Durmuş Yilmaz: Financial Stability Report – II

Speech by Mr Durmuş Yilmaz, Governor of the Central Bank of the Republic of Turkey, at the presentation of the "Financial Stability Report – II", Ankara, 13 June 2006.

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Distinguished Guests, Dear Members of the Press,

Last August, we shared with you the first Financial Stability Report, which we consider to be supportive of price stability, our primary objective, and involves a compilation of our studies on the evaluations of financial stability. I am happy to present the second report to you today. I would also like to remind you that this report will be on the Bank's web page as of today.

Today, I would firstly like to focus on the definition and significance of financial stability and central banks' approaches to the issue. Then I will touch on the duties and powers of the Bank regarding financial stability. Lastly, I would like to emphasize the main points in the Financial Stability Report.

Distinguished Guests,

Providing a clear definition of financial stability is as difficult as achieving and maintaining it. In a broader sense, financial stability can be defined as the condition of an economy's mechanisms for pricing, allocating resources and managing financial risks functioning well enough to contribute to the performance of the economy.[1] The European Central Bank defines financial stability as a condition whereby the financial system is able to withstand shocks without impairing the transformation of savings to investment opportunities. Moreover, some definitions are also derived from the concept of instability.

In recent years, globalization of financial markets, increased richness in financial instruments, financial deepening and structural changes have caused the system to become much more complicated, thus enhancing the significance of financial stability. Any fluctuation that may occur in foreign markets may rapidly spread to other countries. As a matter of fact, recent developments in international financial markets were also reflected on Turkey. I can say with great pleasure that the strengthened financial structure of Turkey has minimized the unfavorable effects of recent fluctuations. This case, once again, has proven the significance of a sound financial system with risk sensitive policies, which is reinforced by effective monitoring and supervision. It is a widely known and accepted fact that the primary objective of central banks is to achieve price stability. Monetary policy is conducted via operations carried out in financial markets and its success depends on the flawless operation of financial institutions and markets. Therefore, financial stability is a *sine qua non* for effective monetary policy. Besides, the responsibility of central banks for the operation and supervision of payment systems oblige them to monitor financial stability.

The fact that financial instability may pose serious risks to macroeconomic targets such as sustainable growth and price stability enhances the significance of financial stability for central banks. Therefore, central banks and governments increasingly pay more attention to the monitoring of structural and macroeconomic developments that may pose risks to financial stability as well as to the effectiveness and robustness of institutions operating in financial markets.[2]

Under the CBRT Law, financial stability has been stated as a supportive objective. In this framework, the Bank is empowered to monitor the financial markets, to regulate the volume and circulation of Turkish lira, to establish payment, securities transfer and settlement systems and to set forth any regulations regarding these systems; and to set up the procedures and conditions regarding the liabilities of financial institutions for reserve requirements. The Central Bank takes the necessary measures in order to achieve stability in the financial system in the face of developments, shares its evaluations on financial stability with the public in line with the principle of transparency and issues warnings concerning the fragilities and risks in the financial system.

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1 Schnasi, Gary (2004), "Defining Financial Stability" IMF Working Paper, WP/04/87.

2 V. Sundararajan, Charles Enoch, Armida San José, Paul Hilbers, Russell Krueger, Marina Moretti, and Graham Slack, IMF, Occasional Paper No:212, 2002.

Distinguished Guests,

As I have just emphasized, the function of monitoring financial stability takes place within the framework of the goals of central banks to achieve price stability and develop sound payment systems and it is of a different nature to the supervision of other institutions operating in financial markets. Indeed, monitoring the robustness of the financial system requires the evaluation of various factors that threaten the financial system as a whole and create systemic risks. For this reason, the perspective of the Bank is a macro and risk-focused one, similar to the perspective used in the financial stability reports published by other central banks.

The definition of objectives and functions of central banks are different from those of supervisory authorities. Though central banks increasingly tend not to deal directly with the monitoring and supervision of banks in recent times, they continue to monitor developments in the banking sector as well as the basic systemic risks.

Today, 38 central banks around the world publish the Financial Stability Report. In a total of twenty countries, fourteen European and six non-European countries, supervisory authority is separate from the central bank.

Especially in systems where the power to monitor is granted to autonomous institutions other than the central bank, the function of monitoring and supervising the financial system focuses on the issue of financial soundness and effectiveness of individual institutions. However, the monitoring of the financial system as a whole in terms of financial stability is carried out by central banks.

In countries such as England, Australia, Norway, Finland and Sweden, where the supervisory authority is not the central bank, central banks, including that of Turkey, focus on the objective of price stability and carry out operations consistent with monetary policies by monitoring the developments in financial markets. Besides, they establish a strong and reliable payment system and take the necessary measures in order to prevent the problems faced by any financial institution from affecting the financial system as a whole. Central banks also function as the “lender of last resort”.

Evaluations made by supervisory authorities gain importance as regards the sound monitoring of financial stability by central banks and, effective corporate cooperation with these authorities becomes more critical. I am pleased to say that the cooperation between the Central Bank and Banking Regulation and Supervision Agency, the Undersecretariat of Treasury and the Capital Markets Board as supervisory authorities, is increasingly progressing.

The Financial Stability Report, the first of which was published last August, analyzes macroeconomic developments with respect to their effects on sectors, presents analysis and evaluations about the banks and evaluates current and future risk factors.

Distinguished Guests,

We are undergoing a period where the banking sector has increased intermediary activities, which is the primary function of banks, and where mutual interaction between the sectors in the financial system gains more importance because of the risks that require close monitoring. Therefore, in this part of my speech, I would like to discuss the developments in the banking sector within the framework of macroeconomic perspective and the risks involved.

Despite the fact that giant steps have been taken regarding public finance thanks to current tight fiscal policy, maintaining fiscal discipline and achieving the primary surplus target are still of great importance as regards financial stability.

In the rapidly growing Turkish economy, the ratio of current account deficit to gross national product became 6.4 percent in 2005. The rapid increase in the share of long-term capital inflows and direct investments in the financing of the current account deficit, which is expanding due to high growth rates, is deemed favorable for the sustainability of the deficit.

As it is known, in parallel to changing interest rate policies of Bank of Japan, the Federal Reserve and the European Central Bank in recent periods, uncertainty about interest rates has increased globally, leading to capital outflows from emerging markets. Nevertheless, reinforced macroeconomic fundamentals, tight monetary and fiscal polices, the shock-absorbing function of the floating exchange rate regime, the reduced ratio of short-term foreign credits to international reserves and disciplined implementation of the current economic program minimize the adverse effects of outflows on the Turkish economy.

The rapid rise in the consumption tendency despite the relatively low increase in disposable income increases the indebtedness of households. Therefore, close monitoring of likely risks for the household that may arise from the increasing demand for housing loans, which is still low compared to other countries, is of great importance. Indeed, as seen in (other) country experiences, asset prices can rise rapidly in periods of expansion to be followed by slumps in housing prices, which would simultaneously push down the value of the collateral for the financial sector and decrease household wealth. Therefore, these are important risk factors that should seriously be taken into account.

Dear Guests,

I would like to draw your attention to credit cards regarding the household indebtedness issue. As it is known, in general, the credit card is a payment instrument that enables its owner to purchase goods and services at member businesses without using cash. Moreover, if credit card users wish to withdraw cash or to delay their credit card payments for a determined period, the relevant amounts spent turn into credit and thus the credit card becomes a credit instrument. Institutions issuing credit cards incur POS (Point of Sale) machine investment and membership to national and international payment systems expenditures, and they are exposed to liquidity risk due to unforeseen cash withdrawals.

Consequently, banks tend to determine higher credit card interest rates than those of consumer credits due to their higher risk exposures, namely the higher credit risk because of weak collateral structure and liquidity risk because of unforeseen cash withdrawals. A survey of country practices also reveals that credit card interest rates are determined higher than interest rates set for consumer credits. Therefore, it is in the interest of credit card users to meet their short-term credit needs via consumer credits rather than their credit cards.

Moreover, the interest rates applicable to credit card transactions differ significantly from bank to bank. The tendency of customers towards credit cards of banks with lower interest rates will enhance competition in the banking sector and the interest rates applicable to credit cards will be pushed down. The highest interest rates applicable to credit cards by banks are announced on the Bank's web site.

Distinguished Press Members,

The reduced credit costs in an environment of falling inflation has enhanced credit opportunities of firms in the corporate sector and has played an important role in the growth of investments expenditures. Nevertheless, we consider the open foreign exchange position of firms that utilize foreign exchange credits, despite their lack of foreign currency revenues, as a significant risk factor. Therefore, the effective use of risk aversion techniques, taking into consideration the İzmir Derivatives Exchange facilities, is of vital importance.

Furthermore, considering the likely implications of Basel II, especially on the financial system, both the banking sector and firms should carry out the necessary studies relating to capital accord and accomplish the necessary initiatives and arrangements for the improvement of their corporate management structures.

Distinguished Guests,

In 2005, the most outstanding development pertaining to the banking sector, which constitutes 87 percent of the entire financial system, was the gradual acceleration of foreign capital inflows. According to the final figures for share transfers, the share of non-residents in total assets of the banking sector in 2005 was 12.4 percent. Including the portion of shares of non-residents in some banks, which have been agreed upon, although the legal permit process thereto has not been completed yet, the share of non-residents in total assets has reached over 16 percent. Comparing the ratio of assets of the banking sector to the GNP in Turkey to those of developed countries, it is seen that Turkey ranks considerably lower on the list. As long as the favorable developments continue, the banking sector should grow in parallel or, even more. However, it is obvious that in a sector so capital-intense, achieving growth will not solely be domestically**.** I believe that foreign capital inflows to the banking sector should be handled within this framework.

In 2005, while the balance sheet of the banking sector grew in size, the share of TL-denominated assets and liabilities increased. As the crowding-out effect of the public sector diminished, the share of credits in assets continued to increase. This indicates that the banking sector has come close to its fundamental function. Despite the fact that the rapid upsurge in credit volume has increased the credit risk, the decline in the NPL ratio and the high provisioning policy adopted by the sector during the same period are considered as favorable developments. Meanwhile, the monitoring of credit risk, which may increase due to the policies on credit allocation that are likely to be eased in the growth period of the economy, is of great importance.

In 2005, while the maturities of assets of the banking sector were extended, the liabilities still had short-term maturities. This shows that the vulnerability against the interest rate risk and the maturity mismatch of the sector increased. In order to facilitate banks' interest rate risk management, it is deemed necessary to make regulations that will also allow floating rate consumer credits along with the currently available fixed rate credits.

In 2005, the ratio of liquid assets to total assets decreased as a result of the continuation of the upward trend in credits. Nevertheless, despite the short-term structure of deposits, especially the renewable nature of the major portion of term savings deposits, low condensation and the fact that the assets, which can be accepted by the Central Bank as collateral, comprise a significant part of the assets of the sector are considered risk-reducing factors with respect to liquidity management.

Distinguished Guests,

In a falling inflation environment, increasing fundamental banking activities along with banks' narrowing profit margins, and the rise in net wages and commission revenues, which is a more stable source of income, make a positive contribution to the diversity of assets and income of the sector. Hence, they have a favorable effect on profitability performance, which has an important role in financial stability.

The capital adequacy ratio of the banking sector is realized well above the legal limit of 8 percent. The capital adequacy ratio is high due to the facts that the government securities portfolio of the sector is high and the mentioned portfolio is evaluated in the zero percent risk weight category. The high capital adequacy ratio improves the resistance of the financial structure of the banking sector against shocks.

The Financial Strength Index, which provides information about the soundness of the banking sector and which has been enhanced by the sub-index of interest rate risk compared to the previous Report, reached its highest level at the end of 2005. Despite the declines in profitability, capital adequacy and interest rate risk indices, the recovery in the asset quality and liquidity indices were effective on this development. The Financial Strength Index is observed to maintain almost the same level in the first quarter of 2006 as well.

In order to measure the resistance of the banking sector against shocks, the development of credit and market risks were analyzed via stress tests and scenario analyses. It was found that a sufficient amount of capital was maintained for the assumed risks and the sector's resistance against probable shocks was strong. Thus, in May 2006, significant market movements were experienced, which can also be perceived as tests of the resistance of the sector. It was observed that due to their strong capital structures, our banks were less affected by these activities compared to the past.

Distinguished Members of the Press,

Now, I would like to give you some information about the Financial Sector Assessment Program that our country has recently participated in, which is of vital importance as regards the evaluation of the components of financial stability.

The Financial Sector Assessment Program was established in May 1999 with cooperation between the International Monetary Fund and the World Bank in order to strengthen the financial structures of countries in consideration of the risks and problems posed by the financial sector. The Program is carried out with the support of numerous national central banks and supervisory authorities.

The major objectives of the Financial Sector Assessment Program are to encourage the pre-determination of the fragilities of the financial system, to formulate necessary policies, to provide an environment for effective communication with national authorities and to create a joint platform in order to ensure the effectiveness of policy proposals and the technical assistance provided by both the International Monetary Fund and the World Bank. In addition to these functions, the Financial Sector Assessment Program aims to set the vital priorities of the financial sector and encourage the enhancement of the sector in this respect.

The number of countries, which have already participated in and are planning to participate in the Financial Sector Assessment Program in the near future, is 184. A report including the assessment of the financial system will be issued at the end of the program. It is planned to finalize the studies on the Financial Sector Assessment Program, which were started at the beginning of 2006 with the coordination of the Undersecretariat of the Treasury in order to contribute to the ongoing reform process of the Turkish financial sector, by the end of the year.

The Financial Sector Assessment Program process in Turkey is expected to contribute to the development of the financial sector in terms of institutional infrastructure. Furthermore, the resistance of the sector will be analyzed on an international platform via stress tests to be applied to banks within the framework of the Program.

Distinguished Guests,

Proper and effective implementation of macroeconomic policies, in other words, the achievement of macroeconomic stability, is the sine qua non of financial stability. It is very important for the banking sector, which should be able to cope with the Basel II process in the near future, that the improvement of the infrastructure of the financial system continues and that efficient control and supervision is carried out. As firms will contribute to stable growth with the funds that they obtain from banks, the compatibility of the corporate sector with the Basel II process is of great importance as well.

In this framework, determined implementation of current economic policies, increased confidence in financial markets, the establishment of risk culture and the adjustment of economic actors' risk perceptions according to dynamic conditions will strengthen the stability in financial markets.

Esteemed Guests,

Before concluding my speech, I would like to thank you for your participation. I hope our assessments and analyses will help the participants of the financial market to undergo a better decision-making process.