ICR Review
Operations Evaluation Department

Report Number: ICRR11746

1. Project Data:		Date Posted:	04/16/2004	
PROJ ID:	P070560		Appraisal	Actual
Project Name:	Programmatic Financial Sector Adjustment Loan II	Project Costs (US$M)	1350	450
Country:	Turkey	Loan/Credit (US$M)	1350	450
Sector(s):	Board: FSP - Central government administration (54%), Banking (40%), Non-compulsory pensions insurance and contractual (2%), Other social services (2%), General industry and trade sector (2%)	Cofinancing (US$M)		
L/C Number:	L4656; L4657			
		Board Approval (FY)		3
Partners involved:		Closing Date	12/31/2002	06/30/2003

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2. Project Objectives and Components

a. Objectives

The main objective of PFPSAL II was to support the second phase of the Government's financial and public sector reform program in response to the February 2001 financial crisis, while continuing to ensure that social programs were adequately funded.

b. Components

Components included maintenance of a satisfactory macroeconomic framework and meeting certain minimum levels of social expenditure, as well as achievement of reforms in the financial sector and in the public sector. In the financial sector, subcomponents included: (1) overhaul of the regulatory framework for banking activity, (2) institutional development of the Bank Regulation and Supervision Agency (BRSA), (3) problem bank/bank failure resolution, and (4) state bank restructuring and privatization. In the public sector, subcomponents included: (1) further deepening of structural fiscal policies in support of sustainable fiscal adjustment, (2) broadening public expenditure management reforms including implementation of concrete improvements to the framework for budget planning and execution, financial accountability, and public liability; (3) implementing the Government's strategy to strengthen public sector governance including adoption and implementation of a national anti-corruption strategy and initial steps toward civil service reform.

c. Comments on Project Cost, Financing and Dates

The project initially envisioned 3 equal tranches of US$450 million. The first tranche was released upon effectiveness in April, 2002, however a change of government (following November, 2002 elections) and turbulent conditions in the region (e.g., Iraq) resulted first in the delay and then in the cancellation of the second and third tranches. The project closed six months later than planned on June 30, 2003. As noted below, most second and third tranche conditions were satisfied during identification of the prospective PFPSAL III, which is scheduled to be considered by the Board in June, 2004.

3. Achievement of Relevant Objectives:

Macroeconomic Performance --PFPSAL II benchmarks were largely met:
Macroeconomic performance was good during the project period. Real GNP growth in 2002 was 7.8% compared to the PFPSAL II program target of 3%; CPI inflation was 29.7% at end-2002, compared to the program target of 35%. GNP growth continued to be good in 2003 at 5.0%, with CPI inflation declining to 20% (both were in line with the IMF program). However, the consolidated public sector primary balance was 4.0% in 2002, 2.5 percentage points lower than the program level. The government took measures to improve the fiscal balance, and the primary balance for 2003 was 6.25% compared to the (IMF) program level of 6.5%. It should be noted that recent macroeconomic performance in Turkey has been quite favorable compared to the last few decades.

Social Expenditures --PFPSAL II benchmarks were largely not met:
Benchmarks for public spending on health, education and social protection as shares of GNP were set for the PFPSAL program as a whole, with specific triggers for 2002 spending. Estimated actual social expenditures in 2002 were around 17.5 percent of GNP, well above the PFPSAL II trigger of 14.5 percent. However, this overall result was due to a large overrun in social security expenditure, and masked shortfalls in other social protection programs. Social assistance spending fell short of targets in two key areas; the Social Solidarity Fund (SSF) was 0.22 percent of GNP for 2002, short of its spending target of 0.3. Expenditure under the Direct Income Support (DIS) program for farmers was TL 1.47 quadrillion in 2002 compared to a commitment of TL 1.9 quadrillion. In addition, payments by the unemployment insurance fund (ISKUR) were TL 57 trillion compared to an original estimate of TL 336 trillion. During identification of PFPSAL III, the government has agreed to complete all payments under the 2002 DIS program and enact legislation to institutionalize DIS, and the 2003-04 budget contains increases for the SSF and DIS.

Financial Sector --PFPSAL II conditions in this area were fulfilled or have been agreed to by the government as conditions of PFPSAL III (except as noted in section 5):
(1) Regulatory framework for banking activity--Corrective action plans for excessive connected exposures were introduced in early 2002. Connected exposure regulatory limits were reduced as of January 1, 2003 and will decline each year until reaching parity with EU regulation by January 1, 2010. BRSA will monitor bank compliance with the new limits. Other requirements concerning collateral valuation and bringing repos on balance sheets as collateralized finance transactions were also met.
(2) Institutional development of the Bank Regulation and Supervision Agency (BRSA) and Savings Deposit Insurance Fund (SDIF)--The BRSA Board approved a time-bound strategic plan for BRSA development covering a number of key areas: Development of a PCA Manual; establishment of a Quality Assurance Department; and adoption of a risk-based supervision and early warning system. The SDIF Board adopted a time-bound institutional development plan with a more effective organizational structure with clearer line responsibilities for liquidation, bank resolution, asset disposition, administration of deposit insurance, and supporting functions (PFPSAL II second tranche condition). A new law adopted in December, 2003 clarifies the roles of the two agencies; BRSA focuses on regulation and supervision, while SDIF concentrates on deposit insurance, bank resolution, and asset management. The principle of providing for greater financial and organizational independence of BRSA and SDIF has been accepted by the government; in this regard, stronger provisions of the Banking Act are a Board condition of PFPSAL III and are also the subject of cross-conditionality with the Fund. These amendments would obviate problems of the interference of other government agencies in BRSA and SDIF decisions, restrictions on staffing and compensation, etc.
(3) Problem bank/bank failure resolution:
(A) Enforcement of Capital Restoration Plans for Private Banks. A 3-stage audit of 25 deposit-taking banks was completed in June, 2002 and resulted in significant restatements of financial statements and completion of the re-capitalization process (PFPSAL II third tranche condition). A number of banks that fell below the minimum CAR level were re-capitalized from private sources (satisfying PFPSAL II third tranche condition).
(B) Resolution of all SDIF banks. This condition was not completely fulfilled. Two banks remain with SDIF; one has been offered for sale, and two offers to purchase it are being evaluated; the status of the second --which has been used as an agent to liquidate other banks--is under review.
(C) Upgrading of Bankruptcy Legislation. A review of necessary improvements in bankruptcy legislation was completed (PFPSAL II second tranche condition), and amendments embodying most recommendations were enacted in mid-2003. Additional legislative changes--completing the study recommendations--are expected in 2004.
(4) State bank restructuring and privatization. All required branch closures and staff reductions of Ziraat and Halk banks have been completed, and the Treasury has adhered to the agreed protocol for cash payment of interest and principal on government securities held by these banks (second and third tranche conditions of PFPSAL II). The government has agreed to a PFPSAL III condition that "a privatization strategy acceptable to the Bank" be developed for Halk. However, Vakif bank has not yet been sold, as a June, 2002 public tender did not result in any viable bids. The Bank is in discussions with the government on a viable plan to sell Vakif, which plan would be made a condition of PFPSAL III.

Public Sector --Public sector conditions were fulfilled as envisioned, or are expected to be fulfilled as part of PFPSAL III, except as noted in section 5:
(1) Structural Fiscal Policies
(A) Medium-Term Tax Strategy. Starting in 2002, the government adopted several new tax measures in accordance with PFPSAL II conditions: a Special Consumption Tax (SCT) law replacing the complex system of excise taxes was adopted by Parliament in June 2002, and a decree to eliminate earmarking of SCT revenues was published in January 2003.
(B) Public Employment An assessment of 45,800 state economic enterprise (SEE) redundancies was provided to the Bank in 2002 (a PFPSAL II second tranche condition) and a circular implementing the redundancy program was issued. As of October, 2003, the 45,800 redundant workers had been reduced by about 36,700, more than fulfilling a third tranche condition.

(2) Budget Reform
(A) The Program for Government Finance Statistics (GFS) was expanded to all general government agencies (a PFPSAL II second tranche condition), and is expected to be implemented in the near future in independent boards, local governments, etc. Publication of the GFS circular is a Board condition for PFPSAL III.
(B) PFMC Law. The Public Financial Management and Control law (enacted in December, 2003) establishes the legal framework for harmonizing and modernizing budgetary practices across all of general government. It reduces fragmentation, provides for a more comprehensive presentation of the budget, and also allows for future decentralization of financial control to spending agencies. Finally, it extends the external audit mandate of the TCA to all general government agencies and allow for external audit of TCA itself. Expansion of TCA's mandate meets a PFPSAL II second tranche condition, while PFMC enactment would comprise a Board condition of PFPSAL III.
(D) Extra-budgetary Funds. As agreed with the Bank, most extra-budgetary funds have been abolished. However, their special accounts remained open, and so the government agreed as a PFPSAL III Board condition to close these accounts.
(E) Public Investment Program (PIP). The average completion time for a government project was reduced substantially, and an action plan for further rationalization of PIP in 2003-04 was adopted in October, 2002, meeting a second tranche condition. The plan includes quantitative targets for further reductions in average project completion time of at least 3% per year.
(G) Operational Performance. The pilot program to improve operational performance was implemented as required by a PFPSAL third tranche condition.
2. Financial Accountability
(A) Accounting Reform. The initiative to introduce modified accrual accounting in compliance with GFS requirements was partially completed, however the PFPSAL II second and third tranche conditions (new draft accounting standards issued for all government agencies, and published in the official gazette) were not fully met.
(B) Public Procurement. A new public procurement law (PPL) was enacted in January 2002, a Public Procurement Agency (PPA) was established, and amendments to the PPL to reduce the procurement thresholds in line with international practice were enacted in June 2002, meeting a third tranche condition. The Government is now working on a set of further revisions to the law as well as new procurement legislation for SEEs in the public utility sector consistent with EU requirements. The Bank is providing support to the PPA under a US$ 350,000 IDF grant.
(C) Audit Reform. A Public Financial Management and Control Law (PFMC) was passed (a PFPSAL II third tranche condition), which clarifies the responsibilities of line agencies, the MOF and the Turkish Court of Accounts (TCA). It will allow the TCA to discontinue involvement in budget execution and focus on ex-post audits, including performance audits.
3. Public Liability Management
(A) Law on Public Finance and Debt Management was adopted in March 2002. Communiques for the issuance of government guarantees and for borrowing by SEEs were published in April 2002 (meeting a PFPSAL II third tranche condition). A Communique on establishment of the middle office and a Public Debt Committee to set policy within the Treasury was reissued in January 2003 with a strong emphasis on the risk control function of the middle office. In April, 2003, Treasury published its first Quarterly Fiscal Risk Report covering risks coming from both its direct debts and contingent liabilities. A review of the government guarantee portfolio was also completed, supported by the Bank's Public Financial Management Project.
4. Public Governance
(A) A national strategy to enhance transparency and good governance in the public sector was published in March 2002, and the Freedom of Information Law envisaged under the strategy was enacted in October, 2003. Implementation of the strategy was satisfactory, a PFPSAL II second tranche condition.
(B) Work on civil service reform has progressed, with a functional review re-launched under the responsibility of SPO (meeting a second tranche condition). However, a firm timetable has not yet been set for preparation and adoption of the civil service reform strategy.

4. Significant Outcomes/Impacts:

- The legal and regulatory framework for banking activity was strengthened
- The importance of state-owned banks was diminished
- Public sector financial structure and management was strengthened and improved
- Public procurement was improved

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

- Many project benefits were achieved later than initially envisioned, or are expected to be achieved under PFPSAL III
- PFPSAL II social expenditure benchmarks were largely not met
- Vakif Bank was not privatized
- All SDIF Banks were not resolved
- While a formal tranche condition on civil service reform was fulfilled, little actual change occurred
- The project condition on introduction of modified accrual accounting in compliance with GFS requirements was not fully met
- Despite efforts to strengthen bank regulation and enhance transparency in the financial sector, the failure of Imar Bank in mid-2003 illustrated that the process was far from complete. Subsequent investigation determined

that: the bank had deposits of US$ 550 million listed on its balance sheet, whereas the actual total was US$ 5.5 billion; had not paid most of its withholding tax obligations; sold US$ 550 million in T-bills that it did not own and was not licensed to sell. Repayment of depositors will cost the Treasury about 2.2% of GNP.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments
Outcome:	Satisfactory	Moderately Satisfactory	While most relevant objectives were achieved, many were achieved later than envisioned (or are expected to be achieved under PFPSAL III). Also, the failure to achieve social expenditure benchmarks, privatize Vakif Bank, and resolve all SDIF banks detract from project achievements. If outcome had been rated at project completion, the project would have been considered unsatisfactory. However, taking into account the accomplishments since PFPSAL II closed, it is possible to consider the project as moderately satisfactory. OED consideration of PFPSAL III, if approved, will need to assess the accomplishments of that project in light of the achievements that have already been attributed to PFSAL II.
Institutional Dev .:	Modest	Substantial	Improvements in the legal and regulatory environment merit a rating of "substantial"
Sustainability :	Likely	Likely	
Bank Performance :	Satisfactory	Satisfactory	
Borrower Perf .:	Satisfactory	Satisfactory	
Quality of ICR :		Satisfactory	

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

7. Lessons of Broad Applicability:

- Historically, adjustment lending has had mixed results in Turkey. For this reason, a series of one-tranche adjustment loans, with up-front conditionality, would have been preferable to a multi-tranche loan.
- In further policy-based lending, greater emphasis should be placed on achievement of actual results, rather than simply putting into place process measures (e.g., functional review of civil service, national strategy to enhance transparency)

8. Assessment Recommended? ○ Yes ● No

9. Comments on Quality of ICR:

The ICR is of good quality. It concisely presents information on a wide range of subjects, and is objective in its assessments.