Regulatory Compliance Costs on International Banks in Turkey

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Abstract
The Turkish government set a policy to become a regional financial center in 2007. This policy involved encouraging international banks to enter Turkey and take a more prominent role in the Turkish banking industry. Since then the progress has been slow to achieve this policy objective. The primary indicator of being a financial center is to have the presence of international banks. Even though there are many representative offices in Turkey, few of them changed their status to subsidiary or branch to this day. On the contrary, some international banks announced that they would downsize their operations. Representative offices have lower investment and compliance cost than that of branches and subsidiaries. Banking regulations in Turkey does not differentiate much by type, operations and size. Also international banks have to comply their head office rules in line with regulators in their home countries. In this article, we focus on the regulatory compliance costs on international banks to open branches and to establish subsidiaries with niche market strategy in Turkey. We argue that regulatory compliance costs play a major role on the reluctance of international banks’ lack of enthusiasm.

Key Words: International Banks, Regulatory Compliance, Banking Regulation, Banking

JEL classification: G21; G28; G15, F33

Introduction
Turkey set a policy to create a financial center in Istanbul in 2007. (Özince, 2007) Turkish Bankers Association (TBA, 2009) issued a special report for evaluation of becoming financial center and for comparison of major financial centers such as England (London), Singapore, Ireland (Dublin), Spain (Madrid), Russia (Moscow), Israel (Tel Aviv) and Turkey (Istanbul). The aim was to compete with cities such as Dubai and attract more international funds to Turkey. This requires attracting international banks to open branches or subsidiaries in Turkey. However, the speed for achieving this goal has been limited.

We believe that the goal of being a financial center is the right strategy for Turkey and will have positive contribution to the Turkish economy. Isık and Gunduz (2012) suggest that new entries could be instrumental in boosting resource allocation and utilization based on the analysis of Turkish banking data.
In this article we show that some of the banking provisions create obstacles for international banks to operate in Turkey. The policy makers should analyze these provisions whether they are necessary to control any supervisory risk or they are just a red tape for international banks increasing regulatory compliance costs.

In an important study, Berger et al., (2000) found that, on average, domestic banks have higher profit efficiency than foreign banks. They analyzed two main hypotheses: the home field advantage hypothesis versus the global advantage hypothesis. The home field advantage hypothesis claims that domestic banks are generally more efficient than foreign banks. The global advantage hypothesis assumes some efficiently managed foreign banks are able to overcome these cross-border disadvantages and operate more efficiently than the domestic banks.

Recently, some international banks in Turkey closed down their operations and some downsized or exited. Portigon A.G. Istanbul Branch ended its operations and initiated liquidation process with decision of BRSA in August 2013.\(^1\) Citi Group (2013) announced their consumer business to be sold to another bank in Turkey. Banco Commercial Portuguese sold its bank in Turkey (Turkish Daily News, 2011) to a Turkish businessman. HSBC Turkey searched for a buyer and decided to restructure its business after struggling to find one. (Bloomberg, 2016)

In this article, we will analyze the regulatory compliance costs on international banks to operate in Turkey. The next section provides a survey of the literature. In this section, we discuss the relevant analytical works and empirical studies on banking regulation, international banks, and taxation and reserve requirements. In the third section, we will analyze international banks operating in Turkey with respect to their home countries. The fourth section investigates regulatory compliance costs of international banks in Turkey and their challenges to comply with those regulations. The final section concludes.

**Literature Review**

It was one of the main discussions was whether to allow international banks to have a higher share in the Turkish banking industry during the drafting process of the new Banking Act number 5411. (Turkish Daily News, 2005) The Banking Act did not have any directly banning provisions for international banks. Moreover, the former provisions of the banking law were kept mostly intact and a more detailed and structured banking law was designed in line with the European Union and international practices. The amendments were mainly to control new entry into the banking system, orderly exist process, personal liability of senior managers, strong deposit insurance, frequent external audit, detailed call reports and concrete penalties etc.

Demirgüç-Kunt and et al., (2003) measured the tighter regulation is by fraction of entry denied, activity restrictions, reserve requirements and banking freedom. The “fraction entry denied” is practically 100 percent until 2011 since Banking Regulatory and Supervisory Agency (BRSA) of Turkey, the independent regulator of banking in Turkey, verbally declared its unwillingness to issue any new licenses (Hurriyet, 2011). They defined the activity restrictions on bank activities in securities markets, insurance, real-estate, and owning shares in non-financial firms. Banking Act limits most of those activities in Turkey. Barth et al., (2001) defined a variable for “bank activities and ownership restrictiveness”. The scale is between 1 and 4, and 4 is the most restricted one. Turkey is considered as 3 within the group of Mexico and US.

International banks increased their activities through their representative offices and credit sales persons in Turkey. BRSA (2006a) issued a regulation to limit those activities. Their regulatory requirement is to obtain operating license from BRSA and to provide activity reports to BRSA on a regular basis.

BRSA remained hesitant to issue a new license for a subsidiary or branches until 2011 (Hurriyet, 2011). The general policy was to direct investors (mainly foreign banks) to acquire an existing bank in the sector. This kept the number of banks in the industry constant and controlled competition so that systemic risks remained low. It had also the unintended consequence of reducing supervision costs of BRSA. BRSA had

\(^1\) [https://www.bddk.org.tr/WebSitesi/english/Institutions/Banks/Banks.aspx](https://www.bddk.org.tr/WebSitesi/english/Institutions/Banks/Banks.aspx)
the authority to assess the business plan of banks that applied for a banking license. We believe the franchise value of banking license increased significantly due to this policy.

BRSA declared to have 300 million USD of the minimum capital requirement in 2011. (Turkiye Gazetes, 2011) The Banking Act states banks to have minimum of around 10 million USD. BRSA issued a new license for OdeaBank, BTMU Turkey and Rabobank, subsidiaries of banks in Lebanon, Japan and Netherland respectively. Intesa Saopolo from Italy received a new license to open a branch as a deposit taking bank. These banks completed their establishment and started their operations. BRSA issued establishment license to the Bank of China in April 2016 and the establishment process should be completed within a year.

During the 1990’s, there were 20 international banks in Turkey but their market share were around 3 percent in terms of deposits and credits. (Akguc, 2007) The regulatory environment in Turkey was not so tight during those years. Some consolidation has occurred during the 2001 banking crisis of Turkey and regulations changed significantly. (Yay and Yay, 2012: 56-87). Bakir and Öniş (2010: 90) gives the elements of improvements in the performance of the banking sector.

Bağdadioğlu and Halisçelik (2012: 17-21) explained how regulatory environment, political governance and economic stability strengthened in Turkey during the 2000s. Major international banks bought mid-size Turkish banks to provide retail banking services to individuals and small and medium enterprises (SMEs). Aysan and Ceyhan (2006) examined the individual cases of foreign bank existence in Turkey and found that their reasons confirm ones spelled out in the literature. Aysan and Ceyhan (2007) found that foreign banks in Turkey were more efficient than domestic banks and efficiencies converged afterwards. Aysan and Ceyhan (2008) determined in their analysis that there are no significant relationship between the performance indices and ownership of foreign vs. domestic in Turkey.

During the 2007-2009 Global Crisis, many international banks faced financial difficulty in their home countries and central banks supported their banking system with public funds. Laeven and Valencia (2010) provided a classification of those supports as extensive liquidity supports, significant restructuring costs, significant asset purchases, significant guarantees on liabilities, and significant nationalizations. None of those supports implemented in the Turkish Banking sector because of its strong regulatory environment and conservative approach of the banking regulator on credit expansion and use of derivatives. (Yay and Yay, 2012: 73-79) Cetorelli and Goldberg (2011) analyzed the transmission ways of the Global Crisis due to liquidity shocks.

Yayla (2012: 117) found that the concentration in Turkish Banking had been increasing during the 2000s and that net interest margins had been declining during the same period. Oliver and Wyman (2016:8) mentioned that the Turkish banking sector is at the mature stage and is at the highest level of competition in the banking sector among key European countries. Risk adjusted return on assets has been declining and banks focused on profitability rather than growth since sector is at the maturity stage since 2014. There is limited opportunity for new banks to take share in sector with adequate profit. For new banks, it is very difficult to obtain retail and SME customers since switching costs are high for those customers to change their existing relationships with banks.

International banks are challenged to apply one of three generic corporate strategies (low cost, differentiation and focus) as defined in Porter (2008). The best strategy is to focus on selected corporates and their international trade as applied most of the small size international banks such as BTMU Turkey, such as Rabobank and Intesa Saopolo. Only OdeaBank has got into the small and medium enterprises (SME) and retail customers.

Demirgüç-Kunt et al., (2003) found that tighter regulations on bank entry and bank activities increase the cost of financial intermediation. They examined two dependent variables to gauge the cost of financial intermediation: the net interest margin and overhead expenditures. From our practical experience, we observed that international banks in Turkey have low borrowing advantage from their parents since parent has capacity to access international money markets with lower borrowing costs. However lending rates are similar to the local market rates because of competition with other banks. The net interest rate margins are
higher than the local banks. However, local banks have cross-selling capacity to price with other services and better customer relationship management.

Demirguc-Kunt et al., (2003) defined overhead expenditures as expenses due to operational and control factors. Operational costs depend on the number and amount of transactions performed by banks. Control costs shall be considered as overhead expenses due to regulatory requirements of head office and local regulators. Local regulator, BRSA, require significant amount of call reports, disclosure requirements with the external audit approvals and use of local accounting plan. BRSA require those for all banks with almost no differentiation of bank size and type.

Demirguc-Kunt et al., (2003) defined reserve requirements as dummy variable. The level of reserve requirements is important for funding cost of banks. Demirguc-Kunt et al., (2003) defined “banking freedom” as an index based on the Economic Freedom Index of the Heritage Foundation. However, banking freedom definition can be extended to implicit operational requirements such as oath in the commercial court with physical presence, requirement for public notary for board decisions, submitting comprehensive files to BRSA for senior management and board of directors to prove “fit and proper” criteria, and physical meeting of boards etc.

Demirguc-Kunt and Huizinga (1998) find that interest margins and profitability are negatively related to the official reserves based on the data of 80 countries over 1988-1995. This is an implicit taxation. The estimated coefficient on the corporate tax rate in the profitability regression is consistent with a full pass-through of the corporate tax on the bank customers.

Demirguc-Kunt et al., (2001) extended the analysis to distinguish between domestically owned and foreign owned banks. The profitability of foreign owned banks was found to raise relatively little with local corporate tax. This can be explained by international profit shifting or by international double tax relief provided by parent countries.

Huizinga and Voget (2009) finds a negative impact of international double taxation on the head quarter location following international M&A using individual deals as well as aggregated data. The paper examines the impact of international double taxation on the FDI in the banking sector only using information for all banks rather than just for those that are newly formed through M&A. The banking focus of this paper allows us to consider both a price response through FDI to international double taxation. After the 2008 Global Crisis, many countries are thinking of new taxes on their financial systems to help prevent the next crisis and also increase the overall tax contribution of the financial sector (IMF, 2010).

Huizinga et al., (2014) found that international double taxation of foreign-source bank income reduced foreign direct investment in banking-sector. For instance, international banks control their operations in Turkey from the UK and appoint the board of directors within the UK operations. Since there is no tax treaty between the UK and Turkey, those international banks with majority of board resident of the UK are subject to double taxation. Their source of income is Turkey and the majority of the board of directors is residents of the UK. The only alternative for international banks to avoid double taxation is to have the majority of the board from residents of Turkey.

Schenk (2002) explained that Hong Kong became an international banking center with the unique combination of laissez-faire government policy and a vibrant traditional local banking system. Also, the number of offices of foreign banks is used as an indicator to become international banking center for the comparison. Reed (1980) used additional factors to measure such the size of foreign assets and liabilities.

**International Banks in Turkey**

International banks have to follow home country and host country rules and set local bank policy and procedures in line with both rules. Although the international standards such as Basel Committee on Banking Supervision and EU directives converges, these standards are designed a minimum level of prudential rules. Additional prudential regulations are welcomed and accepted as normal application. Due to the 2001 crisis of Turkey, the Turkish banking sector has some additional provisions limits international
banks to operate in Turkey. We believe that those provisions limit realization of the policy that Istanbul becomes a financial center.

International banks had three major stages to get into the Turkish banking system as shown in the Figure 1. During the first stage, between 2005 and 2007, international banks such as ING, Dexia, Fortis, BNP Paribas and NBG bought midsize banks from Turkish residents. The ratio of total assets of foreign banks in Turkey increased to 17 percent from 4 percent.

The second stage is the BRSA issuance of license for 3 international banks during 2011-2013, namely OdeaBank, BTMU Turkey and Rabobank. Since their asset size is small compared to total banking, there is very small impact on the ratio of total assets of foreign banks to that of total. The third stage is the jump from 20 percent to 30 percent in 2015. This was due to ownership changes in Garanti Bank. BBVA bought the share of Garanti Bank in 2015 and controlled the bank with a local partner since then. BBVA purchased the some of the shares from the local partner and became controlling shareholder. (FT, 2014)

Figure 1: Foreign/ Total Assets, Source: BRSA

Foreign banks can exist in three ways in Turkey, representative offices, branches and subsidiaries. The representative offices are the weakest form of existence. They can only act as liason for the head office and have limited operational authority in Turkey. These offices have low funding costs abroad and low regulatory requirements, so they prefer to extent their loans from abroad to Turkey. Generally international banks prefer to this form since its regulatory compliance cost is lower than branches and subsidiaries.

As shown in the Table 1, foreign banks have 49 offices and 32 of them based in European countries as of 2015. Turkey has many EU companies and high volume of international trade with EU countries. Also, there are some Asian, American and Gulf Cooperation Council (GCC) countries.
Table 1: Representative Offices of Foreign Banks in Turkey

| Country   | EU | Banks                                                                                                                                 |
|-----------|----|---------------------------------------------------------------------------------------------------------------------------------------|
| EU        | 32 | Aareal Bank A.G., Commerzbank A.G., Deg-Deutsche Investitions-und Entwicklungsgesellschaft MBH, DZ Bank A.G., KFW (Kreditanstalt Für Wiederaufbau), IPEX-Bank GMBH " , Landesbank Berlin, Ziraat Bank International AG |
| Germany   | 7  | Credit Europe Bank N.V., Demir-Halk Bank (Nederland) N.V., Garantibank International N.V., ING Bank N.V., Rabobank International, The Economy Bank N.V. |
| Nederland | 6  | Axion Swiss Bank SA, Bank Julius Baer & Co.Ltd., BSI SA, Credit Europe Bank (Suisse) S.A., UBS A.G., Union Bancaire Privée, UBP SA |
| Switzerland | 6 | Banco Bilbao Vizcaya Argentaria S.A.(BBVA), Banco Popular Espanol S.A., Banco Sabadell S.A., Caixabank S.A. |
| Spain     | 4  | "Banque Internationale de Commerce-, BRED, BNP Paribas S.A., Credit Industriel et Commercial, Natixis Sa |
| France    | 4  | ABC International Bank PLC, Goldman Sachs International Bank, Nomura Bank International PLC |
| UK        | 3  | Banca Monte Dei Paschi di Siena S.P.A., Intesa Sanpaolo S.P.A. |
| Italy     | 2  | Mizuho Bank Ltd., Sumitomo Mitsui Banking Corporation |
| Asian     | 9  | Korea Exchange Bank, The Export-Import Bank of Korea |
| Japan     | 2  | Bank of China Limited |
| South Korea | 2 | State Bank of India |
| China     | 1  | JSC Bank of Georgia |
| India     | 1  | Near East Bank Limited |
| Pakistan  | 1  | Bank Al Habib Limited |
| Other     | 8  | Citibank N.A., The Bank of New York Mellon, Wells Fargo Bank N.A. |
| US        | 3  | The Bank of Nova Scotia Türkiye |
| Canada    | 1  | Alubaf Arab International Bank B.S.C., Dubai Islamic Bank |
| UEA       | 2  | Doha Bank, Qinvest LLC |
| Total     | 32 | Source: Turkish Bankers Association, 2015 |

As of 2015, foreign banks have 25 branches and subsidiaries in Turkey. As shown in the Table 2, 9 of them based in European countries and similarly the same number have Asian origin.
### Table 2: Branches and Subsidiaries of Foreign Banks in Turkey

| Country   | EU    | Subsidiaries                                |
|-----------|-------|---------------------------------------------|
| EU        | 9     | HSBC Bank plc, The Royal Bank of Scotland Plc., Standard Chartered |
| UK        | 3     | ING Bank A.Ş., Rabobank A.Ş.                |
| Netherland| 2     | Deutsche Bank                               |
| France    | 1     | Societe Generale                            |
| Italy     | 1     | Intesa Sanpaolo S.p.A.                      |
| Spain     | 1     | BBVA                                        |
| Asia      | 9     |                                             |
| Iran      | 1     | Bank Mellat                                 |
| Israel    | 1     | Bank Hapoalim                               |
| Pakistan  | 1     | Habib Bank Limited                          |
| Russia    | 1     | Syberbank                                    |
| China     | 1     | ICBC                                        |
| Japan     | 1     | Bank of Tokyo-Mitsubishi UFJ                |
| Azerbaijan| 1     | Pasha                                       |
| Lebanon   | 2     | Bank Audi, BankMed                          |
| Other     | 7     |                                             |
| US        | 3     | Citibank A.Ş., JPMorgan Chase Bank N.A., Merrill Lynch Yatırım Bank A.Ş. |
| Qatar     | 2     | The Commercial Bank (Q.S.C.), Qatar National Bank SAQ |
| Kuwait    | 1     | Burgan Bank                                 |
| Libya     | 1     | Libyan Foreign Bank                         |
| Total     | 25    |                                             |

**Source:** Turkish Bankers Association, 2015
In the Turkish banking system, traditionally, investment banks are supervised by BRSA. On the other hand, these banks are supervised by securities market regulators in EU. For instance, Merrill Lynch is supervised by the Securities Exchange Commission of US whereas it is supervised by BRSA in Turkey. These banks do not have authority to take any deposit and they are exempted from some of the regulation mentioned in the Banking Act such as credit lending limits, commercial trade etc.

The summary statistics are given in the Table 3 with home country base. BBVA has a very big subsidiary. Qatar, Russia, Netherland and UK have midsize subsidiaries. Investment banks are subsidiaries of Bank Hapoalim, Merrill Lynch, Pasha and Standard Chartered. They don’t have deposit taking license and fund their investment through issuance of bonds or bank borrowings. Bank Mellat, Habib Bank Limited, Intesa Sanpaolo S.p.A., JPMorgan Chase Bank N.A., Societe Generale and The Royal Bank of Scotland Plc. are formed as branches. As branches, they may open branches within Turkey.

| Home Country | Deposit Subsidiaries | Deposit Branches | Taking Investment Subsidiary | Number of Branches | Number of Employees |
|--------------|----------------------|-----------------|-----------------------------|--------------------|--------------------|
| Spain        | 1                    | 980             | 19937                       |                    |                    |
| Qatar        | 2                    | 684             | 13698                       |                    |                    |
| Russia       | 1                    | 689             | 12733                       |                    |                    |
| Netherlands  | 2                    | 283             | 5413                        |                    |                    |
| UK           | 1                    | 1               | 193                         |                    | 4240               |
| Lebanon      | 2                    | 90              | 2218                        |                    |                    |
| Kuwait       | 1                    | 51              | 1015                        |                    |                    |
| China        | 1                    | 44              | 825                         |                    |                    |
| US           | 1                    | 1               | 10                          | 592                |                    |
| Libya        | 1                    | 7               | 288                         |                    |                    |
| Israel       |                      | 1               | 1                           | 127                |                    |
| Germany      | 1                    | 1               | 121                         |                    |                    |
| France       |                      | 1               | 1                           | 93                 |                    |
| Japan        | 1                    | 1               | 61                          |                    |                    |
| Iran         |                      | 3               | 49                          |                    |                    |
| Azerbaijan   |                      | 1               | 1                           | 33                 |                    |
| Italy        | 1                    | 1               | 28                          |                    |                    |
| Pakistan     | 1                    | 1               | 16                          |                    |                    |
| Grand Total  | 15                   | 6               | 4                           | 3041               | 61487              |

Source: Turkish Bankers Association, June 2016

Regulatory Compliance Costs for Entry

Regulatory compliance costs can be during the establishment period. Those during the establishment period are mainly minimum capital requirement, “fit and proper” criteria, standard general ledger system, memberships and licenses as defined in the Banking Act. These requirements are applied to all banks in Turkey and in line with prudential regulations of EU Directives and Basel standards. However, these requirements creates additional regulatory compliance costs for international banks to enter and operate in Turkey.
The minimum capital requirement in Banking Act is around USD 10 million. After 2011, BRSA implemented a policy to require the minimum capital of 300 USD and to target the minimum capital adequacy ratio of %12. Article 9 of EU Directive (2006) requires 5 million EUR of minimum capital. Banks with corporate portfolio exposures have 100 percent of risk weighting on average in Turkey. This amount of capital should support 2.5 billion USD (=300/12%) assets.

BRSA conducts detailed “fit and proper” criteria conditions for shareholders having more than 10 percent shares directly or indirectly. Similarly decreasing below this threshold requires the BRSA approval. BRSA gives approvals on the transfer of shares after the assessment process. In this assessment process, BRSA examines documentation from the buyer of the shares to conduct the fit and proper test. This approval process can take several months due to delays of corresponding between the regulators and submitting necessary documentation.

The transfer of shares without BRSA approval is legally not valid and liability of seller of the shares continues as defined in the Banking Act. In line with EU regulation, this approval process required having above or below of the threshold values of 20 percent and 30 percent of the bank's shares. This approval process has a cost to be paid to SDIF for deposit insurance fund according to the Article 18/2 of the Banking Act. The cost “transfer of shares fee” is one percent of the nominal value of the transferred shares.

The new license issuance has two stages as establishment license and operational license. In the first stage, BRSA examines the business plans, projections, and fit and proper criteria of shareholders. After this permission, bank management has 9 months to complete the establishment process including governance, systems, and risk and control procedures.

At the second stage, BRSA examines if the bank is ready to operate properly. In case of failure, BRSA can extend this period for 3 months to complete this process. Before the application for approval, bank has to pay “system entrance fee” of 10 percent of the minimum capital requirement of 10 million USD. Practically, banks pay 1 million USD as system entrance fee to Savings Deposit Insurance Fund (SDIF) of Turkey. On the other hand, investment banks pay 0.7 million USD since their minimum capital requirement is 7 million USD.²

BRSA (2007) requires banks to apply for a standard general ledger system with detailed account names and numbers. This general ledger system is used as the base for all other regulatory reports to BRSA. Regulation does not allow banks to use their own general ledger system and convert to the required General Ledger system of BRSA. This creates additional costs for banks to implement a local banking system and convert data for consolidated financial reports and supervision of the head office.

There are few providers of local banking system with proper maintenance support. The costs of the software and its implementation costs can be very high. Also, banks need some additional development based on their business requirements and head office data requirements. This causes significant increases in establishment costs of subsidiaries and branches of international banks.

Banks are required to obtain licenses from Capital Market Board (CMB) if they have any operations related with securities market. Even buying and selling foreign exchange forward contracts requires CMB license. Similarly, fixed income and other security market transactions require additional licenses. In order to perform transaction, CMB regulations require banks to have licensed staff for treasury, risk management and operations. Banks staff can obtain these licenses through taking exams conducted by the CMB approved exam center.³ Furthermore, the central counterparty of Turkey (Takasbank) requires to be a customer for security market transactions and local money market transactions.⁴

In order to send and receive Turkish Lira wire transfer for banks’ customers, the Central Bank of Republic of Turkey (CBRT) requires banks to become a member of Electronic Fund Transfer (EFT) system. Banks send this application to CBRT after receiving operational license from BRSA. IT departments of banks and

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² The Banking Act spells the amounts in TRY and the rate of 1 USD = 3 TRY is used for conversion.
³ http://www.spl.com.tr/Home/Anasayfa
⁴ https://www.takasbank.com.tr/en/Pages/MainPage.aspx
CBRT set up technological infrastructure and security protocols. CBRT senior management approves the application within almost one month.

The Credit Registry Bureau requires banks to become a member and report regularly all credit activities for each customer. Non-compliance for those rules such as misreporting or not meeting deadlines requires monetary penalties.

The Banking Act requires banks to become a member of Turkish Bankers Association. After a formal application, the board of TBA approves the application. TBA has authorities and responsibilities to banks and BRSA. Banks has to pay an annual fee for the membership. For the Islamic banks, there is another organization, namely Participation Banks Association of Turkey.

International banks can form their entity in Turkey as subsidiary or branches. Almost all the provisions are the same for subsidiaries and branches established in Turkey. A few differences are their board structure and governance committees. Practically, BRSA requires subsidiaries to appoint a minimum of 5 Board members and establish audit committee, nomination committee and credit committee etc. If a bank is below the 5 Board member threshold and does not appoint a new member within a limited time, the Banking Act requires applying monetary penalty. Bank executives like chief officers or deputy general managers cannot serve as Board members. Whereas, branches of international banks should have minimum of 3 board member and board members can serve as executive officers.

Board members and senior managers have to provide evidence of their education and submit criminal reports from their home country for the fit and proper criteria. They shall give declaration of wealth to BRSA at the beginning and end of their service at the banks. They have to take an oath in a Turkish court to abide the Banking regulations properly. This is an additional burden on subsidiaries and branches of international banks.

**Regulatory Compliance Costs for Operations**

Those during the operation period are deposit insurance, regulatory reports, independent internal systems, external financial audit, external IT audit, regulatory penalties and labor law requirements. “Monetary penalties” and “deposit insurance premiums” are paid to SDIF for deposit insurance system in Turkey.

Cabukel and Frisch (2012: 150-153) explained the ex-ante based the “deposit insurance premium” in Turkey. The deposit insurance premium is based on a differential premium system and determined based on 15 risk factors. Banks are divided into 4 groups and pay quarterly 0.11–0.19 percent on insured deposits. Insured deposits are real person deposits that are not related with business up to approximately 30,000 USD.

BRSA has created very detailed call reports on daily, weekly, monthly and quarterly basis. These reports are a base for off-site monitoring of BRSA. BRSA produces and publishes regularly some of those reports with consolidated basis on their website. These reporting mechanisms was created after the 2001 Crisis of Turkey and have supported the transparency of the banking sector. Especially subsidiaries and branches of international banks have limited number of transactions and has to bear reporting costs due to allocating reporting staff and maintenance of reporting systems. There are cross controls between forms and BRSA approval should be received for the completion of the reporting. Non-compliance of this reporting requirement has monetary penalty and cause supervisory warnings of BRSA.

BRSA (2006) regulation requires to appoint a board member responsible from internal systems on behalf of the board. This means, the board member is the direct reporting line for departments of internal audit, risk management, internal control and compliance. This function cannot be outsourced to external parties including Head office and cannot be consolidated or merged with others. Considering compliance for the regulation in a timely manner and backup structures, these offices require minimum 2 staff each and total of 6 staff.

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5 https://www.tbb.org.tr/en/home
6 http://www.tkbb.org.tr/en
7 http://www.bddk.org.tr/WebSitesi/english/Statistical_Data/Statistical_Data.aspx
BRSA (2015) requires banks’ financial statements to be audited by external auditors on a quarterly basis, approved by board of directors and send to BRSA and TBA. The external auditors should be on the list approved by BRSA. The list consists of local offices of international big four audit firms because of selection criteria’s. The audit costs are high because of its frequency and oligopolistic market structure of auditors. Also, annual audit requires process audit to make sure proper control functions set within the banks.

 Aktan et al., (2009) described the financial shenanigans of Imar Bank Inc. After the fraudulent Imar Bank failure, BRSA (2006b) issued a regulation on information technology (IT) audit requirement by external auditors. BRSA (2010a) updated the regulation with some changes. Banks required having this audit once in every 2 years and sending to BRSA after approval of their Board. The audit process requires additional cost for auditors, staff cost for banks and remediation cost for the findings.

The Banking Act stated rules and regulation of banking in Turkey. In case of non-compliance to those provisions such as reserve requirements, IT audit requirements, financial reporting, credit lending limits etc. BRSA board has the authority to charge monetary fines as mentioned Article 143-146. These penalties paid to the SDIF for deposit insurance system. Banks in Turkey paid around a total of 2 million USD annually on average during 2006-2014. There are on average 50 banks in Turkey and each bank on average paid 40.000 USD annually.

Labor law requires to employ handicapped or formerly imprisoned person for banks more than 50 staff. Banks are allowed to have one expatriate for the employment of 4 Turkish citizens. So, subsidiaries and branches of international banks required to optimize their human resources policy accordingly.

Turkish Treasury (2011) has a regulations limit local companies to borrow in foreign currency for financial stability purposes. Since USD and EUR interest rates are lower, companies willing to borrow in foreign currency. Companies that have foreign currency income can borrow in foreign currency. Others restricted to have loan amount with minimum of 5 million USD with 1 year of average maturity.

Bank in Turkey has pay tax on interest charged for loans, namely Banking and Insurance Transaction Tax (BITT, the Turkish abbreviation of BSIV) on interest charged by banks located in Turkey. Companies have to pay a special tax on credits borrowed abroad. The tax name is The Resource Utilization Support Fund Rate (RUSF, Turkish abbreviation of KKDF). This means that subsidiaries or branches of foreign banks pay BITT and representative offices pay RUSF due to loans intermediated. BITT is 5% on interest income. RUSF has different rates based on the average maturity of loans. RUSF rates are 3% up to 1 year, 1% up to 2 years, 0.5% up to 3 years and 0% for others.

Alper and et al. (2014) showed evidence the use of reserve requirements and the central bank funding mechanism. International banks are disadvantaged to utilize the central bank funding mechanism in case subsidiaries of international banks do not to hold Turkish Treasury Bills and Bonds.

Conclusions

The Turkish banking sector is highly competitive and requires local market knowledge, and fast decision making processes. Generally, the international banks try to standardize the processes and set risk controls on processes and decisions of subsidiaries and branches. This limits their competition ability to cope with the speed of market. The best strategy is cost controlled and niche market strategy for them. Due to high entrance cost and implicit operational cost as explained in this article, this strategy can be hard to implement.

8 These kind of monetary penalties are no common the banking regulation around the World. These penalties create additional reputational and regulatory risk for Head Offices. A Head Office might be challenged by home supervisors the reasons for the penalty.

9 The amount of penalties collected can be found in the Annual Reports of SDIF. http://www.tmsf.org.tr/yillik.rapor.en

10 https://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/taxnewsflash/Documents/turkey-jan4-2013.pdf
Furthermore, there are some implicit restrictions for activities of international banks. The reporting and control requirements of BRSA and Head Office make some operations practically not feasible to provide some product and services. International banks generally product approval processes for consolidated financial and regulatory reporting. Even if they extended one single piece of deposit for individuals they are obliged to use certain accounting general ledger and to fill in call reports to Head Office and BRSA. They are required to define additional internal control and risk management processes for each product and services.

The establishment period of a bank takes almost one year. Especially, international banks consider this establishment as a new project with so many international advisors. International banks should carefully take into account the cost of establishment for their cash flow analysis.

BRSA apply the same rules for all banks without differentiation of type, operation or size. We believe regulatory compliance costs have significant impact on the decision of international banks to operate in Turkey. Policy makers in Turkey should evaluate these regulatory compliance costs if they are really needed or they are just a red tape for international banks. The banking regulations should be balanced in way that Turkey meet the standards of international banking regulations such as Basel and EU. However, having unnecessary prudential regulations limits Turkey’s policy objectives of being a financial center.

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