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## Borrowing Practices of Municipalities in Turkey

In recent years, the municipal needs such as infrastructure, health care and education services have increased in parallel with rapid urbanization which has caused the municipalities to find new resources through borrowing in order to resolve the delays and failures in municipal services. As to the legal framework, the principles and procedures in relation to the internal and external borrowing of the municipalities are regulated under the laws and the secondary legislation thereof, mainly including the Law No. 5393 Municipality Law (the "**Municipality Law**"), the Law No. 4749 Law on Public Finance and Debt Management (the "**Finance and Management Law**") and the Regulation on Principles and Procedures Regarding External Financing within the Scope of Law No. 4749 (the "**External Financing Regulation**") of the Undersecretariat of Treasury of Turkey (the "**Treasury**").

*Domestic and Foreign Loans:*

With respect to the domestic financing, the municipalities may utilize loans from the public and private banks in Turkey. For domestic borrowing which does not exceed %10 of total revenue of the latest actual budget of the relevant municipality in a year increased by the revaluation ratio determined by the Tax Procedure Law No. 213 (the "**Tax Procedure Law**") the approval of the municipal council is required. For domestic borrowing which exceeds %10 of such revenue amount requires the approval of Ministry of Interior of Turkey as well.

Apart from the Turkish public and private banks, Bank of Province of Turkey (*İller Bankası*), which was established in order to, among others, meet the financing needs of special provincial authorities, municipalities and their affiliated organizations, may also provide a loan to the municipalities. A municipality using investment credit and cash credit from Bank of Provinces of Turkey (*İller Bankası*) is obliged to present the payment plan to this bank. Bank of Provinces of Turkey (*İller Bankası*) is entitled to reject the loan request of the municipality where the re-payment plan is considered as insufficient.

Nowadays, the municipalities also create resources via external financing for their services and investments which require advanced technology and high amount of financing such as transportation, environment & waste management, purchase of heavy construction equipment etc. In this respect, the development and investment banks and international finance institutions seek providing long term

## Legislative Highlights

- ✓ The Banking Regulation and Supervision Agency (the "**BRSA**") published a draft regulation that would replace the Regulation on Provisions and Classification of Loans and Receivables as of January 1, 2017 if adopted without changes. This proposed regulation would require banks to adopt IFRS 9 principles (unless an exemption is granted by the BRSA) related to the assessment of credit risk by the end of 2017 and to set aside general provisions in line with such principles. If an exemption is granted by the BRSA, the banks would be allowed to set aside general provisions as stipulated under the proposed regulation. According to the proposed regulation, the general provisions for Group I loans (*Standard Loans*) would be raised from 1.0% to 1.5% and those for Group II loans (*Loans under Close Monitoring*) would be raised from 2.0% to 3.0% starting from 2018.

- ✓ The BRSA also published a regulation regarding domestic systemically important banks ("**SIBs**") in the Official Gazette dated February 23, 2016 and No. 29633 in order to introduce additional capital requirements for D SIB in line with the requirements of Basel III. The BRSA defines SIBs according to their size, complexity and impact on the financial system and economic activity. The banks are to be classified under four categories based upon a score set by the BRSA and will be required to keep additional core Tier 1 capital buffers up to a further 3% buffer for Group 4 banks, 2% for Group 3, 1.5% for Group 2 and 1% for Group 1. In 2016, capital buffer requirements for SIBs will be introduced at one-fourth of the full requirements. The buffers are to be fully implemented by 2019.

- ✓ Pursuant to the amendment to the Regulation on Principles Regarding Establishment and Activities of Asset Management Companies published in the Official Gazette dated March 5, 2016 and numbered 29644, the BRSA imposed new rules regarding asset management companies. Among other changes, the minimum capital requirement for asset management companies has been increased to TL 20,000,000 from TL 10,000,000. The asset management companies are required to satisfy this minimum capital requirement until December 31, 2017. Also, the asset management companies will be required to establish an internal control system.

loans to the municipalities. As an example, European Bank for Reconstruction and Development (EBRD) has stated in the strategy document for Turkey on 2016 published on EBRD's website that "*EBRD has so far had mixed results in working on municipal projects in mid-sized and smaller cities, which depend largely on concessional state or EU finance. Based on this experience, the Bank will concentrate going forward on creditworthy metropolitan municipalities with a particular focus on second-tier cities.*"

The municipalities become clearly entitled to utilize the loans provided by the foreign financial institutions under the Finance and Management Law and External Financing Regulation. As stipulated under the External Financing Regulation, the municipalities are obligated to obtain the approval of the Treasury for its projects to be funded via external financing. In addition, the External Financing Regulation states that the Treasury must obtain the opinion of Ministry of Development of Turkey before granting such approval (with certain exceptions concerning military defense and security projects) in relation to the importance and suitability of the project in annual investment program, total amount of the project envisaged under the annual investment program and the needs for external financing for such project.

Please note that domestic and foreign borrowing (including the accrued interest) of a municipality is limited to the total revenue of the latest actual budget of the relevant municipality increased by the revaluation ratio determined by the Tax Procedure Law.

*Bond Issuances:*

As permitted under the Municipality Law, the municipalities may also issue bonds domestically or abroad for the financing of their projects defined its investment program.

The principles and procedures regarding the domestic bond issuances by the municipalities are regulated under the Treasury's Regulation on the Procedures and Principles of the Permission Process of Domestic Market Bond Issuances of Local Governments published in the Official Gazette dated 15 March 2012 and numbered 28234 (the "**Bond Issuances Regulation**"). According to Article 4 of the Bond Issuance Regulation, the municipalities must apply to the General Directorate of Public Finance of the Treasury of Turkey (*Hazine Müsteşarlığı Kamu Finansmanı Genel Müdürlüğü*) for the approval of the Treasury together with the documentation and information listed under the Bond Issuance Regulation. As to the external financing via bond issuances; pursuant to the External Financing Regulation, the municipalities are under obligation to have the approval of the Treasury as parallel with utilizing foreign loan. Apart from the municipality specific procedures contemplated under the Bond Issuance Regulation (for domestic bond issuances) and External Financing Regulation (for bond issuances abroad), the municipalities must follow the general procedures and principles for bond issuances stipulated under the Capital Markets Law and its secondary legislation. Accordingly, once the above mentioned approvals are obtained, the relevant municipality has to apply to the Capital Markets Board of Turkey in order to obtain the necessary approval for bond issuances.

*Treasury Guarantee for Foreign Financing:*

As a security of the foreign financing including the bond issuances abroad, the Treasury may provide guarantee for the repayment obligations of the municipalities. Pursuant to Article 8 of the Finance and Management Law, preparations, communications and negotiations in relation to providing Treasury repayment guarantee are conducted and finalized by the Treasury itself. Additionally, pursuant to Article 15 of the External Financing Regulation, the Minister, in charge of the Treasury, is authorized to approve the Treasury repayment guarantee for the foreign financing. In the process of providing Treasury guarantee, the Treasury takes into account the external borrowing limits of the municipalities envisaged under the Municipality Law and examine whether the cash flow of the municipality is sufficient to satisfy the debt services under the relevant financing. In order to finalize this process, the authorized body of municipality must obtain a decision permitting the relevant financing in the amount equal to the Treasury guarantee and in case of project financing, approves opening the project accounts. The municipalities may also utilize foreign loan or issue bonds abroad without treasury guarantee, however, such process (except for the foreign financing with the maturities of a year or shorter, provided by the public investment and development banks) is also subject to the approval of the Treasury. In this respect, the Treasury examines whether or not there is any outstanding debt of the municipality which is due and payable to the Treasury and whether such municipality has exceeded its external borrowing limit. The Treasury additionally takes into account the opinion of State Planning Organization (*Devlet Planlama Teşkilatı*) on the relevant project to be funded via foreign financing.

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Yours faithfully,

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