Turkey domiciled banks' credit profile improved but vulnerability remains

by Anthony Prayugo

At the height of the 2018 Turkish currency and debt crisis, the Turkish lira (TRY) lost approximately 45% of its value to US dollar (USD) and year on year inflation rose to 25%, forcing the Turkish central bank to gradually raise its benchmark 1-week repo rate from 8% to 24%. The credit profile of Turkey domiciled banks deteriorated sharply as a series of central bank interest rates hike led to a tighter liquidity condition. As shown in Figure 1a below, the NUS-CRI 1-year aggregate (median) Probability of Default (Agg PD) for publicly-listed Turkey domiciled banks surged upwards during the crisis as funding pressures mounted, especially since Turkey domiciled banks mostly rely on foreign wholesale markets for funding. However, as the lira stabilized and interest rate level declined, the Agg PD for Turkey domiciled banks dropped back to their pre-crisis level. Despite the improvement in their credit profile, Turkey domiciled banks' continued reliance on foreign wholesale markets for funding and lira's volatility causes Turkey domiciled banks' credit profile to remain vulnerable.

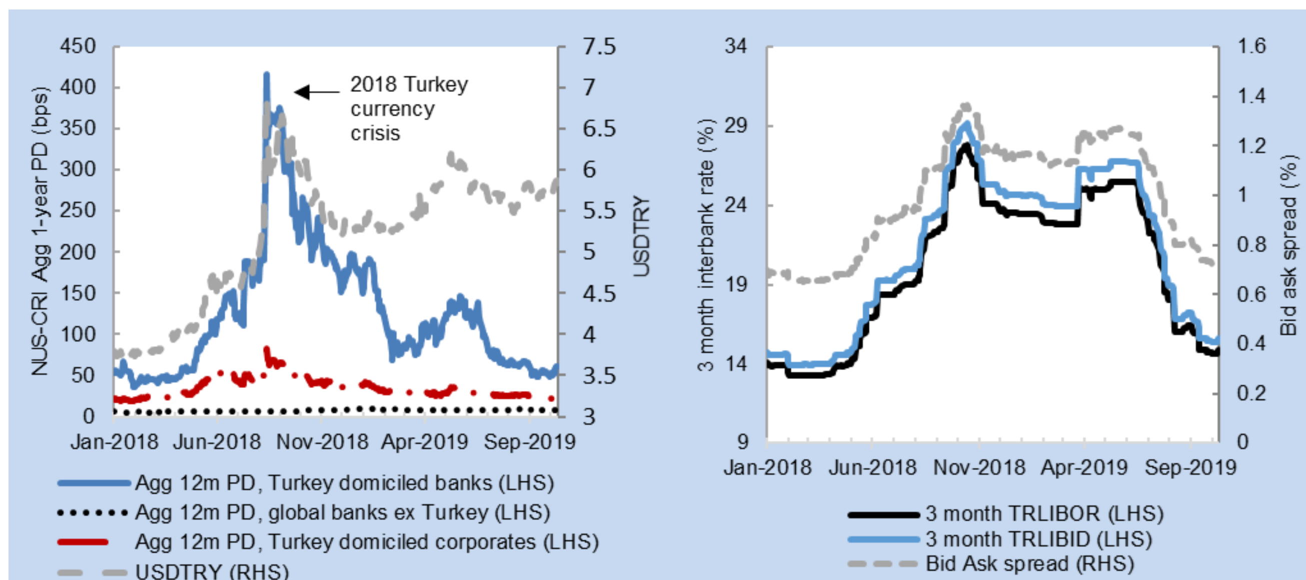

Figure 1a (LHS) & 1b (RHS): USDTRY, NUS-CRI Aggregate 1-year PDs for publicly-listed Turkey domiciled banks from 2018 and the 3 month Turkish Lira Interbank Offered Rate (TRLIBOR) and Turkish Lira Interbank Bid Rate (TRLIBID). Source: *NUS-CRI*, *Bloomberg.*

To begin with, one probable reason why the Agg PD for Turkey domiciled banks decrease this year was due to the improving liquidity condition. As exhibited in Figure 1b above, as the 3 month interbank ask and bid rate fell this year, the bid-ask spread of the interbank rate has also narrowed down approximately back to the pre-crisis level. Another reason for the improving credit profile of Turkey domiciled banks might be attributed to the current favourable environment of a decline in global interest rates. Since some Turkey domiciled banks have been tapping the foreign syndicated loan market, which is an important source of foreign funding for Turkey domiciled banks, the decline in interest rates has helped some Turkey domiciled banks to cut interest rates on syndicated loans by as much as 10% and therefore lowering their external borrowing costs. This is significant as currently around 56% of the total debts owed by publicly listed Turkey domiciled banks are denominated in foreign currency. Figure 2a below exhibits the average margin of 367-loans on US dollar and euro for Turkiye Is Bankasi AS (Isbank), Turk Ekonomi Bankasi AS (TEB), Turkiye Vakiflar Bankasi TAO (Vakifbank) and Akbank TAS (Akbank), which are some of the leading banks in Turkey. In tandem with the weakening of lira to the US dollar in 2018, the average margin on the US dollar and euro jumped to 200bps and 190bps respectively. As the lira stabilized this year, however, the respective average margin subsided to 185bps and 170bps.

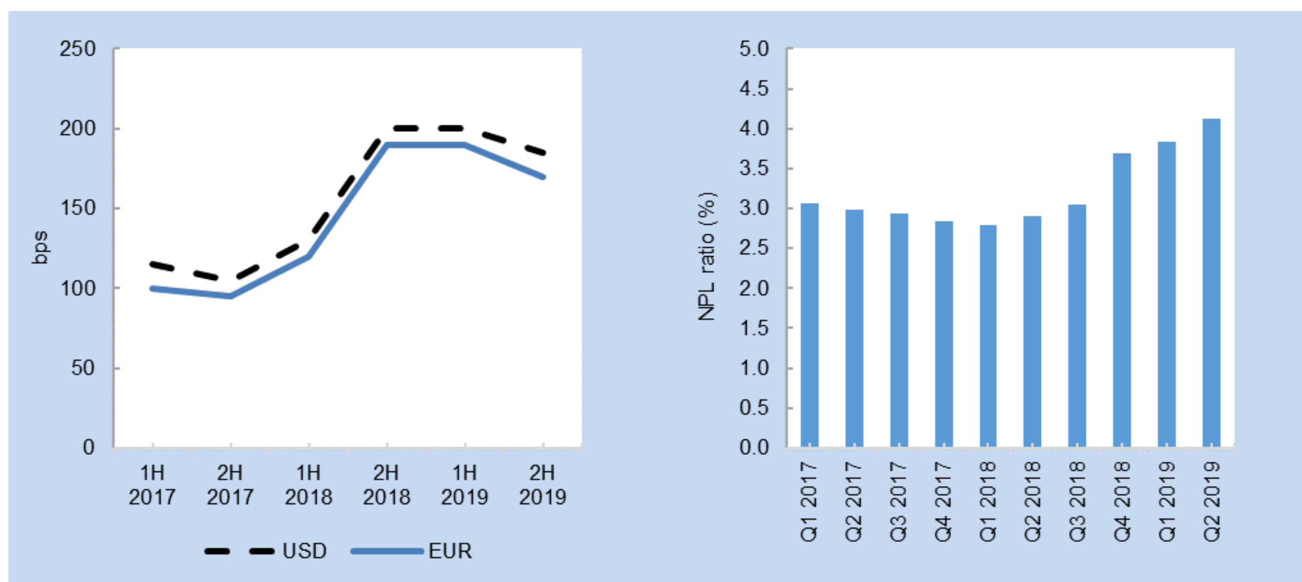

Figure 2a (LHS) & 2b (RHS): Average margin of 367-day loans on USD and EUR for Isbank, TEB, Vakifbank, Akbank and Turkey domiciled banks non-performing loan ratio rate (NPL). Source: *Bloomberg*, *IMF-IFS.*

As Turkey's banking regulator, the Banking Regulation and Supervision Agency (BRSA), is striving to improve asset-quality transparency and bad-debt standards in the banking sector, it told banks to reclassify about TRY 46bn of their loans as non-performing by the end of 2019 and make provisions to cover losses. Consequently, Turkey domiciled banks' non-performing loans (NPL) ratio, which has been steadily increasing since the 2018 lira crisis (see Figure 2b), will likely continue to increase from 4.6% to 6.3%. The increase in bad loans will also likely reduce the capital adequacy ratio of the sector from 18.2% to 17.7%, which is nevertheless still above the minimum 12% set by the regulator. Although this move could lead to a worsening credit outlook for Turkey domiciled banks in the short term, as evidenced in the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD)[1] below (see Figure 3a), some analysts believed that this move could dispel concerns that lenders were understating their bad debt problems in the aftermath of the 2018 lira crisis. In addition, by dealing with the bad debts now, Turkey's domiciled banks will have more capacity for lending in the future. According to the World Bank's recent estimate, Turkey's GDP growth is expected to rebound to a higher 4% in 2021 while inflation will ease to 11% next year.

[1] 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. In Figure 3a, the 6-month forward 1-year PD for a typical Turkey domiciled bank standing from Oct 2019 means the probability that the bank defaults during the period from Apr 2020 onwards to Apr 2021, conditional on the firm's survival until Apr 2020.

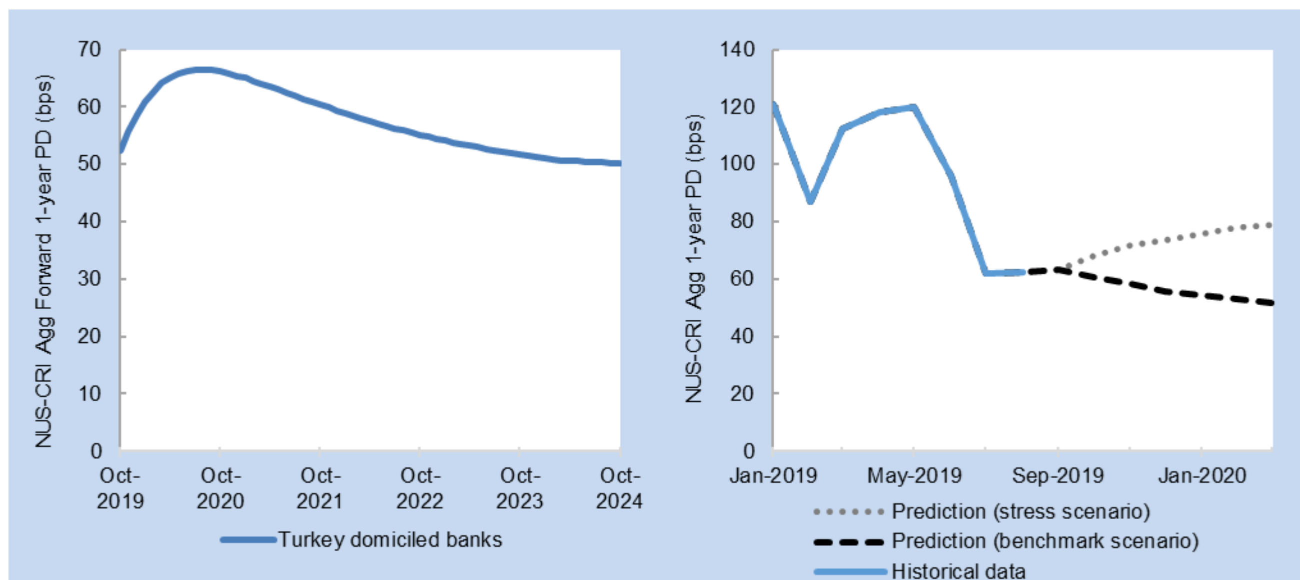

Figure 3a (LHS) & 3b (RHS): NUS-CRI Forward 1-year PD for Turkey domiciled banks in Oct 2019, and Historical and predicted development of the Turkey domiciled banks Agg PD for the stress testing and benchmark scenario based on information in Aug 2019. Source: *NUS-CRI*

In spite of the recent positive developments, some vulnerabilities remain on Turkey domiciled banks. Firstly, instead of implementing the long-awaited structural reforms, the Turkish government is trying to revive the economy via credit-fuelled expansion in the aftermath of the 2018 crisis. This could lead to a higher level of bad debts that Turkey domiciled banks need to face when an economic downturn happens. The corporate debt level in Turkey has already doubled to 70% of GDP since 2008 and an economic slowdown could increase the default risk on Turkey domiciled corporates. A lira devaluation could also lead to a higher NPL ratio as Turkey domiciled firms are highly dependent on external financing. As of Q2 2019, Turkey's private sector foreign debt to its GDP ratio stands at approximately 42%.

Secondly, Turkey domiciled banks might come under severe funding stress if a significant lira devaluation happens as it depends on short-term wholesale funding in foreign currency. Foreign deposit makes up 54% (around USD 209bn) of total Turkey domiciled banks' deposit while liquid assets and central bank net foreign exchange reserves stand at around USD 100bn and USD 27bn respectively. These liquid assets and foreign currency reserves amount are likely to be insufficient to withstand severe funding stress.

The state of the Turkish economy is also highly dependent on external market sentiments, making it vulnerable from capital outflows. Morgan Stanley included Turkey in both of its original and updated "Fragile Five" countries list. The "Fragile Five" represents emerging market economies that are too dependent on unreliable foreign investment to finance their economic growth. Looking at past events, whenever there are sharp outflows from these countries (such as the 2013 taper tantrum), their currencies experienced significant devaluation.

To give an insight into the potential consequences of such an event, the Bottom-up Default Analysis (BuDA) toolkit is used to simulate the effects of a possible repeat of a similar event.[2] Therefore, the macro variable chosen to receive a negative shock for our scenario analysis is the value of the lira, represented by its nominal effective exchange rate (NEER). For the benchmark scenario, the stable trend of lira is assumed to continue until next year. As for the stress testing scenario, we take the average monthly devaluation rate of lira during the 2018 lira crisis, with the assumption of a continued monthly change rate in the NEER of -6.6% for 6 months based on historical data. In Figure 3b, it can be seen that the Agg PD would increase under the stressed scenario as the lira depreciates. Meanwhile, under the benchmark scenario, the Agg PD would initially increase slightly before decreasing conditional on the lira continue being stable. In all, the results of the BuDA highlight that while

[2] Duan, J.-C., W. Miao, J.A. Chan-Lau, and The Credit Research Initiative Team of the National University of Singapore, 2019. BuDA: A Bottom-Up Default Analysis Framework, version 3.1.0. This document is accessible via https://www.rmicri.org/en/white_paper/. To analyze the dynamics of credit risk under macro-financial scenarios, BuDA provides a unique framework to evaluate the credit quality of each individual firm over given scenarios, which in turn forms a bottom-up portfolio of interest.

credit profile of Turkey domiciled banks improved this year, they are still vulnerable from events that could affect lira's volatility.

Credit News
As falling rates bite into revenue, US banks turn to cost cuts **Oct 11.** The largest US banks will be releasing Q3 results next week, where investors can observe how lenders have been managing falling borrowing costs and thinning net interest margins (NIMs). Banks are now relying on cost-cutting measures to attain their objectives, by trimming their efficiency ratios. Looking past Q3, investors will be observing how the Fed's easing cycle will affect annual revenue in 2020. On the other hand, with US unemployment at all-time lows, consumer-related businesses are expected to be a boon to bank earnings. The housing market is also benefitting from lower interest rates, leading to higher mortgage originations and refinancing. However, the loans and capital markets divisions are expected to perform poorly. (Bloomberg)
Credit woes in India seen pressuring Modi to take more steps **Oct 10.** Even with the recently account USD 20bn tax cut and decade-low rates, Indian firms still struggle to improve their credit profiles, placing pressure on the authorities to continue boosting the economy. A 15-month long cash crunch in the shadow banking sector and a sharp drop in growth has smother Indian firm's financial health – Care Ratings index shows that credit metrics are the lowest in 7 years. The Reserve Bank of India has slashed its economic growth projection from 6.9% to 6.1%, the biggest cut in forecast in 5 years. Looking forward, policymakers announced several measures – including mergers of state-run banks and tax benefits on vehicle purchases, while RBI has cut borrowing costs 5 times this year and promised further easing if required. (Bloomberg)
Europe recession risks test USD 1.3tn debt on junk trapdoor **Oct 9.** As Europe's economy continues to weaken, bond investors lay their eyes on the lowest ranks of investment-grade (IG) corporate debt – a potential EUR1.2tn market. Half of all European credit carry BBB ratings, 3 notches above high yield (HY) grade. With the recession around the corner, and falling corporate earnings, IG funds may be forced to sell their holdings, sparking rating downgrades to junk-grade. Demand is scarce in the region due to ECB's refusal to enter the HY market and the limited pool of HY investors in Europe. Based on Bloomberg Barclays data, BBB spreads have already widened 17 bps since July as investors' worries stockpile from Brexit, trade tensions, and signs of slowdown in Germany, Europe's largest economy. (Bloomberg)
Trouble is brewing in the darkest corner of China's shadow banking **Oct 9.** As China's economy faces headwinds and corporate defaults surge, China's shadow banking sector is primed to face mounting losses, with confidence in the industry plunging since July. The repercussions could be significant if losses on shadow banking's high yield assets fuel a retreat from the wider group of Chinese high-yield securities. Since the products are not well understood and regulation is minimal, concerns are that nobody knows exactly how much money is at risk. The China Securities Regulation Commission provided draft rules in February for wealth managers and distributors of investment products that would increase punishments for those who fail to disclose risks properly, in an effort to curb further trouble in the sector. (Bloomberg)
Central bank stimulus is distorting financial markets, BIS finds **Oct 8.** Since the global financial crisis, central banks' balance sheets have undergone unprecedented growth, causing a negative impact on the way in which financial markets function. Over the last decade, central banks have been buying trillions of dollars' worth of bonds and lending copious amounts of cheap money to stimulate global growth. However, negative side-effects include a scarcity of bonds available for investors to purchase, squeezed liquidity in some markets, higher levels of bank reserves, and fewer market operators actively trading. These side-effects had so far only rarely affected financial conditions in a way as to impede central

banks' monetary policymaking, though it added that the full consequences were unlikely to become clear until major central banks started to shrink their balance sheets. (FT)

World's most-loved megabank is surrounded by a lending crisis (Bloomberg)

Leveraged loan prices fall to lowest since January (FT)

Junk bond blowouts have investors jittery over earnings season (Bloomberg)

Regulatory updates

Fed finalises rules easing regulations for banks

Oct 11. The US Federal Reserve has finalised rules easing capital and liquidity requirements for banks. The changes of rules make all but the largest and most complex banks be subject to lower liquidity and capital requirement, and allow some large regional US banks to avoid undergo annual stress tests. No foreign banks will have to comply with the new rules. Some dissented the changes considering an increasing risk to the financial stability, while Jay Powell, Fed chair, stated that the rules would maintain the long-term built-in fundamental strength and resiliency of the financial system. (FT)

Federal Reserve to resume Treasury purchases to prevent a cash crunch

Oct 9. The Federal Reserve is going to resume purchase of short-term US Treasury bonds to expand its balance sheet, hoping to prevent a repeat of the recent disruption in overnight repo market in September. This action is differed from QE, aiming to facilitate short-term lending rather than stimulate the long-run US economy. Strategists warned that this expansion of the balance sheet may not add reserves fast enough to return short-term funding markets to normal functioning, making the case instead for the Fed to buy anywhere from USD 200bn to more than USD 300bn of shorter-dated Treasury bills over the next six months. (FT)

Central Banks are fast running out of room for further rate cuts (Bloomberg)

Federal Reserve approves simpler 'Volcker Rule' ban on proprietary trading (Reuters)

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