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Potential changes in central bank policy may cause Turkish banks' credit quality to deteriorate

by Vivane Raj

- **The firing of the previous central bank governor, Naci Agbal, has led to turmoil in Turkey's capital markets and a sharp depreciation of the Turkish lira**
- **NUS-CRI Forward PD indicates that the Turkish banking sector short-term credit risk has increased amidst worsening markets' sentiment**

In our Weekly Credit Brief published in Feb 2021, we covered the positive outlook for Turkey domiciled corporates as the country's central bank, headed by Naci Agbal, returned to orthodox monetary policy measures. His unexpected firing after a four-month stint in Mar 2021, however, has thrown the Turkish capital markets into turmoil, with the Turkish lira falling by over 15%. With Turkey's central bank leadership likely to lower interest rates, the Turkish banking sector may feel the pinch from falling rates as well as a weakening lira going forward. The expected fall in interest rates as the central bank governor is replaced has lead to large capital outflows from the country, which in turn, dampens the value of the lira. As the banking sector is highly reliant on external funding, large changes in the value of the local currency would affect their ability to repay their foreign currency (FX) denominated obligations. The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[1]) in Figure 1 below demonstrates the heightened short-term credit risk in the Turkish banking sector caused by the worsening investors' sentiment witnessed in the country.

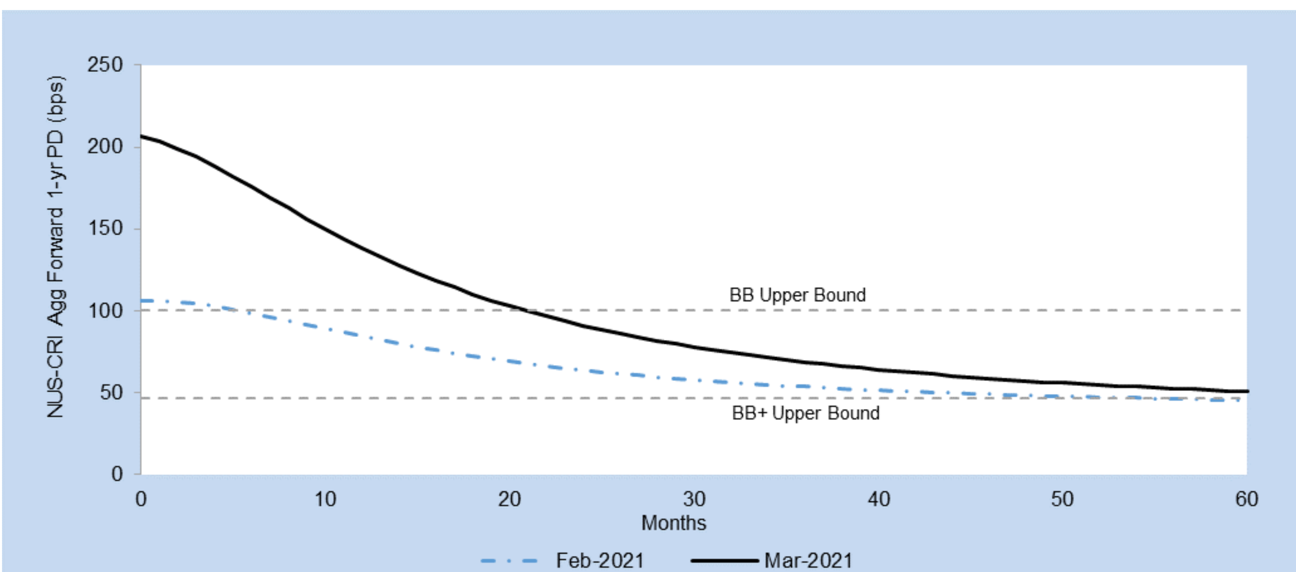

Figure 1: NUS-CRI Agg Forward PD for listed Turkey domiciled banks based on Feb and Mar 2021 data feeds with reference to PDiR2.0[2] bounds. *Source: NUS-CRI*

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[1] 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.

[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.

The country is no stranger to bouts of inflation, as it consistently struggled with inflation rates above 10% throughout 2020 and 2021. In order to manage its high inflation, the ex-central bank governor made several interest rate hikes raising the key rate from 10.25% in Nov 2020 to 19% in Mar 2021. These measures were received well by the public, as more locals chose to hold on to lira as opposed to storing value in US dollars. Furthermore, as foreign investors regained confidence in a key emerging market, capital inflows into the country rose leading to a lira appreciation. This, in turn, lowered borrowing costs for Turkish banks, which are heavily reliant on short-term FX debt. However, hiking rates were at odds with President Erdogan's economic perspective, who was a proponent of low rates as a viable tactic to manage inflation as well as boost economic growth. This eventually led to the replacement of Naci Agbal with a successor who would be more willing to suppress rates. The resulting replacement of the central bank governor led to a loss of investor confidence in the economic stability of the country. At the same time, potential further rate cuts led to capital outflows and the subsequent depreciation of the lira.

The Forward PD shown above in Figure 1 demonstrates the heightened credit outlook for Turkish banks in Mar 2021 when compared to that of Feb 2021. The large difference seen in the short-term credit outlook between the two Forward PD curves demonstrates the drastic increase in credit risk driven by the exogenous shock caused by the lira depreciation and the worsening markets' sentiment. Agbal's departure and the subsequent fall in the lira have led to increased yields of FX bonds issued by Turkish banks. For example, the yield on a bond issued by Turkish lender Isbank due in 2028 rose from 6% to 11%. At the same time, the yields of state lenders Ziraat Bank and VakifBank, some of the largest banks in the country, had increased from 5% in Feb 2021 to 8% in Mar 2021. These bumps in yields would compound the risks faced by the banking system, as they could face increasing woes in refinancing their debt.

This is exacerbated by strong capital outflows as interest rates in Turkey are likely to fall going forward while interest rates rise in the US. The resultant capital flight could most likely lead to lira depreciation. However, the central bank's ability to intervene in the falling currency is weaker than before, due to having diminished foreign currency holdings. The strong FX interventions to stave off a freefall in the lira in 2020 included a sell-off of foreign currency holdings of USD 120bn. These aggressive attempts led to the central bank's FX reserves falling to an estimated USD 35.7bn in Mar 2021, which limits its ability to prop up the currency. In fact, future FX interventions will be limited according to the new central bank governor, as free-market conditions will be more relevant in pricing the lira going forward.

As the lira goes into freefall, Turkish banks stand to lose. The country's banking sector finances significantly through external debt, exposing their credit health to fluctuations in the lira. The Turkish banking sector owes USD 88.7bn in foreign denominated short-term loans within the next year, which stands at around 12.4% of the country's GDP in 2020. At the same time, over USD 7.3bn in FX debt would be payable by Apr and May 2021, which could add strain to the credit health of the banking system in the short term.

While the asset quality of Turkey-domiciled banks has so far remained healthy, with the NPL ratio improving to 4.02% in Feb 2021 from 5.20% in Feb 2020, the current loose credit conditions in Turkey has also led to a credit boom. The flooding of loans in the market could lead to a future rise in NPLs in case of an economic downturn, especially if riskier borrowers are given wider access to loans. In addition, a loosening of loan classification standards would now mean that loans are now only classified as Stage 3 (considered impaired) if they are 180 days overdue as opposed to 90 days previously. This increase in loan volume in conjunction with looser reporting standards may have contributed to improved NPL ratios as of late. However, this may reverse with a future pullback in COVID-19 emergency measures and tightening of regulatory forbearance, possibly leading to a jump in NPL ratios in the future.

As interest rates change, there may still be a silver lining for banks.The fall in rates may be beneficial for their margins. Due to their asset-liability mismatches, lower rates may lead to a widening of net interest margins. In essence, the liabilities of these banks have a shorter tenor as compared to their assets. A fall in interest rates may reprice the lira-based liabilities of these banks at lower costs faster than their assets, widening margins. While possible rate cuts in the future may look good for the profitability of banks, the major changes in Turkish central bank leadership have left investors worried. Even though the new central bank governor has made attempts to reassure the public that monetary policy will be strict going forward, it remains to be seen whether issues still remain regarding central bank independence.

Credit News

Greenpeace accuses ECB of helping heavy polluters with collateral shift

Apr 5. Environmental activists have criticized the ECB for loosening collateral rules for heavy carbon polluters such as airlines and carmakers. The loosening of collateral came as a way to help companies survive the impacts of the pandemic. The change in collateral rules has impacted carbon-intensive assets specifically due to the market trend of countries aiming to move towards a carbon-neutral economy. Critics have encouraged the ECB to stop 'blindly' supporting these companies and to correct the 'climate imbalance' present in its monetary policy. (FT)

Airlines raise debt at near-record pace at start of 2021

Apr 2. In the first quarter of 2021, airlines raised USD 16.6bn to buffer for continued travel disruptions witnessed globally. Not only does the cash influx help in fortifying their balance sheets, but also demonstrates the positive investor confidence of long-term prospects for the strongest companies in the industry. Investors are specifically more willing to lend to strong airlines that are expected to emerge from the crisis relatively unscathed. As carriers have cut costs significantly over the last year, raising cash to survive the tailing slowdown in air travel is a necessity. Recovery is expected to be the quickest in the US, where the domestic industry has shored up billions from taxpayer funds and government protection programs. (FT)

Chinese banks cautious on bad loans despite bumper profits

Apr 2. China's largest banks are still concerned with an expected rise in bad debts, even after posting the largest quarterly profit post the global financial crisis of 2008. The bad debt pile has increased since PBOC has marginally tightened monetary policy and reduced support for domestic MSMEs, putting pressure on the banks' asset quality. These pressures are set to last till the end of 2023, as expectations of rising NPLs and write-offs are present over the next two to three years. Chinese banks are therefore cautious moving forward, though an improving operating environment provides a breath of relief for the country's biggest lenders. (Nikkei Asia)

China leads global green-bond sales boom but faces headwinds

Apr 1. While green bond sales in China have surpassed those in the US in the first quarter, more are still needed to help fund its USD 21tn carbon neutrality pledge. Some concerns include the need to raise investor awareness of the environment, harmonizing fragmented rules and tackling greenwashing. To meet the goal of net-zero emissions in 40 years, China, the largest carbon dioxide emitter, needs around CNY 140tn of debt financing. Green bonds account for less than 1% of China's bond market and there is not enough market support for green projects as they take a long time to complete and are seen as risky. These headwinds call for incentives to encourage private participation in meeting the country's carbon goals and a harmonized domestic standard regarding green bond issuance. (Reuters)

PE groups raise more than USD 20bn from loan investors to fund dividends

Mar 31. Private equity groups such as Ares and Golden Gate Capital have raised more than USD 20bn to provide shareholders with dividends. Dividend deals in the loan market have reached USD 21.7bn as fears of rising inflations pushing interest rates higher have increased the attractiveness of leveraged loans. Private equity groups have pulled money away from their companies and put it into leveraged loans to take advantage of the rising demand. Leverage loans dividend deals act as a good way for private equity firms to recoup initial investment when sustained, elevated equity prices have made it difficult to make a profit through acquisition and sales. (FT)

After failed takeover, Air Transat seeks help as debt crunch looms (Reuters)

Sritex appoints Helios Capital for debt restructuring (Bloomberg)

China Evergrande vows to meet Beijing's 'three red lines' by 2023 (Nikkei Asia)

Regulatory Updates

Shanghai bourse tightens scrutiny over corporate bond issuance

Apr 2. The Shanghai Stock Exchange (SSE) announced that it has tightened its inspection on corporate bond issuance and has punished a brokerage for lax due diligence in bond underwriting. Before the recent announcement, Chinese exchanges have already strengthened their inspections on initial public offers (IPO) to limit financial risks and bolster the growth of China's capital markets. Since the securities issuance in China adopted the US-style registration system, lax due diligence by underwriters appeared and led to tightening scrutiny by regulators last year. SSE said its inspectors of bond issuance would draw lessons from their IPO market counterparts and has launched on-site inspections to enhance the quality of information disclosure and due diligence. (Reuters)

Singapore banks to stop issuing Sibor-linked loans, SOR derivatives by September

Mar 31. Singapore-based financial institutions will have to discontinue issuing SIBOR based financial products and swaps by the end of September 2021. This new timeline is set to firmly position Singapore Overnight Rate Average (SORA) as the benchmark banking rate. Close to SGD 1.4tn of notional value are currently outstanding Singdollar derivative contracts that are due to expire by the end of this year. Banks are encouraged to contact their existing customers at an appropriate time and provide sufficient notice to consider switching existing loans to other alternative loan packages. (Straits Times)

Turkey fines foreign banks for 'short-selling irregularities' (FT)

India rolls back decision to cut interest rates on small savings (Reuters)

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