Credit profiles of Turkish firms improved but risk remains

By Luo Weixiao

Fuelled by foreign capital influx, Turkey was once one of the fastest growing countries in terms of GDP growth rate. However, economic growth has dropped for three consecutive quarters and stood at -3% in Q4 2018. The country's lurch into recession, together with the weak Turkish lira and high interest rate, hamper firms' ability to meet debt obligations. The decline in credit profile is evidenced in NUS-CRI Aggregate 1-year PD (Agg PD) for Turkey domiciled firms- it peaked at 65.34bps in August 2018 when the lira slumped. Though the Agg PD fell to 28.15bps in March 2019, it is still at the second highest level since Jan 2016 and risk remains.

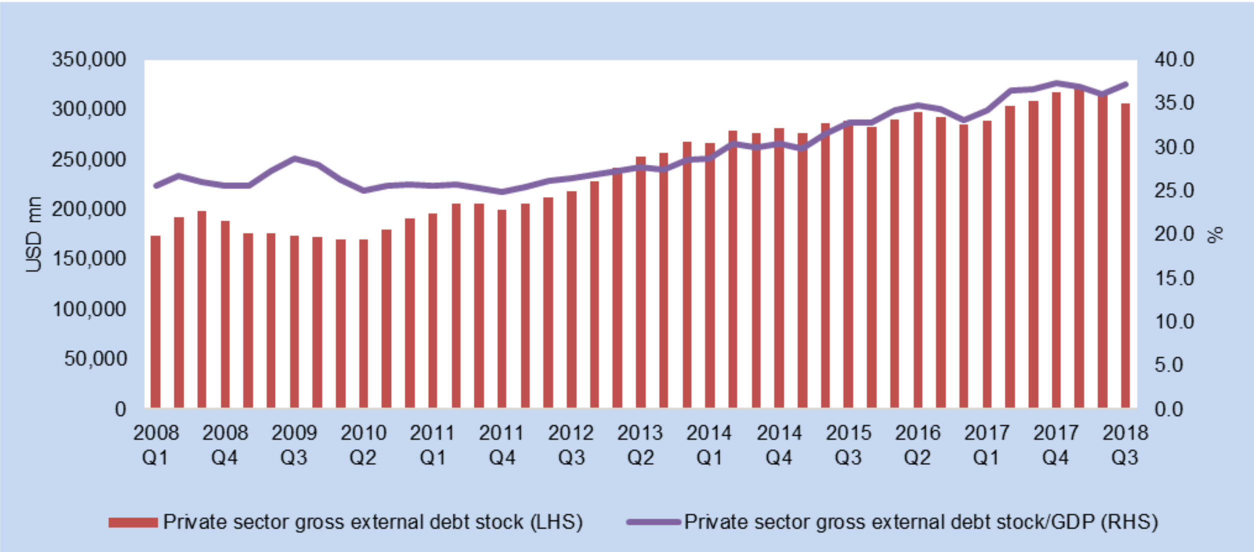

Figure 1: Gross external debt stock of Turkey's private sector. Source: *Republic of Turkey Ministry of Treasury and Finance.*

Foreign loans were built up at an unprecedented fast pace in Turkey during the low interest rate era after the financial crisis in 2009. As foreign funds pour in, corporate credit almost doubled amid 10 years' of loose monetary policy. The amount of outstanding foreign credit extended to the private sector peaked at USD 325bn in Q1 2018 and makes up around 65% of total gross external debt stock. High dependence on external financing leaves Turkey as the country with the highest total foreign debt in private sector to GDP ratio among emerging countries, standing at 37.2% in Q3 2018.

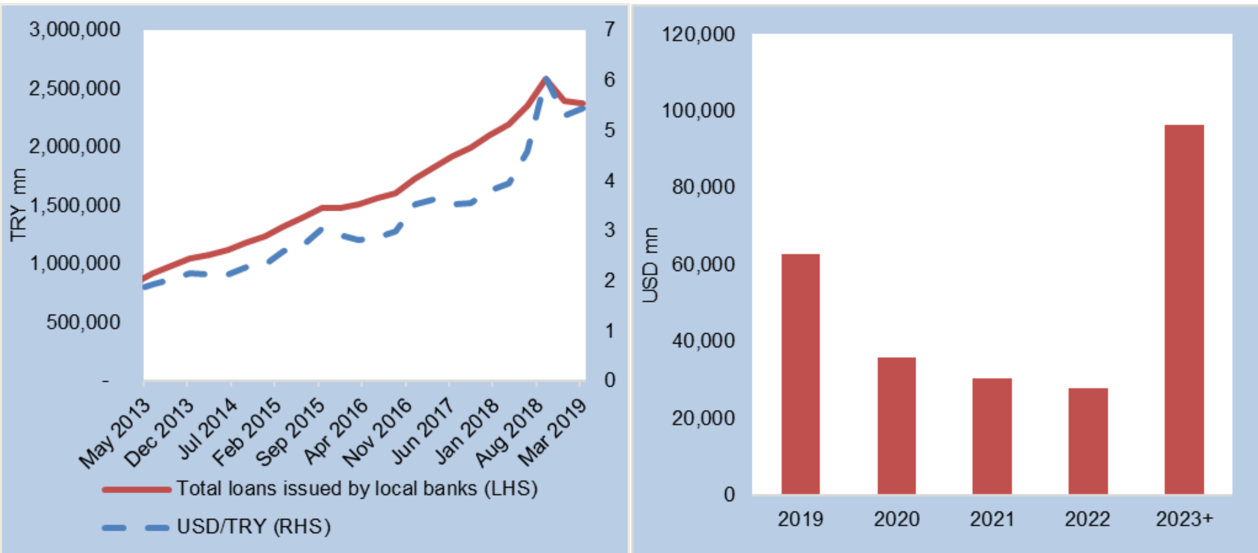

Figure 2a (LHS): Local banking credit and exchange rate of Turkey lira. Figure 2b (RHS): Mature date of outstanding external debt in private sector. Source: *Republic of Turkey Ministry of Treasury and Finance, Bloomberg.*

External debt in USD and EUR accounted for around 87% of total external debt, but the Turkish lira tumbled when the US imposed sanctions in Aug 2018, making it more costly for firms to repay foreign debts. The currency hit at a historical low in Aug 2018 and despite the partial recovery of the Turkish lira thereafter, companies are still facing pressure. From Jul 2018 to Dec 2018, Turkey recorded a capital account deficit for six months, the longest period after 2009. Though Jan 2019 experienced a capital account surplus, it remains to be seen whether the capital inflow will persist.

To stabilize the lira, the Central Bank of the Republic of Turkey hiked rate in Sep 2018 for the first time since 2015, holding the policy rate as high as 24% till now. The high interest rate shrank local banking credit by 7.2% on a quarterly basis in the last three months in 2019 and loans issued by local banks fell sharply. The massive credit crunch further exacerbated the output slump. In addition, Turkish's foreign debts are maturing soon as around USD 80.1bn matures in 2019 and USD 62.8bn of it is owed by the private sector (see Figure 2b).

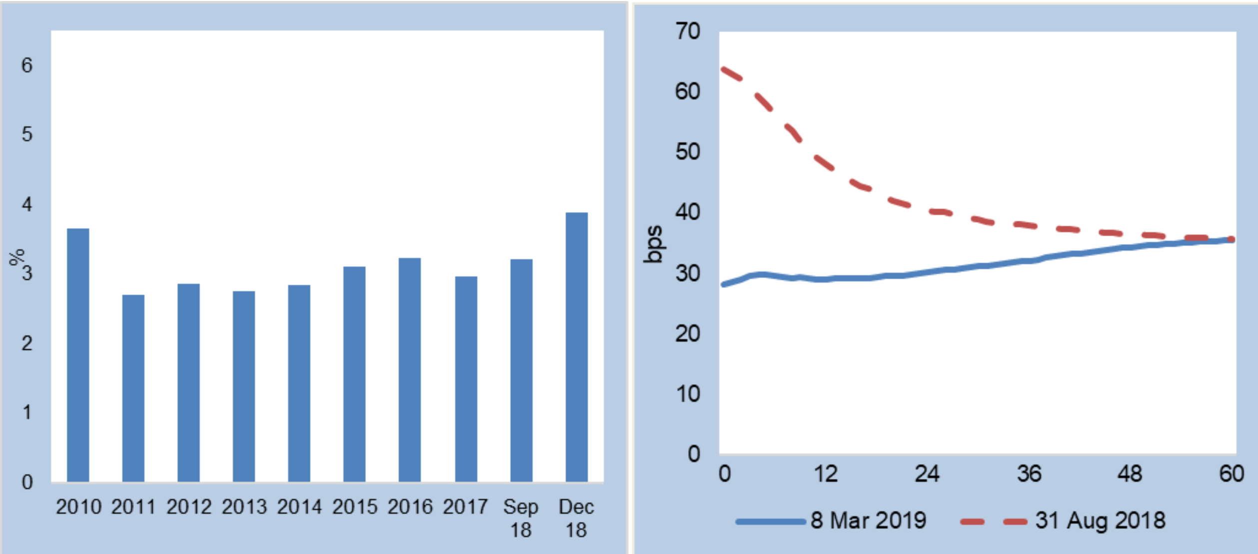

Figure 3a (LHS): NPLs to Loans ratio in Turkey banking sector. Figure 3b (RHS): NUS-CRI Forward 1-year PD for Turkey domiciled firms based on market information in 31 Aug 2018 and 8 Mar 2019. Source: *BDDK, NUS-CRI*

Driven by President Erdogan's push for growth at all costs, the government has placed pressure on state banks to ramp up credit despite the deterioration in banks' asset quality. The non-performing loans (NPLs) to total loans ratio was at 3.88% in Dec 2018, highest since 2010. Turkey's largest companies have either completed or sought almost USD 24bn of loan restructurings and some of Turkey's biggest conglomerates are putting some assets up for sale to avoid a debt crunch. A higher probability of corporate default is expected due to heightened financial stress reflected by higher NPL ratio which can be attributed to the high borrowing cost and weak currency. The banking regulator expects the NPL ratio to climb as high as 6% in 2019 and the rising risk is reflected in the NUS-CRI Forward 1-year Aggregate PD term structure. The Forward PD computes the credit risk of a company or a portfolio of companies in a future period, which can be interpreted similar to a forward interest rate. For example, the 10-month Forward PD is the probability that the firm defaulted during the period from 10 months onwards to 1 year plus 10 months, conditional on the firm's survival in the next 10 months. The 0-month Forward PD (which is the Agg PD) stands lower in Mar 2019 as compared to the curve in Aug 2018 representing an improvement in the credit profile of Turkish firms but the credit outlook suggests that risk still remains.

Credit News

China wants its stock, bond markets to step up funding role

Mar 18. China's chief financial regulator have urged for a stronger capital market so as to boost direct funding to companies. The regulators are trying to transform how the economy is funded which have been relying on state-run banks in particular the government-owned companies. Some measures being proposed include a new exchange designed to encourage technology companies to go public and relaxing rules to make it easier for local governments to issue bonds instead of resorting to shadow financing. Next, the authorities will also allow quantitative traders to use their own software to automatically execute trades through brokerages. These changes are aimed at improving the liquidity in equities and bonds and stimulate a more active market. (Bloomberg)

Ningbo becomes first local government in China to issue bonds to individuals

Mar 16. As the first among six local Chinese municipalities, Ningbo will begin offering CNY 300mn in regional bonds to individual investors later this month. This is the first time individual investors will be able to participate in the regional Chinese bond market alongside their institutional counterparts. In the midst of a slowing economy, Beijing has started encouraging local governments to obtain financing through the bond market, discouraging the excessive use of alternative local government financing vehicles in fear of a potential credit crisis. (TODAY)

USD 10bn corporate debt sale highlights credit market's recovery

Mar 15. The world's largest maker of automotive batteries is set to sell more than USD 10bn worth of speculative-grade debt, underscoring the recent resurgence in demand for low-rated bonds and loans. At the same time, banks were able to cut the expected yields on all of the bonds and loans for deals closed this week, an indication that demand had outstripped supply. Banks were also able to increase the size of the loan portion of the deal, while decreasing secured bond by the same amount. It was a positive sign for private equity-backed companies as loans are usually easier to repay ahead of their scheduled maturities as compared to bonds. Though fears of an economic slowdown led to a sharp decline in bond and loan sales in the end of 2018, issuance picked up in the middle of January and has been fairly steady since then. (WSJ)

UOB issues Singapore's first Panda bond

Mar 14. Southeast Asia's second Panda bond was priced at 3.49 percent, which is among the lowest priced issues among all Panda bonds. The SGD 404mn notes from UOB Bank were 2.7 times oversubscribed from investors including asset managers from China and Asian commercial banks. The bonds mature in 3 years and is rated AAA by China Chengxin rating agency. Market observers say that the bond increases the size of China's foreign bond market and facilitates capital flows between Southeast Asia and China. (Straits Times)

Boeing 737 Max issue may have broad aviation credit effects

Mar 14. After two deadly crashes in just half a year involving the Boeing 737 Max, one in October 2018 and one more recently on March 10, the credit rating agency Fitch has issued a statement regarding the potential consequences for Boeing as well as the aviation credit sector as a whole. According to the agency, the 737 Max crisis will continue to influence the sector for the rest of 2019, with much of its impact dependent on the underlying crash causes, which are currently being investigated. The main economic strain, in Fitch's view, will be put on both Boeing and its suppliers, due to a large number of outstanding 737 Max orders in the pipeline, while competing aircraft manufacturers and aircraft lessors are expected to be less affected. (Business Times)

AHAB files for financial restructuring under Saudi bankruptcy law (Reuters)

Etihad Airways claims progress with restructuring while reporting another huge loss (Forbes)

British American Tobacco's Canadian unit files for bankruptcy in US (WSJ)

Regulatory Updates

US agencies adopt interim final rule to facilitate transfers of legacy swaps

Mar 15. US agencies such as the FDIC and Board of Governors of the Fed are adopting and invite comment on an interim final rule so that qualifying swaps may be transferred from a UK entity to an affiliate in the EUR or the US without triggering new margin requirements. This action is required due to the possibility of non-negotiated Brexit deal. The interim final rule adopted would ensure that any legacy swap currently exempt from the agencies' rule on margin for non-cleared swaps would not become subject to the rule if such swap is for the purpose of transferring to an affiliate due to a non-negotiated Brexit deal. (Federal Reserve)

Working group on euro risk-free rates recommends transition path from EONIA to euro short term rate structure

Mar 14. The working group of the European Central Bank on euro risk-free rates has published its recommendations regarding the transition from the Euro Overnight Index Average (EONIA) to the use of the so-called €STR as the new overnight interest rate for bank-to-bank lending. While publishing of the €STR will begin in October 2019, a transition period until the end of 2021 is recommended by the working group. Further details include a 15% trimming mechanism for calculating the EONIA-€STR spread (effectively using 70% of the past 12 months' data to compute the average), as well as recommendations regarding the implementation of a forward-looking term structure based on the €STR. (ECB)

ECB attacks EU plans for boosting supervision of clearing houses (FT)

Simpler capital rule for small US banks proving hard to pull off (American Banker)

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Contributing Editor: Liu Hanlei