Implications of COVID-19 crisis for the Turkish banking sector

Client briefing

March 2020
After severe market disruptions, a long-term pandemic might put the economic system under severe stress.

COVID-19 pandemic: Initial situation

Perspective

Global COVID-19 pandemic currently causing significant market disruptions

External shock hits a fragile global economy – limited headroom for responses of central banks

Containment is the best solution for society, but fatal for the economy – the longer the pandemic persists, potentially the deeper the recession

Liquidity shock due to decline in sales already impacting SMEs and specific sub-industries

Disruption of supply chains and production stops could soon potentially lead to more widespread liquidity shortages in many industries

Rising expectations of the society and regulators from banks to continue supporting the economy and acting responsibly

Source: European Centre for Disease Prevention and Control, World Health Organization; Strategy& analysis
European banking sector already hit by first negative effects of the crisis – likely affecting Turkish banking sector as well

Impact on the European and Turkish banking market

Challenges before the crisis

- **Macroeconomic pressure on asset quality**
  - Concerns over bank’s asset quality due to worsening macroeconomic environment continue to rise

- **Profitability slump**
  - Difficulties to compensate for declining net interest income

- **Pressure on fees & commissions**
  - Regulatory pressure to fee & commission income

- **End of the economic cycle**
  - Key risk indicators are at an increasing trend

COVID-19: First effects in the banking sector

- Corporate customers draw their undrawn credit facilities to increase liquidity buffer
- Importance of operational resilience increased, burden over alternative distribution channels surged
- Government and regulator taking action to minimize impact of COVID-19
- Increasing pressure to make decisions in dealing with covenant breaches and unprofitable customers
- Securing regional and overseas wholesale funding potentially becoming more difficult

New business already in slow-down during 2019 due to asset quality concerns – what will be banks’ reaction to the crisis in 2020?
COVID-19 has the potential to infect banks at various levels and lead to losses

Risks for banks in case of a long-term pandemic

- Covenant breaches, payment delays and defaults are increasing
- Growing default risk drives RWA increase
- Pressure from interbank and counter-party credit (or margin) effects and in wholesale funding increases
- Income decreases sharply
  - Declining interest rates due to further central bank interventions and "flight to safety" in the markets
  - Non-interest income drop due to slowing financing and payment activities driven by declining consumer confidence and cautious spending
  - Economic uncertainty and slumps in financial results reduce demand/fees from investment loans
  - Decline in custody, administration and management fees in billing models based on asset values
- Service provider/eco-system partners break down
- Own workforce not fully functional
- High level of uncertainty regarding impact

Fiscal and monetary policy responses and other policy measures to be defined

Credit risk | Income risk | OpRisk | Capital risk

Time

Today | 3-6 months | 6-12 months
This is important now: to prepare as best as possible for the economic storm of the COVID-19 crisis

Management priorities

1. Ensure operational and funding resilience
   - Activation of crisis or business continuity plans and teams
   - Ensuring operational resilience (internally) and checking readiness of customers, channels, partners as well as managing operational and security burden on alternative distribution channels
   - Ensure funding resilience going forward
   - Crisis communication with stakeholders including own workforce

2. Perform scenario analysis of credit portfolios
   - Rapid, model-driven review of loan portfolios
   - Focus on exposure of particularly affected industries/regions/products (e.g. project financing activities and covenant breaches)
   - Implementation of scenario analyses (e.g. worst case) and stress testing
   - Identification of particularly critical loans

3. Adapting market strategies
   - Assess potential impact on different business (e.g. payments volume decrease)
   - Derive potential options (business as usual, origination stop, balanced approach)
   - Analysis of options per market area / client segment (client profitability, acceptable level of covenant breaches)
   - Accelerate digital sales and service enablement in preparation for «social distancing» and reduced branch footfall

4. Develop portfolio strategies
   - Identification of critical loans and / or group of loans that require action
   - Development of potential options to mitigate risks (e.g. sale, restructuring, maturity / limit extension, exit)
   - Analysis of options and development of guidelines to handle possible scenarios going forward
   - Implement portfolio strategy

5. Cost and liquidity management
   - Based on scenario and other analyses, estimation of potential balance sheet and P&L impact of current situation
   - Identification of cost reduction (e.g. expense and channel optimization) and liquidity management levers to ensure business continuity and profitability
   - Implement levers

Three to six months remaining until impact of income, credit and capital risks become fully visible
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