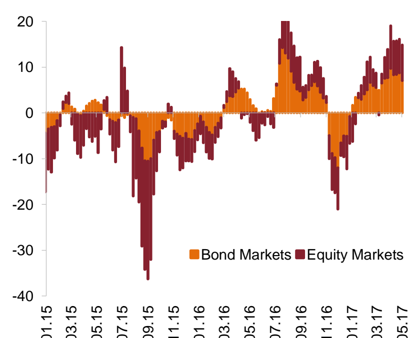
Overview

Since the November 2016 Financial Stability Report, global economic activity has gained momentum and an increasingly stable global financial environment has been observed. Domestically, downside risks related to economic activity have significantly decreased owing to the incentives and supportive measures taken. In the final quarter of 2016, the economic activity compensated for the losses compared to the previous period, and the recovery trend is expected to gain further pace in 2017 with accommodative macroprudential policies, fiscal policy and credit incentives to be implemented. These incentives contribute to financial stability by supporting the well-functioning of the credit channel. On the other hand, the CBRT has significantly tightened monetary policy starting from January to contain the upside risks on inflation. The firm stance of monetary policy resulted with a clear decline of currency volatility in the succeeding period of the policy response.

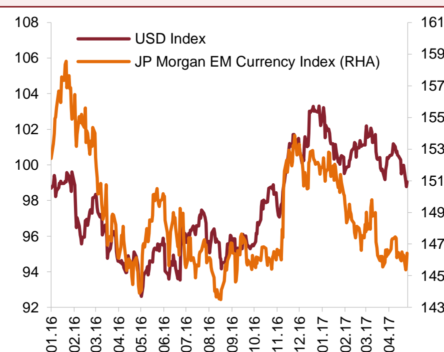
The uncertainty in the US financial markets, which were heightened in the aftermath of the presidential elections of the US, abated in the first quarter of the year. As a result of investors' expectations for expansionary fiscal policy, increases in infrastructure investments and regulatory rollbacks in the financial system, equity prices increased substantially in the US. Currently, amid diminishing uncertainty about the Fed's policies, expectations continue that the tightening of the monetary policy will diffuse over an extended period. Global market players expect that the European Central Bank and the Bank of Japan will maintain low interest rates. The risk premiums have fallen and the volatility in the financial markets has decreased as a result of stronger global economic growth prospects and the measured decline in uncertainty about monetary policies. These factors also led to a surge in global risk appetite. The optimism for the global markets and stronger growth prospects in emerging market economies have had a positive impact on the risk perceptions pertaining to these markets. This positive impact increased portfolio flows to emerging markets in recent months, which in turn started compensating for the losses in the value of domestic currencies and other asset prices in the last quarter of 2016 (Charts 1 and 2).

Chart 1
Weekly Capital Flows to Emerging Markets
(Billion USD, 4-Week Cumulative)



Source: EPFR (Latest Data: 05.17)

Chart 2
Exchange Rate Indices



Note: JP Morgan EM Currency Index is inverted.
Source: Bloomberg (Latest Data: 05.17)

The banking sector balance sheets have continued to expand thanks to the recent recovery in economic activity, incentives for access to finance and prospects of moderate growth. The share of loans remained high in bank balance sheets. Credit growth was supported by the macroprudential regulations introduced for consumer loans, the recent measures towards supporting the financing of the corporate sector and the arrangements made in the cost, collateral and maturity conditions of loans. Corporate loans have displayed a significant rise particularly after the second half of March 2017 as corporate loans backed by the loan guarantees provided by the Credit Guarantee Fund (KGF) accelerated (Chart 3). Thus, the recovery in the total credit volume was mainly driven by the TL corporate loans backed by the KGF. Housing loans and consumer loans have also contributed to the recovery in loans. It is expected that these developments will continue to make a positive contribution to the economic activity in the upcoming period. The fact that credit growth is mainly driven by the rise in corporate loans, mitigates the negative impact of the recovery in domestic demand on the current account deficit. Macroprudential policies, the tightening in the monetary policy stance and other measures and incentives introduced have been the factors that have affected loan prices (Chart 4).

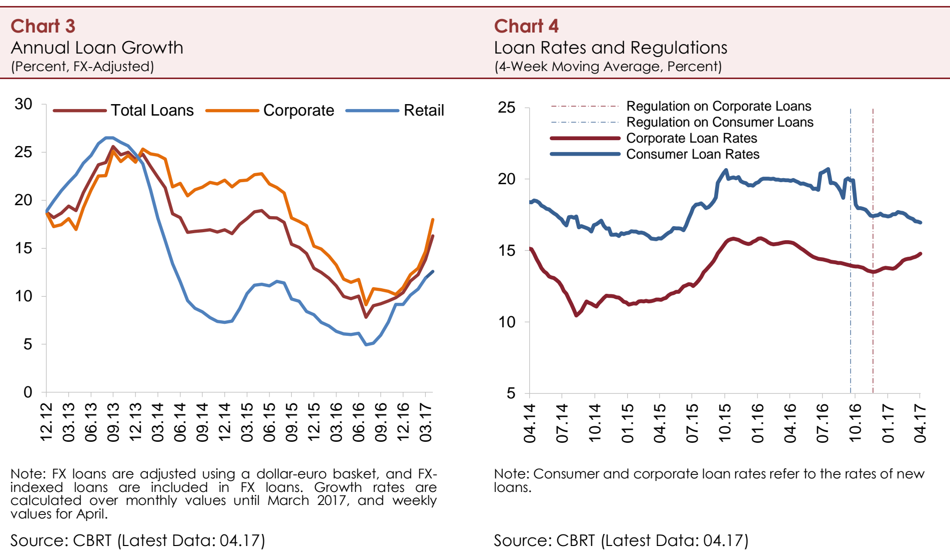


Chart 3
Annual Loan Growth
(Percent, FX-Adjusted)

Note: FX loans are adjusted using a dollar-euro basket, and FX-indexed loans are included in FX loans. Growth rates are calculated over monthly values until March 2017, and weekly values for April.

Source: CBRT (Latest Data: 04.17)

Chart 4
Loan Rates and Regulations
(4-Week Moving Average, Percent)

Note: Consumer and corporate loan rates refer to the rates of new loans.

Source: CBRT (Latest Data: 04.17)

As of the second half of 2016, owing to the fluctuations in foreign exchange rates stemming from local and global developments and increase in the costs of financing from abroad, corporate sectors' foreign debts decreased with a tendency to switch from foreign currency (FX) loans to TL. The changes in the composition of loans coupled with the improvement in the net foreign exchange position of the corporate sector resulting from the measures taken by relevant institutions and the increase in the share of long-term foreign liabilities are considered as positive developments with respect to financial stability. The data monitoring system established at the CBRT is expected to help obtain healthy data on firms' foreign exchange risk and bring about an improved data monitoring framework. In line with the objective of providing a structural underpinning to financial stability and price stability, it is important to reinforce cooperation and coordination among all participants in the

financial system to enhance the systemic risk measurement capacity, to ensure prudent borrowing and to contribute to risk management practices in the upcoming period.

The banking sector maintains its strong liquidity position and remains resilient to a possible liquidity risk. In light of the funding composition of the sector, a significant portion of TL-denominated resources is composed of core liabilities, which in turn contributes to the liquidity position. The share of non-core liabilities in total liabilities has remained stable in recent years (Chart 5). Despite a moderate decline in external borrowing due to domestic demand-driven factors in the recent period, maturities of non-core funding items have continued to increase as a result of the measures in practice, and hence strengthened the resilience of the banking sector against possible global liquidity shocks. As a reflection of the stable course of non-core liabilities, the loan to deposit ratio has remained flat in recent years (Chart 6). The core liabilities and improvement in banks' profitability, henceforth their internal capital generation have been key sources of credit growth.

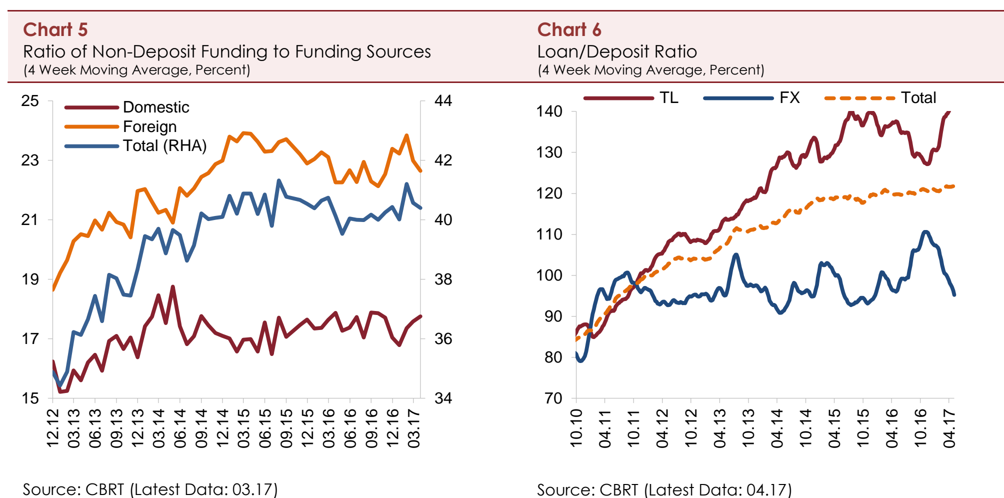
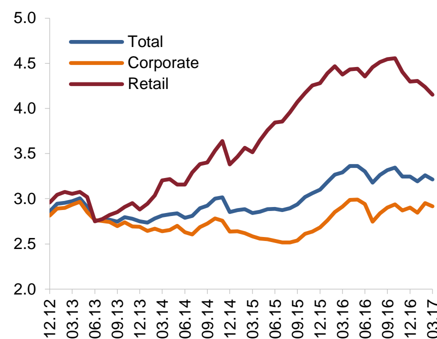


Chart 5
Ratio of Non-Deposit Funding to Funding Sources
(4 Week Moving Average, Percent)
Source: CBRT (Latest Data: 03.17)

Chart 6
Loan/Deposit Ratio
(4 Week Moving Average, Percent)
Source: CBRT (Latest Data: 04.17)

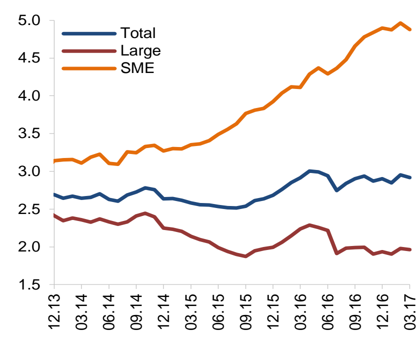
The banking sector retains its healthy asset quality. The total nonperforming loan (NPL) ratio, one of the key indicators, has reached a plateau, whereas the credit restructuring has occurred mostly in performing loans in a way to include credit characteristics such as maturity, collateral and pricing, and the restructuring in NPLs has been modest. Recent data indicate that the growth rate of loans under close monitoring has begun to decline after a hike in the third quarter of 2016. Credit risks for these loans are anticipated to remain at a reasonable level in the upcoming period due to the expectations of a recovery in the economic activity as well as the incentives given to SMEs and the collaterals provided through the KGF (Chart 7 and 8). The current level of the banking sector capital and the recent recovery in profitability support banks' capital structure and their lending capacity.

Chart 7
NPL Ratios
(Percent)



Source: CBRT (Latest Data: 03.17)

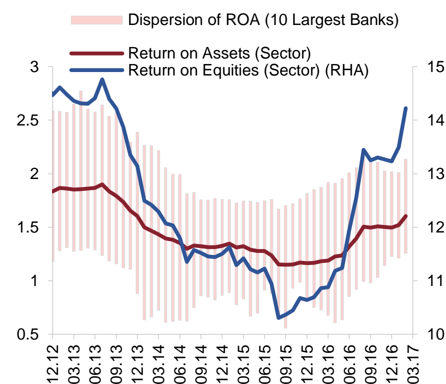
Chart 8
Corporate NPL Ratios
(Percent)



Source: CBRT (Latest Data: 03.17)

The upward trend in banking sector profitability observed in 2016 has continued through 2017. The recovery in lending appetite, the improvement in net interest income and the persistent measures to minimize non-interest expenses have all contributed to the profitability of the sector (Charts 9 and 10). Profitability is expected to continue in the upcoming period as a result of the accelerated loan volume, increasing interest and commission income and the positive contribution of net interest margins.

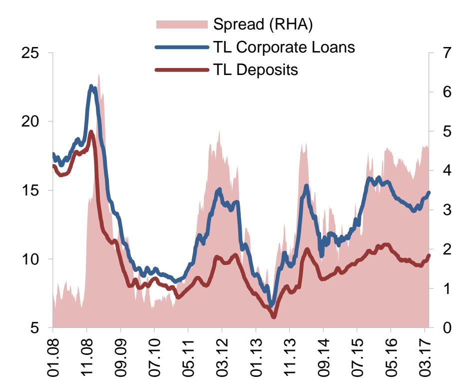
Chart 9
Return on Assets (ROA) and Return on Equities(ROE)
(Percent)



Note: Profitability ratios are estimated via dividing one year accumulated profit by associated denominator

Source: CBRT (Latest Data: 03.17)

Chart 10
Spread between Loan and Deposit Rates
(Percent)



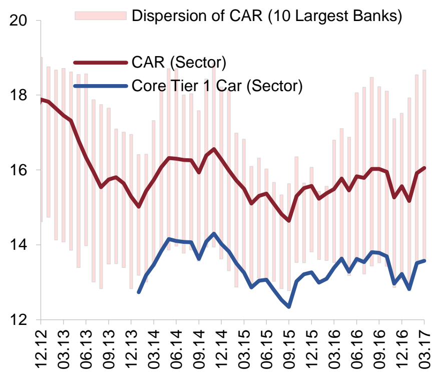
Note: Overdraft accounts, credit card accounts and zero-interest credits since July 2015 are excluded.

Source: CBRT (Latest Data: 04.17)

The capital structure of the banking sector remains strong. As of March 2017, the sectors' capital adequacy ratio (CAR) was well above the regulatory (8 percent) and target ratios (12 percent), and the sector continued to have adequate buffers to cover possible negative shocks. Credit rating agencies' outlook related to the banking sector had a limited impact on external funding costs. On the other hand, the leverage effect driven by the recovery in credit volume and the increase in risk-weighted assets triggered by the exchange rate effects on foreign currency assets have slightly reduced the capital adequacy ratio. However, the capital adequacy ratio has reached the level of the third quarter of last year due to the stability in exchange rates, the upward trend in profitability and the changing risk weights (Chart 11). In this report period, the banking sector has been able to sustain loan growth rates through capital generation as well as through foreign financing. The increase in profitability has been the main factor boosting the regulatory

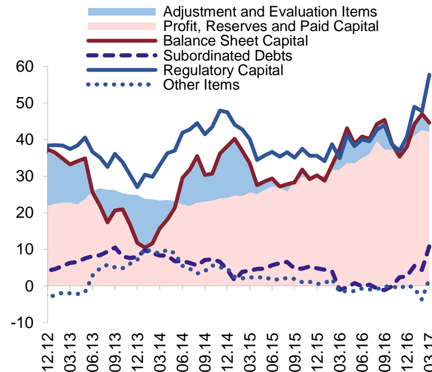
capital within the last one year period. On the other hand, the increase in yields on government domestic debt securities (GDDS) has limited the previous positive effect arising from the revaluation of securities (Chart 12).

Chart 11
CAR and Core Tier 1 CAR
(Percent)



Source: CBRT (Latest Data: 03.17)

Chart 12
Changes in Items Affecting Capital
(12-Month Accumulated, Billions TL)



Source: CBRT (Latest Data: 03.17)

Global geopolitical developments and uncertainties about economic policies are perceived as the main risk factors undermining the global financial stability in the upcoming period. Other potential risk factors include the limited size and impact of the expansionary fiscal policy projected to be implemented in the US, the emphasis on possible protective foreign trade policies, policy normalization of the Fed, the possibility of a decline in the risk appetite due to the political uncertainties in the European Union and the concerns about the Chinese economy. It is assessed that the Turkish banking sector is resilient to such risks thanks to its strong capital structure, asset quality and liquidity buffers.