

# tepav

## LOGBOOK of the TURKISH ECONOMY

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**REENSURING FLOW OF CREDIT TO RETURN  
TO GROWTH**

**THE CASE FOR A TURKISH TROUBLED ASSETS  
RESTRUCTURING PROGRAM**

**Second Log**

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*April 2019*

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*The ideas expressed on this paper are solely the opinions of the author(s) and do not necessarily represent the opinions of TEPAV.*

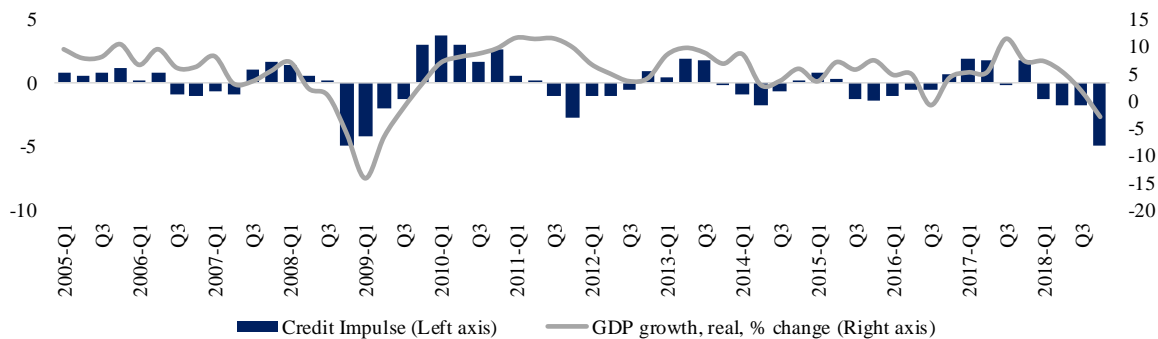
Over the past decades, Turkish economic growth was fueled by availability of credit. A potential credit starvation poses a significant risk for the private sector, which has been the main beneficiary of the last decade. In order to avoid a long recovery, which is typical for recessions accompanied by debt overhangs, Turkey needs to have banks resume lending. This doesn't seem possible given the at-limit sources and unattractive profitability of the banking sector. Therefore, troubled assets on bank balance sheets need to be cleared with timely and competent action. Naturally, this could work only if accompanied with a rational, predictable and market-friendly macroeconomic framework and certain regulatory/ judiciary support.

The public-private partnership approach to deal with distressed assets advocated in this paper would (i) support private sector (employment, commercial capacity, value chains around certain firms) while improving its competitiveness (elimination of zombies, creating at scale firms); (ii) enable banking system to resume lending thanks to released capital; (iii) use taxpayer funds effectively through an independent, transparent and performance-oriented vehicle; (iv) mobilize foreign funding resources; and (v) send a strong positive signal to the broader market. Enough experience on distressed asset relief programs has been accumulated by EBRD and IFC in the aftermath of the global crisis.

## I. A CREDIT FUELED ECONOMY

Over the past decade, Turkey's annual real growth rate of Turkey was over 5 percent. This was essentially driven by the availability of increased resources (especially credit), rather than increased productivity.

**Figure 1 Real GDP and credit impulse<sup>1</sup>, quarterly, 2005 - 2018**



Source: BRSA, TURKSTAT, TEPAV calculations

<sup>1</sup> Defined as correlation between new borrowing and change in new borrowing, based on CBRT working paper, "GDP Growth and Credit Data", Working Paper No: 13/27.

Flow of credit was key, from both balance of payments and domestic financial system perspectives. Funding provided by foreign creditors to Turkey (i.e., cumulative current account deficit) between 2009 and 2018 was over \$426 billion (over half of 2018 GDP). Private sector was an important recipient of this windfall: foreign exchange liabilities of non-financial sector more than doubled from \$151 billion in 2008 to \$321 billion a decade later.<sup>2</sup>

As a result, the corporate sector has a short FX position of \$200 billion (FX deficit/GDP tripled over the past decade).<sup>3</sup> The appreciation of the currency basket (half \$ and half €) by 1.5 TL against Turkish Lira in 2018 meant an additional debt load of TL 300 billion for Turkish corporations. This is equivalent of destroying half of the total market cap of BIST 100 stocks as of December 2018. That said, there are mitigating factors to consider: (i) the short FX position does not factor natural and financial hedges – these may include export income and government backed FX denominated income streams (PPPs, renewable energy purchase agreements); (ii) corporates, in aggregate, have more short-term FX assets than short term liabilities, before considering any FX assets their owners may be willing to use, as needed; and (iii) the debt is quite concentrated – as of February 2018, 90 firms with over \$500 million debt constitute 1/3 of total balance, while 2,200 with \$15-500 million constitute another 1/2 of the balance. 20,000 firms with below \$15 million debt owe the rest (15 percent of total), according to CBRT<sup>4</sup>.

**Figure 2 Corporate sector FX position, billion US \$, 2004-2018**

	2004	2008	2012	2016	2017	Oct. 2018
<b>FX Assets</b>	<b>38</b>	<b>80</b>	<b>89</b>	<b>99</b>	<b>115</b>	<b>118</b>
Deposits	25	60	61	68	78	76
Export Receivables	6	9	12	12	15	17
FDI	6	11	16	19	21	24
<b>FX Liabilities</b>	<b>57</b>	<b>151</b>	<b>226</b>	<b>305</b>	<b>329</b>	<b>321</b>
Loans	47	136	203	272	288	281
Domestic Loans	20	48	122	178	183	173
External Loans	27	88	82	94	105	108
Import Payables	9	15	22	33	41	40
<b>Net FX Position</b>	<b>-19</b>	<b>-71</b>	<b>-137</b>	<b>-206</b>	<b>-214</b>	<b>-203</b>
<i>Net FX Position/GDP</i>	-8	-9,2	-15,6	-23,9	-25,1	-24,7

Source: Morgan Stanley, TEPAV visualization

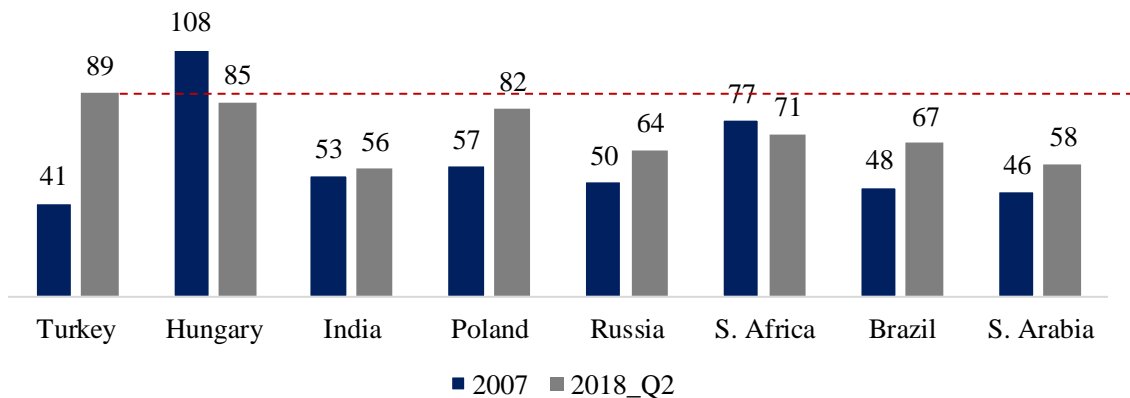
<sup>2</sup> CBRT, Monetary and Financial Statistics

<sup>3</sup> Ibid

<sup>4</sup> Hürriyet (2018, June 1). *44 bin şirket yasaklı*. Retrieved from <http://www.hurriyet.com.tr/ekonomi/44-bin-sirket-yasakli-40854226>

Domestic banks also followed the suit. Turkish banks' balance sheets have expanded from TL 723 billion (\$447 billion) in January 2009 to TL 3.9 trillion (\$746 billion) in January 2019. Corporate loans grew from TL 366 billion (\$226 billion) to TL 2.4 trillion (\$459 billion) over the same period. As Morgan Stanley notes<sup>5</sup>, Turkish private sector became one of the highest leveraged (in terms of debt/ GDP) emerging markets, excluding Eastern European peers.

**Figure 3 Total Credit to non-financial private sector, % of GDP, 2007-2018**



Source: Morgan Stanley, TEPAV visualization

## II. A NEW NORMAL?

Recent data (see Figure 5 below) indicates that credit is not and may not be as available as it used to be. This would present a challenge for the economic growth, private sector sustainability and job creation, given the dominant role of credit in Turkish economic growth.

On the balance of payments side, a Fed tightening (seems delayed for now), a change in perspective towards emerging markets, or geopolitical developments remain as potential risks for availability, price and quality (FDI, portfolio flows or net errors and omissions) of financing. These potential headwinds come at a time when net international investment deficit hovers around half of GDP.

<sup>5</sup> Morgan Stanley Research (2019, February). Turkey Debt Chartbook: 360-Degree View.



**Figure 4 Turkish net international investment position, % of GDP, 2002-2018**

	2002	2007	2012	2017	Nov. 2018
<b>Assets</b>	<b>26</b>	<b>25</b>	<b>25</b>	<b>27</b>	<b>30</b>
<b>FDI</b>	2	2	4	6	6
<b>Portfolio</b>	0	0	0	0	0
<b>Other (Loan&amp;Deposit)</b>	12	12	7	9	12
<b>Reserve Assets</b>	12	11	14	13	12
<b>Liabilities</b>	<b>62</b>	<b>71</b>	<b>73</b>	<b>82</b>	<b>76</b>
<b>FDI</b>	8	23	22	23	17
<b>Portfolio</b>	10	18	21	20	18
Equity	1	9	8	6	4
Debt Securities	9	8	12	14	14
<b>Other (Loans)</b>	44	30	31	38	41
<b>Net Int. Inv.Position</b>	<b>-36</b>	<b>-46</b>	<b>-49</b>	<b>-54</b>	<b>-46</b>

Source: Morgan Stanley, TEPAV visualization

A reduced demand for foreign financing, driven both by corporate sectors' reluctance to borrow in FX and declining imports partially mitigate this. Imports contracted by over 20 percent since July 2018. 12 months rolling current account deficit came down to \$20 billion levels from \$60 billion levels in early 2018. Current account deficit/ GDP, which was around 5 percent over the past decade is expected to be around 3 percent of GDP in 2019, according to Expectation Surveys of the CBRT in February 2019<sup>6</sup>. However, all these are driven by economic contraction rather than prudence.

On the domestic financial sector side, lending and private consumption, a key GDP component, have been on decline. According to BRSA data total banking credit shrank by 7.5 percent on quarterly basis in the last four months of 2018. Precisely at that time, Turkey officially entered a recession (two consecutive quarters of contraction) first time since Global Financial Crisis. The annually decline in private consumption was 8.9 percent in 2018 Q4. The effect on employment was also significant: Turkish economy lost over 600 thousand jobs in 2018 (previous annual job loss was 50 thousand in 2009 and the economy created 850k jobs per year on average in the period since then)<sup>7</sup>.

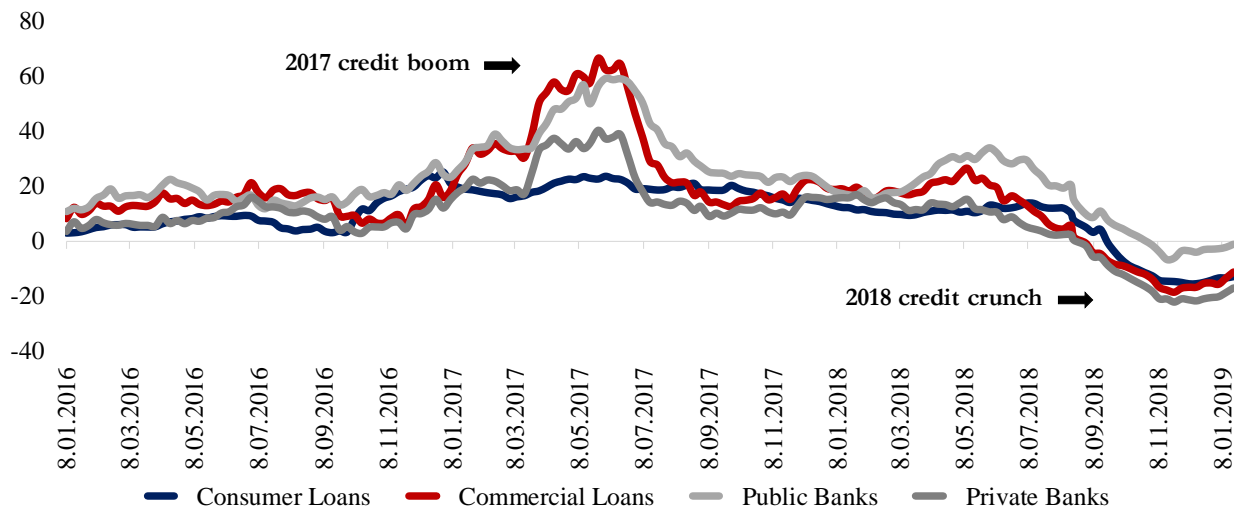
The risk is the start of a potential negative feedback loop: credit starvation, causing economic contraction, triggering private sector defaults or even permanent loss of economic capacity (loss of plant and equipment or trained personnel), resulting in inability to pay down debt to banks and hurting financial sector balance sheets, further augmenting credit starvation.

<sup>6</sup> CBRT (2019, February). Survey of Expectations.

<sup>7</sup> TURKSTAT, Labour Force Statistics

The recent recovery in lending was a green shot. However, that seems almost exclusively driven by TL loans provided by state banks, as shown below. If private banks do not (cannot) join the state banks, lending growth would not be sustainable. Understanding the reasons of their reluctance and addressing the structural issues is essential for a healthy recovery.

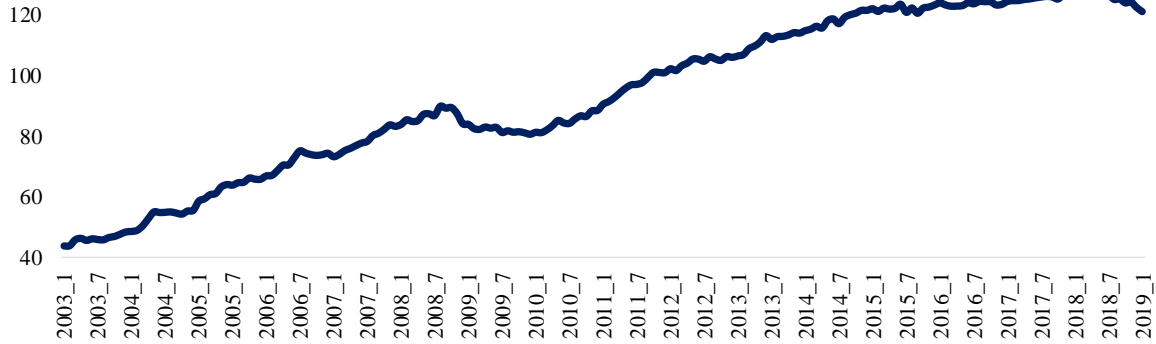
**Figure 5 Total TL Credits (weekly %, 13-week moving average, annualized), 2016-2019**



Source: Turkey Data Monitor, TEPAV visualization

First, they don't have sources. Turkish banks have already lent -more than- all their TL: Loan to deposit ratio was 116 percent as of January 2019. To source more TL, they would need to swap their FX in international markets. This need is augmented by domestic depositors' migration to FX accounts. The regulations sharply increasing swap costs for currency speculation could inhibit banks' ability to offer TL loans. Between December 28<sup>th</sup> 2018 and March 8<sup>th</sup> 2019, TL loans grew by TL 36 billion (while TL deposits were flat) and FX loans remained flat (while FX deposits increased by \$7 billion)

**Figure 6 TL loan to deposit ratio, monthly, %, 2002-2019**



Source: CBRT, TEPAV visualization

**Figure 7 FX deposits' share in total deposits, %, 2002-2018**



Source: CBRT, TEPAV visualization

Secondly, banks have been not sufficiently profitable for their shareholders, who would have no incentive to inject additional equity into the sector. Bank returns on equity (ROE) have been well below inflation, depreciation in TL or even the deposit rates (i.e., how they fund themselves). A private citizen who deposited his/her savings in a bank has handily outperformed bank's owners, even before accounting for the much lower risk undertaken (fixed income, government guarantee).

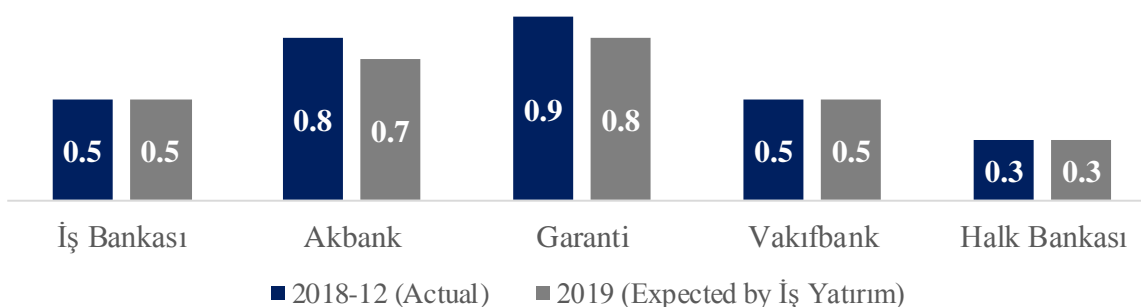
**Figure 8 Bank ROEs, %**

	Jan.18	Apr. 18	Jul. 18	Oct. 18	Dec. 19	Jan. 19
Sector	14.9	15.3	13.7	13.4	9.0	9.1
Private	16.4	14.4	15.5	13.6	8.4	10.3
State	16.0	18.4	9.8	9.3	13.3	4.5

Source: HSBC, Morgan Stanley, TEPAV visualization

No wonder, banks are trading at substantial discounts to their book values. This is driven by a combination of their inability to pass through the increasing funding costs, relatively low yields in their existing loan books (compared to today's standards) and potential non-performing loans (NPLs) or loans in "watchlist" (also see next point).

**Figure 9 Bank Price to Book Ratio, %, 2018 (Actual)–2019 (Expected by İş Invest)**

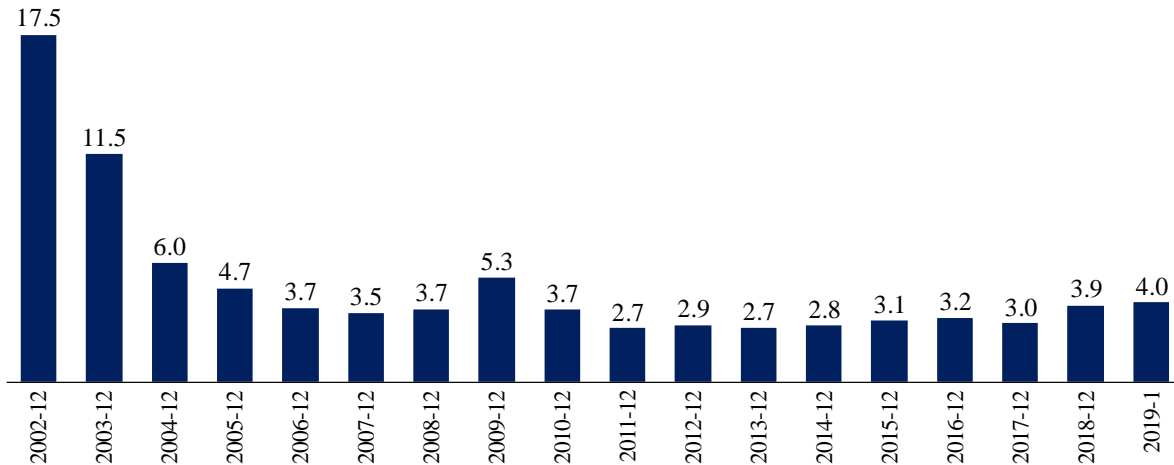


Source: İş Invest, TEPAV visualization

Thirdly, restructurings and likely increases in NPLs/ watchlisted loans limit banks' ability to lend. Mr. Hüseyin Aydın, Chairman of Banks Association of Turkey, indicates restructurings in 2018 amount to TL 120 billion, corresponding to 6.4 percent of Turkish corporate loan book. Naturally, restructurings are needed at volatile times, but delays in cash receipts limit banks' ability to extend new credit. When banking system cannot grow its resources, restructurings turn into a zero-sum game – one firm's restructuring becomes another's credit starvation.



**Figure 10 NPL Ratios, 2002-2019**



Source: BRSA, TEPAV visualization

The ratio of NPLs to total loans indicates solvency of an economy, asset quality and risk level in banks. NPLs (and watchlisted loans mentioned below) inhibit loan growth due to both liquidity and capital adequacy reasons. On liquidity, less cash received from existing book means ability to lend less, especially given the inherent maturity mismatch between the funding base (deposits) and loans. On capital adequacy, bank equity provisioned for NPLs or write offs mean less ability to lend new money. Lost bank equity means up to 10x less lending, given highly leveraged nature of bank balance sheets.

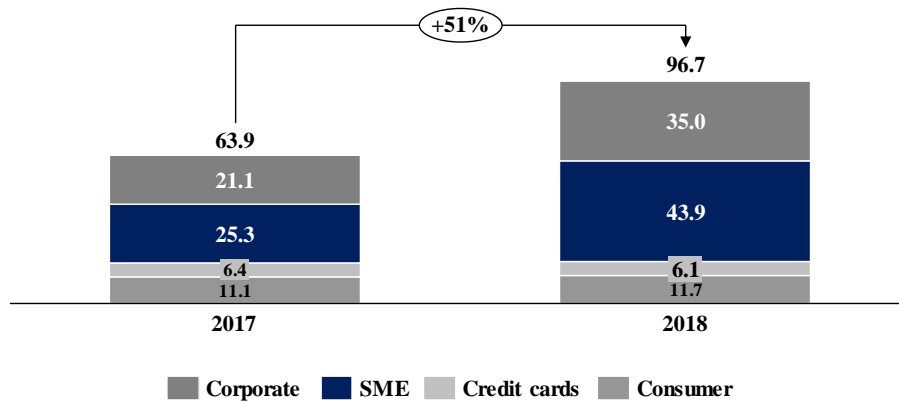
NPLs were around 4 percent of total loans at year end 2018. While this is a bit higher than the recent era average, it is lower than the 2009 level and much lower than the post 2001 crisis levels. That said, in terms of TL amounts (just shy of TL 100 billion), NPLs grew by 50 percent over the past year, given the sharp increase in total loan book thanks to KGF (Credit Guarantee Fund) initiative in 2018. The meaningful increase in corporate and SME (which also doubled as a percent of total since 2014) segments are particularly noteworthy.

An increase of NPLs to 6 percent, as projected in BRSA stress test or 8 percent as noted by Standard and Poor's<sup>8</sup> would have meaningful effects on banks' ability to lend. Just to put things

<sup>8</sup> G. Forss & M. Rybnikov (2019, March). *S&P Global Ratings*. Black Sea Trade And Development Bank Outlook Revised To Positive On Prospects For Wider Policy Role; Ratings Affirmed.

in perspective, Capital Economics<sup>9</sup> notes: “Turkey’s NPL ratio would need to increase to 12 percent before the sector as a whole required recapitalisation. If the NPL ratio were to rise to 16 percent – similar to that seen in Hungary, Latvia and Bulgaria in the aftermath of the global financial crisis – that would reduce the Tier 1 capital ratio to 2.4 percent and a recapitalisation of 2.9 percent of GDP would be needed. Turkey’s relatively healthy public finances – the budget deficit is around 2 percent of GDP and public debt around 30 percent – means it could probably absorb this cost.”

**Figure 11 NPL Volume in Turkey, TL billion, 2017-2018**



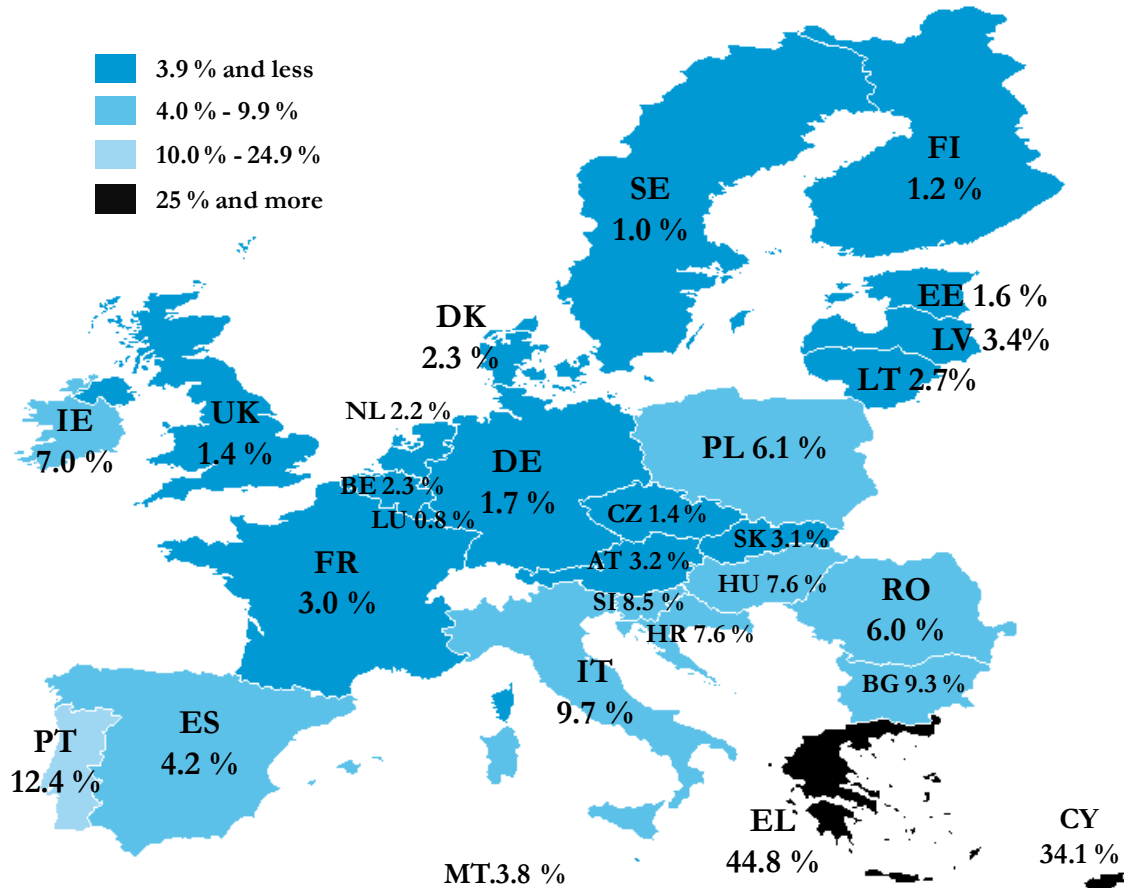
Source: PriceWaterhouseCoopers, TEPAV visualization

As a comparison, according to White & Case<sup>10</sup>, NPL ratio across European banks in Q1 2018 was 4.8 percent. However, a wide range of ratios underline the significant effect of overall economic performance (especially in Southern Europe) and potentially different regulatory standards.

<sup>9</sup> Capital Economics (2018, August 13). Where do the risks in Turkey’s banking sector lie?. Emerging Europe Economics Update

<sup>10</sup>White & Case (2019). Europe reaches for a new normal on NPLs.

**Figure 12 NPLs in EU Countries, as of 30 June 2018**



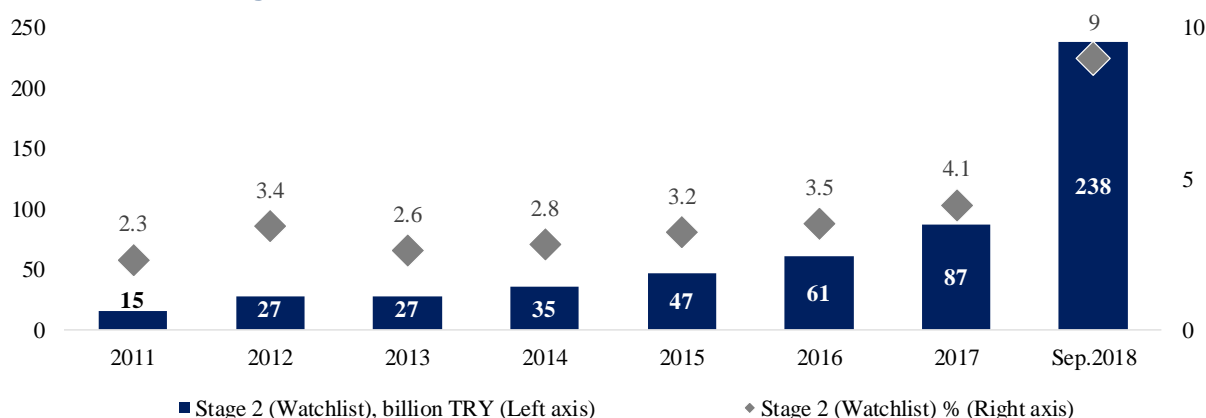
Source: Excerpt from White & Case NPL report, TEPAV visualizations

In addition to NPLs, watchlisted (“Category II”) loans that are closely monitored on bank’s balance sheets also limit banks’ ability to lend. These loans reached a significant level: more than 2x the size of NPLs or 6.4 percent of Turkish GDP (so any deterioration here would also have a meaningful, but potentially still manageable effect on bank balance sheets). This is not a surprise given the loan restructurings, over 1,500 concordato applications since August 2018 and anecdotal evidence regarding financial distress in corporate sector.

That said, IFRS 9 standards updated at the beginning of 2018 also had an impact in increasing volumes. Previously, provisions for credit losses were recognized only once there has been an incurred loss event. IFRS 9 brought a more forward-looking perspective requiring banks to consider a broader set of information, causing an earlier recognition of losses. Moreover, as

BDO<sup>11</sup> audit and tax firm notes, IFRS 9 “expands the scope of the impairment requirements – for example, certain issued loan commitments and financial guarantees will now be within the scope of these new requirements.”

**Figure 13 Watchlist Loan Volume, billion TL, 2011-2018**



Source: PriceWaterhouseCoopers, TEPAV visualization

### III. SO WHAT?

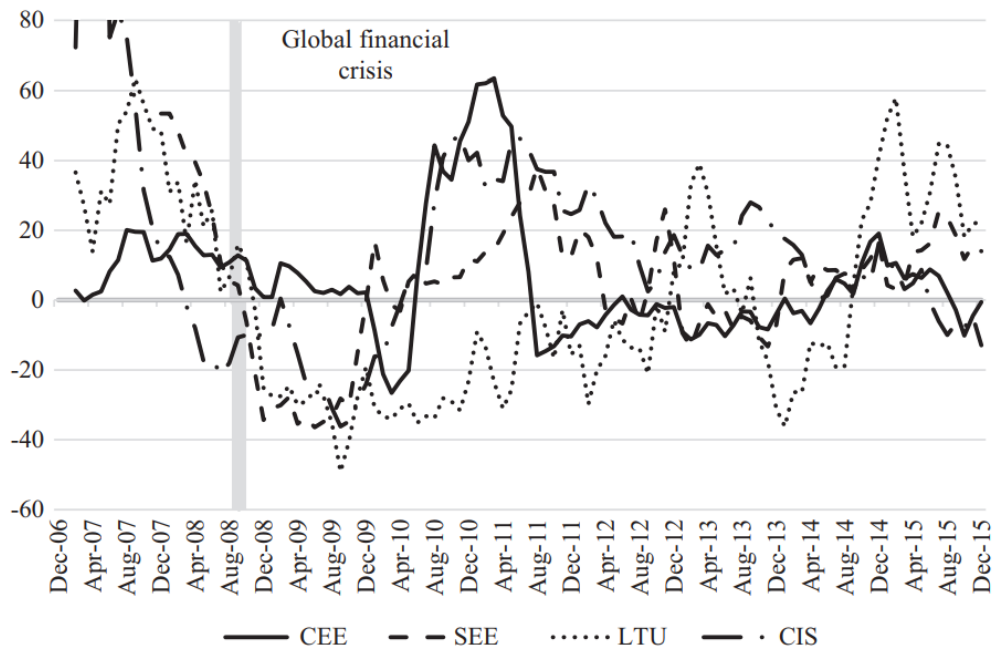
A sustained decline in availability of credit would have meaningful negative implications on Turkish economy (and private sector, in particular). As noted above, unlike in 2001, leverage resides with corporates, not with government (or households, for that matter). Turkish public finances are in reasonable order, with potential room for some fiscal maneuver: Public debt is at just over 30 percent of GDP vs. 80 percent for EU, budget deficit is around 2 percent of GDP. Size of the available fiscal space is discussed extensively at the first log of this series in January: “Maliye Politikasında Manevra Alanı Var mı?” The problem will essentially be felt by the corporates, the solution needs to address the corporates.

Turkey is used to V-shaped recoveries with quick return to significant growth rates immediately after crisis years. The business community hopes for a similar performance in 2019. However, recessions with debt overhangs tend to have U or L shaped recovery patterns. As shown in Figure 14, bank loans in Central & Southeastern Europe, which had a debt overhang problem, stayed essentially flat after the Global Financial Crisis until a certain level of deleveraging and accumulation of domestic deposits were accomplished. A similar situation in Turkey would mean

<sup>11</sup> BDO (2017, September 20). Article: IFRS 9 Explained – the new expected credit loss mode. Retrieved from: <https://www.bdo.co.uk/en-gb/insights/business-edge/business-edge-2017/ifrs-9-explained-the-new-expected>.

below-trend growth, inhibiting job creation and risking productive capacity of Turkish private sector if necessary measures ca not be taken on time. Timely and competent action is key to restore credit flows and hence growth on a sustainable basis.

**Figure 14 New bank loans to non-financial private sector in CESEE, three-month moving average of year-on-year growth rates as a percentage, December 2006–2015**



Note: CEE: Central Eastern Europe, SEE: South East Europe, LTU: Lithuania; CIS: The Commonwealth of Independent States

Source: M. Holzner (2017). The Financial Effects of the Crisis in European Emerging Markets. In: Havlik P., Iwasaki I. (eds) Economics of European Crises and Emerging Markets.

#### **IV. WHAT DID WE AND OTHERS DO?**

Troubled loans need to be recognized and cleaned up from bank balance sheets to restore lending. This is a quite delicate task. Delay it too long and end up with clogged lending channels (i.e., a delayed recovery). Take an aggressive tone and substantially wipe out bank equity, causing widespread repercussions. Countries that skillfully addressed these challenges have been successful to resume growth.

Turkey has a history of bank restructuring: in the aftermath of the 2001 crisis, banking system as a whole was strengthened at the outset. State banks were successfully rehabilitated to operate as commercial banks rather than welfare organizations with heavy “duty losses”. This was achieved through a combination of (i) restoring confidence in the system by establishing a credible macroeconomic framework; (ii) ensuring fiscal discipline and solvency in the public sector; (iii) injecting equity in the form of treasury bills, as needed; and (iv) replacing problem assets (essentially low yield government debt instruments) with high yield ones through an effective debt swap program.

Other countries also dealt with the same problem. A recent and high-profile example is Troubled Asset Relief Program (TARP) in the USA, which was used to save corporate sector (i.e., car companies), salvage financial institutions by investing equity and purchasing toxic assets and restore confidence.

TARP had four major initiatives: (i) equity purchase program (\$205 billion to purchase bank equity shares: \$40 billion in stock purchases of Citigroup and Bank of America, \$68 billion purchase of preferred shares of AIG); (ii) mortgage-backed securities purchase program (\$22 billion toxic assets); and (iii) automotive industry program (\$80 billion loans and capital injections to automakers and their financing arms); and (iv) homeownership preservation and loan guarantees (remainder).

TARP was exclusively funded by taxpayer money (no external resources). In order to protect its investments, TARP received equity warrants from financial institutions selling assets to it, introduced limits on top executive compensation at participating companies, established clear route to exit investments and abide by high disclosure and transparency standards. TARP invested \$426 billion and recovered \$442 billion within a few years, essentially fulfilling its mission at no cash cost to taxpayer.



Another example is Korea after the Asia crisis of 1998<sup>12</sup>. Korean government restructured banking system by changing legal framework, deploying public funds and creating Korea Asset Management Company (KAMCO). KAMCO was instrumental in cleaning bank balance sheets by developing uniform pricing criteria and increasing average discount on its purchase prices (from prices of 70-75 percent of collateral value to 45 percent on secured loans; from 10 to 20 percent of principal balance to a uniform price of 3 percent on unsecured loans). Various corporate restructuring vehicles involving foreign partners with restructuring capabilities were established to take over distressed assets from banks. An out-of-court workout process was introduced for most troubled and leveraged firms and 200 banks signed a corporate restructuring agreement that committed all creditors to abide by specific workout procedures. As a result, the level of NPLs declined from 17 percent of total loans as of March 1998 to 2.3 percent at year-end 2002. After a 5 percent contraction in 1998, Korea grew by 25 percent in the following three years.

On the other hand, countries who avoided this and tried to “kick the can down the road” have limited credit flows in their financial system and experienced prolonged recessions. Greece, which still has extremely high NPL ratios (over 40 percent of loans) despite entering recession a decade ago, is a case in point<sup>13</sup>. Greek Parliament passed a legislation to facilitate the reduction of NPLs just in 2015 and allowed asset management companies to manage enforced/ mortgaged real estate assets only in 2017. While these measures helped Greek banks to liquidate NPLs and resume lending, it was too little too late. Non-performing exposures (loans and advances and debt securities) of the four main banks in Greece still remain over EUR 100 billion (or half of Greek GDP).

Italy, a much larger economy also has the same problem, at a lower rate. NPLs’ share of total loans grew from just above 5 percent in 2007 to 17 percent in June 2014. This figure seems to have declined to around 10 percent, though it remains high. As IMF notes<sup>14</sup>, “the rapid rise [of NPL rates] reflects in part the prolonged recession which has worsened the creditworthiness of borrowers, particularly small- and medium-sized enterprises (SMEs). At the same time, the inefficient and lengthy judicial process, combined with the limited incentives to write off loans, has held back the pace of NPL resolution. Without a significant pick-up in write-offs, NPLs will continue to remain high and a drag on bank profitability and market confidence.” This, indeed, is the risk Turkey is facing today.

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<sup>12</sup> N. Jassaud & K. Kang (2015). A Strategy for Developing a Market for NPLs in Italy, IMF Working Paper/15/24.

<sup>13</sup> Greece: NPL Market Snapshot 1Q2018. A review of the Greek non-performing loan market by Delfi Partners & Co..

<sup>14</sup> N. Jassaud & K. Kang (2015). A Strategy for Developing a Market for NPLs in Italy, IMF Working Paper/15/24.

## V. WHAT SHOULD WE DO NOW?

Turkey needs to act decisively to protect financial and real sectors, ensure flow of credit and resume growth. Both practical experience and academic research support this argument. Josef Korte makes the case in his paper *Catharsis* published on *Journal of Financial Stability*<sup>15</sup>: “A relatively stronger implementation of bank resolution rules has a statistically and economically significant positive effect on firm growth – particularly with respect to firms that are structurally more dependent on bank financing. (..) Investigating the transmission channels of this ‘catharsis effect’ reveals that it essentially works by means of benefiting higher quality firms (quality channel) and reallocating credit to firms that need it most (quantity channel).”

Over the past couple of months, Turkish authorities have been experimenting with the idea of bank restructuring. However, a fundamentally fresh approach is needed. Most current restructurings (i) do not bring new funding to the banking system—on the contrary it is a zero sum game among corporates who need to restructure existing loans and who need new financing; (ii) do not involve fresh funding to borrowers, despite critical working capital needs of some corporates (understandably, banks are extremely reluctant to “throw good money after bad”); and (iii) do not include operational changes, mergers & acquisitions processes or orderly phase outs which are key for a healthy economic recovery.

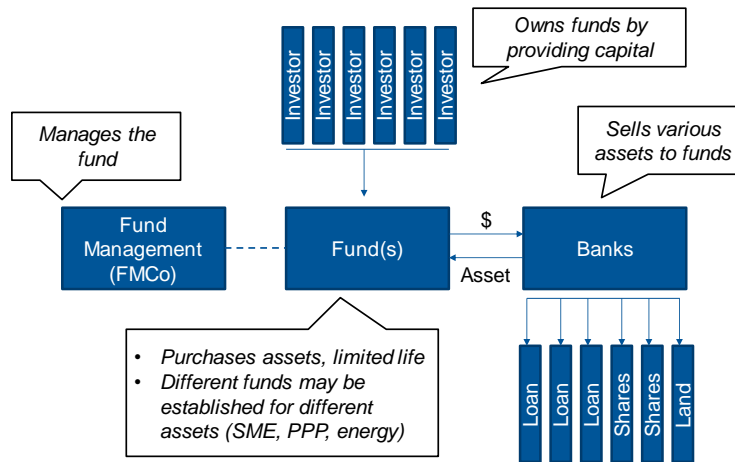
The new approach should rest on three pillars: (i) a rational, predictable and market-friendly macroeconomic framework, as general confidence is a pre-requisite; (ii) an independent fund management structure further detailed below; and (iii) regulatory (banks’ recognitions of losses) and judicial (insolvency process, available instruments) support, also detailed below.

The general macroeconomic framework point does not need further explanation. So, let’s discuss the fund management structure, which needs to be established to acquire troubled assets (e.g., loans, enforced shares/ land) from banks. Depending on the type of assets (risk-return, sectoral focus) there should be several funds with different characteristics and thus different investors. It would work based on three principals: (i) a rigorous triage/ categorization; (ii) a fair public private partnership; and (iii) an independent, competent and transparent management.

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<sup>15</sup> J. Korte (2015). *Catharsis—The real effects of bank insolvency and resolution*. *Journal of Financial Stability*, 16, 213-231.

**Figure 15 Layout of the solution**



**Triage/ categorization.** The loans that would be taken off bank balance sheets need to be clearly grouped given different risk profiles and restructuring needs. There are inter related three perspectives. First, they may be grouped based on level of distress: (i) NPLs; (ii) watchlisted loans; and (iii) performing loans that yield below today’s markets interest (performing but should be marked to market with a discount). Secondly, they may be grouped based on sector, size and complication: (i) loans backed by direct/ quasi government guarantees (public private partnership infrastructure, renewable energy); (ii) loans to industry leaders, typically involving multiple banks, with effect on entire value chains; (iii) general SME loans. Thirdly, they may be grouped based on action, such as: (i) simple transfer of risk (e.g., loans backed by direct/ quasi government guarantees or performing loans marked to market at discounts); (ii) restructuring with additional safeguards (e.g., additional governance or economic rights, route to exit) and potentially provision of new financing; and (iii) liquidation through sale of company or assets. Each of these categories would command different discounts in purchases from banks, require different types of management oversight and attract different investors as buyers.

**Public private partnership.** Any solution addressing troubled assets needs to include public sector, banks and new investors. Public sector involvement is key given the need to coordinate multiple parties, reach a critical size and mobilize external financing. Moreover, government may ask for specially managed accounts with different mandates than market return (e.g., job creation). As long as this is done transparently, it is possible. To put things into perspective, the entire NPL and watchlisted loan volume is around 9 percent of GDP. Therefore, any public involvement probably remains within the realistic room for fiscal maneuver, as demonstrated by

Sak and Özatay<sup>16</sup> in their TEPAV paper published in January 2019. Bank involvement is important to ensure they retain some “skin in the game”, source funding for the system and partly overcome the pricing issue (troubled assets would need to be purchased at discounts at the expense of banks). Having banks transfer some assets as “in kind” contributions to the vehicle(s) and become shareholders or establishing synthetic mechanisms could help bridge the potential gap. New investor involvement is needed to bring fresh capital, ensure independence and transparency, and attract performance-oriented talent.

**Management.** As in any principal investing case, management needs to be independent, competent and act with full transparency. The management should be able to restructure, actively oversee and exit assets (e.g., IPO, sale of real estate collateral).

As mentioned above, another critical point is regulatory and judicial support. An appropriate banking regulation not only establishes general credibility (and hence confidence in general system) but also effectively drives the supply of troubled assets. An optimal balance needs to be struck between regulatory forbearance (makes reported financial information questionable) and aggressively forcing banks to recognize losses (severely impairs bank equity).

An efficient and flexible judiciary process is as important. What IMF<sup>17</sup> noted for the Italian context is also relevant for Turkey: “Lengthy inefficient judicial process raises the cost of foreclosure and lowers the return on NPL restructuring. (..) For example, it takes on average more than seven years to complete a bankruptcy procedure and three years to foreclose on real estate collateral. (...) Legal uncertainties and a lengthy foreclosure process limit the options for and drive up the cost of restructuring.” The focus of the judiciary should be salvaging the economic entity (or quick liquidation to avoid zombies). This requires achieving quick resolution, employing expert courts led by informed judges who can bring various stakeholders on the table in an orderly manner (U.S. Chapter 11-like procedure) and opening way for financial flexibility. Specifically, lending new money to a distressed company in a super-senior capacity (ranking above existing credit holders), conducting debt to equity swaps in a tax and process efficient manner to strengthen balance sheets and enforcing security (e.g., share collateral) or contractual rights (e.g., drag along) comfortably, would certainly make potential restructurings more successful.

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<sup>16</sup> F.Özatay & G.Sak (2019, January). Maliye Politikasında Manevra Alanı Var mı?, Ekonominin Seyir Defteri, TEPAV

<sup>17</sup> N. Jassaud & K. Kang (2015). A Strategy for Developing a Market for NPLs in Italy, IMF Working Paper/15/24

## **VI. CONCLUSION**

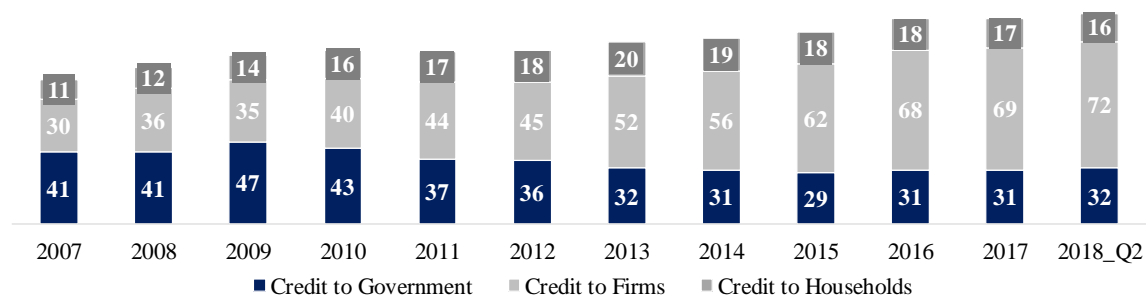
A timely and competent action on addressing bank balance sheets is needed to (i) support private sector (employment, capacity to operate as a commercial entity) and improve its competitiveness (elimination of zombies, creating scale); (ii) enable banking system to start lending again thanks to released capital; (iii) use taxpayer funds effectively through an independent, transparent and performance-oriented vehicle; (iv) mobilize foreign funding resources; and (v) send positive signal to the broader market. A public – private partnership is the optimal way to pursue this line.

An inability to clean bank balance sheets and restore credit flows in a timely and competent manner would risk triggering a negative feedback loop (credit starvation, economic contraction, loss of corporate sector capacity to operate and service debt, impaired bank balance sheets, further credit starvation). Simply arguing “it is private sector debt, and hence their problem” completely misses this point. What is owed by private sector is the main asset of the banks, and governments are the ultimate risk managers ensuring stability of the financial system.

It is important to note that financial resources and efforts required to solve the problem increases, arguably in a non-linear manner, as the problem diffuses through the economy. Naturally, any action could only work if general confidence in macroeconomic framework is in place.

**APPENDIX**

**Figure A1 Total Credit to non-financial sector, % of GDP, 2007-2018**



Source: Morgan Stanley, TEPAV visualization

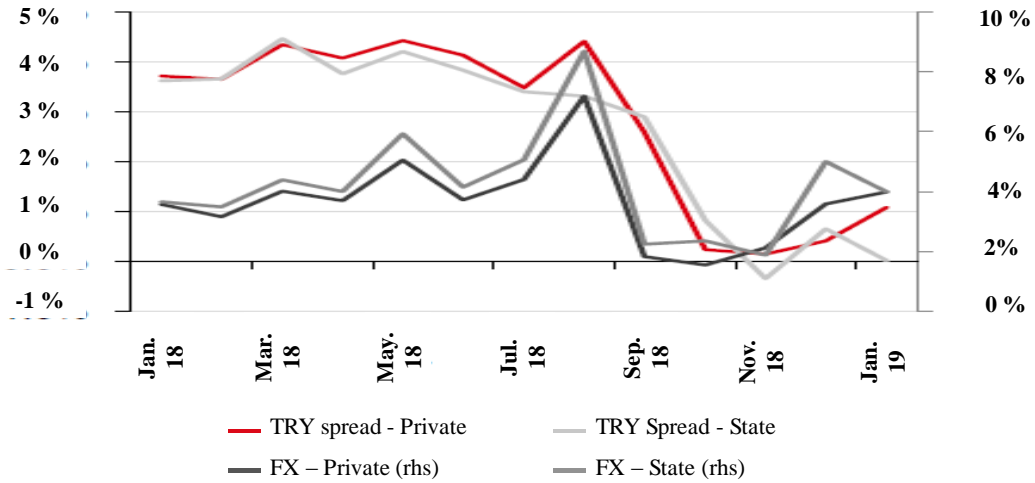
**Figure A2 Interest rates, flow data, % of EOP, 2017-2019**

	Dec.17	Jan.18	Apr.18	Jul.18	Oct.18	Dec.18	Jan.19
<b>Policy Rate (Blended Funding Rate)</b>	12.5	12.8	12.8	17.8	24	24	24
<b>TRY Deposit Rate (1-3M)</b>	14.4	13.4	13.6	17.4	25.3	23.2	21.7
<b>USD Deposit Rate (1-3M)</b>	3.4	3.4	3.4	3.8	5.3	4.2	3.8
<b>TRY Commercial Loan Rate</b>	17.1	17.2	17.3	23.5	33.4	28.3	26.8
<b>TRY Consumer Loan Rate</b>	17.7	18.6	18.8	22.8	37.7	33.1	29.7
<b>TRY Mortgage Loan Rate</b>	13.5	14.1	14.9	16.9	29	27.8	25.8
<b>USD Commercial Loan Rate</b>	4.8	4.3	5.4	5.4	6.4	7.1	6.5

Source: Morgan Stanley, TEPAV visualization

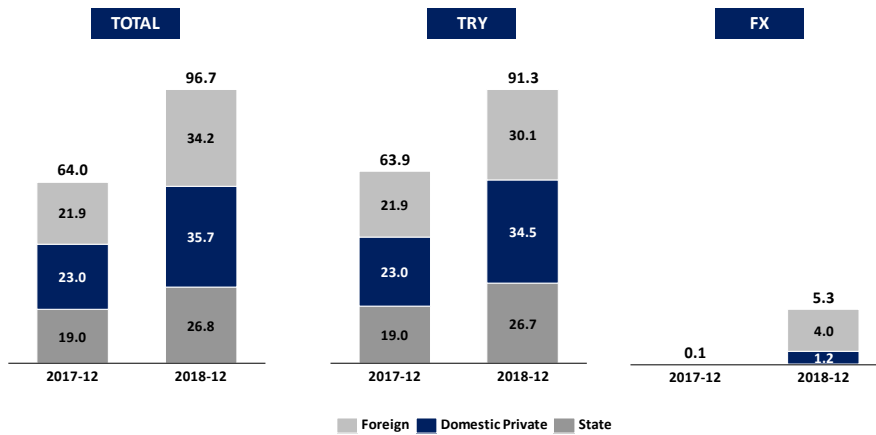


**Figure A3 Bank Monthly Lending Spread Trends, 2018-2019**



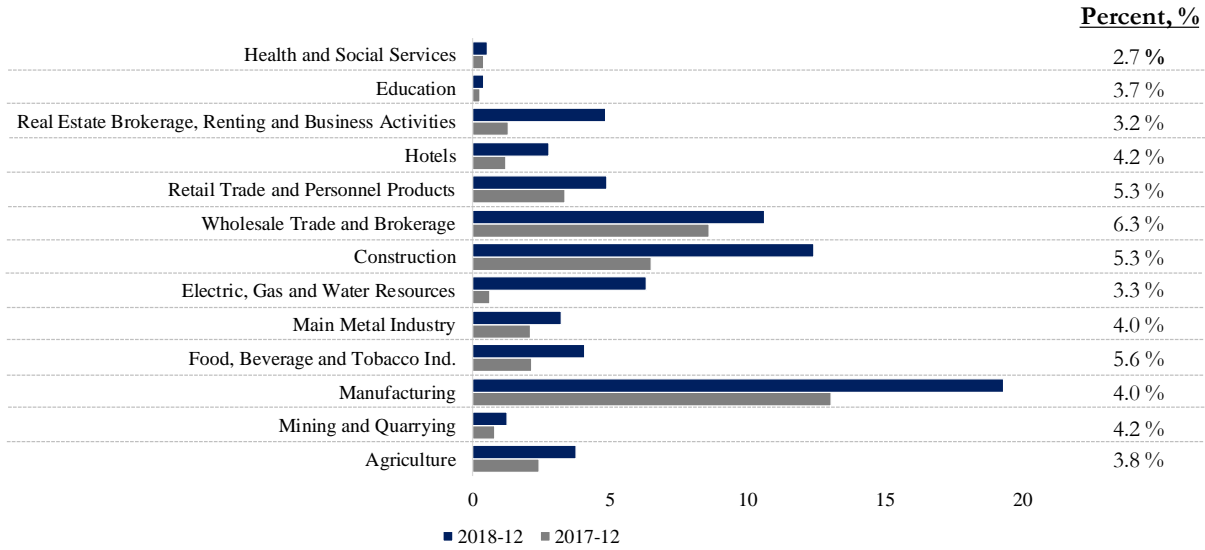
Source: BRSA, HSBC estimates

**Figure A4 NPLs, billion TL, 2017-2018**



Source: BRSA, TEPAV visualization

**Figure A5 NPL Sectoral Breakdown, billion TL and NPL to Total Loans, %, 2017-2018**



Source: BRSA, TEPAV visualization

**Figure A6 Watchlisted loans by maturity breakdown, billion TL, and their expected loss provision, as of 31.12.2018**

		Category II Loans			Expected Loss Provision
		Non-Restructuring	Restructuring	Non-Restructuring +Restructuring	
GARANTİ	Short Term	8.5	0.5	38.7	4.0
	Medium and Long term	20.9	8.7		
AKBANK	Short Term	3.6	1.4	29.4	2.9
	Medium and Long term	14.6	9.7		
VAKIFBANK	Short Term	3.3	0.8	20.6	1.3
	Medium and Long term	10.3	6.1		
ZİRAAT	Short Term	1.7	0.4	17.5	2.3
	Medium and Long term	13.1	2.3		
İŞBANKASI	Short Term	3.8	1.2	35.8	3.1
	Medium and Long term	21.5	9.3		
YAPIKREDİ	Short Term	3.4	0.4	33.6	3.6
	Medium and Long term	25.5	4.3		
TEB	Short Term	2.1	0.4	10.3	0.8
	Medium and Long term	6.1	1.6		
QNB	Short Term	0.8	0.6	9.9	1.7
	Medium and Long term	4.8	3.7		
ING	Short Term	2.0	0.2	11.9	0.4
	Medium and Long term	9.2	0.5		

Source: Relevant Bank Annual Reports, TEPAV visualization

Note: Data are based on annual reports of Garanti Bankası (2018), Akbank (2018), Vakıfbank (2018), Ziraat Bankası (2018), İş Bankası (2018), Yapı Kredi Bankası (2018), TEB (2018), QNB Finansbank (2018), ING (2018).