FINANCIAL MARKETS

Overview of the Financial System

Growth potential of the Turkish banking attracted over $6 billion foreign capital in 2005 and the sector is expected to grow an average 8% during 2005-20, with its asset size reaching $790 million. The potential rewards for investors include still relatively high margins in a large and fast-growing market, particularly regarding retail banking. Financial intermediation level is still very low as private sector loans to GDP is only 21% and the ratio of retail loans to GDP is about 10%. Standard & Poor bases its above said argument on the following lines:

- ✓ This market of 72 million people still has a very low level of financial intermediation.

- ✓ The drop in inflation and interest rates has sparked a vast demand for consumer borrowing during the past two years.

- ✓ Under pressure from the IMF, many reforms have already taken place in Turkey, removing key financial risk factors in the financial system. Turkey's EU convergence process should underpin further economic and institutional reform, and maintain a stabilizing force on the banking system in the future.

- ✓ The government's continued commitment to the reform process is a fundamental factor underpinning the current positive climate.

Encouraged by the strong economic growth and measures taken within the Banking Sector Restructuring Program, which was intensified in response to the 2001 financial crisis and backed by the IMF with multi billion loans, the sector has made marked progress over the last five years in developing its ability to manage risks. A new Banking Law was enacted in July 2005 as a structural benchmark of the current Letter of Intent to bring the legal framework more closely in line with EU standards.

- ✓ The market has been stabilized, completed its harmonization process with its European counterparts and adjusted its regulatory framework and operational ratios to international standards.

- ✓ The total assets of the sector, which was $130 billion at the end of 2002, increased to $295 billion as of end 2005.

- ✓ State banks have been recapitalized and restructured. The recapitalization and restructuring of the two large state banks (Halk Bankasi and Ziraat) has removed the need for short-term financing and eased the pressure on the domestic interbank market. State banks are now providers of liquidity on the money market due to their liquidity surplus

- ✓ The profitability performance of the banking sector also improved, with most Turkish banks having reported strong performances, in terms of both profits and growth. The quality of earnings is also improving with lower market-sensitive income and the earnings outlook is positive..

SUBSTANTIAL IMPROVEMENTS FOLLOWING THE OPERATIONAL AND FINANCIAL RESTRUCTURING

* Decrease in the ratio of public debt stock/GNP as per the 60% Maastricht criteria.
* Consolidation in the banking sector
* Decline in the share of state banks
* Increase in mergers and acquisitions
* Reduction of financial risk to manageable levels
* Stricter supervision by an independent regulatory board
* Improved transparency
* Improved profitability
* Strengthened capital structure
* Tighter regulations and moving towards international standards

Capital adequacy index rose to 144 in 2003 and has stayed thereabout since then, while asset quality and profitability indices improved comparatively late and continue to improve.

STRENGHTENING BANKING SECTOR, 1999-2005
Index, 1999 = 100

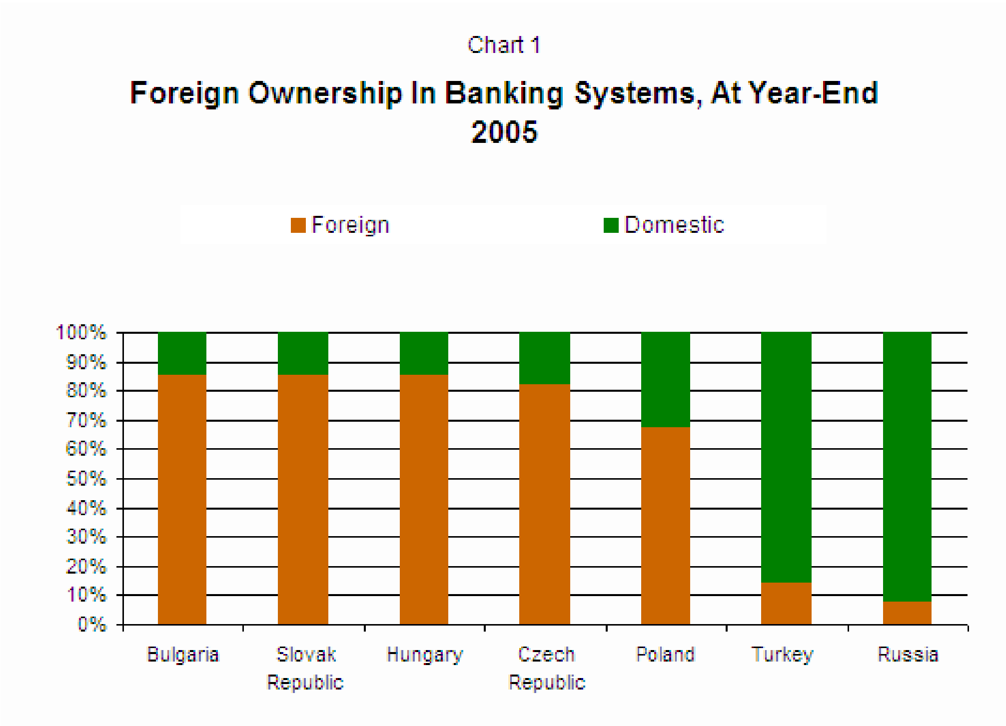
	Asset Quality	Liquidity Risk	Foreign Exch. Risk	Profitability	Capital Adequacy	Financial Strength
1999	100	100	100	100	100	100
2000	93.4	87.9	97.7	93.6	98.9	94.3
2001	73.3	91.4	120.8	87.8	113.9	97.4
2002	85.8	74.9	121.0	104.0	126.7	102.5
2003	101.0	73.4	121.8	105.7	144.0	109.2
2004	109.6	75.1	121.4	105.4	145.0	111.3
2005 May	112.6	68.6	121.4	107.0	143.0	110.5

Source: Central Bank of Turkey

Increased economic and political stability, coupled with the EU membership talks, encourages international banks to seek opportunities. 2005 has seen a number of key international banks entering Turkey through acquisitions worth $6 billion. The top transaction in the banking system came in August when U.S. General Electric Consumer Finance bought a 25.5% share of Türkiye Garanti Bankasi, Turkey's fourth biggest commercial bank, for $1.556 billion. With the acquisition, GE Consumer Finance also gained shares in 27 financial subsidiaries of the bank.

GROWING FOREIGN INTEREST IN BANKING, 2005–2006 February			
Turkish entity	**Foreign Owner**	**Owned, %**	**Deal, $ million**
Garanti Bank	General Electric Consumer Fin.	25.5	1,556
Yapi Kredi Bank	UniCredito Italiano /Koc Bank	57.4	1,460
Dis Ticaret Bank	Fortis	89.3	1,051
Turk Ekonomi Bank	BNP Paribas	50.0	217
C Kredi ve Kalkinma Bank	Bank Hapoalim	57.5	113
Basak Insurance	Groupama International	n.a.	268
MNG Bank	Dubai Islamic Bank	n.a.	160
Vakifbank	IPO	25.2	1,270
Bender Securities	Deutsche Bank	remaining 60	n.a.

Despite this increased interest, foreign participation remains limited with about 12.5% - much lower compared with more than 90% in several Eastern and Central European countries.



Source: Standard & Poor's

Foreign presence in the Turkish banking sector is expected to continue to increase rapidly. Smaller banks, with their discounted prices over book value, are prime targets in the years ahead. Merrill Lynch, which has announced its plans to open an investment bank in Turkey, will be the first foreign investment bank in Turkey. Foreign interest is expected to be directed to the state banks as well. The government is committed to privatize three state banks as per the Letter of Intent to the IMF. These banks have made significant progress at becoming leaner and developing their commercial franchise in recent years. The privatization of state-owned banks started in November 2005 with Vakifbank. Vakifbank's IPO raised $1.3 billion--almost two-thirds from foreign institutional investors--making it one of the largest listings in the emerging markets banking sector in 2005. This is expected to be followed by **the privatization** of the other two state banks - about a 30%-40% stake in Halk Bankasi will be sold via public offering in 2006, and Ziraat's privatization is scheduled to start in 2007 or early 2008.

Capital Markets

The capital markets have made rapid progress during the last two decades despite long standing macro-economic imbalances and overwhelming dominance of the public sector. As a consequence of improvements in macroeconomic indicators, both primary and secondary markets have achieved a much better performance in 2003 and 2004 compared to 2002. The value of ISE (the Istanbul Stock Exchange) National 100 Index rose almost threefold during the 2002-05 period from 10,369 to 39,776. The market capitalization for all the companies listed in ISE went up from $33.8 billion at the end of 2002 to $163 billion at the end of 2005.

Nevertheless, the degree of support by the financial services industry to investment and production activities has been low, indicating to the lack of depth and diversity in these markets. A persistently high public sector borrowing requirement, the issuance of government debt securities for financing public debts, high rates of real interest paid on these securities and high inflation rates have prevented the capital markets from improving; and have restricted the amount of funds available to the private sector.

While the ratio of outstanding Government debt securities to GNP was stable until 1991, it has significantly increased since then. Due to the banking crisis, it has established a record high by 68.5% in 2001, and decreased to 58.7% with $ 140 billion in 2003, and further to 56.6% with $169 billion in 2004.

Outstanding private sector securities mainly consist of equities and mutual fund participation certificates. Flexible and sophisticated financial instruments were difficult to introduce during the high inflation period and not all large companies are open to the public. Most Turkish firms retain their family structure, typically making only about one-quarter of the equity publicly tradable when listed. The corporate bond market is almost non-existent. The funds having transferred to the private sector via stock issues have accumulated as much as $ 26 billion since 1986.

OUTSTANDING/SECURITIES ISSUED, 1990-04
$ Million

Year	Stocks	Mutual Funds	Asset Backed Securities	Bank Bills & Bank Guarantee Bills	Other Debt Securities	Total
1990	1,576	328	0	127	377	2,407
1995	1,122	93	2,491	28	2,572	6,307
2000	4,823	4.438	0	20	0	9,281
2001	1,375	3,126	0	121	0	4,621
2002	1,060	1,597	0	55.5	71	2,758
2003	1,172	4,071	0	0	36	5,279
2004	2,690	4,621	0	0	209	7,520

Source: Capital Markets Board (CMB)

The Istanbul Stock Exchange (the only securities market in Turkey), which was opened in 1985, grew considerably in the late 1990s and has taken place among the world's major markets. However, it remained small, with 297 companies being listed and a capitalization of $98 billion as of the end of 2004. The capitalization rate is also low at about 30% of GDP. Its performance has tended to be extremely volatile, mainly because of a lack of local institutional investors. The recent establishment of private pension funds may go some way towards reducing volatility in the long term. The first pension contract has become effective in October 2003. Average daily turnover in the ISE equities market was $ 407 million and total trading volume was $ 100.2 billion in 2003. The figure indicates a 42% increase over the previous year. The corresponding values were $593 million and $147.8 billion in 2004, representing a 47.5% increase over 2003.

The ISE comprises the National Market, Regional Market, New Companies Market, Watch List Companies Market and the Real Estates Certificates Market. The number of corporations with shares traded on the ISE equities market was 80 in 1986 when the ISE was first established. As of the end of 2004, there were 274 corporations traded in the national market, 18 corporations in the second national market and 5 in watch market, making a total of 297. During 2004, twelve primary IPO's and nine secondary offerings were conducted. Market capitalization, which was only $ 938 million in 1986, reached $ 69.0 billion in 2003 and $98 billion in 2004 and $163 billion in 2005. Price earnings ratio became 13.3 and turnover ratio 182.3 in 2004.

MAIN INDICATORS IN CAPITAL MARKETS, 2004

Companies registered by the CMB (number)	625
Corporations listed on the ISE (number)	307
Corporations not listed on the ISE (number)	318
Market capitalization of corporations traded on the ISE	$98.1 bn
Investors on the ISE (number)	1,402,128
Investors of mutual funds (number)	2,633,426
Financial institutions (number)	154
Banks	42
Financial intermediaries	112
Mutual funds (number)	300
Portfolio values – Domestic	$18.3 bn
Portfolio values - Foreign	$19.9 mn
Investment trusts – number	23
Investment trusts – portfolio values	$233 mn
Real estate investment trusts – number	9
Real estate investment trusts – portfolio values	$989.3 mn
Venture capital investment trusts – number	2
Venture capital investment trusts – portfolio values	$77.2 mn
Portfolio management companies – number	21
Portfolio management companies – portfolio values	$18.1 bn
Independent Auditing Firms	83

Source: CMB (Capital Markets Board)

Recent developments regarding the capital markets included mainly the following:

- CMB finalized the harmonization of the International Financial Reporting Standards in 2003, and accordingly, all firms listed on the Exchange, as well as all brokerage houses and portfolio management firms shall be obliged to adopt these standards commencing at the beginning of 2005.
- In order to enhance the efficiency of the conduct of independent auditing, boost investor confidence and avoid any conflict of interest, the regulations that were enacted in 2002 were put into effect in 2003. Among these regulations are: the separation of audit activities from consultancy activities, the requirement that each audit firm be subject to rotation after 5 years, and that audit committees, responsible for checking for the accuracy of periodic instruments. Further, the legal infrastructure has been completed for the establishment of a new market devoted to the trading of financial instruments of Small and Medium Size Enterprises (SME). Trading will take place in an electronic trading platform similar to Nasdaq.
- The regulation on the principles of transactions and clearing of Future and Options Exchange Corp. was put into force in 2004.
- The Turkish Derivatives Exchange (TurkDEX), Turkey's first and only derivatives exchange, opened its doors in early 2005. It is headquartered in Izmir but its trading system will be remotely run from an Istanbul location.

Insurance Sector

Turkey has a fast growing insurance business, which recorded a CAGR of 15% since 1990, and CAGR of 30% since 2001. The sector continued its strong growth in 2005 as well, with domestic premiums rising by 15%, on top of a surge of 38% in 2004. A further 14% growth is expected in premium generation in 2006.

As compared with the EU countries, main indicators of Turkish insurance sector imply that the sector is still at its early stage of development, but has a great potential still not used. Insurance penetration (premiums as percentage of GDP) is still considerably low compared to the European averages. Turkey’s insurance penetration realized as 1.53% of GDP in 2004, whereas the Europe average stood at 7.9%, North America 9.2% and selected emerging markets at 3.1%. Number of insurance companies declined from 62 in 2003 to 46 in 2005. In addition, there is one reinsurance company. In the field of the private pension, there are 10 private pension companies.

Although tiny by Western standards, the sector has shown steady growth since 1990s, except 2001 when premium production decreased by over 30%. Total domestic premiums increased from $1.8 billion in 1998 to $2.6 billion in 2000. Hit by the economic recession in 2001, these fell to $1.7 billion in 2001 and $2.2 billion in 2002. Domestic direct premium grew 38% in 2004 and 15% in 2005, totaling $5,6 billion. The revaluation of the Turkish Lira against $ since 2003 has had a significant effect on these rates.

The 2001 financial crisis also provided impetus for a series of financial reforms, including measures to reform the outdated insurance regulations. The sector regained the lost ground in 2002 and currently gets prepared for an era of fierce competition. Main factors contributing to higher expectations in the insurance sector include:

- Lower inflationary environment is expected to make saving easier for the life insurance segment.

- Regulatory framework is entirely put into line with that of the EU. A recent regulation effective as of January 2003 imposes daily provisions to be allocated for unearned premiums. The infrastructure of monitoring and surveillance system has been built in electronic environment.
- The sector is currently without a Law after the abolition of the key provisions of the insurance decree by the Constitutional Court five years ago. This is seen as an obstacle to growth. The draft Law on Regulation and Supervision of Insurance Activities is planned to be enacted in 2005 and will be a major move forward.
- The Private Pension Law, which became effective in October 2003, is expected to boost the growth and also encourage the life insurance segment in the medium-to-long term.

The insurance sector has a great potential to grow, with direct insurance premiums being equivalent to 1.5% of GDP in 2005 whereas the Europea average stood at 7.9% and selected emerging markets at 3.1%. Per capita direct insurance spending in 2001 was only $25.0 (down from $40.4 in 2000), one of the lowest rates in Europe. The direct premium per capita amounted to $76.3 in 2005. Penetration rate is a mere 1% for health insurance and 5.3% for life insurance.

DOMESTIC DIRECT PREMIUM PRODUCTION, 2000-05
$

	Total (million)	**Per capita**
2000	2,642	40.4
2001	1,731	25.0
2002	2,215	31.5
2003	3,568	49.8
2004	4,935	67.7
2005	5,685	76.3

Source: Insurance Supervisory Board

Aware of the general need of Turkish financial markets for larger institutional investors and the fact that it is right time to get involved in the private pension business, many of Turkey's leading insurance firms are currently looking for foreign partners to provide them the expertise needed in this new business area and more polished marketing techniques to reach the untapped segments. Meanwhile, Basak Sigorta was acquired by the French Groupama in 2005 during the privatization process. Following Basak's tender, other acquisitions may take place.

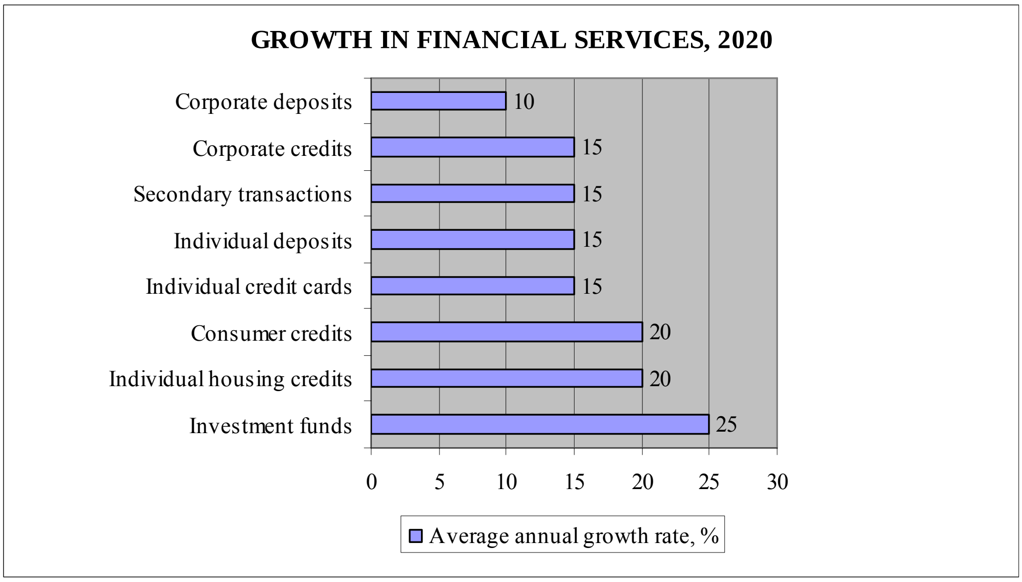
Prospects

Total banking assets will jump considerably as the GNP continues its fast growth in the years ahead. Given that product diversification, technology infrastructure and international transactions expertise are all in place anymore, what the Turkish banking sector needs at this stage of development is the cooperation with international institutions which are competitive globally. Drawing attention to the intensifying competition between Western and Middle East banks, Wall Street Journal argues that Turkey is the last frontier for which international banks have been fighting. The daily adds that the fact that banks from both world, including Citibank and Dubai Islamic

Bank, are envisaging Turkey as an investment destination, will push the bank prices further higher.

The financial sector is now preparing to operate in the single digit inflation environment, reviewing its existing strategies to remain competitive. Prospects include the following:

- The valuation of Turkish banks tripled during the past one year and they are expected to show a **strong growth performance** in the coming years. The forecast of Akbank Deputy GM is that the banking sector will grow average 7.9% per year during 2005-10 and 8.1% per year during 2010-20. "The asset size will reach $360 billion by 2010 and $790 billion by 2020, while the ratio of total assets to GDP will become 90% and 115% in 2010 and 2020, respectively."



Source: Burhan Karacam Partners

- The banking sector has great potential in terms of both **the scale and depth of** the market as indicated by **low product and channel penetration** levels compared to the EU. The ratio of total assets to GDP (81% for Turkey and 474% as EU average) and average asset size per bank ($3 billion in Turkey compared to $5.7 billion as the EU average) together indicate that the economy needs a larger banking sector with fewer banks.

TURKISH FINANCIAL SECTOR

	Assets $ billion	**Assets/GDP %**
Banks (1)	295.6	81.3
Insurance companies (2)	7.4	2.0
Financial leasing companies (3)	5.0	1.4
Factoring (4)	3.5	1.0
Investment trusts (3)	1.7	0.5
Pension companies (2)	3.2	0.9
Mutual funds (1)	21.9	6.0
Consumer finance companies (4)	1.3	0.4
REIT (1)	1.0	0.5
ISE capitalisation (1)	162,6	44.7
Central Bank (1)	67.1	18.5
Total	*575.4*	*158.3*

(1) 2005 December (3) 2005 September
(2) 2004 December (4) 2005 June

Source: Banking Regulatory Board

- **Mergers and acquisitions are expected to accelerate**. Decelerating inflation and falling interest rates will lead to a rationalization of the sector: Small banks will be forced to merge, specialize, or disappear. Large private banks, which have a real customer franchise, sophisticated IT systems, and good management, should survive and might even grow stronger and larger. A recent study by IBM Global Banking Directorate also expects competition to get stronger, leading to emergence of mega banks in the next 10-15 years. In parallel with this, the share of foreign presence will expand further. They added: "Turkish banks are simplifying procedures and this is a big change for Turkey since structure of the banking sector is wide open to changes."

- **Foreign presence** will continue to increase significantly as privatization efforts gain momentum and macroeconomic fundamentals and financial reforms pave the way.

- High **intermediation costs** will rationalize, with a gradual reduction already started in mid-2000. Financial intermediation tax will be phased out by May 2007.

- The changing competitive environment due to disinflation should lead the banks to focus on **real banking activities** rather than government securities, putting emphasis on consumer credit, SME loans, and credit cards.

- Reducing and eliminating the uncertainty caused by inflation will set the conditions for **the development of long-term credit markets and derivatives.** As of May 2005, banks have already started 3-year deposit after a long period, and deposits with over 1-year maturity increased their share from 5.5% at end-2002 to 8.6% in mid May 2005.

- **The share of public banks will diminish further,** especially with the intended privatization of Ziraat and Vakif. After downscaling the size of the public sector in financial markets, a considerable amount of resources will be available for the use of the private sector. The forecast is that share of government securities in total assets will decline and loans will constitute 47% of assets by 2007, up from 32% as of end 2004.

- Increasing wealth and rising savings will lead to demand for **more sophisticated financial products:**

  - ✓ The insurance sector has a great potential to grow given the rising demand for insurance policies. Direct insurance premiums are equivalent to about 1.5% of GDP. Per capita direct insurance spending is one of the lowest rates in Europe and penetration rate is a mere 1% for health insurance and 5.3% for life insurance. Social security reform might over time lead to the emergence of insurance and pension funds and thus for demand for long-term financial products, as it was the case in other emerging markets.

  - ✓ Improvements in macroeconomic environment will continue to show its positive reflections in the capital markets in the period ahead. Further, EU-inspired corporate governance and financial market regulation would lead to the development of a more liquid and deeper domestic bond and better developed equity market. The mortgage market is set to start formally in 2006.