Turkish Banks: High inflation poses profitability and asset quality risks

BankFocus Research
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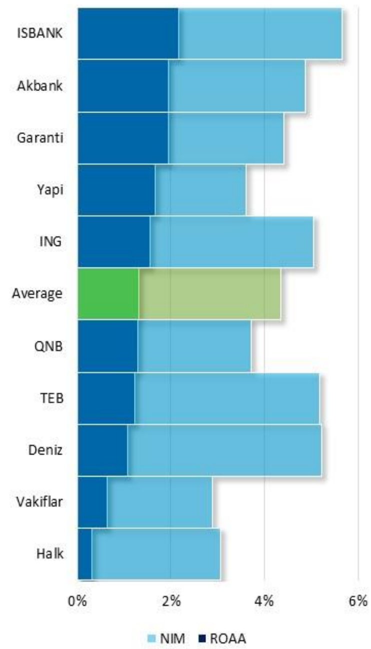
Turkish banks'[1] profitability is expected to come under further pressure due to high inflation and increased cost of funding. Provisioning expenses amount to almost half of Operating profit and may raise further. However, capital ratios are adequate and coverage ratios remain high.

- Türkiye's steep inflationary trend is the worst among emerging markets and is expected to **hike operating and funding costs** as Turkish banks have high dependency on wholesale funding.
- The latest financials of the 11 Turkish banks **indicate that despite healthy interest margins they are already under cost pressure.** On average their cost-to-income ratios were above 40%, despite having high NIMs exceeding 4.2% as at end-2021.
- The risk-weighted capitalisation of the Turkish banks is adequate, with the average CET1 ratio above 12.5% as at end-2021. However, **internal capital creation rates remain modest at 13%.** This is considerably below the average Total asset growth rate of 51% in 2021 and is likely to constrain future growth. The privately-owned banks fared better compared to state-owned banks on this metric.
- High inflation may contribute to asset quality deterioration and result in **increased impairment provisioning,** which is already high at 48% of Operating income (average for last 3-years). Such high levels of impairment provisioning will erode Turkish banks net profitability.
- However, the Turkish banks maintained **high loan loss coverage ratio** at 138% as at end-2021. This reduces pressure on capital from potential losses.

RoAA & NIM, FY2021



This report has been created using the data of Moody's Analytics BankFocus. If you would like more information on how to replicate the research, or would like a free trial, email
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[1] *For the list of banks refer to "Research methodology and scope" pg. 12*

Challenging operating conditions for Turkish banks

In this report we focus on 11 largest Turkish banks in the context of difficult macro-economic environment. Türkiye recorded the highest inflation rates among emerging market economies with the Consumer Price Index (CPI) raising to 80% in August 2022[2].

However, the Central Bank of Republic of Türkiye (CBRT) has refrained from raising its key interest rates. Instead, it lowered the 1-week repo rate four times in 2021 to 14% by December 2021 from 19% in March 2021. More recently, on 18 August 2022, the CBRT cut the repo rate by 100bps to 13%. In addition, the Turkish government twice increased the minimum wage to address inflationary pressure and has cut Value Added Tax (VAT) on several food commodities. The first minimum wage hike by 50% was announced in January 2022 and followed by another 30% in July 2022. The government also reduced VAT on basic food items to 1% from 8% in February 2022.

Reflecting these macroeconomic trends, the Turkish Lira depreciated against US dollar by 81% in 2021 and by another 37% in the first eight months of 2022. In light of these developments, we examine the relative positioning of the selected Turkish banks on following financial indicators - *Profitability, Capital* and *Asset quality* and indicate our expectation of trends.

Profitability pressure to intensify

We divided the profitability exhibit into four quadrants based on the intersection of the two ratios (Cost/Income and NIM) as per the latest financials accounts.

The average combined ratio for the 11 Turkish banks was positioned in the blue quadrant bordering the yellow and red quadrants. **This indicates that despite healthy interest margins, the Turkish banks are coming under cost pressure.**

The entities in the green quadrant have the strongest profitability profiles. Their NIMs were relatively high (exceeding 4%) as well as stronger than the average Cost-to-income ratios (below 40%). This would enable them to mitigate pressure from the worsening operating environment. In case of migration to the blue quadrant these entities can absorb profitability pressure through higher NIMs. A total of four banks out of 11 were positioned in this quadrant.

The blue quadrant had banks with NIMs above 4% but weaker operating efficiency ratio of over 40%. The banks in this quadrant are likely have their earnings vulnerable to rising costs and wage increases. Also, NIMs could come under pressure as Turkish banks rely on market-sensitive wholesale funding in excess of 40% of Total funding. We expect the banks in this quadrant to move towards the red quadrant as the difficult economic conditions persist.

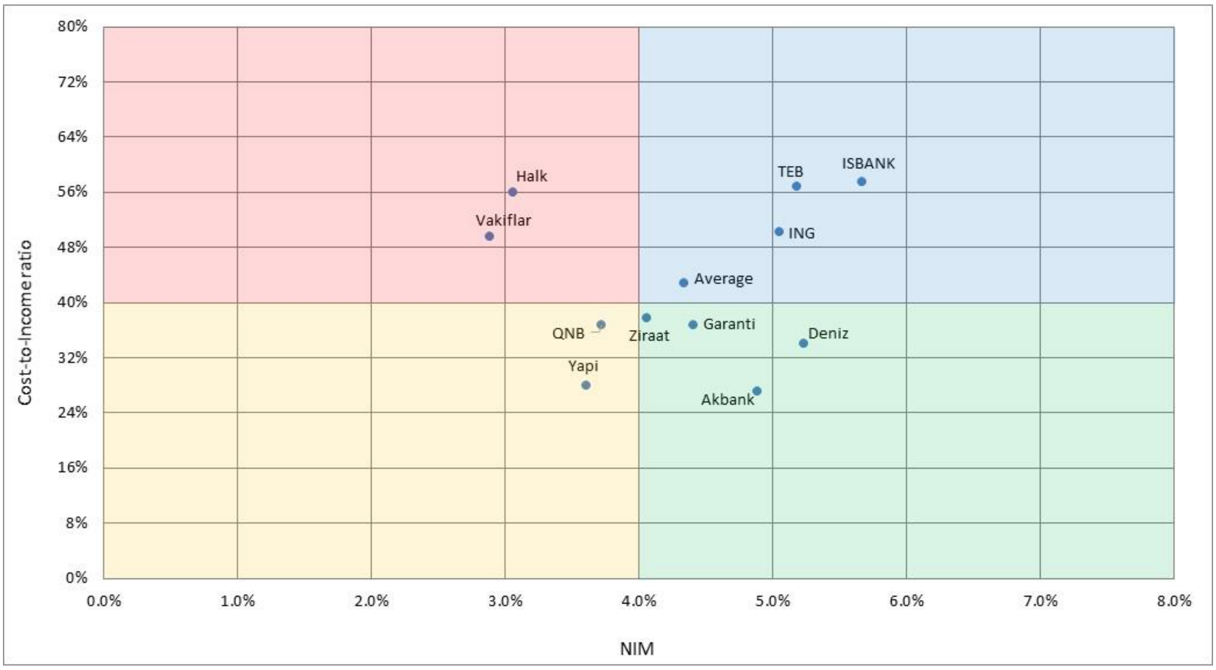
The entities in the yellow quadrant were on average better positioned in terms of efficiency (Cost/Income ratio below 40%) combined with modest interest margins to compensate for cost inflation. These peers will experience cost pressures but their profitability will be less impacted due to a better starting point. Only two banks were positioned in this quadrant.

The entities in the red quadrant have high cost-to-income ratios exceeding 40% which are likely to come under further pressure in the high inflationary environment. At the same time they have lower than the average NIMs - below 4%. These NIMs will be further squeezed by the increase in funding costs. A total of 2 out of 15 Turkish banks were positioned in the red quadrant.

All three state-owned banks **Ziraat, Halk** and **Vakif**, showed weaker operating efficiencies and low NIMs as they complied with government decree to support the economy during the pandemic. The state-owned banks were pricing loans close to the central bank's lending rates which lead to weaker NIMs.

[2] *https://www.tcmb.gov.tr/wps/wcm/connect/EN/TCMB+EN/Main+Menu/Statistics/Inflation+Data*

Exhibit 1: NIM vs Cost-to-income ratio



In terms of the trends, **we expect migration to occur to blue and red from the green and yellow quadrants, respectively** as the elevated inflation, volatility in the currency and increase in minimum wages will result in higher operating costs.

Capital ratios are adequate but creation rate is below growth

We examined the relationship between internal capital generation and capital ratios using a similar approach of dividing the exhibit into four quadrants. The average combined ratio for the 11 peers was in the green quadrant, just above the yellow quadrant. **This indicates that despite adequate CET1 ratios, internal capital creation rate is significantly below asset growth rate (ranging from 40%-50%) for the Turkish banks** (Appendix III). Overall, the leading Turkish private sector banks had much stronger position compared to the state-owned banks.

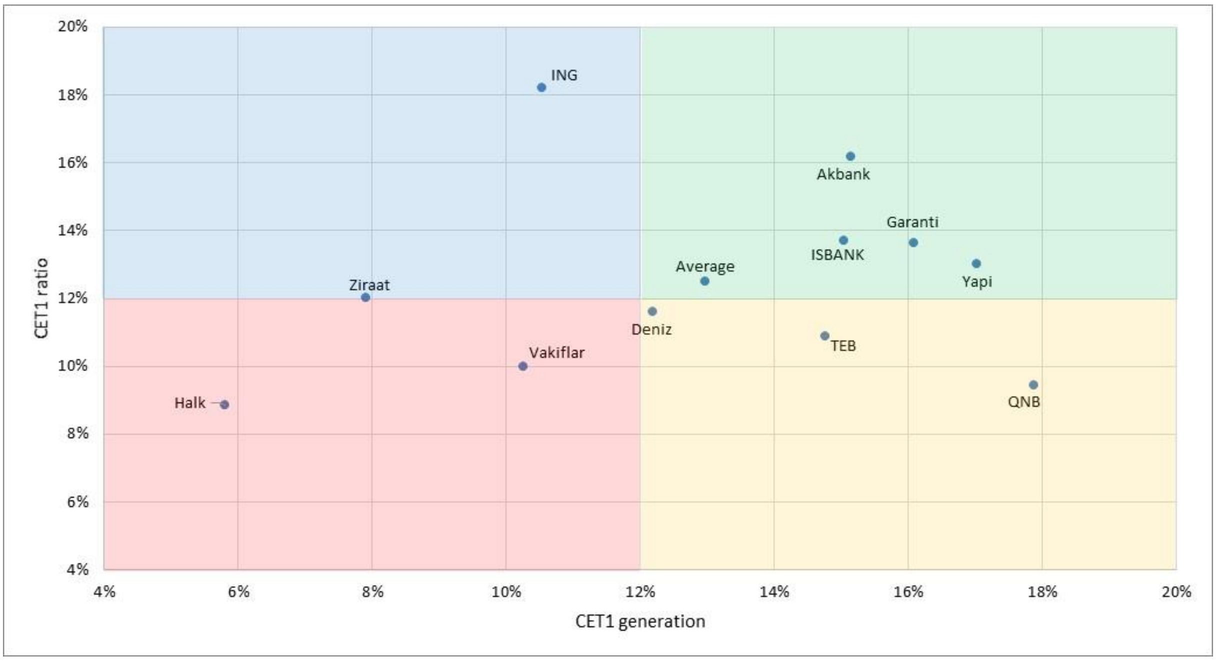
The green quadrant indicates the ability to generate above average capital growth as well as maintain a higher stock of capital. The banks in this quadrant had CET 1 ratios exceeding 12% as per end-2021 and were able to generate Tier 1 capital over 12% pa. There were four private-sector banks in the green quadrant.

The banks in the blue quadrant had relatively high CET 1 ratios exceeding 12% but internal capital creation rates below 12%. The banks in this quadrant are likely to maintain their high capital ratios but ability to grow RWAs is likely to be curtailed. Only **ING** bank was in this quadrant.

The state-owned banks in the red quadrant (**Ziraat, Halk** and **Vakif**) had below average capital metrics combined with lower internal capital creation rates (below 12%). They are more susceptible to pressure on capitalisation. However, all three banks are state-owned and likely to benefit from the government support through policy adjustments or regulatory relaxation.

The banks in the yellow quadrant have higher capital generation but their CET1 ratios were below 12%. There were 3 banks in this section of the exhibit. **Denizbank** was on the borderline and could be pushed into the red quadrant given the adverse environment.

Exhibit 2: CET1 capital generation vs CET1 ratio



We expect the **average for the 11 Turkish banks to end up in the blue quadrant which indicates insufficient internal capital creation rates in light of the fact the fast assets** growth trends spurred by inflation.

Strong provisioning coverage at the expense of net profitability

The Turkish banking system is expected to face asset quality pressure reflecting the accelerated inflation. The lingering impact of the pandemic on the Turkish economy has particularly affected sectors such as tourism, real estate, construction energy and consumer finance. Also, the Turkish Lira depreciation will elevate Turkish banks' asset risks as most of them hold significant amount of foreign currency loans. Borrowers with unhedged foreign currency loans could find it hard to service debt in local currency leading to deterioration in banks asset quality.

We looked at the combination of the following ratios to examine potential pressure on asset quality metrics. For Loan loss reserves coverage ratio[3], we took the latest figures as at end-2021. For Total net impairment charges[4], we took three years' average as the latest results (end-2021) were impacted by write-backs from pre-emptive pandemic provisions in 2020.

The average combined ratio for the 11 Turkish banks was in the yellow quadrant. **This indicates that the leading Turkish banks are already facing asset quality issues as the banks are allocating over 48% of their operating income for credit impairments.** However, their average loan loss coverage ratio of 138% shows some headroom to absorb pressure on asset quality from the deteriorating operating environment.

The bank in the green quadrant had loan loss coverage ratio above 120% and three-year average provisioning expenses less than 40% of Operating profit. These banks were better positioned to absorb higher impairment costs and pressure on capital ratios from increased impaired loans. There were only two banks (**Isbank and TEB**) in the green quadrant.

The banks in the yellow quadrant were spending a high proportion of their operating income on provisioning expenses (exceeding 40%). However, their loan loss coverage levels were adequate with the ratio ranging

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[3] *Loan loss coverage ratio is computed by taking Loan loss reserves as a percentage of Impaired loans*

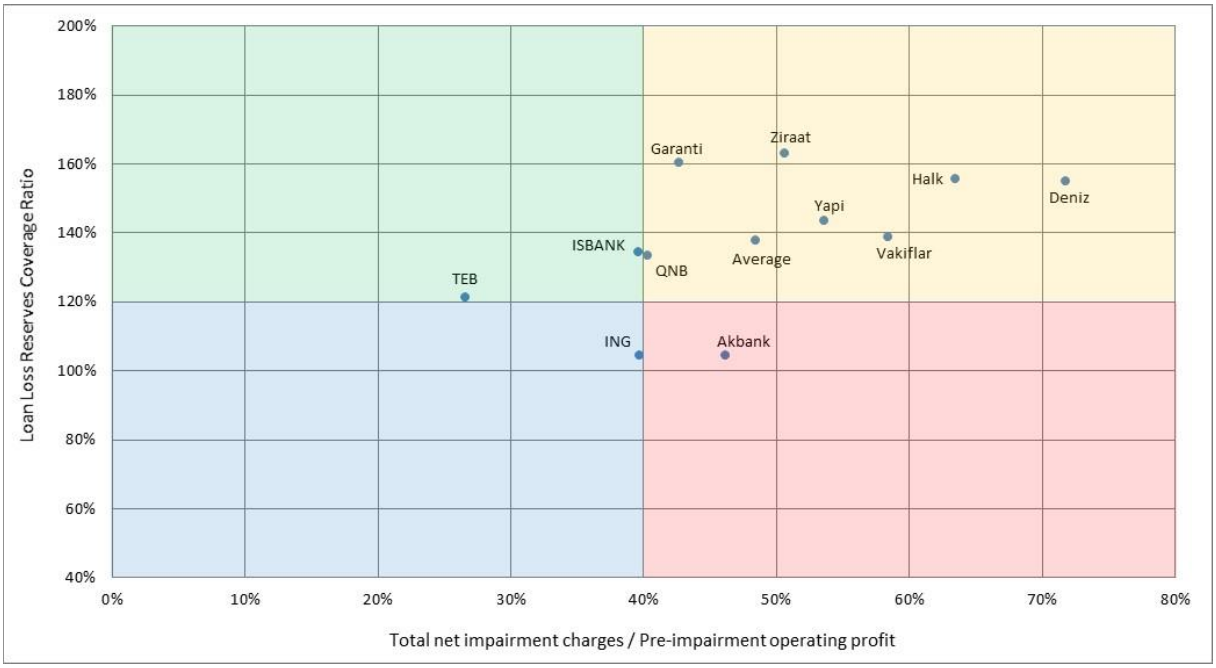
[4] *Total net impairment charges is calculated by taking Provisioning expenses as percentage of Operating income*

between 130%-160%. There were seven entities in this quadrant. **Deniz bank's** higher provisioning was driven by increases in provisioning expenses for its Stage 2 loans.

ING bank was the only bank in the blue quadrant that had relatively low provisioning expenses and coverage ratio of 104%, which is still considered adequate.

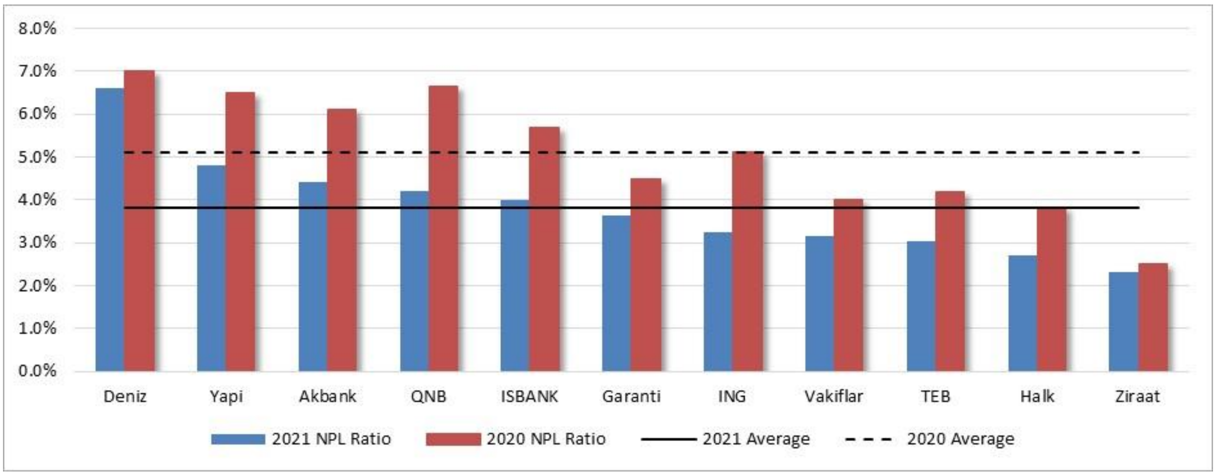
There was one bank (**Akbank**) in the red quadrant which has relatively lower loan loss coverage than its peers. However, the average Net impairment charges for 3-years was over 40% of its pre-impairment operating profit.

Exhibit 3: Total net impairment charges vs. Loan loss coverage ratio

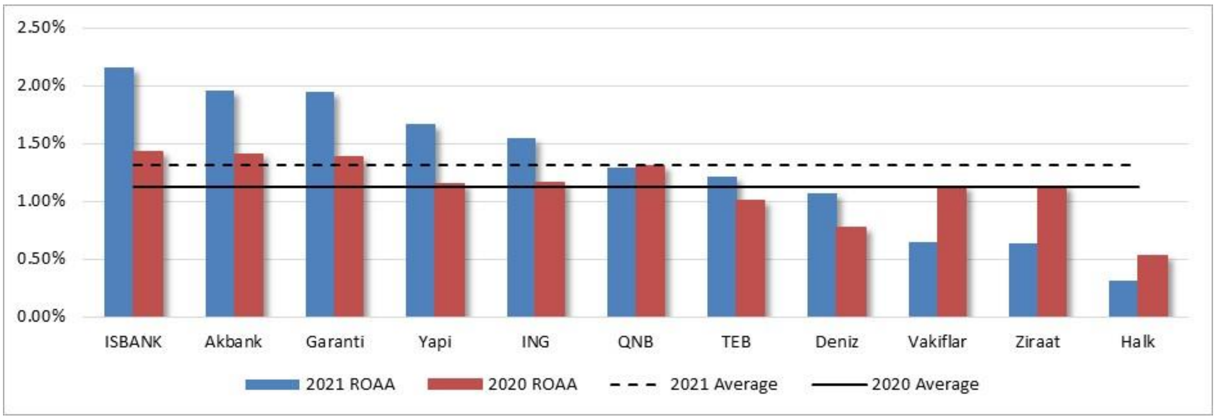


Due to higher impairment charges, we expect most likely migration of the peers into the red and yellow quadrant. **This indicates that the Turkish banks are likely to increase impairment expenses to maintain their stronger coverage ratios.**

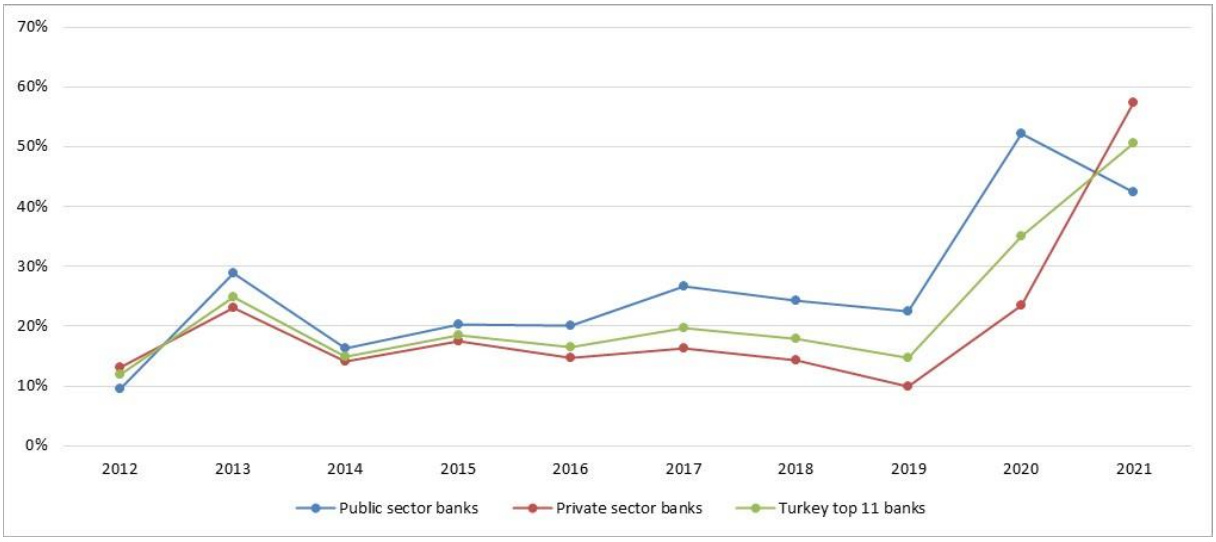
Appendix I: Impaired loans as % to Customers loans ratio (2021 vs. 2020)



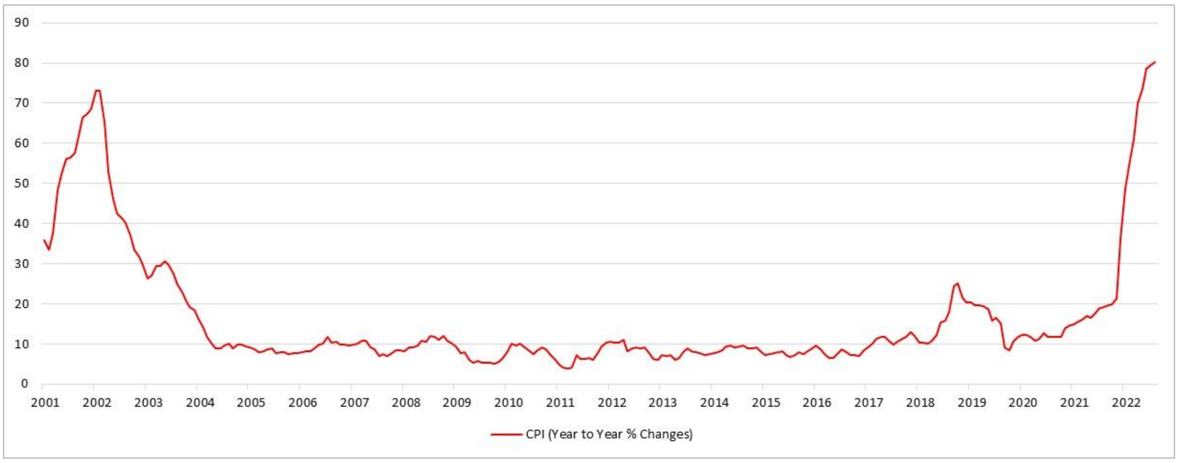
Appendix II: Return on average assets (ROAA) (2021 vs. 2020)



Appendix III: Average total assets growth (2012-2021)

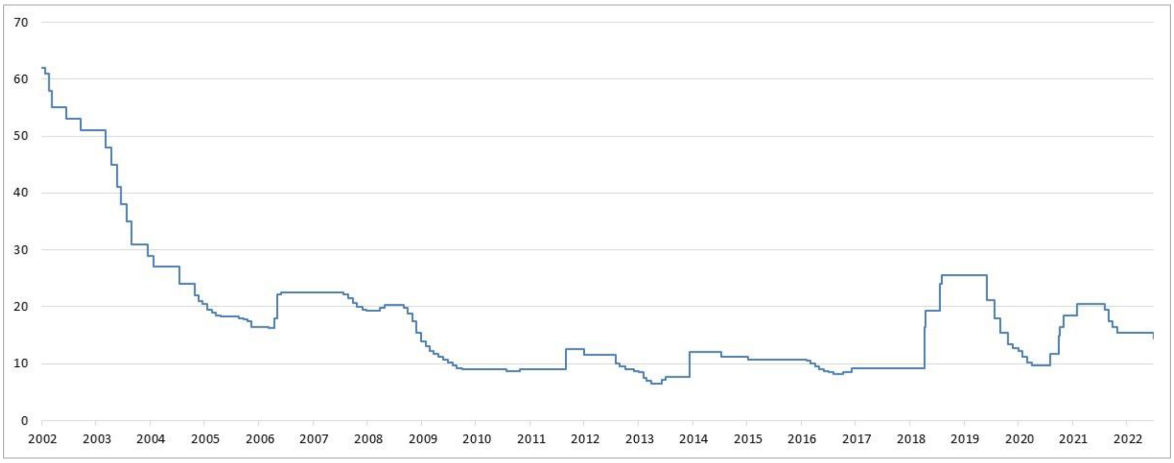


Appendix IV: Türkiye inflation rate



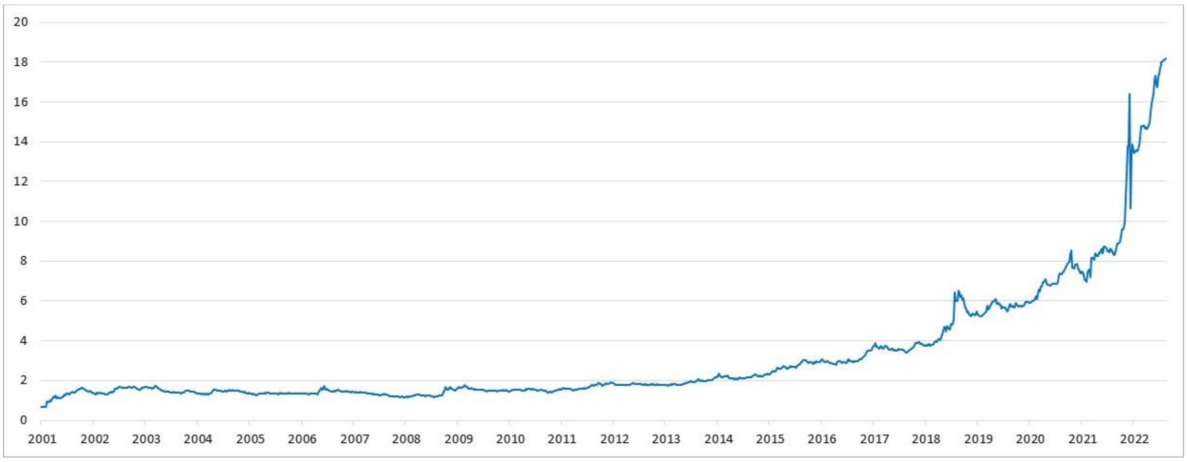
Source: The Central Bank of the Republic of Türkiye

Appendix V: CBRT Interest Rates (%) Overnight lending



Source: The Central Bank of the Republic of Türkiye

Appendix IV: Turkish Lira exchange rate (USD/TRY)



Source: Investing.com

Research methodology and scope

Using BankFocus search steps we analysed the impact of inflation and interest rate hike on the following financial factors: NIM, Cost-to-income, CET1 capital generation, CET1 ratio, Total net impairment charges / Pre-impairment operating profit, and Loan loss reserve ratio for year-end 2021.

Principal Ratio definition

For more detailed definitions refer to Bank Focus **Global detailed format – data and ratio definitions in the Help section of Popular guides, Financial data.**

We analysed the following Commercial and Savings banks in Türkiye:

T.C. Ziraat Bankasi A.S., Türkiye is Bankasi A.S., Türkiye Vakiflar Bankasi TAO, Türkiye Halk Bankasi A.S., Garanti BBVA, Yapi Ve Kredi Bankasi A.S., Akbank T.A.S., QNB Finansbank A.S., Denizbank A.S., Turk Ekonomi Bankasi A.S., and ING Bank A.S.

Get in touch if you have any analytical questions

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