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REPUBLIC OF TÜRKİYE

FINANCIAL SECTOR ASSESSMENT

Prepared By
Finance, Competitiveness, and Innovation Global Practice and
The Europe and Central Asia Regional Vice Presidency

A joint IMF-World Bank team led by Erik Feyen, World Bank, and John Nelmes, IMF, visited Türkiye during January 31-March 7, 2022 on a virtual basis, and in person during May 10-16, 2022 and between June 20-July 5, 2022 to update the findings of the Financial Sector Assessment Program (FSAP) which took place in 2016. This report summarizes the main findings of the mission, identifies key financial sector vulnerabilities and development issues, and provides policy recommendations.

PREFACE

This Financial Sector Assessment (FSA) report offers an update to the findings of the Financial Sector Assessment Program (FSAP) which took place in 2016. The report summarizes the main findings of the update, identifies key financial sector vulnerabilities and development issues, and provides policy recommendations. The work comprised an evaluation of: selected issues related to supervision and regulation of banks; capital market development and long-term finance; financial inclusion and the role of fintech; the role of the State in the financial sector; the crisis management, bank resolution, and the safety net framework; management and resolution of non-performing loans; climate risks and opportunities; crypto-assets and cyber risks; progress made on financial market infrastructures (PFMI) and Insurance Core Principles (ICP) assessments since the previous FSAP; the systemic risk oversight and macroprudential framework; systemic risk and resilience; systemic liquidity management; and selected AML/CFT issues.

The FSAP team was led by Erik Feyen (World Bank (WB)) and John Nelmes (IMF), and included deputy mission chiefs Johanna Jaeger (WB) and Katharine Seal (IMF); Fernando Dancausa, Harish Natarajan, Heinz Rudolph, Ines Fila, Jing Zhao, Jose Antonio Gragnani, Martijn Regelink, Matei Dohotaru, Pamela Lintner, Tetsutaro Shindo (all WB) and Joaquin Gutierrez (WB external expert); and Vincenzo Guzzo, Caterina Lepore, Dulani Seneviratne, Piyabha Kongsamut, Ana Carvalho, Joelle El Gemayel, Rangachary Ravikumar, Natsuki Tsuda, and Francisca Fernando (all IMF) and Peter Lohmus (IMF external expert). The World Bank team thanks Erdem Atas and Etkin Ozen (both WB) for valuable contributions.

The FSAP team met with officials from regulatory and government agencies, including the Central Bank of the Republic of Türkiye (CBRT), the Banking Regulation and Supervision Agency (BRSA), the Ministry of Treasury and Finance (MOTF), the Capital Markets Board (CMB), the Savings Deposit Insurance Fund (SDIF), the Insurance and Private Pension Regulation and Supervision Authority (IPRSA) and other public sector institutions, financial institutions, industry organizations, and the private sector.

The FSAP's cut-off date is end-June 2022 except for the stress tests which have a cut-off date of end-2021.

CONTENTS

FIGURES

TABLES

APPENDICES

GLOSSARY

AMC	Asset Management Company
AML/CFT	Anti-money laundering/counter terrorist financing
ARA	Assessing Reserve Adequacy
BaaS	Banking as a Service
BAT	Banking Association of Türkiye
BCP	Basel Core Principles for Effective Banking Supervision
BCBS	Basel Committee for Banking Supervision
BIST	Borsa İstanbul
BKM	Bankalararası Kart Merkezi (inter-bank card payment system)
BL	Banking Law
BRSA	The Banking Regulation and Supervision Agency
BTK/ICTA	Information and Communications Technologies Authority
CAR	Capital Adequacy Ratio
CBAM	Carbon Border Adjustment Mechanism
CBRT	Central Bank of the Republic of Türkiye
CBDC	Central Bank Digital Currency
CCDR	Country Climate and Development Report
CCP	Central Clearing Counterparty
CET1	Common Equity Tier 1
CGS	Treasury-backed Credit Guarantee System
CMB	Capital Markets Board
CPMI	Committee on Payments and Market Infrastructures
CPSS	Committee on Payment and Settlement Systems
DSIB	Domestic Systemically Important Banks
DTO	Digital Transformation Office
EBC	Enforcement and Bankruptcy Code
EIM	Early Intervention Measures
ELA	Emergency Liquidity Assistance
EM	Emerging Market
ESG	Environmental, Social, and Governance
FATF	Financial Action Task Force
FA	Framework Agreements
FMI	Financial Market Infrastructure
FOP	Finance Office Presidency of the Republic of Türkiye
FPS	Fast Payment System
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	Financial Stability Committee
FX	Foreign exchange
GDAP	Green Deal Action Plan
GHG	Greenhouse Gas

HQLA	High Quality Liquid Assets
ICR	Interest Coverage Ratio
ICP	International Association of Insurance Supervisors' Insurance Core Principles
ICT	Information and Communication Technology
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPRSA	Insurance and Private Pension Regulation and Supervision Authority
IRRBB	Interest Rate Risk in the Banking Book
ISSB	International Sustainability Standards Board
KA	Key Attributes of Effective Resolution Regimes for Financial Institutions
KKB	Kredi Kayıt Bürosu (Credit Bureau)
KOSGEB	Small and Medium Enterprises Development Organization
LCR	Liquidity Coverage Ratio
MASAK	Financial Crimes Investigation Board
ML/TF	Money Laundering / Terrorist Financing
MOI	Ministry of Interior
MOTF	Ministry of Treasury and Finance
MSME	Micro, Small and Medium Enterprises
NFC	Non-Financial Corporation
NGFS	Network of Central Banks and Supervisors for Greening the Financial System
NPE	Non-Performing Exposure
NPL	Non-Performing Loan
NRA	National Risk Assessment
NSFR	Net Stable Funding Ratio
ORSA	Own Risk and Solvency Assessment
PE/VC	Private equity/Venture capital
PFI	Public Finance Institutions
PFMI	CPSS-IOSCO Principles for Financial Market Infrastructures
PSB	Presidency, Strategy and Budget
PTT	Turkish Postal Service
REPL	Regulation on Procedures and Principles for Classification of Loans and Provisions To Be Set Aside
RWA	Risk-weighted assets
SDIF	Savings Deposit Insurance Fund
SME	Small and Medium Enterprises
SOB	State-owned Bank
SWF	Sovereign Wealth Fund
TCIP	Turkish Catastrophe Insurance Pool
TRA	Türkiye Revenue Administration
VASP	Virtual Asset Service Provider
WB	World Bank

EXECUTIVE SUMMARY

Overview: Context and cross-cutting issues

Türkiye's financial sector exhibited resilience and made modest development progress in some areas following the last Financial Sector Assessment Program (FSAP) in 2016. The bank-dominated system has grown considerably and supported economic growth, showing resilience through the currency and capital account pressures of 2018 and the COVID-19 pandemic. While development needs for capital markets and non-bank institutional investors remain significant, advances have been made in financial inclusion, financial market infrastructures, and the enabling policy environment to deepen the financial sector and promote innovation. The Insurance and Private Pension Regulation and Supervision Authority (IPRSA) was established.

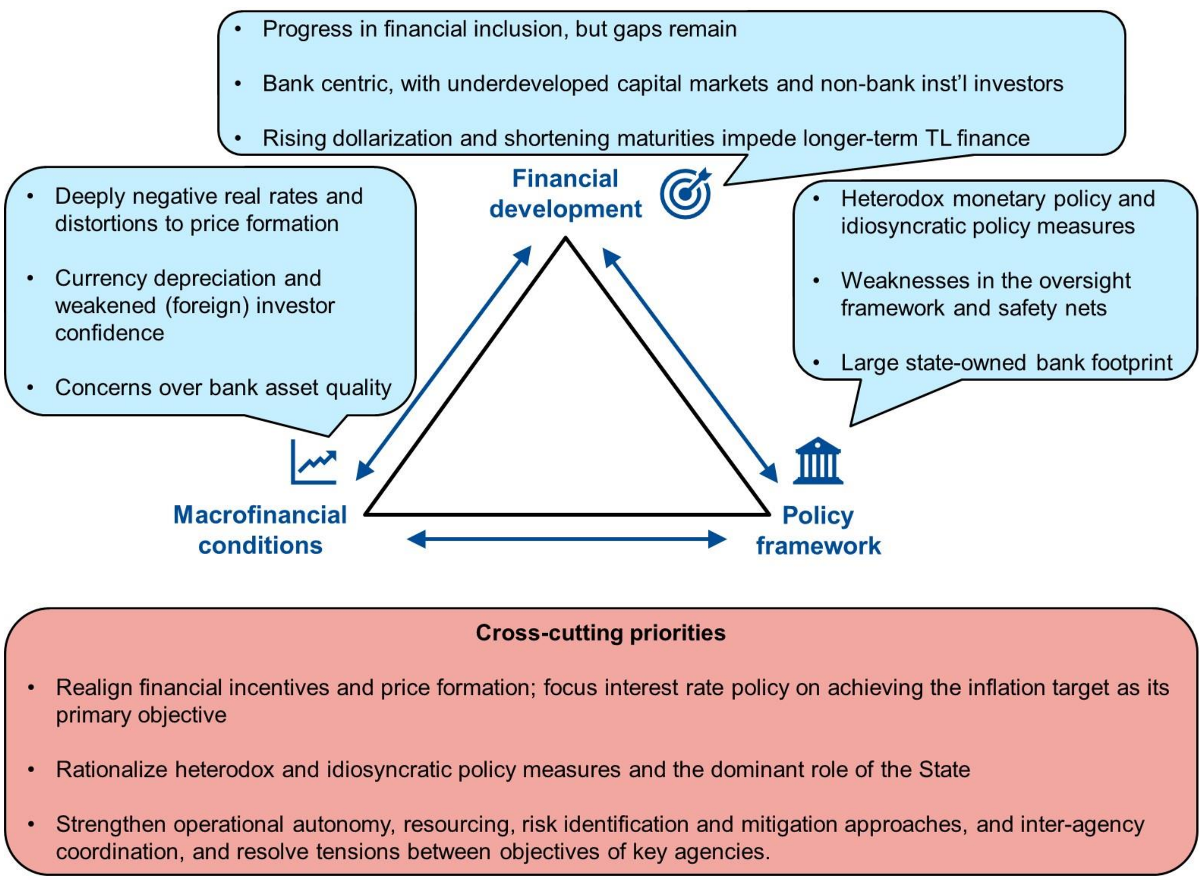
The financial sector has been challenged by periods of macrofinancial volatility, which has risen significantly recently, driven by the pursuit of heterodox monetary policies. Inflation has been persistently very high and rising, the Turkish Lira (TL) has depreciated markedly, bank credit growth has been extremely rapid, foreign investors have receded from local markets, and demand for dollarized deposits and state-guaranteed FX-protected TL deposits has risen alongside the adoption of a heterodox monetary policy stance that has resulted in a deeply negative real policy interest rate and other distortions which undermine financial stability and development against the backdrop of rapidly tightening global financial conditions. The impact of Russia's invasion of Ukraine has further complicated the macrofinancial environment. In this context, financial sector risks are now high and growing. Stress tests point to banking sector vulnerabilities and a strong nexus exist between banks and the sovereign as well as the central bank which poses risks.

Idiosyncratic policy measures have been employed which are unlikely to be effective over the medium term. These measures largely aim to manage credit growth and direct it to priority economic activities, limit dollarization, support the exchange rate, and lower government funding costs. The result is a complicated mosaic of policies, some of which work at cross-purposes or diverge from international standards. Taken together, these measures reduce policy transparency and predictability, increase risk premia, create distortions in price formation and capital allocation, and may mask underlying risks. Furthermore, risks are increasingly being transferred to the government's balance sheet. At the same time, the prudential oversight and crisis management frameworks need important enhancement.

In this challenging context, attaining durable financial development will require a normalization of macrofinancial conditions and a strengthening of the policy framework. Financial development, macrofinancial conditions, and the policy framework are closely interlinked in Türkiye. Weakened macrofinancial conditions have adversely interacted with idiosyncratic policy measures, while a strengthening of the policy framework is needed to mitigate macrofinancial volatility. Further, persistent macrofinancial challenges impede financial development compounded by weaknesses in the policy framework. In turn, an undiversified, bank-centric financial sector may not be able to mitigate macrofinancial volatility and can even amplify it.

Three fundamental cross-cutting priorities need to be addressed first to achieve a deeper, more inclusive, diversified, and resilient financial system. First, achieving macrofinancial stability to support financial development, including of credit and capital markets, will require realigning financial incentives and price formation such that real interest rates reflect macroeconomic fundamentals. Interest rate policy should focus on achieving the inflation target as its primary objective. Second, rationalizing idiosyncratic financial sector policies and the dominant role of the State is key to strengthen capital allocation and reduce distortions. Third, implementing such a transition calls for strengthening operational autonomy, resourcing, risk identification and mitigation approaches, inter-agency coordination, and resolving tensions between objectives at key agencies, which all have seen limited progress or have deteriorated since the last FSAP (see Appendix I).

Republic of Türkiye: Financial Development Triangle: Selected Challenges and Cross-cutting Priorities



Source: World Bank staff analysis

Financial stability: Risks and resilience

Financial sector risks are high and growing. FX liquidity risks have increased along with deposit dollarization and falling Central Bank of the Republic of Türkiye (CBRT) reserves. A strong nexus exists between the banks and the central bank as banks' FX assets held at the CBRT are about double CBRT readily available FX gross reserves and gold holdings in mid-2022. There is high uncertainty over bank asset quality (see below). Corporate FX debt has declined, but high leverage and low interest coverage ratios are risks.

Various stress tests conducted on end-2021 data suggest bank vulnerabilities. Solvency stress tests indicate that banks could face capital pressure in the absence of restrained credit growth. Liquidity stress tests suggest that banks were resilient to moderate FX deposit outflows, but were vulnerable to severe outflows, and meeting FX liquidity needs could potentially drain CBRT international reserves to low levels.

Policy framework: Role of the State, oversight, and safety nets

Government programs delivered through State-owned banks (SOBs) in particular have fostered economic growth, but also contributed to distortions and risk transfer to public balance sheets. SOBs have played key roles in supporting: i) currency stability; ii) countercyclical credit policies, including during the pandemic, as well as procyclical policies; and iii) the financing of the Government. SOBs have a material presence in TL government securities markets which has further grown due to regulation that applies to all banks which has tightened the bank-sovereign nexus. SOBs have led credit growth enlarging their market share in lending markets driven by subsidized interest rates, contributing to an unlevel playing field as concentration has increased, and a sizeable Treasury-backed credit guarantee system (CGS). These interventions have promoted a low interest rate environment, contributed to a distortion of price signals, and increased contingent liabilities. SOBs have been recapitalized on several occasions to maintain capital adequacy ratios (CARs) and bolster lending capacity. State-guaranteed FX-protected TL deposits have been introduced in all banks to arrest deposit dollarization. Particularly in light of their considerable footprint, evaluating the market impacts of SOBs as well as safeguarding their corporate governance is key to support financial development.

Protracted policy and resource pressures have resulted in banking supervisory practices and a regulatory framework that require important enhancement. Limited progress has been made since the previous FSAP and the situation has deteriorated in important areas. The financial stability mandate and operational autonomy of the Banking Regulation and Supervision Agency (BRSA) has been compromised by government policies and changes to the Banking Law. The BRSA's effectiveness is also significantly impaired BRSA is severely resource constrained. Official information on credit quality, capital adequacy, and liquidity risk is unlikely to reflect increased risks owing to regulatory revisions and forbearance. To enhance BRSA's effectiveness, various other shortcomings need to be promptly addressed, including providing adequate remuneration to avoid staff attrition and maintain a strong core of expertise, reengineering the supervisory process, re-aligning regulatory and accounting practices with Basel and other international standards, and intensifying liquidity monitoring (especially in FX).

NPL management and resolution has been made a priority, but there is scope for improvement, particularly as concerns around bank asset quality and classification have risen. Restructured loans have grown resulting in a material stock of problem assets, and regulatory changes may have resulted in misleadingly low NPL and provisioning ratios while facilitating pervasive loan refinancing on which data is not collected has been a cause for concern regarding loan evergreening. BRSA has accelerated efforts to align the prudential treatment of problem assets with international guidelines, but remaining key deficiencies need to be addressed expeditiously. BRSA has also required banks to prepare NPL reduction strategies and set up workout units to deal with problem assets. The Framework Agreements have helped to deal with distressed large firms and the Capital Markets Board (CMB) introduced new measures to strengthen the market for problem assets, but there is a need for further improvement.

Addressing gaps identified in the last FSAP in the bank resolution and crisis management framework is critical given elevated financial stability risks. Türkiye has a reasonably clear institutional framework for recovery and resolution. Although recovery planning for domestic systemically important banks (DSIBs) has been introduced and the resolution framework is being updated, the authorities should consider extending recovery planning and requirements to all banks and there is a short-term need to enhance the Savings Deposit Insurance Fund's (SDIF) resolution powers, resolvability assessments, resolution planning, the resolution toolkit, and resolution financing.

With the establishment of the IPRSA, insurance and pensions supervision has improved since the last FSAP, but important gaps remain. Despite progress, IPRSA's practices do not yet meet international standards. IPRSA should introduce an Own Risk and Solvency Assessment (ORSA) process and enhance on-site and group-wide supervision. IPRSA's objective should ensure primacy of financial stability and the agency's operational and policy independence as well as governance practices should be strengthened. As well, the institutional and regulatory framework for private pension funds requires further improvement to enhance funds' performance, including their investment allocations which are driven by short-term benchmarks. In particular, the fragmented approach to supervision by the CMB and IPRSA does not allow the authorities to promote policies that connect individuals' pension contributions with their expected pensions at retirement age and misses the opportunity of switching towards risk-based supervision.

The Financial Action Task Force (FATF) has placed Türkiye on its grey list. This was based on the Mutual Evaluation Report in 2019 which notes deficiencies in areas related to technical compliance and effective implementation.

Financial development: Challenges and opportunities

Deepening capital markets, including the non-bank institutional investor base, remains a priority as the system is undiversified and not able to meet TL longer-term finance needs. The authorities have introduced a range of welcome reforms to improve investor protection and enable new instruments. Yet, improving the composition and extending the average maturity of public debt has lagged and foreign and domestic investor confidence in TL markets has deteriorated. The domestic non-bank institutional investor base requires expansion as it remains underdeveloped compared to peers. Furthermore, corporate bond markets remain shallow and short-term, while equity markets have expanded rapidly from a low base.

Macrofinancial normalization and a stronger enabling environment are required to achieve durable deepening of capital markets. Weak macrofinancial conditions, including negative real interest rates and other distortions to price formation, inhibit the durable deepening of (long-term) TL capital markets and demand from non-bank institutional investors. Moreover, the enabling environment is further challenged by limited policy predictability, FX-protected TL deposits that compete with capital market instruments, and a complex and unbalanced tax framework. This testing environment has resulted in a "short maturity, dollarized" equilibrium that is not conducive to absorb macrofinancial shocks, meet TL investment needs, and engender competition between capital markets and banks. Over time, the authorities should consider reducing the reliance on the issuance of FX debt instruments and defining the benchmark size of TL instruments.

Financial inclusion has improved since the last FSAP, but lags peers. As of 2021, 74 percent of adults in Türkiye have a transaction account compared to 69 percent in 2017, behind peers, and the gender gap has narrowed by 6 percentage points to 23 percent, still one of the largest in the world. In 2019, 28 percent of MSMEs still cited lack of access to finance as their main constraint, above peers. Several government efforts have supported MSME credit growth, including the Treasury-backed credit guarantee system (CGS) and the SME Finance Support program (SFSP) of the Small and Medium Enterprises Development Organization (KOSGEB). A comprehensive monitoring and evaluation framework should be developed for the SFSP and the CGS, to provide support to MSME segments that are credit constrained, while mitigating risks.

Türkiye has embraced technology to strengthen financial efficiency and inclusion and advanced on an enabling policy framework that attends to risks, including cyber and crypto. High levels of digitalization have helped to promote financial inclusion. Fintech offers further potential to improve efficiency and address the financing gaps for MSMEs and households, particularly for women and the poorest 40 percent. The authorities have embarked on various strategic policy and regulatory initiatives to encourage the safe adoption of fintech, including supporting the implementation of "Open Banking" and a Digital ID framework with a view to paving the way for "Open Finance" and "Open Data". Fintech, ICT/cyber, and crypto-asset risks are well recognized. Integrating these risks into the supervisory framework, ensuring a level playing field, and fostering institutional coordination is important. The authorities are exploring the issuance of a retail central bank digital currency (CBDC) – the broader benefits and risks should be compared with alternative approaches.

The authorities recognize climate risks and the need for sustainable finance. The authorities recognize the need to deepen their capacity to assess climate risks and continue to integrate them into their supervisory framework and align with international best practices, principles, and guidance. Green and sustainable finance in lending and capital markets is nascent, owing to an adverse macrofinancial environment as well as specific challenges related to knowledge exchange, coordination, and disclosure. The authorities have been working on these issues and could benefit from introducing a holistic national climate finance strategy.

Table 1. Republic of Türkiye: Main Recommendations[1]

Recommendations	Agency	Timing*
Cross-Cutting Financial Development Priorities		
Realign financial incentives and price formation such that real interest rates reflect macroeconomic fundamentals. Focus interest rate policy on achieving the inflation target as its primary objective.	CBRT, BRSA	ST
Rationalize heterodox and idiosyncratic policy measures and the dominant role of the State to reduce distortions and strengthen capital allocation.	CBRT, BRSA, MOTF	ST
Strengthen operational autonomy, resourcing, risk identification and mitigation approaches, and inter-agency coordination, and resolve tensions between objectives at key agencies.	CBRT, BRSA, SDIF, IPRSA	ST
Banking Supervision and Regulation		
Amend the Banking Law to confirm financial stability as the primary objective of the BRSA and enshrine policy independence, operational autonomy, sound governance, and adequacy of resources to provide a stable cadre of experienced staff and modern tools.	MOTF, BRSA	MT
Restore and/or enhance, as applicable, the standards for intrusive, effective supervision notably of liquidity, FX, sovereign and concentration risk, credit risk, including problem assets and provisions, and interest rate risk in the banking book. Revisions must include aligning regulations with international minimum standards, or higher.	BRSA	ST
Intensify supervisory engagement and monitoring using meaningful reporting practices, accompanied by robust, timely intervention and follow up with banks.	BRSA	ST
Enhance the risk-based, forward-looking perspective of CAMELS process, integrating Pillar 2 assessments (ICAAP and SRP), off-site work, stress-testing and ICT/Cyber dimensions.	BRSA	MT
Insurance Supervision and Regulation		
Add and prioritize financial stability as an objective of insurance supervision and formalize macroprudential and group-wide supervisory frameworks.	IPRSA	ST
Ensure transparency of the nomination, appointment, and dismissal processes of IPRSA's board members.	Presidency, IPRSA	ST
Introduce a formal Own Risk and Solvency Assessment (ORSA) process and strengthen on-site supervision through using ORSA results, targeted inspections and thematic reviews.	IPRSA	ST
Financial Integrity		
Take steps to exit the FATF grey list by demonstrating effectiveness and addressing all areas identified in the FATF's action plan, including with respect to politically exposed persons.	MASAK, BRSA, CBRT	ST
Implement FATF Recommendation 15 to address virtual asset risks.	MASAK, CMB	ST
Monitor key financial integrity risks stemming from the grey listing, and other cross-border regulatory actions.	MASAK, MoTF, BRSA, CBRT	MT
Crisis Management and Resolution		
Introduce resolution planning and consider extending recovery planning to all banks; extend recovery requirements to entire groups and foreign affiliates.	SDIF, BRSA	ST
Enhance SDIF resolution powers in line with the FSB Key Attributes and empower SDIF to start preparations in the run up to resolution. Introduce a full P&A concept beyond insured deposits for all banks regardless of SDIF shareholdership status.	SDIF, MOTF	ST
End the use of SDIF funds for all loss coverage, liquidity, and recapitalization purposes and introduce loss absorbance principles in line with the liquidation hierarchy. Introduce resolution funding and the least-cost concept for SDIF funds.	SDIF, MOTF	ST
Resolution of Non-Performing Loans		
Strengthen the reporting system to monitor the quality of the loan portfolio, with emphasis on stage 2 loans and restructured loans and realign REPL with international standards.	BRSA	I

[1] See Appendix I for the implementation status of 2016 FSAP recommendations.

Ensure the consistent implementation NPE strategies and creation of workout units in banks.	BRSA	ST
Improve FA restructurings by (i) requiring preparation of a third-party viability assessment post-restructuring and (ii) lowering relevant requirements applicable to the "Small-Scale FA".	BAT	ST
Allow (i) investors to use "risk-sharing" structures and (ii) AMCs to "mix and match" different receivables when securitizing a portfolio of NPLs.	CMB	MT
Role of the State		
Given their rapid growth and sizeable footprint, evaluate the market impacts of state-owned banks and safeguard their corporate governance.	MoTF	ST
Capital Markets, Institutional Investors, and Long-Term Finance		
Improve the institutional and regulatory framework for private pension funds to: strengthen IPRSA-CMB coordination and address a regulatory vacuum; and enhance their performance, including by promoting competition to maximize expected pension benefits and identifying optimal portfolio benchmarks for peer groups.	IPRSA, MoTF, CMB	ST
Streamline the tax framework to ensure neutral treatment across instruments and issuer type.	MoTF, TRA	MT
Lower, over time, the reliance on the issuance of FX debt instruments to strengthen the debt composition and define the benchmark size of TL fixed instruments.	MoTF	MT
Mitigate impediments to support real sector issuance and tenor extension.	MoTF, CMB, TRA	MT
Financial Inclusion and the Role of Fintech		
Adopt a comprehensive fintech strategy which encompasses improving financial inclusion and MSME finance as strategic objectives.	FOP	I
Strengthen monitoring, regulatory and supervisory frameworks to safely enable fintech activities and new entrants, ensure a level playing field, and mitigate risks.	CBRT, BRSA, CMB, IPRSA	I
Develop a comprehensive monitoring and evaluation framework for KOSGEB's SFSP and the CGS, to support MSME segments that are credit constrained, including women-owned MSMEs, micro enterprises, and first-time MSME borrowers, while mitigating risks.	KOSGEB, CGS, FOP	ST
Support the implementation of a full range of "open banking" services with a view to paving the way for "open finance" and "open data".	FOP, CBRT, BRSA, CMB, IPRSA	MT
Develop a Digital ID framework for use in authentication, consent, and e-signing.	DTO, FOP, MOI, BTK/ICTA	MT
Green and Sustainable Finance		
Introduce a national climate finance strategy, strengthen the climate information architecture by introducing a green taxonomy and enhancing climate-related disclosures for firms, and continue to align the supervisory framework with international principles and guidance.	BRSA, CBRT, IPRSA, MUECC, MOTF, CMB, KGK	MT

* Immediate (I) = within one quarter; short-term (ST) = within one year; medium-term (MT) = over one year

MACROFINANCIAL SETTING

A. Recent Macrofinancial and Policy Developments

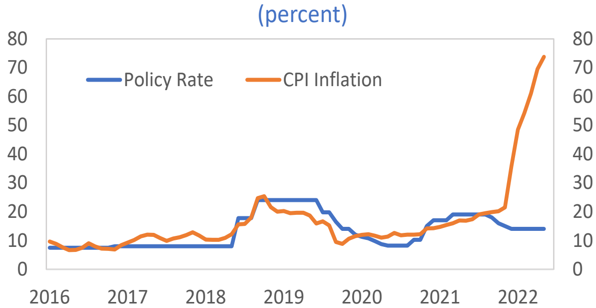
Also see Tables 2 and 4

1. Türkiye has experienced high, but volatile growth since the last FSAP, driven by credit growth. Real economic growth has averaged almost 5 percent, but periods of strong expansion were followed by sharp slowdowns which exacerbated vulnerabilities. Inflation has been persistently very high and the lira has depreciated. External financing needs have remained significant and deposit dollarization has risen steadily, while foreign exchange (FX) reserve adequacy has slipped. The public debt ratio has increased, although, at just over 40 percent, it is relatively low. Yet, FX-denominated public borrowing is relatively large and steady currency depreciation is raising debt service costs.

2. Prudential regulatory standards have eased since 2016 to support credit growth at the potential expense of financial stability. Several regulations have been amended in the pursuit of broader policy objectives since the last FSAP. This has diluted credit discipline and has likely resulted in artificially low NPL and provisioning ratios. Several measures diverge from international standards (See section *Financial Sector Regulation and Supervision* for further details).

3. The authorities responded resolutely to the COVID-19 pandemic in 2020, facilitated by exceptional measures. The CBRT cut its policy rate repeatedly and expanded its balance sheet. Credit grew rapidly – driven by state-owned banks (SOBs) – to support non-financial corporates (NFCs) and households and was facilitated by guarantees, payment deferrals, and extensive regulatory measures (e.g., a regulatory Asset Ratio and changes in reserve requirements). Some of these measures masked non-performing loan (NPL) data (e.g., forbearance measures related asset classification). Various COVID-19 related measures have been revoked.

Policy Rate vs. CPI Inflation
(percent)



Source: CBRT, TurkStat

4. Macrofinancial volatility spiked in late 2021. The extraordinary expansionary monetary policy led to a sharp depreciation of the lira (TL). Conversion of domestic lira deposits into FX deposits accelerated sharply, while sizable portfolio outflows resumed. The CBRT stepped in to support the lira despite scarce reserves.[2] The authorities also announced a "Liraization Strategy" to incentivize holdings of lira assets to promote de-dollarization and stabilize both prices and the lira, including, but not limited to, a scheme compensating lira term deposits for losses against the dollar. Deposits in these FX-protected TL accounts had reached 15 percent of total deposits by mid-2022.

[2] Reserves fell below 90 percent of the ARA metric.

5. Acute market turmoil receded in early 2022, but macrofinancial risks persist going forward. The authorities' strategy temporarily managed to stabilize the exchange rate. Inflation and credit growth rose to almost 80 and over 60 percent in mid-2022, respectively. Despite a positive output gap and very high inflation, in late 2021 the CBRT reduced the policy rate by 500 basis points contributing to macrofinancial pressures.[3] A deeply negative real policy rate and a structural lack of foreign exchange remain, and sovereign credit default swap spreads have soared. Russia's invasion of Ukraine has contributed to inflation challenges and exacerbated the current account deficit, adding to external financing needs and pressuring international reserves.[4]

6. Taken together, a complicated mosaic of idiosyncratic financial sector policies has emerged (Table 2) contributing to distortions. Against a backdrop of deeply negative real interest rates and elevated macrofinancial volatility, these measures largely aim to manage credit growth and direct it to priority economic activities, limit dollarization, stabilize prices, support the exchange rate, and lower government funding costs. Some of these measures work at cross-purposes. Taken together, they reduce policy predictability, increase risk premia, and contribute to distortions in price formation and capital allocation impeding durable financial development (See section *Development challenges* for further details).

[3] Further reductions have taken place since the FSA cut-off date.

[4] Cross-border claims vis-à-vis Russia and Ukraine are very low (both bank and nonbank sectors). Claims on Russia amounted at 0.021 percent of GDP as of 2021Q3 and claims on Ukraine were close to zero percent.

Table 2. Republic of Türkiye: Selected Policy Measures, June 2017-June 2022[1/]

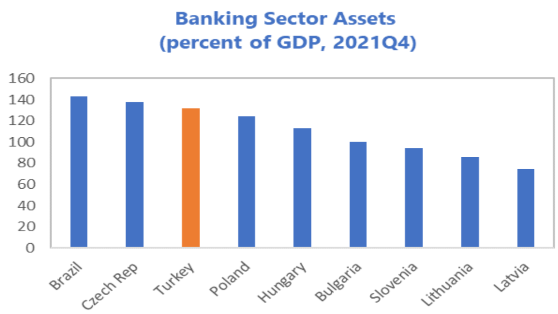
	Macroprudential	Banking Supervision and Regulation	Systemic Liquidity	Other
Early Lira Depreciation: 2017H1-2019H1	• NFC FX borrowing up to $15m subject to FX income test • Capital conservation buffer fully phased in • D-SIB buffers fully phased in • Increased general provisions • Maturity restrictions on consumer loans adjusted, caps on credit card installments (easing and tightening) • LTV limits on housing (energy use) and vehicles introduced • Offshore FX swaps restricted to 25% (wrong-way) of capital	• **Loan refinancing criteria eased** • **Probation for restructured stage 2 loans never classified as NPL lowered to 3m** • **Fixed exchange rate on FX assets in credit risk RWA** • **FX required reserves zero-risk weighted in CAR calculations** • Required reserves fully included in LCR HQLA • **Revision to derivative market valuations in LCR**	• LLW rate raised by 375 bps • One-week repo rate restored as policy rate and symmetric interest rate corridor introduced • One-week repo rate hiked by 1,600 bps cumulatively • TL reserve requirements cut by 300-350 bps; FX reserve requirements cut by -350bp/+250 bps • ROM upper limit cut by 25 pp • CBRT FX swaps introduced • Qatar/China swaps agreed	• State-owned bank recap • Fixed exchange rate for repayments of export rediscount credits • FX surrender requirements for exporters set at 80%
COVID-19 Pandemic: 2019H2-2020H1	• Minimum payment for credit cards lowered, raised cap on credit card installments • LCR allowed to fall below regulatory minimum limit • Offshore FX swaps further restricted to 1-10% of capital	• **Fixed exchange rate on FX assets in RWA reinstated** • **Exclusion of securities' losses from capital/FX net position** • **FX government securities zero-risk weighted in CAR calculations** • **Delayed classification of stage 2 loans and NPLs** • **Grace periods on credit cards** • **Loan collateral revaluation frozen**	• One-week repo rate cut by 1,575 bps cumulatively • Outright purchases of govt bonds to 10% of CBRT assets • Liquidity provided through repo and swap auctions 100-150 bps below policy rate • Primary dealer limits raised • Collateral pool expanded • Qatar swap raised to $15b	• New Asset Ratio to incentivize bank credit • Reserve requirement ratios linked to loan growth rates • State-owned banks recap • CGF limit doubled and extended to households • CBRT precautionary reserves and above-normal profits transferred to the Treasury • Firms' dividend payments limited to 25% of 2019 profits • Financial reporting delays allowed
Policy Normalization: 2020H2-2021H1	• Flexibility on LCR regulatory minimum limit revoked • Tightened maturity restrictions on consumer loans • Offshore FX swaps loosened to 5-30% (right-way) and 10% (wrong-way) of capital	• Grace periods on credit cards revoked • Loan collateral revaluation normalized	• One-week repo rate hiked by 1,075 bps cumulatively • All funding provided through the one-week repo rate • TL reserve requirements increased by 200 bps, • Daily reports info on FX swaps/weekly reports on reserves and FX liquidity • China swap raised to $5.5b	• Asset Ratio revoked • Linking of reserve requirements to loan growth rates revoked
Türkiye's Liraization Strategy: 2021H2-2022H1	• Consumer loan risk weights raised • Maturity caps and LTV ratios on consumer loans lowered • Minimum monthly payments on credit cards increased • Risk weights on TL corporate loans raised to 200% • 500 bps risk weights for NFC engaging in derivatives with offshore counterparts • Differentiated housing LTV ratio	• Delayed classification of stage 2 loans and NPLs phased out • **Fixed exchange rate in RWA set at year-end 2021**	• One-week repo rate cut by 500 bps cumulatively • Export rediscount credit linked to FX surrender requirements • Haircut for non-TL collateral in CBRT operations increased • TL fixed rate securities in collateral pool increased • TL fixed rate securities held as required reserves on FX deposits • Remuneration on TL required reserves reduced to 0% • Korea/UAE swaps agreed	• TL FX-protected deposits introduced/NFC tax exempted • 1.5% fee on FX RR if conversion to TL deposits <10% / FX RRR raised by 500 bps if FX-protected deposits <5% by September • FX surrender requirements for exporters at 25%, then 40% • Reserve requirement on certain TL commercial loans set at 20% • Lower mortgage rates if 50% of purchase through FX sale • NFC loan ban depending on FX cash position thresholds • State-owned bank recap

1. Bold indicates not Basel compliant. Some measures could constitute capital flow management measures.

Source: Turkish financial sector authorities, IMF and WB staff analysis.

B. Financial System Structure and Performance

Also see Figures 1-6 and Table 3



Source: Haver, IMF staff calculations

7. The financial system is dominated by banks and has grown rapidly, especially during the COVID-19 pandemic. Financial assets stood at 148 percent of GDP in 2021, significantly higher than at the time of the last FSAP. Banks account for 90 percent of these assets and the size of the banking system is above most emerging market (EM) peers. Banking sector assets have expanded nearly four times since the last FSAP and, while the exchange rate has inflated the TL value of FX assets, TL assets have also grown threefold. Deposit dollarization is significant. The footprint of state-owned banks (SOBs) is significant (See section *Role of the State* for further details). Participation banks (i.e., Islamic banks) and development and investment banks account for smaller, albeit rising shares of the broader banking system. Several banks and insurance companies operate within large conglomerate groups in Türkiye.

8. Banks' cost and return profile is similar to its peers while net interest margins are relatively higher. However, banking sector profitability was on a declining trend since 2017, driven by SOBs. Net interest margins remained high compared to Türkiye's peers but declined due to SOBs' below-market lending driven by government programs. At the same time, Turkish banks' overhead costs are comparable to peers.

9. There is high uncertainty over bank asset quality. Supported by strong loan growth and regulatory forbearance, the NPL ratio peaked at 5.4 percent in 2019 and declined to 2.5 percent system-wide. For SOBs, the ratio peaked at 3.6 percent in 2019 and stands at 1.7 percent, in part due to their faster credit growth compared to the rest of the banking system. The stage two loan ratio has remained broadly stable at just below 10 percent and loan restructurings rose to 6.5 percent in 2021 and have since edged down to 5.7 percent. However, there is no information on the types and performance of restructured loans. Regulatory easing which was not compliant with international norms was extensive, even before the COVID-19 pandemic. Furthermore, regulatory changes allowed existing loans to be refinanced including through the Credit Guarantee System (CGS) and SOBs while retaining their performing status. Data on these refinanced loans is not collected. Despite regulatory easing, reported asset quality in some sectors, including construction, energy and tourism, is showing pressure (See section *Resolution of Non-Performing Loans* for further details).

10. Capital ratios have rebounded lately but would be much closer to regulatory limits in the absence of forbearance. Reported system-wide capital was over 18 percent of risk weighted assets at end-May 2022, well above regulatory requirements, but this is inflated by regulatory flexibility, and significant disparities across banks exist.[5] Leverage ratios, which strip out the impact

[5] The BRSA has a minimum CAR of 8 percent, consistent with Basel III, and a target CAR of 12 percent.

of lower risk weights used to calculate regulatory RWA, have been trending downward, raising banks' risk profile (See sections *Stress Tests and Network Analysis* and *Banking Sector Regulation and Supervision* for further details).

11. A strong bank-central bank nexus, exacerbated by a scarcity of readily available CBRT FX reserves, represents a key systemic risk. Almost three quarters of CBRT FX liabilities are owed to domestic banks, in the form of deposits or swaps. This alone is larger than total CBRT FX reserves assets and is a large share of banks' FX liquid assets.[6] In addition, a steady decline in foreign holdings of Turkish government securities has been offset by SOBs' holdings, heightening sovereign-bank interconnectedness (See section *Role of the State* for further details).

12. In contrast, the non-bank financial sector remains relatively small and underdeveloped, including compared to other EMs. The sector accounts for only 10 percent of domestic financial sector assets as of Q3-2021. The share of pension funds and insurance companies stand at 3.5 percent and 2.4 percent respectively, while investment funds account for an even smaller share. Factoring, financing, and leasing companies are also small, accounting for less than 2 percent of financial sector assets.

13. Despite a fast-growing life segment in recent years, Türkiye's insurance sector remains small and underdeveloped compared to peers. Gross written premiums grew steadily by almost 20 percent a year through 2020, but lately high inflation and the weak lira have led to higher claims and compressed profits, especially in the dominant motor segment. Total insurance penetration, measured as premiums to GDP, stood at less than 1.6 percent at end-2020, well below the average for upper middle-income countries, while the life insurance business was only 0.3 percent (See section *Insurance Regulation and Supervision* for further details).

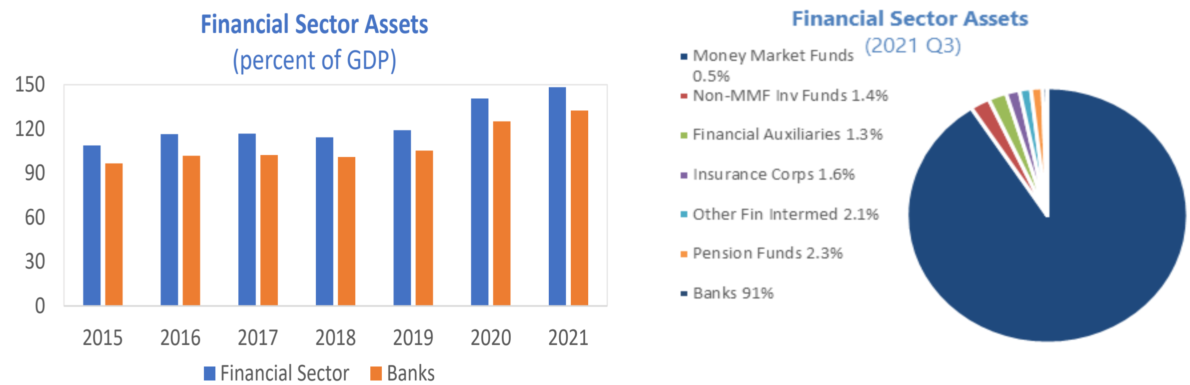
14. Capital markets and long-term savings remain underdeveloped, while foreign investors have withdrawn from Türkiye. At end-2021, outstanding public and private debt securities amounted to 39.7 and 7.6 percent of GDP respectively, while stock market capitalization stood at 30 percent of GDP, below peers. Government bonds, two thirds of which are issued abroad, dominate the fixed income market, accounting for more than 90 percent of debt securities. SOBs own more than 38 percent of government bonds, while the CBRT holds just over 4 percent through outright purchases. The corporate bond market is still underdeveloped compared to other large emerging economies and characterized by short tenors. The turnover ratio of the stock market has increased significantly from an already high level. Foreign investor holdings of public debt securities declined from 20 percent in 2017 to just 1.6 percent by mid-2022. Foreign participation in equity markets has also fallen precipitously. The size of private equity and venture capital (PE/VC) investments is limited (See section *Capital Markets and Long-Term Finance* for further details).

15. Households are increasingly diversifying their financial assets to seek protection from high inflation and TL depreciation. Crypto assets have become popular. Households are seeking to protect their savings through local equities, real estate, FX and gold deposits, and more recently

[6] Readily available reserves—excluding gold, non-hard currency FX, Treasury FX cash, and SDRs—fell to 22 percent of total CBRT gross reserves (at mid-2022) from 80 percent at the last FSAP. For details on the bank-central bank nexus, see the IMF's Financial Sector Stability Assessment (FSSA).

FX-protected TL deposits. Türkiye is among the highest ranked EMs in terms of crypto-asset activity (See section *Crypto Assets* for further details).

Republic of Türkiye: Financial and Banking Sector Assets



Source: CBRT, TurkStat, Fitch, IMF Staff Calculations.

C. Development Challenges

16. Impediments to financial development have their roots in a bank-centric, undiversified sector with a shallow domestic investor base. Despite progress, development needs remain significant, in particular for capital markets and long-term finance. The infrastructure finance gap in Türkiye is estimated at US$405 billion[7] and access to (long-term) finance through diversified sources is even more challenging for micro, small and medium enterprises (MSMEs) who rely mostly on banks. Although Türkiye has made progress in financial inclusion for individuals. In 2021, 74 percent of adults had a transaction account, up from 69 percent in 2017. However, inclusion gaps for women, the poorest 40 percent, and MSMEs remain (See section *The State of Financial Inclusion*).

17. These impediments are compounded by challenging enabling macrofinancial preconditions which have deteriorated recently. Persistent bouts of currency depreciation and high inflation and dollarization in conjunction with a heterodox monetary policy and negative real interest rates reflect a lack of macrofinancial stability that is required to achieve a deeper, more inclusive and diversified financial system. Maturities of bank loans and deposits have shortened, and deposit dollarization has increased impairing TL longer-term financing, although deposit maturities have lengthened again more recently.

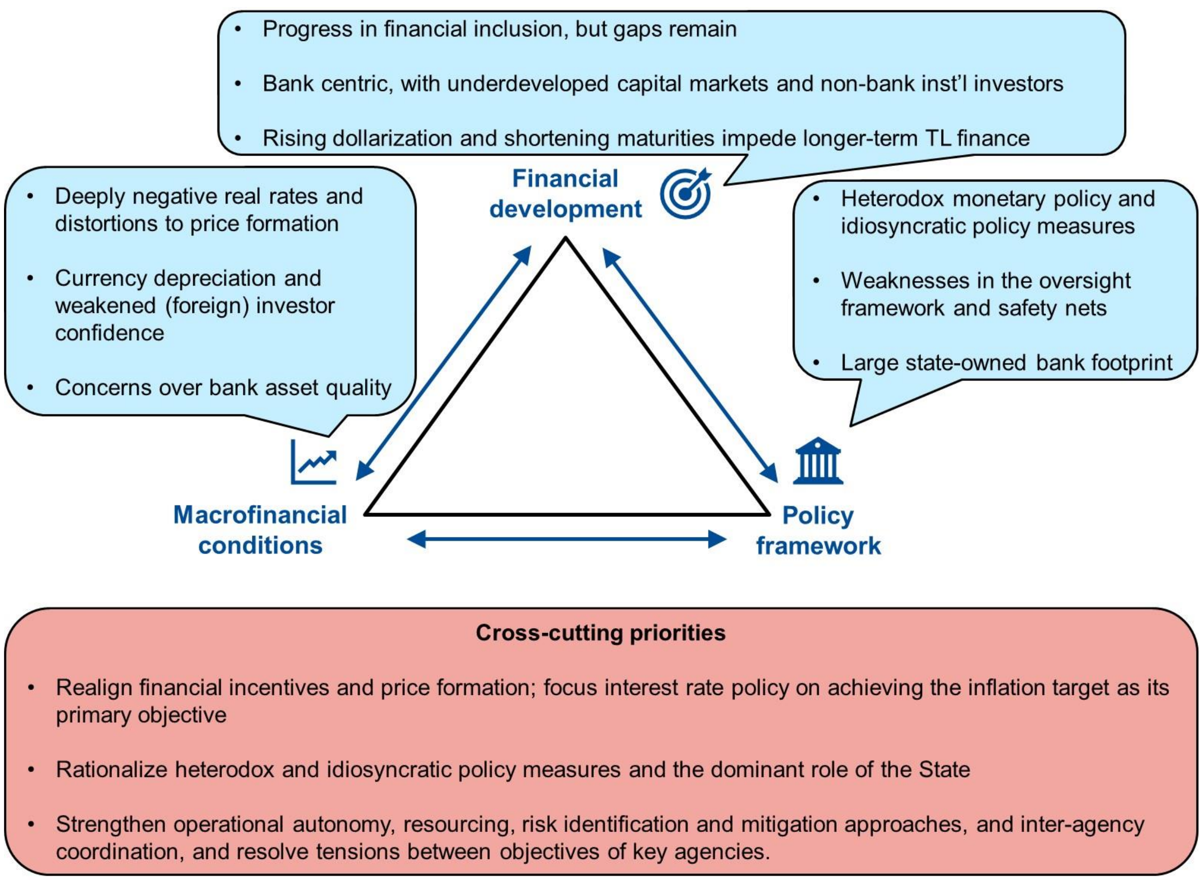
18. The growing footprint of state-owned banks (SOBs) and number of idiosyncratic policy measures have contributed to distortions and new risks that jeopardize financial development. The increased role of government programs, SOBs, and idiosyncratic policy measures which aim to support short-term economic growth and address certain pressures (e.g., credit growth, deposit dollarization, exchange rate, cost of government funding), but also reduce policy

[7] Global Infrastructure Outlook – A G20 Initiative; https://outlook.gihub.org/

predictability, distort price formation and capital allocation, and create new risks -- such an environment is not conducive to producing durable financial sector development outcomes. As such, the authorities are facing a set of increasingly challenging trade-offs.

19. Financial development, macrofinancial conditions, and the policy framework are closely interlinked -- durable financial development requires stable macrofinancial conditions and a sound policy framework. Weakened macrofinancial conditions have adversely interacted with idiosyncratic policy measures, while a strengthening of the policy framework is needed to mitigate macrofinancial volatility. Further, persistent macrofinancial challenges impede financial development compounded by weaknesses in the policy framework. In turn, an undiversified, bank-centric financial sector may not be able to mitigate volatility and can even amplify it.

Republic of Türkiye: Financial Development Triangle: Selected Challenges and Cross-cutting Priorities



Source: World Bank staff analysis

20. Several sectoral and topical strategic plans are in place or under preparation. BRSA's Strategy Plan (2022-2024) aims to strengthen the institutional, legal and regulatory arrangements in view of maintaining confidence and stability in the system. A sustainable banking strategy was adopted by BRSA at the end of 2021, with similar work underway at CMB and IPRSA. Moreover, the development of a national Fintech strategy is ongoing.

21. The authorities have also formulated high-level strategic objectives, but the overall approach appears fragmented. The 2019-2023 Development Plan – Türkiye's overarching strategic framework for development – includes a set of high-level measures aimed at increasing financial intermediation and capital markets development.[8] Moreover, the 2021 Economic Reform Program (ERP) provides an important basis for short-term reforms in the areas of capital market development, NPL resolution, financial inclusion, fintech and sustainable finance (See section *Green and Sustainable Finance*). An integrated multi-year strategic approach focusing on cross-cutting financial sector issues with clear timelines, targets and accountability appears to be absent.

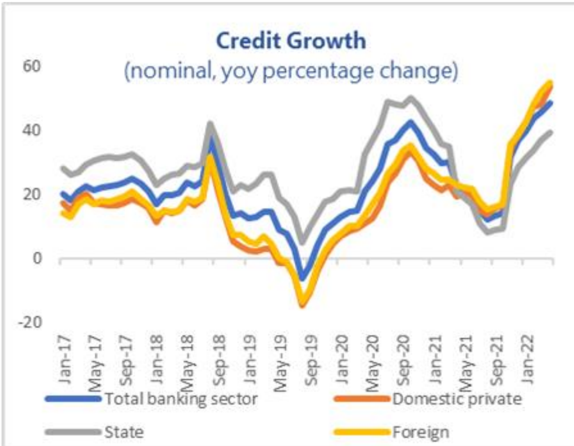
D. Role of the State

Also see Figures 7 and 8

22. The footprint of the State in the financial sector is significant. The market share of SOBs increased from 34 percent to 43 percent of total assets in December 2021 since the last FSAP. In addition, the State controls three investment and development banks, three participation (Islamic) banks, and an export credit agency. The Ministry of Treasury and Finance (MoTF) is the majority shareholder of the CBRT. The State also controls some smaller financial institutions with local operations.

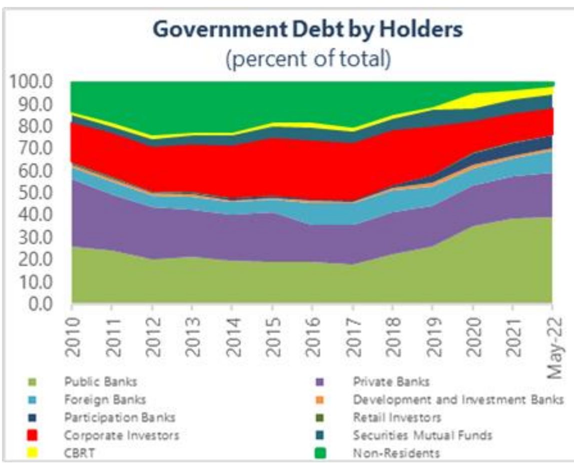
23. SOB's actions have aligned with several broader policy objectives. They have played important roles in i) supporting currency stability (second half of 2020); ii) offering counter-cyclical credit policies, including in the first months of the pandemic, as well as procyclical policies; and iii) supporting the financing of the Government, as foreign and corporate investors have significantly reduced their exposure to the sovereign, particularly in TL instruments.

[8] Four targets envisage for 2023 an estimated growth in bank loans to GDP from 67.3 to 82.2 percent, an increase in the share of participation bank loans to total loans from 4.7 to 7.0 percent, BIST market capitalization/GDP rising from 21.5 to 39.3 as well as the nominal stock of private sector debt securities to GDP amounting to 5.8 percent (compared to 1.7 percent in 2018).



Sources: BRSA, WB Staff calculations.

24. SOBs are facilitating a low interest rate environment. Given persistent macrofinancial challenges, the investor base has been exiting the TL government bond market, putting upward pressure on the yield curve. In parallel, SOBs' total exposure to securities, driven by Government debt exposures, has increased from 21 to 27 percent of assets for the three largest SOBs[9] over the last two years and SOBs have been able to benefit from a risk-free carry trade. In this context, corporate lending interest rates, including rates offered to SMEs, are priced below the cost of funding of the Government, creating a competitive disadvantage for other banks.



Sources: MOTF, WB Staff calculations.

25. In the absence of long-term sources of funding in TL, SOBs and private banks face difficulty in providing TL long-term financing to the real sector. Despite their growth in market share, SOBs are largely providing short-term financing to companies in TL. Contributing factors include a limited supply of bankable longer-term projects, the short maturity of the funding profile, and the limited availability of longer-term TL funding for banks. In the presence of real negative interest rates, investors have little appetite for providing long-term financing to banks in TL.

26. A growing footprint of SOBs and guarantees have supported credit growth but contribute to distortions and transfer some risks to the Government. Since 2020, SOBs have been recapitalized twice. Treasury-backed CGS guarantees supported SOB-led credit growth, in particular during the pandemic, although uptake has moderated afterwards. Concerns about bank asset quality and classification have risen, even though official asset quality indicators of loans extended under the CGS appear broadly adequate. A normalization of macroeconomic policies or a macrofinancial shock may contribute to a deterioration of private balance sheets leading to a sharp rise in calls of CGS guarantees with significant fiscal implications.

27. The support of SOBs to government policy objectives appears to take place in a context of the need to strengthen corporate governance. Clear SOB mandates, intrusive fit-and-proper requirements for SOB board members, and a broad definition of independent directors appear largely absent. Exploring the scope to strengthen these concepts in the legal and regulatory

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[9] Based on individual banks' reports.

framework and the monitoring and evaluation processes to assess performance and market impacts of SOBs will be important.

RESILIENCE AND VULNERABILITY ASSESSMENT

A. Stress Tests and Network Analysis[10]

Also see Table 5

28. Banking stress tests (ST) examined systemic solvency and liquidity resilience using end-2021 data. The ST covered the 10 largest banks (four of which are state owned) by asset size, constituting approximately 80 percent of banking system assets. There were two ST scenarios with a three-year horizon (2022-2024).[11]

Solvency Stress Tests

29. Excluding regulatory forbearance leads to a sizable decline in the banking system total capital adequacy ratio (CAR) in 2021Q4.[12] These adjustments decreased the banking system CAR in 2021Q4 by 4 percentage points to 13.6 percent. Under the baseline scenario, banking system CAR would gradually decline close to the regulatory minimum of 8 percent, in the absence of restrained credit growth.[13] Under the adverse scenario, banking system CAR would decline significantly, falling below the regulatory minimum. If restructured loans were to become non-performing, capital ratios would decline further by 0.5 and 0.7 percentage points.[14]

Liquidity Stress Tests

30. A cash-flow-based liquidity stress test (LST) and an LCR-based stress test were conducted to test the banking-sector resilience to liquidity stress at end-2021. The LST assessed banks' liquidity, both total (TL and FX) and FX, under three scenarios of increasing severity. Three assumption options were made regarding the CBRT's readily available FX liquidity to support the banking system.

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[10] For details see the IMF's Financial Sector Stability Assessment (FSSA).

[11] A baseline scenario drew on the preliminary July 2022 World Economic Outlook, in which growth decelerates, inflation and credit growth rise, and the Lira depreciates. An adverse scenario featured a sharp economic downturn followed by a recovery. It also incorporated an increase in inflation, currency depreciation, capital outflows and a rise in sovereign risk, resulting in increased funding costs for NFCs and solvency and liquidity pressure on banks.

[12] In this section the banking system refers to the 10 largest banks by asset size, and the data/policy cut-off date is 2021Q4. In line with BRSA stress testing, the impact of forbearance was excluded from the starting points. Furthermore, risk weights on sovereign debt securities in FX, and FX required reserves and receivables from the CBRT were increased to 100 percent, in line with Basel.

[13] Idiosyncratic policy measures and recapitalization of SOBs in 2022 were not included in the analysis, as the stress test starting point is based on 2021Q4 data.

[14] A fraction of restructured stage two loans (25 percent in the first counterfactual and 50 percent in the second) is assumed to become non-performing in 2021Q4. This would lead to an increase in NPL ratios of 1.5 and 3 percentage points in the first and second counterfactual analysis respectively.

31. The results of the LCR stress test revealed that banks could withstand moderate deposit outflows at end-2021 but were vulnerable to severe outflows. FX LCRs remained above the regulatory minimum of 80 percent under the stress scenarios for all banks. However, under the severe scenario banks' FX LCRs reached close to the minimum. Total LCRs stayed above the 100 percent regulatory minimum for all banks under scenario one. However, under the severe scenario, total LCR fell below 100 percent for one bank under assumption options 1 and 2, and for three banks under option 3. The key driver was funding outflows from retail and corporate deposits. The cash-flow-based liquidity stress test analysis provided similar results. The results demonstrate the importance of the CBRT's readily available FX in determining systemic liquidity risk.

Systemic FX Liquidity Stress Tests

32. Systemic FX liquidity stress tests assessed the impact of stress stemming from NFCs, households, and general government, and the transmission to CBRT reserves. The analysis incorporated large off-balance sheet FX derivatives positions (e.g., swaps) of the banking system vis-a-vis other sectors. Results indicated that moderate FX liquidity stress could be met at end-2021. A severe FX liquidity stress scenario would require CBRT liquidity support, reducing CBRT readily available liquidity, significantly if accompanied by a reversal of capital flows.

Interconnectedness and Contagion

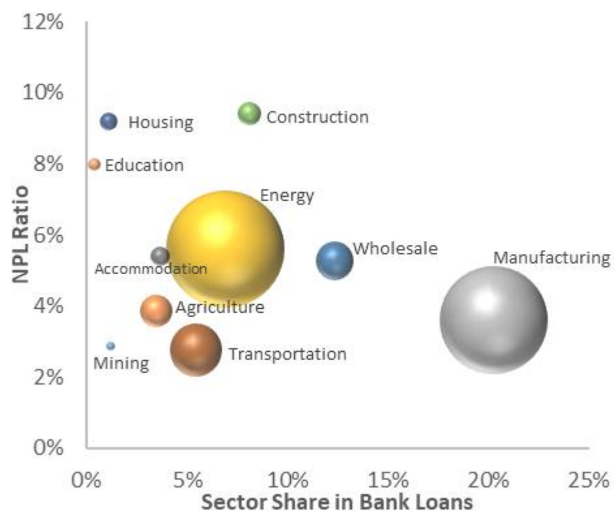
33. The banking system's high degree of interconnectedness with the domestic NFC sector and households implies potential for shocks to propagate if risks were to materialize. The banking system has considerable exposure to NFCs and households via deposits and loans. If stress materializes in the corporate sector, it could reverberate through the system via the credit risk channel. Interbank contagion analysis indicates that contagion risk among the 10 largest banks is limited reflecting low interbank credit exposures. The Turkish banking system could be adversely affected by spillovers from abroad, but it is not a source of contagion to other major banking systems.

Nonfinancial Corporate Sector Stress Tests

34. Stress tests to assess NFC resilience indicated viability could deteriorate significantly for about one third of firms as real interest rates rise. Many NFCs have high leverage. In both the baseline and adverse ST scenarios, firms would face substantially higher interest burdens as real interest rates rise. The median firm's ICR remained around the critical threshold of two at the trough of the stress episode. However, about 35 percent of NFCs in the sample faced viability challenges with their ICR falling below one. Larger and non-services sector firms appear to be more resilient. Moreover, credit risk increases significantly during the stress episode.

B. Climate Risk

35. National plans to support climate change mitigation and adaptation are in place. There is a National Climate Change Strategy (2010-2023), Green Deal Action Plan (GDAP), Climate Council advisory decisions, and targets to reduce carbon emissions to net zero by 2053.



Source: WB CCDR, 2022.

36. Türkiye's financial sector faces low- to mid-range exposure to climate-related risks range. Türkiye is exposed to physical risks[15], including wildfire, drought and flood, and ranked in the lower mid-range in terms of transition risk[16]. Transition risk could increase if the European Union finalizes its Carbon Border Adjustment Mechanism (CBAM) which would impose import tariffs on carbon-intensive products, although the impact on NPLs is not significant according to a BRSA study. BRSA is conducting a pilot exercise on physical risk analysis to build a risk assessment model. The insurance sector's exposure to climate-related risks appears limited and centered on the agricultural sector for which most policies are written by the Agricultural Insurance Pool (TARSIM).

37. The authorities recognize the need to deepen their understanding of climate risks by developing risk assessments and enhancing data capacity in a collaborative fashion. The BRSA and the CBRT have started to analyze climate risk impacts. These efforts could be supported by harmonizing and enhancing climate related data, such as firm-level carbon intensity or granularity of data on location for loans. Undertaking simplified risk assessments for the pensions and insurance sectors (e.g., by measuring exposures) and their supervisory objectives would be beneficial.

38. Turkish financial regulators have taken initial steps to integrate climate issues in their governance and strategy, but supervisory guidance is limited. Efforts include a sustainable banking strategy by the BRSA and the creation of a climate department at the CBRT. CMB launched a "Sustainability Principles Compliance Framework" (2020).[17] Most financial institutions are at an early stage of integrating climate risks into their strategy and operations and have called for more guidance. In time, the authorities could integrate climate risks into their overall supervisory approaches in accordance with international guidance.

C. Crypto Assets

39. Crypto asset activity has grown significantly. There are 37 active centralized exchanges operating in Türkiye with an estimated 15 million accounts. In 2021, two exchanges failed. The average total daily trading volume was about $0.8 billion, and total crypto holdings amounted to about $5 billion (0.6% of GDP) at end-2021. There has been a notable rise in trading volumes of Tether against TL.

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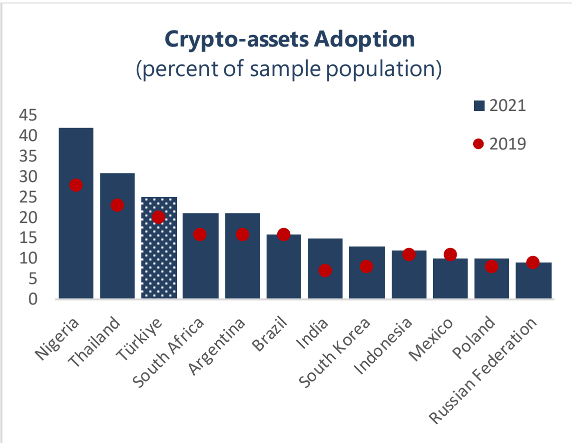
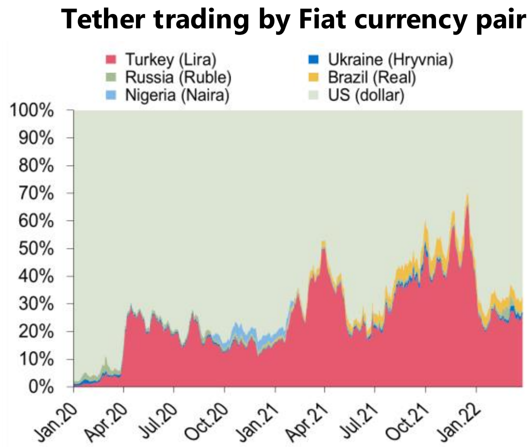
[15] According to the INFORM climate index, a collaboration of the UN Inter-Agency Standing Committee and the European Commission.

[16] See "Diversification and Cooperation in a Decarbonizing World", Chapter 5.

[17] Recently, CMB also introduced a reporting template to facilitate the ESG disclosures.





Sources: Statista Global Consumer Survey, CryptoCompare, WB and IMF Staff calculations.

40. The regulated financial sector plays a limited role in crypto asset activities and the authorities recognize their financial stability, consumer protection, and other risks. Only banks and the Turkish Postal Service (PTT) can be used to transfer TL and FX between domestic and global crypto exchanges. Banks may not lend for crypto investment purposes, take direct holdings in crypto assets nor provide crypto-related services, such as custody services, but they remain exposed to indirect crypto risks through their customers' exposures. The authorities prohibited the use of crypto assets for payments in April 2021.[18]

41. A regulatory framework for crypto asset ecosystem is nascent and the implementation of binding FATF standards on virtual assets is advised. The Capital Markets Board (CMB) is drafting a law and formulating a regulatory framework for crypto investment platforms with a focus on investor protection. The CBRT is working on a framework for the use of stablecoins which satisfy the conditions to be accepted as e-money for payment. The Financial Crimes Investigation Board (MASAK) has identified Virtual Asset Service Providers (VASPs) as obliged entities for Customer Due Diligence (CDD), Suspicious Transaction Report (STRs) and periodical reporting for AML/CFT purposes. Expeditious and effective implementation of the Financial Action Task Force (FATF) Recommendation 15 on virtual asset activities is advised.

42. Strengthening institutional coordination would be important. Inter-institutional coordination arrangements are unclear and may give rise to arbitrage. Developing a comprehensive, consistent, and coordinated regulatory and supervisory approach, including regarding data collection, would therefore be important.

[18] See "Regulation on the Disuse of Crypto Assets in Payments" (No. 31456).

FINANCIAL SECTOR OVERSIGHT

43. The FSAP recommends addressing several cross-cutting issues regarding the overall financial sector oversight framework:

- *Prioritizing financial stability*. Rebalancing toward financial stability over near-term economic growth is imperative given the financial risks that have emerged.
- *Ensuring operational autonomy* of the CBRT, BRSA, IPRSA, SDIF, and other relevant institutions, rationalize idiosyncratic regulatory measures, and allow for policy normalization.
- *Increasing resources* for institutions to fulfill their mandates effectively, by providing space to deepen the analysis necessary to support prudential supervision, improving their ability to attract and retain talent, ultimately building strong foundations to address future challenges.
- *Strengthening coordination* across financial regulatory agencies in the areas of systemic risk monitoring, crisis management and preparedness, cyber-resilience, and climate (e.g., risk assessments, knowledge sharing on green finance).

A. Financial Sector Regulation and Supervision

Banking Regulation and Supervision

44. Vital recommendations in this FSAP for the stability and health of the banking system are presented regarding: alleviating tensions between objectives and restoring the operational autonomy and resources at the BRSA; strengthening the supervisory approach, including techniques and tools; intensifying the supervision of liquidity and credit risk management (including revising loan restructuring and classification); and deepening corporate governance and risk management supervision.

45. A formal assessment of Basel Core Principles (BCP) in the last FSAP found five principles to be materially non-compliant and various weaknesses persist.[19] Shortcomings relating to credit risk and the supervisory approach have deteriorated further including regulatory dilution and supervisory practices left exposed by resource limitations. FX vulnerability, liquidity risk, information and communication technology (ICT) risk, operational resilience and the impact of COVID-19 related measures have also emerged as concerns.

46. The BRSA's effectiveness is significantly impaired by restrictions on its independence and resources as well as tensions between its objectives. Legislative changes have hard coded the incursions on BRSA independence. Notably, the Banking Law has been amended to require the BRSA

[19] Core principles (CP) on independence, accountability, resourcing and legal protection for supervisors (CP2); supervisory approach (CP8); corporate governance (CP14); credit risk (CP17); and problem assets, provisions and reserves (CP18).

to comply with principles, strategies and policies set down in government plans and programs.[20] Furthermore, the President may now remove public officials for failure to achieve institutional goals, irrespective of other grounds set out in law. Measures taken since the last FSAP to increase the provision of credit to the economy highlight the conflict between the BRSA's objectives of financial stability and broader government policies. In addition to starving supervisors of modern tools, budgetary constraints and the imposition of the civil service pay scales have led to a major outflow of staff and experience that the BRSA finds itself unable to replenish. Restoring the BRSA's budgetary autonomy and ensuring the primacy of financial stability objectives are essential. Revamping the governance processes of the agency is also important.

47. Prudential regulatory terms and criteria have been eliminated or eased to support credit growth at the potential expense of financial stability.[21] Easing refinancing terms and treatment of problem loans challenges effective supervision and can undermine banks' balance sheets. Regulations on loans, classification and provisioning[22] have been amended since 2016 and now require strengthening to ensure transparency on asset quality and to discourage loan evergreening practices. Two complementary new credit risk guidelines have been published in June 2021 and banks required to be fully compliant with them by July 2022, but they will be overshadowed by the weakening of credit classification practices and by a range of extraordinary measures taken since 2018. The regulatory changes have diluted credit discipline and facilitated untracked problem loan refinancing, which, in addition to COVID-19 measures (revoked effective from April 2022), have probably resulted in artificially low NPL ratios and provisioning and compounded the difficulties facing supervisors. Following implementation of reforms, an independent third-party asset quality review (AQR) would also be helpful in assessing credit risks and restoring confidence to the system.

48. The supervisory approach needs significant strengthening from gatekeeping to enforcement, focusing on enhanced and forward-looking risk approaches. Enhancements to techniques and tools and deepening corporate governance and risk management supervision are key. Fit and proper requirements and assessments need urgent strengthening since they are compliance-based and not in line with international standards. The annual CAMELS (Capital, Assets, Management, Earnings, Liquidity, Sensitivity to Market Risk) rating process consumes most of the onsite supervisory resources. It lacks a risk-focused approach that is grounded in key risk assessment criteria which, among other concerns, does not properly identify problem banks. Examinations focus on regulatory breaches and errors, rather than root causes. Offsite supervisory work also needs to be incorporated into the CAMELS ratings to comprehensively capture risks. Although a stress testing framework has been established, it is not clearly reflected in the CAMELS ratings. Finally, supervisory enforcement seems to be ineffective. There is no formal response policy to the CAMELS ratings, making it difficult to operationalize early remedial powers. Of concern, there

[20] Decree-Law Nº 703/2018.

[21] Also see Section *Resolution of Non-Performing Loans*.

[22] Regulations on Loan Operations of Banks and on Procedures and Principles for Classification of Loans and Provisions to be Set Aside.

is limited enforceability based on qualitative requirements, such as corporate governance and risk management guidelines.

49. Supervision and enforcement activities need enhanced communication and integrated functions. Key supervisory departments—Onsite, Offsite, Enforcement, Risk Management—appear to function in silos and need formalized, fluid, and effective communications. The lack of the full suite of supervisory inputs into the CAMELS ratings process is indicative of the siloed nature of the BRSA. Effective communication is essential for identification of concerns, timely intervention, and when necessary, escalation in use of BRSA powers. The loss of large numbers of staff will have hindered the BRSA.

50. Effective consolidated supervision of banks that are members of mixed-financial and mixed-activity groups requires imposing supplemental standards on their parent entities. Governance, risk management standards, capital and other prudential requirements should apply at the level of the mixed-activity holding company, which is outside the scope of prudential regulations. Banks should be ring fenced from the non-financial and contagion risks from the non-financial part of these mixed-activity groups. In time, ensure separation of banking and non-financial activities, including that independent directors serve in the banks' boards. Enhanced suitability, governance, and reporting requirements should also be imposed throughout the ownership chain up to the last significant level of ultimate ownership. Such measures should include extended reporting systems to identify, monitor, and report inter-group transactions above the level of the regulated bank.

51. Official capital ratios are unlikely to reflect the increase in risk since the last FSAP and there is an urgent need to restore the CAR calculation according to international standards. For four months in 2018 and since March 2020, Turkish banks have been permitted to use an exchange rate for FX assets in credit risk RWA based on the CBRT's average FX buying rates over the previous 252 business days—changed in 2022 to the end-2021 exchange rate. Banks can also exclude mark-to-market losses of available-for-sale securities. In addition, contrary to Basel standards, banks' Turkish FX sovereign exposures are zero risk weighted. The BRSA monitors the capital adequacy impact of the first two measures, which, as of end-2021, increased the consolidated banking system CAR by 280 basis points.

52. Reported LCRs also likely underestimate risks, particularly in FX, and the net stable funding ratio (NSFR) has not been implemented. The LCR calculation has been boosted by regulatory changes to include the totality of CBRT required reserves as Level 1 HQLA; inflows from FX swaps with the CBRT; and revisions to the inclusion of outflows from market valuation changes on derivatives transactions. In addition, although FX receivables from the CBRT due to swaps and required reserves are included in the LCR calculation, which is in line with Basel standards, they may not be readily available given low CBRT FX reserve assets. A range of measures related to the intensification of the supervision of liquidity risk should be adopted, including reverting to conservative liquidity metrics—e.g., a 50 percent haircut for FX required reserves in the LCR; revamping contingency planning for a significant FX shock; and enhancing liquidity risk monitoring.

53. **With the banking book representing 90 percent of the Turkish banks' assets, interest rate risk in the banking book (IRRBB) is a major risk in the highly volatile macrofinancial conditions**. The 2011 regulation on IRRBB does not incorporate the 2016 BCBS standard and needs to be updated. The BRSA must also upgrade its Supervisory Review Process of banks' IRRBB management and internal economic capital calculation, challenging banks' assessments.

54. **Revisions to the corporate governance framework should be advanced and enforced to address shortcomings found in the last BCP assessment**. Standards must be applied equally to SOBs to ensure they adopt good risk management and underwriting practices, and avoid creating market or systemic distortions, for example through non-commercial lending rates.

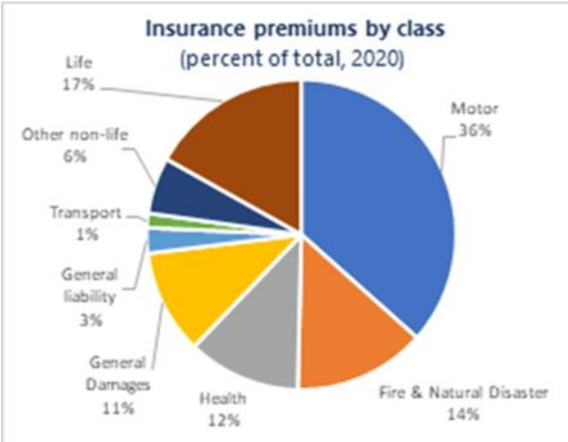
55. **The BRSA's approach to information and communication technology (ICT) risk, covering cyber security and operational risk, is fragmented.** It is important for the BRSA to integrate ICT risk assessments and other ICT issues into operational risk and resilience framework and assessments as well as ensuring that ICT issues are seamlessly incorporated into communication and decision-making structures.

Insurance Regulation and Supervision

Also see Figure 9

56. **Insurance supervision and regulation in Türkiye has significantly improved since the last FSAP.**[23] The establishment of the IPRSA – a standalone, independent insurance supervisor - has improved the institutional framework for insurance supervision and regulation. The unified structure allows for integration of off-, on-site and enforcement activities. Insurance companies are now required to establish compliance, risk management, actuarial and internal audit units under the supervision of an audit committee, which functions independently from senior management. Duties and roles of these key control functions are more clearly defined by regulation.

[23] The FSAP has not conducted a full ICP assessment, but focused on the progress that the Turkish authorities have made since the 2017 FSAP.



Sources: IPRSA, WB staff calculations.

57. Despite progress, IPRSA's practices do not yet meet international standards. The nomination, appointment, and dismissal processes of IPRSA's board members lack clarity and transparency. A formal Own Risk Solvency Assessment (ORSA) process has not been implemented although most ORSA components appear to exist. On-site inspections have been constrained in quality and frequency due to reduced technical capacity following staff exits after organizational restructuring and targeted on-site inspections have been infrequent even after material events such as the mergers of six state-owned insurers.

58. The IPRSA needs to put a groupwide supervisory framework in place. At present insurance supervision and regulation is mainly focused on legal entities, but the insurance market is typified by financial or conglomerate groups, under which insurance companies operate. For example, the largest life and non-life insurance companies in Türkiye are state-owned entities held by the Sovereign Wealth Fund and operate as an insurance group under its umbrella. Other Turkish insurance companies are controlled or partially owned by Turkish banks.

59. Turkish Law does not require insurance supervision to support financial stability and IPRSA has no macroprudential framework in place. The Insurance Law does not set out financial stability as an objective of insurance supervision although under the Insurance Core Principles (ICPs), financial stability is one of the three fundamental objectives of insurance supervision. Partly related to this concern, there is no macroprudential framework and at a practical level, the IPRSA has designed but not yet implemented supervisory stress testing.

Private Pensions Regulation and Supervision

60. While the creation of the IPRSA is a positive development since the previous FSAP, it left a vacuum in the design of pension policy. The segregation of regulatory and supervisory functions between CMB and IPRSA does not allow authorities to promote policies that connect individuals' pension contributions with their expected pensions at retirement age. The focus of the regulatory framework is largely operational, but there is room for improving the voluntary pension system. In particular, the performance measures of pension portfolios are designed for short-term portfolio optimization instead of long-term returns. In addition, the supervisory cycle of entities supervised by IPRSA are not necessarily aligned with the cycle of those supervised by the CMB. The fragmented approach to supervision misses the opportunity of switching towards risk-based supervision.

B. Financial Market Infrastructure

61. Progress has been achieved by CBRT and CMB in strengthening financial market infrastructures. Recommendations outlined in the last FSAP have been addressed.[24] Türkiye has well-developed Financial Market Infrastructures (FMIs) commensurate with its economic development and financial market needs. The CBRT has enhanced its risk management framework covering critical participants and dependent FMIs as well as extended the framework's coverage to liquidity, operational risk, and cyber security risks. Open market operations and usage of intraday liquidity facilities are now free of charge. Moreover, an overnight collateralized liquidity facility has been introduced and liquidity optimization algorithms have been automatized. Rules and procedures for handling defaults of participants have been adopted and are tested periodically. Operational risk assessments stemming from systemically important participants have been strengthened. CMB also issued a communique in 2018 establishing a regulatory framework for trade repositories.[25]

C. Financial Integrity

62. Türkiye was put on FATF's grey list. The FATF's Mutual Evaluation Report (MER) in 2019 noted deficiencies in Türkiye's anti-money laundering/counter terrorist financing (AML/CFT) framework in areas related to technical compliance and effective implementation.[26] As a result, in October 2021, the FATF placed Türkiye in the list of jurisdictions with strategic deficiencies (grey list) and provided a comprehensive action plan with timelines.[27] Continued close monitoring is advised, including over correspondent banking pressures which could materialize, particularly for smaller and medium-sized financial institutions. Efforts to expeditiously address the FATF's action plan in the agreed timeframe is recommended.

63. Progress towards addressing the FATF action plan is being made, but continued efforts are required with respect to key issues. The authorities should introduce enforceable legal measures and guidance for politically exposed persons (PEPs) and approve the law on crypto assets to ensure full compliance with R.15.[28] Continuing to demonstrate the ability to implement targeted financial sanctions without delay, and to pursue domestic designations for TF, is critical. Continuous

[24] A detailed assessment report (DAR) conducted during the 2016 FSAP against Principles for Financial Market Infrastructures (PFMI) noted areas for improvement for the EFT and ESTS system in the risk management framework, liquidity risk management, default management, and operational risk management. In addition, for the EFT system areas for improvements were noted for tiered participation as well. As regards the responsibilities, a lack of regulatory framework for TRs was noted.

[25] The communique establishes the obligation of counterparties and CCP processing the transaction to report the salient aspects of all derivatives trades include those conducted OTC. The communique also describes the process to be followed, use of unique transaction identifiers, and establishes high level principles for reporting.

[26] 9 out of the 11 immediate outcomes ratings related to effectiveness were low or moderate.

[27] FATF Jurisdictions under increased monitoring – June 2022: https://www.fatf-gafi.org/publications/high-risk-and-other-monitored-jurisdictions/documents/increased-monitoring-june-2022.html.

[28] The introduction of measures related to PEPs, in line with the FATF's Recommendation 12, was a recommendation of the previous FSAP and is now a requirement under the FATF's action plan.

monitoring of emerging risks by supervisors and adoption of mitigation measures is needed. Efforts to enhance supervision should be in line with Türkiye's risk profile but not take away resources from other areas (e.g., banking supervision). Comprehensive statistics to demonstrate the effectiveness of financial intelligence, ML/TF investigations and cases is important.

64. Close monitoring, management, and mitigation of emerging risks as result of the geo-political context is also warranted. The extraterritorial impact of bilateral sanctions against third countries, cross-border financial flows, and the presence of non-residents in Türkiye's financial sector require close monitoring, while raising financial institutions' awareness of risks arising from possible cross-border regulatory actions. Türkiye's citizenship by investment (CIB) program should be watched for financial integrity risks and supervisory efforts focused on sectors closely associated to the CIB program (e.g., real estate).

CRISIS MANAGEMENT, SAFETY NETS AND RESOLUTION OF NON-PERFORMING LOANS

A. Crisis Management and Resolution

65. Türkiye has a reasonably clear bank recovery and resolution institutional framework. It covers the SDIF as the resolution authority, BRSA, CBRT and the MOTF, as well as structures to facilitate domestic coordination. The laws applicable to bank recovery and resolution contain many essential provisions, including corrective action powers and several resolution powers. However, shortcomings in the framework also exist, and there remains considerable scope to strengthen many elements.

66. There has been limited progress in aligning the bank resolution and crisis management framework with the Financial Stability Board Key Attributes (FSB KA) and addressing the gaps identified in the last FSAP. Recovery planning requirements for D-SIBs were introduced in 2020 and the BRSA has assessed the first round of submissions by banks, who have started to embed recovery planning into their risk management frameworks. The restructuring of the FSC, including re-establishing a working group on crisis management, is expected to improve inter-agency cooperation and crisis preparedness. The Deposit Guarantee Scheme coverage was increased to 200,000 TL and the scheme remains well funded.[29] Work on reforms to address gaps continues, including proposals for strengthening the Banking Law (BL), developing, enhancing and amending existing policies covering recovery planning, resolvability assessments, resolution planning, and enhancing the resolution toolkit and reform of resolution financing.

[29] As of end-September 2021, the size of the SDIF deposit insurance reserve was TL 80,537 million, and the deposit insurance limit provides full coverage to above 90 percent of natural person depositors. The coverage ratio of the deposit insurance reserve to total insured deposits was about 8 percent. Insurance pay-outs are made in TL.

67. The introduction of recovery planning requirements for the DSIBs has been a significant step forward but gaps remain. The DSIBs reported their first recovery plans to the BRSA in 2021 and have started to embed recovery planning into their risk management frameworks. Over time, the authorities should consider making recovery plans mandatory for all banks operating in Türkiye, including the subsidiaries of foreign banks. The information exchange between the BRSA and SDIF should be enhanced during the use of early intervention measures (EIMs), and in assessing recovery plans once the necessary amendments have been made to the Banking Law. While the BRSA has reasonably comprehensive statutory powers for EIM, the SDIF should be enabled to start detailed preparations for resolution during EIM. The recovery plans should also be shared with the SDIF for soliciting comments. The BRSA should strengthen its framework for early warning indicators and triggers for various EIMs and recovery options. The BRSA may also benefit from stronger sanctioning powers and from developing procedures for situations where banks are under stress, drawing from the corrective action framework and recovery plans.

68. The modalities for placing a bank into resolution, including liquidation, require further clarification. Although the trigger system for declaring a bank failing is relatively well developed, it lacks some important elements, and the non-viability assessment should be set with a forward-looking element to provide for early entry into resolution. The power to decide whether a failing bank should be put into resolution or liquidation should move from BRSA to SDIF as the resolution and liquidation authority (after BRSA decides that the bank is failing or likely to fail (FOLTF)). In parallel, the SDIF should be empowered to undertake resolvability assessments, draft resolution plans, and develop a related policy framework in close cooperation with BRSA. Consideration should be given to empowering the SDIF with the ability to proactively request FOLTF decisions. The SDIF should also have the powers to remove obstacles to bank resolvability keeping in mind that resolution should be a credible option for all failing banks, including SOBs.

69. The resolution toolkit is missing several key tools, such as bridge bank and good-bad asset separation powers. A temporary stay of contractual acceleration, termination and other close-out rights avoiding the termination of large volumes of financial contracts upon entry into resolution should be introduced. Also, existing moratoria powers should be enhanced. Resolution powers are centered around the take-over of the failing bank's management and control along with shareholder rights without any prior separation between good and bad assets. Certain tools like a pre-packed transfer of assets and liabilities to a purchaser should be available for all banks regardless of their systemic relevance or SDIF shareholdership status. In parallel, the legal framework should provide SDIF with clearly defined statutory resolution objectives and accountabilities.

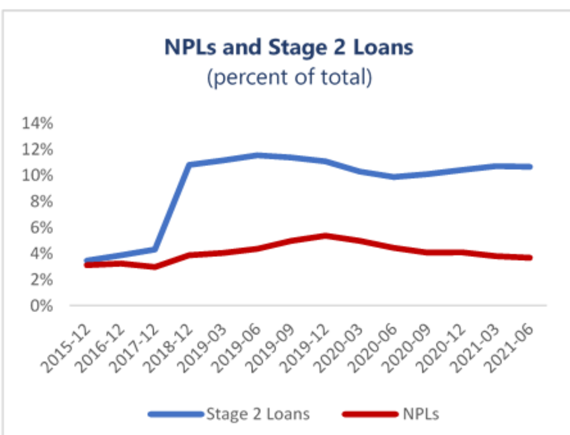
70. Future changes to the resolution regime should clearly stipulate that in addition to equity holders, creditors should absorb losses. SDIF funds (combined with government backup funding) are the only available source of resolution funding to stabilize and recapitalize a failed bank. In line with the FSB KAs the principle of private loss coverage in accordance with the liquidation hierarchy should be introduced while ensuring that creditors are protected under the "no creditor worse off" safeguard.

71. Improvements to the framework for resolving a systemically important bank and addressing a systemic banking crisis are needed. The most appropriate way to introduce bail-in conversion powers should be assessed. As it is important to ensure that banks bear the costs of their own failures, the SDIF, in consultation with BRSA, should be able to request banks to increase their loss-absorbing capacity and to convert or write down liabilities upon entry into resolution. Open bank bail-in should be applied only to D-SIBs with viable business prospects to restore commercial viability. In this context, the legal framework should contain strong investor protection for retail investors while ensuring sufficient loss absorbing capacity will be built up over time.

72. The FSC should play a leading role in contingency planning and crisis preparedness, and the legal provisions should be amended to make this clearer. The FSC's operating principles should distinguish between its role in normal times and in potential crisis times. The FSC should have responsibility for coordinating the development of contingency plans in each of the member authorities, which can eventually be integrated into a national plan. The legal arrangements should be reviewed to ensure effective operational autonomy of the SDIF and BRSA, subject to robust transparency and accountability. As there are no substantive cross-border coordination arrangements in place to facilitate cross-border bank recovery and resolution, the authorities need to adequately address all aspects related to cross-border resolution for subsidiaries and branches both as a home and a host country as part of the process of revising the legal framework for crisis management. A major hurdle to cross-border cooperation is the SDIF's lack of powers to share bank-specific information with foreign authorities. A memorandum of understanding in this context is recommended.

B. Resolution of Non-Performing Loans

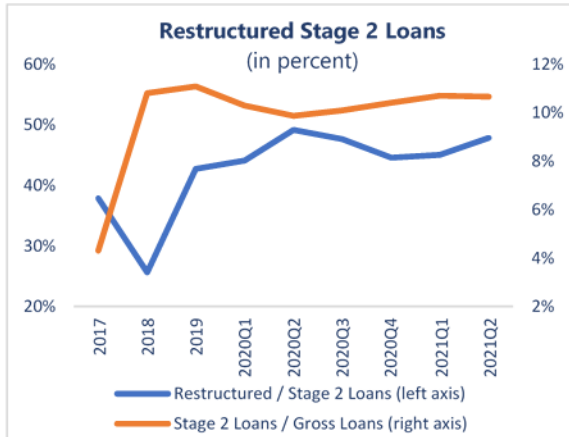
Also see Figure 10



Source: BRSA, WB staff calculations.

73. Despite an adverse macrofinancial environment, NPLs have remained moderate. Yet, in a context of extraordinary policy measures, concerns regarding asset quality have emerged, raising financial stability risks. The NPL ratio has in fact decreased since the start of the COVID-19 pandemic and stood at 3.2 percent in December 2021 following its 2019 peak at 5.4 percent. It has since further fallen to 2.5 percent in June 2022. This trend is largely explained by a combination of factors, including the strong credit growth observed in 2020-21, the increase in TL of FX loans due to depreciation, significant regulatory forbearance and a sharp increase in restructured loans, which reached 5.6 percent of total loans in June 2021. Despite this apparent positive trend, concerns remain surrounding recent restructuring practices which, combined with a relaxation of prudential standards applicable to asset classification and forbearance, may conceal the real levels of asset quality in the system. There is a risk that the widespread use of refinancing observed in recent years may have led to systematic "evergreening".

74. The approach adopted by the authorities to support bank credit growth involves certain risks, and key obstacles remain. Maintaining high bank lending growth, which could reduce the NPL ratio through additional refinancing and the 'denominator effect', is likely not sustainable. The CGS has played a key role in ensuring the flow of credit, especially to SMEs, but the terms of the CGS guarantees may have led to unsustainable restructurings which compromise asset quality. Banks' ability to accept further restructurings may also be diminished in the near term, especially if key provisions of the Regulation on Procedures and Principles for Classification of Loans and Provisions To Be Set Aside (REPL) on forbearance were to be strengthened. More importantly, the lower-quality restructurings observed in recent years will be put to the test and may require asset classification downgrades and higher provisions.



Source: BRSA, WB staff calculations.

75. Since 2018, the authorities have made NPL management and resolution a priority. The policy response has encompassed different areas and agencies which have acted in a coordinated manner. The BRSA has accelerated efforts to align regulations and their implementation applicable to NPL classification with the BCBS 2016 guidelines on prudential treatment of problem assets as well as other relevant international guidance,[30] although key shortcomings still remain on the treatment of forbearance. Banks have been provided with the opportunity to restructure the loans of distressed borrowers and use the Framework Agreements (FAs) prepared by BAT and approved by the BRSA resulting in the restructuring of approximately TL 102 billion since 2018. The BRSA and CMB introduced new transaction structures for the sale and securitization of NPLs in 2021. To increase banks' capacity to deal with NPLs, the BRSA has also required banks to prepare NPE reduction strategies accompanied by operational plans and set up workout units by mid-2022, in accordance with the amendments in the related regulations. The Ministry of Justice has optimized the structure of execution offices, modernized auction procedures, and is working on a new Enforcement and Bankruptcy Code aimed at strengthening in-court insolvency and debt enforcement procedures.

76. Optimizing NPL management and resolution would require authorities' focus to address shortcomings in several key areas. In effectively doing so, BRSA would require policy independence, operational autonomy and adequacy of resources (also see Section *Financial Sector Regulation and Supervision*). The actions could be grouped into the following pillars:

[30] See "Guidelines – Prudential Treatment of Problem Assets – Definitions of Non-Performing Exposures and Forbearance" (https://www.bis.org/bcbs/publ/d403.pdf), BCBS (2016).

- *Scrutinizing bank asset quality:*[31] In light of concerns surrounding asset quality, strengthening the prudential framework should be given priority. Restructured and refinanced loans, in particular, should be scrutinized and reported conservatively based on objective circumstances and the risk profile of the borrower. Changes introduced to the REPL in 2018 should be reversed. Improved loan sampling policies should be adopted to monitor and ensure adequate classification. The reporting system used by the BRSA to monitor the quality of the loan portfolio should also be strengthened by collecting more granular information about banks' restructuring activities and reasons for loan migration across categories.
- *Implementing NPL management rules*: The BRSA should ensure that banks continue to make progress towards meeting the newly introduced obligations such as developing non-performing exposure (NPE) strategies and establishing workout units. The BRSA should monitor compliance closely and ensure consistent implementation.
- *Updating the legal framework*: The enactment of a new Enforcement and Bankruptcy Code (EBC) is a unique opportunity to modernize the insolvency and creditor rights system and foster NPL resolution. The insolvency framework in particular needs an urgent overhaul, while the systems for debt enforcement also present significant shortcomings. The embezzlement risk that bank officers face when entering into informal restructurings involving debt forgiveness should be mitigated.
- *Improving out-of-court restructuring:* The FAs have proven to be an efficient tool to deal with corporate financial distress. However, their success remains limited to large corporate restructurings. A refocused 'Small-Scale Framework Agreement' could help smaller firms benefit from the advantages afforded to these types of arrangements under Provisional Article 32 of the BL. Similarly, some shortcomings identified in the 'Large-Scale Framework Agreement' could also be addressed to improve its efficiency and maximize its use including requiring preparation of a third-party affordability assessment post-restructuring.
- *Enhancing the market for distressed assets:* Efforts should focus on providing more flexibility to Asset Management Companies (AMCs)[32] and incentivize foreign investors to enter the Turkish market. Consideration should be given to extending the tax treatment applicable to AMCs to SPVs collecting loans originally purchased from the AMCs. The 2021 reform of the Regulation on the Principles of Establishment and Operations of Asset Management Companies and Transactions Related to the Acquisition of Receivables by the BRSA is a positive development but its ultimate objectives are unlikely to be achieved due to the obstacles imposed to NPL securitizations. It is particularly important that the CMB finalize the reform initiated by the BRSA and revise the approach taken in the 2021

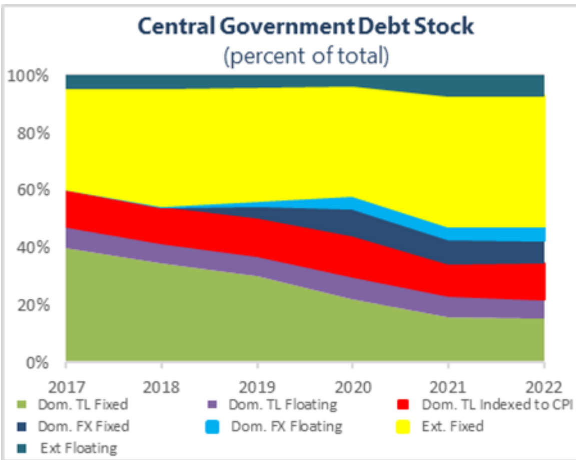
[31] See the Banking Regulation and Supervision section for more information on improving the regulatory and supervisory framework.

[32] An AMC is a corporation established with the purpose of purchasing, collecting, restructuring and resolving non-performing assets in the financial system.

Communique to provide more flexibility for parties to structure NPL investments following those practices observed in other jurisdictions.

FINANCIAL SECTOR DEVELOPMENT

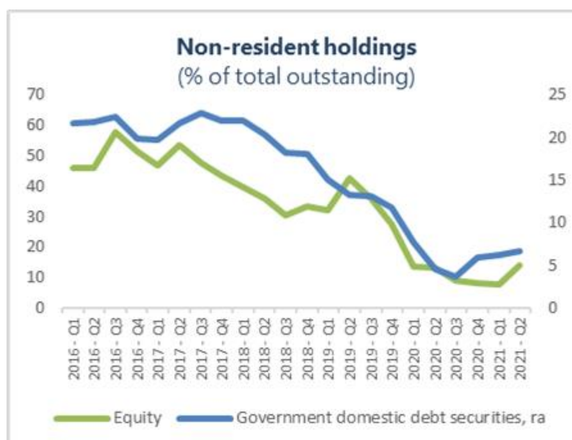
A. Capital Markets and Long-Term Finance



Sources: MOTF, WB Staff calculations.

77. Capital markets are an important pillar to support sustainable economic growth and the authorities have introduced a series of capital markets reforms to boost investor confidence and promote new instruments. The amendments to the Capital Markets Law[33] and several secondary regulations (Communiqués) introduced a wide range of reforms to improve investor protection and enable new instruments and concepts. The reforms are generally welcomed by the market and the regulatory approach is viewed as accommodative and proactive.

78. Challenges of capital market development in Türkiye arise from the lack of fundamental enabling conditions. Sound price formation of interest rates is the cornerstone for the development of capital markets, yet the policy environment is unconducive with different implications for borrowers (issuers) and financiers (investors). Market volatility has increased in an environment of high inflation, negative real interest rates, unstable yield curves along with frequent and unpredictable regulatory changes. The dominance of banks and their favorable funding position have crowding-out effects on capital markets.



Sources: CBRT, MOTF, Haver Analytics, WB Staff calculations.

79. The CBRT provides a wide range of instruments to support the money market and implement monetary policy. Repo-Reverse Repo and outright transactions are largely used to

[33] Including the February 2020 amendment and a few other amendments since the last FSAP.

manage market liquidity, but FX futures interventions may create distortions in exchange rate formation. The CBRT could consider offering FX derivatives settled in TL through auctions only, instead of relying on the less transparent methods. The launch of the Turkish Lira Overnight Reference Rate (TLREF) was an important action to establish a reliable short-term reference rate in the market, supporting the TLREF futures and improving the hedging mechanisms available in the market. However, TLREF calculation should exclude CBRT's transactions. Despite the high liquidity of BIST Repo-Reverse Repo market, the TLREF committee must supervise transactions that are at the base of the TLREF, as banks imbalances between TLREF assets and liabilities may create incentives for collusion.

80. While in the past seven years the stock of government debt has increased, the implementation of the debt management strategy aimed at improving the composition and extending the average maturity of public debt has lagged. Türkiye's total general government debt[34] to GDP ratio has increased from 27.3 percent in 2015 to 42 percent at the end of 2021, returning to the same level of 2010. Although the MoTF would benefit from strengthening the debt composition, replacing FX with TL, defining the bond benchmark size, and reducing fragmentation and lengthening maturities, CBRT's low interest policy creates a challenge to achieve these objectives. The demand for TL-fixed income securities is largely driven by regulation. Despite this unfavorable macrofinancial backdrop, MoTF could improve the debt composition focusing issuance on a single floating rate, instead of two. Also, the matching of fixed rate benchmark bonds with TLREF future contracts maturities should contribute to better risk management mainly in turbulent moments when investors try to mitigate volatility of their portfolios.

81. Corporate bond market development is impaired by various structural issues and an unfavorable macrofinancial environment. Despite significant regulatory efforts[35], the Turkish corporate bond market has difficulties competing with other financial instruments in the environment and its development is limited. The lack of FX risk protection, low real returns, unfavorable tax treatments, low credit quality and weak liquidity make domestic corporate bonds a short-term hold-to-maturity instrument. Domestic investment funds are the leading investors, and banks dominate the issuer base, both with a declining appetite. Non-financial corporate issuers, however, have recently picked up. No issuance activity has been seen since the introduction of project-based securities that aim to facilitate infrastructure finance. Credit enhancement and tenure extension could promote real sector debt financing, however, options should be evaluated very carefully.

82. The recent fast expansion of the equity market brought both opportunities and risks. The equities market has performed better, driven by prevailing macrofinancial and credit market conditions, strong focus on exports, and policy incentives. However, the expansion of the stock market is coupled with extremely high turnover (including high-frequency trading), a dramatic increase of retail participation, and an increasing use of digital services. The CMB is closely monitoring the fast-evolving market and is advised to continue updating its policy toolkit and

[34] Defined by European Union Standards.

[35] Such as to improve the default and liquidation regime for corporate debt securities, introduce new corporate debt financing instruments (such as project-based bonds) and improve corporate disclosure.

strengthen its capacity to address potential issues arisen from new market features. Private equity financing (PE/VC) may present opportunities for SME finance and should be supported.

83. The complex and constantly changing tax framework for the Turkish capital market requires a thorough review and streamlining. The tax framework differentiates between instruments, issuers, and investor types. The impact of extensive temporary tax benefits[36] should be carefully evaluated, as certain asset classes (such as repo and reverse repo makes liquidity transactions, corporate bonds, and securitization) are subject to less favorable tax treatments as a result.

84. There has been a significant change in investor composition and appetite in recent years. Foreign investors are gradually exiting various markets, including equities, fixed income and local and hard currency instruments. Domestic institutional investors are playing a dominant role in domestic debt markets with a strong appetite for Government risk, but weak confidence in TL-denominated securities. Retail investors found competitive investment alternatives in state-guaranteed, FX-protected TL deposits, gold and riskier assets, with a significant increase in stock market participation. A general short-termism and drive for high real returns have led to a further shortening of tenures of corporate debt securities (predominately below 6 months), even higher turnover ratio in the stock market (686 percent as of 2021, the highest in the world), and a strong appetite for inflation and FX-protection products as well as riskier assets.[37]

85. Pension and investment funds are the two main types of institutional investor. As of end of May 2022, they manage assets of slightly less than US$ 40 billion with similar participation. Pension funds invest approximately 60 percent of their portfolios in government securities, mostly either dominated in FX or indexed to gold. Pension fund holdings of TL-denominated government securities, which have been offering negative real returns, are directed by the government-designed portfolio benchmark associated with the state contribution funds that manage the 30 percent matching contribution by the Government. Investment funds have limited investment in government securities, and approximately 60 percent of their portfolio is invested in private sector securities.

B. The State of Financial Inclusion

Also see Figure 12

Individuals

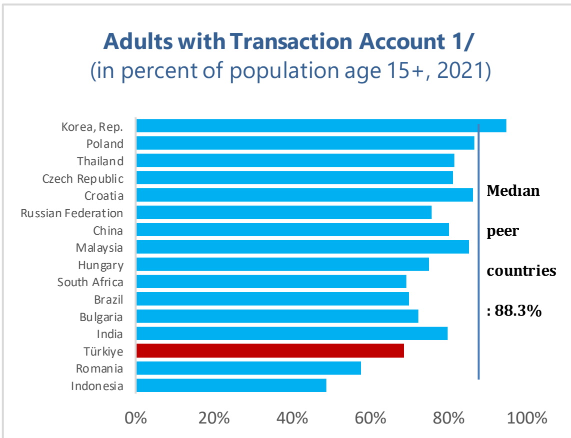
86. Account ownership and usage have improved, however savings have declined and financial resilience lags peers. As of 2021, 74 percent of adults in Türkiye have a transaction account compared to 69 percent in 2017 and the gender gap has narrowed by 6 percentage points to 23 percent. The percentage of adults making or receiving digital payments increased by 4 percentage points to 68 percent. The pandemic led to more usage of digital payments - around 15 percent of adults made their first digital payment at a merchant during the pandemic. There has

[36] Including but not limited measures to combat Covid-19 effects, to stabilize TL, or to promote certain instruments.

[37] Such as stocks and crypto assets.

however been a sharp decline in adults saving in a financial institution to 20 percent in 2021 compared to 39 percent in 2017. This is also accompanied by lower levels of financial resilience in comparison to peers in Europe and Central Asia– 41 percent of adults in Türkiye reported finding it difficult or somewhat difficult to have access to emergency funds, in comparison to 37 percent in ECA countries. Women in Türkiye are 62 percent less financially resilient than men.

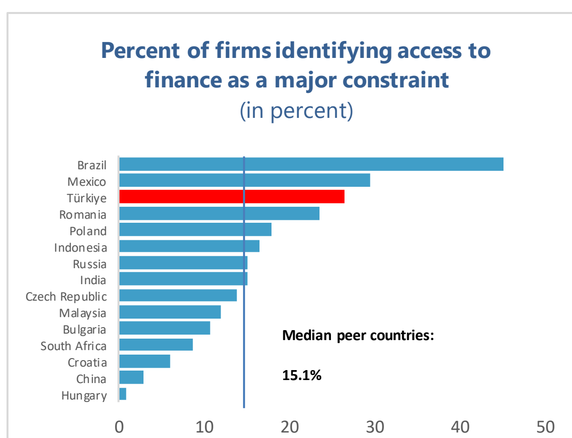
87. Increased digitization of social benefit transfers and e-money accounts has contributed to improvements in financial inclusion. However, several population segments lag behind. As of 2021, 72 percent of adults in Türkiye have an account (69 percent and 57 percent in 2017 and 2014, respectively) and 16 percent have a mobile money account (up from 1 percent in 2014). Women and the bottom 40 percent by income have significantly lower levels of financial inclusion (54.3 and 56.4 percent, respectively). Further, the adult population outside the labor force exhibits significantly lower levels of inclusion (43.9 percent). There is however only a small gap between rural (65.6 percent) and urban areas.



88. Financial inclusion programs primarily focus on financial literacy. There are no targeted interventions to help bridge specific gaps. The strategic approach to improve financial inclusion mostly focuses on financial literacy. There have however been no specific initiatives to address the significant access and usage gaps related to gender and labor force participation. The existing government programs, notably the social protection programs, could provide a channel to reach these segments. This would need to be accompanied by integrating the existing financial literacy programs into the lifecycle of these disbursements.

Micro-, Small-, and Medium-sized Enterprises

89. Despite notable progress, the MSME financing gap remains significant. SME funding is mainly provided by banks and has grown reliant on government programs. The MSME financing gap is estimated at 11 percent of GDP in 2017, below regional peers. However, in 2019, 28 percent of MSMEs still cited lack of access to finance as their main constraint. The KOSGEB interest rebate program has seen lower uptake since 2019, mainly due to the requirement of a pre-agreed interest rate.



90. Recent MSME credit growth is driven by support from the credit guarantee system (CGS). Between 2017 and 2020, CGS-guaranteed loans to SMEs accounted for well over 20 percent of total SME loans and drove SME loan growth. During that time, there were an estimated 3.1 million MSMEs in Türkiye of which only around 600,000 were able to access KOSGEB and CGS services. The share of SME credit provided by private banks has declined as state-owned banks expanded.

91. Albeit from a low base, leasing and factoring have grown. This has been driven by regulatory changes in 2016-17 and in 2020 provided TL 101 billion in financing compared to TL 61.7 billion in 2015. Lower levels of digitization and higher cost of funds due to additional taxes constrain leasing and factoring services.

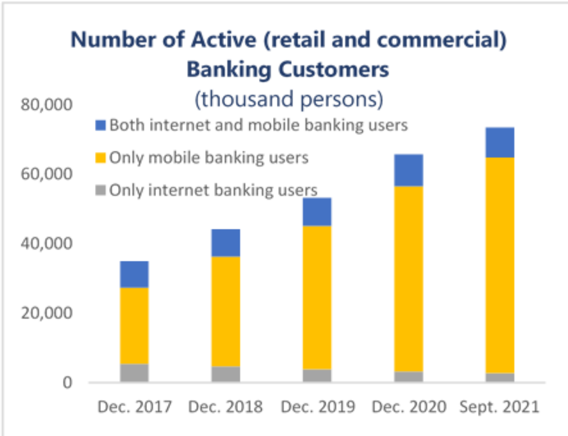
92. Supported by proper monitoring and evaluation, there is scope to fine-tune Government programs by strengthening the application process, targeting, and distribution. KOSGEB applicants face various operational hurdles. Further, KOSGEB and CGS support could be expanded to factoring and improve targeting of underserved segments. The programs would benefit from a well-structured monitoring and evaluation (M&E) program using the existing institutional arrangements for M&E in KOSGEB, to measure the effectiveness and overall impact of these programs.

C. The Role of Fintech

Also see Figure 13

Fintech landscape

93. The financial sector is characterized by a high degree of digitization of incumbents, a robust financial infrastructure, and rapidly growing digital channels, products, and services. Banks are introducing their own fintech solutions and there is an incipient collaboration with new entrants. Over 90 percent of all bank transactions are now conducted through digital channels. Further, over 50 percent of loan applications are originated through digital channels. There are about 520 active fintech companies, of which half focus on payments. E-commerce platforms are embedding finance products and retail companies are partnering with fintechs to provide financial solutions. Digitization in the non-bank sector lags banks, and amongst banks, participation banks and state-owned banks lag private conventional banks.



Source: TBA, WB Staff calculations.

94. There has been no systematic analysis on the impact of Fintech in Türkiye thus far, but a few trends are clearly visible. In addition to an increased use of digital channels, these trends include a greater use of e-money services and crowdfunding reaching hitherto under-served segments. At the same time, the authorities are recognizing that consumer protection and fraud concerns are emerging in e-money where regulation and oversight are well established and CBRT issued secondary regulation to protect consumers. The authorities also recognize consumer protection risks in the more nascent crypto-assets space where two crypto-asset exchanges recently failed.

95. Well-established infrastructures are able to support further digitalization of the financial services eco system. Key financial infrastructures are mature (e.g., payments, credit reporting, registering leasing and factoring interests, distribution for mutual funds and pension funds, and shared reporting and information for insurance) and can help enhance digitalization of interoperability, improve efficiencies, and digitization of financial services.

Policy framework

96. The Turkish authorities recognize that Fintech can play an important role to promote financial inclusion and have embarked on various initiatives to create a safe, enabling environment. Financial sector authorities and the Presidency have undertaken several initiatives, and a few more are underway (see Box). The recent regulatory changes notably regarding open banking, digital banking, and remote identification are expected to promote fintech activity. The Presidency is well advanced in its plans for developing a holistic national fintech strategy. The CBRT has established a dedicated unit for Fintech while the other three financial sector authorities are pursuing a strategy of integrating fintech monitoring and research into existing functions.

97. In developing the national fintech strategy, authorities could strategically focus on various elements. The Presidency is well advanced in its plans for developing a holistic national fintech strategy. Integrating several strategic considerations would be important, including: leveraging fintech to strengthen financial inclusion, improving effectiveness of Government incentives programs, developing a Digital ID and Open Finance and Data exchange framework, strengthening public-private collaboration, and creating a comprehensive policy framework for crypto-assets.

98. The fast-paced fintech developments will necessitate a robust supervisory and monitoring framework to complement recent regulatory changes. The recent regulatory changes introduce a new set of entities such as crowdfunding platforms, third-party payment initiation services, and digital banks. Moreover, fintech developments raise several considerations on data protection, consumer protection, privacy, and AML/CFT, among others and these could evolve over time. Regulatory bodies need to assess whether their monitoring and supervisory tools and processes as well as coordination mechanisms with industry remain fit for purpose. A rapidly changing landscape calls for a pro-active approach, not just within the existing regulatory perimeter, requiring the development of new monitoring tools and establishing dedicated organizational arrangements that have a mandate for pro-active monitoring.

99. Without compromising the primacy of financial stability objectives, the Turkish Competition Authority and financial sector regulators should also coordinate to strengthen contestability and a level-playing field in the financial sector. The recent regulatory changes in the financial sector would enable market entry for new entrants and new business models. However, in the absence of other accompanying reforms, new entrants might not be able to effectively compete which could lead to concentration and an unlevel playing field. Authorities should therefore ensure that Open Banking enables the provision of a meaningful range of services to new entrants, enable non-banks and new entrants to have a meaningful role in governance arrangements of critical infrastructures such as KKB, and expand the range of services offered by the financial infrastructures.

Retail central bank digital currency (CBDC)

100. Türkiye is exploring a retail CBDC. The broader benefits and risks need to be assessed and compared against alternative approaches. Amongst the risks, particular emphasis should be placed on the implications for competition in the market and impact on financial stability due to effects on the banking sector, monetary policy operations, and money markets. Further, how a CBDC would fit into Türkiye's national payment system would need to be evaluated. Apart from the retail Digital R&D project, the CBRT is also internally investigating a wholesale CBDC. The CBRT could also consider expanding the scope of this wholesale CBDC research to cover cross-border payment aspects. Lastly, the benefits and risks of CBDC should be compared with those of other ongoing reforms like FAST, TR QR-code payments, open banking, expanding access to payments infrastructure, e-money, and digital banks.

Box 1: Regulatory initiatives for the development of Fintech

E-Money, fast payments, and crypto-assets: The CBRT became the sole regulatory authority for e-money when the Payments Law was amended in 2019. Following the amendment, the e-money regulatory framework was enacted by the CBRT at the end of 2021. The updated framework enables market entry of non-bank payment service providers. The CBRT also took a controlling stake in a key payment system operator – BKM – reportedly to give itself more control over the evolution of the payments market and level the playing field for new entrants. The CBRT also introduced new regulations on QR code-based payment services to complement the introduction of a new Fast Payment System (FPS). Further, the CBRT has issued regulations to prohibit usage of crypto-assets for payments, and entities from enabling such services for the crypto ecosystem. Lastly, CBRT has announced a research agenda on Central Bank Digital Currencies (CBDC) focused on retail payments.

Open banking: CBRT introduced regulations allowing third-party payment initiation services and account information services along the lines of PSD2 in EU and open banking initiatives in other countries. The CBRT has developed and published the standards for payment initiation services and account information services in close collaboration and cooperation with the industry. These services are expected to be launched by year-end. The CBRT has also led the efforts in establishing the BKM as gateway for open banking services, enabling a single access to the participating institutions. The BRSA is working on developing regulations covering other types of open banking services. Turkish banks appear to have fully embraced open banking and are in state of readiness.

Digital Banking: The BRSA established a regulatory framework for digital banks in December 2021. This allows new-entrants to offer pure-play digital only banking services and incumbent banks to establish digital only offerings. In addition, this regulation establishes a framework for provision of "Banking as a Service" (BaaS) – which enables banks to offer digital interfaces to non-banks enabling the latter to offer banking services to their customers under the former's regulatory authorizations.

Remote onboarding: The CBRT, BRSA, CMB, and the IPRSA in co-ordination with the MASAK introduced regulatory changes in their respective domains to allow financial institutions to remotely onboard customers.

Cloud Computing: The Digital Bank regulations also enabled banks to use community cloud domiciled in and with data storage in Türkiye. Similar provisions were introduced in the regulations of the CMB, CBRT, and IPRSA. This, while short of a full-fledged cloud computing framework, provides for a pathway for migrating from on-premises deployment of IT assets. Several conventional and participation banks are well-advanced in their adoption of cloud.

Crowdfunding: In October 2019, the CMB introduced regulations enabling equity-based crowdfunding platforms, this was followed in October 2021 allowing debt-based crowdfunding. Seven equity-based crowdfunding platforms have been launched. As of June 2022, there are around 6000 investors (comprising both individuals and qualified investors) and 23 companies have raised in total TL 46.3 million.

Insurance: Recent regulatory changes by IPRSA opens the market for embedding insurance products in new contexts. The "Regulation on Activities to be Evaluated within the Scope of Insurance and Insurance Contracts Concluded at a Distance" (#31513) issued on June 16, 2021, expands the coverage of insurance to new categories. This includes theft and damage of electronic device, machine/equipment, and white goods. Passenger transportation services has also been covered. It is expected that this will lead to insurance products being integrated with the online sale of such devices, equipment, and services.

Fintech Strategy: The Finance Office of the Presidency, is spearheading the development of a national fintech strategy. This strategy will be informed by primary research on international experiences and developments thus far, stakeholder interviews and surveys, and industry consultations. The strategy will cover the regulatory framework, ecosystem development, and integration with other relevant domestic and regional developments.

D. Green and Sustainable Finance

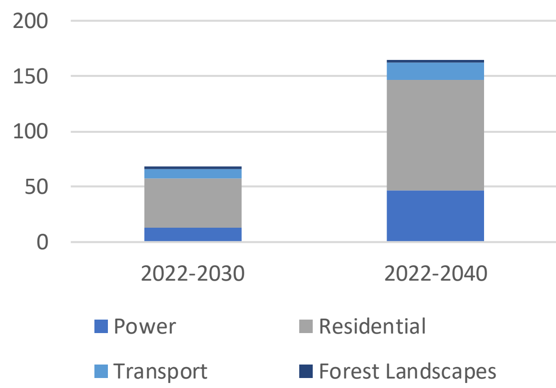
101. The financial sector faces challenges in closing the financing gap required to reach Türkiye's climate goals and the authorities are working to address this. The World Bank estimates climate investment needs in Türkiye for a selection of industries to be around $165 billion for 2022-2040.[38] While the authorities and the banking sector have become increasingly active, green and sustainable finance markets remain small, with low levels of green debt issuance and

[38] World Bank (2022). Türkiye Country Climate and Development Report (CCDR). The CCDR estimates that roughly half of additional investment needs for the 2022-2040 period need to come from private sources.

limited involvement of local investors. Barriers to scale up green finance include i) limited capacity in the financial sector to integrate climate aspects in operations, ii) a lack of transparency of climate risks and opportunities, and iii) limited incentives and guidance to stimulate green finance.

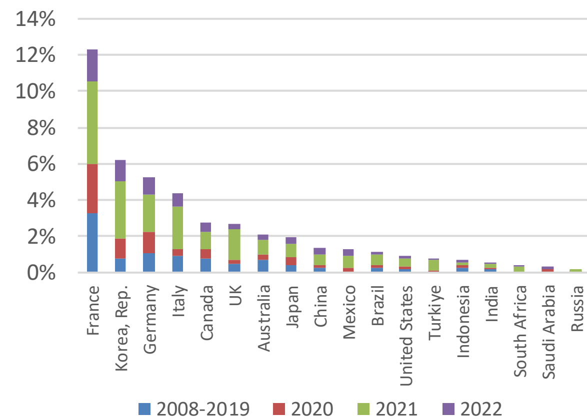
Additional Investment Needs in a Resilient Net Zero Pathway

In USD bn



Source: World Bank (2022). Türkiye CCDR, WB Staff calculations. Note: Amounts are discounted using a 6 percent discount rate.

Labelled bond issuance in Türkiye compared to G20 peers[39]



Source: Bloomberg, WB Staff calculations.

102. Several measures could be considered to stimulate green finance markets:

- **Introduce a national climate finance strategy and improve knowledge exchange and coordination on green finance.[40]** A national climate finance strategy could help to further identify climate finance investment needs, a pipeline of investable projects, and a strategy on how to mobilize private sector finance for climate objectives, in addition to public sources. Moreover, the authorities should consider creating a national platform on green finance to strengthen coordination and knowledge exchange among financial sector authorities and institutions on issues related to green finance.
- **Develop a comprehensive climate information architecture.** To support disclosures and labelling of green finance products, Türkiye could introduce a green taxonomy, which is a priority action under the GDAP, and should be appropriately aligned with the EU taxonomy. The authorities could also include climate disclosure standards for firms in accounting standards[41], once disclosure requirements by the International Sustainability Standards Board (ISSB) are finalized. CMB could follow up on current sustainability disclosure guidance

[39] This includes green, social, sustainable, and sustainability-linked bonds. For Türkiye the relative share of green bonds per total labeled issuance is around 28 percent.

[40] Türkiye's authorities note that the implementation of this recommendation can build on the ongoing work on a climate finance strategy as part of the GDAP and plans to establish an inter-agency green finance working group, with both actions also listed in the recent Türkiye Climate Council Advisory Decisions.

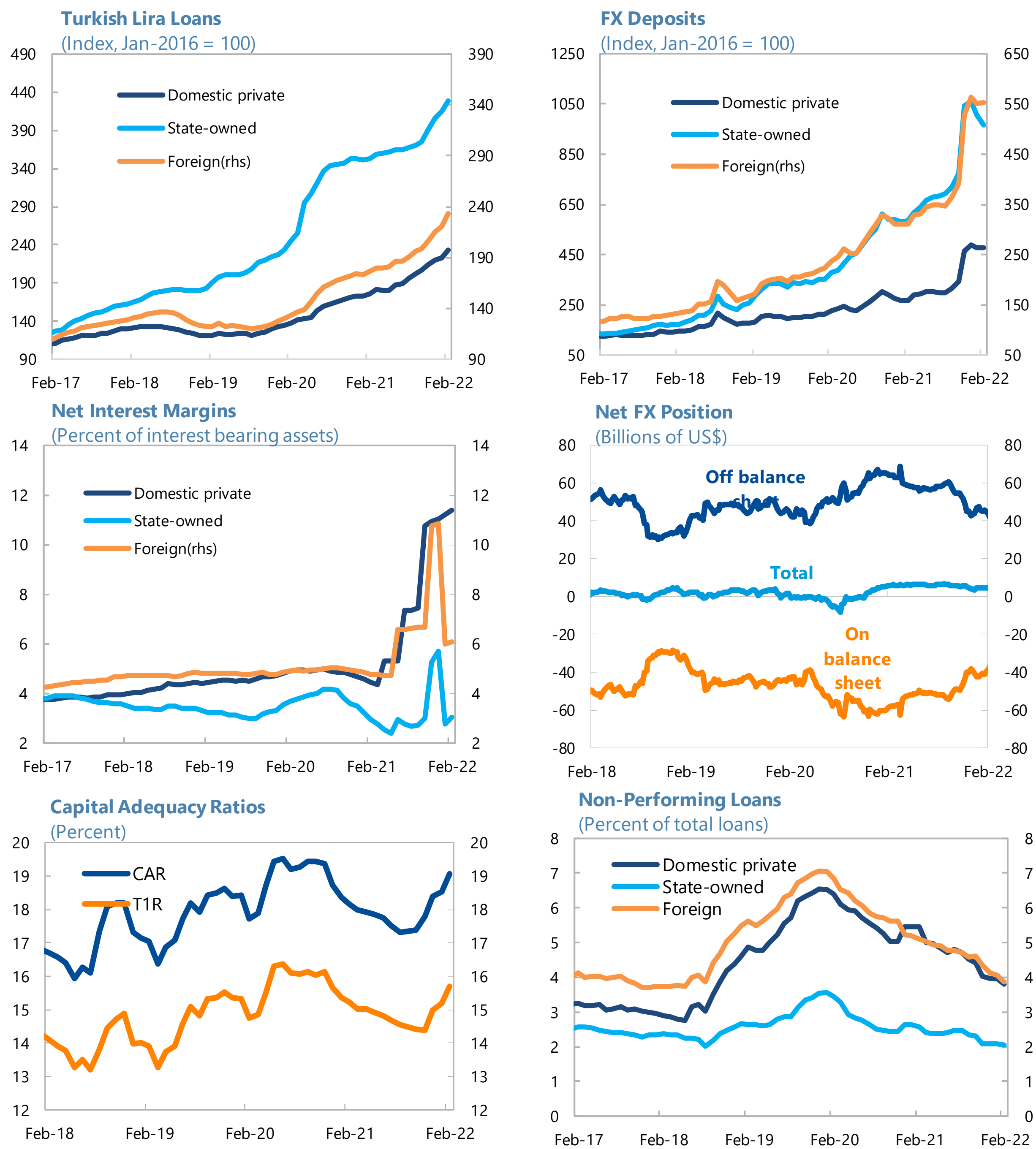
[41] To facilitate this, the Turkish Commercial Code was recently amended to allow the Public Oversight, Accounting and Auditing Standards Authority (KGK) to issue standards on (non-financial) sustainability information.

for listed firms, as well as data products and external reviewers. The authorities could strengthen disclosure of firm-level greenhouse gas (GHG) emissions data, which is a key climate metric for financial sector analysis.

- **Incentivize green bond issuance and investor participation in green bond markets.** CMB has issued green and sustainable bond guidelines and lowered green bond listing fees. The authorities could further explore subsidizing third party verification costs and designing appropriate tax incentives (e.g., by lowering withholding taxes) while mitigating perverse incentives. MOTF could follow up on the commitment to issue a sovereign green bond. Furthermore, CMB and IPRSA could raise awareness among institutional investors on green finance practices, and issue guidelines for pension funds to incorporate climate aspects into investment decisions.
- **Explore further greening of public finance institutions (PFIs).** While Türkiye's development banks are already prioritizing green investments, there could be opportunities to further align operations of PFIs with climate goals. For example, by utilizing the country's credit guarantee system, CGS, to de-risk green lending to SMEs. However, it is advisable to carefully explore such options, including an assessment of whether necessary pre-conditions and safeguards are in place. Moreover, given Türkiye's climate risk profile, the authorities should continue exploring the options for expanding and incentivizing insurance coverage – including through the Catastrophe Insurance Pool (TCIP)[42] - of climate risks for households and firms, which is currently non-existing, except for farmers.

[42] The authorities are currently aiming for an expansion of TCIP – which facilitates mandatory earthquake coverage to homeowners – with compulsory coverage of flood and other hazards. It will be important to carefully consider design futures of such a product, as well as implications for TCIP, policyholders and the insurance sector.

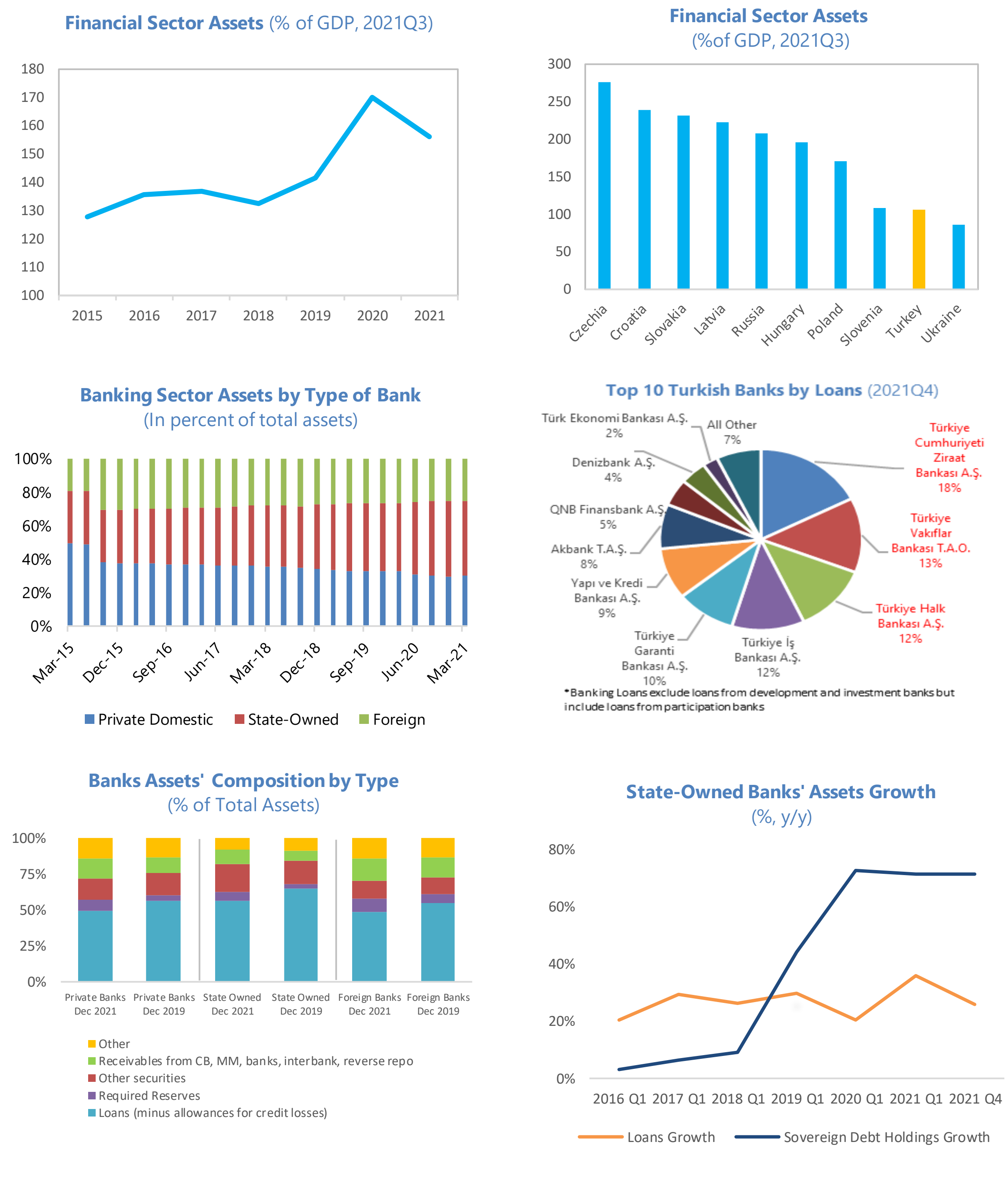
Figure 1. Republic of Türkiye: Financial Sector I



Notes: Monthly EOP NSA. CAR= Regulatory Capital/RWA. T1R= T1 Capital/RWA.

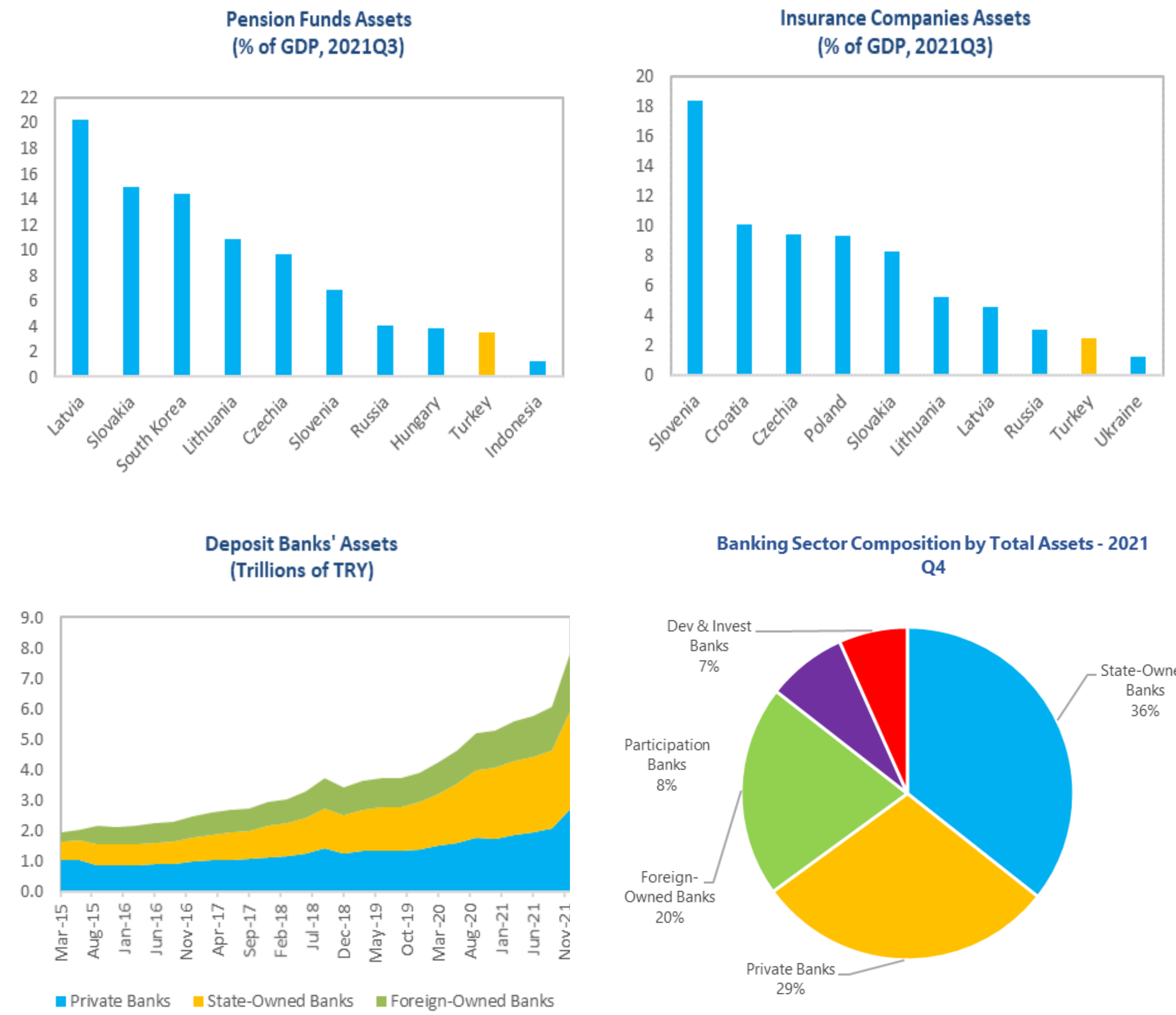
Sources: BRSA; CBRT; and IMF staff calculations.

Figure 2. Republic of Türkiye: Financial Sector II



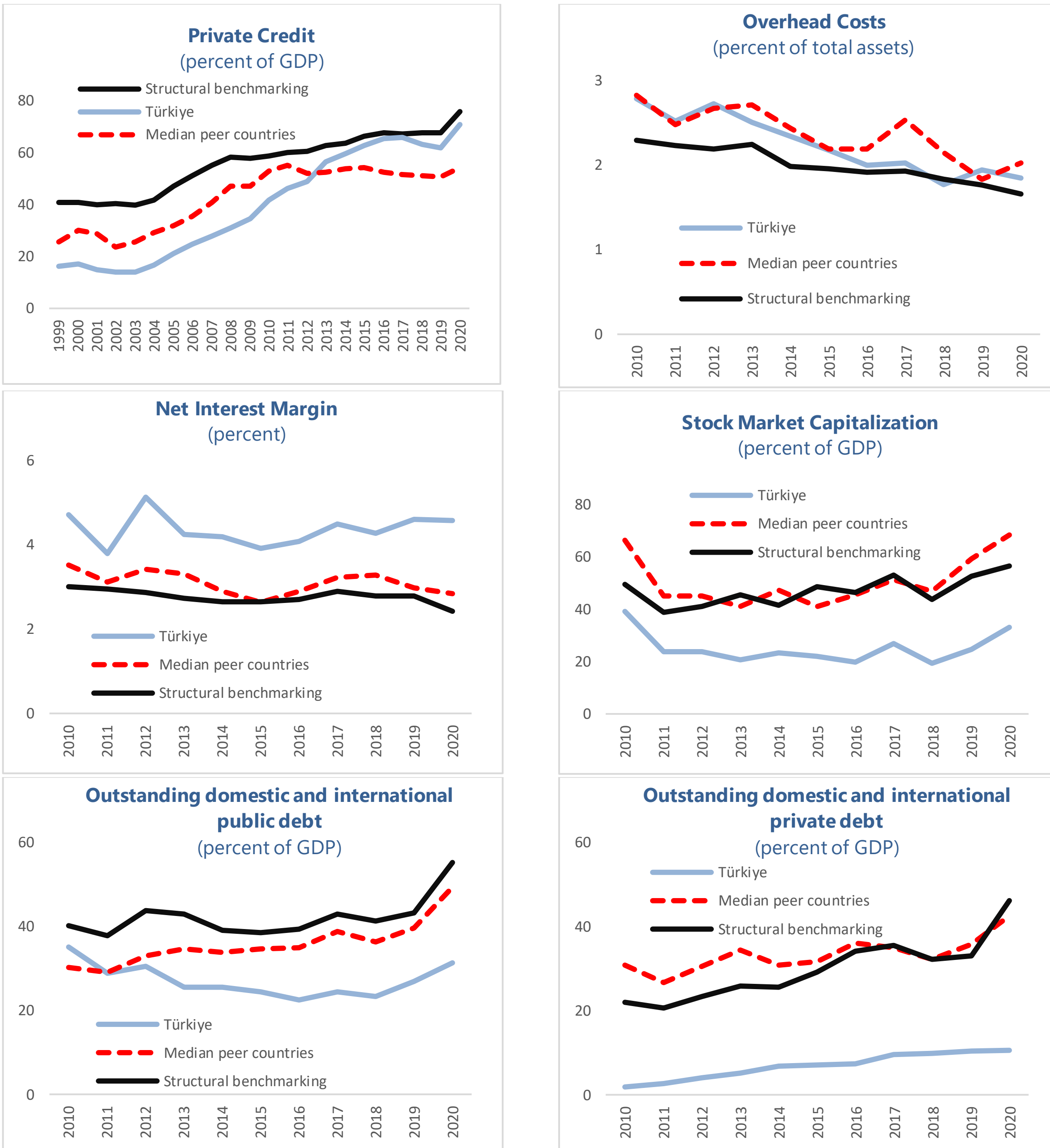
Sources: CBRT; Haver Analytics; and IMF staff calculations.

Figure 3. Republic of Türkiye: Financial Sector III



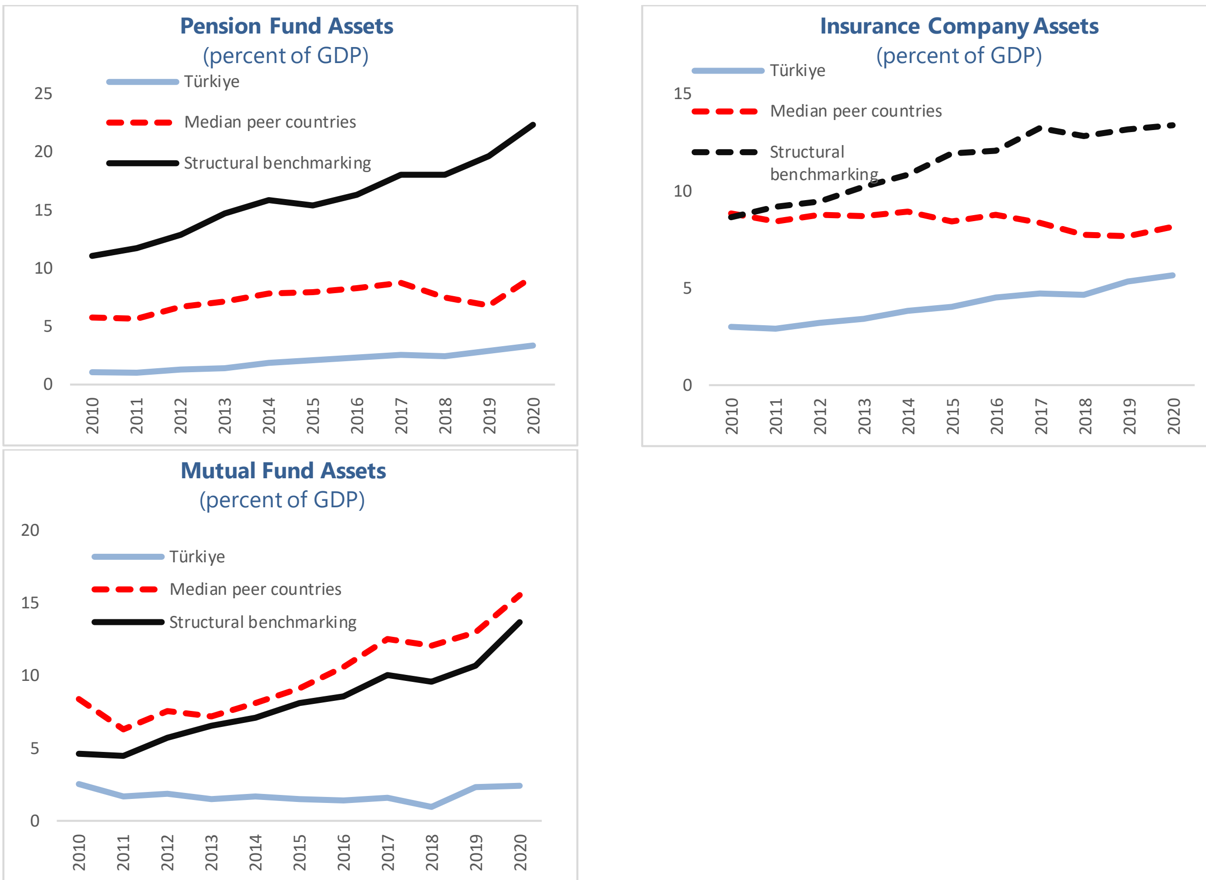
Sources: CBRT; Haver Analytics; and IMF staff calculations.

Figure 4. Republic of Türkiye: Benchmarking Key Features of the Financial System I



Sources: WB Finstats, TURKSTAT, WB Staff calculations.
Median peers: Bulgaria, Brazil, China, Czech Republic, Hungary, India, Indonesia, Korea Rep., Mexico, Malaysia, Poland, Romania, Russia, South Africa. Note: The structural benchmarking is a statistical benchmark based on a quantile regression applied to a global country panel dataset using a country's structural characteristics such as its income, population size and density, age distribution, and whether it is an oil exporter or offshore financial market.

Figure 5. Republic of Türkiye: Benchmarking Key Features of the Financial System II



Sources: WB Finstats, WB Staff calculations.
Median peers: Bulgaria, Brazil, China, Czech Republic, Hungary, India, Indonesia, Korea Rep., Mexico, Malaysia, Poland, Romania, Russia, South Africa. Note: The structural benchmarking is a statistical benchmark based on a quantile regression applied to a global country panel dataset using a country's structural characteristics such as its income, population size and density, age distribution, and whether it is an oil exporter or offshore financial market.

Table 3. Republic of Türkiye: Structure of the Financial System (September 2021)

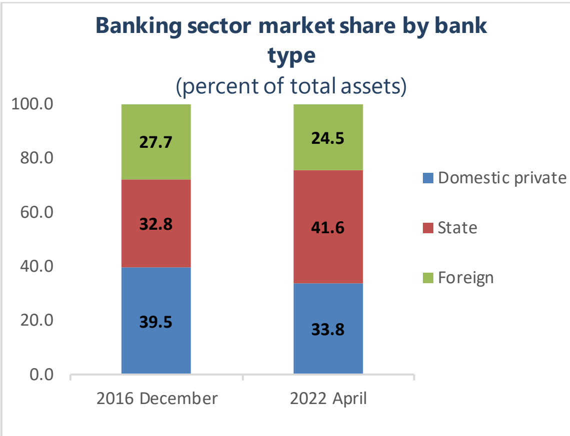
	Number of Institutions	percent of total assets	percent of GDP	Assets, TL billion
Deposit Banks	34	80.3	99.2	6,392
State	3	32.2	39.7	2,561
Foreign	21	22.2	27.4	1,768
Domestic private	8	25.9	32.0	2,063
Portfolio management companies	53	6.1	7.5	483
Insurance companies	66	4.3	5.3	340
Mutual funds	742	2.5	3.0	196
Unemployment insurance fund	1	2.4	3.0	191
Pension investment funds	14	1.4	1.8	114
Real estate investment companies	35	1.0	1.2	80
Financial leasing companies	23	0.7	0.8	53
Factoring companies	54	0.6	0.7	46
Financing companies	15	0.6	0.7	44
Intermediary institutions	65	0.1	0.1	5
Reassurance companies	10	0.1	0.1	9
Venture capital investment companies	7	0.1	0.1	5
Securities investment companies	34	0.0	0.0	0.6
Total	411	100	123.5	7,958

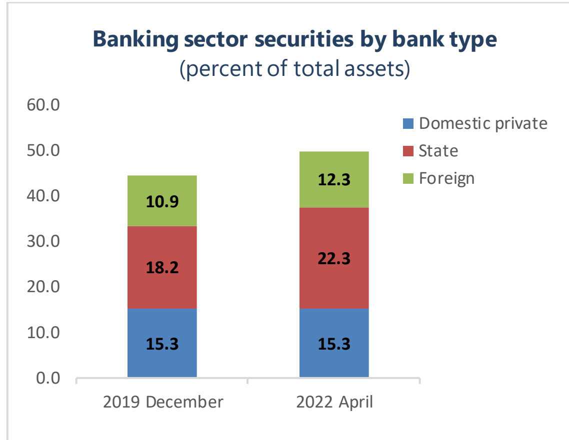
Source: Türkiye Bankers' Association of Türkiye (BAT); Takasbank; WB Staff calculations.

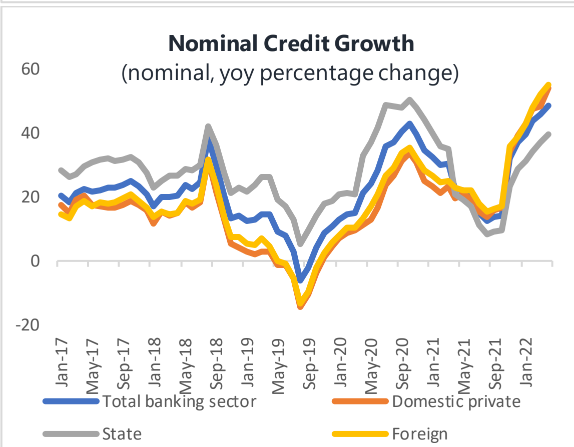
Figure 6. Republic of Türkiye: Banking Sector Balance Sheet Composition

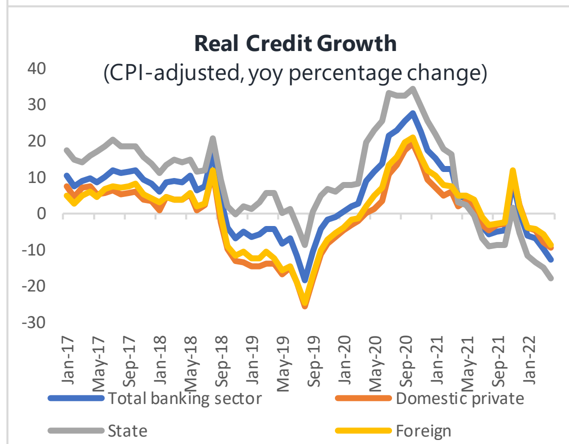
Sources: BRSA, CBRT, WB Staff calculations.

Figure 7. Republic of Türkiye: Role of the State I

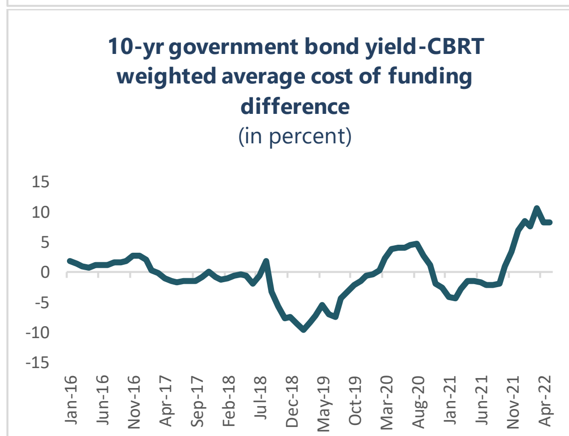






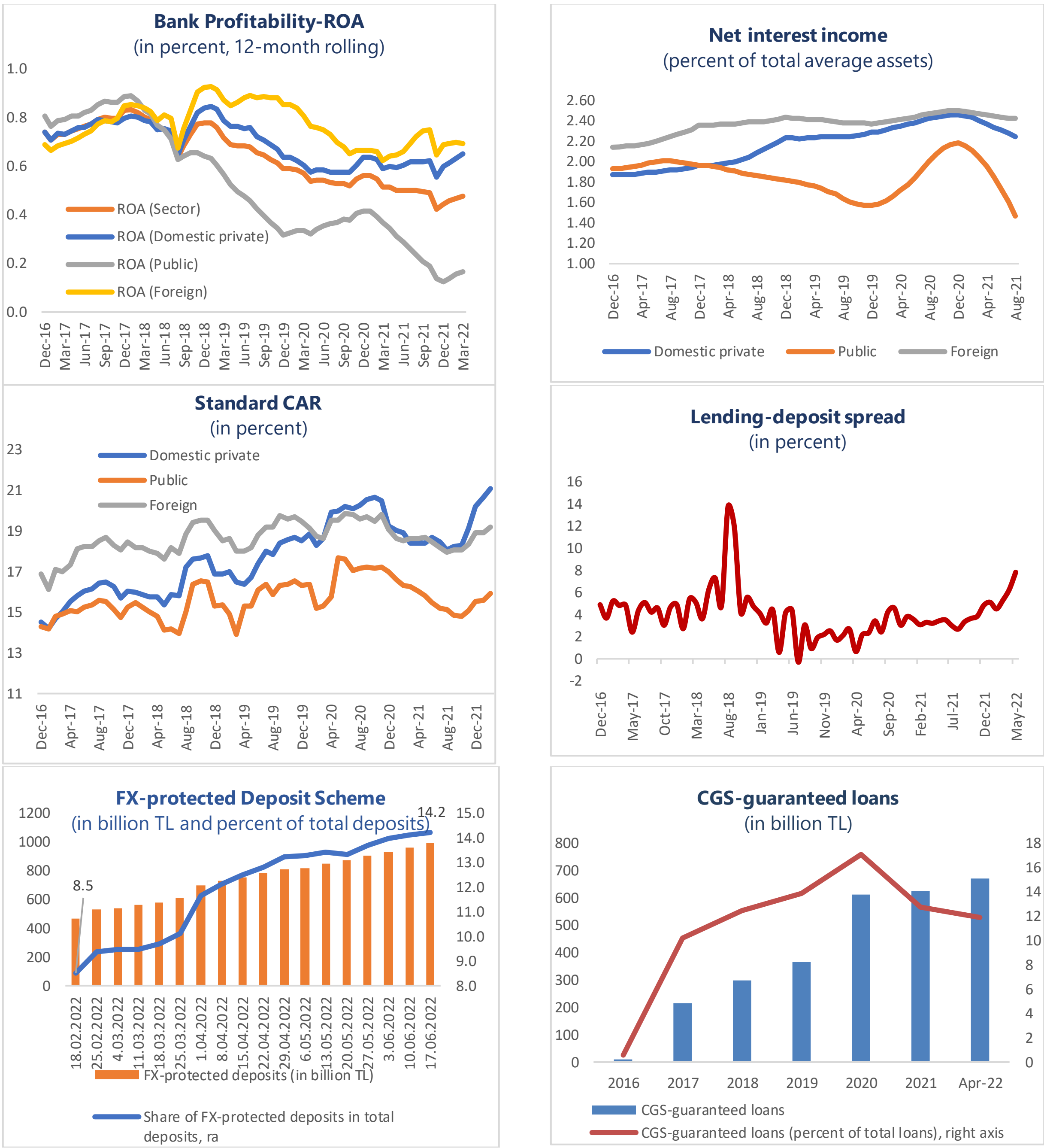


Capital injections: state and Tier-1 domestic private banks (billion TL)	2020	2021	2022
Vakifbank	7	0	13.4
Halkbank	7	0	13.4
Ziraatbank	7	0	21.8
Türkiye İş Bankasi	0	0	5.5
Türkiye Garanti Bankasi	0	0	0
Yapi ve Kredi Bankasi	0	0	0
Akbank	0	0	0



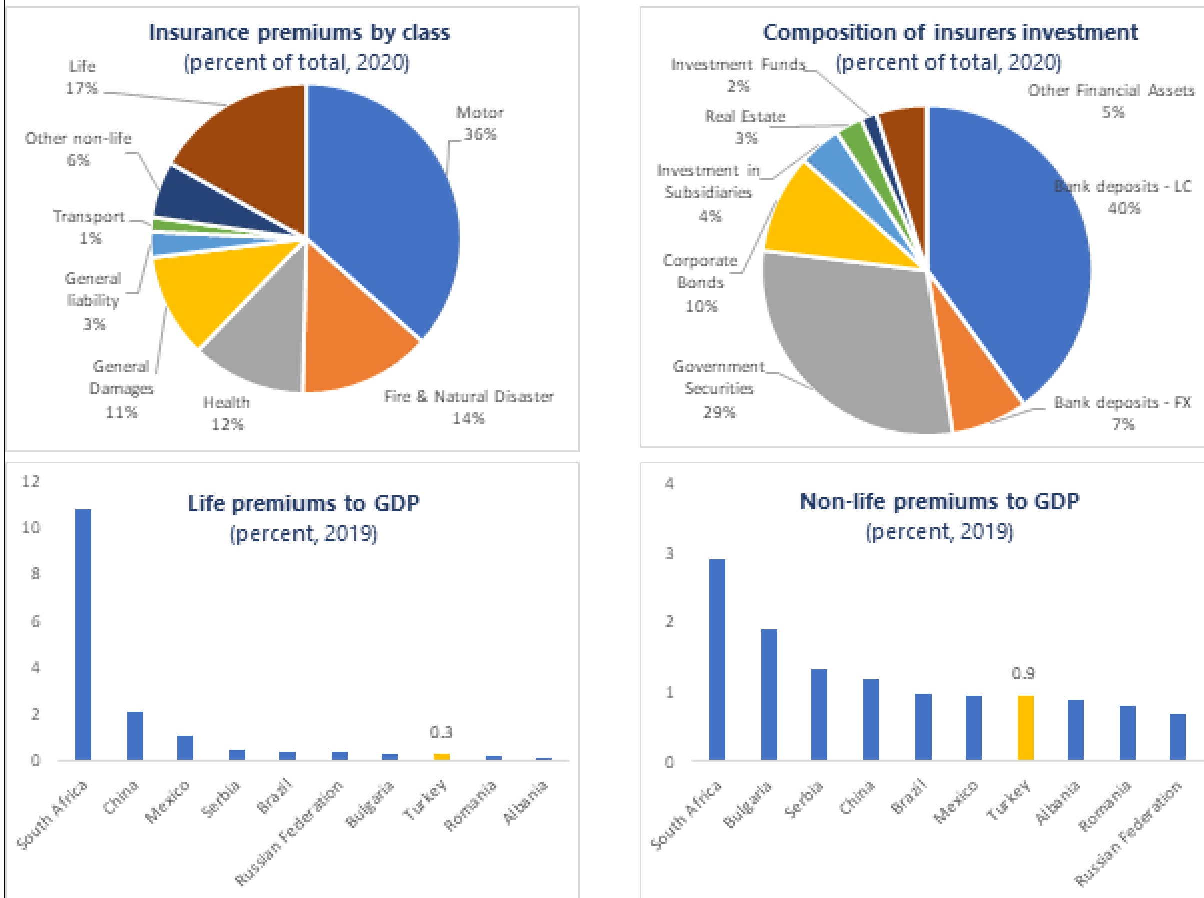
Sources: BRSA, TBA, MOTF, CBRT, WB Staff calculations.

Figure 8. Republic of Türkiye: Role of the State II



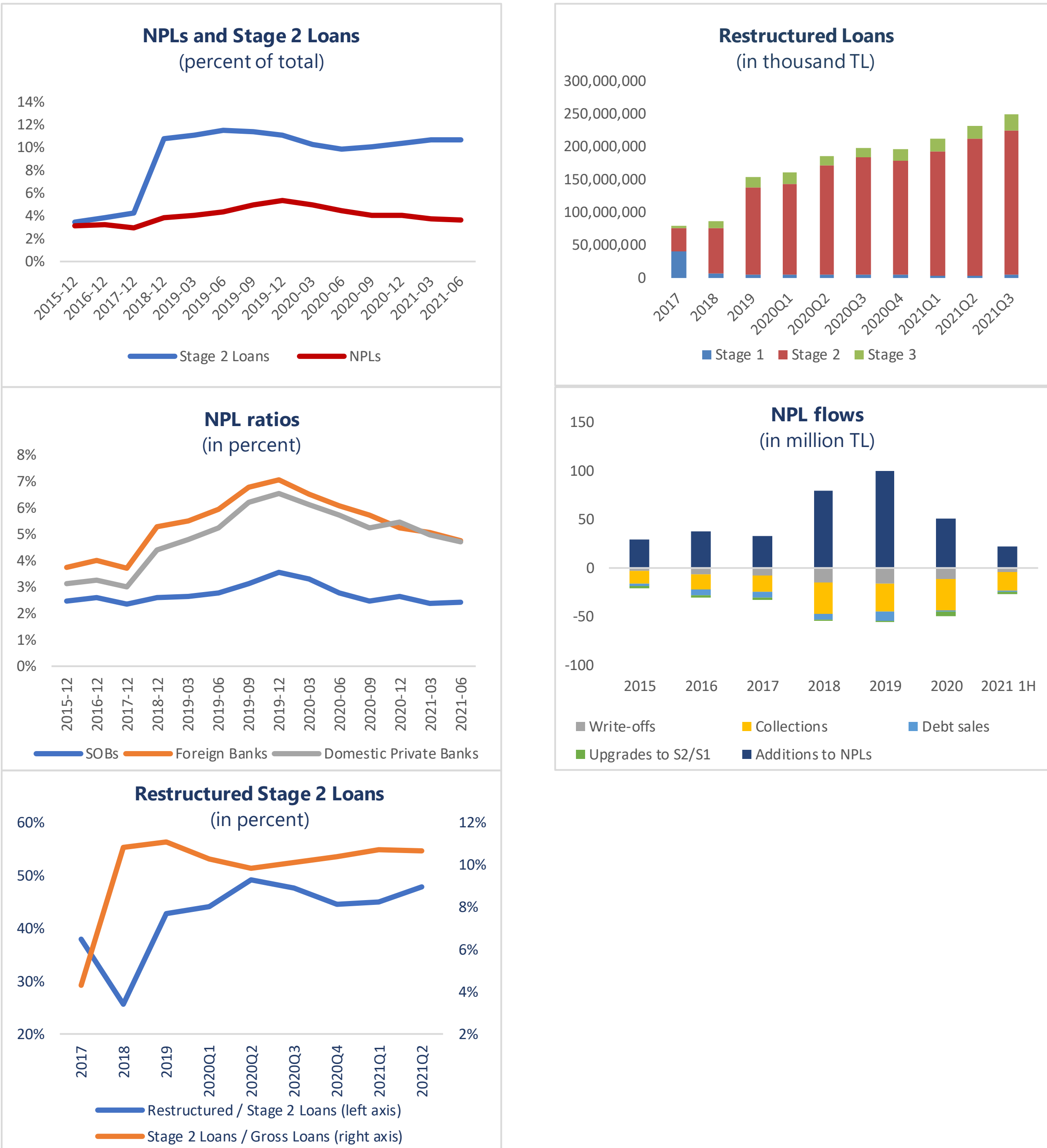
Sources: BRSA, CBRT, MoTF, WB Staff calculations.

Figure 9. Republic of Türkiye: Insurance Sector



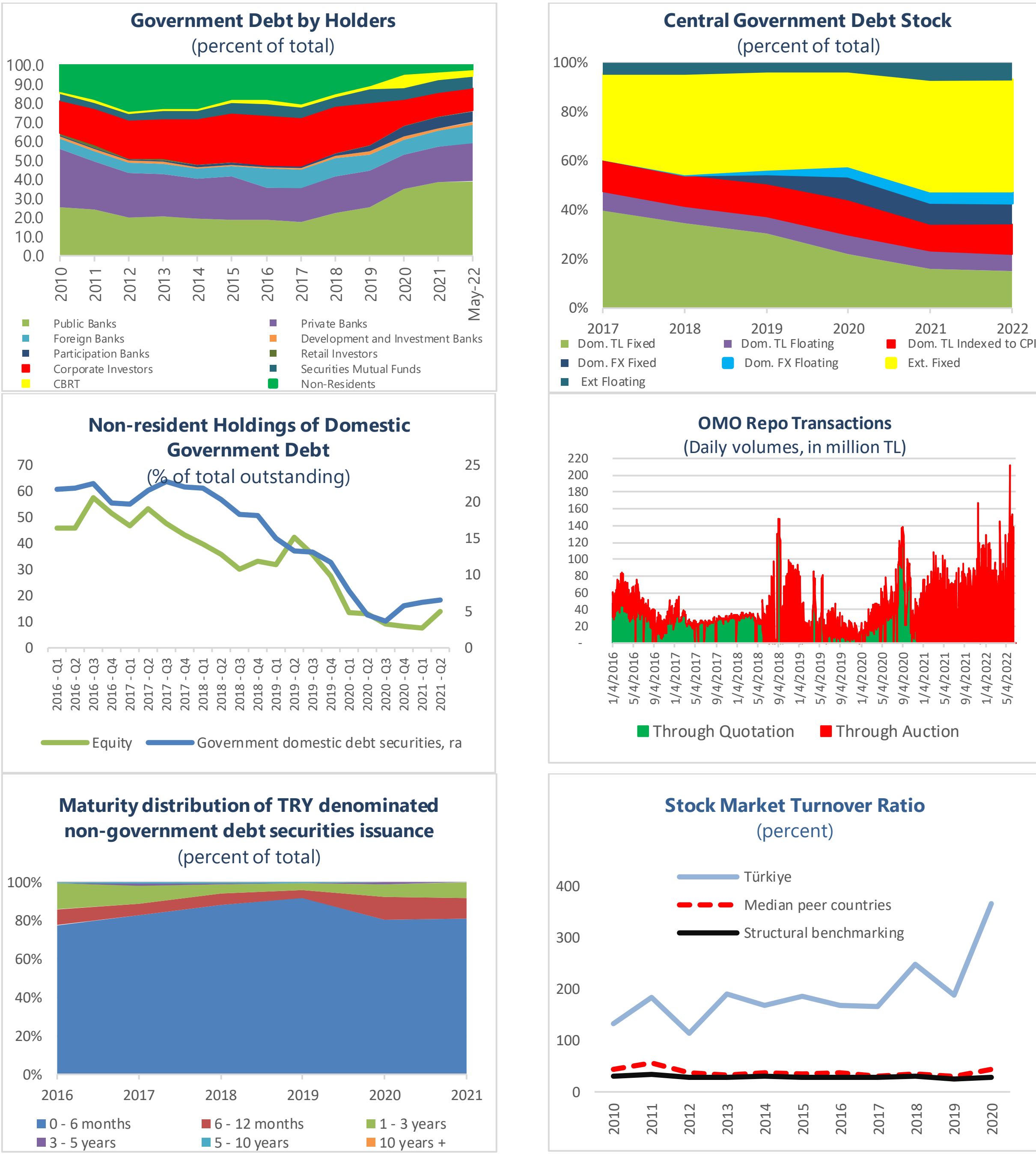
Sources: CBRT, IPRSA, World Bank FinStats, WB Staff calculations.
Notes: Figures Life and non-life premiums do not include personal accident and health insurance.

Figure 10. Republic of Türkiye: NPLs and Asset Classification



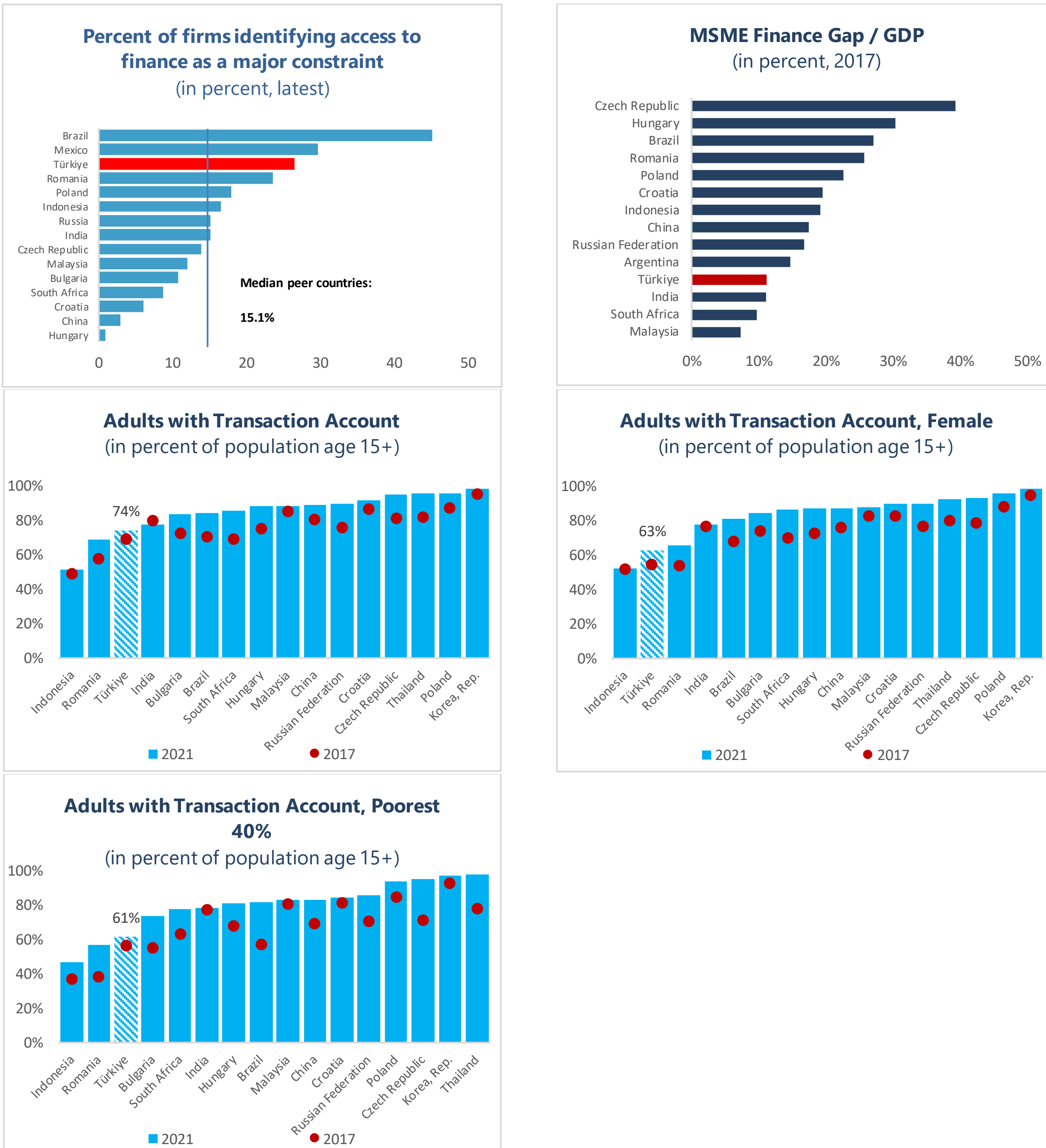
Sources: BRSA, WB Staff calculations.

Figure 11. Republic of Türkiye: Capital Markets and Long-term Finance



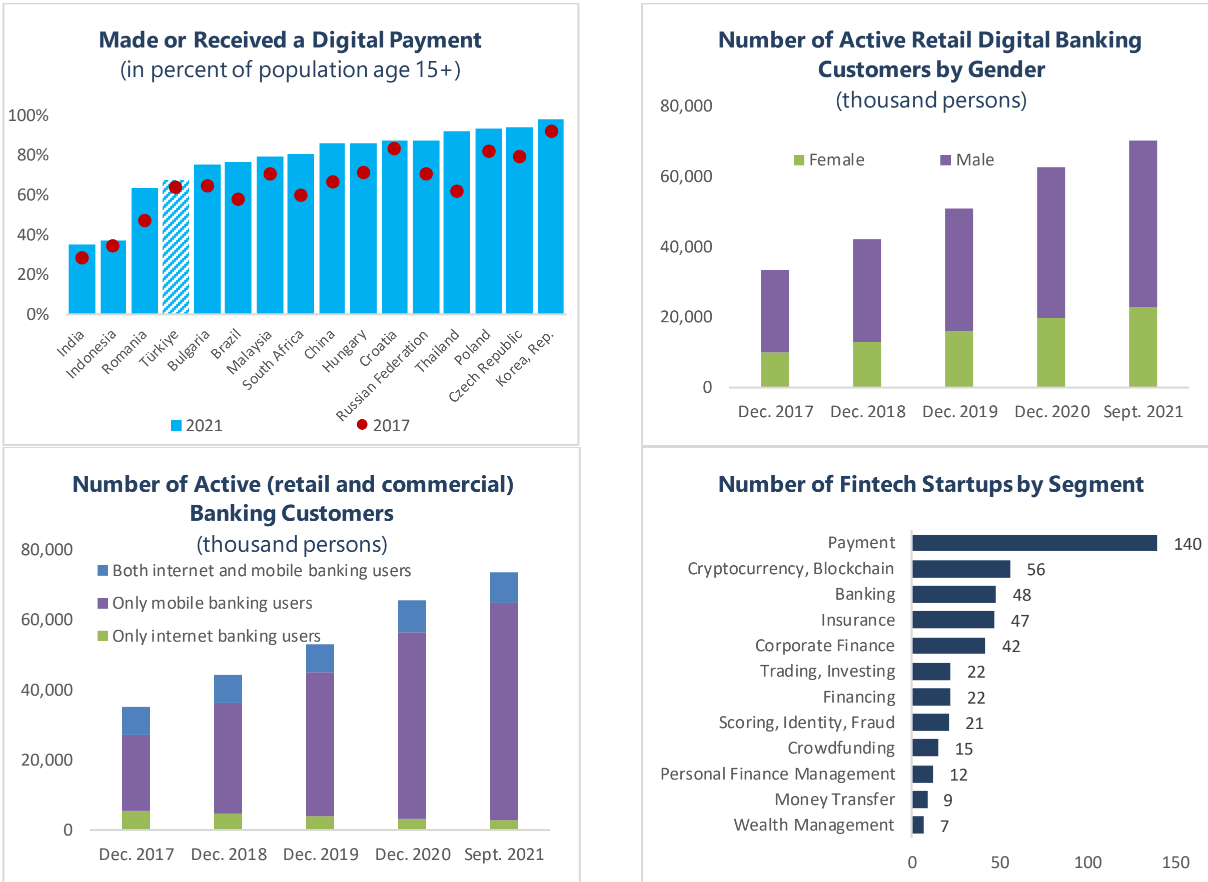
Sources: MOTF, CBRT, WB FinStats, WB Staff calculations.

Figure 12. Republic of Türkiye: Financial Inclusion



Sources: WB Global Findex, IFC MSME Finance Gap database, WB Enterprise Survey 2021, Türkiye Bankers' Association, Finance Office, Presidency of the Republic of Türkiye, WB Staff calculations.
Median peers: Bulgaria, Brazil, China, Czech Republic, Hungary, India, Indonesia, Korea Rep., Mexico, Malaysia, Poland, Romania, Russia, South Africa.

Figure 13. Republic of Türkiye: Fintech



Sources: WB Global Findex, Türkiye Bankers' Association, Finance Office, Presidency of the Republic of Türkiye, WB Staff calculations.
Median peers: Bulgaria, Brazil, China, Czech Republic, Hungary, India, Indonesia, Korea Rep., Mexico, Malaysia, Poland, Roman ia, Russia, South Africa.

Table 4. Republic of Türkiye: Selected Economic Indicators, 2018–27

Population (2021): 84.7 million
Per capita GDP (2021): US$9,654
Life expectancy (2019): 77.7 years
Gini index (2019): 41.9
Quota: SDR 4,658.6 million

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
					Est.		Proj.			
Real sector					*(Percent)*					
Real GDP growth rate	3.0	0.8	1.9	11.4	5.5	3.0	3.0	3.0	3.0	3.0
Final domestic demand	1.1	-2.1	4.2	11.4	10.5	4.7	3.3	3.3	3.2	3.1
Private consumption	0.6	1.5	3.3	15.3	15.3	3.4	3.4	3.5	3.5	3.2
Public consumption	6.5	3.8	2.5	2.6	2.8	13.1	3.2	2.8	3.0	3.5
Investment	-0.2	-12.5	7.4	7.4	2.8	3.9	3.0	2.9	2.5	2.5
Exports	8.8	4.2	-14.4	24.9	9.8	5.5	8.0	7.6	6.3	5.7
Imports	-6.2	-5.0	6.7	2.4	5.5	7.9	6.2	6.8	6.0	5.6
Contributions to real GDP growth 1/										
Private consumption	0.3	0.8	1.9	8.7	8.4	2.0	2.0	2.1	2.1	2.0
Public consumption	0.9	0.6	0.4	0.4	0.4	1.6	0.4	0.4	0.4	0.5
Investment (incl. inventories)	-2.4	-3.5	6.4	-4.1	-4.8	0.9	0.2	0.5	0.5	0.6
Net exports	4.1	2.9	-6.7	6.4	1.5	-1.4	0.3	0.1	-0.1	-0.1
GDP deflator growth rate	16.5	13.8	14.9	29.0	83.3	51.7	24.1	19.3	18.5	18.2
Nominal GDP growth rate	19.9	14.7	17.1	43.6	93.3	56.2	27.9	22.9	22.1	21.8
Inflation (period-average)	16.3	15.2	12.3	19.6	72.1	50.6	24.0	20.2	20.0	20.0
Inflation (end-year)	20.3	11.8	14.6	36.1	70.0	36.0	21.3	20.0	20.0	20.0
Unemployment rate	10.9	13.7	13.1	12.0	10.8	10.5	10.5	10.5	10.5	10.5
Output gap (percent of potential GDP) 1/	1.1	-2.1	-4.4	1.5	2.2	1.7	1.2	0.6	0.1	0.0
					(Percent of GDP)					
Fiscal sector										
Nonfinancial public sector										
Primary balance	-2.4	-3.0	-3.2	-2.6	-2.5	-3.2	-2.4	-2.0	-1.7	-1.6
Overall balance	-3.9	-5.0	-5.1	-4.3	-4.4	-5.3	-5.0	-4.9	-4.8	-5.0
General government gross debt (EU definition)	30.1	32.6	39.7	41.8	35.6	35.4	36.6	38.4	39.8	39.6
External sector										
Current account balance	-2.6	1.4	-4.4	-0.9	-6.0	-3.4	-2.5	-2.2	-2.2	-2.2
Gross international reserves (billions of US dollars)	93.0	105.7	93.6	111.2	125.2	102.2	94.9	93.5	91.5	89.5
Ratio to ARA Metric for emerging markets (percent)	77.3	88.7	77.6	88.0	...	...	...	...	...	...
Gross financing requirement	24.4	18.7	24.9	21.2	26.2	24.7	23.4	23.2	23.4	23.3
Gross external debt 2/	54.7	54.7	60.1	54.8	57.8	48.6	47.7	46.9	46.1	45.6
Net external debt	35.7	33.2	40.1	33.7	35.8	32.5	33.0	32.9	32.9	33.1
Net international investment position	-43.1	-40.8	-53.7	-31.3	-27.9	-26.4	-27.6	-28.3	-29.1	-29.9
Short-term external debt (by remaining maturity)	19.6	19.4	23.0	21.1	25.8	22.0	22.2	22.3	22.1	22.0
REER (CPI-based, 2003=100)	77.1	75.1	67.3	60.4	...	...	...	...	...	...
Monetary conditions					*(Percent)*					
Real average cost of CBRT funding to banks	1.4	5.4	-1.7	-1.9	...	...	...	...	...	...
Nominal growth of M2 broad money	18.4	27.3	33.9	53.0	...	...	...	...	...	...
Memorandum items										
GDP (billions of U.S. dollars)	780	759	720	818	850	1030	1086	1150	1210	1271
GDP (billions of Turkish lira)	3,759	4,312	5,048	7,249	14,012	21,885	27,981	34,392	41,991	51,143
Real effective exchange rate (year-on-year percent change)	-14.4	-2.7	-10.3	-10.2	...	...	...	...	...	...
GDP per capita US$	9,508	9,133	8,612	9,654	9,925	11,888	12,385	12,976	13,518	14,054
Population (million)	82.0	83.2	83.6	84.7	85.7	86.7	87.6	88.6	89.5	90.5

Sources: Turkish authorities; and IMF staff estimates and projections.
1/ Staff estimates.
2/ The external debt ratio is calculated by dividing external debt in US$ by staff-estimated GDP in US$. GDP in US$ is calculated as GDP in TL divided by the annual average exchange rate.

Table 5. Republic of Türkiye: Financial Soundness Indicators, 2012–20
(In percent, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Capital Adequacy									
CAR	18	15	16	16	16	17	17	18	19
T1R	15	13	14	13	13	14	14	15	16
RWA / Assets	80	84	83	83	82	76	77	77	67
Asset Quality									
NPLs / Gross Loans	3	3	3	3	3	3	4	5	4
Provisions / Gross NPLs	75	76	74	75	77	79	68	65	75
Profitability									
Total Int. Income / Int. Bearing Assets (av) 1/ 2/	9	8	8	8	8	9	11	11	8
Cost / Income (Efficiency) 3/	73	71	74	76	72	73	77	78	-
ROAA 1/ 4/	2	2	1	1	2	2	1	1	1
ROAE 1/ 4/	16	14	12	11	14	16	15	11	11
Funding and Liquidity									
Loan-to-Deposit ratio	103	111	118	119	119	123	118	103	104
Loan-to-Deposit ratio (TL)	113	127	133	142	134	148	138	130	-
Loan-to-Deposit ratio (FX)	82	84	92	89	99	90	96	78	-
Non-Core / Core Liabilities 5/	44	52	55	56	56	57	57	47	51
Non-Core / Core Liabilities (TL) 5/	26	29	30	32	29	32	33	28	-
Non-Core / Core Liabilities (FX) 5/	91	103	113	101	106	101	94	71	-
Leverage Ratio 1/ 6/	5	5	6	5	5	5	5	6	5
Liquid Assets / Assets 7/	26	24	23	22	21	23	21	23	25
Assets / Liabilities (3 months, int. sensitive)	82	79	75	74	76	73	78	71	72
FX Risk									
FX Assets / FX Liabilities (on-balance sheet) 6/	94	91	91	91	94	88	91	88	86
NOP / Regulatory Capital	2	-1	-2	1	-1	1	3	0	4
NOP before hedging / Regulatory Capital	-14	-29	-28	-30	-22	-43	-34	-41	-58
Balance Sheet					*(Percent of GDP)*				
Total Assets	87	95	97	100	104	104	103	104	122
o/w Gross Loans	50	57	60	63	66	67	64	61	71
Liabilities	75	84	86	89	93	93	92	93	110
o/w Deposits	49	52	51	53	55	55	54	59	69
Shareholders' Equity	12	11	11	11	11	11	11	11	12
Off-Balance Sheet					*(Percent of GDP)*				
o/w Commitments	109	89	83	88	94	103	95	93	100
o/w Contingencies	15	18	19	20	21	21	21	19	20
Miscellaneous									
Deposit Interest Rate (Percent) 8/	8	8	9	11	10	13	23	10	16
Loan Interest Rate (Percent) 9/	12	13	13	16	15	18	32	15	22

Sources: BRSA data; and IMF staff calculations.
1/ Current year data are annualized using 12-month rolling sums.
2/ Net of NPL provisions.
3/ Other non-interest income added to expenses when <0.
4/ Net income as a share of average assets or equity over last 12 months.
5/ Core liabilities include deposits and shareholders' equity.
6/ Proxied by T1 Capital over last 2 months average balance sheet assets and average off-balance sheets exposures (> 3 percent).
7/ Liquid assets as reported by the BRSA in their liquidity position table.
8/ On TRY only, excluding sight and interbank.
9/ Consumer Loans (Personal+Vehicles+Housing).

Appendix I. Republic of Türkiye: Implementation of 2016 FSAP Recommendations

Recommendations	Timeframe	Status
Financial Sector Oversight and Regulation		
Banking		
Revise legislation to further strengthen BRSA independence.	MT	No action taken. The issues identified in 2016 regarding independence and accountability are now more exacerbated, and that the BRSA resources are under serious stress.
Deepen and broaden the risk assessment nature of banking inspections and follow up.	MT	Some broadening of methodology, but majority of detailed recommendations from the BCP assessment have been or appear to have been left untouched. As resources are exceptionally constrained, special inspections have been discontinued and issues are being tracked on a slower cycle than before, the status of bank inspections appears less robust than at the last FSAP. Also, on-site inspectors dedicate up to 40 per cent of their time to conduct inspections at the request of other national authorities in detriment of the main responsibilities and mandate of the BRSA.
Strengthen corporate governance rules and enforcement.	MT	Partial achievement. Progress has been made with respect to a guideline on corporate governance that is awaiting public consultation. This will meet a number of required elements, including a bank's board to have collective sound knowledge of the bank's material activities; requiring the majority of the board to be composed of non-executive members and expanding the minimum number of independent directors on the audit committee; separating risk management responsibilities from the audit committee; requiring banks to establish risk management committees; and requiring CROs to oversee risk management activities. However, there is a need to significantly enhance the fit and proper assessment of bank managers (administrators) to ensure the experience, education, and reputation criteria are properly assessed and enforced.
Evaluate and revise the definition of credit classifications and strengthen enforcement.	ST	Partial achievement. Indications of material loosening of credit standards were identified, but new guidelines on credit risk are due to be enacted from July 2022.
Insurance Supervision		

Recommendations	Timeframe	Status
Improve independence, governance and accountability of supervisor and resources for internal control functions.	ST/MT	Partially achieved. The IPRSA as a standalone insurance supervisor was established in line with the recommendation made in the previous FSAP. Regulation around risk management and internal controls was also amended to strengthen resources for key internal control functions, which requires insurance companies to establish compliance, risk management, actuarial and internal audit units. Yet, ORSA is not formally implemented. Moreover, transparency in the nomination, appointment and early dismissal of the insurance supervisor's board members need to be further improved.
Integrate offsite, onsite and enforcement activities, develop risk-based approach and group wide supervision.	MT	Partially achieved. The IPRSA's unified structure allows for the integration of supervisory activities (both onsite and offsite) and enforcement actions although the full integration appears to be constrained by decreased technical capacity of the authority, which was caused by its organizational restructuring. While the planned implementation of IFRS 17 is expected to strengthen the risk-based approach, little progress was made on group wide supervision.
Strengthen corporate governance rules and enforcement.	ST	Partially achieved. Alongside the requirement for insurance companies to establish key internal control functions, they must create an audit committee, which is composed of independent board directors and responsible for overseeing those internal control functions, separately from senior management. Nonetheless, the importance of separating the management function of the company from the supervisory function of the board of directors does not appear to be fully understood by insurance companies.
Financial Market Infrastructure		
Improve risk management of EFT/ESTS liquidity and FMI interlinkages.	ST/MT	Done. The risk management framework of EFT/ESTS has been enhanced to cover the risks posed by systemically important participants, interlinkages across FMIs, and critical service providers. Specific emphasis on assessing and mitigating liquidity and operational risks posed by systemically important participants and critical service providers. The risk management framework has also been updated taking into account the experiences from the pandemic.
Crisis management and Resolution		
Strengthen recovery and resolution planning and enhance resolution powers by: (i) Strengthening the	MT	The progress on strengthening the recovery and resolution planning framework has been fairly limited, consisting of a new recovery planning requirement for the D-SIBs. No enhancement of resolution powers and resolution financing.

Recommendations	Timeframe	Status
Banking Law; (ii) Developing guidance (#43).		
Strengthen domestic and cross-border coordination arrangements (#45, #47).	ST	No action taken on cross-border coordination and work on-going in strengthening domestic coordination.
Financial Integrity		
Determine reason for low money laundering (ML) conviction rates and plan to address them.	MT	Partly done. Authorities are taking steps to improve the ML conviction rate, including by adopting a national strategy to strengthen enforcement and judicial processes. Undertaking complex ML investigations and prosecution is a requirement under the FATF's action plan for Türkiye.
Introduce customer due diligence requirements for politically exposed persons.	ST	No Progress. Authorities have not yet introduced legal provisions related to customer due diligence requirements for politically exposed persons and were rated non-compliant on this issue in the FATF AML/CFT assessment. This is a requirement under the FATF's action plan for Türkiye.
Ensure compliance with requirements of the United Nations Security Council Resolution (UNSCRs) and strengthen border controls on currency transportation.	MT	Partly done. Authorities have introduced a new law (Law no.7265) to implement targeted financial sanctions. Powers and processes are in place to manage cash movement and bearer negotiable instruments cross-borders, but authorities need to demonstrate results, including by effectively pursuing cases in court.
Broadening Markets and Services		
Developing/Deepening Capital Markets		
Support and promote BIST overnight repo futures.	ST	Done. The BIST created a new reference rate – TLREF – and the BIST launched interest rate futures with TLREF as underlying in August 2019.
Introduce an organized call market.	ST	No action taken. Authorities considered that the call market could drain liquidity from BIST and OTC markets.
Consider sovereign TL Eurobonds issuance.	ST	No action taken.
Strengthen issuance regulations and disclosure of corporate bonds.	I	Implemented and will require continuous efforts. A series of regulatory amendments were enacted with the purpose of enhancing investor confidence in the corporate bonds market, including an amendment to Article 31 and 31A of the Capital Markets Law (CML) in June 2019 and February 2020 and secondary regulations enacted in September 2020.
Enhance governance standards and launch special segment for firms listed in BIST.	MT	Implemented and will require continuous efforts. Templates for corporate governance compliance reporting were amended and became effective in 2018. The results of monitoring by the CMB for

Recommendations	Timeframe	Status
		the year 2019 were published in a Corporate Governance Monitoring Report in September 2020. A Corporate Governance Index was published by Borsa Istanbul. Companies that will be included in the index are determined according to corporate governance ratings assigned by rating agencies authorized by the CMB.
Islamic Finance		
Enhance regulatory and governance framework; Build capacity, financial awareness and literacy.	ST/MT	Partly done. The new law on participation finance is pending and is currently included in the Economic Recovery Program as a 2022 deliverable. In 2018, the Association of Participation Banks (TKKB) established an Advisory Board, which also functions as the Central Shariah Advisory Board. A dedicated unit focused on participation finance has been established in the Presidency's Finance Office. New BIST indices have been created to support investors seeking Shariah-compliant investment opportunities. Participation finance topics are actively integrated into ongoing financial awareness and literacy programs.
Promoting Financial Inclusion		
Target underserved segments, enhance public/private sector coordination and design M&E framework.	ST/MT	Partly done. Special programs launched for financing women entrepreneurs and credit guarantee programs shifted from covering individual loans to taking a portfolio approach. Large scale relief programs targeting MSMEs as part of the pandemic relief. No progress on the M&E framework for assessing effectiveness and efficiency of public support programs for advancing financial inclusion.
Ensure level playing field between banks and non-banks.	MT	Partly done. The regulatory framework for non-bank e-money providers, and payment institutions has been strengthened and strikes a balance between fostering innovation and safeguarding stability, integrity, and competition in the financial system. Regulatory changes to allow non-bank e-money issuers and payment institutions to access relevant payment systems have been completed. Open banking and Banking as a Service (BaaS) regulations allow for more space for non-bank players to operate in the market. Many of these regulatory changes are recent and are in the process of implementation, and as such the impact will depend on the pace of implementation and choices made during implementation. However important safeguards like intensive market-wide consultations have been put in place. Further, the Turkish Competition Authority, has been actively studying the implications of fintech developments for competition and has pro-

Recommendations	Timeframe	Status
		actively identified potential issues and proposed some planned actions – for e.g., prior review of all fintech related acquisitions of banks irrespective of the deal size.
Improve oversight of CRS, retail payment services and design of electronic instruments for government payments.	ST/MT	Partly done. The social protection payment recipients are primarily directed to the PTT bank, and while it has been improving its products and services, it still lags the market. During the distribution of temporary and emergency reliefs during the pandemic, more choice on payment methods was provided to the recipients – this policy change should be continued and extended to social protection payments.