ECONOMIC & BANKING SECTOR OVERVIEW

Republic of Turkey

June, 2020

TRUST . TRANSPARENCY . INDEPENDENCE

Economic Overview – The Republic of Turkey

Amounts in USD'b, unless otherwise stated	2015	2016	2017	2018	2019
Population ('000)	78,741	79,815	80,810	82,004	83,155
Nominal GDP (US$ Bn)	861.9	862.7	852.6	789.0	753.7
GDP per capita (US$)	11,019	10,883	10,537	9,622	9,064
Real GDP - constant prices growth rate (%)	6.10	3.20	7.4	2.8	0.9
Inflation (CPI Year End, %)	8.8	8.5	11.9	20.3	11.8
Unemployment Rate (%)	10.3	10.9	10.9	13.5	
Current Account Balance as % of GDP	-3.7	-3.8	-5.6	-3.5	0.7
Fiscal Balance as % of GDP	-1.0	-1.1	-1.5	-2.4	-2.9
Central Government Debt Stock as % of GDP	27.6	28.3	28.3	28.7	30.2
Gross External debt (US$)	400	410	455	441	437
External debt as % of GDP	46.4	47.4	53.4	56.3	58.0

With a nominal GDP of USD 754bn in 2019, the Republic of Turkey is a diversified economy, and is classified in the upper middle-income category as per the World Bank country classification. GDP per capita has continued its downward trajectory reaching USD 9,064at end-2019 (2018: USD 9,622), owing to sustained population growth and slackened GDP growth in USD translated terms, during the period.

A Turkish economy expanded by 0.9% in 2019 – significantly below potential - with recessionary conditions prevailing in the early part of the year. Recovery in the second half of 2019 was marked by accelerated credit offtake, spurred by lower benchmark rates supporting domestic demand. In the first quarter of 2020, economic activity remained strong and is estimated to have hovered around 5% growth as indicated by Industrial Production figures and strong credit growth, however with the spread of COVID-19, production, trade and tourism has subsequently fallen sharply. IIRA's current year forecast for growthhas been revised down to a 1% contraction, assuming gradual pick up of the economy in the third quarter of 2020. On the other hand, we expect our earlier 4% growth estimate for thisyear, to have been pushed forward to 2021, with further upside potential, as pent up demand of the 2018-2020 period, along with normalization of tourism, factor in the aggregate demand composition.

Following the COVID-19 spread, the government and the CBT along with the Banking Regulation and Supervision Agency ("BRSA") released some early indications. Fiscal measures taken, are equivalent to around 2% of GDP and include raising minimum pension salaries and cash assistance to families in need, reduced/postponed taxes for affected industries, and doubling the credit guarantee fund among others.

As opposed to Lira's sharp fall against USD during 2018, it demonstrated relative stability in 2019, before plummeting sharply in the wake of COVID-19 amid portfolio investment flight to safety and an appreciating US dollar. As a result, USD TRY parity moved to 6.97 as of April 21stmarking around 15% depreciation for the local currency year to date. In the same period, portfolio outflows from Turkish equities and bonds amounted to a sizable USD7.5bn.

In view of receding inflation, CBT had begun to cut its policy rate successively since July 2019, bringing the rate down to 10.75% by February 2019, from a high of 24% since September 2018, and then further to 8.25% in May 2020 to support economic activity in the aftermath of COVID-19. Consumer Price Inflation ('CPI') stands at 10.9% as of April 2020, and is projected to decline further in the 8%-9% rangeby the end of the yearas aggregate demand conditions are expected to remain disinflationary and the sharp reduction in commodity prices is likely to weigh negatively on inflation, overcoming the impact of a depreciating currency.

Following the rebalancing in the economy after the currency crisis in August 2018, annual current account deficit[1] came down to USD 20.7bn in 2018 from USD 40.6bn during 2017. The trend has carried through in the following year as the

[1] The current account statistics have been revised by the CBT on March 2020 and the prior data was revised downwards

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trade deficit narrowed mainly on account of contracting imports and despite tourism revenues maintaining strong up trend. As a result, a USD8.7bn surplus was posted in the current account for the year 2019. During the ongoing year, current account balance should generate manageable deficit as the positive impact from the lower commodity prices is to be balanced by much lower tourism receipts where as the sharply weaker demand from EU is expected to dent exports. In the first three months, Turkey registered USD7.6bn deficit against USD0.4bn in the same period of the previous year as exports contracted 4% while the imports increased 10.4%. In the remainder of the year, as the energy import bill narrows down, the deficit will likely begin to moderate.USD10 drop in per barrel oil prices lowers the deficit by around USD5.3bn, and impact of recent tariffs on imports is expected to weigh negatively on imports.

With drawdown of funds from emerging countries to developed countries amidst the 'flight to quality' following the spread of pandemic, Turkey's financial account posted deficit as well with only USD2bn of foreign direct investment and USD6.3bn of portfolio outflows which led to erosion of CBT's FCY reserves to the tune of USD16.5bn in the first three months of 2020. According to the weekly CBT data, as of May 15th, gross FCY reserves of CBT inclusive of gold reserves amounted to USD84.4bn, down from USD106.3bn in December 2019. Recently, Central Bank of Qatar increased the limit on the swap agreement with CBT to USD15bn from USD5bn. Meanwhile concerns over the reserve adequacy for the short to medium term, persist.

As growth in the economy receded significantly during 2019, tax revenues paced well below inflation rate, while non-tax revenues were supported by some one-off revenue streams, mainly as revenues from the Central Bank. To balance the slowdown, a fiscal stimulus was given under the revised National Economic Plan and contributing to already elevated expenses. Increasing indebtedness and high associated costs had the most meaningful impact to the expense base, as did the inflationary adjustment to personnel costs, pushing the fiscal deficit to -2.9% of GDP during 2019, against an initially budgeted deficit of -2.0% of GDP. For the ongoing year, the burden coming from the fiscal support measures along with the weaker tax collection and the absence of one-off revenue items should lead to significant increase in the budget deficit. In the first four months of 2020, budget deficit grew by 33.6% to TL72.8bn.Meanwhile, deterioration was much more significant in April, whereby the COVID-19 measures were fully effective with monthly budget deficit surging 135.8% to TL43.2mn. High fiscal dependence on indirect taxes continues to be a challenge for the economy as weaker economic activity reduces value added tax and special consumption tax collection, weighing negatively on fiscal balances.

Turkey's EU defined general government debt stock level increased to TL 1,329b by end 2019 (end-2018:TL 1,067b). While external debt has remained range bound since 2017, its share in terms of GDP has increased by 170bps y-o-y to 58% at the end of 2019. In the current year, Treasury sold USD4bn of Eurobonds within the context of its USD9bn borrowing plan for the year. The remaining part of the plan is expected to be executed later in the year with the normalization of financial markets.

We see some deleveraging in the private sector, starting from 2018 and continuing for the larger part of 2019. Nevertheless, the high level of foreign currency indebtedness in the private, non-financial sector, remains a concern. As per the Central Bank data, maturing external debt over the next twelve months as of March 2020,amounts to USD168.8bn. Including the recent swap deal, the CBT reserves cover around 56% of short-term external debt. Relatively low reserve coverage has been one of the key stress factors. On the other hand, banking sector debt constitutes around 45% of this short term external debt stock and in the months of April and May, several Turkish Banks rolled over their syndicated financings, with a roll-over ratio between 80%-85% indicating no significant constraints in renewing FCY funding lines.

Net FCY position of the non-financial sector continues to be one of the key vulnerabilities of the Turkish economy. As of February 2020, net FCY position stood at negative USD170.4bn which is deemed quite high and has the potential to severely undermine private sector debt-payment capability in the foreground of continued pressure on the TL.

Labor market indicators worsened slightly as the unemployment ratio increased to 13.7% in December 2019 as against 13.5% in December 2018; further, these levels are well above 2013-2017 average of 10.9% and point to deterioration in the labor marketsover time. As of February 2020, period, the unemployment rate edged down to 13.6%, although foreseen to

increase by a few points in the coming periods, following the pandemic related slowdown.

Banking Sector

Banking sector assets had reached TL4.5tr as at December 2019 and stood at about 1.05 times the GDP (2018: 1.04x). Despite continuous growth, Turkey remains under penetrated in terms of banking,with sector deposits at 59% in relation to GDP, vis-à-vis the EU average of 111%. Relatively higher share of unbanked population at over 40% and the rather low median age of the population presents an upside to the longer-term growth potential of the sector.

Turkey's banking sector comprises 51 institutions, comprising 32 conventional banks, 13 development and investment banks and 6 participation banks. Conventional banks continue to form a significant portion (about 87%) of the overall banking sector in Turkey, of which seven banks[2] command around 70% market share[3] as of September 2019. This could be viewed with caution in the light of high systemic risk, in an event of financial stress. The ongoing regulatory drive to create an Islamic finance center in Istanbul and driving the increase in participation banking assets share to 15% of overall assets by 2025, is viewed positively, given the potential of Islamic banking to serve as an alternative asset class and diversify system risks. While the share of Islamic Banking has notched above 6% (6.6% in terms of assets and 9.6% in terms of deposits as of March 2020), it is yet considered to be at a scale which may be considered below potential. Recapitalization of two state PBs via tier-2 issuances and the launch of another state PB, Emlakbank, in March 2019 are recent addition to segment assets.

Given the challenges on the economic front, the banking sector's growth has posted deceleration in 2019 as loan growth dropped to 10.9% while assets and deposits expanded by 16.1% and 26% respectively. Average loan rate for newly extended commercial loans and consumer loans fell to as low as 9.2% and 10.2% respectively by May, 2020 from a peak of just below 40% in September 2018. Therefore, the pick-up in lending was maintained in the year 2020 as the banking sector's healthy liquidity and capital positions remain supportive of expansion as does a regulatory framework, which incentivizes continued credit supply to the economy. In the first 19 weeks of the year, banking sector registered loan growth of around 18.8%,vis-à-vis 31% in the PB sector. In the same period, deposit growth was quite strong at 17.2% and 29.3% respectively.

In April 2020, the BRSA introduced a minimum asset ratio guideline for banks, with the intention to minimize the negative impact of the pandemic on production and employment and the most efficient use of the resources available to banks. To be calculated on weekly basis starting from May 1st, with conventional banks and participation banks required to maintain minimum asset ratios of 100% and 80% respectively, this measure is likely to sustain credit supply. However, under current circumstances, the borrowing appetite of corporations may not be enough, to enable a pass through of funds made available for financing, into the economy.

Aggregate banking book is reasonably diversified with retail & wholesale trade, construction, electricity & gas distribution, and real estate segments commanding dominant shares. Taking into account, consumer mortgage lending, total exposure to real estate and construction segment hovers around 17.1% of aggregate financings; exposure to the sector has been deemed high risk, and the construction sector was a key driver of NPLs during the year, with NPLs in the sector rising to 9.3%. Low household debt levels provide a degree of protection, while leaving much room to grow.

At the end of 2019, absolute levels of non-performing Financings ("NPFs") have grown significantly by 55.7% from end-2018 surging to 5.4% at year-end (2018: 3.9%). Banks classified additional amounts as mandated by BRSA and following an asset quality review process. These new classifications largely constitute energy loans. Impairment ratios may yet increase, given the high quantum of restructured loans, high levels of stage-2 loans of around 12% and expectations of sharp slowdown in economic activity following the spread of the pandemic. As of March 2020, the gross NPF ratio of the sector eased to 5.0% as the volume growth accelerated.

[2] *Comprising 3 state owned banks (Ziraat, Halk, Vakif), 3 private-owned banks (Akbank, Isbank, YapiKredi) and one foreign bank (Garanti)*
[3] *In terms of total assets*

The vulnerability of the banking sector to weaker economic activity and depreciating currency due to sizable FCY debts in the non-financial corporate sector, remains a pressing concern. The share of FCY deposits in total deposits has remained atan almost similar level of 47.7% as of December 2019 (2018: 48.8%, 2017:44.2%). Even though this ratio has been on a decline after peaking at 54.6% in May 2019 in tandem with improvement in inflation expectations and relative stability of currency, dollarization trends need to be carefully monitored from the financial stability point of view.

%	2014	2015	2016	2017	2018	2019
NPLs to Total Loans	2.9	3.1	3.2	3.0	3.9	5.4
Specific Provisions to NPLs	73.9	74.6	77.4	79.3	68.3	65.1
Loans to Deposits	121.6	123.4	123.6	126.6	122.6	109.7
Capital Adequacy Ratio	16.3	15.6	15.6	16.9	17.3	18.4
Return on Assets	1.3	1.2	1.5	1.6	1.4	1.2

With a slight knock down, banks have been able to largely maintain profitability, despite increasing loan charge-offs. In the year 2019, sector's net earnings shrank 9.4% as the surge in provisions (up 32.5% y-o-y) outweighed the increase in revenue with net interest income and net fee income growing at lower rates. As such, RoAA of the sector contracted further to 1.2%, for the third consecutive year in a row. In the upcoming year, the net fee income of the sector is expected to be pressured as new regulations cut fee from money transfers, cash advance commissions, credit allocation fees for commercial customers and elimination of account maintenance fees for commercial clients. Given that the total fee income of the sector comprised 21.5% of operating revenues and had been increasing markedly over a timeline, this regulation is likely to reduce profitability of the sector, however, the hit to the PB sector should be lower as net fee income accounted for a relatively lower 12.4% of total revenues.

For full year 2020, stronger volume growth should compensate for narrower margins for the sector while another round of surge in impairment charges, along with weak performance on the fee income side is likely to lead to contraction of the aggregate net income of the sector. During the first quarter of the year, the banking sector posted over 26% increase in net earnings driven by net spread income growth of around 56% on the back of wider profit margins, whereas impairment charges also grew by 37.4%. In the remainder of the year, spread income growth should dissipate owing to base effects and narrower margins, whereas provision buildup is likely to accelerate in tandem with accretion of new impairments following the pandemic.

Deposits funded 57.2% of total assets in 2019, up from 52.6% a year earlier given both the strong deposit growth and deleveraging of the sector as the demand for FCY financings subdued. As of November 2019, Liquidity Coverage Ratio ("LCR")reached 165% and 293% on an aggregate basis and in FCY terms respectively, both of which are well above the regulatory minimums of 100% and 80%. Similarly, loan to deposit ratio of the sector retreated during the year to 106% from 117% in the year earlier while the Turkish Lira loan to deposit ratio remained still high at 134% (2018: 141%).We expect the loosening monetary policy stance of major central banks should allow Turkish banks continued access to foreign funding. However, geopolitical risk remains high, and any deterioration in diplomatic relations could jeopardize such access.

Capitalization of the overall banking sector remained strong through the recent periods supported by internal capital generation and supplementary capital issuances, topping up risk buffers. As of December 2019, the banking sector and Participation Banking sector featured total capital adequacy ratios ("CAR") of 18.4% and 18.04% respectively . Some larger private banks issued fresh capital; meanwhile, state-owned banks bolstered their capital bases via tier-2 issuances. Given the acceleration in the business volumes, CAR and CET-1 ratios of the sector retreated to 17.9% and 13.7% respectively, as of March 2020.As of May 2020, the capital bases of 3 state banks increased by total amount fof TL21bn which would increase the aggregate CAR of the banking sector by around 60bps, as per IIRA calculations.

CBT has announced several measures to counter potentially negative impact on the Turkish economy, due to the spread of the COVID-19 pandemic including the two policy rate cuts to inject much-needed liquidity into markets and improving the cash flow of firms. These measures were aimed firstly to enhance predictability, by providing flexibility in the banks' Turkish lira and foreign exchange liquidity management. Secondly these aim to secure uninterrupted flow of credit to the

hardest-hit corporate sector. Third objective was to support the cash flow of exporting firms through rediscount credits. Lastly, the CBT enacted several steps to prop up the Primary Dealership system and liquidity in the Government Domestic Debt Securities. In addition, the Central Bank expanded the scope of the collateral pool to offer banks which bring high-quality collaterals, access to a variety of liquidity facilities, such that the asset-backed securities and mortgage-backed securities were transferred into the collateral pool.

Banking Authority provided flexibility for capital calculations (fixing FCY rates at December 2019 levels for capital calculation purposes) until the year end and the delinquency period of 90 days stipulated for loans to be classified as non-performing loans has been extended to 180 days.In addition, further relief was provided to consumer loans and credit cards via extension of maturities and decreasing minimum amount to be paid for the cards. Enhanced amount of funds allocated to the Credit Guarantee Fund shall bolster the business volumes. The LTV limit on mortgages was raised from 80% to 90%. Overall, regulatory measures are likely to be provide relief for the capitalization and asset quality indicators in the short term and help maintain stability through sustained confidence in the banking sector, while making sufficient liquidity available.

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