# Turkish banks' credit profile is vulnerable but more resilient compared to the 2018 crisis

by Anna Sophie Wupper

It has happened again. The Turkish Lira, which was already vulnerable due to concerns over the country's high debt levels and diminishing foreign reserves, fell to a new record low against the US dollar in May 2020 amid the Covid-19 crisis. Usually, Turkish banks' credit risk increased whenever the Turkish Lira depreciates since they rely on the foreign wholesale markets for funding. This time, despite the Lira depreciation, the increase in Turkish banks' credit risk is not as pronounced as during the Turkish currency and debt crisis in 2018. Improvements in liquidity buffers, asset quality and foreign currency denominated debt could play an important part in the Turkish banks' relatively resilient credit profile during this crisis, particularly when compared to past events. Despite these improvements, caution remains as domestic deposits are barely sufficient to fund lending activities. Furthermore, Turkish banks are exposed to refinancing risk whilst dealing with the direct consequences of the Covid-19 crisis.

Figure 1 presents the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of publicly listed banks in Turkey. In Mar 2020, when the Covid-19 crisis hit Turkey and the Turkish Lira (TRY) started to lose its value more rapidly than before, the Agg PD of the banks jumped to 150bps, which is still much lower compared to the peak of the 2018 crisis at 385bps. Afterwards, the credit profile started to improve which is not only due to the improvements in the banking sector but also because of the recent Turkish stock market rally[1]. However, the latter should be treated with caution since the development is caused by the diminishing attractiveness of Turkish equities for foreign investors, forcing them, who already sold USD 3.96bn of those equities in this year, to exit the stock market and locals to enter as they have difficulties to find alternative investments to fixed income or deposit accounts.

[1] The stock index return is one of the inputs of the NUS-CRI PD model and the market capitalization of the corporates affects their Distance-to-Default, which is another input of the NUS-CRI PD model.

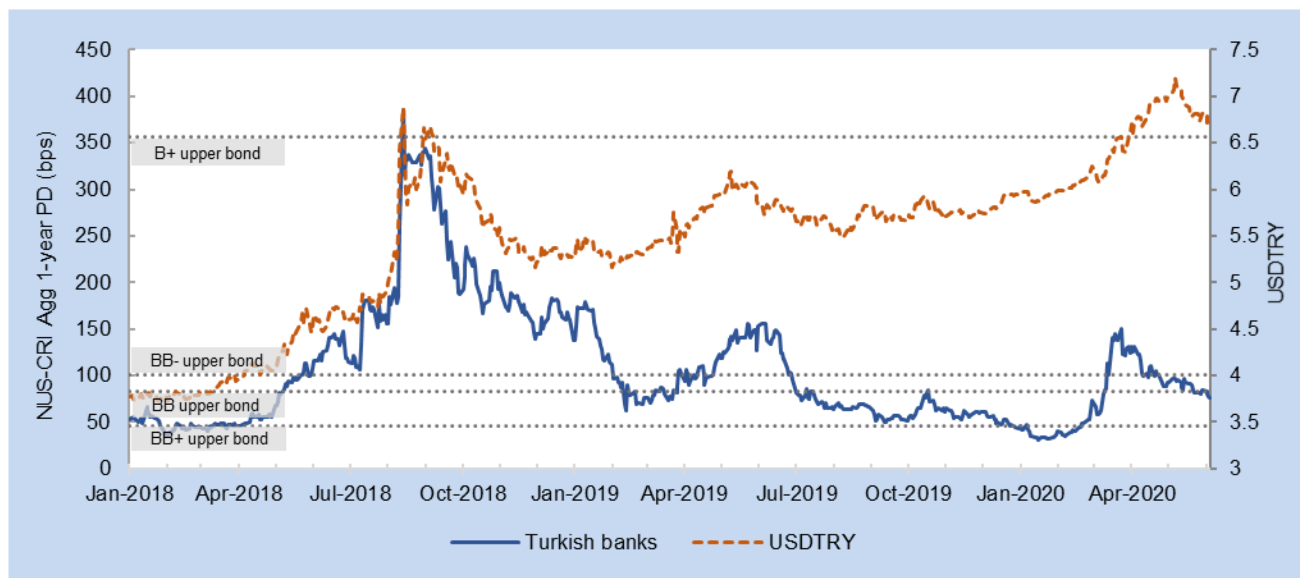


Figure 1: NUS-CRI Agg PD of Turkish banks (LHS), bounded by PDiR 2.0[2], and USD/TRY currency exchange rate (RHS). *Source: NUS-CRI.*

The Covid-19 pandemic hit Turkey heavily – by now, the country has over 170,000 reported cases, which is the 11th highest number of infected in the world. The consequences of this brought a deep disruption to the Turkish economy and will reduce borrowers' capacity to repay loans and increase problematic loans in the future, causing a negative outlook on the Turkish banking system. In particular, lenders with high exposure to SMEs as well as tourism, transportation and related sectors are likely to be hit heavily. S&P expects this summer's tourism season to be largely lost and Turkey's exports to contract by 15% this year.

Within the META region (Middle East, Turkey and Africa), Turkey is one of the most exposed to tackling aggravated bank's funding and liquidity weaknesses. 50-60% of the Turkish bank funding comes from domestic customer deposits, which are barely sufficient to fund lending. Figure 2a presents loan-to-deposit ratios above 100%, implying a relatively smaller deposit base than their lending activity. However, the ratio has already improved by decreasing from 126.6% during the Turkish currency crisis in 2018 to 109.6% in this year's first quarter. In Turkey, both residents and non-residents can hold deposits in foreign currencies, which represents a source of risk for banks especially during episodes of local exchange rate volatility. In the first quarter of 2020, about half of the deposits are denominated in a foreign currency. To compensate for the scarcity of domestic funding, Turkish banks engage in external wholesale funding. Due to currency fluctuations, banks might face higher funding costs, increasing capital outflows and lower lending growth in future months. These consequences will likely contribute to constrained market access, which exacerbates their funding vulnerability. At the same time, Turkish banks see an improvement in asset quality, as shown in Figure 2b as in Q1 2020, Turkish banks registered the first decline in ratio of NPLs since the 2018 currency crisis. Having influence on this improvement is also the relaxation in classification for NPLs until Dec 2020 wherein not 90-days delinquent loans, but 180-days delinquent loans have to be recognized as NPL.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

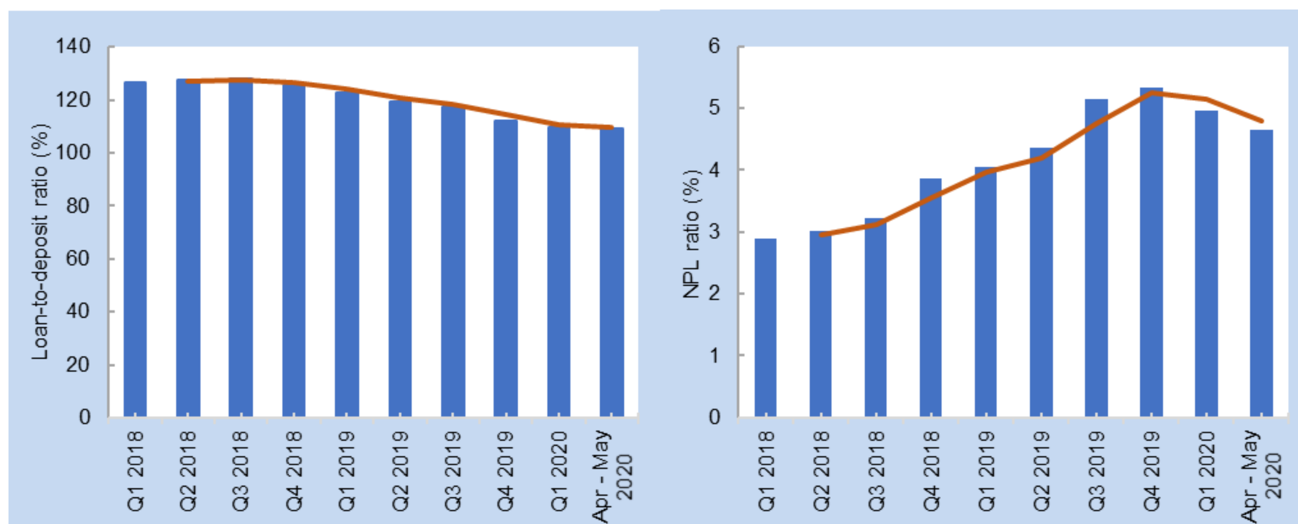


Figure 2a: Loan-to-deposit-ratio of Turkish banks. Figure 2b: Non-performing loan (NPL) ratio as percentage of total loans. *Source: Bloomberg.*

Regarding the refinancing risk of Turkish banks, this may be elevated due to large maturing foreign-currency external debt. In total, USD 82bn of external debt will mature in 2020 of which Fitch estimates that USD 35-40bn will have to be repaid even after assuming that relatively stable funding sources as intra-group facilities and some foreign customer deposits do not need to be repaid. Nevertheless, banks enter the downturn with moderately strengthened liquidity buffers since mid-2018. Foreign currency liquidity amounts to USD 81bn, mainly consisting of short-term deliverable FX swaps, cash and interbank placements. This liquidity would be enough to cover the estimated debt repayments.

Figure 3 presents the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[3]) of publicly listed banks in Turkey. In the short term, it shows a deteriorating credit risk outlook until the end of this year. Especially in this time, Turkish banks have to deal with the direct consequences of the Covid-19 crisis. These include a disrupted economy, which can cause corporates having difficulties to repay their loans and bank asset quality to deteriorate, the lack of sufficient local funding sources and the exposure refinancing risk. With the beginning of the next year, the credit profile is expected to improve until 2025. This is in line with the GDP forecasts, which expect the Turkish economy to recover with a growth of 4.2% in 2021 and 3.5% afterwards. Despite the improvements, this crisis will have long-lasting consequences since it may take a long time for the credit profile to get close to its pre-Covid-19 level.

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

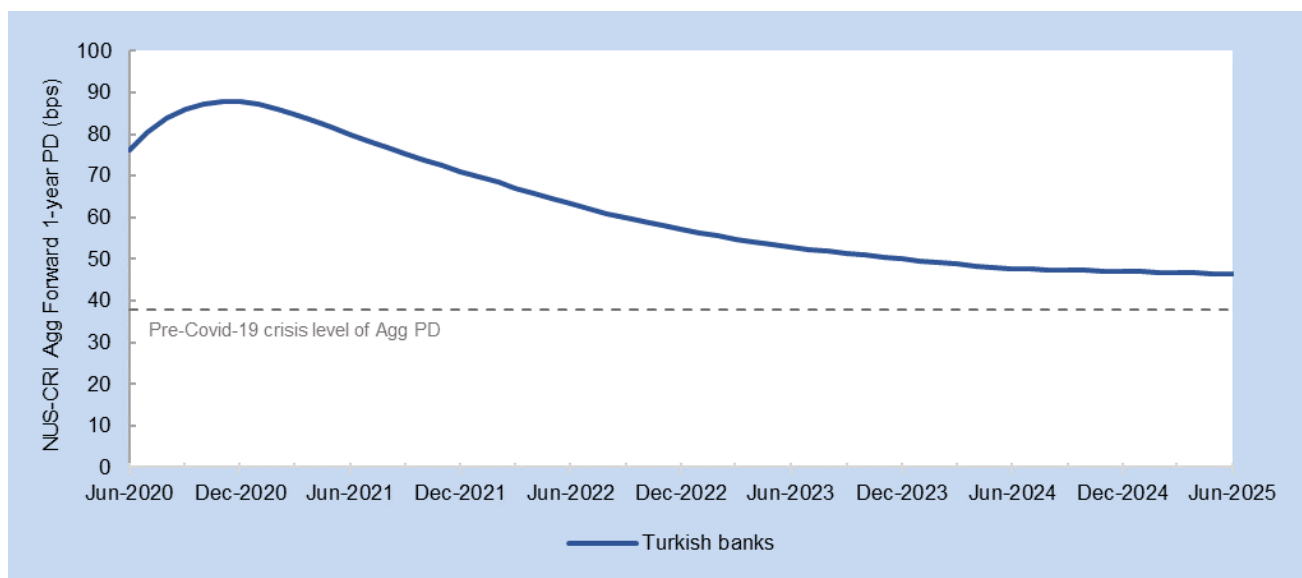


Figure 3: NUS-CRI Aggregate Forward 1-year PD of Turkish banks. *Source: NUS-CRI.*

## Credit News

### Investors expect credit to outperform despite Covid downturn

**Jun 8**. The world's biggest asset managers have predicted that US corporate debt will outperform sovereign bonds in the coming 12 months thanks to the central bank's aggressive interventions creating a recovery in capital markets. The survey finding from 200 fund managers with a combined USD 20tn in assets shows that confidence that investment-grade corporate bonds will outperform treasuries over the next year lies at a two-thirds while confidence that high-yield corporate bonds will outperform top-rated debt lies at 55%. This signifies that investors are confident that the weaker companies will be able to survive the pandemic too. With central banks around the world launching various stimulus packages to cushion the economic repercussions of the pandemic, we see many central banks such as the European Central Bank and US Federal Reserve pledging vast bond-buying programs. Such moves prevent a wave of default in the credit market and assure investors that this is an illiquidity crisis more than an insolvency crisis. However, the falling revenues continue to pose a threat for businesses and the Fed also cannot prevent if a business were to default from insolvency because of that. (FT)

### US lenders see hopeful signs in loan repayments

**Jun 7.** US banks expect a significant number of borrowers to recommit to normal payment schedules. According to analysis by Autonomous based on public disclosures, between 4% and 22% of borrowers across various types of loans sighted up for 90-day payment holidays as the COVID-19 threatened their livelihoods. Whether those borrowers are able to get back on track with normal payments is an indicator of the level of defaults and loan losses banks are likely to face. A senior executive at one of America's biggest banks said about 40% of those who were granted forbearance continued to make full payments on their loans, and the far better than expected unemployment data were a further sign that consumers were doing better than anticipated. (FT)

### China considers USD 28bn of funding to back troubled banks

**Jun 6**. China is considering using about USD 28bn in proceeds from government bond sales to help address risks in the banking sector. Chinese banks are poised to post an unprecedented drop in profits this year as they grapple with the fallout of the coronavirus. Lenders face additional credit costs, pressuring their capital

strength. The debt, as part of the total issuance planned by the central government in 2020, will be used for measures including re-capitalization for medium and small-sized lenders. However, the exact way to use the fund to help the troubled banks isn't yet clear. (Bloomberg)

**Payment problems rise in fast-growing private-debt market**

**Jun 5.** Debt-repayment problems are rising among smaller business borrowers in the private-credit market amidst the COVID-19 pandemic. In the private-credit loan market, specialist funds make direct loans to smaller companies, without the involvement of banks, hence leading to higher risks and higher yields. Increasingly, investors who are in for a higher yield are venturing into private credit and the total assets under management in private-debt and direct lending funds had grown from USD 125bn in 2006 to USD 740bn in the third quarter of 2019. However, highly leveraged loan and private-credit markets are expected to see increasing default rates of about 10%, given that after less than a month of economic restrictions, we are already now at a 5.9% default rate. One main reason is that these smaller business borrowers are less likely to withstand the financial stress imposed by the pandemic, hence are more likely to default. (WSJ)

**Big banks in Canada see a surge in energy loans**

**Jun 4.** As energy firms tapped credit lines to combat plunging oil prices, Canadian banks' exposure to oil-and-gas loans has surged to a record. Energy loans at the country's six largest lenders jumped 23% to USD 52.9bn in the fiscal second quarter from the prior period. However, many oil-and-gas producers are still seeing the total amount of credit available reduced despite increased borrowing showed in bank figures, as this year's first adjustment period, known as redetermination, is going on now in the country, and early results show banks have been shrinking credit lines in response to falling prices. (Bloomberg)

**Offshore Chinese bond holdings rise in May on yield gap appeal** (Reuters)

**Green bond crisis premium theory debunked by Covid, manager says** (Bloomberg)

**UK regulator launches GBP 350mn 'handout' for weaker energy suppliers** (FT)

**Regulatory Updates**

**Fed to stay full throttle with credit support despite debt rally**

**Jun 7.** The Federal Reserve may have stoked one of the strongest corporate debt market rallies in decades, but it's too soon to declare an all-clear for credit with the economy facing a potential rocky road ahead. The Fed's emergency pandemic lending programs are just getting started. The Fed will adopt a "belt and suspenders" approach to continued credit easing policies and announce a program of USD 80bn per month in longer-term Treasury purchases sometime over its next two meetings. However, there are still worries that the economy could drag as double-digit unemployment punches holes in consumer demand and corporate revenue growth. (Bloomberg)

**Specialist lenders seek access to cheap BoE funds**

**Jun 3.** UK's non-bank lenders are in talks for access to cheap funding from the Bank of England (BoE). Currently, specialist lenders are left to fund loans through expensive wholesale funding while large banks having the access to cheap funding from BoE. Hence, this puts specialist lenders out of competition as they, unlike large banks, could not fund state-backed bail out loans at attractive terms to SME borrowers. So far what is being discussed includes: allowing non-bank lenders to use the loans or receivables held by them

as collateral to access cheap BoE money and this includes bounce-back loans which will serve as a very secure form of collateral because of its 100% government guarantee. Specialist lenders play a crucial part in the lending market as they serve high-risk borrowers and also provide competition to the large banks. Thus, cheap cost of capital is necessary so that they may continue to compete with large banks in providing government loan schemes to SMEs. (FT)

**UK banks told not to assume losses on longer loan holidays** (FT)

**ECB Goes All Out With 600 Billion Euro Increase in Bond Buying** (Bloomberg)

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