GEDİK & ERAKSOY

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Implementation of the Basel III Capital Accord in Turkey

*The international regulatory capital standards recommended by the Basel Committee (known as Basel III standards) in response to the recent financial crisis have been transposed into Turkish law through secondary legislation enacted by the Banking Regulation and Supervision Agency (**BRSA**).*

General Framework

The BRSA has released the Regulation on Equity of Banks (published in the Official Gazette dated 5 September 2013 and numbered 28756), the Regulation Amending the Regulation on the Measurement and Evaluation of Capital Adequacy of Banks (published in the Official Gazette dated 5 September 2013 and numbered 28756), the Regulation on Capital Conservation and Countercyclical Capital Buffers (published in the Official Gazette dated 5 November 2013 and numbered 28812), the Regulation on Measurement and Assessment of Leverage Levels of Banks (published in the Official Gazette dated 5 November 2013 and numbered 28812) (together **Basel III Framework**), all of which came into force on 1 January 2014. Furthermore, in line with the Basel III liquidity standards, the BRSA has published the draft form of the Regulation on Measurement of Liquidity Matching Ratio of Banks, which is expected to be promulgated in due course.

Minimum Capital Requirements

The total capital adequacy ratio is set at a rate of 8% of risk weighted assets. Banks must hold common equity Tier I capital of at least 4.5% and additional Tier I capital of at 1.5%, with the remaining 2% being Tier II capital. Furthermore, the BRSA currently imposes 4% additional capital requirement to Turkish banks as a prudential requirement.

Features of Tier I Capital

Tier I capital is composed of common equity Tier I capital (*cekirdek sermaye*) and additional Tier I capital (*ilave ana sermaye*). Common equity Tier I capital is calculated after the addition and deduction of certain elements. Banks are permitted to include preferential shares (*imtiyazli paylar*) and debt instruments as additional Tier I capital. Eligibility of debt instruments as additional Tier I capital is subject to certain conditions being fulfilled and is further subject to the approval of the BRSA.

Features of Tier II Capital

Tier II capital of banks is composed of loss provisions (*genel karsiliklar*) and debt instruments that do not qualify as Tier I capital. For the purposes of calculating Tier II capital, there are certain items deducted from equity such as certain periodic losses etc. Eligibility of debt instruments as additional Tier II capital is subject to certain conditions being fulfilled and is further subject to the approval of the BRSA.

Debt instruments qualifying as Tier II capital and having an outstanding maturity of less than five years must be decreased by 20% each year, on an amortised basis, for the purpose of Tier II capital calculations. The portion of the general provisions exceeding the 1.25% of the amount subject to credit risk would not be included in Tier II capital calculations. In relation to participation banks, the general provisions reflected in the expenditure accounts must be taken into account while adding up the general provisions to Tier II capital.

Capital Buffers

As part of Basel III standards, the BRSA has introduced additional capital buffers for banks, including the capital conservation buffer and the countercyclical buffer. The capital conservation buffer rate is set at 2.5% and is defined as the amount of additional common equity Tier I capital to be set aside by banks to prevent depletion of regulatory capital levels following economic weaknesses. Furthermore, the BRSA will impose countercyclical capital buffer on banks in response to periodic excess credit growth. The countercyclical capital buffer shall consist of common equity Tier I capital at a rate to be determined by the BRSA.

Contractual Loss Absorption Feature

Basel III Framework adopts contractual loss absorption features. Accordingly, contractual terms and conditions of Tier I and Tier II instruments issued by a Turkish bank must contain a provision that allows such instruments, at the discretion of the BRSA, to either be written down or converted into common equity upon the occurrence of a trigger event. Otherwise, such instruments would not be treated as Tier I or Tier II instrument.

Point of Non-viability (PoNV) Loss Absorption

The PoNV loss absorption for both additional Tier I capital and Tier II capital is linked to the occurrence of likelihood that the operational licence of the bank will be revoked, or the management of the bank will be transferred to the Saving Deposit Insurance Fund pursuant to Article 71 of the Banking Law (No. 5411). Following the occurrence of the above mentioned event and upon the decision of the BRSA, the debt instruments should either be written down temporarily or permanently, or converted into equity shares by the bank. The Basel III Framework remains silent as to whether partial write down is permitted or not. Likewise, the Basel III Framework is silent as to whether a debt instrument which has been written down can be written-up again, if the relevant deficiency is cured. Furthermore, it is not clear whether, after the PoNV is triggered, the Tier I capital will be hit first before the Tier II capital.

Loss Absorption at Pre-specified Trigger Point

The Basel III Framework sets a pre-specified trigger point only for additional Tier I capital. On this basis, if the core capital adequacy ratio of the bank falls below 5.125%, upon the decision of the BRSA the bank must either: (i) convert the relevant debt instruments into equity share(s); (ii) fully write-down the debt instruments from its records in return for equity shares; or (iii) partially write-down the debt instruments, which will be implemented as follows:

1. if the bank is being liquidated, the amount receivable arising out of the debt instruments must be reduced;

2. if the repayment option is exercised, the repayment amount must be reduced; or

3. the dividend payments or the coupon payments must be partially or fully cancelled.

The Basel III Framework is silent as to whether a debt instrument, which has been written down, can be written-up again if the capital deficiency is cured.

Grandfathering Provisions

Instruments which do not meet the eligibility conditions for additional Tier I capital or Tier II capital will continue to be treated as such provided that they are subject to an amortisation of 10% each year, starting from 1 January 2015. The instruments not qualify as common equity Tier I capital as of 1 January 2014 will be subject to the above mentioned treatment if the following conditions are satisfied:

1. the instruments are issued by a company incorporated in a form other than a joint-stock company; and

2. the instruments are accounted for as "equity" according to Turkish Accounting Standards and taken into account at a ratio of 100% within the core capital.

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