Istanbullish

Turkey's banks are well placed to absorb an increase in capital requirements when the country switches to the Basel II regime this month, but larger institutions are frustrated that the modelling approaches contained in the new rules remain out of bounds. ***David Wigan*** *reports*

On July 1, capital ratios across the Turkish banking industry dropped an estimated 1.4 percentage points, as the country switched to the Basel II regulatory framework – a result of stricter risk-weights for certain assets, and the fact that Turkey's banks must initially apply the standardised weights rigidly, with no freedom to adopt Basel II's internal modelling approaches.

But this is something Turkey's bank supervisor – the Bankacılık Düzenleme ve Denetleme Kurulu (BDDK) – expects to change. Within one to four years, it anticipates most of the country's banks will adopt the advanced internal ratings-based (IRB) approach to credit risk, which could produce lower capital requirements for some portfolios. However, bankers say conflicts between Turkish rules and the Basel standards need to be resolved first, and there is no clarity on when a model approval regime will be introduced.

"Current local regulations don't allow us to establish a fully fledged Basel II advanced approach organisation, so we are in a grey area and cannot copy one-to-one what some western European banks do," says Wolfgang Schilk, Istanbul-based executive vice-president for risk management at Yapı Kredi Bank, Turkey's fourth-largest bank, which is part-owned by Italy's UniCredit. "Local regulation is very strict and very clear, so either it will go on like this or we will need to see some harmonisation with European Union (EU) countries."

That is already constraining Turkey's largest banks. Some of them – including Yapı Kredi Bank, Garanti Bank and Akbank – currently use market and credit risk models to work out exposure levels and assign economic capital. But without approval from the BDDK, they will have to use the standardised approach like the rest of the industry. It does at least mean the switch to Basel II should be reasonably smooth.

"At the moment, it is clear that all banks will be expected to use the standardised approach. With most banks already using the advanced IRB for credit risk and value-at-risk models for market risk, so far as the standardised approach is concerned, they are completely ready," says Alper Özün, head of asset-liability and capital management and market risk at HSBC in Istanbul.

Wolfgang Schilk, Yapı Kredi Bank

For now, that means capital requirements will go up, and capital adequacy ratios will fall, says Yapı Kredi's Schilk. "In our case, the capital adequacy ratio will decline by around 1.2 percentage points, from 16.5% in March. Nobody likes to see a decrease in capital adequacy ratios, so it's not something we like or appreciate, but it's not creating a headache."

The same kind of numbers – and sentiment – can be found elsewhere. The BDDK estimates a 140-basis-point reduction in capital ratios for Turkey's banks, bringing the average down to around 15.2% – well above both Basel II's 8% minimum and the 12% level the BDDK requires banks to have if they want to open new branches.

That explains why – despite grousing about the standardised approach – bankers in Istanbul are fairly relaxed about the impact of the new rules. It helps that the industry is also doing well commercially – net earnings for the sector rose to 6.1 billion lira ($3.5 billion) in the first quarter of this year, up 11.9% on the corresponding period in 2011, according to the BDDK.

But it may not last. Loan portfolios have grown dramatically in the past few years and Turkish GDP is expected to slide from around 8% in 2011 to as little as 2% this year. In addition, a weakening lira is making it more expensive for the country's banks to repay unhedged foreign currency debt – an increasing portion of which is dollar-denominated (see box).

Nonetheless, the current health of the industry is in stark contrast to the picture a decade ago, when Turkey's banks were hit by the combined effects of the bursting dotcom bubble, domestic political instability and soaring inflation. In 2001, GDP fell 5.7% in real terms, consumer price inflation soared to 55%, and the lira lost 51% of its value. The crisis eventually led to the collapse of 24 banks, and the creation of the BDDK.

"Put simply, the reason why the Turkish banking sector has been stronger during the recent period was the severe crisis that hit the country in 2001," says Coşkun Küçüközmen, a lecturer at Izmir Ekonomi Üniversitesi, and a former regulator at the BDDK. "The risk management framework put in place after 2001, together with an aversion to complex derivatives, laid the groundwork for the strong financial position banks now find themselves in as they prepare for Basel II."

The slight decline in capital adequacy as a result of the new rules is partly due to the fact that some of the most significant risk-weight reductions offered by Basel II's standardised approach are not expected to be available in Turkey, as they conflict with the central bank's unorthodox approach to monetary policy. After loan growth hit 34% in 2010, fuelling demand for imports and helping create a record external deficit, the Central Bank of Turkey started managing inflation targets and financial stability through capital and loan-loss reserves and currency market interventions, rather than hiking interest rates.

Basel II's standardised risk weight for retail loans is 75% – down from 100% in the Basel I framework Turkey has been using to date. But the central bank forces lenders to apply risk weights of anything from 150–200% instead, with the higher level assigned to loans maturing in more than two years. Also, any bank holding more than 20% of its credit portfolio in consumer loans must provide 400% in additional provisioning for loans above that level.

The industry's response has been to make fewer loans – Yapı Kredi, for example, expects its loan growth to be 17–18% this year, the bank's chief executive said in April – and to consider keeping them shorter dated. "One sensible response in terms of capital requirements may be to shorten maturities for general-purpose loans and credit cards," says Ebru Ogan, Istanbul-based senior vice-president for risk management at Garanti Bank.

Basel II will also be directly responsible for an increase in risk-weighted assets on sovereign debt portfolios, which have a zero risk weighting under Basel I but are weighted according to external credit ratings under Basel II. The rules allow national regulators to apply a zero weight for banks holding domestic sovereign bonds denominated in the local currency, but the waiver does not apply to foreign currency denominated bonds – and Turkey's current BB rating from Standard & Poor's would imply a risk weighting of 100%.

"The increase in counterparty credit risk for sovereign debt holdings could be quite expensive for banks with a large amount of Turkish government eurobonds in their portfolios," says HSBC's Özün.

But the new regime also offers some benefits. Loans to small and medium-sized enterprises (SMEs) carry a 75% risk weighting under Basel II, compared with 100% under Turkey's current rules, where SMEs are defined as companies of less than 50 employees, with turnovers of less than 5 million lira. Loans to larger SMEs will continue to be subject to a 100% risk weighting.

"There has been no announcement from the BDDK regarding retail loans, but we believe we will get the benefit of the change in weightings on the SME loans," says Özün. The BDDK did not respond to requests for comment.

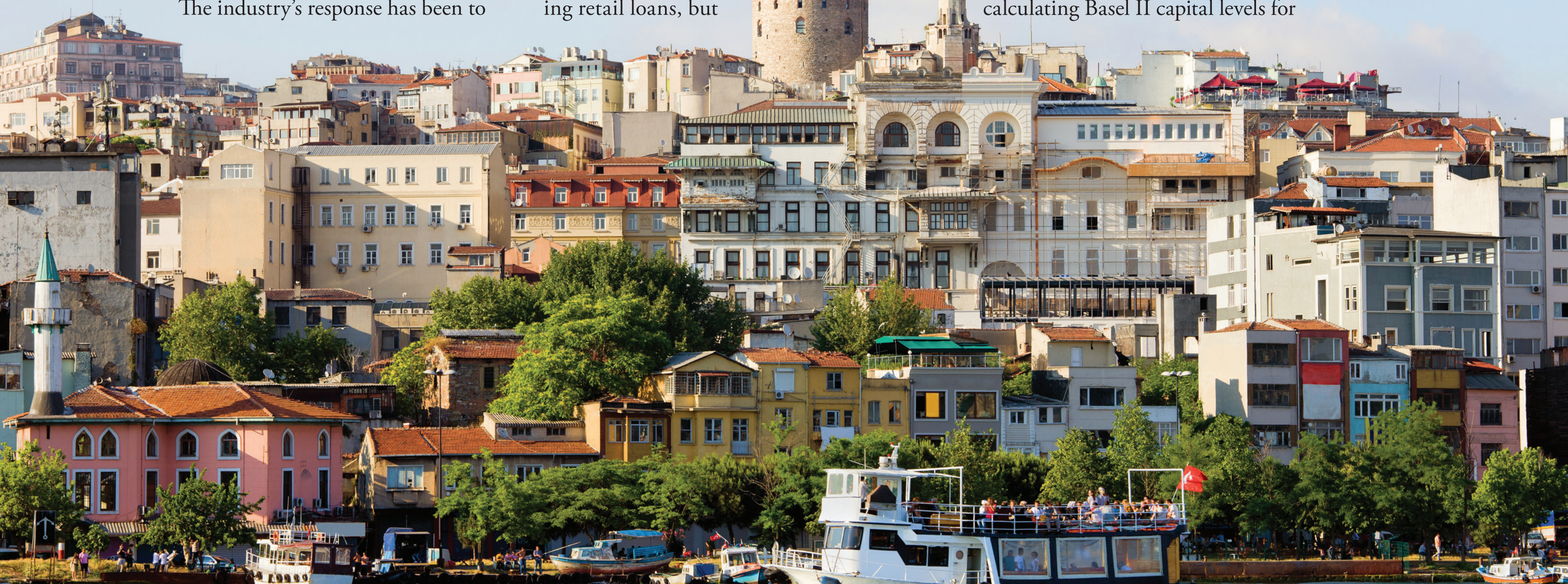
The SME sector is a mainstay of the Turkish economy. There are more than 2.4 million SMEs in the country, which comprise 99.9% of all corporates and account for 55% of the economy, according to data from the Turkish Statistical Institute. Loans to the sector represent 23–24% of the Turkish credit market, according to an estimate by Yapı Kredi Bank.

Despite the predicted fall in average capital adequacy across the Turkish banking sector resulting from Basel II, confidence remains high in Istanbul that there will be no immediate additional requirements for capital.

"In comparison with other countries, our capital adequacy will remain very strong after the implementation of Basel II," says Yapı Kredi's Schilk. "Legally we won't need to raise capital, so any decision is likely to be strategic, and we have not made one yet."

In time, larger Turkish banks hope to be allowed to calculate their own risk weights. Alongside the standardised regime, Basel II offers banks two ways to model capital requirements for credit risk, subject to regulatory approval. The advanced IRB is the most challenging, requiring banks to model three main inputs – probability of default (PD), exposure at default and loss given default – while the foundation IRB requires banks to calculate PDs and use prescribed numbers for the other two inputs.

Around half of Turkish banks are more or less able to meet these requirements, according to the BDDK. Since last July, the country's banks have been operating under the outgoing regime while also calculating Basel II capital levels for



monitoring purposes – a so-called parallel run that has enabled the BDDK to carry out a series of quantitative impact studies, of which the March study is the most recent. In the accompanying report, the regulator gave its view on the industry's readiness to move away from the standardised approach – at that point, 55% could adopt the foundation IRB with a compliance level of 50–100%, while 46% could adopt the advanced IRB at a compliance level of 50–75%, it concluded.

A 1996 amendment to the Basel framework also allows banks to model capital requirements for market risk, and the BDDK says almost 90% of banks would be able to do so for general interest rate risk, although only 44% are in a position to model specific risk for interest rate and equity positions.

One reason the capital modelling door remains closed is a number of conflicts between Turkish legislation and Basel II requirements, in particular in respect of qualitative standards. As an example, the chief compliance officer at one large Turkish bank says local rules require banks to have reporting lines for the risk function that are inconsistent with Basel standards. Other differences have more to do with local loan practices. For example, while Turkish banks define a default as any loan for which the payment is more than 90 days past due – consistent with Basel II – there are differences in what counts as a missed payment, bankers say.

For now, Turkey's banks will continue to use their internal models to assess risk, inform loan pricing and allocate capital internally – but they are hoping for a road map to regulatory capital modelling to be laid out soon. "Internally, we work with these numbers to be ready for the IRB approach, but there is no detailed understanding of what the local regulator's expectation will be," says Yapı Kredi's Schilk.

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Further down the road, the Turkish regulator has said it plans to implement Basel 2.5 – the revisions made to the market risk regime that were implemented in the EU from the start of this year – and also the broader prudential overhaul known as Basel III, which augment the capital standards with new rules on liquidity and leverage. Preparations are already being made, according to a Bank for International Settlements report in April, although timelines appear to be slipping – the report claimed the BDDK would publish its version of Basel 2.5 early this year, with a Basel III draft due by mid-2012. Of course, until banks are allowed to model internal capital, the introduction of Basel 2.5 will have little impact on capital requirements for Turkish banks.

"Since internal models are not used in capital requirement calculations in Turkey, changes regarding the trading portfolio will not make a difference to capital adequacy calculations," says Garanti Bank's Ogan. "With respect to Basel III, no road map has been announced, although we have had three quantitative impact studies."

If new capital is required under Basel III, Turkish banks' existing resources will stand them in reasonable stead. The new regime clamps down on the quality of bank capital, putting the emphasis squarely on common equity to absorb losses and excluding subordinated and hybrid instruments from the ratio. As of June 2010, the BDDK states that 91.2% of Turkish bank capital counted as Tier I. With the vast majority of Turkish banks being at least partly owned by foreign interests, group relationships could also help meet additional capital requirements, BDDK vice-chairman İhsan Uğur Delikanlı, said in a recent presentation.

"At the moment we are not urgently concerned about Basel III, although we are doing some work around the liquidity calculations," says HSBC's Özün. "It's on the agenda, but for the moment we are confident because our capital base is strong." ■

Turkish delinquencies

Whether or not Turkish banks need to raise capital in the coming months, there is a question mark over the medium term, and analysts at Morgan Stanley are among those that expect some banks will need to boost their ratios. That is partly due to an increase in risk-weighted assets (RWAs) under Basel II, and partly because loan portfolios – and default risk – will continue to grow over the next couple of years.

"Banks have been net consumers of capital since the beginning of the credit boom in 2005, and we believe Isbank's and Yapı Kredi's capital bases will need to be strengthened to counter the negative effect of the Basel II regime introduction and support stronger RWA growth in 2013–2015," said London-based Morgan Stanley analyst Magdalena Stoklosa, in an April research note.

Banks can effectively mitigate capital deficits by optimising RWAs, selling financial and non-financial participations, retaining earnings and issuing subordinated debt, Stoklosa said. However, debt issuance is becoming a more expensive option: yields on Turkey's benchmark debt soared 390 basis points last year, the biggest jump since 2006, according to Bloomberg.

The Turkish currency also remains under pressure. Despite gaining around 4% against the US dollar this year, the lira weakened significantly in 2011, falling 18% as the central bank cut interest rates to a record low of 5.75% and the current account deficit hit 10.3% of GDP, the highest rate among 60 major economies tracked by the International Monetary Fund. Inflation in April was 11%, way above the year-end target of 5%.

"The banking system is a source of risk in Turkey, and may not be able to absorb a cyclical slowdown or further currency devaluation," says Thierry Apoteker, chief executive of country risk consultancy TAC Financial. "The evolution since 2009 is worrying, with credit leverage rising 50% and the economy expected to slow sharply this year."

The total amount of domestic credit outstanding in Turkey was $500 billion at the end of 2011, compared with $310 billion at the end of 2009, Apoteker says, while growth is likely to slow to 3.5–4% this year, compared with 8% last year.

"Another issue is that Turkish bank funding is increasingly geared towards the dollar, so a weaker currency is going to increase the cost of servicing that debt." Turkish banks had $75 billion of dollar-denominated debt at the end of last year, compared with $40 billion in June 2009, Apoteker says.

"In the end, we are not likely to see any serious problems when Basel II is adopted in July, but it may be more difficult by the end of next year as non-performing loans start to pick up," he adds.