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DenizBank Political & Economic Update

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DenizBank

DEXIA

DenizBank Economic Research – (90) 212 272 99 65 or ekonomikarastirmalar@denizbank.com

The DTP ruling and further outcomes…

Turkey has a long history of outlawing political parties that are deemed a threat to national security, including Islamists and Kurdish groups. Lately, the AKP was under the risk of closure on allegations of engaging in anti-secular behavior. At the end, by a narrow margin, the Turkey's Constitutional Court ("CC") did not ban the AKP. However, the CC has banned the Democratic Society Party ("DTP"), the only Kurdish party at the Parliament on December 12th. It was closed due to its close links with the banned PKK, which is currently the primary separatist terror organization in Turkey. The decision was somehow expected, however with discomfort since it is likely to further underline tensions over the Kurdish issue, potentially damage relations with the EU, and yet threaten by-election. As feared, the EU issued a statement of concern without a delay.

The CC banned 38 members of the party from politics for five years, which includes two of party's 21 members of parliament. There are 19 remaining former DTP deputies at the Parliament. The former DTP representatives at the Parliament had two choices. The remaining 19 deputies at the Parliament had the choice of resigning hoping to force by-election. However, their resignations would have to be approved by other members of parliament and simple majority decision (of the participants to the session) with (very unlikely). In this case, the BDP could participate at the by-elections which could lock Turkey for several months. However, the former DTP deputies did not choose to resign.

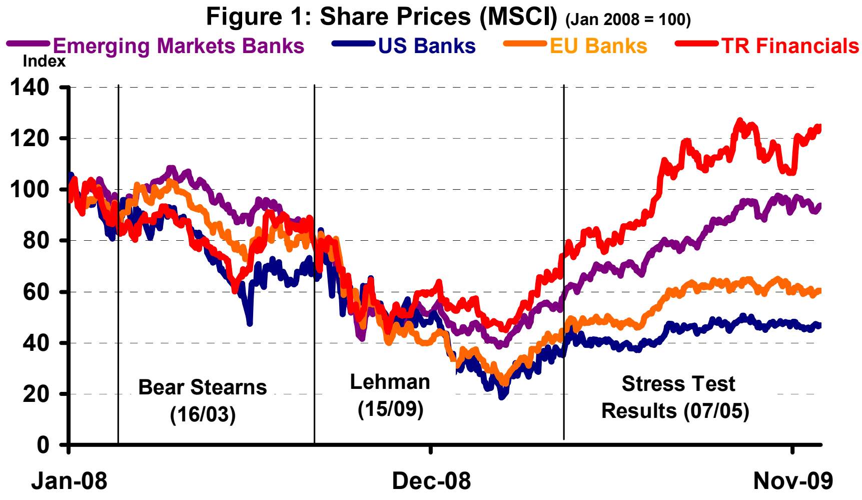
A new Kurdish party, Peace and Democracy Party (BDP), was founded about a year ago, thanks to the DTP closure case; so that the DTP deputies and members could gather under it in the case the DTP was banned. The former deputies had the second option of joining the BDP. The CC decided to implement a political ban to two deputies at the Parliament, so the DTP lost 20 deputies required to form a parliamentary group. Yet, they could add one independent deputy to their group in order to form a new group at the Parliament. Hence, one of the independent deputies in the Parliament, namely Ufuk Uras, was willing to join the remaining former DTP deputies.

Looking forward, advancement of the democratization efforts will not be smooth, especially with the approaching 2011 elections. The current parliament's term only ends in 2011. Just a few months ago opinion polls showed majority supporting Mr. Erdogan's reform efforts, but recently this support is declining rapidly according to the polls. This obviously creates a huge difficulty for Mr.Erdogan, and the CC's decision regarding the closure of the DTP further amplifies this issue.

In addition to the 38 members of banned DTP, 98 heads of the municipalities representing the banned DTP joined the BDP. Recently, some of the head of the municipalities from the banned DTP were taken into custody. These could strengthen Kurdish separatist movement by undermining confidence in the democratic process and the government's Kurdish reform (through ''the democratic initiative''), backed by the United States as a way to help bringing stability to neighboring Iraq. These decisions could boost ethnic tensions and ruin the AKP's support among Kurds and nationalists ahead of a general election set for 2011. Finally, they will play into the hands of Turkey's opponents in Europe who are looking for an excuse to ruin Turkey's EU bid.

The immediate effect of the ban of the DTP on the markets was limited, almost none. The CC had banned the pro-Kurdish parties several times and therefore market participants were probably prepared to see a similar decision regarding the DTP. Additionally, the DTP's closure did not paralyze the Parliament, nor affected the government adversely. The discussions of the remaining DTP deputies and members have no immediate outcomes which could ruin the political outlook.

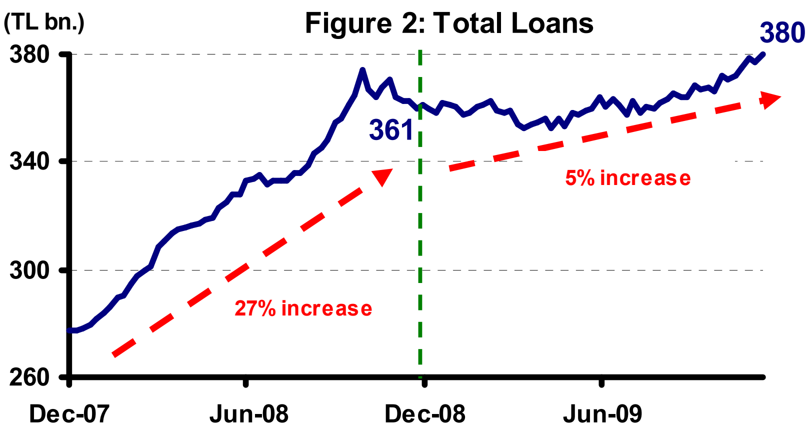
Turkish Banks' spectacular performance …

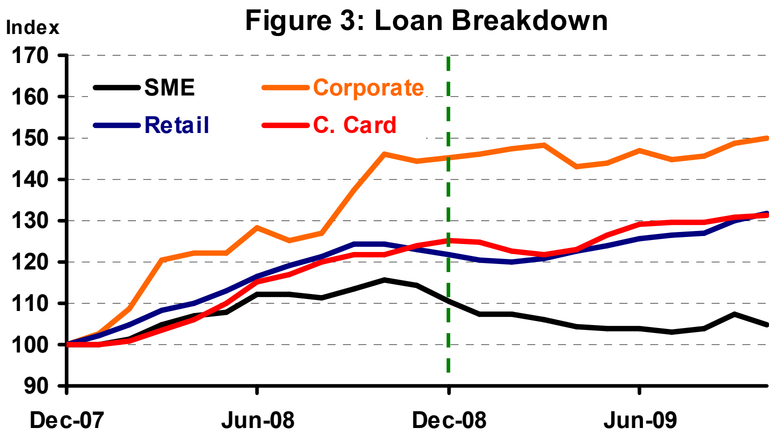


In this month's report, we will focus on Turkish Banking System ("TBS") in several respects including assets, liabilities, profitability and future expectations. It is paradoxical that at the end of 2008 most of the analysts were expecting 2009 to be one of the toughest years ever faced. The end of 2009, on the other hand, depicts totally opposite picture. As it could be seen in Figure 1, following the global crisis, Turkish banks has outperformed their emerging peers by more than 20 pps. This performance can be mainly attributed to exceptional profitability and more importantly to the fact that the TBS is well positioned for growth in the next years.

Lending stagnated, especially for small companies…

Loans, which have risen by a CAGR 41% since 2002, are 47% of total assets by 2008. As an immediate response to the uncertainty of the global crisis, the Turkish Banks became more selective in their lending resulting in stagnating loans. As seen in the graph, loans went down and stay around those levels till December 2009, albeit showing some signs of revival during the last couple of weeks. Year to date performance of 5% growth; taking 5.5% CPI into account, total loans, in fact, diminished in real terms (Figure 2). When analyzed by loan sub-groups, most of the deleveraging was on the SME segment (Figure 3). As per BRSA classification, SME loans are divided into three subgroups: micro, small and middle. In contrast to the micro and the small, the growth in the middle segment, as it is the case for corporate and commercial segment, is still robust. In other words, the companies which have an asset/turnover size above TL5 mn ($3.3 mn) did not suffer much from the credit crunch.

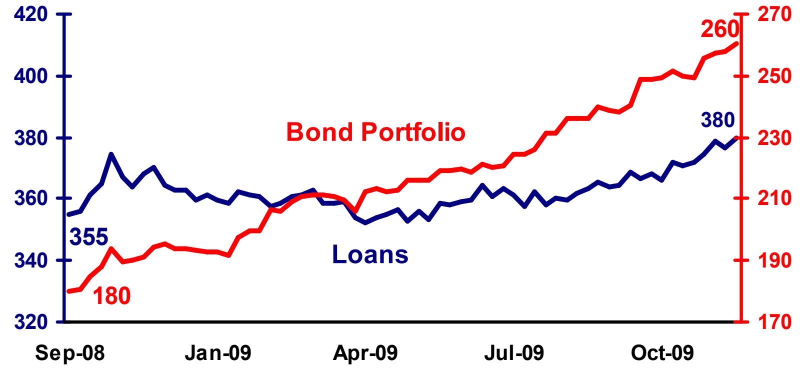




Bonds: perfect asset class to park liquidity at difficult times…

The loan demand from the credible companies in the mentioned segments was, however, limited due to the recession, which technically started in the first quarter of 2009. The domestic demand contracted severely, resulting in historical low capacity utilization rates and surging unemployment. In such an atmosphere, the banks have to find a place in order to park their vast amount of liquidity: local government bonds came to the rescue on time (Figure 4). Since the beginning of crisis, September 2008, total bond portfolio of the TBS has jumped by 45%, corresponding to TL80 bn increase. 1050 bps rate cut of Central Bank of Turkey (“CBT”) has certainly eased the shift in the TBS’ balance sheet, since there is chronic duration mismatch between assets and liabilities (compared to one year average asset duration, liabilities, mostly deposits, have one month maturity). As a result, investing in bonds has helped Turkish Banks in three ways: 1- higher asset quality, 2- higher liquidity and 3- higher profits.

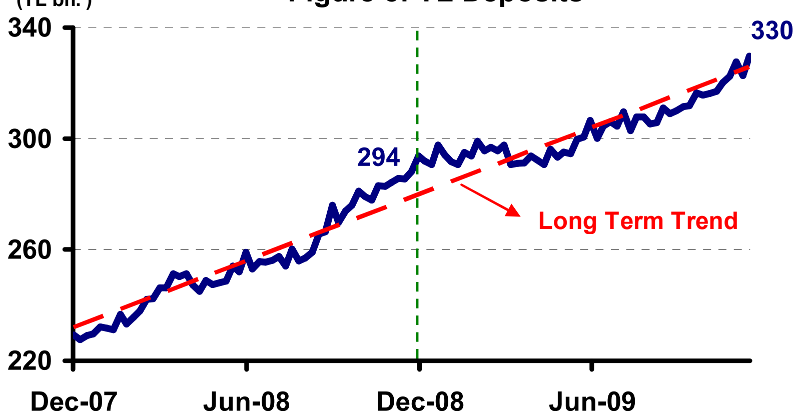
Figure 4: Bonds and Loans



Both domestic and foreign funding were vigorous…

Turkey, along with Australia and Canada, is among the 3 major economies which did not have to take emergency measures to rescue its banking system. At the beginning of the crisis, it was widely discussed that whether TL50K ($33K) deposit guarantee scheme should be increased or not. Even though no extra action was taken in this respect, deposits have been rising gradually since then. Surprisingly, 1050 bps rate cut did not mitigate TL deposit appetite of the local depositors (Figure 5). The second important funding source, wholesale foreign funding, especially syndications, were also satisfactory. 12M trailing LT borrowing rollover ratio has plunged to %44 in August from %273 in August 2008. Thanks to superior performance of the TBS, improving financial conditions and ample global liquidity, foreign funding has improved substantially in the last two months to a %140 on average. As a result, 12M trailing rollover has climbed to 54% in October.

Figure 5: TL Deposits



The “changes” in the banking sector balance sheet since September 2008 are summarized in Table 1. Accordingly, the TBS invested heavily in bonds; remained flat on company loans and retail loans went up especially since the beginning of summer. On the contrary, TL time deposits rose strongly both on retail and corporate segments.

Δ in BS of the TBS btw Sep. 2008 and Dec. 2009 (TL Bn)

Assets	**Loans**	**26**	Liabilities	**Deposit**	**86**
	Bonds	**82**		**Syndication**	**-3**
	TL Loans	**10**		**TL Deposit**	**56**
	Retail Loans	10		Retail Demand	4
				Retail Time	30
	Corporate Loans	0		Corporate Demand	-1
				Corporate Time	17
				Participation Banks TL	7
	FX Loans ($)	**-3**		**FX Deposit ($)**	**-1**
	Retail Loans	0		Retail Demand	0
				Retail Time	-3
	Corporate Loans	-3		Corporate Demand	1
				Corporate Time	2
				Participation Banks FX	0

An increase in volumes and decreasing NPL provisions will help to sustain high profitability

The TBS has experienced its best performance in terms of profitability. Net profit has surged from TL11.9 bn ($7.9 bn) in Jan-Oct 2008 to TL17.4 bn ($11.6 bn) in Jan-Oct 2009, corresponding to 46% YoY increase. Thanks to the surging interest income from bonds and the rising spread between loans and deposits (while deposit interest rate went down in tandem with the CBT policy rate, lending rates were resistant to some extend due to the rise in the non performing loans (“NPL”) concerns), net interest income went up by TL1 bn on average on monthly basis (Figure 6). However, we witnessed TL5.5 bn increase in net profits in the first 10 months of 2009 instead of TL10 bn. The difference was due to the rise in provisions for NPLs, that surged from TL0.3 bn to TL0.8 bn on average on monthly basis. For the next year, there are concerns regarding the sustainability of high profitability. For sure, we will observe tightening in the net interest margin to some extend. On the other hand, surging volumes and moderating NPL provisions will cover substantial amount of the diminishing net interest income, in our view.

Figure 6: Net Interest Income (Monthly)

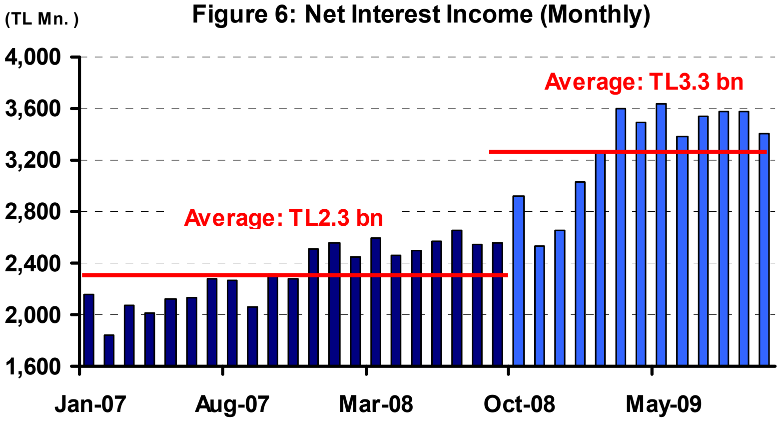
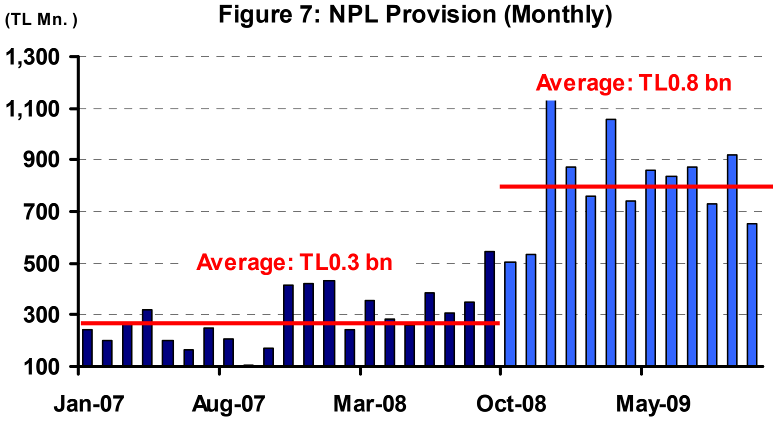
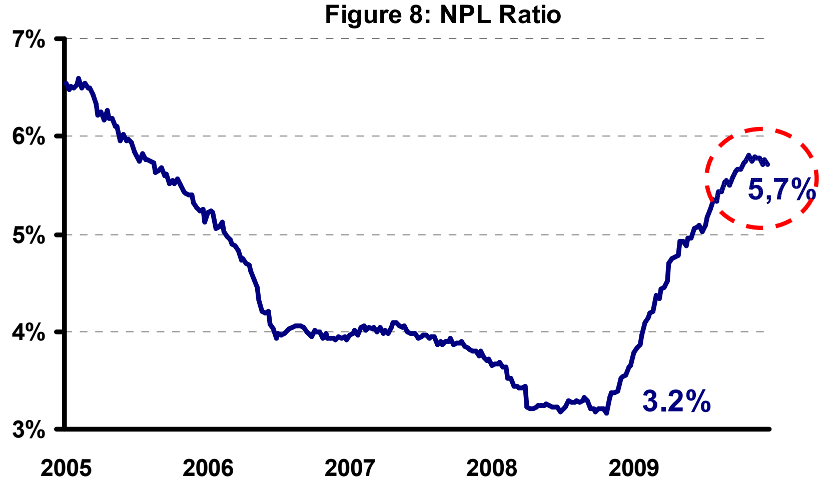


Figure 7: NPL Provision (Monthly)



Looking forward, Top three potential risk for the TBS:

Figure 8: NPL Ratio



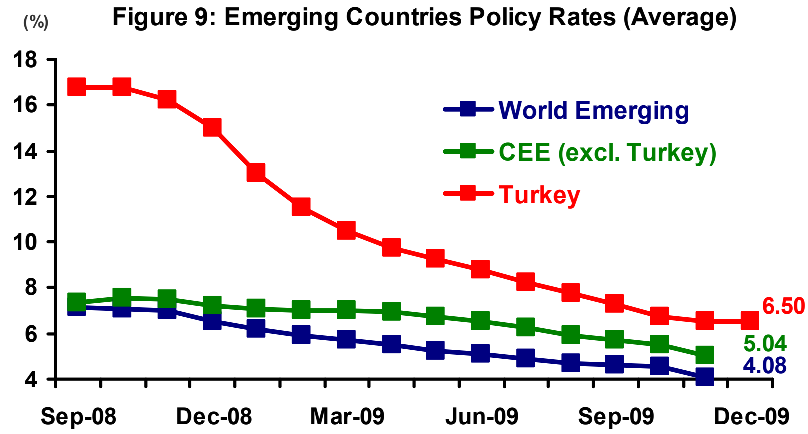
1- Higher NPL Ratio: The NPL ratio has surged to 5.7% today from 3.2% in September 2008. This corresponds to a jump of TL10.4 bn in the NPL balance. It is promising that the NPL ratio is moving sideways for the last couple of weeks and it appears to have peaked. However, it is too early to expect an immediate decline. Rather, it is more rational to expect the NPL ratio will move sideways until loans get back on the pre-crisis trend. So where is the risk? Turkish companies are quite adept at coping with the short term effects of the economic crisis through productivity gains, stock reductions, temporary factory closing, massive layoffs and increase in exports. On the other hand, this crisis is different; it may take longer for the economy to grow at its true potential of 5% to 7%. In other words, in our view, there is probability that growth in the NPL balances could extend into 2010. If combined with stagnant loans, this may carry the current 5.7% NPL ratio upwards.

2- Higher Interest Rates: Although the CBT has conveyed its intention to keep policy rates at the current levels through 2010, the market is currently expecting tightening between 150 and 350 bps in CBT's O/N policy rate, particularly starting in second half of 2010. We presume that the two factors below will have a significant influence on the CBT's policy rate decisions.

i- Inflation: next year inflation target is 6.5% and current inflation outlook is benign in this respect. Domestic demand conditions, global commodity prices and TL appreciation/depreciation will be important drivers of the CPI inflation.

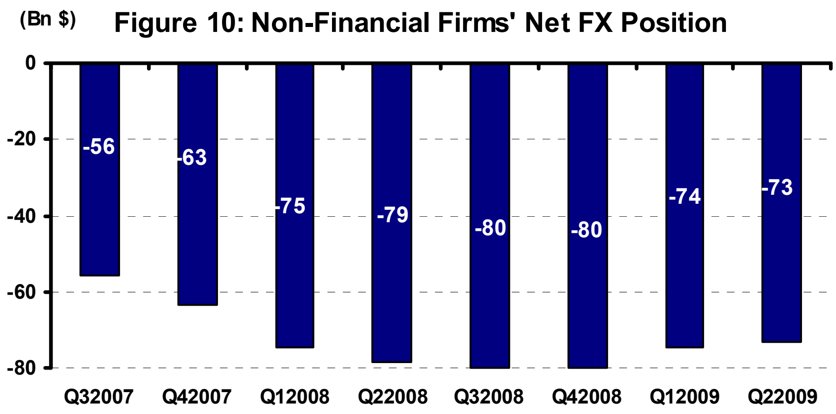
ii- Peer pressure: Easing cycle all over the world has helped the CBT to slash its policy rates by 1050 bps. Although Turkey's emerging market peers keep on their easing cycle, better economic data and increasing inflation could lead some of them to start tightening in the first half of 2010.

Figure 9: Emerging Countries Policy Rates (Average)



Wrapping it up, it is probable that the CBT could start to increase the policy rate above 6.5% in 2010, albeit involuntarily. If the tightening is slow and gradual, it would not be a serious problem for the banks. However, if the CBT is forced to go aggressive tightening –due to rising inflation, peer pressure or any other reason, net interest margins of the TBS would drastically squeeze due to the fact that while interest bearing assets, bonds and loans, have maturities mostly between one to two years and fixed returns; interest bearing liabilities, deposits, have average duration of one month. In such a balance sheet structure, if CBT increases its policy rate, deposit rates go up accordingly, resulting in increase in funding costs for banks.

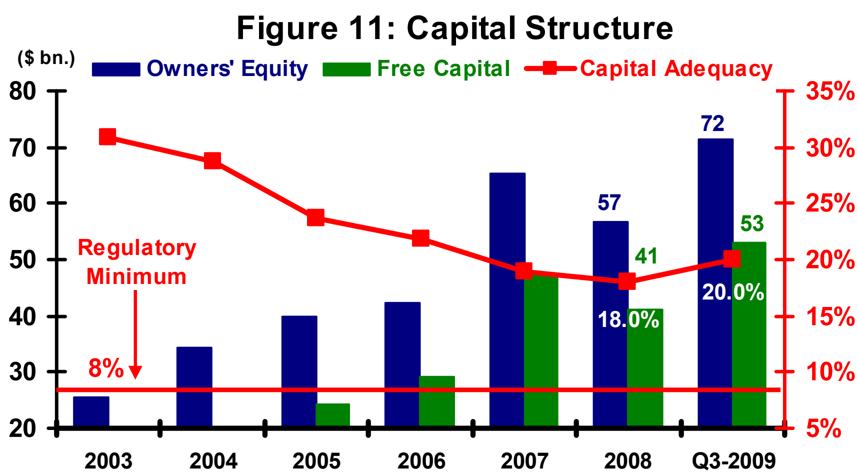
3- Higher $/TL: A third risk for the TBS, albeit inferior to the first two, could be an indirect FX risk. Unlike 2001 banking crisis, the TBS has no open position in its balance sheet at all. However, it has indirect FX risk through the real sector. Despite $7 bn decrease following the crisis, open position of real sector is still high, such that standing at $73 bn. It is good news that this risk did not prove so dangerous in the 2009 where TL devalued more than 30%.



The TBS is well positioned for future growth…

In spite of the risks they face, the TBS is well positioned for future growth for the reasons described below:

1- **Strong Capital:** As of October 2009, the TBS's CAR ratio is 2.5 times higher than minimum international ratio of 8% as set by Basel II. For comparison purposes, average CAR ratio of the major emerging economies is standing at 13% at the end of 2008.



2- **Low Leverage:** Leverage (assets/capital) of the TBS is 8.5 compared to 30s and 40s of the developed world, empowering the TBS to grow without much concern. Accordingly, the loan/GDP ratio is standing at 76%.

3- **Untapped/Undertapped Segments with Huge Growth Prospects:** Since 2001 loans of the TBS is growing at an incredible CAGR ratio of 41%. Starting from next year, Turkish economy is expected grow at its true potential of 5% to 7% again. Combining the growth prospects with the deferred loan demand, we would see significant jump in loan amount.

If the recovery scenario remains intact, the biggest increase is likely to be seen in retail and SME sub segments. Small and medium-sized enterprises (SMEs) play a very important role in the Turkish economy owing to their large share in the total number of enterprises and in total employment. According to the most recent estimates published in 2007, the SME sector composes 98.9% of the total number of enterprises, 45.6% of total employment, 6.5% of capital investment, 37.7% of value added and roughly 10% of exports and bank credit (which is 22% as of October 2009). Therefore, while SMEs dominate the economy in terms of employment, they evidently operate with comparatively little capital equipment, generate relatively low levels of value added, make only a small contribution to Turkish exports and receive only a marginal share of the funds mobilized by the banking sector. In sum, after negative performance of 2009, we would see strong growth for SME loans in the next years.

It is the first time Turkey experiences the combination of 1- low (real and nominal) interest rates, 2- tamed inflation, 3- longer mortgage durations of 10 years and more (couple of years ago maximum duration for mortgage loans was around 3 to 5 years in Turkey), and 4- stable TL. Combining these factors with a huge young population with need to consume should spike retail loan demand in the future. Mortgage loans deserve special attention. When we compare the surging NPL ratio across all of the loan sub groups, the NPL ratio of mortgage loans is standing at a mere 2.2%. It means in addition to demand, there will be a vast amount of supply for mortgage loans. The trend of last two months is strengthening our positive expectations for mortgage loans. Put it differently, if the same growth rate of last two months continues in year 2010, mortgage loans would increase as much as 35%!

Figure 12: Mortgage Penetration (Mortgage Loans/GDP %)