ICR Review
Operations Evaluation Department

Report Number : ICRR11255

1. Project Data:		Date Posted :	06/27/2002	
PROJ ID :	P066511		Appraisal	Actual
Project Name :	Financial Sector Adjustment Loan	Project Costs (US$M)	777.78	392.78
Country :	Turkey	Loan/Credit (US$M)	777.78	392.78
Sector(s):	Board: FSP - Banking (84%), Central government administration (8%), Micro- and SME finance (4%), Other industry (4%)	Cofinancing (US$M)		
L/C Number :	L4588			
		Board Approval (FY)		1
Partners involved :		Closing Date	03/31/2002	06/20/2001
Prepared by :	Reviewed by :	Group Manager :	Group :	
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2. Project Objectives and Components

a. Objectives

The project objective was to lay the foundation for an efficient, sound, and healthy banking system competitive in quality and performance at the international level. The financial sector reform supported by the project included four main components: (1) creation of an efficient and independent Banking Regulation and Supervision Agency (BRSA); (2) bringing prudential regulations up to international best practice standards; (3) providing new legal authority and operating guidelines for the bank failure resolution entity, the Savings and Deposit Insurance Fund (SDIF); and (4) making a major tangible push toward restructuring and privatization of state -owned banks. These four "pillars" or components comprised the Government and Bank strategy for banking sector reform, which has consistently guided Bank interventions since 1999.

b. Components

The project had one component, Financial Sector Adjustment, in the amount of US$ 777.78 million.

c. Comments on Project Cost, Financing and Dates

The FSAL originally consisted of two tranches, the first of US$ 392.78 million to be disbursed upon effectiveness (and completion of specified actions prior to Board presentation), and the second of US$385 million after completion of additional actions. Within 3 months of project inception, a severe financial crisis required the Bank and the Government to reconsider their strategy, and management developed a new approach consisting of a series of Programmatic Adjustment Loans. The second tranche of the FSAL was canceled, and FSAL conditions that had not yet been met were shifted to the PFPSAL. The FSAL first tranche of US$392.78 million was disbursed in December, 2000, as scheduled, and the project was closed on June 20, 2001, instead of March 31, 2002 as originally envisioned.

3. Achievement of Relevant Objectives:

(1) **Establishment /strengthening of BRSA** : Amendments were passed that: strengthened BRSA and enhanced its independence; implemented tightened large/connected exposure limits; and established BRSA /SDIF bank failure resolution roles. BRSA was provided with TA by the Bank and the US Treasury that provided software, manuals, operating procedures, training and study tours . Also, BRSA, CBT, and other agencies signed an MOU to assure appropriate information exchange and policy coordination; (2) **Enhanced prudential regulation** : a stronger loan loss provisioning rule, and a more comprehensive FX exposure limit and minimum capital adequacy requirement were implemented; BRSA announced its intention to conduct surprise on -site examinations to verify compliance with FX rules; a risk management system "Best Practice" regulation was issued; and market risk changes in the bank capital adequacy rule were introduced (3) **Bank failure resolution** : Treasury initiated an action plan encompassing corrective actions covering all known problem banks; (4) **State Bank privatization** : Legislation was enacted allowing corporatization and privatization of state banks; subsidized lending was prohibited (except if a specific budget allocation was provided); plans were developed for commercialization and pre -privatization restructuring of state banks.

4. Significant Outcomes/Impacts:

The FSAL was implemented after two financial sector adjustment operations in the late 1980s that failed to meet most of their objectives and were rated as unsatisfactory. By contrast, the 2000 FSAL had overall an appropriate design with relevant objectives and met most of its objectives. In accordance with the Bank/Government four pillar strategy to strengthen the banking sector, the following outcomes were achieved:

- BRSA was strengthened, with new legal authority, and enhanced technical skills.
- BRSA directed diagnostic audits of all private banks by independent private auditors (an IMF condition); these are expected to identify banks that have insufficient risk-adjusted capital, which will then be the subject of further actions.
- There were several improvements in the legal framework for banking. For example, stronger prudential regulations were put into place including loan loss provisioning, large/connected lending limits, capital adequacy, FX exposure, and risk management.
- The financial condition of Emlak bank (one of four state banks) had deteriorated, and it could not be commercialized/privatized as envisioned in the FSAL. Instead, it was closed in July, 2001; its banking assets and staff were distributed to other state banks, and its physical and other assets are currently being liquidated.
- Two state banks--Zerat and Halk--have had their balance sheets restructured, and are now undergoing an operational restructuring; these two banks have closed nearly 900 branches and have discharged nearly 16,000 staff.
- Vakif bank has hired Merrill Lynch as its privatization adviser, has established a short list of bidders, and is having its portfolio examined in detail by prospective bidders.
- The March, 2001, financial crisis accelerated the government's propensity to act, as well as its fiscal support for bank restructuring. In 2001, BRSA merged, sold, or closed 15 weak banks.

5. Significant Shortcomings (including non-compliance with safeguard policies):

1. The FSAL was approved in an unstable macroeconomic environment, which is unfavorable for the successful outcome of financial sector reforms. Although there was an IMF program in place at the time of approval, the Government's fiscal program was insufficient to ensure macroeconomic stability and successful financial reforms. Not only the Government failed to meet the primary surplus target of 5 percent of GDP, but state enterprises were not included in the fiscal targets (several of which were loss-making), and there was no provision in the budget for payment of interests on Government debt to state banks, leaving these banks in a difficult liquidity position. The ICR acknowledges that there was a financial system crisis shortly before and shortly after project approval. The February 2001 crisis involved a very large exchange depreciation, strong increases in inflation and interest rates, and a strong contraction of output, resulting in the insolvency of several banks (especially those with open FX positions) and widespread corporate distress. IMF disbursements were suspended for 3 months before a new "framework agreement" was reached in May, 2001. The crisis eventually had positive effects, as it led to a much stronger fiscal program, much greater fiscal support to bank restructuring, and an acceleration in the implementation of necessary financial sector reforms. However, the crisis also revealed the absence of sound macroeconomic foundations in 2000, forced the redesign of some reform elements, and probably increased the fiscal costs of bank restructuring. It should be noted that, as a result of the February crisis and its ramifications, the second tranche was cancelled and Bank support resumed through programmatic lending.
2. Although the regulatory and supervisory framework were generally improved, some specific elements of regulation and supervision may not have been sufficiently improved yet. For example, prompt corrective action (PCA) rules are contained in a manual for bank supervisors. It can be argued that in civil law countries with a history of regulatory forbearance and supervisory inaction, there should be a clear identification of capital adequacy thresholds in the law, complemented by more detailed rules in binding secondary regulations. At a minimum, the triggers requiring supervisory intervention should be included explicitly in binding secondary legislation (e.g., BRSA regulations), as opposed to an internal manual. Although supervisors did intervene in several weak banks, there are no clear regulatory provisions forcing supervisors to continue doing so in the future.
3. The FSAL does not contain a time-bound privatization plan for the state banks; it is now envisioned that the remaining state banks will be sold under PFPSAL II, but there is no firm conditionality. The FSAL seems to assume that political support for privatization will continue, however there have been recent indications that this may not be the case.
4. Some FSAL conditions do not specify outcomes or benchmarks of specific compliance actions. For example, satisfactory creation and full operationalization of BRSA with appropriate operational procedures. There is no minimal elaboration in the loan documentation of what are "appropriate" procedures. (It is understood that additional detail is presented in the minutes of negotiations).
5. Some second tranche conditions do not seem to have been implemented. For example, there was no progress in improving loan loss provision rules for watch loans.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments
Outcome:	Satisfactory	Moderately Satisfactory	1. Although most relevant objectives

			were achieved, there were also significant shortcomings. 2. The major shortcoming was related to the absence of a stable macroeconomic environment based on a robust fiscal program. These conditions contributed to a major banking crisis two months after loan approval. 3. PCA rules are not yet embodied in binding legislation. 4. The FSAL did not contain a time-bound privatization plan for the state banks (it is now envisioned that the remaining state banks will be sold under PFPSAL II, but there is no firm conditionality) 5. Some second tranche conditions have apparently not yet been implemented yet, such as provisions for watch loans.
Institutional Dev .:	Substantial	Substantial	(Annex 5 of the ICR states that IDI is substantial.)
Sustainability :	Likely	Likely	
Bank Performance :	Satisfactory	Satisfactory	
Borrower Perf .:	Satisfactory	Satisfactory	
Quality of ICR :		Unsatisfactory	

NOTE: ICR rating values flagged with ' * ' don't comply with OP/BP 13.55, but are listed for completeness.

7. Lessons of Broad Applicability:

- Successful financial sector reforms require a stable macroeconomic framework, centered on a sound and credible fiscal program. The fiscal program was strengthened after the February 2001 crisis, but was not sufficiently robust to ensure macroeconomic stability and successful banking reforms at the start of the FSAL .
- The presence of an IMF agreement, per se, may not be a sufficient indication of macroeconomic stability for some types of Bank operations
- The FSAL would have been stronger if its conditions focused to a greater degree on outcome and made greater use of compliance benchmarks
- Use of a time-bound privatization plan for the state banks would have made the program stronger and more credible
- Complementary TA played an important role in strengthening BRSA

8. Assessment Recommended? ○ Yes ● No

9. Comments on Quality of ICR:

The ICR does not provide sufficient information to reach evaluative judgments :

- The ICR does not provide an analysis of recent macroeconomic developments backed by a minimum of statistical information. It is difficult to evaluate an FSAL without such an analysis, because "satisfactory implementation of the macroeconomic reform plan" was an FSAL condition, and also because financial sector operations are particularly sensitive to macroeconomic conditions
- The ICR does not clearly identify which FSAL second tranche conditions have already been achieved (under PFPSAL I), and which conditions still remain to be achieved under PFPSAL II (e.g., see loan loss provisions in section 5, above)
- The ICR states that TA was provided to BRSA, but does not provide details on the nature of that TA, what it actually achieved, or on complementary TA provided by other agencies (e.g., the US Treasury)
- While the ICR states that most FSAL conditions were met, it provides little information on outcomes, e .g., the BRSA-directed diagnostic audits; the restructuring of Zerat and Halk banks; BRSA achievements in closing weak banks; and details on the disposition of Emlak bank .