The beginning of an era of Turkish bank capital securities

As the Basel III requirements continue to take effect, Turkish banks find themselves under increased pressure to boost their capital and grow their balance sheets

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The beginning of an era of Turkish capital securities

As the Basel III requirements continue to kick in, Turkish banks are under increased pressure to boost their capital base in order to continuously grow their balance sheet. Various structures for capital securities are being discussed more exigently than ever, and diversification of products is on the horizon

Managing a bank in Turkey with unstable currency, inflationary pressures, occasional downgrades of the sovereign debt from major rating agencies to junk status, and immense competition for profitability, deposits, loans and capital presents significant challenges. The Turkish banking industry is characterized by various evolutionary stages, including a generous growth period from 2003 to 2013, followed by a maturity period from 2014 onwards. At present, Turkish banks are required to use their capital very cautiously as "every penny counts" on the cost of capital and return on equity. On the other hand, a hunt for yield continues among investors who are desperate for decent returns. Owing to these components, we may be looking at a future where investors and Turkish banks meet at reasonable yields, bringing in a new era of Turkish capital securities.

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Basel III framework and Turkish approach

Basel III explained: Why and how did it begin?

In the aftermath of the global financial crisis of 2008, the Basel Committee on Banking Supervision (BCBC) published an internationally agreed-upon set of minimum requirements in December 2010, which apply to internationally active banks. One of the main underlying causes of the global crisis was the lack of strict regulation, supervision and risk management of banks. Therefore, the BCBC aimed to address this issue by strengthening the existing capital standards and introducing, among other measures, new requirements for "internationally active banks," the usual suspects of the 2008 crisis. These requirements are collectively known as "Basel III."

BCBC's Basel III titled *"A global regulatory framework for more resilient banks and banking systems"* was incorporated into EU law through the fourth Capital Requirements Directive (2013/36/EU) (CRD IV) and the Capital Requirements Regulation (Regulation 575/2013) (CRR), applicable from January 1, 2014. Similarly, the US implementation became effective as of January 2014.

In line with the EU and US approach, the Turkish Banking Regulation and Supervision Agency (the BRSA) implemented the Basel III framework in respect of the regulatory capital requirements with the Equity Regulation issued by the BRSA, published in the *Official Gazette* dated September 5, 2013, effective as of January 1, 2014 (the "Equity Regulation").

Basel III framework for capital requirements came into effect

Bank capital explained: Regulatory components and BRSA oversight

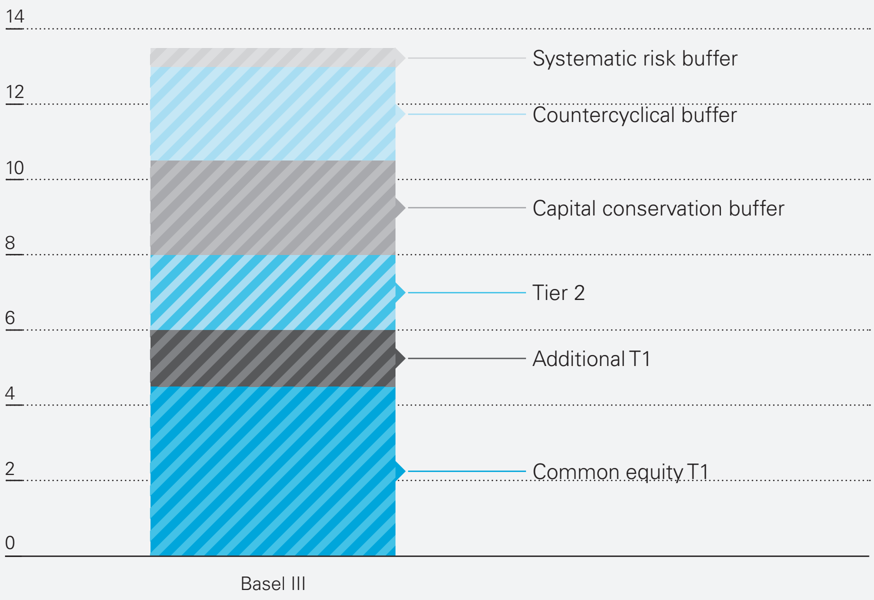
The Basel III framework strengthened the existing Basel II framework and introduced new capital and liquidity requirements for banks. A bank's capital consists of three main capital items, namely, (i) the common equity Tier I capital (CET 1); (ii) additional Tier I capital (AT1); and (iii) Tier II capital (Tier 2). The Basel III framework also introduced capital buffers as macroprudential tools to preserve the CET 1 of a bank, namely (i) capital conservation buffer (applied to all banks and at all times); (ii) countercyclical capital buffer (applied to all banks in times of excessive credit growth); and (iii) systemic buffers (i.e., the higher of Systemic Risk, G-SII and O-SII Buffers) for systemically important banks (SIBs).

Banks must maintain these minimum levels of capital calculated by reference to their risk-weighted assets, which in turn constitute the capital adequacy ratio (CAR). In line with the Basel III framework, the Turkish regulator requires the minimum level of (i) CET 1 to be 4.5 percent; (ii) CET 1, together with AT1 to be 6.0 percent; and (iii) CET 1, together with AT1 and Tier 2 to be 8.0 percent. In addition, further CET 1 buffers, namely, (i) the capital conservation buffer set at 1.75 percent for 2018 and increasing to 2.5 percent for the year 2019; (ii) the countercyclical capital buffer (which can vary between 0 percent and 2.5 percent, and the BRSA applies 0 percent since January 2016); and (iii) the systemic risk buffer, being 2.25 percent for the systemically important banks that it classifies in Group IV, 1.5 percent for Group III, 1.125 percent for Group II, and 0.75 percent for Group I, increasing in 2019 to, respectively, 3.0 percent, 2.0 percent, 1.5 percent, and 1.0 percent. In addition, although the Turkish Banking Law sets the CAR as 8.0 percent, it entitles the BRSA to set a higher targeted capital adequacy ratio, which the BRSA has set at 12.0 percent, pursuant to a decision in November 2006.

Turkish banks explained: Do they have adequate resilience?

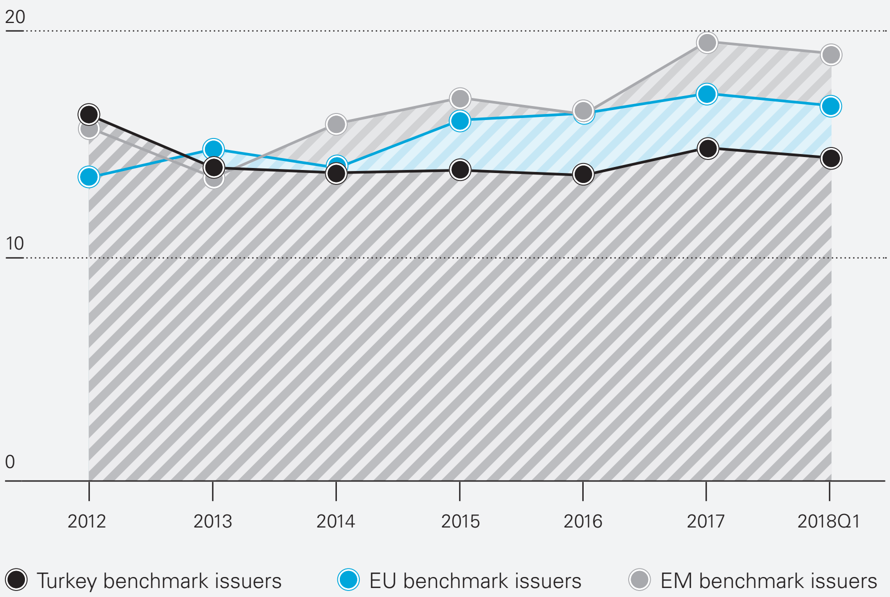
Since 2008, Turkish banks have been as resilient as their EU counterparts in terms of average CARs. A Fitch paper in August 2017 noted that Turkish "banks are mostly reasonably well capitalized, helped by recent profit growth, Tier 2 capital issuance, lower capital requirements for lending covered by the CGF and regulatory forbearance on risk-weightings for foreign-currency reserves." Figure 2 indicates the average CAR of Turkish benchmark issuers[1] compared to EU benchmark issuers[2] and other emerging market benchmark issuers[3].

Figure 1: Basel III capital buffers



Source: *Thomson Reuters*

Figure 2: Average CAR: Turkish benchmark issuers vs EU and emerging markets benchmark issuers



Source: *Thomson Reuters*

1 Turkish benchmark issuers: (i) Akbank; (ii) Garanti Bank; (iii) Halkbank; (iv) İşbank; (v) Vakıfbank; and (vi) Yapı Kredi Bank. Please note that the capital adequacy ratios in the year-end financial statements of the Turkish issuers have been taken into account for the purposes of this chart, to the extent publicly available.

2 EU benchmark issuers: (i) Intesa Sanpaolo; (ii) BNP Paribas; (iii) Société Générale; (iv) Crédit Agricole; and (v) UniCredit. Please note that the capital adequacy ratios in the first-quarter financial statements of the EU benchmark issuers have been taken into account for the purposes of this chart (except for 2012 and 2013, in which case the year-end figures have been taken into account), to the extent publicly available.

3 Other emerging market benchmark issuers: (i) Itau Unibanco; (ii) Credit Bank of Moscow; and (iii) Banco de Brasil. Please note that the capital adequacy ratios in the year-end financial statements of the other emerging market benchmark issuers have been taken into account for the purposes of this chart, to the extent publicly available.

Figure 3: CET 1 AT1 and Tier 2 instruments specifications

	CET 1	AT1	Tier 2
Maturity	Perpetual	Perpetual	Minimum 5 years. 20 percent reduction in capital recognition in each of 5 final years to maturity
Calls	None	First Issuer call ≥5 yrs. Limited early calls with regulatory approval. No incentives to redeem	
Subordination	Most junior	Senior only to Equity. Below Tier 2	Above Tier 1. Below depositors and senior creditors
Claim on winding-up	Share of surplus	Fixed claim: prevailing principal + interest	Fixed claim: principal + interest
Distributions	Discretionary MDA/capital conserve Not fixed/capped Distributable items	Discretionary MDA/capital conserve Fixed (may reduce) Distributable items Payment of principal requires approval of the BRSA	Can be mandatory (but limited enforcement) Fixed Pre-payment of principal requires approval of the BRSA
Loss absorption	Absorbs losses through the reserves	Upon point of non-viability Mechanic trigger (if CET 1 < 5.125 percent)	Upon point of non-viability
Accounting	Equity	Equity/Liability	Liability
Events of default	None		Non-payment when due; winding-up; limited enforcement

Source: *White & Case*

A sustainable method for resilience: Capital securities

AT1 and Tier II bonds explained: Basics of capital securities

The Equity Regulation, which closely mimics the Basel III framework, enables certain debt instruments to be included in the calculation of AT1 and Tier 2 capital of Turkish banks, provided that the terms and conditions of these debt instruments comply with the specifications set out in the Equity Regulation and upon the BRSA approval. The table above indicates the key specifications of debt instruments to be included in the calculation of AT1 or Tier 2 capital, with a comparison against the CET 1 capital of banks.

Loss absorption mechanics explained: How do write-down or conversion mechanics in capital securities work?

US$5 bn

Total issuance of Tier 2 bonds by Turkish banks since 2015

Terms and conditions of AT1 and Tier 2 bonds must include mandatory loss absorption mechanics:

- **Cancellation of payments (AT1 bonds):** A bank is entitled to cancel interest—and dividend—payments without incurring any payment obligation in respect of the difference between the contractual amount to be paid and the actual amount paid. Such cancellation will not be deemed an event of default. The bank is free to use the proceeds corresponding to the cancelled payment at its discretion. Furthermore, such cancellation should not restrict the bank (other than restricting its payments to be made to any shareholders)
- **CET 1 falls below 5.125 percent (mechanical trigger for AT1 bonds):** If the CET 1 of the bank falls below 5.125 percent, the bank is entitled to write down or convert the bonds into shares to ensure that the CET 1 of 5.125 percent is reached. As a result of the write-down: (i) the payables to bondholders in the event of liquidation can be reduced; (ii) the payables in the event of exercise of the repayment can be reduced; and (iii) interest payments can be cancelled
- **Point of non-viability (discretionary trigger for AT1 and Tier 2 bonds):** The point of non-viability is the non-viability trigger point at which it is probable that the bank will fail, in which case the BRSA may (i) revoke the banking license of such bank; or (ii) transfer the management and control of such bank to the Saving Deposit Insurance Fund (SDIF). In case the bank reaches the point of non-viability, AT1 bonds and Tier 2 bonds can be written down or converted into equity at the discretion of the BRSA

Figure 4: Turkish Tier 2 issuances

Issuer	Tenor (years)	Deal size (in millions)	Coupon rate (percent)	Spread	Investment grade	Date
Vakıfbank	10	US$500	6.875	MS + 543.9bps	BB	02.02.2015
Yapı Kredi Bank	10	US$500	8.5	MS + 731bps	BB+	09.03.2016
Akbank	10	US$500	7.2	T + 510.2bps	BB	16.03.2017
Fibabanka	10.5	US$300	7.75	MS + 591.5bps	B+	24.05.2017
Garanti Bank	10	US$750	6.125	T + 427.7bps	BB+	24.05.2017
İşbank	11	US$500	7.0	MS + 511.7bps	BB	29.06.2017
Odeabank	10	US$300	7.625	T + 579.9bps	B+	01.08.2017
Vakıfbank	10	US$228	8.0	-	BB	01.11.2017
TSKB	10	US$300	7.625	MS + 564.2bps	BB-	28.03.2017
Akbank	10	US$400	6.797	-	BB	20.02.2018
Alternatifbank	10	US$300	8.75	MS + 783.3bp	BBB-	16.04.2016
Albaraka Sukuk Limited	10	US$250	10.50	MS + 891bps	B	30.11.2015
KT Sukuk Company	10	US$350	7.90	MS + 675bps	BBB-	17.02.2016

Source: *Thomson Reuters*

Although the conversion into equity is a mechanical trigger for AT1 bonds and is a discretionary trigger for AT1 and Tier 2 bonds, the BRSA has not clarified in practice how such a conversion will work.

Current market prospects

A well-established Turkish Tier 2 bond practice: From 2015 to today

With the entry into force of the Equity Regulation in January 2014, the BRSA paved the way for the issuance of bank capital securities. However, given that the Turkish commercial banks, as well as potential investors, were not very familiar with these instruments in a Turkish context and the regulatory framework was untested (although TEB had issued subordinated bonds back in 2012 and Albaraka had issued a Tier 2 sukuk in 2013), the first Basel III-compliant Tier 2 issuance by a Turkish commercial bank was only made possible in February 2015 by Vakıfbank, a state-owned bank. As a first-mover encouraged by the BRSA, Vakıfbank placed US$500 million fixed rate resettable Tier 2 bonds with a ten-year maturity, and the deal was priced at a yield of 6.95 percent with a coupon of 6.875 percent, paying approximately 115 bps more than its counterparts.

Following in Vakıfbank's footsteps, 11 Turkish banks issued Tier 2 bonds with a combined issuance of approximately US$5.4 billion, all of them being fixed rate resettable issuances with ten to 11-year maturity periods. Among these issuances, there were two Basel III Tier 2 sukuk (Shari'ah-compliant bond) issuances by two Turkish participation banks, primarily subscribed by investors in the Middle East and North Africa (MENA) and Gulf Cooperation Council (GCC) regions.

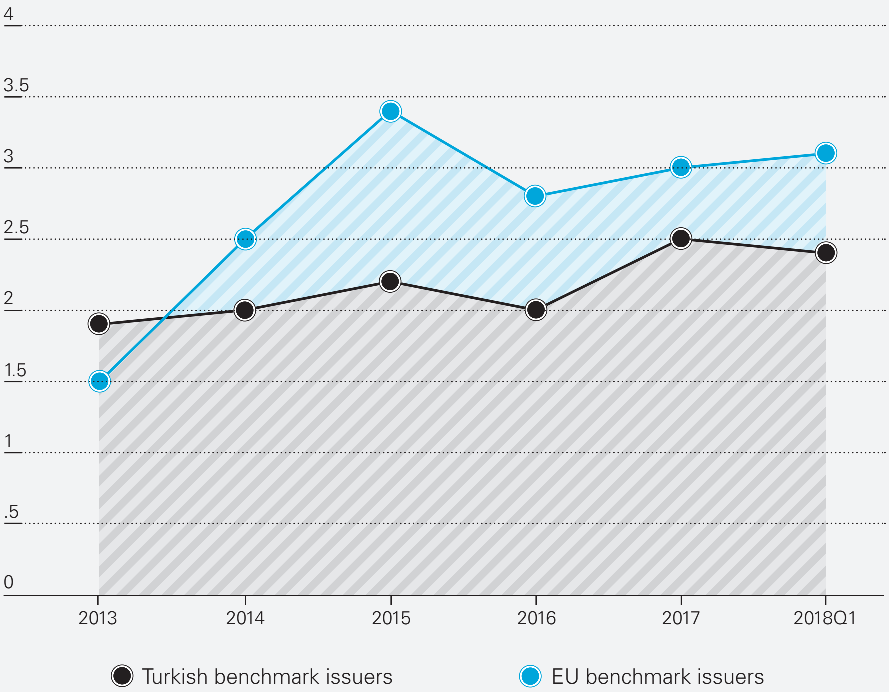
11

Turkish banks issued Tier 2 bonds since 2015, following in Vakifbank's footsteps

As a result of the initiatives to boost Tier 2 capital issuances, the Turkish average Tier 2 ratio rose to 2.4 percent in the first-quarter of 2018 compared to 1.91 percent in 2013, just before the implementation of the Basel III framework. This figure is approximately 0.6 percent lower than the EU benchmark issuers' average Tier 2 ratio in the first-quarter of 2018, which is 3.1 percent. Figure 5 indicates the average Tier 2 capital of the benchmark Turkish banks compared to EU benchmark issuers[4].

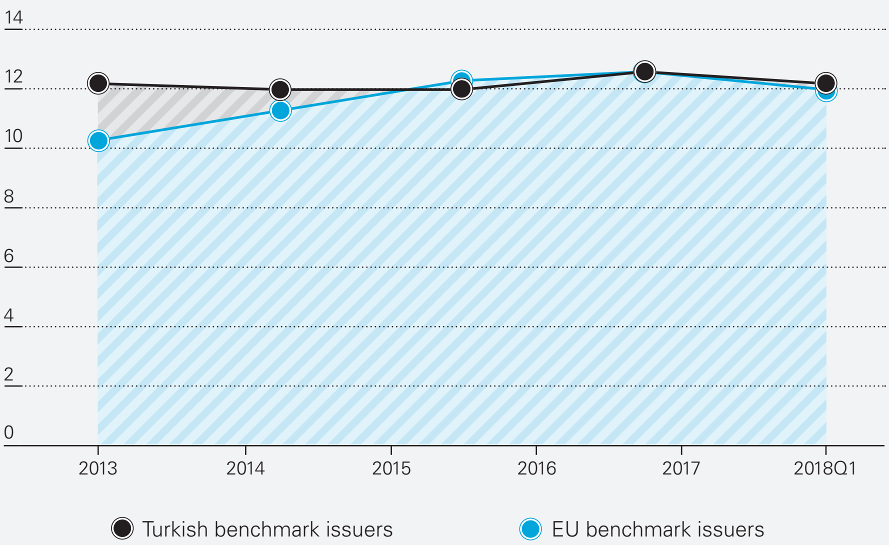
4 For the purpose of this chart, Tier 2 capital ratios in the first-quarter financial statements of the EU benchmark issuers and Tier 2 capital ratios in the year-end financial statements of the Turkish benchmark issuers for the relevant years have been taken into account to the extent possible.

Figure 5: Average Tier 2 capital: Turkish banks vs EU benchmark issuers



Source: *Thomson Reuters*

Figure 6: Average CET 1 capital: Turkish banks vs EU benchmark issuers



Source: *Thomson Reuters*

Potential need for AT1 capital: Will there be a future for AT1 bond issuances?

Although the Equity Regulation enables the issuance of AT1 bonds, the Turkish market is yet to experience an AT1 bond issuance, although notably, Albaraka issued an AT1 sukuk in February 2018. This is primarily because the CET 1 ratios of the Turkish banks (which are the main pillar of CARs of the Turkish banks) have historically been at comfortable levels. This is, slowly but surely, changing. Especially, the Turkish lira's depreciation has increased the role that the FX-denominated assets play in the Turkish banks' risk-weighted assets, whereas the CET 1 ratios of Turkish banks have taken the hit due to the depreciation, as they are composed of Turkish lira-denominated share capital. The average CAR of Turkish benchmark issuers decreased to 14.5 percent in the first-quarter of 2018 compared to 16.2 percent in 2012, whereas the average CET 1 ratio of Turkish benchmark issuers decreased to 12.1 percent in the first-quarter of 2018 compared to 12.5 percent in 2017. In the same period, the other emerging market benchmark issuers' average CAR increased to 19.0 percent in the first-quarter of 2018 compared to 15.8 percent in 2012; and the EU benchmark issuers' average CAR increased to 16.68 percent in the first-quarter of 2018 compared to 13.71 percent in 2012.

Similar to the trend in the Tier 2 levels, the CET 1 levels of the Turkish banks have mostly been at the same levels as EU benchmark issuers—in the first-quarter of 2018, the average CET 1 of the Turkish benchmark issuers was 12.1 percent while the average CET 1 of the EU benchmark issuers was 11.9 percent. Figure 6 indicates the average CET 1 capital of the benchmark Turkish banks compared to EU benchmark issuers.

Therefore, the difference between EU benchmark issuers and the Turkish banks in terms of CAR is now primarily attributable to the difference in AT1 capital. Notably, the Turkish banks are yet to benefit from AT1 capital.

According to 2018 first-quarter financial statements, the Turkish benchmark issuers had either negligible or no AT1 capital. In contrast to the Turkish banks, the EU benchmark issuers had on average approximately 1.85 percent of AT1 capital according to 2018 first-quarter financial statements.

The gradual (and somewhat consistent) relative decrease in Turkish banks' CARs will trigger a boosting requirement at some point to prevent the "dangerous" level that is close to the BRSA's CAR threshold from being breached and also for the Turkish banks to compete with their European peers. In particular, some banks may be closer to the "danger levels" than others. Given that further rights issuances (which is the plain vanilla form of CET 1 capital) have significant costs for the shareholders and that their Turkish lira-denominated nature does not allow them to mitigate the increasing weight that the FX-denominated assets of the Turkish banks have on their balance sheet, and given that most of the Turkish banks have already benefited from Tier 2 issuances to boost their CAR (as the average Tier 2 capital level of the Turkish benchmark issuers is already above 2.5 percent), we believe that the most convenient (and efficient) method for the Turkish banks to increase their CAR may be to target the capital markets with AT1 bond issuances, and potentially reach the same levels of AT1 capital as their European peers.

Regulatory roadblocks: Will there be a future for convertible issuances?

Although capital securities may be issued on a write-down or convertible basis, all Tier 2 bonds have been structured on the basis of a write-down at the point of non-viability. The lack of (or issuers' reluctance relating to) the issuance of convertible capital securities can be tied to certain regulatory uncertainties with respect to both the capital markets regulatory framework (regulated by the Capital Markets Board (the CMB)) and the banking regulatory framework (regulated by the BRSA). In particular, the Turkish regulations lack detailed provisions relating to convertible debt instruments (especially with respect to conversion mechanics), which are excluded from the application of the CMB's Communiqué on Debt Instruments (VII-128.8) if issued by a bank, following an amendment in 2017. These regulatory uncertainties cause legal and practical "roadblocks" and should be addressed by the regulators to diversify capital instruments. Notably and recently, on June 7, 2018, the BRSA published the Communiqué on Debt Instruments to be included in the Equity Calculation of the Banks (the "Communiqué"), a regulation setting out the rules and procedures for de-registration, write-down or conversion into equity of capital securities. Highlights from the Communiqué include the following:

- The banks are to seek CMB approval prior to conversion into equity
- Certain mandatory provisions are to be included in the terms and conditions of the contingent convertible bonds, such as conversion ratio, maximum shares to be issued in the event of conversion, and pricing mechanics to be applied in the calculation of the conversion ratio
- A temporary write-down is possible (only for AT1 bonds and limited to the mechanical trigger (i.e., the bank's CET 1 falling below 5.125 percent)) only at the discretion of the bank. The banks may increase such bonds' written-down value based on the bank's net profit for the period, subject to a threshold calculated on the basis of the bank's distributable net profits for the period and the total value of its Tier 1 capital
- Even after the contingent convertible bonds are converted into equity, the bondholders holding such contingent convertible bonds are senior to the shareholders in case of a liquidation of such bank
- An independent audit firm must issue an opinion, with respect to any debt instruments to be included in the calculation of equity of the banks, confirming that they possess the necessary regulatory characteristics qualifying them as includable in the calculation of equity.

1.85%

EU benchmark average of AT1 capital

In addition to the regulatory roadblocks, the "first-mover disadvantage" for the issuers of such capital instruments cannot be ignored as currently, except for one particular domestic issuance in January 2018 by a real estate investment partnership, the corporate convertible bond market in Turkey is a blank canvas waiting to be painted by eager issuers.

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