

Perspectives of Turkish Banks on Basel II

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Abstract

This research is concerned with Turkish banks' perception on effectiveness of Basel II, it also aims to capture the possible 'side-effects' of Basel II on real economy. It examines how new regulations affect banks' risk management strategies and bank-borrower relationships and analyzes the role of rating agencies and possible consequences of this intermediation on credit allocation to Small and Medium Sized Enterprises and on banks' marketing strategy(ies). The effects of new regulations on the competitive structure of the sector, and the issue of procyclicality and financial volatility in emerging economies is also debated to understand the risk management environment in Turkey as well as the effectiveness of new regulation in enhancing the stability of Turkish banking system. The paper ends with a general discussion of the findings derived from open-ended interviews with risk managers of 24 banks and related authorities from the Turkish Banking Regulation and Supervisory Agency.

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1 Discussion of Basel II

Basel II has two fundamental objectives, one of which is "to develop a framework that would further strengthen the soundness and stability of the international banking system..." [1]. However, although it is widely acknowledged that Basel II regulation will improve the existing financial system, it is also criticized "for allowing the use of bank internal models to determine capital charges, for boosting pro-cyclicality of the banking industry, for reliance on rating agencies and for being an exclusionary, discriminatory and a one-size-fits all approach"[2]. For this reason, it is not only important to discuss the possible 'side-effects' of Basel II on real economy, but also to understand how risk managers evaluate the effectiveness of Basel II in enhancing both the risk management

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capability of banks and the stability of Turkish financial system. New regulations indeed bring about important questions on risk management culture among public and private sector actors in Turkey.

Concomitantly, the role of institutional pressures on the organizational structure of banks and the extent of change in top managements' attitude towards risk managers and risk management department should be investigated. Drawing on institutional theory, more concretely on DiMaggio & Powell's [3] conception of institutional isomorphism, some powerful agents may impose formal structures and practices on other organizations. In relation to the banking sector, prior research highlights the lack of strong normative (i.e. risk management culture and rating based approach) influence on banks in the new regulatory environment, as well as the limited capacity of the BRSA in monitoring risk management procedures and practices [4]. Nor did banks are found equipped with adequate risk management systems of their own. The increasing coercive influence exerted on banks and/or their behaviours through the regulatory agency, both during the rule-making and adoption procedures, offers an interesting case in portraying the enforcing and regulative aspects of the environment in which banks operate: for banks are required to function within the regulations set by the BRSA and failure to comply may lead to various sanctions and penalties. Such coercive pressures is thus worth studying the potential of new regulations in implanting new structures or layers within the organizational hierarchy as well as in legitimizing certain practices within the organization culture, especially in the absence of normative expectations and standards, rules and values.

Another controversial topic is the effect of capital adequacy regulation on competition in the banking sector. One of the important motivations for Basel II is "maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks" [1]. Thus the main focus of Basel regulation is on internationally active banks. These are the large banks that would easily adapt the changes - also known as IRB-banks (Internal Ratings Based-banks). However, smaller banks or community banks most probably would not be able adopt Internal Ratings Based (IRB) Approach and use Standardized Approach (SA) instead. Shin in [5] indeed expects further mergers and acquisitions in the sector, since sophisticated banks using IRB with the advantage of having less capital requirements would buy the unsophisticated banks. Thus foreign bank entry levels are among the important topics. Shin also argues that "for corporate loans, there will be market segmentation between local banks and the branches and subsidiaries of international banks.....the market for all but the highest-rated corporate borrowers will be captured by the domestic banks" (p.22). In close connection, Altman and Sabato [6] assert that "large, well-diversified banks, which will be the first to implement the A-IRB (Advanced-IRB) approach, will reap the biggest benefits, probably reducing or possibly even eliminating the current competitive advantage of small, specialized banking organizations based on their privileged "relationship lending" situation" (p.34).

This study argues that there is a large probability that Basel II would increase already existing monopolistic tendencies in Turkey: while large banks would tend to couple with less risky customers (since less capital requirements allow them to offer favourable prices), small banks (not being able to use IRB method) would have to finance smaller and riskier firms/projects. It can be expected that new regulation would create incentives to change the credit allocation of the banks so that large banks would mostly choose its customers among less risky large firms. Besides, large firms would prefer large banks

since, with less capital requirements; they would be able to offer more favourable pricing to their customers. However, small banks, not being able to use IRB method, would have to work with smaller firms and riskier projects. Thus, the nature of bank-borrower relations would be expected to change. It may be even possible to foresee two separate markets: one for large banks and firms (including local branches of international banks), the other for small banks and firms. To argue further, competition may lead small banks and firms to disappear, leaving the market for only big players. To no less extent, as argued by Shin, Basel II may widen the gap between foreign banks and domestic banks, thus increasing the chances for mergers between international and local banks.

As stated in the literature, new regulation may change the ways in which banks allocate their credits between large and small firms in the long-term, thus alter their previous market segmentation strategies and practices. However, due to the banks selective approach towards specific portfolios, changes in the credit allocation can also be expected even in the short term. To illustrate, several researches provided that banks would tend to increase their retail portfolios, as their risk weight is smaller under SA compared to Basel I [5][7][6]. Jacobson, et al. [8] also points that retail credit and loans to SMEs receive a differential treatment than corporate loans; since the former is generally found to be less sensitive to systematic risk. Similarly, since capital requirements are higher for sovereign portfolios, their share may be expected to fall over time [5][7]. Moreover, Basel II may have different effects on sectors, i.e. making certain sectors more preferable in the eyes of banks. Thus, it is worth studying the expectations of bank managers in terms of their banks' credit allocation and marketing strategies in tandem with Basel II.

The implementation of Basel II holds potential implications for commercial loans to small firms. Therefore another related issue is how Basel II affects borrowing relationships and shape firms' credit accessibility. In reference to bank-customer relationships, the interaction of these actors can be distinguished on two bases: Arm's length ties, simply put as shopping at the market for potential loan offers; or embedded ties, which can be described as repetitive economic activities based on social, interpersonal, reputation and trust based relationships [9]. Sociological approaches to the small business loan market show that the ability to meet financial selection criteria is not only a matter of economic decision but also is a product of firm's characteristics and socially arranged opportunity structures which it is embedded. In the context, the research also asks in which ways Basel II arrangements would alter these embedded relationships. One important advantage of embedded ties is that firms and banks may try to find solutions to financing problems of the former if they have pre-existing relationship [10],[11]. Moreover, banks can customize deals and create innovative risk-reducing instruments for their client firms when they develop strong ties. If Basel II would not allow these partners to develop such embedded ties, SMEs may find themselves alone in dealing with their financial problems. If Basel II (more concretely banks implementation of the Accord) helps banks to improve their customer care system, then banks should be expected to meet their customers more regularly, hence develop stronger ties and to be more sensitive to the needs of SMEs. Besides, in the eyes of SMEs, embedded ties may reduce SMEs' unwillingness to grant banks too many insights, hence increase the potential efficiency of the regulation. However, it is also possible to play the devil's advocate: Not only can one argue that Basel II may decrease the chance of SME's access to credit opportunities, but it may also deteriorate already existing social structure by imposing an economic rationality (the imperatives of the market) over inter-personal relationships. The destruction of such extra-economic relationship may reduce bank's risks and stabilize the banking sector, but

it may also weaken the relationship of financial sector with real (productive) sector, especially in the long run. For policy purposes, it may be argued that the trade-off between financial crises and implementation costs of Basel II are miscalculated since several observers expect a possible restrictive lending policy. Given that SMEs accounted almost 90% of all manufacturing firms in Turkey, the reduction in the lending activity toward SMEs would have long-term negative effects on economic parameters.

Finally, the problem of procyclicality and financial volatility in emerging economies needs to be addressed. Since Basel II is deliberately aimed at increasing the risk-sensitivity of capital requirements, it is argued that the regulation may lead to an amplification of business-cycle fluctuations [12]. This is because capital requirements under A-IRB will tend to increase as economy falls into a recession and to decrease as an economy enters an expansion. The procyclicality of the financial system is strongly related to the rating behavior of lenders. When economic conditions improve, capital requirements will be lower due to favorable ratings. However when the economy enters a recessive period, it is very likely that the capital requirements will increase under A-IRB due to unfavourable ratings, thus Basel II may accelerate financial instability. Kim and Lee [13] show that since bank credit is still the most popular source of funding in developing countries, a decline in bank loans would likely to increase the impact of economic recession; while in quite contrast procyclicality may not be a problem at all in advanced countries.

There are also two related studies that should be mentioned here. First one studies the implications of new regulations for the Chinese banking system. The study frames three specific propositions, namely, “Basel II will improve risk management; Basel II will improve capital allocation efficiency; and compliance with advanced risk management systems is biased in favor of the large banks”[14]. The results of their study strongly support the first two propositions and partly support the last one. The other study focuses on the perspectives of Austrian banks and SMEs regarding Basel II[15]. The study focused on issues such as customer-bank relationship, competition, pricing, alternative financing, and pro-cyclicality. Overall results showed that how Basel II will transform the system will depend on the strategic interactions of banks and SMEs. The current study looks at the similar issues from the perspective of risk managers in Turkish banking sector.

Within this framework, four research propositions were formulated to portray the implications of Basel II on broad macro-economic environment:

Proposition 1: Basel II seeks to improve risk measurement and management practices at banking organizations; it however does not necessarily prevent financial crisis at home and abroad.

Proposition 2: Basel II will lead to a new customer segmentation in the banking system: while large banks would prefer large (and secure) firms as their customers, small and medium banks will have to work with SMEs.

Proposition 3: Since the capital structure of banks will be purely shaped by risk considerations, Basel II may lead to a decline in investments to productive but risky.

Proposition 4: Basel II will also alter the competitive structure in the banking sector: internationally active banks will benefit most, followed by the largest actors in the sector. Small banks will be at a disadvantaged position due to relatively larger costs and risks.

2 Methodology

As the objective of this study is to understand how actors within the domestic banking system perceive short to long-term consequences of new Basel regulations, in-depth interviews are found the most effective method. As Boyce and Neale [16] noted “in-depth interviews are useful when one wants detailed information about a person’s thoughts and behaviours”. Open-ended interviews were conducted with a number of risk managers. Although a total completeness cannot be claimed due to inaccessibility to some banks, the sample claims to be representative for the following reasons: In order to include a wide variety of respondents, banks are first categorized in four different segments: public, private, foreign partnerships/foreign branches, and participation banks, and then according to their type, ownership structure, market share, number of branches, and scope. In total risk managers of 24 (out of 49) banks in Turkey are interviewed. The sample includes three public banks, ten private banks, and eleven global banks (two of which are participation banks). In total it covers the 81.19% of banking sector in terms of asset size. Moreover, total number of respondents included not only big players (the market makers), but also small-and-medium sized ones and/or the ones operating at the niche (six large-scale banks, five medium-scale banks, six small-scale banks and seven micro-scale banks). To assess their position vis-à-vis new regulations, an interview was also conducted with representatives of participation banks. Besides banks with foreign partnerships, investment banks, which were mostly operating as branches of foreign big players, were also contacted and their statements were also included in the findings. Although the latter group is not directly bounded by new regulations, their contribution is found significant to give a comprehensive portrait of the domestic banking sector. Finally, a representative from the BRSA is also interviewed to obtain further information on the process.

The participants (risk managers) were contacted either by e-mail or phone to arrange an appointment. They were provided with a clear idea on the objective and scope of the research in advance, and if demanded interview questions were sent electronically before the actual face-to-face meeting. Interviews lasted approximately an hour and held at meeting or conference rooms (with few exceptions) at the headquarters of the participants’ respective banks. As they were isolated from other employees, this allowed a semi-informal atmosphere. A guided approach is preferred in directing the questions to the interviewee to gather general information and ideas on Basel II. Each interview is thus started with general questions and continued with a systematic investigation of main propositions of the research and other related sub-questions. Lastly, the participants were asked whether they have any other comments or suggestions on Basel II. The questions can be provided by authors upon request.

While answering questions, the participants were allowed to approach the subject from different perspectives. The answers were mostly given from the viewpoint of the risk manager of the bank under question. In few cases they clearly indicated that answers are their own personal opinion and do not represent their respective banks’ policy on the subject matter. This flexibility allowed a certain degree of freedom and adaptability in getting the information from the participant. Every effort was made not to direct the participants in answering questions. This not only aimed to avoid bias, but also to convey the meanings in the subjects’ specific words, descriptions and/or central reference themes. In short, the reason behind open-ended interviews was to understand what the respondents say by getting the whole story from the perspective of the risk managers while pursuing

in-depth information around the topic. This method also gave the authors the opportunity to probe or ask follow up questions.

3 Results

The main research question and sub-questions are reformulated around certain propositions, which aimed to capture bank's perception on Basel II from various angles. The interviews were also designed around various sections (around different propositions with their own set of sub-questions). The first set of questions was on the effectiveness of Basel II in terms of stability of banks and financial system, in general, and in emerging markets, in particular (with a special reference to Turkey). This was followed by a set of questions on possible effects of Basel II on bank-customer relations and on probable changes on credit allocation in the banking sector. A group of questions were also devoted to understand the possible impacts of Basel II on competition in the banking sector. Moreover, the respondents were asked to comment on the measures taken by their respective bank to implement Basel II and the relationship with the supervisory agency (BRSA) and so on.

3.1 Proposition 1

There has been a general consensus on the part of the respondents that financial system as a whole has significantly improved in Turkey in the last decade, and that Basel II will also contribute to this process. Nevertheless, quite a number of interviewees refrained to define Basel II as the sole determinant. Instead, the growing importance of regulations is strongly associated with the 2000/1 Turkish financial crises, which severely hit the domestic banking sector and led to a clean sweep among small and risky banks, whereas the regulatory agency became a prominent and active actor in limiting the actions of institutions. The Banking Act No.4389 issued in 1999 had required banks to establish their internal control, and risk control and management systems so as to monitor and govern the risks banks may face due to upswings in the market. Yet, the most notable change came with new regulations on February 8, 2001: For it aimed to determine the principles and procedures that banks would refer to when establishing and governing internal audit and risk management systems. More importantly, it maintained the separation of internal control and risk management systems and made them accountable directly to the Bank Board and senior management. Besides, some respondents, especially the ones from large banks and/or from foreign affiliated banks, argued that the change in the regulatory environment was to fulfil the necessary conditions to fit local actors into the global banking system: The internalization process forced such large actors to establish and develop their own risk management systems so as to obtain syndicated credits from global actors. As some respondents commented, new techniques and a novel attitude towards risk management had to be adopted, regardless of Basel Accords. Thus, the implementation of Basel II is seen in a continuum.

Above arguments however does not mean that institutional pressures were absent or had a limited role in mediating this change. On the contrary, both the 2000/1 financial crises and the internationalization process rendered actors within the domestic market highly dependent on the institutional environment and forced them to exist under high

uncertainty. As it will be discussed below due to the existence of high coercive pressures, banks tended to adopt new structures more quickly.

The regulatory agency had postponed the implementation of Basel II until July 2012 due to the global financial crisis. The delay had two inter-related consequences: First it provided banks and their respective risk management departments with necessary time to develop related systems and processes to fit the standards of the new Basel Accord. Second, meetings organized by the regulatory agency with various types of banks during the preparation period have increased the legitimacy of new regulations in the eyes of the participants. The BRSA indeed held three very important meetings: while first two of which was held with the largest players (known as QIS-TR1 and QIS-TR2), the last one (QIS-TR3) also included small banks. In addition to these meetings, there has been an ongoing debate within the media and academic circles on the possible effects of Basel II.

While in-house training programs allowed risk managers to transfer technical knowledge and to diffuse certain practices to other layers within the bank hierarchy, new governance models were developed to institutionalize the logic and new practices of risk management. Some contributors argued that risk management techniques not only became a common practice, but also were internalized by other departments and, in few cases, even by top management where the final decision is taken. These respondents also noted that upper management layers have become more responsive to the suggestions and contributions of risk management departments. Put differently, the communication channels between risk departments and upper management have altered throughout Basel II preparations and thicker the information has become.

Although it is possible to argue that coercive pressures have accelerated the rate of adoption of both forms and/or vocabularies of the new structure, the net effect of institutional pressures is far from presenting homogeneity. It would be too ambitious to argue that 'the change', as described above, is experienced and/or perceived in a similar manner: While largest players along with foreign owned-banks and their local partners adopt new regulations to improve efficiency, small banks adopt (only the structural form) primarily to maintain legitimacy. Thus, the change in risk management culture has been more significant and observable for the former group. Our findings also coincide with other observations that foreign participation alleviates the costs of adaptation to Basel II as it provides support and oversight in internal control and risk management [4]. Since risk management departments are still seen as a source of cost for most small banks, the very same change has manifested itself quite differently. The respondents from the latter group stated that top management has rather adopted an instrumental approach towards new regulations. In short, they seemed quite content with fulfilling the basic requirements instead of portraying a full commitment to the new principles in risk management. Nevertheless, risk managers from such banks also argued that Basel II preparations were helpful in strengthening the role of risk managers within the organizational hierarchy. In other words, BRSA regulations have been more important as a driving force for the latter than the former. One of the participants from the latter group indeed described the situation as "rising from their own ashes".

Quite a few interviewees addressed the domestic banking system as a 'conservative' one. There are various reasons for this observation. First, although the regulations governing the mortgage market were active for some time, this has not been true for the related toxic financial products and instruments. This feature is strongly associated with the BRSA's risk aversion. Yet to no less extent, the market makers (large banks) are also found conservative in their demands from the policy makers and regulators. Second, the

regulatory limits brought by the BRSA were already in line with the standards of Basel III, thus long before the adaption process had started: the minimum required capital ratio, capital adequacy ratio (CAR), has been %12 in Turkey, whereas the very same ratio was set at 8% worldwide. When the quality of capital held and the difference between CARs are considered, it is observed that foreign banks have much higher leverage ratios compared to their counterparts in Turkey. The limits for liquidity ratios (part of Basel III) and capital for operational risk (part of Basel II) were already required for banks in the Turkish market starting from 2007, thus long before parallel implementation of Basel II on July 2012. As an in-house joke, the system is often referred as 'Basel 1.5' by Turkish risk managers. Last but not the least, all banks are required to start Basel II with standard method without exception; whether they were ready to adopt the advanced approach was not taken into account. In sum, this 'conservative approach' was regarded among the reasons why the banking sector in Turkey did not severely hit by the global financial crisis.

On the other hand, almost all contributors underlined that neither Basel II nor its follow-ups would prevent new, country specific or worldwide financial disruptions. Nevertheless, they acknowledged that banks would be on a stronger position in protecting themselves from immediate effects of a new crisis. In this context, our respondents have referred to 'the procyclicality effect' rather frequently. It is identified as one of the central issues of the credit market and as a deadlock. Few told us they fear that the pro-cyclical effect could increase, if the market is overly regulated. However, they also immediately noted that it is not exclusively brought about by new regulations, but rather it should be seen as an inherent characteristic of the current financial system. Basel II in this regard, may work as a catalyst by increasing the risk-sensitivity of capital requirements. Furthermore, risk managers commented on the possibility of new measures such as capital buffer, limitations on leverage ratio, and/or counterparty credit risk in securing financial stability. According to them, one of the most important reasons behind the 2007 global financial crisis was the liquidity problem. Consistently, Basel III includes liquidity ratio requirements. However, one of our interviewees claimed that "[e]ven if Lehman Brothers' capital requirement were calculated according to Basel III criteria, the firm would still be expected to bankrupt"⁴. Others also confirmed this hypothesis. Several other commentators argued that the tendency towards riskier instruments and the growing risk appetite in the sector (before the global crisis) was also strongly related to the ever increasing bonuses granted to upper executives of financial institutions. Thus, there is a firm commitment among the market players that new capital requirements to be announced by Basel III are not as sturdy as they may seem: For the problem lies elsewhere.

3.2 Proposition 2

The objective of the questions in this set is two-fold: First, it aimed to identify possible changes in lending relations. Second, since this question gained importance particularly in

⁴The respondent explained the reason behind the comment as follows: Once colossal finance company Lehman Brothers had reported their official leverage ratio to be 31 - 1 before they went bankrupt in 2007. Basel III is expected to limit this ratio to 33 - 1. Thus, Basel III is far from limiting Lehman Brothers' risk appetite.

reference to banks' relationship with SMEs, the research also focused on the possible changes in banks' credit allocation.

Evidently, there has been a general concern on how Basel II would affect banks' preferences in distributing their credits. It is argued that the Turkish media had a negative role in encouraging such concerns regarding the possible decline in credits allocated to SMEs. Yet all respondents (except the ones from investment banks) clearly underlined that these concerns had no sound ground. Nor will it ever be. For them, instead of limiting SMEs' credit opportunities, Basel II would offer new advantages. To alleviate SMEs concerns, panels and conferences were organized with the help of various chambers of commerce and industry, brochures were prepared, and meetings were held with customers between 2006 and 2008. There was a general consensus that if SMEs follow an open and transparent information policy, there would be no reason to worry about changes in credit allocation patterns. On the social nature of the ties between the lenders and borrowers, while large banks tend not to comment on the issue, small-scale banks, including participation banks, confirmed they have strong embedded ties with their customers and that they do not foresee a change in the nature of relations in the long-run. Contrariwise, they argued that experiences from previous dealings, firm reputation, repetitive interactions that stems from trust and/or social capital would continue to be important criteria in channelling funds to their customers. The risk manager of participation banks also underlined that since they are serving a niche clientele with a conservative worldview and lifestyle, they found it very unlikely to lose their customers due to Basel II. Nevertheless, it would not be false to argue that none of the banks had launched an active customer care system.

Interestingly enough, most respondents remained silent on how Basel II will affect different sectors: For it could be classified as confidential information. Yet few commented that then-locomotive sector of Turkey, namely textile, could be negatively affected. When asked about another locomotive sector (construction) and a rising sector (energy), commentators argued that their future depends less on Basel II than government's future economic policies. Few also commented size-related choices or sectoral preferences are generally taken at the executive level and Basel II may not bear a strong direct impact on them. Thus, it can be argued that there is a firm belief among the banks that Basel II would not bring about sudden changes in lending relations in the short to medium run.

While most large banks argued that they are not expecting a radical change in terms of customer segmentation even in the long-run, small banks seemed sceptical. The latter argued that there is a great chance that their positions *vis-a-vis* customer segmentation will be determined by the actions of large players, especially when larger banks shift to advanced method and some medium and small players continue with the standard method. Two different scenarios are described: First, thanks to the advantages of using advanced methods, competition would intensify within the financial sector, which would also alter the pricing of credits. This is very much related with the assumption that SMEs fall into a higher risk category in the eyes of larger banks. If SMEs want to work with large banks, they then would have to obtain credits at higher interest rates. Or they would have to seek lower prices at other places, from small and medium banks.

This would result in *de facto* segmentation in the banking sector⁵. Second, even if large banks start to use advanced methods and internal rating, they would prefer not to reflect any costs related to the risk of SMEs to the pricing of the loans, thus SMEs would stay as a part of large banks' target market and segmentation would not occur. This concludes that medium and small sized banks would either have to create a niche market for themselves, or would have to merge with larger banks, if not then or fail.

3.3 Proposition3

As stated above, risk considerations have been internalized not only by risk managers but also by upper managers and other related units within the organizational hierarchy such as marketing and credit departments. The growing awareness took various forms (such as questioning the amount of capital allocated for a loan) yet welcomed by the risk managers.

Table 1: Capital Adequacy Ratios (CAR) Based on Types of Banks*

(%)	2010/12	2011/3	2011/12	2012/3
Development and Investment Banks	58,66	56,45	48,17	48,50
SDIF Banks	53,01	54,44	58,77	44,04
Private Banks	18,21	16,94	15,48	15,35
Foreign Banks	17,34	16,66	16,88	16,91
Public Banks	16,74	16,16	14,53	14,97
Participation Banks	15,07	14,59	14,04	13,91
Banking Sector	18,97	17,97	16,55	16,56

*Source: Turkish Banking Sector General Report, BRSA, March 2012/2

Thus other departments have started to consider the risk measurements and requirements of their bank: they either have preferred to approve less risky credits or institutionalize the lending process further. The latter option required more attention on the preparation of legal documents by the related department within the bank, so that required level of capital for a specific loan could be decreased with the increasing transparency of firms. However, it would be too strong to argue that banks' capital structure will be purely shaped by risk considerations at the current conjuncture. Table 1 in the previous page shows the changes in the average capital adequacy ratio (CAR) in years for Turkish banking sector. The last figure realized as average CAR is equal to %16,56 on March 2012. It is seen clearly from the table that although CAR has a trend of decreasing, it is more than %4 higher than the target percentage (12%), twice the legal limit imposed by Basel II (8% - when looked CAR for each bank, the picture does not change). This is an

⁵There is partial support for this scenario. When SME credit concentration is compared among the banks, it is observed that for large and small-scale banks, this measurement has decreased for the last four years, however it increased for medium scale banks and participation banks. Eventually it can be also speculated that micro or small scale banks are going to disappear, only large banks and medium banks that can create a niche market for themselves will be able to survive in the sector.

important observation emphasized by risk managers in terms of our third proposition. For the banks are not on the edge of legal limits of CARs, the market is not governed by purely risk considerations. Rather the Turkish Banking sector is not saturated and thus is still profit oriented. Indeed some of risk managers also agreed that risk considerations could be much more important if the CARs were close to legal limits.

The interviewees were also asked whether they expect any changes in their credit allocation due to Basel II. Although the immediate response was negative (that they do not foresee any significant change), as the discussion goes on it becomes apparent that risk concerns brought about by Basel II have already led (and will lead) to some changes. First, almost all of risk managers have mentioned the attractiveness of SME market, as it is profitable and risk is diversified with many borrowers⁶. They have noted that there will be an inclination to work with retail SMEs rather than corporate SMEs since new regulations bring capital requirement advantages for that category. Besides, since the regulation dictates that retail SMEs do not receive more than 1 million Euro bank credit, risk managers may prefer to partition larger credit demands from SMEs. Risk managers, thanks to this advantage associated with the retail category, stressed that Basel II would increase the capital allocated to the SMEs contrary to negative expectations. Yet, they also underlined that certain SMEs would find themselves at a disadvantaged position, especially if the Internal Rating Based Approach (IRBA) used. Yet, these SMEs are generally the ones that operate within the boundaries of informal economy and do not provide transparent balance sheets. For the IRBA, not only rating becomes more important, but also the data provided in the firms' balance sheet. The ones that successfully present themselves as companies with solid and transparent balance sheets would likely survive; the others either would default or look for consolidations. Thus, in long term Basel II is a cause of solidity not only for banking sector but also indirectly for the real sector.

3.4 Proposition4

The discrepancy among banks in answering how Basel II will affect competition in Turkish banking sector was evident. The largest market actors are convinced that Basel II would not have a direct impact on competition. They firmly believed that the financial market in Turkey has yet to be saturated and there will always be enough room for various and a fair number of players. However, when the same question asked to representatives of smaller banks, banks with foreign partners or ownerships, the story changed suddenly. Although they do not disagree that several unexploited opportunities are still on the air, a different scenario was found very likely. According to them, the Turkish financial market would go through a serious process of centralization and concentration, thus a process of devalorization: While the largest ones would increase their market share, medium-scale banks would either merge (thus consolidate) to survive or go out of business. Others (often small ones) would withdraw to the niches of the market by offering unique services: such as providing almost exclusively export-oriented services to certain geographies, interest-free banking and so on. The respondent from the participation bank also confirmed the likelihood of this scenario and further argued that

⁶One risk manager very rightly claimed that during the crisis since the correlations among these small companies are high, defaults can be quite detrimental, thus he/she emphasized the risk diversified is the unsystematic one here.

consolidation among participation banks may also occur when the competition becomes more intense. Moreover, as argued, it is very likely that the remaining ones would have strong international linkages in different forms. Thus, foreign bank penetration is likely to increase according to these respondents. Some respondents tend to see this as an ongoing process and refrained from attributing this likelihood of this scenario exclusively to Basel II. Nor could they ignore its role in accelerating the process⁷.

Finally, on the standardization of the system, all respondent agreed that BRSA policies should cover all the banks operating in Turkey, despite their scale, type and/or ownership. When asked particularly about whether Basel II adaptation of participation banks should differ due to their different risk-taking behaviour, or whether small banks may have some privileges since they are too small to cover the expenses related Basel II, interviewees firmly pointed that no exceptions should be allowed and all banks should implement Basel II in the same way. However, BRSA has already adapted a smaller risk weight⁸ to the “participation funds” collected by participation banks due to the different risk type of these funds⁹, thus participation banks apply a different rule in the implementation of Basel II. However, this difference does not create a real advantage for participation banks for the moment since the proportion of “participation funds” in assets is quite small in their balance sheet, whereas this account is the one that really differentiates the participation banks from conventional banks. Only if participation banks can increase their proportion in participation funds in future, then the difference in regulation can create an advantage. Only then we can expect the demand on loans to drift to participation banks. Therefore, it seems that participation banks may benefit from Basel II only if in the long term when they start to work along the participation bank principles set for them.

4 Conclusion

The banks have devoted enthusiastically both their time and energy to prepare themselves for Basel II since the announcement of the regulation in 2003. However, the implementation of Basel II was postponed in 2006 until the summer of 2012. Therefore, the transition rather followed a slow pace. Although this created problems in terms of motivation and commitment on the part of banks, it did not appear merely as the regulatory agencies’ decision or dictation. Risk managers also confirmed that this was the right decision in the wake of the global financial crisis. Moreover, thanks to the delay, not only did banks find enough time to prepare technically for the implementation of

⁷ On the other hand, foreign capital ratio in assets is already equal to 49% currently. One of the risk managers has commented that BRSA is inclined not to allow a higher foreign capital ratio in the sector, thus even if more foreign capital demands to enter to the Turkish market, an increase in the penetration is not expected.

⁸ According to Draft Regulation on Measurement and Assessment of Capital Adequacy of Banks by BRSA(2006), the basis for credit risk of balance sheet accounts other than participation funds amounts to their value in the balance sheet, on the other hand that of participation funds amounts to seventy percent of their value in balance sheet.

⁹Participation funds are like venture capital loans; there is no guarantee that these funds are going to return anything to the depositor. Only if the investment makes profit, then the depositor also gains, otherwise not. Besides, depositor cannot withdraw money before the investment ends. In that sense, the risk due to these loans for the bank is smaller compared to a conventional deposit account.

Basel II, but they also had a chance to make changes in credit allocation structures. Thus their required capital would not need to change significantly. Eventually all banks are planning to use the IRBA (approximately within 5 years). However, they are required to implement Basel II with the Standard Approach first and then to transfer to the IRBA. This stands true for even those who are technically ready to use AIRBA. The rationale behind this is Turkey being an emerging economy with a conservative banking sector. Indeed, most of the firms are not rated, and even if they were, they probably would have got negative ratings. Therefore, the SA is much more advantageous than the IRBA.

Most of the interviewees agree that the banks will be on a stronger and safer position in protecting their liquidities in the event of a financial crisis with Basel II; this is not only due to the required level of capital adequacy ratio, which provides a certain degree of protection against possible fluctuations, but also due to the improvement in risk management culture of banks. On the other hand, new regulations are not found totally effective in preventing financial crisis. Furthermore, the banking sector is concerned that the procyclicality issue would be a serious threat if the market were 'over-regulated'. Thus, the results strongly support the Proposition 1. In terms of improvement in banks' risk management culture, it is worth noting that this improvement is not realized similarly at all banks. For large banks, with Basel II requirements, the bank as a whole becomes responsible to the Risk Management Department. On the other hand, for small banks, despite all positive improvements in terms of risk management practices, Risk Management Department is still seen as a factor of cost at least at the governance level.

A change in customer-bank relations due to new regulations is not anticipated by the banking sector in the near future. Besides, most large banks do not expect a radical change in terms of customer segmentation even in the long run. However, small banks do have a rather sceptical view on the issue. They argue that in the long run, larger banks may choose to work with larger businesses, since SMEs would fall into a higher risk category with the advanced risk measurement methods. On the other hand, small and medium sized banks would be more aggressive to attract SMEs offering them better interest rates. Thus Proposition 2 is not supported for the foreseen future, but medium and small banks see it as a plausible argument in the long term.

The analysis of the capital adequacy ratio of the Turkish banking sector indicates that the market is not purely governed by risk considerations; the market is unsaturated and it is still profitable. The risk managers admit that financing SMEs carry relatively higher risks. However profitability of crediting *risky* businesses remains attractive to them. The banking sector chooses to reduce such risks by holding a diversified customer portfolio. As a part of their strategy to minimize the required level of capital, banks increase the amount of mortgages and/or decrease the amount of sovereign portfolio (in Foreign Currency) in their overall portfolios. Thus, the results partly support the Proposition 3, which argued capital reallocation is done purely by risk considerations. Although there are indeed more advantaged sectors in terms of risk management, that fact does not mean that investments allocated to productive but risky sectors are going to decrease in the near future.

An interesting conclusion derived from the research is that large and small-and-medium banks have different perceptions on how competition would be affected by the implementation of Basel II. While the former believed that Basel II would not have a direct impact on competition, the latter expected the domestic banking sector would experience a serious process of centralization and concentration. Although the general idea is that the market is yet to be saturated and new market opportunities will remain present

in the near future; new regulations are expected to centralize the sector eliminating some small scale banks. While larger and international banks would increase their market shares, small and medium scale banks would have to either merge or find niche markets offering unique services. Besides, the fact that foreign oriented banks possess the technical ability to adopt Basel II rules easier, gives them a competitive advantage in the market. Therefore it can be argued that Proposition 4 is supported to some extent. Another important contribution of the collected empirical data is related to the expectations of risk managers from the BRSA. The commentators underlined that the BRSA should go through a change in its role as an audit. The managers want the regulator to inform and cooperate with them more regularly. Although the BRSA has taken several steps to satisfy such expectations (through QIS meetings, reports and frequently answering questions), the efforts are found still inadequate. They also expect the BRSA to have a flexible structure to accelerate the processes in decision-making and implementation.

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