Commission of Inquiry
into the Supervisory
Implications of the Failure
of the Imar Bank

The Supervisory Implications of the Failure of Imar Bank

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Executive Summary

The Commission was appointed to consider the implications of the failure of the Imar Bank for the efficacy of the system of banking supervision in Turkey and to recommend changes that would reduce the likelihood of such failures in the future. The Commission was not asked to ascribe responsibilities for the failure and this report has no implications for the judicial processes still continuing.

The Commission discussed the issues with officials in the Banking Regulation and Supervision Agency (BRSA), Government, and with representatives of the banking community and the audit profession. It concluded that the systems of controls were not as effective as they should be and this report recommends improvements.

A good supervisory system relies on four levels of control: internal controls operated by the management of the bank itself, controls exercised by the Board of Directors over the management, which involve an effective system of corporate governance, and controls exercised by external auditors appointed by the shareholders to ensure that the Board's financial statements properly represent the true state of the bank. Finally, because banks have the privilege of using depositors' funds for profit, there must be a control exercised by the bank supervisory agency on behalf of depositors and the public at large.

The Imar Bank failure shows that there were weaknesses at all four levels. This report recommends changes to modernise the system of corporate governance in banks. It suggests modernisation of the external audit processes and, finally, changes to the ways in which the BRSA ensures that all the control systems operate.

These changes will require some further reform to the legislative framework, already under review. The skills available to the BRSA need to be expanded. This will require more flexibility to the way the BRSA is managed. Supervision is a more complex activity than regulation alone. It requires a more effective and business oriented management approach together with greater accountability. Responsibility for the supervision of individual banks needs to be allocated more precisely and co-ordination among the different functions of the BRSA made more effective. In particular, the onsite examination function needs to be incorporated more effectively within a continuous and permanent supervisory process. Changes in the structure of the Board are also proposed, together with a more effective quality assurance system involving effective review by the Board of the BRSA's performance in achieving its objectives.

Although implementation of the reforms suggested in this report will not necessarily rule out future failures, the chances of them recurring should be considerably lessened. Weaknesses in banks should be identified and dealt with more effectively and promptly. Implementation of these changes will also bring banking supervision closer to best practice internationally and in the European Union.

Introduction

This inquiry into the failure of the Imar Bank was set in train by the Government of the Republic of Turkey in April 2004. The government made clear that the intention was not to ascribe blame for the failure but to draw lessons from the episode in order to make recommendations for strengthening the system of regulation and supervision so as to reduce the chances of such failures occurring in the future. Accordingly, this report has no implications for the judicial processes still continuing. The commission was given no legal authority to require evidence and all those who assisted the inquiry did so voluntarily and in confidence. The commission visited Turkey on three occasions in May, June and July 2004. This report is based on information provided by officials in the relevant government departments and agencies during those visits. The commission also interviewed a number of individuals who had been involved in the regulatory process during the period leading up to the failure. Interviews with commercial bankers and accounting firms also assisted the inquiry. The Commission did not have an opportunity to examine documentary material such as examination reports and material submitted to the BRSA board.

The timetable for preparation of the report was short so this report is brief and deals with the major issues as concisely as possible. It does not attempt to describe in detail the Turkish regulatory and supervisory system nor does it make detailed recommendations for changes in laws and regulations. Instead, this report draws the principal conclusions from the failure and identifies the major reforms that are, in the opinion of the Commission, necessary to minimize the opportunities for failure in the future.

This report draws on international regulatory and supervisory practice in EU and other major countries and its recommendations are designed to assist Turkey in bringing its own practices into line with best practice internationally. But it does not purport to be a comprehensive review of the adequacy of banking supervision in Turkey. At an appropriate stage, probably after the new banking law is fully implemented, it would be useful to conduct such a review.

Principal Reasons for the Failure

It has been alleged that the principal shareholders of Imar Bank produced false financial statements to the creditors of the banks, including its depositors, and misleading reports to the supervisory authorities over a prolonged period. By failing to account for a substantial volume of deposits the management was able to misappropriate funds not reported in the financial statements of the bank and its prudential reporting. The bank appeared to be relatively small with less than one percent of total deposits. After its failure it was discovered that the bank's true liabilities were ten times as great. It appears that this under reporting of deposits may have persisted over a number of years. Knowledge of the true figures, and the systems for disguising them, appears to have been confined to a relatively small number of senior managers and shareholders. The arrangement only came to light when problems in related companies led to a substantial increase in depositor withdrawals. The resulting liquidity problems revealed the under reporting. This led the principal shareholders and management to attempt to walk away from the problem leaving depositors without recourse. The government subsequently rescued the depositors and the substantial cost has been born by the public sector.

Why did the under reporting begin in the first place and why did it remain undetected for so long? The first question can only be answered by the perpetrators. But it is clear that where a controlling shareholder of a bank can design and implement a control system that serves his interests at the expense of those of the bank's creditors then there is a powerful incentive to use the bank for the shareholder's own purposes. In the case of Imar Bank, the only lending business of the banks was to other affiliated companies. It did no arms length lending at all.

The answer to the second question is more complex but the principal factors can be identified. The corporate governance structure of the bank was weak in the sense that it served the interests of the principal shareholders but not those of creditors. Nor did the work of the bank's external auditors and the supervisors ensure that the corporate governance framework and practice took account of depositors' interests.

It is, of course, true that fraud in financial institutions can be difficult to detect and the difficulty is enhanced if the misreporting is perpetrated by the owners and managers as is alleged in this case. Moreover, supervisory institutions are not specifically equipped to detect false accounting, although they are increasingly devising policies and procedures to mitigate the impact of what are now known as operational risks. But there are a number of steps that can be taken that will make it more difficult to evade detection and reduce the likelihood of successful and long lasting fraud. In many of these areas the Turkish system is still deficient. This report identifies improvements that could be made that would mitigate the risks. It cannot be safely said that if all these changes had been adopted the Imar losses would not have occurred but it can be stated with some confidence that the chances of misreporting on a large scale persisting for so long would be substantially reduced.

The next section of the report describes the elements necessary for a sound control system that will ensure that the interests of depositors are protected. The following section identifies where the system failed in the Imar case and the final section makes some recommendations for reform. Of course, many of the failings have already been identified and changes put in hand that will, when implemented, rectify the deficiencies, but in some cases further steps are also necessary.

Elements of a sound control structure

The control structure of any company consists of several layers. Companies that act in a fiduciary capacity, that is they operate with other people's money, have a particularly onerous responsibility which is why in most cases they are regulated and supervised by legislation in the interests of the public at large and specifically in the interests of their customers. This section outlines the control structures necessary in any banking system. It draws on best practices in EU and other major countries. Supervisory authorities are devoting more and more attention to these elements, within a banking regulatory and supervisory structure, and many of the features outlined below are relatively recent developments although the basic framework has been established for some years.

Internal control exercised by the shareholders

All companies should possess a system whereby the directors of a company exercise controls over that company and its management on behalf of the shareholders. The methods used vary from country to country, but normally the shareholders elect a board of directors whose members are charged with ensuring that appropriate controls are in place and that they are properly used. In the case of a bank where, under its authority to act as a bank, it has accepted an obligation to protect the value of funds entrusted to it by its depositors, the need for adequate internal controls becomes even more important. In 1998, the Basel Committee on Banking Supervision established principles for internal control and these principles are outlined in Box 1.[1] Principles 1 and 2 deal with the respective responsibilities of the board of directors and the senior management. Principle 6 (segregation of duties), Principle 8 (the need for independent monitoring of electronic data systems), Principle 9 (channels of communication), and Principle 11 (internal audit) are also of particular importance in this context. On the segregation of duties, the Committee states: "In reviewing major banking losses caused by poor internal controls, supervisors typically find that one of the major causes of such losses is the lack of adequate segregation of duties. Assigning conflicting duties to one individual gives that person access to assets of value and the ability to manipulate financial data for personal gain or to conceal losses. Consequently, certain duties within a bank should be split, to the extent possible, among various individuals in order to reduce the risk of manipulation of financial data or misappropriation of assets." On internal audit, the Committee notes: "It is critical

[1] The full paper can be found at http://www.bis.org/publ/bcbs40.pdf

that the internal audit function is independent from the day-to-day functioning of the bank and that it has access to all activities conducted by the banking organisation, including at its branches and subsidiaries.” The paper also notes that “the internal audit function…..should report directly to the board of directors or its audit committee and to senior management”.

Box 1: Principles for the Assessment of Internal Control Systems

Management oversight and the control culture

Principle 1 :
The board of directors should have responsibility for approving and periodically reviewing the overall business strategies and significant policies of the bank; understanding the major risks run by the bank, setting acceptable levels for these risks and ensuring that senior management takes the steps necessary to identify, measure, monitor and control these risks ; approving the organisational structure ; and ensuring that senior management is monitoring the effectiveness of the internal control system. The board of directors is ultimately responsible for ensuring that an adequate and effective system of internal controls is established and maintained.

Principle 2 :
Senior management should have responsibility for implementing strategies and policies approved by the board; developing processes that identify, measure, monitor and control risks incurred by the bank; maintaining an organisational structure that clearly assigns responsibility, authority and reporting relationships ; ensuring that delegated responsibilities are effectively carried out; setting appropriate internal control policies; and monitoring the adequacy and effectiveness of the internal control system.

Principle 3 :
The board of directors and senior management are responsible for promoting high ethical and integrity standards, and for establishing a culture within the organisation that emphasises and demonstrates to all levels of personnel the importance of internal controls. All personnel at a banking organisation need to understand their role in the internal controls process and be fully engaged in the process.

Risk Recognition and Assessment

Principle 4 :
An effective internal control system requires that the material risks that could adversely affect the achievement of the bank’s goals are being recognised and continually assessed. This assessment should cover all risks facing the bank and the consolidated banking organisation (that is, credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk and reputational risk). Internal controls may need to be revised to appropriately address any new or previously uncontrolled risks.

Control Activities and Segregation of Duties

Principle 5 :
Control activities should be an integral part of the daily activities of a bank. An effective internal control system requires that an appropriate control structure is set up, with control activities defined at every business level. These should include : top level reviews; appropriate activity controls for different departments or divisions; physical controls; checking for compliance with exposure limits and follow-up on non-compliance; a system of approvals and authorisations; and, a system of verification and reconciliation.

Principle 6 :
An effective internal control system requires that there is appropriate segregation of duties and that personnel are not assigned conflicting responsibilities. Areas of potential conflicts of interest should be identified, minimised, and subject to careful, independent monitoring.

Information and communication

Principle 7 :
An effective internal control system requires that there are adequate and comprehensive internal financial, operational and compliance data, as well as external market information about events and conditions that are relevant to decision making. Information should be reliable, timely, accessible, and provided in a consistent format.

Principle 8 :
An effective internal control system requires that there are reliable information systems in place that cover all significant activities of the bank. These systems, including those that hold and use data in an electronic form, must be secure, monitored independently and supported by adequate contingency arrangements.

Principle 9 :
An effective internal control system requires effective channels of communication to ensure that all staff fully understand and adhere to policies and procedures affecting their duties and responsibilities and that other relevant information is reaching the appropriate personnel.

Monitoring Activities and Correcting Deficiencies

Principle 10 :
The overall effectiveness of the bank's internal controls should be monitored on an ongoing basis. Monitoring of key risks should be part of the daily activities of the bank as well as periodic evaluations by the business lines and internal audit.

Principle 11 :
There should be an effective and comprehensive internal audit of the internal control system carried out by operationally independent, appropriately trained and competent staff. The internal audit function, as part of the monitoring of the system of internal controls, should report directly to the board of directors or its audit committee, and to senior management.

Principle 12 :
Internal control deficiencies, whether identified by business line, internal audit, or other control personnel, should be reported in a timely manner to the appropriate management level and addressed promptly. Material internal control deficiencies should be reported to senior management and the board of directors.

Evaluation of Internal Control Systems by Supervisory Authorities

Principle 13 :
Supervisors should require that all banks, regardless of size, have an effective system of internal controls that is consistent with the nature, complexity, and risk inherent in their on- and off-balance-sheet activities and that responds to changes in the bank's environment and conditions. In those instances where supervisors determine that a bank's internal control system is not adequate or effective for that bank's specific risk profile (for example, does not cover all of the principles contained in this document), they should take appropriate action.

Corporate governance

An essential aspect of the internal control system is that of corporate governance, the process by which shareholders and other stakeholders in a bank ensure that its management takes proper account of their interests. Considerable attention is being given to corporate governance in many countries following recent failures. The Basel Committee has also paid attention to this subject in respect of the corporate governance of banks. In a recent paper, it listed the main features of an effective corporate governance system in a bank.[2] The role of the board of directors is stressed, particularly the need to ensure that the board is composed in such a way that it can exercise effective control over the management. For example, one way is by ensuring that internal auditors report to the board and not to the management, and that the board also has direct communication with the bank's external auditors. For this purpose it is now common for bank boards to appoint an audit committee, a majority of whose members, including its Chairman, should be independent of management.

[2] See http://www.bis.org/publ/bcbs56.htm

External controls

In addition to the internal controls, there need to be two levels of external controls. The first consists of an effective external audit procedure. The function of the external auditor is to certify, for the benefit of the shareholders, that the financial statements are properly drawn up and portray a true and fair view of the financial position and performance of the bank.

There have recently been considerable advances in establishing reliable accounting standards for the preparation of financial statements of companies. Harmonisation is still progressing but more and more countries have adopted accounting standards that are in accordance with the international financial reporting standards (IFRS) published by the International Accounting Standards Board. Turkey's accounting standards which were not consistent with IFRS are now, following recent reforms, regarded as being much closer to best international practice. Generally, accounting standards apply to all companies but in view of the unusual aspects of banking business the IASB has established an accounting standard on the presentation of bank accounts (IAS 30).[3]

However, good accounting standards by themselves are not enough. The external audit process also needs to be of a high standard and the International Federation of Accountants has published Auditing Standards to help ensure that company audits are reliable. The Basel Committee, in the paper referred to above on corporate governance in banks, noted that "the role of auditors is vital to the corporate governance process. The effectiveness of the board and senior management can be enhanced by: (1) recognising the importance of the audit process and communicating this importance throughout the bank; (2) taking measures that enhance the independence and stature of auditors; (3) utilising, in a timely and effective manner, the findings of auditors; (4) ensuring the independence of the head auditor through his reporting to the board or the board's audit committee; (5) engaging external auditors to judge the effectiveness of internal controls; and (6) requiring timely correction by management of problems identified by auditors".

Finally, the last layer of control is that of the banking supervision authority. The responsibility of the bank supervisor is to ensure that the bank continues to meet the obligations it accepted when it was licensed and to ensure that all the three layers of control mentioned above are operating properly; where there are doubts that they are functioning correctly, it is the supervisor's responsibility to ensure that the bank's systems are tested, either directly through onsite examination, or by having suitably qualified outside experts carry out the necessary testing.

All four levels of control need to operate well if a bank's depositors are to be assured that the bank will be managed safely and soundly. In particular, it is the role of the supervisory authority to ensure that this happens. Here again the Basel Committee has issued guidance and discussed the relationship between the supervisor and the external

[3] See http://www.iasb.org

auditor.[4] For example, the committee noted “supervisors must have a means of validating the information they receive either through on-site inspections or the use of external auditors. On-site work, whether done by the banking supervisor’s own staff or commissioned by the supervisor but undertaken by external auditors, is structured to provide independent verification of whether an adequate internal control system, meeting the specific criteria the supervisor mandates, exists at individual banks and whether the information provided by banks is reliable”.

Where did the system fail in the Imar case ?

The initial problem in Imar Bank was the approval of the change of control of the bank in 1984. It seems that from that point the bank was run overtly as a ‘company’ bank in that all its lending was to group companies. At the time, this was an important deficiency in the licensing arrangements. Indeed, a number of bank failures throughout the world have had their origin in such a close relationship, and many countries consequently outlaw common ownership of banks and commercial companies. But even those countries that do permit such relationships ensure that there are powerful safeguards so that the bank is not overly dependent on connected parties as a single source of income. For example, the licensing authority will impose strict limits on lending to related parties; insist on the presence of independent board members; ensure effective audit and examination procedures to test the integrity of the systems etc. Imar Bank does not appear to have been an isolated case; indeed several bank failures in Turkey can be attributed to such links, although the extent of the reliance on them in this case (there was no other lending apart from that to related companies) does seem to have been unusual.

Misreporting instigated by senior management rather than by lower level staff, where senior management are as much the victims of the misreporting, is clearly more difficult to guard against. Nonetheless, an effective control system can do much to make the perpetration of such misreporting difficult to conceal for long. In one sense the internal controls worked well in the Imar case. The accounting system was designed to ensure that the bank was run in accordance with the major shareholders’ wishes and that the true scale of the business did not become widely known. In that sense they protected the interests of shareholders, at least in the short run. In that the bank failed in the end, and the shareholders lost control of the bank, the controls can hardly be regarded as having done so in the long run. But in any event the interests of depositors were clearly not protected and, as has been shown above, the purpose of bank licensing is to ensure that depositors’ interests are protected. Moreover, the board of Imar Bank did not function properly. From June 2001, the BRSA had a representative on the Imar Bank board but the BRSA representative was kept unaware of the true state of the bank despite that fact and remained in ignorance until the very end. After the revocation of the license, the BRSA discovered that there was an internal audit function and it had made some critical comments, but these reports were submitted to the chairman of the bank, did not reach the board as whole, and were not

[4] See http://www.bis.org/publ/bcbs87.htm

available to the BRSA. There was, therefore, no chance of the board, as distinct from the controlling shareholders, exercising a view independent of the management. There appears to have been no board audit committee.

A feature of Imar Bank's systems was that much of the accounting work was carried out, not by the bank's own staff, but by an outside IT firm. This firm was within the same group of companies but carried out no work for third party companies, that is all its work was for group companies. Apparently it is not that unusual in Turkey for such work to be outsourced although the extent in this case may have been. Suffice it to say the arrangement does not appear to have been subject to any particular verification process. The bank's board does not appear to have received any independent audit reports on the service company. As no discrepancies were apparent, the BRSA, through its representative on the board, did not see any reason to request any investigation.

As regards the external controls, the bank was audited by a firm approved by the BRSA but with none or few other banking clients. As noted above, there appears to have been no audit committee or other forms of corporate governance safeguard. Considerable reliance appears to have been placed on the fact that Imar Bank was subject to the recapitalization program after the banking crisis. This program involved assessments of solvency and capital need by the BRSA, and the bank's external auditors; the process was checked by a second firm of auditors. Imar Bank was found not to require additional capital in the program on the basis of the BRSA assessment and the external audit assessment validated the financial statements. The second firm, appointed by the BRSA in this case, also raised no questions. It is not clear whether at any of the three levels of audit any substantive testing was carried out but it seems that the task of the auditors, particularly at the second level was simply to verify that the correct method of calculating capital need was followed and that they simply relied on the data produced by the bank itself.

Finally, the fourth level of controls, that exercised by the BRSA, also failed to detect any serious weaknesses although the BRSA had for some time been concerned about the banks as evidenced by the fact that it had, in 2001, appointed a director to the board. (At one stage it even appointed a second director to the board.) In other words the BRSA was itself participating in the first level of controls. In addition, the BRSA subjected the bank to the usual onsite examination process. Apparently this examination process failed to detect any misreporting. The major reason is that no substantive testing of the systems in the bank and in the outsourced provider of IT services was done either by the BRSA or by a reliable third party. Although it is conventional for supervisors to rely on management and existing control systems, where confidence in these systems has not been established supervisors would normally dig deeper than the high level controls. For example, BRSA examiners do not inspect, or require others to inspect, branch records nor do they audit IT systems. A further factor was the lack of professional skills, particularly on IT audit, and experience of banking business within the corps of bank examiners. A crucial deficiency is that the onsite examination function is not fully integrated with offsite analysis to provide permanent supervision based on a full and continuous understanding of the bank and its performance.

Moreover there appear to have been additional indications of problems in Imar Bank. In 1990, the CMB cancelled the license of Imar Bank to sell government securities to its customers. As subsequent developments are subject to litigation no comment can be made here, but the fact is that Imar Bank contested the decision in open court but, after a period during which it regained its license, eventually lost the case on subsequent appeals. However, the bank itself, even after the withdrawal of its license, advertised sales of government securities to customers and apparently conducted a certain volume of such business. The Istanbul Stock Exchange also continued to register such transactions. The securities were alleged to be held by the bank to the order of customers. There is no process for verifying the existence of securities in such cases.

There is also evidence that the bank was advertising heavily for deposits at above market interest rates. If successful, this would mean that the deposit levels revealed by the financial statements would be implausible.

Recommendations

While the principal function of a banking supervisory authority is not to detect possible fraud and supervisory authorities are not always well equipped to do so, nonetheless supervisory authorities do have a responsibility to protect the interest of depositors, and misreporting, especially on a scale as egregious as in the Imar case, clearly defeats the purpose of supervision. Many supervisory authorities have put in train reforms designed to mitigate the risks arising from such occurrences. For example, following the discovery of major fraud at a senior management level in BCCI, the UK authorities commissioned a thorough investigation of the supervision of the bank and following its publication made major changes to the supervisory process.[5] These included both changes to the law and to the management of supervision. More recently the Basel Committee has done a great deal of work on what is known as operational risk, that is the risk of loss arising from systems failures and other unexpected events, such as fraud. Much of this work, to which the major international banks have contributed, is designed to identify the risks and to find ways to mitigate them. See, for example, the Basel Committee's paper "Sound Practices for the Management and Supervision of Operational Risk".[6] The main principles are in Box 2. As noted above, one of the peculiarities of Imar Bank was its heavy reliance on an outside firm for its accounting systems. In this connection, the report notes: "Growing use of outsourcing arrangements….can mitigate some risks but can also present significant other risks to banks." (See also Box 3 below.)

[5] For a useful discussion of the supervisory implication of this and other bank failures see Basel Committee on Banking Supervision working paper 13 on http://www.bis.org

[6] See http://www.bis.org/publ/bcbs96.pdf

Box 2: Principles for the management and supervision of operational risks

Developing an Appropriate Risk Management Environment

Principle 1 :

The board of directors[4] should be aware of the major aspects of the bank's operational risks as a distinct risk category that should be managed, and it should approve and periodically review the bank's operational risk management framework. The framework should provide a firm-wide definition of operational risk and lay down the principles of how operational risk is to be identified, assessed, monitored, and controlled/mitigated.

Principle 2 :

The board of directors should ensure that the bank's operational risk management framework is subject to effective and comprehensive internal audit by operationally independent, appropriately trained and competent staff. The internal audit function should not be directly responsible for operational risk management.

Principle 3 :

Senior management should have responsibility for implementing the operational risk management framework approved by the board of directors. The framework should be consistently implemented throughout the whole banking organisation, and all levels of staff should understand their responsibilities with respect to operational risk management. Senior management should also have responsibility for developing policies, processes and procedures for managing operational risk in all of the bank's material products, activities, processes and systems.

Risk Management: Identification, Assessment, Monitoring, and Mitigation/Control

Principle 4 :

Banks should identify and assess the operational risk inherent in all material products, activities, processes and systems. Banks should also ensure that before new products, activities, processes and systems are introduced or undertaken, the operational risk inherent in them is subject to adequate assessment procedures.

Principle 5 :

Banks should implement a process to regularly monitor operational risk profiles and material exposures to losses. There should be regular reporting of pertinent information to senior management and the board of directors that supports the proactive management of operational risk.

Principle 6 :
Banks should have policies, processes and procedures to control and/or mitigate material operational risks. Banks should periodically review their risk limitation and control strategies and should adjust their operational risk profile accordingly using appropriate strategies, in light of their overall risk appetite and profile.

Principle 7:
Banks should have in place contingency and business continuity plans to ensure their ability to operate on an ongoing basis and limit losses in the event of severe business disruption.

Role of Supervisors

Principle 8 :
Banking supervisors should require that all banks, regardless of size, have an effective framework in place to identify, assess, monitor and control/mitigate material operational risks as part of an overall approach to risk management.

Principle 9 :
Supervisors should conduct, directly or indirectly, regular independent evaluation of a bank's policies, procedures and practices related to operational risks. Supervisors should ensure that there are appropriate mechanisms in place which allow them to remain apprised of developments at banks.

Role of Disclosure

Principle 10 :
Banks should make sufficient public disclosure to allow market participants to assess their approach to operational risk management.

The Imar case suggests a number of changes are needed to the legal framework, the financial and human resources devoted to supervision, and, most importantly in this case, to the management and organisation of the supervisory process. The remainder of this report outlines some of the principal changes required to mitigate the risks in the future. These are also changes that will be necessary if Turkey is to have a banking supervisory system that meets best international practice. These basic practices have been set out by the Basel Committee on Banking Supervision in its *Core Principles for Effective Banking Supervision* published in 1997. These principles also underlie the supervisory framework that is required in all members of the EU, most of whom have subjected their supervisory practices to a formal independent assessment of compliance with the *Core Principles*. It follows that adoption of these practices would help ensure that in due course Turkey can also be found compliant with the best practices set out in the *Core Principles*.[7]

Bank ownership

One of the principal factors contributing to bank problems in Turkey has been inappropriate ownership of banks. Many banks are owned by powerful commercial groupings. This is a factor in many countries where the only readily available source of risk financing is often in such groups. While in many countries such ownership structures are illegal and banks cannot form part of non-financial conglomerates, in those where such an affiliation is permitted there are rules regarding the exposure of the depositors to risks originating outside the bank but inside the group. These usually take the form of strict limits on connected lending, as well as a requirement that any such lending is, and can be demonstrated to be, conducted at arm's length, that is the decision-making process must be, and be seen to be, completely independent of the beneficiary of the loan. Normally, the supervisor, when he is not satisfied that the arm's length requirement is met, has the power to deduct any such exposures from the bank's capital in order to protect the interests of depositors. It is important that owners do not see banks as a financing mechanism for their other commercial interests. Supervisory authorities should have the power to ensure that controlling shareholders in banks do not abuse their positions and do not have an incentive to subordinate the interests of the bank to their other commercial interests. In many countries, the supervisory requirements in such cases are so onerous that, even where permitted by law, common ownership of banks and non-finance businesses is, in practice, extremely rare. Where, on the other hand, there are incentives for such a structure, the presumption must be that the arrangement is likely to run counter to the interest of depositors, and this must be the predominant concern of any bank authorisation policy and supervisory practice.

This danger has been appreciated in Turkey for some time and steps were introduced some years ago to limit connected lending. However, it was necessary to phase in these requirements. This phase-in period was long and although Imar Bank was subjected to them some years ago, it was still the case at the time of the failure that all the commercial lending of the bank was to group companies. Essentially the bank was run as a financing vehicle for group companies. The BRSA had instigated a supervisory plan to change this state of affairs, and the volume of such lending reported by the bank had been reduced by a half while the bank's capital had been substantially increased thereby also contributing to a reduction in the proportion of capital accounted for by connected lending. But the fact remained that the bank had made no progress in diversifying its lending which remained exclusively to connected parties. While the regulatory position may now be more satisfactory the policy clearly needs to be more fully implemented so that banks are not entirely reliant on connected lending as a source of income.

[7] See http://www.bis.org/publ/bcbs30a.pdf for the Core Principles and http://www.bis.org/publ/bcbs61.pdf for the detailed criteria for assessing compliance.

Internal Controls

Observance of the internal control structures described above is an essential aspect of sound management. It is clear that in the Imar Bank case, the internal control structure lacked integrity. It was designed to promote the ends of the controlling shareholders. While wholesale subversion of the internal control system of a bank cannot always be prevented by the normal processes of supervision, nonetheless effective external audit processes and supervision can ensure that not only are the systems and controls present but that they are well designed and are used effectively. This latter demands a degree of substantive testing. As the supervisory maxim puts it: 'trust, but verify'. It is clear that the verification process needs improvement and the BRSA should undertake a review of its supervision of internal controls. It should also ensure that external auditors also do significant substantive testing of controls except where they have good reason to suppose that there is an effective and established internal audit function on which they can safely rely.

Several areas demand particular attention. First, the role of internal auditors needs to be strengthened. The appointment of internal auditors needs to be approved by the BRSA who should issue guidelines as to the competence and experience expected from incumbents of that position. Second, the position of the internal auditor must be safeguarded so that he or she has access to the Board and not just to management in order to preserve independence. This means that there should be an audit committee of the board, a majority of whose members should not be involved in the bank's management and whose Chairman is drawn from this group. Third, the BRSA should regularly review the internal auditor's reports and ensure that the audit committee requires management to implement their recommendations. Finally, the BRSA's onsite examinations should test the effectiveness and independence of the internal auditor before relying on his work.

Corporate governance

Good corporate governance is essential for any company, particularly a public company, if those with whom the company does business are to be assured of the integrity of those who purport to act for the company. Given that a bank is entrusted, as a condition of its license, with the responsibility of taking deposits from the general public, a significant privilege, it is even more important that banks maintain the highest standards of corporate governance. This involves implementing the provision of the OECD's corporate governance code and, for banks, also complying with the Basel Committee's principles outlined earlier. To ensure that banks do comply is, of course, not just a matter of regulation. Both offsite and onsite supervision processes will need to raise the priority attributed to effective corporate governance. It was the failure of Imar Bank to establish a corporate governance structure of integrity, and the failure of the supervisors to ensure that it did so, that enabled the bank to be run in the direct interests of shareholders and contrary to those of depositors for so long. The audit committee process referred to above is an important component in effective corporate governance.

External audit

The external audit process must be improved. The BRSA already has control over the choice of external auditor and no firm that is not approved by the BRSA to undertake the audit of a bank can do so. But it seems that this approval process is not particularly rigorous in that there are firms on the list with little experience of what has become a very specialized form of audit. Moreover, there is no case by case approval of an individual bank's choice of external auditor. A firm that may be suitable for one bank may not be suitable for another. For major banks, it is highly likely that only firms affiliated to the major international accounting firms, all represented in Turkey, would qualify to undertake audits of such banks, although smaller firms may be acceptable to audit simpler banks.[8] The BRSA should also review its policies for the rotation of auditors and ensure that no audit firm is unduly dependent on a bank, its affiliates, or its shareholders for a substantial part of its revenues.

Once appointed, the BRSA should have direct contact with the firm. It should arrange meetings with the management of the bank and with the partner responsible for the audit. It should also ensure that the firm has direct access to the bank's audit committee. It should also require the bank to commission work from the auditor in cases where it sees the need for some substantive testing of systems and controls and lacks the capacity to do the work itself. This approach could be used as an alternative to, or reinforcement of, onsite work by the BRSA. External auditors should also be empowered to communicate directly with the BRSA where they learn in the course of their work that breaches of laws and regulations have occurred, or where they believe that the management is acting contrary to depositors' interests. The exchange of reports between the BRSA and external auditors should be formalised. An external auditor needs to be aware of any criticism by the supervisor and it is in the interests of the supervisor that he should be. Similarly the supervisor should be aware of the external auditor's views, especially on the operations of the bank's internal controls.

Outsourcing

It has become customary for banks and other companies to outsource activities where the company does not have the necessary expertise and where it may be more economical to contract another firm to undertake the work on its behalf. This has become common, particularly for specialist IT functions. Very recently the Joint

[8] In practice, correspondent banks and large corporate depositors are likely to require that a bank's financial statements be audited by a well known and reputable firm. But small depositors are less likely to be concerned which means that the supervisory authority also needs to exercise some control.

Forum[9] has issued a set of principles to help financial institutions and their supervisors to deal with this issue. The principles in brief are set out in Box 3 below.[10] Principle III (the outsourcing arrangement should neither diminish the bank's ability to fulfill its obligations to customers and regulators, nor impede effective supervision by regulators) seems particularly important in this context. Imar Bank appears to have taken outsourcing to an extreme degree by contracting out not only the design or the resource intensive activities but the entire central accounting function. Moreover, the firm contracted to undertake the work was a related company which only did IT work for group companies. There was therefore no independent expertise available to the BRSA as to the standards and integrity of the work. In any case both the external auditors and the BRSA should make their own assessments of the integrity of such a relationship. There is a related issue that is relevant where the outsourced service involves the provision of technical expertise not possessed by the user. This concerns the methods by which the user can be assured that the services provided are sound and adequately controlled. This is also a problem for the external auditor and supervisor. At a minimum both need to have access to the service provider and be able to make whatever checks are necessary to ensure that adequate controls exist and that the integrity of the service provided is maintained. The Joint Forum paper provides helpful guidance in this respect. The resource implications of this recommendation are dealt with below.

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[9] The Joint Forum is a group representing the Basel Committee and the international bodies representing securities regulators and insurance supervisors.

[10] The paper in full can be found at http://www.bis.org/publ/joint09.pdf

Box 3: Principles for Treatment of Risks in Outsourcing

The Joint Forum has developed the following high-level principles. The first seven principles cover the responsibilities of regulated entities when they outsource their activities, and the last two principles cover regulatory roles and responsibilities.

I. A regulated entity seeking to outsource activities should have in place a comprehensive policy to guide the assessment of whether and how those activities can be appropriately outsourced. The board of directors or equivalent body retains responsibility for the outsourcing policy and related overall responsibility for activities undertaken under that policy.

II. The regulated entity should establish a comprehensive outsourcing risk management program to address the outsourced activities and the relationship with the service provider.

III. The regulated entity should ensure that outsourcing arrangements neither diminish its ability to fulfil its obligations to customers and regulators, nor impede effective supervision by regulators.

IV. The regulated entity should conduct appropriate due diligence in selecting third party service providers.

V. Outsourcing relationships should be governed by written contracts that clearly describe all material aspects of the outsourcing arrangement, including the rights, responsibilities and expectations of all parties.

VI. The regulated entity and its service providers should establish and maintain contingency plans, including a plan for disaster recovery and periodic testing of backup facilities.

VII. The regulated entity should take appropriate steps to require that service providers protect confidential information of both the regulated entity and its clients from intentional or inadvertent disclosure to unauthorised persons.

VIII. Regulators should take into account outsourcing activities as an integral part of their ongoing assessment of the regulated entity.

Regulators should assure themselves by appropriate means that any outsourcing arrangements do not hamper the ability of a regulated entity to meet its regulatory requirements.

IX. Regulators should be aware of the potential risks posed where the outsourced activities of multiple regulated entities are concentrated within a limited number of service providers.

Supervision

While the Imar Bank case demonstrates some basic failures in the controls that ought to apply at a bank both internally and through the external audit process, none of these can be guaranteed to be effective without an effective banking supervision capability. There are three attributes that an effective supervisory authority requires. First, a sound legal basis, second adequate resources, both financial and human, and finally an effective organisational structure that will ensure that the supervisory process is well managed and the right action is taken promptly when it is needed.

The legal basis for supervision

The statutory basis for supervision in Turkey is relatively modern and reflects a major organizational change which brought onsite examination carried out within the Treasury together with the Central Bank's offsite role into a new agency, the BRSA, in 2000. This agency has overall authority which is based on the Banks Act. The activities of banks in capital markets are licensed and supervised by the CMB under the Capital Markets Act, but the BRSA is seen as the lead supervisor in so far as banks are concerned and there is no doubt about the BRSA's predominant role as the consolidated supervisor of banking groups. The BRSA will also acquire authority over non-bank financial institutions in the near future. An additional reform was to separate out the role of the Savings Deposits Insurance Fund, which had originally been managed by the Central Bank, but taken over by the BRSA on its creation. There are clear advantages in separating out the asset management function in respect of the failed banks taken over by the Fund.

The Banks Act is in the process of substantial revision and some of the recommendations in this report may be relevant to that revision process. A major consideration that needs to be born in mind in the process is the danger of over-legislating and reducing the flexibility of the supervisory authority. The extent to which detailed supervisory rules and requirements are contained in primary legislation or delegated to the rule making powers of the supervisory body itself varies considerably from country to country. But as a general principle it is helpful if the detailed application of general requirements is left to secondary legislation or rules which can be altered to meet the changing market environment. It is also important that the major thrust of the recommendations in this report be addressed by the BRSA in its management of the supervisory process. Not all the reforms mentioned here can be achieved simply by legislation.

The Commission was able to examine a translation of an early draft of the proposed law on credit institutions. It supports the majority of the changes recommended with the exception of the following points which will need further consideration if they are to support the recommendations in this report.

- The articles entitled ‘audit’ and ‘onsite audit’ seem unnecessarily restrictive. The powers to conduct onsite examination and to request information etc. should belong to the BRSA as a whole and not exclusively to the Sworn Bank Auditors (SBA). While this department of the BRSA would normally conduct the bulk of onsite work, it may well be necessary to supplement their role with expertise and experience found elsewhere among BRSA staff. The present legal requirement that only the SBA can do onsite work removes a desirable element of flexibility and can therefore hinder effective supervision. The BRSA also needs to be able to commission others to act on its behalf, e.g. audit firms. Moreover, those staff responsible for the permanent supervision of a particular bank need authority to request information and documents from banks at times other than during onsite examinations.

- The article entitled ‘protective measures’ provides for the appointment at the BRSA’s expense of a director of a bank in certain circumstances. As noted earlier in this report, this is an unusual supervisory practice and risks a conflict of interest between the external supervisors and those, the members of the board, who represent the shareholders. This is not to say that there will not be times when the BRSA needs to give directions to banks and may need to have its staff in the bank to ensure that they are properly carried out. But they should be appointed as representatives of the BRSA and not as directors of the bank.

- The article entitled ‘prohibitions’ would prevent the appointment of part-time members of the Board recommended below.

- The article entitled ‘chairman’ makes the Chairman alone responsible for setting the objectives of the agency and evaluating the performance of the staff of which he is the head. Good corporate governance practice suggests that this responsibility should be held by the Board as a whole.

- The article entitled ‘sworn bank auditors’ repeats the second paragraph of Article 5 of the present law. This appears to put the role of the SBA as examiners of bank’s prudential standards in a position subsidiary to that of tax auditor etc. The law needs to be very clear that prudential supervision is the major task of the SBA. Indeed consideration should be given to removing the tax audit function altogether. This is an extremely unusual element. In most countries it is felt important that supervisors should have no responsibilities in this field and that if they do have them it will inhibit the supervision process by making supervised institutions less willing to be frank with the supervisory authorities.

As noted above, relations between the BRSA and external auditors need to be developed. This may well need legislative changes, e.g. to allow external auditors to inform the BRSA if they discover deficiencies in the course of their audit work. The BRSA should establish a working group with representatives of the audit profession to review ways in which they can work together more effectively.

Resources – financial and human

As with any form of preventive security, it is always possible to produce arguments for greater resources to be devoted to supervision and these are difficult to combat. And it is also true that most countries have in recent years substantially increased the resources assigned to bank supervision, in part because the business of banking has become more complex and the risks more difficult to identify and measure. But resources are finite and even though in most countries the burden falls on banks rather than directly on the taxpayer, there comes a point where the burden becomes so heavy that it begins to interfere with the efficient operations of financial markets and encourages the growth of unregulated intermediation.

In a brief report such as this, it is difficult to draw specific conclusions as to the adequacy of resources devoted to the supervision of banks in Turkey. Although the intellectual capacity of the BRSA appears to be relatively high, and the numbers of professional staff not low in relations to the number of institutions supervised, the recommendations of this report do have significant resource implications. On the other hand, there may well be efficiency gains, deriving from the management reforms contained in this report that can offset some of these additional costs. So the net financial costs may be more limited. There may also be solutions to some of the resource issues which do not involve costs that fall directly on the supervisory authorities' budgets. That does not mean that the costs are not real, and that banks' customers will not have to bear them, but they may be easier to finance. But the answer to these questions will require a more in-depth analysis of the adequacy of the resources devoted to supervision. This should be commissioned.

What is clear is that there are deficiencies in the skill base of the BRSA. Although well educated in a general sense, the BRSA lacks some of the skills necessary to do an effective job. This is an issue that confronts all supervisory authorities around the world as banking becomes more complex. Moreover, in most countries supervisory pay levels are not always sufficient to attract the skills needed. But there are solutions available that will help the BRSA to meet these needs.

One of the basic resources that the BRSA possesses is a corps of inspectors, the SBA, who are well educated and at entry are subject to a highly competitive examination process. However, this corps is relatively young with an average age of about 32. Indeed, membership of the Board of SBA is regarded as a stepping stone to a career elsewhere in the public and private sector. This does of course bring certain benefits to future employers, including those in the public sector, but there is a cost to the efficacy of supervision. Moreover, although well educated, the SBA is recruited almost exclusively direct from the universities. It therefore lacks the breadth of background that other countries are able to tap in order to develop an effective inspectorate. For example, although SBA are often sent to universities to acquire higher degrees including in business administration and acquire considerable exposure to the workings of banks, there are no individuals with experience as commercial bankers or as practising external auditors of banks, nor with an information technology or IT audit background, nor do they have experience in trading and back office management skills. There would therefore be advantage in widening the skill base by recruiting post experience personnel with such skills. To do this would require a salary structure that had the flexibility to reward individuals with such skills. Some countries are able to do this by offering short or medium term assignments which, although not remunerated at market levels, nevertheless provide attractive career development possibilities. Other countries achieve this objective by arranging secondments of staff from the private sector.

The offsite staff are mostly ex-central bank staff who transferred from the Central Bank to the BRSA when the latter was established, as well as ex-government employees. The Research Department also has staff with higher academic economic qualifications. This group of staff is well placed to contribute effectively although until recently they had very little contact with the banks which they analysed. It is clear that much could be done to improve the skill base overall with a more flexible staffing policy and more specialist training. This would result from the organizational changes described below. It would also benefit from some senior recruitment from the private sector, whether in a managerial capacity or an advisory capacity. A more broadly based and effective board structure could also help. This is also referred to in the next section.

It is, however, not necessary for all these additional skills to be employed directly within the supervisory authority. Many other authorities around the world have solved, at least in part, this skill and experience deficiency by using outside resources. For example, several European countries which do not have large teams of bank examiners use accounting firms that are commissioned to report on certain aspects of the banks' business and control systems to the supervisors. A less direct way of using the same resources is to require banks themselves to commission, at their own expense, reports on specific aspects. The terms of reference are approved by the supervisor who will discuss the report with the authors and the banks' management and board. In this way supervisory authorities can access these skills without having to employ them directly. However, even using such techniques requires some capacity in the supervisory authority if it is to be able to judge critically reports done by skilled experts, as well as to ensure that the experts appointed are sufficiently well qualified. It is also in this context that the process for the approval of external auditors of banks needs considerable enhancement.

The BRSA has begun this process in connection with IT but it has yet to initiate the process of acquiring staff with external audit experience or with commercial banking expertise. To achieve these reforms it is important that pay structures do not interfere with the efficient working of the supervisory process. Artificial constraints can prove a false economy, although it is important that the agency provides, and is seen to provide, value for money. At present the agency is financed by a levy on supervised institutions which is subject to a cap specified in the law. This is a reasonable approach common in many supervisory agencies. There are, however, additional constraints in Turkey. Salaries of Board members are linked to those judged to be performing equivalent tasks in the public sector. Although the Board has some freedom to determine remuneration within the staff, Board salaries effectively impose a ceiling and this has led to a massive compression of differentials. It is therefore difficult to reward outstanding performance and difficult to recruit from the market. The Government should consider relaxing this constraint so that the Board has freedom along the lines enjoyed by the Central Bank. It would, and should, continue to be subject to the overall limit on financial resources referred to above. Removal of the ceiling would, however, enable a more flexible structure to be adopted which could well be financed by efficiency gains within the agency.

The organization of supervision

While effective supervision depends on adequate statutory powers and competent human resources, even more important is the way in which the supervisory process is organized, decisions taken, and follow through action implemented. It is here that the Turkish authorities have the greatest capacity for improvement.

Two major deficiencies are evident in the organisational structure of the BRSA. First, there is a lack of overall responsibility for the supervision of each bank. Thus, staff responsible for the various functions operate almost independently with no central manager responsible for co-ordinating the whole process of supervision. Secondly, and partly resulting from the first, there is a lack of communication between the various functions. Reforms have already been put in place combining the old offsite monitoring function with the "enforcement" function - the latter being more broadly defined than in many supervisory authorities. But more should be done.

As a first step, a single officer should be appointed with responsibility for the permanent supervision of each bank. Offsite supervision is an ongoing process and involves not only analysis of reports provided by the bank but also frequent contact with the bank at various levels. The process should enable the supervisor to build up a picture of the bank and to make periodic assessments on the CAMELS model.[11] In practice one officer might be responsible for one large bank or several smaller ones. He might have a small team working for him. He should be accountable up the line, and ultimately to the BRSA board for his stewardship. He should also be responsible for liaising with the Central Bank, with government departments, with the CMB etc. He should be responsible for briefing the SBA when they conduct onsite examinations, for determining what areas the examiners should concentrate on, and for ensuring that the bank undertakes any actions arising out of the SBA's reports. He should be responsible for liaising with the external auditors. He should have the responsibility of

[11] This method, developed by US supervisors, and already used by the BRSA, is based on the acronym CAMELS: the initial letters stand for Capital, Asset quality, Management, Earnings (or profitability), Liquidity, and Sensitivity to market risk, respectively.

deciding whether additional expert resources should be deployed. If the bank were to fail, he would be responsible for managing the relationship with the SDIF.

The onsite function is also important. Offsite supervision is based on information provided by the bank. Onsite work enables the supervisor to verify the reliability of the material provided to offsite supervisors. It adds a final layer to the control system described above and should be coordinated with the work of the external auditor. While the functions of auditor and examiner are different reflecting their differing motivations, there is a considerable degree of overlap in the actual work done by the two functions and they can contribute to each other's work. But the greater part of the value of onsite examination is lost unless it is closely integrated with the permanent and ongoing offsite supervision. As recommended above, the focus of onsite work, whether carried out by the SBA or using other resources, should be one of the principal tasks of the officer with overall responsibility for the supervision of the bank.

Therefore steps should be taken to improve relationships between the SBA and the offsite supervisory staff. Although the two groups of staff now work for the same agency, their working relationships do not appear to be as close as is necessary to ensure effective supervision. This no doubt reflects the historical context when the two groups worked for different organisations. Various steps could be taken to improve these relationships. First, the officer responsible for the continuous supervision of an individual bank should prepare a brief for each examination, whether it is a general examination or a special examination of a particular aspect. Where the SBA do thematic visits, then such a brief would involve not just the officers responsible for supervision of the banks to be visited but others as well. Contact should be maintained during the examination and afterwards. There should be meetings to discuss the SBA report and follow-up action. This would involve both parties in the drafting of the letter sending the report to the bank. One way of maintaining this close liaison would be for one of the offsite team responsible for the bank to participate in the examination team.[12] Although the officer with responsibility for the supervision of the bank would be responsible to the board for the overall supervision of the bank, the head of an onsite examination team should have the right to be heard and any differences of view should be adjudicated at a senior level, ultimately by the Chairman of the BRSA. Both groups could report periodically to the board on developments in the industry and the risks as they saw them.

A second means of promoting further integration would be to set up a training program so that all new recruits to the BRSA should spend one or two years as an assistant SBA and as an assistant bank specialist so that they have experience of both sides of the supervisory process before being appointed to a permanent position. This reform would be facilitated by the current process of recruiting university graduates. Potential staff applying for positions as both assistant SBA and assistant bank specialists are currently subject to identical recruitment procedures and a similar high

[12] For this and some of the subsequent recommendations to take effect, the existing law which only permits SBA to undertake onsite work will need to be amended.

standard is required of both categories. The decision as to which side of the agency they ultimately specialize in could be deferred until after both the individual and the agency has had the benefit of the experience gained in the training grade in both functions. In addition, existing staff should be required, as soon as practicable, to spend a period of at least six months working in the other wing of the agency to familiarise themselves with the work of their counterparts.

Finally, there is the corporate governance aspect within the BRSA itself. Frequently supervisory authorities fail not because they were not aware of problems in a bank but because the decision-making process was too slow or too cumbersome to determine an action plan and to apply the pressure needed to ensure that the bank complies with it and the remedial action works, or, if it does not work, that sanctions are progressively brought to bear. For this to happen in practice demands a strong governance culture in the supervisory authority. This means that accountability should be pushed down from the Chairman to individual officers. There also needs to be an internal quality assurance process independent from the management of the agency reporting directly to the Board. This function parallels that of the internal auditor of a bank. It is designed to enable the board to assess the agency's performance. The BRSA is currently establishing such a function by devising benchmarks and standards against which performance can be assessed. Priority should be given to this work which should include the review process already contained within the SBA structure. The head of the quality assurance function should report directly to the Board which should use the output of the process in its ongoing assessment of the agency's performance. This function parallels that of a company board's review of the work of its internal auditors. It is also for consideration whether there should be provision for periodic external reviews of the efficacy of the agency. To this end the BRSA should publish its objectives and standards and report periodically on progress in achieving them.

The Board also needs to review its own performance. The Board should consider to what extent it should itself implement the corporate governance code of the OECD. The status of the Board members should be reviewed. At present all are full time employees but, apart from the Chairman, have no executive function. The problem with this arrangement, based on that used in other public sector agencies in Turkey, is that it is difficult to recruit board members other than from the public sector or an academic background as pay would be regarded as inadequate. While board members from such a background can be valuable it would help to widen the pool of experience within the board. Consideration could be given to appointing some part-time members with private sector experience who might continue to derive their main source of income from outside the board. Of course, conflicts of interest could arise, but experience in other countries suggests it is possible to handle these issues satisfactorily with appropriate disclosures and ethics codes etc. Genuine outsiders could bring some independent thought to the effectiveness of the board. A less satisfactory alternative would be the appointment of part-time advisers to the board who would have the right to attend board meetings.

The government is currently considering legislation which would provide a generally applicable framework for all regulatory bodies. It will be important that this legislation does not constrain the implementation of the proposals in this report. Supervision is a very different process to regulation. It requires different skills and a different and more flexible management approach.

Conclusions and recommendations

Although no bank supervisory authority is fully equipped to detect fraud and deliberate misreporting, banking supervision agencies can do much to ensure that the possibility of fraud being committed and going undetected can be significantly minimised. The principal methods to do this involve the encouragement and development of a system of internal and external controls. It is the efficacy of these control systems that now forms the basis for effective modern banking supervision.

It has not been the function of the Commission to attribute responsibility for the failure of the Imar Bank. It would in any case be wrong to attempt to do so as long as judicial proceedings are in train. But it is nonetheless clear that the Imar Bank failure shows that the controls described in this report did not operate well. The internal controls systems of the bank lacked integrity and did not take account of the interests of depositors. This resulted from an inappropriate system of corporate governance. There was no effective presence on the board other than those who represented the interests of the controlling shareholders. The BRSA attempted to redress this deficiency by appointing one of its own staff, not an action consistent with modern supervisory practices, but he was not in a position to verify the adequacy of the information provided. The external auditor reportedly lacked experience of the specialised processes now needed for an effective audit of a financial institution. The accounting system was run by a third company also owned by the bank's principal shareholders. But, perhaps because there were no independent directors of the bank, no external verification procedures were put in place and no-one thought fit to question the system's output.

Although the bank was under intensive supervision, because of the predominance of lending to companies also controlled by the principal shareholders, again no substantive testing of the systems was done because the supervisors, both offsite and onsite, saw no reason why they should not rely on the figures produced by management. As the Basel Committee has noted (see reference earlier in this report) "supervisors must have a means of validating the information they receive….On-site work….is structured to provide independent verification of whether an adequate internal control system, meeting the specific criteria the supervisor mandates, exists at individual banks and whether the information provided by banks is reliable".

The Commission makes a number of recommendations which could improve the effectiveness of the four levels of controls in banks. Some of these suggestions are already in the process of implementation, but more needs to be done. The Commission's recommendations fall under three headings, the legal framework for supervision, the resources available to the supervisory authorities, and the organisation of supervision, especially within the BRSA. In the Commission's view it is this last area that is most important. The BRSA is a product of a merger between staff previously in the Treasury, the bank inspectorate, known in Turkey as SBA, and other staff mainly working in the Central Bank. Several attempts at reforming these structures have been carried out, and it is too soon to know how effective the latest reform has been. But, in the Commission's view, one further step is required and that is to ensure a greater integration between the onsite examiners and the continuous or permanent supervision exercised by the rest of the BRSA staff. This integration would need further legislation, not present in early drafts of the new banking law, and a substantial organisation and management reform within the BRSA.

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