VAKIFBANK TURKISH ECONOMY WEEKLY

How will RRR hike affect Turkish Banking Sector?

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CBRT raised reserve requirement ratios (RRR) sharper than expected to restrain credit growth...

- **The CBRT raised the TRY reserve requirements on;**
  - ✓ Demand deposits, notice deposits and private current accounts by 400 bp (from 8%to 12%),
  - ✓ Deposits/participation accounts up to 1-month maturity by 200 bp (from 8% to 10%),
  - ✓ Deposits/participation accounts and special fund pools up to 3-month maturity by 200 bp (from 7%to 9%),
  - ✓ Liabilities other than deposits/participation funds by 100 bp (from 8% to 9%).
- **Meanwhile, CBRT left the rates unchanged on;**
  - ✓ Deposits/participation accounts up to 6-month maturity at 7%,
  - ✓ Deposits/participation accounts up to 1-year maturity at 6%,
  - ✓ Deposits/participation accounts with 1-year and longer maturity and cumulative deposits/participation accounts at 5%,
  - ✓ Special fund pools up to 6-month and longer maturity at the corresponding ratios according to their maturities.
- **The FX RRR was kept unchanged .**
- **Therefore, based on current data, CBRT plans to withdraw approximately TRY 9.8 billion from the market. This is 10% of M1 and around 3% of M2.**
- **With this decision CBRT aims to slow down credit growth and reduce maturity mismatches.**

Liquidity impact of RRR change on banking sector...

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Table 1: Change in RRR and the liquidity impact (2010-2011)

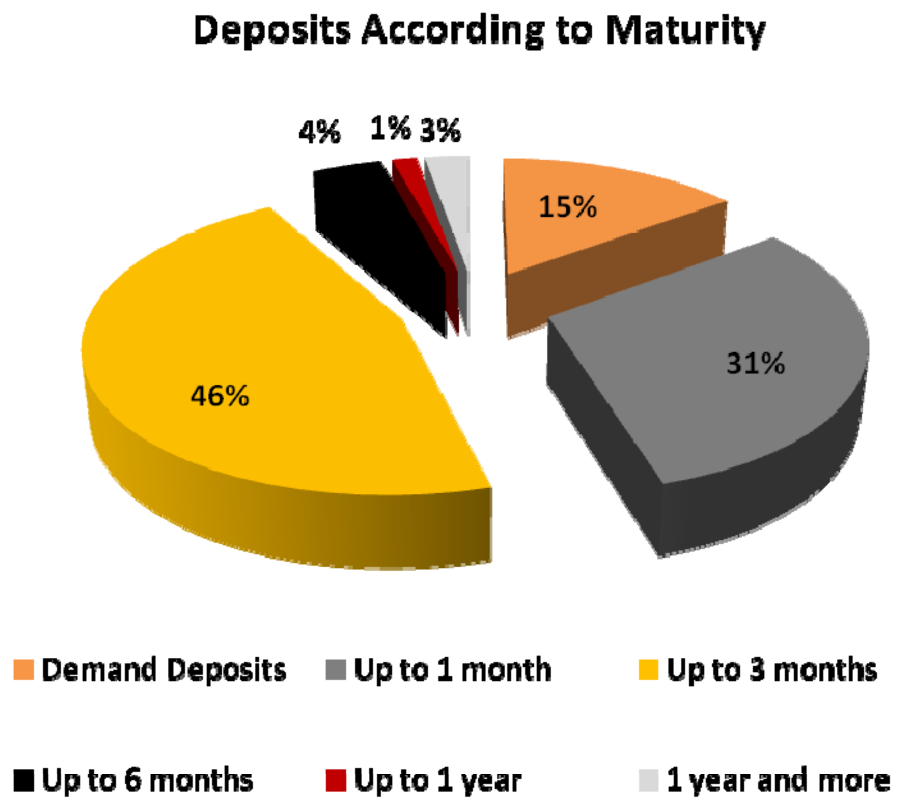
Date	TRY-RRR	Change	TRY Liquidity (TRY m)	FX-RRR	Change	FX liquidity ($ m)
26/04/2010	5.0%	0 bps	0	9.5%	50 bps	-693
29/07/2010	5.0%	0 bps	0	10%	50 bps	-720
23/09/2010	5.5%	50 bps	-2.100	11%	100 bps	-1.500
12/11/2010	6.0%	50 bps	-2.100	11%	0 bps	0
17/12/2010	Change in Scope*		-7.600	Customer repo included		-200
24/01/2011	Change in Scope**	200 bps on average	-9.800	11%	0 bps	0
Total		100 bps	-21.600		200 bps	-3.113

* TRY	Demand and 0-1 m	3-6 m	6 m-1 y	1 year and longer
17/12/2010	8%	7%	6%	5%

**TRY	Demand	Up to 1 m	1-3 m	3-6 m	6 m-1 y	1 year and longer
24/01/2011	12%	10%	9%	7%	6%	5%

Source: CBRT

Turkish banking sector will have to keep 9.5% of its TRY deposits at Central Bank after this recent RRR hike...



Source: BRSA

- According to November data, deposits between 1-3 months have the highest share in total deposits (46%). With the recent RRR hike, reserves for the deposits between 1-3 months will increase by 28.6%, for demand deposits by 50% and for total TRY by 30%.

Cost of RRR rise on banking sector- Credit Growth...

The reserve requirement hike will increase cost of lending hence it will reduce credit growth. In order to see how this occurs, we modeled the relationship between RRR and credit growth. According to our estimates, 100 bp increase in required reserve ratios for Turkish Lira will drop credits by 2% after two periods. Then, the cumulative RRR hike in the last two decisions will lead to 5% decrease in total credit in the forthcoming period.

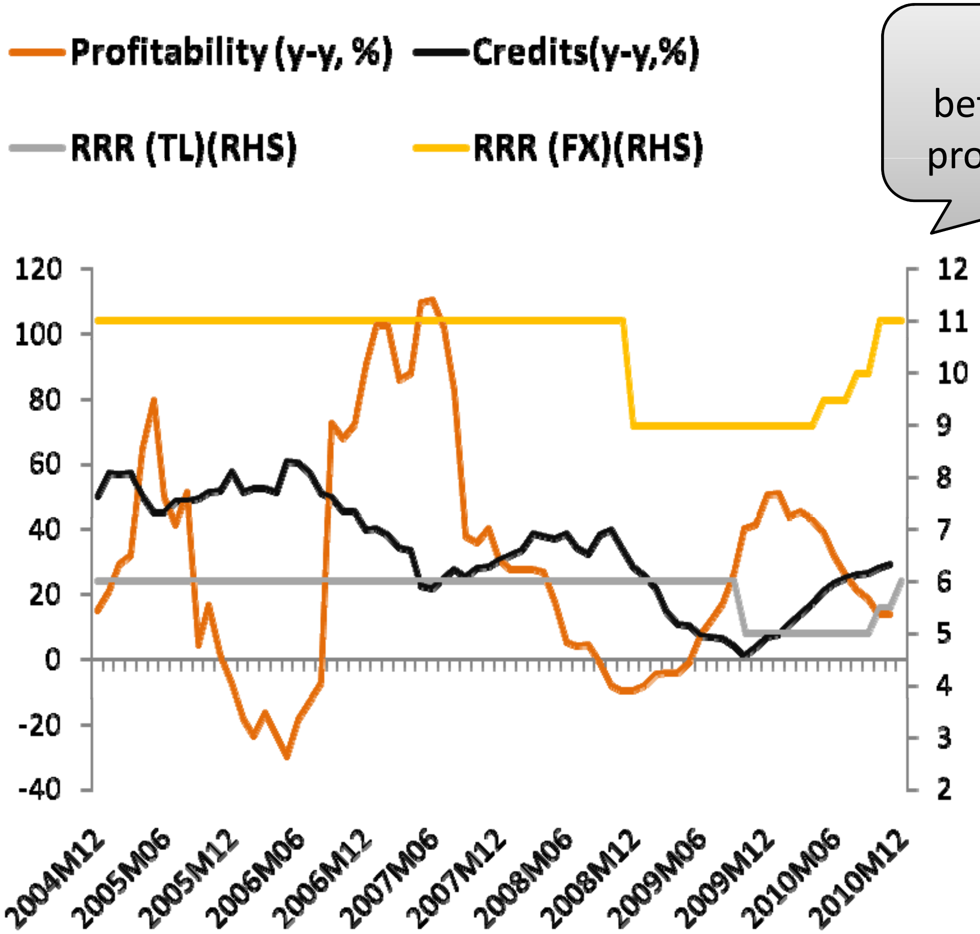
The Impact of RRR

100 bp increase in TRY required reserve ratios drops credits by 2% after two periods...

100 bp increase in FX required reserve ratios drops credits by 0.8% after two periods...

Recent rise in RRR will lead to 5% decrease in total credit.

Cost of RRR rise on banking sector- Net Profit...



Source: CBRT, BRSA

Correlation between RRR and profitability =-0.70

- CBRT has withdrawn TRY17.4bn from the market through the recent two RRR hike decisions. This tightening in liquidity leads to a decline in profitability of banking sector as the credit growth pace decelerate.

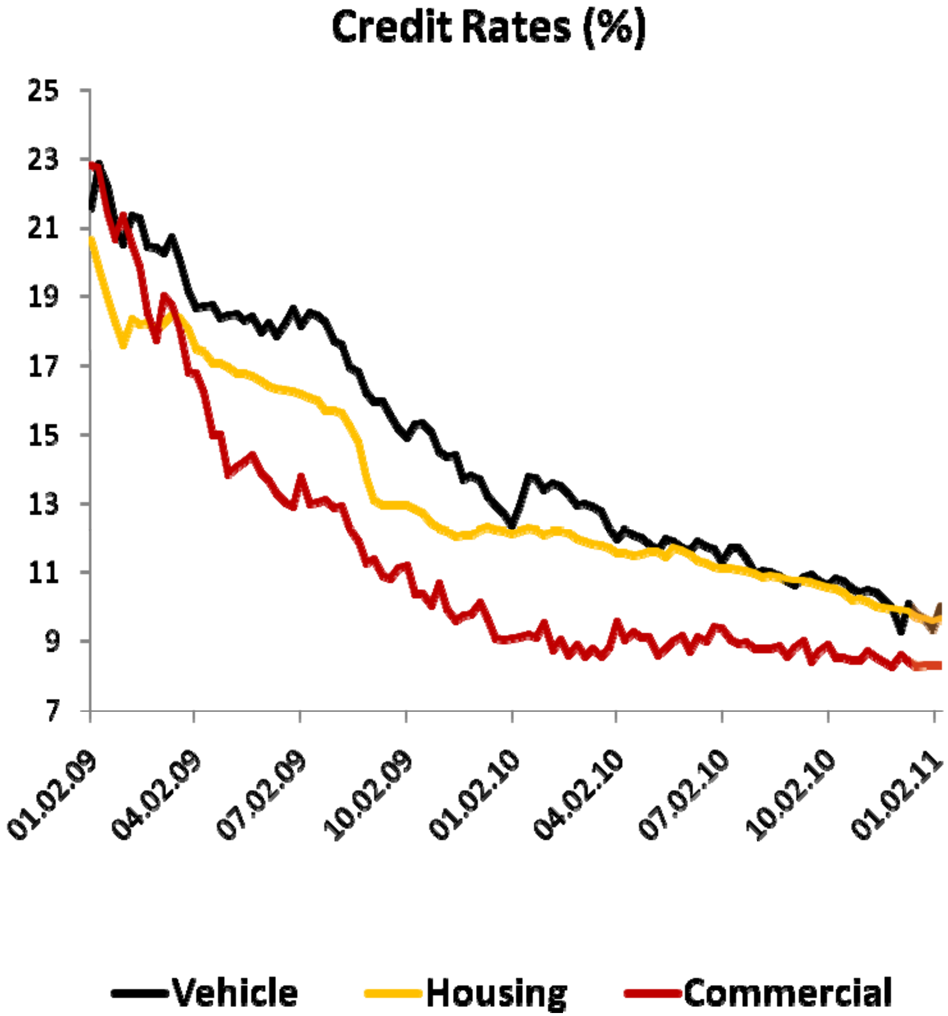
- To measure the effect of RRR hike on profitability of banking sector, we modeled the relationship between credit growth and profitability. According to our estimates, the cumulative RRR hike in last two decisions may result in % 2.5 decrease in profitability in 2011.

What can banking sector do after the sharp increase in RRR?

In order to reduce current account deficit and credit expansion, CBRT prefers a policy mix of a lower policy rate coupled with higher reserve requirements. These measures taken by CBRT will lead to some changes in banking sector that can be examined in two different points of view.

- ***Asset Side***
- ***Liability Side***

1- Actions that can be taken on the Asset Side of the balance sheet...



Source: CBRT

Increase in Credit Rates

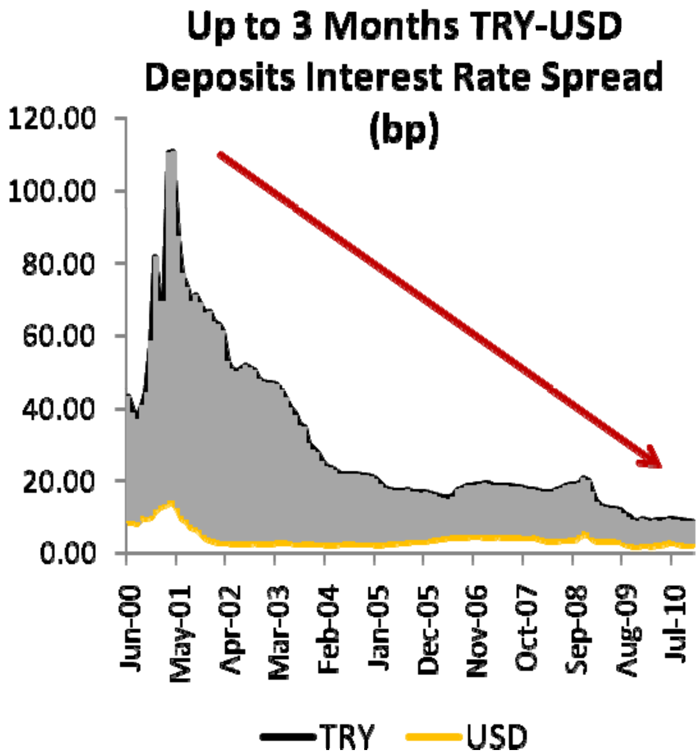
- The sharp reserve requirement hike will increase cost of lending in banking sector. Since the banks will not want to undertake this cost, they may increase the credit rates which declined towards the end of the last year in high competitive environment.
- According to CBRT weekly data, average credit rates has started to increase after the CBRT's December decisions. For instance, the average vehicle credit rates has increased by 0.70bp during the first week of January 2011.

! Credit Risk: If the increase in USD/TRY continues, the currency risk of private sector may split into banking sector as a credit risk.

2- Actions that can be taken on the Liability Side of the balance sheet...

- Although reducing deposit rates can be an option for banking sector to decrease the costs of lending, it is hard to be done due to historically low levels in interest rates. Moreover, it is risky since household savings would decrease if deposit interest rates futher reduced.

- After December measures on RRR, banking sector tended to trade in cross currency swap operations in January as CBRT did not take any other measures against the off-balance sheet items.



Source: CBRT

- The interest rate spread between TRY and USD time deposits has declined to historically low levels. This poses a risk in controlling the sharp moves in FX currencies.

- When the spread between TRY and USD deposit rates were wide, TRY deposits were more attractive then USD deposits despite the risk of rise in exchange rates. However, today narrowing spread can decrease the attractiveness of TRY deposits.

- In other words, with these low levels in TRY and USD interest rates spread, the risk of TRY depreciation can not be compensated.

- At the first stage, increasing credit rates especially on vehicle and housing will have a negative effect on credit demand. However, declining in credit volume may be limited since the economy continues to improve and the risk appetite keeps rising.

To sum up...

- The RRR hike will raise both assets and liabilities funding cost however there will be limited changes in deposit and loan interest rates in strong competition environment.
- In this situation, the banking sector will undertake increasing costs by narrowing profit margins.

Net interest margin continue to norrow

Due to interest rates upward movements, securities portfolio would write off

Due to long and fixed interest rate structure of credits, an upward movement in interest rates do not affect the previous credit rates

- **Under these considerations, we expect net profit of banking sector will decrease in the forthcoming period.**

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