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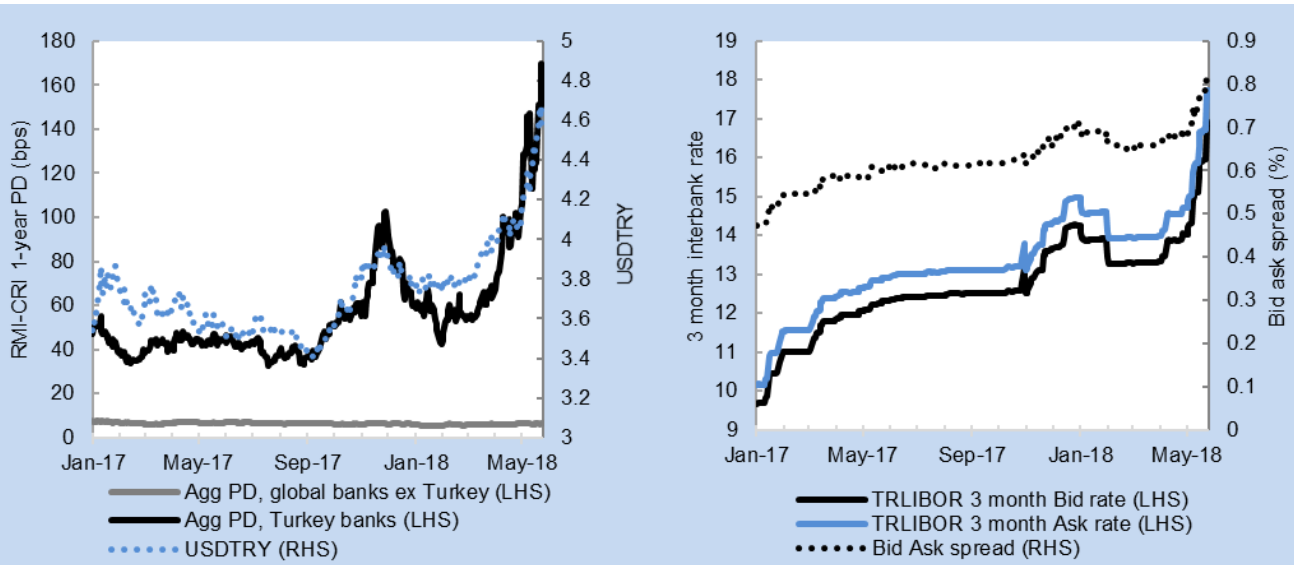
Weekly Credit Brief May 22 - May 28

# Downside risk intensifies for Turkish banks as Lira hits record low

by Dexter Tan

Last week, Turkey's currency fell to a record low against the US dollar amidst a flurry of heightened worries about capital outflows and the central bank's ability to manage the country's financial system. The credit outlook for Turkey-listed banks has deteriorated sharply as the lending environment and economic growth weakened considerably. Bank asset quality could decline further as borrowers find difficulty in repaying their debt against a slowing economy backdrop and high unemployment rate. The RMI-CR 1-year aggregate Probability of Default (PD), a median of PDs for 12 Turkish banks trended up sharply, as funding pressures mounted.



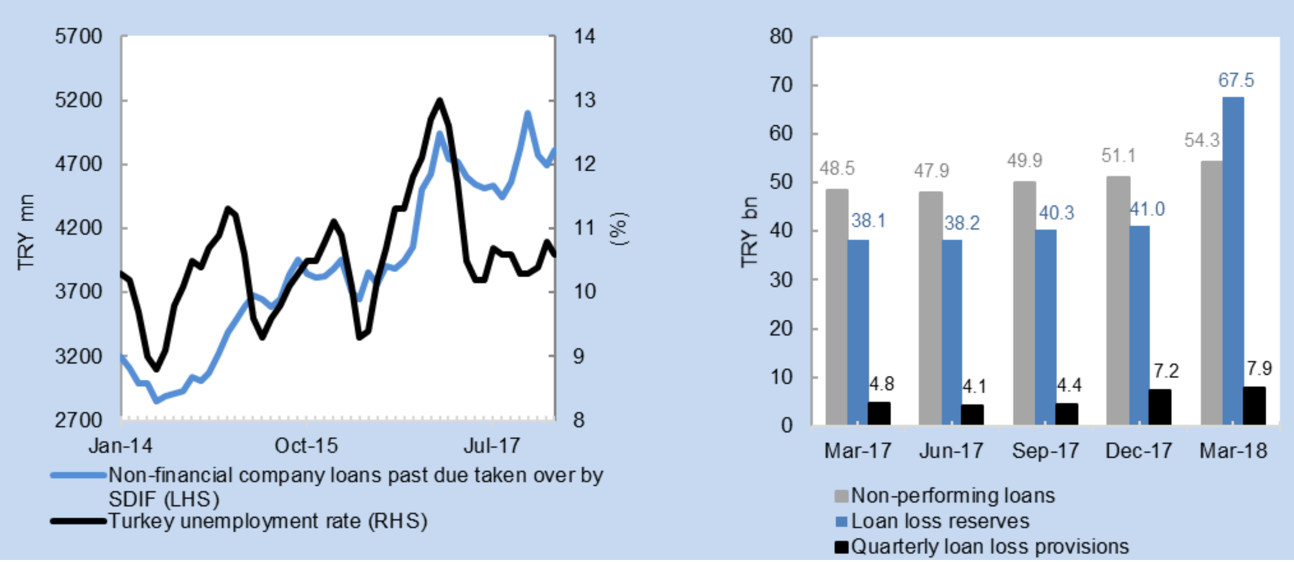

Figures 1a & 1b: USDTRY, RMI-CRI 1-year aggregate PDs for commercial banks and the 3 month Turkish Lira Interbank Offered Rate (TRLIBOR). *Source: RMI-CRI, Bloomberg, Bank Association of Turkey*

Lenders registered a large increase in credit risk in the wake of a series of central bank inflation-controlling measures that have led to a slowdown in credit growth and increased borrowing costs. Interbank rates have risen and the 3 month interbank ask rate has climbed 759bps to 17.73% since 2017. In a sign of continued financial pressures in the interbank market, the bid-ask spread of the interbank rate has also widened sharply as transaction volumes declined (See Figure 1b).

Concerns have been rising that Turkey's tighter liquidity conditions and weaker economic outlook could cause a surge in non-performing loans. According to central bank data, the non-financial sector has TRY 586bn of foreign currency loans, which indirectly exposes the banks to risks resulting from a high level of non-Lira currency denominated debt. 14 percent or, TRY 83bn of loans will be due by February next year. Weak funding conditions may persist and borrowers may not be able to rollover their loans and secure new funds from lenders.

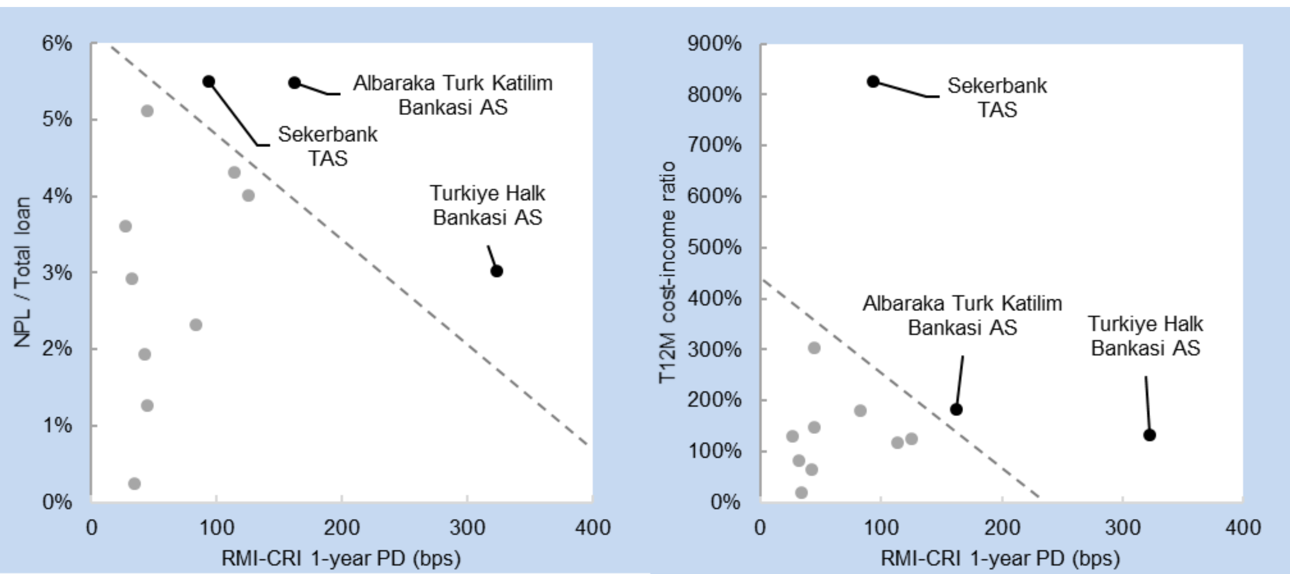
The amount of bad loans taken over by the Savings Deposit Insurance Fund (SDIF), a fund which protects deposits held in Turkish banks and takes control and management of a bank in a bankruptcy situation, has been on an uptrend since 2014, reaching as TRY 5.1bn in November last year from less than TRY 3bn four years ago (see Figure 2a).

Additionally, financial disclosures from 12 public banks showed that non-performing loans and loan loss reserves have increased to TRY 54.3bn and TRY 67.5bn in Q1 2018, respectively. As shown in Figure 2b, bank provisions grew significantly in Q1 and Q4 2017, due to the implementation of IFRS9 and uncertain macro environment. Under IFRS9, lenders are to provide for the use of macroeconomic forecasts and probability-weighted outcomes when accounting for the impairment of financial assets in their expected loss models.




Figures 2a & 2b: Turkey's unemployment rate, loans taken over by the SDIF and credit metrics for 12 Turkish lenders. Figure 2b was compiled using Bloomberg estimates and industry's averages. *Source: RMI-CRI, Bloomberg, Central Bank of the Republic of Turkey*

On May 22, banks involved in a TRY 22.37bn loan to the owner of Turk Telekomunikasyon AS (Turk Telecom) have agreed to a restructuring plan that would settle Turkey's largest default. Negotiations around a loan restructuring started over a year ago but the rapid depreciation of the Lira likely forced creditors and debtor to an agreement. Akbank TAS, Turkiye Garanti Bankasi AS and Turkiye Is Bankasi AS, with exposures of TRY 8bn, TRY 4.7bn and TRY 2.4bn to the deal, respectively, are expected to write down their loan portfolios in Q2 in exchange for shares in Turk Telecom.




Figures 3a & 3b: A breakdown of 12M PDs, non-performing loan to total loan ratio and cost to income ratio for the 12 banks as of Mar 31, 2018. Firms to the right of the dotted line have the worst mix of a high likelihood of default, large NPL and cost ratios. *Source: RMI-CRI, Bloomberg*

As the operating environment becomes more challenging in the coming months, funding and liquidity metrics for banks may deteriorate. Figures 3a and 3b identify lenders with the worst combination of a high default risk, elevated NPL and high cost to income ratios - Turkiye Halk Bankasi AS, Sekerbank TAS and Albaraka Turk Katilim Bankasi AS have a relatively high non-performing loan ratio that affects the banks' capital and liquidity profiles. These lenders also have a low operating income to cost structure and weak cost efficiency that may impede their ability to attract future investments.

Turkey's high interest rates could hamper GDP growth and reduce credit demand, although it may help to stem the currency's decline in the short term. Turkey's GDP growth performance of 7.4 % exceeded China and India last year but the IMF expects a growth of 4.4 percent in 2018. An economic slowdown and tight monetary policy may affect the credit profiles of the banking sector as bank asset quality could fall on rising debt servicing costs. In other words, the industry may be heading for a bumpy road ahead.

## Credit News

### European non-performing loan sales rise sharply

**May 25.** The total book value of non-performing loans (NPLs) portfolios traded in the Eurozone has hit EUR 66bn in the fourth quarter of 2017, the highest since 2015. According to research by the European Central Bank (ECB), the transaction of NPLs started in Greece and Cyprus, with Italy and Spain accounting for most of the deals. NPL will be recognized in European banks when its interest or principal is 90 days late. To avoid the crisis, the ECB announced rules that will require banks to make full provisions for losses on new NPLs, which make it expensive for banks to hold on to these loans. Such moves could create more opportunity for investors on NPLs. US investors including private equity firms and investment banks have been engaging in purchasing of European NPLs since last year. The total NPLs of European banks has declined from 7.5% in mid-2015 to 5% at the end of 2017. (FT)

### Fitch and S&P to launch China credit-rating units

**May 25.** Recently China has committed to allowing foreign rating agencies to operate wholly owned units on the mainland. Rating agencies S&P Global and Fitch Ratings said in statements that they will seek licenses to rate domestic Chinese bonds. The changes in China's regulatory landscape provide an opportunity for foreign rating agencies to serve the needs of local and global capital markets. This move could draw greater foreign participation into the world's third-largest bond market as offshore investors have largely confined themselves to sovereign bonds instead of corporate debt, in part because they distrust local rating agencies. The entry of western rating agencies could provide greater comfort for foreign investors and encourage greater participation. (FT)

### China Inc tightens reins on debt, raises specter of slowdown

**May 25.** According to Reuters, debt level for Chinese public companies are growing at the slowest pace in at least 13 years, amid tighter profit margins and slowing revenue growth. In the first quarter of 2018, the amount decreased 6.2% from the fourth quarter of 2017, with the revenue growth for the first quarter 2018 decreased to 12.3% from 26.7% a year ago. During the same time, China's fixed asset investment also grow at its slowest rate since 1999 in April. As the government cracks down on riskier lending practices and investors have become pickier about their investments, borrowing costs are on the rise. According to S&P Global, the slower debt growth would result in side effects such as slower industrial growth and slower GDP growth compared to the results of 2017. Economists polled by Reuters are expecting a gradual slowdown of Chinese economic growth to around 6.5% this year from 6.9% in 2017. (Reuters)

### Italian bond fears turn to Monte Paschi debt

**May 23.** In response to the mooting threat from the incoming populist Italian government with regards to the raising of Italian banks' funding cost, Bank Monte dei Paschi di Siena's bonds have accelerated selling in Italian bank debt. The bond market selling has been dominated by Monte Paschi's 10-year tier 2 bond, which will be sold for a further EUR 700mn before year-end to strengthen the bank's balance sheet. However, the poor market condition that tumbled Monte Paschi's bond price to less than 91 cents implies that the bank will face a sharply higher cost from selling additional tier 2 paper later this year. In addition to the potential of peaking funding cost, the success of Monte Paschi's effort to remove EUR 24bn of non-performing loans (NPLs) from its balance sheet with complicated government-backed securitization remains uncertain. The potential policy choices made by Five Star and the League parties to forcibly recover debts from Italian citizens without judicial approval increase investors' concerns on NPL securitizations. (FT)

**Hyflux seeks court protection for debt reorganization**

**May 22.** Hyflux, a Singapore water treatment firm, has suspended trading of its shares and started a court-supervised reorganization process on May 22, 2018. The market capitalization of Hyflux declined by 39% last year. An oversupply of gas depresses electricity prices in Singapore market and as a result, Hyflux's energy business suffered a lot. The company is facing short-term debt, as well as the need to maintain cash to meet their bond covenants. But the reorganization move will provide the company with room to focus on ongoing discussions with strategic investors while seeking to optimize operations and maintain cash flows. (Straits Times)

**Europe's bank bosses stress need for consolidation** (FT)

**Doorstep lending crackdown to save vulnerable from debt** (The Guardian)

**New Bank Indonesia governor is wasting no time on rate hikes** (Bloomberg)

**Regulatory Updates**

**Trump signs law rolling back post-financial crisis banking rules**

**May 25.** On May 24, the US President Donald Trump signed a Bill that rolls back Dodd-Frank regulations, a set of regulations passed in response to the 2008 financial crisis. Claiming that the regulations are crashing community banks and credit unions nationwide, the US President initiated the Bill to exempt some small and regional banks from stringent regulations and provide needed relief for community and local banks struggling to extend credit. Under the new law, banks with more than USD 50bn in assets would no longer be automatically subjected to the depressing federal regulations which include a yearly stress prove. The Bill would raise the threshold to USD 250bn in assets and would also exempt banks with less than USD 10bn in assets from the Volcker rule. (Straits Times)

**EU agrees new capital rules, large banks secure easier terms**

**May 25.** Finance ministers from the European Union have reached an agreement on reforming bank capital rules. The Total Loss-Absorbing Capacity will be set at 8% of large banks' total liabilities and own funds. However, the Eurozone's agency for troubled banks, the Single Resolution Board (SRB) will be able to require a higher buffer for banks that it finds insufficiently safe or a lower buffer for safer institutions. Capital treatment for large banks such as France's BNP Paribas and Netherlands' ING will be on a favorable term. Progressive steps have also been made towards a deal that supports its bank-rescue fund, known as Single Resolution Fund, in June. The fund is currently equipped with EUR 17bn and it is expected to be further supported by the state-backed bailout fund, the European Stability Mechanism. (Reuters)

**Corporate watchdog wants to put its staff in the nation's banks to monitor clean-up of industry** (ABC)

**Islamic finance gets IMF backing** (Khaleej Times)

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