

III. Financial Sector

In the previous Report period, supportive fiscal policies assisted loan growth through both supply and demand channels. Loan growth rates continued to increase at an accelerated pace in the current Report period due to continuing effects of these policies and the base effect, but converged to their past averages after September. Due to the moderate increase in economic activity, strong TL credit growth, and positive developments in loan collections as well as the regulation on restructuring of loans, NPL ratios remained flat at low levels. It is expected that the growing credit use due to supportive measures and heightened economic activity will be offset by the tight monetary policy stance whose effects on credits were postponed due to the incentive schemes.

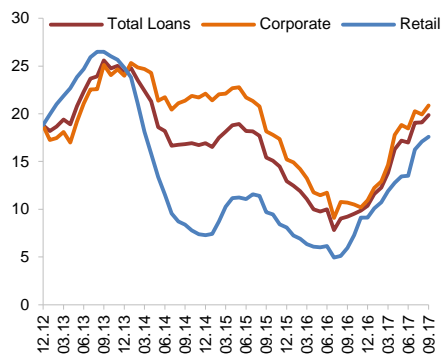
Banks remain resilient to liquidity risk. The maturity of non-core funding items has continued its high-level path thanks to measures taken, and have increased the resilience of the banking sector against possible global liquidity shocks. The fact that the roll-over ratio of syndicated loans exceeded 100 percent in the recent period and banks could borrow syndicated loans with maturities of up to two years, and the improvement in costs in 2017 indicate that there is no significant negative change in the credit supply of foreign financial institutions. During the last report period, TL liquidity needs of banks, which emerged as a result of the rapid growth in TL loans, as well as supportive market conditions led banks to use alternative funding instruments, thereby causing an increase in long-term bonds and subordinated securities issued by banks.

The banking sector's on-balance sheet and off-balance sheet assets-liabilities positions in TL and FX of all maturities have limited sensitivity to interest rate risk via the repricing channel. However, the sector's sensitivity to interest rate risk seems to have slightly increased in the last one-year period. This increase was triggered by the lengthening of assets' maturities in TL positions, and by both the lengthening of assets' maturities and the shortening of liability maturities in FX positions. The Turkish banking sector maintains its resilience to FX risk from the balance sheet channel. The sector's

Credit growth rates continue to increase, albeit at a slower pace as supportive measures reach allocated limits, due to high demand and the base effect.

Chart III.1.1

Annual Loan Growth
(FX-Adjusted, Percent)

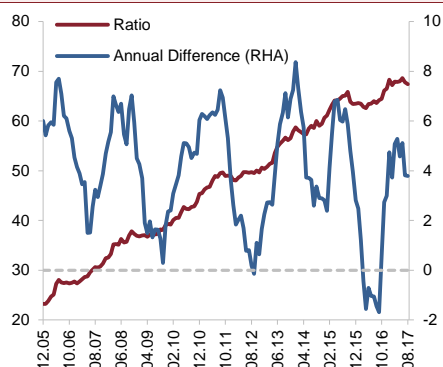


Note: FX-indexed loans are included in FX loans and adjusted for exchange rate using a weighted basket of 0.3 for the euro and 0.7 for the US dollar.

Source: CBRT (Latest Data: 09.17)

Chart III.1.2

Credit/GDP Ratio
(Percent)

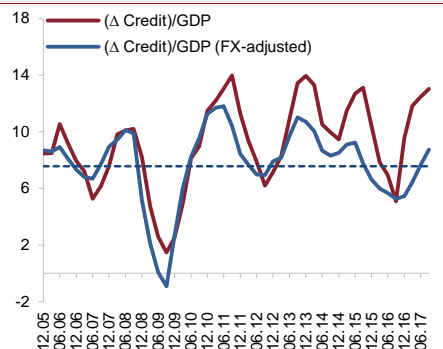


Note: The ratio takes stock of credit over the sum of monthly GDP over the past 12 months.

Source: CBRT, TURKSTAT (Latest Data: 09.17)

Chart III.1.3

Annual Change in Credit Stock to GDP
(Percent)



Note: The annual change in credit is reported as a ratio of GDP. The change in corporate FX credits takes 3-month differences of stock values to calculate the flow variable. The value is then FX adjusted using 3-month averages of CBRT buying rates. 4-quarter differences in TL and FX-adjusted values are added to give the annual difference. FX-indexed loans are included in FX loans. The blue dashed line shows the long term average since 2004 for the FX-adjusted value.

Source: BRSA, CBRT, TURKSTAT (Last Data: 09.17)

FX Net General Position/Equity ratio is close to zero, well below the two-way legal cap of 20 percent. The sector continues to use currency swaps as the main instrument in FX risk management. However, while the growth in volumes of currency swap transactions hedges against the FX risk, it generates at the same time a probable pressure on profitability by increasing banks' interest rate sensitivity.

The banking sector's profitability indicators, which have been on the rise since the last quarter of 2015, remain robust despite a limited decline since the second quarter of 2017. However, the profit generation power of the sector has outperformed the growth in credit risk as the recent loan growth mostly stemmed from the loans under the KGF guarantee and the exchange rates relatively stabilized. On the other hand, the regulatory capital has been positively affected by the growth in profitability and the increase in subordinated debt issues in the last one-year period. These developments have resulted in a remarkable increase in capital adequacy ratios.

III.1 Credit Developments and Credit Risk

Credit growth continued its recovery in the aggregate following various stimulus policies from the third quarter of 2016 until the third quarter of 2017, both in corporate and retail loans. As of September 2017, FX-adjusted rate of total credit growth registered at around 20 percent, and in the following period has converged down to its past average (Chart III.1.1). The revival in retail loans seen in the previous Report period triggered by the decline in housing loan interest rates, financial incentives for private consumption expenditures and the partial easing in macroprudential measures accelerated in this period. Increased maturity caps and the base effect were decisive in the developments seen in the two most important items of retail loans, namely housing and general-purpose loans. Corporate loans continued to grow in TL following the supportive incentive schemes and due to the contractionary effect of exchange rate movements on both the demand for and supply of FX loans. As a result of these developments in retail loans and TL corporate loans, credits continued to grow faster than GDP, and the annual net credit utilization from the banking system recovered in

nominal terms while the exchange rate-adjusted series exceeded the long-term average (Chart III.1.2 and Chart III.1.3)

As of the first quarter of 2017, the ratio of loans extended by banks to the non-financial sector as a share of GDP was at a moderate level in Turkey compared to peer developing countries while the annual change of this ratio was high. In this period, particularly due to the recovery in corporate loans as an effect of Treasury-backed KGF implementation, Turkey has increased its ranking among peers as expected. Turkey also diverged from its peers in terms of the two-year increase registered in this ratio (Chart III.1.4). Moreover, the accelerated corporate loan growth in the April-June period due to the KGF incentive offered since the first quarter of 2017 continued in July, but it hovered around the historical average in the rest of the year.

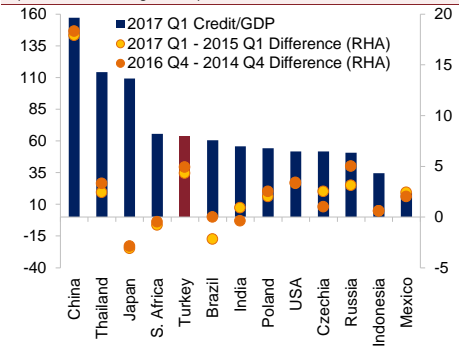
Both supply and demand dynamics have played a role in the recent credit developments. On the retail side, supportive changes in macroprudential regulations were effective in these developments while on the corporate side, restructuring of debts, increasing domestic consumption demand and postponed inventory increases in this period were influential. In the third quarter of 2017, banks kept their credit standards stable compared to the previous quarter for retail and corporate loans with the exception of general-purpose loans. With the waning impact of supportive measures and incentives, FX-adjusted loan growth slowed and converged to the historical average. In the upcoming period, the effects of tight monetary policy are expected to become more pronounced.

III.1.1 Corporate Loans

Corporate loan growth rates, which accelerated at the end of the first quarter of 2017 due to KOSGEB's interest-free loan support, TOBB's low-interest Respite Credit, and Treasury-backed KGF guarantee scheme, have continued to grow at a slower pace due to the base effect and loan issuance reaching the upper limit of the KGF scheme. The total corporate loan growth rate, adjusted for the exchange rate effect, was 20.9 percent in September, reaching levels seen two years ago (Chart III.1.1). Currency movements and

Credit growth rates registered an increase in international comparisons.

Chart III.1.4
International Comparison of Credit/GDP
(Percent, Percentage Points)

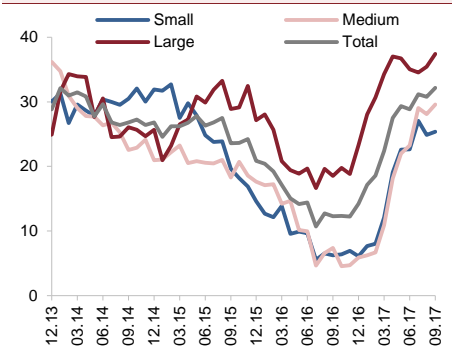


Note: Data covers all private non-financial sector credit, with the latest data available from 2017Q1. Two-year differences are calculated between the first and last quarters of the years shown.

Source: BIS (Latest Data: 03.17)

TL corporate loans continued to grow across all firm sizes.

Grafik III.1.5
Annual Growth in TL Corporate Loans by Firm Size
(Percent)

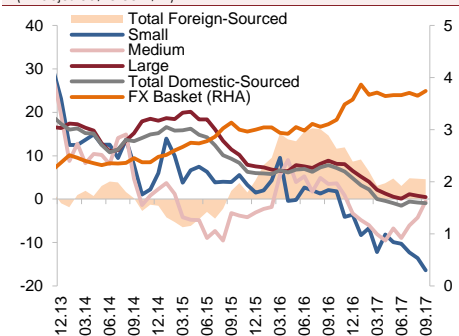


Note: FX-indexed loans are excluded. Micro and Small SMEs are grouped together under the Small heading.

Source: CBRT (Latest Data: 09.17)

FX corporate loan growth slowed down in tandem with rising foreign exchange rates.

Chart III.1.6
Annual Growth in FX Corporate Loans by Size and the Exchange Rate
(FX-adjusted, Percent, TL)

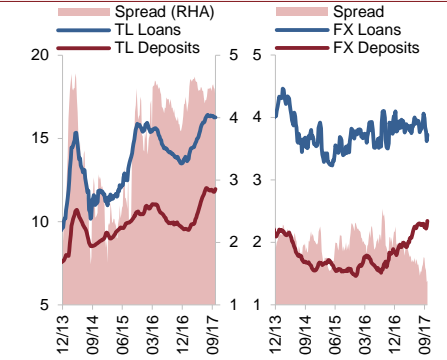


Note: Total foreign sourced FX credit growth takes the foreign FX loans and other FX liabilities of all non-financials, excluding foreign branches and affiliates of domestic banks, in USD. The figures by size as well as the total include FX-indexed loans. Micro and Small SMEs are grouped together under the Small heading. The weighted FX basket uses weights of 0.3 for the euro and 0.7 for the US dollar.

Source: CBRT (Latest Data: 09.17)

the increase in TL loans were the decisive factors in this growth rate. The TL loan growth rate was 32.2 percent in total as credit growth increased across all firm sizes (Chart III.1.5). At the same time, due to the increase in exchange rates and the signaling effect of regulatory efforts in foreign exchange risk management, domestic sourced FX loans of small and medium sized firms continued to contract while large-scale firms' FX loan growth remained stable (Chart III.1.6). The decline in FX credit utilization of large-scale companies, which receive about 85 percent of FX loans, was decisive in the overall course of FX loan growth while total domestic-sourced FX loans registered a limited contraction in September.

Chart III.1.7
Corporate Loan Interest Rates and Spreads
(4-week MA, Percent)



Note: Overdraft accounts and credit cards, as well as loans with zero interest starting from July 2015 are excluded.

Source: CBRT (Latest Data: 29.09.2017)

Interest rate developments play an important role for corporate loans both in terms of aggregate demand and the currency type of the loan demand. However, in the current period exchange rate movements rather than interest rates had a dominant effect on currency preferences of firms. Previously, when firms' domestic FX loans declined due to the impact of prices or supply on loan demand, the growth rates of external FX loans had increased. As a result, firms that generally prefer to use FX loans for long-term investments met their funding needs by substituting foreign sources for domestic ones. However, in the current period, firms have reduced their use of FX loans in the aggregate, rather than exercising this substitution. The decline in the total FX loan utilization in this period when TL commercial credit interest rates increased while domestic FX loan rates remained stable is associated with increased exchange rate risk awareness and management in addition to exchange rate developments (Chart III.1.6 and Chart III.1.7).

To meet their increasing TL funding needs, banks increased TL and FX deposit rates, leading to an increase in TL loan interest rates and a narrowing in the spread between FX loans and deposits (Chart III.1.7). The sharp increase in TL loans in this period when FX deposits were strong caused banks to intensify swap transactions with the aim of obtaining funds for TL loans.

According to the Bank Loans Tendency Survey, in the third quarter of 2017, the standards that banks applied to corporate loans generally remained flat compared to the previous quarter. While

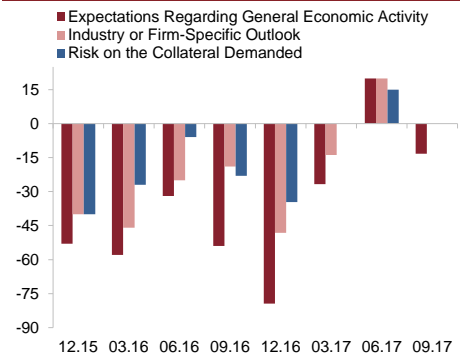
credit standards registered a limited easing in corporate loans regardless of firm size, they remained the same for both long and short term loans. Lending standards continued to tighten in FX credits while TL lending standards did not change after two quarters of easing. This development is believed to have played a role in the deceleration in FX loan growth along with the decreasing demand. While the expectations regarding the overall economic activity did not have a net effect on supply in the last two quarters, the two-year long tightening effect of industry, firm and collateral related risk factors on supply was replaced by a loosening in standards due to the ongoing positive influence of supportive policies on the risk perception for loan collaterals, (Chart III.1.8). On the demand side, while the demand for FX loans decreased, the demand for TL loans were positively affected by the loan demand related to short-term, operating cycle-dependent working capital needs such as inventory increase and restructuring of debts as well as discount opportunities in cash purchases (Chart III.1.9).

III.1.2 Retail Loans

The acceleration particularly in general-purpose and housing loans continued as a result of enhanced loan and installment facilities brought about by favorable interest rates and macroprudential policy regulations in the second half of 2016, as well as the growing demand for retail loans in 2017.¹ Following the base effect in the summer months, retail loans grew by 18 percent in September 2017 (Chart III.1.1, Chart III.1.10 and Chart III.1.11). Growth rates in retail loans in total and in all subcomponents, excluding credit cards, have been the highest of the past three years. Increased consumption demand and base effects have been influential on the growth in credit card balances. The recent growth in retail vehicle loans despite the declining market share of the banking system is also associated with the base effect and the exchange rate developments over the past year. As a matter of

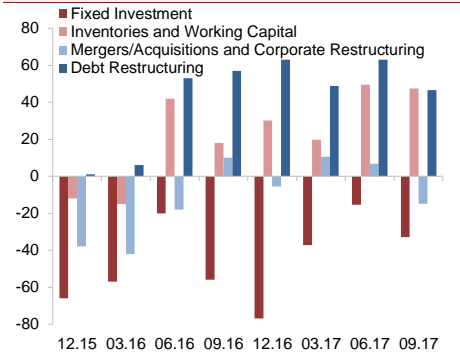
¹ According to the amendments made to the regulations regarding the credit transactions of, and credit cards issued by banks on 27 September 2016; the maturity cap for general-purpose loans, while retaining some exceptions, has been raised to 48 months and current balances on performing loans are allowed to be restructured with maturities up to 72 months. If this restructuring requires a new credit issuance, the maturity is again limited by 48 months. The loan-to-value ratio for housing loans or loans with housing as collateral other than vehicle loans has been increased from 75 percent to 80 percent. With the exclusion of various consumption items, the number of instalments in retail and corporate credit card spending and cash withdrawals has been increased from 9 to 12 months, and as in general-purpose loans, current balances on performing loans are allowed to be restructured with maturities up to 72 months.

Chart III.1.8
Factors Contributing to Corporate Loan Supply
(Net Percent Change)



Note: The quarterly Survey asks respondents to compare the current quarter to the previous. Zero is the neutral state indicating no change.
Source: CBRT (Latest Data: 09.17)

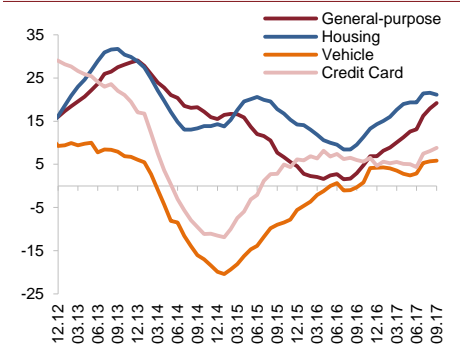
Chart III.1.9
Factors Contributing to Corporate Loan Demand
(Net Percent Change)



Note: The quarterly Survey asks respondents to compare the current quarter to the previous. Zero is the neutral state indicating no change.
Source: CBRT (Latest Data: 09.17)

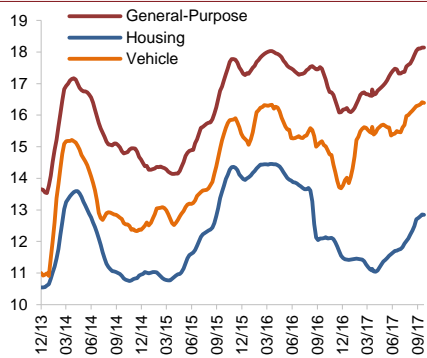
The acceleration in retail loan growth was due to housing and general purpose loans.

Chart III.1.10
Annual Growth in Retail Loans
(Percent)



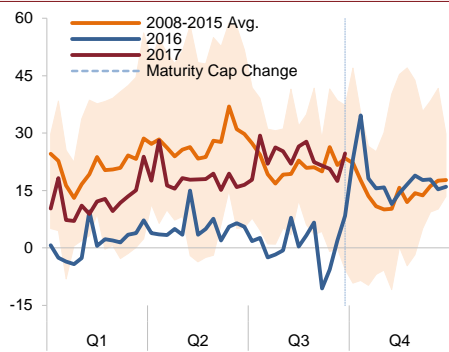
Source: CBRT (Latest Data: 09.17)

Chart III.1.11
Retail Loan Lending Rates
(4-week MA, Percent)



Source: CBRT (Latest Data: 29.09.17)

Chart III.1.12
General Purpose Loan Weekly Growth Rates
(4-week MA, Annualized Percent)

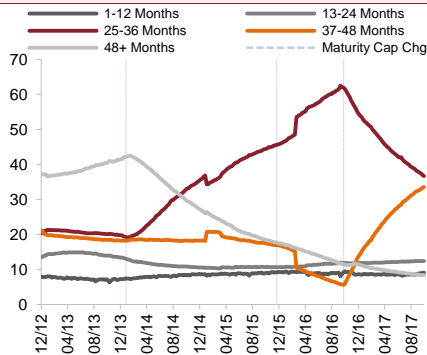


Note: The maturity cap change is shown to include the week it took effect in. The area shaded in yellow marks the the peak and trough of the values used in the 2008-2015 averages.

Source: CBRT (Latest Data: 29.09.17)

General-purpose loan maturities continued to shift in favor of the 37-48 month bracket.

Chart III.1.13
General-Purpose Loan Maturities
(Percent Share)



Note: Calculated using stock of loans. The maturity cap change in 2013 limited the maturities to 36 months. The change at the end of 2015 removed the cap for education loans, and in 09.2016, the 36-month maturity cap was increased to 48 months for all general-purpose loans. The sharp movements in the beginning of 2015 and 2016 are due to changes in definition and coverage. As general-purpose loans and "other" types of retail loans not classified elsewhere are reported together since 2015, they are graphed together for the entire duration shown in the Chart. The maturity cap changes are shown to include the weeks they took effect in.

Source: CBRT (Latest Data: 29.09.17)

fact, with a weaker base effect and the termination of the VAT reduction stimulus in domestic appliances and furniture expenditures in October, the weekly rate of FX adjusted consumer loan growth declined to around 17 percent.

It is noteworthy that despite rising housing loan interest rates since April 2017, the demand remained vibrant and housing loans stood as the fastest growing retail loan type. This development is evaluated in relation to the fact that the maximum loan-to-value ratio limit applied to housing loans were increased from 75 percent to 80 percent in September 2016, the favorable effects of past period consumer confidence in the housing market as reported by the Bank Loans Tendency Survey, and the base effect arising from the loan growth that decelerated due to the relatively high housing loan interest rates in the same period of 2016.

General-purpose loans are performing close to their long-term average since the beginning of 2017 (Chart III.1.12). The change in the maximum maturity cap introduced in 2016 and simultaneous interest rate developments have played a major role in the recovery of the loan growth rate to averages seen between 2008 and 2015.

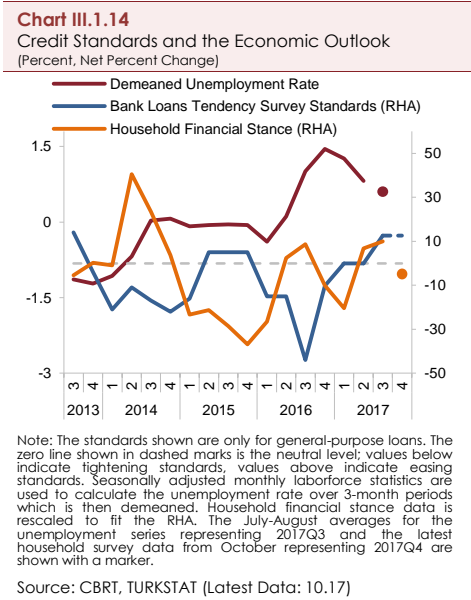
In the first quarter of 2017, credit growth remained slightly below the average level due to the increase in the maximum maturity cap and incentives for furniture and domestic appliances consumption. In the second half of the year, in addition to the ongoing incentive and maturity effects, the contribution of the base effect helped push the growth rate above the said average. The strong course of credit demand despite the recent increase in interest rates is considered to be related to the reduced interest rate sensitivity of individuals due to the increasing maturity structure. As a matter of fact, the lending policies of banks as well as individuals' demand continued to respond sensitively to the increase in the maximum maturity cap within the scope of the policy change, and loans with maturities between 25-36 months which included the old maturity cap continued to lose its share in favor of maturities between 37-48 months (Chart III.1.13). As stated in the Bank Loans Tendency Survey, in the current Report period, the competition between banks and the positive expectations regarding the overall

economic activity have resulted in an easing in credit standards, which has supported credit growth. Demand for durable goods and purchases of securities played a role in the rising demand coupled with increased consumer confidence. The extension of the incentives for the furniture and domestic appliances sector into the third quarter of the year is considered to have brought forward demand that may emerge in the remainder of the year. The demand for these items is expected to slow down in the fourth quarter of the year.

Household indebtedness and indicators for overall economic activity will be effective on the credit risk outlook of retail loans. With the revival in the economic activity since the beginning of 2017, the downtrend in the unemployment rate due to increased employment opportunities in the current period, and the extended maturity and installment facilities have produced more favorable levels of consumer debt service capacities (Chart III.1.14). It is expected that this development will have a positive effect on individuals' credit risk outlook. As noted in Section II.1, the decline in household leverage ratios since 2014 has halted with the growth in housing and general-purpose loans. The easing in bank lending standards in the third quarter of 2017 will facilitate credit access for individuals in need of loans, while the high demand and accordingly the relatively higher interest rates on bank lending will improve the banking sector's profitability.

III.1.3 Non-performing Loans

With the contribution of the steps to revitalize the credit channel and the increase in economic activity, NPL additions and write-offs have declined in the recent period and the collections within the period have increased. As of September, the increase in NPL provisions had a limited tightening impact on bank assets. The NPL ratio, favorably supported by these developments, remained flat at 3 percent during this period (Chart III.1.15). Demand-driven acceleration in retail loan growth and restructuring opportunities offered for existing loans supportive of debt service capacities have been effective on the falling NPL ratios. As a result of NPL sales to asset management companies, retail loan NPL ratios, which grew steadily since the beginning of 2015, fell to levels seen in 2015 (Chart



NPL ratios declined in retail loans, and continued its horizontal movement in corporate and total loans.

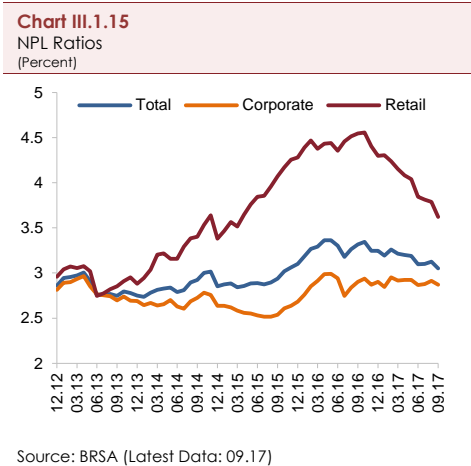
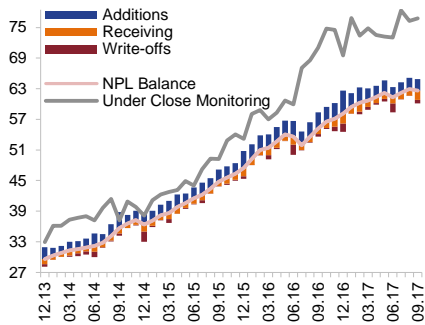
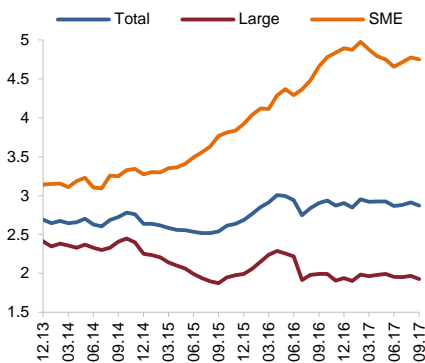


Chart III.1.16
Components of NPL
(Billion TL)



Source: CBRT (Latest Data: 09.17)

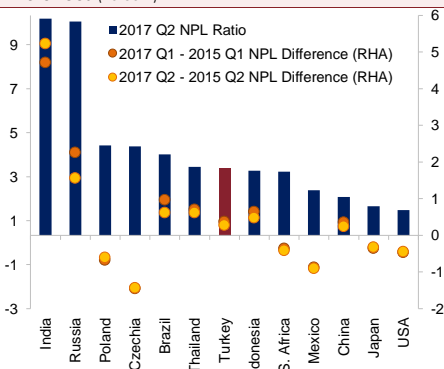
Chart III.1.17
Corporate NPL Ratios
(Percent)



Source: CBRT (Latest Data: 09.17)

The NPL ratio is relatively moderate in an international comparison.

Chart III.1.18
International Comparison of NPL Ratios and Differences (Percent)



Note: The two-year differences are calculated between the first and second quarters of the years indicated. For Japan and Russia where the data is not updated, bars show 2017Q1 values with the two year differences taken over 2017Q1 and 2016Q4.

Source: IMF-IFS, BRSA, China Banking Regulatory Commission (Latest Data: 06.17)

III.1.16). On the other hand, the flat course of large firms' NPL ratio at a relatively low level was decisive on the corporate credit risk outlook and contributed positively to the asset quality of banks (Chart III.1.17). It is estimated that the increase in corporate loans triggered by incentives reflected positively in real sector debt repayment indicators and is a determinant factor in the preservation of bank asset qualities. As of the first quarter of 2017, Turkish banking sector's NPL ratio and the change in this ratio over the last two years are close to the average of peer developing countries (Chart III.1.18).

The total NPL ratio, which had been below 3% for over a year, was registered at 2.9 percent in September, and it continued to vary according to the size of firms (Chart III.1.17). Large-scale enterprises, which account for the largest share in terms of loan volume, have had NPL ratios just below 2 percent for almost a year, standing as a determinant factor in the total corporate NPL ratio. Although SME NPL ratios declined as SME loan growth increased in the period when supportive programs were implemented, they are now getting close to 5 percent again as the support programs have lost pace. The recent pickup in economic activity is expected to have a positive effect on the NPL outlook. As stated in Section II.2, corporate leverage ratios have remained relatively flat since early 2017, with maturities continuing to lengthen. It is estimated that the positive developments in economic activity and accordingly in consumer demand will positively affect the revenues and hence the debt roll-over capacities of firms.

Corporate NPL ratios continue to diverge in terms of currencies, and the total corporate NPL largely results from TL loans (Chapter II.2). Although exchange rate developments in the last one-year period have had a dominant effect on the growth of FX loans, it is estimated that firms' resilience against exchange rate shocks and longer-term borrowing have been effective in the horizontal course of the FX-denominated corporate NPL ratio.

Corporate NPL ratios diverge not only on a size or currency basis, but also on a sectoral basis. The NPLs in the manufacturing industry and the wholesale and retail trade sectors, which make up approximately half of the total volume of sectoral borrowing,

remained relatively flat and played a decisive role in the overall NPL ratio (Table III.1.1). It is estimated that these sectors will be positively affected by the expected domestic and foreign demand developments in economic activity in the coming periods. The NPL ratios in the construction sector continued to decline, albeit at slowing rates, following the supportive policies and interest rate movements since the last quarter of 2016 as well as the ongoing strong demand. The tourism sector, which has recovered partially, had a relatively stable share in total corporate loans, and NPL ratios in the sector remained at average levels reflecting the favorable effect of the incentives given to the sector. Incentive programs are also believed to have played a role in the flat course of NPL ratios in the energy sector which benefited from restructuring facilities.

NPL ratios continued to decline in all retail loan types as a result of the strong rebound in retail loans (Chart III.1.15 and Chart III.1.19). NPL ratios in housing loans, which have a stable outlook given their collateral structure and loan-to-value restrictions, continued to decline due to the recent credit growth. The NPL ratios in vehicle loans showed a limited decline and continued their long-standing flat course around 3 percent. Individual credit card NPL ratios stood at 7 percent, declining to the levels of about two years ago, due to the rise in the number of installments allowed and the restructuring facilities introduced for existing balances. The option to pay in installments is being used more intensively following the increase in the maximum number of installments allowed, and balances with installment sales have grown at a faster pace than non-installment sales (Chart III.1.20). As a result of this differentiation in growth rates of installment and non-installment balances, the ratio of installment balances to total credit card balances slightly increased to above 45 percent.

The NPL ratios for general-purpose loans declined to 5.1 percent in September 2017, following the changes introduced in September 2016. The fact that these changes, which lengthened maximum maturities and allowed existing loan balances to be restructured with longer maturities, reduced the likelihood of individuals to become delinquent by increasing the payment rates of current and future debts of individuals through facilitating their debt service with a reduction in their monthly credit obligations stands as a positive reflection of the change in implementation.

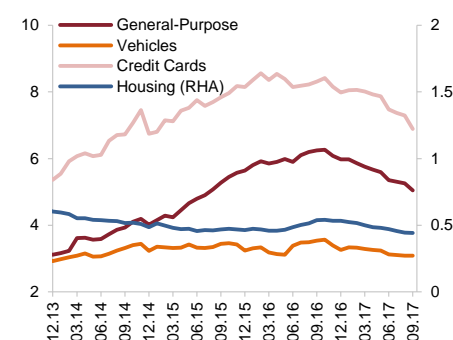
Table III.1.1
Sectoral Breakdown of NPL Ratios
(Percent)

	09/16 NPL	09/17 NPL	Percent Change	Credit Share
Manufacturing Industry	3.5	3.5	-1.3	25.0
Wholesale and Retail Trade	4.0	4.0	0.6	21.1
Construction	3.8	3.5	-7.5	11.9
Energy (Electricity, Gas and Water Res.)	0.6	0.5	-14.1	9.1
Transport, Inventory, Communication	1.9	1.9	-2.8	7.1
Real Estate, Renting, Management	1.0	1.2	18.9	7.3
Agriculture, Livestock, Forestry	2.6	2.7	4.7	5.9
Hotels and Restaurants	2.4	2.7	12.5	4.2
Mining and Quarrying	2.7	2.4	-11.6	1.6

Note: Sectoral breakdown is based on the loan purpose indicated at the time of application. The shares are calculated excluding retail loans and the financial sector, and the selected sectors represent 93% of real sector's performing loans.

Source: BRSA (Latest Data: 09.17)

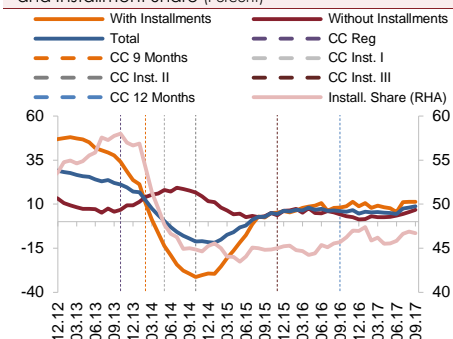
Chart III.1.19
NPL Ratios in Retail Loans
(Percent)



Source: BRSA (Latest Data: 09.17)

The share of retail credit card balances with installments has started moving around a higher average.

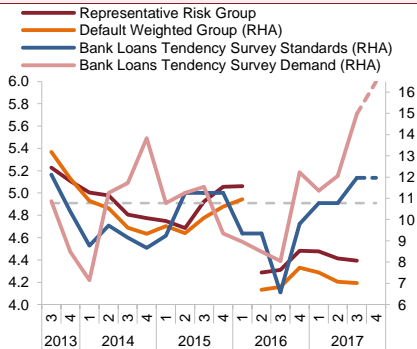
Chart III.1.20
Annual Growth in Personal Credit Card Balances
and Installment Share (Percent)



Note: Highlights of the 2013 regulation are linking minimum payments to card limits and new card limits to income. In February 2014, the number of monthly installments were limited to 9 with some exceptions. Credit card installment regulations I, II, and III have removed the right to installments for gift cards and cheques, brought about 4 months of installments to jewelry, and extended household goods, furniture and educational expenses to 12 months of installments, respectively. Changes in September 2016 extended the maximum number of installments to 12, with some exceptions.

Source: CBRT (Latest Data: 09.17)

Chart III.1.21
New General Purpose Loans and the Survey
(Average Risk Group)

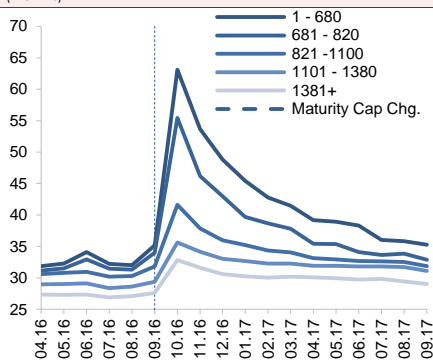


Note: Standards and demand values from the Survey are only for general-purpose loans. These values, which were also graphed in Chart III.1.14 as net percent change, are rescaled in this Chart to fit the risk group range on the RHA. The dashed zero line shows the neutral point for the Survey. Values above this point imply easing and values below imply tightening. Expectations about the standards are shown in dashed lines. The representative and default weighted risk groups show a plain average and default probability weighted average of RLS groups for general purpose loan customers. Following a methodological change in the second quarter of 2016, the series have shifted and should be evaluated independent of their past levels.

Source: Credit Bureau of Turkey (KKB), CBRT (Latest Data: 09.17)

Following the increase in the maturity cap, general-purpose loan maturities are longer across all RLS brackets.

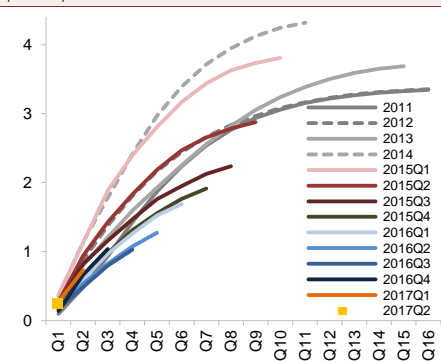
Chart III.1.22
General-Purpose Loan Maturities by RLS
(Months)



Note: Group means are calculated using the 11 RLS groups for scores between 1 and 1900.

Source: KKB (Latest Data: 09.17)

Chart III.1.23
General-Purpose Loan Vintage Curves
(Percent)



Note: The vintage analysis reports NPL ratios cumulatively in the quarter following the issuance of a loan.

Source: CBRT (Latest Data: 09.17)

According to the Bank Loans Tendency Survey, credit standards began to ease in the third quarter of 2017, which creates a probability of an upward risk in general-purpose loans' asset quality (Chart III.1.21).

The average loan maturity is expected to lengthen as individuals prefer to extend their debts over longer periods by using the longer-maturity and restructuring facilities. As a matter of fact, as can be seen in Chart III.1.13, following the first maturity cap introduced in 2014, average maturities began to concentrate in the bracket just below the maximum limit even then. It is therefore consistent with this expectation that the average maturities in new loans increased shortly after the latest change in implementation and the increase in maturities is higher for Retail Loan Score (RLS) groups that are more likely to be in need of credit (Chart III.1.22). However, the rapid decline in maturities following the increase in 2016 shows that these changes in implementation did not lead to a permanent shift in individuals' consumption tendencies or in banks' lending standards; on the contrary, the increase was a short-term development where users benefited from the new opportunities created by the implementation change. The fact that the highest increase in maturities after this change was registered in the lowest RLS group, which is most likely to have loan repayment difficulties, reveals that the change in implementation has had a positive impact on loan quality.

The rate at which performing loans turn into NPLs is determined by both banks' lending policies at the time of credit issuance and the macroeconomic outlook in the following period. It is possible to examine the effect of these factors on credit performance by means of a vintage analysis that shows the rates at which loans become NPLs in the quarters following their issuance. According to the vintage analysis on general-purpose loans, all loans issued since the first quarter of 2015 have always performed better than the previous quarter in terms of asset quality, while loans issued in the first two quarters of 2017 have shown an initial performance corresponding to the average of the last two years (Chart III.1.23). With the improvement in macroeconomic outlook, increasing employment opportunities in the current period, higher domestic demand, and the contribution of longer maturities, the NPL outlook in retail loans is not expected to deteriorate in the period

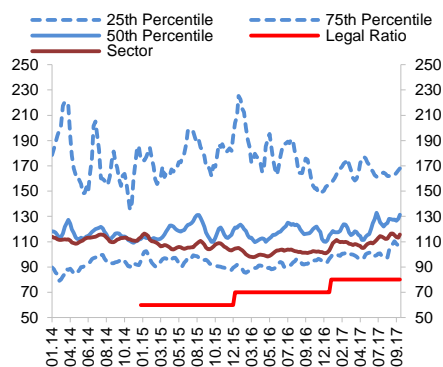
ahead. Since households' access to FX loans has been restricted as part of the macroprudential measures taken in 2009, households are not exposed to exchange rate risk, which will also support this outlook.

III.2 Liquidity Risk

The sector's LCR calculated for the total is well above the legal limits.

Chart III.2.1

Quantiles of Banks by Total Liquidity Coverage Ratio (Percent, 4-Week Moving Average)

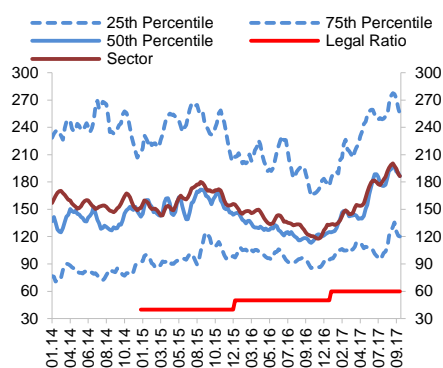


Note: Excluding development and investment banks. Based on non-consolidated reportings. These quantiles represent the banks in the 25th, 50th and 75th percentiles, respectively, from the smallest to the largest.

Source: CBRT (Latest Data: 17.11.17)

Chart III.2.2

Quantiles of Banks by FX Liquidity Coverage Ratio (Percent, 4-Week Moving Average)



Note: Excluding development and investment banks. Based on non-consolidated reportings. These quantiles represent the banks in the 25th, 50th and 75th percentiles, respectively, from the smallest to the largest.

Source: CBRT (Latest Data: 17.11.17)

The banks' short-term liquidity position is on a safe path. The Liquidity Coverage Ratio (LCR), which indicates how banks can meet 30-day net cash outflows out of their high-quality liquid asset stocks, was 125 and 196 percent for total and FX November 17, 2017 and are well above the legal lower limits (80 percent for total, 60 percent for FX) (Charts III.2.1 and III.2.2). Gold and FX liquid assets held by the banks at the CBRT in the scope of the ROM continue to support FX LCRs. In the second half of 2016, when capital inflows weakened, ROM reserves decreased due to the rise in FX costs and the increase in exchange rates. As of February 2017, there has been a rebound in the ROM reserves as a result of the accelerated capital movements and falling exchange rate volatility, which in return were reflected in FX LCRs. The distribution of banks' LCRs according to their percentiles indicates that all banks satisfy the legal limits by a significant margin. After the amendments made to the LCR calculation by the BRSA on August 15, 2017, the LCRs of banks increased by a limited amount.¹ Banks that are close to the legal lower limit may show a higher demand for deposits than alternative funding sources since deposits are a stable source of funding. In this context, it is estimated that deposit demand of banks that are close to legal lower limit may reduce by a limited amount as a result of this regulation.²

The share of non-core liabilities in total liabilities has decreased marginally. The strong course of TL loans during the last Report period also had a positive effect on deposit growth. Growth in deposits contributes to achieving a more stable structure in bank balance sheets. Moreover, the high profitability level of the banking sector, has led to an increase in the share of core liabilities in the funding composition of banks. The foreign resources provided via

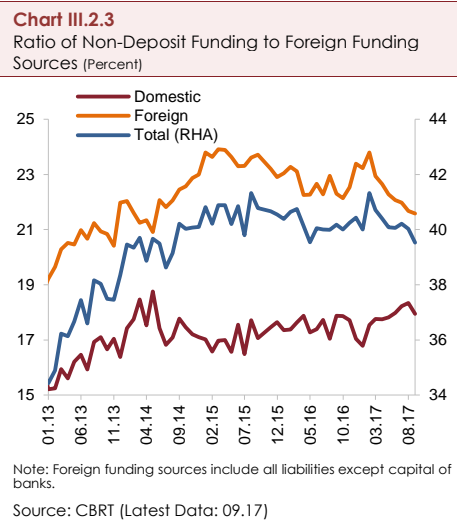
¹ According to the "Regulation on the Amendment of the Regulation on the Calculation of the Bank's Liquidity Cover Ratio" published by the BRSA on 15 August 2017, the ratio of the reserve requirements of the banks in the CBRT has been increased from 50 percent to 100 percent. In other words, the reserve requirements held in the CBRT by banks were accepted as "high quality liquid assets".

² The special topic titled "Liquidity Position and Deposit Rates of Banks" in the Financial Stability Report released in November 2016 analyzes the relation of the deposit rates with the Liquidity Coverage Ratio (LCR) and Loan/Deposit ratio (L/D) that represent the short-term and long-term liquidity positions of banks, respectively. The estimation results suggest that the L/D ratio is an important factor in explaining the recent deposit competition, especially for the banks whose L/D ratio value is higher than the 110 percent level. Besides, it has been found that LCR, which is a short-term liquidity measure, has more limited effects than L/D ratio on deposit rates, and this effect is more evident in the banks whose LCRs are below the 100 percent level. It is foreseen that the effect of LCR on deposit rates may be strengthened somewhat by raising the legal limit to 100 percent in 2019.

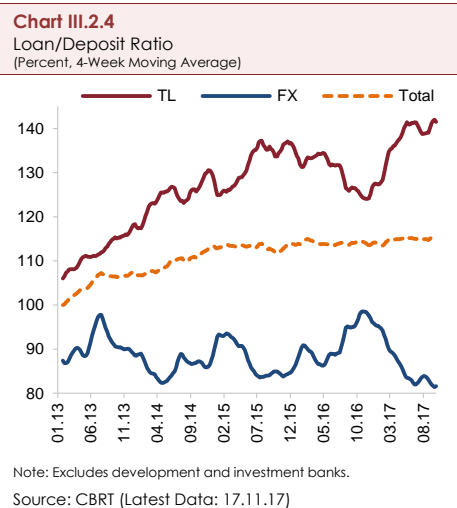
bonds issued in foreign markets and the debts obtained from banks abroad constitute about 60 percent of non-core liabilities. In this period, the share of funds obtained from domestic markets in non-core liabilities increased as well. Domestic non-core liabilities are mainly composed of repo transactions, bank borrowings and bonds issued in domestic markets. In addition to the recent subordinated bonds and traditional domestic bonds issued by banks, the rise in domestic borrowing from banks led to an increase in the share of domestic funds in non-core liabilities (Chart III.2.3). The increase in both core liabilities and the share of domestic resources in the non-core liabilities points to the deepening in domestic markets.

Despite strong loan growth, banks' Loan/Deposit ratio (L/D) remains flat. Being one of the key indicators of long-term liquidity position of the banking sector, the L/D ratio was approximately 115 percent by the end of 2014 and has assumed a flat course (Chart III.2.4).¹ The flat course of the L/D ratio indicates that the rapid growth in loans due to the recent supportive incentives and macroeconomic policies has also brought about deposit growth. The growth of loans and deposits in close proximity enables banks to maintain their long-term liquidity positions on a safe path and supports financial stability. Moreover, the flat trend of total L/D ratio implies that banks do not have any constraints on total funding. The L/D ratios calculated for TL and FX continue to diverge. Depositors' stronger preference for FX deposits continued in the last report period. Exchange rate developments and increasing awareness of foreign exchange risk management has weakened firms' FX borrowing appetite. Depositors' FX deposit preferences and the change in favor of the TL in the loan composition of banks led to a widening in the gap between the TL and FX L/D ratios. The difference between TL and FX L/D ratios indicates that banks need TL liquidity. As a result of depositors' FX deposit preferences and banks' TL liquidity needs increased FX swap transactions with foreign residents. Therefore, the amount, maturity, cost and counterparty structure of FX swap transactions have recently become important with respect to monitoring the liquidity risk of banks.² The fact that

The share of non-core liabilities in total liabilities decreased by a small amount.



Despite strong loan growth, banks' L/D ratio remains flat.



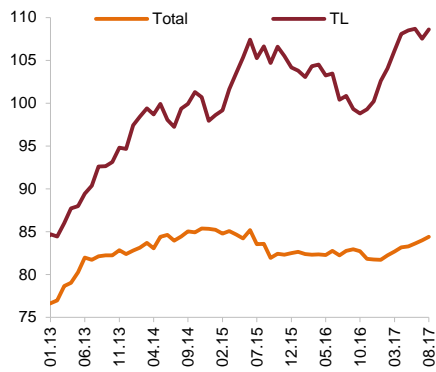
¹ Development and investment banks that grant loans but do not have the authority to collect deposits are not included in the L/D ratio calculation. When the development and investment banks are included, the L/D ratio of the sector reaches 122 percent by October 2017.

² The amount, maturity and cost-based analysis of FX swap transactions made by the banking sector are given in Box III.2.1.

Banks are able to sustain credit growth without weakening the quality of their funding by using relatively stable funding sources.

Chart III.2.5

Loan/(Deposit+Other Stable Sources) Ratio (Percent)



Note: Other includes equity, long-term issues, subordinated loans and other loans with maturities longer than one year.

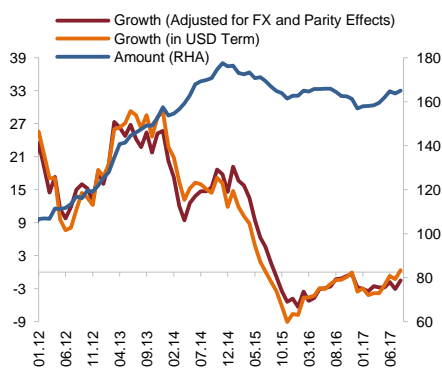
Source: CBRT (Latest Data: 09.17)

Stable funding sources other than deposits contribute to the long-term liquidity position of banks. According to the perspective set out in the Basel III accord, long-term borrowings other than deposits may be a stable source of funding, provided that the maturity structure of banks are compatible with their assets.¹ In this framework, deposits, equities, subordinated debts, long-term issuances and debt items with a maturity longer than one year are also considered as stable sources of funding. In this context, the L/(D+other stable resources) ratios of the banking sector calculated by including the mentioned resources are 82 for total and 108 percent for TL. (Chart III.2.5). Therefore, banks are can meet credit demands without weakening the quality of funding and by keeping long-term liquidity positions in a safe zone especially by extending the maturity of foreign borrowing.

There has been a moderate increase in the banking sector's external debt.

Chart III.2.6

Amount and Growth Rate of Banks' External Liabilities (Annual Percentage Change, Billion USD)



Note: The series that is adjusted for FX and parity effects is calculated based on the USD/TRY and EUR/USD parity at end-2013.

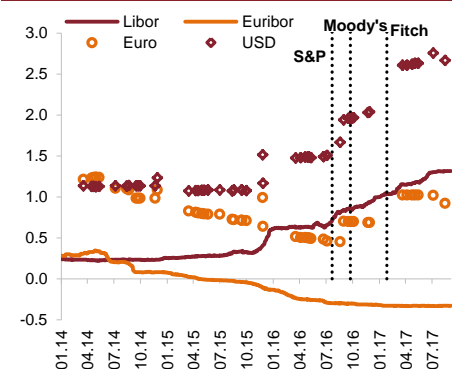
Source: CBRT, MKK (Latest Data: 09.17)

There has been a moderate increase in the banking sector's external debt in terms of US dollar. By September 2017, 67 percent of external debts were obtained in US dollar and 27 percent in euro. The amount of external debt remained flat when the effect of the increase in euro/US dollar parity during the last Report period is adjusted. The recent growth in loans has led to an increase in banks' demand for funds. Nevertheless, banks' demand for foreign funding remained moderate as the deposits grew in tandem with growth in loans and increased profitability rates contribute to banks' funding sources. In this period, due to TL liquidity needs of banks and supporting market conditions, banks opted for alternative funding instruments such as domestic subordinated bond issues and TL-denominated bond issues abroad. In this context, the increase in banks' bonds issues continued. The fixed investment appetite, which is expected to increase in the coming period, may trigger the banks' demand for foreign sources (Chart III.2.6).

¹ the Net Stable Funding Ratio (NSFR) has been developed by the Basel Committee in order to measure the long-term liquidity position of banks more extensively and to limit the risks arising from the maturity difference between banks' assets and liabilities. Details of this ratio are provided in Box III.2.1 of the Financial Stability Report released in May 2017.

There was a limited decrease in banks' cost of external debt during the last Report period (Chart III.2.7). The roll-over ratio of syndicated loans has exceeded 100 percent, banks can borrow syndicated loans with a maturity of up to two years, and there has been some improvement in costs in 2017 which altogether indicate that there is no significant negative change in the credit supply of foreign financial institutions. In this period, unlike the intensive fund flows and the increasing risk appetite for the capital markets of the developing countries including Turkey, there has been a moderate increase in the external debt of the banks. This supports the argument that the main determinant of external debt is the weak demand of domestic banks rather than supply constraints of foreign banks.

Chart III.2.7
Cost of Syndicated Loans with a Maturity of 367 days (Transaction Based, Percent)

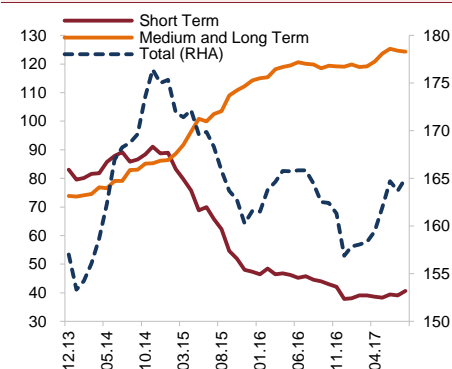


Note: Includes only large-scale banks. Dashed lines represent the date of credit rating agencies' decisions.

Source: PDP (Latest Data: 11.10.17)

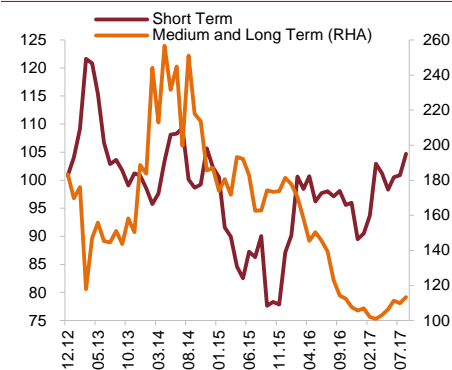
The maturity of banks' external debt is still long. The facts that external debts are sensitive to global liquidity developments and the tendency of banks to limit the risks arising from maturity mismatch make the maturity structure important as well as the amount and costs of foreign resources. With reserve requirement policies, the CBRT encourages banks to borrow from abroad with longer maturities. The transition from short to long-term has been going on for a while (Chart III.2.8). Recently, both short and long-term foreign debt roll-over ratios of banks have exceeded 100 percent (Chart III.2.9). As a result of the tendency of the banks to roll-over their short-term debt with long-term resources, the average weighted maturity of the sector's external debts has reached 59 months (Chart III.2.10). The longer maturities of banks' external debt imply that there is no significant change in the conditions of banks' access to external resources. The change in the maturities of banks' external debts in favor of longer terms positively contributes to the "Reserves/Short-Term Debt" ratio and supports financial stability. The extension in maturities will also contribute to banks' Net Stable Funding Ratio. Moreover, it should be noted that the positive developments in the funding composition increase the sector's potential to bolster medium and long-term infrastructure investments.¹ Favorable developments in the maturity and cost composition of non-deposit alternative funding sources will also have

Chart III.2.8
Change in Banks' Short Term and Medium-Long Term External Liabilities (Billion USD)



Source: CBRT, MKK (Latest Data: 09.17)

Chart III.2.9
External Debt Roll-Over Ratio (Percent)



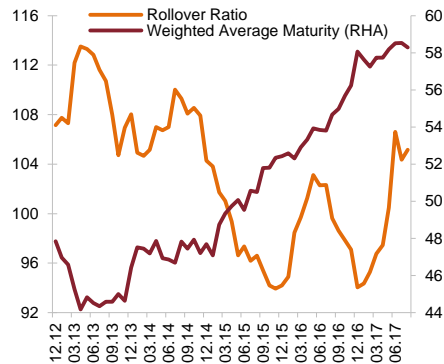
Note: Roll-over ratios are calculated based on 3-month and 12-month moving totals of banks' borrowings and repayments of total external liabilities including securities issued abroad for short term, and medium and long term, respectively.

Source: CBRT, MKK (Latest Data: 09.17)

¹ The special topic IV.3 titled "Central Bank Policies and Maturity Management in the Banking Sector" finds that the CBRT has encouraged banks to borrow longer-term foreign resources by using reserve requirement policies that aim at extending the maturity of non-core liabilities, and thereby contributed to banks' ability to offer longer-term loans to firms.

The maturity of banks' external debt is long.

Chart III.2.10
External Debt Roll-Over Ratio and its Average Maturity (Percent, Month)

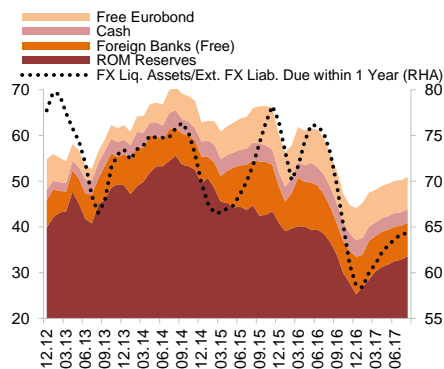


Note: The external debt roll-over ratio is calculated based on 6-month moving totals of banks' borrowings and repayments of total external liabilities including securities issued abroad.

Source: CBRT, MKK (Latest Data: 09.17)

Banking sector has sufficient liquidity buffers providing a one-year window for banks to hedge themselves against liquidity shocks.

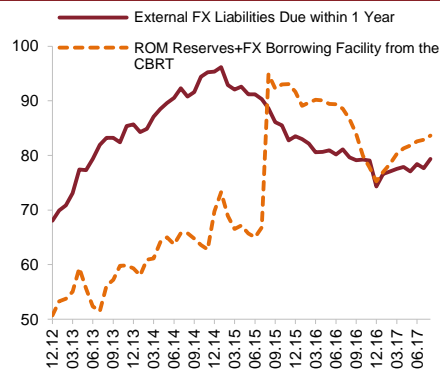
Chart III.2.11
FX Liquid Assets and FX External Liabilities Due Within 1 Year (Billion USD, Percent)



Note: Selected FX Liquid Assets: Cash+Foreign Banks (free) + free Eurobonds + Required Reserves held within the ROM facility. The dashed line represents 3-month moving average of the FX Liquid Assets / External FX Liabilities Due within 1 Year ratio.

Source: CBRT, MKK (Latest Data: 09.17)

Chart III.2.12
ROM Reserves + FX Borrowing Facility and External FX Liabilities Due Within 1 Year (Billion USD)



Source: CBRT, MKK (Latest Data: 09.17)

a downward effect on deposit rates that change depending on many factors.

The banking sector has sufficient liquidity buffers against negative risk scenarios. The fact that the LCRs, which allow banks to keep their 30-day windowed liquidity positions in the safe zone, are well above the legal lower limits and that the indicators representing the long-term liquidity position are in the safe zone increase the resilience of the sector against possible shocks in international markets. In addition, diversification in the number of countries/banks those provide funds and the change of maturity composition of foreign debt in favor of longer term support the resilience of sector.¹ Moreover, the liquid asset portfolio of the sector provides room for maneuver for banks to cover FX liquidity shocks even under the most negative scenarios within the one-year window. Developments in global markets continue to be important for domestic banks with respect to maturity, cost and limit components of external debt. The liquid asset portfolios of banks are composed of cash, free accounts at foreign banks, free Eurobonds and ROM reserves, which can cover 64 percent of foreign liabilities which will be due in one year (Chart III.2.11). Moreover, when the FX borrowing facilities allocated to the banks are included, the liquid assets of banks are at a level where they can respond to the most negative shocks (Chart III.2.12).

The revival in FX-denominated securities issued abroad by the banking sector continues. The sector's FX-denominated security issues abroad has increased by 14 percent since the beginning of 2017 on the back of increased risk appetite in the global markets and the monetary policies of advanced countries' central banks supporting liquidity conditions. The increase in bond issuances that are relatively sensitive to global liquidity developments is considered to be a positive factor in terms of banks' access to foreign resources. Meanwhile, as banks prefer long-term bond issues rather than short-term, the maturity of these bonds became 70 months limiting the risks that may arise from possible volatility in the international markets (Chart III.2.13). In this period, banks issued TL-denominated and long-term bonds abroad during the last Report period as well. The

¹ The special topic titled "Global Liquidity and Regional Distribution of Cross-Border Bank Loans" in the Financial Stability Report released in May 2017 analyses the effects of diversification in the number of countries/banks those provide funds on the sensitivity of external debts to global liquidity developments.

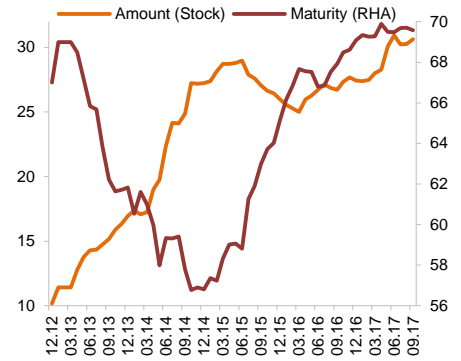
increase in the issuance of TL-denominated long-term bonds abroad is also an indicator of the fund flows to developing countries from international markets. The fact that banks can obtain TL-denominated and long-term borrowing from abroad also suggests that supply-side conditions are favorable.

Banks' domestic TL-denominated bond issuance has also accelerated. In this period, some banks issued subordinated bonds, resulting in an increase in the amount and average maturity of domestic bonds (Chart III.2.14). The maturity of the mentioned bonds is longer than the traditional issuances, thus they prolong the maturity of TL resources and increase the resource diversity of banks.

Thanks to the global liquidity developments, the recovery in banks' foreign bond issues continues.

Chart III.2.13

FX Issues Abroad
(Billion USD, Month)

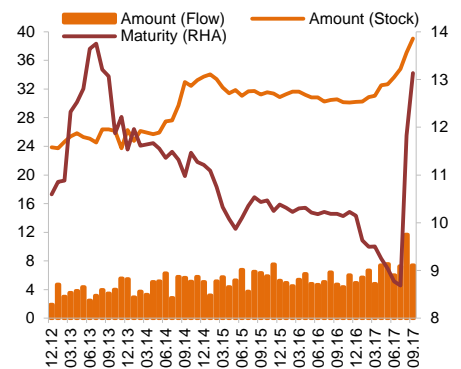


Source: MKK (Latest Data: 09.17)

Banks' domestic TL-denominated bond issues accelerated.

Chart III.2.14

Domestic TL Bond Issues
(Billion TL, Month)



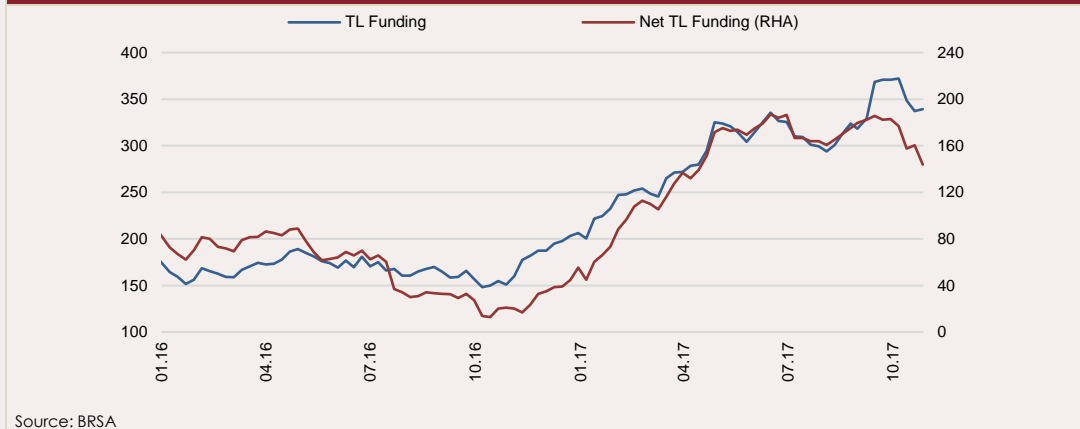
Source: MKK (Latest Data: 09.17)

Box
III.2.1

Swap Transactions

Total loan growth (FX-adjusted), standing at 10.5 percent at the end of 2016, reached 20 percent as of 27 October 2017, with the contribution of KGF-backed loans. Due to the significant improvement in TL loans within the KGF guarantee scheme, the TL funding need of the banking sector increased. However, in the same period, since the increase in TL deposits fell short of covering the TL funding need, banks substantially financed the KGF-backed loans by converting the FX funds to TL through swap transactions. As a result the increase in FX deposits since the end of 2016, banks have increased their TL swap transactions. Thus, banks' need for TL liquidity came to the fore in 2017 (with the effect of increased FX preference of depositors), and was met by foreign investors through the swap market (Chart III.2.1.1).

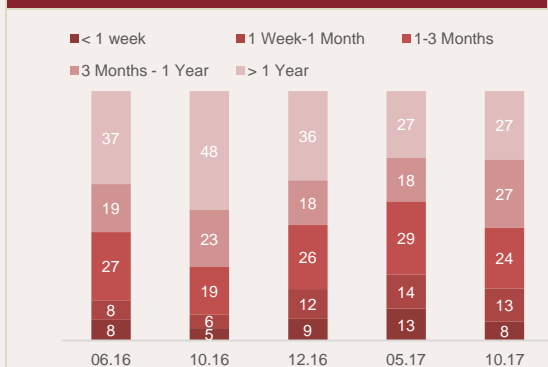
Chart III.2.1.1
Swap Transaction Amount
(Billion TL)



Source: BRSA

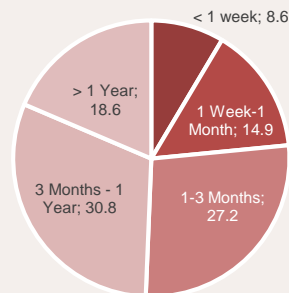
On the other hand, an analysis of the maturity of TL swap transactions during the last 1-year period shows that while the share of swap transactions with a maturity of more than 1 year has decreased, the share of transactions with a maturity of 1 to 3 months has surged by nearly 5 percentage points (Chart III.2.1.2). When the flow TL swap transactions carried out in the October 2016 - October 2017 period are taken into consideration, it is revealed that about 51 percent of the transactions were concentrated in maturities of less than 3 months (Chart III.2.1.3).

Chart III.2.1.2
TL Swap Maturity Tranches
(Outstanding, Percentage Share)



Source: BRSA

Chart III.2.1.3
TL Swap Maturity Tranches
(Flow, Percentage Share)



Latest Data: 27.10.2017
Source: BRSA

The shortening in the maturity of swap transactions is more visible when swap transactions are reviewed based on remaining maturity. As of 27 October 2017, approximately 85 percent of net TL swap transactions will be due in the coming 3 months. The weighted average remaining maturities of TL, FX and net TL swap transactions are 7 months, 9 months and 6 months, respectively (Table III.2.I.1).

Table III.2.I.1
Swap Transactions According to Remaining Maturities
(As of 27.10.2017, Billion TL)

	TL Funding	FX Funding	Net TL Funding	Weighted Ave. Maturity (Months)
Nov 17- Jan 18	233	115	118	1
Feb-Apr 18	33	22	11	4
May-July 18	10	13	-3	8
Aug-Oct 18	10	16	-6	11
After Oct 18	53	29	24	35
TOTAL	339	196	144	6

Source: BRSA

An analysis of the interest rates of TL swap transactions reveals that the interest rates of short and long-term swap transactions do not significantly differ. Thus, it is considered that the reason for the decrease in swap maturities cannot be explained only by the interest cost advantage. In addition, the counterparty credit risk and credit valuation adjustment¹ (CVA) capital charges for swap transactions increase as the maturity lengthens, causing foreign banks to demand additional CVA premium from Turkish banks.² In this context, it seems that the banks' preferences based on costs criteria other than swap interest rates can have an impact on the shortening of TL swap maturities. Furthermore, when swap transactions are made in long maturities, banks may be exposed to repricing risk in the case of a decrease in TL swap rates. It is considered that the repricing risk concern can also be a possible reason for banks to prefer short maturities in swap transactions.

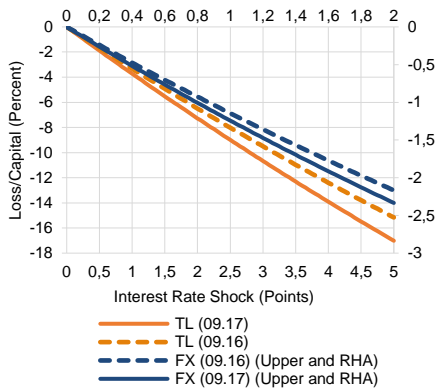
In the upcoming period, with loan growth returning to its historical average, it is expected that banks will reduce their funding transactions in the swap market and maturities of TL swaps will lengthen slightly.

¹ Basel III imposes an obligation of capital charge for credit valuation adjustment (CVA). CVA is an adjustment to the fair value (or price) of derivative instruments to account for counterparty credit risk. The CVA capital charge can be calculated by using either the advanced method or the standard method. For instance, as the credit rating of the counterparty gets lower, the risk weight for this counterparty will be higher in the standard method. The capital charge for CVA will be higher in case of an extension in the transaction's maturity or the deterioration in the counterparty's credit rating.

² As a result of the downgrades of Turkey's credit rating to non-investment grade in September 2016 (Moody's) and January 2017 (Fitch), the CVA premium for long term swap transactions by domestic banks increased considerably.

The interest rate sensitivity of the sector via the repricing channel slightly increased over the last one year.

Chart III.3.1
Interest Rate Risk via Repricing Channel Measured with Economic Value Approach

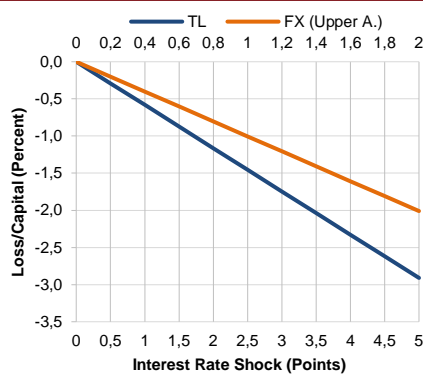


Note: In the economic value approach, the change in the present values of all assets and liabilities is referenced

Source: CBRT, Authors' estimations (Latest Data: 09.17)

The direct impact on capital via securities revaluation channel is limited.

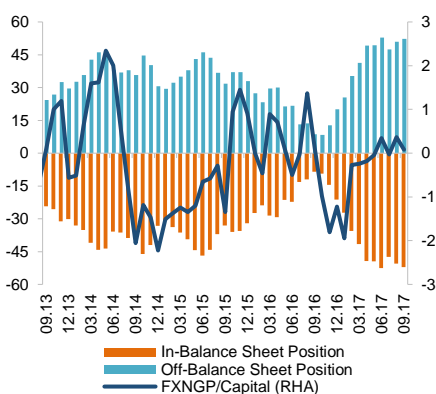
Chart III.3.2
Interest Rate Risk on Securities with Fixed Interest Rate in Trading Portfolio



Source: CBRT, Bloomberg, Authors' estimations (Latest Data: 09.17)

FXNOP is close to zero.

Chart III.3.3
FX Position in the Banking Sector (Billion USD, Percent)



Source: CBRT (Latest Data: 09.17)

III.3 Interest Rate and Exchange Rate Risk

The banking sector's in-balance sheet and off-balance sheet assets-liabilities positions in TL and FX of all maturities has limited sensitivity to interest rate risk via the repricing channel. These positions have been tested against positive interest rate shocks with magnitudes of 5 points and 2 points for TL and FX sides, respectively. The potential loss has been estimated with the economic value approach and its proportion to capital has been inspected. Accordingly, the likely loss that would arise from an interest rate shock in TL up to 5 points in the current values of interest rate-sensitive positions of banks is calculated as 17 percent of capital. On the other hand, the maturity mismatch between assets and liabilities in FX side is more limited and the associated loss with an interest rate hike up to 2 points in FX would be up to 2.3 points of capital. Nevertheless, the interest rate sensitivity of the sector via the repricing channel has slightly increased over the last one year (Chart III.3.1).

An analysis of the increase in interest rate risk sensitivity by breakdowns across all maturities reveals that the growing maturity mismatch in TL positions stemmed from extension of the maturities of assets. This lengthening was mostly driven by not only from the extension of maturities of fixed-rate installment loans but also from increasing weights of these loans on the balance sheet. Meanwhile, the effect on FX positions stemmed both from the extension of maturities of assets and from contraction in maturities of liabilities. The extension in maturities of both fixed-rate and floating rate loans is the leading cause of the changes on the asset side, whereas contraction in maturities of derivative (currency swap) positions was significant in changes on the liabilities side.

In addition to repricing, another channel through which the financial intermediation system may be affected by exogenous interest rate shocks is the revaluation channel in securities. To measure the extent of this channel, the fixed-rate securities in available-for-sale portfolio tested against positive interest rate shocks with magnitudes of 5 points and 2 points, for TL and FX respectively. **Accordingly, the potential loss that interest rate hikes may exert directly on capital via securities revaluation channel is up to 3 percent of capital for TL**

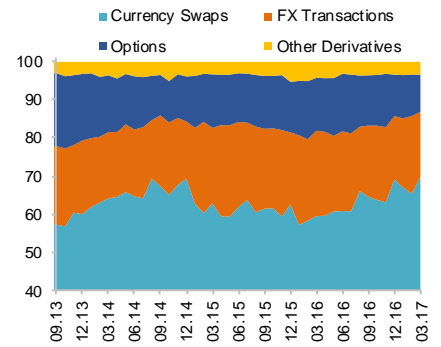
securities and up to 2 percent for FX securities. This likely impact has not changed compared to the last Report period (Chart III.3.2).

The Turkish banking sector preserves its resilience against exchange rate risk directly via the balance sheet channel. Over the last year, although the in-balance-sheet open FX position significantly increased, banks prudently hedged their open positions with off-balance sheet transactions. Accordingly, the FX net open position (FXNGP/capital ratio) keeps its position well below the two-way standard legal cap of 20 percent and is close to zero level (Chart III.3.3).

Currency swap transactions continue to be used as primary tools in FX risk management, whereas the utilization of FX-options instruments is shrinking. While the growth in volumes of currency swaps supports the hedging of FX risk, it increases sensitivity to interest rate risk and generates a potential pressure on profitability. (Chart III.3.4).

Currency swap transactions are primary tools in management of FX positions.

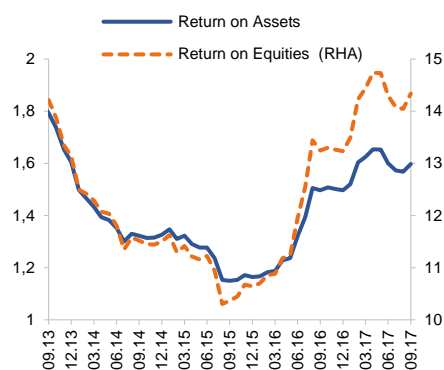
Chart III.3.4
Shares of Gross Positions of Off-Balance Sheet FX Transactions (Percent)



Source: CBRT (Latest Data: 09.17)

Profitability Indicators showed a limited decline.

Chart III.4.1
Return on Assets and Return on Equities
(Percent)

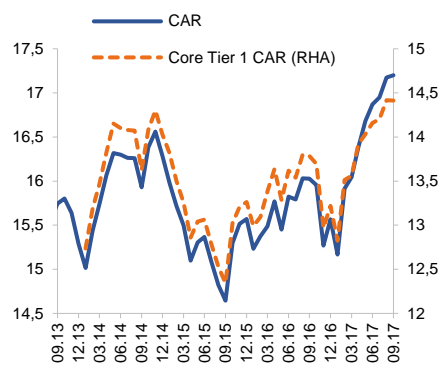


Note: Profitability ratios are calculated by dividing the annual cumulative profit by one year's average denominator.

Source: CBRT (Latest Data: 09.17)

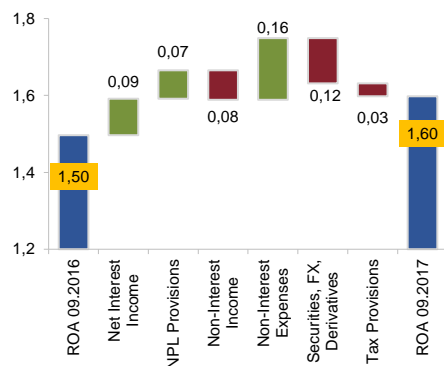
Capital adequacy continues to strengthen

Chart III.4.2
CAR and Core Tier 1 CAR
(Percent)



Source: CBRT (Latest Data: 09.17)

Chart III.4.3
Effects of Income Statement Items on ROA
(Points)



Note: Red bars indicate reducing effect, green bars indicate increasing effect

Source: CBRT (Latest Data: 09.17)

III.4 Profitability and Capital Adequacy

The banking sector's profitability indicators, which have an upward trend since the last quarter of 2015, remain robust, with a limited decline after the second quarter of 2017. That decline was mainly driven by the obsolescence of one-time income entries in 2016 and the increase in need for currency swap transactions to meet the TL loan demand (Chart III.4.1). The profit generation power of the industry has exceeded the credit risk growth due to effect of CGF guarantees in near-term loan expansion and relative stabilization in exchange rate. This, in return, has led to a significant increase in capital adequacy ratios (Chart III.4.2).

III.4.1 Profitability

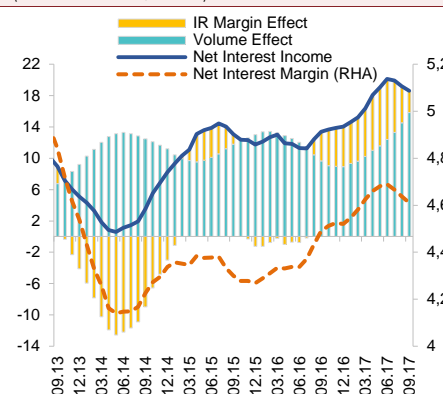
An analysis of the factors affecting return on assets (ROA) by income statement items over the last year reveals that the increase in net interest income, the improvement in the asset quality, and the relative decrease in the non-interest expenses all positively affected profit. At the same time, the one-time entries in the non-interest income recorded in 2016 that faded in 2017 and the expenditures on derivative positions due to increasing currency swap transaction needs had a negative impact (Chart III.4.3).

Over the last 12 months, the impact of net interest income on ROA was around 9 basis points. However, interest margins started to expand as of the third quarter of 2016 and the strong contribution to this item started to be re-balanced due to the rise in the funding costs of banks. Nevertheless, the impact from the volume channel driven by loan growth stemming from the easing in financial conditions, thanks to CGF support, has been gradually increasing and helped the positive outlook in net interest income to continue (Chart III.4.4). Considering the effects of domestic economic developments and the Fed's balance sheet reduction program on emerging economies, the outlook for interest margins is likely to remain limited for a while, as funding costs of the sector will remain high in the upcoming period.

The decline in NPL rates, caused by the rapid growth in loans, influenced profitability positively by around 7 basis points in the past one year. However, banks, preserving their prudential positions, showed a tendency to increase NPL provision rates, which in turn limited this contribution. Meanwhile, the downward trend seen for about a year in the ratio of closely-monitored loans signals that the positive effect is likely to continue in the upcoming periods. It is believed that the continuing limited performance in NPL collection rates, apart from periodic effects and independent of other indicators, may be a reflection of the change in banks' business models for NPL collection (Chart III.4.5). Because banks increasingly transfer their NPL portfolios to asset management companies, which specialize in collections, the role of these companies in the financial sector becomes stronger accordingly.

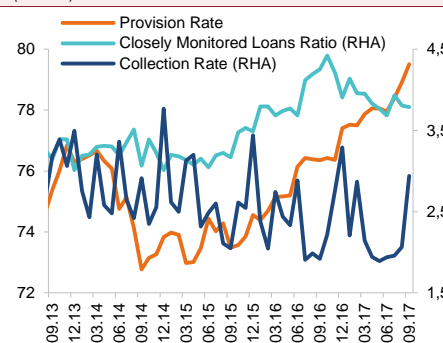
The other non-interest income/expenses item, in which banks record their position in securities trading, derivatives and foreign exchange transactions, has had negative impact on profitability since the last Report period. The underlying reason was the increase in the utilization of FX resources in TL funding by currency swaps due to faster growth of TL-denominated loan demand than TL-denominated resource growth and weak demand for FX-denominated loans. Moreover, the rise in currency swap interest rates aggravates this effect (Chart III.4.6). Meanwhile, the convergence of the net income from securities trading to neutral level led to the disappearance of the positive effect that came from this item previously. Non-interest income reduced profitability by 8 basis points with the loss of the contribution of one-time entries in 2016 on an annual basis¹. On the other hand, despite the increase in the general provisions on the back of credit growth, the positive impact of non-interest expenses on profitability continued thanks to the sector's efforts to reduce operational costs. The regulations raising the corporate tax rate from 20% to 22% in the financial sector in the upcoming period will have a downward impact of 4 basis points on return on assets and 36 basis points on return on equities, based on the current levels.

Chart III.4.4
Contribution to Changes in the Net Interest Income
(Annualized Billion TL, Percent)



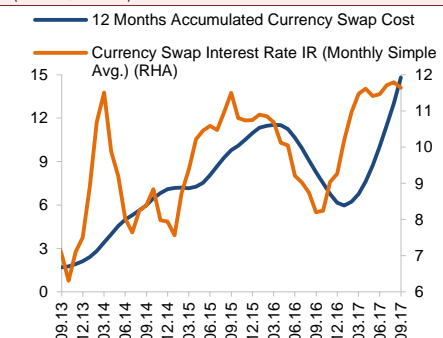
Source: CBRT (Latest Data: 09.17)

Chart III.4.5
Additional NPL Indicators
(Percent)



Source: CBRT (Latest Data: 09.17)

Chart III.4.6
Currency Swap Transaction Costs and Interest Rates
(Billion TL, Percent)



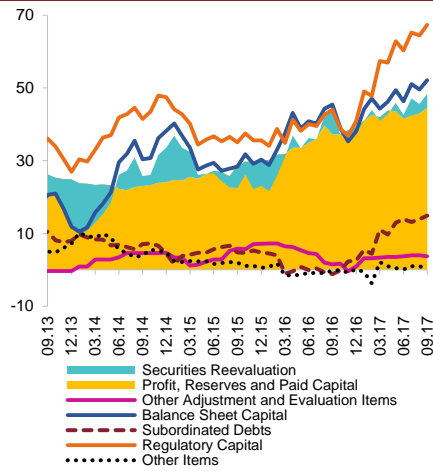
Note: The monthly simple average of 3-Months USD-TL currency swap interest rates is used as a reference and the cost is estimated with monthly average net TL-FX currency swap positions and monthly average USD rate.

Source: CBRT, Bloomberg, Authors' estimations (Latest Data: 09.17)

¹ The payment made to Turkish banks due to the transfer of Visa Europe Ltd. to Visa Inc.

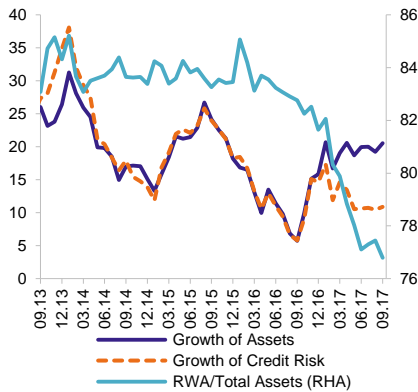
III.4.2 Capital Adequacy

Chart III.4.7
Changes in Items Affecting Capital
(Annualized Billion TL)



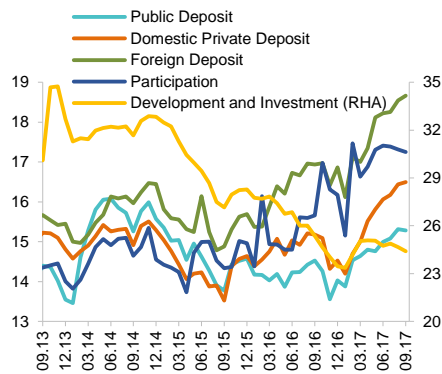
Source: CBRT (Latest Data: 09.17)

Chart III.4.8
Risk and Assets Developments
(Percent)



Source: CBRT (Latest Data: 09.17)

Chart III.4.9
CARs According to Bank Types
(Percent)



Source: CBRT (Latest Data: 09.17)

Over the last year, legal capital has been positively affected by escalating profitability and increasing subordinated debt issues.

The subordinated debt accumulation in the sector has accelerated especially after the first quarter of 2017. In addition to the new acquisitions, some banks substituted their existing subordinated debts with new issues compliant with Basel III and strengthened their supplementary capital (Chart III.4.7). As a result, the increase in the standard CAR surpassed the increase in the core CAR (Chart III.4.2).

Although there is no significant change in the composition of the risk weighted assets, the growth in the total credit risk has slowed down due to the decrease in risk weight of some assets and receivables in terms of FX after the regulations made by the BRSA and loans granted under CGF guarantee (Chart III.4.8).

The sector's capital adequacy ratios continued their upward trend on the back of profitability growth and subordinated debt acquisitions. Driven by these factors, the sector's capital adequacy continued to strengthen in all banking groups in 2017 (Chart III.4.9). In the upcoming period, it is expected that the change in corporate tax rates in the financial sector will have a limited downward effect, of around 5 basis points, on the standard CAR. Given the current levels of profitability and capital adequacy, capital adequacy does not constitute a constraint in the short- or medium-term to support of the loan growth in the banking system.

Developments leading to temporary effects on income-expenditure items, regardless of the banks' performance in the current year, can affect the profitability of the period. As these effects are usually transitional or can change rapidly due to regulatory changes, analyzing profitability performance of banks becomes difficult. This study provides a decomposition of items that have a temporary effect on profitability performance analysis. This allows a more meaningful analysis of the profitability performances of banks arising solely from banking activities in the related period.

Net income from the sales of assets as well as fees and commission rebates has effects on profitability that do not depend on the performance of the banking system. In addition, banks can set general and specific provisions above the minimum rates. Provisions of banks over the minimum rates may cause banks to show a profit performance different from what it actually is. Moreover, regulations regarding general provisions may also have an impact on bank profitability. The Banking Regulation and Supervision Agency (BRSA) sets minimum ratios for general provisions and the banks allocate provisions according to these ratios. Raising or decreasing general provisions or rapid credit growth can lead to significant fluctuations in period profits.

The Sale of Assets

Banks' income from sale of assets¹ is not a continuous flow. In some periods, fluctuations are observed in this item due to the high volume of sales. For example, the acquisition of Visa Europe by Visa Inc. was completed in June 2016. Banks generated one-off income in June 2016 as a result of the revaluation of existing shares. The sale of Visa affected the profitability of banks with shares in Visa Europe positively.

Fees and Commission Rebates

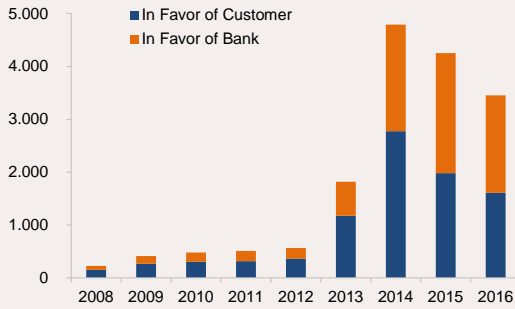
Fees and commission rebates may negatively affect the profitability performance of banks in a particular period. Financial consumers have the right to apply to consumer arbitration committees established in provinces and districts as well as to consumer courts for the fees and commission rebates. Applications made to the consumer arbitration committee are generally concluded in favor of the consumers. Although the number of such applications has been falling, it has been rising in the last 4 years and a significant part of these applications resulted in the customer's favor (Chart III.4.1.1).

Fee and commission rebates are recorded in the "adjustment for the past years income" account, which is a sub-account of other non-interest expenses in the income statement. This account rapidly increased between 2014 and 2016. This rise is mostly attributed to the decisions made by arbitration committees and courts in favor of the consumers. Since the other transactions recorded in the "adjustment for the past years income" account, where fees and commission rebates are included, cannot be broken down into components, it has been assumed that the entire amount included in this account originated from fees and commission rebates. The amount of "adjustment for the past years income", which was 245 million TL at the end of 2013, reached 1.2 billion TL by the end of 2014 and 2.4 billion TL by the end of 2015. The fee and commission rebates started to decrease after 2015 and came down to 400 million TL in September 2017 (Chart III.4.1.2).

¹ It is calculated by subtracting costs acquired by the sale of assets from the revenues acquired by sale of the assets.

Chart III.4.1.1

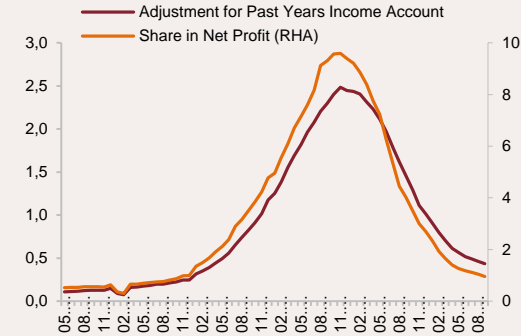
The Results of Applications to BAT Customer Complaints Arbitration Committees (Number)



Source: BAT

Chart III.4.1.2

Adjustment for Past Years Income Account (Annualized, Billion TL, Percent)



Source: BRSA (Last Observation: September 2017)

The "Regulation on Procedures and Principles Regarding the Fees to be Obtained from Financial Consumers", which took effect in October 2014, describes the scope of banks' fees and commission income. With this regulation, the items from which banks can earn fee and commission income have been limited while these limited items have been given legal status. Fee and commission rebates significantly declined in 2016 and 2017 with the effect of this regulation.

General Provisions

General provisions are expense items that are effective on the period profit but not directly related to the performance of the banking system in the related period. Regulatory authorities require banks to allocate general provisions when they extend loans in order to reflect the future possible losses of the loans to the financial statements today. The loans continue to contribute to the profitability of the bank as long as they are performing. General provisions are set aside when the loan is extended and are canceled when the loan is closed, thus they reduce the profitability of the banks during this period. General provision expenses rise in periods of rapid credit growth due to the volume effect. Meanwhile, regulatory amendments pertaining to general provisions can significantly affect the size of these provisions and their impact on profitability.

With the legal amendments made in 2011 and 2013, the general provision rates for consumer loans except vehicle and housing loans were increased by four times under certain conditions¹. The amendment stated that the increased amounts in general provisions resulting from this regulatory change could be gradually reflected in the 2013, 2014 and 2015 financial statements.

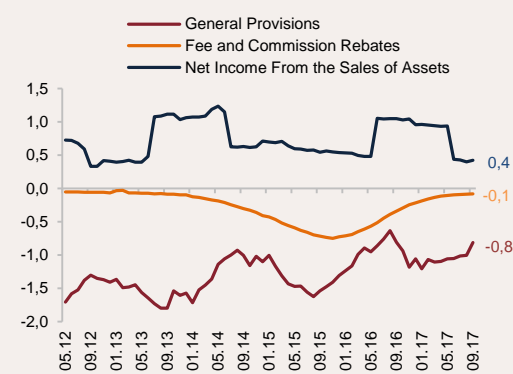
In October 2013, the exemptions provided for vehicle loans were removed and these loans were also subject to the incremental general allowance scheme with the same conditions. The sum of annualized general provision expenses of banks reached 5.3 billion TL in August 2015 on the back of the amendments made in the legislation. After the incremental phase ended in 2015, this amount declined to 2.7 billion TL in August 2016. Although the regulation raising the general provision ratios by four times was abolished in September 2016, the general provision amount rose to Turkish lira 3.9 billion on an annualized basis in September 2017 owing to the rapid credit growth in 2017.

¹ Banks with a ratio of consumer loans to total loans above 25 percent, and banks with a ratio of non-performing consumer loans other than vehicle and housing loans to performing consumer loans other than vehicle and housing loans above 8 percent, allocate 4 percent general provision for standard loans except vehicle and housing loans, and 8 percent general provision for consumer loans under close monitoring except vehicle loans and housing loans.

Decomposing Items with Temporary Effects on Return on Equity of the Banking Sector

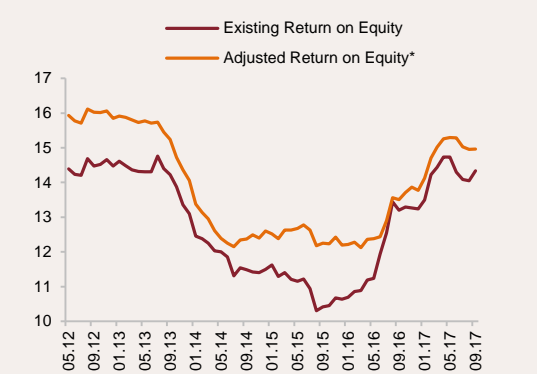
Banks' return on equity was 14.3 percent in September 2017. Net income from the sale of assets made a positive contribution of 0.4 percentage points to the return on equity (Chart III.4.1.3). The biggest impact of fee and commission rebates on profitability was observed in 2015. Fees and commission rebates reduced the return on equity by 0.7 points in August 2015, and the impact fell to 0.1 points in September 2017. General provisions made the highest impact on profitability in 2015 as well. While general provision expenses reduced return on equity by 1.6 percentage points in August 2015, -when the return on equity was at its lowest level,- this effect came down to 0.8 percentage points in September 2017.

Graph III.4.1.3
The Impact of Selected Items on Return on Equity of the Banking Sector (Percent)



Source: BRSA (Last Observation: September 2017)

Graph III.4.1.4
Existing Return on Equity and Return on Equity Adjusted for Temporary Effects (Percent)



Source: BRSA
* Adjusted return on equity refers to return on equity adjusted for temporary effects.

To conclude, these three items had a downward impact on return on equity by 0.6 points in total in September 2017. This effect was 1.9 percentage points in August 2015. It can be asserted that when the temporary effects are decomposed, return on equity of the banking sector in 2015 was not significantly different than other years. The recovery in profitability performance observed particularly in the third quarter of 2016 is sustained when adjusted for temporary effects.