

IV. Financial Sector

In the current Report period, consumer loans accelerated while TL corporate loans posted a mild recovery and the loan growth initiated by state banks spread across the sector. The improvement in banks' liquidity conditions and their strong capital structure, the decline in the risk perception and uncertainties, the improvement in expectations, the fall in loan rates, and the recovery in economic activity played an important role in the pickup of TL loans that has become apparent since September. Moreover, the link established between loan growth and reserve requirement implementation has encouraged a sector-wide TL loan growth. On the other hand, FX loan growth contracted due to the amendments made in May 2018 to the Decree No. 32 Regarding the Protection of the Value of Turkish Currency, the reduced investment demand, and the enhanced awareness of FX risk management. The robust liquidity and capital structures of the sector remain supportive of loan growth in the upcoming period.

NPL ratios continued to increase on the back of corporate loans, due to the lagged effect of the rebalancing process in economic activity on firms' balance sheets and to the decelerating loan growth. The current capital structure of the banking sector is assessed to be strong enough to manage asset quality-driven risks. The recent rise in the CAR was primarily driven by the limited loan growth and banks' strengthened capital structures. Although the classification of certain loans as NPLs in line with the Banking Regulation and Supervision Agency's (BRSA) statement on 17 September 2019 may lead to a slight decline in the CAR, it is projected that the banking sector will maintain its robust capital structure. It is assessed that the rise in the NPL ratio will decelerate and the asset quality will not register a significant deterioration as the recovery in economic activity becomes more apparent, the improvement in financial conditions continues, and the loan growth remains on the uptrend in the upcoming period.

The decrease in the external debt rollover ratio continued due to favorable FX liquidity indicators and the declining need for financing of the banking sector. The decrease in the external debt balance is a positive development in terms of banks' short-term debt repayment capacities, as well. Banks are assessed to have adequate amount of liquidity to cover the invigorated demand for loans driven by strengthened depositor preference for the TL due to the improvement in inflation expectations and the decline in perceptions of uncertainty. Moreover, following the TL loan-driven recovery trend in loan growth and the falling interest rates in the recent period, there has been an increase in banks' borrowing from domestic markets resulting in a rise of domestic fundings. Recently, the increase in TLREF-indexed bond issues in the domestic securities market has been contributing to financial deepening.

In the current Report period, there has been a decline in profitability indicators driven by special provisions. Compared to the same period of the last year, while the interest rate risk that the TL-denominated on-balance sheet and off-balance sheet assets and liabilities of the sector face via the repricing channel decreased, there was a moderate increase on the FX side. In the upcoming period, the recovery in economic activity and the revival of loan growth are expected to affect the profitability indicators of the sector favorably.

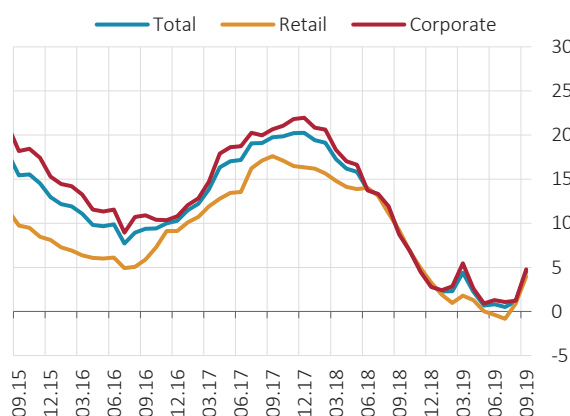
IV.1 Credit Developments and Credit Risk

After having fallen since mid-2018 due to tight financial conditions, the macroeconomic outlook and base effects, credit growth rates picked up in the current Report period. Prior to September 2019, the impact of the cautious stance of private banks on credit stock was offset by public banks' proactive behavior and pricing in the credit market. In fact, as of mid-August 2019, the annual TL credit expansion of public banks reached 14.3% while the credit stock of private banks shrank by 5.1%. Hence, public banks helped to soften both the credit market downturn and the economic rebalancing.

The upswing in the credit market can be attributed to the decline in loan rates after June 2019, the easing in financial conditions, improved liquidity conditions of banks driven by rising TL deposits, and public incentives. In addition, the positive effects of subdued perceived risks, decreased uncertainties and improved expectations on credit supply and credit demand played a key role in credit dynamics in this period. Thus, the exchange rate-adjusted total annual loan growth amounted to 4.5% in September 2019. The recovery of growth rates is evident in both corporate loans and retail loans (Chart IV.1.1). Annual growth rates of retail and corporate loans adjusted for total exchange rate are 3.9% and 4.7%, respectively.

Exchange rate developments in 2018 drove the TL equivalents of FX loans higher, causing the domestic loans to GDP ratio to increase above historical averages. This ratio went down in the following period amid more stable exchange rates, to 60% as of September (Chart IV.1.2). With the base effect disappearing and loans recovering, the annual change in the loans to GDP ratio picked up in September. Credit gap indicators suggest that the loan/GDP ratio remained below its long-term trend implied by economic activity in 2019 (Special Topic V.1).

Chart IV.1.1: Annual Loan Growth (BTS, %)

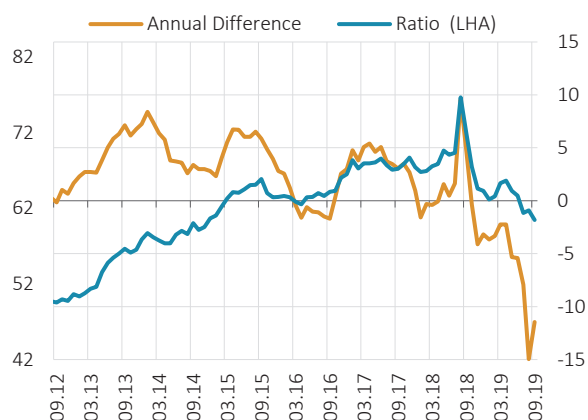


Source: CBRT

Last Observation: 09.19

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

Chart IV.1.2: Loan/GDP Ratio (%)



Sources: CBRT, TURKSTAT

Last Observation: 09.19

Note: The ratio takes the monthly stock of credit over the sum of GDP provided by the Turkish banking sector over the past 12 months.

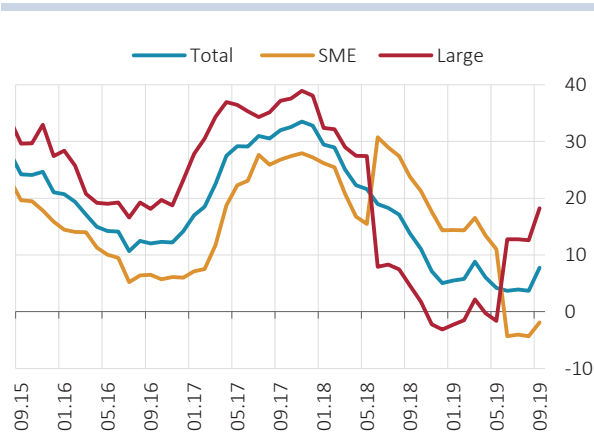
The step taken by the CBRT to use the RR policy within a countercyclical macroprudential framework and in a flexible way seems to have had a positive effect on credit growth. The RR regulation announced on 19 August 2019 prescribes a lower RR ratio and a higher remuneration rate to apply to banks with a TL cash loan growth within the reference range of 10% to 20%. Compared to the previous Report period, loan growth improved across a wider range of banks while the number of banks with a positive loan growth increased. The increase in TL-denominated loans played an important role in this improvement.

Loan growth will remain on the upside over the upcoming period thanks to the recovery in investment and consumption demand, the materialization of the deferred credit demand amid falling interest rates, the strong capital structure of the banking sector, and favorable liquidity conditions.

IV.1.1 Corporate Loans

After having been stable since the first quarter of the year, the annual growth rate of corporate loans has risen moderately recently (Chart IV.1.3). TL-denominated corporate loans increased by 7.8%. Despite an ongoing base effect from the definition change made in June 2018 in scale-based loan balances, this increase was recorded across all firm sizes. The annual growth rate of TL loans used by large firms reached 18% as of September. Loan growth was weaker across SMEs due to a worsening asset quality caused by past shocks. The rising loan demand of firms since the previous Report period is mostly attributable to the need for working capital and the paying off or restructuring of existing debts, with investment-related demand showing no sign of strong recovery yet.

Chart IV.1.3: Annual Growth of TL Corporate Loans by Firm Size (%)

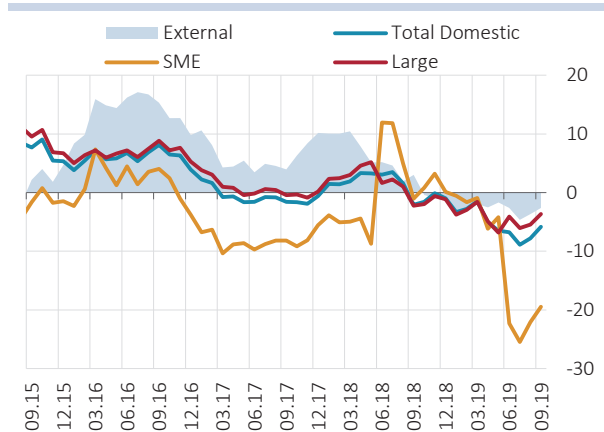


Source: CBRT

Last Observation: 09.19

Note: FX-indexed TL loans are excluded from calculations. The new SME definitions were announced on the Official Gazette of 24 June 2018, and influenced the decline in July.

Chart IV.1.4: Annual Growth of FX Corporate Loans by Firm Size (Currency Basket, %)



Source: CBRT

Last Observation: 09.19

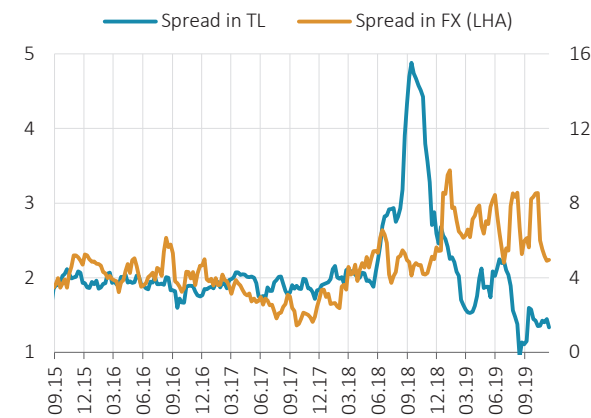
Note: FX-indexed TL loans are included in calculations. The new SME definitions were announced on the Official Gazette of 24 June 2018, and influenced the decline in July.

In the current Report period, the dynamics of corporate loans were also reinforced by selective loan policies that help the real sector access funding at more favorable conditions. The IVME Finance Package initiated in the second quarter of the year aims to support the sectors that provide a high contribution to employment and have high export potential. Available only through public banks, this package granted firms that operate in the fields of raw materials/intermediate goods and machinery production an investment loan of no more than TRY 150 million with a maximum term to maturity of ten years and a principal repayment deferred for up to two years and a business loan of no more than TRY 30 million with a maximum term to maturity of five years and a principal repayment deferred for up to one year. Similarly, firms in the agricultural sector, especially its sub-sectors, were provided with longer maturities and interest rate subsidies to finance operating expenses and investments. The Economic Value Loan package, which was recently launched to reduce the financing costs of businesses, particularly SMEs, aims to provide businesses with inflation-indexed variable-rate loans amounting to TRY 25 billion including a Treasury-backed guarantee of TRY 20 billion. Loans extended in this category were largely intended for working capital.

Having FX income set as a prerequisite to obtain FX loans as per the amended Decree No 32 of the Protection of the Value of the Turkish Currency in May 2018, the termination of FX-indexed TL loans, the increased awareness of foreign exchange risk management, market volatility, and weak investment appetite all played a role in the downward trend in FX loan growth. This trend continued into the current period, with domestic FX loans contracting by 5.8% as of the latest observation (Chart IV.1.4). Across firm scales, FX loan growth continued to shrink moderately in large-scale firms, while the new SME definitions of June 2018 and the weakening investment outlook brought SME FX loans significantly down. Likewise, foreign-sourced FX loans of firms remained on the decline.

Having elevated to high levels in September 2018 amid market fluctuations, the TL loan and deposit rate spread converged to its historical averages in the following period. This spread has fallen below its recent average thanks to monetary policy actions, improved liquidity and financial conditions and the anchoring of expectations (Chart IV.1.5). On the FX side, interest rate spreads were relatively volatile and high in line with the risk premium, funding conditions and volume effects.

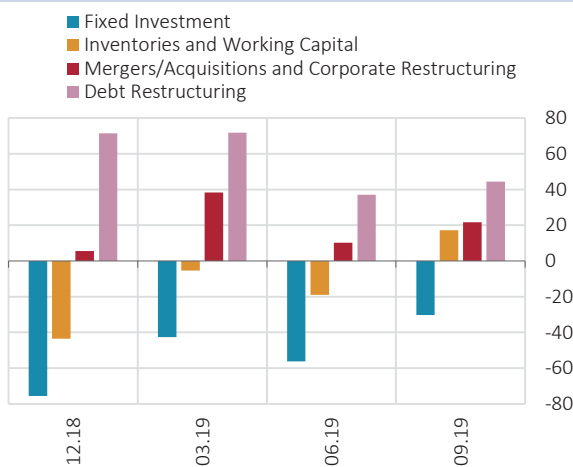
Chart IV.1.5: Credit-Deposit Interest Rate Spreads (4-Week MA, %)



Source: CBRT
 Last Observation: 15.11.19
 Note: Interest rate spreads are the differences between TL and FX corporate loan rates and corresponding deposit rates.

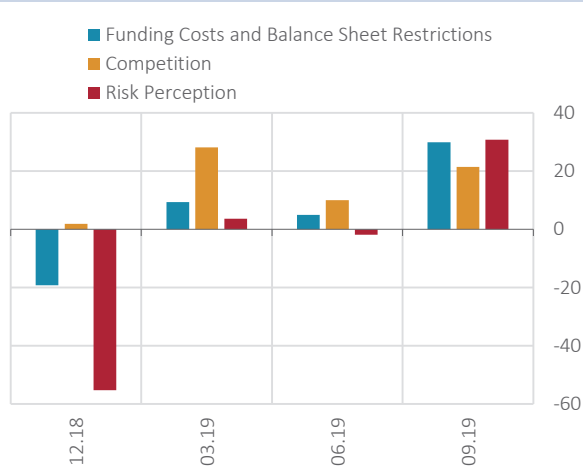
According to the third quarter's BLTS results regarding factors affecting loan demand since early 2019, the demand for fixed investment loans followed a negative trend in line with the reduced gross fixed capital formation in the first two quarters, and the loan demand for restructuring remained a determining factor (Chart IV.1.6). In the third quarter, loan demand remained weak for fixed investments. In this period, inventory buildup and working capital needs were influenced by the recovering domestic demand. In line with the results of the survey, there was no recovery in FX loans, those used for investment purposes in particular, in the third quarter, while among TL loans, business loans saw a widespread rebound based on both maturities and firm scales.

Chart IV.1.6: Factors Contributing to Corporate Loan Demand-Financing Needs (Net % Change)



Source: CBRT
 Last Observation: 09.19
 Note: The quarterly survey asks banks to compare the current quarter to the previous. Zero is the neutral state indicating no change.

Chart IV.1.7: Factors Contributing to Corporate Loan Supply (Net % Change)



Source: CBRT
 Last Observation: 09.19
 Note: The quarterly survey asks banks to compare the current quarter to the previous. Zero is the neutral state indicating no change. Series displayed in the chart are the arithmetic average of related subcategories in the BLTS.

In terms of loan supply, BLTS results point to an easing in business lending standards for the third quarter, especially in TL and short-term loans. According to banks, the third-quarter recovery in the outlook for sectors and firms and in expectations for overall economic activity played an important role in the easing of lending standards. Improvements in funding costs, balance sheet constraints and risk sentiment contribute to the easing in loan supply conditions (Chart IV.1.7).

The relatively low levels of real credit costs as well as the ongoing moderate recovery in economic activity, buoyant corporate profitability and low leverage ratios over the upcoming period are expected to stimulate corporate loan demand, particularly for investment loans.

IV.1.2 Retail Loans

In the first two quarters of the year, retail loan growth was dampened by the weak consumption demand, labor market developments, the consumer inflation outlook and high credit costs. However, improved financial conditions and the economic recovery as well as the significantly lower loan rates led to an acceleration in retail loan growth in the third quarter (Chart IV.1.8). Lower interest rates are assessed to have provided an additional boost through the deferred retail loan demand.

Chart IV.1.8: Annual Growth Rates of Retail Loans (%)

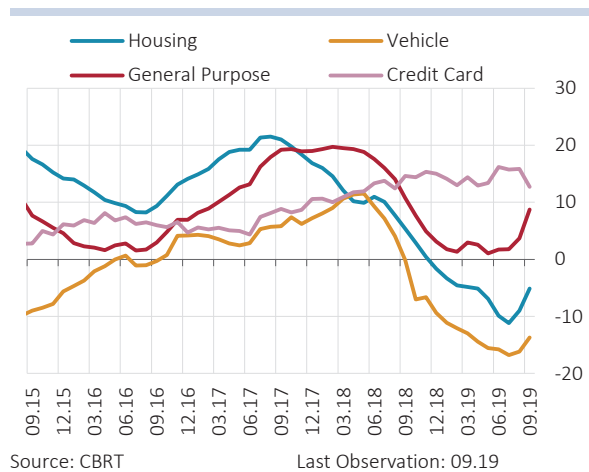
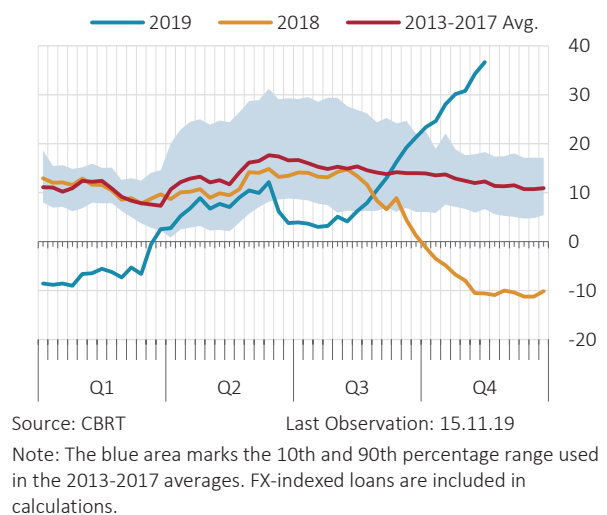


Chart IV.1.9: Retail Loan Growth (13-Week MA, Annualized %)



Across loan types, annual growth rates were higher in general purpose loans and credit card balances but lower in housing and vehicle loans despite some recovery. Calculations based on weekly stock values indicate that the tendency to use retail loans has significantly exceeded last year's and historical averages (Chart IV.1.9). Interest rates, one of the most important factors fueling retail loan growth recently, declined to reflect the CBRT's policy rate cuts (Chart IV.1.10). With interest rates falling across all loan types, retail loan rates returned to levels before the financial volatility in 2018.

The BRSA regulation that extended the maximum maturity of general purpose loans from 36 months to 60 months provided a boost to these loans in the first quarter of the year (Chart IV.1.11). In the third quarter of 2019, loan growth exceeded historical averages in this category and became the main driver of the recent acceleration in retail loan growth. As of October, the annualized 13-week moving average of the weekly growth in general purpose loans is above 50%. This growth can be attributed to the deferred loan demand that falling interest rates brought forward.

Chart IV.1.10: Retail Loan Rates (4-Week MA, %)

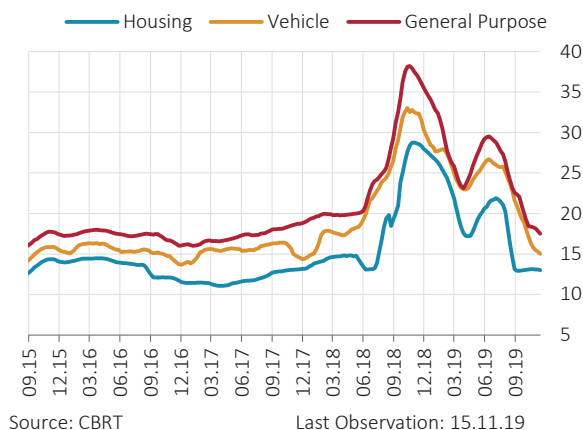
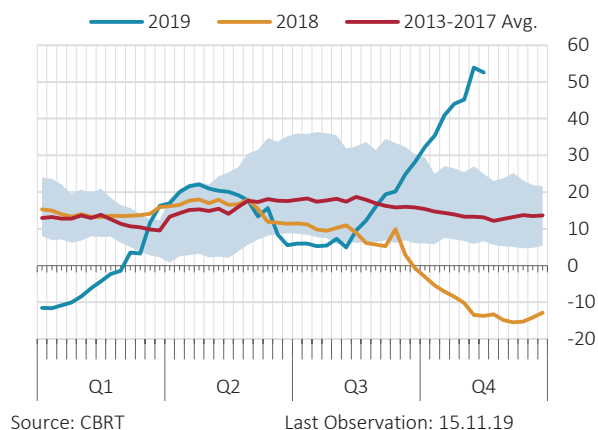


Chart IV.1.11: Growth Rates of General Purpose Loans (13-Week MA, Annualized %)



Note: The blue area marks the 10th and 90th percentage range used in the 2013-2017 averages. FX-indexed loans are included in calculations.

In the past period, housing loan growth was brought down mainly by weak real returns on real estate and the developments in individuals' debt repayment capacity; this tendency ended in the current Report period thanks to a competitive pricing by public banks, economic recovery and lower interest rates. Recent campaigns introduced by public banks have enabled borrowing costs to go down for real estate purchases and helped to extend loan maturities. High new real estate prices and aforesaid campaigns offering mostly loans for no more than TRY 500,000 supported mortgages for used real estate rather than new ones.

Despite relatively stable exchange rates, sales of automobiles and light commercial vehicles continued to contract on an annual basis. This contraction was mostly due to high exchange rates, in spite of reduced exchange rate volatility. In this context, both the share of banks in the retail vehicle loan market and the share of vehicle loans in consumer loans remained low. However, there has been some rebound in auto sales as of September 2019 on the back of these campaigns.

The growth of PCC balances was flat in the current Report period. The June increase in the maximum number of installments and the second-quarter's 30% limit on minimum payment supported the annual rate of increase in PCC balances. A recent regulation brought an upper limit to member merchant commission rates for sales of goods and services by credit card as of November 2019 (Box I.1.1).

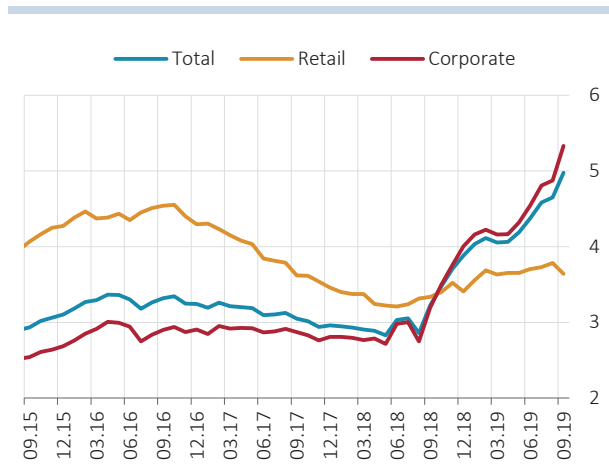
IV.1.3 Non-Performing Loans

In the third quarter of 2018, NPL rates continued to increase due to deteriorated loan growth as well as the lagged impacts of financial market volatilities and sluggish economic activity on firm balance sheets and NPL realizations. Better lending conditions and improved economic activity are expected to have a positive impact on NPL ratios in the upcoming period. The NPL ratio of the banking sector increased slightly in September 2019 to 4.9%. This ratio was 5.3% in corporate loans and 3.6% in retail loans. The retail NPL ratio remained unchanged from the previous Report period, while the corporate NPL ratio increased by 1.1 percentage points (Chart IV.1.12).

The breakdown of the NPL balance shows that the NPL additions were up in the third quarter of 2019 whereas receipts declined (Chart IV.1.13). It is also noteworthy that banks continue to manage their increasing NPL balances by writing them off and/or selling them to asset management companies. In September, the BRSA announced that solvency assessments based on financial statements for July 2019 reported a loan balance of TRY 46 billion to be transferred to non-performing accounts for loans granted particularly to construction and energy sectors. In addition, the BRSA notified related banks that they

should make the necessary classification changes for these loans and set aside expected loan loss provisions by the end of 2019. In the relevant asset quality reviews conducted to enhance the transparency of bank balance sheets, the BRSA stated that this transfer would have a small effect on the asset quality of the banking sector and the NPL ratio could increase moderately to 6.3%. Nevertheless, the current capital structure of the banking sector is assessed to be strong enough to manage credit risks (Chapter III.4). Meanwhile, Stage 2 loans were flat compared to the previous Report period due to some migration to NPLs.

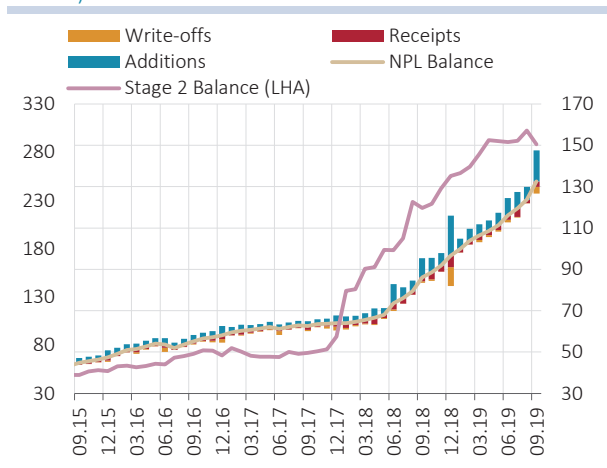
Chart IV.1.12: NPL Ratios (%)



Source: CBRT

Last Observation: 09.19

Chart IV.1.13: NPL Balance and Components (TRY Billion)

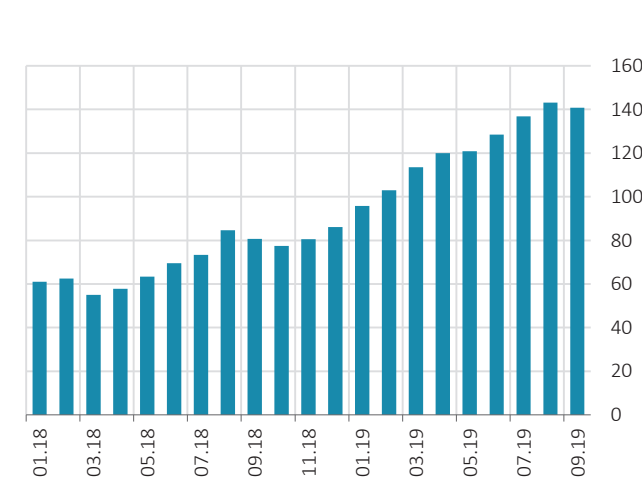


Source: CBRT

Last Observation: 09.19

Loan restructuring has recently been another factor to shore up the asset quality of the sector. The loan stock subject to restructuring was higher in the current Report period than in previous periods (Chart IV.1.14). Maturity extensions and interest rate cuts limit the migration of performing loans into NPLs by harmonizing firms' debt repayment projections with their cash flows. Moreover, the July amendment to the Banking Law allowed debtors to fulfill their repayment obligations through measures to be taken under banks' framework agreements and contracts. In this regard, the Banks Association of Turkey (BAT) announced on 14 October that a "Financial Restructuring" scheme would be established to assist large-sized enterprises that owe to banks and financial institutions, and the scope of the Framework Agreement on Financial Restructuring would be expanded to cover loans over TRY 25 million, instead of TRY 100 million. Thus, there is an increasing number of firms now that have the opportunity to continue production, investment and employment activities through debt restructuring.

Chart IV.1.14: Restructured Loan Balance (TRY Billion)



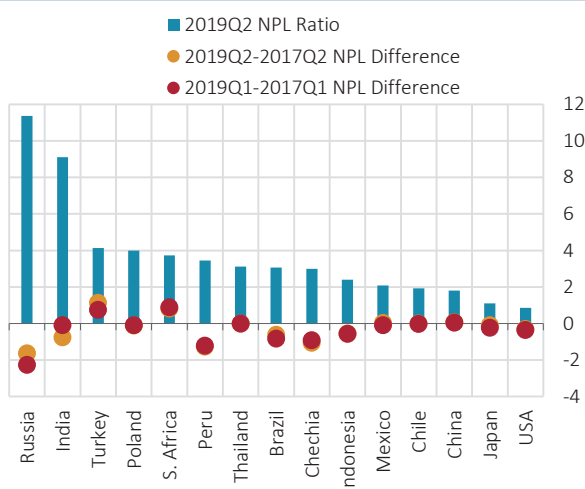
Source: CBRT

Last Observation: 09.19

Despite the recent increase in NPL ratios, the NPL ratio in Turkish banking sector and its change in the last two years hover around the averages of peer countries as of the first quarter of 2019 (Chart IV.1.15). In the forthcoming period, it is expected that the rise in the NPL ratio will slow and there will be no significant deterioration in asset quality as economic recovery becomes more evident, better financial conditions remain, and credit growth increases.

On the corporate side, the NPL ratio is rising across all sizes (Chart IV.1.16). In September, NPL ratios of total firms, large firms and SMEs came in at 5.3%, 4.2% and 7.7%, respectively. Granting loans to micro and small size enterprises in particular, the Value Loan package intended for SMEs helps these firms to have better access to finance and banks to improve their asset quality, and thus supports financial stability.

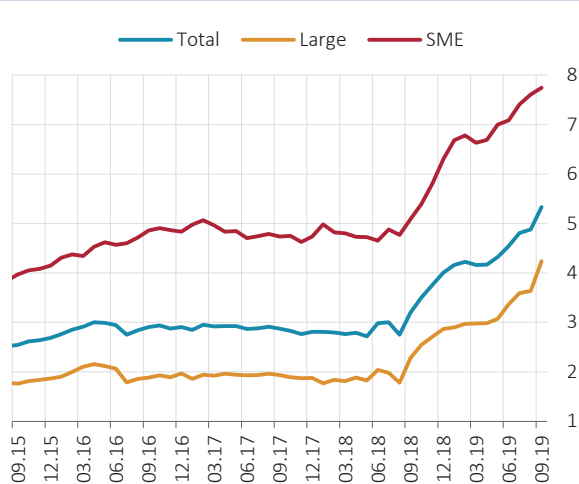
Chart IV.1.15: International Comparison of the NPL Ratio and Its Change (%)



Sources: IMF-IFS, BRSA, Bloomberg Last Observation: 06.19

Note: As data for Japan and Poland have not been reported yet, bars show 2019Q1 values with the two-year differences taken over 2019Q1 and 2018Q4.

Chart IV.1.16: Corporate NPL Ratios (%)



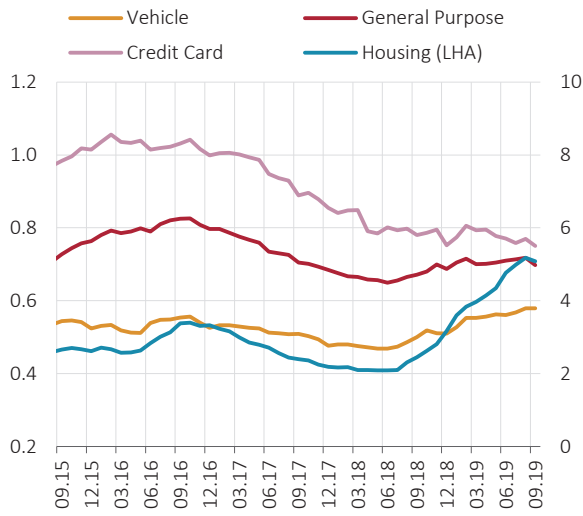
Source: CBRT

Last Observation: 09.19

Compared to corporate loans, NPL ratios were up only slightly for retail loans. This increase spread across all subcategories of retail loans except credit cards (Chart IV.1.17). Comprehensive macroprudential regulations applied to retail loans curbed the rise in the NPL ratio for these loans. As suggested by September data, the NPL ratio increased to 0.7% for housing loans, but it is still low by international standards. In the same period, the NPL ratios were 3.8%, 5% and 5.5% for vehicle loans, general purpose loans and PCC, respectively. The positive lagged effects of the accelerating economic activity on the labor market and an unchanged overall outlook for prices may support individuals' debt servicing capacity and thus help reduce NPL ratios for retail loans in the upcoming period.

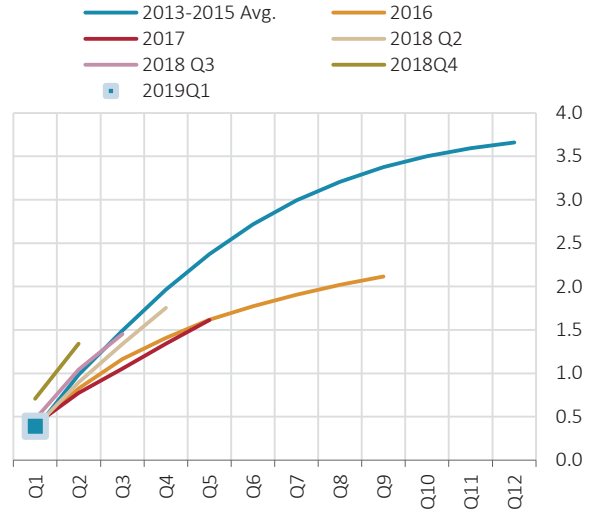
After remaining relatively flat through 2018, the NPL ratio for PCC trended downward in 2019, albeit mildly. The ongoing growth in credit card balances and general purpose loans had a positive impact on NPL ratios for retail loans. Moreover, the opportunity to restructure outstanding credit card debts contributed to moderate NPL ratios. Credit card holders who have an outstanding credit card balance transformed into a loan debt through debt restructuring but have not defaulted on their credit cards were provided with general purpose loans at affordable rates, and thus debt relief options were increased for individual clients. Besides, allowing for a restructuring of general purpose loans over a period up to 60 months and an increase in the maturity ceiling for general purpose and auto loans to 60 months in the previous Report period had a positive effect on individuals' solvency by increasing their debt servicing capacity. In addition, as illustrated by aging analyses, the migration of recently granted loans into NPLs has hardly changed from the previous period (Chart IV.1.18).

Chart IV.1.17: NPL Ratios for Retail Loans (%)



Source: CBRT Last Observation: 09.19

Chart IV.1.18: General-Purpose Loan Aging Analysis (%)



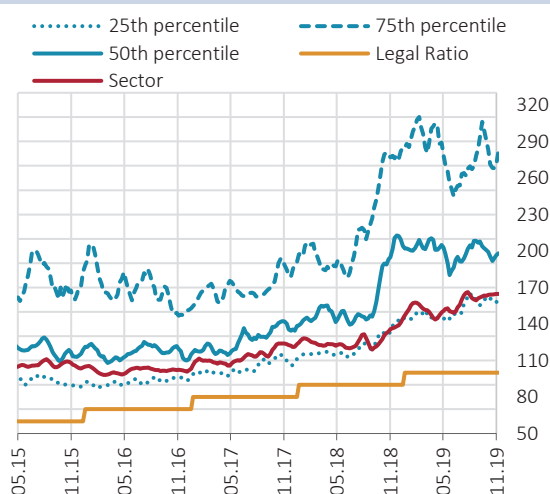
Source: CBRT Last Observation: 03.19

Note: The aging analysis reports NPL ratios cumulatively following the quarter in which general-purpose loans are granted.

IV.2 Liquidity Risk

The short-term liquidity position of the banking sector remains resilient (Charts IV.2.1 and IV.2.2). The liquidity coverage ratios (LCRs), which measure the capability of high-quality liquid assets on banks' balance sheets to offset net cash outflows over a 30-day period, are well above the minimum legal limits of 100% and 80% for total and FX assets, respectively. The sector's LCRs, calculated for both total and FX assets, were slightly up due to the increase in FX liquid assets since early-2019, standing at 165% and 293%, respectively, as of November 2019. This increase in LCRs was driven by the rises in banks' unencumbered GDDS accounts and FX reserve requirement items.

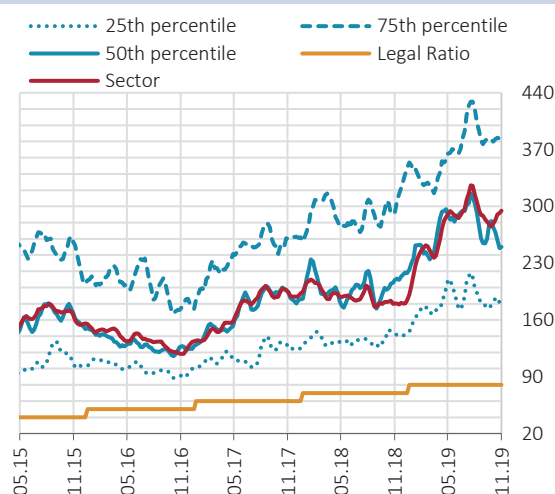
Chart IV.2.1: Total Liquidity Coverage Ratios of Banks by Quantiles (% , 4-Week MA)



Source: CBRT Last Observation: 15.11.19

Note: Development and investment banks are excluded. Based on non-consolidated reports. These quantiles represent the banks on the top of the first, second and third quartiles, sorted based on an ascending order of banks' LCRs.

Chart IV.2.2: FX Liquidity Coverage Ratios of Banks by Quantiles (% , 4-Week MA)

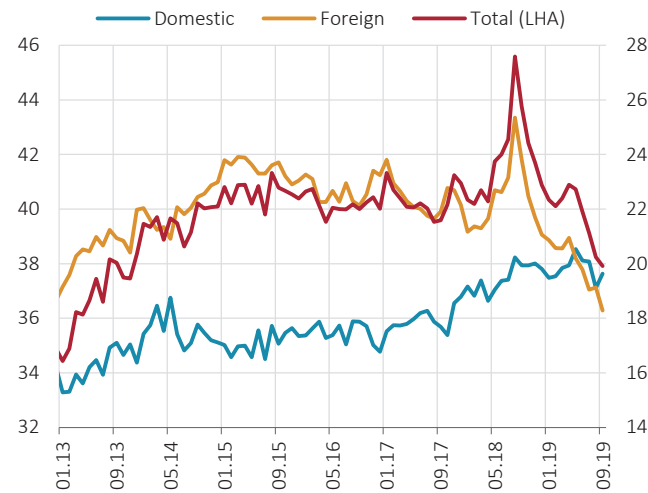


Source: CBRT Last Observation: 15.11.19

Note: Development and investment banks are excluded. Based on non-consolidated reports. These quantiles represent the banks on the top of the first, second and third quartiles, sorted based on an ascending order of banks' LCRs.

While the growth in deposits, particularly on the TL side, drives the share of core liabilities in funding higher, it also contributes to rendering banks' balance sheet structures more stable. The share of non-deposit liabilities in external funding sources slightly decreased to 38% in the current Report period (Chart IV.2.3). Bond issues that account for approximately 60% of the funds obtained from abroad, and direct borrowings from banks have declined in the recent period, which has been a determining factor in the fall in the ratio of total non-deposit funding sources to external funding sources. As a result of the recent strong increase in domestic bond issues and subordinated debts, the share of domestic funds in total external sources rose, exceeding the share of funds obtained from abroad in external sources. This curbs the vulnerability of the banking sector to volatilities in international markets.

Chart IV.2.3: Ratio of Non-Deposit Funding Sources to External Funding Sources (%)



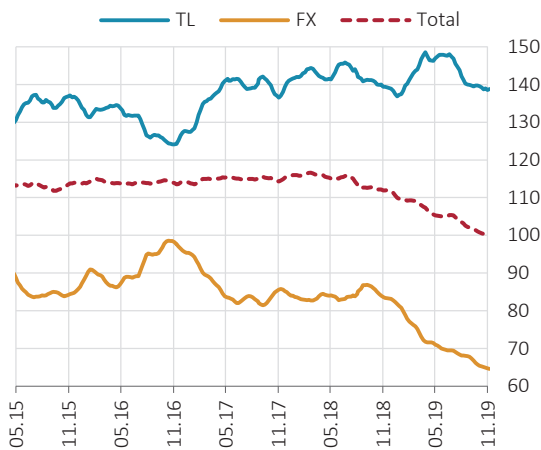
Source: CBRT

Last Observation: 09.19

Note: External funding sources include all liabilities except equity.

The rebalancing in the loan-to-deposit ratio (LDR), one of the main indicators of long-term liquidity position which represents the extent of the funding of loans that have the largest share in banks' illiquid assets via deposits as a stable source, also continued in the current Report period. The LDR stood at 101% as of November 2019, converging to its level before the quantitative easing period in 2013 (Chart IV.2.4).¹

Chart IV.2.4: Loan-to-Deposit Ratio (% , 4-Week MA)

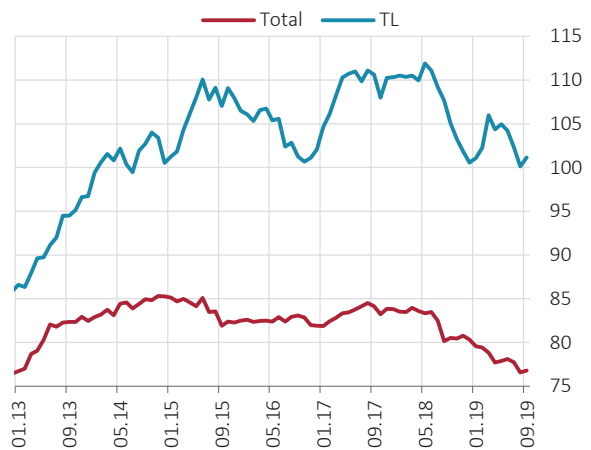


Source: CBRT

Last Observation: 15.11.19

Note: Development and investment banks are excluded.

Chart IV.2.5: Loan/(Deposits+Other Stable Funds) Ratio (%)



Source: CBRT

Last Observation: 09.19

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

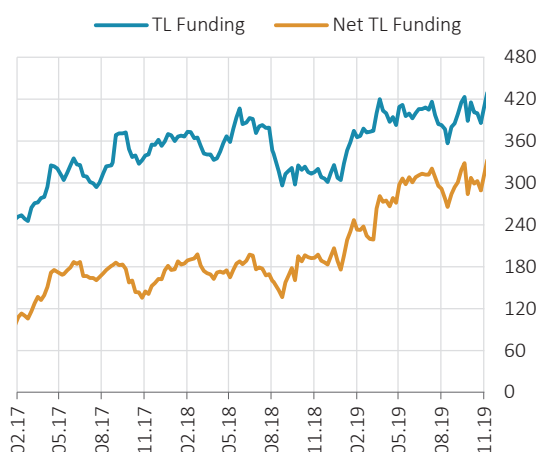
The currency preferences of firms, banks and depositors have a determining role in the currency divergence seen in the LDR. Market volatilities in August 2018 and the perception of uncertainty strengthened depositors' preference for FX deposits. In addition, the weakening investment appetite of firms led to a significant fall in the FX LDR. In the latest Report period, the decline in exchange rate

¹ Development and investment banks, which can grant loans but do not have the authority to collect deposits, are not included in the LDR calculation. When development and investment banks are included, the sector's LDR reaches 108% as of October 2019.

volatilities and the improvement in the inflation outlook subdued the dollarization of deposits. On the other hand, the FX LDR registered a moderate decline due to the persistent contraction in FX loans driven by the policy measures taken and the increase in the awareness of exchange rate risk. On the TL side, the TL LDR started moving downwards as of June 2019 due to depositors' strengthened preference for TL deposits despite the recovery in the loan market. As of September 2019, the TL and FX LDRs were 140% and 67%, respectively.

Since the LDR takes into account neither the maturity matching between assets and liabilities on banks' balance sheets, nor other stable funds in particular, the ratio of loans to the sum of deposits and other stable funds (LDR+) is monitored separately. As of September 2019, the LDR+ for the total and the TL dropped to 77% and 101%, respectively (Chart IV.2.5). This decline was mainly triggered by the loan utilization trend and increasing deposits as well as by the rise in equities and subordinated debts. The decreases in both the LDR and the LDR+ suggest that the long-term liquidity positions of banks are at an adequate level to meet the recovering loan demand.²

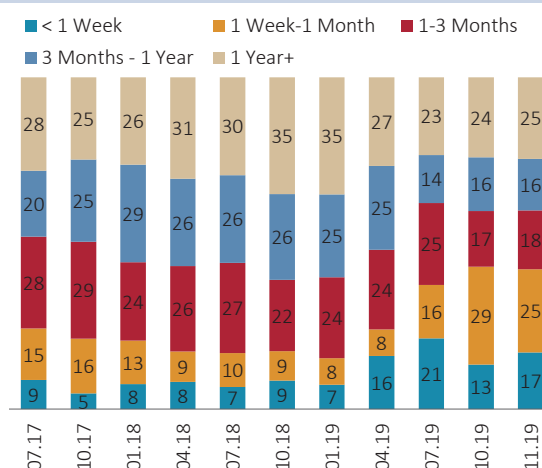
Chart IV.2.6: Amounts of TL Currency Swap Transactions (TRY billion)



Source: CBRT

Last Observation: 15.11.19

Chart IV.2.7: Maturity Brackets of Spot TL Buying Currency Swaps (Stock, % Share)



Source: CBRT

Last Observation: 15.11.19

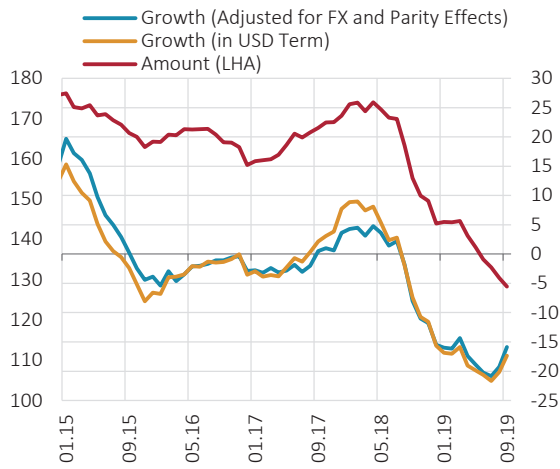
Note: The original maturity is taken into account for total spot TL buying currency swaps with residents and non-residents.

The currency divergence in the LDR leads banks to conduct currency swap transactions to meet their TL funding needs. Banks that actively trade on the offshore currency swap market have been intensely using the domestic swap market in the recent period. In the current Report period, TL currency swap funding slightly increased based on domestic funding, and the total net TL funding reached TRY 311 billion by November 2019 (Chart IV.2.6). In the recent period, spot TL buying swap transactions have been concentrated on shorter-term maturities (Chart IV.2.7).

In the previous period, in addition to the improvement in the current account, the weakening FX loan growth due to decelerated corporate sector investments played a significant role in the decline in banks' use of external funding sources. Moreover, the rise in FX deposits was influential in the fall in banks' external borrowings (Chart IV.2.8). On the other hand, the increase in borrowing costs observed in the previous Report period was replaced by a gradual improvement due to diminishing financial volatilities and the macroeconomic outlook that turned positive (Chart IV.2.9).

² For annual loan growth developments, see Chart IV.1.1 in the "Credit Developments and Credit Risk" section.

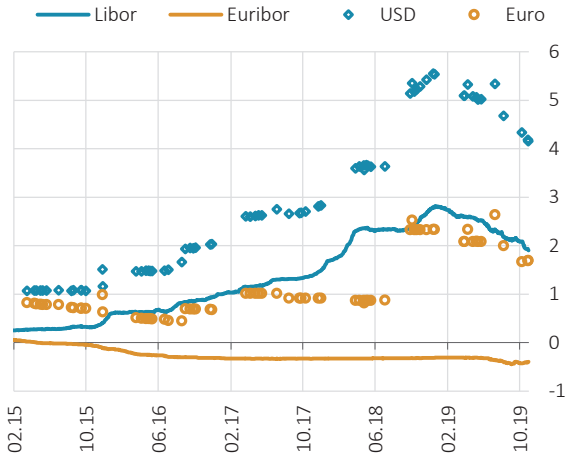
Chart IV.2.8: Amount and Growth Rate of Banks' External Liabilities (Annual % Increase, USD billion)



Source: CBRT, MKK Last Observation: 09.19

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

Chart IV.2.9: Cost of Syndicated Loans with a Maturity of 367 days (Transaction-Based, %)

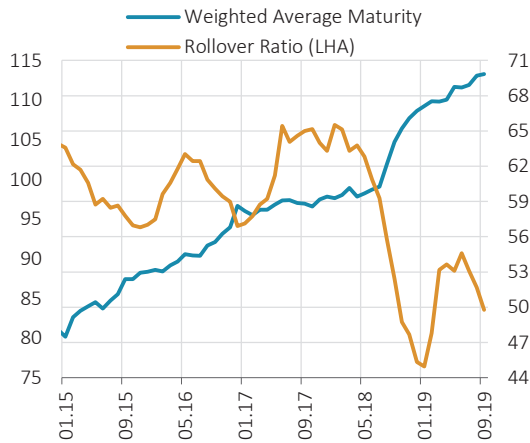


Source: PDP Last Observation: 10.19

Note: Calculated for 10 large-scale banks.

The increase in the number of participating banks and countries in syndicated loans that started to be renewed as of October points to a greater investor interest. In this period, approximately 80% of maturing syndicated loans were renewed due also to the decline in the external financing need.

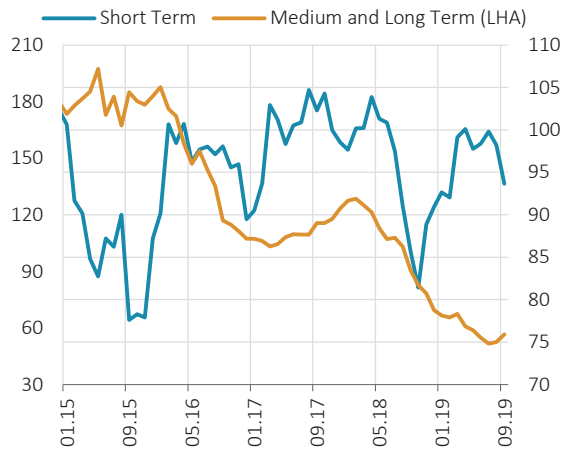
Chart IV.2.10: Total External Debt Rollover Ratio and Its Average Maturity (Month, %)



Source: CBRT, MKK Last Observation: 09.19

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

Chart IV.2.11: External Debt Rollover Ratio (Month, %)



Source: CBRT, MKK Last Observation: 09.19

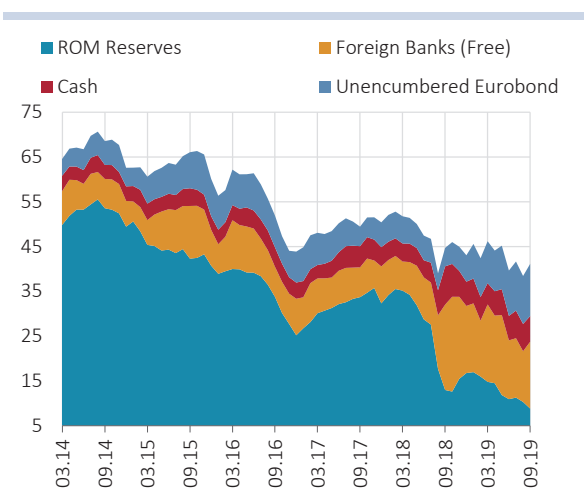
Note: External debt rollover ratios are calculated based on three-month (for short term) and 12-month (for long-term) moving totals of banks' total borrowings and repayments of external liabilities including securities issued abroad.

The long-term outlook in external debts remain in place, with an average maturity of 70 months. The external debt rollover ratio, which had increased as of March 2019 due to largely renewed syndicated loans, recorded a slight fall in the recent period and stood at 84% as of September 2019 (Chart IV.2.10). This was due to the fact that banks reduced their syndicated loan renewal ratios in particular and their bond issues. Persistently high funding costs lead banks to renew their low-interest short-term external

debts. The reduced risk premium due to the improvement in macroeconomic indicators may contribute to a decline in funding costs and an extension in borrowing maturities.

The banking sector has adequate amount of liquidity buffers against possible shocks in financial markets. The long-term outlook in external debts enhances the resilience of the banking sector to likely vulnerabilities in international markets. Banks' liquid asset portfolio, which includes unencumbered eurobonds, cash, accounts at foreign banks and reserves under the reserve options mechanism (ROM), is strong enough to cover all their FX-denominated external debts due within six months and 73% of their FX-denominated external debts due within one year (Chart IV.2.13).³ This is due to the decline in the sector's external debt balance driven by its low demand for FX loans. Moreover, taking into account the net FX funding sources that banks had used for their USD 56 billion worth of currency swap transactions by September 2019, their FX required reserves at the CBRT, and the USD 50 billion worth of FX deposit limits allocated by the CBRT to banks, the liquidity facilities of the banking sector reach a level high enough to cover all external debt repayments that will be due within one year.

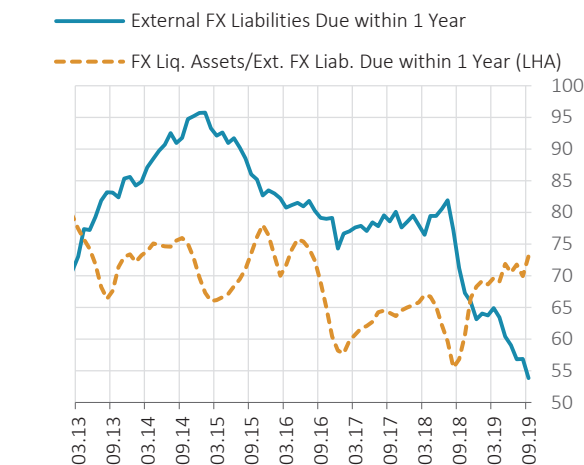
Chart IV.2.12: Amount of FX Liquid Assets (USD billion)



Source: CBRT, MKK Last Observation: 09.19

Note: FX liquid assets include ROM reserves and cash reserves, free accounts at foreign banks, and unencumbered eurobonds.

Chart IV.2.13: FX External Debt Due within 1 Year and Ratio of FX Liquid Assets to FX External Debt Due within 1 Year (USD billion, %)



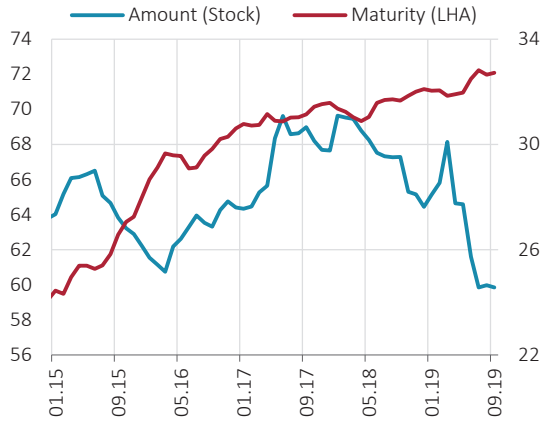
Source: CBRT, MKK Last Observation: 09.19

Note: The dashed line represents the three-month moving average of the FX Liquid Assets / Short-Term FX External Debt ratio.

Due to sluggish demand for FX funds and persistently high costs, banks' external FX securities issues decreased in the current Report period. However, the maturity structure remains favorable (Chart IV.2.14). In the upcoming period, the high risk appetite in global markets and the developments in the monetary policies of emerging market central banks may buoy up conditions for external FX securities issues. The TL funding that banks obtain from domestic markets via securities issues and the product diversity continued to increase in the current Report period, which contributes to the financial deepening in the domestic securities market (Chart IV.2.15). Since August 2019, banks have issued a total of TRY 13 billion worth of TLREF-indexed securities at different maturities ranging from three months to 10 years (Box II.2.I).

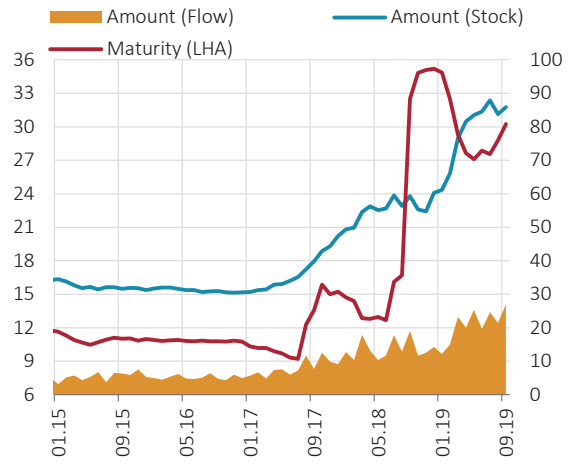
³ The banking sector's external debt due within one year is USD 53.8 billion while banks' cash, accounts at foreign banks, eurobonds and ROM reserves are USD 5.7 billion, USD 14.9 billion, USD 11.7 billion and USD 8.8 billion, respectively.

Chart IV.2.14: FX Securities Issues Abroad (USD billion, Month)



Source: MKK Last Observation: 09.19

Chart IV.2.15: Domestic TL Securities Issues (TRY billion, Month)



Source: MKK Last Observation: 09.19

IV.3 Interest Rate and Exchange Rate Risk

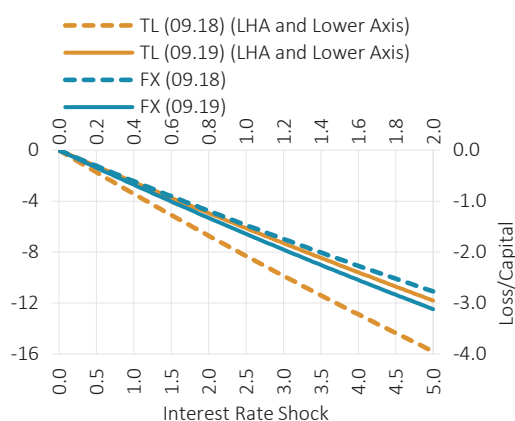
The banking sector's on and off-balance sheet interest rate-sensitive FX open position rose by 2% to TRY 273 billion compared to the previous Report period, while its TL excess position increased by 1% to TRY 650 billion. The rise in the interest rate-sensitive FX open position was driven by the decline in the loans and derivatives position, whereas loan developments were the determinant of the modest increase in the TL excess position.

The probable loss to capital ratio was calculated based on the economic value approach by exposing the sector's interest rate-sensitive TL and FX positions to a positive interest rate shock. Accordingly, up to 5 percentage points of a positive interest rate shock exposure on interest rate-sensitive TL positions leads to a probable loss of approximately 12% of capital. On the other hand, up to 2 percentage points of a positive interest rate shock exposure on interest rate-sensitive FX positions leads to a probable loss of 3% of capital. Compared to the same period last year, the positive interest rate shock-led probable loss to capital ratio posted a marked decline for the TL position but slightly increased for the FX position (Chart IV.3.1).

The average maturity of interest rate risk-sensitive TL assets shortened by one month to 17 months over the previous Report period as a result of the declining share of long-term loans. Meanwhile, the average maturity of interest rate risk-sensitive TL liabilities remained the same at six months. The average maturity of interest rate-sensitive FX liabilities was 12 months while that of FX assets lengthened by one month to 23 months due to the increased share of long-term derivatives.

Fixed interest rate securities at fair value through other comprehensive income may have a positive or negative impact on capital through the channel of revaluation based on changes in interest rates. To measure the probable loss caused by such impact, likely interest rate hikes of up to 5 percentage points and 2 percentage points were imposed on TL and FX securities, respectively, as in the interest rate-sensitive position analysis. The probable loss to capital ratio for TL securities was estimated to be up from the previous Report period, reaching 1.9%. On the other hand, the probable loss to capital ratio for FX securities was estimated to be down from the previous Report period, standing at 1.6% (Chart IV.3.2).

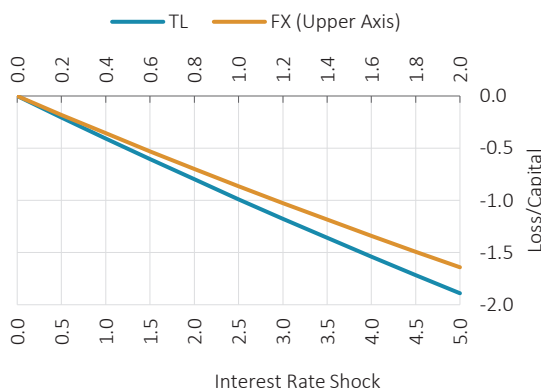
Chart IV.3.1: Interest Rate Risk via Repricing Channel Measured with Economic Value Approach (%)



Source: BRSA, CBRT calculations Last Observation: 09.19

Note: In the economic value approach, the change in the current value of interest rate-sensitive assets and liabilities is taken into account in the face of a change in interest rates.

Chart IV.3.2: Interest Rate Risk of Fixed Interest Rate Securities at Fair Value through Other Comprehensive Income (%)



Source: BRSA, Bloomberg, CBRT Last Observation: 09.19 calculations

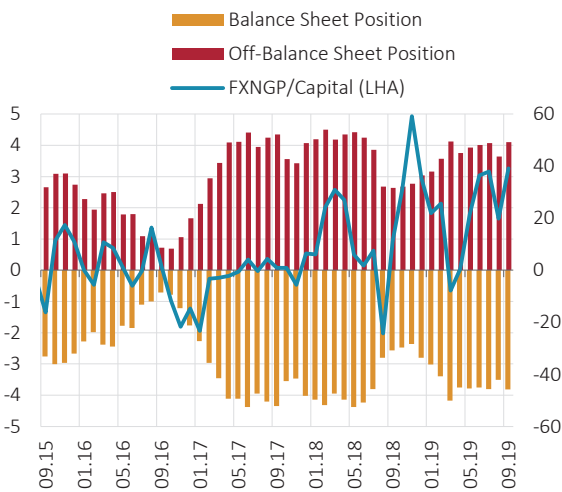
Note: Since January 2018, when the TFRS 9 standards were put into effect, the Securities Available for Sale (Net) item on bank balance sheets has been renamed "Securities at fair value through other comprehensive income".

The banking system's on-balance sheet and off-balance sheet FX positions are largely shaped in line with the TL funding need. As the FX liquidity is in excess, the banking system meets its TL liquidity need predominantly through swap transactions. The CBRT covers a significant portion of the liquidity shortage in the market through swap transactions, which also increases the total amount of swap transactions. Thus, the sector registers an on-balance sheet FX open position and an off-balance sheet FX excess position.

The banking sector's on-balance sheet FX open position dropped by 9% over the previous Report period to USD 46 billion. Meanwhile, the off-balance sheet FX excess position remained flat at USD 49 billion. Banks maintained their cautious stance regarding their net FX position. The sector's FX net general position/capital ratio was around 3%, well below the two-way legal limit of 20% (Chart IV.3.3).

A breakdown of off-balance sheet FX transactions actively employed by the sector in FX risk management reveals that currency swaps continued to be used heavily. On the other hand, the share of options in this composition decreased (Chart IV.3.4).

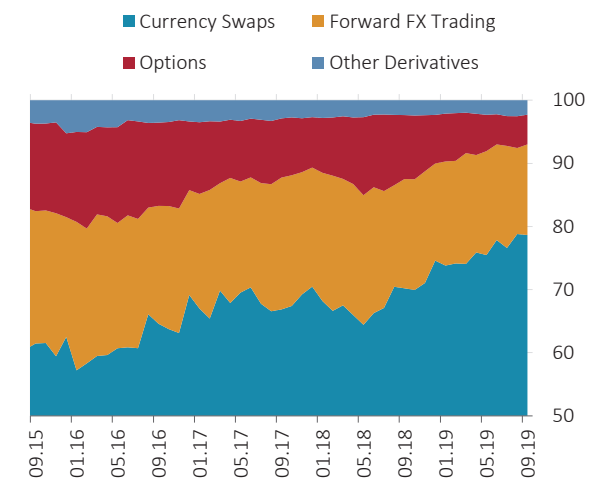
Chart IV.3.3: Banking Sector's FX Position (USD billion, %)



Source: CBRT Last Observation : 09.19

Note: FXNGP refers to FX net general position.

Chart IV.3.4: Shares of Gross Positions (Assets+Liabilities) of Off-Balance Sheet FX Transactions (%)

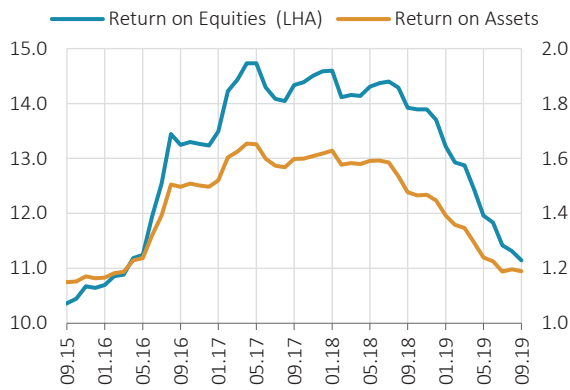


Source: CBRT Last Observation : 09.19

IV.4 Profitability and Capital Adequacy

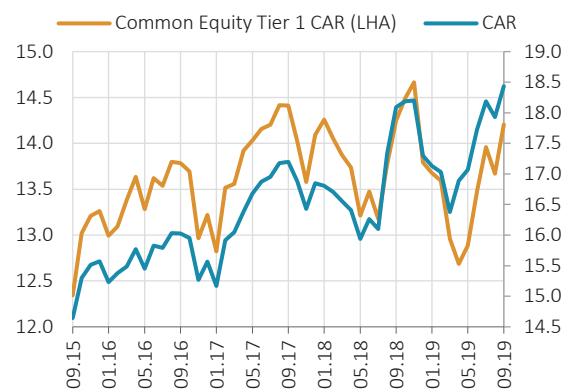
The fall in profitability indicators of the banking sector due to the sluggish loan growth and developments in asset quality has recently lost pace (Chart IV.4.1). The rise in NPL provisions since the previous reporting period has become the main determinant of the downward trend in return on assets and equities. Meanwhile, the flattening in profitability indicators in the last couple of months has been noteworthy. Amid the mild recovery in economic activity and the rebound in loan growth, profitability performance is likely to be positive. The recent rise in CAR is attributable to the limited loan growth and strengthened equity structures of banks (Chart IV.4.2, Box IV.4.1).

Chart IV.4.1: Return on Assets and Equities (%)



Source: CBRT Last Observation: 09.19
 Note: Profitability ratios are calculated by dividing the annual cumulative profit by one year's average denominator.

Chart IV.4.2: CAR and Core Tier 1 CAR (%)

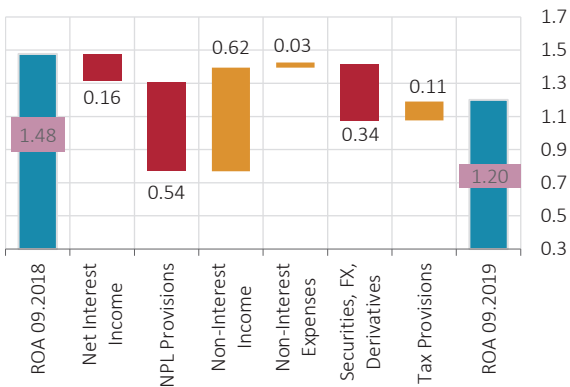


Source: CBRT Last Observation: 09.19

IV.4.1 Profitability

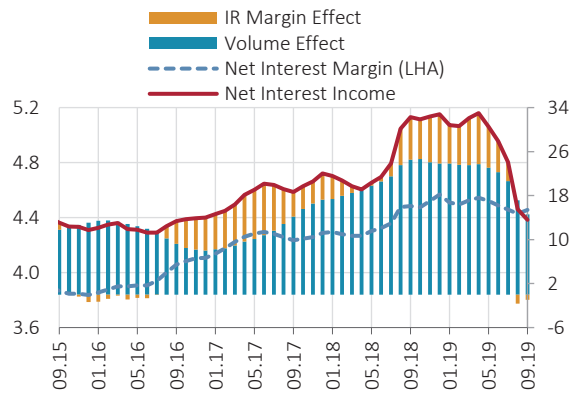
The factors that affected the change in return on assets ratio (ROA) over the past year reveal that non-interest income has had a positive effect on the one hand. On the other hand, net interest income, special provisions of nonperforming loans and losses stemming from derivative financial tools had a negative effect on profitability (Chart IV.4.3). By September, ROA of the sector dropped by 28 basis points to 1.2%.

Chart IV.4.3: Effect of Income/Expense Items on ROA (Annual, %)



Source: CBRT Last Observation: 09.19
 Note: Red columns denote downward impact whereas yellow columns denote upward impact.

Chart IV.4.4: Contribution to Changes in the Net Interest Income (12-Month Cumulative, TRY billion, %)



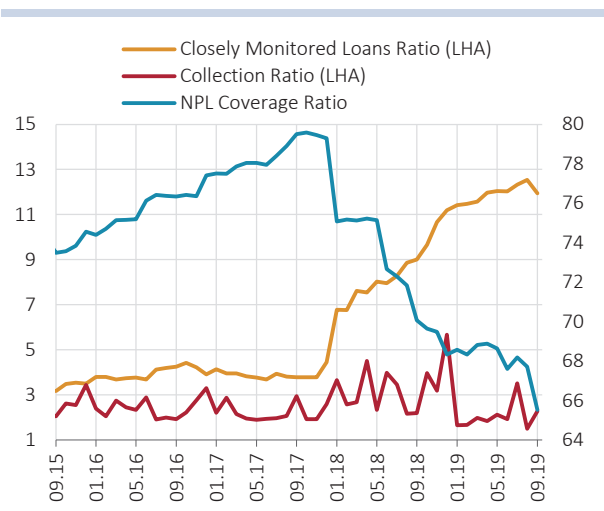
Source: CBRT Last Observation: 09.19

Twelve-month cumulative net interest income has increased at a slower rate since the previous reporting period. In this respect, net interest income contributed negatively to the sector's ROA in the last 12-month period by around 16 basis points. This decline was caused by interest income received from loans that grew less than interest expense paid to deposits. As for the volume effect and the interest rate margin effect, the mild credit growth reduced the volume effect. Meanwhile, a notable fall was seen in net interest margin, which has recently turned negative (Chart IV.4.4).

The recent rise in stage-two loans is attributable to increases in restructured loans (Chart IV.4.5). The collection ratio remained flat. NPL coverage ratio denotes the ratio of special provisions allocated for non-performing loans to non-performing loans. This ratio remained almost unchanged in the previous reporting period, and declined as the non-performing loans increased towards the end of the current reporting period.

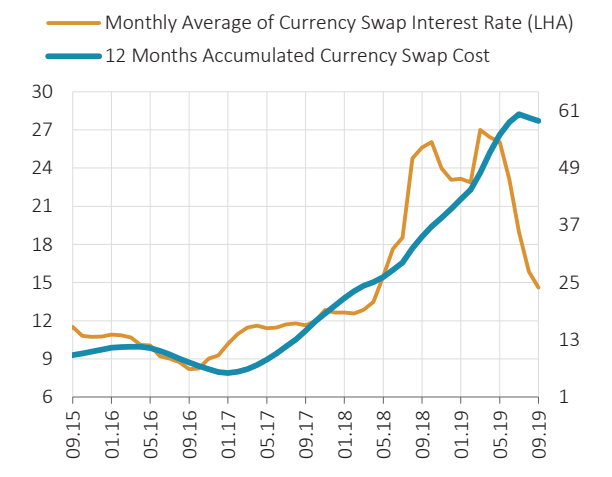
The other non-interest income/expenses item, in which banks record their profits and losses in securities trading, derivatives and foreign exchange transactions, had a negative impact on profitability compared to a year earlier. The underlying reason was losses incurred on trading of financial derivatives. Meanwhile, currency swap transaction costs registered a decline due to interest rates (Chart IV.4.6).

Chart IV.4.5: Additional NPL Indicators (%)



Source: CBRT Last Observation: 09.19

Chart IV.4.6: Currency Swap Transaction Costs and Interest Rates (TRY billion, %)



Source: CBRT, Bloomberg, Authors' calculations Last Observation: 09.19

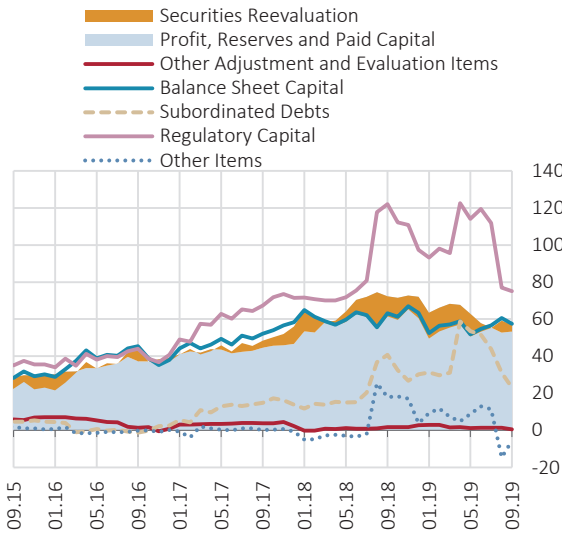
Note: In calculating the currency swap interest rate, the monthly simple average of 3-Month USD-TRY currency swap interest rates was used as a reference rate and the cost was estimated by using the monthly average net TRY-FX currency swap positions of banks and the monthly average USD rate.

ROA increased by about 62 basis points thanks to a moderate rise in the non-interest income led by provision cancellations and revenues from banking activities in the current reporting period. Rising credit card fees and commissions have recently been the main drivers of the increased banking services income.

IV.4.2 Capital Adequacy

Over the past year, the legal capital has been positively affected by the increase in subordinated debts included in capital estimation and the level of profitability, albeit less contributive recently. Meanwhile, contribution of securities valuation, which has been negative since the first quarter of 2018, turned positive due to positive valuation differences related to securities at fair value through other comprehensive income led by the decline in interest rates (Chart IV.4.7).

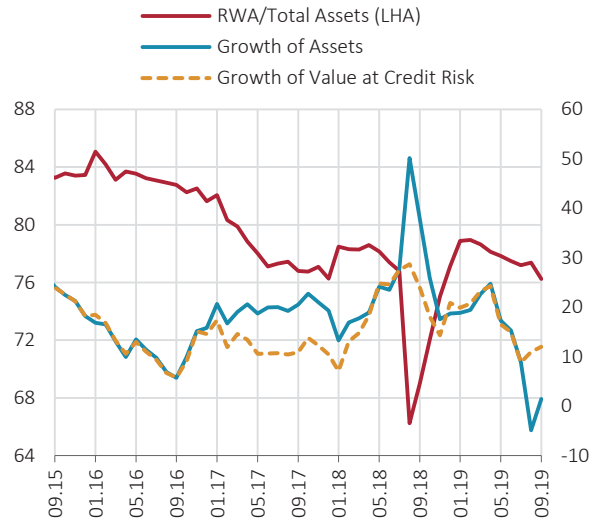
Chart IV.4.7: Changes in Equity (12-Month Cumulative, TRY billion)



Source: CBRT

Last Observation: 09.19

Chart IV.4.8: Risks and Assets Developments (%)



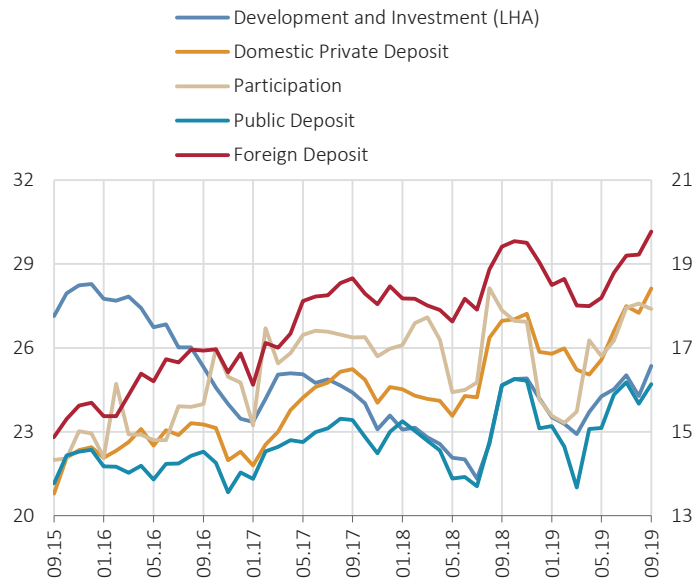
Source: CBRT

Last Observation: 09.19

Although there has been no significant change in the composition of risk-weighted assets, credit risk growth has displayed a similar outlook to asset growth since the second quarter of 2019 due to the base effect. Meanwhile, the ratio of risk-weighted assets to total assets has declined moderately since the previous report (Chart IV.4.8).

According to the announcement of the BRSA made on 17 September 2019, some loans may be reclassified as NPL until the year-end under the scope of the asset quality review. This is projected to have a limited effect on the sector's CAR and that the sector's strong capital structure is expected to be preserved (Chart IV.4.9).

Chart IV.4.9: CARs by Types of Banks (%)



Source: CBRT

Last Observation: 09.19

Box IV.4.1

Actions Taken to Strengthen Banks' Equities

Exchange rate movements, increased interest rates, and rising NPLs due to muted economic growth became pressure factors for the banking sector's profitability and capital adequacy following the financial turbulence in August 2018. Against this background, as well as measures taken to improve financial conditions, the recent steps taken by banks to bolster their equity capital are worth noting. This box explores definition of equity along with capital buffers laid down by the Basel III framework, and presents subordinated debt instruments used frequently to bolster equity in the recent period.

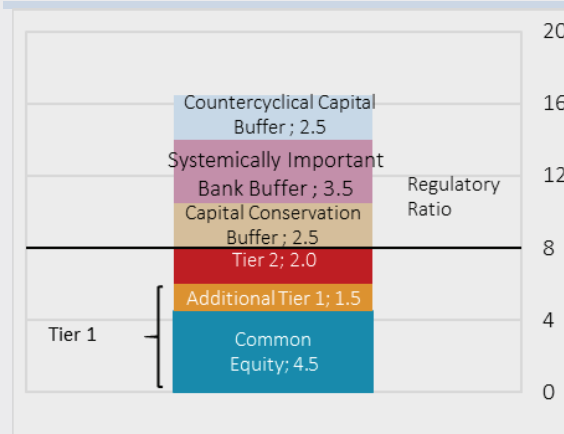
Definition of Capital

Basel III capital regulations aim to establish a capital structure of good quality for financial institutions in view of their loss absorbing capacities. Accordingly, financial institutions' Tier 1 capital is mainly composed of common equity Tier 1 and additional Tier 1 capital. Common equity Tier 1 is composed of items such as paid-in capital which has the highest loss absorbing capacity, share premiums and retained earnings. Items such as subordinated debt instruments that have a secondary importance in terms of loss absorbing capacity, that are not included in common equity Tier 1 and conform to the relevant regulatory criteria are classified as additional Tier 1 capital. Items that include a specific percentage of general provisions and subordinated debts conforming to the relevant regulatory criteria are defined as Tier 2 capital. In this context, the minimum regulatory capital adequacy limit, which stipulates a capital of 8% of risk-weighted assets (RWA) at least, was further broken down, with the quality and quantity of capital improved. Thus, the minimum ratio of 8% was broken down into: at least 4.5 points to constitute common equity Tier 1 capital, at least 1.5 points to constitute additional Tier 1 capital, and at least 2 points to constitute Tier 2 capital.

Additionally, Basel III regulations define capital buffers to serve several purposes. The first one of those, the capital conservation buffer, is built up to preclude any instance where equities fall short of fulfilling capital adequacy requirements due to likely losses that may stem from a deterioration in economic and financial indicators. The capital conservation buffer has been increased gradually over time to bring its level to 2.5 points of the risk-weighted assets. In case a capital conservation buffer cannot be built up, banks can continue their operations as usual, but are subject to profit distribution limitations at varying ratios. Moreover, Basel III standards also entail the use of a countercyclical capital buffer varying between 0 and 2.5% that is expected to shape in view of the financial cycle and where the country stands within that cycle. The aim of the countercyclical buffer that can be altered depending on the pace of economic growth is to avert rapid credit growth, and when the cycle is receding, to enable it to reverse its movement by using the buffers already accumulated. Besides, systemically important institutions determined as per the Basel III criteria of size, complexity, interconnectedness, cross-jurisdictional activity and substitutability are subject to a systemically important bank buffer at varying ratios between 1% and 3.5%. These buffers are required to be composed of common equity Tier 1 that accounts for quality capital (Diagram IV.4.1.1).

In Turkey, banks' share of common equity Tier 1 in their regulatory capital is high at 77%. Additional Tier 1 capital that accounts for 23% of regulatory capital, and approximately three fourths of Tier 2 capital are built up by instruments in the form of subordinated debt, loan or security (Chart IV.4.1.1).

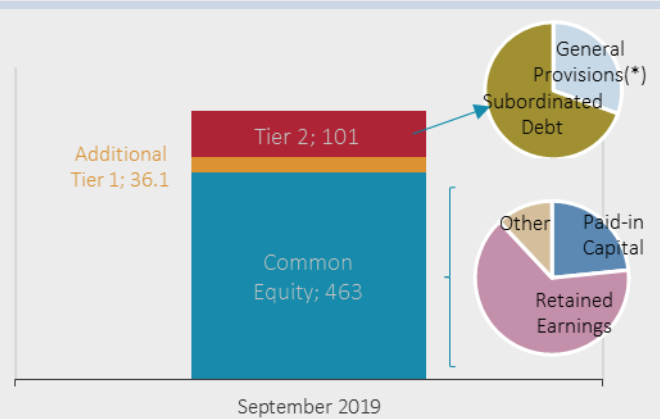
Diagram IV.4.1.1: Capital and Capital Buffers as per Basel III Regulations * (% of RWA)



Sources: BRSA, Basel III documents

Note: According to Basel III regulations, the systemically important bank buffer varies between 1% and 3.5% depending on banks' qualities, and the countercyclical capital buffer varies between 0 and 2.5% depending on the country's qualities. Maximum ratios are given in Chart.

Chart IV.4.1.1: Equity Structure in Turkey (September 2019, TRY Billion)



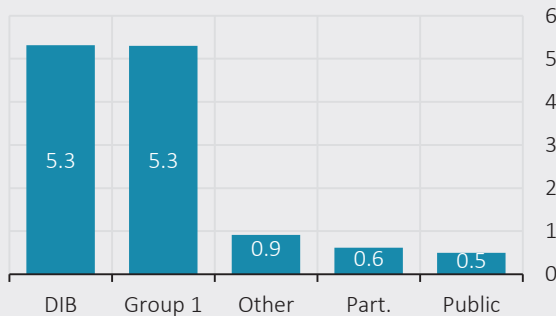
Source: BRSA

Note: General provisioning is the portion up to 1.25% of the sum of risk weighted receivables (calculated by standardized approach)

Capital Increases

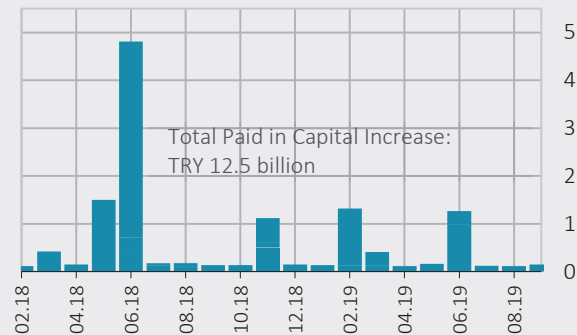
According to Article 44 of the Banking Law No. 5411, paid-in capital is any bank's actual paid-up capital or paid-up capital set aside for Turkey free of any collusion less its loss disclosed in the balance sheet not met from retained earnings. Together with paid-in capital, retained earnings account for a significant portion of common equity Tier 1. As per the regulations of Capital Markets Board of Turkey (CMB), it is obligatory to set aside retained earnings up to 20% of the paid-in capital. Accordingly, some banks, of which the retained earnings amount has reached 20% of their paid-in capital, make transfers from retained earnings to paid-in capital. Capital increases paid in cash strengthen banks' capital structure and adds to their CARs.

Chart IV.4.1.2: Paid in Capital Increase by Bank Groups Between January 2018 – September 2019 (TRY Billion)



Sources: BRSA, CBRT Calculations Last Observation: 09. 19

Chart IV.4.1.3: Banks' Total Paid in Capital Increase (TRY Billion)



Sources: BRSA, CBRT Calculations Last Observation: 09.19

Since early 2018, banks' paid-in capital increased by a total of TRY 15 billion. Of this amount, TRY 2.5 billion was driven by transfers from retained earnings, while TRY 12.5 billion accounted for paid in capital transfers (Chart IV.4.1.2 and Chart IV.4.1.3). The contribution of paid in capital transfers to the CAR is estimated approximately 40 basis points.

Subordinated Debt Instruments

The Regulation on Banks' Equities specifies the qualifications required for an issued debt instrument to be included in calculation of capital, in other words, to be treated as "subordinated debt instrument". The main criterion in this regard is that in the event of a bank's liquidation, the owners of the debt

instrument can use their right to claim after depositors and other senior creditors, and the issuer bank can use the repayment option after five years at the earliest. Another important qualification that should be sought in a debt instrument is it can be written off from the balance sheet or converted to equity, should the likelihood of revocation of the bank's operating license or in case the bank's transfer to the Savings Deposit Insurance Fund (SDIF) occur.

Debt instruments are classified as such that they can be included in the additional Tier 1 capital or Tier 2 capital as per their qualifications. When the maturity and the specified threshold are exceeded, the debt instrument can be subjected to a write-off or converted to equity, which constitutes the main difference between the two debt instruments (Table IV.4.I.1). Accordingly, while the debt instruments that are included in additional Tier 1 capital behave like common equity Tier 1, those that are included in Tier 2 capital are more like bonds. In other words, an investor of additional Tier 1 capital has the right to claim after depositors, other creditors and the investors that have invested in debt instruments included in the calculation of Tier 2 capital, but before shareholders.

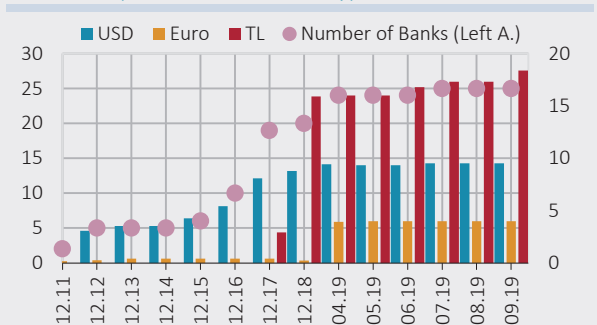
Table IV.4.I.1. Subordinated Debt Instruments

	Additional Tier 1	Tier 2 Capital
Maturity	Perpetual	Original maturity at least 5 years
Trigger¹	Core capital adequacy ratio falling below 5.125%	None

Source: CBRT

Note: If that happens, the relevant bond is converted to equity or its principal value is reduced.

Chart IV.4.I.4: Balance of Subordinated Bond Issuances (Billion, own currency)



Sources: BRSA, CBRT Calculations

Last Observation: 09.19

Banks' balance of subordinated bond issuance and the number of issuer banks have been increasing since 2014. The balance of issuance standing at USD 3 billion in December 2012 reached USD 9.5 billion in September 2019 (Chart IV.4.I. 4). While banks were more active in borrowing subordinated debt instruments from external markets in 2017 and before, they have oriented towards domestic markets since 2018. The balance of TL issuance of subordinated bond, which was approximately TRY 3 billion at end-2017, reached TRY 16 billion by end-2018 and TRY 18 billion as of September 2019. Subordinated bond issues since early 2018 to date have improved banks' CARs by approximately 190 basis points. Meanwhile, the TLREF-based issuance since end-August has totaled TRY 13 billion. Approximately TRY 1.3 billion of this amount has been issued as subordinated securities that can be included in the TLREF-indexed Tier 2 capital (Box IV.4.I).

Conclusion

The capital structure of the Turkish banking sector remains robust. Banks adopt a proactive and cautious approach by increasing capital or using subordinated debt instruments, thereby strengthening their capital structure. The recent capital increases and subordinated debts, along with similar actions that can be taken in the upcoming period, will, on the one hand, underpin the strong capital structure of banks, and on the other hand, continue to contribute to the variety of financial tools, expansion of the investor base and deepening of financial markets.