

Fraud and Banking Crises: Evidence from Micro-level Transactions Data

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December 1, 2003

Comments welcome

Abstract

Can widespread fraud cause large scale banking crises? We address this issue in the context of the recent Turkish banking crisis of 1999, which was followed by a severe currency crisis. Using detailed micro-level transactions data from a bankrupt bank, we show that related lending and back-to-back loans across banks were used to circumvent regulation and transfer deposits to private holding companies that were ruined. Our evidence suggests that systemic fraud can be a source of banking crisis.

Keywords: banking crises, looting, currency crises, Turkey

JEL Classification: G21, G33, G28

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1. Introduction

There is now a large and important literature on the relationship between banking and currency crises. The consensus view is that in the post-capital account liberalization and financial de-regulation era (since the early 1980's) banking crises tend to precede the currency crises – although they also tend to share common causes (Graciela and Kaminsky, 1999).¹ While in most cases “weak” economic fundamentals, as measured by the deterioration in the terms of trade, declining exports and real output, and real exchange rate appreciation, emerge as the key drivers of these crises, the question remains: Why do certain countries end up in severe banking and currency crises during episodes which otherwise appear to be “normal” phases of the business cycle? One possible explanation is that the combination of institutional weaknesses and economic vulnerabilities create an ideal environment for opportunistic individuals to engage in fraudulent activities in the financial sector, which in turn lead to a further deterioration of economic fundamentals.

This paper, using micro level transactions data from a bankrupt Turkish bank, demonstrates that widespread fraud and looting can be an important determinant of severe banking crises. The evidence we present is based on an auditor's report that (i) not only documents the transactions that are unequivocal manifestations of looting, but also provides us with insights about the “true” intentions of the agents, and (ii) demonstrates the participation of a range of other bankrupt banks and ruined firms in the bankruptcy for profit strategies. Akerlof and Romer (1993) define looting (or bankruptcy for profit) as a situation in which “firms have an incentive to go broke for profit at society's expense (to loot) instead of to go for broke (gamble on success). Bankruptcy would occur if poor accounting, lax regulation, or low penalties for abuse give owners an incentive to pay themselves more than their firms are worth and then default on their debt obligations.” Indeed, this definition captures a striking aspect of reality in Turkish banking before the banking and currency crises of 1999 and 2001.

Specifically, the strategies we document include falsified increases in equity capital of the bank, using intermediary firms to lend above the legally set limits to companies that are controlled by the bank's owners (“related lending”), and back-to-back

¹ Diaz-Alejandro (1985) and Velasco (1987) are the early studies that link currency crises to bank bailouts.

lending among banks that apparently reduce the exposure of the bank to its own companies. All these companies were later ruined, leaving behind many insolvent banks.

The idea that the banking sector may be especially prone to looting is not new. Many academics and commentators have long recognized fraud as a potential source of banking crises. However, most studies on banking crises focus on the link between banking crises and macroeconomic factors that are beyond the banks' control; see, e.g., Gavin and Hausman (1996) and Demirgüç-Kunt and Detragiache (1998). Part of the difficulty in empirically tackling looting as a cause of banking crisis arises from the fact that the econometric evidence falls short of explaining, say, why banks with higher share of related lending in their total assets performed relatively poorly. Fraud is certainly not the only possibility. Given the importance of asymmetric information in day-to-day banking operations, it is possible that banks' managers might be genuinely more optimistic about the prospects of these loans than the ex-post evidence might suggest. Disentangling these issues is a complex empirical task, and we feel that our study provides a "smoking gun" in an important example of banking crisis.

As well, for looting to be viewed as a cause of a banking crisis, it must be a widespread practice. However, most evidence that appears in the aftermath of these crises is usually anecdotal, and one wonders whether the problems were isolated instances of mismanagement or had a systemic component. Again, the detailed evidence we present, especially in the context of back-to-back loans, shows that numerous banks, now all defunct, participated in these schemes, suggesting that looting was not an isolated incidence.

What makes the recent Turkish banking crises of 1999, from which our evidence is drawn, even more striking is that Turkey had a number of banking crises since the early 1980's. There have been numerous attempts to streamline the banking industry, open it to foreign competition, and introduce state-of-the-art regulatory and supervisory framework, which would have presumably provided safeguards against such outright bankruptcy for profit strategies. The failure of such attempts to mitigate the recent banking crisis in Turkey suggests that, especially in developing countries, the banking sector will continue to be vulnerable to systemic fraud and corporate mismanagement.

While the case we examine and the evidence we present may be viewed as somewhat “extreme”, the Turkish case has a number of similarities with other recent banking crises. Several authors have argued that the Asian currency crisis was largely driven by the problems originating from the banking systems of the affected countries (Burnside et al., 2001; Corsetti et al., 1999). Indeed, most commentators have taken the position that the banking sector problems were the stylized manifestations of “crony capitalism”, especially in Indonesia, Malaysia, and Thailand.

The important work by La Porta et al. (2003) is closest in spirit to our work. They argue that related lending had a considerable impact on the Mexican bank’s overall performance circa 1995. They interpret their findings as evidence for looting in the Mexican banking sector. We contribute to this line of research by documenting a range of looting strategies and the significance of collusion among like-minded bankers.²

We certainly do not claim that all banking crises had a component of fraud. We do, however, feel that the sort of evidence we present in this paper has important policy implications. Looting thrives when legal and political institutions are weak. In particular, diligent supervision and corporate transparency are important determinants of an overall institutional environment, and the effectiveness of supervision technology may interact with macroeconomic environment. Figure 1 summarizes our conceptualization of these issues, in general.

The evidence we present also has theoretical implications for explaining banking and currency crises. One of the explanations advanced for the Asian currency crisis was that foreigners rationally anticipated large government deficits due to implicit bank bailout guarantees (Burnside et al., 2001). In the context of looting, bank failures may not only contain information about prospective government deficits (and inflation tax), but may also be sending a strong signal about future macroeconomic performance (real sector). To the extent that foreign lenders react to these signals differently, the fundamental cause of the banking crisis may help distinguish among the alternative explanations of currency crises.

² Although our focus is on banking sector, there is now a growing literature on similar aspects of private expropriations called *tunneling*. In these cases, controlling shareholders siphon profits off high cash flow firms to low cash flow firms for their own narrow interests. See Johnson, La Porta, Lopez-de-Silanes, and Shleifer (2000) for a formalization, and Johnson Boone, Breach and Friedman (2000) for an analysis in the context of the Asian crisis.

The rest of our paper is the paper is organized as follows. Section 2 provides some background on the Turkish banking crises. Section 3 introduces the bank that we analyze and presents our detailed evidence on looting strategies. Section 4 concludes.

2. Institutional Background

The institutional development of the regulatory and supervisory mechanisms in the Turkish banking sector has typically lagged behind the deregulation of the financial sector. The primary example is the introduction of (explicit) deposit insurance after 1983, immediately following the massive collapse of the savings and loans institutions. These then novel financial institutions grew at a phenomenal rate in the early 1980s through blatant pyramid schemes until a run put a quick end to that era. However, financial deregulation continued with weak banking and financial sector institutions, endowing Turkey with 3 major banking crises in 1994, 1999 and 2001 (see figure 2 for a timeline of Turkish banking history).

Of course, there were also attempts to streamline the legal framework. The 1985 law on banking regulations (Banks Act No. 3182), which also retroactively formalized the limited deposit insurance, was a landmark and represented the first major endeavor to regulate the banking sector (Alper and Öniş, 2001).³ With this Act, the Treasury became the principle institution responsible for bank supervision and regulation. The Act authorized the Board of Sworn Bank Auditors associated with the Treasury to examine banks' legal compliance and their financial standing. Banks identified as performing in an “unsatisfactory” manner were reported to the Minister responsible for Economic Affairs, who typically placed the bank under the surveillance of the Treasury (under Article 64).

However, Article 64 was replete with moral hazard problems. For instance, it exempted the bank from reserve requirements and gave the Minister the authority “to take all measures”, including tax breaks, “to strengthen its financial health” (Denizer, Güntekin, and Güntekin, 2000). This Article effectively sheltered those banks whose financial health was deemed poor or deteriorating. Indeed, more than 15 banks had been put under Article 64 for an average of about *nine* years, as banks, reluctant to be removed

³ On the evaluation of the legal framework of the banking regulation in Turkey, see Canevi and Çetinkaya (2001), Alper and Öniş (2001). For regulations and legislation, see the web site of BDDK: <http://www.bddk.org.tr>.

from the list, made the regulatory process vulnerable to political intervention. None was declared bankrupt until the IMF, for the 1999 stand-by-agreement, required the immediate closing of five of them.⁴

Deposit insurance legislation provided further impetus to the banking sector problems as the coverage became progressively more generous. Initially the coverage on Turkish lira deposits was 100 percent up to a legally set maximum and 60 percent thereafter (Banks Act No. 3182). In 1992, the coverage was extended to foreign currency accounts. Finally, after the banking crisis and a run on banks, the Treasury on May 5, 1994 declared 100 percent insurance on all deposits.⁵ Although this helped to stabilize the banking sector during the 1994 crisis, it also encouraged further risky behavior leading up to the crisis in 1999.

The severe banking crises in 1999 highlighted the need for instituting an autonomous and independent banking supervisory and regulatory framework. The Banking Regulation and Supervisory Agency (BDDK) was formed following the enactment of the Bank Act No. 4389 in 1999. This represents an important milestone in banking regulation in Turkey. As an independent regulatory agency, BDDK would not face the same political pressures that plagued the supervisory functions of the Treasury. However, this organization is not entirely isolated from political intervention: its chairman and board members are appointed by the Cabinet. In fact, in 2000, the appointment of the first board bitterly divided the governing coalition and the final decision was repeatedly delayed.⁶

Since the inauguration of the BDDK, it has seized 22 private banks, some of whose owners and senior managers are on trial for embezzlement. A number of state banks have

⁴ The letter of intent can be accessed at www.imf.org/external/np/loi/1999/120999.htm.

⁵ Three banks become insolvent in 1994. The 1994 banking crisis was associated with a currency crisis, when the currency was devalued by 50 percent after the central bank lost 50 percent of its official reserves, and macroeconomic deterioration (6 percent decline in real output), 50% loss of CBRT reserves, skyrocketing interest rates and the closing of three banks. However, Kazgan (2001) argues that these banks were already insolvent before the crisis, and behaved opportunistically by attributing their problems to the currency crisis and the recession.

⁶ The appointment of the board was a “structural performance criterion”, which had to be met to qualify for financial assistance from the IMF. The appointments were announced one day before the IMF deadline. Hence, with the new legislation, “political” intervention appears to have been shifted to another level. After the crises in February 2001, the IMF requested the dismissal of the first set of board members, raising serious questions in public concerning the true credibility and autonomy of BDDK (Alper and Öniş, 2001).

also been reorganized. So far, BDDK has injected more than US\$42 billion into the banking sector.

3. Bankruptcy for Profit Strategies

3.1. Esbank and the Zeytinoğlu Business Group

The bank that we focus our examination on is Esbank JSC. This was one of the oldest commercial banks in Turkey, having been established in 1927. It grew swiftly during the 1990s when banking was at its peak in Turkey. Prior to its closure, it had 91 branches and employed 1,898 people (BAT, 2000.) Esbank JSC was owned by the Zeytinoğlu Group, which had numerous investments and operations in different industries such as cement, concrete, construction, automotive, heavy machinery and tourism, in addition to its involvement in the finance sector.⁷ Esbank JSC was declared insolvent on December 23, 1999 when the control of the bank was transferred to the Saving Deposit Insurance Fund (SDIF).

Table 1 shows selected items from Esbank's 1999 balance sheet. The Table reflects Esbank JSC management's official declaration, and shows total assets of US\$ 1.9 billion as of September 31, 1999. However, evaluations made after its transfer to SDIF on December 23, 1999 show actual total assets of only US\$814 million resulting in a shareholders' equity deficit of approximately US\$957 million.

As shown on Table 2, Esbank JSC's performance ratios were positive and successful in 1996 and 1997. However, starting in 1998, the performance ratios began deteriorating and by 1999 they had reached significant negative values. Both 1999 and 2000's profitability ratios show that Esbank JSC had significant losses during this period. The capital ratio indicates that Esbank JSC lost all its capital in 1999.

In addition to performance ratios, another important indicator of the quality of a bank's assets is the non-performing loan to total loan ratio. As shown in Table 2, in 1999 and 2000 Esbank JSC's non-performing loan / total loan ratio skyrocketed compared to

⁷ The Zeytinoğlu business group included: Zeytinoğlu Holding JSC, Zeytinoğlu Insurance JSC, Esiem Fertilizer Industry JSC, Esen Machine Industry JSC, Jamak Machine Industry JSC, Eston Concrete JSC, Eşçim Cement JSC, Eston Construction JSC, Entil Industrial Investment JSC, Petsa Petroleum JSC, Kümaş Magnesium JSC, Estron Electronic JSC, Estron Computer JSC, Es Leasing JSC, Zeytinoğlu Automotive JSC, Emaş Heating JSC.

previous years. What is not shown in this table is that over half of the non-performing loans were to related companies of Esbank JSC.⁸

Was this dramatic shift in Esbank's financial position generated from Turkey's macroeconomic deterioration during the same period, or are there any other reasons behind this? It is true that in the second half of 1999 Turkey's overall macroeconomic situation started deteriorating, and it is possible that this might have contributed to the performance of on balance sheet items. However, as we argue below, the insolvent banks during that time already had been looted and became bankrupt due to "bankruptcy for profit" strategies.

Specifically, the causes behind Esbank JSC's deterioration in the years 1998-1999, and finally Esbank's transfer to SDIF as an insolvent bank, will be shown to be widespread fraud through illegal loans and transfers to related companies in the Zeytinoğlu business group. Then prevailing Turkish Banking legislation⁹ restricted the amount of loan extensions from banks to their affiliated group of companies to a maximum of 50% of the bank's equity capital. The examination of Esbank's transactions indicates that these legal requirements had been repeatedly and significantly exceeded after 1998 in an attempt to transfer funds out of the bank.

Table 3 Column 1 shows the extent to which Esbank's group loan limits were exceeded based on equity capital reported by the Bank.¹⁰ Although the first quarter of 1999 does not indicate any significant excess of the limits, in the 4th quarter of 1999, the legal limit was exceeded by US\$159 million. The sudden increase in the amount of loan transfers just before Esbank's transfer to SDIF on December 23, 1999 (increasing from US\$130 million to US\$221 million between September and December of 1999), indicates premeditation on the part of Esbank's executives to maximize their looting.¹¹ While this fraud was perpetrated in many forms, most of it was done by falsified increases in equity capital of the bank, using shell firms to lend above the legally set limits to companies that

⁸ For more on the loans by Esbank to family owned Zeytinoğlu business group see Soral (2003).

⁹ Bank Acts was amended several times during the inspection. Therefore, the results of the inspection are based on Act 3182 for the period of 01.01.1995 – 23.06.1999, and Act 4389 for the period of 24.06.1999-31.12.1999.

¹⁰ As will be seen in the following sections, the official capital and the real capital are different, due to collusive transactions.

¹¹ In a personal interview, the auditors of Esbank indicated that the members of the board had withdrawn all their deposits from the bank in mid-1999.

are controlled by the bank's owners ("related lending"), and making back-to-back loans to other banks. Each of these types of fraudulent strategies is of interest and will be discussed in turn.

3.2 Falsified equity capital

One of the strategies pursued by the Bank to circumvent already generous regulatory limits (50%) on related lending was falsified capital expansion. Esbank JSC executives, on numerous occasions, artificially increased the amount of equity capital of the bank, and their sole purpose appears to increase the lending limits to the Zeytinoğlu Group. Although a bank's equity capital is supposed to be increased by injecting cash from shareholders, to raise capital Esbank borrowed from related firms while in turn issuing letters of credit for the same amount. As well, firms in the Zeytinoğlu business group purchased the bank's equity (however no cash was ever paid for these shares.) Due to these transactions, the Bank's records show improved equity capital, while in reality the bank's equity exhibited no increase.

The following is a representative illustration of such dealings. At a meeting on August 2, 1996, Esbank's executive committee decided that the existing paid capital of US\$73.4 million should be increased by US\$48.9 million cash, to a total of US\$122 million. According to a Report¹² by Official Banking Auditor of the Turkish Treasury, only US\$4 million was paid in the form of cash. The rest was sourced as follows: US\$15 million borrowed from international financial markets obtained by Zeytinoğlu Holding JSC (for this same loan amount Esbank JSC issued a letter of credit), US\$8.6 million loaned on behalf of Zeytinoğlu Holding JSC from Tarişbank and Türk Ekonomi Bankası (for this same loan amount, Esbank made a depot account¹³ at Tarişbank and Türk Ekonomi Bankası), US\$9.1 million originated from Esbank JSC as a Zeytinoğlu group loans, and the rest was provided miscellaneously .

Clearly, while Esbank's paid capital was increasing, cash and non-cash loans to the Zeytinoğlu Group increased proportionately. In other words, Esbank's liabilities

¹² The Report of the Official Banking Auditor of the Turkish Treasury on October 4, 1996, number M-4/23. These reports were prepared by independent auditors for the Treasury.

¹³ A "depot account" is an account that is used for transactions between banks. After a bank loans an amount of money to another bank's group of companies, the second bank repays the first by depositing the same amount into a depot account. Thus, it is usually used to block the same amount in the form of cash or non-cash.

increased for the loans that the Zeytinoğlu Group took and used for capital expansion. The actual increase in the Bank's paid capital was limited only to US\$ 4 million.

Another interesting aspect of such fraudulent capital expansions is that they were typically fabricated to meet explicit regulatory requirements and directives. For instance, the report of the Official Banking Auditors of the Turkish Treasury¹⁴ on June 18, 1998 classified Esbank's equity capital as "insufficient". To meet the legal 8% capital adequacy requirement, the Bank needed to inject an additional US\$111 million.¹⁵ This report also indicated that Esbank should further provide about US\$114.4 million to maintain the bank's financial viability.

Esbank executive committee met on October 23, 1998 and, based on the Report's recommendations, voted to increase its equity capital by US\$124 million, of which US\$96.5 million should be in the form of cash. However, the latter amount was never supplied to the bank. The executive decided that several of the Zeytinoğlu business group companies would purchase shares in the bank.¹⁶ Incidentally, the cash amount for these shares was never paid; instead it was entered in an account as liabilities due to the capital expansion of Esbank JSC.

The outcome of these fabricated capital expansions was a balance sheet whose true health was masterfully disguised. The second column of the Table 3 shows the loan/equity capital calculations based on the legally acceptable paid equity capital. According to these amounts, in each quarter in 1998 and 1999, the legal limits to lending loans to its group of companies were exceeded dramatically. By 1999, the exceeded amount was greater than the total equity capital of the Bank and steadily increased. In the third and fourth quarters of 1999, the amount above the legal limit was respectively, twice and four times that of the equity capital of the bank.

3.3. Group Loans through Shell Firms

Bankruptcy for profit strategies usually included a web of shell firms whose primary task was to obscure the true exposure of Esbank to Zeytinoğlu business group. In this context, Esbank AG was particularly instrumental in intermediating related loans. The Zeytinoğlu

¹⁴ The financial analysis report, number R-2.

¹⁵ This refers to the consolidated and solo capital adequacy standard ratio, as defined in the "Regulation on Measurement and Assessment of Capital Adequacy of Banks" (BRSA, 2002).

¹⁶ The executive committee decision on 31 December 1998, and number 44/6.

Group was the major shareholder of Esbank AG, which was established in Austria. It was used to borrow from Esbank JSC and in turn lend to the Zeytinoğlu Group in an attempt to circumvent legal limits, which had already been exceeded in large amounts.

Again these transactions were skillfully designed to minimize the explicit exposure of Esbank to Zeytinoğlu business group. To issue a loan through to Esbank AG, Esbank JSC opened a “depot account” at Esbank AG for the equivalent amount of the loan that would be issued. Then, Esbank AG, after deducting a certain amount of profit margin from the loan, distributed these funds to Zeytinoğlu Group companies, as directed by Esbank JSC.

Column 3 of Table 3 shows the total Zeytinoğlu Group loans through Esbank JSC and total Zeytinoğlu Group loans through Esbank AG. The Table also shows the amount that legal limit was exceeded based on the legally valid capital expansion. When we compute the loans that were issued to the Zeytinoğlu Group via Esbank JSC and through Esbank AG, the results are again very telling about the causes of Esbank JSC’s failure. In the fourth quarter of 1998, a total amount of US\$258 million was loaned to the Zeytinoğlu Group in contrast to only US\$78 million equity capital of Esbank JSC. As well, in the fourth quarter of 1999, a total of US\$378 million was loaned, compared to only US\$49 million equity capital.

3.4 Back-to-back Loans

So far we have shown that Esbank JSC expropriated funds from the bank to related firms by exceeding legal loan limits. Was Esbank JSC an isolated instance of fraud, or did the fraud have a systematic component throughout the Turkish banking system? The internal audit report used in this paper only addresses Esbank JSC.¹⁷ However, some of the information provided in this report clearly suggests that other banks were engaged in similar bankruptcy for profit strategies. This is most evident in back-to-back loans. These transactions allowed the banks to circumvent the regulations and the legal limits without being subject to any scrutiny or investigation

¹⁷ The report was prepared on June 07, 2000 by order # 671 of the Internal Auditing Office after its transfer to SDIF. The report is confidential, and those who wish to access it should direct their requests to the Esbank JSC Board of Internal Audit Office. This is the only audit that has been made available for the authors. Audits from other bankrupt banks have not so far been disclosed and/or made public.

Back-to-back loans involved Esbank making loans to firms that owned banks, which in turn made loans to Zeytinoğlu Group. Analyses of the loan amounts, opening days and their interest rates clearly indicate that these loans were back-to-back, and engaged in mutual knowledge of their illegality. Indeed, *all* the banks that exchanged loans with Esbank were also classified as insolvent during the period of 1999–2002 (See Table 4).

Table 5 shows the total amount of back-to-back loans made by Esbank JSC and through Esbank AG to each of partner bank. The total amount of back-to-back loans add up to approximately US\$217 million and DM29 million.

Appendix A shows the detailed transactions of each back-to-back loan made. In total, there were 11 other banks used to make back-to-back transactions. The dates, amounts, and rates of interest of each of these loans were almost identical indicating a clear “back to back” motivation. There is also no doubt that these transactions were orchestrated by senior managements on both legs of the transaction. Auditors concluded from their investigations that directives were directly given by the office of the Chief Executive Officer and/or from the members of board. The audit report is unequivocal about the fact that the top management and board members of Esbank JSC were well aware of the back-to-back loan transactions.

3.5 Other Bankruptcy for Profit Strategies

The above three bankruptcy for profit strategies were by no means the only illegal methods used by Esbank to expropriate wealth. During the period between 1995 and 1997, almost all the interest on Group lending was accrued and collected without any delay. However, during the period 1998-1999, when outright looting took place, almost no interest on loans to the Zeytinoğlu Group was collected. Instead, “reeskont” (fake accounting) transactions were applied to all accumulated interest amounts essentially including this uncollected interest as income.

An alternative bankruptcy for profit strategy is the misuse of temporary accounts. Temporary accounts were supposed to include any transaction which could not be properly accounted for. These transactions had to be put into a temporary account for a maximum of one-business day. Between January 1, 1995 and December 31, 1999

\$US115 million in loans transferred to the Zeytinoğlu Group by Esbank JSC were kept in temporary accounts significantly longer than the one-day limit.

3.6 Net Effect of Bankruptcy for Profit Strategies

Table 5 summarizes all the losses faced by Esbank for each of the strategies discussed. Esbank had losses of over \$US 490 million

4. Conclusion

We have presented micro level transactions data to argue that looting was an important factor in the 1999 banking crisis of Turkey, and documented several of the important strategies used for private expropriation of deposits. None of the evidence we have access to from the comprehensive audit report makes any reference to exchange rate risk, macroeconomic deterioration, or differential risk-assessment based on Esbanks' superior access to information about Zeytinoğlu Group. Even if such factors have played a role in the collapse of Esbank, we feel that they fade to insignificance in light of the blatantly fraudulent deals and related lending that we have documented.

We, of course, do not argue that looting was the sole determinant of the Turkish banking crises of 1999, and the ensuing recession which was the deepest in modern Turkish history. Even those banks that had a clear track record were severely affected by the crisis. Although we have not identified and discussed such links, our conceptual framework (Fig. 1) allows for such feedback effects.

What were the principle sources of supervisory and regulatory ineffectiveness that eventually led to the banking crisis of 1999? Two political economy considerations were important in the context of Turkey. First, the Treasury was lax on regulation because banks were fulfilling an important role in meeting its large borrowing requirements during this period. Second, at times banking licenses were granted to unscrupulous campaign financiers as kickbacks. Perhaps much of the shenanigans of the corrupt banks could have been avoided with a stronger legal and supervisory environment.

Indeed, it is generally believed that BDDK has improved the regulation and supervision, reduced the scope for lobbying, and curtailed politicians' ability to intervene

in the process. However, while reducing conflict of interest and granting independence to the supervisory agency are significant, BDDK has only been partially effective in containing “looting” in the Turkish banking system. In fact, the latest (2003) failed bank in Turkey (İmar Bankası) has an astonishing track record. According to BDDK, Uzan family, who owned the bank, embezzled about US\$6 billion (equivalent to 3 percent of Turkey's GDP) from the bank, using a specially coded computer program. The BDDK inspectors found "an extraordinarily large discrepancy" between deposits registered in the bank's books and money deposited by the public (Financial Times, 2003). They concluded that: "The bank hid more than 90 percent of the deposits it collected and did not show it in the accounts it published for the benefit of the public and in official documents [sent to BDDK]."

Much of what we have discussed here might, of course, be viewed as a malaise of underdevelopment and financial sector immaturity. However, given recent concerns about corporate fraud and tunneling, we believe that regulators and auditors must be mindful of dishonest dealings, and corrupt business practices.

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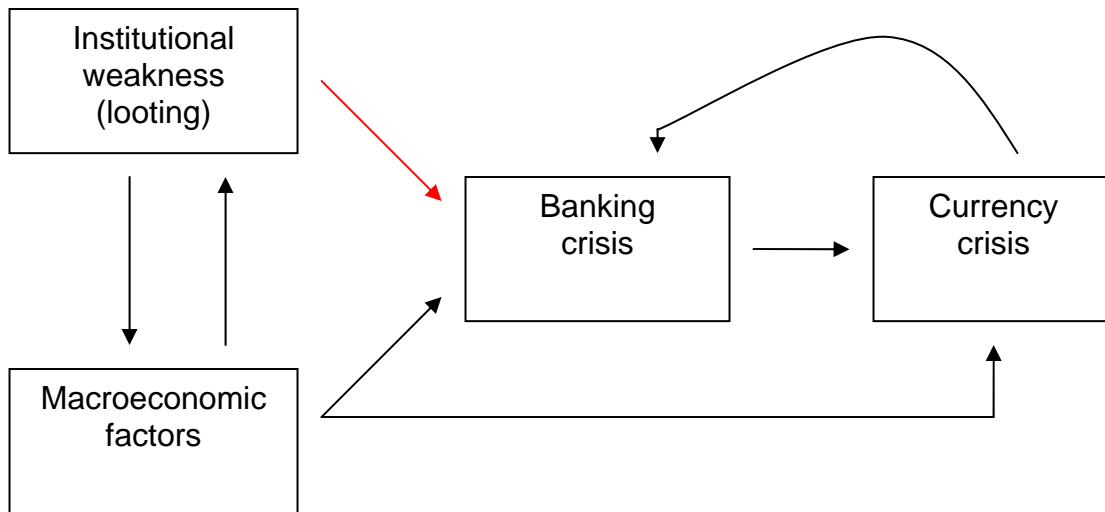


Figure 1: Schematic representation of causal factors

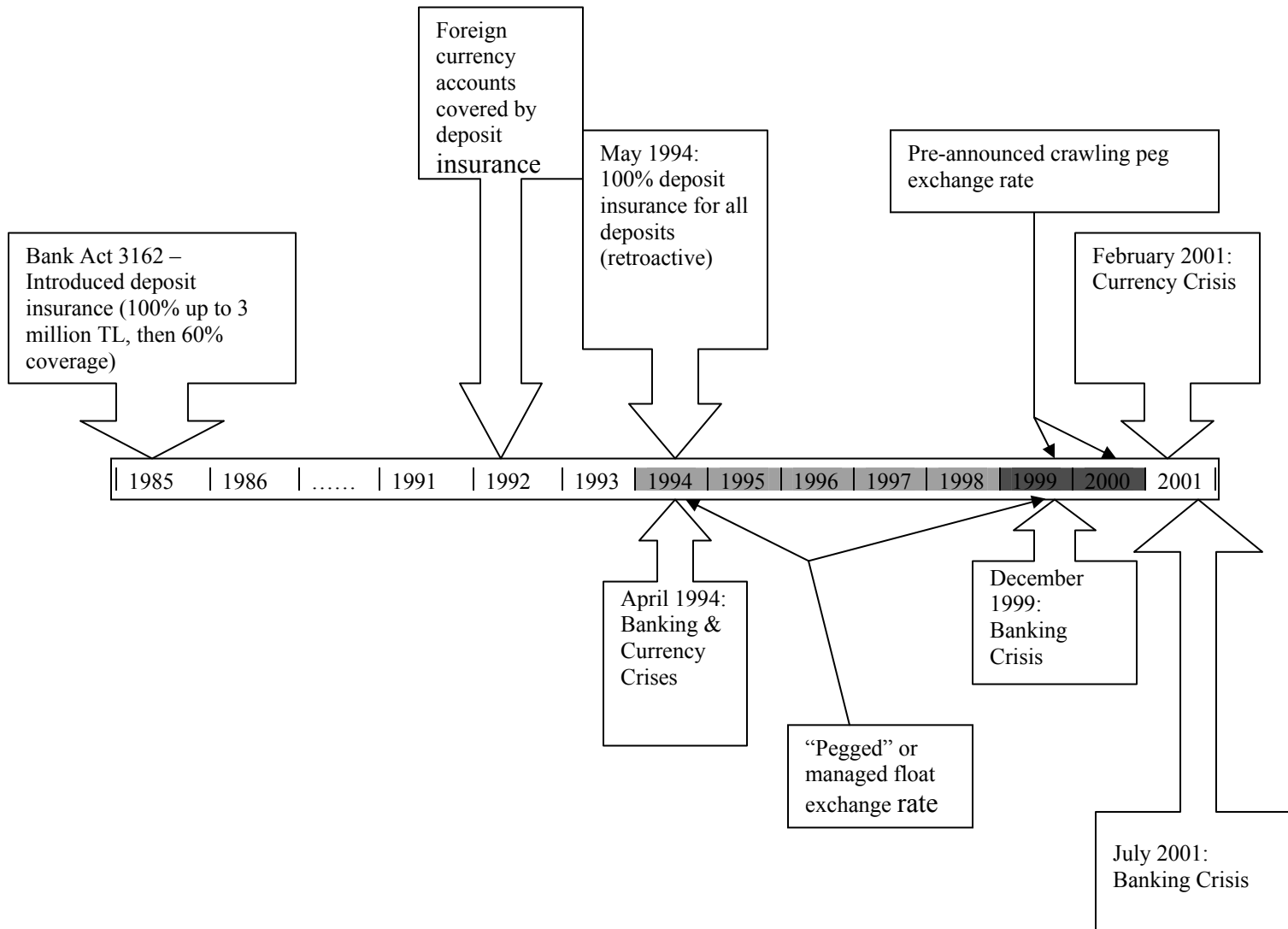


Figure 2: History of Turkish Banking

Table 1: Balance Sheet of Esbank JSC.

Balance Sheet Item	31. September. 1998		31. September. 1999		31. March. 2000	
	US\$ (000)	(%)	US\$ (000)	(%)	US\$ (000)	(%)
Assets						
Liquid Assets	608,000	34	616,000	32	412,000	51
Loans	789,000	45	515,000	27	319,000	39
Investments in Other Companies	16,000	1	67,000	4	3,000	0.1
Total Assets	1,767,000	100	1,896,000	100	814,000	100
Liabilities						
Deposits	1,430,000	81	1,576,000	83	1,527,000	188
Other Liabilities	99,000	6	100,000	1	169,000	21
Shareholders Equity	94,000	5	142,000	7	-957,000	- 118
Total Liabilities	1,767,000	100	1,896,000	100	814,000	100

Source: Banks Association of Turkey (2002).

Table 2: Performance Ratios of Esbank JSC

	March 2000	1999	1998	1997	1996
Capital Ratios					
(Shareholders' Equity + T. Income) / Total Assets	-117.6	-78.3	10.9	7.2	9.2
(Shareholders' Equity + T. Income) / (Deposits + Non-deposit Funds)	-59.7	-49.9	13.1	8.1	10.6
NWC / Total Asset	-118	-77.3	1.4	2.1	0
Assets Quality					
Loans / Total Assets	39.2	34.9	42	43.5	41.5
Non-performing loans / Loans	67.1	50.5	1.5	3.1	6.9
Liquidity					
Liquid Assets / Total Assets	50.6	47.8	28.7	36.5	34.7
Liquid Assets / (Deposits + Non- deposit Funds)	25.7	30.5	34.4	41.1	40.1
Profitability					
Net Income (Loss) / Average Total Assets	-17.4	-71	0.9	1.4	0.8
Net Income (Loss) / Average Share Capital	-209.2	-877.2	13.3	25.5	10.8
Income-Expenditure Structure					
Interest Income / Interest Expense	66.1	90.7	182.5	152.2	122.5
Non-Interest Income / Non-Interest Expenses	-185.4	-123.9	-78.5	-58.9	49.9
Total Income / Total Expenditure	10.6	37.9	108.5	108.8	109.7
Share in Sector					
Total Assets	0.6	0.8	1.4	1.5	1.6
Loans	0.8	1	1.6	1.5	1.6
Deposits	1.7	1.8	1.7	1.9	1.8

Source: Banks Association of Turkey (2002).

Table 3: Loans to the Zeytinoğlu Group Above Legal Limits by Esbank JSC, in US\$*

Explanation	Based on Reported Capital	Based on Actual Capital¹	Including Loans made by Esbank AG
31. Dec. 1998			
Equity Capital	184,523,054	62,227,069	62,227,069
Equity Capital x 0.50 (Legal Limit)	92,261,527	31,113,534	31,113,534
Loans to Zeytinoğlu Group via Esbank JSC	94,041,036	94,041,036	94,041,036
Loans to Zeytinoğlu Group via Esbank AG			164,174,776
Total Group Loans			258,215,812
Excess Over the Legal Limit	1,779,509	62,927,502	227,102,278
31. March. 1999			
Equity Capital	124,707,609	48,709,658	48,709,658
Equity Capital x 0.50 (Legal Limit)	62,353,804	24,354,829	24,354,829
Loans to Zeytinoğlu Group via Esbank JSC	82,667,489	82,667,489	82,667,489
Loans to Zeytinoğlu Group via Esbank AG			102,254,074
Total Group Loans			184,921,563
Excess Over the Legal Limit	20,313,684	58,312,660	160,566,734
30. June. 1999			
Equity Capital	124,707,609	48,709,658	48,709,658
Equity Capital x 0.50 (Legal Limit)	62,353,804	24,354,829	24,354,829
Loans to Zeytinoğlu Group via Esbank JSC	121,206,774	121,206,774	121,206,774
Loans to Zeytinoğlu Group via Esbank AG			94,380,455
Total Group Loans			215,587,229
Excess Over the Legal Limit	58,852,970	96,851,945	191,232,400
30. Sep. 1999			
Equity Capital	124,707,609	48,709,658	48,709,658
Equity Capital x 0.50 (Legal Limit)	62,353,804	24,354,829	24,354,829
Loans to Zeytinoğlu Group via Esbank JSC	130,123,164	130,123,164	130,123,164
Loans to Zeytinoğlu Group via Esbank AG			104,259,551
Total Group Loans			234,382,715
Excess Over the Legal Limit	67,769,360	105,768,335	210,027,886
31. Dec. 1999			
Equity Capital	124,707,609	48,709,658	48,709,658
Equity Capital x 0.50 (Legal Limit)	62,353,804	24,354,829	24,354,829
Loans to Zeytinoğlu Group via Esbank JSC	221,556,944	221,556,944	221,556,944
Loans to Zeytinoğlu Group via Esbank AG			156,811,220
Total Group Loans			378,368,164
Excess Over the Legal Limit	159,203,140	197,202,115	354,013,335

Notes:

* All amounts in Turkish lira were converted into US\$ using that year's CBRT average official exchange rate, 1 US\$ = 81,795 TL for 1996, 1 US\$ = 152,805 TL for 1997, 1 US\$ = 262,233 TL for 1998, 1 US\$ = 422,152 TL for 1999.

1. Based on the legally valid capital expansions on 20. Dec. 1996 and on 23. October. 1998.

Source: Report of the Office of Internal Audit, Esbank JSC.

Table 4: Banks that were involved in “Back to Back” Loans with Esbank and their date of closure

Partner Bank	Date of Transfer to the SAIF
Bank Express	12 December 1999
Interbank	22 December 1999
Egebank	22 December 1999
Yaşarbank	22 December 1999
Sümerbank	22 December 1999
Bank Kapital	27 October 2000
Etibank	27 October 2000
İktisat Bank	15 March 2001
Kentbank	09 July 2001
Toprakbank	20 November 2001
Pamukbank	19 June 2002

Table 5: “Back-to-Back Loans” Between Esbank JSC (or via Esbank AG) and Partner Banks, in \$US

Partner Banks	Amount of Total Loans from Partner Bank	Amount of Total Loans From Esbank JSC / Esbank AG to Partner Bank’s Related Company
Bank Ekspres	10,500,000	10,500,000
İnterbank	28,000,000	28,500,000
Sümerbank	21,548,560	20,444,934
Egebank	22,800,000	22.,800,000
Yaşarbank	6,000,000	6,000,000
Pamukbank	37,850,000	37,850,000
Yapı ve Kredi Bankası	10,502,505	10,786,727
Bank Kapital	30,000,000	27,000,000
Toprakbank	15,000,000	15,000,000
İktisatbank	14,000,000	14,000,000
Etibank	7,000,000	25,000,000
	30,210,000*	28,662,000*
TOTAL	203,098,560	217,255,477
	30,210,000*	28,662,000*

Notes:

* The amounts are in DM.

Source: Report of the Office of Internal Audit, Esbank JSC.

Table 6: Esbank JSC’s Losses Due to Bankruptcy for Profit Strategies

Explanation	Amount and Currency
Loss Due to Loans made to Zeytinoglu Group (either directly or through intermediary firms)	\$US 112,344,967 DM 39,017,870 BF 5,998,500
Loss Due to “Back-to-Back Loans”	\$US 142,611,651
Interest Loss Due to “reeskont” Applications	\$US 202,354,678 ¹⁸
Loss Due to Misuse of Temporary Accounts	\$US 9,786,248
Other Misc Losses	24,083,661 \$US 52,420 DM
TOTAL LOSS DUE TO BANKRUPTCY FOR PROFIT STRATEGIES	491,181,205 \$US 39,070,290 DM 5,998,500 Belgian Francs

* As 31. Sep. 1999.

Source: Report of the Office of Internal Audit, Esbank JSC.

¹⁸ This amount includes interest not collected on both defaulted and non-defaulted loans.

Appendix A

From Other Banks	To Zeytinoğlu Group Companies	Date	Amount of Principal capital	Int. Rate	From Esbank JSC / Esbank AG	To Other Banks' Group of Companies	Date	Amount of Principal capital	Int. Rate
Bank Ekspres ¹	Eston Const. JSC	26.12.1997	5,500,000	17	Esbank JSC	Panorama İnşaat	26.12.1997	5,500,000	17
Bank Ekspres	Eston Const. JSC	02.04.1998	3,500,000	17	Esbank JSC	Vadim İnşaat	02.04.1998	5,000,000	17
	Zeytinoğlu Holding JSC	02.04.1998	1,500,000	17					
Total			10,500,000					10,500,000	
İnterbank ²	Zeytinoğlu Insurance JSC	30.10.1997	10,000,000	30	Esbank JSC	Sifaş Sentetik	30.10.1997	10,000,000	15
Total			28,000,000					28,500,000	
Sümerbank ³	Zeytinoğlu Mot. A.Ş.	01.12.1998	911,204	25	Esbank JSC	Amasya Tekstil	20.11.1997	2,500,000	25
Sümerbank	Esen Mach. JSC	31.12.1998	1,000,000	25	Esbank JSC	Ceyteks Tekstil	20.01.1997	5,000,000	25
Total			21,548,560					20,444,934	
Egebank ⁴	Zeytinoğlu Holding JSC	30.09.1997	5,500,000	13	Esbank AG	Otomobilcilik Ticaret	30.09.1997	13,000,000	15
Egebank	Eston Const. JSC	30.09.1997	1,500,000	13	Esbank AG	Föy Otomotiv	30.09.1997	6,800,000	13
Egebank	Estron JSC	30.09.1998	2,000,000	13	Esbank AG	Ege Finans	06.07.1999	1,000,000	13
Egebank	Es Leasing JSC	21.07.1997	3,000,000	13	Esbank AG	Ege Finans	19.07.1999	2,000,000	13
Egebank	Kümaş JSC	30.09.1998	10,400,000	13					
Egebank	Zeytinoğlu Automotive JSC	30.09.1997	400,000	13					
Total			22,800,000					22,800,000	
Yaşarbank ⁵	Kümaş Es Leasing	11.12.1997	5,000,000 1,000,000	6	Esbank JSC	Yaşar Leasing	26.12.1996	6,000,000	5
Total			6,000,000					6,000,000	
Pamukbank ⁶	Eston Const. JSC	05.12.1997	5,000,000	9,5	Esbank AG	İntercorp	21.09.1998 05.12.1997	3,000,000 5,000,000	9,5 9,5
Pamukbank	Zeytinoğlu Holding JSC	07.01.1999	2,000,000	9,5	Esbank AG	Çukurova Dış Tic.	13.03.1998	7,500,000	13
Pamukbank	Eston Const. JSC	22.01.1998	2,350,000	9,5	Esbank AG	CH Financial	28.10.1998	5,000,000	12
Pamukbank	Zeytinoğlu Holding JSC	16.03.1998	7,500,000	13	Esbank AG	Market Res.	28.10.1998	5,000,000	12
Pamukbank	Petsa JSC	01.10.1998	5,000,000	12	Esbank AG	Endüstri Holding	03.12.1996	2,500,000	12
Total			37,850,000					37,850,000	
Yapı ve Kredi Bankası ⁷	Kümaş Magn. JSC	30.09.1997	10,502,505	13	Esbank JSC	Otomotiv Mam. A.Ş.	29.09.1997	10,786,727	9,25
Total			10,502,505					10,786,727	

From Other Banks	To Zeytinoğlu Group Companies	Date	Amount of Principal capital	Int. Rate	From Esbank JSC / Esbank AG	To Other Banks' Group of Companies	Date	Amount of Principal capital	Int. Rate
Bank Kapital ⁸	Kümaş Magn. JSC	27.02.1998	5,000,000	1	Esbank JSC	Cey-Tur Turizm	08.12.1998	4,500,000	1,5
Bank Kapital	Es Leasing JSC	03.12.1998	3,000,000	1	Esbank JSC	Selena Turizm	06.11.1998	2,500,000	25
Bank Kapital	Zeytinoğlu Holding JSC	13.11.1998	4,650,000	1	Esbank JSC	K Leasing	29.05.1998 28.09.1998 26.10.1998 19.11.1998	2,500,000 2,500,000 2,500,000 8,000,000	1
Bank Kapital	Eston Const. JSC	13.11.1998	2,350,000	1	Esbank JSC	K Faktoring	19.11.1998	2,000,000	1
Bank Kapital	Estron JSC	06.11.1998	5,000,000	25	Esbank JSC	Cey-Tur Turizm	06.11.1998	2,500,000	25
Total			30,000,000					27,000,000	
Toprakbank ⁹	Eşçim Cem. JSC	06.05.1997	3,000,000	11	Esbank AG	Toprak Dış Ticaret	06.05.1997	5,000,000	11
Toprakbank	Eston Concrete JSC	06.05.1997	4,000,000	11	Esbank AG	Toprak Kağıt	27.05.1997 03.06.1997	2,000,000 1,000,000	11
Toprakbank	Eston Const. JSC	27.05.1997	2,000,000	11	Esbank AG	Toprak Seniteri	09.07.1997	3,000,000	11
Toprakbank	Eston Const. JSC	03.06.1997	3,000,000	11	Esbank AG	Toprak Seniteri	03.06.1997	2,000,000	11
Toprakbank	Eston Const. JSC	09.07.1997	3,000,000	11	Esbank AG	Toprak Kağıt	06.05.1997	2,000,000	11
Total			15,000,000					15,000,000	
İktisatbank ¹⁰	Eston Beton JSC	19.09.1997	1,000,000	15	Esbank JSC	AKS Televizyon	30.12.1997	2,500,000	15
İktisatbank	Eston Const. JSC	29.12.1997	5,000,000	15	Esbank JSC	Avr.upa - Amr. Hold	21.10.1997	2,500,000	12
İktisatbank	Eston Const. JSC	20.10.1997	3,000,000	12	Esbank JSC	Cine 5	31.12.1997 20.10.1997 21.10.1997	2,500,000 3,000,000 1,000,000	15 12 12
İktisatbank	Zeytinoğlu Holding JSC	04.11.1997	3,500,000	12	Esbank AG	Facto Finans	19.09.1997	1,000,000	
İktisatbank	Eston Concrete JSC	04.11.1997	1,500,000	12	Esbank JSC	AKS Televizyon	21.10.1997	1,500,000	12
Total			14,000,000					14,000,000	
Etibank ¹¹	Zeytinoğlu Holding JSC	11.09.1998	4,275,000*	25	Esbank JSC	Girişim İthalat İhracat	11.09.1998 29.09.1998	4,275,000* 10,056,000*	25 25
Etibank	Petsa JSC	29.09.1998	8,280,000*	25	Esbank JSC	Medya Basım	11.09.1998 29.09.1998	4,275,000* 10,056,000*	25 25
Etibank	Es Leasing JSC	30.07.1998	5,000,000	25	Esbank JSC	Satel Sabah	30.07.1998	5,000,000	25
Etibank	Tektar JSC	29.09.1998	8,380,000*	25	Esbank JSC	Yeşim Tekstil	30.07.1998	5,000,000	25
Etibank	Es Facto JSC	17.09.1998	2,000,000	25	Esbank JSC	Medya İpek Holding	25.02.1998 25.06.1998	7,500,000 7,500,000	1,5 1,5
Total			7,000,000					25,000,000	
TOTAL			203,098,560					217,255,477	
			30,210,000*					28,662,000*	

Notes:

* The amounts are in DM.