



An Analysis of Global Governance: How the State and Non-State Actors Interact in the Turkish Banking Sector? ¹

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Abstract

The aim of this study is to examine the issue of local and global financial governance through the analysis of the activities of banking sector in an emerging country. The paper explores the impact of foreign bank entry, as required by the structural adjustment suggestions of the IMF on the governance structure of banks in Turkey. The potential consequences of the international regulations' implementation are analysed by taking into account the strategies of state and non-state actors and by using the game theoretical tools. The current functioning of the financial governance brings both advantages and disadvantages for all of the actors.

Keywords: *Global governance – game theory- Turkish banking sector – International Monetary Fund (IMF) – foreign direct investment*

INTRODUCTION

Foreign direct investment in the financial sectors of emerging markets increased during the 1990s. The main advantages of foreign direct investment to emerging economies, especially for those who apply structural adjustment programs as acknowledged by the International Monetary Fund (IMF), appear to be the increase in competition, in the quality of banking services, easy transfer of technology and easy access to capital. Within this context, the aim of this study is to examine the consequences of foreign direct investment, in the financial sector, in an emerging country, on the emergence of a “flexible” but efficient order expected by international financial institutions, by taking into

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account the objectives of the state and non-state actors. These latter having sometimes conflicting but sometimes converging objectives try ultimately to achieve “good governance”², while for the international financial institutions, mainly the IMF, the sum of these good governance practices could grant “global governance”³. Turkey provides a very prominent setting for analyzing the behavior and the strategies of such actors as the foreign bank entry has increased following the improvement of economic performance and the decrease in inflation after the 2001 crisis. In this perspective, the strategies of Turkey and foreign banks are determined through the use of game-theoretical approach and the interaction among them is evaluated, on the basis of the collective action framework formulated at the international level. In other words, this study, is based on the comparison between the expected governance and the concrete outcome of the achievement of governance through the analysis of the Turkish case.

The remainder of the paper is organized as follows: Firstly, the global regulation tendencies deriving from international financial institutions are studied in order to determine the principles and norms that shape the actions of state and non-state actors. Then, the rapidly changing market conditions and banking system in Turkey are described and analysed by considering the conditions of foreign bank entry to the Turkish banking sector and the transformation of this latter. Finally, the paper uses the non-cooperative game theoretical approach to analyze the interaction between state and non-state actors through the strategies of the Turkish government and foreign banks in order to evaluate the efficiency of a flexible governance as required by the IMF.

² The ‘good governance’, has been used by the international financial institutions since 1980s in order to define the criteria of good/efficient public administration in the countries subject to structural adjustment or economic stability programs.

³ We use the ‘global governance’ concept in the sense provided by James Rosenau : “a system of rule depending on intersubjective meanings, that works if only accepted by the majority” and not only emanating from official authorities but also from the proliferation of networks in a more interdependent world. James Rosenau, ‘Governance, Order and Change in World Politics’, James Rosenau, Otto Czempiel (eds), *Governance without Government*, (Cambridge: Cambridge University Press, 1992), p.4. It “encompasses the activities of governments, but also includes any actors who resort to command mechanisms to make demands, frame goals, issue directives, and pursue policies”, James Rosenau, *Along the Domestic-Foreign Frontier. Exploring Governance in a Turbulent World*, (Cambridge: Cambridge University Press, 1997), p. 145

GLOBAL REGULATION TENDENCIES SHAPING THE ACTIONS OF STATE AND NON-STATE ACTORS

The regulation of international financial activities has been one of the major functions of international organizations as the IMF, the World Bank, the Bank of International Settlement (BIS). These institutions, whatever their structural particularities, have aimed at creating cooperation between member states and sub-state institutions as central banks, in order to achieve a stable and predictable financial system. The IMF tried to coordinate different national policies by accomplishing periodical surveillance⁴ function and within specific stand-by arrangements requiring the fulfillment of benchmarks. However, the globalization process and chronic debt problems increased and transformed the IMF's role in financial governance. In order to build up an appropriate solution for unpredictable crises and to conceive preventive measures, the IMF is revising its policies and strategies. The recent approach of this organization is based on double-level surveillance in cooperation with the World Bank: firstly, as a global framework defining guidelines the Financial Sector Assessment Program⁵ (FSAP) has been launched in 1999, including also specific periodical assessments for participating countries that may have very different development levels. Secondly, a very-well known and continuously discussed instrument used by the IMF, is country-specific Structural Adjustment Programs (SAPs), involving a little group of indebted countries in which Turkey is included.

The IMF's approach on banking activities is based on the "Basel Core Principles for Effective Banking Supervision, Experiences, Influences, and Perspectives" (BCP) introduced by the Basel Committee on Banking Supervision (BCBS), in 1997. BCP comprises 25 principles that could build a

⁴ Article IV, section 3-b of IMF statutes, <http://www.imf.org/external/pubs/ft/aa/aa04.htm#3>

⁵ The FSAP comprises a wide range of countries regardless of their development levels: Albania, Algeria, Austria, Kingdom of Bahrain, Barbados, Republic of Belarus, Belgium, Bulgaria, Chile, Colombia, Costa Rica, Republic of Croatia, Czech Republic, Finland, France, Gabon, Georgia, Germany, Ghana, Greece, Hong Kong Special Administrative Region, Hungary, Iceland, Israel, Italy, Jamaica, Japan, Republic of Kazakhstan, Republic of Korea, Kuwait, Kyrgyz Republic, Republic of Latvia, Republic of Lithuania, Luxembourg, FYRM, Malta, Mauritius, Mexico, Republic of Moldova, Morocco, Republic of Mozambique, Netherlands, New Zealand, Norway, Pakistan, Philippines, Republic of Poland, Romania, Russian Federation, Rwanda, Senegal, Serbia and Montenegro, Singapore, Slovak Republic, Republic of Slovenia, Sweden, Switzerland, Tanzania, Trinidad and Tobago, Tunisia, Uganda, Ukraine, United Arab Emirates, United Kingdom

supervisory system effective in all countries. Banking system malfunctions can harm both national and international financial stability, for this reason it should be a global concern to improve and to strengthen this sector in a wide range of countries. Consequently, a competitive banking system is expected to offer good quality services. In the framework of a flexible institutionalization, the cooperation process between state and non-actors at national and international levels would constitute governance; the Basel Committee would serve as a standard-setting and coordination body. The implementation of BCP is based on pre-conditions that must be fulfilled before the assessment of various requirements. The most important of these latter states out that the supervision agencies should have “operational independence and adequate resources” and act in a “suitable legal framework” that will give them the right to authorize banking operations and that will assure for them a legal protection (principle 1).⁶ The Basel principles have been developed in time; first it has been reviewed in 2000 according to the compliance assessments achieved by the IMF in several countries. This reviewed version, the new Basel Capital Accord, is known as Basel II. Subsequently, the BCBS developed a Methodology for clarifying the interpretation of principles: “Core Principles Methodology”.⁷

As another global governance effort, in 1999, the IMF and the World Bank established the Financial Sector Assessment Program (FSAP) including banks, mutual funds, insurance companies, and foreign exchange and money markets⁸ with the objective of “reducing the potential for crisis”. The FSAP uses the instruments and methodology conceived by the BIS (BCP remains a main component of the Program), other international standard-setting bodies (International Association of Insurance Supervisors’ Insurance Core Principles, International Organization of Securities Commissions’ Objectives and Principles of Securities Regulations) and national governments.⁹ The Program has two complementary objectives: harmonization and international

⁶ BIS - Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, Basle, September 1997.

⁷ International Monetary Fund and the World Bank, *Implementation of the Basel Core Principles for Effective Banking Supervision, Experiences, Influences, and Perspectives*, September 23, 2002, p. 7, http://www1.worldbank.org/finance/assets/images/Effective_Banking_Supervision.pdf

⁸ Paul Hilbers, *The IMF/World Bank Financial Sector Assessment Program*, 2001 <http://www.imf.org/external/np/vc/2001/022301.htm>

⁹ World Bank/IMF, *Financial Sector Assessment: A Handbook*, (Washington, DC: World Bank, 2005), p. 3-8

convergence of financial policies, included financial development (function of the World Bank) and effective surveillance of national systems for participating countries (function of the IMF). The framework program comprises an analysis of stability and development of the financial sector. Within this context, *financial stability* is defined as circumstances eliminating insolvency risks, assuring the avoidance of financial sector failures that would harm services like deposits, insurance, loans to investors... *Financial development* is the strengthening process of financial services in order to satisfy the needs of economic agents and achieve economic growth. However, it is accepted that such development may be “orderly” or “disorderly”.¹⁰ While the “orderly” development refers to the smooth and relatively safe and sound movement of financial actors and of the capital flows, the “disorderly” development may derive from sudden and speculative movements having potential to entail financial instability. This orderly or disorderly character of the development is closely related to the stability policies due to the costs of “regulatory compliance” and their side effects on the financial market. Equally, development instruments may possibly increase macro-economic and financial risks. Such concerns, although conceived on national level, constitute the basis of a global approach¹¹.

Consequently, we can describe the overall approach of the IMF (the adoption of Basel guidelines and the implementation of the FSAP), as a “programmatic regime”: a sum of “integrated monitoring and assessment programs designed to broaden and deepen common knowledge about the problems that regimes address” accomplishing the “regulatory” and “procedural” characters of the international monetary regime¹².

The SAPs undertaken by IMF can be considered as another effort to govern the international financial system. The conception of SAPs takes its roots from the successive crises in the 1980’s occurred in Latin America countries. Furthermore, new crises in 1990’s and at the beginning of 2000’s, forced the IMF to provide these programs as the basis of global financial governance, of

¹⁰ Susan Strange, *States and Markets*, Second Edition, (London: Pinter, 1994), p. 98.

¹¹ The FSAP lays also a great stress on the concept of governance infrastructure based on legal and institutional provisions deriving from international codes such as the Fund’s Code of Good Practices on Transparency of Monetary and Financial Policies, International Financial Reporting Standards and International Standards for Auditing, OECD’s Principles of Corporate Governance and New Basel Accord.

¹² Oran Young, *Governance in World Affairs*, (New York: Cornell University Press, 1999), pp.29-31

the convergence of best international practices. Generally, the SAPs, have been accomplished in two periods and supervised by the IMF and the World Bank. The first period has aimed at ensuring economic stability in short term. In the second period the economic structure has been “adjusted” for a complete liberalization. The banking system is one the initial sectors to be transformed: the privatization would be achieved by limiting the government control over commercial banks and the control of the central bank over monetary policy. Although the privatization is required, the reforms ask paradoxically the government to be more active during a transition period in order to restructure public institutions and facilitate a fair competition in the financial market for private agents. The following obligations for the government demonstrate the steps of public withdrawal: (1) to strengthen the legal framework by supporting regulations for banking activities; (2) to reduce the role of public actors in favor of intermediate, independent institutions; (3) to privatize public sector banks and prepare them before privatization in order to increase their “operational efficiency and to ensure level-playing field competition in the banking sector”¹³; (4) to integrate liquidated and intervened private banks within public banks or to restructure them by independent financial institutions, including the value of their assets based on market rates; (5) to lift blanket guarantee (to remove general bank guarantee) and replace it with limited protection deposit; (6) to lower financial transaction taxes including exemption from value-added tax for specific sales; (7) to attend to the soundness of private banking sector (increases in capital and reduction of risks), to “sustain the profitability and the capital adequacy levels of the banks”¹⁴; (8) to reduce intermediate costs to facilitate the access of the real sector to financing opportunities; (9) to enhance the investment climate for efficient privatization, including the strengthening of corporate governance.

We can also add some political changes mentioned in the “Supervisory Guidance on Dealing with Weak Banks”¹⁵ and which can be implemented by countries in the framework of the stand-by arrangements concluded between them and the IMF. These changes consist of merger or acquisition possibilities for weak commercial banks by healthy banks, which is a factor increasing foreign bank investments in financial markets, the intervention of public funds to provide liquidity or, if necessary solvency support.¹⁶

¹³ Turkey—*Letter of intent*, April 2, 2004, <http://www.imf.org/external/np/loi/2004/tur/01/index.htm>

¹⁴ Turkey—*Letter of intent*, April 5, 2003, <http://www.imf.org/external/np/loi/2003/tur/01/index.htm>

¹⁵ This document was adopted by Bank for International Settlements in March 2002.

¹⁶ BIS - Basel Committee on Banking Supervision, *Supervisory Guidance on Dealing with Weak Banks*, March 2002, pp. 1-2.

FINANCIAL SYSTEM IN TURKEY AND FOREIGN BANK ENTRY

Before conducting our analysis in the next section, we provide a brief overview of the banking sector in Turkey, focusing on foreign bank entry. It has been an important number of entries and exits (domestic and foreign) in Turkish banking market since 1980. The introduction of the liberalization process in 1980, 1994 crisis and 2000 & 2001 crises can be considered as three watershed for the Turkish banking system. During these crises periods, more specifically, in the post-crises stages, Turkish government has always been assisted by the IMF in order to find recovery opportunities.

The liberalization process of Turkey started at 1980's along with a stabilization program, which had been developed according to neoclassical model, aiming not only the stabilization with export-led recovery but also the liberalization of the Turkish economy. The execution, which started with foreign trade continued with domestic financial market and foreign capital movements. Especially, after 1984, external capital movements begun to be liberalized substantially. In the same year, Turkish residents were allowed to open foreign currency accounts in banks. Then, in 1989, the biggest changes were occurred¹⁷: (1) Turkish residents were allowed not only to buy foreign exchange from financial institutions including banks but also to buy securities abroad and to transfer the foreign exchange required to purchase such securities abroad. (2) Non-residents were allowed not only to buy and sell Turkish securities but also to transfer income and sales proceeds of these securities abroad through financial institutions including banks. (3) Turkish commercial banks were permitted to extend credits denominated in foreign currency to foreign trade companies. These were important changes considering the earlier constraints on financial markets¹⁸. Due to these changes, a significant number of banks, both Turkish and foreign, entered Turkish banking sector and sectoral concentration decreased. In 1980, the Turkish banking system was composing of 12 state-owned, 24 privately-owned and 4 foreign-owned commercial banks and 3 development and investment banks. Until 1993, the number of state-owned commercial banks decreased to 6, while the number of privately-owned commercial banks increased to 32. However, the most significant increase was on the number of foreign-owned

¹⁷ Oğuz Esen, 'Financial Openness in Turkey', *International Review of Applied Economics*, Vol:14, No:1, 2000, pp:5-23

¹⁸ Cevdet Denizer 'Foreign Entry in Turkey's Banking Sector, 1980-97', Mimeo, The World Bank, 1998 <http://www.econturk.org/wbank1.pdf>

commercial banks. At the end of 1993, the number of these latter was 20. Most of them were large European, American or Middle Eastern banks. In terms of market share, the situation was changed in favor of privately-owned commercial banks. Between the period 1980-1993, while the market share of state-owned commercial banks (in terms of total assets) decreased by 7,2%, the same ratio increased by 8,1% for privately-owned commercial banks. Between 1980 and 1994, the structure of uncompetitive, bank-dominated financial sector was begun to change, especially by the reopening of the Istanbul Stock Exchange in 1985¹⁹.

Unfortunately, in early 1994, a severe currency crisis occurred in Turkey. It can be claimed that 1994 crisis was the result of the failure of an exchange rate-based stabilization program followed up by Turkish government. Along the 1994 crisis, the confidence towards the Turkish financial system was completely broken down. The banks, with large open positions in terms of foreign exchange, moved towards foreign exchange market. Consequently, The Central Bank of Turkey decided to intervene into the foreign exchange market for preserving the parities. In spite of the intervention of the Central Bank, the parities were disturbed and the USD/TL parity, which was around 14500 at the first day of 1994, reached 35000 by the end of April 1994. The main result was the liquidation of three commercial banks (Marmara Bank, TYT Bank, Impexbank) with the decision of the government²⁰. Thereafter, Savings Deposits Insurance Fund (SDIF) decided to increase the level of “deposit insurance” to %100, in order to protect the depositors from the negative effects of financial crisis. The aim was to prevent the risk of deposit runs and to preserve the market discipline. However, deposit insurance, itself, can be considered as an important contributor to several bank failures. Deposit insurance subsidizing risk-taking has the potential to create “moral hazard” and “adverse selection” problems. More specifically, the banks with insured deposits may prefer to assume more risk than they would otherwise. Then they may invest the proceeds in risky assets with expected yields²¹. Due to such a

¹⁹ The first stock exchange dates from 1866 (Dersaadet Tahvilat Borsası). The second one (İstanbul Menkul Kıymetler ve Kambiyo Borsası) has been created in 1929 as an institution that would support the ‘national’ economy.

²⁰ Bülent Şenver, ‘Banka Krizi’, *MUFAD Muhasebe ve Finansman Dergisi*, 9(January), 2001, pp. 22-24.

²¹ Michael C. Keeley, ‘Deposit Insurance, Risk and Market Power in Banking’, *The American Economic Review*, Dec. 80 (5), 1990, pp. 1183-1200; David C. Wheelock and Subal C. Kumbhakar, ‘Which Banks Choose Deposit Insurance? Evidence of Adverse Selection and

regulatory environment, Turkish banking sector became an attractive target for the opportunistic investors. Consequently, Turkish banking sector witnessed successive ownership changes and new entrants between 1995 and 1999. The total number of banks, in the Turkish banking sector, was increased from 68 to 81, in this period. The year of 1997 might be remembered as a year in which the first bank failures were occurred. Towards the crises of 2000 & 2001, due to capital inadequacy and improper management, several private banks were failed.

The crises that started in Turkey in November 2000 and aggravated in February 2001 can be considered as a consequence of the distortions in the real sector and the financial sector at the same time.²² These crises, occurred in a financially liberal environment, are stimulated by the unsustainable policy followed up by governments. The Turkish lira came under pressure toward the end of 2000 as a result of continuous budget deficits and extreme inflation that remained at 60 percent in 2001. Though their reasons were similar, the intensity of the consequences of 1994 crisis and of the recent 2000 and 2001 crises were not the same. For instance, while the number of failed banks after the 1994 crisis was only three, the last crisis, which can be considered as the worst one that the Turkish Republic had ever witnessed, had severe consequences. The most obvious impact was on the banking sector where successive cases of financial fragility took place. As a consequence of the latest financial crisis, the number of banks operating in Turkey decreased to 61 in 2001, from 81 in 1999. In the meantime, Turkish government made some attempts to reform the banking sector within the context of a three-year IMF-led austerity program initiated in December 1999. The foundation of BRSA in 1999 by the Banking Law approved in June of the same year can be considered as a milestone for the Turkish financial system in good governance terms. With the new structure, the BRSA took the role of monitoring the conditions of all banks operating in Turkey²³.

Moral Hazard in a Voluntary Insurance System', *Journal of Money, Credit and Banking*, 27(1), 1995, pp. 186-201.

²² For further information see Fatih Özatay and Güven Sak, 'Banking Sector Fragility and Turkey's 2000-01 Financial Crisis', *The Central Bank of the Republic of Turkey Research Department Discussion Paper*, Ankara, September 2003.

²³ Ahmet Faruk Aysan and Hüseyin Al, 'Assessing the Preconditions in Establishing an Independent Regulatory and Supervisory Agency in Globalized Financial Markets: The Case of Turkey', *Munich Personal RePEc Archive Paper No. 5481*, 2006, <http://mpra.ub.uni-muenchen.de/5481/>

Following the “Banking Sector Restructuring Program” launched after the crisis in 2001, in January 31, 2002, Turkey and IMF have signed another stand-by agreement and the “Law on Restructuring of the Debts to the Financial Sector and Amendments to Some Laws No: 4743”, is established in order to reshape the legal framework of the restructuring of the debts of firms to banks and to strengthen the private banks’ capital. Within this framework, necessary legislation and institutional arrangements were adopted in order (1) to ensure the institutional and operational restructuring of the state banks and to enable them to participate in the restructuring process of the debts to the financial sector; (2) to accelerate the follow-up and collection proceedings of the banks in the SDIF in terms of receivables and to strengthen the organizational structure of SDIF; (3) to provide capital support for strengthening the capital structures of the privately-owned banks.²⁴ In the IMF letter of intent dated April 26 2005, the Turkish government undertook to introduce a new banking law that would improve the sector's supervisory and regulatory framework. Accordingly, the government adopted the Banking Law, No:5411 in October 2005. This law provides a regulatory framework in compliance with international standards and EU directives and introduces many new concepts to the Turkish banking system. These new concepts are as follows: financial holding companies, BRSA’s regulation, effective supervision, corporate governance and BASEL II Accord²⁵.

After the 2001 crisis, the most significant change in the Turkish banking sector is the increase in foreign bank penetration. This penetration occurred and still continues to occur as foreign direct investment through the full acquisition of Turkish banks or via strategic partnerships²⁶. The market share,

²⁴ www.tbb.org.tr

²⁵ Hergüner Bilgen Özeke, ‘Turkey: The New Banks Act’, *International Financial Law Review*, 2005, <http://www.iflr.com>

²⁶ Firstly, the HSBC Group acquired Demirbank TAŞ in October 2001. In October 2002, Koç Financial Services finalized a 50/50 partnership with UniCredito Italiano (UCI). In 2003, BankEuropa A.Ş. is launched as Millenium BCP’s investment in Turkey. The French banking group, BNP Paribas, finalized on 10 February 2005 the purchase of a 50% stake in TEB Mali Yatırımlar A.Ş. In July 2005, Fortis acquired the full ownership of 89.34% of the shares of Dışbank from majority shareholders. On December 23rd, 2005, Dođuş Group and General Electric Consumer Finance (GECF) signed an agreement to form an equal partnership in Garanti shareholding. Under the terms of the agreement, GECF acquired half of Garanti Bank's ordinary shares held by Dođuş Group - a 25.5% stake. In April 4, 2006, Fiba Group announced the sale of 46% of the ordinary shares and of 100% of the founder shares of Finansbank to National Bank of Greece. In April 2006, Koç Financial Services increased its shareholding in

in terms of total assets, of fully foreign owned banks in the Turkish banking market increased to %15,5²⁷ (as end of 2007) from %3 (in 2002).

GAME THEORETICAL ANALYSIS OF STRATEGIES OF ACTORS INVOLVED IN THE TURKISH BANKING SYSTEM

As previously stated, a non-cooperative game theoretical approach is used in this study to analyze the interaction between state and non-state actors through the strategies of the Turkish government and foreign banks in order to evaluate the efficiency of a flexible governance as required by the IMF. The choice of the non-cooperative approach is derived from the fact that the objectives of state and non-state actors may be intrinsically conflicting since one is focusing on public good while the other is profit-oriented. This approach requires, first of all, the determination of the potential gains and losses of the involved actors in order to understand their strategies. Secondly, this approach imposes the

Yapı ve Kredi Bankası A.Ş. to 67.3% through the acquisition of an additional 9.9% Yapı ve Kredi Bankası A.Ş. shares by Koçbank. Shareholders of both Koçbank and Yapı ve Kredi Bankası A.Ş. approved the merger of the two banks on 21 September 2006 through their Extraordinary General Assemblies. Finally, on 2 October 2006, the legal merger process was completed. Koçbank was dissolved, and all its rights, receivables, obligations and liabilities were transferred to Yapı Kredi. The new combined legal entity retained the Yapı Kredi name. On January 9, 2007, Citigroup and Akbank announced that they have successfully completed the acquisition by Citigroup of a 20% stake in Akbank. In June 2006, Şekerbank signed a Partnership Agreement with Bank Turan Alem (financial group in Kazakhstan) to sell its 33,979% of shares to BTA. In March 2007, the partnership agreement is successfully accomplished. Eurobank EFG acquired a 70% stake in Tekfenbank with the Tekfen Group maintaining its strategic partnership with a 30% share. The legal process is completed on 16 March 2007. In September 2006, Arab Bank Plc and BankMed Sal applied to the Turkish regularity authorities to acquire % 91 shares in MNG Bank. On December 28, 2006 the BRSA approved the transaction. Thus the new shareholder structure became as follows: Arab Bank Plc %50, BankMed Sal %41 and Mehmet Nazif Günel %9. Subsequent to acquisition by the new shareholders, the Bank's name was changed to Turkland Bank A.Ş. as from April 3, 2007. Besides these Turkish banks having already established the partnerships with foreign banks, there are also foreign banks having branches in Turkey. As of end of April 2006, the names of these banks are as follows: ABN AMRO Bank N.V., Banca di Roma S.P.A., Bank Mellat, Habib Bank Limited, JPMorgan Chase Bank N.A., Société Générale (SA), WestLB AG. On the other hand, the total number of foreign banks founded in Turkey is equal to six as of end of April 2006: Arap Türk Bankası A.Ş., Citibank A.Ş., Deutsche Bank A.Ş., Fortis Bank A.Ş., HSBC Bank A.Ş. Finally, as of the same date, there are two foreign development and investment banks founded in Turkey: Calyon Bank Türk A.Ş. and Taib Yatırım Bank A.Ş.

²⁷ This ratio is calculated by the authors based on the following document: 'Turkish Economy and Banking System in 2007, Banks in Turkey 2007, <http://www.tbb.org.tr/english/book2007/2007.a.sp>'

analysts to designate the players among various actors since some overlaps of their gains and losses may entail coalitions between them.

Expectations of State Actors

The expectations and risks are classified according to the major state and non-state actors involved in the Turkish banking system which are the Turkish government, IMF and the local and foreign banks operating in the Turkish banking sector. In fact, the expectations of state actors, i.e. the IMF and the Turkish government can be considered as converging since both of them undertake similar pathways though their ultimate goals are not the same. For instance, the capital accumulation will have a positive impact on real sector and will, in turn, increase the wealth level of Turkey, while the same capital accumulation will be beneficial for the IMF, since it will reduce the risk of default on the loans granted by the IMF to Turkey. The other expectations of state actors from the foreign bank entry to the Turkish banking system can be summarized as the increase in competition, the privatization of state-owned banks, the improved regulatory and supervisory environment, the reduced credit risk, the decrease in the probability of domestic shocks, the adoption of advanced and standardized risk management techniques, which lead to better corporate governance practices.²⁸

In general, global banks can be considered as a source of new capital for a banking sector in crisis. In addition, the presence of international banks may motivate other foreign firms to consider investing in the host country. Therefore, the presence of well-capitalized foreign banks may reduce the severity of domestic shocks in the host country. Consequently, the stability of the overall economic system of the host country increases.²⁹

Expectations of Non-State Actors

As opposed to the case of state actors, the non-state actors' (domestic banks and foreign banks) ultimate goals are common: wealth maximization. However,

²⁸ BIS, *Foreign direct investment in the financial sector – experiences in Asia, central and eastern Europe and Latin America*, Committee on the Global Financial System, No: 25, June 2005; BDDK, 'Bankacılık Sektörüne Yabancı Giriş: Küresel Gelişmeler ve Türkiye' [The Entry of Foreign Capital to Banking Sector: Global Developments and Turkey], *ARD Çalışma Raporları* [ARD Working Papers], 2005/6

²⁹ Joe Peek and Eric S. Rosengren, 'Implications of the Globalization of the Banking Sector: The Latin American Experience', *Federal Reserve Bank of Boston*, June, 2000, pp. 145-170

the impact of internationalization of the banking market may eventually be different for each of them. Foreign banks' rational owners aiming at increasing their wealth level invest in Turkish banks in order to profit from the advantages of an emerging market. Regarding the Turkish banks' owners, bearing capital scarcity, it could be preferable to benefit from the current attractive position of the banking market, by selling their properties totally or partially to the foreigners. In the medium term, foreign entry will potentially change the structure of the Turkish banking market in favor of foreign banks, which may hold a dominant position shaping the future of Turkish financial system. Finally, it can be said that although the impact of the ultimate goals of local and foreign non-state actors may be different, their expectations are not totally divergent. For instance, whether their participation is in the form of full ownership of banks or joint ventures with domestic banks, foreign financial firms may provide significant competitive pressure on domestic banks³⁰. Such a pressure may stimulate domestic banks to reduce costs and increase efficiency³¹. Competitive pressure will also motivate the small and medium sized Turkish banks to restructure themselves. On the other hand, foreign-owned banks may demand improved systems of regulation and supervision from the regulatory authorities in the host countries. Consequently, foreign bank entry may provide a better-constructed regulatory and supervisory environment³². In a better-regulated and supervised environment, Turkish banks may engage in more fair competition with multinational banks.

Risks Faced by State Actors

As in the case of expectations, risks faced by state actors are convergent. Some negative impacts of foreign bank entry may endanger the ongoing reform process required by the IMF. Crisis potential may put at risk not only the Turkish government but also the IMF. More specifically, multinational banks, despite an image of soundness and stability, may create the speculative bubbles that sooner or later lead to financial crises. Moreover, these latter may also be contagious. For instance, Japanese multinational banks had speculated

³⁰ Nicholas R. Lardy, 'Foreign Financial Firms in Asia', Unpublished paper presented at Brookings/World Bank/International Monetary Fund Conference: *Open Doors: Foreign Participation in Financial Systems in Developing Countries*, 2001

³¹ Robert Lensink and Niels Hermes, 'The Short-Term Effects of Foreign Bank Entry on Domestic Bank Behavior: Does Economic Development Matter?', *Journal of Banking and Finance*, 28, 2004, pp. 553-568.

³² *Ibid.*

in real estate in Thailand in the early 1990s with the objective to recover the losses incurred in Japan in the late 1980s. Such an attempt had contributed to the financial crisis in Thailand in 1997. Thus, it does not necessarily mean that multinational banks finance always, sounder projects than domestic banks. Moreover, if the actions of multinational banks compel less well-capitalized domestic banks to engage in speculative operations to remain competitive, domestic financial systems may be destabilized.³³ If the foreign entrance to the banking sector remains at an unmanageable level, in other words, if the deregulation creates an uncontrollable environment, Turkey may be endangered with a new financial and economic crisis. If the deregulation, within the framework of governance required by IMF, becomes unmanageable and the actors shape the sector according to their special interests, the host country's government's intervention becomes difficult. Therefore, the cost of the crisis increases. On one hand, increased cost of crisis makes Turkey more dependent to the IMF; on the other hand, a new financial and economic crisis is desired neither by IMF nor by Turkish government. Additionally, it seems that foreign banks may transfer the proceeds of financial activities to their home countries or to the more attractive countries. In such a case the income transfer objective of foreign banks will be incompatible with the Turkish government's objectives. Another important aspect of foreign entry is about the SMEs. Foreign banks may focus more on serving multinational corporations from their home country³⁴ and may be reluctant to finance risky SMEs. The unwillingness of foreign banks to finance the SMEs may jeopardize the survival of SMEs in Turkey, which is evidently not a desirable case for Turkish government.

Risks Faced by Non-State Actors

Although the risks faced by domestic and foreign banks are of the same kind, their impacts on their market positions may be different. For instance, if the economic conditions in the host country are not improved as expected by the foreign banks, these latter may prefer to leave the host country. Nevertheless, domestic banks, not having the chance of leaving the market easily, may find themselves in a worsened situation. The same consequences may be observed

³³ Christian E Weller and Adam Hersh, *Banking on Multinationals*, (Washington D.C.: Economic Policy Institute Issue Brief. No. 178. 2002)

³⁴ M. Sabi, 'An Application of the Theory of Foreign Direct Investment to Multinational Banking in LDCs', *Journal of International Business Studies*, fall 1988, pp. 433-447

in the case of unstable political conditions and unfavorable changes in regulatory environment.

The Interaction between Players' Strategies

In our analysis, we consider as “players” the state actor (Turkey, which is subject to the IMF’s requirements) and the non-state actors (foreign banks). Firstly, the motivation of choosing Turkey as the state actor derives from the fact that Turkey represents the implementation authority, which is supposed to behave in accordance with the IMF’s structural adjustment program. In other words, the IMF only proposes the framework for action, while Turkey develops strategies and acts by taking into account this framework. Moreover, the suggestions of the IMF may not be compatible with the national interests or populist policies of governments. In such a case, Turkey’s strategic choices may not be well-suited with the IMF’s expectations.

Secondly, we consider the foreign banks as the opposite player. We decide to neglect the role of domestic banks due to the fact that they are only exposed to the state actors’ governance requirements and also they have to rearrange their activities in accordance with the foreign bank entry. In other words, domestic banks are dominated by the new structure of the “internationalized” market, rather than shaping the market.

Under these circumstances, we define the pay-offs of the players (the values we assign to their preferences) as follows:

- “4” is the most preferred outcome for the players;
- “3” signifies a situation in which players want to get expected gains but there is a factor that can reduce the gains;
- “2” reflects a situation in which players incur losses to some extent;
- “1” is the less preferred outcome for both of the parties since maximum losses are valid for both of them.

Analysis of Expected Situation

In the light of the requirements of IMF stand-by arrangements and the guidelines of BIS, the interaction between Turkish government and foreign direct investment in the banking sector is expected to bring good governance, stability and preventive capacities before any financial crisis occurs. Within this

framework, the players will act according to the following set of preference orderings:

Turkey

“4”: The factors such as increase in capital injection, competitive pressure, improvements in regulation and supervision, decrease in state dependence, reduced credit risk enhance the stability and reduce the probability of domestic shocks. In such an environment, the disbursement of debts to IMF will be facilitated as well as the economic recovery.

“3”: If the support of public banks continues as a result of the strategic choice (populist policies) of Turkish government, the reforms on regulatory and supervisory mechanisms may be postponed. Such a support may increase the cost burden of the Turkish government.

“2”: As the foreign banks continue to consider the host country risk and choose to serve large size, less risky firms, highly risky small and medium size enterprises will be deprived from foreign banks’ funds, or the cost of financing for them will increase dramatically. Therefore, the role of small and medium sized enterprises in economic recovery will remain limited.

“1”: Turkish government may occasionally suspend the application of some reforms in regulatory and supervisory mechanisms because of the reasons such as electoral benefit expectations. In such a case, foreign owned banks may transfer all of their investments, totally or partially, to more attractive countries. This capital outflow may jeopardize the financial and macroeconomic situation of Turkey.

Foreign-owned Banks

“4”: In a stable politic and economic environment, foreign banks will benefit from the supervision and regulation reforms provided by Turkish government and will perform in a more transparent sector. Thus, they will reach their wealth maximization objective.

“3”: If foreign banks continue to consider host country risk and concentrate heavily on risk free corporate clients, this may create decrease in their profit margins. (high profile/low profile customer discrimination)

“2”: If the privileged circumstances for public banks continue, foreign banks may be deprived from serving publicly supported sectors, which in turn, reduce their expected benefits. Therefore, they may transfer a part of their investment to more attractive markets.

“1”: Foreign banks engaging in speculative operations in Turkish markets may destroy the financial stability. Such instability may jeopardize the situation of foreign banks themselves. Therefore, foreign banks will either have to bear the cost of crisis or have to leave the market without reaching the expected benefits.

These preference orderings create a “harmony game”³⁵ in which the Nash Equilibrium³⁶ and the Pareto Optimum³⁷ are coinciding in the outcome of mutual common interest.

TURKEY

	common interests (implements supervisory and regulatory reforms)	individual interests (does not implement supervisory and regulatory reforms)
FOREIGN BANKS	<p>common interests (favors stable environment) 4,4</p>	<p>2,3</p>
<p>individual interests 3,2 (makes high profile/low profile customer discrimination)</p>		<p>1,1</p>

³⁵ A ‘harmony game’, represents a case of mutual respect and beneficial common interests among players. However, this may not mean that the cooperation is desired for altruistic concerns, but eventually due the fact that they can only maximize their individual utilities by cooperating. Vinod K. Aggarwal and Pierre Allan, ‘Preferences, Constraints and Games: Analyzing Polish Debt Negotiations with International Banks’, Pierre Allan, Christian Schmidt (eds), *Game Theory and International Relations*, (Cambridge: Edward Elgar, 1994), pp. 9-49.

³⁶ John Nash defined his non-cooperative equilibrium as “a profile of strategies, one for each player in the game, such that each player’s strategy maximizes his expected utility payoff against the given strategies of the other players. John Nash, ‘Equilibrium Points in n-Person Games’ (1950), cited by Roger B. Myerson, ‘Nash Equilibrium and the History of Economic Theory’, *Journal of Economic Literature*, Vol. XXXVII, September 1999, pp. 1067-1082.

³⁷ The Pareto optimality is a competitive equilibrium that ‘means that no one individual can be made better off without making someone else worse off’. Gary Romp, *Game Theory. Introduction and Applications*, (New York: Oxford University Press, 1997), p. 4.

Consequently, the players need to act in conformity with the expectations of others in order to maximize their returns. Therefore, their common interests are so fully harmonious that to forward some of the individual interests may entail losses for themselves as well as the counterparts.

Analysis of Current Situation

Following the crisis in 2001, in the light of the requirements of IMF from Turkish government, the penetration of foreign banks to Turkish banking sector is increased. Under these circumstances, both Turkey and foreign banks have chosen to promote the private priorities although having common interests. We can summarize their strategies and related pay-offs as follows:

Turkey

“4”: Although the market share of public banks continue to decrease in the Turkish banking sector, the government prefer to hold some of the large public banks probably in order to continue to have some power over the financial intermediation process.

“3”: The Turkish government tries to accomplish all necessary supervisory and regulatory arrangements. Under these circumstances, a massive entry of foreign banks into to the Turkish banking sector (which is significantly observed in 2006 and 2007) may jeopardize the competitive situation of Turkish banks.

“2”: The decrease of the market share of public banks limits the decisive power of the Turkish government on the financial intermediation process. As foreign banks choose to finance less risky corporate firms, Turkish risky SMEs are deprived from sufficient credit lines or the cost of funding is very high for them, which endanger the development of the real sector and sustainable economic development.

“1”: The current debate in Turkey concerning the increase in foreign penetration is focused on the potential compromises of the Turkish state. For instance, some argue that the growing presence of foreign banks may threaten the application of autonomous economic policies. In other words, actually there is such a risk that, in the short term, the reaction of the supporters of nationalism may lead the government to bring some restrictions on foreign bank entry and to fail, voluntarily or unwillingly, to apply the regulatory and supervisory reforms. Within this framework, capital injection may be limited,

existing foreign investors may leave the country, and therefore financial instability may force the government to negotiate for further arrangements with the IMF, the creditworthiness of Turkey may be reduced.

Foreign-owned Banks

“4”: As rational economic agents, the priority of foreign banks is to meet their individual interests: to operate in a stable, less risky environment dealing with large corporate firms and reach wealth maximization in a less risky way, therefore they do not prefer to finance risky SMEs.

“3”: Although the foreign banks behave in accordance with the expectations of Turkish state by respecting the “fair competition” rules, they are constantly subject to “instability” (political, economic) risk.

“2”: Sometimes The Turkish government may not behave in compliance with the private interests of the foreign banks due to political and economic constraints such as a regional security problem (i.e. Irak) that forces Turkey to intervene, therefore the situation of foreign banks may be endangered and their profit margins may be reduced and they may leave the market reluctantly.

“1”: The failure of Turkish government in the proper application of regulatory and supervisory reforms and the potential restrictions on foreign investments may entail an unstable economic environment. In such a case, foreign banks continuing to have minority position in the Turkish banking market may distort the financial market by engaging in short-term operations including the speculative actions. Consequently, they may endanger even their own profits.

These preference orderings create a “chicken game”³⁸ in which there are two Nash Equilibria. Therefore, there are two possible outcomes in which Turkey or foreign banks prevail by pursuing their individual interests.

³⁸ A chicken game represents a situation in which two players pursue reckless behaviour against each other in order to force the counterpart to retreat and where the solution of the game depends on their asymmetrical power.

TURKEY

	common interests (implements supervisory and regulatory reforms)	individual interests (does not implement supervisory and regulatory reforms)
common interests (favors stable environment) 3,3		2,4
FOREIGN BANKS		
individual interests 4,2 (makes high profile/low profile customer discrimination)		1,1

These outcomes and their possible results can be evaluated as follows:

If foreign banks prevail: In this case, Turkish state, thinking that they are aligned with the interests of foreign banks, makes the necessary reforms, in terms of economic and regulatory infrastructure, in Turkish banking system and accordingly, continues to privatize the public banks. The major expectations of Turkish state from such an effort are the increased capital inflow and the sustainable economic growth. However, foreign banks may behave in contradiction of the expectations of Turkish state and may not only make customer discrimination (high profile/low profile) which in turn limits the development of the real sector consisting considerably from SMEs, but also generate speculative movements, which may trigger economic crisis. In such a case, the counterattack of Turkish government may come out in several ways. One of the defensive policies may be to take measures in order to dismiss the foreign banks. For instance, Turkish state may restrict the weight of foreign banks in Turkish banking system in terms of several criteria such as total assets, total deposits, total capital, etc. Such an endeavor of Turkish state may inevitably create capital outflow from Turkey, liquidity crisis and economic downturn. Nevertheless, the negative outcomes should not be envisaged only from the Turkey's side but also from the foreign banks' aspect. Consequently, the investments and the expected benefits of foreign banks having direct investments in Turkey may be jeopardized.

If Turkey prevails: While making reforms in banking sector, Turkey looks after only its own national interests. For example, although the Turkish government tries to limit the market share of public banks, it continues to hold some of the large public banks in order to preserve some decision power. Moreover, the Turkish government may, sometimes, be obliged to behave in contradiction with the expectations of foreign banks. In other words, political and economic circumstances may impose the Turkish government to make policy choices that may create short-term crisis. In such a case, the losses of foreign banks will depend on the type and the amount of their investments in Turkey. For instance, while foreign banks having direct investments in Turkey may be affected negatively, the banks having only portfolio investments may benefit from the increased real interest rates as a result of economic instability.

CONCLUDING REMARKS

This paper encourages policy makers of state and non-state actors to evaluate the uncertainties brought by the foreign bank entry to national financial markets and provides a discussion basis by representing different perspectives. These different perspectives derive from the existence of various actors having both complementary and conflicting objectives.

Firstly, though the IMF aims to establish an order in the financial sector of sovereign states, the loans that the IMF grants are not free of interest. It means that there exists a relationship based on mutual interests between the IMF and the member states in need of financial and structural support, like Turkey. More specifically, this latter obtains necessary liquidity and solvency capacity while the IMF benefits from the situation in various ways:

- It establishes an order and stability in the global financial sector, by supporting the most problematic countries and therefore takes the necessary measures in order to prevent further crises, which may have contagious effects.
- It “governs” a member state by imposing the modalities of utilizing granted loans. In other words, the IMF, like other international financial institutions, enforces national commitments by the implementation of reform programs, which gives it a power to control sovereign states.³⁹

³⁹ Jacquet Pierre, Jean Pisani-Ferry, Laurence Tubiana, ‘Les Institutions Economiques de la Mondialisation’, Pierre Jacquet, Jean Pisani-Ferry, Laurence Tubiana (eds), *Gouvernance mondiale*, (Nancy : La Documentation Française-Conseil d’Analyse Economique, 2002), pp. 9-114.

- It continues to hold the role of governance in the globalization process, which is also a source of “bureaucratic reality” for the institution.

Secondly, sovereign states, which have to deal with the IMF’s financial framework, are expected to organize their financial markets. For instance, they have to adopt the necessary norms and standards required by international organizations such as IMF, BIS, etc. However, it is worth to note that the states, while meeting the requirements, may behave in an egoistic way. For example, the political concerns may lead the governments to favor some special sectors through the financial support provided by their public banks.

Thirdly, the expectations from the non-state actors should not be underestimated. They have to fulfill not only the capital injection function, but also they have to contribute to the improvement of regulations and supervision, to bring to the system better corporate governance practices, standardized credit evaluation techniques and product diversification. However, these non-state actors have also the potential of exploiting the system by strictly focusing on their wealth maximization objective.

The current functioning of the financial governance brings both advantages and disadvantages for both the state and non-state actors at different levels. Potentially the most vulnerable actor appears to be the state as the unexpected negative outcomes of internationalization of the banking sector may harm the macroeconomic balances and prospects for future stability and growth. On the other hand, the foreign banks have the advantage of acting in a dynamic and competitive market as long as they wish. In case of crisis, these latter can minimize their losses due to their mobility capacity and non-territorial nature.

Does the outcome of this interaction provide really a “flexible order” or a governance path? It appears that this “flexible order” has general principles, rules and norms that differ, in terms of application, according to the involved state. The IMF “persuades” supported countries by suggesting regulatory norms asking for deregulation, policies regarding exchange rates, monetary issues and corporate governance. In this case, even though the expectation of IMF is to prevent potential crises, in front of unexpected short-term capital inflows and outflows, the intervention capacity of sovereign states may be restricted. Furthermore, because of not only the egoistic behaviors of actors but also the unpredictable nature of the globalization, unexpected outcomes such as crises may occur.

In fact, as long as public institutions and private banks behave in an egoistic way, the problems unforeseen by IMF may occur. According to the liberal approach of international political economy, the cooperation between different actors is expected to improve their position as compared with the lack of cooperation. However, in actual conditions, state and non-state actors, while cooperating, continue to privilege their individual interests deriving from their distinct natures.

From this perspective, is it rational to expect that foreign banks contribute to the improvement and regulatory efficiency of sovereign country's banking system in terms of governance? The answer of this question is a little bit ambiguous since the foreign banks are private actors and their principal objective is the wealth maximization. Besides, to treat the state as an actor having parallel objectives with non-state actors does not seem realistic, since the objective of the state, which is (national) public interest, is not shared by the foreign banks.

In this context, the sovereign state, Turkey in our case, acts as intermediate between the actors of two different levels: the global financial institutions and the foreign banks investing in this country. While the IMF requires a perfectly governed financial system in order to maintain global equilibrium, some private actors try to benefit from this transformation. On the other hand, Turkey desires to empower its financial sector in order to avoid crises and to protect its system from opportunistic actors' operations. In such circumstances, from the state's perspective, it becomes problematic how to use the power. Is it rational to act as an effective and dominant actor or to create a completely self-regulated financial system? As a result, the endeavors of the IMF to establish a stable financial system (through strategies such as privatization, creation of independent supervisory and regulatory authorities, and promotion of equal treatment for national and foreign capital) render the state's action ambiguous. Therefore, paradoxically, the governance may be weakened.