A Chronicle of Turkish Banking 2013 - 2016

How State Policies Shaped the Trends and Altered the Composition of Balance Sheets

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The experience of Turkish banking presents an exemplary case on the role and importance of the operating environment in the analysis of a particular sector. In many ways it offers a story that could be used as a case study on the relevance of the operating environment. At least we, rating analysts, are strong believers in the significance of the political and economic background of the country in assessing the dynamics of any sector.

Projects Gained Priority

Turkey has successfully completed several impressive projects in a span of a few years. Totaling a highly remarkable cost volume in USD terms, these projects were funded in large part by Turkish banks. Despite a few delays in the financing closures, these projects progressed as planned and major ones were completed on their previously targeted deadlines. In addition to the monumental infrastructure projects, like the two bridges and the Bosphorus tunnel, an extraordinary volume of construction and energy projects materialized. Additionally, 19 PPP city hospital projects, privatizations and overseas acquisitions were funded by Turkish banks. Since these projects were successfully completed, one can surmise that these projects were to a large extent unaffected from the turbulent international, regional and local events that took place during those years.

This paper summarizes the turbulent period beginning mid 2013 ending in 2016. We view year 2013 as a key turning point in terms of macro-economic indicators and shall begin our analysis with what changed that year. Our observations reveal that in the very same period these mega projects were obtaining funds, some segments of the corporate world in Turkey were deeply affected by international, regional and local events. Once again Turkish banks have unquestionably demonstrated their resilience to external shocks of all kinds in that period.

Defining Events of 2011 and 2012

It is important to note that back in November 2011, the AK Party government had won the elections for the third time and already relations with the EU were no longer as warm as in 2005. The Arab Spring that began in January 2011 in Tunisia had spread to Syria by April 2011. At the end of 2012 Turkey was hosting 240,000 refugees. Turkey's exports to Iraq were US$10.8 billion in 2013 (US$7.6 million in 2016).

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In years from 2013 through 2016, almost all major macroeconomic indicators weakened. These years are now characterized as the "slow growth - high inflation - high unemployment" years. Yet, in the 2010-2012 period, Turkey had experienced high GDP growth and all leading economic indicators were signalling a robust recovery. So much so that on November 4, 2012 Fitch Ratings had upgraded Turkey to BBB- investment grade after 18 years.

In the three year period through 2016, the Turkish people went to the poles four times (one local election, two general elections and one referendum), the Prime Minister changed three times despite the continuation of the AK Party rule. The country experienced a coup attempt on July 15, 2016.

2013 Made a Good Start - Investment Grade from Two Agencies

Turkey had experienced a successful recovery after the 2008 global crisis and the banking sector had attested to its strength. Until the end of May 2013, most economic indicators were steadily improving along with the narrowing down of the current account deficit. In the first half of 2013 interest rate were coming down boosting the growth momentum. In fact, 2013 posted 4.2% GDP growth after 2.1% in 2012.

In the first half of 2013 signs of economic indicators were positive and promising (lower inflation, lower interest rates and lower unemployment). On May 13, 2013 Moody's also upgraded Turkey to a Baa3 investment grade with a stable outlook. Turkey finally had two investment grade ratings that could dramatically improve external funding and FDI.

At the end of 2011 the government had initiated macro-economic measures such as increasing reserve requirements on lending to constrain credit growth. Credit card payments by installments had been particularly targeted and led to a sharp reduction in the credit volume. In January 2013 the Central Bank once more indicated that "the reasonable credit growth rate" was 15% and that if need be they would further tighten rules. During an interview, Governor Başçı said that 15% credit growth would suffice for and be compatible with just over 4% GDP growth and was appropriate for the inflation target. He said he expected that the 2012 year-end credit volume of TL780 billion would rise to TL900 billion at year-end 2013.[1] In 2013 annual credit growth turned out to be 32% with Ziraat marking an annual 50% increase. By year-end loans had reached TL1047 billion. Total deposits had increased by only 22.5% lagging behind credit growth. In the meantime, despite robust loan growth industrial production had dropped to 1.8% and private consumption gained momentum.

Year 2013 US$6.3 billion Privatizations had to be Financed

What makes year 2013 an important milestone in the history of the Turkish economy is the emergence of an unprecedented demand for project finance that year. This was both the outcome

[1] Dünya Gazetesi, 25 January, 2013

of deliberately launched public projects and the result of the coincidental culmination of projects that had been dragging for long years. Out of the 27 PPP Hospital Projects which the Ministry of Health had been trying to materialize since 2005 the tenders of 15 were completed in 2013. The health sector was attractive to investors and it was reported that there were also ongoing investments of 30 new private hospitals.

On the privatization front, a series of electricity distribution projects that had failed to obtain financing came to fruition in 2013. The transfer of operating rights of Boğazici, Akdeniz, Gediz, Aras, Vangölü and Dicle Electricity Distribution Companies were concluded. The privatization of Başkent Natural Gas distribution company and Seyitömer Thermal Power Station (US$2.2 bn), all adding up to US$6.3 billion were concluded. That year no foreign company had participated in these privatizations and all the financing had to come from Turkish banks. Moreover the tender of the Gebze Bridge and its highways had been awarded to the Nurol-Özaltın-Makyol-Astaldi-Yüksel-Göçay Joint Venture on April 9, 2009. The agreement signed on September 27, 2010 finally became effective on March 15, 2013 after the state guarantee was expanded by US$3.0 billion to US$4.9 billion.

A turning point for all emerging markets was May 20, 2013 the day the FED announced the end of quantitative easing and shook the international financial markets. Shortly after, on June 30th, the Gezi uprising took place in Istanbul triggering the political tension. That year the tense atmosphere worsened in December with the 17 and 25 December corruption accusations which were followed by several Cabinet members' change.

In the second half of 2013 nothing was going to be the same. The Sledgehammer trials were dominating the agenda of the press and former Chief of Staff Ilker Basbug was sentenced to life imprisonment by the courts in August 2013 for his role in the Ergenekon conspiracy to overthrow the government. On October 10, Economy Minister disclosed a new Medium Term Program covering 2014-2016. He envisaged $12,670 per capita income in 2016 and 5.7%, 8.2% and 9.2% increase in private sector fixed investments for years 2014, 2015 and 2016, respectively.

The agenda of mega projects was running smoothly. On May 3rd, the tender of the Third Istanbul Airport was finalized. A consortium of five companies (Limak-Kolin-Cengiz-Mapa-Kalyon) was awarded the tender for €22,152 million ($34.0 billion incl. VAT). The tender agreement was signed on May 20. On May 19, 2013 the construction of the Third Bridge (Yavuz Sultan Selim) officially started and subsequently a US$2.3 billion 9-year project financing was arranged by seven Turkish banks.

In September, Turkey applied to host the 2020 Olympic Games in Istanbul. In October an official delegation was in London visiting financial circles with a request for project finance totaling US$100.0 billion. On October 29, the Eurasia tunnel in Istanbul was officially opened to traffic.

On May 24, 2013 Turk Telekom refinanced its US$4.5 billion syndication with 29 Turkish banks. The next year in June 2014, Turk Telekom raised an additional US$1.0 billion through US$500 million 10-year Eurobonds and US$500 million 5-year Eurobonds.

Turkey's external debt rose by US$50.0 billion to US$390.0 billion in 2013, an unprecedented hike in a single year. Ironically, Turkey had paid off IMF the last installment of the Stand-by loans in 2013.

Two Elections in 2014 and the Escalation of Political Tensions in the Middle East

During 2014 domestic politics dominated the agenda; local elections were held on March 10 and in August 2014 Tayyip Erdoğan was elected president with 52% approval votes. Meanwhile on June 10, 2014 ISIS took over Musul in Syria and captured 49 people at the Turkish Consulate including the Consul for 101 days. At the end of April, Prime Minister Erdoğan reported that the number of Syrian refugees were nearing one million.

Year 2014 started off with the acceleration of the depreciation of the Turkish Lira which compelled the Central Bank to raise the overnight lending rate to 12.00% from 7.75% and the weekly repo rate to 10.0% from 4.5% on 21 January. The impact was minimal. On March 18, 2014 Moody's placed 10 banks under review referring to the potential impact of the tense political environment and on April 11 revised Turkey's sovereign rating outlook to negative citing "political turbulence, increased external financing pressure and weaker growth prospects". This had triggered concerns over a possible credit downgrade in the months to follow. GDP growth moderated to 2.9% in 2014 from 4% in 2013.

Mid-2014 oil prices began to fall impacting Russia's economy. The weakening of the purchasing power in Russia already started impacting the Turkish leather industry, exports and tourism. The Fed did not raise interest rates in 2014 and not until December 2015. Turkey had no difficulty rolling over external debt though the borrowing rate had increased to 5.8% from 4.3%[2]. In the meantime, large projects had encountered difficulties in raising funds for the full commitment of the projects. On April 19, 2014 the government officially published a decree providing full state guarantee on specific projects. In May a US$2.3 billion financing package for the third Bosphorus Bridge was concluded with the participation of seven banks. To date five projects amounting to an estimated US$24 billion are covered under state guarantee.

In addition to these projects, Turkish banks were financing international acquisitions. Yildiz Holding's acquisition of United Biscuits for US$3.2 billion was partially (US$1.6 billion) financed by Turkish banks. That year the Turkish Petroleum Company (TPAO) purchased 10% stake in the Shah Deniz Project for US$1.45 billion and obtained US$1.0 billion 7-year loan from Isbank and Vakif Bank with a 3-year grace period.

[2] Source: Treasury Presentation (July 2017)

Global Contraction and Fall in Oil Prices in 2015 - Two General Elections in Turkey

Year 2015 was not easy throughout the world. According to World Bank data global GDP growth remained at 2.4%. "World merchandise remained sluggish in 2015, at 2.7 per cent as measured by the average of exports and imports."[3] This weak performance was attributed to the economic slowdown of China, recession in large developing countries in particular in Brazil, strong fluctuations in exchange rates and financial volatility. The steep fall both in oil prices and the Baltic Dry Index that year reflected the situation. While in volume terms world trade had marked a modest growth, in value terms world merchandise trade had declined by 14%. In tandem with falling oil prices, prices of most commodities had declined. The impact of these developments on Turkey was inevitable.

Instead of coping with these global issues local politics dominated the agenda in Turkey. During 2015 the country experienced two general elections, one in June and one in November, which caused a long period of persistent uncertainty. At the general election of June 7, 2015 AK Party failed to win majority votes. The 34% support to AK Party in 2007 and the 50% support in June 2011 had diminished to 40.9%. Despite the election of 258 deputies, AK Party did not have the required majority to be in power. HDP gained 13.1% votes largely surpassing the 10% threshold. The existing three parties failed to agree on a coalition and the election had to be repeated on November 1st. This time AK Party obtained 48.9% of the votes and its 4th term began with plans of sweeping changes in the country.

Terrorist attacks escalated in 2015. The first attack was in January in Sultanahmet, the center of tourism. The attack on July 20 in Urfa caused 34 deaths. In addition to several attacks in eastern provinces, the attack during a rally in Ankara on 10 October caused a large number of deaths and wounded.

Another turning point in Turkey's economy happened on November 24, 2015 when Turkey shot down a Russian plane by accident. Russia's reaction was harsh; the Russian government banned its citizens to travel to Turkey leading to a reduction of Russian tourists to less than 900 thousand in year 2016 from 4.5 million in 2014. Meanwhile the embargo on Russian imports from Turkey resulted in a sizeable drop in Turkish exports to Russia. The US$7.0 billion exports to Russia had already dropped to US$6.0 billion in 2014. The fall continued to US$4.0 billion in 2015 and US$1.7 billion in 2016. These were severely reflected on the financial strengths of hotel owners and businesses in Antalya and needless to say on all exporter companies.

The economy suffered 30% devaluation in the first 9 months of the year. With some recovery on the last quarter the Turkish Lira had lost 25% value by the end of the year. Turkish companies were heavily indebted in foreign currency and incurred FX losses. This prompted the banks to wait and see the balance sheets before revising their credit limits.

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[3] World Trade Organization, World Trade Statistical Review 2016

With lower oil prices, Turkey's energy imports bill fell to US$38 billion from US$55 in 2015, and to US$27 billion in 2016. Yet, the opportunity could not be used to reduce oil prices in Turkey because of the depreciation of the Lira. Lower oil prices had also caused price falls in the commodity markets. In tandem with a sharp fall in the Baltic index that year, shipping had contracted and some sectors suffered due to lower export prices. For instance, one of Turkey's major export sectors, manufacturing steel products, experienced 29% drop in its annual exports. Total exports had decreased by 8.7% in 2015. At the end of 2015, all economic targets underperformed and indicators continued to worsen. The Association of Shopping Malls and Retailer (AMPD) reported that 50,000 stores had been closed.

Long periods of uncertainty had negatively impacted the economy. GDP growth was 4% but unemployment and inflation were rising. Treasury borrowing rates continuously rose throughout 2015 and reflected on corporate lending rates. Policy uncertainties and lack of economic predictability damaged small businesses. The number of bankruptcy suspensions exceeded 1000 that year (732 in 2014) and the annual NPL volume increase was above 30%. Some well known companies that had existed for long years failed. Some suppliers insisted on prepayments or shorter payment terms triggering higher liquidity and working capital needs which was difficult to obtain.

The banks' profitability as measured by ROAA and ROAE ratios declined between 2012 and 2015[4]. Banks managed to maintain high capital adequacy ratios (15.6%) but as the pace of deposit growth lagged behind credit growth they had to increase their external borrowings. Loans to deposit ratios were nearly 120% as non-deposit funding continued to increase. The composition of Turkish banks' external borrowings drastically changed towards long-term in 2015. The composition that was 60% short-term/40% long-term in 2013, became 40% short-term/60% long-term in 2015 on the back of project financing requirements.

The Turkish Banks Association reported that total outstanding project finance risk had reached US$71.0 billion at the end of 2015. In June 2015, the US$5.0 billion financing of the Istanbul-Izmir highway was signed with the participation of 7 large banks and Deutsche Bank London and Yapı Kredi's overseas participations. Subsequently, in October the US$4.5 billion loan for the Third Istanbul Airport was signed with the participation of Ziraat Bank (€1.5 billion), Halkbank (€960 million), Vakifbank (€960 million), Denizbank (€300 million) and Finansbank (€300 million).

Already at the beginning of February 2015 Bank Asya (known to belong to the Gulenist) had been taken over by SDIF. That entailed the discontinuation of a large number of loans to corporations and individuals.

[4] Source: BRSA

Significant Fall in Tourism in 2016

The losses from tourism were more pronounced as of 2016. It was not only the sharp drop in the number of Russian and European tourists. In 2015, at least 40 international conferences were annulled and Turkey lost its place among the top 20 countries hosting conferences. The majority of cruise liners had decided to exclude Turkey from their programs. The number of cruise ship visits fell to 590 in 2016 from 1542 in 2013 partly caused by the construction work in the Istanbul Galata Port and partly because of some travel insurance companies refused to cover Turkey. These had repercussions on a large number of sectors, notably hotels, restaurants and small stores. In April 2016 Hürriyet Daily reported that 600 stores had close down at the Covered Bazaar of Istanbul. Hundreds of hotels were in the market for sale, dozens of shopping malls were seeking investors. But, sadly terrorist attacks continued.

2016 was expected to be a period of recovery. In fact in the first few months interest rates were subsiding and confidence indices were up. Yet, looking back it was the year of the worst terrorist attacks which eventually dried up Western tourists from Turkey. On February 17, the attack in Istiklal Caddesi, a main pedestrian street in Istanbul, which left 28 dead and 61 wounded had targeted German tourists. Another attack was staged at the Istanbul Airport on June 28 and the worst happened at a nightclub in Istanbul on 31st December. In those days it never occurred to us that these terrorist attacks would be so consequential to economic indicators; Turkey lost US$10.0 billion tourism revenues in 2016 offsetting the benefits of the lower oil bill. The same loss was repeated in 2017 despite the increase in Russian tourists. Hundreds of hotels were put on sale, hundreds of small restaurants in Istanbul were closed and the Airbnb market nearly disappeared. Foreign direct investments fell by 44%. The situation in Syria was far from settled. By April 2016 the number of Syrian refugees had climbed to 1.7 million. With other refugees from other countries the official number of refugees in Turkey was 2.3 million.

Political stability was not totally restored although there were no elections on the horizon. Prime Minister Davutoğlu resigned on May 4, 2016 and AK Party held an Extraordinary Congress and elected Binali Yıldırım (the sole candidate) as party chairman. He subsequently became Prime Minister.

Finally on July 15th, the failed coup attempt set the tone of a sharp reversal in economic activity. The coup affected consumption and economic activity stalled. In a few months more than 100,000 civil servants lost their jobs. The third quarter GDP growth turned out negative.

Industry Lost its Glitter

Since 2010 industry's contribution to GDP declined. The share of manufacturing industries declined over the years. We note that loans to the manufacturing sector had more than 19.0% share in 2013. After peaking to 19.6% its share moderated to 17.6% at the end of 2016. Compared to construction and energy, incentives to the manufacturing industries were inadequate as industry had no priority in the annual plans.

Between December 2012 and December 2016, Turkey's installed electricity generation capacity rose from 57,059 MW to 77,000 MW. This achievement reflects a very significant volume of investments. The companies' ability to raise the necessary funding for these investments is unarguably the key contributive factor in this accomplishment.

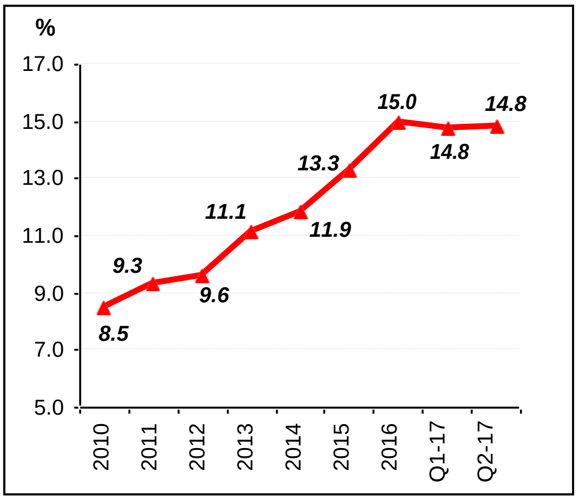
Energy sector loans were not only allocated to new investments. The privatization of electricity distribution companies were completed in 2013 generating US$13.0 billion revenue to the Privatization Administration. Over the years, payments to the PA were completed but that was thanks to loans obtained from banks. Additionally, EMRA designated investment targets to these companies which also required funding. In February 2017, Serhat Çecen from IC İçtaş Energy told reporters that the sector's total liabilities to Turkish banks including interest payments were US$20.0 billion. It was also reported that between 2012 and July 2016, 10 thermal power stations having 6000 MW capacity and 68 hydro power plants having 842 MW capacity were privatized.[5]

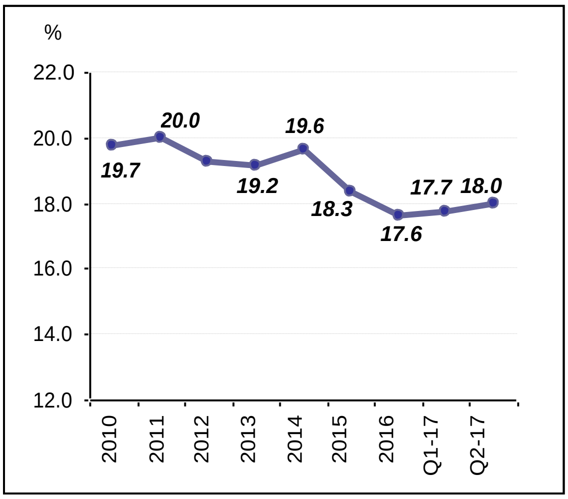
Meanwhile, M&A deals reported by companies like PWC and Deloitte showed a large volume of sales in the energy sector. At the end of 2016 total outstanding loans of the Turkish banking sector to the energy sector was US$34.7 billion (2012: US$17.9 billion). At the end of September 2017 the volume had risen to US$37.0 billion. Additionally, the outstanding external debt of the energy sector was US$11.3 billion.

The share of energy and construction sectors in total loans exhibits a steep rise after 2010. The share of energy loans that was less than 3% in 2010, had already advanced to 4.6% by 2013. At the end of 2016 this ratio was 6.8%. Similarly, the construction sector which already had a good 5.6% share in 2010 had gained 6.6% share by 2013 and risen to 8.2% at the end of 2016. These two sectors together had reached 15.0 share at the end of 2016. This was largely at the expense of loans that would otherwise be directed to the manufacturing sectors. To what extent this was due to the lack of credit demand from the manufacturing sectors (given the low level of investments) to what extent the end result of the banks' more stringent lending policies in those years is a debatable question.

[5] Ministry of Finance, The 2017 Budget

The Share of Energy&Construction in Total Loans The Share of Manufacturing Goods in Total Loans





Source: BRSA

Loans to the construction sector stood at US$41.7 billion at the end of 2016 (2012: US$27.5 billion). At the end of September 2017 the volume had risen to US$49.7 billion. The outstanding external debt of the construction sector stood at US$13.0 billion as of year-end 2016.

In comparison, total SME loans were US$119.8 billion at year-end 2016 with the relatively larger ones having US$48.6 billion. According to BRSA 45,125 medium-sized companies were benefiting from US$48.6 billion credits. Following the implementation of Credit Guarantee Fund this was expanded to 49,340 medium sized companies benefiting from US$49.3 billion.

Retail Lost the Brand Names

By 2017 there were few international brands left in shopping malls. Recently Debenhams also announced its departure. The exits began with the closure of dozens of stores who could not survive the rents fixed in dollar terms and the decline in purchasing power, mainly due to the restriction on credit card installments.

First Habitat which had a fairly large place at Kanyon left in 2015 followed by Mothercare. Dorothy Perkins, Top Shop, Top Men and Douglas were the early leavers. C&A left in 2016. The impact of the 2015 devaluation and the restriction on retail lending terms hit electronics retail.

The Results of the Top 500 Industrial Companies

The corporate sector also had to bear its share of the cost of such a challenging environment. On the back of the economic conditions described above leverage ratios climbed together with the continuous rise in financing expenditures. Net earnings declined.

In 2013 the sales of the ISO 500 had increased by 8.3% (flat in real terms) and their exports volume had remained unchanged. Financing cost had hiked by 122.5% driven by FX losses, higher interest rates and 25.6% rise in financial liabilities. The equities of the private sector companies (487 corporations) had increased by 8.2% but their equity/total assets ratio declined to 39% (43% in 2012). At the end of the day pre-tax income was down by 8.5%.

Basel III Rules' Impact on Capital Adequacy

Yet another factor that played a role in this process was the advent of Basel III Accord requirements. BRSA introduced a series of regulations throughout 2013 - 2015 related to equity, capital adequacy, liquidity, leverage, and capital buffers. Finally, on 16 March 2016 it was announced that Turkish Banking had become compliant.[6] While all analysts expected that the banks' capital adequacy ratios would fall by one or two points when these regulations were applied, banks adopted strategies to mitigate the impact of Basel III rules. One of their strategies was to be selective in building their "risk weighted assets" with "a reorientation of lending towards lower margin corporate lending and a policy induced squeeze on retail credit margins[7]. SEE lending, particularly to micro companies, inevitably lost its priority under the advantages of state guaranteed project loans and corporate lending to heavy weight corporations.

Both Supply Side and Demand Side Factors Led to the Slowdown in SME Loans

There appears to be a satisfactory level of consensus on the view that a combination of supply and demand side factors impacted the slowdown in SME lending. Under persistent cycles of uncertainty companies postponed their investments or simply could not invest if their sector had been particularly hit by geopolitical events. On the other hand banks were reluctant to lend to small companies who could not provide satisfactory collaterals and strong financials.

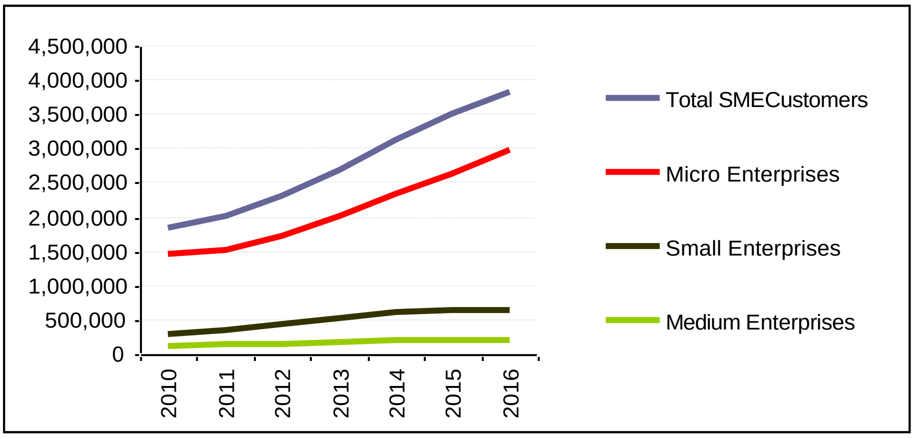
The State Statistics Institute's findings show that as of the end of 2012, in term of numbers, SMEs constituted 99.8% of all companies in Turkey, they employed 75.8% of total employment, generated 54.2% of value-added and realized 59.2% of total exports. The share of SMEs in total exports gradually receded from 62.6% in 2012 to 59.2% in 2013, to 56.4% in 2014 and 55.1% in 2015.[8] 91.6% of their exports are manufactured goods.

[6] BRSA Press Release dated May 16, 2016

[7] IMF Country Report No.17/46, February 2017

[8] State Institute of Statistics. The State Institute of Statistics' definition of SME is any company employing less than 250 people. BRSA defines SMEs as companies with max TL40 million turnover and employing less than 250 people.

The Number of SME Borrowers



In 2012 SMEs share in total loans in Turkey was 25.1%. The redefinition of SMEs had increased their share. The 2010-2016 period has not been favorable to SMEs although a number of banks claimed that they were SME focused. In six years the number of SMEs utilizing bank loans doubled to 3.8 million but the increase came from micro enterprises. Medium size enterprises who needed most to borrow only increased from 120 thousand to 209 thousand. Banks interest in SMEs continuously lost momentum decelerating from an annual growth rate of 35.9% in 2013 to 8.2% in 2016.

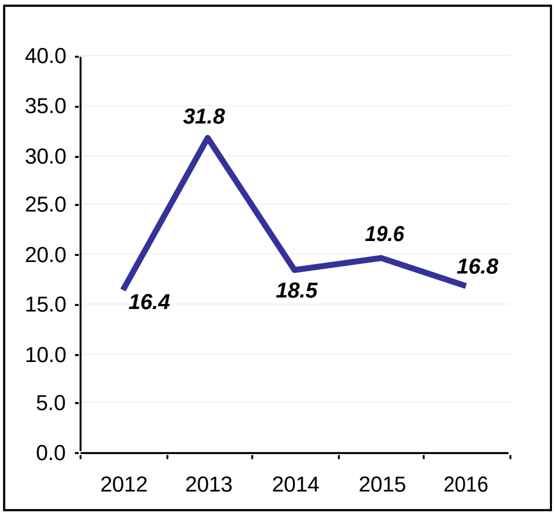
The Central Bank's Financial Stability Reports Regularly Gave the Facts

The only economic research team that was fully aware of these developments and in fact had better data on these loans was the Central Bank of Turkey team. They dutifully reported these developments in various Financial Stability Reports. In fact their last, May 2017 Report, contains very useful graphs. They preferred to comment on these developments as a positive shift to longer term external borrowings which reduces the rollover risk.

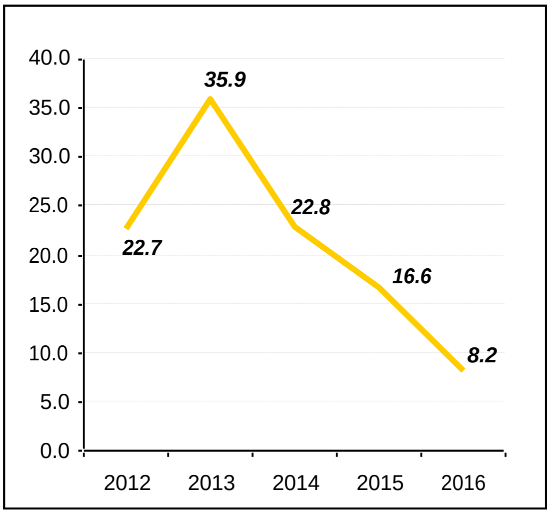
Macro-prudential Policies Relaxed after September 2016 and in 2017

In the first half of 2013 credit growth was escalating at a pace well above the Central Bank's 15% reference rate. By the time it reached 30%, BRSA decided to take action; provisioning regulations on credit cards, overdrafts and vehicle loans were extended, credit card limits were linked to income and credit card payments and risk weights were increased. This hit the low-income groups and small businesses. The pace of retail loans sharply fell from 26.2% in 2013 to 7.6% in 2014, while the pace of SME loans dropped from 35.9% to 22.8%. Meanwhile large corporations were less affected.

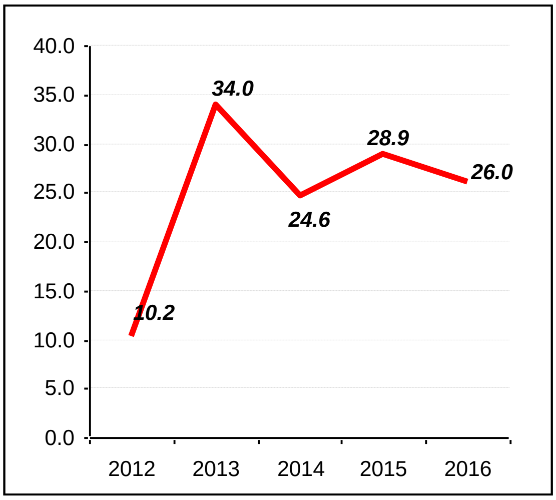
Annual Loan Growth of the Banking Sector (%)



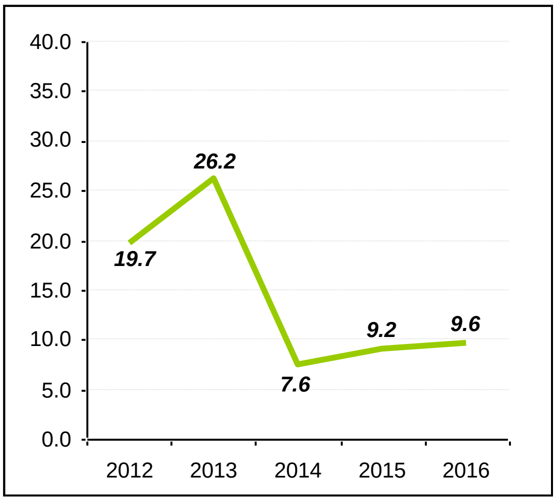
Annual Loan Growth of SME Loans (%)



Annual Loan Growth of Corporations (%)



Annual Loan Growth of Retail Loans (%)



Macro prudential measures were undoubtedly effective in restraining credit growth. Yet at that point nobody questioned whose credits were restrained. No one questioned the disproportionate impact of these measures on different segments of society. Small business owners, who when needed, used their credit cards for their working capital requirements, were hurt. At a time unemployment was rising credit card payments defaulted pushing up the NPL ratios. These macroeconomic measures were introduced against a backdrop of heightened political uncertainties. Moreover, the Household Debt as a percentage of GDP had reached 20%. This was the year bankruptcy suspension news began to escalate (645 bankruptcy suspensions in 2013, 720 in 2014). The volume of unpaid checks and protested bills rose. The social divide widened under a system of unfair access to bank loans and business opportunities.

Moreover, while the pace of growth in corporate loans moderated from 34% to 24.6% what was overlooked was the fact that a large portion of these loans were no longer the traditional investment-working capital-export loans, they were project loans + loans financing acquisitions and privatizations. Private sector investments were historically low. We now know that by the end of 2014 project loans had reached TL131.1 billion on cash basis, TL227.4 billion in total commitments.

Already by mid-2015, a large number of sectors were affected for different reasons. The financial strength of hundreds of companies had weakened due to either local conditions, weaker export opportunities or the impairment of international relations totally cutting off the export destinations in North Africa and the Middle East. Banks prudently tightened lending requirements and increased their collateral demands. From the banks' perspectives, they preferred to extend loans to the government guaranteed project finance opportunities presented to them.

In most banks "others" account for more than 50% of the total. "Services" also covers a wide range of sectors including telecommunications, health, retail and wholesale trade. Until the Turkish Banking Association reported the volume of project loans at the end of 2014, there was no way one could calculate the exact volume, although some banks like Ziraat and Halkbank reported their major contributions in their annual reports.

Credit Guarantee Fund (CGF) Effective in Stimulating Economic Growth

In the weeks after the failed coup of July 15 consumer confidence was at an all-time low. Credit growth between August and September was negative in real terms. Confronted with a sharp fall in economic activity and consumption, the government's policies changed starting from September 2016. To revive the economy, regulations on retail banking were relaxed. Then in beginning of 2017 the government finally decided to attach a higher priority to SMEs and introduced the Credit Guarantee Fund. With the introduction of the Credit Guarantee Fund, the situation has totally reversed. The scheme provided state guarantee to more than TL200.0 billion and provided access to bank loans without collateral requirements to more than 350 thousand companies in nine months.

In fact, the CGF was very effective in reviving the economy. The second quarter of 2017 posted 5% GDP growth. Indications are that Q3 GDP growth will be even higher. Factual evidence once again confirmed the role and importance of SMEs. At this point, can state policies remain supportive of SMEs while new projects need to be financed? Presently there is a good backlog of new projects (including the Canakkale Bridge recently awarded to a Joint Venture) and refinancing demands for previous financing packages. As clearly there is no deposit growth prospects, is Turkey heading for more international borrowings?

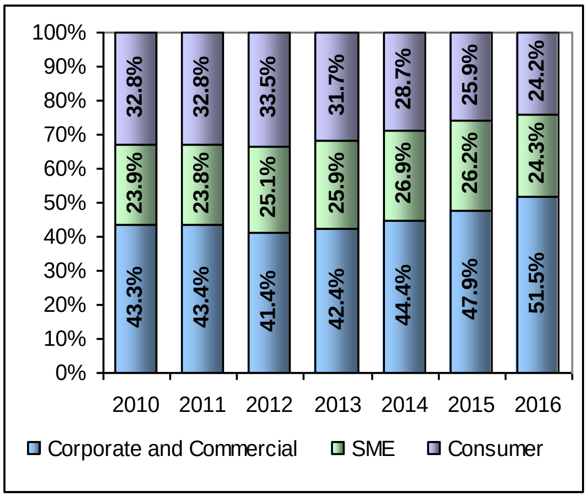
Impact on Banking

The total assets and the credit volume of the banking sector continued to grow in the five years through 2016. However, in USD terms the picture was different. After advancing to US$535.5 billion in 2014 from US$448.4 billion in 2012, under persistent devaluations the total loan volume declined to US$494.5 billion in 2016. The crowding-out effect of the Treasury's borrowings at high rates took a different pattern after 2013. The state led project financing requirements soaked up a major portion of Turkish banks' funds leaving little room for SME's needs. While outside observers saw a moderate slowdown in the annual pace of bank lending growth, the discrimination in favor of the project finance was never debated.

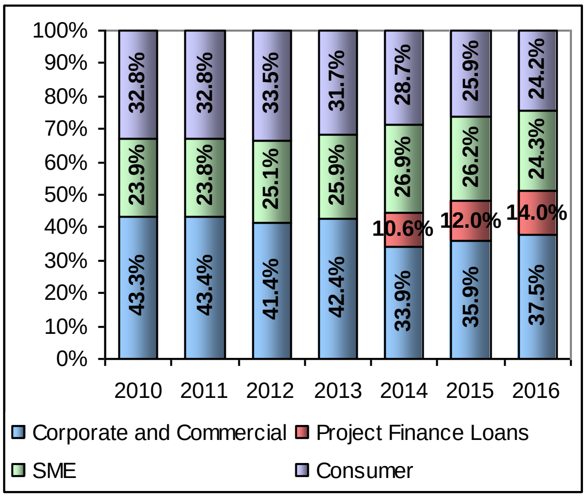
1. The reorientation of bank lending, from retail and SME segments to very large corporations' requirements of financing projects, privatizations and acquisitions, changed the banks' funding structure. These financing requirements were in foreign currency and long-term. Therefore, the funding had to be from international sources as rates were far below the cost of local funds. Secondly, securitizations gained priority, as 5 to 7 years tenors were only possible there. As a result the shift of debt maturity was from short-term to long-term. In 2010, 62.5% of Turkey's external debt was short-term, 37.5% long-term. This composition reversed at the end of 2014. By the end of 2016 64.4% of Turkey's total external debt was long-term and 35.6% short-term.

2. Traditionally, Turkish banking loan volume is reported under a standard classification of three segments: Corporate & commercial, SMEs and Consumer. We also initially used this classification and noted that the share of the corporate and commercial segment had risen from 40.2% in 2012 to 51.5% in 2016 at the expense of lowering the share of the consumer segment from 33.5% to 24.2%. However, we suggest that it would be more appropriate to use a four- segment classification by adding project loans. BRSA statistics illustrate that the share of the "corporate and commercial" segment increased to 51.5% by the end of 2016 from 43.3% in 2010 at the cost of the decline in the shares of the "consumer" and "SME" segments. When project finance is removed from the corporate segment as a separate segment, we note that in fact the share of corporate and commercial loans has decreased.

The Composition of Credits

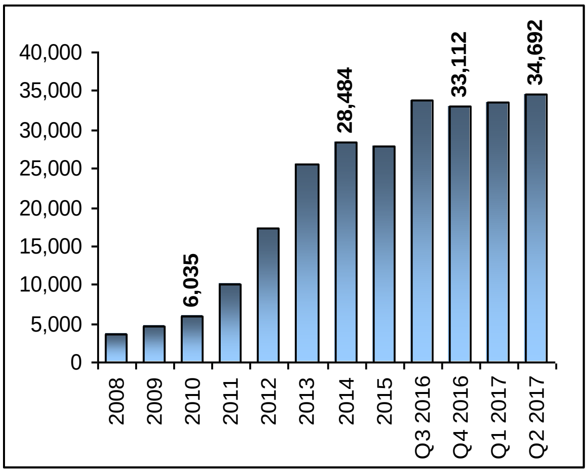


The Composition of Credits Incl. Project Loans

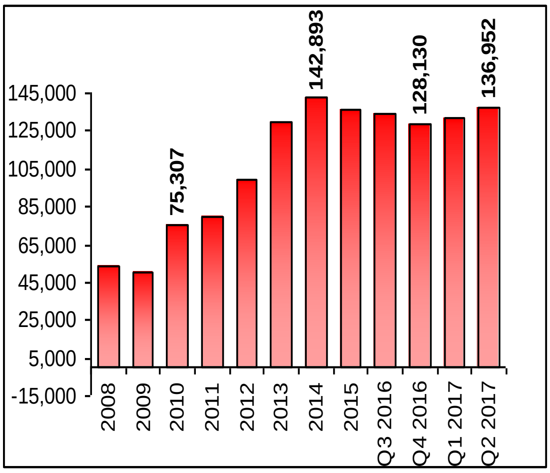


3. In years 2014 through 2016 the increase in external debt has been triggered by state-owned banks. The external liabilities of the major private banks did not increase, their rollover ratio remained around 100%. The outstanding external debt of state-owned banks grew threefold from US$10.1 billion in 2011 to US$33.1 billion at year-end 2016 (US$34.7 billion mid 2017). Whereas private banks' external debt increased by 60%, from US$80.1 billion to US$128.1 billion in the same period.

The External Debt of State Banks



The External Debt of Private Banks



4. Over the years the share of deposits in total assets has been diminishing because the pace of deposit growth remained below credit growth. The difference was covered with external borrowings. The share of bank borrowings and issued securities steadily increased. As a result, the loans/deposits ratio also steadily increased reaching nearly 120%. To be able to benefit from the CGF private banks once again began to increase their international borrowings in 2017.

Date: November, 2017

TABLES

Table 1 - The Composition and Number of SME Borrowers

	2010	2011	2012	2013	2014	2015	2016
Total SME Customers	**1,850,200**	**2,013,434**	**2,317,334**	**2,693,165**	**3,141,098**	**3,494,800**	**3,834,915**
Micro Enterprises	1,447,941	1,520,093	1,730,008	2,006,292	2,343,479	2,630,640	2,969,340
Small Enterprises	282,334	343,485	448,661	521,289	603,356	656,372	656,525
Medium Enterprises	119,925	149,856	138,665	165,584	194,263	207,788	209,050

Source: BRSA

Table 2 - Turkish Banking Loan Volume (Million TL)

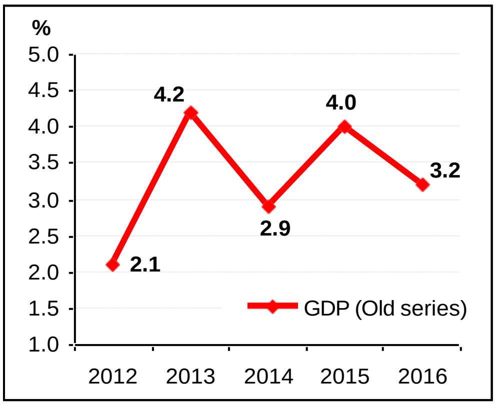
	2010	2011	2012	Share	2013	2014	2015	2016	Share
Corporate & Commercial	227,768	296,200	329,103	**41.4%**	444,044	420,252	532,122	650,625	**37.5%**
Project Loans*	-	-	-	**-**	-	131,116	178,518	242,435	**14.0%**
SME Loans	125,468	162,803	199,743	**25.1%**	271,421	333,278	388,749	420,539	**24.3%**
Consumer Loans	172,615	223,891	265,910	**33.4%**	331,945	356,060	384,867	419,979	**24.2%**
Total	**525,851**	**682,893**	**794,856**	**100.0%**	**1,047,410**	**1,240,706**	**1,484,256**	**1,733,578**	**100.0%**

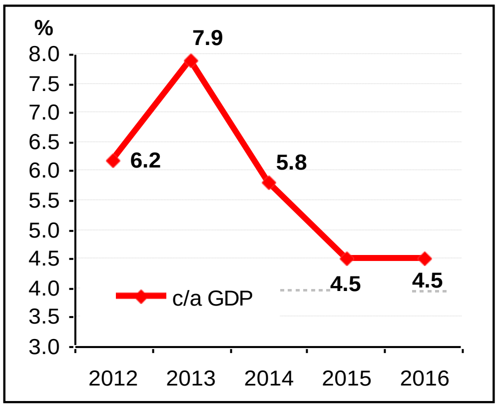
Source: BRSA and *TBA

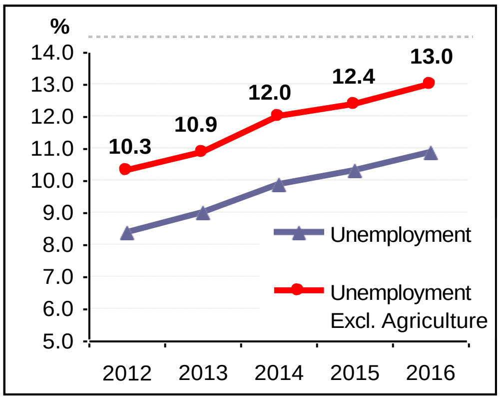
Turkey's External Debt

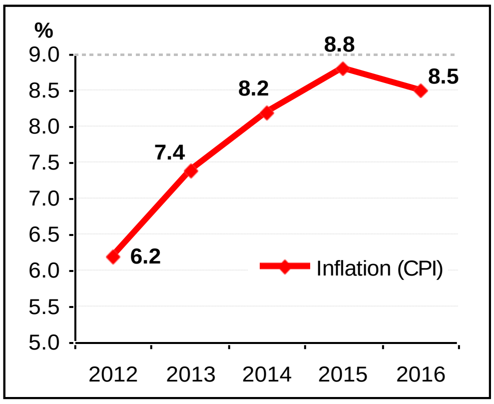
	2010	2011	2012	2013	2014	2015	2016	Mar-17	Jun-17
Public Sector	**89,109**	**94,279**	**104,023**	**115,945**	**117,687**	**113,144**	**119,839**	**123,060**	**129,348**
General Administration	81,750	82,990	85,481	89,325	88,213	84,446	85,530	88,206	93,358
Central Government	78,085	79,184	81,710	85,663	85,163	81,738	82,615	85,200	90,113
Local Administrations	3,618	3,789	3,768	3,661	3,050	2,708	2,915	3,006	3,244
Funds	47	17	3	0	0	0	0	0	0
Financial Institutions	6,035	10,064	17,285	25,439	28,484	27,841	33,112	33,544	34,692
State Banks	**6,035**	**10,064**	**17,285**	**25,439**	**28,484**	**27,841**	**33,112**	**33,544**	**34,692**
Non-Financial State Institutions	1,324	1,225	1,257	1,181	989	858	1,197	1,310	1,298
SEEs	1,183	1,162	1,214	1,158	989	858	1,197	1,310	1,298
Others	141	64	43	23	0	0	0	0	0
The Central Bank	**11,565**	**9,334**	**7,088**	**5,234**	**2,484**	**1,327**	**821**	**809**	**806**
Private Sector	**190,963**	**200,079**	**228,451**	**268,587**	**281,641**	**281,611**	**283,799**	**288,154**	**302,198**
Financial Institutions	88,732	94,361	116,089	149,700	163,655	156,986	148,391	150,502	156,972
Banks	75,307	80,072	99,038	129,483	142,893	136,038	128,130	131,462	136,952
Non-Bank Financial Inst.	13,425	14,289	17,051	20,217	20,762	20,948	20,262	19,039	20,021
Non-Financial Institutions	102,230	105,718	112,362	118,887	117,986	124,625	135,408	137,652	145,225
Total Gross External Debt	**291,637**	**303,692**	**339,562**	**389,766**	**401,811**	**396,083**	**404,460**	**412,023**	**432,352**

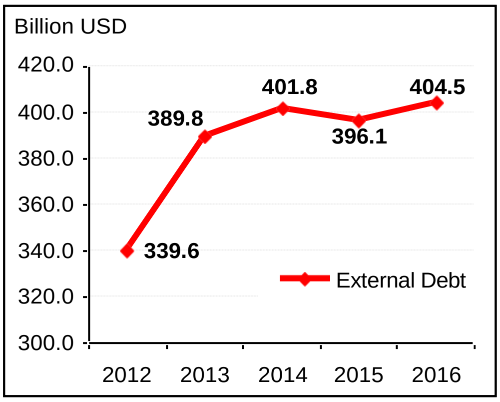
MACRO ECONOMIC INDICATORS 2012 - 2016

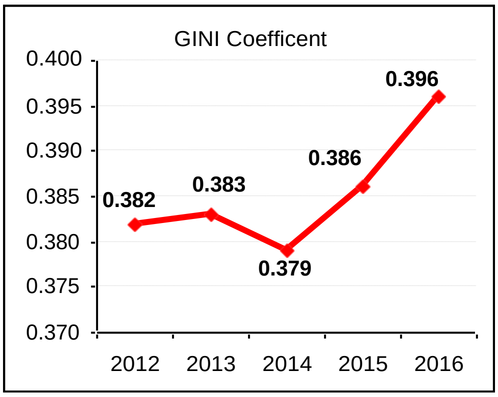




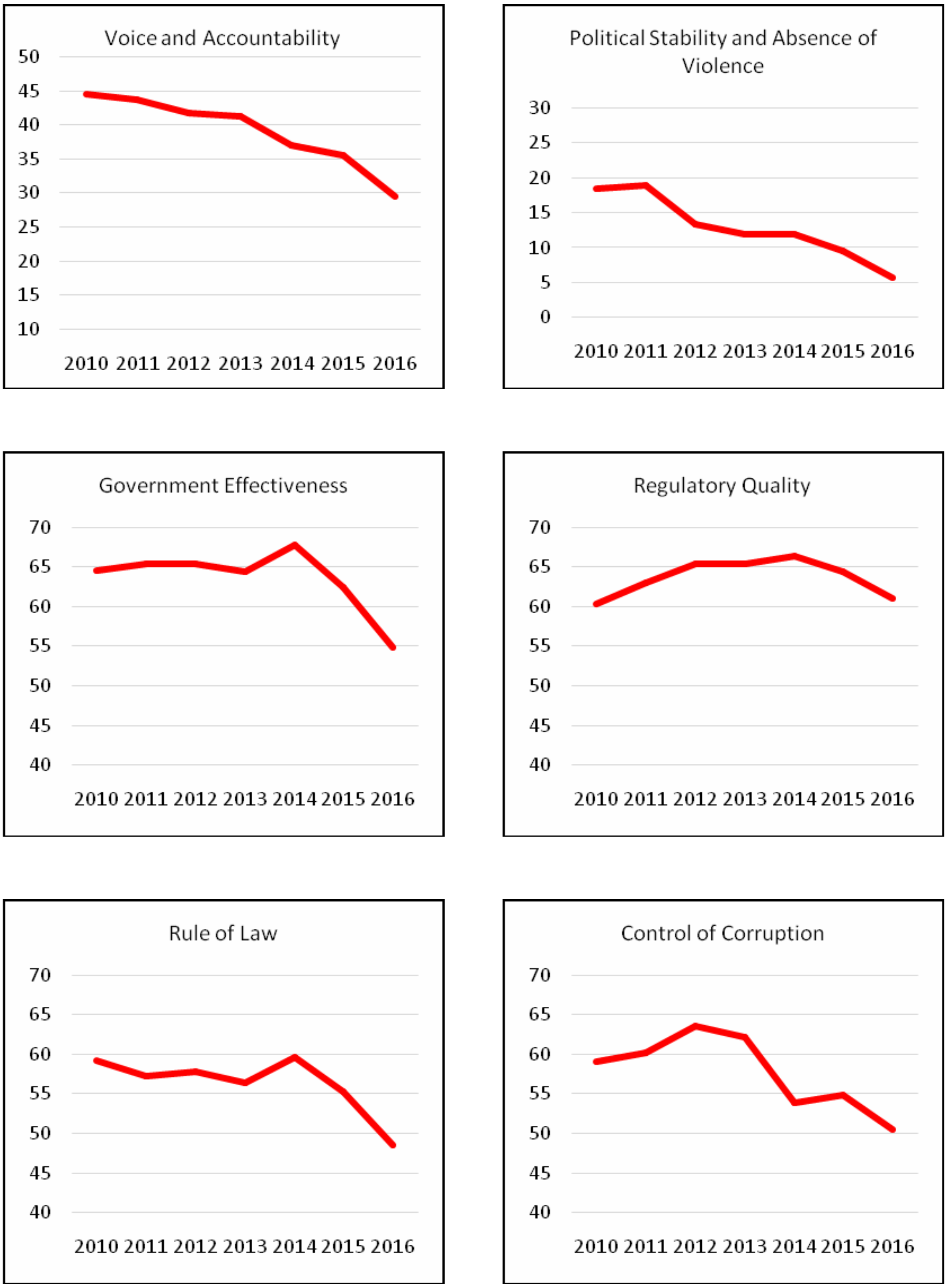








TURKEY'S CORPORATE GOVERNANCE INDICATORS 2010 - 2016



Source: http://info.worldbank.org/governance/wgi/index.aspx#home