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Macroeconomic headwinds set to potentially derail the recovery in the credit profile of Turkish banks

by NUS-CRI Market Monitoring Team

- **NUS-CRI Agg PD indicates that Turkish banks have improved their credit profile in 2022 due to improved profitability, liquidity and lower NPLs, amidst a bull run that has seen investors flock to the sector**
- **NUS-CRI Forward PD suggests that potential monetary policy uncertainty and "Lira-ization" of the economy could pose headwinds in the near term**

Perils in Turkey's domestic markets, which have been roiled with sky-high inflation over the past year, have continued to show reprieve as domestic investors carry on flocking to the country's stock markets searching for yield. One of the biggest benefactors from this influx of capital is Turkey's banking industry (Turkish banks), which have outperformed their European counterparts. This has led to the sub-sector's NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) dropping to nearly 10bps at the end of last year, close to BBB+ upper bound when proxied by PDiR2.0[1] (See Figure 1a). Though Turkish banks have seen their profitability increase and aid the recovery in the industry's aggregate credit profile, they face headwinds relating to potential policy uncertainties, increased regulatory scrutiny, and the 'Lira-ization' of their deposit base that poses increasing risks to the industry's overall financial performance and health, as suggested by the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) in Figure 1b.

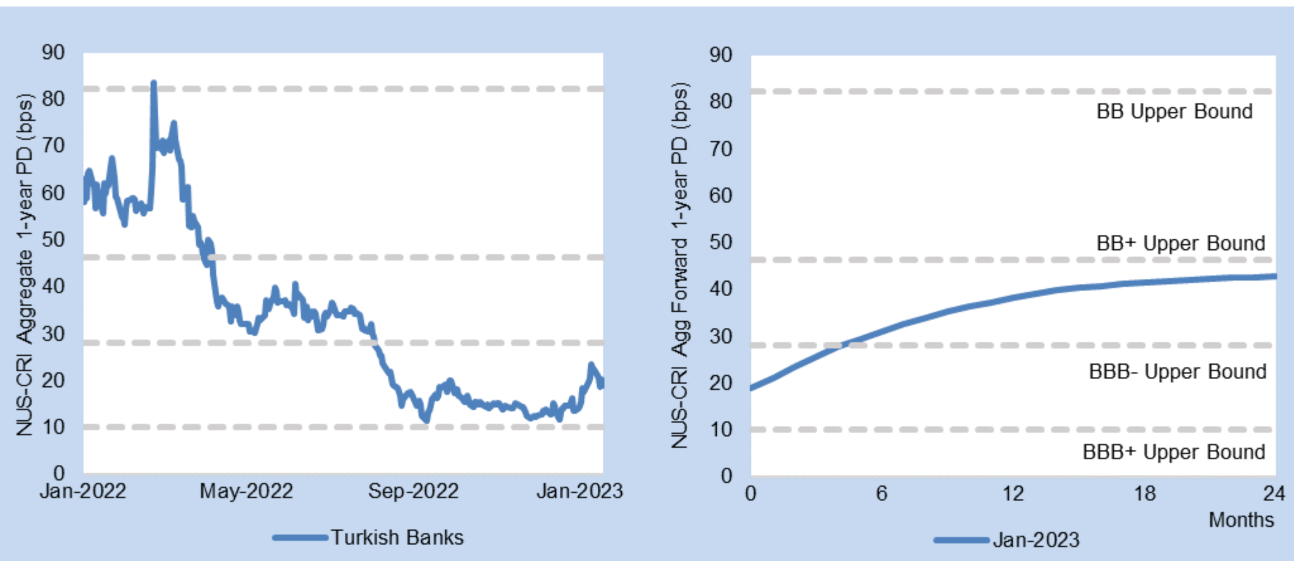

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Turkish banks with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Turkish banks as of Jan-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

As of Dec-2022, the central bank of Turkey has left its policy rates unchanged, after easing in Nov-2022, at 9%, continuing on the path of unorthodox monetary policy in the face of high inflation. The lack of yield available in the domestic currency and the fixed-income market has seen investors flock to riskier assets, such as equities, in an effort to protect their purchasing power. The resultant impact due to the bull run on Turkish equities saw the aggregate financial health of all Turkish corporates improve in the first half of the year. Turkish banks were also key gainers of the bull run seen in the second half of last year, with the Borsa Istanbul banks sector index

[1] 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.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly 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 18 months – this is conditional on the firm's survival in the next 6 months.

increasing by close to 159% in H2 2022 (See Figure 2a). In addition, Turkish banks' credit profile benefitted from a substantial increase in profitability, with the industry's aggregate net income increasing to TRY 389bn YTD in Nov-2022, compared to TRY 75.43bn over the same period in 2021[3]. However, pressures on profitability are still present for the financial sector, as the government continues to narrow the spread between policy rates and interest charged on commercial loans by banks to ensure smoother policy transmission. This has led to interest rates charged on TRY-denominated loans falling lower than the total deposit rate for the lira (See Figure 2b).

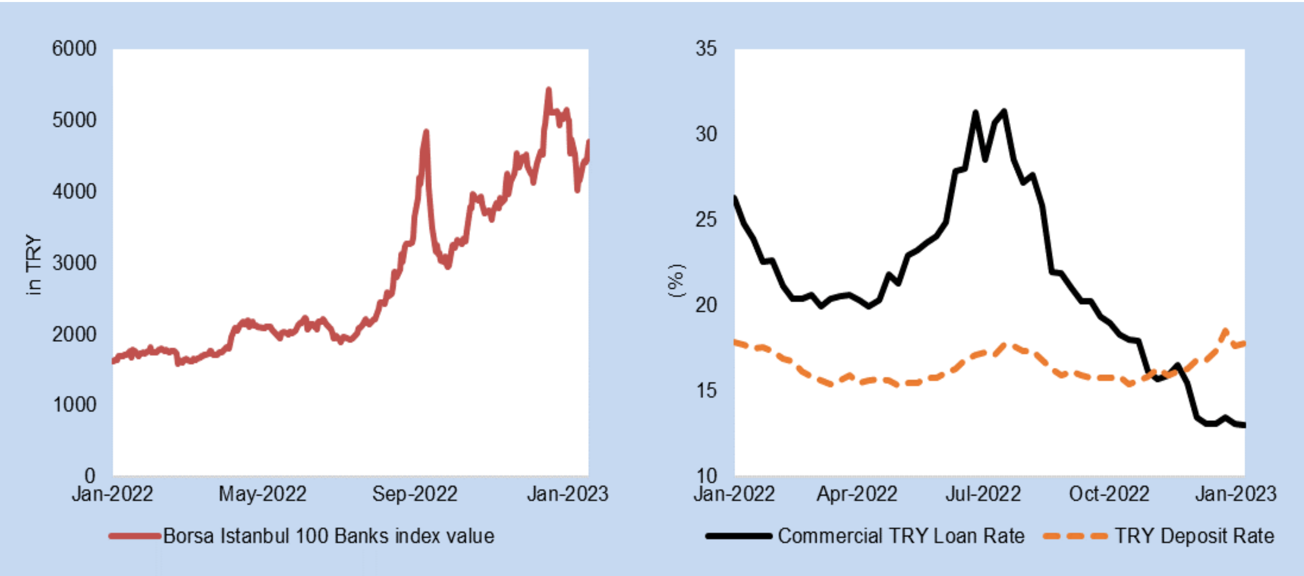

Figure 2a (LHS): Value of the Borsa Istanbul 100 banks index. Figure 2b (RHS): Interest rates paid by commercial banks to deposits denominated in TRY, and interest earned on loans disbursed to corporates. *Source: Bloomberg, CBRT*

Turkish corporates have also increased the amount of Lira-denominated loans borrowed from banks by close to 89% YoY in Nov-2022 while decreasing the amount of foreign-currency-denominated loans by close to 11% over the same period. With TRY depreciating by close to 41% against the USD in 2022, a reduction of new loans in foreign currencies could ease pressures on NPLs arising from higher foreign-currency debt servicing costs for corporates. The overall transition away from foreign-currency-denominated financing has already contributed to reducing the industry's NPL ratio from 3.5% to 2.2% from Jan-2022 to Nov-2022. Therefore, improving asset quality, robust capital buffers, and prudent loss recognition through provisioning all provide tailwinds to the credit profile of the sector.

Improving liquidity metrics and reduction in non-funded lending allows banks to better weather potential shocks that arise in the future. The total loans to deposit ratio for Turkish banks have been declining since the beginning of last year to around 80%. With Turkey's President, Recep Erdogan, potentially pulling the elections forward by a month, heightened political uncertainty may lead to lower depositor confidence and regulatory actions by the central bank, which may require banks to buffer with increased liquidity. With the "Lira-ization" of banks' balance sheets well underway, Turkey's central government has also asked commercial banks to stop using derivatives and options that will allow TRY-denominated deposits to create new FX demand, potentially impacting the bank profitability through lower fee income moving forward. Though the overall liquidity position of the Turkish banks remains relatively robust, it is likely that should Erdogan's Justice and development party (AKP) not win the elections this year, policy reversal towards a more orthodox monetary policy by the new ruling party may lead to liquidity strains for the financial network, and could worsen the financing conditions for Turkish corporates, edging them closer towards distress and creating potential headwinds to the asset quality on banks' balance sheets.

Though Turkish banks' credit quality has improved substantially since the beginning of last year due to their improved profitability, lower NPLs, and improved liquidity amidst significant Lira loan growth, headwinds remain as the industry is going to operate in a potentially unfavorable macroeconomic and political landscape over H1 2023. Turkish banks are also acting as key channels for the central bank to enforce the wider "Lira-ization" policy by maintaining more than half of their deposits in TRY. Though the banks have been trying to circumvent the penalties of missing that deposit ratio by offering attractive returns on deposits, further regulation by the central bank, especially if the re-election is won by Erdogan's party, could see profitability hurdles for the banking sector, possibly shown by the upward sloping term structure of the Forward PD in figure 1b.

[3] The increase in profitability was driven primarily due to higher net interest income from increased loan growth and an increase in capital gains, including through foreign exchange transactions.

Credit News

Global bond sales off to record start of nearly USD 600bn

Jan 19. A rebound in bond returns in the beginning of the year has helped boost global bond issuances by around half a trillion dollars. The unprecedented jump of 4.1% in bond prices has driven a surge in issuances in sovereign as well as corporate bonds. Borrowers that were impacted by lack of investor demand in 2022, are now experiencing renewed investor interest as inflation appears to be on the decline, fueling expectations of a slowdown or halt in monetary tightening by central banks. (Bloomberg)

Foreign investors pulled USD 91bn from China's bond market last year

Jan 18. Foreign investment in China's domestic bond market showed a net decline for the first time in a decade. Over the past year, foreign investors reduced their yuan-denominated bond holdings by USD 91bn, driven by net sales of USD 51bn from policy-bank bonds and USD 24bn from the Chinese government bond market. The outflow of foreign investment stopped towards the end of December when the Chinese government announced an end to its strict zero-covid policy. (WSJ)

Corporate insolvencies climb in England and Wales as costs bite

Jan 17. Dec-2022 recorded a significant increase in corporate insolvencies in England and Wales as data revealed that the number of registered company insolvencies had reached 1,964, 76% higher than the level seen in Dec-2019 before the pandemic. A higher number of businesses have succumbed as inflation and higher borrowing costs squeeze their cash-generating abilities even as they experience a demand slowdown brought on by a weakening economic condition. The borrowing costs are at the highest level in more than a decade driven by the central bank's rate hikes. At the same time, the end of government pandemic-related support is also responsible for pushing up insolvencies. (FT)

China developers' debt risks persist after support policies' slow start

Jan 18. Developers in China face a massive maturity wall of USD 141bn in 2023 raising expectations of a further increase in defaults in the troubled sector. Although the government has finally come to the aid of the developers, most policies have been designed to lend support to healthy developers. At the same time, the sector might see improved sales and liquidity only in the second half of the year. Thus, defaults may increase amongst the weaker entities in the sector. While the government's expanded onshore bond program, allows developers to use proceeds from issuances under this program to repay offshore bond obligations, the issuer is required to put unpledged and healthy assets as collateral. Most developers find it difficult to provide such collateral as they disposed several assets last year as they tried to raise cash. (Reuters)

Global property market faces USD 175bn debt spiral

Jan 20. The global property market is facing a challenging time as it faces higher borrowing costs amidst a demand slowdown. Around USD 175bn of real estate debt has already been pushed into distressed territory. The stress in Europe's real estate market is at a decade high as developers face a liquidity crunch. Similarly, UK and US real estate market have seen commercial property prices fall by 20% and 9% respectively. The decline in the real estate sector may eventually impact the real economy and pose a threat to jobs and growth. (BT)

Egypt's local debt beckons with record yields compared to peers (Bloomberg)

Eurozone bond yields at lowest in more than a month (BT)

Treasury Rally Intensifies After Signs of Slowing Growth (Bloomberg)

Regulatory Updates

Bank of Japan defies market pressure and holds firm on yield curve control

Jan 18. Defying market expectations, the Bank of Japan stuck to its ultra-loose monetary policy by keeping its yield curve control measures unchanged. Over the past few weeks, the markets saw an increase in volatility as yields surged driven by market speculations of yield curve abandonment. Resultantly, the BoJ was forced to buy bonds equivalent to 6% of Japan's GDP as it tried to keep yields within control. After the announcement, the yields on 10-year government bonds dropped to 0.405% while the yen fell by around 2%. The BoJ's decision will add tremendous pressure on the new central bank governor who will take control in April as the market continues to support abandonment of yield control measures. (FT)

Fed policymakers call for further rate hikes to beat inflation

Jan 19. Fed policymakers indicated that they will continue to support interest rate hikes even when recent data has exhibited signs of slowing inflation and subdued economic activity. Most policymakers believe that the interest rate should be hiked to a target range of 5 - 5.25% over the coming quarters. The current benchmark overnight lending rate lies in a target range of 4.25 – 4.5%. Several policymakers have, however, supported a slowdown in the pace of rate hikes in response to the cooling inflation. (Reuters)

India govt switches bonds with cenbank in a cash-neutral deal (Reuters)

Key African economies to slow rate hikes with inflation peaking (Bloomberg**)**

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