FitchRatings

Fitch Downgrades 24 Turkish Banks; Removes from Rating Watch Negative

Fitch Ratings-London/Frankfurt-20 July 2018: Fitch Ratings has downgraded the Long-Term Foreign Currency Issuer Default Ratings (LTFC IDRs) of 24 Turkish banks and their subsidiaries, in most cases by two notches. The agency has also downgraded the Viability Ratings (VRs) of 12 banks. The banks' Long-Term IDRs have been removed from Rating Watch Negative, but have been assigned Negative Outlooks. A full list of rating actions is available at www.fitchratings.com or at the link above.

The rating actions follow the downgrade of Turkey's sovereign rating on 13 July 2018 (see Fitch Downgrades Turkey to 'BB'; Outlook Negative at www.fitchratings.com), which was driven by increased downside risks to macroeconomic stability and the recent deterioration in economic policy credibility.

The downgrades of banks' VRs reflect the increased risks to performance, asset quality, capitalisation and liquidity and funding profiles, following the recent period of market volatility and given the increased risk of a hard landing for the economy and a material deterioration in investor sentiment. Fitch forecasts GDP growth of 4.5% in 2018, underpinned by solid growth in 4M18, but with the likely contraction of the economy for the rest of the year, and 3.6% in 2019.

The downgrades of foreign-owned banks' FC IDRs to 'BB' from 'BBB-' reflect both the sovereign downgrade and Fitch's view that it is no longer appropriate to rate banks above the sovereign in Turkey. This view reflects our belief that, in case of a marked deterioration in Turkey's external finances, the risk of government intervention in the banking sector in the form of capital controls or restrictions will increasingly be equal to that of a sovereign default.

The downgrade and revisions of most state-owned banks' FC IDRs and SRFs to 'BB-' from 'BB+' reflect both the sovereign downgrade and Fitch's view of the weaker ability of the Turkish authorities to provide support in FC given the greater potential for stress in the country's external finances. The banks' Local Currency IDRs are downgraded by one notch and remain in line with the sovereign Local Currency IDR.

When Fitch placed Turkish banks on RWN on 1 June 2018, we had said that any downgrades would likely be limited to one notch. Today, we have downgraded most banks by two notches, due to the downgrade of the sovereign rating. The two-notch downgrades of the banks include one notch for the sovereign downgrade and one notch to reflect our revised view of the appropriate levels of bank ratings relative to the sovereign.

Fitch plans to resolve the RWN on the VRs of small and mid-sized Turkish banks, and on the IDRs driven by these VRs, at a further review in 2H18. These ratings are less closely linked to the sovereign than the ratings of banks covered in this review.

KEY RATING DRIVERS

VRs OF ALL BANKS

The banks' VRs reflect exposure to the high-risk Turkish operating environment. They also reflect, to varying degrees, the banks' solid franchises, and in most cases track records of stable and sound performance, moderate non-performing loans (NPLs), reasonable capitalisation and acceptable liquidity buffers.

However, the banks' risk profiles have deteriorated significantly as a result of local currency depreciation and higher interest rates, which put pressure on asset quality, margins and capitalisation. In addition, the risk of a reduction in access to foreign funding markets has increased, raising refinancing and liquidity pressures. Risks to financial stability remain significant, given potential unpredictability in the policy framework and Turkey's large external financing requirements.

Asset quality risks for banks have increased given the weakening growth outlook, generally high FC lending (equal to about 37% of sector loans) and the potential impact of local currency depreciation on often weakly hedged borrowers' ability to service their debt. Higher interest rates (which could negatively impact lira borrowers' debt service capacity) could also weigh on loan performance. Exposures to the construction and energy sectors and high borrower concentrations are also significant sources of risks at many banks.

Non-performing loan (NPL) ratios have in most cases remained broadly stable in recent quarters, but the emergence of some big-ticket problematic exposures (notably on the books of the largest banks in the sector) and growth in group 2 watch list loans (partly explained by banks' transition to IFRS9 in 1Q18) suggest the potential for future increases in NPLs. The sector's NPL ratio (loans overdue by 90+ days) was a still moderate 3% at end-1H18, with total reserve coverage of 122%. However, group 2 loans averaged 8% at the larger banks in the sector.

Fitch expects sector profitability to moderately weaken in 2H18 and into 2019 due to higher funding costs - which banks may not be able to fully pass on - slower credit growth and higher impairment charges. Performance could deteriorate more significantly in case of a marked weakening of asset quality. The sector's return on average equity (ROAE) was a solid 14.7% in 2017 and 15.9% in 5M18, supported by Credit Guarantee Fund-driven loan growth in 2017 (21%), solid margins and manageable impairment charges.

Capital ratios are under pressure from lira depreciation (which inflates FC risk-weighted assets) and higher interest rates (which result in negative revaluations of government bond portfolios). Potential asset quality deterioration also represents a risk to banks' capital positions, but strong pre-impairment profit provides most banks with a considerable buffer to absorb credit losses.

The sector's average total capital ratio (on a solo basis) stood at 15.9% at end-May 2018. This is down only moderately from 16.9% at end-2017 as solid internal capital generation and the partial hedge offered by FC tier 2 instruments have partially offset the impact of a weaker lira and higher rates. Since 2017 banks have benefited from capital relief from regulatory measures, which have reduced risk weightings on certain exposures.

Turkish banks' refinancing risks have increased as a result of recent market volatility - which has seen the Turkish lira depreciate against the US dollar-euro basket rate by about 27% (year to date) and the authorities have responded by raising the key policy rate by 500bps to 17.75% - and tightening global financing conditions driven mainly by an increase in USD interest rates.

Turkish banks have a proven record of accessing external funding even in adverse market conditions and external debt rollover rates have continued to hold up. The banks typically also have access to sufficient FC liquidity to cover their FC wholesale funding liabilities maturing within a year. Nevertheless, market demand for some instruments has tailed off and the cost of financing has risen. Refinancing risks are less pronounced at most foreign-owned banks, given potential FC liquidity support from shareholders.

The sector loans/deposit ratio was a high 127% at end-5M18, and banks' external debt stood at USD186 billion at end-1Q18, of which USD103 billion matured within 12 months. However, as some of the latter represents more stable funding (for example, from parent banks, subsidiary banks or offshore Turkish corporate entities), Fitch estimates banks' external debt servicing requirement over one year, in case of a complete market shutdown, at about USD55 billion-USD60 billion.

Available FC liquidity of approximately USD90 billion (comprising mainly FC placed with the central bank under the reserve option mechanism (ROM) and short-term currency swaps with foreign counterparties) provides solid coverage of the banks' potential refinancing requirement. However, a scenario in which Turkish borrowers have to pay down foreign debt would result in a reduction in central bank's foreign exchange reserves and add to pressures on the exchange rate, interest rates and economic growth.

IDRS, SENIOR DEBT RATINGS AND NATIONAL RATINGS DRIVEN BY VRS

Akbank TAS (LTFC IDR 'BB-'/Negative)
Turkiye Is Bankasi (LTFC IDR 'BB-'/Negative)

The downgrades of the LTFC IDRs of Akbank and Isbank to 'BB-' from 'BB+' are driven by the downgrades of the banks' VRs. The 'BB' Long-Term Local Currency (LTLC) IDRs, one notch above the LTFC ratings, reflect the banks' lower refinancing risks in Turkish lira than in foreign currencies. The Negative Outlooks on the IDRs reflect the potential for further deterioration in the operating environment, which could place greater pressure on the banks' financial metrics.

The revision of the Support Rating Floors (SRFs) of both banks to 'B' from 'B+' reflects the weaker ability of the sovereign to provide support, as captured by the downgrade of the sovereign ratings. The SRFs are three notches below the sovereign's LTFC IDR, notwithstanding the banks' systemic importance, because of the Turkish authorities' limited ability to provide support in FC in case of need, in light of its only moderate level of FC reserves.

The downgrade of the National ratings of the two banks reflects the downgrades of the banks' LTLC IDRs.

IDRs, SUPPORT RATINGS, SENIOR DEBT RATINGS AND NATIONAL RATINGS OF STATE-OWNED COMMERCIAL BANKS AND DEVELOPMENT BANKS

T.C. Ziraat Bankasi A.S. (Ziraat; LTFC IDR 'BB-'/Negative)
Turkiye Halk Bankasi A.S. (Halk; LTFC IDR 'BB-' /Negative)
Turkiye Vakiflar Bankasi A.S. (Vakifbank; LTFC IDR 'BB-' /Negative)
Vakif Katilim Bankasi A.S. (Vakif Katilim; LTFC IDR BB-/Negative)
Turkiye Sinai Kalkinma Bankasi A.S. (TSKB; LTFC IDR 'BB-'/Negative)
Turkiye Ihracat Kredi Bankasi A.S. (Turk Eximbank; LTFC IDR 'BB-' /Negative)
Turkiye Kalkinma Bankasi A.S. (TKB; LTFC IDR 'BB'/Negative)

The LTLC IDRs of the state-owned commercial banks (Ziraat, Halk, Vakifbank and Vakif Katilim) and development banks (TKB, Turk Eximbank, TSKB) are aligned with those of the Turkish sovereign and, as a result, have been downgraded by one notch. The banks' LTFC IDRs, FC debt ratings and SRFs have mostly been downgraded by two notches to 'BB-', as a result of which they are now one notch below the sovereign's LTFC IDR, reflecting the weaker ability of the sovereign to provide support in FC.

TKB's SRF and LTFC Currency IDR have been revised and downgraded by only one notch, and remain equalised with the sovereign, due to the bank's small size and nearly all of its funding being guaranteed by the Turkish treasury.

The two-notch downward revision of the state-owned commercial and development banks' SRFs considers the sovereign downgrade and increased risks to the authorities' ability to provide support in FC given the greater potential for stress in Turkey's external finances. At end-May 2018, the central bank's foreign exchange reserves were a moderate USD107 billion, while net reserves (adjusted for USD73 billion of banks' placements with the central bank, including under the ROM) were low at USD35 billion.

Fitch continues to view the government's propensity to support the state-owned commercial and development banks as high, in case of need, based on their majority state ownership (except for TSKB), systemic importance and significant state-related funding (state-owned commercial banks) and policy roles (Ziraat, Halk and the development banks). The Negative Outlooks on these banks' Long-Term IDRs reflect those on the sovereign's ratings.

The RWN on Halk's VR reflects Fitch's view of a still material risk of the bank becoming subject to a fine or other punitive measures as a result of the U.S. investigation, which resulted in the conviction of its Deputy General Manager for violation of U.S. sanctions. Such measures could materially weaken solvency, increase refinancing risks or negatively impact other aspects of the bank's standalone credit profile.

The removal of Halk's Long-Term IDRs and SRF from RWN reflects Fitch's view that at the 'BB-' level, the LTFC IDR adequately captures the moderate risk of delays in solvency support in case of quite punitive measures being taken against the bank. In Fitch's view, even in such a case the bank would likely receive sufficient liquidity support and/or regulatory forbearance from the Turkish authorities to be able to continue to service its obligations.

The affirmations of the National ratings of the state-owned commercial and development banks reflect Fitch's view that their creditworthiness in local currency relative to other Turkish issuers remains largely unchanged as a result of the latest rating actions.

IDRs, SUPPORT RATINGS, SENIOR DEBT RATINGS AND NATIONAL RATINGS OF FOREIGN-OWNED BANKS

Turkiye Garanti Bankasi A.S. (Garanti; LTFC IDR 'BB'/Negative)
Yapi ve Kredi Bankasi A.S. (YKB; LTFC IDR 'BB'/Negative)
Turk Ekonomi Bankasi (TEB; LTFC IDR 'BB'/Negative)
QNB Finansbank A.S. (LTFC IDR 'BB' /Negative)
ING Bank A.S. (LTFC IDR 'BB'/Negative)
Kuveyt Turk Katilim Bankasi (Kuveyt Turk; LTFC IDR 'BB'/Negative)
Alternatifbank A.S. (Alternatifbank; LTFC IDR 'BB'/Negative)
Turkiye Finans Katilim Bankasi (TFKB; LTFC IDR 'BB'/Negative)
Burgan Bank A.S. (Burgan Bank Turkey; LTFC IDR 'BB'/Negative)
ICBC Turkey Bank A.S. (LTFC IDR 'BB'/Negative)
BankPozitif Kredi ve Kalkinma Bankasi (LTFC IDR 'BB'/Negative)
Denizbank A.S. (LTFC IDR 'BB'/Negative)

The IDRs, Support Ratings, FC senior debt ratings and National ratings of these banks are driven by potential support from their shareholders. This reflects Fitch's view that the banks constitute strategically important subsidiaries, to varying degrees, for their parents. It also considers ownership stakes, integration, the subsidiaries' roles within their respective groups and, for some, common branding.

The two-notch downgrade (one notch for Denizbank) of the banks' LTFC currency IDRs and FC senior debt ratings, to the level of the sovereign LTFC IDR, reflects Fitch's view that it is no longer appropriate to rate banks above the sovereign in Turkey. This view reflects our belief that, in case of a marked deterioration in Turkey's external finances, the probability of government intervention in the banking sector would not be less likely than that of a sovereign default.

Fitch continues to view the risk of capital controls being imposed in Turkey as remote given Turkey's high dependence on foreign capital (and ensuing strong incentive to retain market access) and the eventually orthodox policy response to recent market pressures. Nevertheless, in case of a marked deterioration in Turkey's external finances, some form of intervention in the banking system that might impede the banks' ability to service their FC obligations cannot be completely ruled out, in Fitch's view, and policy predictability has weakened following the Presidential elections.

The one-notch downgrade of the LTLC IDRs of the foreign-owned banks (with the exception of Denizbank, which was affirmed, removed from RWP and assigned a Negative Outlook), in line with the sovereign's LTLC IDR, reflects Fitch's view of a low likelihood of any form of government intervention that will impede their ability to service obligations in local currency.

SUBORDINATED DEBT RATINGS
The subordinated notes ratings of YKB, Kuveyt Turk, Garanti and Alternatifbank -

which are notched down once from their support-driven IDRs - and the subordinated notes ratings of Isbank, Akbank, and Vakifbank - which are notched down from their VRs - have been downgraded by two notches in line with the downgrades of their respective anchor ratings. TSKB's subordinated debt rating has been downgraded by one notch similar to that of its VR.

The notching in each case includes one notch for loss severity and zero notches for non-performance risk (relative to the anchor ratings).

SUBSIDIARY RATINGS

Akbank AG (LTFC IDR 'BB-'/Negative)
Ak Yatirim (LTFC IDR 'BB-' /Negative)
Ak Finansal Kiralama (LTFC IDR 'BB-' /Negative)
Alternatif Finansal Kiralama AS (LTFC IDR 'BB'/Negative)
Deniz Finansal Kiralama (LTFC IDR 'BB'/Negative)
Joint-Stock Company Denizbank Moscow (LTFC IDR 'BB'/Negative)
Garanti Faktoring (LTFC IDR 'BB'/Negative)
Garanti Finansal Kiralama (LTFC IDR 'BB'/Negative)
Is Faktoring (LTFC IDR 'BB-'/Negative)
Is Finansal Kiralama (LTFC IDR 'BB-'/Negative)
Is Yatirim Menkul Degerler (National Long-Term 'AA(tur)'/Stable)
QNB Finans Finansal Kiralama A.S. (LTFC IDR 'BB'/ Negative)
Yapi Kredi Finansal Kiralama (LTFC IDR 'BB'/ Negative)
Yapi Kredi Faktoring (LTFC IDR 'BB'/ Negative)
Yapi Kredi Yatirim Menkul Degerler (LTFC IDR 'BB'/Negative)
Ziraat Katilim (LTFC IDR 'BB-' /Negative)

The ratings of the subsidiaries of Akbank, Alternatifbank, Denizbank, Garanti, Isbank, QNB Finansbank, YKB and Ziraat are equalised with those of their respective parents, reflecting their strategic importance to, and integration with, their respective groups.

Akbank AG's Deposit Ratings are aligned with the bank's LTFC IDRs. In Fitch's opinion, debt buffers do not afford any obvious incremental probability of default benefit over and above the support benefit factored into the bank's IDRs.

RATING SENSITIVITIES
VRs OF ALL BANKS, AND IDRS, SENIOR DEBT RATINGS AND NATIONAL RATINGS OF AKBANK AND ISBANK
Further downgrades could result from (i) a further marked deterioration in the operating environment, as reflected, in particular, in negative changes in the lira exchange rate, domestic interest rates, economic growth prospects and external

funding market access; (ii) bank-specific deterioration of asset quality; (iii) marked erosion of capital ratios; or (iv) a weakening of the banks' FC liquidity positions (without this being offset by shareholder support).

Downgrades of state-owned banks' VRs will only result in negative action on the banks' IDRs if at the same time Fitch believes the ability or propensity of the Turkish authorities to provide support - as reflected in their SRFs - had also weakened.

Halk's VR could be downgraded if a fine or other punitive measures resulting from the U.S. investigation materially weaken solvency, increase refinancing risks or negatively impact other aspects of the bank's standalone credit profile.

The Outlooks could be revised to Stable if economic conditions stabilise and bank financial metrics do not deteriorate significantly.

IDRs, SUPPORT RATINGS, SUPPORT RATING FLOORS, SENIOR DEBT RATINGS AND NATIONAL RATINGS OF STATE-OWNED COMMERCIAL BANKS AND DEVELOPMENT BANKS

The SRs and SRFs of Ziraat, Halk, Vakifbank, Vakif Katilim, TSKB and Turk Eximbank could be further downgraded and revised lower if Fitch concludes that the stress in Turkey's external finances is sufficient to materially reduce the reliability of support for these banks in FC from the Turkish authorities.

Downward revision of the SRFs of Vakif Katilim and Turk Eximbank will result in downgrades of their LTFC IDRs and FC senior debt ratings. Downward revision of the SRFs of Ziraat, Halk, Vakifbank and TSKB will only result in downgrades of their LTFC IDRs and FC senior debt ratings if their VRs are also downgraded.

The ratings of these banks, and of TKB, could also be downgraded if the Turkish sovereign is further downgraded or if Fitch believes the sovereign's propensity to support the banks has reduced (not Fitch's base case). The introduction of bank resolution legislation in Turkey aimed at limiting sovereign support for failed banks could also negatively impact Fitch's view of support, but Fitch does not expect this in the short term.

IDRs, SUPPORT RATINGS, SENIOR DEBT RATINGS AND NATIONAL RATINGS OF FOREIGN-OWNED BANKS

The LTFC IDRs, FC senior debt ratings and SRs of foreign-owned banks could be downgraded if the Turkish sovereign is downgraded, or if there is a sharp reduction in a parent bank's ability or propensity to support its Turkish subsidiary.

SUBORDINATED DEBT RATINGS

Subordinated debt ratings are primarily sensitive to changes in anchor ratings, namely the VRs of Isbank, Akbank, Vakifbank and TSKB, and the Long-Term IDRs of YKB, Garanti, Kuveyt Turk and Alternatifbank.

The ratings are also sensitive to a change in notching from the anchor ratings due to a revision in Fitch's assessment of the probability of the notes' non-performance risk or of loss severity in case of non-performance.

SUBSIDIARY RATINGS
The ratings of these entities are sensitive to changes in the Long-Term IDRs of their parents.

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Additional information is available on www.fitchratings.com

Applicable Criteria
Bank Rating Criteria (pub. 22 Jun 2018)
(https://www.fitchratings.com/site/re/10034713)
National Scale Ratings Criteria (pub. 18 Jul 2018)
(https://www.fitchratings.com/site/re/10038626)
Non-Bank Financial Institutions Rating Criteria (pub. 22 Jun 2018)
(https://www.fitchratings.com/site/re/10034715)
Sukuk Rating Criteria (pub. 14 Aug 2017)
(https://www.fitchratings.com/site/re/902221)

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