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TAKING TURKISH FINANCIAL RESTRUCTURING AND NPL MARKET AHEAD

What needs to be cured on the legal and tax fronts: A proposal for a financial restructuring and NPL reform

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Turkish economic growth was supported by credit, especially foreign currency denominated funding. As of July 2019, total FX debt (long term and short term) owed by the private sector in Turkey was USD 211 billion (USD 103 billion is owed by financial institutions and USD 108 billion by the real sector).[1] Following major fluctuations of TRY against USD in the beginning of 2018, Turkish companies with high FX exposure are now experiencing liquidity and solvency issues.

Further, the Banking Regulatory and Supervisory Authority (the "**BRSA**") recently published a press release which revealed that loans amounting to TRY 46 billion must be classified as NPLs. These NPLs mostly relate to energy and construction companies. In this respect, the banks notified by the BRSA were asked to reclassify these loans and set aside the required reserves by the end of 2019. The BRSA further stated that the global capital adequacy ratio of Turkish financial institutions fell from 18.2% to 17.7%, whereas the rate of NPLs increased from 4.60% to 6.3%.[2]

The growing size of toxic assets on Turkish banks' balance sheets is causing these banks' liquidity to dry out, indicating that credit is not and may not be as available as it used to be. The banks' ability to disburse new loans is negatively affected by the increase of NPLs in their balance sheets since they must maintain strict capital adequacy levels and set aside reserves for NPLs on an ongoing basis. This could be a major challenge for economic growth and sustainability, given the dominant role of credit in Turkish economic growth. Recovery is dependent on ensuring that Turkish banks resume lending, which is dependent on the removal of the troubled assets on bank balance sheets.

There are two alternatives to removing these troubled assets: either banks successfully restructure these loans, which would change their classification and diminish reserve requirements, or they dispose of these assets. In other words, creating a healthy and established financial restructuring and NPL market for Turkish banks.

Two decades after the 2001 Turkish financial crisis, the concept of "financial restructuring" was re-introduced in Turkey following the 2018 currency shock. Financial restructuring, defined as revising a debtor's financial structure and re-determining its financial strategy, became a major agenda item for Turkish financial institutions. It is crucial not only to provide relief to the borrowers, but also to deleverage bank balance sheets to ensure that banks can continue to disburse loans. Therefore, an optimum solution acceptable to all stakeholders is needed and still needs to be reached in terms of financial restructuring. Regulators intervened immediately and began working to create a legal framework for financial restructuring.

The first step toward this was the introduction of the Regulation on Restructuring of Debts Owed to Financial Institutions (the "**Regulation**") by the BRSA on August 15, 2018 which set out the path to the introduction of a 'framework agreement' to facilitate financial restructurings. Within a month, following the Regulation's introduction, the Banks' Association of Turkey (the "**BAT**") prepared a framework agreement (the "**First Framework Agreement**"). Market players criticized the Regulation and First Framework Agreement because they failed to take into account international bank loans to Turkish borrowers and how the international banks might participate in the financial restructuring process. Therefore, the Regulation and First Framework Agreement was amended on November 21, 2018 and November 28, 2018, respectively, so foreign credit institutions were then able to be parties to the Framework Agreement by signing up on a case-by-case basis.

Not following the usual or a wholly coordinated approach to law making was understandable given the necessity to respond quickly to the significant impact of the fluctuations of TRY. However, considering that financial restructurings would take place over a longer term, it was necessary to provide a basis for financial restructuring in law. To achieve this, the BRSA prepared a Draft Law on the Restructuring of Debts Owed to the Financial Sector and distributed it to banks on May 13, 2019. The legislative preference, however, was to include a provisional article related to financial restructuring (the "**Provisional Article**") in the Banking Law No. 5411 (the "**Banking Law**"), with an omnibus bill called The Law on the Amendment to the Income Tax Law and Certain Laws (the "**Omnibus Law**"), rather than having a standalone restructuring law.

[1] Available at: https://www.tcmb.gov.tr/wps/wcm/connect/TR/TCMB+TR/Main+Menu/Istatistikler/Odemeler+Dengesi+ve+Ilgili+Istatistikler/Ozel+Sektorun+Yurtdisindan+Sagladigi+Kredi+Borcu/Veri+%28Tablolar%29/

[2] Available at: https://www.bddk.org.tr/ContentBddk/dokuman/duyuru_0730_01.pdf

The Provisional Article will be in force for two years from the date of its publication, July 19, 2019, which can be extended by the president for another two years. The Provisional Article aims to incentivize financial restructuring by providing various tax exemptions and some comfort as regards possible allegations of regarding the crime of embezzlement, which has been a major concern for banks in the context of restructuring.[3]

Recently, the BRSA amended the Regulation to align it with the Provisional Article. Further, the BAT divided the First Framework Agreement into two different framework agreements (i.e., a Large Scale Framework Agreement (the "**Large Scale FA**"), applicable to debtors with an aggregate principal debt equal to, or more than, TRY 25 million, and a Small Scale Framework Agreement (the "**Small Scale FA**"), applicable to other debtors who have less debt).The Large Scale FA and the Small Scale FA (together, the "**Framework Agreements**") have been executed by a majority of Turkish banks and other financial institutions and entered into force. Despite all these efforts, the Turkish financial restructuring and corporate NPL market has not become fully functional in the fifteen months after the 2018 currency shock. This paper elaborates on the necessary legal and tax infrastructure reform to establish a market that will help Turkish banks offload the heavy burden of troubled assets to other market players, including international investors.

A) What needs to be done on the legal front?

1) Financial Restructuring Considerations

Universal Effect on All Creditors: While the Framework Agreements provide for a statutory regime, it is not intended to provide for a properly "collective" insolvency procedure including all creditors of a debtor. As drafted, the Framework Agreements only bind those who have signed it. As such, many parties who commonly operate in the credit markets in Turkey (including many foreign financial institutions) will work outside the Framework Agreements, and compromises struck by and between the parties to the Framework Agreements will not bind non-signatories. The general situation clearly requires a restructuring regime to be instituted that would have collective effect. Otherwise, there will be continuing asymmetry between the treatment of signatory creditors, on the one hand, and non-signatory creditors, on the other, because non-signatory creditors will be able to continue with their enforcement proceedings at a time when the debtor is in the process of restructuring its financial debts and signatory creditors are subject to a moratorium. Such a situation is likely to force debtors to perform all their due obligations owed to non-signatory creditors, but not vis-a-vis signatory creditors. This very effect will discourage non-local creditors from becoming parties to the Framework Agreements, as well as discouraging debtors from investing time and effort in attempting to achieve a financial restructuring through the Framework Agreements process, in particular, where such debtors have a number of non-signatory creditors.

There are numerous examples of insolvency regimes in other countries which deal with all creditors collectively. Indeed, for a process to be properly considered an effective restructuring and insolvency process, many would say that it should include a universal moratorium as an essential element. For example, in the US, Chapter 11 provides for an "automatic stay" where all judgments, collection activities, foreclosures and repossessions of property are suspended and may not be pursued by creditors, similar to what the composition/concordat process offers in Turkey.

Action recommended: The entire financial restructuring regime must be revised so as to have collective effect (with limitations) on creditors, and which would thereby require all banks and financial institutions dealing with Turkish borrowers to be part of the process. Although the effects of a local insolvency procedure in one jurisdiction (for example, to write off claims) may not be effective in another, it should still be possible to legislate towards such a position through international treaties and in particular international recognition of key elements of Turkish insolvency procedures.

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[3] Pursuant to the Banking Law, if a director or employee of a bank embezzles any money, valuable document, securities or other assets which have been entrusted to them in connection with their duties or placed under their custody and supervision in their own or others' favor, they shall be sentenced to imprisonment from six to twelve years and a judicial fine up to 5,000 days, and shall compensate any losses the bank incurred. Furthermore, real person shareholders who de jure or de facto held control of the management and supervision of a bank whose permission for banking transactions were revoked or transferred to the SDIF proven to have used the credit institution's resources directly or indirectly in their own interests or in the interests of third persons so as to endanger the soundness of the credit institution, thereby causing loss to the credit institution in any manner whatsoever, shall considered to have committed embezzlement. Those who commit this offence shall be sentenced to imprisonment from ten to twenty years and a judicial fine up to 20,000 days; however, the judicial fine amount cannot be less than three times the loss suffered by the bank. In addition, the losses incurred must be jointly indemnified.

Can Konkordato Be An Alternative: Composition (concordat, *konkordato*) is an alternative to financial restructuring under the Framework Agreements that does have universal application to all creditors, including non-financial creditors. Except for secured receivables, during the initial and definitive grace period of the composition, no debt enforcement proceedings can be initiated or continued and no interim attachment nor injunction decisions can be exercised, including enforcement proceedings for public receivables. Although during the grace period the secured creditors can initiate or continue debt enforcement proceedings, they cannot obtain any protective measure (such as sequester of movables) or liquidate the pledged assets.

Composition has existed in the Enforcement and Bankruptcy Code (the "**EBC**") for a long time, but it was only at the beginning of 2018 that the EBC was modified, making it easier for debtors to meet the composition requirements. Since these changes, many distressed companies in Turkey have applied for composition and benefitted from the universal moratorium it provides, granting them the opportunity to overcome liquidity issues mainly caused by their FX exposure.

There are both advantages and disadvantages of the composition process, explained below.

First, the main difference between financial restructuring under the Framework Agreements and the Kondordato is that a Kondordato composition is a court-led process. Following the receipt of the composition application, the court may grant an initial grace period of up to three months (which can be extended for up to another two months) and, later, a definitive grace period of up to one year (which can be extended for up to another six months), and appoint 'commissars' (effectively, supervisors) to the debtor. While, in principle, debtors still have the ability to run their businesses as they were, the composition process requires all transactions of the debtor to be performed under the supervision of the commissars.

The rationale is that as the debtor can continue its business during the initial moratorium period under the supervision of the commissars and the court, this protects the interests of creditors while balancing the interests of the debtor and its creditors. It may be expected that since the commissar and the court have extensive powers during the composition process, such as refusing to approve a debtor's important decisions and transactions, it restricts the debtor's ability to operate in a flexible manner and may cause bottlenecks, especially where dealing with commissars who may be unfamiliar with the business of the debtor, and the critical urgency of the situation, and where slow-footedness may materially and adversely affect the debtor's business and prospects. However, in practice, we have experienced that debtors have a great deal of freedom, and the commissars create trust in the creditors, which result in a smooth process for the debtor.

Furthermore, the extent of creditors' involvement (in terms of dialogue and influence) in a Kondordato composition is not as great as in financial restructurings under the Framework Agreements process. As the Konkordato composition is a court-led process, creditors' input is much less than in a financial restructuring process, which is ultimately a contractual matter as the law currently stands. In particular, during the Konkordato moratorium period, which can last up to 18 months from the time of application for the composition, i.e., until the point where the composition plan requires to be approved by creditors, the creditors' involvement is very limited including in relation to what the composition plan proposal provides for or recommend. In addition, unsecured receivables cease to accrue interest from the beginning of the initial Konkordato moratorium period until the composition plan is approved by the creditors. Therefore, a Konkordato composition may also result in a loss of interest income for unsecured creditors. This may cause an imbalance between the interests of unsecured creditors and the debtor.

Lastly, applying for a Kondordato composition usually results in reputational damage for the debtor because it is perceived in the market as being bankrupt or on the verge of bankruptcy. The financial restructuring process pursuant to the Restructuring Agreement process, however, is a confidential and out-of-court process and, hence, does not attract the same stigma.

Available Restructuring tools: Restructuring processes, if properly conceived, generally contain certain "tools" i.e. have features and tools which facilitate timely and effective restructuring. The tools for financial restructuring provided for under the Framework Agreements are, however, limited compared to other international restructuring regimes (such as Schemes of Arrangement in the UK and Chapter 11 in the US).

Under Schemes of Arrangement and Chapter 11, the restructuring of both secured and unsecured claims is possible whereas, in financial restructurings under the Framework Agreements, the principle is to protect existing securities and, therefore, security rights cannot be impaired without individual secured creditor consent.

Chapter 11 and Schemes of Arrangement seem to require higher thresholds for restructuring (i.e., 2/3 in amount and majority in number; 75% in amount and majority in number, respectively). However, both provide for the ability to "cram down," whereby the dissenting minority creditors can be forced to restructure, including by writing-down debt (on a *pari passu* basis with consenting creditors). The Large Scale FA, however, does not include a "cram down" feature but instead states that a write-down requires the unanimous consent of all creditor institutions. In addition to a write-down, an extension for an additional loan requires the consent of 90% by volume and two by number. On the other hand, write-down will not be possible under Small Scale FA and creditor institutions cannot be forced to extend additional loans but they may decide individually therefor. Furthermore, a debt-for-equity swap is used as a restructuring tool under Chapter 11 and Schemes of Arrangement. However, the Framework Agreements do not contemplate debt-for-equity swaps without shareholder consent. These features make it difficult to achieve a fruitful restructuring agreement between the debtor and creditors because, essentially, it requires all involved parties' interests to be aligned.

Action recommended: The Framework Agreements should be updated to provide additional restructuring tools (in particular, a "cram down"), as in other international restructuring regimes, to facilitate the process of reaching an agreement on restructuring.

Embezzlement risk: The crime of embezzlement is regulated under Article 160 of the Banking Law, which states that "[an officer's] damaging [of a] credit institution by any means whatsoever by using the credit institution's resources to their or others' benefit is deemed embezzlement."

The pre-existing Article 160/4 of the Banking Law states that making available additional loans, extending terms of existing loans, or making an instalment plan, receiving additional securities or using other tools for restructuring in accordance with the banking legislation and principles and procedures do not constitute "embezzlement." However, this general wording does not create enough security and, given the risk of criminal liability, bankers are reluctant to use financial restructuring tools, such as write-downs or debt-to-equity swaps.

The new Provisional Article clarified that the actions to be taken to restructure loans, including write-downs, made in accordance with the Provisional Article do not constitute an "embezzlement." However, this provision is limited to financial restructurings conducted under the umbrella of the Framework Agreements. This means that the embezzlement risk is no longer a major concern for those restructurings. On the other hand, the risk remains the same for the financial restructurings carried out by financial institutions that are not parties to the Framework Agreements, as well as for financial restructurings implemented through processes other than the Framework Agreements construct. Considering that there are many ongoing financial restructurings being pursued other than under the Framework Agreements, lawmakers must also take action to mitigate the embezzlement risk in relation to those other types of financial restructurings.

Action recommended: We recommend removing the reference to the Framework Agreements in the Provisional Article.

2) Considerations Regarding NPLs

Trading NPLs: Banks have a real need to sell their NPLs to repair their balance sheets and to increase their liquidity in light of the strict capital maintenance requirements in Turkey. This is particularly important for the Turkish economy as Burak Dalgın and Güven Sak also pointed out: "an inability to clean bank balance sheets and restore credit flows in a timely and competent manner would risk triggering a negative feedback loop (credit starvation, economic contraction, loss of corporate sector capacity to operate and service debt, impaired bank balance sheets, further credit starvation)"[4]

Nevertheless, as per banking laws and market practice, NPLs can only be sold to Turkish asset management companies while Group I loans (i.e., standard loans and other receivables) and Group II loans (loans under close monitoring) can be sold to other third parties as well. Asset management companies are established solely for the purposes of purchasing and trading NPLs. Therefore, in practice, sale of NPLs to a third party other than asset management companies is believed to be problematic from the perspective of the crime of embezzlement since such a sale will result in reduction of bank's assets in a way not expressly permitted under applicable law. Therefore, to clear their balance sheets of NPLs, only option for banks seems to sell them to asset management companies. For instance, following in the footsteps of Yapı ve Kredi Bankası A.Ş. and Türkiye Garanti Bankası A.Ş., Türkiye İş Bankası A.Ş. recently announced its sale of receivables amounting to TRY 1.1 billion to asset management companies for TRY 32.4 million.[5]

Asset management companies are licensed companies supervised by the BRSA, whose operations include acquiring bank loans, making collections, restructuring and reselling debts. Despite large scopes of operation, in practice, they are inclined to acquire loans and hold said loans until they collect receivables via enforcement procedures. They are not designed to trade loans and, thereby, create financing or restructuring opportunities for the debtors, or to restructure the loans themselves and, thereby, enable debtors to continue their operations. Therefore, the option to sell NPLs to asset management companies does not serve one of the main aims of financial restructuring, which is protecting and enhancing the viability of financially distressed but viable companies in a sustainable way.

Furthermore, while Turkish asset management companies have two decades of experience in purchasing, managing and collecting large consumer loan portfolios, they are not very much experienced in dealing with big-ticket large corporate loan portfolios, nor do they have the financial resources to buy these assets.

Considering that there is a high number of big-ticket corporate NPLs in Turkey and that this number is constantly increasing, it would be unfair to expect those Turkish asset management companies to carry the major NPL burden alone. Therefore, it is essential for the Turkish economy to attract international funds focused on NPLs to buy Turkish NPLs.

In addition to the foregoing, the BRSA has expressed that a Turkish entity cannot sell the receivables that a Turkish debtor owes it to a non-Turkish party. This is a major obstacle for Turkish banks selling their NPLs to non-resident investors.

Action recommended: The sale of NPLs to third parties other than Turkish asset management companies (including international distressed asset funds) must be permitted.

Disclosure of Information: Disclosure of information about loans and borrowers to purchasers is another issue in the sale of NPLs. As a general rule, the Banking Law prohibits banks from disclosing client-related information to third parties.[6]

However, Article 73 of the Banking Law permits the disclosure of client information as part of a valuation carried for the sale of bank assets, including loans. Furthermore, Article 190 of the Turkish Code of Obligations sets forth that the assignor must provide all documents substantiating the assigned receivables and other documents that would be necessary for the assignee to claim the assigned receivables.

While these two provisions provide a certain level of comfort to Turkish financial institutions in indirectly enabling them to provide client information to third parties, Turkish banks are hesitant to rely on the provisions when disclosing client information to potential buyers.

Action recommended: Article 73 of the Banking Law must be clarified to ensure that Turkish banks are able to disclose client information to third parties for NPL sales purposes (auctions and bilateral basis), even before entering into definitive sale and purchase agreements with them.

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[4] Dalgın Burak, Güven Sak. *Logbook of the Turkish Economy, Reensuring Flow of Credit to Return to Growth, The Case for a Turkish Troubled Assets Restructuring Program Second Log*. p. 17 April 2019.

[5] Available at: https://www.kap.org.tr/tr/Bildirim/788686

[6] The Banking Law sets forth that those who, by virtue of their positions or in the course of performance of their duties, have access to confidential information about banks or clients are not permitted to disclose such confidential information to any person or entity other than the authorities expressly authorized under the applicable laws.

Securitization of NPLs: Securitization can be summarized as the collection of illiquid assets, such as long-term receivables, into a pool and the transformation of the pool into a security, which is tradable and, therefore, more liquid than the underlying loan or receivable. Under the Capital Markets Board of Turkey's regulations, asset-backed securities and covered bonds can only be issued in respect of Group I loans (i.e., standard loans and other receivables: loans where the credit risk has not risen significantly), and not NPLs.

Action recommended: In order to help banks clear their balance sheet and increase liquidity, banks must be allowed to issue these securities in respect of their NPLs as well.

3) Other Considerations

Information Requirements: Under the Framework Agreements, the debtor is required to provide various documents and information in order to apply to enter into the Framework Agreements financial restructuring process, that information relating both to itself and its associates, including shareholders. While there are material disclosure obligations under similar international restructuring regimes, they do not require all such information to be provided at the outset. It seems that this requirement is a material deterrent for Turkish debtors (in particular, where a foreign entity, such as a shareholder, is involved in the process) who might otherwise wish to invoke the regime and the protection (and flexibility) that it affords.

While the Large Scale FA may solve this problem somewhat, by giving creditors the option to accept the application without all required documents being provided to them, this is a major issue for debtors because their application might be rejected if they are unable to provide all the required information. Additionally, occasional protection is required urgently and there may simply be insufficient time available to assemble the required information especially as it is also required for third parties whom the debtor may not be able to compel to make disclosure to it. In addition, the information requirement is still applicable under the Small Scale FA.

Action recommended: The Framework Agreements must be changed so as to require less information to be provided by a debtor wishing to enter into the process sand that the information requirements are replaced with disclosures by the debtors over the course of the process but subsequent to commencement.

Turkish Enforcement Laws: Creditors' ability to enforce rights, including security rights, is very important in terms of tidying up overstretched financial markets. Where it is desirable that outside parties relieve incumbent holders of distressed debt, potential purchasers will wish to know that the path to enforcement is as smooth and efficient as possible, that proper recourse is available against debtors and their assets and that enforcement procedures will allow realization of assets within a reasonable time period and achieve value.

As per Article 45 of the EBC, a creditor may initiate enforcement proceedings by way of either (i) an enforcement proceeding based on a judgment (*ilamlı icra*), or (ii) an ordinary enforcement proceeding (*ilamsız icra*). While the faster way would be initiating an ordinary enforcement proceeding rather than completing a litigation process to receive a judgment, that route may also be inefficient because the debtor is entitled to object to the payment order without having to justify the objection. If the debtor files an objection, the creditor must file either an "action for lifting the objection" or an "action for the cancellation of the objection" before the competent court to be able to continue the enforcement proceedings, which means that the enforcement process becomes lengthy and cumbersome if the debtor refuses to cooperate and even if it does so entirely without showing justification.

The enforcement process is also lengthy given the procedure and time period prescribed for the sale of goods. Sale by auction, for instance, must be announced one month prior to the sale. An asset cannot be sold in the first auction if a particular value (equal to the aggregate of (i) 50% of the estimated value of the asset and (ii) the amount of enforcement costs) is not obtained. Thereafter, the enforcement office must proceed with the second auction, which cannot be earlier than twenty days after the first auction. Although this

is mainly to ensure value is achieved for the asset, it makes the process lengthy and cumbersome.

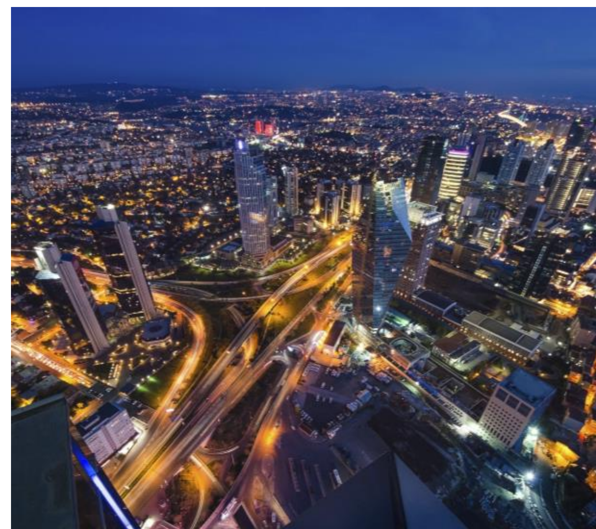
There are other methods which ensure both that value is obtained and which do not lengthen the process. There are examples under international regimes where independent valuations by properly qualified valuers of assets (which can be obtained without any undue delay) can serve to ensure that value is achieved, without holding up enforcement or realization.

The cleaner the enforcement processes, the greater the attraction local loans will have to international investors and the quicker they will enter the market to acquire them, and the quicker local banks' balance sheet issues will be resolved. This is particularly important for international funds that may not be familiar with the Turkish enforcement regime, which is quite debtor-friendly due to the lengthy and cumbersome enforcement process. Ironically, though, as much as that feature might favour debtors wishing to defer enforcement, it also acts as a major deterrent to international investors who would otherwise be willing to acquire exposures (at a discount to face value) and to restructure them to allow viable businesses to carry on in business with their balance sheet repaired, enhancing equity value, employee prospects and the general economy.

Action recommended: The Turkish enforcement regime should be revisited in its entirety to ensure that creditors are subject to an expedited enforcement process. In particular, the fact that debtors have an objection right at almost every stage of enforcement without any justification is a tool that can be used by debtors to make it difficult for creditors to recover their receivables and is a discouraging factor for foreign financial institutions lending to Turkish companies who would otherwise bring restructuring skills and liquidity to the market.

Dispute Resolution: The Regulation sets forth that the disputes arising from restructuring agreements will be settled by an arbitral tribunal established according to the Framework Agreements. The BAT determined the principles for the formation of the arbitral tribunal: the arbitral tribunal will not be composed of professional arbitrators who are legal experts and arbitrators will not receive monetary compensation for their duties. Further, there is no requirement for all of the arbitral tribunal to be composed of legal experts. This particular arbitral tribunal composition creates the possibility that disputes cannot be settled quickly and efficiently. An arbitral tribunal composed of finance law experts and that operates according to international arbitration standards is crucial to quickly and effectively settle disputes arising from such complex and multilateral legal relations as financial restructuring.

Action recommended: Authorizing the Istanbul Arbitration Centre, which is the domestic institutional arbitration institution of the Republic of Turkey, to hear financial restructuring disputes will allow them to be settled quickly and efficiently.



B) What needs to be done on the tax front?

1) Financial Restructuring Considerations

The Provisional Article provides various tax reliefs and exemptions in relation to financial restructuring transactions.

The Omnibus Law's general preamble states that the purposes of the amendments to the Banking Law are (i) resolving financial issues that have or may arise in the real sector due to the macroeconomic developments (ii) restoring solvency to debtors in financial trouble by facilitating the operation of reconciliation platforms that include financial restructuring programs; and (iii) establishing the legal infrastructure enabling debtors to comply with their obligations towards financial institutions.

With those broad purposes in mind, various tax exemptions were provided by the Provisional Article for financial restructuring transactions implemented under the Framework Agreements process.

- These financial restructuring transactions are exempt from fees under the Law on Fees No. 492 (including judiciary fees), and the documents to be issued in connection with the restructuring (including framework agreements and financial restructuring agreements) are exempt from stamp tax under the Stamp Tax Law No: 488 (the "**Stamp Tax Law**").
- Amounts collected by creditor institutions are exempt from the banking and insurance transaction tax under the Expenditures Taxes Law No. 6802.
- Loans granted and to be granted in connection with such restructurings are

exempt from the resource utilization support fund deduction[7].

However, the tax exemptions would only apply to transfers between the transferor and the original creditor (and transfers between creditors) such that, for example, if the assets and collateral in question were restructured by a party that acquired it who then proceeded to transfer, that would result in above tax implications, which would only make restructurings more challenging.

In addition:

- Asset for debt swaps:
  - Real estate and shares: The corporate income tax exemption provided under Article 5/1-f of the Corporate Income Tax Law No. 5520 (the "Corporate Income Tax Law") applies to debt/asset swaps made under the Framework Agreements umbrella, as well as to the income that credit institutions generate from the sale of these assets. Accordingly, if the debtors transfer real estate, shares, dividend right certificates and preferential rights to creditor institutions in a restructuring implemented under the Framework Agreements umbrella to be offset from their debts, the entire income corresponding to the portion used for closing the debt will be exempt from corporate income tax which the debtor would otherwise have to pay on the disposal. The creditor institutions are not required to initiate legal proceedings against debtors to benefit from this exemption. With regard to any onward disposal of those assets which might give rise to a tax liability in the hands of the credit institution, the income that credit institutions generate from the sale of these assets benefits from a 50% corporate income tax exemption for real estate transfers, and 75% corporate income tax exemption for other asset transfers.
  - VATable assets: The value added tax ("VAT") exemption provided under Article 17/4-r of the Value Added Tax Law No. 3065 (the "VAT Law") will apply to the transfer of otherwise VATable assets to creditor institutions effected under the umbrella of the Framework Agreements, as well as to the transfer of these assets by credit institutions who acquired these assets in this way. Accordingly, the transfer of real estates and participation shares by credit institutions and by debtors in the scope of financial restructuring will be exempt from VAT.
- Treatment of write-offs: Loans written-down due to the inability to collect will be treated as "bad debts" for the creditors and as "waived loans" for the debtors under the Tax Procedural Law No: 213 (the "Tax Procedural Law"). As a result, creditor institutions will be able to treat receivables waived in a Financial Restructuring umbrella restructuring as deductible expenses when determining their corporate income tax without requiring a court decision or a similar document. However, financial restructuring transactions with debtors in the banks' risk group defined under Article 49 of the Banking Law cannot benefit from this opportunity. They will be treated as taxable gains but with the tax deferred in that the gains can be recorded in special provision accounts in their books and offset against any losses arising within three years from the end of the year when the receivables were waived. Any amounts that cannot be depreciated against losses in that way are required to be transferred to the profit accounts and will be taxable as such.

However, if the debts of a debtor who has gone through financial restructuring become subject to financial restructuring again within two years, these tax exemptions will not apply. That said, these exemptions and incentives will be applicable without being subject to the two-year time limit and they will not need to be returned even if the restructuring is a failure.

There is no doubt that the aforementioned tax exemptions and incentives will have a positive impact on the financial restructuring of debts owed to creditor institutions by those who are in financial trouble. However, there are aspects of the new exemptions that create doubt as to whether they will serve their purpose. These more questionable features are as follows:

- The exemptions of fees, stamp taxes and banking and insurance transactions taxes in relation to financial restructuring transactions do not apply to the disposition of assets and collateral acquired by credit institutions, except as regards transfers between creditors and the transferor itself.

  Action recommended: Tax exemptions applicable only to the transfer of assets acquired within the scope of Framework Agreements umbrella between creditor institutions and/or to the transferor should apply to all transfers regardless of the process used to implement the restructuring. This would incentivize

[7] The resource utilization support fund is a type of charge levied on the loans Turkish companies/real persons obtain abroad. The rate and application of the resource utilization support fund change depends on the maturity, type and currency of the loan.

creditor institutions to be involved in financial restructuring.

- The corporate income tax exemption is 100% for income derived from the transfer of the debtor's assets to creditor institutions within the scope of financial restructuring (provided that the entire income is used for the debt collection), whereas the corporate income tax exemption is 50% for real estate and 75% for other assets in any onward disposal of those real estate and other assets by creditor institutions. In addition, since the corporate income tax exemption is applied within the scope of, the transfer of real estate, shares, dividend right certificates and preferential rights can only benefit from the corporate income tax exemption. Moreover, although it is contrary to the purpose of The Provisional Article incentivizing financial restructuring, it seems that (i) asset transfers by corporate parties other than debtors and guarantors cannot benefit from the corporate income tax exemption, and (ii) asset transfers by individuals under the financial restructuring framework cannot benefit from income tax exemption (save for the specific exemptions stated in the Income Tax Code), since The Provisional Article refers directly to the Article 5/1-f of the Corporate Income Tax Law which is applicable for only corporate debtors and guarantors.

  Action recommended: The corporate income tax exemption for corporations and the income tax exemption for individuals within the scope of financial restructuring should be regulated through a separate exemption (instead of referring to Article 5/1-f of the Corporate Income Tax Law) providing that (i) the corporate income tax exemption applies to all assets transferred within the scope of financial restructuring, (ii) the corporate income tax exemption applies to all corporations other than corporate debtors and guarantors, (iii) the income tax exemption applies to individuals transferring their assets to the creditors under the financial restructuring framework, and (iv) a full corporate income tax exemption also applies to assets acquired by creditor institutions through financial restructuring.

- As the Provisional Article refers to Article 17/4-r of the VAT Law regarding the VAT exemption provided for financial restructurings, the VAT exemption will only be applicable for the transfers of real estate and shares. Furthermore, although it is contrary to the purpose of The Provisional Article incentivizing financial restructuring, it seems that (i) asset transfers of by corporations other than corporate debtors and guarantors, and (ii) asset transfers by individuals under the Financial Restructuring Framework cannot benefit from VAT exemption, since The Provisional Article refers directly to the Article 17/4-r of the VAT Law which is applicable for only corporate debtors and guarantors.

  Action recommended: The VAT exemption within the scope of financial restructuring should be regulated through a separate exemption article (instead of referring to Article 17/4-r of the VAT Law) providing that (i) the VAT exemption applies to all assets transferred within the scope of financial restructuring, (ii) the VAT exemption applies to asset transfers of all parties including debtors, guarantors and third parties, and (iii) the VAT exemption applies to asset transfers of individuals to the creditors under the Financial Restructuring Framework.

- *Action recommended*: To incentivize financial restructuring transactions more broadly, we recommend the revised tax exemptions applied under the Framework Agreements umbrella be provided for all financial restructuring agreements (regardless of whether those agreements are signed under the Framework Agreements umbrella) without any restrictions such as any period, the parties of the financial restructuring agreements, type of assets transferred under the financial restructuring. Considering the current financial issues and macroeconomic developments in Turkey, we believe resolving financial troubles that debtors have is much more crucial than the taxes that the government will waive to collect as a result of above-mentioned exemptions.

2) NPL Considerations

In Turkey, there are certain tax exemptions which apply to transfers of NPLs to Turkish asset management companies:

- The delivery of assets and rights securing receivables transferred by banks, private financial institutions and other financial institutions to asset management companies for the collection of these receivables (including sale through auction) is exempt from VAT.
- Transactions carried out by asset management companies and documents issued relating to the operations of asset management companies (including their establishment), are exempt from (i) stamp tax; (ii) fees under the Law on Fees No. 492; (iii) banking and insurance transactions taxes under the Expenditures Taxes Law No. 6802; and (iv) resource utilization support fund deduction for a five-year period starting from the year following its foundation.

The abovementioned exemptions are only available for asset management companies established in Turkey that are licensed and supervised by the BRSA. This fact restricts banks' transfers of NPLs to buyers that are not resident asset management companies. In addition, the five-year time limit for the exemptions from stamp tax, fees, banking and insurance transactions tax and resource utilization support fund deduction has a negative impact on these transactions since these taxes will be applicable after the five-year period.

Action recommended: The exemptions available only to asset management companies established in Turkey must also be extended to all corporations that acquire banks' and financial institutions' NPLs. We also believe that the time limit on the stamp tax, fees, banking and insurance transactions tax and resource utilization support fund deduction should be removed.

As discussed above, according to views expressed by the BRSA, a Turkish entity cannot sell receivables owed to it by a Turkish debtor to a non-Turkish party. Even if this were possible, unless interest is paid to a "foreign credit institutions" (i.e. institutions which are authorized in their home jurisdictions to grant loans regularly and which grant loans not only to related persons but also to all individuals and legal entities.by the) the payment will be subject to corporate withholding tax under Article 30 of the Corporate Income Tax Law. This greatly reduces the appeal of Turkish NPLs to foreign purchasers. And only to add to that, Turkish legislation provides no clear definition of "foreign credit institution ".

On the other hand, banks' transfers of receivables abroad may be subject to resource utilization support fund deduction for the interest amount for TRY loans, and for the principal amount for FX loans, depending on the average maturity of the loan.

In addition, if the transferee of the receivable is not a bank or foreign credit institution, the interest paid by the debtor in Turkey to the creditor will be subject to 18% reverse-charge VAT (noting though that this VAT can be offset from the VAT calculated over the debtor's deliveries of goods and services).

According to the Turkish Stamp Tax Law, documents related to loans granted by banks, foreign credit institutions and international institutions, the collateral in relation to such loans and documents related to their repayment, and the transfer and assignment of receivables owed in respect of such loans, and annotations on such documents are exempt from stamp tax. Although this stamp tax exemption clearly covers banks, foreign credit institutions and international institutions, there are uncertainties in the practical application of this exemption, as the legislation is not clear on the definitions of "foreign credit institution abroad" and "international institution[8]". The inapplicability of the stamp tax exemption for institutions abroad that are not banks, credit institutions or international institutions would adversely impact the transfer of NPLs especially whilst the legislation is unclear as to what kinds of entity would be so classified.

Action recommended: In order to encourage the sale of NPLs: (i) the corporate income tax on interest payments must be removed not only for foreign credit institutions, but also for other third parties, including investors resident abroad; (ii) the sale of NPLs must be exempt from resource utilization support fund deduction; (iii) interest payments must be exempt from VAT; and (iv) any agreements effecting such dealings must be exempt from stamp tax. In addition, the definitions of "foreign credit institution" and "international institution" should be clarified to eliminate uncertainties on the application of corporate withholding tax and stamp tax.

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[8] The 9th Chamber of the Council of State's Decision dated October 15, 2018 No. 2014/400 K. 2018/6214 stated that there is no restriction or determination in relation to international institution loans in the law, but before the law was amended through Article 30 of the Law No. 5035, the law required the lender to be a credit institution to benefit from the stamp tax exemption. The amendment removed this requirement by adding "international institutions" to the article, and accordingly the scope of the exemption was broadened; within this scope, international holding institutions comprising group companies should also be considered international institutions for stamp tax exemption purposes.

According to the Provisional Article, loans written off due to the debtor's inability to pay and that are therefore considered bad debts within the scope of Article 322 of the Tax Procedural Law after setting a provision, can be treated as expenses and deducted from the corporate income tax base without requiring a court decision or similar document.

Although this amendment must promote write-offs of NPLs by banks, the impact may be less than hoped for since the relaxation is unavailable to asset management companies.

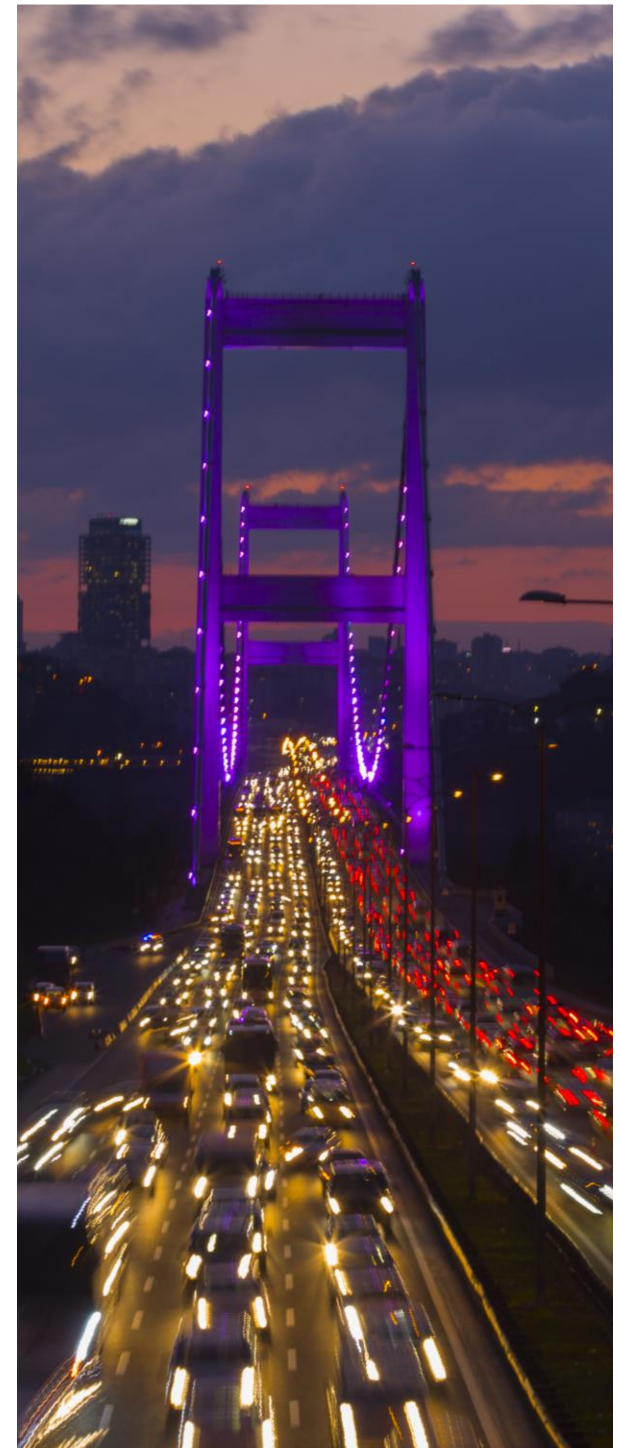
Action recommended: The receivables that asset management companies write off due to the debtor's inability to pay, after setting aside a provision, must be considered bad debts within the scope of Article 322 of the Tax Procedural Law to facilitate write-offs of NPLs by asset management companies.

C) Conclusion

Following Turkey's currency crisis in the beginning of 2018, companies have faced extensive liquidity problems because of the limited further credit available from Turkish financial institutions which only worsens their solvency position. Since then, a number of legislative steps have been taken in order to promote financial restructuring and, thereby, provide relief to the debtors, and also deleverage bank balance sheets to ensure that banks maintain their ability to disburse loans. While these steps must be regarded as moves in the right direction, there are still significant issues that need to be addressed by the relevant authorities to make the financial restructuring process more efficient.

It is of prime importance that financial restructurings have universal effect vis-a-vis creditors and debtors and creditors are armed with real restructuring tools such as cram down and debt-to-equity swaps, similar to other international restructuring processes. The new tax exemptions for financial restructurings are a very good start but need to be expanded to incentivize creditor institutions to implement financial restructurings as regards their debtors, and to incentivize foreign investors to enter the Turkish NPL market.

Further, given the latest BRSA press release revealing that existing loans on bank balance sheets amounting to TRY 46 billion must be classified as NPLs, the most important issue is to ensure that the banks will be able to withstand the regulatory capital pressure that will result from the increasing proportion of NPLs in their balance sheets. To relieve that burden, regulatory and tax reforms aimed at establishing a solid market for corporate NPLS and attracting international funds to acquire NPLs from Turkish banks would be very useful.



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