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DISTRESSED LOANS IN THE TURKISH BANKING SECTOR

In the Turkish banking sector, lending activities gained a great momentum after the financial crisis in 2001. The loan volume provided to the private sector expanded significantly. Such increase and the rapid growth trend in loan transactions lost its momentum in the last three years but continued at a certain level. In 2020, due to COVID-19, significant commercial and consumer loans have been provided to the market, in particular by public banks, to satisfy the companies' urgent cash and working capital needs and to keep the economy alive. According to the data published by the Banking Regulation and Supervision Agency (the "BRSA"), the total loan volume in the Turkish banking sector reached approximately 3.5 trillion Turkish Liras in September 2020.

As the developments in the domestic market and changes in macroeconomic conditions adversely affected the borrowers' repayment ability, the distressed loan ratio in the total loan volume increased in recent years. Thus, it became a crucial problem for the Turkish banking sector. On the other hand, it is foreseen that the loans provided due to COVID-19 will also turn into distressed loans and make this a more serious issue. Non-performing loans create a liquidity problem for the relevant bank and cause costs arising from the provisioning requirements under the banking regulations during the period during which they remain in the bank's balance sheet. Distressed loans' management solutions and investment models are significant for banks, borrowers and investors that are interested in distressed loans.

Classic Method: Restructuring and Refinancing

One of the methods that banks and borrowers often use for distressed loans' management is to restructure or refinance the loan. In refinancing and restructuring transactions carried out until 2018, loans were refinanced or restructured through amendment agreements, terms of which were freely determined by the parties. In 2018, the loan amount that needed to be restructured increased significantly. For this reason, the BRSA adopted the "financial restructuring" model to

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meet the market's needs. At the same time, the Banks Association of Turkey published the restructuring framework agreements for small-scale and large-scale companies to ensure implementation of these regulations. Many companies restructured their loans by using these framework agreements.

Nevertheless, in practice, many distressed loans have been restructured using the methods freely determined by the parties, without being subject to the BRSA regulations. In addition, as of 2019, there was still 46 billion Turkish Liras¹ worth of loans which had not yet been structured and remained as distressed loans in the banks' balance sheets. This fact also brings criticism that the regulations do not satisfy the market's needs.

In addition, in these restructuring transactions -regardless of whether these are subject to the BRSA's regulations- parties prefer simple and short-term solutions such as due date extension, suspension for principal and interest payments or additional loans under a collateral. Even if these amendments provide a short-term relief, they do not solve the fundamental issues in relation to repayment in the long-term projection. Banks come across the same distressed loans with the need of restructuring. For this reason, more sophisticated methods and mechanisms are needed in restructuring and refinancing transactions.

Distressed Loan Sales: Asset Management Companies and Securitization

Another method for distressed loans' management is to transfer the loans to asset management companies. This method enables banks to remove distressed loans from their balance sheets and minimise their liquidity problems. This also helps banks reduce their costs related with provisioning obligations under the banking regulations.

Over the last decade, the volume of distressed loans purchased by asset management companies has increased. In March 2020, the ratio of non-performing loans in the total loan market was approximately 5%. The loans purchased by all of the 18 asset management companies operating in Turkey mainly consist of consumer loans with non-performing nature. Despite the asset management companies' extensive field of activity stipulated under the relevant regulations, Turkish asset management companies focus on direct collection of non-performing loan receivables or resale of loans. Investments in distressed loans using restructuring tools may be a way for asset management companies. The distressed loan market can grow and the number of market players can increase in the future, if Turkish banks' motivation for the sale of distressed loans -that are suitable for restructuring, such as close monitoring loans- and asset management companies' demand to invest in this kind of loans, increase. Further, if the loans that public banks provide to the market due to COVID-19 turn into distressed loans, it would be reasonable to anticipate that state-owned banks will also be included among the market players that sell loans in the market.

Securitization is another method to relieve the banks' balance sheets and to satisfy the banks' liquidity needs. In many countries, non-performing loans or loans that are closely monitored by banks and financial institutions, are being securitized by way of transfer to onshore or offshore

¹ According to the BRSA's announcement.

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funds. As for Turkey, certain receivables and assets can be securitized by establishing an onshore fund in accordance with the Communiqué on Asset and Mortgage Backed Securities published by the Capital Markets Board. In addition, the Capital Markets Board introduced a new concept under the Capital Markets Law, which enables market players to securitize the receivables arising from project finance loans. The secondary legislation for this securitization concept is expected to be published soon. However, Turkish capital markets legislation only allows the securitization of standard loans (*i.e.*, classified as first group loan). Accordingly, it is not possible to securitize non-performing or closely monitored loans in Turkey. Thus, establishing the regulatory framework for distressed loans' securitization would be an important development for the Turkish banking sector in terms of distressed loan management.

Debt-Equity Swap

Another method used by banks for management of distressed loans is to acquire the shares representing the borrower's share capital, in exchange for the unpaid loan. As a result of this exchange, the distressed loan can be partly or completely cancelled and removed from the bank's balance sheet. It is also possible to consider this method as "loan restructuring". Indeed, according to the Banking Law and its secondary legislation this method can be applied within the scope of "financial restructuring". However, this transaction does not eliminate the complications caused by the distressed loan, as the distressed loan in the relevant banks' balance sheets turns into shares representing the distressed company's share capital. As a result, banks need to profitably sell these shares as soon as possible. At that point, banks must consider the limitations and requirements under the banking legislation in terms of share acquisition. In Turkey, the OTAS-Türk Telekom transaction was one of the examples in which leading Turkish banks provided a syndicated loan to Türk Telekom. Then, as Türk Telekom was not able to repay the loan, its shares were transferred to a special purpose vehicle incorporated by these leading banks. Another example was the recent transfer of Keskinöğlü's shares, a Turkish company operating in the poultry market, to three major state-owned banks due to the non-repayment of the loan.

As the distressed loans' ratio in the market has been increasing, distressed loans' management in the Turkish banking sector is becoming more important every day. The methods currently applied cannot eliminate this problem. For this reason, the BRSA and relevant authorities may adopt new regulations to ensure the implementation of the existing methods on a wider scale and introduce new methods for such purposes.

CONTACT



Fahri Can Doğan

fcdogan@kolcuoglu.av.tr



İrem Cansu Demircioğlu

icdemircioglu@kolcuoglu.av.tr



İrem Delen

idelen@kolcuoglu.av.tr