definitions used and the reporting periods may vary.

[59] Best practice suggests that at least one of the two functions of portfolio management and fund administration/ back office should be undertaken by entities separate from the fund sponsors, to protect the interests of unit holders.

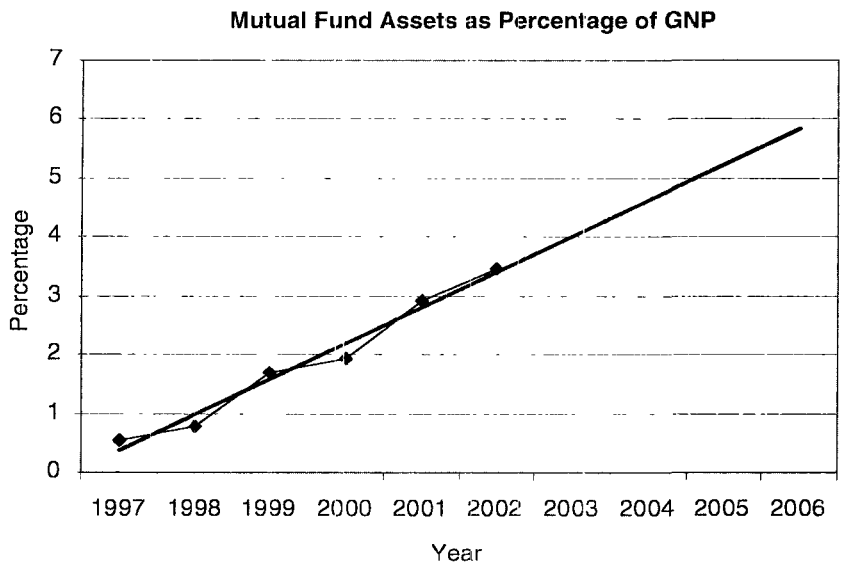
TABLE 13: OPEN ENDED MUTUAL FUNDS IN TURKEY AND COMPARATOR COUNTRIES

(DATA FOR END 2001)	NUMBER OF FUNDS	TOTAL ASSETS OF FUNDS (US$ MILLION)	AVERAGE SIZE OF FUNDS (US$)	GDP (US$ MILLION)	ASSETS AS % OF GDP
Argentina	219	3,751	17.13	268,773	1.40
Brazil	2,452	148,189	60.44	502,509	29.49
India[1]	292	13,490	46.20	477,555	2.82
Italy	1,059	359,879	339.83	1,090,910	32.99
Korea	7,117	119,439	16.78	422,167	28.29
Mexico	350	31,723	90.64	617,817	5.13
Poland[1]	92	1,317	14.32	174,597	0.75
South Africa	426	14,561	34.18	113,274	12.85
Spain	2,524	159,899	63.35	557,539	28.68
Turkey	277	3,576	12.91	147,627	2.42
United Kingdom	1,982	316,702	159.79	1,406,310	22.52
United States	8,307	6,974,976	839.65	10,171,400	68.57

[1] As of end September 2001.

Source: CMB, World Bank, Investment Company Institute

FIGURE 3: GROWTH OF MUTUAL FUND ASSETS



Source: CMB.

ent directors on their boards of directors-which would alleviate some of the conflict of interest concerns associated with REIT founders appointing related parties to give advice, manage the assets etc.[60] At the present time, the CMB's Mutual Fund Communiqué is under review to bring it in harmony with the new regime governing private pension funds and the Undertakings for Collective Investment in Transferable Securities (UCITS) Directives of the EU.

Medium Term Targets

As macro-stability is restored, interest rates on short-term instruments should drop, making the return on longer-term instruments such as equities and corporate debt more attractive. Turkey should expect to see an upturn in equity investment by mutual funds. The high of nearly 22% of mutual fund portfolio investment in equities seen in 2000 was reached when tax incentives were in place to encourage equity investments. It should be possible to reach or exceed this level in the medium term as stability is achieved, provided that the tax structure doesn't skew investment decisions in another direction.[61]

In Turkey, the percentage of GDP that assets held in all collective investment schemes represents has been growing steadily over the past five years (Figure 3). Assuming a linear growth function and extrapolating from the recent figures, the current trend would produce an expected asset size of approximately 5–6% of GDP in the medium term. This is a fairly conservative target as the

[60] Concerns about the independence of the custodial function for REITS are typically less, as their assets are much harder to manipulate or lose.

[61] There are two effects that work at cross purposes here, making predictions somewhat difficult. The previous high level of equity ownership was achieved when there were tax incentives in place boosting equity investments by mutual funds. The elimination of these incentives as of end 2002 will depress demand for equities. However, with an increase in stability, long term investments may become more attractive, as the risk/return ratio becomes more favourable. Also, as the insurance and pension fund industries develop, the demand for long term investments will increase. With a neutral tax structure, one would expect that the effect of increased demand would be greater than the negative effect of the elimination of the tax incentives. Therefore, overall growth should be expected.

current trend has been achieved despite a very unstable environment. A more aggressive figure might be in the range of 8-10%.[62]

Policy Recommendations

Fund Consolidation. The large number of relatively small funds seen in Turkey is a rather troubling feature as it is acknowledged that there are some significant economies of scale in running a mutual fund.[63] Lower costs usually translate into higher returns for investors. The CMB recognizes the issue and now requires that mutual funds disclose all expenses incurred. The CMB also places that information on its website so that investors can compare costs across funds. Although several large fund sponsors are already voluntarily merging their funds to take advantage of these scale economies, the Government and the CMB should consider adopting practices that would encourage the smaller funds to merge, or encourage fund sponsors offering several different types of funds under one umbrella to pass on the cost savings inherent in such a structure to individual fund investors. The usual methods of fostering consolidation through advantageous tax treatment and/or reducing fees for larger entities may not be effective here. More promising alternatives include moral suasion and encouraging or mandating higher minimum and ongoing portfolio size requirements for individual funds, especially open-ended funds (currently the minimum portfolio size requirement for such funds is TL100 billion or only US$61,200 before they may offer their shares/units to the public).

The project harmonizing the Mutual Fund Communiqué with the new regime for private pension plans and with the UCITS Directives of the EU should be completed as soon as possible. The CMB should also consider two changes directed at enhancing corporate governance: (i) give priority to developing a framework to permit mutual funds and other collective investment schemes to play a more active role in the governance of the companies in which they invest; the CMB could then remove the prohibition (that applies to all funds other than venture capital investment companies) on being represented on the boards of companies in which they invest; and (ii) the Capital Markets Law or governing CMB Communiqués should set out explicitly the duty of the directors and founders of mutual funds to act prudently and diligently in the best interests of the mutual funds' investors.

Tax Treatment. Ideally, the tax policy for investments in mutual funds and other collective investment schemes should encourage both retail customers to put their savings into mutual funds for the longer term, and funds to invest in longer-term instruments such as equities. With the exemption from income tax for Type A fund investors abolished as of end 2002, the Government's decision to reform the tax structure on investments and implement a common, pooled inflation adjusted exemption during 2002-03 will assist in this regard. Care should be taken, however, to ensure that the mutual funds at the same time are transformed into pure pass through vehicles from a tax perspective (i.e., the current 10% corporate income tax applicable to mutual funds should be abolished) to avoid double taxation of investment income. Additionally, the pooled exemption should include income earned on investments in foreign mutual funds (such investments are currently also exempt from income tax), to ensure that a level playing field is maintained between such foreign funds and the domestic mutual funds once the pooled exemption (and taxation of the excess over and above the exemption) comes into force.

---

[62] In comparison, as of June 2001, the European savings and investment market was growing at a compound annual rate of around 12% for the last five years, with equity and mutual fund investment growing at more than twice that rate. Mutual funds grew at 30% a year in the UK, with life insurance and pension business up 15% a year. Source: Howard Davies: *The Regulation of Fund Management In Europe,* 11th Annual Fund Forum International Conference, Grimaldi Forum, Monte Carlo, July 4, 2001.

[63] See for example the study conducted by the Investment Companies Institute: *Operating Expense Ratios, Assets and Economies of Scale in Equity Mutual Funds* by John Rea, Brian Reid and Kimberlee Millar in ICI Perspectives, December, 1996 available at www.ici.org.

CHAPTER IV

DEVELOPING SECURITIES MARKETS

Section 1. Deepening and Broadening Securities Markets

Efficient securities markets provide a stable and competitive source of funding for sovereigns and corporates, and can enhance efficiency in the use of capital for generating output and growth[64]. They also enable mobilization of domestic long-term financial resources to finance investment and development without relying excessively on external borrowing and, therefore, exposing the economy excessively to foreign exchange risks. Their development has emerged as a critical agenda for emerging economies, particularly after numerous banking and currency crises during the 1990s. Equity markets provide risk capital to issuing corporations, improve their solvency and risk-tolerance, and enable safer bank lending and greater mobilization of debt capital by issuers. By allowing companies to diversify their sources of funding, capital markets also enable the private sector, including the banking sector, to enhance their resiliency to shocks. In Turkey, though, due to long standing macro-economic imbalances and the associated dominance of Government debt markets, equity markets have remained small, commercial paper and corporate fixed income markets don't exist and derivative markets are still in their infancy. This chapter focuses on how existing equity markets can be deepened and broadened, and corporate debt and formal derivatives markets can be developed.

Deepening and Broadening Equity Markets

Current Situation

The rapid expansion of the Government debt market resulting from the recent financial crises and the concomitant economic recession have interrupted the growth of the Turkish equity market (Table 14). The Government debt market, particularly the repo segment, also has enjoyed a long-

[64] As measured by the Incremental Capital Output Ratio or ICOR.

TABLE 14: THE TURKISH GOVERNMENT DEBT MARKET

	Total Net Public Sector Debt			Total Turnover (on & off ISE)			Turnover Ratio (%)		
US$ billion		% of GNP	Tradable Government Debt Stock	Outright Purchases & Sales	Repos & Reverse Repos	Total	Outright Purchases & Sales	Repos & Reverse-Repos	Total
1996	65.21	35.52	29.29	91	963	1,054	311	3,288	3,599
1997	61.54	31.92	30.69	118	1,421	1,539	384	4,630	5,014
1998	75.10	36.72	37.14	303	1,514	1,817	816	4,076	4,892
1999	88.66	47.70	42.44	488	1,854	2,342	1,150	4,368	5,518
2000	107.63	53.58	54.22	765	2,509	3,274	1,411	4,627	6,039
2001	115.44	79.01	84.86	127	1,403	1,530	150	1,653	1,802
2002	143.57[1]	82.18[1]	91.69	157	759	916	171	828	999

[1] Projected

Note: The figures for 2001 and 2002 include US$44.32 and US$37.07 billion of non-cash debt held by SDIF banks (issued to meet capital shortfalls) and state-owned banks (issued to repay so-called "duty losses"—claims on the Government arising from subsidized credit programs for agriculture and small business development). The turnover ratios for 2001 and 2002 would have been higher if this non-cash portion would have been excluded from the outstanding debt stock for the year.

Source: World Bank, CBT, Undersecretariat of Treasury, ISE.

standing cost advantage vis-a-vis bank deposits. Before July 2001, the withholding tax rates for interest income on repos and deposits were 16%, but deposits were also subject to a 6% minimum reserve requirement, and the CBT did not pay any interest on these required reserves. After July 2001, the withholding tax rate on repos was increased to 20%. Also, the CBT started paying interest on required reserves from August 2001. These two factors reduced the attractiveness of repo transactions in Turkey. The decrease in the number of banks in the Turkish financial market post the 2000–2001 crises has also contributed to a decrease in secondary market transaction volumes. However, the volume of repo transactions, per se, is still high.

After expanding in the mid to late nineties, equity market trading volumes and market capitalization declined sharply during the last few years, while the flow of new share offerings-primary and secondary-virtually dried up (Table 15). The number of companies listed at the ISE also fell, but was already in decline earlier, partly because of reductions since 1993 in tax incentives tied to the size of companies' free float, but more recently also because of and non-compliance with continuous trading requirements.

Notwithstanding significant nominal gains, the equity market has also been depressed in terms of real rates of return, despite the recognition that Turkey has been successful in managing the crisis and that the economy is now recovering (Figure 4)

The unattractiveness of investing in equity in comparison with investing in Government debt, overnight repos and even FX deposits-all evidence of the toll taken by the recent macro-economic disturbances- is also apparent from the shape of the efficiency frontier in Turkey (Figure 5), which indicates that the most efficient portfolios were a combination of overnight repos and FX deposits, while a portfolio of 100 percent investment in ISE equities was the least efficient.

Despite the recent shrinkage, the Turkish equity market is still of reasonable size compared with some other emerging markets, but clearly below the level in more developed economies (Table 16).

TABLE 15: THE TURKISH EQUITY MARKET

(US$ MILLION)	NO. OF COMPANIES LISTED ON THE NATIONAL MARKET SEGMENT	NO. OF COMPANIES TRADED AT ISE (ALL SEGMENTS)	VALUE OF IPOS AND NEW SECONDARY OFFERINGS	MARKET CAPITALIZATION	MARKET CAPITALIZATION (% OF GDP)	AVERAGE DAILY TURNOVER	TOTAL TURNOVER	TURNOVER RATIO (%)
1996	213	228	1,885	30,797	16.58	153	37,737	133.3
1997	244	258	2,286	61,879	32.29	231	58,104	113.5
1998	262	277	3,082	33,975	16.86	284	70,396	154.9
1999	256	285	3,791	114,271	61.32	356	84,034	102.8
2000	287	315	4,140	69,507	34.96	740	181,934	206.2
2001	279	310	903	47,689	32.30	324	80,400	161.5
2002	262	288	17[1]	34,402	19.69[2]	281	70,756	n/a

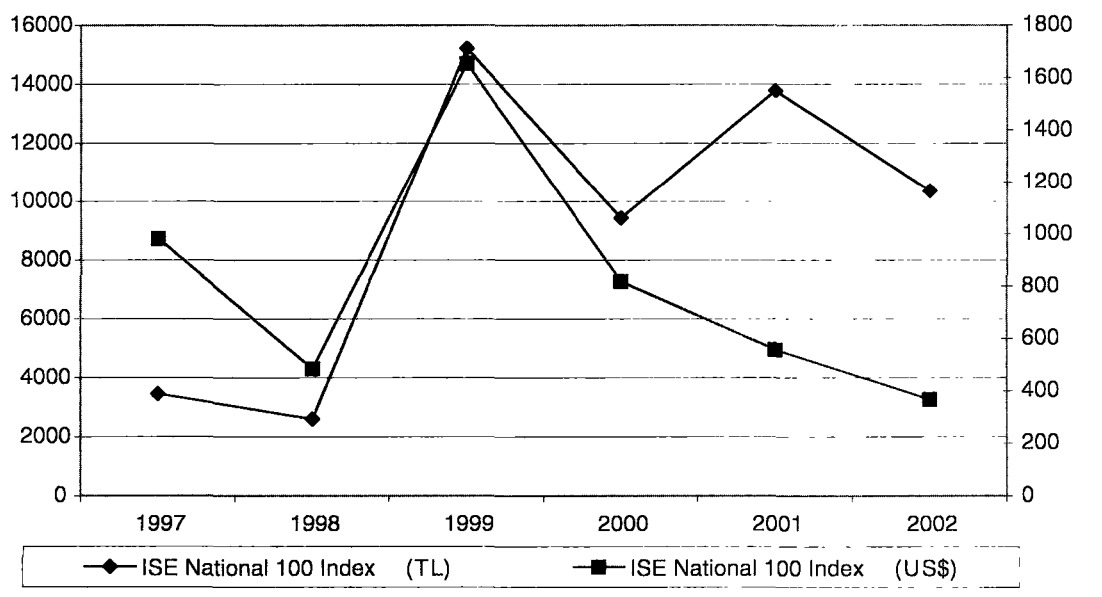
[1] IPOs only. [2] Estimated.

Note: "Listed companies" do not include the companies listed on the minor ISE segments (Regional Market, Watch List), while "traded companies" include companies listed on all segments.

Source: ISE, World Federation of Stock Exchanges, S&P Emerging Markets Database.

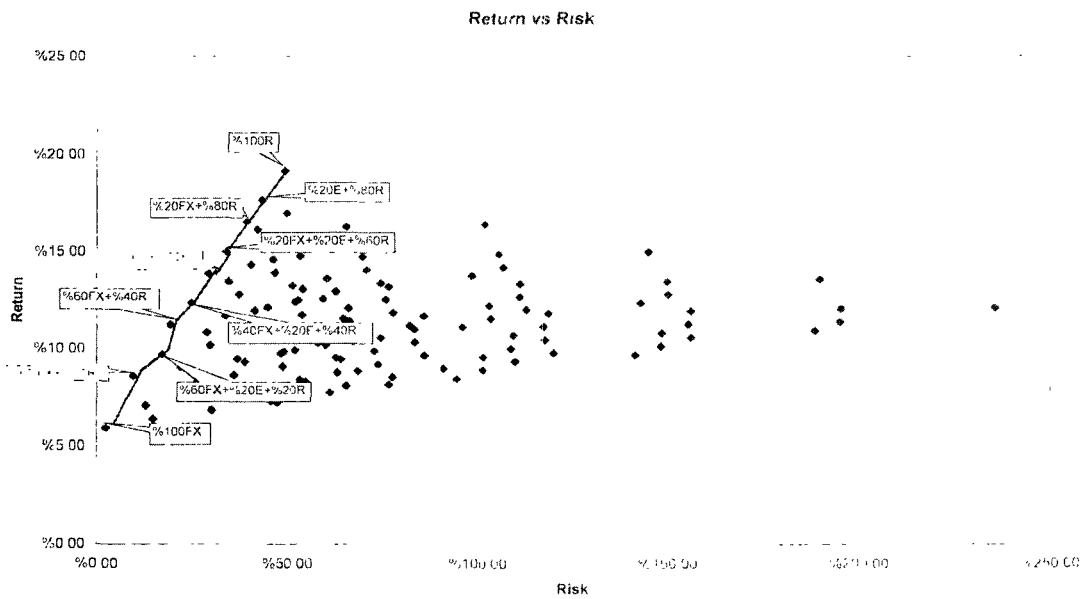
However, a comparison based on market capitalization alone may be misleading because the free float in the Turkish market (estimated to be on average 20% of the total outstanding equity, but in fact much lower for several very large companies, including majority state-owned companies—see Table 17) is significantly lower than the 30% and above levels seen in other markets (see Annex 1).

FIGURE 4: ISE NATIONAL 100 INDEX RETURN



Source: ISE.

FIGURE 5: THE TURKISH EFFICIENCY FRONTIER



Note: Based on average returns during the period January 1997-April 2002 for several investment instruments including FX deposits (FX), Eurobond Index (E), ISE traded overnight repos (R) and ISE 100 Equity Index (the latter is represented by the dot furthest to the right of the efficiency frontier). The chart indicates that combinations of FX deposits, Eurobond Index and overnight repos all were more efficient (higher return for a given risk expressed as standard deviation of returns, or lower risk for a given return) than an investment in the ISE 100 Equity Index.

Source: HSBC Securities.

TABLE 16: MARKET CAPITALIZATION—CROSS COUNTRY COMPARISON

	GDP PER CAPITA (CONSTANT 1995 US$)	MARKET CAPITALIZATION OF LISTED COMPANIES (% OF GDP)					
	2001	1996	1997	1998	1999	2000	2001
Argentina	7,550	16.41	20.22	15.16	29.57	58.4	71.62
Brazil	4,636	28	31.63	20.43	43.05	38.09	37.06
India	472	31.96	31.35	25.4	41.46	32.4	23.12
Italy	21,258	20.94	29.54	47.62	61.71	71.54	61.61
Korea	13,420	26.69	9.66	38.21	97.44	37.18	54.97
Mexico	3,739	32.06	39.06	21.79	32.06	21.58	20.49
Poland	4,274	5.83	8.43	12.91	19.08	19.85	14.85
South Africa	4,068	168.07	155.95	127.27	199.74	160.21	78.0
Spain	18,272	39.81	51.81	68.63	71.95	90.27	103.46
Turkey	2,902	16.58	32.29	16.86	61.32	34.96	32.3
United Kingdom	22,084	147.53	151.4	168.34	203.47	182.18	152.85
United States	32,103	109.46	136.97	154.1	180.09	153.54	137.48

Source: World Bank.

TABLE 17: FREE FLOAT OF LARGEST ISE LISTED COMPANIES

Companies with Low Free Float (<15%)				Companies with High Free Float (>50%)		
(Data as of September 2002)	Paid-up capital (TL billion)	Free float	Percentage State Ownership		Paid-up capital (TL billion)	Free float
Turkcell	500,000	14.0		Vestel	159,100	61
Petkim	204,750	4.0	95.6	Net Holding	56,407	81
Türk Hava Yollari	175,000	2.0	98.2	Egs Gmyo	50,000	71
Alternatifbank	160,000	9.0		Gsd Holding	43,000	88
T.Kalkinma Bank.	125,000	1.0	99.1	Global Menkul Deg.	40,000	86
Nuh Çimento	75,107	7.0		Is Yat. Ort.	30,000	80
Ünye Çimento	63,434	9.0		Goldas Kuyumculuk	26,000	51
Günes Sigorta	43,200	14.0	34.2	Kardemir	25,270	98
Bsh Profilo	40,019	6.0				
Kordsa Sabanci Dupont	36,125	14.0				
Arat Tekstil	27,000	14.0				

Note: Only companies with paid-up capital in excess of TL25 billion (approximately US$15.3 million) are included. Both the number of companies with very low and very high free float are low, indicating that most ISE listed companies, including all but one listed bank, have a free float between 15 and 50 percent (15% is the minimum free float required for ISE listed companies to qualify for tax incentives).

Source: ISE.

At a minimum, therefore, Turkey has suffered a painful setback in achieving a higher level of equity market depth, at the cost of reduced GDP growth and wealth.

Medium Term Goals

Taking into account the clear correlation between market capitalization and development (Figure 1 and Table 16), a market capitalization of 100% of GDP or more would be an ideal long term target. In the medium term, Turkey should strive to raise its existing ratio of around 20% of GDP (end 2002 estimate) to at least the pre-crises sustainable trend level of around 35% of GDP. An annual 20–30 percent growth rate in equity market capitalization, coupled with GDP growth of 5% annually, would allow this goal to be reached within the next 3–5 years. A 20–30 percent growth rate is not unreasonable to expect given that: (i) the average free float (20%) is still low, and a higher free float (35–40%) would still be consistent with company owners' preference for majority shareholder control, (ii) ISE-listed companies represent only a small portion of the universe of listable companies in Turkey, indicating that there is significant room for expanding listings (Box 2); and (iii) price volatility has historically been high, suggesting that the market will respond sharply to improvements in economic conditions. While listing of the entire universe of listable companies may not be feasible in the medium term, the ISE should aim to increase the number of listings by 40–60 per year over the next 5 years.

Policy Recommendations

Beyond macro-economic stabilization and economic recovery, a number of measures can be taken to encourage initial and secondary public offering of equity.

The existing minimum initial public offering requirement should be increased from 5–15% in a stepwise fashion over the next 2–3 years to 25%, and a policy should be developed to allow the

BOX 2: POTENTIAL FOR LISTING TURKISH COMPANIES

Of the 850 publicly held companies registered with the CMB as of end 2001, only 310 were ISE-listed (279 on the main, National Market, 13 on the Regional Market and 18 on the Watch List Market). ISE listed companies accounted for 36 percent of net sales, 37 percent of equity and about 23 percent of employment represented by the 975 largest companies in Turkey (by net sales) in a 1999 ISO dataset. Discussions with various market participants confirm that the universe of listable companies is 1000-1500. Thus, there is considerable room for expanding the number of listed companies.

The recent banking crises may also provide an impetus towards renewed growth of the equity market, as: (i) companies try to avoid relying too heavily on bank financing; (ii) tighter connected bank lending rules may encourage group companies to seek equity market financing to replace previously available group bank lending, and (iii) the value of equity as risk capital to withstand risks in an event of a crisis is now better recognized. Awareness among companies of the need for better corporate governance also has increased, and there is an initiative underway to improve the corporate governance of listed companies. These are encouraging signs in terms of the prospect for increasing the free float in the market, as well as to expand the listed company universe.

However, the large pool of listable companies does not automatically imply that they will go public. Many Turkish companies are family-owned and-controlled and are reluctant to dilute their ownership control by going public. Clearly, a fundamental incentive for such companies to access primary equity markets is the availability of competitively priced long-term capital for investment beyond what is available from their retained earnings. Economic recovery and greater business opportunities are essential to call for such investment. Corporate growth often also calls for introduction of professional management to replace family management, which necessitates separation of ownership and management.

free float to reach 35–40% on average. To dispel fears of losing control when offering shares to the public, a program should be launched to educate issuers on the free float–control relationship. Founding family shareholders should be made well aware that they collectively do not need too large a share of a company to control it. Benefits to corporates and promoters arising from making public offerings and listing at a stock exchange should be highlighted in such a program. Potential issuers should also be convinced that better corporate governance and minority shareholder protection will in fact bring more value than cost to their companies[65]. Under-represented industries and regions could be specifically targeted. While the program can involve the participation of the CMB and local chambers of commerce and industry, the ISE as the key institution that will attract new stock exchange listings should take the lead in its development and delivery. Progressive tax incentives for offering a greater portion of equity for free float could also be considered (such incentives existed before 1993, but since 1993 only a 15% free float requirement is needed to qualify for tax relief).

The IPO clearance mechanism with simultaneous examination and inspection of the issuer company by three agencies, i.e. the Lead Manager, the CMB and the ISE, should be streamlined. IPO clearance should be entirely based on disclosures and on the strength of the due diligence exercise of the Lead Manager without requiring inspections by the CMB and the ISE, as is the case in all developed markets. This can be backed with sufficient penal provisions in the law and applicable regulations against the lead merchant banker for its failure to undertake proper due diligence to ensure true, fair and adequate disclosures. Post IPO CMB inspections or audits may be carried out selectively in order to keep issuers and Lead Managers on toe. This would remove a procedural irritant for issuers, and would also provide incentives to issuers and lead managers to

[65] This requires the existence of potential demand for shares of companies with better corporate governance and minority investor protection. Some foreign institutional investors such as CalPERS (the California Public Employees' Retirement System) openly claim that they invest in companies with such qualities.

accelerate preparation of the necessary documentation for IPOs (which currently often takes 3 months or longer to complete).[66]

The scope for reduction in floatation costs-listing fees, registration fees, etc.—should be explored. Specifically, the Education Support Fund and special transaction tax components of the 0.3% tax on IPOs (together comprising 0.1%), which in effect are taxes on new issues collected by the Government through the CMB, should be abolished (the remaining 0.2% is in fact not a tax but a registration fee retained by the CMB to cover its administrative costs). There is also a case for abolition of BITT on emission premium income at the establishment stage as a result of issuance of shares above their nominal (face) value (this tax is currently payable by all non-bank financial institutions; banks are exempt). The ISE has recently set up a WAN (wide area network) to facilitate electronic trading by its members from off-exchange premises. The use of this WAN could be explored for mobilizing primary market offerings for the purpose of lowering floatation costs and improving efficiency.

Listing requirements, initial as well as continuing, need to be reviewed both in terms of cost and complexity of compliance. Continuing listing requirements in particular need attention in light of the consistent decline in the number of listed companies over the years. Reportedly, the decline would have been even higher if ISE enforcement of such continuing listing standards—especially as concerns information disclosures—would have been stronger; however, weak enforcement will not help build the credibility required to ensure the listing standards carry weight with domestic and foreign investors, and hence serve to facilitate capital mobilization. Thus, enforcement of listing standards should be stepped up. Requirements for the second tier market should also be reviewed. The current "watch list" market is in fact not a market segment, but a market to which previously listed companies are relegated if they fail to meet the continuous listing requirements for the main market. Once a company is on the watch list, it can stay there indefinitely,[67] as there is no requirement to de-list after a predetermined period of time. De-listing should be mandated after one month, or alternatively the watch list market should be abolished altogether. To develop the domestic primary market, issuers not listed in Turkey going to stock exchanges abroad may be required to offer a minimum stake in the Turkish market. To provide a boost to protection of minority shareholder rights, it is recommended that the ISE includes in its listing rules more stringent disclosure requirements concerning the presence of multiple voting rights, as well as some type of cap on, or a requirement for a large majority of shareholders (for example, two-thirds) to approve the use of such rights.[68]

SOE privatization should be accelerated and used to deepen securities markets. All companies in the privatization program should be mandated to make public offerings, and exemptions for such companies from the minimum free float requirement should be discontinued. To stimulate the interest of lay investors in the primary market, a small investor tranche could be made available at discounted prices.

Turkey currently doesn't have a tax integration structure to avoid the double taxation of income earned from equity investments (dividends and capital gains). Tax integration structures are

---

[66] Due mostly to issuers submitting incomplete documentation, rather than slow processing on the part to the CMB. However, even if CMB prior review does not cause delays, an ex-post review system is likely to result in a more efficient use of CMB staff time and resources.

[67] The board of the ISE has the authority, though, to de-list any company on the watch list market whose shares have been suspended from being traded for three months or more.

[68] An alternative approach would be prior review on a case by case basis by the ISE of the specific structure of multiple voting rights proposed by a corporate, as for example is done by NASDAQ and AMEX in the US. This would require, however, that the ISE first builds a strong reputation and credibility as a stock exchange standing for protection of minority shareholder rights, with strengthened SRO ability. In the interim until the ISE reaches that stage, rule-based restrictions would be preferable. As further elaborated in Chapter VI, the use of multiple voting rights could also be limited by the new commercial code.

important to prevent such double taxation. Double taxation arises when the return on equity is taxed at the corporate level, and then taxed again at the personal level when distributed as dividends, or when the retained earnings are reflected in capital gains. This double taxation biases investment in corporations against equity and in favour of debt and "sweat equity" (owner supplied labour), especially among small and closely held corporations, aside from also causing equity holders to demand a higher before-tax return at a given debt-equity ratio to cover the higher taxes on equity. As a result, investment in the corporate sector is reduced, and the development of equity markets is discouraged. To eliminate these biases, the Government should consider adopting some form of tax integration for dividends, and re-assess the impact of capital gains tax on shares traded on securities markets (see Box 3).

BOX 3: AVOIDING DOUBLE TAXATION OF EQUITY INVESTMENTS

There are five basic tax integration systems for dealing with the double taxation of dividend distributions: (i) the classical system (no integration); (ii) the single stage taxation system; (iii) the dividend gross-up and tax credit system; (iv) the dividend deduction system; and (v) the full integration system. These systems are elaborated in more detail in Annex 2. Turkey currently uses the classical system. With a corporate tax rate of 33% and a personal tax rate of 45%, this can yield a total tax rate of up to 63% on fully distributed income from equity investments. A partial dividend tax credit system is currently in place, but no other integration exists at the personal level to deal with small and closely held companies.

The choices of tax integration that put a ceiling on the total tax rate are: (i) a more complete dividend tax credit (backed up by a dividend tax account to deal with concerns over integration and dividend stripping from tax loss firms), or (ii) a dividend deduction system. The latter would be administratively simpler, and mimics the interest deduction on debt. Dividend tax credit systems are fairly complex at the personal level, and also dividend tax credits are not awarded to non-resident equity owners and to tax free owners such as pension funds. Accordingly, the corporate tax remains for pension and other tax-free investments. For non-resident investors, any tax integration would depend on the nature of the mechanisms available in their home countries for avoidance of double taxation on foreign investment income.

In a dividend deduction system, the withholding tax on dividends distributed to residents at 15% could be retained as a creditable, but non-refundable tax at the personal level, but not charged on exempt investors such as pension funds, but charged on dividend distributions to non-residents (as adjusted by international tax treaties). The dividend deduction can apply to all types of corporation, and does not raise concerns about dividend stripping out of tax-loss corporations. Such corporations could only capture its value through loss carry forwards. It would also make pension and other tax exempt funds more interested in equity investments, as it would increase the returns on investment at the corporate level. The dividend deduction could be full or partial. At a corporate tax rate of 33%, for example, a 72.5% dividend deduction would reduce the total tax rate to 50%, with a 45% top personal rate. The tax on distributions to non-residents would be 22.7%. A higher rate or full dividend deduction could be offered to small businesses, so that they can achieve full tax integration on dividend distributions.

The dividend deduction system would raise two concerns: (i) that there would be increased reliance on tax collection at the personal level, and (ii) that there would be an incentive to raise equity finance from low-tax rate countries. Both these concerns could be dealt with by raising the withholding tax on dividend distributions to 20% or higher. This would raise the taxes collected at the corporate level, and lower amounts collected at the personal level. In the case of tax treaty countries, the withholding tax would be overridden by the treaty rate; otherwise, the full withholding would apply for equity investment coming from low tax rate countries. For closely held small businesses, it is important to remove the biases against equity investment, given the options to use debt or labour expenses to move income to the personal level. To achieve this, a 100% dividend deduction could be offered on the first TL10 billion in annual dividend distributions to all corporations, and a 70% deduction on all dividends above this limit.

continued

BOX 3: CONTINUED

Integration systems focus on the integration of dividends or distributed corporate income with the personal income tax. This leaves retained earnings (RE) in the company, raising the value of equity shares. Where capital gains (CG) are subject to tax , RE will be taxed if shares in the company are traded, leading to double taxation. A small, closely held business can avoid the capital gains tax if it has access to an integration mechanism (such as a full dividend deduction or dividend tax credit), as it can distribute the RE before any sale of shares in the company and avoid the tax on the gain. This disbursement option is not generally available to a company with widely held or publicly traded shares, unless all the after-tax earnings are continuously disbursed to shareholders which is not practical, as they are needed to finance new investments and avoid the transactions costs of having to issue new shares to raise equity capital.

Tax-free persons, such as a tax-exempt pension funds, can trade freely in shares without incurring CG tax. Taxable persons, by contrast, generally tend to lock into investments, and minimize their trading in shares with gains to avoid tax. This lowers the liquidity in markets. Tax-free investment funds, therefore, play an important role in increasing capital market liquidity. Persons owning shares with capital losses have a tax incentive to sell these to realize the tax loss. Shares with gains give the reverse incentive–delay trading to avoid realizing taxable gains. Therefore, CG taxes set up asymmetrical incentives for trading. As a consequence, typically, tax laws only allow capital losses to be deducted from capital gains in determining annual taxable income. Unabsorbed capital losses have to be carried forward. (This provision does not exist in the income tax in Turkey. It appears that capital losses can only be deducted from current income.)

The equity value of a company will capitalize any shifts in expected future after-tax profits from changes in tax structure, productivity, sales or costs. This happens continuously where shares are traded publicly. As a result, CG taxes can result in double taxation of these changes in after-tax profits, even before they arise and get reflected in the subsequent company profits and GDP accounts. The value of a company will vary, as the expectations of future after-tax profits vary with changes in prices of inputs and outputs and changes in technology and productivity (whether generated from inside or outside the company). Such changes in after-tax expected profits can be either positive or negative. Hence, CG taxes can result in double taxation of future gains, or double tax reductions from future losses or reduced profits. Considerations such as these lead to pressures to moderate or remove CG taxes on publicly traded shares. Capital gains do not represent incremental current economic activity; they reflect changing prices of existing assets such that one person's gain is another person's loss. Hence, CG taxes are not a significant source of revenues. There is thus an argument in favour of low or no tax on capital gains from publicly traded shares (excluding the unquoted shares of public companies).

Developing Corporate Debt Markets

Current Situation

Tax advantages and the high return offered on Government debt securities have completely crowded out the private debt securities market in Turkey. Such a market existed in the early to mid 1990s, but the Government prohibited payment by corporates of interest rates above rates paid on Government paper; hence this market dried up. This prohibition has since been lifted, but interest income on corporate debt securities remains subject to 12% withholding tax, while T-bills and Government bonds carry a 0% withholding tax on interest income.

As can be seen from Table 18, Government debt dominates the domestic debt market in almost all countries, but such dominance is more pronounced in Turkey than in most other countries.

Medium Term Targets

A well-functioning Government debt market often precedes and facilitates development of a private sector fixed income market. While Turkey first needs to put its Government debt market in

TABLE 18: DOMESTIC DEBT SECURITIES—CROSS COUNTRY COMPARISON

	Amount Outstanding (US$ billion)		Percentage Distribution					
			Public Sector		Financial Institutions		Corporate Issuers	
	2000	2001	2000	2001	2000	2001	2000	2001
Argentina	49.5	40.2	72	68	13	14	15	18
Brazil	297	309.9	83	84	16	15	1	1
India	113.6	130.2	98	99	0	0	2	1
Italy	1275.7	1277.2	77	74	21	21	2	5
Korea	269.4	292.7	27	27	33	33	40	40
Mexico	72.3	88.9	81	84	7	6	12	10
Poland	32.1	44.4	100	100	0	0	0	0
South Africa	56.8	38.4	90	88	4	4	6	8
Spain	357.4	361.3	78	74	12	14	10	12
Turkey	54.7	85.3	100	100	0	0	0	0
United Kingdom	896.7	920.8	47	45	32	31	21	24
United States	14577.5	15377	55	56	29	28	16	16

Note: For India, the BIS data understate the size of the corporate debt market. National Stock Exchange of India data indicate that as of March 31, 2002 traded non-financial sector corporate debt (other than commercial paper) amounted to US$3.28 billion (representing 2.56% of total debt) and traded financial sector debt amounted to US$6.52 billion (representing 5.92% of total debt). The BIS data classify these two types of debt as public sector debt.

Source: BIS Quarterly Review, June 2002.

order (see the section on Enhancing the Efficiency of the Government Securities Market), the authorities should create the conditions for, and remove existing impediments to, developing a private sector fixed income market in the medium term. A target share of corporate and financial institution traded debt in total domestic traded debt of 5–6% within 3–5 years appears feasible, taking into account the state of debt securities markets in comparable economies. This would imply a corporate debt market of around US$8–10 billion or 3.5-4.5% of GDP. A longer term goal would be a 15–20% share.

Policy Recommendations

The maturity of Government debt should be lengthened[69] to create some room for corporate debt in the shorter maturity area. In fact, lengthening and diversification of maturity is necessary first and foremost for the Government itself to smoothen its debt maturity profile and manage its cash flows through redemption. Some progress is already being made on this front with the support of the central bank by availing a repo window and conducting open market operations to provide liquidity to the market.

The distortion in the withholding tax regime that has led to the elimination of the corporate debt market should be corrected, and a tax level playing field between Government and corporate debt established.

[69] As of end December 2002, 24.7% of the total domestic debt stock consisted of T-bills with an average maturity of 4.2 months, while the average maturity of Government bonds was 18.9 months as of the same date (*Source: Treasury website*).

Credit rating, securities registration and disclosure systems should be developed, and the bankruptcy law should be upgraded to facilitate development of corporate fixed income markets. To enhance safety, credit ratings should be used besides regulatory financial ratios for permitting companies and financial institutions to publicly issue debt securities (commercial paper, certificates of deposit and corporate bonds/debentures). Portfolio diversification requirements for contractual savings institutions can also be formulated by use of credit ratings, thus encouraging the use of such ratings. It would also provide flexibility for institutional investors to invest in corporate bonds, thus generating demand for such bonds and, therefore, encouraging issuance.

Creating A New Companies Market

Current Situation

As per the Official Gazette of January 28, 2000 (No. 23948) 99.5% of the manufacturing firms in Turkey were SMEs,[70] accounting for 61.1% of employment and 27.3% of value added. An important subset of these SMEs—2,247 medium sized companies[71]—accounted for 14.1% of employment and 13.2% of value added.[72]

In case of SMEs, funding gaps are often attributable to lack of track record, limited ability to raise collateral-based lending, information gaps between entrepreneurs and investors, etc. Many SME development programs therefore focus on improving access to venture capital and other types of private financing, making development of secondary stock markets for SMEs imperative to allow easy entry and exit for venture companies. Second tier markets for SMEs and new companies have witnessed significant activity world-wide in the mid and late 1990s (for example, NASDAQ, EASDAQ, KOSDAQ).

The ISE has a Regional Market, a New Companies Market and a Watch List Companies Market besides its main segment called National Market. The Regional Market has been established for promoting trading in stocks of SMEs, while the New Companies Market, started in 1995, seeks to provide start-up companies with growth potential and opportunity to offer their stocks to the public via the ISE, and enable the trading of such stocks in an organized market. However, the roles of these market segments are not entirely clear. The Regional Market mixes: (i) companies which have lost listing status and have been down-graded from the National Market, and (ii) new companies which would like to be listed in the National Market in future, but currently do not qualify. This market segment is thus similar to what is typically called a second tier market, but seems to include companies which are in the process of de-listing. With respect to such companies, it is not quite clear how the Regional Market differs from the Watch List Companies Market, which also carries companies that currently don't meet all listing requirements (but previously did). In fact, the Watch List Companies market is not a market segment, but rather a temporary

[70] This is in line with ratios seen elsewhere. There are almost 19 million SMEs in the European Union (<250 employees), representing 99.8% of all enterprises. In Japan, SMEs (<300 employees) represent almost 99% of all enterprises. Source: OECD Small and Medium Enterprise Outlook: 2000 Edition.

[71] These refer to the companies employing 50–199 employees. KOSGEB and the Undersecretariat of Treasury define small and medium-sized companies in Turkey as those employing 50–150 and 50–250 employees respectively. The Undersecretariat of Foreign Trade defines small and medium sized companies as those which have 1–200 employees and fixed capital of less than US$2 million. The EU adheres to the limit of 250 employees, which is the most frequent upper limit designating an SME. Financial assets are also used to define SMEs. In the EU, SMEs must have an annual turnover not exceeding EURO 40 million and/or a balance sheet valuation not exceeding EURO 27 million.

[72] In the size-class (no. of employees) of 50–249, Turkey had 2,632 companies accounting for 21.8% of production. In this size-class, by comparison Korea in the late 1990s had 7,841 companies accounting for 23.8% of production, and Greece had 841 companies accounting for 16% of production. Source: OECD Small and Medium Enterprise Outlook: 2000 Edition.

parking space for companies that fail to meet the continuous listing requirements for the National Market (see above).

As of end 2002 only 14 companies were traded on the Regional Market, with their market cap amounting to US$279 million, representing only 0.78% of the total market cap. No companies have been traded on the New Companies Market since 1999. Most stock markets world-wide have tried to develop special market segments for SMEs and new companies. For instance, KOSDAQ in Korea was formed to facilitate corporate financing for venture firms and SMEs. KOSDAQ is said to have played a significant role in Korea's recovery from the economic crisis in 1997. The number of companies listed on KOSDAQ has grown substantially from 331 in 1996 to 843 as of end 2002,[73] with their market capitalization at US$31,281 million.

Medium Term Targets/Goals

Considering a very large universe of small and medium-sized companies in Turkey, there is a lot of scope for increasing the number of listings of these companies in the stock market. The authorities should first focus on the 2,200 or so medium sized companies, and target to have at least 10% of these companies listed in the next 3–5 years.[74]

Policy Recommendations

The processes of going public for SMEs and subsequent trading should be made less complex, less time consuming and less expensive. The Regional Market should be transformed into a conventional second tier or New Companies Market, with all companies in the process of de-listing relegated to the Watch List Market. Companies should be de-listed from the Watch List Market after one month, or alternatively the Watch List Market should be abolished altogether. The current order-driven, continuous double auction market may not be the most effective for trading of SME shares, and adoption of a quote-driven market making mechanism for the New Companies Market should be considered. Market making largely depending on the financial muscle of the market makers can stimulate liquidity in the absence of market depth. As the companies that are/will be trading on this market are small and medium sized, the financial exposure for market makers would be relatively small. The New Companies Market may be divided into two tiers: one where companies are quoted by market makers, and one where companies without market makers can be traded. Market making is a risk taking business for broker-dealers, and they would be willing to make a market for securities for which minimum necessary liquidity (and thus less volatility) can be expected. It would be too risky to make a market for very illiquid and volatile securities. For such securities, an electronic bulletin board type market may be organized.

Developing Hedging Instruments and Formal Derivatives Markets

Current Situation

Essential pre-requisites for an effective derivatives market include (i) moderate price volatility—the price of the underlying item must change enough to warrant the need for shifting price risk, but not so much as to make taking on the price risk excessively risky; (ii) cash market competition—the underlying cash (or physicals) market must be broad enough to allow for healthy competition, which creates a need to manage price risk and decreases the likelihood of market manipulation; and (iii) trading liquidity—active trading is needed so that sizable orders can be executed rapidly

[73] At KOSDAQ, companies are categorized into non-venture companies and venture companies, with different listing requirements. As of end 2002, the number of non-venture companies listed amounted to 467, while the number of venture companies listed was 376.

[74] Incidentally, Korea had 7,800 or so medium sized companies in the late 1990s. KOSDAQ had 843 listed companies as of end December 2002, which as a quick and crude estimate suggests that 10% of the universe of medium sized companies was listed.

and inexpensively. These conditions are only partially met in Turkey, and therefore derivatives trading to date has remained limited. For example, excessive volatility of the Turkish Lira has kept the FX futures market on the ISE illiquid, with no transactions occurring since August 2001. Trading in gold and silver on the state-owned Istanbul Gold Exchange, while growing rapidly in the first three years after the exchange's creation in 1995, has generally been in decline since 1998[75], and thus never reached the critical mass required to allow the Istanbul Gold Futures and Options Exchange, set up in 1997, to flourish. As a consequence, this market also has remained illiquid, with only 4 transactions worth less than US$1 billion completed in 2001. Among other potential financial derivatives, ISE index futures and options are considered, but unless the equity market expands, insufficient trading in the underlying instruments will likely remain a bottleneck. Surprisingly, given the large size and liquidity of the Government bond market, there are currently no exchange traded interest rate futures, disallowing proper management of interest rate risk.

Part of the reason that derivative markets have not developed also is lack of demand—given that there is no sizeable institutional investor base in Turkey. One factor that may increase demand for exchange traded derivative products in the near future is the introduction of a market risk charge requirement for banks applicable as of 2002, encouraging banks to hedge their market risk positions.

The Izmir-based business community has worked on setting up a new futures and options exchange since 1995. While all formalities for the opening of this exchange were recently completed and a General Director has been appointed, trading has not yet commenced, partially due to legal problems (which were resolved with the 1999 amendment of the CML), but possibly also because the ISE has not looked favorably upon competition from such a new exchange.

Medium Term Goals and Policy Recommendations

Macro-economic stabilization and the resulting lower volatility of the Turkish Lira are likely to revive the FX futures market. Consideration should also be given to formalizing informal cash markets in gold and FX (i.e., such as the informal gold market that operates in the Istanbul bazaar).

The Izmir-based Istanbul Futures and Options Exchange should begin operations as soon as possible, and both this exchange and the ISE should seek to establish strategic linkages with foreign organized derivative markets to enhance trading interest. Consideration should also be given to privatizing the Istanbul Gold Exchange. Given that trading volumes on both the cash and futures markets on this exchange have been quite low/in decline, a review should be undertaken of trading rules and fee structures for these markets to determine whether these could usefully be adjusted to stimulate trading activity.

Securities markets should be developed enough to allow and facilitate hedging of risks by local market participants and foreign investors (see the relevant sections in this report).

Considering: (i) the large volumes of Government securities being issued and outstanding; and (ii) the need for the Government to lengthen the maturity of its instruments as much as possible, interest rate or Government securities futures seem to have the most potential demand in the near future. Interest rate futures should thus be considered as one of the priority instruments to be introduced. Such futures will also be important to support market making activities by Government securities dealers, particularly now that a primary dealer system has been reintroduced (see below).

Capital rules for capital market intermediaries should provide appropriate credit for risk reduction through use of derivative positions. Investment restrictions applicable to capital market participants should be reviewed to ensure that they do not unnecessarily limit the use of derivatives.

---

[75] Gold trading picked up slightly, though, in 2002—probably due to the sharp increase in the price of gold during the latter half of that year. While the volume of trading in silver has oscillated sharply over the years, it has remained insignificant in US$ terms.

Section 2. Enhancing the Efficiency of Existing Markets

Efficient secondary markets enable investors in securities to readily dispose of their investments at competitive market prices. It is this flexibility that encourages investors to aggressively buy in the primary market, thus providing competitive prices for issuers. Generally, it is very important to create such an efficient and competitive secondary market for Government securities, where credit risk-free market interest rates[76] can be established in terms of market yield on the instruments concerned. Such credit risk-free interest rates can serve as a benchmark to price all other riskier debt instruments, thus supporting development of the overall domestic debt market. In the case of Turkey, the issue is of even greater significance given the heavy fiscal burden arising from the extraordinary amount of Government debt outstanding. Obtaining fully competitive market prices for its debt will allow the Government to reduce its fiscal cost, sustain its finances and avoid transferring an excessive fiscal burden to future generations of the population. A reduction in the public debt to GDP ratio is also required for eventual EU accession. This section assesses distortions in the secondary Government securities market, as well as weaknesses in the existing market infrastructure and securities industry, that should be addressed to allow the overall domestic capital market to achieve its growth potential.

Enhancing the Efficiency of the Government Securities Market

Current Situation

The majority of the domestic Government debt stock is traded in the secondary market,[77] while only 20% of corporate equity (accounting for about 30% of the total equity market capitalization as of end May 2002) is estimated to be freely floated.[78] As a result, Government securities trading constituted over 90% of secondary market activity (in terms of value) during 2001. Banks are the main players in the Government securities market. Banks' trading in Government securities accounted for a dominant 78% share in the total trading volume in the secondary markets including equity at the Istanbul Stock Exchange (ISE) during 2001. In the telephone-based OTC market,[79] their share was even greater and consistently has exceeded 90% at least since 1999. Trading of Government securities in both the ISE and OTC markets is concentrated in repos (about 80% in both markets) and particularly overnight repos (about 50% at the ISE).[80]

Statistics from the ISE indicate that an increasing share of the trading in Government securities is conducted at the ISE (Table 19).

As is well known, most Government securities trading around the world takes place in over-the-counter (OTC) markets organized by dealers rather than on stock exchanges, for good reasons. In Turkey, a key reason for centralization of trading at the ISE is that the ISE discourages OTC trading (i.e., trading outside the ISE) of Government securities (as well as other securities) by requiring its

---

[76] Government securities denominated in domestic currency are often regarded as credit risk-free instruments, although there is still a risk of sovereign default.

[77] As of end December, 2002 47.2% of the total debt outstanding (TL149,870 quadrillion) was held and traded by private financial institutions and investors. The remainder was held by the Central Bank (18.8%), state-owned banks (16.2%), SDIF (7.4%) and other public sector bodies including state-owned enterprises (10.5%). However, the Central Bank and the state-owned banks participate in the secondary market. In particular, the Central Bank is the most active participant in the secondary market.

[78] The remainder is in the hands of the founding families or other controlling shareholders.

[79] Reuters monitors are used as an information system, not a trading system. Based on bid and ask price quotes observed in the system, market participants call each other to trade.

[80] Aside from the heavy short-term orientation of the market, the order-driven trading system of the ISE is more suited to very short-term repo trading than outright transactions, thus mutually reinforcing the concentration of such repos at the ISE.

participants to register off-ISE trades and charging high registration fees for it (Table 20).[81] In fact, registration fees for off-exchange transactions are much higher than transaction fees charged for on-exchange transactions. The ISE considers the centralization of trading on its exchange through off-exchange registration fees useful in enhancing price discovery in Government securities trades. However, price information is disclosed by the ISE to market participants only with a significant delay (weekly rather than daily), and thus in reality contributes little, if anything, to the price discovery process. Banks which are the main traders in this market have the technical capacity to disclose price information much faster, but currently have no incentive to do so.

TABLE 19: SHARES OF ON- AND OFF-ISE GOVERNMENT SECURITIES TRADING

YEAR	TOTAL TRADED VALUE (US$ BILLION)[1]	ON EXCHANGE	OFF EXCHANGE
		(PERCENTAGE DISTRIBUTION)	
2000	3.274	35	65
2001	1.530	44	56
2002	916	60	40

[1] Includes both the Outright Purchases/Sales Market as well as the Repo/Reverse Repo market, both on and off the exchange.

Source: ISE.

In addition to these fees, banks or intermediary institutions have to pay 25% (of transaction and registration fees) to an Education Support Fund and 25% Special Transaction Tax. The registration fees (for off-exchange transactions) generate handsome income for the ISE-US$26.1 million (13% of total ISE income) during 2001-as against income from exchange fees (for on-exchange transactions) of US$13.8 million.[82] The transaction fees also serve as a base for these Government taxes which increase the fee costs by 50%. Any reduction in the exchange fees therefore implies a reduction in tax revenues, in addition to ISE revenues. On the other hand, however, particularly with the decline in yield on Government securities, this registration fee for off-ISE transactions has emerged as an important impediment to the development of secondary markets and is proving to be costly for the Government

TABLE 20: ISE TRANSACTION AND REGISTRATION CHARGES FOR GOVERNMENT DEBT

(AS OF FEBRUARY 2003)	ON-EXCHANGE TRANSACTION FEES	OFF-EXCHANGE TRANSACTION REGISTRATION FEES
	PER HUNDRED-THOUSAND TL	
Repo/Reverse Repo Market		
– Overnight Transactions	0.75	2.93
– Other Maturities	4.00	9.00
Outright Purchases/Sales Market		
– Buy/Sell	2.00	9.00

Source: ISE.

[81] It should be noted that the ISE is required by law to charge these fees, and that their level is determined by the CMB. Thus, the presence of these fees is not so much the result of a deliberate ISE decision as of the current legal and oversight arrangements governing the ISE's operations.

[82] Currently, much of the ISE's income is derived from investment income, which is earned on its capital invested in Government securities as well as property (own building, etc.). As market interest rate comes down, however, this income will fall significantly, leaving the income from registration fees proportionally more important than now. A decline in market interest rates is likely to cause demand for further reduction of the registration fees, as they will make OTC trading prohibitively expensive. See the section on "Governance Reform and Privatization of the ISE" for further discussion of the ISE's finances and its impacts.

as issuer,[83] as well as for market participants including both intermediaries and investors. In the recent past, the very high yield on Government securities (about 100%) dwarfed the transaction charges, and market participants therefore traded actively in the OTC market. As the yield dropped to around 40%, however, OTC trading has become proportionally very costly for the already struggling banking sector which dominates this market. This appears to have forced banks to move a greater volume of Government securities trading into the cheaper on-ISE market.

A Primary Dealer (PD) system was introduced by the Treasury in May 2000 to improve public debt management, attain stability in public borrowing and deepen the secondary market for Government securities. However, this system had to be abandoned *de facto* after the December 2000 banking crisis, and *de jure* with the expiration of contracts entered into with primary dealer banks in May 2001. The PD System was reintroduced on September 2, 2002. The new system should be more sustainable than the previous one as a result of structural reforms implemented during the last one and a half years, including restructuring of the banking system, enactment of a Public Borrowing Law that enhances public sector borrowing discipline, and amendment of the CBT law enhancing the CBT's independence. In particular, the Central Bank no longer grants advances to the Treasury and no longer purchases debt instruments issued in the primary market by the Treasury and public institutions. In the new system, the CBT will not be a counter-party to the contracts to be entered into between the Treasury and the PD banks. The CBT will provide a TL liquidity facility for the PD banks through open market operations. This liquidity facility, which is actually in contrast with the past quasi-currency board monetary policy, is consistent with the current monetary policy under the floating exchange rate regime, whose aim is to adopt inflation targeting.

Medium Term Goals and Policy Recommendations

The ISE should stop taxing OTC transactions in Government securities immediately, while continuing to register transactions for the moment in order to maintain market transparency. Reporting of OTC transactions should be made a regulatory requirement by the CMB or the CBT for the time being. The Government, the CBT and the CMB should come up with an appropriate regulatory structure for the bond market with clearly identified regulatory authority for the market and its participants.

While lack of transparency of current telephone-based OTC trading is a legitimate concern, effective price discovery and transparency can be achieved by better organizing OTC trading through an electronic bond trading platform,[84] different from the existing order-driven trading system of the ISE. In the global market place, there is a general market trend to move from inter-dealer to multi-dealer systems which provide greater transparency. Multi-dealer systems assume more significance in a market where institutional investors have important presence and demand greater transparency for the dealer-to-client segment of the market. In an emerging market, however, financing of such a platform can be an issue. Institutional investors may not want to invest in developing the system, particularly at the initial stages when the market is developing and liquidity is low. There is room for the Government, being a major beneficiary of sovereign bond trading, to step in to meet the costs initially. For example, MTS in Italy,[85] which is now a private body, was initially introduced and funded by the Government.

---

[83] While ideally a full cost benefit analysis should be done, it is understood that the tax is costing the Government more than the returns it generates.

[84] There are numerous providers of such platforms around the world, including some information vendors such as Bloomberg. It may also be of interest to study platforms adopted by EU member countries. Annex 3 provides more detail on the choices available and design parameters to be considered.

[85] Incidentally, MTS in Italy has been a success story which led the way for adoption of MTS in other European countries like the Netherlands, Belgium, France and Portugal. Brazil, Korea and Japan have also adopted electronic bond trading systems along the lines of MTS. Annex 3 provides further details.

The Government should take the lead in forming a committee, comprising regulatory agencies and key market participants, that will be tasked with adoption of such a platform. The platform should be designed to flexibly accommodate trading and investment needs of market participants to encourage their active participation, as well as differentiated market access by different groups of market participants, especially now that the Treasury has decided to reintroduce a primary dealer system. The ISE itself should not be restricted from providing such a platform and competing with other possible private providers of the service. As a matter of fact, ISE's strong capital position and high profitability should easily allow it to invest in the development of such a system.

Clearly, introduction of an electronic bond trading system is not costless. However, its benefits are likely to significantly outweigh its costs, especially when implicit as well as explicit costs are all taken into accounts. A more liquid secondary market which enables market participants to competitively sell their holdings of Government securities when needed will encourage aggressive bidding at primary auctions. This in turn will help the Government to place issues more surely and competitively in the primary market and reduce its funding cost. This should also contribute to enabling the Government to gradually lengthen the maturity of its instruments and enhance the efficiency of its debt and risk management.

The Treasury should further elaborate how the obligations of the PDs in the new PD system are expected to assist in meeting its debt management objectives, which should be clearly established. The Treasury should also, together with the CBT and key bond market participants, continuously monitor the PDs' performance against their obligations. While high performers may be rewarded with proper recognition, poor performers failing to meet some of the obligations should be disqualified and a new PD should be brought in from a pool of pre-qualified prospective candidates. In this way, a position of a PD can be kept contestable and the PD system competitive.

Governance Reform and Privatization of the ISE

Current Situation

The ISE, created by Decree-law 91 in 1983, is a state-owned body governed by an Executive Council composed of 5 members. The chairman of the Executive Council is appointed by the Government and acts as Chief Executive Officer. The ISE's main responsibilities are to organize reliable, stable and competitive trading markets, to develop listing standards and to review and approve applications of securities for listing/delisting, to disseminate closing price and trading volume information on a daily basis, to determine in which markets its members (banks regulated by the BRSA and securities firms regulated by the CMB) are allowed to operate,[86] and to sanction member violations of ISE regulations.

By law, the CMB has extensive powers to regulate and supervise the operations of the ISE. For example, the CMB must ratify all decisions of the ISE's General Assembly before they can come into force. However, the ISE being a state body and a monopoly, the regulatory efficacy of the CMB over the ISE in practice appears limited. As a result, the functioning of the ISE as a self-regulatory organization is somewhat uneven-satisfactory in some areas such as market surveillance, where it has modern systems in place to detect price manipulation, and approving members for trading in specific market segments, where it can rely to a large extent on the presence of the requisite BRSA and CMB licenses, but less satisfactory in other areas such as enforcing compliance by issuers with ISE listing standards, especially as concerns information disclosures.

The ISE is said to be operationally independent from the Government, with market representatives dominating the Executive Council. However, the practice of penalizing off-ISE trading of Government securities, which is not liked by ISE members (banks and securities firms), reveals

[86] These include: primary market operations, secondary market operations, portfolio management, providing investment consultancy services, dealing in repo/reverse-repo operations, margin trading, short-selling and securities lending, and intermediation in derivatives instruments/transactions.

that it is not really a member-driven organization. A demutualization plan being considered also underscores the recognition of the existence of issues regarding ISE's governance. Another peculiar feature about the ISE is that while it is legally a state body, there is no financial contribution from the Government to the ISE. Interestingly, ISE's balance sheet does not show any capital. Its profits are retained and are not distributed to any third parties.

The Capital Markets Law (CML) contains provisions mandating that all securities exchanges should be organized as public entities, and that their assets are state property. These provisions hinder both the privatization and demutualization of the ISE (and of the Istanbul Gold Exchange as well) and the appearance of competing exchanges and trading platforms.

Medium Term Targets and Policy Recommendations

The institutional framework of the ISE requires a fundamental review both in terms of law (legal and regulatory aspects including by-laws and charter) and practice. The CML should be amended to allow all securities exchanges to be organized as private, for profit entities. A strategy for demutualization of the ISE should be developed and implemented after a thorough evaluation of its existing ownership and control structure, its future financial viability and objectives to be achieved, such as enhanced governance, independence and credibility to be an SRO (self-regulatory organization); enhanced ability to raise money flexibly to invest in technology to upgrade its trading and other systems; and enhanced commercial orientation and inter-market competition.

The proposed demutualization of the ISE will first require privatization which would, in the first stage, most likely transfer the ownership and/or governance of the ISE to member intermediaries. However, full demutualization is unlikely to be achieved soon, as there is ambiguity on the issue amongst the authorities due to the peculiar institutional characteristics of the ISE. The ISE must first be truly mutualized or corporatized to leave the hands of the Government before it can be fully demutualized. To fully demutualize after corporatization, the ISE will need to go public and offer shares to investors other than its members. Whether that extent of full demutualization is what should be sought for the ISE is an open question. Demutualization is a means, not an end in itself. Exchanges in different countries considered and implemented demutualization for different reasons and achieved different levels of success. To be fully demutualized, ISE's commercial viability should be carefully assessed especially if it has to stop charging registration fees for off-ISE (i.e., OTC) trading. Presently, the ISE is an extremely profitable organization.[87] As noted earlier, a significant 13.4% of ISE's income is generated from transaction fees for OTC trading in Government securities. Interest income accounts for a dominant 63.5% of total ISE income due to the current high yield on Government securities, in which a significant portion of ISE's reserves are invested. However, when interest rates decline, interest income will also decline. Also, a very large part of the on-ISE trading is in Government securities, as the equity market has remained small[88] (see also in Section 1 of Chapter IV: Deepening and Broadening Equity Markets). If the ISE stops charging registration fees for OTC trading, much of the current on—ISE trading may migrate to the OTC market. Therefore, a time-table for privatization and eventual demutualization of the ISE should be carefully benchmarked against key reform events to ensure its commercial viability. In particular, introduction of an electronic bond trading platform either by the ISE or a separate private provider (or both) should be considered in conjunction with the demutualization plan.[89]

---

[87] For the year ended 2001, it earned a surplus of TL133.72 trillion, i.e. 47% of its total income of TL283.53 trillion and its accumulated reserves amounted to TL314 53 trillion.

[88] As per the aggregate turnover figures for 2001 and 2002, over 90% of the total on-exchange trading is concentrated in the bonds and bills markets. See also Table 21.

[89] Even if an electronic bond trading platform would be provided by the ISE, it could be considered an OTC trading platform if it would be used only by professional institutions as principals, and less stringent regulation than for the traditional ISE market could be required in that case.

Ownership and Governance Reform of Key Market Infrastructure Institutions

Current Situation

The ISE is a major shareholder[90] in the ISE Settlement and Custody Bank (known as Takas Bank—TB), the new Central Registry Institution (CRI)[91] and the Istanbul Futures and Options Exchange based in Izmir, and Government ownership and control thus extends indirectly to all these institutions through the ISE. Cross-holdings and commonalities in the management of these institutions[92] reinforce the linkages amongst them in addition to unifying their interests, creating a de facto state-owned market infrastructure monopoly. Privatization and demutualization of the ISE would have direct implications for these capital market institutions.

Medium Term Targets and Policy Recommendations

The CMB should carry out a comprehensive study of the centralized monopolistic structure of the nexus of market infrastructure companies, and establish policies for a suitable future structure taking into account the parameters of the demutualization of the ISE. Such policies should determine whether inter-market competition should be encouraged, or centralization of the trading markets should be promoted in consideration of possible EU accession. The CMB should incorporate the findings of its review in its medium-term goals for capital market development.

A distinction may be made between the trading market operators (such as the ISE and the Istanbul Futures and Options Exchange) and clearance and settlement (C&S) institutions (such as TB and the CRI). Generally, exchanges are increasingly becoming competing for-profit businesses, while C&S institutions remain or even increasingly become public utilities. If sufficient competition cannot or should not be encouraged for the exchanges within the domestic market (in effect, to allow a centralized trading system to effectively compete with foreign trading systems), then the governance structures of the exchange(s) should be made to reflect the business interest of the users. Demutualization of the ISE is understood to be at least partly a response to this consideration. At the same time, if any of the exchanges and C&S institutions are expected to perform self-regulatory functions, the credibility of incentives they face in carrying out such responsibility should be carefully evaluated. In particular, incentives arising from the governance structure of the bodies need to be carefully reviewed. For example, an exchange governed and financed entirely by its member brokers is often not well suited to apply sanctions against its own members (see Box 4).

Tough future competition from foreign trading systems and exchanges, especially EU systems/exchanges in the run-up to and after eventual EU accession, may necessitate complete centralization of the domestic trading markets to reduce trading costs. To choose centralization as a policy for the Turkish capital markets, however, competition, particularly from overseas markets, should be promoted and impediments to it removed to avoid exploitation of monopoly power. Policy makers should carefully consider the role sharing between foreign and domestic markets, and develop a vision for the role of the domestic market in the foreseeable future.

---

[90] The ISE's shareholdings in TB, CRI and the Istanbul Futures and Options Exchange amount to 23%, 30% and 18% (9% for its own account and 9% available for transfer to other institutions as per a clause in the Futures and Options Exchange's Articles of Association) respectively. The Istanbul Gold Exchange, which runs both a cash market in gold and silver and a gold and silver Futures Exchange, currently remains 100% Government owned.

[91] The CRI was recently created to undertake dematerialization of securities, central depository functions and also the management of an investor protection fund and has not yet started operations.

[92] TB has a 65% shareholding in the CRI. The ISE has a prominent presence on the Board of Directors of TB and the CRI. Similarly, TB has nominees on the Board of the CRI.

BOX 4: SELF REGULATION

The IOSCO Principles 6 and 7 on Self-Regulation list a useful set of qualities/competences which a Self-Regulatory Organization (SRO) should have, i.e., an SRO should: (i) have the capacity to carry out the purposes of governing laws, regulations and SRO rules, and to enforce compliance by its members and associated persons with those laws, regulations, and rules; (ii) treat all members of the SRO and applicants for membership in a fair and consistent manner; (iii) develop rules that are designed to set standards of behaviour for its members and to promote investor protection; (iv) submit to the regulator its rules for review and/or approval as the regulator deems appropriate, and ensure that the rules of the SRO are consistent with the public policy directives established by the regulator; (v) cooperate with the regulator and other SROs to investigate and enforce applicable laws and regulations; (vi) enforce its own rules and impose appropriate sanctions for non-compliance; (vii) assure a fair representation of members in selection of its directors and administration of its affairs; (viii) avoid rules that may create uncompetitive situations; and (ix) avoid using its oversight role to allow any market participant unfairly to gain advantage in the market.

While SROs can be used as an instrument for the development of efficient and stable financial markets, their role has recently come under scrutiny due to various corporate frauds in he US and elsewhere. In the context of emerging markets, development of SROs is particularly dependent on the presence of strong standards of corporate governance. The authorities in Turkey first need to decide the objectives, extent and degree of self-regulation to be reached in different areas of the market (e.g. market surveillance, prudential supervision, information disclosure, clearing and settlement etc.). The development of SROs (institutional framework, mechanisms, rules, etc.) is a gradual process, and an area-specific timetable should be drawn up in accordance with the specified objectives for each SRO. The authorities also need to ensure that the adequate conditions for SRO operations are in place, SROs possess the right incentives, and that SRO rules and practices are and remain fair.

Source: IOSCO.

Enhancing the Efficiency of Clearance, Settlement and Registration Systems

Current Situation

In terms of functionalities, TB and the CBT are providing sound clearing and settlement (C&S) services for the Turkish capital markets. With respect to the Government securities market, however, there appears to be some room for further efficiency gains through possible further integration of the account holding structure of TB and the CBT for their participating intermediaries. TB primarily provides custody, settlement and clearing functions. It also operates an inter broker-dealer money market by acting as a central counter party (CCP). It has a regular banking function and maintains its own portfolio of Government securities while acting as a central securities custodian and transfer agent, as well as a money settlement bank for broker-dealers, giving rise to potential conflicts of interest. Such conflicts are partially kept in check by measures such as TB refraining from short term (day) or margin trading. Also, TB receives pricing data through data vendors such as Reuters at the same time as other market participants, and receives information related to positions of market participants only after closure of trading sessions.

Medium Term Targets and Policy Recommendations

The CMB should consider the positioning of the C&S institutions (TB and CRI) and establish an organizational policy for them. Reform of ownership and control of TB in particular should be carefully reviewed upon privatization and demutualization of the ISE.

C&S activities benefit from centralization, particularly when many intermediaries participate in more than one exchange and share market and settlement risks. While some trading markets around the world may appear to be merging to centralize trading activities, their business decisions

have actually been driven by a need to survive and thrive in the increasingly competitive global market place. On the other hand, C&S institutions are under pressure from their member intermediaries, who trade at various exchanges, to consolidate to enable members to net out exposures in various markets and instruments, and use collaterals in the most efficient manner, thus reducing settlement cost without compromising safety.

Also, from a policy perspective of promoting greater inter-market competition, centralization of C&S activities is useful to level the playing field for competing exchanges. For example, it will be crucial for TB to provide fair[93] support for all exchanges including a possible electronic trading platform for Government securities, so that trading markets can compete fairly and effectively. If a C&S institution is owned and/or controlled by a single exchange while there are several competing trading markets, the former would have an incentive to prevent its subsidiary C&S institution from providing adequate services to other exchanges or an electronic trading platform(s) to main tain its competitive edge. That might necessitate other markets to create separate C&S institutions, which would fragment the C&S arrangements and push up aggregate settlement cost for the Turkish capital markets as a whole.[94]

Creation of a National Clearing House may deserve consideration. Currently, the CBT acts as the central registrar for Government securities, while TB acts as sub-custodian to the CBT. Bank participants can have accounts in both the CBT and TB, and transfer of securities between the two systems appears to be efficiently carried out as needs arise (e.g., upon need of collateral in the ISE market supported by TB). However, a National Clearing House may further simplify the process and reduce cost by eliminating the duplication of investments in the systems. Examples are found in Sicovam (France), Crest (UK), VPC (Sweden), and NZ CSD (New Zealand).

Setting up of the CRI separately from TB[95] can be a basis for further useful reform of the C&S arrangements. One way is to separate the clearing function from the settlement institution with the clearing house assuming a role of a central counter party (CCP) for multilateral netting with novation. In order for a clearing house to assume an effective CCP role exposed to settlement risk, it is better to legally separate central registration and custody of securities so that the assets in custody and their ownership record will not be exposed to the risk assumed by the CCP. As a possibility, TB can be the clearing house, with the CRI acting as a settlement institution with a custody function. This would also help resolve the potential for conflicts of interest in TB.

A more simple but important role of the CRI in the immediate future is to implement full dematerialization of securities of all publicly held companies. The 4–5 year time frame for achieving full dematerialization seems to be too long, however. While education of the shareholding public who are accustomed to holding paper certificates is necessary and may take time, the CRI should be encouraged to explore ways to complete the task in 2–3 years.

Developing the Broker-dealer Industry

Current Situation

As noted earlier, the growth of the Turkish equity market that was apparent in the mid to late nineties was interrupted by the Government's excessively large financing needs as a result of the financial crises during 2000–2001. While equity market trading volumes thus declined, the

---

[93] Not necessarily "equal" support, as participants in different markets may have different technical capabilities, risk tolerances, etc.

[94] However, this does not necessarily imply that the C&S services provided by TB for the ISE and the Istanbul Gold Exchange should be consolidated. Differences in participants, instruments, trading volumes, etc. should be carefully reviewed in considering the magnitude of savings, and who would (or would not) benefit by consolidation without sacrificing safety.

[95] TB is the major shareholder in CRI with a stake of 64.9% in its share capital. Other shareholders are the ISE (30%), TSPAKB (5%) and the Istanbul Gold Exchange (0.1%).

TABLE 21: EQUITY AND GOVERNMENT DEBT MARKET TURNOVER

(US$ MILLION)	1996	1997	1998	1999	2000	2001	2002
Total Turnover—Equity	37,737	58,104	70,396	84,034	181,934	80,400	70,756
Total Turnover—Government Debt	1 054,099	1,539,404	1,817,401	2,341,723	3,273,528	1,529,589	915,467
Total Turnover—Repos/Reverse Repos	962,991	1,421,593	1,513,707	1,853,603	2,508,335	1,402,632	758,723
Total Turnover—Combined	2,054,827	3,019,105	3,401,504	4,279,360	5,963,797	3,012,621	1,744,946

Source: ISE.

increase in Government debt trading volumes compensating for this decline recently has tapered off, attesting to the initial success of the stabilization program (Table 21).

Asset management activity is also still in its infancy due to the lack of an institutional investor base and a sizeable wealthy individual investor class. Securities firms' almost exclusive business is thus in Government debt/repo trading. Once macro-economic stabilization takes hold firmly, trading volumes and turnover in these markets are likely to shrink further. While a certain amount of "crowding-in" is expected with equity markets and asset management activity growing once the Government's debt dynamics improve, this effect may not be large enough, at least not in the near term, to compensate the industry for the loss of income from Government securities trading.

In this environment, there still appear to be too many securities firms for the size of the business, despite a freeze on new licenses for brokerage houses in place since 1991[96] (Table 22). Due to the depressed market conditions in the aftermath of the financial crises, almost all the brokerage houses are losing money in terms of operating income, and 80 are practically out of operation. Many seem to be surviving on interest income which they earn by investing their relatively high levels of capital and liquidity in the high yield Government securities and repo/reverse repo markets. The dire situation of many firms is also further evidenced by the fact that in 2001 the top 30 brokerage houses accounted for almost 70% of total traded value in the equity market. Similarly, in the Government securities market, the top 30 players, accounting for more than 80% percent of total traded value, were mostly banks (including the CBT) and brokerage subsidiaries of the largest banks. Therefore, the industry is in need of consolidation, and a trend in this direction is already apparent.

[96] Except for the registration of brokerage houses founded (or taken over) by banks, pursuant to a CMB decision taken in August 1996.

TABLE 22: NUMBER OF BROKER DEALERS

	1998	1999	2000	2001	2002 (NOVEMBER)
Brokerage Houses, of which	143	136	133	130	121
– Founded by banks	45	46	47	45	31
– Other	98	90	86	85	90
Banks	66	73	72	56	47[1]
Total	209	209	205	186	168

[1] As of February 2003.

Source: ISE.

Intermediaries are permitted to charge a minimum of 0.2% (mainly used for large institutional transactions) and a maximum of 1% commission (used for small retail transactions. In emerging markets, this kind of regulation of commissions is often adopted to protect small broker-dealers when the industry is considered to be still in its infancy and in need of being promoted. Recently in Turkey, however, intermediaries have been permitted to refund up to 35% of their commission income to selected customers which are understood to be large institutions.[97] This allowance practically eliminates regulatory restrictions on the commission level. Total deregulation of commission levels is being considered.

There is a recognized association of capital market intermediaries known as The Association of Capital Market Intermediary Institutions of Turkey (TSPAKB), which was set up in March 2001. The aims and duties of the association include contributing to the development of the capital market and intermediary activities, facilitating solidarity between its members, conducting research, and establishing professional rules and regulations, although in this area its role falls short of that of a full-fledged SRO. As of February 2003, the association had 168 members (all licensed broker-dealers).

Medium Term Targets and Policy Recommendations

The CMB should facilitate consolidation of the securities industry. Mergers and acquisitions (M&A) among securities firms could be facilitated with penalties or faster license revocation/limitation for inactivity[98] and tax incentives similar to those granted for bank mergers after the 2000–2001 crises. Deregulation of commission rates is a sensible measure to promote consolidation through competition for survival. It would also promote specialization among intermediaries in certain market segments (for example, discount brokerage aimed at day traders, institutional brokerage, asset management aimed at high net worth individuals, etc.). The CMB needs to be prepared to permit or encourage intermediaries to undertake such a wide variety of business services.

Currently, TSPAKB's Board of Directors consists entirely of members' nominees and it has so far been active only in the area of determining the principles for commissions and fees charged by its members and proposing the same to the CMB. This implies that it currently acts more as a typical industry association working to protect the interest of its members than as an SRO. The authorities should re-consider to what extent it will be feasible for TSPAKB to act as credible SRO for broker-dealers, and re-define its role accordingly (see Box 4). TSPAKB currently is ill equipped to perform the role of a full-fledged SRO in terms of its legal authority, financial resources, facilities and staff. In the current depressed market, it would also be difficult for the industry to financially support the Association's activities adequately if its activities are expanded. Hence, it may take some time before full-fledged SRO status can be reached.

---

[97] Though for each customer, commission charges cannot be less than zero.

[98] Although current CMB regulations foresee withdrawal or limitation of a securities firm's particular license if the CMB determines that no operation or task has been realized in one of the activities under that license within 12 months , or if it notifies the CMB that it does not plan to undertaken a particular activity for a period of 6 months or longer, there are currently no monetary penalties for prolonged inactivity. While these provisions are in line with the applicable EU Directive, there may be a case in Turkey for temporarily going beyond these minimally required regulatory sanctions, given the fragmented state of the industry.

CHAPTER V

DEVELOPING OTHER NON-BANK SOURCES OF FINANCE

Developing the Leasing Industry

Current Situation

Financial leasing companies are subject to Financial Leasing Law No. 3226 enacted in 1985, and the Regulations Dealing with the Establishment and Activities of Financial Leasing Companies that were last amended in 1992. A financial leasing company needs to be incorporated as a joint-stock company, and have a minimum paid-in capital of US$2 million. Total lease transactions cannot exceed 30 times a leasing company's net worth (15 times for transactions with connected parties). Under the banking law, commercial banks are prohibited from directly engaging in financial leasing transactions; therefore they operate through (mostly wholly owned) leasing subsidiaries. Special finance institutions and non-deposit taking investment & development banks are allowed to engage directly in financial leasing. Leasing companies are regulated and supervised by the Banking and Foreign Exchange Department of the Treasury.

According to the Financial Leasing Law, the title of the leased assets remains with the lessor. Due to the security provided by keeping the title to the assets, leasing companies are able to finance many SMEs which otherwise do not have sufficient capital or access to bank loans. Lease contracts can be based on local or foreign currency and can have either fixed or floating interest rates. Due to the volatility of the TL, generally foreign currency based contracts are used in leasing. The minimum lease period as defined by the law is four years. In some cases, this period can be reduced to two years for certain types of assets specified by the Treasury.

Although both financial and operating leasing are used in Turkey, financial leasing is much more prevalent. Market penetration (percent of total investments financed by leasing) increased from 2.5% in 1993 to 3.9% in 2001 (down from 5.1% in 2000 due to the recent recession, see below). This is still a fairly low level of penetration in comparison with more developed economies (Table 23), and Turkey ranked 16th in 2000 and 18th in 2001 among EU countries in terms of

TABLE 23: LEASE PENETRATION—CROSS COUNTRY COMPARISON

(DATA FOR 2001 IN US$ BILLION)	ANNUAL VOLUME	MARKET PENETRATION (%)[1]	ANNUAL VOLUME AS % OF GDP
Argentina	0.47	3.7	0.16
Brazil	3.52	7.6	0.50
India	1.05	3.0	0.20
Italy	17.58	10.4	1.57
Korea	1.17	1.6	0.23
Mexico	0.9	2.0	0.15
Poland	2.0	n/a	1.17
South Africa	2.79	n/a	2.08
Spain	7.44	5.2	1.26
Turkey	0.72	3.9	0.34
United Kingdom	20.31	14.4	1.38
United States	242.0	31.0	2.29

[1] Leasing volume as a percentage of all fixed investments in plant and equipment.

Source: World Leasing Yearbook 2003.

annual lease volume.[99] More recently also, growth has levelled off, especially in 2001 as a result of the crisis in that year, and the leasing industry's assets and share in total financial system assets declined (Table 24). As the industry has a large and growing number of players (107 as of end 2001, of which 11 investment and development banks, 5 special finance houses and 91 stand-alone leasing companies), these are thus sharing a relatively small and recently sharply declining volume of business, with the crisis putting further pressure on already thin profit margins (in fact, in 2001 the industry in the aggregate incurred a loss of US$65 5 million).[100] As a result, the industry is poised for consolidation and/or exit of the marginal players.

Medium Term Targets and Policy Recommendations

Leasing is an important source of finance for SMEs and has many additional advantages (see Box 5). In Turkey, leasing is still in the very early stages of development, and needs a new legal and regulatory

[99] Source: World Leasing Yearbook 2002.

[100] While the industry returned to profitability in the first half of 2002, it did so on a much lower total asset base; enhanced competition is thus likely to put further pressure on profit margins of the smaller industry players.

TABLE 24: DEVELOPMENT OF THE TURKISH LEASING INDUSTRY

(US$ BILLION)	1996	1997	1998	1999	2000	2001
Number Of Leasing Companies	50	78	82	87	91	91
Total Financial System Assets	93,466	104,781	131,618	149,427	174,076	133,593
Leasing Company Assets	2,167	2,443	3,258	2,375	3,239	1,945
Leasing Company Assets as % of Total System Assets	2.32%	2.32%	2.45%	1.57%	1.86%	1.46%
Leasing Company Assets as % of GNP	1.15%	1.26%	1.58%	1.27%	1.61%	1.33%

Source: See Table 1.

BOX 5: STATE OF DEVELOPMENT AND ADVANTAGES OF LEASING

Leasing typically develops through six phases. These phases can be defined as: financial leasing evolving into flexible/creative leasing, operational leasing, innovative leasing, the maturity phase and the post-maturity phase. The transformation in the US from the first to the fourth phase was completed in 30 years, while moving from the fourth to the sixth phase took another 90 years. In Turkey, leasing has been in existence for the past 16 years and can be considered to be in the second phase of the development process.

Leasing became a popular method of capital asset finance in the 1950s in Europe and the US, especially for small and medium sized companies (SMEs) which were traditionally not able to borrow from banks due to various lending requirements. Starting in the 1970s, leasing became popular initially in Japan and Korea and later throughout Southeast Asia. Introduction of leasing to developing economies was initiated by IFC, and between 1975–1995, under IFC's guidance, leasing played an important role in increasing the contribution of SMEs to economic development in over 30 countries.

The advantages of leasing are:

- As the ownership of goods to be leased remains with the leasing company (lessor), the collateral required from the investor is minimized, reducing the financing costs for the investor (lessee).
- Due to the nature of the transactions being financed (e.g., equipment purchases), leasing provides incentives to SMEs to record these transactions, thereby increasing transparency and tax revenues.
- Leasing allows for better cash management of working capital by providing 100% financing (i.e., no down payment is required) and a fixed payment, based upon a fixed rate of interest (i.e., the lessor carries the interest rate risk and as a financial institution is better placed to do so than lessees). Leasing, although an extension of credit, typically conserves bank credit lines due to its traditional status as "renting", and requires payment for only the value of the property's use when ownership is not needed (e.g., if equipment costs 100, and the residual value is 35 at the end of the lease term, then the lessee gets to use all (100%) of the equipment, but only has to pay for 65% of it).
- Leasing is a flexible form of financing. Leasing often has a more entrepreneurial culture than banking and is usually far less regulated than banking, if at all. Lessors in more developed leasing markets can and do offer rent vacations, step-up and step-down lease payments, pre-lease and interim financing packages, early-out and continual upgrade options, and many other creative elements that can be custom-matched to the particular needs of a lessee's business situation. Lessors can also be creative in using supplemental collateral, equity interest stakes, and other compensatory mechanisms to still be able to provide financing to less than stellar credits. Leasing may also avoid the imposition of restrictive covenants typically used by banks on larger loans. This flexibility is one of the significant reasons that leasing is particularly advantageous to small and medium sized entities (SMEs).
- Leasing provides a hedge against inflation and technical obsolesce. As lease payments are usually fixed over the typical lease term of three to five years, there is a lock against the impact of inflation during that period. It is easier to upgrade to technologically advanced equipment by returning the equipment at the end of the lease to the lessor. In this case, the remarketing effort is the lessor's responsibility and the asset risk is borne by the lessor.
- Leasing allows better utilization of tax benefits by both lessor and lessee. Tax benefits (such as accelerated depreciation) are the same as cash— money not paid as tax is available to be spent on other needs. Frequently the lessor is in a better position to utilize these benefits in reduction of its tax liability than the lessee, particularly a start-up enterprise that has yet to attain profitability. While these benefits would accrue to a lessee on a loan, in an (operating) lease, these benefits accrue to the lessor, who may use them to lower the interest rate on the lease, thereby reducing the overall cost of the equipment to the lessee.
- Leasing may provide non-financial services not readily available from other credit sources, such as equipment service and maintenance.

(continued)

BOX 5: CONTINUED

- Leasing may offer the lessee the advantage of the economies of scale of the lessor's purchasing power. This can be especially true if the lessor is a specialist regarding a particular type of equipment or if the lessor does a lot of volume with a particular vendor on behalf of a number of its lessees.
- Leasing may better accommodate capital budgets than alternative financing. Loans to finance equipment purchases of any significance will almost invariably come from the capital budget, which is more tightly controlled and apportioned than the operating budget for regular and ordinary business expenses. Leasing expenses are usually handled as part of the operating budget.

framework that will introduce standards for certain minimum turnover[101] and/or higher minimum capital requirements for leasing companies and tax incentives for mergers, to speed up the required industry consolidation. Legal and regulatory changes are also needed to facilitate the use of new leasing methods/products, and to allow leasing to achieve a higher penetration level and a larger share in total financial system assets. Taking into account the level of development of the lease finance industry in other countries, a penetration level (percent of total investments financed by leasing) of 7–8% and a share of the leasing industry in total financial sector assets of around 5–6% (twice the pre-crises level, but at par with levels currently prevailing in several Eastern European countries) are reasonable medium term targets for Turkey in this respect.

New legislation. A new draft law covering both the leasing and factoring industries is currently being prepared by Treasury. The new law should address the following issues:

- *Sale and lease back.* Article 4 of the financial leasing law is ambiguous as to whether this is an allowable transaction. Sale and lease back transactions can help companies facing working capital problems and/or access to finance problems (especially SMEs) to raise cash by leasing some of their existing assets through this method. Some clarification with respect to this article is required in order to clear the way for implementation.
- *Sub-leasing.* This is an area that needs to be clearly defined in the law, especially with respect to the transfer of right of usage by the lessee. Legal clarification of the sub-leasing transactions will also open the way for a domestic leasing company to act as an intermediary for cross-border leasing, thus increasing foreign capital injection into the economy.
- *Disputes.* According to article 25 of the financial leasing law, in case of cancellation of a leasing contract because of a dispute, assets subject to lease are given back to the lessor, but the lessor is prohibited by law to sell or lease these assets until the dispute is resolved by the courts. Court decisions normally take more than a year and in the interim period the assets are unusable. For high tech and information technology products, this causes the assets to lose their economic value.
- *Flexibility of lease term and operational leasing.* The four year minimum allowable lease term acts as an impediment to operational leasing, where the objective is not the eventual transfer of ownership to the user, but offering the services of the same good to different users within its economic life, and should be abolished.

Taxation. Financial leases should be introduced in a consistent fashion in both income tax and Value-Added Tax (VAT) based on IAS 17. Under a financial lease, the leased goods are treated as a sale and the financing as a loan. The lessor provides the loan and receives interest income. The

[101] These should be structured so as to eliminate entities too small to be viable, while not unduly limiting competition.

lessee pays and deducts interest expenses, depreciates the asset and qualifies for any investment incentives based on the activities and characteristics of the lessee. Under an operating lease, the lessor provides rental services, receives rental income and deducts depreciation and any investment allowances for which the lessor may qualify. The lessee uses the leased items in its business, and pays and deducts rental payments.

Currently in Turkey, VAT is charged at 1% on the supplying and leasing of goods subject to finance leases, except on consumer durables in List III where the rate is 26% (18% after the introduction of the Special Consumption Tax) and on motor vehicles other than cars, where it is 8%. Under the VAT, all leases are treated as operating leases and hence supplying rental services. The low VAT rate on the leasing company under the current system merely avoids the leasing company from requiring a VAT refund—it would pay 18% on the purchase of the capital equipment, and without the 1% special rate would have to charge 18% on the rental services (basically interest on the financing) which would result in it being in a refund position for some time. Under new proposed VAT arrangements for finance leases, the leased goods would be treated as a sale and 18% VAT would be charged on the full value of the goods, but no VAT would be charged on the loan repayment of principal and interest. Therefore, the output tax on the leased goods (treated as a sale) would cover the input tax on the leased goods, and there would be no refund problem. The finance lease transaction would be in the same position as a bank-financed purchase of the same goods, creating a level playing field for leasing companies and banks. At the same time, a public policy objective to encourage the development of small businesses-the main clients of leasing companies-may argue against creating such tax neutrality. It is recommended that the Government carefully assesses these two competing objectives, to determine whether differential VAT treatment of the underlying equipment purchases is the most efficient way to balance them and to achieve SME development, and adjusts the tax structure accordingly.

The Banking and Insurance Transaction Tax (BITT) rates are different for leasing companies (5%) and investment & development banks (0%). Although as argued in Chapter II, the BITT should ideally be abolished altogether, in the interim period until such abolition takes effect, the BITT rate should be equalized for leasing companies and investment & development banks to create a level playing field.

Fixed asset leasing in Turkey is underdeveloped (comprising only 4% of all lease transactions) due to a mismatch between the lengths of the lease period—mostly the minimally required four years due to unavailability of longer term funding-and the much longer depreciation periods for fixed assets prescribed by applicable tax legislation, which is around 20–25 years. The allowable amortization period for leased fixed assets should be shortened to address this problem.

Provisions for doubtful lease receivables (4.3 percent of total lease receivables as of end June 2002) should be made tax fully deductible for all financial institutions undertaking leasing, as they are a legitimate business expense. Currently, such provisions are not tax deductible for stand-alone financial leasing companies and for investment and development banks. Special finance houses, however, can currently deduct provisions fully from taxes for leases financed by their own funds and up to 20% of provisions for leases financed by deposits ("Profit and Loss Participatory Accounts"). Introducing full tax deductibility of lease provisions for all financial institutions would stimulate leasing, and create a level playing field for all lease industry players.

Accounting. In addition to allowing the recognition of financial leasing for tax purposes, general purposes financial statement reporting standards for both leasing companies and lessees should be brought fully in line with IAS. Under IAS 17, the international accounting standard applicable to leasing, lessors only book lease claims (rather than the underlying assets) on their balance sheets and lease payments as income. Lessees carry the leased asset and the associated debt on their balance sheet, and take depreciation and lease payment expenses into income. This will enhance the transparency of lessee financial statements, as the debt associated with asset purchases is no longer off balance sheet, and hence the detection of the debt by creditors would no longer depend on footnote disclosure, which is currently not mandated.

Developing the Factoring Industry

Current Situation

Factoring companies are subject to law-empowered Decree no. 545 and the "Regulations related to the Principles of Establishment and Operations of Factoring Companies," both dating from 1994. These regulations have been amended four times since their first issuance in order to increase the minimum capital requirement for factoring companies and to improve the regulatory framework for dealing with emerging issues in factoring. Factoring companies must be incorporated as joint-stock companies and are subject to a minimum paid-in capital requirement of TL3 trillion (US$1.8 million); however, this requirement is still being phased in and will not become fully effective until August 2004.[102] They are not allowed to engage in activities other than factoring, to issue letters of guarantee or to accept deposits. Their total borrowings are limited to fifteen times their net worth.[103] Factoring companies are regulated and supervised by the Banking and Foreign Exchange Department of the Treasury.

Although banks are allowed to undertake factoring transactions directly on their own books, factoring transactions are regarded as loans, and thus subject to exposure limits set by the Banking Law and the Bank Regulation and Supervision Agency (BRSA). Therefore, many banks have set up factoring subsidiaries, and of the 108 factoring companies operating at the end of 2001, 26 were bank subsidiaries. Although the total volume of factoring transactions grew from US$100 million in 1990 to US$3.6 billion in 2001, factoring transaction volume in Turkey as percent of GDP, while at par with or higher than in some other emerging markets, is still considerably below the levels achieved in several more developed economies (Table 25). Additionally, the growth of factoring activity in Turkey has actually been in decline for several years and turned negative in 2001 as a result of the banking crisis in that year, mainly due to a sharp fall-off in domestic factoring activity where post crisis the credit risks are very high, while the number of players is increasing (Tables 26 and 27). The industry in aggregate also for the first time incurred a loss of almost US$42 million in 2001 after having been profitable the previous four years.[104] Thus, as is the case in the leasing industry, the factoring industry appears to have too many players sharing a shrinking volume of business, setting the industry up for rapid consolidation/exit of the marginal players. The share of export factoring transactions in total factoring transactions in Turkey is high when compared internationally, reflecting the importance of exports to the Turkish economy (such high and even higher rates are not unusual, however, for export oriented emerging market economies; for example, the comparable rates in 2001 were 38% for Taiwan, 50% for Hong Kong and 89% for Israel).

Factoring is an important source of short term financing for SMEs that do not have easy access to bank loans, and helps them meet cash management needs. Export factoring, in addition to guaranteeing payment and accelerating the transfer of export proceeds, has the additional advantage of simplifying export transactions for SMEs which generally are not familiar with such transactions, and thus helps stimulate exports (see Box 6).

Medium Terms Targets

Once economic stability is restored, Turkey should at a minimum be able to return to pre-crisis growth rates of factoring transactions volume of 25–30% annually. Such a level of growth should

---

[102] All factoring companies with less than TL1 trillion minimum capital as of August 19, 2001 were required to reach TL1 trillion minimum capital by August 19, 2002; these companies and all companies with capital below TL2 trillion as of the same date are required to reach the TL2 trillion level by August 19, 2003; and these companies and all companies with capital below TL3 trillion as of the same date are required to reach the TL3 trillion level by August 19, 2004 as per Regulation 24498 issued on August 19, 2001.

[103] Defined as the remaining balance after deducting the losses if any, from the sum of paid-in capital, reserves, premiums and half of the profit figure indicated by the balance sheet which is prepared quarterly.

[104] The industry returned to profitability, though, in the first half of 2002-but with a much lower asset base; enhanced competition is thus likely to put further pressure on the profit margins of the smaller industry players.

TABLE 25: FACTORING—CROSS COUNTRY COMPARISON

(DATA FOR 2001 IN US$ MILLION)	VOLUME			GDP	TOTAL VOLUME AS % OF GDP	EXPORT FACTORING AS % OF TOTAL
	DOMESTIC	EXPORT	TOTAL			
Argentina	886	15	901	268,773	0.3%	1.7%
Brazil	9,746	18	9,764	502,509	1.9%	0.2%
India	576	35	611	477,555	0.1%	5.8%
Italy	106,320	4,430	110,750	1,090,910	10.2%	4.0%
Korea	18	58	75	422,167	0.0%	76.5%
Mexico	5,927	177	6,105	617,817	1.0%	2.9%
Poland	2,685	266	2,950	174,597	1.7%	9.0%
South Africa	4,873	71	4,944	113,274	4.4%	1.4%
Spain	20,289	620	20,910	577,539	3.6%	3.0%
Turkey	2,658	975	3,633	147,627	2.5%	26.8%
United Kingdom	117,200	6,698	123,898	1,406,310	8.8%	5.4%
United States	110,750	3,544	114,294	10,171,400	1.1%	3.1%

Source: World Bank, Factors Chain International.

TABLE 26: DEVELOPMENT OF THE TURKISH FACTORING INDUSTRY

(US$ BILLION)	1996	1997	1998	1999	2000	2001
Number of Factoring Companies	58	87	92	100	113	108
Total Financial System Assets	93,466	104,781	131,618	149,427	174,076	133,593
Factoring Company Assets	777	385	1,428	1,800	1,891	1,071
Factoring Company Assets as % of Total System Assets	0.83%	0.37%	1.08%	1.20%	1.09%	0.80%
Factoring Company Assets as % of GNP	0.41%	0.20%	0.69%	0.97%	0.94%	0.73%

Source: See Table 1.

TABLE 27: ANNUAL GROWTH RATES OF FACTORING TURNOVER

	1997	1998	1999	2000	2001
Argentina	335.6%	17.4%	44.3%	15.8%	–40.7%
Brazil	–3.7%	632.6%	24.9%	–29.4%	–8.3%
India	62.4%	–47.5%	47.3%	82.9%	46.8%
Italy	46.4%	10.8%	16.8%	25.0%	13.6%
Mexico	12.5%	31.0%	40.9%	41.7%	37.0%
Poland	285.8%	85.7%	–0.6%	244.6%	59.7%
Spain	27.0%	32.5%	26.1%	55.6%	21.0%
Turkey	102.5%	32.6%	29.9%	21.7%	–35.8%
United Kingdom	65.1%	7.7%	22.5%	19.9%	13.0%
United States	32.8%	–1.7%	62.2%	15.2%	7.5%

Source: Factors Chain International.

BOX 6: STATE OF DEVELOPMENT AND ADVANTAGES OF FACTORING

Factoring is a global industry with a vast turnover, and has become well established in both industrialized and developing countries. In recent years, the growth of factoring has been dramatic in various Asian countries, while in Latin America, financial institutions continue to join the industry. Similar growth has occurred in Eastern Europe and the Baltics. Hundreds of thousands of businesses with millions of customers worldwide currently use factoring companies. They do so because factoring gives them the benefits of consistent cash flow, lower administrative costs, reduced credit risks and more time to concentrate on their core business activity. Assigning domestic and international accounts receivable to a factor is a flexible way of managing trade debts. Money normally owed on either short or open terms can be factored. The factor will also provide professional help with credit control, debt collection and sales accounting.

Most factors are owned by or associated with well-known international banking or other financial institutions, and businesses that turn to factoring companies are reassured that the industry is closely related to banking. Although factoring companies remain highly specialized institutions, nearly all major banks now have factoring subsidiaries. This has enabled the industry to promote its services with great success and to work for businesses of every size, and factoring is now universally accepted as vital to the financial needs of small and medium-sized businesses.

One of the greatest problems facing exporters is the increasing insistence by importers that trade be conducted on open account terms. This often means that payment is received many weeks or even months after delivery. Unsurprisingly, many exporters find that giving buyers credit in this way can cause severe cash flow problems. Further problems can arise if the importer delays payment beyond originally agreed terms, or makes no payment at all because of financial failure. International factoring provides a simple solution regardless of whether the exporter is a small business or a major corporation. The role of the factor is to collect money owed from abroad by approaching importers in its own country, in its own language and in the locally accepted manner. A factor can also provide exporters with 100% protection against the importer's inability to pay. The advantages of export factoring have proven to be very attractive to international traders. It is now seen as an excellent alternative to other forms of trade finance, and the role of the letter of credit is gradually diminishing as a consequence. Typical services provided by factoring companies include investigating the creditworthiness of buyers, assuming credit risk and giving 100% protection against write-offs, collection and management of receivables and provision of finance through immediate cash advances against outstanding receivables.

The advantages for importers are that they can buy on open account terms. They do not need to open letters of credit and can expand their purchasing power without using existing lines of credit.

Source: Factors Chain International Annual Report 2001.

allow factoring to achieve a modest expansion in its share of total financial system assets, from less than 1% currently to perhaps 4–5% over the medium term. A higher target growth rate may be warranted, however, given the importance of the SME sector to economic growth and exports. Higher growth rates (for example, 45–50%) are not unusual in economies going through rapid development (Table 27). Thus, it is of key importance that policy issues hindering growth of this industry are addressed.

Policy Recommendations

Need for New Legislation. Law-empowered Decree no. 545 regulating factoring is basically an amended version of the earlier law-empowered Decree no. 90 which deals with money lending operations, and therefore treats factoring as a simple money lending operation rather than as a full-fledged financial/commercial service. This approach has two negative impacts on the factoring industry: (i) since factoring is regarded as a simple money lending operation, its image is nega-

tively influenced by the shady activities of some money lenders (shylocks) in the market; and (ii) due to being regarded as a simple money lending operation, services provided by factoring, especially the "advance payment" function of factoring, are underrated and not enough attention is given to other problems of the factoring industry. Therefore, factoring needs a new law and regulatory framework that would differentiate it from simple money lending, and provide a separate identity to factoring operations. The new law should set minimum standards for the management of factoring companies to comply with, and specify the tools to be used to manage the key risks in factoring operations (for example, specialized tracking software to detect fraudulent issuance of receivables by producers/exporters, and to monitor the payment behaviour of buyers/importers). Consideration should also be given to introducing an FX exposure limit for factoring companies to ensure they do not fund domestic receivables with FX borrowings. For bank-owned factoring companies, such exposure limits could be part of the consolidated FX exposure limits applicable to the bank and its factoring and other financial subsidiaries combined. Furthermore, the consolidated large and connected exposure limits applicable to banks and their factoring and other financial subsidiaries combined should recognize that the credit risk of factoring companies is not primarily on the producer/exporter in case the factoring company has provided pre-financing, but on the issuers of the receivables, which serve as self-liquidating collateral for the pre-financing provided to the producer/exporter. Finally, bankruptcy and creditor rights legislation should be upgraded[105] to facilitate quick execution of overdue receivables held by factoring companies.

Need for Industry Consolidation. To encourage industry consolidation, the existing TL3 trillion minimum capital requirement should be rigorously enforced, and licenses revoked in case of non-compliance. Consideration should also be given to introducing certain minimum turnover standards for factoring licenses,[106] and to providing tax incentives for mergers of factoring companies.

Need for Credit Evaluation/Rating Services and Reverse Factoring. In markets where factoring is well developed, factors are often able to rely on sophisticated outside credit evaluation and rating services for the management of their credit risk. Such services (e.g., as provided by companies like Dun & Bradstreet) can provide factoring companies with high quality information on the credit risk underlying receivables offered for factoring. While such services typically are provided by private sector entities on a for profit basis, the Government may be able to facilitate their development by identifying and seeking the removal of legal obstacles (such as secrecy and privacy considerations embedded in law) to the sharing of credit related information on companies with third parties like factors. In the interim period until credit evaluation and rating services are well developed, the factoring industry might want to focus on so-called reverse factoring as one of the more viable lines of business. Such reverse factoring involves the selective purchase by factors of only high quality receivables, oftentimes issued by foreign-owned companies with good name recognition and high credit grades, rather than the purchase of a client's overall outstanding receivables portfolio. This technique has been quite successfully used in some other emerging markets to jump start the factoring industry (for example, in Mexico where factors selectively purchase receivables of suppliers-mostly SMEs-to companies like Wal-Mart).

Tax Issues. Factoring companies, like banks doing factoring on their own books, are subject to BITT both on their borrowing and on their lending. Banks, however, pay only 1% BITT on their borrowings, while factoring companies pay 5% (both pay 5% on their lending). In anticipation of

[105] A formal Assessment of the Insolvency and Creditor Rights Framework recently undertaken by the World Bank in cooperation with the Turkish Government provides specific recommendations in this regard.

[106] These should be structured to weed out those companies that are not truly in the factoring business, while not unduly limiting competition.

full abolition of the BITT, to further encourage development of the factoring industry and to establish a level ground for competition, the BITT rate on borrowing by factoring companies should be lowered to 1%. Such a reduction, given the small size of the factoring industry, should have negligible fiscal implications. Just as in the case for the BITT, there is a difference between banks and factoring companies in the treatment of provisions for doubtful receivables. While banks are able to treat specific provisions as a tax deductible expense, factoring companies can only provision for losses when such losses are established through a legal process certifying the debtor's insolvency. In the current economic situation where credit risk is very high, especially on domestic factoring transactions without recourse, provisioning for potential losses on such transactions and being allowed to treat these provisions as a tax deductible expense is crucial for factoring companies and for revival of the domestic factoring business. Also, tax deductibility of specific provisions for factoring companies would create a level playing field for all factoring activity, and eliminate the competitive advantage banks now enjoy over stand-alone factoring companies when they do factoring transactions on their own books.

Export insurance. As noted, factoring companies in Turkey are actively involved in factoring for exports. In developed markets, there are factoring companies on the importer's side which have correspondent relationships with Turkish factoring companies, and these companies operate as guarantors for export payments. Risks for the factoring companies increase when exports are made to markets where there are no corresponding factoring companies to provide such security. In order to reduce this risk, factoring transactions involving such markets could be covered by export credit insurance (either country risk coverage only, or a combination of country and commercial risk coverage on a time-limited basis). Since a considerable portion of Turkish export are to the Central Asian republics, such an insurance scheme could help in increasing the volume of exports to these markets. Therefore, coverage of such risks by the Turkish Export-Import Bank could be considered.

Developing the Venture Capital Industry

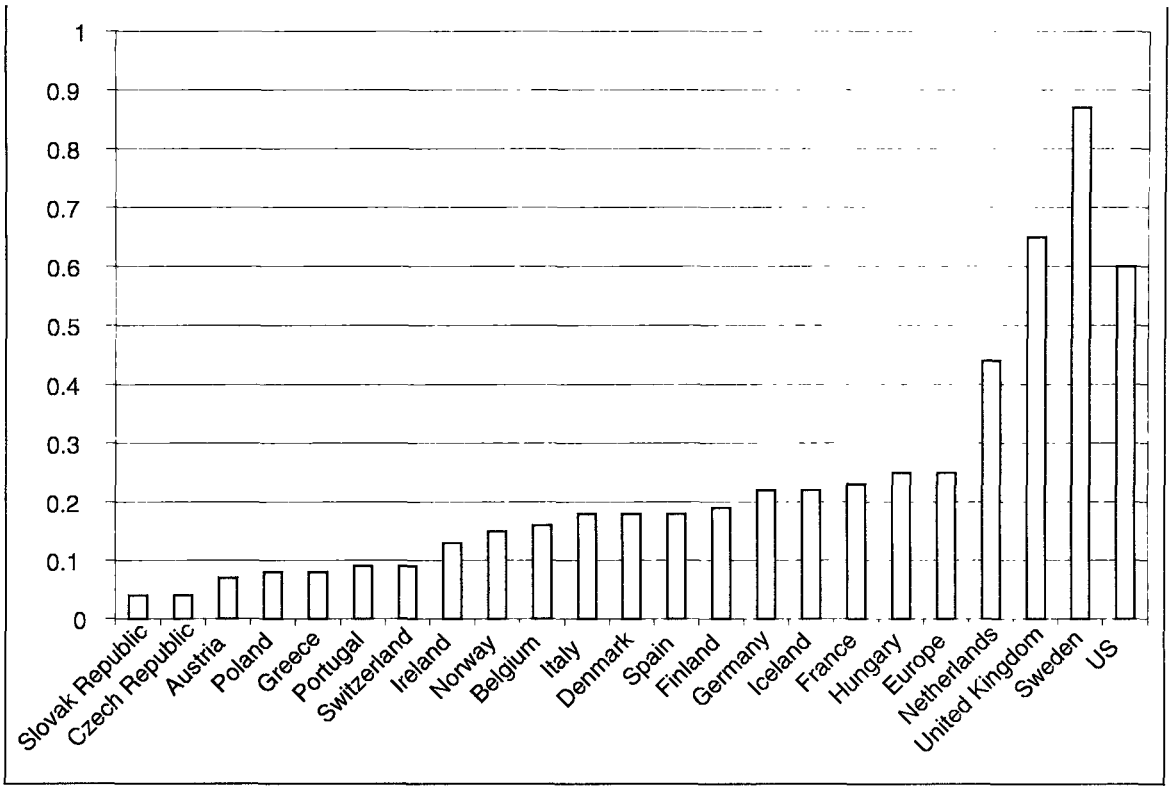
Current Situation

The rules governing the formation and operation of publicly traded Venture Capital Investment Trusts (VCITs) are set out in a 1993 Communiqué of the CMB, and such trusts are regulated and supervised by the CMB.[107] VCITs are exempt from corporate income tax, and VCIT investors are exempt from personal income tax. Despite such generous tax treatment, today there is only one VCIT operating in Turkey with very low total assets (US$2.7 million as of end 2001), representing a negligible percentage of GDP. This puts Turkey at the bottom of the scale when compared with other countries (Figure 6). On top of that, the Turkish venture capital investment trust is currently only 65% invested in venture companies, a somewhat lower percentage compared with many other countries were venture funds are typically 70% invested, with about 30% of their capital in cash or marketable securities to facilitate subsequent investments and ensure liquidity. Venture capital trusts in the United Kingdom are actually required to keep at least 70% of their capital invested in eligible companies, as are Canadian venture capital companies. The CMB acknowledges that it has not been successful in facilitating the establishment of VCITs at the desired level, and has indicated it has plans to improve the regulatory framework for these trusts.

Venture capital investments reportedly have not taken off in Turkey partly because competing private sector investment returns have been unusually high as a result of investment of excess liquidity in high yielding Government paper. Thus, once yields on Government paper and hence private sector investments normalize, venture capital investments should become relatively more

[107] Venture capital companies organized in a form other than VCITs are not subject to CMB regulation. There currently do not appear to be any such non-VCIT venture firms in Turkey, although reportedly at least one venture capital company is arranging to make venture capital investments in Turkey through an offshore vehicle.

FIGURE 6: VENTURE CAPITAL—PRIVATE EQUITY INVESTMENT AS % OF GDP IN 2001 —CROSS COUNTRY COMPARISON



Note: Private Equity, providing equity capital to enterprises not quoted on a stock market, refers to all stages of industry, such as Venture Capital and Buyouts, while *Venture Capital* refers to Early-Stage (=seed and start-up) and Expansion finance.

Source: European Venture Capital Association.

attractive and capable of producing the excess return required to compensate for the risk involved. For the industry to really take off, however, it is important that a number of structural barriers to venture capital investment (either through private or public equity investments) are addressed:

- Legal and accounting environment:
  - Contract/corporate law: it isn't clear how effective shareholder agreements are in limiting actions by majority owners of companies;
  - Corporate law/governance: the rights of minority shareholders are not sufficiently protected; weaknesses in minority shareholder rights are reportedly the reason why at least one venture capital fund planning to do business in Turkey has chosen to incorporate offshore;
  - Accounting and other disclosure standards, particularly for private companies, are not in line with best practice standards;
- The usual methods to exit from venture investments are not easily accessed:
  - A mergers & acquisitions market is not well developed;
  - Volatility of equity markets and listing requirements make IPOs problematic;[108]

[108] See Levent Bosut, *Role of Advisors and Cooperation Attempts, Presentation to Turkish Venture Capital and Private Equity Association* (June 2002), http://www.turkvca.org/Articles/PLeventBosut_20020624.pdf

- There is no dedicated new companies segment on the ISE that can be used by venture capitalists to exit their investments;
- Investor preferences for short-term investments and lack of institutional investor base;
- Owner hostility to selling equity, let alone sharing control with venture capital firms.

BOX 7: VENTURE CAPITALIST FUNDING

Venture capitalists provide long term funding to assist new companies to grow, and often provide management advice and expertise to the companies in which they invest. Therefore, they can play a crucial role in enhancing the development of small and medium sized enterprises, which are important engines of economic growth.

In most countries, venture capital funding comes from direct investment by banks, pension funds and insurance companies in individual enterprises and private equity investment through the purchase of venture capital funds, the managers of which then make the direct investments. Very few of these funds or their managers raise capital through publicly offering their securities via a prospectus. The investors in these private pooled funds or limited partnerships are generally high net worth individuals and institutional investors. There are some listed venture capital funds in the US, the UK and Canada; however, publicly traded venture capital investment vehicles are the exception.

In both the UK and Canada, there are programs to encourage investments in SMEs by retail investors. In the UK these are called Venture Capital Trusts and in Canada, they are called Labor Sponsored Venture Capital Companies. In both cases, the funds are offered by prospectus and investors receive significant tax deductions for their original investment, plus additional tax incentives in the form of reduced capital gains taxes and/or exemptions for dividend income. These tax benefits must be repaid if the investment is sold before the expiry of a set period (5 years in the UK program and 5–8 years or before age 65 in the Canadian program). The venture capital vehicles are subject to investment rules regarding the nature of the companies in which they can invest, and the minimum aggregate amount that must be invested in venture companies rather than other instruments.

In the US, the venture capital industry was relatively small until the Government reduced income tax rates on long-term investments and expressly allowed pension funds to invest in venture capital entities. Exit options in the US markets were enhanced by the formation of the NASDAQ which made listing of IPOs less difficult.

Other countries have established special programs or tax incentives for venture capital companies making direct investments in SMEs. For example, Trinidad and Tobago established a Venture Capital Incentive Program. This program was introduced in 1994 to promote the formation of Venture Capital Companies (VCCs) to make arm's length equity investments. There are provisions for tax credits to be granted to investors in VCCs. The prime objective is to increase the supply of risk capital to the entrepreneurial business sector, thus fostering the expansion and preservation of businesses as well as creating new jobs. The program is described at http://www.vcip.org/the_programme.htm.

The Israeli model is particularly interesting. In 1993, the Israeli Government provided US$100 million "seed capital" to the industry. An investment company—Yozma Venture Capital—was created that then used the capital to establish 10 funds (see http://www.yozma.com/overview/default.asp). Additional capital for each of the funds was raised from strategic partners, including foreign industrial companies (like Daimler Benz), foreign venture capitalists (e.g., Advent International) and domestic and foreign pension funds and private investors. Yozma invested US$8 million in each fund and the Government gave its strategic partners a 5-year option to buy out its share. It also made 15 direct investments. By 1997, the option had been exercised on 8 of the funds and 8 of the 15 companies directly invested in had gone public or had been acquired. Before the program was established, the Israeli venture capital industry was very small In 1991 only US$58 million in venture capital was raised. By 2000, more than US$6.5 billion was under management (of which 25% was in cash) and over US$2.3 billion new funds were raised during that year (see http://www.reseaucapital.com/JT2001/Yigal_Erlich.pdf).

Medium Term Targets

Given the very nascent state of the venture capital industry in Turkey, there is significant scope for development. At a minimum, during the next 3-5 years Turkey should aim to reach the level of venture capital funding seen in the more advanced Eastern European countries (upwards of 0.08% of GDP). A more ambitious target could be pursued if Turkey decided to adopt a targeted program to develop the industry, as was done, for example, by Israel (see Box 7 on previous page).

Policy Recommendations

The impediments to venture capital outlined above should be alleviated by implementing the recommendations contained elsewhere in this report (for example, improving corporate governance and the protection of minority shareholder rights, upgrading accounting & auditing standards and practices, creating a new companies market segment at the ISE, etc.).

Additionally, the Government and the CMB should encourage institutional investors such as banks, insurance companies, pension funds and collective investment schemes to invest in venture companies. The new regime for private pension plans allows these plans to invest up to 5% of their assets in venture capital investment trusts; this allowance should also be made available for investments in venture capital companies organized in a form other than VCITs (limited partnerships, closely held joint stock companies). Where there are restrictions on the investments other institutional investors may make in non-listed securities such as those issued by venture capital companies, they should be modified to permit these investors to place up to 5% of their portfolio in this type of firm or in publicly traded VCITs.

The CMB, working with TSPAKB, the Turkish Venture Capital and Private Equity Association, and other interested parties, should undertake a study of the venture capital industry in Turkey as compared to other developing[109] and developed countries to determine what specific improvements might be made in the legal or business environment governing venture capital investments. These improvements should then be implemented. Given the experience in other countries, it may be necessary to broaden the tax incentives for venture capital development beyond the publicly traded investment trust vehicle to other forms of venture capital such as limited partnerships or closely held joint stock companies. While such forms of venture capital company are typically not regulated by the securities markets regulator, it might be advisable for the CMB to encourage such companies to become members of the Turkish Venture Capital and Private Equity Association, so that a central source of information on the state of development of the industry will be available, against which the authorities could benchmark progress towards reaching their venture capital development goal.

Once some of the impediments identified above have been reduced, the Government should consider implementing a specific program to foster the venture capital industry in Turkey. An overview of such programs undertaken in other countries can be found in Box 7. The Israeli program appears of particular interest.

---

[109] There is not much literature on fostering venture capital in developing countries. However, the Kennedy School of Government at Harvard University has a number of interesting articles. See http://www.ksg.harvard.edu/dvc/. One of the models advocated would involve international financial institutions acting as guarantors of venture capital investments.

CHAPTER VI

STRENGTHENING CONFIDENCE IN FINANCIAL MARKETS

Section 1. Market-Wide Objectives

Improving Corporate Governance

Current Situation

In a survey of corporate governance of 23 major emerging markets, Turkey ranked 11th, stronger than Indonesia, Russia and the European Union-accession countries but weaker than Brazil, Argentina or India.[110] The primary corporate governance weaknesses in Turkey derive from the structure of the corporate sector, which is dominated by mixed industrial-financial conglomerates. Thus, the same holding company may include companies whose shares are publicly traded on the ISE and those whose equity is privately held by founding families. The resulting structure can create weaknesses in the rights of both minority shareholders and other stakeholders. As in many emerging markets, the most common forms of corporate governance abuse are generally tied to related party transactions. They are: (i) transfer pricing, where products are sold at off-market prices to affiliated companies to reduce tax liabilities or dividend distribution obligations, (ii) asset stripping, where assets are transferred among affiliated companies to put them out of the reach of creditors or minority shareholders, and (iii) share dilution, where dominant shareholders may instruct the company to issue new capital to specific classes of shareholders to the detriment of other shareholders.

Medium Term Target and Policy Recommendations

Turkey should strive to improve its overall corporate governance regime and associated outside corporate governance ratings, with a view to position itself higher up in the league of emerging

[110] Credit Lyonnais Securities (2002) rated major emerging markets as Indonesia 2.9, Czech Republic 3.1, Poland 3.5, Russia 3.6, Philippines 3.6, Thailand 3.8, Hungary 4.2, China 4.2, Turkey 4.7, Brazil 5.1, Argentina 5.2, South Africa 5.9, India 5.9, Mexico 6.1, Singapore 7.4.

markets. Towards this end, the corporate governance regime should be improved through: (i) enhancing transparency and disclosure of ownership and control structures, (ii) strengthening the oversight provided by companies' governing bodies, and (iii) training members of boards of directors, as further elaborated below.

Transparency and Disclosure. While the CMB requires disclosure by public companies of direct shareholdings of 10 percent or more and those working in cooperation, it does not explicitly require disclosure of indirect shareholdings of 10 percent or more, as mandated in the EU by the applicable Directive.[111] Such explicit disclosure of indirect shareholdings should be mandated, preferably by company law or the Capital Markets Law[112] rather than by CMB regulation.

Ownership information held by TB, acting as a central depository, has been limited to the shareholdings of the free float, that is, the shares that are publicly traded (and under the listing rules of the ISE, the free float may be as low as five percent of the company's equity, with the balance privately held). The recently created central share registry will mark some improvement in this respect, since it will hold information on all shareholders of publicly traded companies. However, the registry is not expected to be fully operational until 4–5 years from now, and although the identity of the beneficial owners of shares held in nominee name will be made available to Government regulators, such as the CMB, it will not be made available to investors or market participants, except when a significant change in shareholder composition constitutes a material event requiring disclosure under applicable CMB regulation. Consideration should be given to substantially accelerating the operationalization of the new central share registry and centralization of ownership records allowed by the planned full dematerialization of securities (that is, a time table of 2–3 years rather than 4–5 years). Additionally, once ownership information is available in an electronic, centralized form, consideration should also be given to allow access to this information-to the extent ownership disclosure is required by the company law-through creation of an electronic link with the company register which is also being transitioned to an electronic form (see below).

Strong corporate governance also requires ease of public access to company articles of association. In principle, these articles are available from the trade registries in the city in which a company is located, and the existing Turkish Commercial Code mandates disclosure of ownership information. However, the 236 trade registry offices nation-wide are not electronically connected, and interested persons are obliged to visit the local office to obtain copies of the articles. The Union of Chambers of Commerce has initiated an ambitious US$10 million project to provide centralized electronic access through the internet, but the program is expected to take five years to be implemented[113]. In addition, there are currently no plans to create electronic links between the central share registry and the trade registry, which would better enable shareholders (and other stakeholders) to obtain current information on a company's shareholding structure. The new company law should specify the requisite level of ownership disclosure of publicly held companies through the company register. At a minimum, information on shareholders of record should be made available to the general public. The merit of routine disclosure of the identity of beneficial owners holding

---

[111] European Union Second Directive 2001/34/EC of May 28, 2001which may be found at http://europa.eu.int/eur-lex/en/archive/2001/l_18420010706en.html.

[112] While the Capital Markets Law, Article 16A, currently already authorizes the CMB to require such disclosure, disclosure is not automatic and relies on the discretion of the CMB to ask for it in individual company cases, which is a second best solution. The planned overhaul of the Commercial Code would provide an opportunity to make this disclosure automatic and more explicit for all publicly held companies. Alternatively, the Capital Markets Law could be amended for this purpose.

[113] The CMB and the ISE plan to operationalize a website within the next six months on which they wil disclose the articles of incorporation of all ISE listed companies, which is a subset of all publicly held companies. This will fill part of the current void until the new electronic trade register is up and running.

shares in nominee name should be judged in the context of a decision on replacing the current mixed system of registered (mostly traded) and bearer (mostly non-traded) shares with a registered shares only system.

Reliable financial reporting is the keystone in building investor confidence. Significant reform in the accounting and auditing regime will be necessary to ensure such high quality financial reporting, not only by listed and publicly held companies, but also by other public interest entities such as financial institutions (such as banks, insurance companies, pension funds, mutual funds). Recommendations in this area are detailed in the section of this chapter on "Strengthening Accounting and Auditing Standards and Practices."

Strengthening Oversight by Governing Bodies. Improving corporate governance in Turkey will also require strengthening of the roles and responsibilities of two governing bodies of Turkish corporations: (i) shareholders' meetings, and (ii) boards of directors. Court decisions have confirmed the implicit right of shareholders' meetings to approve large asset transfers that in effect could change the nature of a publicly traded company's business. However, specific authority for such approvals should be provided by law and should apply to all joint stock companies, not just to those traded on the ISE. Similarly, approvals for the creation of subsidiaries and affiliates should be made by the shareholders' meeting, since affiliated companies can be used to facilitate transfer pricing within a business group. In addition, the legislation sets low quorums and minimum voting requirements for joint stock companies, even for such important issues as changing a company's articles of association. While 50 percent of share capital must be present at the shareholders' meeting, only 50 percent of the votes present are required to give approval (rather than the usual 75 percent). A still greater weakness are sections in the commercial code and the capital markets law (in effect, the so-called "registered capital" system) that allow the shareholders' meeting to authorize the board of directors to issue new share capital without maintaining pre-emptive rights of existing shareholders and for an unlimited period of time. While temporary limitations on such rights can be a practical way to facilitate IPOs, to raise a company's free float and to bring in new shareholders, any blanket approvals for authorized but un-issued capital should have sunset provisions, so that existing shareholders are not at risk of permanently losing their pre-emptive rights. In this context, Turkey should seek harmonization of both the commercial code and the capital markets law with the applicable EU Directive, which specifies a maximum duration for limiting shareholders' pre-emptive rights of five years, after which the board of directors would have to seek general shareholders' meeting permission to extend the limitation for another five years.

In addition, the functioning of board of directors of joint stock companies, and in particular the election of members of such boards, should be improved. In Turkey, even institutional investors with 30 percent of the voting shares of a company would be unable to gain a single representative on a large vote. Privileged shareholders, which in Turkey are typically members of the family of the company founder, generally have multiple voting rights on the election of the board of directors. Furthermore, there are no provisions that would allow minority shareholders to obtain a representative, such as through cumulative voting[114]. To strengthen minority shareholder rights, the presence of multiple voting rights should be better disclosed and at the same time restricted in some fashion, either by ISE listing rules placing caps on their use for all listed companies, or by requiring a large majority of shareholders (for example, two-thirds) to approve them, or by the new commercial code. Also, cumulative voting rules should be introduced in the new commercial code, with their use possibly initially being voluntary. Once an institutional investor base has emerged that would be able to efficiently administer such rules (which are quite complex), cumulative voting could be made mandatory for all companies with large numbers of shareholders.

[114] In cumulative voting, each shareholder can accumulate his votes for one board member, or distribute them among the roster. Thus, for a five-person board, using cumulative voting, a minority shareholder with 20 percent or more of the shares could elect one representative.

The commercial code does not prescribe a minimum frequency of board meetings, leaving that to the company's articles of association. Although in practice the Ministry of Industry and Trade (which must approve the articles of association of all joint stock companies) requires monthly or bi-monthly meetings, a provision for at least quarterly meetings should be included in the commercial code.

Boards of directors will also need guidance concerning their roles, responsibilities, functions, operation and structure. Boards of directors of publicly traded companies should be encouraged to have a minimum number of independent directors, with the non-executive directors represented on key board committees, such as risk exposure and management, nomination, finance and audit. The guidance for boards is generally provided by voluntary corporate governance codes (discussed below) which endeavor to identify best practice for the business and financial sectors, rather than by law. For example, the codes of France and the Netherlands recommend (but don't mandate) that the board of directors include an audit committee within the board with specific responsibility for financial and auditing matters[115]. An exception is the recently approved Sarbanes-Oxley Act in the US, which was adopted in response to a series of corporate scandals. This Act envisages that audit committees and nomination/compensation committees should be composed entirely of independent directors to avoid management over-reaching. While in an emerging markets context this may not be feasible given that most companies are family controlled, the Sarbanes-Oxley Act has set a new best practice standard in this area that should be given serious consideration. In this context, thought should be given to the extent to which the new commercial code should guide companies in the direction of having independent internal audit committees.

At the same time, consideration should be given to other corporate governance mechanisms. For example, the role of the Turkish board of auditors, elected by the shareholders' meeting, would better be fulfilled by independent external auditing companies,[116] under the supervision of a new Chamber of Auditors for the auditing industry (see the section in this chapter on Strengthening Accounting and Auditing Standards and Practices).

Also of importance in Turkish corporate governance are the roles of the Ministry of Industry and Trade (MOIT) for all joint stock companies and the CMB for publicly listed companies. In addition to approving all changes in companies' articles of association, the MOIT must send a representative to the annual shareholders' meetings of all 89,000 or so joint stock companies in Turkey. The MOIT representative plays an important role in checking the shareholders' register and counting the votes of the shareholders' meetings, and indeed the decisions of the meeting would be considered null and void if the representative were not present. For the 850 companies that are registered with the CMB, the CMB attends the shareholders' meetings (although as an observer), and in addition approves changes to companies' articles of association.

The strong role of the MOIT in shareholders' meetings could be replaced by private sector organizations, working under the supervision of the MOIT. These could include, for example, independent share registrars, that would also be responsible for maintaining the shareholders' register. Similarly the CMB, through a prior approval requirement for all amendments to the articles of association of publicly held joint stock companies, plays an important role in requiring that publicly traded companies delete from their articles of association any measures that, while permitted under the commercial code, could be implemented to abuse shareholders' rights. For both types of activities, a more efficient solution would be to include stronger shareholder rights provisions and stronger enforcement powers for the CMB in the governing legislation to avoid and resolve abuses of shareholder rights.

---

[115] A full listing of world-wide audit committee practices can be found in Good Practices for Meeting Market Expectations, prepared by Price Waterhouse Coopers at http://www.pwcglobal.com/extweb/pwcpublications.nsf/docid/253e1c17db806b13802569a10036c92d.

[116] This idea is already under consideration as part of the planned overhaul of the Turkish Commercial Code.

Director Training. In addition to amending the commercial and the CML, it may be helpful to consider measures that encourage the business sector to take an active role in strengthening corporate governance through both informal and formal training of directors. Available mechanisms for this purpose include: (i) preparation of a voluntary corporate governance code, and (ii) establishing an institute of directors.

Virtually all stock exchanges in developed markets and in most emerging markets have prepared voluntary corporate governance codes.[117] Following the approach of the London Stock Exchange, for which the business advisory task force known as the Cadbury Commission developed a corporate governance code, many emerging markets have taken the approach of requiring mandatory disclosure of the extent of compliance with the code. The important value-added of corporate governance lies in the educational impact of a broad-based discussion of the provisions of the code as it is being drafted and revised, although an established corporate governance code may also be helpful in setting a benchmark for industry practice, against which a court of law can determine the extent to which directors have met their fiduciary responsibilities.

Emerging markets from Thailand to Russia to South Africa have leaned on institutes of directors to provide formal training for boards of directors on not only their legal obligations as board members, but also best practices for strengthening the governance of their companies. While institutes of directors could be established under the auspices of the CMB, best practice internationally and the approach of the US National Association of Corporate Directors is to encourage business-sector leaders to found and operate the institute of directors.

Strengthening Accounting and Auditing Standards and Practices

Context

During the past two decades, state intervention in the economy, chronically high inflation and high fiscal deficits all have repressed the development of financial markets, and hence the impetus for modernization of the Accounting and Auditing (A&A) regime for the corporate sector in Turkey. More recently, however: (i) state intervention in the economy is reducing and the role of the market is increasing; (ii) chronically high inflation and high deficits are giving way to more stable prices and fiscal discipline, reversing the crowding-out of the private sector from financial markets; (iii) the hitherto crisis-prone banking sector may lose some of its intermediation role to capital and financial markets; (iv) family-controlled enterprises with little accountability to external stakeholders are likely to move towards raising capital from the markets to fund new investment once growth picks up, requiring greater transparency and improved corporate governance; and (v) economic inter-linkages will increase as Turkey integrates with the European and global economy. As a result, A&A arrangements in Turkey are at a crossroads.

The shortcomings of previous arrangements have contributed at least partially to the recent crises. Equally, the benefits of moving to standards and institutions which are based on international requirements and best practice are now being recognized, and have been reaffirmed by recent developments in the EU, which mean that convergence on the EU's *acquis communautaire* is consistent with moves to international norms. To undertake these reforms, however, a break in long-established and ingrained practices is required. Fragmented approaches, based on a multiplicity of stand-alone special purpose accounting and auditing systems for confidential use, need to give way to a coordinated effort to put in place a single robust general-purpose system, which treats disclosure and transparency as public goods available to all market participants. Individual users may require supplementary information, building on a common platform, but this should

[117] A listing of corporate governance codes by European countries can be found at the website of the European Corporate Governance Institute at http://www.ecgi.org/codes/menu_europe.htm. Codes of emerging markets world-wide can be seen on the World Bank website at http://www.worldbank.org/html/fpd/privatesector/cg/codes.html.

remain within reasonable limits. A culture of control and inspection by each agency of the information it receives should shift to one which can rely on high quality financial statement audit providing assurance to a range of users, and the governance structures of the accountancy profession should evolve accordingly.

Current Situation

Legal and Regulatory Framework

The basic A&A obligations which apply to companies in Turkey are laid down in the Commercial Code, which was last revised in 1956. Chapter V of Book One of the Code sets out certain minimum book-keeping requirements, but these do not govern the preparation or publication of financial statements as such. Chapter IV of Book Two contains provisions with respect to auditors of joint stock companies. These cannot be more than five in number, and if there is more than one, together they form the Board of Auditors. Limited liability companies are required to have one auditor if the number of shareholders is greater than twenty. Their task is to oversee the affairs of the company by checking its transactions and accounts, by verifying that the statutory books have been properly kept and that the accounts have been drawn up accordingly. However, the functions of such auditors do not correspond to the audit of financial statements as this is understood elsewhere (for example, under the EU Company Law Directives). Instead, their role is to ensure the formal correctness of certain actions of the company, and there are no licensing, qualification, or education requirements to be met in order to be appointed.

More detailed requirements were introduced in the Tax Procedures Law of 1950 (which has since been consolidated into the Tax Procedures Code). Under the powers granted to it by the Code, the Ministry of Finance (MOF) introduced a Uniform Chart of Accounts which became effective on January 1, 1994. This prescribes certain fundamental accounting concepts, a code of accounts, and a format for the presentation of financial statements which, with the exceptions listed below, is applicable to all limited liability companies. (There are simplified requirements for small businesses, which constitute the majority of taxpayers by number.) The purpose of these requirements is to provide information to the taxation authorities; there is no obligation to publish the financial statements, nor are they subject to a mandatory financial statement audit. Large companies are required to have their financial/tax statements certified by a Sworn Certified Public Accountant (see below), but this process of certification is concerned with tax compliance issues, and is not a financial statement audit.

Under the Capital Markets Law, the CMB has powers to regulate companies whose shares are traded on the ISE; other companies which have issued, or plan to issue, shares to the public; mutual funds; investment funds; and financial intermediary companies. Among the objectives of the CMB are ensuring full transparency and disclosure. Since 1983, the CMB has issued decrees governing financial reporting by the companies which it regulates. These requirements are in addition to those laid down by the MOF for tax reporting purposes. All CMB-regulated companies must publish and file their audited annual financial statements with the CMB (non-audited quarterly reports must also be published; and semi-annual financial statements should be subject to limited review, filed with the CMB, and published), which can request the correction and re-issuance of accounts with which it does not agree. Should a company refuse, the CMB can publish amended financial statements itself. Financial statements filed with the CMB are subject to in-depth review on a sample basis, or in response to specific complaints. Since 1989, the CMB has also issued requirements applicable to the audits of the companies which it supervises. Only those audit firms directly approved by the CMB may perform such audits, and all changes of auditors by companies must be approved by the CMB. The auditor approval process includes an annual on-site review of the firms' procedures and audit working papers. There are currently 77 audit firms on the approved CMB list (February 2003), but the majority of engagements is in the hands of firms with international affiliations. The CMB places great reliance on the work of audit firms, to ensure the reliabil-

ity of financial information disclosed to investors, and since it began approving firms, it has also removed over 15 firms from the list for unsatisfactory performance. Monitoring and enforcement of the CMB's accounting and auditing requirements is handled by the CMB's Corporate Finance, Enforcement, Institutional Investors, Intermediary Activities and Accounting Departments, and no reliance is placed on the oversight activities of TURMOB (see below).

Amendments made in 1999 to the Capital Markets Law foresee the establishment of an administratively and financially autonomous Turkish Accounting Standards Board (TASB) reporting to the Prime Minister's Office. The Board of TASB will have nine members, and its own secretariat. The members should include one representative each from the CMB, the BRSA, the Ministries of Finance and Industry and Trade, the Treasury, the Chamber of Commerce, the Council of Higher Education, and two from TURMOB. Once it is fully operational, it is intended that the CMB delegates its power to set accounting requirements for listed companies to the TASB. While other regulatory agencies such as the BRSA for banks and the GDI for insurance companies are supposed to likewise delegate their accounting standards setting powers for the entities under their oversight to the TASB, articles in the CML and in banking and insurance legislation appear to preclude such delegation (see below).

The Banking Law provides to the BRSA the power to determine the A&A requirements applicable to banks. These requirements are in addition to those laid down by the Ministry of Finance for tax reporting purposes. For listed banks, the Capital Markets Law (CML) delegates the power to set A&A standards for purposes of financial reporting to shareholders to the BRSA.[118] The BRSA issued a new comprehensive regulation on accounting standards for banks in July 2002 (post crises), which brings these standards in line with IAS. However, the BRSA regulation does not require full application of IAS 27 (consolidation of subsidiaries), as banks only have to consolidate their financial subsidiaries, while for non-financial subsidiaries separate financial statement disclosure is mandated. The statements of such non-financial subsidiaries are not IAS-based,[119] however, and thus their disclosure will not allow the user to consolidate these with the IAS-based consolidated statements of the parent bank and its financial subsidiaries. Also, as the IAS are subject to change, any such change will necessitate an adjustment of the BRSA regulation.

The BRSA also issues rules governing the external audit of bank financial statements, and only auditors approved by the BRSA may carry out such audits[120]. All changes in auditor must also be approved, and a change can be imposed where there is dissatisfaction with the performance of the auditor. At present (February 2003), 35 firms are authorized to audit banks; in practice, though, the Turkish member firms of the four major international accounting firm networks dominate the bank audit market. No reliance is placed on the oversight activities of TURMOB (see below). In addition to opining on the financial statements, the external auditor is required to report to the BRSA on banks' internal control and risk management systems, as well as obliged to report directly to the BRSA with respect to certain issues which may threaten the going concern nature of a bank.

Banks' unaudited and audited financial statements, as well as prudential returns, are reviewed at the BRSA by Sworn Bank Auditors (SBAs). The duties of SBAs are set out in the banking law and include verifying the accuracy of banks' financial statements. For this purpose, SBAs have

---

[118] Similar arrangements apply to insurance companies, for which the CML delegates the authority to set A&A standards to the GDI. See also Chapter III.

[119] Only if all non-financial subsidiaries of a bank are listed or publicly held, and only if the CMB requires the use of full IAS for all listed or publicly held entities, will the financial statements for such non-financial subsidiaries be IAS-based and allow full consolidation with the IAS-based financial statements of the parent bank and its financial subsidiaries.

[120] In effect, the Regulation on Principles for Independent Auditing and the Regulation on Authorization of the Auditing Institutions and Permanent or Temporary Withdrawal of their Authorities, both published in the Official Gazette Nr. 24657 on January 31, 2002; these regulations are broadly in line with ISA.

the authority to undertake onsite examinations and request information from banks and their subsidiaries as necessary, and can propose corrections to banks' financial statements to the BRSA's Enforcement Department, which in turn can require banks' managements to make the necessary adjustments in their financial statements. This ability was relied upon after the 2001 banking crisis, when the BRSA ordered a one time, three stage audit for all private deposit taking banks, with the financial statements prepared by the banks' own external auditors being audited a second time by external auditors appointed by the BRSA, and a third time by the SBAs. The three stage audit resulted in significant restatements for many banks, especially of their levels of non-performing loans, and as such has confirmed the need for much stronger independent oversight arrangements for external auditors (see below), on which the bank regulator (as well as other financial sector regulatory agencies) ideally should be able to rely to a large extent, rather than having to substitute for it with its own efforts.

The Turkish financial sector consists in large part of financial-industrial conglomerates. Some of these have commercial banks at the center of their groups, surrounded by both financial and non-financial subsidiaries Others are organized as holding companies owning banks and other financial and/or non-financial businesses, either directly or through parent-subsidiary structures. There are significant intra-group transactions and balances within these conglomerates, and many group companies can have loan and equity exposures to the same entities outside the group. In terms of the provision of adequate information to both supervisory authorities and external shareholders, the absence of a requirement for such conglomerates to prepare fully consolidated IAS-based financial statements is therefore a serious weakness. As noted above, for conglomerates headed by a parent bank, this deficiency has to a large extent, though not completely, been rectified by the July 2002 BRSA accounting regulation for banks. For other types of conglomerates, however, this is not yet the case; for listed conglomerates, the CMB accounting standards do not yet require consolidation and are not fully IAS compliant in several other respects (see Box 8), and non-listed conglomerates comprising financial institutions also are not subject to IAS.

Similar to the sector-specific obligations applicable to banks, there are also separate requirements with respect to accounting and auditing for insurance and new third pillar private pension companies, leasing, consumer finance and factoring companies (all regulated by the Treasury), securities firms, mutual funds and asset management companies (regulated by the CMB); and existing second and third pillar pension funds (regulated by the Ministry of Defense and/or the General Directorate of Foundations).

The Accountancy Profession

The 1989 Accountancy Law gave legal recognition to the accountancy profession, established qualification requirements, and regulated the organizational structure of the profession. The law created and defined three categories of professionals: (i) Independent Accountant (IA) that may provide bookkeeping services, prepare financial statements, and prepare tax declarations, (ii) Certified Public Accountant (CPA) that may do the same but also audit financial statements, and (iii) Sworn Certified Public Accountant (SCPA) that may not provide book-keeping services, but may prepare and audit financial statements, and prepare and certify tax declarations. The 1989 Law provides the taxation authorities with rights of access to all documents held or prepared by IAs, CPAs and SCPAs. There are approximately 27,000 IAs, 20,000 CPAs, and 3,000 SCPAs. IAs and CPAs are together organized into 68 provincial Chambers, while there are 7 Chambers of SCPAs in the major cities. The Union of Certified Public Accountants and Sworn Certified Public Accountants of Turkey (TURMOB) was created by the 1989 Law to be the national umbrella body for the 75 local Chambers, and it alone is authorized to issue professional licenses and to set professional standards. However, in relation to those matters specified in the Law (e.g., ethics), before any rules adopted by TURMOB can take effect, they must be submitted for approval to the MOF. Disciplinary matters are dealt with in the first instance at the level of the local Chambers,

Box 8: Discrepancies between Turkish and International Accounting and Auditing Standards

In the field of financial reporting, the internationally recognized standards are the International Accounting Standards (IAS) issued by the International Accounting Standards Board (IASB). EU legislation also makes the use of IAS mandatory for the preparation of the consolidated financial statements of all listed companies in the EU by 2005 (except for certain companies which issue debt securities only, or are currently using other internationally accepted standards (e.g., US GAAP); the latter may delay application of IAS until 2007). General endorsement of IAS has also been provided by the International Organization of Securities Commissions (IOSCO). IAS are designed to apply to general purpose financial statements addressed to a broad range of users, with particular emphasis on meeting the information needs of investors.

The Turkish requirements which are closest in purpose to IAS are the accounting standards issued by the CMB, although these apply only to the companies subject to CMB oversight. In three key areas, the absence of Turkish requirements leads to important differences from IAS: (i) Parent companies are not required to prepare consolidated financial statements (IAS 27). Separate requirements for banks mandate the preparation of consolidated financial statements, but these include financial companies only, not commercial, industrial or other group companies. (ii) There are no requirements for hyperinflation adjustments (IAS 29); and (iii) disclosure of transactions with related parties other than shareholders, subsidiaries and other equity participations falls short of IAS 24. (While the CMB issued regulations in 2001 requiring consolidation and hyperinflation adjustment for companies under its jurisdiction along the lines of IAS 27 and IAS 29, the application of these regulations was subsequently postponed by the Government until end 2003). There are also no specific rules requiring disclosures of: (i) primary statement of changes in equity; (ii) FIFO or current cost of inventory when LIFO is used; (iii) fair values of financial assets and liabilities except for marketable securities; (iv) discontinuing operations; and (v) segment reporting. Other inconsistencies between Turkish and IAS requirements include: (i) Foreign exchange losses can be capitalized as part of the costs of assets under some circumstances; (ii) Finance leases are not capitalized; (iii) Pension obligations are not discounted; (iv) Deferred tax liabilities are accounted for partially on the basis of timing differences; deferred tax assets are not permitted; (v) A broader definition of extraordinary items is used than under IAS; (vi) Items in a cash flow statement are classified differently; (vii) In the calculation of earnings per share, the denominator is not adjusted for bonus shares, which are used very extensively in lieu of dividend payments; (viii) Pre-operating, set-up and research costs can be capitalized; (ix) Non-consolidation purchased goodwill must be amortized over a period of five years; (x) Lease payments are generally recognized in line with the legal arrangements, which may not be on a straight-line basis; (xi) Inventories can be held at above net realizable value in some circumstances; (xii) Construction contracts are accounted for on a completed contract basis. Turkish recognition and measurement practice may also differ from that required under IAS because of the absence of specific rules in the following areas: (i) Impairment of assets; (ii) Treatment of lease incentives; (iii) Discounting of provisions; (iv) Provision for employee benefits other than lump-sum termination indemnities; and (v) Accounting for an issuer's financial instruments and own (treasury) shares. The CMB is working on a new draft regulation that would bring the Turkish accounting standards closer to IAS, and has disclosed a first version of the draft on its website for comments. It is expected that the regulation will be issued some time during 2003.

In the field of financial auditing, the internationally recognized standards are the International Standards on Auditing (ISA) issued by the International Auditing Practices Committee of the International Federation of Accountants (IFAC). There are no Turkish standards governing the audits of the financial statements of companies generally, although the CMB and the BRSA have laid down requirements for the execution and documentation of audits of companies under their respective jurisdiction, which are broadly in line with ISA. A set of universally applicable ISA-based audit standards, along with the creation of a new central enforcement body such as a Chamber of Auditors, would thus be needed to achieve coverage of the full universe of private sector entities subject to external audit requirements. These measures would also help relieve the CMB and the BRSA, as well as other financial sector regulatory agencies, of the responsibility to maintain and enforce sector specific audit arrangements for the entities under their jurisdiction, and would be a more efficient way to organize such arrangements.

with appeals being handled by TURMOB. Neither the local Chambers nor TURMOB have any external quality assurance mechanisms in place to monitor the compliance of members with the relevant requirements.

The main education, training and examination requirements for licensing are as follows: (i) IAs must have a minimum of relevant vocational-level education, and then undergo a minimum of two years (university graduate) to six years (vocational school graduate) supervised practical training under an IA, CPA or SCPA. There is then a final qualifying examination. (ii) CPAs must have a relevant university degree and undergo a minimum of two years supervised practical training under a CPA or SCPA, before sitting for the final qualifying examination. (iii) SCPAs must have a minimum of ten years experience as a CPA, and then pass a supplementary examination. However, transitional arrangements contained in the 1989 Law still continue in force whereby certain categories of civil servants (primarily tax inspectors) and academics, with specified periods of experience in those positions, have the right to the SCPA license without any examination or supervised practical experience under a CPA or SCPA.

In 1994, TURMOB created the Turkish Accounting and Auditing Standards Board (TMUDESK), which is comprised of 60 members drawn from government, academe and TURMOB. Taking IAS as a basis, but making adaptations, TMUDESK has so far issued 15 Turkish Accounting Standards, with a further 10 in draft. These standards are in addition to the requirements of the MOF, the CMB and the BRSA, and have no legal force. Instead, they are a source of guidance in relation to issues not explicitly dealt with by the other legally binding rules. TMUDESK has not yet issued any auditing standards. With the creation of the Turkish Accounting Standards Board (see above), it is intended that TMUDESK will cease its accounting-related activities, and focus exclusively on auditing standard-setting. As auditing standards are not among the topics mentioned in the 1989 Law, it is understood that TMUDESK will be able to issue auditing standards on its own authority, rather than having to submit them to the MOF for approval, but this does call into question the legal authority of such standards and their binding nature with respect to the work carried out by CPAs and SCPAs. Neither the CMB nor the BRSA have indicated any intention to discontinue the issuance of auditing requirements with respect to the companies under their jurisdiction.

As explained earlier, the authorization of CPAs and SCPAs to perform financial statement audits is not sufficient by itself to permit these individuals to audit the financial statements of companies regulated by the CMB or of banks regulated by the BRSA. The financial statement audit authorization provided under the 1989 Law gives the right, by itself, to carry out only a limited number of engagements regulated by specific laws, such as those governing agricultural cooperatives, employment insurance funds, and the like Given the limited number of financial statement audit engagements in Turkey (approximately 2,000 in total), and the reservation of the most significant of these to the small number of firms authorized by the CMB and the BRSA, the majority of CPAs and SCPAs perform no financial statement audit work, but instead focus on activities related to accounts preparation and taxation compliance. IAs are in any event limited to book-keeping and the preparation of accounts and tax declarations. This finds its reflection in the heavily tax-oriented nature of the education, training and examination requirements to be licensed as an IA, CPA or SCPA, and also in the relative lack of attention to audit-related matters in the activities of TURMOB and TMUDESK. This, in turn, is mirrored in the separate auditing pronouncements issued by the CMB and the BRSA, the separate authorization by the CMB and the BRSA of those firms which may audit the entities subject to their oversight, and (in the case of the BRSA and the SBAs) the carrying out themselves of certain tasks which in other countries would be assigned to the external financial statement auditor. It is normal for regulatory agencies to play an active role in the enforcement of accounting and auditing requirements, but their degree of involvement in Turkey goes further than is customary internationally, yet it is not evident that this has had a proportionately positive impact on the quality of published audited financial statements.

Dissemination of Financial Information to the Market

For "accounting-literate" domestic users of companies' financial statements who have no supplementary access to internal financial and management information (primarily financial analysts), published financial statements prepared in accordance with current legal and regulatory requirements suffer from major shortcomings (see Box 8).

The problems encountered by domestic users are shared by potential foreign investors, and the experience of Turkish companies seeking to attract foreign capital (by way of either listing abroad or attracting buyers to the ISE) is that supplementary information is required. In response to these user pressures, certain groups/companies now prepare IAS financial statements on a voluntary basis, but there is still dissatisfaction with this approach. Firstly, the number of companies/groups involved is small (approximately 20 are estimated to prepare full IAS-based consolidated accounts).

Secondly, such voluntary financial statements are not included among the information which must be disclosed to the market, and there is a feeling on the part of some parties that not all shareholders are treated equally in terms of access to them. Domestic minority shareholders, in particular, are concerned that more information may be provided to foreign institutional investors.

Thirdly, these financial statements are prepared outside a central regulatory or enforcement framework (even though financial sector regulatory agencies have regulatory and enforcement responsibility for the entities under their jurisdiction), and there are concerns that their reliability may be less as a result. Users are not convinced that market incentives alone are sufficient to achieve the necessary improvements in financial reporting.

Although there is evidence of growing responsiveness to shareholder pressure, this is nonetheless moderated by the underdeveloped nature of the Turkish capital market. Controlling shareholders do not wish to see their stakes diluted below 51%, and there is as yet no market in corporate control in Turkey. Secondary issues are not frequent, and there is a perception in some sections of the market that once initial offerings have succeeded, controlling shareholders and management are not that concerned with meeting the needs of minority shareholders and maintaining the share price. Remedies are available to minority shareholders under law, but these cannot be enforced on a timely basis by the CMB. Instead, legal action before the courts is required, and this can be a very long process. Reliance on the work of auditors is not considered to provide sufficient protection, and TURMOB is not perceived as playing any meaningful role with respect to enforcing the quality of audit work in Turkey.

Medium Term Objectives

As demonstrated by the recent banking crises, weaknesses in private sector A&A can contribute to systemic risk and lead to large claims on the budget. Among the major sources of risk are: (i) Failure to follow IAS leads to an absence of transparency, particularly with regard to groups of companies, risks faced by enterprises and banks, and performance measurement which is distorted by the effects of both taxation requirements and chronically high inflation. The usefulness of published financial information is reduced; the protections available to minority shareholders diluted; and the ability of Turkish companies to raise international capital impaired. (ii) The multiplicity and fragmentation of separate bodies, each imposing and enforcing their own financial reporting requirements, is an obstacle to progress in developing a robust general purpose reporting framework, and leads to gaps and weaknesses in enforcement mechanisms; and (iii) The strong focus on accounting for tax compliance purposes has shaped the accountancy profession and its institutions in a manner which does not pay adequate attention to the development and enforcement of high standards in the fields of auditing, ethics and independence, or to the education and training necessary to apply them.

To mitigate these risks and reap the benefits in terms of better access to finance and enhanced external discipline of higher quality financial statement information and disclosure, the authorities

should seek to overhaul the existing A&A arrangements to bring them in conformity with IAS[121]/ISA and the EU's *acquis* in the area of A&A (see Box 9 below). The accountancy profession should also be strengthened to a point where it is able to adhere to, and meaningfully implement, these standards.

Policy Recommendations

The current fragmented regulatory and institutional arrangements for A&A, with multiple agencies each administering their own special-purpose regimes should be replaced by a common general-purpose financial reporting platform (in compliance with both EU requirements and IAS), supplemented by limited special-purpose requirements, such as prudential reporting requirements for banks and other financial institutions. This would result in the provision of higher quality information to the market; reduce the costs associated with duplication and conflicting requirements; encourage regulatory cooperation and integration; and enhance the attraction of Turkish securities to foreign portfolio investors. At the same time, regulatory agencies would not be required to forego any of the information and assurance which they currently receive.

A major exercise has begun to revise the Turkish Commercial Code in order to bring it in line with the *acquis*. The advisory commission drafting the amendments to the Commercial Code on behalf of the Ministry of Justice has decided to base its work generally on the *acquis* currently in force. However, it is understood that an exception is being made for A&A so as to have regard to the *looming acquis* (that is, the likely future, rather than present, provisions, see Box 9), to avoid that Turkey will find itself locked into an obsolete regulatory framework, one which gives inadequate recognition to international standards and which will not even be EU-compatible in the space of a few years.

In revising the Commercial Code, new provisions (together with any consequential amendments required to the laws governing the A&A mandates of the MOF and financial sector regulatory agencies such as the BRSA, the CMB and the Treasury) should mandate the transformation of the TASB[122] into a body responsible for developing and maintaining a common financial reporting platform for Turkey. The new law should also mandate the use of "pure" IAS (rather than national requirements) by all listed companies and financial institutions (including mixed conglomerates containing financial institutions and financial holding companies), such requirement to enter into force no later than for financial years beginning on or after January 1, 2007. Non-IAS reporting requirements for other companies, including SMEs, could be phased in over a longer period. Such accounting obligations should be accompanied by a requirement for ISA audits carried out by auditors licensed to ensure compliance with international standards of competence and objectivity.

---

[121] The CMB is already in the process of introducing IAS for the companies under its oversight. The CMB has prepared a draft regulation comprising all IAS standards and has posted it on its website for comment. Comments are currently being evaluated. Similarly, as noted earlier, the BRSA has recently issued a regulation bringing the accounting standards for banks in line with IAS (except for the full application of IAS 27). However, the IAS themselves are continuously subject to change, and rather than financial sector regulatory agencies such as the CMB and the BRSA issuing regulations describing a particular version of IAS current at the time of issuance, it would be more efficient to allow the TASB to maintain the use of IAS in Turkey as the mandatory, common accounting platform for publicly held companies and other public interest entities such as financial institutions (including mixed conglomerates containing financial institutions and financial holding companies), as argued below.

[122] More specifically, the TASB's mandate should be redefined to include the following tasks: (i) ensuring the translation of IAS and SIC Interpretations into Turkish; (ii) issuing implementation guidance on the application of IAS in the Turkish context; (iii) working with the taxation authorities and regulatory agencies to minimize additional tax and prudential reporting requirements over and above IAS; and (iv) assuming responsibility, from the MOF, for the maintenance of the Uniform Chart of Accounts, making it an appropriate common platform for the production of IAS, Commercial Code and tax accounts.

BOX 9: EU ACCOUNTING AND AUDITING REQUIREMENTS

EU harmonization of private sector A&A requirements began with the adoption of accountancy-related Company Law Directives- (the Fourth (1978) on the financial statements of individual companies, the Seventh (1983) on the consolidated accounts of groups of companies, and the Eighth (1984) on the licensing requirements for auditors of these financial statements)—supplemented by specialized directives for banks and insurance undertakings. The Company Law Directives apply to all entities using specified legal forms listed in the Directives and address issues of recognition, measurement and disclosure (including fixed formats for the presentation of financial statements), as well as publication and audit. Certain simplifications and reduced requirements are foreseen for small companies, including an option not to require the audit of such companies, but a financial statement audit is mandatory across the EU for all large and medium-sized companies. Were the same criteria to be applied in Turkey, thousands of companies currently not subject to audit would be obliged to have their financial statements audited by an auditor meeting the licensing requirements of the Eighth Directive. Significant changes to the Turkish Commercial Code would be necessary to bring it in compliance with these Company Law Directives.

A&A harmonization was initially primarily related to considerations of company law, and driven more by an enterprise's legal form than by the manner in which it was owned and financed. The consequence of recent EU reforms, however, is that financial reporting by listed companies will henceforth be treated primarily as an aspect of securities market regulation (as in the US) rather than of generic company law (which is the Continental European tradition). There are significant tensions between these two approaches, the main differences being in the emphasis placed on transparency and disclosure (very important in the former, substantially downplayed in the latter) and in the importance of the role given to banking and securities regulators in the development and enforcement of financial reporting requirements. In addition, existing A&A Company Law Directives are very detailed and prescriptive, whereas the new approach seeks only to establish an overall framework within which it is left to international standards - as updated regularly - to deal with questions of detail. The adoption in June 2002 of Regulation 2002/3626 (directly applicable EU law, as opposed to a Directive, which must be implemented by Member States), whereby EU listed companies will be required to prepare their consolidated financial statements in accordance with IAS as of 2005, embodies the new approach. This obligation supersedes national requirements, so that such companies would no longer be subject to national accounting standards.

Although the same accounting standards will apply across the EU, enforcement mechanisms will remain national. A uniformly high level of audit quality is an essential complement to the use of IAS across the EU. Work leading to explicit endorsement of the use of ISA across the EU is well advanced. In 2000, Quality Assurance for the Statutory Audit in the EU: Minimum Requirements was issued, which has led all Member States to agree to introduce (where one did not exist already) a system of external monitoring by professional bodies, or peer reviews by other firms, to provide assurance to regulators and users generally that auditors and audit firms carry out their work in accordance with the relevant requirements and standards. In May 2002 a further Recommendation on auditor independence was issued, to achieve greater convergence between Member States, which currently have different requirements in this area. Recent changes to IFAC's Code of Ethics were made to ensure consistency with the Recommendation.

The trend in the EU is to distinguish between financial reporting obligations for listed companies and those which are mandated for others, primarily SMEs. This "Big GAAP/Little GAAP" distinction recognizes that the purpose of the former is principally to provide information to markets which are increasingly international in scope, whereas the latter applies to enterprises which are more national in focus, with fewer external stakeholder groups. Financial reporting by the latter can be left to national legislation, with a continuing role for national differences in approach (usually due to taxation requirements), albeit within certain limits defined by EU legislation. Financial reporting by listed companies, however, should be responsive to the needs of international markets, and be based on IAS. Whereas some countries may have had a strategy in the past of bringing national standards closer to IAS, the new consensus is that national standards should no longer apply to listed companies. This has profound consequences for national standard-setting organizations.

(*continued*)

BOX 9: CONTINUED

In the field of auditing, there is no similar "Big GAAS/Little GAAS" distinction, so the strategy is to move towards using ISA for all audits of all companies. However, this must be accompanied by stronger rules for auditor independence, robust systems of external quality assurance to ensure that auditors do in fact comply with the rules, and an enhanced role for regulators in the oversight - together with the relevant professional bodies - of auditors of the entities which are subject to their jurisdiction. Professional organizations do not carry out self-regulation based on a mandate from their members, but instead exercise delegated regulation on the basis of a mandate from the state and regulatory agencies, to which they are accountable, and which can revoke that delegation if performance by the professional body is unsatisfactory.

A new "Chamber of Auditors," constituted as a professional SRO enjoying delegated regulatory authority but accountable to the Prime Minister's Office,[123] should be created to regulate those responsible for financial statement audit in accordance with ISA (an activity currently carried out by only a small minority of TURMOB's members). The Chamber should undertake the following tasks: (i) ensuring translation of ISA into Turkish; (ii) issuing implementation guidance on the application of ISA in the Turkish context; (iii) issuing ethical and independence rules consistent with the relevant IFAC and EU requirements; (iv) exercising quality assurance over the public interest activities of its members, by way of monitoring of their work, in accordance with the relevant IFAC and EU recommendations; (v) exercising disciplinary authority over its members; (vi) issuing audit licenses to both firms and individuals, on the basis of education, experience and examination requirements meeting at least the minimum requirements of the EU Eighth Company Law Directive; (vii) administering robust grand-fathering procedures[124] to admit existing TURMOB members with demonstrated, relevant financial statement audit experience during a transitional period of no longer than 3 years; and (viii) working closely with financial sector regulatory agencies in the development of specific additional licensing, auditing, quality assurance or reporting requirements applicable to the auditors of entities subject to their supervision. To the extent that these agencies wish to retain powers to authorize auditors of entities under their jurisdiction, such arrangements should be coordinated with those governing auditors in general, rather than being separate.

The main regulatory bodies (the MOF for taxation, the BRSA for banks, the Treasury for insurance and pension companies and other NBFIs, and the CMB for publicly held companies) are aware of the Commercial Code revision exercise, but may not fully appreciate the extent to which it could alter their current flexibility. There are general expressions of support for the concept of a common, general-purpose financial reporting platform, but little evidence of any imminent changes in behaviour to advance the creation of such a platform. To build consensus on the way forward, there is an urgent need to ensure that all interested parties understand the evolving EU and international context for A&A reform. A seminar with speakers from the EU and relevant international organizations could be of assistance. Also, it is imperative that one body with sufficient stature takes the lead in bringing together the different agencies and initiatives in the field of A&A.

---

[123] As the TASB is also accountable to the Prime Minister's Office, high level oversight over the work of the TASB and the new Chamber of Auditors could be provided at that level. Alternatively, an advisory committee attached to the Prime Minister's Office could be tasked with such oversight responsibility.

[124] The MOF recognizes that the tax compliance work carried out by TURMOB Sworn CPAs is not financial statement audit, but an activity mandated by the law to compensate for the lack of sufficient numbers of tax inspectors. This facilitates moves to introduce new requirements for ISA financial statement audits, and should reduce pressures for excessive grand fathering of existing TURMOB members without the necessary competence when a new auditor designation is introduced.

Section 2. Strengthening Financial Sector Regulation and Supervision

Strengthening Regulation and Supervision of the Securities Markets

Current Situation

The legal regime governing the Turkish capital markets consists of the Turkish Commercial Code, the Capital Markets Law (CML), various subordinate laws, regulations and the Communiqués promulgated by the Capital Markets Board (CMB).

- The Turkish Commercial Code contains the base set of rules applicable to all commercial enterprises. Among other things, it sets requirements for the forms of business associations, their books and records, corporate governance and accounting rules.
- The CML creates the CMB and sets out provisions intended to ensure the proper functioning of the Turkish capital market and protect investors in that market. Among other things, it governs the issue and sale of capital market instruments to the public and the activities of market intermediaries and exchanges and other organized markets.

The Turkish Commercial Code was promulgated in 1956 and is very outdated in a number of areas. The Government has undertaken a complete review of the Turkish Civil Code, including the Commercial Code. A revised code incorporating most relevant provisions of EU directives applicable to company formation and activity is expected to be presented to the legislature in two or three years.

The CML is a modern securities statute that provides the legal framework for the regulation of the Turkish capital market that meets most of the principles laid down in the IOSCO *Objectives and Principles of Securities Regulation* (the IOSCO Principles).[125] Where there are material differences, they are noted below.[126]

The CML conveys a great deal of discretion and flexibility on the CMB to develop binding rules (Communiqués) to govern specific aspects of the capital markets.[127] Given the speed of change in the capital markets it is important that securities regulators have the ability to react quickly to developments. However, too much discretion may tempt the regulator to try to micromanage activities in the capital markets.[128] If the rules of the market can change at any time, it becomes a challenge for market participants to develop longer-term strategies.

The CMB consists of seven members: a Chairman/Chief Executive Officer, a Deputy Chairman and five other members all of whom are appointed by the Government. The CML stipulates the minimum qualifications that each member must possess, including education and experience requirements.[129] The law also sets strict prohibitions aimed at preventing board

---

[125] International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation*, (February, 2002).

[126] Additional issues regarding the CML and related Communiqués that should be addressed are listed in Annex 4.

[127] For example, section 34 of the CML sets out the authority of the CMB to regulate the capital market intermediation activities of brokers and banks. The section is made up of 7 paragraphs and contains 5 provisions allowing the CMB to set rules and contemplates 2 different areas where the permission of the CMB would be required to engage in the activities specified.

[128] The structure of the law and Communiqués has led to extensive involvement of the staff of the CMB in a wide range of approvals and reviews of day-to-day activities in the marketplace. For example, the CMB has to review and approve all changes to the articles of association of any public company in Turkey.

[129] Article 19 of the CML requires board members to have at least an undergraduate degree in law, economy, finance, banking, business or public administration, international relations or engineering and have at least 12 years experience as an expert, auditor, administrator or faculty member in fiscal affairs, economy, finance, business management, capital markets, banking or law related to these areas.

member conflicts of interests.[130] The CMB has approximately 400 full time staff, about half of who are professionals. There are ten operational departments, each of which reports to one of the four vice-chairmen. The vice-chairman/departmental reporting structure changes with some frequency.

CMB regulations must as a matter of course be approved by the Council of Ministers before they can become effective, and in specific cases input or approval must also be obtained from the Ministry of Finance (such as, for the approval of the establishment of new securities exchanges, and for the admittance of foreign securities for listing on the ISE). These features have the capacity to limit the independence and the effectiveness of the CMB, as is evidenced for example by a recent decision by the Council of Ministers to overturn CMB regulations already issued requiring ISE listed companies to apply IAS 27 and IAS 29 in their financial statements as of 2002 (postponing the applicability of these regulations to 2003).

CMB staff are well trained and informed about market issues. The professionals are recruited directly from university and given training that includes both academic and apprenticeship aspects. Very few, if any, staff have any direct employment experience with public companies or intermediaries. Industry members generally view the CMB staff as dedicated and competent.

In most areas there are enough staff to carry out the work of the CMB in a timely manner. The one department that does have a significant backlog of cases and could use more resources is the Enforcement Department. However, there are some practical constraints to simply adding staff: it takes a significant amount of time to train an investigator and there are only so many people who can be trained at the same time.

The salaries paid to staff, while below market rates, were not seen as causing an increase in turnover or recruiting difficulties, but that may be ascribed to the general downturn in the industry. When the markets pick up and intermediaries start hiring again, the salary disparities will become more of an issue.[131]

The CMB and most of the staff are located in Ankara. The majority of the enforcement staff work in a branch office in Istanbul, where the ISE and most of the intermediaries have their head offices. This latter arrangement makes sense, as most of the activities of Enforcement take place in Istanbul. However, the physical distance between the market regulator and most of the market participants does pose logistical and other issues. Meetings require the expenditure of more time and money than would be the case if the regulator were located in the business center. Also, it is difficult for regulators to keep abreast of market developments without having day-to-day contact with market participants.

The CMB publishes a great deal of information about its activities and those of the capital markets. Its website contains both statistical data and legal information. It publishes a weekly bulletin that discloses most disciplinary actions, new issues and other relevant information. It is less clear that the internal information flows are quite so efficient. Each department seems to have information that is not readily available to other departments.

There are some issues in the Enforcement area that hamper the CMB's effectiveness as a regulator. There are gaps in the enforcement powers that the CMB possesses as compared to those recommended by the IOSCO Principles.[132] In particular, it does not have the power to enter into settlements with market participants who have breached the rules, nor can it accept binding un-

---

[130] Article 20 prohibits board members from accepting employment in another public or private entity, being involved in commercial business, performing a profession independently, being paid to lecture, assuming a role in any examination or acquiring an interest in any undertaking. All shares and participations in mutual funds that contain shares must be sold to arm's length parties before the member may assume his or her position.

[131] As noted in section 6.4 of the IOSCO Principles, The level of resourcing should recognize the difficulty of retaining experienced staff that have skills that are valuable to the private sector.

[132] See the IOSCO Principles at section 8.3 and 12.3.

dertakings.[133] While it can bar managers and directors from acting for market participants, it has no similar power to act against the management of public companies[134]. Under earlier decree legislation (Decree 558), the CMB did have such power, but market reaction to it was quite negative, and with the annulment of that decree it lost its validity. Bad behavior on the part of management of public companies does as much to impair investor confidence in the market as malfeasance by the management of dealers or banks.

Effective enforcement is also impeded by two additional factors. The first is a process that demands most of the serious offences to go through the criminal courts, with the attendant delays. This process has produced a significant backlog of cases awaiting trial.[135] The second factor is the relatively low penalties for breaches of the law. The maximums are set out in the Capital Markets Law in articles 47 and 47/A (as automatically adjusted for inflation through provisions in the Turkish Criminal Code and the Tax Procedure Law). For the most serious criminal offences the fines currently (January 2003) range from TL57.7 billion (US$35,310) to TL144.3 billion (US$88,310), with a minimum of three times the benefit received for insider trading, disclosure violations and market manipulation cases. The administrative penalties currently range from TL7.6 to TL38 billion (as automatically adjusted for inflation).

Medium Term Goals

Turkey should over the medium term strive to come in full compliance with the IOSCO principles for securities market regulation. Several areas where current regulations are not in line with the IOSCO principles have been highlighted in the previous section; Annex 4 provides additional guidance in this area. The CMB, through a targeted institutional development effort, should seek to upgrade its capacity to be fully in line with international best practice standards. Detailed suggestions in this respect are outlined below.

Policy Recommendations

Strengthen Effectiveness of Enforcement Efforts

Powers. The law should be amended to give the CMB the authority to issue regulations independently of the Council of Ministers and to take decisions concerning capital markets related issue (such as issuing licenses for securities exchanges) independently from the Ministry of Finance. Additionally, the CMB should be given the authority to enter into binding settlements and undertakings with participants who have breached the Capital Markets Law. The CMB should also have the authority to bar the management and directors of public companies from continuing to act in those capacities where they have breached the law, at a minimum through CMB instigated court order but preferably through direct CMB instruction. Also, the CMB should be given more flexibility in determining fines, to allow it to tailor them to the severity of the breaches of law committed, and to ensure that fines constitute a meaningful financial disincentive, especially to firms. Thought should also be given to broadening the range of civil sanctions available to the

---

[133] Securities regulators in many countries have these powers, including Australia, Brazil, Canada, Mexico, Poland, the UK and the US.

[134] Securities regulators in Australia, Brazil, Canada, Spain, the UK and the US, among others, can bar individuals from sitting on the boards of public companies.

[135] According to statistics from the Enforcement Department, in 2001, of the 113 investigations completed, 33 were insider trading and manipulation cases, 19 were related to publicly held corporations and 32 were related to intermediary activities. As of June 2002, there were 265 manipulation and 25 insider trading cases to be investigated. At the end of 2001 there were 239 appeals in process against Capital Markets Board decisions; 71 were decided during the year.

CMB beyond fines, as evidence in other emerging markets indicates that such sanctions are typically more effective than criminal sanctions.

Dedicated Court Resources. Most of the criminal prosecutions take place in Istanbul, Ankara and Izmir, so the identification, as a result of negotiations with the Ministry of Justice and the Office of Public Prosecutors to carry all of the CMB cases is of some help. A better option, however, would be to have a specialized court dealing with both civil and criminal securities law matters, or at least have a panel of judges in front of whom all cases would be heard[136] (in case a panel is used, it is important not to constitute it too narrowly with only 1–2 judges, as that would risk getting the wrong judges involved; also, it is imperative that all judges on the panel undergo extensive, specialized training before they take up their duties). This would build the expertise both in the prosecution and the judiciary and would likely speed up the time it takes to finish a case.

Staff Indemnity. CMB staff have been personally sued for actions they took in the course of their duties. The IOSCO Principles note that there should be "adequate legal protection for regulators and their staff acting in the bona fide discharge of their functions and powers."[137] The Capital Markets Law should be amended to provide that, absent bad faith, the staff are immune from prosecution for activities undertaken in carrying out their duties.

Raising Profile of Enforcement Actions. The retail investors' confidence in the market is affected by their view of the effectiveness of the regulator in protecting their interests. The US Securities and Exchange Commission is considered to be an effective regulator, in part because it takes on high profile law breakers and does a very good job in publicizing its "wins" in the subsequent enforcement actions. The CMB should consider adopting a similar approach: focus its efforts on key areas and give its successes general publicity.

Improving Transparency & Efficiency of the Regulatory/Supervisory Process. The CMB by law oversees several of the key decisions of the ISE and TSPAKB, as also specified in the applicable implementing regulations. CMB staff review and approve all bylaws of these organizations and hear appeals from parties dissatisfied with decisions made by the ISE or TSPAKB. However, the CMB has not established a formal review process with either body, nor has it communicated the criteria[138] that it uses for these reviews. The transparency of the regulatory process would be enhanced by the development and publication of an appropriate framework for oversight.[139] Additionally, the CMB currently does not have a real time link in place with the ISE trading systems, allowing it to oversee the ISE's efforts to detect price manipulation and insider training. Such a real time link should be put in place as soon as practical to further strengthen market oversight.

---

[136] For a model of how this might work, one could look to the courts devoted to bankruptcy matters in many jurisdictions. Also, there is some informal specialization in many jurisdictions, as civil courts located in the business centres do over time develop expertise with most of the securities cases brought in front of these judges. In certain jurisdictions (Canada, Australia) there is no formal designation of judiciary to hear commercial cases; however, the bulk of these cases would be heard by certain judges. In the next section of this chapter on strengthening the enforcement of insurance supervision, a similar suggestion for the creation of a specialized court or panel of judges is made. Rather than having two such specialized courts or panels, another option would be to create one, integrated court or panel for all financial system related enforcement actions.

[137] See the IOSCO principles, section 6.2.

[138] See the discussion in the IOSCO Principles, section 7.2.

[139] See IOSCO Public Document No. 53, *Legal and Regulatory Framework for Exchange Traded Derivatives*, IOSCO Emerging Markets Committee, June 1996 at pp. 6–9, *Principles of Effective Market Oversight*, Council of Securities Regulators of the Americas, May 1995, and IOSCO Public Document No. 110, *Model for Effective Self-Regulation*, IOSCO SRO Consultative Committee, May 2000.

Furthermore, the CMB should put in place a formal process for consultation with market participants and the public.[140] Most policies and Communiqués should be published for comment prior to implementation. If a Communiqué is likely to affect the interests of market participants or investors from outside Turkey, it should be published for comment in both Turkish and English. Where appropriate, this might be coupled with consultation with industry experts, either directly or through the ISE or TSPAKB. While public consultations may not always generate timely assistance, it serves as valuable notice to the market of the regulator's views.

The CMB should conduct an assessment of the activities it undertakes in reviewing and approving individual market transactions and activities to determine if case-by-case reviews could be replaced by the formulation of a general policy or Communiqué to govern the routine transaction(s). Compliance with the policy would then be spot checked, rather than every deal being scrutinized before the fact. In the areas where the Capital Markets Law gives the CMB a great deal of discretion, wherever possible, the CMB should issue guidance to the market on how that discretion will be exercised in ordinary circumstances.

Further Rationalizing and Strengthening the CMB's Structure and Operations: Board Members. The qualification requirements for Board members specified in the law are fairly broad and may not mean that the persons appointed have a sufficient level of expertise in capital markets issues. It might be prudent to consider establishing an orientation and training program for new board members whose backgrounds do not include extensive experience directly with the capital markets.

Organizational Structure. The structure of the CMB could be further rationalized. There are currently some unusual divisions and overlaps of responsibility between departments within the CMB. For example, oversight of the ISE generally falls to the Market Regulation Department, but the audits of the ISE are performed by the Enforcement Department. The activities of intermediaries fall into both the Market Regulation and Intermediary Activities Departments. In reviewing the CMB's organizational structure, consideration should be given to a structure set up along adversarial/non-adversarial lines, with the enforcement/disciplinary action function clearly separated from ordinary examination and supervision functions. To improve internal communication, a common database should be developed to allow more effective information sharing between departments.

Location. Most securities regulators have their headquarters located in the business center of their jurisdiction, even if the seat of government is elsewhere.[141] The CMB should consider moving most of its operations to Istanbul. In particular, the activities undertaken by the Intermediary Activities, Market Regulation, and Corporate Finance departments involve market activities that are centered in Istanbul, and thus would be more effectively supervised out of Istanbul.

Strengthening Regulation and Supervision of Insurance

Current Situation

Legal Framework. The three main pieces of legislation regulating the insurance sector are the Turkish Commercial Code, the Obligations Code and the Insurance Supervisory Act (Law No 7397) of 1959, subject to various amendments by decree. An important change was introduced by

[140] See the discussion in the IOSCO Principles in section 6.5.

[141] See for example Australia, where the capital is Canberra but the regulators operate out of Melbourne and Sydney, the business centres; Germany, where the regulator is located in the financial centre of Frankfurt, while the capital is Berlin; and Brazil, where the regulator is in Rio de Janeiro while the capital is Brasilia. The most notable exception to this rule is in the US, where the regulators are located in Washington, but have very large offices in New York and Chicago.

Decree 539 of June 1994, which sets out the operating procedures for insurance and reinsurance companies, and requires them to be formed as joint stock or mutual companies, and to separate their life and non-life insurance activities with effect from January 1, 1998. Decree 539 also lays down the minimum capital requirement, which is indexed to inflation on an annual basis. The Constitutional Court has, however, cancelled several articles of the law that were introduced by Decree 539 (that is, articles 9, 26 and 27 regulating the activities of insurance agents, and article 20d allowing GDI to cancel an insurance company's license- however, GDI still has this authority under article 3, and a broad range of other enforcement tools is available-including the possibility to request a capital increase, to replace a company's board and management, to prohibit a company to write new business and to arrange a portfolio transfer of assets and liabilities of an undercapitalized insurance company to another insurance company).

Regulatory Environment. Solvency of insurance and reinsurance companies is monitored following the formula specified in the applicable EU Directive.[142] GDI requires insurance companies to "block" part of their assets as backing for their policy holder liabilities For non-life companies, blocked assets must equal 15% of annual premiums, and this percentage can be raised by GDI to 20% under the law as necessary. For life companies, blocked assets must equal the total amount remaining after deducting loans made under outstanding life insurance contracts from mathematical reserves.[143] GDI is authorized to partially or completely lift the blocking of assets for life insurance companies. Insurance companies earn investment income on their blocked assets, but cannot use this income without GDI's permission, except when they have a surplus. Article 15 of the Insurance Supervisory Law specifies the following assets as eligible for blocking: (i) cash deposits in Turkish Lira and FX held with the CBT, (ii) domestic and foreign Government bonds, Treasury notes, profit sharing certificates and other stocks and bonds issued by the State, (iii) shares of companies of which more than 51% of the capital is owned by the State, (iv) other capital market instruments acceptable to GDI, and (v) real estate owned by insurance companies in Turkey. The free assets of life insurance companies are also regulated. A GDI regulation specifies in what types of assets life insurance companies can invest these,[144] and sets limits on investments in specific assets (for example, an investment in a single stock cannot exceed 10% of a company's net worth) and groups of assets. The regulation further specifies that life insurance firms should observe the risk diversification principle and prudent-man type rules, with a view to optimizing investment income in the interest of policy holders. Furthermore, GDI also by regulation sets the mathematical reserves to be maintained by life insurance companies.

Currently one third of all insurance companies are under enhanced supervision for failure to meet the minimum solvency requirement (typically involving a request by GDI to the companies concerned to raise capital or dispose of fixed assets) or failure to pay claims, and seven companies have been prohibited from writing new insurance business during the last two years. The true extent of financial difficulty in the industry may be larger than the scope of the GDI enforcement effort suggests, however, given that under a more stringent, EU compliant definition of technical reserves many more companies would likely fall short of the solvency margin requirement. To date, little resolution action has been taken to date on companies under enhanced supervision,

---

[142] The minimum solvency requirement in Turkey is a function of one year's premiums or net claims paid, whichever produces the higher value. In the EU, the requirement is a function of premiums or gross claims paid, based on experience using a three-year average.

[143] Retained from the amount of net life premiums and outstanding losses, as well as the amount of accrued profit share reserve.

[144] (i) TL and FX cash (the latter only if traded by the CBT); (ii) TL and FX demand and time deposits; (iii) loans provided to policy holders, and residential mortgage loans; (iv) mutual funds, (v) profit/loss sharing certificates; (vi) Treasury bills, bonds and repos and corporate bonds; (vii) asset backed securities; (viii) stocks; (ix) real estate; and (x) other money and capital market instruments determined by GDI.

because in several cases their assets are insufficient to cover their policy holder liabilities, precluding the use of portfolio transfers (of assets together with outstanding policy liabilities) to other, more healthy insurance companies as a less disruptive exit mechanism than liquidation. Also, for GDI to be able to arrange portfolio transfers of undercapitalized insurance companies' assets and policy holder liabilities, it must first petition for an insurance company's bankruptcy with the court, a process that can take six months or more.

GDI, in cooperation with the Turkish Association of Insurance and Reinsurance Companies (an industry association with limited self-regulatory responsibility), sets the accounting standards for insurance companies. These standards are not in line with IAS, and reduce the reliability of insurance companies' published financial statements, as well as the prudential information GDI receives. For example, under Turkish accounting standards, insurance companies are not required to carry their assets at fair value (IAS 39). Even though Government securities are required to be marked to market, the lack of fair value accounting impacts the real estate and equity participation components of insurance companies' investment portfolios, and unearned premium balances. Also, information disclosure, especially concerning risk exposures, falls short of IAS requirements, and there is no IAS 29 hyperinflation adjustment. GDI must scrutinize and approve external auditors for insurance companies, rather than being able to rely on an audit oversight body for this purpose. More customary is the arrangement under which GDI regulates actuarial auditors.

Organization of Regulatory and Supervisory System. The functions of regulation and supervision are divided between two units of the Treasury. The General Directorate of Insurance (GDI) has responsibility for the drafting of legislation and regulations, for offsite supervision and for approval of premiums and coverage levels for those classes of insurance for which this is necessary (see Chapter III). In 1997 GDI established an early warning system, and insurance companies are required to submit monthly and quarterly prudential returns to the GDI including information on shareholders, agents and re-insurers being used. The onsite supervision of companies is handled by the Insurance Supervisory Board (ISB), a semi-autonomous entity within the Treasury. Sworn Insurance Auditors, like Sworn Bank Auditors, by law enjoy a special status allowing them exclusive right to access company premises and records. The GDI prepares detailed quarterly analyses of the industry based on the regulatory returns filed by insurance companies, but these are not published. At the same time, ISB publishes a comprehensive annual report with industry statistics and trend analysis using its own information sources.

Both GDI and ISB have around 50 employees. The staff of both organizations includes actuaries and accountants as well as lawyers and economists. For practical reasons, the bulk of the ISB staff is located in Istanbul although the Head Office is based in Ankara. GDI staff are based in Ankara. When a problem situation is identified in a particular institution, ISB will report on its findings to GDI. From that point on, GDI will assume the responsibility for dealing with the troubled institution. This will involve regular contacts with company management and an ever-increasing intensity of regulatory response until the problem is resolved or intervention becomes inevitable. However, due to the special status of Sworn Insurance Auditors and the split responsibility for on- and off-site supervision, GDI will find itself in some cases deprived of access to on-site inspections and other types of control mechanisms because ISB has its own agenda, and once it has transferred responsibility for a company it may no longer be engaged in supervising that company. Also, ISB onsite examination reports are sometimes produced with a major delay (as long as one and a half years), rendering timely enforcement action by GDI in response to onsite examination findings impossible. Such a break in oversight is not desirable and could be avoided if the entire supervisory process was integrated into one organization.

Companies contribute a levy in support of the costs of supervision that amounts to 0.3% of premium income, a reasonable level. However, actual funding of the cost of supervision takes place through the state budget. As a consequence, there are problems in securing adequate resources for the supervisory system and in paying salaries that will attract and retain sufficient numbers of

competent staff, because GDI and ISB are housed inside the Treasury, and thus subject to general civil service pay scales, which are significantly below salary levels paid in the private sector and other regulatory agencies (for example, the CBT and the CMB).

Policy Recommendations

Legal and Regulatory Framework.[145] A new insurance law should be enacted as soon as possible to mobilize the potential in the insurance field, lay the foundation for the sector's restructuring and secure its rightful place in a rapidly expanding financial sector. The new law should further strengthen insurance regulation and supervision (including over insurance agents), as well as the procedures for failure resolution (allowing for the immediate appointment of GDI as administrator/liquidator of insolvent insurance companies), and conform with applicable EU Directives and the IAIS core principles of insurance supervision. Of particular importance are upgrading the definition of technical reserves to the applicable EU standard, and mandating the use of "pure IAS" (rather than national standards) for general financial statement reporting purposes. GDI should also review and as necessary further develop the supplementary prudential reporting information it receives, to ensure all areas not covered by IAS but important from an oversight perspective (for example, calculation of reserves, valuation of policy holder liabilities) are appropriately addressed. Once a new Chamber of Auditors is operational and fully capable of regulating and supervising the audit profession, GDI should adjust its licensing arrangements for external auditors for insurance companies to supplement, rather than substitute for, the role of this new oversight body.

The law could also lay the basis for the creation of workable, separate safety net schemes for the life and non-life segments of the insurance industry to assist the resolution of undercapitalized companies while minimizing the risk of moral hazard and the premium contribution burden imposed on the industry. The law should furthermore incorporate the provisions necessary to rationalize the industry outlined in the section in Chapter III on "Developing the Insurance Industry". Additionally, modern principles of corporate governance should be introduced in the law. At present corporate governance rules applicable are those set by the Turkish Commercial Code, but these are not sufficient for a modern supervisory system governing financial institutions. The law should specify that company Boards of Directors must include a minimum number of independent Directors and that Boards establish audit and compliance committees. Boards should also be required to set company policies for investment, risk retention and fair treatment of consumers. The new law should also mandate that insurance companies establish proper internal control and risk management systems. To strengthen consumer protection, consideration should be given to creating a consumer complaint resolution mechanism (such as an "ombudsman" style).

Supervisory Infrastructure and Enforcement. A major effort is needed to upgrade the institutional structure and enforcement capacity of insurance supervision. As a first step, technical assistance should be obtained to review the activities of GDI and ISB and recommend improvements. These two organizations share the work of regulating and supervising the insurance industry. Efficiency and effectiveness of regulation and supervision should be improved through a rationalization of their respective roles and responsibilities. Coordination needs to be strengthened and it is likely that the ideal format in the longer term will be a merger of the two entities into a more independent organization capable of paying market based salaries to its staff. Also taking into account the high level of integration of the financial services industry in Turkey and the concomitant long term desirability of further integrating financial sector oversight responsibilities (see the next section on "Rationalizing the Financial System Regulatory and Supervisory Agency Structure"), establishing a new, independent insurance regulatory and supervisory agency from scratch may not be the best

[145] See also the section in this Chapter on "Strengthening Accounting and Auditing Standards and Practices" for issues related to accounting and auditing.

solution.[146] Other options should be carefully considered and all pros and cons weighed carefully before any decision in this area is taken. Such options include, among others, affiliating this agency in the first instance with either the BRSA or the CMB-with the latter approach allowing for immediate integration of the split GDI and CMB responsibilities for oversight of the new third pillar private pension funds; as well as the so-called "twin peaks" model, with regulatory responsibility divided along prudential and market conduct lines rather than traditional business lines.[147] Enforcement of applicable insurance regulations should be significantly stepped up, especially as concerns the behaviour of insurance agents and late payment of claims, and a strategy should be developed for proactively resolving the current insolvencies. To accelerate the current slow pace of processing by the court system of GDI enforcement actions, consideration should be given to creating a specialized court, or a specialized panel of judges, to handle all insurance sector cases.[148]

Since the lion's share of the insurance business is conducted by companies based in Istanbul, it would be desirable that the majority of the resources for regulation and supervision also be located there. This has been the finding of the Canadian authorities, for example, when faced with a similar situation. Thus, in the medium/longer term, consideration should be given to relocating insurance supervision to Istanbul.

Strengthening Regulation and Supervision of Pension Funds

Current Situation

As noted in the section in Chapter III on developing the private pension fund industry, there are several different types of private pension plans in Turkey, all with a different regulatory and supervisory regime:

- Article 20 *first pillar substitute funds*, organized as "vakifs" (non-profit foundations), are under the authority of the General Directorate of Foundations (GDF), the Ministry of Labour and Social Security and the Ministry of Finance. Membership in these funds is mandatory for employees of banks, insurance companies, stock exchanges and chambers of commerce. The jurisdiction of the GDF over these funds is limited to administrative matters. There are very general investment rules governing their real estate and security market operations, and the funds have to receive GDF permission before entering into a real

[146] There is a body of opinion within the Turkish insurance community that would prefer insurance regulation and supervision to be organized as an independent agency (separate from Treasury). The main rationale for this view is that within a larger entity like Treasury, the General Insurance Directorate and the issues related to the development of the insurance sector in Turkey tend to get somewhat lost among several priorities competing for attention. Though there is considerable merit in that view, creation of another new independent regulation and supervision agency might not be the most suitable solution, also taking into account that there is likely to be increasing momentum towards creating an integrated financial markets regulation and supervision entity in Turkey in the coming years (see also the section in this chapter on "Rationalizing the Financial System Regulatory and Supervisory Agency Structure"). There is therefore a need for a broader discussion among the existing regulatory entities, the Treasury and the sector, and for this reason a final opinion is not being expressed on this issue in this paper.

[147] This model has the advantage of the prudential aspects of insurance regulation and supervision receiving the requisite attention; as the risks incurred by, and balance sheet structures of, insurance companies and the tools to manage them are more akin to banking risks and regulation & supervision techniques than to securities regulation and supervision (which is more market conduct driven), the prudential aspects of insurance supervision may not receive sufficient attention in a capital markets, hence market conduct, oriented regulatory agency structure.

[148] This report makes a similar recommendation for capital markets related enforcement actions brought to the courts by the CMB. Instead of two separate specialized courts or panels of judges for insurance and capital markets related enforcement actions, consideration could also be given to creating one specialized court or panel for all financial system related enforcement actions. A panel of judges should not be construed too narrowly, as that would risk getting the wrong judges involved; also, it is imperative that all judges on the panel undergo extensive, specialized training before taking up their duties.

estate transaction. The control over their actuarial balance is with the Ministry of Labour and Social Security. The latter has established a supervisory mechanism based upon actuarial reports that must be submitted once every three years. There are no asset allocation requirements imposed on these funds and their asset management function is in-house.

- Formal regulation and supervision requirements for the *existing third pillar funds,* also organized as "vakifs" and in which participation is voluntary, are similar to those for the Article 20 first pillar substitute funds. They are expected to be subject to an annual audit, but report results only to the GDF. There are no asset allocation requirements imposed on these funds and their asset management function is in-house. Many of both types of "vakif"-based funds are believed to invest their assets principally in the shares of their sponsoring organizations. The most extreme case is the Is Bank existing third pillar fund, which has invested almost all of its assets in shares of Is Bank.
- Oyak, the *second pillar pension scheme* for the armed forces in which membership is mandatory, is subject to a slightly more formal system of regulation and supervision. Its activities are regulated by a separate law, and supervised by multiple oversight boards that ultimately report to the Ministry of Defence. There are regular as well as actuarial audit requirements for Oyak, and a "prudent man" rule mandating diversification of investments, but no restrictions on equity investments, having allowed Oyak to develop into a financial-industrial conglomerate owning majority stakes in, and running the day to day operations of, a multitude of financial and real sector businesses, rather than being a traditional portfolio investment-oriented pension fund. Another second pillar-type pension scheme exists for the employees of TTK, the state-owned coal mining enterprise (Amele Birligi), supervised by the Ministry of Labour and Social Security. The rules for Amele Birligi are similar to those for the first pillar substitute funds.
- The *new third pillar funds organized as voluntary individual retirement plans* are under the joint regulation and supervision of the General Directorate of Insurance (GDI) of the Treasury and the CMB. The present role assigned to the GDI is handling the establishment, licensing and supervision of pension companies. The responsibility of supervising the activities of the portfolio managers (asset management companies) and of the pension funds themselves is assigned to the CMB.

The present arrangements show a varied and inconsistent approach to the regulation and supervision of private pension savings in Turkey. For all practical purposes there is no central agency that is responsible for the regulation and supervision of activities of those organizations that are collecting savings with a promise to return retirement benefits to participating workers and individuals.

In addition to providing pensions, the first three types of schemes also sell several different types of insurance products to their members (employees of the sponsor), most commonly health and disability insurance in a mixture of a substitute for state provided insurance and complementary insurance, but occasionally also life insurance. Furthermore, Oyak also provides mortgage financing to its members.

Medium Term Goals

Turkey should aim to achieve full compliance with the standards for supervision of private pension schemes that have been specified by the OECD as including the following

- An institutional and functional system of adequate legal, accounting, technical, financial, and managerial criteria should apply to pension funds and plans, jointly or separately, but without excessive administrative burden. Pension funds must be legally separated from their sponsors (or at least such separation must be irrevocably guaranteed through appropriate mechanisms).
- The governance role and capacity of pension funds should be considered. This includes: the role of guidelines (statutory or voluntary) for governance activities; the impact of share-

holder activism by pension funds on corporate behaviour; and the governance of pension funds themselves and the role of trustees. Self-regulation and self-supervision should be encouraged. The role of independent actuaries, custodial services and internal independent supervisory boards should be promoted within an appropriate regulatory framework.

- Investment by pension funds should be adequately regulated. This includes the need for an integrated assets/liability management approach, for both institutional and functional approaches, and the coordination of principles related to diversification, dispersion, and matching by currency and maturity. Quantitative regulations, and prudent person/expert principles should be carefully assessed, having regard to both the security and profitability objectives of pension funds. Self-investment should be limited, unless appropriate safeguards exist. Liberalization of investment abroad by pension funds should be promoted, subject to prudent management principles.
- Appropriate disclosure and education should be promoted as regards respective cost and benefit characteristics of pension schemes, especially where individual choice is offered. Beneficiaries should be educated on misuse of retirement benefits (in particular in the case of lump sum payments) and adequate preservation of their rights. Disclosure of fee structures, plan performance and benefit modalities should be especially promoted in the case of individual pension plans.
- Effective supervision of pension funds and plans must be set up and focus on legal compliance, financial control, actuarial examination and supervision of managers. Appropriate supervisory bodies, properly staffed and funded, should be established in order to conduct when relevant off- and on-site supervision, at least for some categories of funds and in particular when problems are reported. Supervisory bodies should be endowed with appropriate regulatory and supervisory powers over individuals plans, in order to prevent mis-selling arising from irregularities in distribution and expense methods.

Policy Recommendations

In order to ensure that all organizations involved in the accumulation of private pension savings in Turkey conform to these standards, it will be necessary that a uniform regulatory/supervisory regime be developed and that measures be taken to apply it for the benefit of all participants.

It will be of greatest importance to establish clear requirements for financial reporting and auditing. All pension schemes should be filing an annual financial statement, and those which are operating on a defined benefit basis should also supply regular reports from a qualified actuary to show the extent to which accrued and vested benefits are covered by available funding. There must also be rules for all pension schemes to govern the qualitative and quantitative restrictions that are suitable for a pension portfolio. Given the sometimes ill-suited nature of investments and extreme asset concentrations in several of the existing funds (most notably Oyak and the Is Bank existing third pillar fund) realistic, time based transition plans should be developed to allow these funds to come into compliance with prudent minimum asset diversification standards. Non-pension services such as provision of health and disability insurance, life insurance and mortgage lending should be separated from the funds themselves and transferred either to the appropriate state agency (the state administration responsible for providing basic health and disability insurance for the basic coverage component) or newly established or existing regulated financial institutions (licensed insurance companies for complementary health and disability insurance and for life insurance; mortgage lending activity should be transferred to either a mortgage finance company or a licensed bank).

A suitable regulatory framework of the type just described should be developed in the near future. However, before such a framework could be made effective in Turkey, it will be necessary to identify a single, independent supervisory agency for their enforcement in line with international best practices. The responsibility for supervision of the activities of all existing private pension

schemes that promise retirement benefits should be transferred to this single agency. A decision in this respect should be taken in the context of the considerations highlighted in the section above on the location of insurance regulation and supervision and in the next section below on the need to rationalize the overall financial system regulatory and supervisory agency structure. Technical assistance should be obtained to quickly and effectively operationalize the new private pension fund oversight system.

The Article 20 first pillar substitute funds now in existence are being used as a substitute for the social security coverage offered by the state social security system (SSK). There is no longer any reason for retaining the basic coverage for these workers outside the SSK system. There is, in effect, a backstop guarantee from the SSK for the obligations arising under these plans. The obligations of these plans that correspond to the SSK promise for its participants should therefore be shifted to the SSK, along with appropriate funding for the transfer. If there are any excess assets in the individual substitute funds, these should be transferred to special individual accounts created for the benefit of scheme participants in the style of the new voluntary individual pension savings schemes. The insurance activities of these funds should be transferred to licensed insurance companies.

Rationalizing the Financial System Regulatory and Supervisory Agency Structure

Current Situation

The financial sector regulatory agency structure in Turkey is highly fragmented. Each type of financial institution is governed by its own sector specific legislation, and overseen by a separate agency or department of the Government. Each institutional regulator operates autonomously. However, the powers and activities of the various regulators overlap in some instances, particularly as concerns the regulation of financial and mixed financial/industrial conglomerates. In addition, the CMB's responsibilities cross sectoral lines, as it governs the activities of banks and securities firms as market intermediaries and the activities of banks, securities firms and insurance companies as public companies, and founders of mutual funds and pension plans.

This potential for duplication of activities raises costs, both for market participants that have to comply with a variety of standards,[149] and for the regulators. It also creates the possibility of conflicts between provisions, inequitable treatment of similar activities and opportunities for regulatory arbitrage.[150]

Turkey's financial system is dominated by financial conglomerates (typically defined as a group of companies under common control that engage exclusively or predominantly in financial services in two or more financial sectors such as banking, securities, and insurance[151]), so coordination of activities among the relevant regulators is important. At the present time, there is relatively little

---

[149] For example, the banking, insurance and securities markets regulators have all set different accounting and auditing standards as well as licensing rules for external auditors for the entities under their jurisdiction. This raises the compliance costs for conglomerates containing multiple financial institutions and/or listed entities. See for further detail the section in this chapter on "Strengthening Accounting and Auditing Standards and Practices".

[150] Although the CML delegates the responsibility to set accounting and auditing standards for banks and insurance companies to the BRSA and the GDI respectively, eliminating the possibility of conflicting A&A arrangements applying to listed banks and insurance companies, conflicts could still arise between the regulatory agencies in other areas such as timely disclosure of material events outside the context of regularly scheduled financial statement publication (a CMB responsibility for listed entities), consolidated regulation and supervision of conglomerates owning multiple financial businesses of different types, entry and exit of financial businesses of one type owned by financial businesses of another type, etc.

[151] See The Tripartite Group of Bank, Securities and Insurance Regulators, *The Supervision of Financial Conglomerates*, (July 1995).

overlap between the products and services offered by the three sectors, with the exception of Government debt and repo/reverse repo trading by banks and securities firms, where in addition to the BRSA and the CMB, the CBT also has regulatory and oversight responsibility. Internationally, competition between the three industries has produced a trend toward similar products and services being offered by all three types of firms. For example, insurance companies in many countries sell investment contracts with features very similar to those of mutual funds, and in some markets, certain insurance products are fundamentally investment vehicles, rather than risk management instruments. In the future, as the products and services offered by Turkish financial intermediaries converge, the degree of overlap between the activities of each sector will also increase, accelerating the need for similar standards for similar activities.[152] Even without this convergence, however, the ability to package and cross-sell products and services from various parts of a financial conglomerate raises the need for consistent standards (some conglomerates, like the recently created Koç Financial Services Group, have made a strategic decision to try to cross sell different financial products and services to create synergies.)

These are global issues and countries have responded to these challenges in a number of ways. The responses range from informal coordination arrangements, such as establishing working groups among staff across the regulatory agencies to address common issues, through to full integration of all regulators into one agency administering a single piece of consolidated legislation governing the whole financial system.

As noted in the section on pension fund regulation and supervision, oversight over private pension schemes is currently scattered across a multitude of agencies (the CMB, the Treasury's GDI, the General Directorate of Foundations and the Ministries of Defense and Labour & Social Security), threatening Turkey's ability to move towards a prudent and modern approach to the regulation and supervision of such schemes. Furthermore, insurance regulation and supervision is currently carried out by two separate entities (GDI and the ISB), and the regulation and supervision of leasing, factoring and consumer finance companies is the responsibility of yet another department of Treasury, the Banking and Foreign Exchange Department, while most of these entities are owned by banks which are regulated and supervised by the BRSA. In addition to these functional splits of responsibility between different agencies, there are also differences in the levels of agency independence (with the BRSA and the CMB notably more independent than the departments of the Treasury), creating opportunities for regulatory arbitrage by more and less tightly regulated and supervised entities that are part of the same conglomerate.[153] Differences in salary scales (higher for the CBT and CMB, lowest for Treasury and other governmental department staff) furthermore demotivate the lowest paid staff, and may create undesirable interagency competition for qualified people, as well as threaten the very ability of some of the regulatory agencies to attract and retain such people.

Policy Recommendations

As a first step, the relevant regulators need to establish some regular channels of consultation and cooperation with one another, both at board level and at a technical level. Regular meetings to discuss issues common to the agencies in the areas of accounting, auditing, financial disclosure and intermediation activities would be advisable. Reform of the accounting and auditing regime that would replace the current "vertical" approach with a "horizontal" common accounting standards platform and auditor profession oversight approach, supplemented by the regulatory agencies with sector specific prudential reporting requirements, would eliminate the potential for unnecessary

---

[152] See IOSCO Principles at section 6.2 which notes: "Where there is a division of responsibilities, substantially the same kind of conduct generally should not be subject to inconsistent regulatory requirements."

[153] See the next section in this chapter on Extending Consolidated Supervision to Conglomerates for examples of such regulatory arbitrage.

disputes/duplication of standards, as further elaborated in the section in this chapter on "Strengthening Accounting and Auditing Standards and Practices." The three main regulatory agencies-the CMB, the BRSA and the Treasury-should furthermore enter as soon as possible into formal Memorandums of Understanding (MOUs) spelling out how they will exchange information, coordinate policies and take action in areas where their responsibilities overlap. Their respective responsibilities should be clarified and the possibility for conflict reduced as far as practicable. Pay scales for all financial sector regulatory agencies should be harmonized, and set at levels comparable to those paid in private financial institutions, to allow these agencies to attract and retain qualified staff.

Second, to foster the development of the private pension fund industry, the atomized oversight responsibilities for private pensions schemes should be rationalized and centralized in a single, independent agency. To facilitate growth of the insurance industry and improve insurance industry oversight, the GDI and the ISB should be integrated and put on a more independent footing. As argued in the section on strengthening insurance supervision, the various options available in this regard-creating a new independent insurance agency from scratch, affiliating such an agency with either the BRSA or the CMB, or using the "twin peaks" model which separates oversight responsibilities along prudential and market conduct lines, should be carefully considered before a decision is taken on how to achieve such greater independence. The Treasury and the BRSA are currently debating moving the oversight responsibility for leasing, factoring and consumer finance companies to the BRSA. While that appears a sensible approach from the perspective of the integrated nature of the activities of banks and their leasing/factoring/consumer finance subsidiaries, the timing of any such transfer should be carefully assessed, given that the BRSA itself is still a relatively new agency and is currently in the process of building its own institutional capacity. Adding a new responsibility to the BRSA at this stage may unnecessarily disrupt that effort.

In the longer term, and taking into account the already high level of integration of the financial services industry in Turkey, the Government may want to consider creation of a fully integrated independent financial services regulatory agency (see Annex 5 for some of the models used for this purpose in other countries). Once again, before any decisions are made in this regard, careful consideration should be given to all the different options and the experiences in this regard of other developed as well as developing countries, before a decision is made. The Bank could provide technical assistance in this area if the Government so desires.

Extending Consolidated Supervision to Conglomerates

Current Situation and Rationale

The Turkish financial sector is characterized by the presence of a multitude of conglomerate structures, not all the segments of which are regulated, and where some of the structures may be difficult to regulate (for example, mixed financial/industrial conglomerates, such as the Sabanci and Cukurova groups, or banks owning many real and financial sector subsidiaries, such as Is and Vakif.)

The complexity and size of many conglomerates make them difficult to supervise. Difficulties are greatly magnified when a conglomerate operates several lines of businesses in a multiplicity of legal jurisdictions (many Turkish groups own multiple banks operating in Turkey and the Netherlands, Germany, Eastern Europe and the former Soviet Union and Cyprus) or contains industrial companies not subject to any form of prudential regulation. This is because the powers of regulators generally are limited beyond their own jurisdiction and in many cases, are restricted to one segment of the financial system. Also, there still are fundamental differences in the regulation and supervision of banks, insurance companies and securities firms which make it difficult to supervise a conglomerate on a coherent basis. As a result, opportunities for regulatory arbitrage remain. Turf issues between supervisors may handicap co-ordination and information sharing, which is essential to the effective supervision of a conglomerate.

One of the great opportunities in a financial conglomerate structure with a series of regulated and unregulated companies and a variety of uncoordinated supervisors is the opportunity to count the same capital twice as a buffer against risk in different entities in the same financial conglomerate. Where such "double gearing" occurs, there is less capital on a group-wide basis than within individual regulated entities, which can pose significant risks to the financial stability of the regulated entities. Another problem is the down-streaming of capital whereby a parent company issues debt and uses the proceeds as equity for its subsidiaries ("excessive leveraging").

Mixed conglomerates containing both financial sector and industrial firms under common control (or where an industrial firm controls the financial institution or vice versa) present additional risks, as the ability of a regulator to inquire into the activities of the industrial companies can be very limited, and the activities undertaken by the industrial firms can negatively affect the solvency of the financial firms. In addition, there are enhanced opportunities for self-dealing transactions and other conflicts of interest, where a financial institution enters into transactions with related companies on uneconomic terms to the detriment of its solvency.

The G-10 Joint Forum on Financial Conglomerates published a number of papers setting out principles that should be applied in regulating financial conglomerates. These papers form the basis of a new EU Directive on prudential supervision of financial conglomerates (Box 10) to complement the existing sectoral EU rules applicable to credit institutions, insurance undertakings and investment firms[154].

In most countries, there are some limitations on how much a bank can invest in non-financial firms. According to a recent survey,[155] of 55 countries surveyed, eight had a total prohibition on a bank owning any part of an industrial firm. The majority of the other countries permit equity investments subject to a combination of supervisory approval and exposure limits. Where a bank acquires more than 10% of the equity of a non-financial firm, the EU rules restrict single investments to a maximum of 15% of the bank's capital with an aggregate exposure limit to all non-financial firms of 60% of the bank's capital. The US Bank Holding Company Act prohibits ownership by the bank or its holding company of more than 5% of the voting shares of a non-financial company. Many other countries prohibit banks from owning significant or controlling interest in non-financial companies. Turkey has already adopted restrictions on bank ownership of equity in non-financial firms in line with the applicable EU Directive, but the new limits will come into force in full only by 2010.

The ownership of financial firms by industrial companies is generally less restricted. Canada requires larger banks and insurance companies to be widely held (owned by many shareholders, with no individual owner holding sufficient shares to exercise control).[156] Only China totally prohibits any ownership of a bank by an industrial company. In most cases, any proposed ownership in excess of a fairly low threshold (5–10% of voting shares) requires supervisory approval.

Policy Recommendations

Consolidated Supervision. A regime should be developed that allows at least one financial sector regulatory agency to be able to consider all the operations of a group of financial firms, wherever

---

[154] The Compendium of Joint Forum papers on this topic can be found at http://www.bis.org/publ/joint02.pdf. The new EU Directive can be found at http://europa.eu.int/eur-lex/en/dat/2003/l_035/l_03520030211en00010027.pdf.

[155] Institute of International Bankers, *Global Survey 2001*, (September 2001) which can be found at http://www.iib.org/global/2001/GS2001.pdf.

[156] More specifically, in large banks (banks with equity in excess of $5 billion) no shareholder can own more than 20% of any class of voting shares or 30% of any class of non-voting shares; medium-sized banks (i.e., banks with equity between $1 billion and $5 billion) are allowed to have individual shareholdings of up to 65%, with at least 35% of voting shares being publicly held; and small banks (i.e., banks with equity of less than $1 billion) have no ownership restrictions other than "fit and proper" tests.

BOX 10: THE NEW EU DIRECTIVE ON PRUDENTIAL SUPERVISION OF FINANCIAL CONGLOMERATES

The new EU Directive on prudential supervision of financial conglomerates (2002/87/EC dated December 16, 2002) introduces specific prudential legislation for financial conglomerates. Furthermore, it takes the first necessary minimum steps to align the directives for homogeneous financial groups (those conglomerates that contain only one type of financial institution) and for financial conglomerates in order to ensure a minimum equivalency in the treatment of these groups (i.e., eliminating some of the major inconsistencies). The harmonization between sectoral rules is, however, not the major objective of this directive.

A central issue is the objectives of separate supervisors to ensure that the capital adequacy of the entities for which they have regulatory responsibility is not impaired as a result of the existence of cross-sector financial conglomerates. This requires measures to prevent situations in which the same capital is used simultaneously as a buffer against risk in two or more entities in the same financial conglomerate ("double gearing") and situations where a parent issues debt and down streams the proceeds as equity to its regulated subsidiaries ("excessive leveraging"). In developing capital adequacy assessment methods, the existence of capital adequacy rules in each sector is recognized, as is their effectiveness and reasons for the differences. Sectoral capital adequacy approaches are therefore taken as given, as they reflect the different nature of business undertaken by each sector, different risks to which they are exposed and different approaches to risk management and assessment by supervisors and other stakeholders. This also means that the directive does not pre-empt the ongoing discussions on the review of the solvency requirements in the banking and insurance sectors.

The new Directives introduces effective EU legislation to address the supervisory concerns about intra-group transactions and risk exposures in a financial conglomerate. As it is not yet feasible to introduce quantitative limits in this area, an adequate and effective regulatory approach for intra-group transactions and risk exposures should be built on the following three pillars: (i) an internal management policy with effective internal control and management systems; (ii) reporting requirements to supervisors; and (iii) effective supervisory enforcement powers.

The Directive also requires that an authority is designated to coordinate between the different supervisors involved in the group-wide supervision of financial conglomerates. It thereby aims to enhance effective supervision of supervisors, both within and across financial sectors and borders. The cross-sectoral activities of conglomerates demonstrate the clear need to introduce coordination arrangements between supervisors to ensure their efficient and adequate supervision. The benefits of appointing a coordinator authority for a financial conglomerate are. (i) to avoid "under laps" in the prudential supervision of a financial conglomerate, which will enhance financial stability; (ii) to avoid duplication of supervision, which is burdensome and costly for supervisors and the supervised entities of a group; and (iii) to achieve simplification of procedures and supervisory efforts.

The role and responsibilities of the coordinator(s) depend heavily on the specific circumstances of a financial conglomerate, such as the legal framework and the risk profile of the institution(s) involved. Rules regarding the appointment of the coordinator(s), as well as any further arrangements or obligations with regard to its tasks, should be framed in as flexible terms as possible.

Cooperation between the supervisors involved and information sharing is a precondition for effective supervision. None of the supervisory measures in the new Directive will function effectively in the absence of a proper flow of information from the entities within a financial conglomerate to the supervisors, and between supervisors themselves.

the operations are located and whether they are regulated or unregulated. This coordinator supervisor should also have the power to set and calculate capital on a consolidated basis, to ensure that the appropriate level of real capital is present to support the activities of the group. These responsibilities should fall to the supervisor of the top regulated entity within the group or failing that,

to the supervisor of the most significant regulated entity within the group.[157] While Turkey already has rules in place for the consolidated regulation and supervision of banks owning financial subsidiaries, there are currently no such rules for financial groups dominated by financial institutions other than banks (such as insurance companies) or for groups organized as mixed financial/industrial holding companies or financial holding companies (see below). To further enhance the quality and effectiveness of consolidated supervision, as argued in the previous section, thought should also be given to further integrating the financial sector regulatory agencies.

Holding Company Regulation.[158] To allow for effective oversight of mixed financial/industrial conglomerates, as well as newly emerging financial conglomerate structures such as the Koç Financial Services Group, the Government should develop and seek enactment of legislation governing holding companies that own financial businesses. This legislation should allow financial sector regulatory agencies to have an overview of the group's activities, review both banking and non-banking activities conducted under the holding company, and provide adequate supervisory powers to bring about corrective action. The best-known example of this type of legislation is the US Bank Holding Company Act, which provides a comprehensive regulatory structure for companies that own significant positions in US banks. Many other countries, such as Australia, Canada, Korea and Japan, have specific regimes that govern financial holding companies in their banking and/or insurance legislation.

Holding company parents and their downstream holdings should be subject to consolidated supervision with a risk-based focus. This means that supervision focuses on those activities of the group that may pose material risks to the regulated financial institutions that form part of it. This allows for tailored and flexible supervision based on the particular activities of the group. The consolidated regulator should use its supervisory authority over the holding company and its subsidiaries on a discretionary basis and as events warrant. Where, for example, a holding company places certain activities that pose lesser risks (such as the credit card business) in affiliates outside of a regulated institution, regulation of such affiliates may be lighter than that applied overall to a fully regulated entity. The bank or insurance company within the holding company, however, should continue to be subject to the full applicable supervisory regime. Where feasible, in the supervision of non-regulated subsidiaries of the holding company, greater reliance may be placed on transparency and market discipline to ensure that entities in the group remain well managed and well capitalized. However, the consolidated regulator should have the authority to: (i) set capital rules applicable to the holding company on a consolidated basis,[159] and require the holding company to increase its capital where circumstances warrant; (ii) set rules dealing deal with intra-group transactions and group-exposure to risks, the suitability and professionalism of management at the conglomerate level and the use of adequate internal control mechanisms and appropriate risk management processes and systems; (iii) issue compliance orders; (iv) require special audits; and (v) place limitations on, or require divestiture of businesses the holding company may enter/has entered into directly or through subsidiaries.

---

[157] According to the Institute of International Bankers, a single regulator oversees the activities of all financial conglomerates as a whole in Australia, Bolivia, Canada, Cayman Islands, Columbia, Denmark, Ireland, Japan, Korea, Norway, Peru, Singapore, Sweden and the UK. The lead regulator for a financial conglomerate is determined on the basis of the conglomerate's principal activity in Argentina, Austria, Estonia, Greece, Hong Kong, Israel, Latvia, Philippines, Spain, Switzerland, the US and Venezuela. See *Global Survey, 2001* at p. 6.

[158] A holding company is generally a non-operating company that holds interests in other operating companies. See Annex 6 for more detailed descriptions of regulatory principles applicable to holding companies and some country specific holding company regulatory regimes.

[159] These requirements should be consistent with international standards and best practices. In Australia, Canada, Korea, Japan and the US, bank holding companies are subject to capital rules that mirror those set by the Basel Committee on Banking Supervision for internationally active banks. In the US, Canada and Australia, all outstanding equity investments in financial sector subsidiaries are deducted from the parent bank's capital.

FREE FLOAT REQUIREMENTS - CROSS COUNTRY COMPARISON

Attached is a matrix of the "free float" requirements in listing rules of a selection of exchanges. "Free float" requirements (usually formulated in terms of a specified percentage of outstanding shares that must be distributed widely to the public) are designed to assure that there is sufficient liquidity so as to create a market for a listed share. Greater liquidity can also temper volatility.

There are other listing requirements that serve a similar purpose; not all exchanges use a "free float" requirement. Some exchanges rely on a minimum number of shareholders, restrictions on the percentage of shares held by large shareholders or insiders (a negative "free float" requirement), monthly average trading volume, or various other combinations of factors. The specific thresholds and requirements can also vary depending on which sector or "board" shares are trading on. Many exchanges now have several boards or sectors (large capitalization, mid-caps, senior boards, junior boards, technology companies, resource industries, "entrepreneurial" sector) tailored to different categories of corporation. In addition, in transition countries there is often a "third sector" or "free market" of enterprises taking the form of joint stock companies (as a result of mass privatizations) and which technically report to the stock exchange but in which there is no public market to speak of. Finally, many exchanges retain a greater or lesser degree of discretion in permitting deviation from the listing requirements.

The matrix is based on publicly available information that should be reasonably current and reliable.

BASIC "FREE FLOAT" REQUIREMENTS OF SELECTED EXCHANGES

Toronto Stock Exchange	• One million freely tradable shares and • Aggregate market value of C$4 (US$2.5) million (C$10 (US$6.3) million for technology companies and • 300 public shareholders, each with one board lot (100 shares) or more.
Korea Stock Exchange	• At least 30% of total shares must be offered to the public and 10% or more of the total shares must be offered to the public after the preliminary listing review by the KSE. The large-capitalized companies with shareholders' equity of 50 billion won (US$41.4 million) or more are allowed to offer 10% or more to the public. • The minimum number of shares to be offered to the public varies according to the shareholders' equity of a company. – Less than 100 billion won (US$82.7 million): 1 million shares or more – Less than 250 billion won (US$206.8 million): 2 million shares – 250 billion won (US$206.8 million) or more: 6 million shares • Companies trading on the KOSDAQ market with minority shareownership of 30% or more are exempted from the public offering requirement. • The largest shareholders cannot hold more than 70% of total shares (i.e., 30% "free float') • The number of minority shareholders must be at least 1,000.
Tokyo Stock Exchange	*Basic Listing* • 10 largest shareholders/shareholders having a "special interest" cannot hold more than 80% of shares to be listed (certain exceptions)(these shareholders are the "special few") • Minimum 4 million shares to be listed • Number of shareholders (not including "special few") holding at least 1000 shares: – at least 800 if less than 10 million shares listed – at least 1,000 if greater than 10 million shares but fewer than 20 million shares listed – at least 1,200, if greater than 20 million shares listed (plus 100 for each 10 million shares in excess of 20 million shares) *Second Section Listing* (entrepreneurial) • Minimum 2 million shares to be listed • Number of shareholders (not including "special few") holding at least 1000 shares: 300 or more • Number of shares publicly offered at time of listing: 500,000 or more
National Stock Exchange (India)	• At least 25% of each class of securities must be offered by a new company to the public (Securities Contracts) Rules, 1957, Rule 19(2))
Stock Exchange of Hong Kong	*Main Board Listing* • At least 25% of shares must be held by the public if market value not exceeding HK$4 billion (US$512.9 million)

- At the discretion of the Exchange but not normally below 10% if market value over HK$4 billion (US$512.9 million)
- New securities to be listed must have at least 100 holders, and generally at least 3 holders for each HK$1million (US$128,230) of issue

Growth Enterprise Market (GEM) Listing (entrepreneurial)

- At least 25% of shares must be held by the public if market value not exceeding HK$4 billion (US$512.8 million)
- The higher of:
  (i) the percentage that would result in the market value of the securities to be in public hands equal to HK$1 billion (US$128.2 million) (determined at the time of listing); and
  (ii) 20% of shares in the hands of the public if market value exceeds HK$4 billion (US $512.9 million)
- New securities to be listed must have a market capitalization of not less than HK$150 million (US$19.2 million) and be held among at least 300 shareholders with the largest 5 and largest 25 of such shareholders holding in aggregate not more than 35% and 50%, respectively, of the equity securities in the hands of the public
- The requirements may be varied at the discretion of the exchange

Athens Stock Exchange

Main Market (net equity GRD 4 billion (US$11.8 million))

- At least 25% of outstanding share capital allocated to public (capital increase or sale of existing shares to other shareholders)
- Large companies: 5% distribution (on the basis of at least 2000 shareholders none of which holds more than 2%)
- Discretionary derogation available
- Further restrictions on percentage of shares which may be privately placed in combination with a public offer
- Exemption for shares listed on another EU stock exchange

Parallel Market (net equity GRD 1 billion (US$3 million))

- At least 25% of its existing share capital allocated to public plus any new shares issued as an increase in capital and distributed via private placement
- In case part of the new shares is distributed via a private placement:
  - New shares distributed via private placement must not exceed 5% of those offered to the public
  - The issue price must not be higher than the placement price. The same applies in case the company has decided to increase capital in the six months preceding the application to listing.
- At least 300 shareholders

New Market (entrepreneurial/mid-size)

- At least 100,000 shares offered to public of at least GRD250 million (US$738,500)
- At least 20% distributed to public
- At least 150 holders of not more than 2%

Warsaw Stock Exchange

Main Market

- The value of shares admitted to exchange trading at least PLZ 40 million (US$10.3 million)

- The value of the shares admitted to exchange trading and held by shareholders who hold no more than 5% each of the total number of votes at the general meeting, is at least PLZ 32 million (US$8.23 million)
- The shares referred above constitute at least 25 % of the total number of shares of the company (or a minimum of 500,000 shares with a total value of at least PLZ 70 million (US$18 million) held by holders of no more than 5% voting rights)
- At least 500 holders

Parallel Market

- Value of shares admitted to exchange trading at least PLZ 14 million (US$3.6 million)
- Value of shares admitted to exchange trading and held by holders of no more than 5% each is at least PLZ 11million (US$2.5 million)
- Shares referred to above constitute at least 10% of total number of shares of the company (or a minimum of 200,000 shares with a value of at least PLZ 35 million (US$9 million) held by holders of no more than 5% voting rights)
- At least 300 shareholders of exchange traded shares

Exceptions Available

- At discretion of the Exchange

Exchange Trading by Public Offer

- Offer covers at least 10% of securities to be admitted or the value of the offer exceeds PLZ 6 million (US$1.54 million) on the main market or PLZ 3 million (US$ 770,000) on the parallel market

Thailand Stock Exchange

Distribution of Minor Shareholding

Number of minor shareholders	>= 600 shareholders
Number of shares held by minor shareholders	
Paid-up Cap < Bt 500 million (US$11.5 million)	>= 20% of paid-up capital
Between Bt500 million (US$11.5 million) and 1,000 million (US$23 million) paid up capital	>= 15% or 10 million shares
Between Bt1,000 million (US$22.9 million) and 10,000 million (US$230 million) paid up capital	>= 12.5% or 15 million shares
Paid-up capital >= Bt10,000 million (US$230 million)	>= 10% or 125 million shares

Public Offering

Number of shares cumulatively offered for sale

Paid-up Cap < Bt 500 million (US$11.5 million)	>= 15% of paid-up capital
Paid-up Cap >= Bt 500 million (US$11.5 million)	>= 10% of paid-up capital or 7.5 million shares

Shanghai Stock Exchange

- The proportion of shares to be issued to the public must consist of 25% or more of the total shares to be issued of which the shares

issued to company employees must not be more than 10%. The China Securities Regulatory Commission (CSRC) may reduce the proportion to be issued to the public if the total value of the shares will exceed RMB 400,000,000 yuan (US$48.4 million). But this reduction cannot be less than 10% of the total value to be issued.

New York Stock Exchange

Domestic Listing Requirements (broad discretion exercised)

Number of shareholders:

- 2,000 shareholders of 100 shares each or
- 2,200 shareholders and average monthly trading volume 100,000 shares for most recent 6 months or
- 500 shareholders and average monthly trading volume 1,000,000 shares for most recent 12 months

Public Shares Outstanding: 1,100,000

- Excludes shares held by directors, officers or their immediate family and concentrated holdings of 10% or more

Mexico Stock Exchange

- In the case of a normal issuer:
  - The minimum number of investors must be 100;
  - At least eight million titles must be placed and maintained amongst the investing public
  - 12% of the paid share capital must be placed and maintained amongst the investing public
- In the case of an issuer that has over one hundred and sixty million investment units, at least 5% of the paid share capital must be placed and maintained amongst the investing public

Istanbul Stock Exchange

- The free-float requirements are:
  - 15% if its capital is up to TL 750 billion (US$483,870)
  - 10% if its capital is within the range of TL 750 billion (US$483,870) and TL 1.5 trillion (US$967,740)
  - 5% if its capital is more than TL 1.5 trillion (US$967,740)
- Regardless of the above, companies that initially offer their shares representing less than 15% of their capital to the public must have the balance of the shares registered with the Capital Markets Board by the end of the third year following the date of initial public offering. In the calculation of said rate, the nominal capital as of the date when such rate is increased to 15% is taken into consideration.

ANNEX 2

TAX INTEGRATION SYSTEMS FOR INCOME ON EQUITY INVESTMENTS

Classical System

The classical system offers no tax integration to prevent double taxation of returns on equity investment. Dividends and capital gains from corporate equity shares receive no adjustments for the taxes already paid at the corporate level when subject to tax at the personal level. The US income tax uses this system. This system clearly "works" with widely held publicly traded shares on well-developed capital markets. In such situations the supply and demand sides of the equity market are separated and behave as price takers. This is not the case with small or closely held businesses, however, where owners have strong tax incentives to pay themselves in wages or finance their companies with debt to avoid double taxation on dividend distributions. As a result, the US tax system provides for "S-corporations," which are small corporations with a limited number of individual shareholders that pay no tax at the corporate level. Rather the corporate income (or losses), deductions and credits are shared out across the shareholders and declared for tax purposes in the hands of the shareholders as if it was a limited liability partnership. This effectively results in full integration for such small businesses.

Single Stage System

The single stage system only taxes the return to equity at the corporate level. Dividends are not included in income at the personal level. A final withholding tax may be charged on dividend payments to residents and non-residents. This structure is commonly used in low-income countries to simplify administration where corporate ownership is concentrated in the hands of high-income individuals who typically have income levels in the top marginal tax bracket. The corporate tax rate is set equal to the top personal marginal tax rate bracket. This system has two problems:

- It assumes that profitable corporations pay tax—that tax incentives and tax accounting conventions do not lead to excessive tax avoidance such that companies running persistent tax losses are also distributing tax-free dividends. To resolve that problem either an advanced

corporate tax or dividend tax account system is introduced to ensure corporations are paying dividends out of tax-paid income (explained further below).
- Tax exemptions at the personal level, such as may be granted to pension fund income, are ineffective to encourage equity investment in dividend-paying companies, as all the tax is already charged at the corporate level.

Dividend Gross-up and Tax Credit System

Dividend tax credit systems integrate the corporate tax into the personal by adding back into personal taxable income an imputed amount of income that the corporation must have earned before tax to pay the dividends out of after tax income (this is the imputed gross up of income), and then giving the individual a tax credit for the taxes the corporation is assumed to have paid[1]. In this way the returns on equity are taxed at the personal tax rate of the individual equity owner rather than that of the company. This system applies to small, closely held and public companies. Given the imputed nature of this structure, this method has some similar problems to the single stage tax system:

- The imputation system assumes that dividends are paid out of tax-paid income and that there are no excessive tax incentives or inflation accounting problems leading to economically profitable companies having persistent tax losses. Again, either an advanced corporate tax or dividend tax account system is sometimes introduced to ensure that credit is only given for actual taxes paid. In some countries it is argued, however, that all the tax incentives were intentional and hence there is no intention to charge tax at the personal level where none has been collected at the corporate level due to tax incentives. This argument does not hold for widely held equities where the company is a price taker and its investment behavior is not linked to the tax situation of the individual shareholders.
- Dividend tax credits cannot be given to foreign equity holders as they do not file individual tax returns in the host country. Therefore, foreign and domestic equity holders are treated differently.
- Income-tax exempt investors such as pension funds do not get access to dividend tax credits and hence are often worse of than taxable individuals in equity investments with high dividend distributions. Pension funds, however, do not pay capital gains taxes. This remains an advantage for them in investing in capital markets.

Dividend Deduction System

The dividend deduction system mimics the treatment of interest expenses on debt. The corporation gets a deduction for dividend distributions and tax is collected through withholding taxes on non-residents and personal income taxes on residents. This system deals with resident and foreign investors neutrally. It also handles the case of tax-exempt investors such as pension funds. It handles the small and closely held company situations. There is also no need for dividend exemptions on inter-corporate dividends as companies get deductions on all dividend distributions.[2] Moreover, there is no concern with the profitable company in a tax loss position distributing dividends,

---

[1] If a corporation pays taxes at rate (t_c) and distributes dividends (d) to an individual with a personal tax rate (t_p), then it is assumed that the corporation earned before-tax income of $d/(1-t_c)$ and paid tax on this income of $d*t_c/(1-t_c)$ for which the individual is given a tax credit. Hence the total tax paid at both levels on the before tax income of the company of $d/(1-t_c)$ is $d*t_c/(1-t_c)$ at the company level and $[d*t_p/(1-t_c)-d*t_c/(1-t_c)]$ at the personal level. If t_c is less than t_p, then the tax at the personal level is negative. In cases of dividends paid out from companies with tax holidays, t_c can be set at zero and no gross-up or credit applied as long as there are no multi-layered corporate holdings which make it impossible to trace either the nominal or effective corporate tax rate through to the equity holder.

[2] A company owning shares in another company (whether or not it is a controlling stake) includes dividend receipts in its income and gets deduction on dividend distributions.

as the dividend distribution gives it no advantage. The distribution would only add to its tax loss carry forwards. The "tax losses" from this system can be reduced either by giving partial dividend deductions and/or by charging a non-refundable withholding tax on dividend distributions residents (including tax exempt residents.)

Full Integration

Full integration requires the allocation of corporate earnings to the individual shareholders. This is only feasible where the shareholders are individual residents, the corporation does not own other corporations, and there are relatively few shareholders (less than a few hundred say.) This system can be used for small or closely held companies as with the "S-corporations" in the US.

Advanced Corporate Tax (ACT) and Dividend Tax Account (DTA) Systems

The ACT and DTA system are designed to ensure that all dividend distributions are effectively made out of tax-paid income. The ACT charges a withholding tax on dividend distributions on the grossed up value of the dividend at corporate tax rate and then allows the corporation to credit the ACT against its corporate tax liability. Companies in a tax loss position that distribute dividends effectively prepay their taxes and carry forward their ACT until the company starts generating a tax liability again. This system is effective for dealing with resident shareholders, but tax treaties may exclude its application on non-resident shareholders. The ACT is used in the UK.

The DTA has a similar objective to the ACT, but works in the reverse fashion. The DTA is credited with all corporate taxes paid, and debited by the imputed tax that should have been paid at the corporate tax rate on the grossed up value of dividends when they are distributed. If the DTA goes negative, the company has to pay extra corporate tax to bring the account back to zero. Given that it is not structured as a withholding tax on dividends, the DTA applies evenly to both resident and non-resident ownership. Only companies that pay more dividends than their cumulative tax paying history justify actually pay any added tax with the DTA, but it ensures that either the single stage or dividend tax credit tax system are effective in collecting corporate-level taxes. Note that particular incentives or exemptions can be "protected" from the DTA tax by allowing the tax value of the incentive to be credited to the DTA. DTA structures are used in New Zealand, Kenya and Malawi.

ELECTRONIC BOND TRADING PLATFORMS

Traditionally, trading of fixed income securities has been organized differently from that of equity around the world for many reasons. First, fixed income have a finite maturity, often with fixed interest, fragmenting the market. Second, denominations are traditionally large in amount, and unlike the equity market, the debt market is dominated by institutional participants, particularly professional intermediaries and institutional investors rather than individuals. Within the fixed income market, the Government securities market is a special segment which can offer a large volume of homogeneous, low risk instruments with standardized designs. Such qualities of the Government securities market (i) enable market participants to trade them actively; and (ii) make them suitable for monetary operations by the central bank.

Design Parameters for a Trading Platform for Government Securities

Bond trading often requires a functionality to permit market participants to negotiate while registering the transactions for transparency and price integrity. An important policy, as well as business, consideration is the access of investors to the trading platform, i.e. whether, how and to what extent to permit end investors, particularly institutional investors, to access the trading platform.

So-called multi-dealer systems include dealer-to-client platforms to enable institutional investors to view pre-trade price information (i.e., bid and ask price quotes) quoted by dealers for some segment of the market (e.g., benchmark segment). It, therefore, enables institutional investors to shop around dealers and, in some cases, directly hit a trade with an offering dealer[1]. The possibility of such access would encourage demand from end investors and, therefore, broaden and deepen the market, which benefits the Government as issuer.

If a decision on the architecture of a bond trading platform is left entirely in the hands of dealers only, however, they are likely to choose an inter-dealer system (rather than a multi-dealer

[1] For benchmark segments of the market, if dealer-to-client transactions are supported by DVP (delivery versus payment) settlement arrangements.

system) which serves their convenience but does not provide transparency and market access for end investors. On the other hand, too wide and easy access provided to end investors[2] may discourage dealers to make a market for some bonds, by rendering the market making a risky but less profitable business. If market making is made too difficult, it may reduce the feasibility and benefit of establishing a primary dealer system. Therefore, the extent of access to the secondary trading platform for end investors is an important issue.

Major Types of Electronic Bond Trading Systems

There are numerous providers of trading platforms around the world, including some information vendors such as Bloomberg. It may also be of interest to the authorities in Turkey to study platforms adopted by EU member countries. Four major types of electronic bond trading systems are outlined below:

- **Single Dealer Systems:** single-dealer systems allow investors to execute transactions directly with a specific dealer of choice. This type of electronic trading has been around for a long time and is nothing more than an extension of traditional phone-based trading. In order for the buyer to get a complete picture of the bond market, the institutional trader still needs to get in touch with multiple dealers—whether through an electronic connection or via telephone. Dealers offer access proprietary networks and the Internet through a combination of third-party providers, although in recent years there has been a pronounced shift toward access through the Internet.
- **Inter-dealer Broker Systems:** Inter-dealer brokers provide a valuable service in the fixed income market, facilitating large trades among dealers in expeditious, anonymous ways. However, with the emergence of online bond trading systems, especially cross matching systems which would enable dealers to trade among themselves anonymously without the inter-dealer brokers, the role of the inter-dealer brokers is becoming increasingly unclear. Most of the inter-dealer systems are a mere extension of traditional phone-based trading. The inter-dealer systems have experienced rapid growth, with close to 30 percent of all trading in the inter-dealer brokerage market occurring through these inter-dealer bond trading systems. Leading inter-dealer systems include eSpeed from Cantor Fitzgerald and BrokerTec Global.
- **Multi-dealer Systems:** Multi-dealer systems provide customers with consolidated orders from two or more dealers and with the ability to execute from among multiple quotes. Often, multi-dealer systems display to customers the best bid or ask price for a given security among all the prices posted by participating dealers. Participating dealers generally act as principals in transactions. A variety of security types are offered through these systems. Leading multi-dealer platforms include Market Axess and TradeWeb, both owned and highly publicized by leading bond dealers. The system has been extremely successful in Italy, where it is known as MTS (Mercato dei Titoli diStato or Government Bond Market) currently accounting for 90% of turnover in Italian Government bonds. The success of MTS has led to cloning of the platform elsewhere, especially in Europe[3]. EuroMTS was launched in April 1999 as an international trading system for European benchmark Govern-

[2] So-called cross matching systems (see below) provide even greater access to end investors than multi-dealer systems. Cross matching systems not only provide end investors with opportunities to view and hit a quoted price for a deal, but also enable them to place quotes by themselves, thus allowing end investors to trade among themselves without going through dealers.

[3] Currently, MTS is adopted by many EU member countries and is functioning as a platform to monitor market making performance of primary dealers in European benchmark Government securities. This does not necessarily mean, however, that it has the most advanced technological features. Generally, MTS gained market share as an early starter.

ment bonds. In addition, newly established local trading platforms along the lines of MTS include MTS Amsterdam, MTS Belgium, MTS France, and MTS Portugal. Brazil, Korea and Japan have also adopted electronic bond trading systems along the lines of MTS. MTS is an example of an inter dealer market with hybrid features. It is supplemented by Bond Vision to support the dealer to client trading. Thus, together they function as a multi-dealer system. On the one hand, it is a quote driven, multi dealer system in which major market makers are obliged to display bid/offer prices continuously during operational hours. On the other hand, it can be characterized as a centralized cross-matching system as market makers' quotes are aggregated in a single order book to match best anonymous bids and offers automatically subject to non-discretionary priority rules. This unique market architecture enables MTS markets to simultaneously benefit from the strengths of two distinct systems: transparency and cost efficiency of a central electronic cross-matching system, as well as the liquidity and immediacy of a quote driven system.

- **Cross Matching Systems:** Cross-matching systems generally bring both dealers and institutional investors together in electronic trading networks that provide real-time or periodic cross-matching sessions. Customers are able to enter anonymous buy and sell orders with multiple counter parties that are automatically executed when contra side orders are entered at the same price, or when the posted prices are "hit," or "lifted." In some cases, customers are able to initiate negotiation sessions to establish the terms of trades. These types of systems typically allow users to execute complex portfolio strategies that incorporate multiple orders in different securities. Unfortunately, in reality, the fancy technological features offered by cross-matching systems do not add much without the existence of a proven source of liquidity. This has been proven in the ECN industry on the equities market side. BondBook, Bond Connect, BondLink, BondMart, BondNet, and Visible Markets are some examples of cross-matching platforms.

It is still too early to determine what type of system will ultimately capture enough liquidity to survive. Hence, for the time being, the choice between these systems should be driven primarily by domestic considerations.

ANNEX 4

SUGGESTED CHANGES TO SELECTED CMB COMMUNIQUES[1]

ISSUE	RECOMMENDED CHANGE
PUBLIC COMPANY REGULATION	
Public Company Transparency	
Prospectus form requirements: The Communiqué on Principles regarding Registration with the CMB and Sale of Shares contains extensive lists of information to be filed with the CMB, but does not give guidance on what topics are to be included in a prospectus. CMB staff have indicated that sample prospectuses are available on the Turkish part of its website for reference purposes, and that the CMB requires disclosure in a form modeled on that used by the US Securities and Exchange Commission.	The IOSCO Principles, section 10.4, state that "disclosure rules should extend to, at least: . . . the content and distribution of prospectuses. . . . Disclosure should be clear, reasonably specific and timely. Specific disclosure requirements should be augmented by a general disclosure requirement." The Communique should be revised to explicitly reference the content of the prospectuses and all requisite disclosure requirements.
Continuous disclosure: There is extensive public disclosure of information on ISE listed companies, as the ISE posts all information received from listed companies on its website. Less extensive information on unlisted public companies is	The CMB should create an integrated information access feature on its website for all publicly traded and held companies through electronic linkages with the ISE and the Trade Registry (once it reaches the

[1] Note that these issues are in addition to those identified in the body of the report.

ISSUE	RECOMMENDED CHANGE
filed partially with the Trade Registry and partially with the CMB. It is not clear what part of the information filed with the CMB by these companies is posted promptly on the CMB website.	paperless state; until that time regular information exchange between the two entities should result in publication of relevant information filed with the Trade Registry on the CMB website with a time lag not exceeding one month).
Audit Requirements Not all public companies under the supervision of the CMB are required to be audited on an annual basis by a qualified independent auditor.	The IOSCO Principles, section 10.6, state "Accounting and auditing standards are necessary safeguards of the reliability of financial information." Annual independent external audits, using the International Standards of Auditing, should be required of all public companies, regardless of size.
Public Disclosure of Material Events	
Triggering events: Article 16/A of the Capital Markets Law requires the CMB to adopt regulations governing notice to shareholders of significant events and developments affecting the value of securities. The CMB's Communiqué on Public Disclosure of Material Events does not establish a general duty to make immediate disclosure of information that is material to investment decisions; it merely lists events that would trigger reporting. The net result of this is that there is no obligation to disclose unlisted events even if they may have a material effect on the price of a company's shares.	IOSCO Principle 14 states "There should be full, accurate and timely disclosure of financial results and other information which is material to investors' decisions." The Communiqué should be rewritten to establish a general obligation to make immediate disclosure of all material events (with an appropriate definition adapted from Article 1 of the Communiqué). The various events could then be set out as a non-exhaustive list of examples.
Reporting Periods: Material events regarding listed companies must be reported immediately, but unlisted public companies have 5 days to make reports. Shareholders of unlisted companies already are at an informational disadvantage that this delay only makes worse.	Reporting should be "immediately", whether or not the company is listed.
Insider Reporting of Shareholdings: The Communiqué requires officers, directors and significant shareholders of listed companies to disclose their ownership of securities of company when they have more than 1% of the shares. They must report changes where their ownership increases or decreases by 1% of the number of shares outstanding. These are very high reporting thresholds – particularly for management. Compare these to the US, UK, Germany and Canada where the management of companies must report all ownership of securities and any change (no matter how slight).	Insider reporting should apply to the significant shareholders and directors and management of all public companies, whether or not listed. The initial reporting thresholds should be reduced so that directors and management are required to report all ownership of securities and any change in that level promptly. Once significant shareholder acquires 10% of the voting shares of the company, they should be required to report and also promptly report any changes in their position thereafter.

ISSUE	RECOMMENDED CHANGE
Material Change Exemptions: Article 12 of the Communiqué exempts companies that have only offered securities other than shares to the public from making material event disclosures where there is a change in capital structure or control of the company, or when there are changes regarding administrative issues (such as conviction of the Chairman of the company for fraud). While these changes may have a less immediate effect on the value of securities other than shares, they still are material to a reasonable person's investment decision and should be made available.	There is no particular reason to distinguish between companies that have issued shares and those that have issued securities other than shares with regard to material event reporting. The exemptions in Article 12 should be eliminated.
Take-over Bids Take-over bid rules are not very extensive. CMB staff note that the rules in the CMB's Communiqué on this topic don't deal with situations such as a requirement to make a follow-up offer to shareholders of a listed subsidiary of an acquired company.	The IOSCO Principles, section 10.5, lay out some of the key features a take-over bid regime should contain, including time to make investment decisions, provision of adequate information, equal opportunities to participate in benefits, fair treatment from directors, etc. The CMB should look at other takeover bid regimes (such as proposed EU rules, US SEC requirements, UK Takeover code) and revise the Turkish rules accordingly to meet international best practice standards.
INTERMEDIARY ISSUES	
The rights of investors and the duties of intermediaries to their customers are not codified & expressly laid out in one place.	Add a section in the appropriate Communiqué or in the Capital Markets Law setting out duties owed by intermediaries to customers.
Margin Trading Initial and ongoing margin rates are set at 50% and 35% respectively. No variation based on the nature of the securities or their inherent risk/volatility.	IOSCO Principle 22 states "There should be initial and ongoing capital and other prudential requirements that reflect the risks that the intermediaries undertake."
Initial margin requirement set at 50% for short sales, no ongoing margin rate set, nor any requirement for deposit of proceeds of short sale. The rate does not vary regardless of the type of securities sold short. This treatment does not reflect the risk of the positions.	Margin rules for regular trading and short selling are prudential requirements. The rates for trades should vary based on the risk of the instrument/position.
The CMB is legally responsible for supervising the capital markets activities of banks, but in practice is leaving that to the BRSA:	
• There are no capital rules/requirements for banks' capital markets activities imposed by the	Entities carrying out similar activities should be subject to similar requirements; regardless of which

ISSUE	RECOMMENDED CHANGE
CMB; it is not clear that bank capital rules are equivalent to the requirements applicable to securities firms for the same activities; • Securities firms are required to file financial statements and capital reports with the CMB every 15 days. Banks are exempt from this requirement	agency is their principal regulator. The CMB and the BRSA should ensure that banks and securities firms are subject to equivalent capital requirements and similar reporting & supervision requirements.
OTHER MATTERS	
There are overlaps, duplication and gaps in communiqués in some areas with no policy reason for differences – e.g. related party definitions (takeover bid, insider reporting, accounting rules and capital rules for intermediaries) are not the same, despite the fact that the concerns sought to be addressed are similar (ensuring full transparency, disclosure of beneficial ownership and control and preventing self-dealing).	CMB staff is engaged in an extensive review of the Capital Markets Law and Communiqués to identify areas that may need to be amended in order to comply with EU directives. It is recommended that the review and amendment process be expanded to ensure that the Communiqués are consistent with each other with respect to definitions such as related parties, etc.
ISE There is no requirement for the ISE to take into account public interest in setting its rules etc., despite the fact that it serves a significant role in the economy. There also are no directors on the ISE board who would be viewed as independent or representative of the public interest.	The IOSCO Principles, section 7.3, state, "the regulator should assure itself that the exercise of the power of the SRO is in the public interest".
The rules development process takes place at the staff level of the ISE. Rules are only presented to members after Executive Committee approval. There is no transparent public consultation process and no input from anyone other than CMB staff.	The CMB should establish appropriate public policy directives and criteria that would apply to the ISE in carrying out its functions. The law governing the ISE should be amended to provide for the appointment of representatives of the public to the ISE board. The ISE should be required to publish for public comment any proposed rules or significant changes to its rules.
Effectiveness of CMB Enforcement Actions Not all penalties imposed by CMB are publicized. CMB staff have indicated that sometimes, if party agreed to reimburse investors for losses caused by party's actions, the CMB did not included the complaint and its resolution on its website. While this might facilitate getting compensation for affected investors, it does nothing to encourage compliance by other persons.	To be effective, enforcement actions not only have to be taken, market participants (both investors and others) have to know that breaches have been detected and punishment has been carried out. The resolution of all cases should be transparent and should be published on the CMB website.
TSPAKB The Association is a combination of a rudimentary SRO and a trade association, which does entail a conflict in roles. Neither the enabling legislation, nor the CMB imposes a requirement on the Association to act fairly or in the interest of public/investors (e.g., TSPAKB approved a rebate scheme that allows	The IOSCO Principles, section 7.3, state "the regulator should assure itself that the exercise of the power of the SRO is in the public interest". The CMB should establish appropriate public policy directives and criteria that would apply to the Associa-

ISSUE	RECOMMENDED CHANGE
dealers to allocate 35% of all discounted commissions to whichever clients they want, without any criteria regarding fairness, etc.).	tion in carrying out its functions. Governing legislation should be amended to provide for the appointment of representatives of the public to the board.
Also, all directors are appointed from membership so there is no public representation on TSPAKB's board.	Where Association rules may affect the interests of the public, they should be published for comment before implementation.
COLLECTIVE INVESTMENT SCHEMES	
Mutual Funds	
The self-dealing rules (self-dealing and intra-group transactions) for mutual funds are weaker than the EU UCITS Directive requirements.	A revision of the mutual fund communiqué is underway. The CMB should ensure that any revisions reflect not only the EU UCITS Directive requirements, but also best practices as published by IOSCO.
REITs	
The diversification requirements set out in the REITs Communiqué aren't particularly effective. If there are 3 or fewer projects, each must comprise no less than 10% of the value of the portfolio. But if there are 4 or more projects, the 10% minimum does not apply. This means that if there are 3 projects, the largest can't be more than 80% of the total, but if there are 4, the largest can comprise 99% or more of the total. Single project REITs are also permitted.	It would be better to substitute a general duty on the managers and directors of the REIT to make prudent investment decisions, rather than impose arbitrary and ineffective percentage requirements.

MODELS FOR COOPERATION AMONG FINANCIAL SECTOR REGULATORY/SUPERVISORY AGENCIES

Formal Coordination & Cooperation Structure—Australia
The Australian Council of Financial Regulators aims to facilitate co-operation and collaboration among its members, the main regulators of the Australian financial system—the Reserve Bank of Australia, the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission. Its ultimate objective is to contribute to the efficiency and effectiveness of regulation. The Council provides a forum for:

- Sharing information and views among its members, and liaison with other regulators and agencies;
- Harmonizing regulatory and reporting requirements, paying close attention to the need to keep regulatory costs to a minimum;
- Identifying important issues and trends in the financial system, including the impact of technological developments; and
- Coordinating regulatory responses to actual or potential instances of financial instability, and helping to resolve any issues where members' responsibilities overlap.

Unified Regulator with Separate Institutional Responsibilities and Legislation—South Africa
The South African system of regulation was completely rearranged in the early 1990s as a result of a major failure of a financial institution, which was blamed on gaps between regulatory bodies and the lack of clear regulatory accountability. The South African model combines all institutional regulators into a single agency–the Financial Services Board (FSB). However, within the Financial Services Board, supervisory responsibilities are divided on institutional lines. Banking, insurance, securities and the stock market regulators are separate branches of the FSB, each with their own inspection, licensing and policy staff.

The Financial Services Supervisor in Korea has a similar structure.

Functional Split of Prudential and Market Conduct Responsibilities (Twin Peaks Model)—Australia
Prior to 1998, there were three federal agencies with responsibility for the financial sector in Australia–the Reserve Bank of Australia, which regulated banks and was responsible for financial system stability, the payments system & monetary policy; the Australian Securities Commission, which regulated securities intermediaries and corporations and set disclosure standards for distributions of securities; and the Insurance and Superannuation Commission, which regulated insurance companies and pensions.

Responsibilities for supervision of the financial sector in Australia have been rearranged to fall primarily to two agencies:

- The Australian Prudential Regulation Authority (APRA) is a new body created to take over prudential regulation of deposit taking institutions, life and non-life insurance companies and retirement funds. APRA is also responsible for regulating building societies, credit unions and friendly societies. Prudential regulation includes both policy development and implementation.
- The Australian Securities and Investments Commission (ASIC) is responsible for the regulation of the integrity of market conduct, consumer protection and corporations. It is, at its heart, the old Australian Securities Commission with added responsibility for consumer protection in the banking and insurance industries.
- The Reserve Bank of Australia retains responsibility for financial system stability, and payments system & monetary policy, but ceases to be a direct regulator of financial institutions.

Full Integration of Regulators and Legislation—United Kingdom
Prior to the formation of the new UK Financial Services Authority, regulation of financial sector participants in the UK was divided among the Bank of England and eight other self-regulatory organizations and governmental agencies or departments. The new FSA has responsibility for oversight of banks, trusts and insurance companies, securities firms, building & friendly societies, the stock exchange, and personal investments (collective investment schemes, pension advisory and portfolio management services). There were numerous individual laws governing specific activities and institutions. These have now been combined into a single Financial Services and Markets Act of 2000.

The FSA is split into a number of divisions on a combination of institutional and functional bases. The divisions include Regulatory Processes and Risk, Deposit Takers and Markets and Consumers, Investments and Insurance. Within the Deposit Takers and Markets branch, there are subdivisions organized on functional lines: prudential standards, markets, listing, deposit takers, plus a cross functional area responsible for financial conglomerates–major financial groups. To coordinate the activities of individual business regulators as they may apply to one financial conglomerate, the FSA introduced the concept of lead regulation: one person will be responsible for the consolidated supervision of each financial institution. Responsibility for oversight/control of systemic risk issues remains with the central bank (the Bank of England).

ANNEX 6

FINANCIAL CONGLOMERATES—ISSUES AND APPROACHES

Definitions Of Financial Conglomerates

There are several definitions of what constitutes a financial conglomerate. These include:

- A financial conglomerate is a financial firm active in at least two business lines (e.g., banking and insurance, banking and securities trading/underwriting, insurance and securities trading/underwriting)[1]. A survey conducted by the IMF considering the largest 500 financial institutions worldwide during the period 1995-2000 found that about 87 percent of conglomerates are led by banks.
- A financial conglomerate is a group of corporate entities engaged in financial services activities, such as commercial and retail banking, securities underwriting and trading, investment management and insurance underwriting[2]. Financial conglomerates may form part of mixed-activity conglomerates that engage in substantial commercial and industrial activities.
- According to the new EU directive for the prudential supervision of financial conglomerates[3], a financial conglomerate is "A group of undertakings whose activities mainly consist in providing financial services in different financial sectors. Such groups comprise at least one supervised undertaking according to EU definitions and at least one undertaking engaged in insurance business, with at least one other undertaking from a different financial sector." But there are also other definitions like "mixed financial holding company" and "group" in EU legislation.

[1] Gianni De Nicolo, MAE Department, IMF.

[2] David Scott, "Regulation and Supervision of Financial Conglomerates".

[3] EU Directive 2002/87/EC.

Frameworks For Providing Financial Services

The basic organizational models for the provision of financial services are:

- **Separate Banking System:** Banks are not allowed to engage in the provision of any other type of financial services.
- **Integrated Banking Model:** The non-bank financial services units are placed in a department of the bank.
- **Bank-Parent Company Model:** The non-bank financial services are undertaken by a subsidiary of the bank. If mixed-activity groups are accepted, legal provisions may require formation of a financial institution subgroup within mixed-activity groups and define acceptable structures for the ownership relationship between the financial institution subgroup and group members engaged predominantly in commercial or industrial activities. Concerns about Bank-Parent Models include:
- **Contagion:** The situation where a regulated entity is affected by financial problems such as insolvency or illiquidity arising in another regulated or unregulated group member entity. Banks with significant interests in non banking activities are exposed not just to credit and market risks-which are the primary risks of their business, and which the banks should assess and manage as part of their core competence These banks will also be taking on the business risks of their non-financial activities. If their non-financial activities run into trouble, the banks may feel compelled to support them beyond normal commercial considerations, to protect their own reputation. In so doing the banks may undermine their own soundness; yet if they did not extend the rescue, the problems of the affiliates may trigger a loss of confidence in the bank itself because of the close association.
- **Transparency:** Overstatement of the reported profits with some transactions between the various legal entities that comprise the group and net group capital which is less than the sum of the capital of all group members. Lack of clear ownership relations to see the control over the conglomerate and its entities.
- **Autonomy:** Where a regulated entity is a component of a larger business organization a supervisory concern is the autonomy of those individuals responsible for the sound operation of the regulated entity.
- **The Holding Company Model**: A holding company owns both the bank and the non-bank financial services subsidiary. Some countries require the use of holding companies, whereby all financial institutions within a group must be controlled by a parent company, whose shareholders must be registered and are subject to disclosure requirements intended to make transparent any individual or collective holdings in excess of certain thresholds (such as 5% or 10%). Holding companies can be shell, non-operating entities, or one or more of any type of operating financial institution. The holding company structure may be a particularly appropriate solution in situations where individuals acting in concert own or control multiple financial entities in a non-transparent manner.

Selected Country Experiences

Australia

Regulator: The Australian Prudential Regulation Authority (APRA) is responsible for regulation and supervision of banks.

Definitions: A group containing a commercial entity is called a 'mixed conglomerate'; otherwise, it is called a 'financial conglomerate'. The head of the conglomerate should be either an Authorized Deposit Taking Institution (ADI), itself, or an authorized non-operating holding company (NOHC). The latter requires measures to limit the risk of 'contagion', i.e., the potential for trans-

mission of financial distress, particularly from unregulated arms of the conglomerate to the regulated members of the group.

Scope of Ownership: A NOHC should be authorized under the Banking Act, listed on the stock exchange and have the capacity to raise capital to support the ADI in the group. It should have a wide spread of ownership, unless an alternative ownership profile has been approved under the provisions of the Financial Sector (Shareholdings) Act of 1998. A NOHC should, unless otherwise agreed with APRA, be the only member of the group to hold equity in or provide other capital to an ADI. The entities in a conglomerate should each have separate corporate formalities and accounting records, and a separate identity not likely to be confused with that of any ADI in the group To ensure further that the proposed group structure is transparent and conducive to effective supervision, the financial entities in a mixed conglomerate should form a separate sub-group headed either by an ADI or an intermediate NOHC also authorized under the Banking Act.

In general, the unregulated business of a conglomerate—excluding (for the purposes of this section) highly rated entities – should be small relative to the ADI business.

Management: Shareholders in a NOHC (together with their associates) should not have a disproportionately high representation on the board. The Chair, and a majority of the members, of a holding company board should be non executives of the group and its constituent entities. At least one third (at least two directors) of an ADI board and its committees should be independent of the group (including any NOHC and/or subsidiaries of the ADI) and its members.

In order to facilitate risk assessment on both a group-wide and individual-entity basis, the conglomerate should appoint a single external audit firm to provide APRA with an overview of the whole group. This is notwithstanding that individual entities within the group might be audited by separate audit firms

Permissible activities for NOHCs: A NOHC company will be limited to activities such as: (i) its core role of holding investments in subsidiaries; (ii) holding properties used by group/sub-group members; (iii) raising funds to invest in, or to provide support, to subsidiaries; (iv) raising funds to conduct its own limited activities; (v) investing funds (e.g., surplus capital) on behalf of the group/sub-group; (vi) conducting the usual banking needed for its own limited activities; and (vii) providing back-office services to group/sub-group members.

Impermissible activities: In particular, an NOHC will not be permitted to: (i) itself issue deposit liabilities; (ii) trade in financial instruments; (iii) provide security over investments in subsidiaries without APRA's approval; and (iv) conduct any other business not ancillary to its core role.

Capital Adequacy: Conglomerates will need to meet overall capital adequacy requirements and, in particular, will be expected to ensure that: (i) each regulated entity meets the regulatory capital standard to which it is subject under industry-based supervision; (ii) the group overall has a buffer of capital which is sufficient and available to meet a range of unexpected losses and adverse shocks, (iii) double gearing (i.e., use of the same capital twice) will not be permitted; in particular, when calculating the capital adequacy of each group member, capital held in related entities and in capital deficits (if any) in subsidiaries will be deducted from the subject entity's capital; and (iv) aggregate group free capital—defined as the sum of each entity's (actual or notional) surplus of capital over its prescribed minimum, and which is available across the group should exceed zero or any higher minimum group-wide buffer set by APRA having regard to the circumstances at the time.

Deduction of Capital: If an ADI shifts capital upwards to an NOHC, or invests capital in or provides support of a capital nature (e.g., a guarantee) to another related entity, then APRA will

deduct that capital or support from the ADI's Tier 1 capital for the purposes of calculating the latter's stand alone capital adequacy ratios. Where this deduction will adversely impact on an ADI's compliance with minimum capital ratios, then fair and reasonable transitional arrangements will apply.

An ADI's aggregate exposure (direct and indirect) to all related entities will be limited to a maximum of 15 per cent of its Tier 1 capital for a financial conglomerate, or 10 per cent for a mixed conglomerate. Where ADIs have existing exposures beyond the new regulatory limits, fair and reasonable transitional arrangements will apply.

Risk Concentrations: Risk concentrations may include exposures to, for example, particular counter parties, geographical regions, industrial sectors, financial markets and so on. Accordingly, the conglomerate will be expected to: (i) have internal policies, systems and controls in place to identify, monitor, manage and report regularly to APRA on material risk concentrations at the group level; (ii) ensure each regulated entity meets the regulatory risk concentration standard, including limits, to which it is subject under industry-based supervision; (iii) report quarterly to APRA on concentrations of the group's credit risk to a single counter party and its associates in excess of 10 per cent of the agreed capital for the group (see below). APRA may require a limit on the number of such exposures, or an offsetting increase in the relevant minimum capital buffer, and (iv) notify APRA in advance of any intention to incur a credit exposure to a single counter party and its associates in excess of 15 per cent of group capital and demonstrate why this might reasonably be expected not to expose the group to excessive risk.

Canada

The recent passage of the legislation (Bill C-8) to reform the framework of Canada's financial services sector is the result of more than four years of research, analysis and public policy debate about the future of Canada's financial services industry.

Permitted Investments: Bill C-8 broadens the scope of investments that banks are permitted to make, with the intention of providing greater opportunities for banks to introduce new products and innovations to the Canadian marketplace. Importantly, the legislation also provides a regulation-making power to allow for further expansion in the range of permissible investments, thus adding to the capacity for more flexibility in the financial system.

Holding Companies: Bank financial groups have the option of organizing their business activities in Canada under a holding company structure. Under the present structure in Canada (the "bank as parent" model), all banking functions and all subsidiaries of the bank are subject to the same broad regulatory regime which is designed to protect the safety and soundness of the parent banks. A "holding company" model creates the potential for lighter regulation in parts of the corporate group, because certain activities will be permitted to be undertaken in affiliates that are held by the holding company parent, rather than the regulated bank. Although the holding company itself will be regulated, the fact that activities that do not involve taking retail deposits will be offered through affiliates that may be subject to lighter regulation, should allow banks greater flexibility and lower costs, while still protecting retail depositors.

Ownership: Bill C-8 increases the limit that a single shareholder can hold of a widely held bank from 10% of any class of shares, to 20% of the voting shares and 30% of the non-voting shares. Bill C-8 also creates a tiered ownership regime, with banks that have over C$5 billion in shareholder equity being required to be widely-held, banks with between C$1-5 billion being allowed to be closely-held (though 35% must be publicly available), and banks under C$1 billion being allowed to be 100% closely held.

Denmark

The growing integration of the financial markets and financial groups led the Committee on the Financial Sector (appointed by Ministry of Economic Affairs) to recommend the implementation of a new statutory structure for the financial sector. The aim was to ensure uniform treatment of financial groups and to make various simplification measures possible.

The first part of the reform was completed in May 2001 when the Danish Parliament passed legislation called "The Act on Financial Undertakings". The Act consolidates identical provisions in the Banking Act, the Investments Firms Act, the Insurance Business Act and the Mortgage Credit Banks Act in one Single Act. Thus, the Act contains provisions on joint definitions, good practice (detailed rules will be put forth in an executive order), ownership of financial institutions and financial holding companies, the duties and responsibilities of management, financial groups, new accounting rules, auditing, supervision standards and provisions on passing on customer data by one company to another within a financial group. Some amendments to the financial legislation were made, including the following:

- The Act contains provisions on minimum capital requirements for financial holding companies and upper exposure limits equivalent to those applicable to banks. Financial holding companies are considered as being banks and accordingly the minimum capital requirements have been set at 8% of the risk weighted assets of the holding company.
- The financial statements of financial group companies including the financial holding company must be prepared on a consolidated basis.
- The Financial Supervisory Authority (FSA) may require a bank group to be separated from a financial holding company carrying on other business than banking activities under a new sub-holding financial company.

Singapore

On June 21, 2000 the Monetary Authority of Singapore (MAS) announced that Singapore banking groups would be required to separate their financial businesses from their non-financial businesses. The banking groups are given three years for the necessary restructuring and divestments to be made. The three-year countdown began on July 18, 2001 when the Banking (Amendment) Act, giving legislative effect to the policy, came into force.

In Singapore, the local banks (other than DBS) started as family-owned banks and built up a successful financial business on that basis. Over time they have merged and consolidated. Today the founding families remain the principal shareholders, and are in several instances also involved in the management of the bank.

Besides banking, the principal shareholders have also built up diverse non-banking businesses, especially in property. The local banks participate in these non-financial activities of the group, both by lending and through equity ownership. The banks and non-banks in the same group have developed significant cross-shareholdings. A mixed conglomerate structure has evolved.

The considerations on the basis of which the MAS took the decision to separate the financial and non-financial businesses of conglomerates included:

- Commingling of financial and non-financial activities will potentially expose Singapore banks to the same problems that banks elsewhere have experienced. The decision to separate these activities is precautionary, as Singapore banks have not run into serious problems, so far. This is because the principal shareholders have run the banks prudently and properly. The Monetary Authority of Singapore (MAS) has also been stringent in monitoring related party transactions. Strict laws govern such transactions; for instance, bank directors are jointly and severally liable to indemnify the bank for losses arising from unsecured loans to related companies. But the MAS was concerned that problems will manifest themselves only

in times of stress, and wishes to restructure the banks' participation in non-financial activities before potential vulnerabilities become actual problems.

- The banking environment in Singapore will only become more open and competitive, and less forgiving of weaknesses or under-performance. With banks concentrating on their core competencies and building strong and institutionalized management structures to compete in a globalize industry, their performance should improve to the benefit of all depositors and shareholders, and strengthen the financial system as a whole.

Permissible Structures and Activities of Banks

The following table provides an overview of permissible structures and activities of banks in selected countries (based on the Global Survey 2002, Institute of International Bankers):

Country	Organizational Structure for Conglomerates	Securities	Insurance	Real Estate	Bank Investments in Industrial Firms	Industrial Firm Investments in Banks
Australia	A conglomerate group must be headed either by an Authorized Deposit Taking Institution (ADI), Non Operating Holding Company (NOHC) or a foreign entity.	Permitted	Permitted through subsidiaries or sister companies, subject to controls under the insurance law.	Limited	A bank can make equity investments in non-financial businesses up to an aggregate amount equal to 5% of its consolidated Tier 1 capital without prior reference to the Australian Prudential Regulation Authority (APRA). Individual investments are generally subject to a limit equal to 0.25% of a bank's consolidated Tier 1 capital. A bank may undertake equity investments in non financial businesses in excess of the 5% aggregate limit, provided the excess is deducted from Tier 1 capital of the bank and/or the group as appropriate.	Shareholdings of more than 15% in a bank need regulatory approval. The regulator has signaled a willingness to consider an association between a bank and a non financial company where a sound case can be presented.
Canada	Holding Company	Permitted through subsidiaries.	Permitted through subsidiaries.	Permitted through subsidiaries.	Permitted up to 10% interest in industrial firm.	Permitted to hold up to 10% interest.

COUNTRY	ORGANIZATIONAL STRUCTURE FOR CONGLOMERATES	SECURITIES	INSURANCE	REAL ESTATE	BANK INVESTMENTS IN INDUSTRIAL FIRMS	INDUSTRIAL FIRM INVESTMENTS IN BANKS
France	—	Permitted	Permitted, usually through subsidiaries	Permitted	Permitted, but limited to 15% of the bank's capital; in the aggregate limited to 60% of the bank's capital.	Not prohibited
Germany	—	Permitted	Permitted, but only through insurance subsidiaries	Permitted	Permitted, but limited to 15% of the bank's capital; in the aggregate limited to 60% of the bank's capital.	Permitted, subject to regulatory consent based on the suitability of the shareholder.
Japan	Holding Company	Some services (e.g., selling of Government bonds and investment trusts) permitted to banks, others permitted through subsidiaries.	Some services (selling insurance policies in connection with housing loans) permitted to banks, others permitted through subsidiaries.	Generally limited to holding bank premises.	Limited to holding 5% interest. Bank holding companies and their subsidiaries are allowed to hold in the aggregate up to 15% of the shares of non-financial companies.	Permitted provided total investment does not exceed investing firm's capital or net assets Acquisitions of shares in excess of 5% must be filed and shares equal or in excess of 20% are subject to regulatory approval.
Korea	Holding Company	Permitted through affiliates.	Permitted through affiliates.	Generally limited to holding bank premises and to 60% of bank capital.	Subject to prior approval for investments in excess of 15%.	Permitted, up to 10% of the bank's capital, but subject to prior approval based on suitability of the shareholder.

The Netherlands	—	Permitted	Permitted through subsidiaries.	Permitted	Subject to regulatory approval for voting shares in excess of 10%.	Subject to regulatory approval for voting shares in excess of 5%.
Singapore	Holding Company	Banks may hold equity participation in stock brokering firms with MAS approval.	Locally incorporated banks may own insurance companies with MAS approval.	Limited in the aggregate to 20% of bank's capital.	Interests in excess of 10%, or that give the bank significant influence over the management of a company, require regulatory approval. In addition, a bank may not invest more than 2% of its capital funds in any individual firm.	Acquisitions of 5%, 12% and 20% or more each require regulatory approval.
Switzerland	—	Permitted through specific license as securities dealer.	Permitted through subsidiaries.	Permitted	Permitted.	Not prohibited, but such investments are generally not made.
United Kingdom	—	Permitted; usually conducted through subsidiaries.	Permitted through subsidiaries.	Permitted	Permitted, subject to supervisory consultations.	No statutory prohibition.

COUNTRY	ORGANIZATIONAL STRUCTURE FOR CONGLOMERATES	SECURITIES	INSURANCE	REAL ESTATE	BANK INVESTMENTS IN INDUSTRIAL FIRMS	INDUSTRIAL FIRM INVESTMENTS IN BANKS
United States	Bank Holding Company (BHC), Financial Holding Company (FHC).	Permitted, but underwriting and dealing in corporate securities must be done through (i) a non-bank subsidiary of a BHC (subject to limits on revenue); (ii) a non bank subsidiary of a FHC (no revenue limits); or (iii) a financial subsidiary of a national bank (no revenue limits).	Insurance underwriting and sales are permissible for non-bank subsidiaries of FHCs. National banks and their subsidiaries are generally restricted to agency sales activities.	Generally limited to holding bank premises	Permitted to hold up to 5% of voting shares through a BHC, but a BHC that is designated as a financial holding company and has a securities affiliate may exercise merchant banking powers to make controlling investments, subject to certain regulatory restrictions.	Permitted to make non-controlling investments up to 25% of the voting shares.

BIBLIOGRAPHY

Association of Insurance and Reinsurance Companies of Turkey. 2000. Annual Report 2000.

Bank for International Settlements. 1995. "The Supervision of Financial Conglomerates," the Tripartite Group of Bank, Securities and Insurance Regulators, July.

Bank for International Settlements. 2001. "Compendium of Documents Produced by the Joint Forum," July.

Bank for International Settlements. 2002. Quarterly Review, June 2002.

Beck, Thorsten, Asli Demirguc-Kunt, and Ross Levine. 1999. "A New Database on Financial Development and Structure," June, Policy Research Working Paper No. 2146.

Bosut, Levent. 2002. "Role of Advisors and Cooperation Attempts," Presentation to the Turkish Venture Capital and Private Equity Association, June.

Capital Markets Board of Turkey. 2001a. Annual Report 2001.

Capital Markets Board of Turkey. 2001b. CMB 2001.

Capital Markets Board of Turkey. Monthly Bulletins.

Caprio, Gerard and Patrick Honohan. 2001. "Finance for Growth," May.

Council of Securities Regulators of the Americas. 1995. "Principles of Effective Market Oversight," May.

Davies, Howard. 2001. "The Regulation of Fund Management in Europe," 11th Annual Fund Forum International Conference, Grimaldi Forum, Monte Carlo, July.

Euromoney Books, 2003. World Leasing Yearbook 2003.

Factors Chain International. 2001. Annual Report 2001.

Institute of International Bankers. 2001. Global Survey 2001.

International Organization of Securities Commissions. 1996 "Legal and Regulatory Framework for Exchange Traded Derivatives," Report of the Emerging Markets Committee, Public Document No. 53, June.

International Organization of Securities Commissions. 2000. "Model for Effective Self-Regulation," Report of the SRO Consultative Committee, Public Document No. 110, May.

International Organization of Securities Commissions. 2002. Objectives and Principles of Securities Regulation, February.

Investment Company Institute. 2002. Mutual Fund Fact Book 2002.

Investment Company Institute. 1996. "Operating Expense Ratios, Assets and Economies of Scale in Equity Mutual Funds," ICI Perspectives, December 1996 by John Rea, , Brian Reid, and Kimberly Millar.

Istanbul Stock Exchange. 2001. Annual Report 2001.

Istanbul Stock Exchange, 2002. "Markets and Operations," May.

OECD. 2000. Small and Medium Enterprise Outlook.

Price Waterhouse Coopers, 1999. "Good Practices for Meeting Market Expectations," May.

Republic of Turkey Prime Ministry, 2000. Undersecretariat of Treasury, Insurance Supervisory Board: Reports About Insurance Activities in Turkey, 1999–2000.

Scott, David. 1995. "Regulation and Supervision of Financial Conglomerates," March.

Standard & Poor's. 2000. "Emerging Stock Markets Fact Book."

Swiss Re. 2002. "World Insurance in 2001," No. 6. 2002, Sigma Insurance Research.

TAKASBANK. 2001. Annual Report 2001.

World Bank, 2000. "Structural Reforms for Sustainable Growth," Turkey Country Economic Memorandum, September 2000.

Non-Bank Financial Institutions and Capital Markets in Turkey is part of the World Bank Country Study series. These reports are published with the approval of the subject government to communicate the results of the Bank's work on the economic and related conditions of member countries to governments and to the development community.

This study analyzes the state of development and prospects for future growth of Turkish non-bank financial institutions and capital markets. Currently, credit markets in Turkey are dominated by banking, while capital markets are dominated by Government securities. Longstanding macroeconomic instability and inflation have discouraged investment in financial assets and crowded out funding for the private sector. The resulting lack of depth and breadth has made the financial sector vulnerable to shocks resulting from repeated crises, and has reduced its intermediation efficiency.

To enhance the financial sector's capacity to support private sector development and economic growth, and to reduce its vulnerability to shocks, non-bank sources of finance should be developed. This report identifies the key policy issues that should be addressed for this purpose. The discussion and policy recommendations are structured around the following leading themes: (i) mobilizing savings, (ii) building an institutional investor base comprising insurance companies, private pension funds, and mutual funds; (iii) developing equity markets, debt markets, and derivative markets; (iv) developing leasing, factoring and venture capital companies, and (v) strengthening confidence in financial markets through improved corporate governance, accounting and auditing standards and practices, as well as financial sector regulation and supervision.

World Bank Country Studies are available individually or by subscription, both in print and on-line.

THE WORLD BANK
1818 H Street, NW
Washington, DC 20433 USA
Telephone: 202 473-1000
Internet: www.worldbank.org
E-mail: feedback@worldbank.org

9 780821 355275 155
ISBN 0-8213-552