Ekinci Economics Consulting

For better Financial Foresight

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Why Turkey's banking sector is poised for a rebound

Our out-of-consensus monetary policy call is that the European financial crisis will lead to an easing in the banks' reserve requirements.

Key judgments

- The primary drivers of the performance of Turkish banking shares in the next 12 months will be the Eurozone financial crisis and an expected easing of monetary policy by the Central Bank of Turkey.

- We expect the Central Bank of Turkey to ease monetary policy by cutting banks' reserve requirements in Q1/12.

- Because Turkish banks are among the strongest in the G20 with regard both to capital adequacy and to profitability, we expect them to show their resilience in the face of a worsening global outlook – just as they did in 2009-10.

- We believe the preferred policy mix of Turkey's economic policymakers will include reductions in the already low budget deficit along with an easing of banks' reserve requirements before next April.

- Investors looking for exposure to the leading Turkish bank shares will likely find buying opportunities in the periods of renewed volatility that we believe lie ahead due to the Eurozone crisis.

CONTEXT

Turkey's banking sector was resilient during the last global financial crisis in 2008-09. Investors are concerned about whether this outperformance can be repeated during the current financial crisis in the Eurozone. The worries centre on potential volatility in European financial shares and the possible spill-over effects not only on Turkey but on emerging markets more broadly.

Turkish banking shares owed their outperformance during the last crisis to:

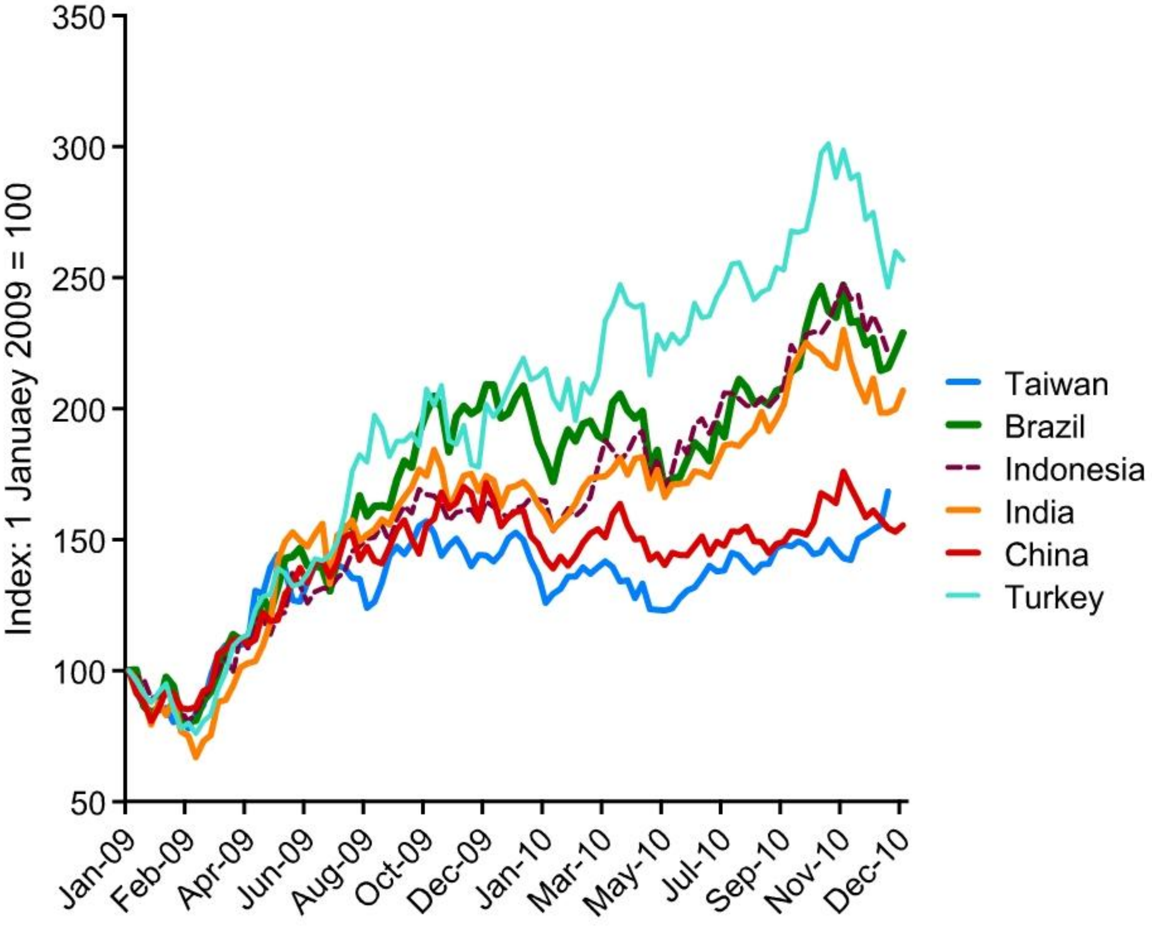
- Strong supervision by the banking regulator (BRSA) which prevented the banks from adding exposure to various "toxic assets"; this was a major reason for the banks' strong showing on capital adequacy measures;

- High capital adequacy ratios, over 18 per cent on average;

- Relatively low dependence on wholesale funding thanks to high levels of retail deposits.

During 2009-10 the MSCI Turkish Index rose about 150 per cent, twice as much as other major EM markets. Turkish financial shares account for nearly 50 per cent of this index.

Chart 1: MSCI equity indices, 2009-10 (US$ terms, three-day moving average)



Source: Bloomberg.

Thanks to their strong capital position, deposit banks recorded an average annual growth rate of 21 per cent in total assets and net profit of the sector rose by 9 per cent year on year in 2010. The growth of assets was driven by the rapid increase in domestic loans, which rose at an annual rate of 36 per cent in this period. Table 1 below shows that the Turkish banking sector compares favourably to other countries on capital adequacy and rate of return measures.

Table 1: Comparative banking data on capital and returns

	Regulatory Tier 1 capital to risk-weighted assets (%)			**ROA**			**ROE**		
	2009	**2010**	**Latest**	**2009**	**2010**	**Latest**	**2009**	**2010**	**Latest**
Turkey	18.6	17.0	15.6**	2.4	2.2	2.4**	18.2	16.4	20.4**
China	12.9	10.1	12.5**	0.8	1.1	1.0**	16.7	19.7	19.3**
India	9.2	10.3	9.3*	1.0	1.0	0.9*	10.0	10.8	14.3*
Brazil	15.1	13.5	13.9*	1.9	2.1	3.3*	20.4	21.7	29.6*
Russia	14.7	13.2	13.2	0.7	2.0	2.0	4.1	12.5	12.5
Spain	9.7	10.2	10.2	0.6	0.5	0.5	9.1	7.9	7.9
Germany	10.8	12.3	12.6**	0.2	0.2	0.2	5.0	5.0	5.0

Source: IMF Global Financial Stability Report.
****Q2/11**
***Q1/11**

Emerging dynamics of Turkey's financial sector

We identify two primary drivers for Turkish banking stocks over the next 12 months. One is the Eurozone banking crisis and its impact on Turkish banks and their stock market valuations. The second is the future direction of the Central Bank of Turkey's (CBT) monetary policy. We believe the evolution of the Eurozone crisis will have an important influence on CBT policy. That is why it is essential to understand the interaction of these two factors before drawing any conclusions about the outlook.

We start from the assumption that a deal to reschedule Greek debt will soon be announced with discounts of at least 40-50 per cent. We expect the rescheduling to be managed with assistance from major Eurozone countries, the IMF and the European Central Bank. We believe that this exercise will be accompanied by the implementation of recapitalization programmes for the Eurozone banks which will likely stretch out over the next 12-18 months.

We draw two conclusions for Turkey from this scenario:

1. Global equity markets will remain extremely volatile in the coming two-three months with high correlation among them regardless of underlying fundamentals. Although empirical research has shown that the Turkish stock market is usually little correlated with its mature counterparts in the EU, high correlation is likely during upcoming periods of high volatility.

2. During periods of panic, as when the bank recapitalizations are announced, we expect that financial stocks will be de-rated in all markets including Turkey.

The second driver of Turkish banking stocks will likely prove supportive of valuations. The earlier period of outperformance of Turkish stocks came to an end when the CBT adopted unorthodox monetary policies last December. Instead of hiking interest rates as expected by the market, the CBT raised bank reserve requirements substantially. The goal of this policy was to dampen the growth in bank lending (to reduce the demand for imported consumer products) and to discourage the inflow of foreign portfolio investment by weakening the lira.

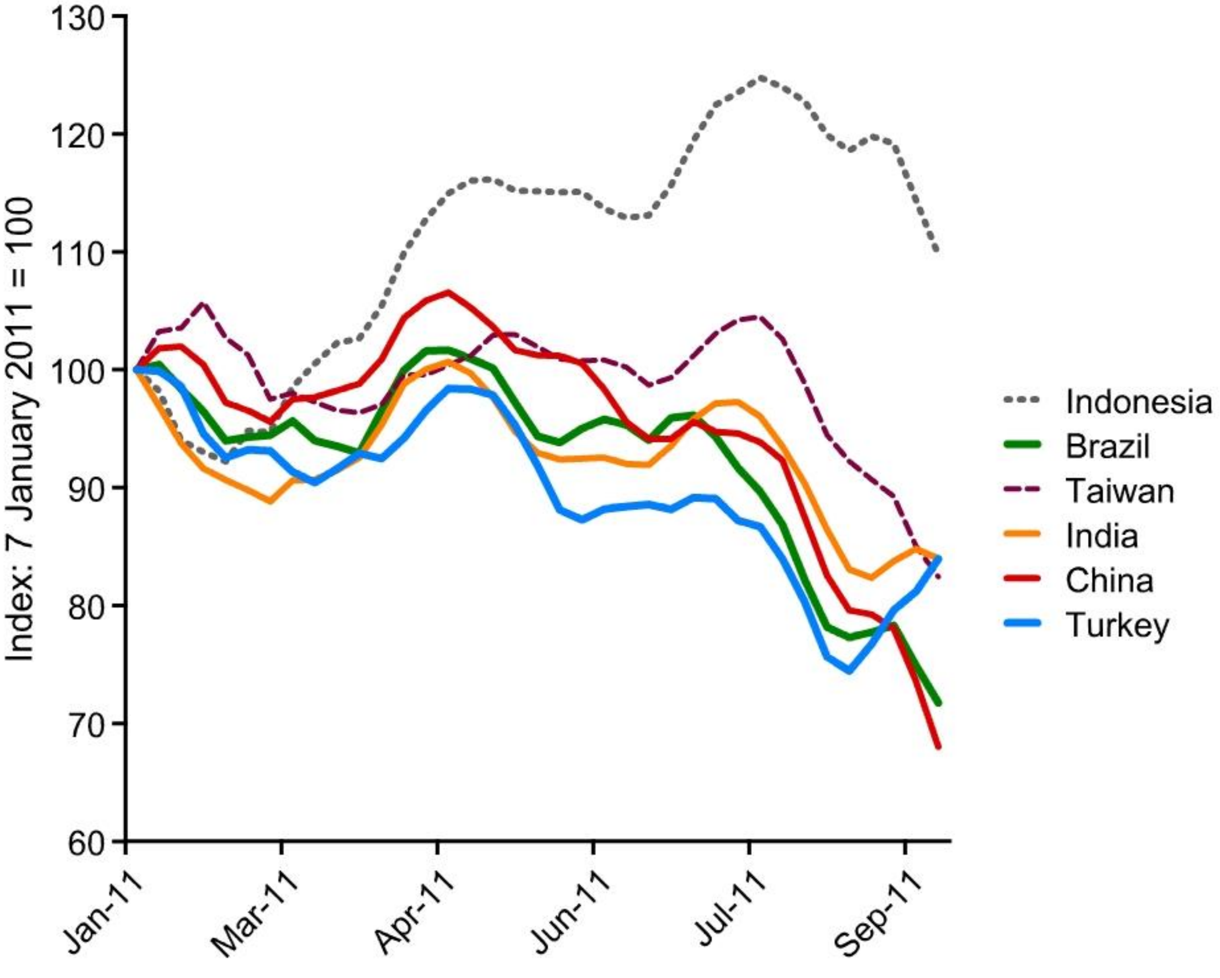
The choice of unorthodox policy measures reflected a concern for systemic stability of the banking system, not just the goal of restraining inflation. In December 2010 Erdem Basci, who in April was promoted from Deputy to Governor of the CBT, explained [link: http://www.tcmb.gov.tr/yeni/iletisimgm/Basci_EU.pdf] that raising interest rates to fight overheating of the economy could conflict with the central bank's responsibility to protect financial stability. His concern with financial stability has remained a primary focus of the CBT's monetary policies in the subsequent months.

The initial verdict on the CBT's unorthodox policies was negative

The markets were not impressed with this new direction in monetary policy. The consensus opinion earlier this year was that the economy was heading towards a hard landing and that cutting interest rates would only aggravate the coming economic collapse and the inevitable reversal of policies would push interest rates sky high. This led to a selloff of Turkish equities, especially bank stocks.

Turkish banks play a dominant role in the local market – they make up nearly 50 per cent of the MSCI Turkish Index and 90 per cent of all financial sector assets. From January to its low point in early August the MSCI Turkish Index fell 35 per cent, the worst performance of any major EM equity market. Financials fell even more, 39 per cent. When the global market selloff hit in September Turkish financial shares rose sharply. A large part of the explanation for this contrary move in Turkish equities was due to the fact that most foreign investors had already exited the market prior to the September events and equities were viewed as oversold. But there is also reason to think that some investors believe fundamentals have turned around and are now improving.

Chart 2: Performance of MSCI financial sector indices for selected emerging markets, 1 January – 30 September 2011



Source: Bloomberg.

The latest data illustrate the impact that these measures had on bank profitability: during January-August 2011 net profit of the sector fell by 15 per cent vs the same period in 2010. Although the decline in profitability was "only" 15 per cent, the new measures were imposed during a period of strong loan demand when banks might normally expect to achieve substantial increases in profits.

A different perspective on the CBT's new measures may be gained by looking at the substantial lag between the time they were imposed and the time their effects on key economic variables became clear. This March we concluded that macroprudential measures such as the Turkish ones were likely to be less effective than old-fashioned interest rate tightening in curbing inflationary pressures. Macroprudential measures target banks' liabilities but leave the banks free to arbitrage market mispricing on the asset side of their balance sheets.

What happened in Turkey was that banks repoed their holdings of government bonds with the CBT in order to generate liquidity that they then directed into new lending. As a result, a slowdown in bank lending (which was the primary target of policy) did not show up until six months later and this reversal was partially due to administrative pressures on the banks to adhere to a CBT guideline to reduce loan growth. The most recent data highlight the recent slowdown in bank lending; these data are adjusted for the depreciation of the lira because 29 per cent of total loans are denominated in foreign currency. The growth rate of consumer loans, which peaked at 34 per cent in May, fell rapidly to 16 per cent on an FX-adjusted basis in August; for the latest data available see Chart 3 below.

Chart 3: Bank loan growth, FX adjusted, January 2007 – August 2011

Although the banks have borne the brunt of the CBT's unorthodox monetary policies since last December, we believe that over the next three-four months they will be the primary beneficiaries of the CBT's response to the developing economic downturn in Europe. As we expected, the CBT has already started to ease monetary policy in October via reductions in required reserve ratios (RRRs). The CBT altered reserve requirements on 12 September to permit 10 per cent of RRRs on Turkish lira deposits to be satisfied with FX holdings (US dollar or euro). This limit was raised in early October to 20 per cent and other RRRs on lira deposits were lowered, mostly on longer-term deposits – the weighted average reserve ratio fell from 13.1 to 12.5 per cent. The CBT's press release said these moves were taken in response to "possible financial turmoil that may be triggered by global developments".

We believe it is very likely that further monetary policy easing will be implemented by gradual RRR cuts over the next six months. The market consensus is currently waiting for a rate hike from the CBT in response to rising concerns over medium-term inflation. Recent tax hikes are expected to push inflation up by two percentage points by end 2011. Recently the weak lira has further complicated the task of the CBT. At its latest meeting, the monetary policy committee decided to widen the interest rate corridor by making a significant increase, from 9 to 12.5 per cent, in the overnight lending rate. However, this is not having a meaningful impact on banks as the official and effective market rate is the weekly repo rate which was kept on hold at 5.75 per cent. We believe this symbolic widening in the overnight interest corridor highlights support for the Turkish lira and it was not a stealth tightening as is suggested by many market analysts. The action has yielded its return. The Turkish lira has already strengthened to 1.82 from 1.86 after direct official interventions by the CBT.

We have an out-of-consensus call on the CBT's policy: there will be no official rate hikes in the next quarter while monetary easing will be implemented by gradual RRR cuts starting from Q1/12. Our assessment is linked to the looming economic depression in the EU which will affect the Turkish growth rate. We think financial stability will be the CBT's priority concern in the next six months, rather than inflation. Since the slowing of economic activity will curtail loan demand and threaten bank profitability, the CBT will likely try to meet the lira liquidity needs of the banking system in a more permanent way and at lower cost. At the same time monetary easing will be accompanied by fiscal tightening to reduce the country's budget deficit – during 2011 Turkey's fiscal deficit is projected at 1.7 per cent, down from 3.6 per cent in 2010. Earlier this month, new tax increases were announced on tobacco, alcohol, motor vehicles and mobile phones. The target for next year's deficit is 1.5 per cent of GDP, despite the projected slowdown in the economy.

Our baseline scenario is that the fallout of the Eurozone financial crisis on Turkey will be limited thanks to hands-on government and monetary policies. Growth for calendar 2011 will not fall below 6.5 per cent because first half results were quite high; for H2/11 we expect average growth of 5 per cent; growth in 2012 will slow to 3.5-4 per cent. Below we spell out the reasons for our optimism about the outlook for Turkey's financial sector.

Unorthodox monetary policy revisited

Our positive view of Turkish banks is based primarily on the monetary policy outlook. We believe that the near-term growth and profitability of the banking sector will be driven primarily by changes in monetary policy. Even more important, CBT policy will react to developments in the Eurozone in ways that will be positive for bank profitability. Despite the expected slowdown in Turkish growth next year and the evolving financial crisis in Europe, Turkish banks should experience stronger bottom-line performance during the course of 2012. This more positive perspective appears already to be supporting a turnaround in the performance of Turkish banking shares.

Two related changes in CBT policy underlie our thesis. First, our judgment is that since last November the CBT is giving greater weight in its monetary policy decisions to potential developments that lie beyond a six-month horizon. The global financial turmoil in 2008-09 provided the CBT with a valuable lesson on how crises in the rest of the world can affect Turkey. Indeed, the minutes of the 4 August meeting at which the CBT took the unexpected decision to cut its policy rate by 50 bps to 5.75 per cent highlighted that the reduction was based on expectations of a significant slowing of economic growth in developed countries. This confirms not only that CBT policy is much more proactive today but also that it is now focused on broader economic stability concerns rather than just the narrow issue of domestic inflation.

Last May, before the general elections, our out-of-consensus call which proved correct, was that a sharp slowdown in growth rates of GDP and bank loans was in the works and because of this rate hikes this year were unlikely. Our call now is that monetary policy easing will take the form of gradual reductions in banks' RRRs starting in Q1/12 but that interest rates will remain unchanged until this year end and into early next year.

From our perspective the logic of CBT policy is very simple: its monetary policy decisions now give as much priority to financial and systemic stability as to price stability. The CBT is currently preoccupied with the coming slowdown in the domestic economy that will result from the global economic crisis. But with inflation still running at 6.2 per cent – close to the top of its target band – we think the CBT will ease liquidity via RRR reductions rather than interest rate cuts.

And given the recent weakness in the lira there are few prospects for further interest rate cuts in the coming months.

How unorthodox monetary policies affected the banks in H1/11

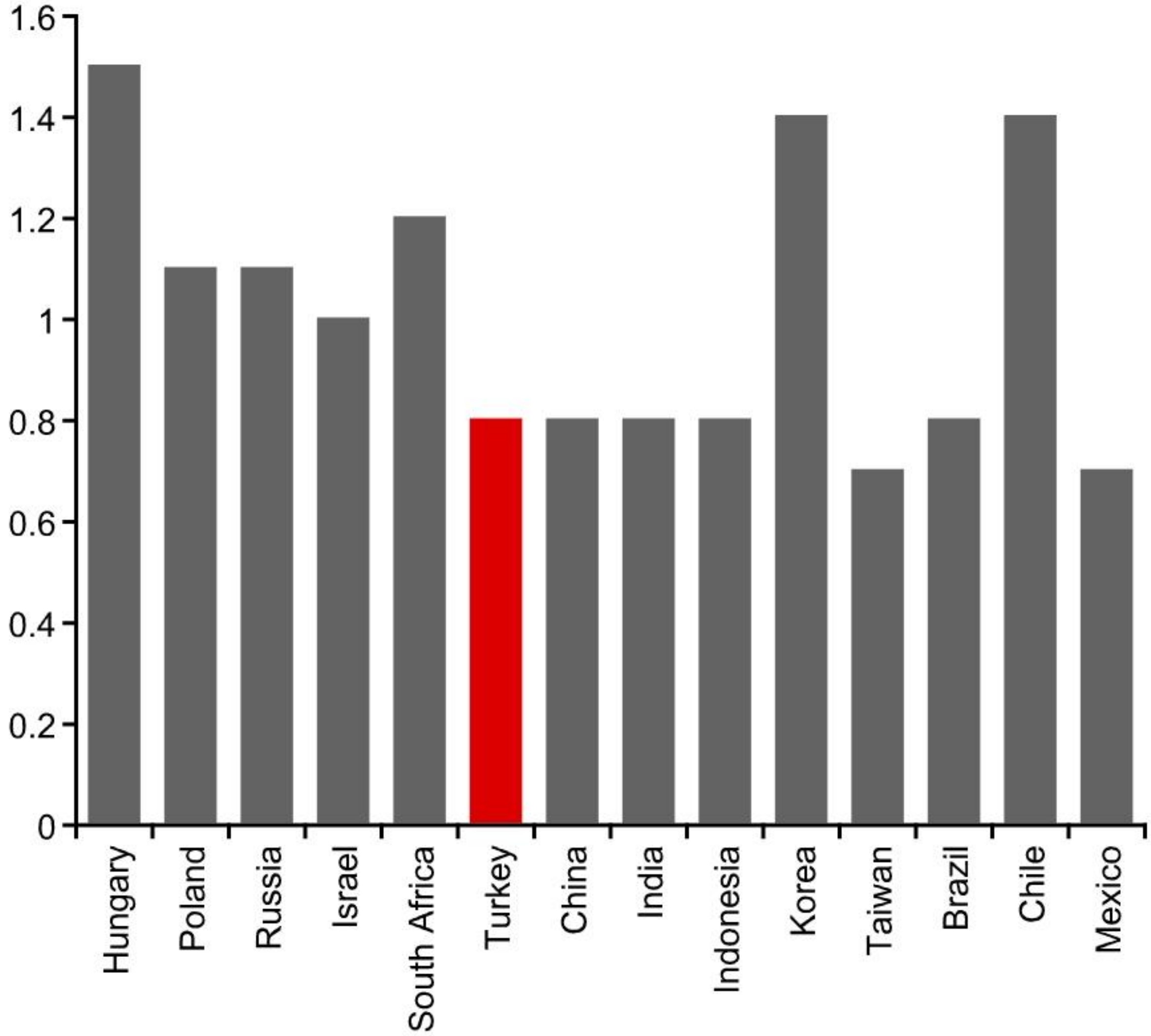
The December hikes in RRRs forced the banks to increase reserves and pushed up interest rates on their loans. Initially they attempted to raise liquidity to sustain loan growth by executing repo transactions of their holdings of government securities with the CBT. After May they were forced to rein in the growth of their lending.

The rising penetration of foreign banks in consumer banking in recent years was largely responsible for the sharp increase in retail loans. The typical strategy of foreign banks was to expand their market share for consumer loans via aggressive marketing. This is why private banks were the most severely affected by the increase in RRRs (among them Fortis, ING, TEB BNP Paribas, Finansbank NBG, Akbank and Denizbank). This can be seen in data showing that total loans by foreign private banks rose by 23 per cent by end August vs the same period last year while those of state banks rose by 40 per cent (these figures are not adjusted for changes in the exchange rate). The capital adequacy ratio of state banks fell two percentage points to 19 per cent from January to end August. This ratio, which reflects banking soundness, fell by 4.3 percentage points to 15 per cent for domestic private banks and by 3 percentage points to 16 per cent for foreign private banks.

The new monetary policy forced the banks to find new funding sources in addition to the short-term alternative of repoing their government bond holdings. Banks secured several billion lira worth of funding via bond issues, syndications and securitization transactions in both local and international markets. The equivalent of US$7.1 billion in international borrowing was raised by Turkish banks in Q2/11. This included the equivalent of US$5.5 billion in syndicated loans and US$1.1 billion in securitized loans. This increase in the banks' foreign liabilities lengthened their maturity, which was likely an unstated goal of the CBT's new policies. Funds raised by banks via syndications and securitized credits rose 37 per cent year on year during H2/11 to reach US$8.8 billion.

An international comparison highlights the relatively modest gearing of the Turkish banks. A measure of overall financial leverage, the loan-to-deposit ratio, shows Turkey as having one of the lowest figures among EM economies (see Chart 4 below). Despite their modest gearing, Turkish banks are among the most profitable in the G20. Turkish banks had the highest regulatory tier 1 capital to risk-weighted assets ratio among G20 countries at the end of last year, 17 per cent (see Table 1 above). Despite high capital levels, Turkish banks perform well in comparisons of profitability: their 2.4 per cent return on assets in Q2/11 was impressive, trailing only Brazil, while their return on equity was relatively strong at 20.4 per cent.

Chart 4: Loan-to-deposit ratios of major EM economies, Q1/11



Source: IMF Global Financial Stability Report.

Where is CBT policy heading?

The vulnerability of EM economies to capital market developments in large developed economies is undeniable and it poses a major practical challenge for domestic policymaking. A common feature of emerging markets that distinguishes them from developed countries is their limited ability to smooth out large external shocks that are characterized by sudden capital outflows.

As we highlighted above, the CBT is focused more on systemic stability now that Erdem Basci has become Governor of the CBT. The bank argued in its latest monetary policy report that both the banks' credit expansion and domestic demand decelerated at the desired pace. The current pace of loan growth on a FX-adjusted basis is already below its end-of-year 25 per cent target. Indeed, the CBT's policy mix of keeping interest rates low to discourage capital inflows while using other macroprudential measures to curb inflation is gradually being adopted by other emerging economies, Brazil and Indonesia among them.

The essential preconditions for our base case of monetary easing via reductions in RRRs are coming into place, but there are still several uncertainties. Recent balance of payment figures show a sharp fall in Turkey's current account deficit (CAD) (see Chart 5 below) from its peak in Q2/11. With prospects of a slowing economy the CAD will continue falling, though it will likely remain relatively high compared to other EM economies. Next year the CAD is officially projected at 8 per cent of GDP, a level that is unsustainable. The CAD will continue to preoccupy Turkish policymakers and the markets. If a squeeze on financing of imports emerges during 2012 this would accelerate the downward adjustment in the CAD.

Chart 5: Current account deficit, January-August 2011

Source: Central Bank of Turkey.

The main uncertainty in the outlook concerns the expected slowdown in loan demand. Before the CBT relaxes measures to restrict loan demand it needs to see convincing evidence that loan growth is moving onto a much slower trajectory. As we highlighted in our last note on Turkey there is a close relationship between loans and the growth rate of the Turkish economy. Although the latest data show slowing in the month-on-month increase in bank loans, several more months' data are needed before any confirmation that the slower trend in bank lending will be sustained.

The CBT has said it does not have an explicit exchange rate target. We think this is true despite the recent large-scale CBT interventions. Our sense is that the CBT is not unhappy with the recent depreciation of the lira, but it is sensitive to any sign that Turkey could become a target of speculators looking to short "vulnerable" currencies in the midst of the worsening European financial crisis. This vulnerability was highlighted in comments by Governor Basci in August that he was prepared to cut interest rates further in order to preserve financial stability. These comments were ill-timed from the perspective of FX markets since they created expectations of further currency weakness and hence increased speculation on just such declines. This is why the CBT has focused on the psychological level of TRY1.90 /US$, which it associates with "excessive market volatility". We think the CBT views the TRY1.90 /US$ level not as a longer-term target but as a short-term trigger for intervention.

We think CBT FX policy will be influenced by two primary considerations. First, the CBT believes that the second-round effects of exchange rate depreciation on inflation will be limited in the next six months due to the expected slowdown in the economy. Second, the CBT sees the pass-through of exchange rate depreciation to inflation as being limited in a floating exchange rate regime, in terms of both speed and magnitude. (Empirical evidence shows that it takes one year for pass-through effects to show up under a floating FX regime such as Turkey's.) This suggests that the pass-through of the lira depreciation will be felt towards the end of next year, not in the near term. On the other hand, the recent tax increases will push up inflation in the short term, possibly close to 10 per cent. This is a reason why we do not expect reductions in RRRs before the end of this year.

All in all, we believe the CBT's new policy mix will feature lower RRRs in four-six months followed by lower interest rates but only when inflation falls back below the current 5.75 per cent level of the bank's policy rate. This is unlikely to happen until H2/12. We expect a total 400 bps reduction in the RRR on short-term lira deposits before next April. This represents half the increase that was enacted earlier this year. The CBT will likely remain committed to flexible exchange rate policy to encourage further adjustment in the current account and will not attempt to peg the lira at any given level.

Conclusions

Positive prospects for banking sector profitability

Our judgment is that the evolution of future CBT policies will boost the profitability of Turkey's banks. We see a reasonable prospect that today's low policy rate, potential declines in reserve requirements and a weak Turkish lira will drive the recovery of the sector's profitability during the course of 2012. In an environment characterized by a significant slowdown of economic growth the banks' net interest margins should improve thanks to lower funding costs. Further declines in RRRs would thus feed directly into an increase in banks' profits.

The outperformance of Turkish banking stocks during September's market volatility suggests that they are bottoming out. However, with prospects of further volatility ahead associated with the Eurozone financial crisis we recommend that investors wait for buying opportunities before taking new positions in the leading Turkish bank shares.

Relevant Companies

AKBANK (AKBNK.IS)

Turkey's fourth-largest bank by assets; total assets rose 19% yoy to TRY133 billion by end Q3/11 and its Tier 1 capital ratio of 16.1% is the strongest among the Turkish banks. Founded in 1948; its major shareholders are Sabanci Holding (40.8%) and Citigroup (20% since 2007). 29% of Akbank's shares are listed on the ISE. It provides retail, commercial, corporate and private banking services, as well as foreign trade financing services. The bank has 912 branches and 15,300 employees. Its net profit contracted 14% yoy in Q2/11.

ALBARAKATURK (ALBRK.IS)

Founded in 1984 by Turkey's Albaraka Banking Group, which operates in the Gulf, Middle East and South Africa. Albarakaturk provides retail, corporate and international banking products and services primarily in Turkey through its 113 branches. Foreign partners own 66.2% of the bank, local partners 11.3% and the public 22.5%. Its total assets rose by 14% yoy to TRY8.7 billion by end Q2/11. It mainly provides loans to SMEs. It is relatively insulated from policy rate hikes due to the participation banking mechanism (Islamic-style banking) and shorter duration mismatch relative to conventional banks.

GARANTI BANK (GARAN.IS)

Turkey's second-largest privately owned bank in terms of total assets (US$96 billion) and equity; founded in 1946. It is jointly controlled by Dogus Holding (24.2%) and Banco Bilbao Vizyaca Argentaria BBVA (25%). It operates in every segment of the banking sector and has 884 domestic branches. It has an 11.7% market share of deposits and 12.1% market share of loans. Its net earnings rose 10% yoy in Q2/11. Garanti shares constitute 24% of the foreign transactions on the ISE and almost half of the foreign transactions among all listed banks. Its total assets increased by 25% yoy to TRY142 bn in Q3/11 and its Tier 1 ratio currently stands at 15.5%.

HALKBANK (HALKB.IS)

Turkey's seventh-largest bank in terms of assets, which rose by 26% to TRY86 billion by Q2/11. The bank was founded in 1933 and operates 655 branches (652 domestic branches and 3 foreign branches in Cyprus and Bahrain). It also has 3 financial service branches in Germany and Iran. The Turkish Privatization Administration Agency owns 75% of the bank, with the possibility of an IPO or block sale in the next 3 years. The bank has an 8.3% market share in loans and 8.8% in deposits. It was one of the banks most exposed to the hike in TRY deposit costs.

ISBANK (ISCTR.IS)

Turkey's largest private bank and its first truly national bank; founded in 1924. Its total assets are expected to increase by 21% by end Q3/11 to TRY151 billion. The bank is the leader in terms of both loans (12.4% market share) and deposits (13.6%). Its Tier 1 capital ratio is 13.8%. Isbank provides corporate, commercial, retail, private and treasury products and services in Turkey (1,143 branches) and internationally (16 branches).

VAKIFBANK (VAKBN.IS)

Turkey's sixth-largest bank with assets of TRY90 billion; founded in 1954. It is owned by the General Directorate of Foundations (58.5%) and Vakifbank's pension fund (16.1%). Its headquarters moved from Ankara to Istanbul this year. It provides corporate, commercial and retail banking services through a network of 543 branches in Turkey and 2 branches in New York and Bahrain. Total assets rose by 20% yoy by end Q2/11. The bank has an 8.5% market share of loans and 8.1% of deposits. In addition, bank subsidiaries engage in producing and selling electrical and thermal energy, hotel business as well as rent hotels.

YAPI KREDI BANK (YKBNK.IS)

Turkey's fifth-largest bank in terms of assets; total assets rose 30% yoy by end Q2/11 to TRY107.5 billion. Founded in 1944, Yapi Kredi is active in retail and corporate and commercial banking as well as private banking and wealth management. It has a network of 868 branches in Turkey and also has operations in the Netherlands, Azerbaijan and Russia. It has a 10% market share of loans and 8% of deposits. Its net earnings contracted by 17% yoy in Q2/11 because the bank's balance sheet was more exposed to NPLs this year than in 2010. It has been one of the worst performers among large-cap stocks since the end of 2010.