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The call for rerouting
Turkish banking sector
outlook 2015

February 2015



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Foreword

Macroeconomic and regulatory environment, competitive landscape and customer dynamics are all reshaping the Turkish banking industry, creating a need for transformation.

New regulatory changes are expected to have a negative impact on the profitability of the banks. Players in the Turkish banking industry will likely continue to be challenged to rake in profits in this difficult environment, with sharper focus on lowering cost of funding, sustaining cost efficiency and managing risk so as to strike a balance between the short term and the long term.

In the near term, we expect Turkish banks to reconsider segments, investments and levers to manage their costs to improve and sustain their profitability figures. We see the emergence of several common themes in this difficult to navigate environment: Pricing and risk analytics, operating model redesign, rationalization of branch network – not just in terms of locations, but also in terms of format mix, and digitalization.

Our report aims to take the reader on a short tour of the macroeconomic landscape in Turkey, implications for banks, and possible paths to follow to mitigate negative impact on profitability. Expectations of some of the leading executives are included to enrich the discussion. We finalize with a summary of important takeaways regarding the factors that would shape the industry in the upcoming year.

We would like to thank the banking executives who agreed to participate in the interviews and shared their insights on the Turkish banking sector. Without their contribution, the report would have had a single voice.

May 2015 be a prosperous year for all banks and real sector businesses.



Hasan Kılıç

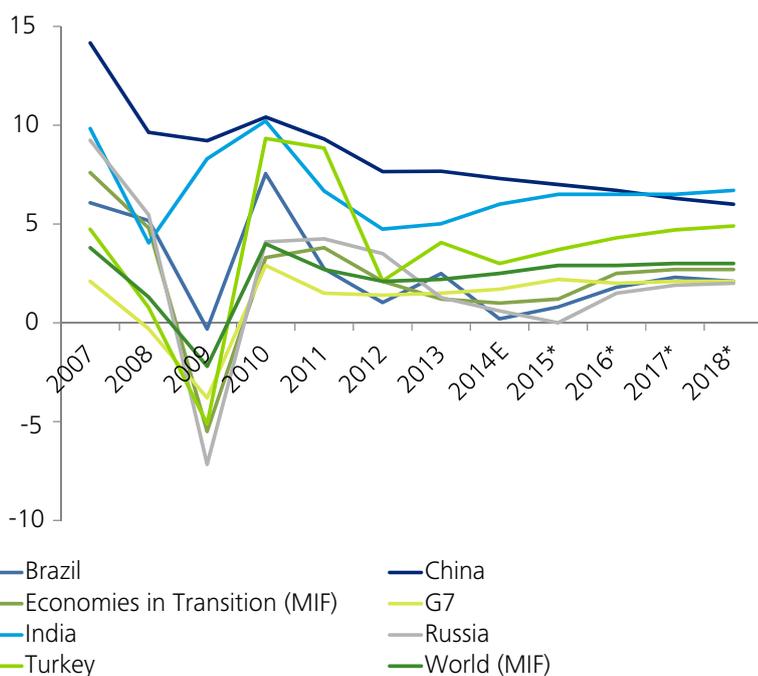
Financial Services Industry Leader
Partner



Yücel Ersöz

Partner

Macroeconomic outlook



Real GDP Growth in %
 * EIU Forecast
 Source: EIU

As the global economy continues an uneven and fragile recovery, the global banking sector is going through severe transformations.¹ As radical transformations take place, including tighter regulations of the banking sector, Basel III, the Volcker² rule, cessation Fed’s asset purchase program and more; global banks need to adjust their models to an environment where operational flexibility and agility are becoming more crucial than ever.

While global macroeconomics are in recovery mode, the European Union is still on the brink of recession and the European Central Bank is pretty much the only game in town for the moment, having decided to “continue quantitative easing to support economic recovery and to eliminate deflation risk”.³

Meanwhile, the end of the Fed’s quantitative easing program had an impact globally, but especially on emerging markets. The program has been concluded in October last year, among others, thanks to “a substantial improvement in the outlook for the labor market with the inception of the current asset purchase program”.⁴

Turkey has shown notable resilience and suffered relatively less from the global financial crisis. In the immediate aftermath of the global financial crisis, Turkey’s real GDP contracted by about 5% in 2009. Well-regulated banking system helped quite a bit; Turkish economy was back on track with an average 9% growth during 2010-11, largely due to the solid domestic demand, lower interest rates, fiscal stimulus, capital inflows and rapid increase in loan amount. However, as investors have become wary and many emerging markets that heavily rely on foreign investors have seen financial capital being drawn away from their economies, it is still an open question how Turkey, with its current account deficit, will be affected from normalization of monetary policy in advanced economies.

In addition to the reliance on capital inflows, the strong signs about the continuation of low economic growth period as well as inflation being significantly higher than the targeted level, are two other important macroeconomic problems that Turkey has to tackle during this normalization process.

Regarding economic growth performance, the EIU forecasts Turkey’s real GDP growth as 3.7%, 4.3%, 4.7% and 4.9% between years 2015-2018. Similarly, Medium Term Program (2015-2017) released by the Government, forecasts GDP growth at 3.3% for 2014, a gradual recovery to 4% next year and then to 5% for 2016-2017.⁵

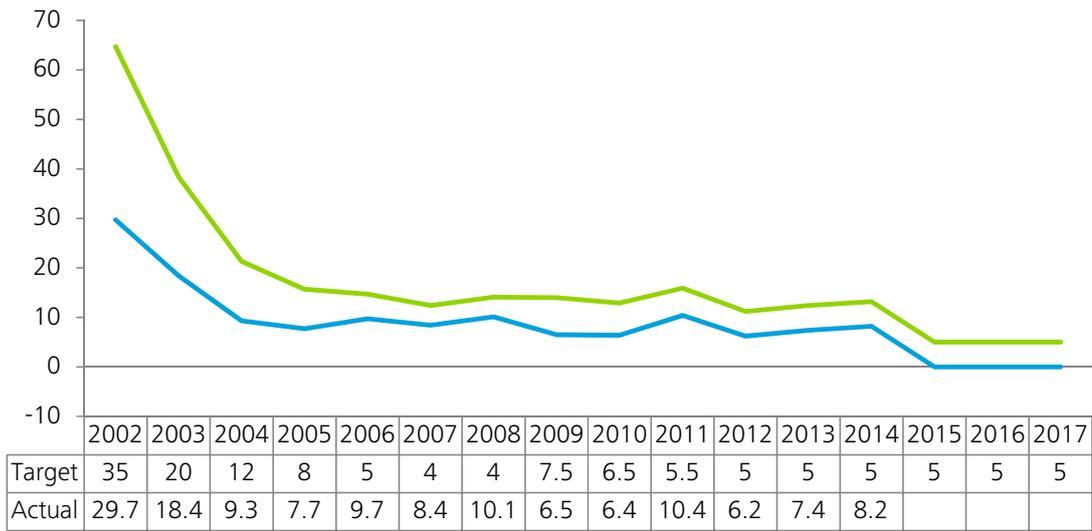
¹ On the nature of recovery, see latest IMF World Economic Outlook, October 2014.

² The Volcker Rule is the federal regulation that prohibits banks from conducting certain investment activities for their own accounts and limits their ownership of and relationship with hedge funds and the private equity funds, also called the covered funds. The Rule, which has been adopted as part of the Dodd-Frank Act, aims to prevent banks from making certain types of speculative investments that contributed to the 2008 financial crisis.

³ http://www.treasury.gov.tr/File?path=ROOT/Documents/Minister%20Speeches%20and%20Presentations/Medium_Term_Program_2015-2017.pptx.pdf

⁴ <http://www.theguardian.com/business/2014/oct/29/us-federal-reserve-end-quantitative-easing-programme>

⁵ It is important to mention that the low economic growth performance is not peculiar to the Turkish economy. In fact, once India and China are excluded from the sample, Turkey performs above the average of both developing and industrialized countries.



— Target — Actual

CPI Target and Actuals %

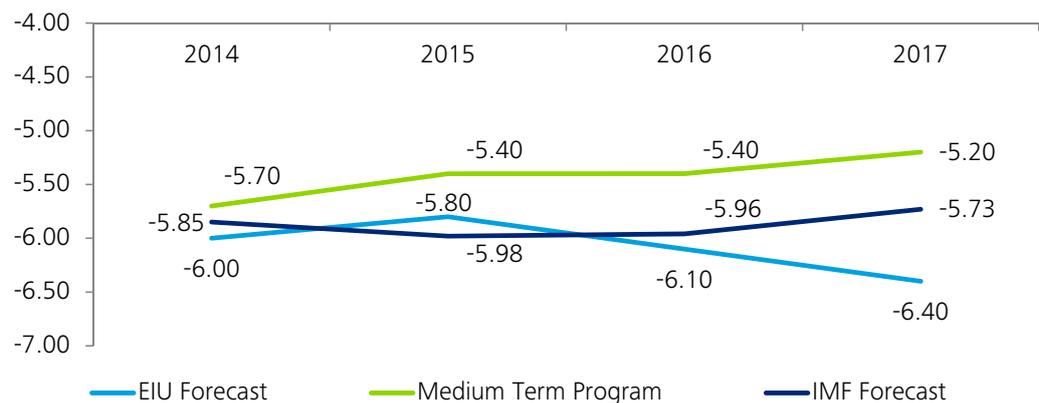
Source: CBRT, Targets (2014-2017)

Regarding price stability, despite limited economic growth and weak domestic demand conditions, inflation is on a rising path and closed 2014 with 8.2%. Food prices -which constitute almost one fourth of the CPI- as well as depreciating Turkish Lira and high degree of exchange rate pass through are major factors behind this increase. When worsening inflation expectations (both 12 months and 24 months) are added to that picture, it is not surprising to see that the CBRT announced achieving low and stable inflation as its main priority and committed to a tight monetary policy stance until inflation gradually approaches its targeted level in 2015.⁶

⁶ According to the Medium Term Program, the inflation rate is expected to be 6.3% by the end of 2015 while the CBRT's official inflation target for 2015 is 5%.

In addition to making “the fight against inflation” as the main priority in the Medium Term Program, reducing the current account deficit is another focus area. Although there is a decrease in current account deficit in the recent periods, it has been consistently above the economic growth rate, imposing further burden on the external debt. As stated in a recent World Bank report, one factor behind Turkey’s worsening foreign trade deficit has been to “specialize in mid-tech sectors which have experienced relatively slow growth in global demand... lacking a comparative advantage in higher growth products⁷ (high-tech exports)”. In the meantime, developments in Europe and the Euro Area are likely to act as a drag on Turkey’s exports, and hence, growth. Recall that Euro member states are still Turkey’s leading trade partners, some diversification into the MENA area notwithstanding. The Medium Term Program forecasts the current account deficit/GDP ratios in a more optimistic way, compared to both IMF and EIU forecasts. According to the program:⁸

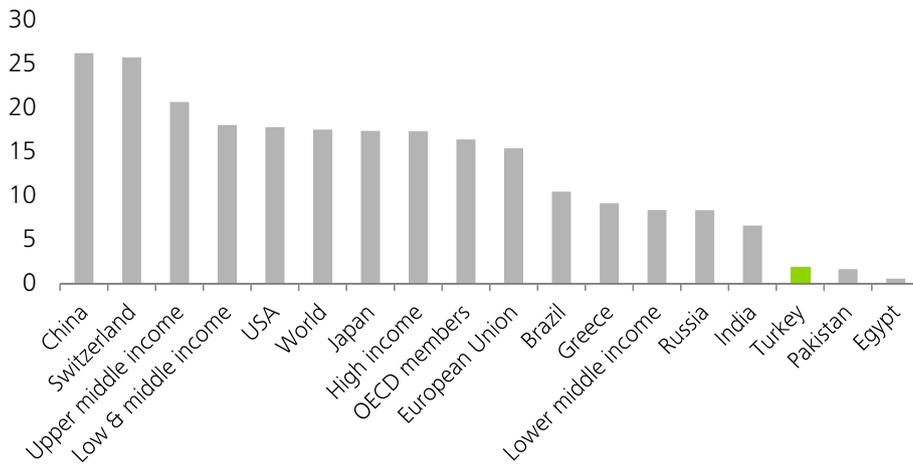
- In order to reduce current account deficit and support monetary policy fiscal policy will continue to maintain its tight stance, mainly by generating new revenue mechanisms and ensuring spending efficiency.
- Structural reforms are going to be accelerated to alleviate import dependency (mainly through decreasing energy imports) and promote overall savings to bring current account deficit to a sustainable level.



Current Account Balance/GDP %
 Source: EIU, IMF, Medium Term Program (2015-2017)

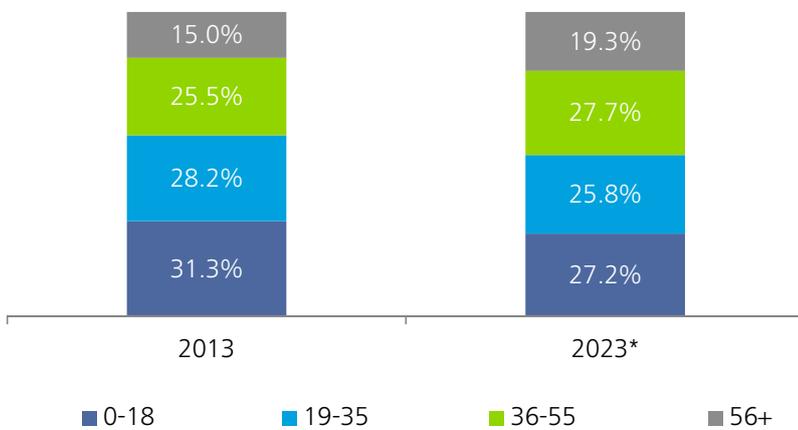
⁷ World Bank, “Trading up to High Income”, May 5, 2014

⁸ Ministry of Development Medium Term Program (2015-2017)



High-technology exports
 (% of manufactured exports) 2012
 Source: WorldBank

In spite of the deceleration in GDP growth in recent years, particularly compared to the very rapid growth of 2003-07 period (at about 7% per annum), it is important to add Turkey's several advantages like its young population, attractive location and entrepreneurial dynamics. As for demographics, for instance, people between the ages 0-35 make up almost 60% of the population, and the ratio is expected to be 53% by 2023, still a relatively high figure.



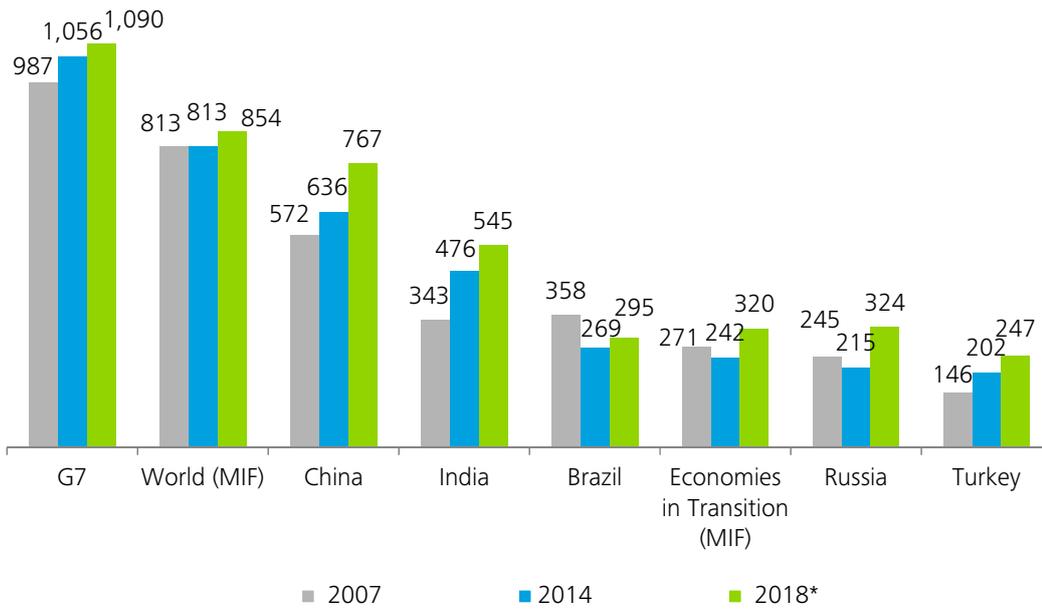
Age Breakdown 2013 vs 2023
 *TurkStat Forecast
 Total Population: 2013: 76.481.849, 2023*: 84.247.089
 Source: TurkStat

Turkish banking sector overview

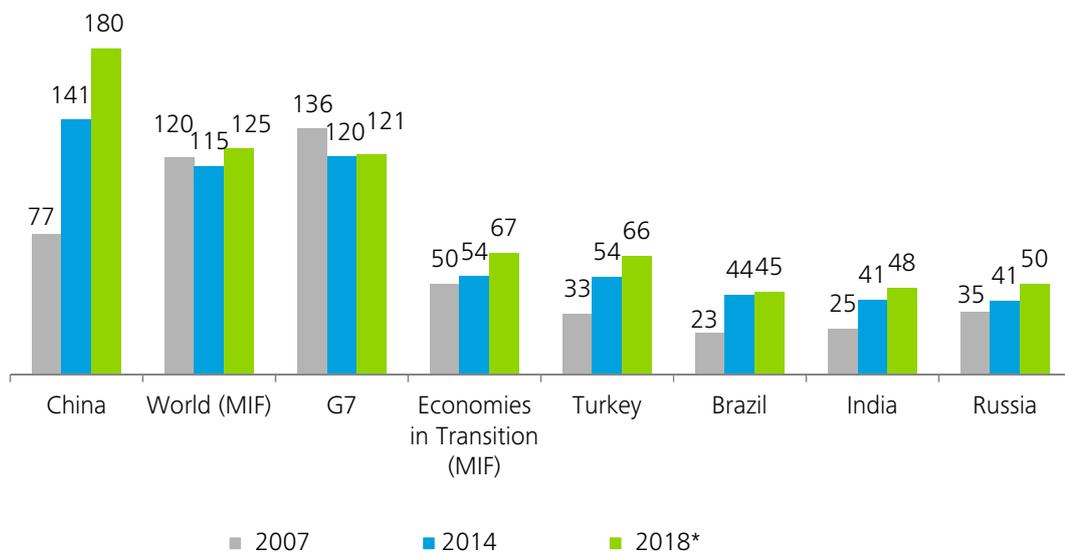
Developed countries have long been looking into the investment opportunities in Turkish financial system and especially the banking sector with hopes of getting higher rates of return than in developed markets. Financial assets to GDP ratio in Turkey reached to 202% in 2014, up from 146% in 2007, yet still remains below world average and that of economies in transition by EIU definition.

Although private sector loans reached 54% of the GDP during the credit boom in the last decade, the ratio is still relatively lower than that of developed countries implying that there is ample room for financial deepening. However, factors such as low savings rate, higher levels of exposure to credit risk and potential vulnerability to global shocks emerge as challenging issues. Savings ratio/GDP reached the lowest level of 12.6% in 2012 since 1980s as opposed to record high private sector credit /GDP ratio. IMF forecasts the savings ratio will slightly increase to 14.3% by year 2018.





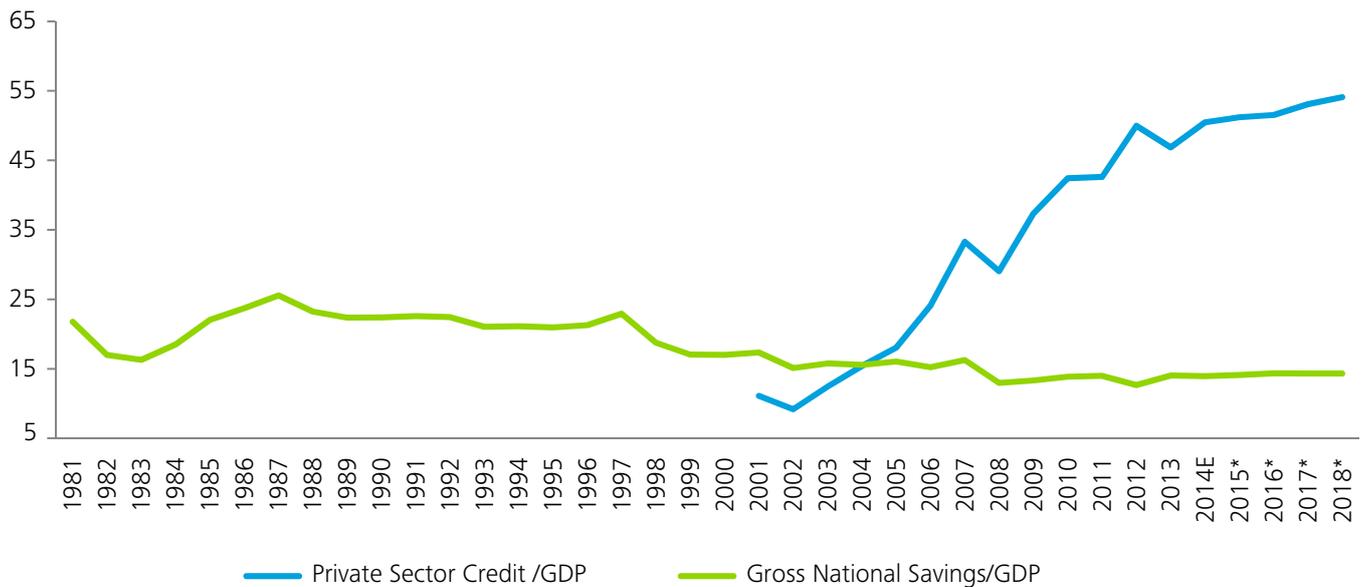
Financial Assets/GDP %
 *EIU Forecast
 Source: EIU



Private Sector Loans/GDP %
 (Total loans to the corporate and household sectors, as % of GDP)
 *EIU Forecast
 Source: EIU

In order to increase the household capability to proactively manage potential risks while increasing household savings ratio, some restrictions have been in effect on retail lending. As the government highlighted, "Tighter regulations on credit card payments and private consumer loans as macro-prudential measures may have a limited effect on growth in the short-term, but Turkey should prepare itself for a period of more modest growth until its current account deficit is lowered permanently."⁹

In the beginning of 2014, Turkey's credit rating outlook started to slide from stable to negative by some of the rating agencies. Standard & Poor's announced the reason as growing risk of a "hard economic landing" as reserves decline and policy makers spar over interest rates.¹⁰



Turkey Historical Private Sector Credit/GDP - Gross National Savings/GDP %
 *EIU Forecast for Private Sector Credit/GDP and IMF Forecast for Gross National Savings/GDP
 Source: EIU, IMF

⁹ <http://www.hurriyetdailynews.com/limitations-on-credit-cards-may-lead-to-lower-growth-turkish-finance-minister.aspx?pageID=517&nID=58635&NewsCatID=345>

¹⁰ <http://www.bloomberg.com/news/2014-02-07/turkey-outlook-cut-by-s-p-citing-hard-landing-risk.html>



Murat Mergin

Garanti Bank, Financial & Strategic Planning, Executive Vice President



What are your expectations with regard to the Turkish banking sector?

Widely expected ending of the Fed's asset purchase program, fluctuation in exchange rates as well as actions towards controlling (loan) demand, will be a limiting factor for the growth of Turkish Banking Sector's assets. In addition, with an already high loan/deposit ratio, in excess of 100%, banks will find it difficult to manage TL cost of funding.

Banks will continue to focus on SME banking, where top-tier banks will continue to lead the market, due to their scale advantage in pricing.



How will the new regulation on banking fees and commissions impact the banking sector?

This regulation has been very much necessary. However, banks would still face some difficulties while implementing what is required by this regulation. I believe, 2015 will be a transition year and further revisions to the regulation may be introduced in the upcoming years to strengthen the regulatory environment of the banking fees and commissions area.



The penetration ratio of the Turkish banking sector is below that of the developed countries; how do you think this could be improved?

The penetration ratio of the Turkish banking sector has increased steadily in recent years thanks to falling inflation and therefore decreasing interest rates. However, the sector has a long way to go before it reaches developed countries' levels. Continued economic normalization, revenue reform and other reforms to increase financial inclusion should be introduced to further increase the penetration ratios.



How do you evaluate the usage of social media and mobile banking in the Turkish banking sector?

Mobile banking is a very important channel in terms of customer acquisition and reaching unbanked population. No other channel is as convenient as mobile banking. Therefore, banks will continue to focus on growing this channel, especially to attract the younger generation.

Banking via social media has not reached its potential yet. The new generation is increasingly using the social media and social media banking. However, there is a lot of room for growth in this area. New applications are released every day, and innovation regarding banking platforms will continue in the near future.



How do you define next generation branch banking in the Turkish banking sector?

Branch banking is a very expensive proposition and leads to high C/I, but remains crucial due to the cultural dynamics. In the developed countries, branches offering only selected products and services with lower number of personnel are very much commonplace. Those who pioneer in managing service excellence through efficient delivery from branches, will gain advantage in the Turkish banking industry.



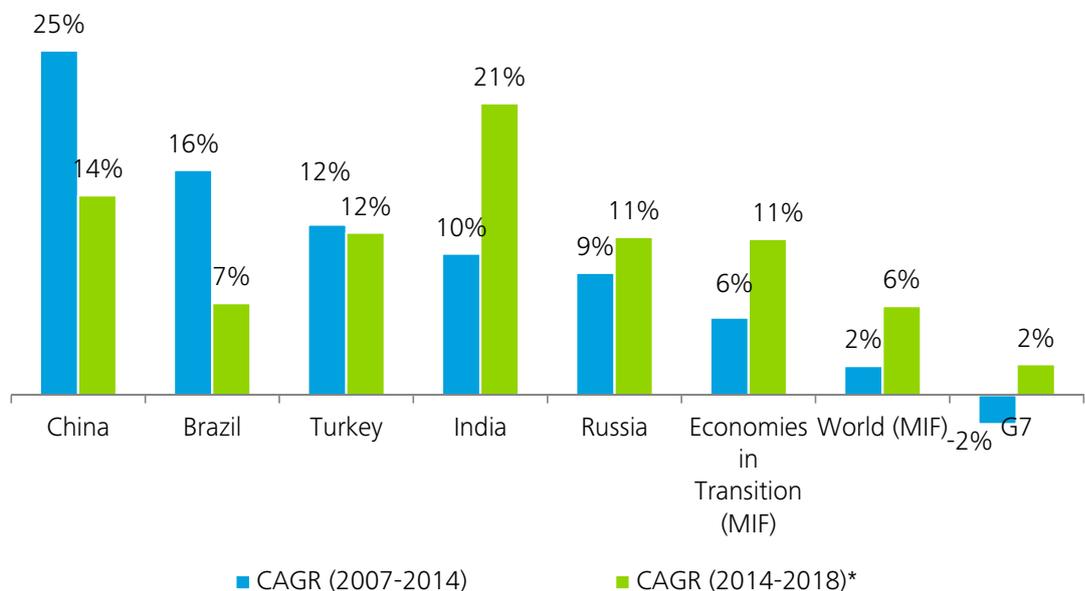
Turkish banking sector performance:

Current and the future

Turkish banking sector lending reached 1,240 billion TL¹¹ as of December, 2014. According to the EIU, the cumulative annual loan growth rate in USD has been 12% between 2007 and 2014 (23% in TL), with a forecast of 12% for the next 4 years, still above the world average, economies in transition as well as developed countries growth averages. Deposit growth between 2007 and 2014 in USD remained low at 6% (17% in TL). Loan demand, which significantly outpaced deposit growth, necessitated policies promoting a higher saving ratio in the economy.

Sustainability of high rate of loan growth is debatable in Turkey due to higher levels of exposure to credit risk as well as potential vulnerability to global shocks. Turkey's gross external financing requirement has reached 27% of its GDP in 2014.¹² As of November 2014, net open FX position for non-financial corporations has been approximately 180 billion USD.¹³

Although banking sector has almost fully hedged its FX lending, there is still an important indirect risk caused by the FX liabilities of the non-financial corporations. This is also reflected in the Fitch Ratings: "Turkish banks' rapid credit growth and higher external debt increase downside risks in the case of extremely stressed market conditions" while "foreign liabilities have increased, particularly at the short-end".¹⁴



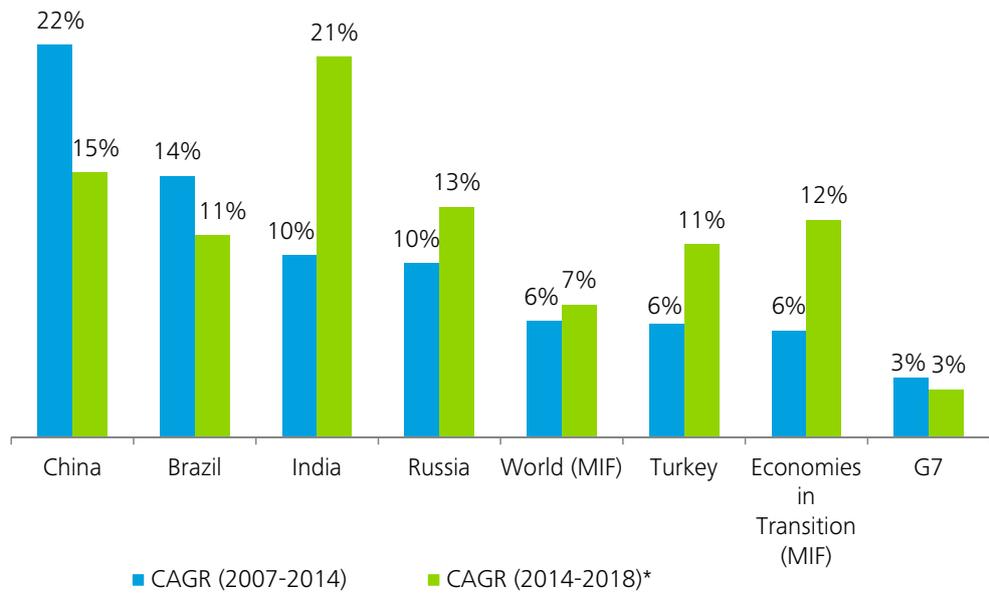
Banking Loan Growth Rate (Loan size in USD) %
 * EIU Forecast
 Source: EIU

¹¹ BRSA Interactive Monthly Bulletin

¹² IMF Turkey Country Report December 2014

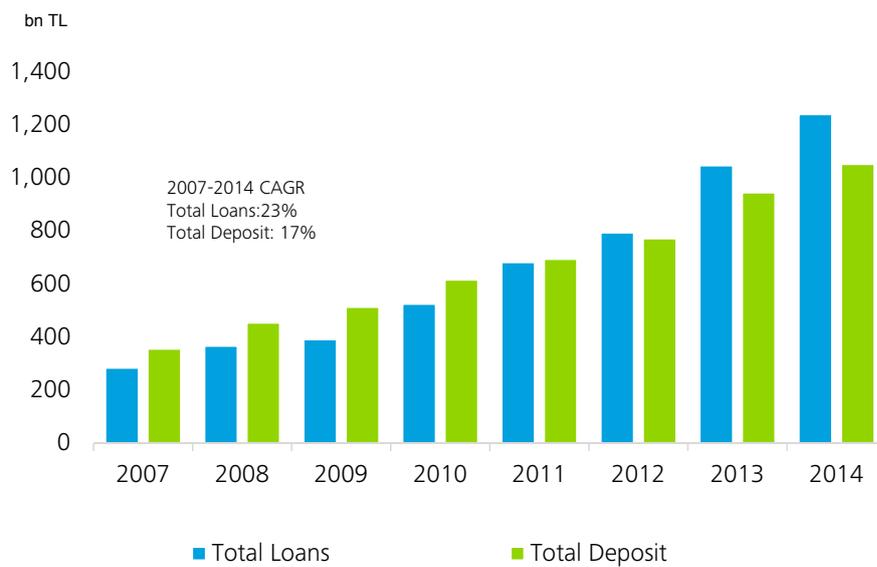
¹³ CBRT Statistics Foreign Exchange Assets and Liabilities of Non-Financial Companies November 2014

¹⁴ <http://www.hurriyetdailynews.com/loan-growth-and-externaldebts-raise-turkish-banksvulnerabilities-fitch.aspx?pageID=238&nid=70693&NewsCatID=346>



Banking Deposit Growth Rate (Deposit size in USD) %

* EIU Forecast
Source: EIU

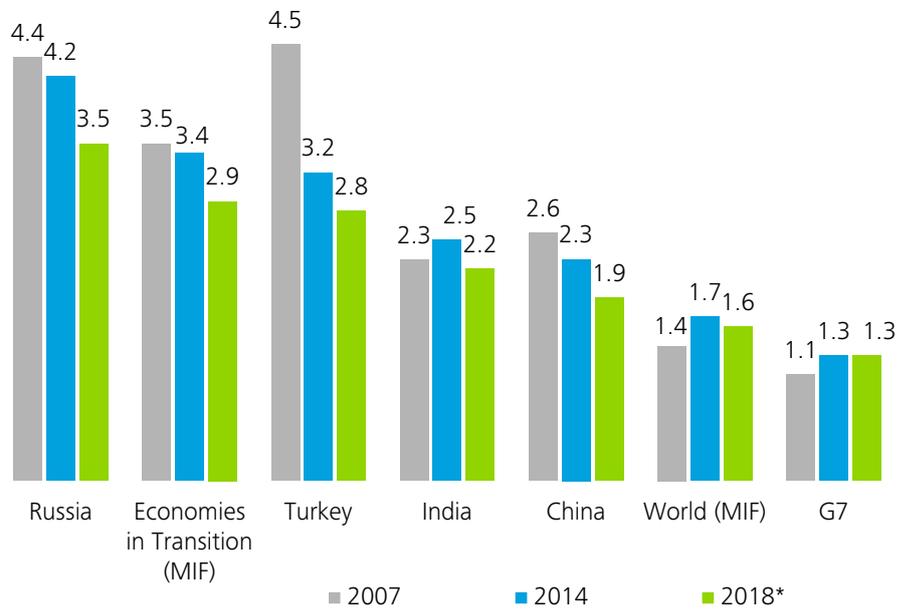


Banking Loan and Deposit Size in bn TL

Source: BRSA

Turkish banking sector profitability has declined recently basically due to regulatory requirements and macro prudential policies to hold credit growth and household debt under control. According to EIU, as of

2014, NIM (Net Interest Margin) of the Turkish banking sector was 3.2%, down from 4.5% in 2007, but still relatively higher than its peers. EIU forecasts the NIM to decrease to 2.8% by 2018, at par with the economies in transition.



Net interest margin (net interest inc/assets) %
 * EIU Forecast
 Source: EIU

Dündar Parlar HSBC Turkey, Internal Systems and Regulations, Assistant General Manager



What are your expectations with regard to the Turkish banking sector?

Managing the balance between costs associated with non-performing loans and income has been an important topic for year 2014. 2015 will be another challenging year for banks to manage their risks (credit, operational, market and reputational risks). Cost control will be even more crucial in order to react to a decline or an insufficient increase in income levels.



How do you think the new regulation on banking fees and commissions will impact the sector?

Banking sector was already expecting such a regulation on fees and commissions. Once the regulation is effective, it has already started to have impact on banks' balance sheets.



The penetration ratio of the Turkish banking sector is below that of the developed countries; how do you think this could be improved?

The increase in production, income levels and therefore the strengthening of the household saving ratios are important for the improvement of the banking sector penetration ratio. The fundamental of banking is trust. We are eventually talking about a sector where trust is crucial between lenders and borrowers. A sustainable relationship between the bank and the customers will be enabled as long as trust is established and maintained with individuals and corporations. If the trust in the sector increases, both the deposit base and the loans granted will grow.



Do you believe that alternative distribution channels play significant role in the increase of penetration?

Branchless and digital banking channels, and especially online banking and call centers are important to improve the banking penetration ratio currently and in the future. Even though branchless and digital banking develop rapidly, income levels will remain to be the primary trigger for the increase in the banking penetration ratio, since the ratio is mostly correlated with the income level. Branch channel will continue to play a significant role among all channels, mostly due to our cultural characteristics. Social media is important in terms of communication, and should be positioned in the communication strategies of banks. In today's open and fast communication environment, many customers can utilize social media in giving both positive and negative feedback about the banks more easily and rapidly.



What are the critical success factors in international banking?

In international trade/banking; speed, technical knowledge and wide correspondent bank network are critical success factors, giving more opportunity to multinational banks. Since increase in foreign trade is crucial in Turkey, I believe that retail or corporate customers would consider successful and competent banks in this area while receiving international transactions services.



How do foreign investors approach Turkish banking sector, do you expect new market entries?

The predictability of the markets is very important for foreign investors, while a solid legal and tax structure play a significant role in shaping the preferences of foreign investors. Rather than evaluating Turkey alone, foreign investors benchmark Turkey against competitor countries. Therefore a good planning would involve the identification of competitor countries' focus areas and preparation of differentiation strategies against those countries. The evaluation should consider not only the potential but also if the potential is actually being realized in that country.





Gökhan Mendi

TEB, Retail and Private Banking Group, Senior Assistant General Manager



What are your expectations with regard to the Turkish banking sector?

Existing business models in the sector should be reconsidered in the near future based on customer behavior and preferences. Therefore, we expect increasing branch network optimization efforts in the banking sector. Branch networks will be optimized based on the micro markets in their locations and will be segmented based on the day / night population profiles. For instance, a bank could be represented by two large flagship branches in Beşiktaş while serving through simpler and lower-cost branches on less crowded streets of the same neighborhood. Even in some areas, bank branches could be moved from ground to the first floors, in order to serve customers that prefer fast banking services.

If “Chip ID” project is implemented in Turkey, no manual signature will be required, the obligation to visit a bank branch for a signature will be annulled, and importance of alternative distribution channels (ADC) will increase accordingly.

With evolving branch networks, we could see new branch concepts such as “online” branches with no staff, and branches with no teller and / or with few staff only to receive signatures. In order to serve in rural areas, mobile and agriculture branches will also be considered in the sector. In addition, alternative distribution channels and especially mobile banking will gain further importance. With rationalization of branch networks, mobile customer representatives will emerge, and relationship managers who serve the mass market will be replaced by the value-added relationship managers who serve based on customer profile and are experts in products they offer.

Based on these developments, structural changes in Turkish banking sector are expected. These can be summarized as:

- Based on new operating models, redefine processes to be centralized, transactions to be transferred from branch to other channels, and transaction types per different branch types
- Build branch structure according to customer ownership
- Structure agent banking in rural areas
- Manage total profitability instead of segment based profitability
- Consider strategic partnerships with telecommunications and retail sectors
- Focus on bulk customer acquisition



➔ How will the new regulation on banking fees and commissions impact the banking sector?

Recent regulations address valid concerns in terms of ethical principles in banking and securing banking services. Even tighter regulations have been introduced in the US and Europe. I believe that the scope of regulatory changes in Turkey will be extended in the upcoming period.

➔ The penetration ratio of the Turkish banking sector is below that of the developed countries; how do you think this could be improved?

Although penetration of banking sector grew considerably, under the pillow money is still considerable in both rural areas and big cities. With expansion of branch network, it would be possible to capture this volume in the banking system. Even though the profit potential is not that high, banks who can reach unbanked population through low-cost branches would eventually gain advantage.

➔ How do you evaluate the usage of social media and mobile banking in the Turkish banking sector?

Not everything that could possibly be done via social media is currently being done by the Turkish banking sector. Although we observe foreign best practices, social media has not yet become a value added “channel” and a profit maker for banks.

While using social media, “Big Data” should be analyzed efficiently in order to convert customer profile data into useful information. Young generation prefer conducting their banking activities through mobile channel rather than PCs; therefore we expect that services offered through mobile banking channel will expand rapidly. Even though security is not one of the top concerns for the young generation, both sector and the customers should remain conscious of this topic.

Competitive overview: Snapshot*

Tier 1 Banks

- “Large-scale private banks” that are clustered as “Tier 1 banks” achieved historically higher profitability while enjoying their advantage in scale, together with state-owned banks. Today, Tier 1 banks target to be the “one-stop-shops” for their customers, meeting end-to-end needs of their customers; in all line of businesses. Tier 1 banks are likely to continue enhancing customer experience and retention, cross sell their products and develop customized/ innovative products and services to better serve their existing customers. To do so, they increasingly use data analytics tools and develop real time analytics with customer segmentation to offer the best product that suits customers’ needs.
- Competition from non-banks such as telecom companies and other payment and e-money institutions can also increase with the new regulation on payment services and electronic money institutions. Tier 1 banks will continue leveraging their scale of operations and customer data advantage to compete and/or cooperate with non-bank payment providers. Within this context, strategic partnership with key sectors such as telecommunications and e-commerce are likely to gain importance, especially in terms of reaching the unbanked customers.

State Owned Banks

- State-owned banks utilize their extensive branch network especially in rural Turkey. With their large branch network, they have the opportunity to reach the unbanked population, supporting the Government’s strategies towards increasing financial inclusion while fighting against the shadow economy. State-owned banks have been authorized to offer participation banking operations that will change the game in the banking industry; with increasing competition in participation banking and potential introduction of new products into the system. Seeking growth in foreign operations is another focus area for the state-owned banks, which also requires investments towards meeting the regulatory requirements of the target countries.

Tier 2 Banks

- Medium-scale” banks that are clustered as “Tier 2 banks”, focus highly on gaining competitive advantage in selected business lines, products or services such as agricultural, SME, start-up and trade finance businesses and compete with “Tier 1 banks” on these selected areas. Due to having a narrower branch network as compared to the Tier 1 banks, utilization of alternative distribution channels are of greater concern, therefore the technological and innovative investments. The competition for market share and reconsideration of pricing strategies will continue putting pressure especially on Tier 2 banks’ profitability. Tier 2 banks are likely to continue their organic growth while focusing more on new sources of funding.

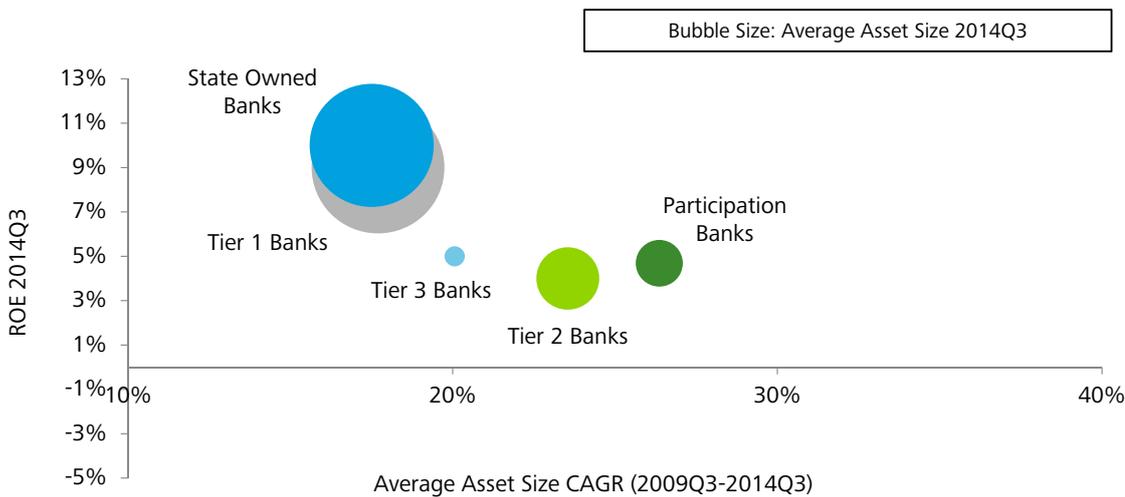
Tier 3 Banks

- “Small-scale” banks that are clustered as “Tier 3 banks”, focus mainly on niche banking services and commercial/corporate banking. They are unlikely to compete with larger scale banks in terms of mass strategies; such as retail banking, complete product mix and lower pricing approach. Rather than trying to position end-to end product/service experience for their customers; a more niche approach towards offering innovative/unique products would remain to be the success factor for Tier 3 banks. These banks will continue to grow in corporate lending and may divest their non- profit making operations to increase their profitability. With declining profit margins, Tier 2 and 3 banks have the highest cost to income ratio among the sector due to their high operating expenses. Tier 3 banks may face consolidation in order to better meet the advantages of scale.

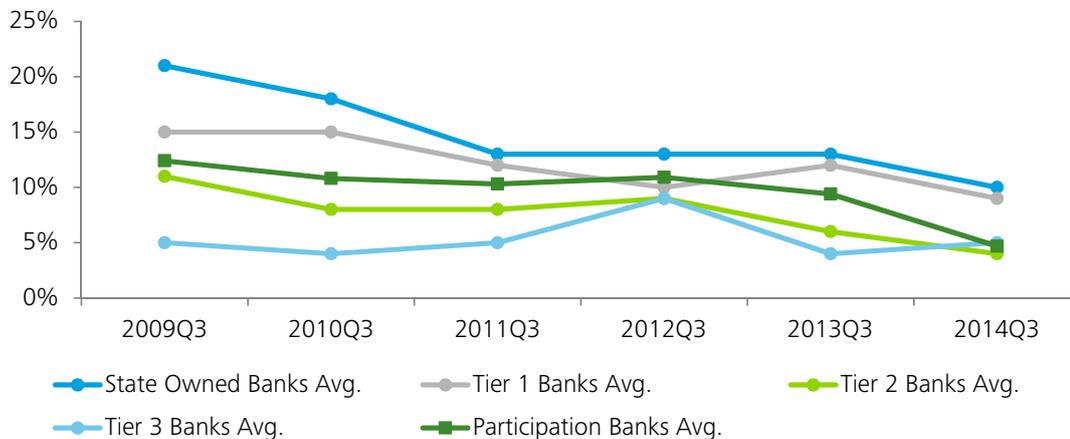
Participation Banks

- “Participation banks are the best performers in terms of asset size growth. They compete against conventional banking while attracting interest sensitive customers and differentiating themselves in interest free banking.
- Despite its growing attention, Turkey has not been fully utilizing all of the Islamic Finance portfolio.
- While the total assets of participation banks in total banking sector has a share of 2.44% in 2005, this ratio has almost doubled to 5.22% by the end of 2014. Recently, state banks have raised capital to get participation banking operation license, which shows the promising future of the sector.

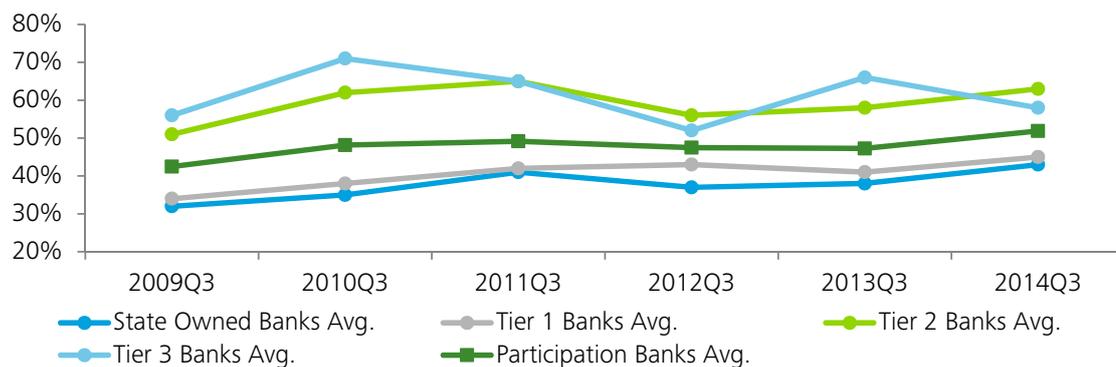
Tier-based performance*



Turkish Banks Growth and Profitability
Source: TBB, Annual Reports



ROE 2009Q3-2014Q3
Source: TBB, Annual Reports



Cost to Income Ratio 2009Q3-2014Q3**
Source: TBB, Annual Reports

* The analysis does not cover development and investment banks in Turkey.
** Other operating cost/ total operating income



Osman Demren
VakıfBank, Commercial & Corporate
Loans, Retail & SME Loans, Appraisal &
Financial Analysis, Executive Vice President



What are your expectations with regard to the Turkish banking sector?

As the US economy started improving; the announcement that Fed's bond purchasing program could slow down in May 2013, and tapering of the program in December 2013, put pressure on developing countries' economies. This situation had a small downward effect on Turkish banks' profitability in 2014.

As quantitative easing by ECB (European Central Bank) and BOJ (Bank of Japan) continues and the expected increase of the US interest rates have not impacted the world economy as expected, the pressure over developing economies has declined. Even though the profitability ratios in 2014 will be below 2013 figures; it is expected that the loss will be recovered next year with the profitability of the sector reaching slightly above its former level.



How will the new regulation on banking fees and commissions impact the banking sector?

It is expected that the regulatory changes on banking fees and commissions will put pressure mostly on the retail segment. As a result of developments in the global economy as well as the expansionary monetary policies of central banks in developed countries; developing countries have regained their position in the world economy. This situation will therefore have a positive impact on transaction volumes and profitability.



The penetration ratio of the Turkish banking sector is below that of the developed countries; how do you think this could be improved?

The strategy of banks with regard to offering products and services in SME, agriculture and start-up business banking aims to increase the penetration of the Turkish banking sector.



How do you define next generation branch banking in the Turkish banking sector?

The branch model in Turkey is culturally based on human interaction. In the future, "Boutique Branch" concept will be developed to expand banking among unbanked population, through providing banking products and services in different locations.

Furthermore, as the new generation has met computers earlier than the older generation and education with tablets has been introduced, technology uptake has expanded rapidly. With the support of increasing technology usage, internet banking will continue to grow, which will have a positive impact on operational costs and therefore on profitability.

Osman Bosna

Yapı Kredi, Strategic Planning, Performance and Budgeting, Retail Banking, Vice President



What are your expectations with regard to the Turkish banking sector?

Aside from a slight increase in the exchange and interest rates, I do not believe 2014 ended quite badly. We observe a little distress with regards to the domestic demand, however, fluctuation level remained acceptable while worse scenarios were expected for the year. A rather uncertain area, fund flow to the emerging markets, resulted relatively positive than the market predicted. We expect 2015 will be a more promising year both from the macroeconomic and banking sector perspectives. Loan growth will continue despite the pressure of new regulations on the profitability.



How will the new regulation on banking fees and commissions impact the banking sector?

It is very obvious that the regulation with regards to the banking fees and commissions would have a negative impact on the profitability. The restrictions on the income would lead the banks to reconsider their costs as well as the services offered.



The penetration ratio of the Turkish banking sector is below that of the developed countries; how do you think this could be improved?

The penetration ratio of the Turkish banking sector would approach to those of developed countries as long as branch networks expand geographically and use of technology and alternative distribution channels increases. The key point here is growth of the economy in our country and rising standards of living in general.

As long as income per capita targets for 2023 are met, penetration ratios would rise accordingly. In addition, there is a positive correlation between incremental increases in income levels and savings behavior. Therefore, we would see the impact of the increase in per capita income in the financial markets.



How do you evaluate the usage of social media and mobile banking in the Turkish banking sector?

The development of the alternative distribution channels will be shaped based on the needs of the young generation. Therefore, it is obvious that mobile and internet banking will be important investment areas for the sector. I believe that the main trend in the alternative distribution channels will be self service banking services.

Banks will consider a more detailed segmentation and optimization of the service channels mainly due to narrowing interest margins as a result of the restrictions in retail banking. It will be mandatory to offer services highly through self-service banking for selected customer groups.

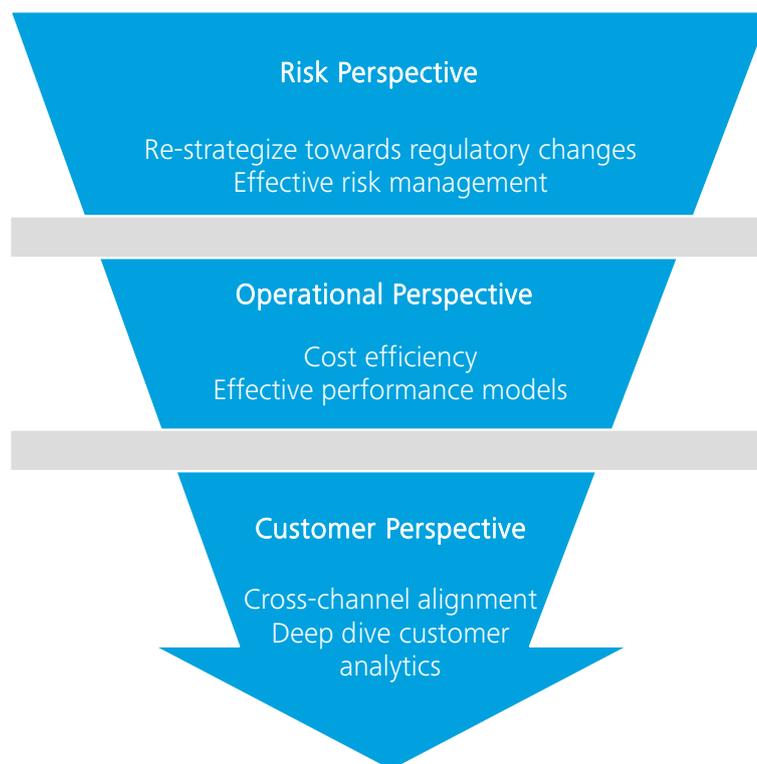
Branch expansion rate will not be the same...

With the developments in the technology as well as the increase in the communication options, branch personnel communication methods and frequency would evolve. Maybe not today, but in few years, branch personnel communicating with the customers through Whatsapp will be acceptable.



The future of the Turkish banking industry

We see the emergence of key takeaways for Turkish banks in this difficult to navigate environment. They are categorized under interrelated themes: risk, operational and customer perspectives.



1. Risk Perspective:

1.1 Re-strategize towards regulatory changes

Complying with changing regulation is even more challenging than ever. In order to better meet the regulatory changes, Turkish banks should increasingly consider:

- **Re-pricing:** Turkish banks should rethink their pricing strategies, especially if the portfolio is strong in terms of credit cards and retail loans. The regulation on the banking fees and commissions as well as limits on installment-based credit card spending put extra pressure on the bank P&Ls, pushing Turkish banks to revise their fee and commission based revenue models with special focus on cost management policies.

While economies of scale favor larger banks in pricing, banks should analyze potential customer response and redefine segments to focus on better pricing decisions in fee generating products and services.

- **Reviewing current credit management structure:**

With the introduction of BRSA's "Best Practices Guideline in Credit Management of Banks" in July 2014, Turkish banks should consider conducting a gap analysis in order to determine the requirements of the guideline that could affect all dimensions of their credit management practice: Strategy, policies, procedures, authorities and organization, documentation, information technology, internal systems, and units such as marketing, underwriting, monitoring, as well as follow-up.

1.2 Effective risk management

Banks should consider the concept of risk management beyond the risk-perspective; but as an integrated part of different units of the bank. In terms of risk management, Turkish banks should consider the following topics:

- **Application for internal rating-based (IRB)**

approach: As part of the Basel II¹⁵ requirements, and BRSA's recent "Draft Guideline on Internal Rating-Based (IRB) and Advanced Measurement Approaches", Turkish banks should follow the pre-defined application process and receive the permission by BRSA, if they consider using the IRB approach method for credit risk modelling.

- **Risk-based pricing:** Risk-based pricing involves offering different interest rates and loan terms for different customers, based on probability of default. Turkish banks should consider revising their pricing strategies towards better predicting the potential revenue as well as the risk associated with the customer. With an increased SME customer portfolio of Turkish banks, the need to identify a smarter pricing / collateralization scheme is even more important in order to optimize the portfolio return. A considerable number of SMEs that appear to be risky in financial analysis are able to counterbalance the risks either by providing stronger collateral or by the ability to pay higher interest rates. Banks should then consider three major dimensions for risk based pricing: 1. Market conditions (Customers' ability to provide collateral, customers' ability to pay higher rates, and pressures from factoring players), 2. Risk management (Overall portfolio risk and customer segment concentration) and 3. Financial performance (Managing profitability at customer / branch / region / segment level, and risk – return profile of the portfolio).

- **Invest in data quality:** The data can be inaccurate, opaque, inadequate or interpreted differently across different units of a bank. Since data is the most critical portion of the risk-and especially credit risk- management/modelling process, analytical investments regarding the data readiness, cleaning, and modelling would be more crucial than ever. Turkish banks should invest in data quality and data governance improvement efforts in order to make optimal decisions and align with the regulatory requirements from the risk perspectives.
- **Introduce performance metrics related to risk management:** Turkish banks should introduce key performance indicators (KPIs) related with risk management at personnel level. For instance, NPL should be a shared KPI across different business units of the bank, including sales, underwriting and monitoring functions.
- **Improved scoring and rating models:** Improved predictability for scorecard and rating models as well as the periodic validation of the models would remain as the major priority areas from the risk management perspective of banks, along with the investments in data quality.
- **Redefining early warnings signals and internal behavior models:** Interpreting early warnings signals and proactively managing the actions for default loans are crucial for Turkish banks. Traditional signals from legal authorities should be considered "late" rather than early warning signals; internal behavior indicators of the customer within the bank should be modelled accordingly to better predict the default of a particular loan at earlier stages and take necessary actions.

¹⁵ Basel Committee on Banking Supervision: "An Explanatory Note on the Basel II IRB Risk Weight Functions" "Institutions will be allowed to use their own internal measures for key drivers of credit risk as primary inputs to the capital calculation, subject to meeting certain conditions and to explicit supervisory approval".

2. Operational Perspective:

2.1 Cost efficiency

Cost efficiency is still a major concern for the Turkish banking sector. Many banks implement short-term cost cutting measures to seek operational efficiency. However, operational efficiency is more than just cost cutting: It entails a sustainable cost controlling strategy while meeting regulatory requirements without deteriorating customer experience. Important topics for Turkish banks in terms of cost efficiency are numerous:

- **Processes and organization redesign:** Turkish banks need to redesign and align their processes and organization to enhance operational efficiency and effectiveness while adopting an agile operating model, switching between internal resources or outsourcing activities. Process and organizational restructuring efforts should consider three main dimensions at the same time: Customer experience, operational effectiveness and risk management. The banks should rethink ways to eliminate redundant activities and paperwork that complicate customer interactions, and they need to act faster than ever before. Efficient procedures are important to remain competitive, while meeting regulatory requirements. Positioning alternative distribution channels optimally will help banks provide their services more conveniently, and with a more cost-effective way. Streamlining banking services calls for a flexible IT architecture, governance and project management while ensuring consistent customer experience across channels. It should not result in deterioration of existing relationships, but should instead emphasize a customer-focused technology and operations infrastructure.
- **Reconsider physical distribution models:** This is not just about location optimization anymore: Segmenting branches according to their location types, redefining the service set for each branch format and cost rationalization of the network are all parts of the branch network optimization effort.
- **Cash management and ATM efficiency:** Cash management optimization and review of ATM efficiency include processes, hardware, software, network and performance-based vendor related components. Detecting sources of issues related with cash and ATM management is a critical step, along with the ROI calculation for both benefits and costs of the improvement areas.

2.2. Effective performance models

- **Employee performance and talent management:** It is crucial to establish a solid performance model in both the head office and the branches to “measure” and incentivize accordingly. Performance metrics should not only involve traditional sales measures, but also non-sales metrics for process efficiency. Introducing non-sales performance metrics, e.g. process time, data completeness/accuracy rate, entry error rate, customer satisfaction, total training hours etc. for individuals will help empower cost management approach across the bank. Performance management systems should be integrated with an efficient talent management and competency development model, aiming to recruit and create high-performers within the bank.
- **Analytical branch performance management:** Traditional branch targeting system is a top-down approach that usually ends in disputes between branches and the region and/or head offices. Banks should increasingly consider analytical methods for branch performance management that allows sales prediction on product and branch levels. Based on the analytical modelling, performance factors are used to group/segment/profile branches with similar potential/properties. Both internal (sales data and other data) and external data should be considered in the development of the analytical branch performance approach.

3. Customer Perspective

3.1 Cross-channel alignment

Banks offering channel integration models will benefit from cross selling opportunities, cost reduction as well as increased customer satisfaction. Therefore, building the right channel integration strategy, pricing of the services offered, consistency of the systems used, and defining multichannel organization and processes will be high priorities for the Turkish banks in the upcoming years.

- **Integrated customer experience across channels:**

Initiating a banking transaction via one channel and completing it via another will give customer the flexibility to choose the channel mix preference with lower costs, thus enhancing the customer experience. Moreover, providing banking services with complete view of customer's preferences will be one of the challenges for Turkish banks, as the need for quality customer data increases. Consistent customer experience across all channels will be critical for retention of banking customers. Today, many Turkish banks are far from this level of maturity in multichannel management.

- **Digitalization:** Customers are more digitally connected and informed than before. They demand a highly personalized approach in communications. While branch is still the most preferred channel for banking services mainly due to the cultural aspects in Turkey, upcoming generation will consider going to a branch to a much lesser extent. Small branches and automated models are going to be tested for future branch banking. Digitalization is not only becoming part of the customer behavior, but that of the relationship managers as well: A tablet PC equipped relationship manager can get a lot more out of a customer visit than before. Internet and mobile channels will remain to be the hot topics in the near future both in terms of customer experience and sales efficiency. Mobile channels continue to be the greatest area for customer focused innovation along with other rather immature innovative solutions such as biometric security, video banking, and wearable technologies. Banks will increasingly consider establishing innovation centers to lead their digital transformation efforts.

3.2 Deep dive customer analytics:

Turkish banks should focus on new approaches to utilize data for developing customer insights, including advanced data analytics. Data should be available real-time for all relevant users, allowing banks to provide customized solution based on a full-view customer profile. Banks which command data and deal with structured/unstructured, huge volumes of data in an effective manner will pioneer in the Turkish banking industry.

- **Customer development plan:** Analytical approach for customer development plan includes three major steps: 1. Segmentation/grouping of customers based on their activities (banking activities or change in transaction behavior), 2. Defining possible key paths/action sets for each group of customers by referring to past data and other key variables, and 3. Modelling customer value and churn rate over agreed time horizon. Customer development plans are important in terms of balancing long-term/sustainable benefits vs. short-term mass-targeted campaign revenues, while realizing potential value of each customer fully. Customer development plan is also important to move away from a "campaign for everybody" to "offer what the customer really needs" approach, while managing customer satisfaction through not bombarding everyone with campaigns.

- **Bundle products dynamically:** Turkish Banks have long been focusing on bundling their products and services, aiming at selling the highest number of products as possible. However, aside from targeting the maximum number of products, dynamically positioning the right product based on the customer preferences is a more sustainable way to increase the value of the customers. In order to better incorporate customer – specific bundle products; quality of existing data as well as need-based customer surveys are crucial for decision making. The bundling decisions should involve both banking and non-banking product and services.

- **Utilize social media beyond branding:** Although still not utilized actively as a sales channel, social media is expected to be another trending channel in the near future as it offers high quality customer interactions at a lower cost. Turkish banks should position social media beyond a tool for branding, especially in terms of following the life patterns and learning more about the customers, therefore being more attuned to customer behavior. As banks can identify customer needs through accessing customer information, interests, daily activities, visits etc. through social media analytics, they can offer the right product at the right time and enhance customer satisfaction and retention. They can also launch new applications and platforms in order to help their customer on their daily life finances/payments, and position social media beyond a communication arena. Of course, social media is still, by and large, a trial and error space. Many projects may underperform before banks find the right formula.



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