

Credit FAQ:

## What's Next For Turkish Issuers?

August 21, 2018

In this FAQ, S&P Global Ratings is responding to questions we have received from investors about the impact of recent extreme lira volatility on issuers in Turkey. The responses are arranged by sector with sovereign-related questions addressed first, followed by banks, corporates, and insurance.

### Sovereign

#### What does S&P Global Ratings think is the root cause of recent developments in Turkey?

In an economy as dollarized as Turkey's, currency crises quickly become solvency crises. Even before the Aug. 1 imposition of U.S. sanctions on two members of Turkey's presidential cabinet, the Turkish lira had already depreciated against the dollar by more than 20% this year. The root causes of the lira's volatility and the economy's increasing vulnerability to a hard landing are not new: Turkey's longstanding reliance on external debt to finance domestic growth; policymakers' pro-cyclical over-stimulation of the economy in the run up to the June 24 parliamentary and presidential elections; and the Central Bank of Turkey's relaxed monetary policy stance have all played their part. Indeed, we are now of the opinion that the "fear of overheating" scenario has already been overtaken by events. The risk to the Turkish economy now is the opposite. It is the risk of a protracted recession.

#### What is S&P Global Ratings' base-case scenario for the performance of the Turkish economy in 2019?

The exceptional volatility of the lira exchange rate over the past two weeks and a significant tightening of both external and domestic financing conditions, as well as a broader decline in confidence will, we believe, undermine the Turkish economy. We project that after average growth of more than 5% over the past three years, the economy will contract by 0.5% in 2019 with both consumption and investments reducing sharply, the latter by a projected 6%. At the same time, we project that inflation will peak at above 20% and the unemployment rate will rise to 12% next year.

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## **What can contribute to reducing Turkish lira volatility, in S&P Global Ratings' opinion?**

In our view, a credible government policy response that directly addresses Turkey's vulnerabilities can contribute to reducing the volatility of the exchange rate, which we regard as fundamentally undervalued. However, we note that currency confidence crises often tend to be self-perpetuating with exchange rates overshooting substantially compared with underlying fundamentals. This is particularly the case where the exchange rate dynamics reflect large net and gross external financing requirements and the volatility of capital inflows, as much as relative prices. Faced with similar circumstances, authorities in other major emerging economies have opted for multiple measures to break the downward spiral. These have included increases in interest rates and commitments to economic adjustment programs and external financing arrangements, such as with the IMF. This was the case in Argentina earlier this year, for instance.

The response from Turkey's monetary and fiscal authorities has been limited so far. The Central Bank of Turkey and the Banking Regulation and Supervision Agency relaxed commercial banks' reserve requirements and introduced de facto limits on lira short-selling. The authorities have also implemented what can be called a "backdoor tightening" by suspending lira lending via the repo facility and providing financing via an overnight lending window with a higher interest rate. In our view, these measures primarily address the symptoms rather than the root cause of the current volatility. Absent a more far-reaching policy response, we believe relief could prove temporary. This could be the case especially if some banks were unable to roll over their external debt while residents increasingly converted their Turkish lira savings to foreign currency. However, although these downside risks exist, our baseline forecast assumes neither scenario will materialize.

## **How high does S&P Global Ratings think inflation can go, and does it matter?**

We project that inflation will peak at 22% in the fourth quarter and remain above 20% in early 2019, before declining thereafter. In the short term, high inflation will erode real incomes and contribute to a decline in consumption--one of the factors underpinning our forecast for a recession in 2019. Additionally, high inflation could have social and political implications, particularly as food inflation remains considerably higher than headline CPI. This portends a larger impact on lower income households, which the government might be able to offset through fiscal policy. Beyond its short-term impact, we believe rapid inflation could also have longer term consequences. High and volatile inflation is often difficult to tame as suggested by past experience in other countries. A rise in inflation expectations may lead to a permanent increase in inflation and dollarization levels with negative implications for the efficiency of monetary policy. This, in turn, would reduce the policy toolkit available to the authorities, making the task of managing the economy through economic cycles more difficult in the future.

## **What sectors in the economy could benefit from the lira depreciation, in S&P Global Ratings' opinion?**

A weaker lira will primarily support export sectors where costs are denominated in local currency while revenues are in foreign currency. This could create room for companies to simultaneously reduce prices in foreign currency and gain market share, while also increasing profitability. We believe this is the case for Turkey's tourism sector. It has already expanded strongly throughout the first six months of 2018, with foreign currency receipts up 30% year-on-year. The textile industry could also benefit given its export orientation and the large domestic value added, even

though some inputs used in production are imported. That said, we believe the recent exceptional lira volatility will likely negatively affect all sectors through its effect on tightening external funding conditions.

**What are the banks' currency swaps and do they pose balance of payments risks?**

Turkish banks have a structural lack of long-term lira funding, which makes them reliant on derivatives--mainly swaps--to close their currency positions. They use these instruments to convert not only borrowing in foreign currencies but also high amounts of domestic deposits in foreign currencies, owing to the use of dollars to fund lending in lira. The total off-balance-sheet foreign currency position amounts to an estimated US\$50 billion (7% of 2018 GDP). Should the counterparties (mostly foreign banks) prove unwilling to extend these contracts, they may also exit their corresponding long Turkish lira positions when the contracts terminate. This, in turn, could create a destabilizing one-time foreign currency outflow.

**Are the Turkish central bank's foreign currency reserves large enough to address the balance of payments risks, in S&P Global Ratings opinion?**

We view the Central Bank of Turkey's buffers to counter balance-of-payments risks as limited. Although headline foreign currency reserves are nearly US\$100 billion (14.5% of 2018 GDP), a large proportion pertains to the Central Bank's liabilities in foreign currency to the domestic banking system. This reflects the required reserves on banks' foreign currency deposits as well as liabilities under the reserve option mechanism. The latter allows commercial banks to maintain some of their required reserves related to lira deposits in foreign currency. As such, they cannot be deployed for balance-of-payments interventions. Excluding these, we estimate the Central Bank's net reserves are a much smaller US\$28 billion (4% of GDP).

**Will Turkey impose capital controls, and what would this imply for corporates' ability to pay their foreign debt, in S&P Global Ratings' opinion?**

We still see the risk that the government would impose capital controls on non-residents as low, albeit increasing, given reduced policy predictability. Turkey's economy requires net external inflows to fund its current account deficits and to roll over the stock of existing foreign debt. By trapping non-resident investors in their current positions, the government would be shutting the economy off from any new external financing. This could lead to a major economic shock. At the same time, however, we see the prospects for the introduction of capital controls on domestic residents as likely rising, given funding pressures on many of Turkey's commercial banks.

**If Turkey negotiated an IMF program, would that support or pressure the sovereign rating on Turkey, in S&P Global Ratings' opinion?**

We tend to view IMF programs--which are usually sought by countries with external funding pressures--as generally supportive of sovereign creditworthiness. They often help break the downward trend in the subject country's balance of payments and fiscal positions. They are usually also a clear expression of the authorities' determination to tackle the root causes of the issues at hand. Credit-supportive aspects of a program typically include low-cost long-term external funding, the adoption of policies to address the source of stress, and various forms of

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technical assistance. In Turkey's case, an IMF program might also provide the kind of external anchor that would lead to a return of large portfolio inflows, helping to stabilize the exchange rate and finance private sector debt rollovers.

### **Given S&P Global Ratings' projection of a recession in 2019, would fiscal tightening help or hinder the Turkish economy?**

In our view, concerns about fiscal easing ahead of the June 2018 elections were justified--also given the multiple layers of budgetary and macroprudential support for rapid credit growth. However, that phase of credit expansion has ended. The current situation is no longer one of private sector leveraging, but of deleveraging. Given Turkey's position in the economic cycle, we therefore believe that significant fiscal tightening could exacerbate an already-sharp projected adjustment. Financing conditions have substantially tightened for the private sector and we expect both consumption and investment to decline next year. A concurrent withdrawal of fiscal stimulus could make output volatility even more pronounced with GDP contracting by more than the currently forecast 0.5%. At present, the fiscal policy direction remains uncertain--the government plans to announce more details in the medium-term program, scheduled to be published in September. Our baseline forecast assumes only a gradual moderation of fiscal stimulus with the authorities remaining wary of implications for the domestic economy. Consequently, we forecast deficits averaging 3% of GDP over the next three years--higher than the official projections. It must be noted, however, that our fiscal projections are also contingent on our economic forecasts.

### **How does S&P Global Ratings view the recently announced US\$15 billion support package from Qatar?**

In our view, if implemented, the \$15 billion support package could provide some support to the Turkish economy. However, details remain scarce and we understand the financing will likely come over a number of years rather than be front-loaded. It is also unclear whether some of the investments included represent net new financing as opposed to ongoing undertakings previously agreed between the two governments. Finally, we believe that Qatar's support will likely come with limited economic conditionality and not require Turkey to address the root causes of current balance of payments stress.

## **Banks**

### **What's S&P Global Ratings' view of the Turkish banking sector?**

The sharp depreciation of the lira is increasingly hampering Turkish private-sector borrowers' ability to repay their debt, a large portion of which is in foreign currency and owed to Turkish banks. During the first half of 2018, a few conglomerates had to restructure large numbers of loans; several other entities are still negotiating with local banks the terms of the potential rescheduling of their borrowings. As a result, the share of "Stage 2" loans (impaired but not classified as nonperforming) in total loans doubled to a decade-high 7%, according to latest figures. Overall, we think that the percentage of problem loans (NPLs plus impaired and restructured) is in the double digits and could increase to 15% within the next 24 months, barring any additional shock or greater depreciation of the lira than we expect. Under a more adverse

situation the number could be higher.

### **In which sectors are loan exposures most at risk, in S&P Global Ratings' opinion?**

We note, particularly, banks' exposure to the energy sector, with its borrowings of around US\$50 billion as of June 30, 2018. The energy sector has been accumulating significant external debt and, amid lira depreciation, has seen severe profitability pressure. We also see risks in the construction sector, which represented about 10% of bank loans as of March 2018. This sector is an important employer in Turkey and key to economic growth, accounting for about 15% of GDP in 2017. In addition, the credit guarantee fund program--which resulted in strong growth for Turkish banks in 2017--has tapered off and increased banks' funding costs. We expect these costs, coupled with higher credit losses, to weigh significantly on Turkish banks' profitability.

### **How does Turkey's institutional framework affect S&P Global Ratings' view of Turkish banks?**

In our view, the institutional framework has weakened in Turkey over the past few quarters compared to its more advanced peer countries, and some Turkish banks lack transparency when it comes to reporting the full extent of their asset-quality deterioration. The latter is exacerbated, in our opinion, by regulatory forbearance in recognizing and reporting problem loans. This is evident from the recent measures that the Banking Regulation and Supervision Agency has introduced and that include a weakening of the classification standards for restructured loans.

What we perceive as a gradual erosion of the Central Bank of Turkey's independence is a contributing factor to increased risks in the banking sector. The sector relies heavily on the confidence of investors (in particular external investors). At the same time, we think that continued currency volatility could lead to a significant decline in banks' profitability, due to rising funding and credit costs, but also to likely weaker new business volumes, and imply gradual changes in the competitive environment in Turkey.

### **Can Turkish banks roll over all of their external debt redemptions over the next 12 months, in S&P Global Ratings' opinion?**

We consider that refinancing risk remains high for Turkish banks, which rely heavily on short-term external debt. While these risks have been kept in check previously, with strong roll-over rates, we believe investors are becoming more averse to Turkish risk and more demanding in terms of remuneration. Banks' access to global capital markets is constrained by investor sentiment, global liquidity tightening, and U.S. sanctions, as well as a U.S. investigation into a large Turkish state-owned bank. For example, interest rates on Eurobonds have reportedly doubled and Turkish banks' access to this market is now constrained. Banks are also exposed to the risk that their foreign currency swaps will not be rolled over (see the question "What are the banks' currency swaps and do they pose balance of payments risks?" above). While Turkish banks defaulting on external debt isn't currently our base case, such risks, while still relatively low, are starting to emerge. We believe that even with roll-over rates on wholesale debt becoming temporarily restrained, the system has enough liquidity buffers to meet its obligations over the next 12 months. Furthermore, customer deposits have remained relatively stable so far. Overall, we now assess Turkey's Banking Industry Country Risk Assessment (BICRA) as being in Group 9.

## How does S&P Global Ratings view the exposure of foreign banks?

Other banks are significantly exposed to Turkey and could see their creditworthiness weaken because of the current situation. One example is Al Baraka Banking Group (ABG), which has a large subsidiary in Turkey. We have therefore revised our outlook on ABG to negative from stable.

Our ratings on Western European banks are not immediately affected by recent events in Turkey. Western European banks carry a total risk exposure to Turkey of about US\$192 billion according to BIS statistics as of March 31, 2018. Although these exposures are not negligible, we don't think they pose systemic risk to European banks, at this stage, given that they are concentrated in a small number of large, internationally diversified banks.

Banco Bilbao Vizcaya Argentaria, S.A. (BBVA), UniCredit S.p.A. (UniCredit), BNP Paribas S.A. (BNP Paribas), ING Bank N.V. (ING), and HSBC Holdings plc (HSBC) have the highest risk exposure to Turkey--what we have long referred to as "pockets of risk". These banks' business and geographic diversity and financial flexibility mitigate the damage that exposure to Turkey could cause to their overall groups. We note the exposures for some banks, such as BBVA and UniCredit, are through joint-ventures in major Turkish banks. We also note the exposures are generally diversified across sovereign, bank, corporate, and retail obligors. We don't think the local affiliates of those European groups will be immune from rising operating risks in Turkey, notably we believe they'll face asset-quality deterioration and therefore likely weaker earnings.

Among European banks, BBVA stands out as the most exposed to Turkey, and the only one for which the loan exposure exceeds, according to our estimates, 10% of the consolidated loan book. BBVA now controls almost 50% of the third-largest Turkish bank, Garanti, with market shares of 11%-12% of the Turkish banking system's deposits and loans. For the other European banks, the loan exposures to Turkey (whether booked at the local affiliate or centrally) are much smaller when compared to the total loan book--about 4% for UniCredit, 2% for BNP Paribas, 1% for ING, and less than 1% for HSBC, according to our estimates. We have therefore revised our outlook on the ratings on BBVA to negative from stable, reflecting that current events in Turkey might have the potential to negatively affect our view of BBVA's creditworthiness, and specifically our current expectations of BBVA's capital strengthening and constrain its ongoing asset quality improvements.

For all the other banks, their international diversification--they are among Europe's most diversified--largely protects them from crystallizing risks in one country. The sensitivity of our capital projections for those banks to the deteriorated economic risk in Turkey isn't enough to challenge our current assessment of their capital and earnings.

## Corporates

### How does S&P Global Ratings think these events influence the corporate sector?

Over the past few years, expansionary fiscal policy through temporary tax reductions, minimum wage subsidies, the expansion of public-private partnerships, and state loan guarantees led to high economic growth (7.4% for 2017). During this period, large Turkish companies increasingly resorted to foreign currency borrowing, attracted by lower prices relative to Turkish lira loans. A number of borrowers had exports or foreign currency revenues or relied on their potential capacity to pass any depreciation of the lira to their final customers. In its Financial Stability Report

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published in April 2018, the Central Bank of Turkey estimated the corporate sector's foreign currency net open position at \$221 billion.

### **How has the depreciation of the lira affected companies' balance sheets, in S&P Global Ratings' opinion?**

The lira's depreciation has inflated debt stock and debt service requirements for companies that borrowed in foreign currency with little or no hedging and report in local currency. Interest and debt stock inflation have led some companies to restructure or refinance. A few companies rated by S&P Global Ratings have natural hedges because they generate revenues in foreign currencies and some hold large amounts of foreign currency in deposits, mainly with local banks. Given the significant depreciation of the lira, we expect that foreign currency borrowing-related problems will likely worsen for the Turkish companies and we expect to see an increase in loan restructurings.

### **Local financial conditions are rapidly tightening. What does this mean for corporates, in S&P Global Ratings' opinion?**

Our expectations for tighter local credit market conditions should also mean a decline in bank liquidity available to Turkish companies. Banks are also increasing their credit pricing levels, which will translate into higher funding costs and lower debt service coverage for many companies. We expect most private-sector companies to curtail significant capital spending programs, where feasible, as they prioritize cash preservation. At the same time, we expect the weaker lira to increase raw material costs for a number of Turkish entities, and some may not be able to pass these costs on to end-clients.

### **With a recession predicted for next year, what is the outlook for companies' profitability, in S&P Global Ratings' opinion?**

We expect revenue generation for most companies and sectors catering to local demand to be hurt by weakening consumer and business sentiment. The situation would potentially be more problematic for importer companies of U.S. goods given the recent tariffs imposed by the Turkish government. While we might see relative strength in some of Turkey's higher value-added export-based sectors (for example textiles) and exporters, the U.S.'s recent imposition of tariffs, for example on Turkish steel and aluminum exports, poses additional hurdles for exporters. We also expect the Turkish real estate and energy sectors to face difficulties with declining revenues and inflated debt.

## **Insurance**

### **How does S&P Global Ratings think the Turkish insurance market has been affected by the recent developments?**

The deterioration of the Turkish financial system risk assessment has triggered a downward revision to our insurance industry and country risk assessment (IICRA) of Turkey's property/casualty (P/C) sector to high risk from moderate risk. In our opinion, the main risks

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Turkish insurers will face relate to foreign exchange movements and asset credit quality.

Though insurance entities in Turkey are largely domestically focused, local motor insurance (both third-party liability and own damage) contributes to about half of the market's premiums (as of end-June 2018). The recent sharp devaluation of the lira will increase claims costs for spare car parts because they are priced in hard currencies. As such, the already-loss-making technical performance of the sector will likely worsen. We estimate a net combined ratio for the sector of about 105% in 2017. (Lower combined ratios indicate better profitability. A combined ratio greater than 100% indicates an underwriting loss.) Furthermore, the high interest rates on government bonds and bank deposits make these asset classes attractive investments for insurers operating in Turkey. This limits their portfolios' credit quality. However, interest income from these investments somewhat mitigates the technical losses from the insurance book.

### **Does S&P Global Ratings think its ratings on insurance entities with exposure to Turkey will be affected?**

The insurance companies we rate aren't directly affected by these developments, with the exception of Milli Reasurans T.A.S. (Milli Re), a reinsurer domiciled in Turkey. Because Milli Re is majority-owned by Türkiye İş Bankası AS (İsbank), we limit our rating on Milli Re to that on İsbank. Consequently we lowered the rating on Milli Re to 'trA+' in line with a similar action on the bank on Aug. 17, 2018, and continue to expect both ratings to move in tandem. Other than Milli Re, all our rated insurers globally have an exposure of less than 10%, as measured by gross written premiums (GWP), with some being exposed by less than 1%. We therefore believe it is unlikely that the downward revision to the Turkey P/C IICRA would affect our view of these insurers' business risk profiles.

Moreover, insurance entities with exposure to Turkey are usually either incorporated in Western Europe or in Gulf Cooperation Council (GCC) countries. Some European entities, such as Allianz SE and AXA SA, have large subsidiaries in the Turkish market. However, in the context of those global multiline insurance groups, the exposure to the Turkish market is insignificant. GCC companies also have a presence through smaller subsidiaries. Yet, they're not significant in the context of the respective groups (as a proportion of GWP, total assets, or total equity). Therefore, while these companies face some foreign exchange risk, the absolute amounts relative to their capital base is limited.

With that, we expect the financial risk profile of foreign insurers exposed to Turkey to remain unaffected. Net profits in Turkey will translate into smaller profits in local currencies whereas losses in Turkey will be cheaper to finance. Nonetheless, we note that these entities view their presence in Turkey as a strategic, long-term investment. As such, we believe they will remain committed to their subsidiaries.

This report does not constitute a rating action.

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