CEEMEA Views – Turkey
Bank Lending Set to Pick Up

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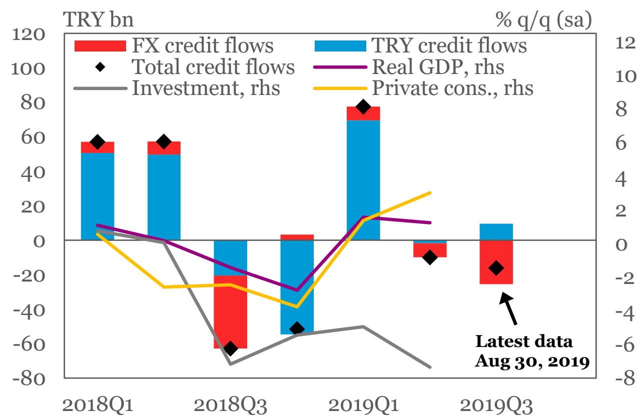
- Borrowing costs have fallen sharply as a result of policy changes.
- Lending remains subdued due to concerns over bank asset quality.
- Credit-fueled growth has increased private sector indebtedness.
- Banks remain well-capitalized and profitability is set to increase.

Growth concerns and a reversal in credit expansion prompted authorities to introduce a set of measures to boost bank lending. Geared mainly towards lowering the cost of funding for banks, those measures include: i) a reduction in the central bank's key policy interest rate by 425bps to 19.75% in late July, ii) lower reserve requirements (and higher remuneration for them) for banks with y/y credit growth above 10%, and iii) the introduction of longer tenor FX swaps which allow banks to acquire TRY liquidity (with a maturity of up to 6 months) from the central bank at a cost lower than the key policy interest rate of 19.75%. With the reduction in funding costs, banks were able to lower their lending rates markedly to 15% in early September from a recent peak of 28% in early July.

Sharply lower lending rates notwithstanding, credit flows have remained negative through late August (Exhibit 1). Large positive credit flows allowed for a recovery in private consumption in Q1, the speed of which picked up in Q2 despite a reversal of credit expansion. The acceleration in seasonally-adjusted private consumption growth from 1.4% q/q in Q1 to 3% q/q in Q2 likely reflected support from temporary tax cuts on durable goods, which expired at the end of June. However, negative credit flows weighed heavily on investment in Q2, leading to faster contraction of seasonally-adjusted gross fixed capital formation (7.4% q/q in Q2 compared to 5% in Q1).

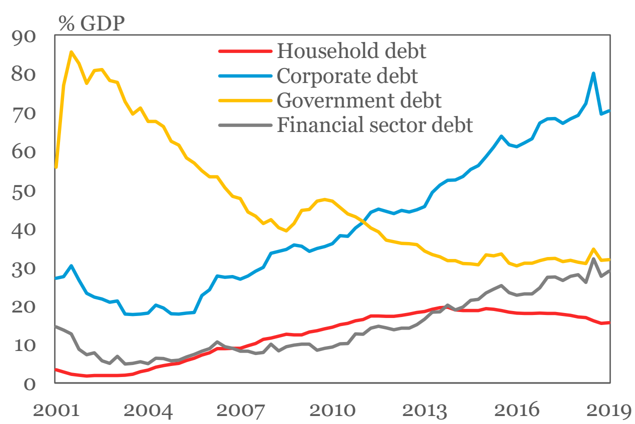
Turkey's credit-fueled growth model has increased leverage and financial risks for banks, households, and companies (Exhibit 2). Heavy reliance on credit to fuel output growth increased private sector indebtedness, especially for corporate sector debt (from 18% of GDP in 2005 to 70% in early 2019). This appears to have led banks to adopt a more cautious and risk-averse attitude towards new lending, considering that significant TRY depreciation since 2013 has deteriorated balance sheets of companies with large unhedged FX debt. Sharp TRY depreciation and weaker economic activity caused the share of NPLs to rise markedly from 2.8% in mid-2018 to 4.5% in mid-2019, excluding restructured loans and those sold to collectors. The share of stage 2 loans (loans classified as significantly higher credit risk) increased much faster, from 8%

Exhibit 1. Credit flows remain negative so far in Q3.



Source: Haver, IIF
Note: Credit flows data are adjusted for FX movements.

Exhibit 2. Credit-fueled growth increased indebtedness.



Source: Haver, IIF

to 12% over the same period. Despite rising NPLs, aggregate capital adequacy of banking system risk-weighted assets rose to 18% in July from a recent low of 16% in March (Exhibit 3).

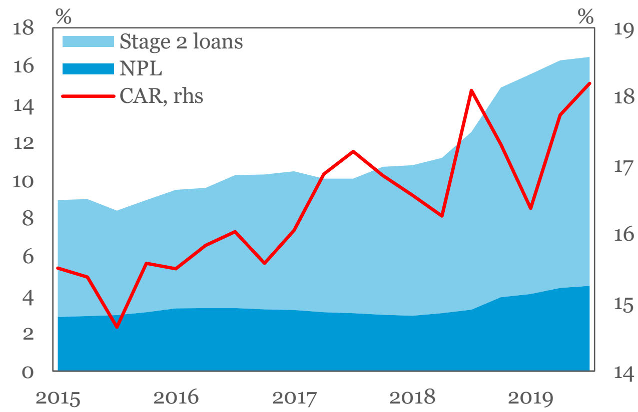
With banks' profitability having suffered from narrowing net interest margins, their appetite to support growth by boosting lending appears to have somewhat weakened lately. Smaller net interest income and rising provisioning costs caused the banking system's annualized return-on-equity to decline to 12% in mid-2019, from 15% in early 2018 (Exhibit 4). After the CBRT cut the required reserve ratio for banks with y/y loan growth above 10% and raised the remuneration rate on those reserves from 13% to 15% in late August, profitability of such banks should improve in the near term. Others will likely try to ramp up their lending towards the loan growth threshold as the remuneration rate for banks below was lowered to 5%.

During periods of declining interest rates, the maturity mismatch between Turkish banks' funding and lending has a positive impact on profitability. Given that the average maturity of deposits (main funding source for loan growth) remains less than 2 months as opposed to a much longer average maturity for loan books (with fixed lending rates), banks' profitability will benefit markedly from lower domestic funding costs in the near term. With the Fed and ECB set to ease their stances further, Turkish banks' funding costs from abroad will likely decrease as well, which should help improve not only profitability but also external debt rollover rates, which have already risen to 95% from a recent low of 80% in January.

The pickup in banks' external rollover rates seems to in part reflect the recent slowdown in the ongoing dollarization, as well as the improved sentiment among foreign creditors. The rise in FX deposits since mid-2018 was coupled with sharply weaker demand for FX loans, allowing banks to lower their rollover ratios for external debt at times of significant market volatility and wider risk spreads in the second half of 2018 (Exhibit 5). With rollover rates remaining below 100% since mid-2018, banks have reduced their short-term external debt from a recent peak of USD73 bn in April 2018 to USD58 bn in mid-2019, reducing the amount of short-term external liabilities in need of frequent rollover.

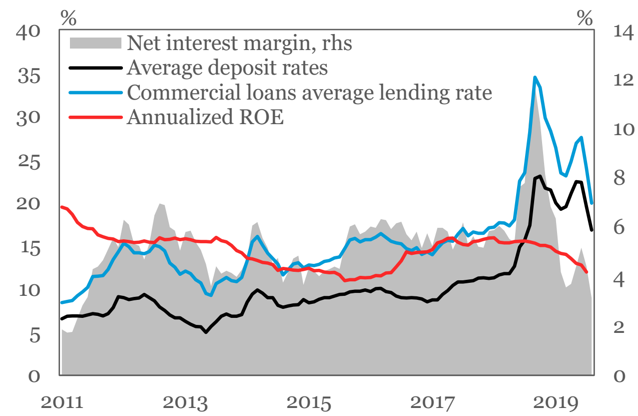
A new round of attempts to clean up banks' balance sheets from problematic energy and construction sector loans, which have been constraining banks' ability to lend, might lead to a rise in NPLs in the near term. To the extent that those attempts will be successful in creating room in banks' balance sheets for new lending without depleting capital buffers, more bank lending should be in the pipeline, which would in turn boost economic activity. Such a push for more credit to fuel output growth, however, will likely require larger external borrowing by banks to finance new lending, which would increase banks' and corporates' leverage risks and potentially put renewed depreciation pressure on the TRY.

Exhibit 3. Banks remain well-capitalized.



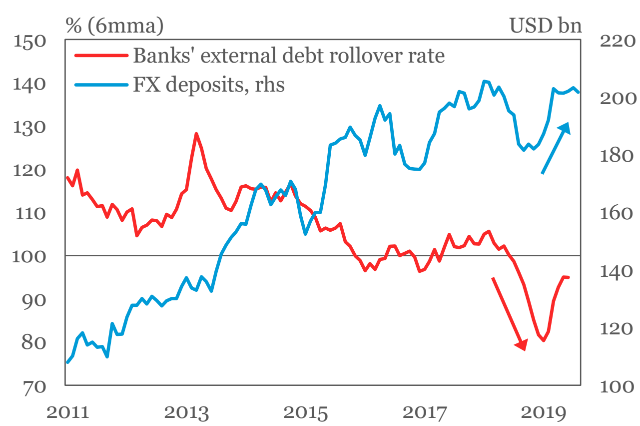
Source: Haver, IIF

Exhibit 4. Maturity mismatch will improve profitability.



Source: Haver, IIF

Exhibit 5. Dollarization cut banks' external borrowing.



Source: Haver, IIF