CHAPTER 4: CORPORATE SECTOR

1 INTRODUCTION

123. The cumulative effects of the 2001 crisis were felt throughout the economy—starting in the financial sector and causing increasing distress in the real sector.¹ Net profitability of listed companies—on the decline between 1997 and 2000—turned into major losses in the first half of 2001 in every manufacturing sector except cement and glass. Losses totaled US$1 billion during the first semester of 2001, down from profits of US$1.6 billion in the same period in 2000. From the first quarter of 1999 through the first quarter of 2001, the share of listed companies at medium risk rose from 63 to 69 percent—while those at high risk jumped from 2 to 11 percent. Together, these companies accounted for 58 percent of listed companies' sales, 56 percent of employment, and 89 percent of bank liabilities. The corporate sector rebounded strongly in 2002, largely due to export-led growth and a modest recovery in domestic demand. Net profit in the corporate sector for the first nine months of 2002 reached US$2.3 billion, slightly higher than earnings for the entire year 2000. The main factor was a decline in financial charges, including foreign exchange losses.

124. To assist in restoring growth, Turkey is in the process of implementing a comprehensive corporate restructuring program known as the Istanbul Approach (IA). Once firms enter the IA, there is a formal review process by a Creditors Committee. Once a workout is agreed to, the creditors and the debtor (the company) sign an agreement stipulating the terms and conditions of the workout, reporting requirements of the debtor and events which would trigger a review of the agreement. The creditors also sign an inter-creditor agreement specific to the specific workout case. The IA does not guarantee the survival of a company in distress. Regulatory authorities do not intervene and, because of its voluntary nature, the IA is only effective if it is mutually supported by the banking and corporate communities. Progress to date in implementing the IA has been reasonable. As of end-June 2003, 299 firms, 208 large firms in 32 groups and 91 small firms had entered the IA with US$4.8 billion in loans being restructured. These firms have approximately 46,335 employees, sales of about US$2.9 billion and exports of close to US$0.8 billion, and over US$7.5 billion in assets. Nevertheless, a number of issues have emerged which, if left unresolved, will impede progress. One issue is the lack of an adequate bankruptcy framework. Other issues involve technical concerns including the handling of so-called category 2 loans in the balance sheets of banks and the participation of state banks. The Advisory Committee consisting of Treasury, the Central Bank, BRSA, the banks, TOBB and TUSIAD may be helpful in pushing the process forward.

125. Several medium-term reforms should complement the short-term corporate resolution process. These include measures to attract foreign direct investment and accelerate the privatization program. A careful review of the performance of state enterprises is required to assess their need for workouts and more fundamental restructuring. In addition, there is a need for accounting reform and improved corporate disclosure, as well as better corporate governance including strengthened independence for boards of directors.

¹ This review of the impact of the crisis is based upon a recent World Bank Study, “Turkey: Corporate Sector Impact Assessment Report”, March 2003.
126. The 2001 crisis hurt all sectors—industry, construction, trade, and services. Industrial production fell 6.9 percent in the first half of 2001 and 9.9 percent for the year. Plant capacity use in the private sector fell to 62 percent in mid year, before recovery to 68 percent in the fourth quarter of 2001. Lower domestic demand was the most important factor undermining capacity utilization. Increased exports in a number of sectors—such as automobiles and textiles—helped mitigate corporate losses but even these sectors suffered significant losses in 2001 (Figure 4.1). The downturn forced most firms to reduce their workforces throughout 2001. Efforts have also been made to control wage costs, with shorter work weeks, strict control on overtime, accelerated vacation and maintenance schedules, and temporary furloughs. Although Turkish firms have been agile in responding to the crisis, worker distress has been considerable. Over the 2000-02, period, the unemployment rate increased from 6.6 percent to 10.6 percent.

127. Data for non-financial companies (industry and services) listed on the Istanbul Stock Exchange (ISE)—a sample representative of Turkey’s mid-cap and large companies—show worrisome trends. The series of crises over the past decade (1994, 1999, November 2000 and February 2001) have lowered company profits and increased financial fragility. Net profitability declined over the 1997-2000 period, then turned into major losses in the first half of 2001 in every manufacturing sector except cement and glass. Losses totaled US$1 billion at the end of second quarter of 2001, down from profits of US$1.6 billion in the same period in 2000. Interest rate coverage on an earnings before interest, taxes, depreciation and amortization (EBITDA) basis dropped below one beginning in the first quarter of 2001 and stayed that way until the fourth quarter. By contrast, the debt coverage ratio was consistently above one through 1999-2000 for most listed companies. In addition, financial expenses rose sharply as a percentage of revenue in the first quarter of 2001, hitting 27 percent (Figure 4.2). For 2001 as a whole, sales of listed companies were down
13 percent, earnings (EBITDA) were down 11 percent, and net earnings were down a staggering 80 percent.

The 2001 crisis put a larger share of listed companies at medium or high risk of default. Between the first quarters of 1999 and 2001 the share of listed companies at medium risk rose from 63 to 69 percent—while those at high risk jumped from 2 to 11 percent. Together these companies accounted for 58 percent of listed companies’ sales, 56 percent of employment, and 89 percent of bank liabilities (Figures 4.3 and 4.4). Distressed companies have limited opportunities for a turnaround in the short term. Companies have cut production costs through import substitution and payroll reductions. They have also tried to improve management of working capital, but a general lengthening of receivables and inventories demonstrates the difficulty of doing so in a systemic crisis. Companies have also cut investments, with private investments down nearly a third in 2001. A few companies and banks have made rights offerings to increase equity capital, but the depressed stock market discourages equity financing.

A major turn around in profitability occurred in the consumer durables sector in 2002, in particular the white goods sector, and that has continued in the first quarter of 2003. Other sectors with significant turn around in profitability in 2002 were electronics and communications, food processing and textiles (Table 4.1). The primary factor for the turnaround in profitability was a reduction of financial charges. Financial expenses include both interest payments and foreign exchange losses under the Turkish accounting principles (Figure 4.5).
130. Implementing a comprehensive resolution strategy has been a continuing priority in dealing with the aftermath of the 2001 crisis and its effects on Turkish companies. Lessons from the recent crises in East Asia and Mexico indicate that the short-term resolution strategy should include: (i) segmenting problem companies by size so that companies of different sizes and needs can be treated appropriately; (ii) implementing a voluntary workout program; (iii) adopting a new bankruptcy framework, including the option for pre-packaged bankruptcies that would recognize the workouts in the courts; (iv) easing tax, legal, and regulatory impediments to crisis resolution; and (v) development of an asset management company or companies. Each of the major crisis countries in recent years—e.g., Mexico, Thailand, Korea, Malaysia and Indonesia—has implemented a voluntary workout program that was important in restoring the creditworthiness of the real sector. Getting the incentives right has proven difficult in other crisis countries including East Asia and Mexico. Companies that have defaulted on loans could face seizure of their collateral if they abstain from the workout process. However, Turkey’s weak bankruptcy framework may well serve as an obstacle to the workout program as debtors seek shelter from their creditor through the bankruptcy process. A resolution program is also vital to restore the soundness of viable banks and may include an asset management agency or company to remove the most distressed assets or special classes of assets such as real estate, cars and other saleable collateral, from the books of these banks.

Segmenting Problem Companies

131. Experience in other crisis countries suggest that thousands of small and medium-size enterprises, hundreds of mid-cap enterprises, and a few large groups may all be in trouble at the same time. Countries have dealt with these issues in various ways, but all have eventually recognized the need to segment problem companies. The types of segmentation discussed below are at the heart of the resolution strategy that has been developed and is known as the Istanbul Approach.

132. Companies can be broadly segmented into three groups. Small and medium-size enterprises—the first and most numerous casualties of such crises, with little power to effect outcomes—are usually too numerous to include in a corporate workout program. Solutions in support of small and medium-size enterprises need to be systemic, such as extended rollovers of credits including re-capitalization of past-due interest and extended grace periods for principal repayments. Mechanisms to improve liquidity in small and medium-size enterprises can help keep them afloat. The financial costs of stabilizing small and medium-size enterprises are small relative to the social and political costs of allowing thousands of them to sink, and should not take much time or effort to apply. At the other end of the spectrum are the large corporate groups that dominate the economy, with complex structures that may include a mix of industrial and financial companies. To the extent that these groups exhibit distress, they need to be monitored carefully and addressed on a case-by-case basis so that their problems do not provoke a secondary crisis and spill over into the banking sector, causing banks and non-bank financial institutions to collapse. The Daewoo collapse in Korea is perhaps the most prominent recent

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example of such a case. Finally, in the middle are mid-cap corporations. Depending on the economy, these firms have US$25-100 million in annual sales, normally require bank financing for working capital and investment, and may be the most adversely affected if a crisis causes a contraction in the stock of credit, as has happened in Turkey (and happened in East Asia and Mexico). Mid-cap companies—usually found using several banks and other financial intermediaries such as leasing companies, as well as supplier credits—normally form the core of a voluntary workout program. With adequate due diligence and a well structured workouts, many mid-sized companies can be restored to creditworthiness.

**The Istanbul Approach**

133. The Turkish Bankers Association, working with Government and industry representatives, has taken the lead in developing a voluntary, non-judicial workout program based on the London approach. The program, informally known as the Istanbul Approach (IA), has required the strong backing of the Treasury and the Ministry of Finance because of the policy and regulatory implications and the tax incentives normally required to make such a program operational. The IA is supported by amendments made by the law (No. 4743) dated January 31, 2002 to the articles of Banking Law (No. 4743) and by a circular of BRSA in April 2002. In addition, the BRSA has established clear provisioning rules in support of workouts and in coordinating workouts with intervened banks. At the heart of the IA is a Framework Agreement (inter-creditor agreement) signed in June 2002 by 34 commercial banks and non-bank financial intermediaries. Intervened and state banks have also signed the agreement. Finally, the agreement has been approved by the BRSA.

134. The IA incorporates key aspects derived from international experience with voluntary workouts. First, creditors must signal that they are willing to pursue a non-judicial resolution of a company’s financial difficulties rather than resort to a formal process of seizing collateral or an insolvency procedure such as liquidation. Second, the out-of-court process under the IA is case-by-case, i.e., each company entering the process is addressed by a separate Creditors’ Committee and that committee is directed by a lead bank holding the largest share of the credits or is appointed by the other creditors holding 75 percent of the credits by value. While the inter-creditor agreement has been signed by banks and non-bank financial institutions, other creditors such as trade creditors may join the workout process through the Creditors Committee. Third, the IA is time bound. That is, the Creditors Committee has a maximum of 90 days plus three 30 day extension periods (180 days) to reach a resolution and agree to a workout with the debtor. Fourth, the IA incorporates a due diligence process. The creditors commission an independent due diligence review of each distressed company’s long-term viability, drawing on comprehensive information made available by and shared between all the likely parties to any workout.

135. A Coordination Secretariat, under the direction of TSKB, is responsible for oversight of the process and to ensure that its logistics and timing of the work (Box 4.1A). A lead bank is chosen to head the Creditors’ Committee formed for each case. If there is no resolution, i.e., less than 55 percent of creditors by value agree to a proposed workout plan, then the case is dropped from consideration. A three-person Arbitration Committee, appointed by the board of the Turkish Bankers Association, makes decisions on workouts if they pass the 55 percent threshold, but do not reach approval of 75 percent of creditors. The arbitration panel can also decide on
any individual matter which the Creditors Committee brings to its attention. For the large groups or conglomerates, a group owned bank cannot take the lead for a group owned subsidiary, nor can the group bank vote in the creditors committee. A group bank is also not able to provide new financing to a group company.

Box 4.1A: Institutional Structure for Istanbul Approach

136. Because of its voluntary nature, the IA is only effective to the extent it is mutually supported by the banking and corporate communities. Regulatory authorities do not intervene and the IA does not guarantee the survival of a company in distress. During the period of the review and negotiation the creditors must agree to support a standstill. That is, each of the creditors agrees to maintain its credit facilities and not to move against its collateral to the disadvantage of the other creditors. This maintains the confidence of the workers, suppliers and the customers by allowing the company to continue operating. At the end of the due diligence period, the creditors have to form an opinion with respect to the company’s viability and make a decision whether or not to go forward with the workout. Until the workout is agreed upon, creditors preserve their legal rights to pursue the debtor through the courts in the event a workout agreement is not reached.

137. Once a workout is agreed to, the creditors and the debtor sign an agreement stipulating the terms and conditions of the workout, reporting requirements of the debtor and events which would trigger a review of the agreement. The creditors also sign an inter-creditor agreement specific to the specific workout case. The IA allows companies to supplement their borrowing in case of a liquidity shortfall or pressing maintenance needs. New money can be provided on a pro rata basis by all existing lenders, by specific lenders with priority arrangements, or by the release of asset disposal proceeds subject to priority considerations. Banks can also benefit from the tax incentives that are a part of the Istanbul Approach. Banks are eligible for these incentives under the program for a period of three years with the option for extending the program. Other principles underlying this critical period of financial support include recognizing the seniority of existing claims and sharing losses on an equal basis between creditors in the same category. If creditors agree that a company is viable over the long term, they can consider a formal rescheduling—such as an interest holiday, re-capitalization of interest in arrears, extension of
loan maturities, lending of new money, or conversion of debt to equity. These longer-term financial changes need to be conditional on the implementation of an agreed business plan that may well require restructuring of the company over the term of the workout. Restructuring may include management changes, injections of fresh equity, sales of assets or divisions, mergers or even company takeovers by new owners. Box 4.1B diagrams the IA process.

Box 4.1B: Istanbul Approach Process

138. Eligibility and sequencing are key issues for the IA. Eligible firms are primarily large and mid-cap manufacturing firms. To qualify as a large firm, companies must meet at least two of the following criteria as of end-2001: having two or more banks as creditors, debt of more than US$10 million, more than 100 permanent employees, annual exports of US$15 million, total annual turnover of at least TL 25 trillion, and assets on an audited balance sheet of at least TL 15 trillion. There is also a need to address sequencing—that is, the criteria used to decide which firms enter the process initially. Although small and medium-size enterprises are covered by a modified form of the process handled primarily by the lead bank, the number of firms that can be restructured in the first phase may need to be limited to prevent the process from bogging down. In Thailand, the workout process bogged down with thousands of SMEs involved in restructuring. Thus a more systemic approach needs to be adopted for small firms. Excluded from the process are marketing and trading firms (that is, non-producing firms) and firms with more than 50 percent state ownership.

Progress in Implementing the Istanbul Approach

139. As of end of June 2003, 299 firms (208 large firms in 32 groups and 91 small firms) were participating in the IA with some US$ 4.8 billion in loans being restructured. These firms have approximately 46 thousand employments, sales of US$2.9 billion and exports of about US$ 761 million, and about US$ 7.5 billion in assets. Many of the cases have completed the 90 days and are on to the first extension. Experience in most crisis countries is that a systemic workout process may well take several years to complete. Moreover, it is difficult to get the workout just

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3 Erzan and Filiztekin (2002), a background paper to this Report, analyzes growth, employment and productivity in Turkish manufacturing industry with respect to industry and size, and scrutinizes the vulnerability of firms with respect to the economic environment.
right the first time, given the unstable economic conditions that normally exist when the workouts are concluded. Therefore, the process has to allow at a minimum for modifications of some workouts a couple of years into the process once economic conditions have stabilized. Although the IA was formally introduced in June 2002, implementation was realistically delayed until the effort to flush out NPLs and re-capitalize the banks was completed as outlined in chapter 3. At that point, newly capitalized banks had the proper incentive to have loans re-classified and to collect on provisioned loans. Following the recapitalization, improvements in loan classification and collection on provisioned loan are directly reflected in increased profits line and capital of the banks.

140. There are several impediments to the IA that prevent it from becoming a more robust restructuring process. The first, and most important, problem is with category two loans\(^4\). The banks are unwilling to bring companies with potentially viable, category two loans that need restructuring into the IA. Banks are also reluctant to provision for these loans, but recognize that they may well need restructuring and/or rescheduling and that the borrowing companies may require new working capital. There are three issues related to category two loans: (i) it is unclear under the legislation governing the IA whether these loans would automatically require provisioning if they are restructured under the IA; (ii) a number of category two loans are denominated in foreign exchange and with 12-18 months maturity which may have already become ineligible for the IA; (iii) the IA requires a 90 percent vote of creditors to approve workouts of performing loans—including category two loans—which is too restrictive.

141. The second problem involves differences between state and SDIF banks and commercial banks. Commercial banks claim that 3-4 large commercial banks are bearing most of the burden of the IA restructurings. That is, state and SDIF banks cannot participate in debt/equity swaps, cannot accept real estate collateral, and are reluctant to extend new financing. This is a material issue as the state and SDIF banks are major creditors in the workouts already underway. State banks claim they are ready to adhere to the IA rules as long as there is independent due diligence of IA cases by TSKB or external investment banks/accountants. Also, to provide new money, the state banks argue that they must be given first priority in accord with IA rules and this new money needs to be backed by new or shared collateral. The third problem is that banks have focused their efforts on rescheduling and not fundamental restructuring of problem companies. Most of the companies that have entered the IA process have large non-performing loans. A number of these companies had problems before the recent crisis. The banks are opting for long-term rescheduling (6-14 years) to lower the debt amortization burdens and to increase free cash flow in these companies. A number of the IA companies are being restructured through debt/equity swaps, debt/asset swaps and even change of management, but more pressure for real restructuring is needed. Most of the workouts will also require some fresh cash, but management of the banks are reluctant to increase their exposure to these companies. This was the experience initially in Korea where the banks focused on rescheduling. In the end, 50 percent of the Korean companies went through a second and third round of restructuring with a number of companies needing to be liquidated. This is likely to happen in Turkey as well. The banks will take larger write downs if they do not restructure the workout cases under the IA. Also, the corporate sector and the economy will be adversely affected.

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\(^4\) Loans that need to be extended but for which delays in repayment, if any, are less than 90 days and due to acceptable reasons – these loan do not need provisioning as NPLs in the balance sheet
142. Looking ahead, experience from East Asia points to some other issues that are likely to come up over the course of implementation of the Istanbul Approach. One will be the disposition of assets as loans are restructured. The SDIF is operating a public asset management company, but public agencies have often found it hard to operate such companies because of the commercial nature of the work. Companies that go through restructuring may well have a need for funds to manage assets that are difficult to dispose of during a crisis. Distressed companies and banks may also seek to divest land and other fixed assets from their portfolios. The lack of an adequate bankruptcy law limits the ability of the banks to press for restructuring. That is, they lack the “stick” in the system to require corporate restructuring. In countries that lacked an adequate bankruptcy system—e.g., Mexico, Thailand and Indonesia—it proved very difficult to follow through on voluntary workouts. In Korea, on the other hand, the bankruptcy system complemented the voluntary workout program. Some 13 large chaebols went into bankruptcy during the crisis and this served as a signal to other firms that they needed to restructure5.

143. The voluntary nature of the Istanbul approach is critical to its success and it is important that Government not interfere in individual transactions. Nevertheless, there are several critical steps that Government can take to facilitate the process. Key recommendations are summarized in Box 4.2.

**Box 4.2: Key Recommendations for Corporate Resolution**

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Timing of expected impact</th>
</tr>
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<tbody>
<tr>
<td>Policies to Support Corporate Restructuring</td>
<td></td>
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<tr>
<td>• Implement a voluntary workout program based on the London approach</td>
<td>x</td>
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<tr>
<td>• Commercialize asset resolution mechanisms</td>
<td></td>
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<tr>
<td>- Sell distressed assets through an asset resolution agency—preferably one not created by the Government</td>
<td>x</td>
</tr>
<tr>
<td>- Sell land and real estate through real estate investment trusts (REITs)</td>
<td>x</td>
</tr>
<tr>
<td>• Strengthen the bankruptcy system and allow for pre-packaged bankruptcies to recognize workouts through the courts</td>
<td>x</td>
</tr>
<tr>
<td>• Ease tax, legal, and regulatory impediments to restructuring.</td>
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</tbody>
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**Asset Resolution**

144. Corporate workouts will leave banks with many assets that they are poorly equipped to manage and that might be difficult to dispose of during the crisis. Moreover, these assets will not earn interest and will impair banks’ reported financial performance. For example, a debt overhang will inevitably require debt-equity conversions or the swap of straight debt at high real interest rates for longer-term convertible debentures at lower interest rates. In Korea the interest rate on convertible debentures introduced in workouts was only 1 percent. In addition, many companies going through a workout will require additional long-term debt or equity injections to operate in the future.

145. Virtually all crisis countries have established asset management agencies or companies. However, most countries have found it difficult to operate publicly created agencies due to the commercial nature of asset disposal. Also, the lack of a secondary market for these assets in most countries significantly slows the process of asset disposal. As a result, the value of such

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5 Woo-Cumings (2001), “Miracle as Prologue: The State and the Reform of the Corporate Sector in Korea”.
assets quickly plummets toward zero. Turkey in fact has already had a public asset management agency. Through the intervention of some twenty commercial banks, the SDIF is operating a public asset management agency. A BRSA circular issued in October 2002 established an enabling environment for the creation of private asset management companies. Diverse forms of asset management companies can be created by private entrepreneurs or major financial institutions. An alternative approach to the SDIF problem of asset disposal, is to consider profit participation deals. In East Asia and Eastern Europe, large financial groups have entered the market to purchase distressed assets—for example, in Korea they did so through a profit participation arrangement with the Korea Asset Management Company. International debt and equity funds could manage these assets for banks and potentially bring in institutional capital to provide some new money. Korea, for example, set up four funds with the participation of the Korean Development Bank, commercial banks, and internationally recognized fund management groups to help mid-cap companies seeking investors. The International Finance Corporation also made several direct investments in mid-cap companies in Korea. Such a role might be ideal for Turkey’s private development bank, supported by commercial banks. A major impediment to the success of a commercially viable asset management company in Turkey will be the willingness of banks to dispose of distressed assets at a fraction of their value. If the banks need liquidity following the provisioning of NPLs, then they may be disposed to sell these loans. However, all indications are that the Turkish banks prefer to wait until the economy improves so that they can realize a better return on these impaired assets.

146. **Land and real estate sales.** Distressed companies and banks may seek to divest excess fixed assets or sell and lease back primary real estate. Banks will also need to divest land and buildings acquired as collateral during the crisis. During its crisis Korea established a land bank to allow companies to divest excess property, with an option to reacquire it in the future. It did so to prevent a precipitous fall in values as occurred in Japan. Although Korea’s land bank was owned by the state, there is no reason Turkey could not attract institutional investors to establish such real estate investment trusts (REITs).

**The Bankruptcy Framework**

147. An important step is the establishment of adequate bankruptcy procedures. As noted above, it will be difficult to get firms to go through the needed restructuring (as opposed to a simple rescheduling of loans) without a functioning bankruptcy framework as a fall-back option. Corporate workouts and restructurings generally take place in the shadow of the law. Voluntary resolution requires reliable fallback options through established legal mechanisms for individual enforcement and debt collection or through collective insolvency procedures. As the Mexican and East Asian experiences show, voluntary workout programs are often constrained by inadequate insolvency systems and by legal environments that discourage restructuring. In many crisis countries, weak bankruptcy systems have proven to be an impediment to the voluntary workout process. Turkey also has a weak bankruptcy system that can leave companies protected by the courts for years (Box 4.3). Currently, Turkish courts can take up to two years to resolve enforcement proceedings. During a crisis, the bankruptcy system is not by itself a viable alternative for restructuring problem companies. The number of distressed companies in Turkey would quickly overwhelm the court system were it to be the only alternative. However, the bankruptcy framework must be an effective alternative to voluntary workouts in order to provide
an important incentive (i.e., “stick”) for companies to participate in the workout process (the “carrot”).

<table>
<thead>
<tr>
<th>Box 4.3: Legal Framework for Creditor Rights and Enforcement in Turkey</th>
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<tbody>
<tr>
<td><strong>Turkey</strong>’s legal framework for creditor rights and enforcement deals with procedures for enforcing the commercial rights of unsecured and secured creditors. For secured creditors it also covers laws and procedures for creating, registering, and enforcing collateral rights such as mortgages and pledges. Up to 90 percent of bank lending in Turkey is done on a secured basis, and most is guaranteed by a major shareholder. Types of collateral include real estate and movable assets; an unconditional mortgage on real estate is the most reliable form of security because it allows the creditor to bypass the courts and move directly to execution or foreclosure procedures. In the event of a default, creditors can pursue execution or apply for an insolvency proceeding. Nearly all cases—almost 500,000 a year—are filed under the execution procedure. Procedures for debt recovery and foreclosure are generally effective, lasting an average of four to eight months over the past decade. Shorter proceedings tend to be uncontested, meaning they go directly to an executioner, which sends a collection order to the debtor. If creditors choose to go to court or a collection order is contested, it generally takes two to three years to reach a final judgment. In most cases, however, either the debtor does not contest the proceeding or a default judgment can be obtained. Courts are stretched to capacity and will likely become even more overburdened by efforts to collect on the non-performing loans of failed banks.</td>
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148. **Enforcement of secured loans.** Turkish banks typically secure their loans with real property worth far more than the loans. If a lender is unable to resolve a dispute with a borrower when a loan is not being properly serviced, the bank may initiate an enforcement action in the courts. While initiation of such lawsuits has traditionally been the trigger for banks to classify such loans as non-performing, new loan loss provision rules require classification based on performance and creditworthiness. The recent effort to push banks to flush out their NPLs could lead to a dramatic increase in the volume of enforcement actions. Given that the courts are already overloaded, the increased caseload will likely slow the completion of enforcement cases as well as all others. Because a contested enforcement proceeding can take more than two years to resolve, the prospect of further delays is worrisome. The banks are confident that court enforcement procedures are effective, if slow. The question is whether the system will work as well when caseloads increase further. Just as important is whether an enforcement system that works for lenders—because they typically hold considerable excess security—is effective in protecting borrowers. Except where lenders work together on an informal or ad hoc basis to work out a restructuring plan, the answer may well be negative.

149. The Savings Deposit Insurance Fund (SDIF) has intervened in some twenty private banks. To expedite recovery, the loan portfolios of these banks have been redefined as state receivables subject to collection under the Public Receivables Act (No. 6183). Because court judgments are not necessary for state receivables, this change could shorten average recovery periods to a little as six months. However, giving the loans of SDIF banks the status of state receivables raises several issues. First, accelerated collections enable the SDIF to recover in less time, thereby potentially giving it access to debtor assets more quickly than other creditors. Second, the Public Receivables Act applies to all assets of a debtor—not just assets that have been pledged—which may give the SDIF an effective priority and greater likelihood that it will be able to recover amounts owed to it relative to other creditors. Because the Act provides limited scope for rescheduling and almost no capacity to write off debt, it can be difficult to
develop a workout plan for a troubled debtor. Just as important, enforcement proceedings under the Public Receivables Act take place outside the commercial court system while other creditors must use the courts—making restructuring more cumbersome. The question of whether the SDIF acquires greater rights than the original holder of the debt simply by virtue of subrogation or assignment is certain to be challenged in the courts, resulting in delays. Indeed, this issue could have a widespread impact because other courts will likely take a wait-and-see approach. Depending on the final ruling, the result could potentially undermine the voluntary resolution process.

150. **Legal framework for insolvency.** Turkish insolvency procedures are usually not relied on as a means of recovering debt even in cases where borrowers are clearly insolvent. The average number of cases, about 1,500 a year—less than 0.5 percent of execution proceedings—reveals that insolvency has been marginalized. Unsecured creditors see the process as ineffective, fraught with extremely long delays, and yielding little or no benefit. Distributions to unsecured creditors reportedly do not exceed 3-5 percent, and no consideration is given to the time value of payments. As a general rule, secured creditors enjoy a privileged status under the Execution and Bankruptcy Act. The declaration of bankruptcy does not result in a stay on actions by secured creditors to foreclose on their collateral. Where foreclosure proceedings have not commenced, pledged assets can be entered as part of the bankruptcy proceeding, and the secured creditor has the option of disposing of the collateral on its own or allowing the administrator to do so. As a general rule it is difficult to salvage viable enterprises when secured creditors are exempt from the process and can collect on collateral that may be essential for the business. Weak insolvency procedures seriously impede the development of viable workout plans for illiquid debtors. The fact that secured creditors can execute against a debtor’s core assets limits the scope for developing a plan to rehabilitate the debtor. However, given the inordinate delays and marginal use of the bankruptcy process, the current treatment of secured creditors offers a more reliable framework for risk assessment and management by lenders.

151. **Pre-packaged bankruptcies.** Experience in East Asia and Mexico highlights the impediments to corporate restructuring that can arise from valid legal checks and balances. These legal concerns—such as protections for public shareholders and controls on tax deductions for credit write-offs—often serve broader public policy interests and cannot be simply eliminated. Public shareholder rights to oppose diluting equity restructuring can be particularly difficult or impossible to override in an out-of-court workout, as seen in recent cases involving Daewoo affiliates in Korea. To deal with valid legal concerns, it may be necessary to rely more on court-supervised processes (such as “prepackaged” reorganizations) to effect equity restructurings of companies. In addition, the insolvency system can provide “front end” support to encourage debtors to cooperate with out-of-court workout efforts—as well as important “back end” support that makes it possible to override dissident creditors or shareholders in a corporate workout.

152. Turkey’s insolvency law should be amended to restrain secured creditors from executing against their collateral as long as their property interests have not been affected. The insolvency law should provide a mechanism that preserves the value of the security for secured creditors, but that allows the excess security value to be used to help restructure the debtor. The amended law should also include provisions for pre-packaged bankruptcies. There is little point to these changes, however, unless it is accompanied by wholesale changes that allow the procedure to be
expedited. Time destroys the chances of successful restructuring—a process that takes years, instead of months, has little to offer. Expediting matters requires changes to judicial procedures, and ideally to the structure of the courts. In light of the comprehensive legal and institutional reforms needed, the Government undertook an overall assessment of its legal and institutional framework for creditor rights and insolvency, using the World Bank’s Principles and Guidelines for Effective Insolvency and Creditor Rights Systems (April 2001). This assessment has identified specific reforms required in Turkey’s legal and institutional framework in core areas related to the enforcement of creditor rights (including creation, registration and enforcement of security), and formal and informal corporate insolvency. The Parliament passed a set of comprehensive amendments to the EBA on July 17, 2003 which address enforcement of creditor rights, formal/informal corporate insolvency and restructuring systems, credit risk management practices, and institutional and regulatory frameworks. In addition, The Government plans to enact a new section of EBA on pre-packaged bankruptcy by end-2003.

153. Easing tax, legal, and regulatory impediments to restructuring. The East Asian crisis highlighted numerous impediments to corporate restructuring, mergers and acquisitions, and the entry of foreign direct investment. Turkish firms face many of the same obstacles. Significant impediments encountered in one or more East Asian countries included: (i) treatment of debtor gains from debt restructuring as taxable gains; (ii) an inability of corporate creditors to deduct losses from corporate debt restructuring and voluntary workouts to reduce taxes; (iii) immediate taxation of non-cash corporate reorganizations such as mergers or spinoffs; (iv) little or no opportunity to transfer net operating tax loss carry-forwards to a corporate acquirer or new merged entity; (v) excessive fees and taxes on property transfers; (vi) constraints—such as the personal liability of staff—on the ability of state-owned financial institutions to incur losses through corporate debt restructuring; and (viii) constraints on the ability of banks to hold equity in debt-equity swaps or similar instruments such as convertible debentures. The Turkish Government has amended corporate tax laws and regulations to encourage mergers, acquisitions, asset spin-offs, and the sale of real estate and participation shares by banks augmenting their capital. It has also eliminated stamp, value added, and other duties on such transactions. These amendments address several of the obstacles to restructuring and workouts encountered in East Asia. However, more impediments may surface that could require Government action.

4 MEDIUM TERM STRUCTURAL REFORMS

154. In addition to the corporate resolution process, other measures are needed to foster the environment for a more dynamic corporate sector. Some of the most important of these measures are discussed in other chapters of this report. Macroeconomic stability including a stable and competitive exchange rate and lower real interest rates are very important for corporate sector recovery. These are discussed in chapter 1. Similarly, a healthy financial sector is critical to growth of the real sector and the relevant financial sector policies and reforms are discussed in chapter 2. Here, three other medium-term structural reforms are briefly considered: privatization, improved financial reporting and accounting standards, and corporate governance.
Accelerating Privatization.

155. Accelerating privatization is a key supply-side element in the effort to sustain growth. While Turkey began its privatization program in 1985—making it the first developing country to do so—it is now lagging far behind comparable economies in Latin America (Argentina, Chile, Mexico) and the main economies in Central and Eastern Europe (Czech Republic, Hungary, Poland). Privatization sales have consistently fallen short of expectations, regularly falling short of US$1 billion per year with the exception of 2000 when sale of a majority stake in POAS (petroleum distribution) and a third GSM license pushed sales above US$5 billion (Figure 4.6). The public sector still accounts for 15 percent of non-agricultural production. In most emerging market economies and many OECD countries, privatization has been major driver of foreign direct investment. Disappointing privatization performance in Turkey may have been a factor in its failure to attract significant levels of FDI.

156. Accelerated privatization could generate significant external resources, improve the efficiency of strategic sectors—such as telecommunications and energy—and send a strong signal to foreign investors and financial markets about Turkey's commitment to reform. But increased efficiency will not happen automatically: it will require implementing appropriate regulations, creating independent regulators, and allowing competition in these sectors. To achieve these tasks, the Government must make a long-term commitment to structural reform. In moving forward with privatization, the Government faces at least two important trade-offs. First, in the energy and telecommunications sectors, there is a clear need for revenues to be raised, but at the same time, establishing as much competition as possible is critical to securing Turkey's competitive position. Decisions favoring a more competitive structure could lower up-front revenues from privatization, but will maximize the long-run benefits. The second trade-off involves whether to prioritize sale of large companies, which can make a significant contribution to the fiscal program, or to focus on the sale of smaller firms which may not generate as much cash revenue but may be extremely important for stimulating the private sector, at least in the short run.

157. Despite the high competence and considerable experience of Privatization Administration (PA) managers in executing privatization transactions, the program has suffered from many flaws. The requirement that the Privatization High Council approves all sales, regardless of size, has forced even small divestitures to be recycled several times—significantly lowering their value and reducing transparency. A number of loss-making companies have been transferred to the PA, and they are absorbing its resources—both financial and human. The PA has effectively become a large state holding group—a function it is not equipped to handle. The bulk of the funds from privatization have been used to finance the unprofitable holdings rather than being
returned to the Treasury to retire debt. Privatization has been viewed as an important way of generating revenue to overcome fiscal problems, particularly during crises. The more fundamental objective of privatization—making Turkish industry more efficient and more competitive—has been subordinated.

158. Determined action to improve and de-politicize the privatization process will help strengthen the Government’s reform credentials. As a first step, the PA’s mandate should be broadened to include a “fast track” privatization process for non-strategic companies in its portfolio. In parallel, the cross subsidization mechanism among companies in the PA’s portfolio should be terminated to improve transparency and operational performance. The PA should be free to clear out its inventory of loss-making companies through mergers and liquidations. All privatization revenues and dividends from profitable companies in the PA’s portfolio should be transferred to the Treasury and recorded in the budget. The costs of subsidizing loss-makers and of severance payments and other payments to workers laid-off or retired as a result of privatization should be provided transparently through the budget. Finally, future privatizations should not be carried out by line ministries but by the PA in order to take advantage of its experience and technical abilities. Despite significant tariff and non-tariff protection and price adjustments, some of the companies to be privatized experienced losses in recent years. The substantial accumulation of arrears needs to be cleared as part of the privatization process for these companies.

159. A new privatization program for 2003, which includes major companies of national importance, has been approved. The current privatization program targets several major holdings: those in PETKIM (petro-chemicals), TUPRAŞ (oil refining, partly divested in 2000), Turkish Airlines, ERDEMIR (steel), TEKEL (tobacco and spirits), and SEKER (sugar). The Privatization Administration should urgently adopt privatization plans for TEKEL and SEKER. The Privatization Administration should also continue to divest its smaller holdings. It should also amend the telecommunications law to authorize privatization of Turk Telekom subsidiaries and adopt new Turk Telekom privatization plan. In addition, state banks will be privatized over the next several years, and intervened banks will be divested or liquidated by the end of 2003. Moreover, the Government plans to sell other assets, such as some of its land holdings.

160. The 2003 privatization program has made reasonable progress. Based on sales contracts signed as of mid-May 2003, cumulative cash proceeds were in line to reach the end-June target of US$90 million. Highlights of the program are as follows:

- The PA has completed tenders for four TDI ports, Taksan (machinery), Gerkosan (iron and steel), TZDAŞ (agriculture machinery), and six SEKA facilities in the framework of the 2003 program. All of these tenders were approved by the Privatization High Council except for those which did not receive sufficient bids (Gerkosan, two of the SEKA facilities, and two TDI ports). Block sale tenders for 51 percent of the ETI group companies (ETI Copper, ETI Silver and ETI Electrometallurgy) have been announced. The PA has also finalized the merger of TURBAN, TZDAŞ and TUMOSAN under the Sümer Holding umbrella.
• A block sale tender for the entire 88.86 percent state stake in PETKIM (petrochemicals) was finalized on June and the winning bid was approved by the Privatization High Council in July.
• A block sale tender for the entire 65.76 percent state stake in TÜPRAS (refineries) was launched in early June and will close in September 2003.
• The PA, working with international consultants, has formulated a privatization plan for TEKEL (alcohol, tobacco and salt), including strategies for dealing with the key issues of over-employment, debt settlement, and excess inventory. The TEKEL privatization plan was approved by the Privatization High Council in March 2003. Tenders for 100 percent of TEKEL’s alcohol and tobacco operations were launched in early June and will close in September 2003.
• A block sale/public offering for THY (national airlines) is scheduled for the third quarter of 2003.

Improving Financial Reporting and Accounting Standards

161. Turkey’s accounting standards do not fully comply with IAS or generally accepted accounting principles. This setup makes it impossible to assess accurately the real financial situation of companies because of obstacles such as high inflation, use of accelerated depreciation laws for taxation purposes, accounting treatment of foreign exchange losses and profits, treatment of finance charges as revenue in cases of deferred payment sales, and lack of consolidation requirements. In the absence of clear financial data, banks often make corporate credit decisions based on collateral. As a result companies that would not be eligible for credits based on business and cash-flow viability are able to borrow, while others may not be able to even though they have a viable business—but not the required collateral. The main problem is the lack of IAS in the reporting and disclosure required for listed companies by the Capital Markets Board, and for unlisted holding groups that have listed subsidiaries or affiliates or that own banks. Turkey’s recovery from its crisis involves, among other things, an expectation of substantial foreign direct investment. While there are many reasons Turkey has not received as much foreign investment as expected, if it is to become more attractive to foreign investors in the future, Turkey must provide financial statements that meet international standards.

162. The solution is to apply IAS in order to determine the real profitability of companies which will benefit all stakeholders in the long run. It is important that accounting standards in Turkey be fully consistent with international standards. Maintaining separate Turkish standards will slow firms’ access to international markets. While Turkish banks were required to adopt IAS for 2002, the Capital Markets Board should apply these standards to all listed companies, including unlisted subsidiaries and affiliates of major groups. A number of groups have on their own moved to IAS and to audits based on generally accepted accounting principles, primarily to raise funds in international capital markets. In addition, reporting should be required on a consolidated basis for all groups. Disclosure rules are needed for all contingent liabilities between a holding company and its subsidiaries as well as collateral (such as shares of the subsidiary) given to banks for loans or guarantees provided by the parent for subsidiaries or

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6 This discussion on accounting standards is based in part on a Deloitte and Touche report. The Bank’s recent Study on Non-Bank Financial Institutions and Capital Markets in Turkey (April 2003) also discusses the accounting standards issue.
cross-guarantees from one subsidiary to another. During Korea's recent crisis, a web of guarantees left many chaebols in trouble. The chaebols were unable to detach good assets (subsidiaries and affiliates) from bad because of the cross-guarantees from subsidiaries and affiliates to other subsidiaries and affiliates. Implementing IAS 29 in Turkey will enable banks and capital markets to analyze the financial situation of holding companies and their subsidiaries. An Accounting and Auditing Standards Board should be established to provide the leadership and incentives needed to rapidly expand the use of these standards. IAS may not be suitable for all types of companies. For example, small and medium-size unlisted companies may not need financial statements prepared according to these standards. However, companies interested in raising capital from foreign sources must prepare financial statements based on IAS.

163. The Capital Markets Board has taken a major step with its new consolidation standards applicable starting from 2003. Previously, Turkish accounting standards did not require consolidation, except for a requirement that banks prepare, in addition to their main annual financial statements (which are unconsolidated), financial statements consolidating their financial sector participations. The lack of consolidation has been a serious weakness considering that large parts of Turkish industry are controlled by holding companies. The financial statements of these holding companies show only the dividend income from subsidiaries. Transactions among group companies often distort the reported profits and assets of individual companies. Consolidated reporting will correct for such transactions. International Accounting Standard 28 requires the equity method of accounting for associated companies (normally those with a shareholding of 20-50 percent). Under the equity method, the reporting company includes in its income statement its share of the profit or loss of its associated companies and adjusts the carrying value of its investment in each associated company to reflect changes in each company's net assets. Until the new Capital Markets Board standards came into effect, equity accounting was not required by any Turkish standard except in the financial statements of banks consolidating their financial sector participation.

164. The lack of inflation accounting has traditionally been a problem in Turkey which distorts the financial statements of businesses in fundamental ways. First, reported profitability may not be "real" for several reasons. If the real value of receivables erodes during the period up to collection, companies will charge higher prices to compensate for the delay in collection. High prices inflate reported gross margins, but losses from the erosion of receivables during the credit period do not appear in financial statements. The amount can be significant when credit periods are long. Payables erode in the same way, but receivables are often larger than payables. Reported profitability and gross margins are overstated because the goods sold were based on inputs purchased earlier, when prices were lower. Second, the real value of fixed assets—especially land—becomes much higher than the book value. Similarly, the current value of stocks is often higher than the purchase cost. Finally, if interest rates are very high but a large part of the interest compensates for an erosion of the principal, companies with borrowings may report profitability below real levels. Financial statements prepared in Turkey ignore all these problems except for the annual revaluation of tangible fixed assets and conversion of revaluation reserves to share capital. Compulsory standards for inflation accounting have been issued by the Capital Markets Board and they have become a requirement for the listed companies starting in 2003. Draft legislation on inflation accounting has also been prepared by GDR to address taxation related issues. At the same time, if disinflation progresses in line with the program targets, then the situation will improve automatically.
165. There are other obstacles to understanding the real position and financial performance of Turkish businesses. These include the lack of publicly available information, which can only be solved with changes in legislation, and a widespread belief that many transactions are not recorded in financial statements for tax evasion purposes. Although there is little research on the second problem, it is thought to affect mainly small and medium-size enterprises.

Enhancing Corporate Governance

166. Internationally, there is growing recognition that strong corporate governance standards are important in establishing an attractive environment for long-term institutional investors. The Commercial Code provides the legal framework for corporate governance in Turkey, focusing on the duties and obligations of directors and protection of minority shareholders. In addition, listed companies must comply with Capital Markets Board requirements on disclosure, independent audits, and stronger minority shareholder rights. Apart from these laws, there is no separate corporate governance code in Turkey. The Capital Markets Board should consider adopting a Corporate Governance Code that incorporates principles of transparency and disclosure and that requires timely, accurate information along with enhanced protection of minority shareholder rights. In addition, an institute should be established to train independent directors for seats on the boards of listed companies.

167. Corporate governance should follow a few basic principles. Boards should operate independently from management with a clear fiduciary mandate to oversee company performance and make policy decisions on such crucial issues as reorganization, sales of substantial assets, mergers with or acquisitions of other companies, efforts to borrow or raise capital, and adoption of corporate strategies. Increasingly, good practice principles of corporate governance require that a substantial portion of board members be independent—that is, not management. It is important to foster responsibility for performance and protect the decision-making power of top managers, as well as the fiduciary and oversight responsibilities of the board. To this end, the roles and decision making responsibilities for execution (management) and supervision/policymaking (the board) should be separated. In Turkish businesses, board and management positions are usually filled by the same individuals making for less effective overall governance. All shareholders, including foreign and minority shareholders, should have equal voting rights and transparent, enforceable rights in the case of significant corporate events such as dividends, mergers, acquisitions, liquidation, and bankruptcy. The Turkish Commercial Code does not provide sufficient voting equality and minority shareholder rights. Each share does not necessarily have only one vote; multiple voting powers are allowed. Minority shareholder rights are infringed on in three main areas: dividends policy, voting rights (that is, blocking rights) for key corporate events, and treatment in cases of bankruptcy or liquidation. Finally, as noted above, corporate activities and performance should be reported and disclosed in a clear, understandable, consistent way based on IAS. Transparency should also be required for entire holdings. Hence requirements for consolidating and disclosing financial results should be imposed on listed holding companies as well as private ones that have listed subsidiaries.