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Sector Review:

ASEAN Banks Can Withstand Asset-Quality Pain In 2016

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Sector Review:

ASEAN Banks Can Withstand Asset-Quality Pain In 2016

Banks in ASEAN (Association of Southeast Asian Nations) countries have had a bumpy ride so far in 2016. Asset quality has been deteriorating and loan growth has been reducing, largely due to a slowing regional economy and a decline in commodity prices.

However, S&P Global Ratings expects most banking systems in the region to remain resilient to external macroeconomic headwinds. Their fair-to-satisfactory profitability and generally sound capitalization should mitigate an erosion in asset quality.

The majority of the ASEAN banks we rate have stable outlooks, reflecting our expectations that these banks have built sufficient buffers over the years to absorb the difficulties. Many of these banks are systemically important and enjoy a high likelihood of government support.

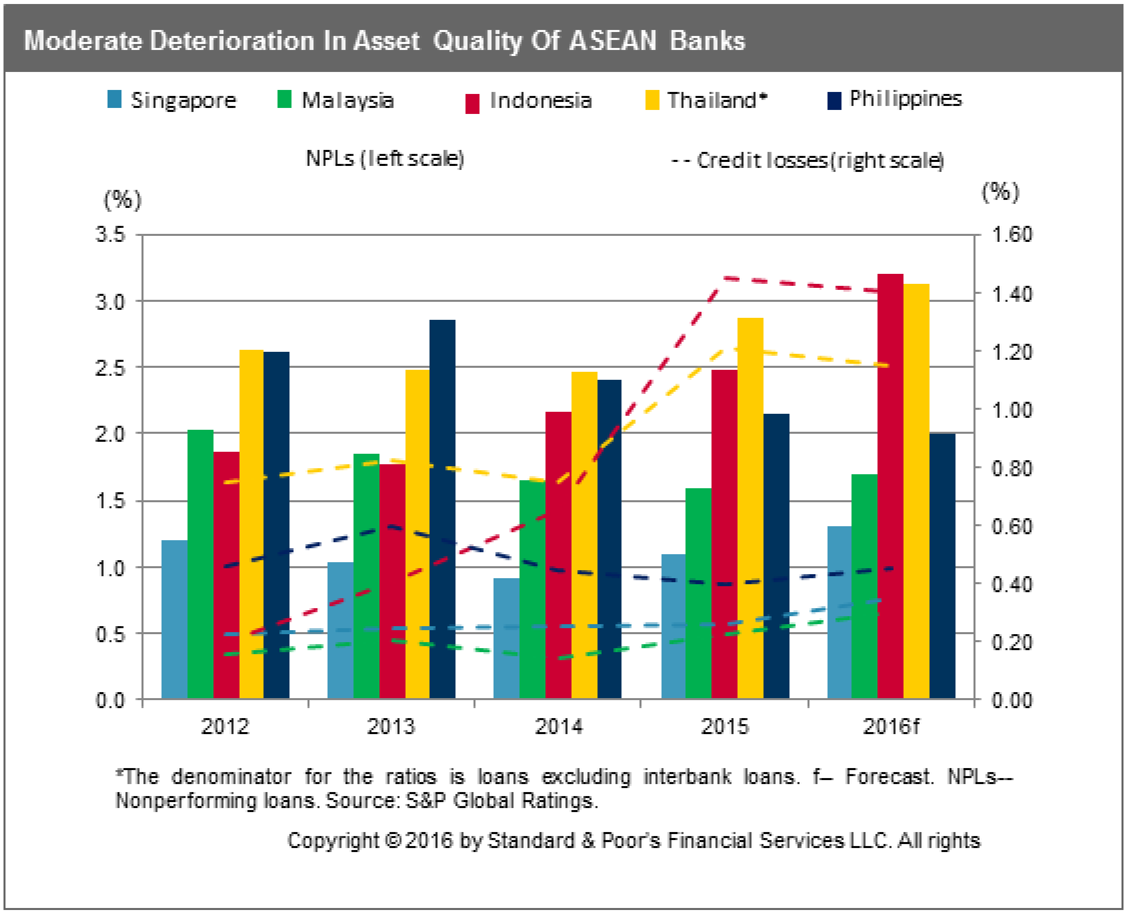
Overview

- Loan growth is likely to reduce for most ASEAN banks due to a slowdown in the regional economies.
- The asset quality of these banks could also deteriorate. Our base case, however, assumes a gradual deterioration, rather than a sharp spike in delinquencies.
- We expect most banks in ASEAN to maintain their credit profiles in 2016 because of their sound capitalization, healthy liquidity profile, and a high likelihood of government support.

Asset Quality Is Likely To Weaken

In our opinion, 2015 was the turning point in the credit cycle for most ASEAN banking systems, and nonperforming loans (NPLs) will continue to rise in 2016. Our base case, however, assumes a gradual deterioration, rather than a sharp spike in delinquencies (see chart 1).

Chart 1



We believe the asset quality of banks in Singapore will be vulnerable to further deterioration in external conditions. The quality of overseas loans, particularly to emerging markets such as Indonesia and India, has continued to weaken. More recently, the domestic portfolio of Singapore banks has mildly deteriorated. These banks have meaningful exposure to oil and gas companies, which, along with commodities finance, account for some 10% of total bank loans. But banks generally have good buffers and proactive risk management to tackle asset-quality challenges from a position of strength. In addition, reported NPLs are coming from a low base, at just 1.1%, with 126% provision coverage.

Malaysia is struggling to cope with low commodity prices, high household debt, and political uncertainties. On the domestic front, compressed commodity prices will soften business sentiment, while consumer spending is crimped by high debt levels and the roll-out of 6% goods and services tax in 2015. The substantial correction in energy prices has also cast a shadow on the near-term growth prospects of Malaysia, one of the few net exporters of oil in Asia. Nevertheless, we believe Malaysian banks will emerge relatively unscathed from the energy market rout. The industry has a small direct exposure to the energy sector. According to Bank Negara Malaysia's industry classification, the mining, electricity, gas, and water segments accounted for only 1.5% of total loans as at March 2016. Furthermore, Malaysia's energy sector is dominated by Petroliam Nasional Bhd., a 100% government-owned entity, which we currently view as having a strong business and financial position. We forecast a gradual increase in NPLs for Malaysian banks to 2.0%-2.5% over the next two years, from about 1.6% as of December 2015. This deterioration will likely be manageable, considering that NPLs are coming from a low base, plus loan loss reserves are strong at 97% of impaired loans as of December 2015.

In Thailand, we project the banking sector's NPLs to keep rising in 2016, given high household leverage and economic weakness. The absence of a stable elected government in Thailand hampers any strong economic revival, with policy decisions vital to economic and social development on hold. The small and midsize enterprise loan segment will continue to bear the brunt of the decline in asset quality. NPLs in this segment increased to 3.5% as of Dec. 31, 2015, from 3.1% at the beginning of the year, pushing up overall NPLs. We anticipate that exports, commodity-related, and certain agriculture-related segments will continue to feel the pinch over the next 12 months. The consumer loans segment will not remain unscathed either. This segment also feels the pinch of a slowing domestic economy at a time when household indebtedness remains high. Low income levels are an added constraint.

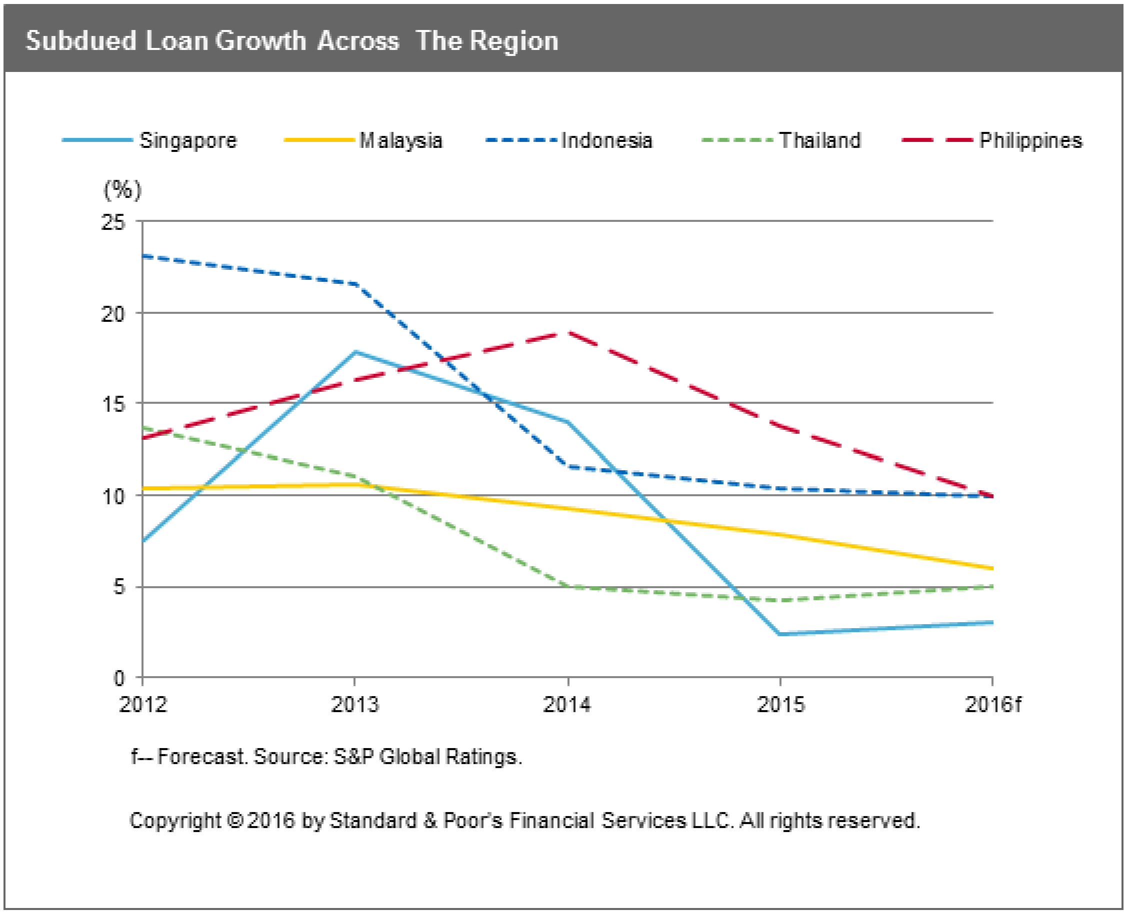
Indonesia's banking sector will continue to face difficult operating conditions in 2016, marked by slower growth and higher credit stress. We expect the Indonesian banks' reported NPLs to increase to 3%-4% of total system loans in 2016, from 2.9% in February 2016. Indonesia's economic slowdown has pushed up the banking system's NPLs from its historical lows of 1.8% in 2013. Special mention loans, an indicator of potential credit stress in the banking system, stood at 6.3%. Fueling this rise in NPLs are commodity-linked sectors, hit by low prices. Indonesian banks' increased exposure to the micro, small, and medium enterprises segment could also push up NPLs. These sectors are more vulnerable to high interest rates and slow economic growth, and the performance of banks in this segment is untested.

Philippine banks' pursuit of consumer loans could result in higher credit costs, given the inherently higher risk in this segment in a growing economy. The ratio of nonperforming consumer loans to total consumer loans has consistently been double that of total NPLs to total loans, although both the ratios have been improving. The country lacks a comprehensive credit bureau, has a weak payment culture, low income levels, and heightening consumer asset-quality risks. Still, contrary to regional peers, systemwide NPLs have actually marginally declined to 2.2% as of December 2015, from 2.4% a year ago, in contrast to NPL trends in Thailand or Indonesia. The establishment of the government-led Credit Information Corp. (CIC) and completion of substantial data collection by early 2017 will likely improve transparency and availability of credit in the consumer loans segment.

Loan And Earnings Growth Should Be Subdued

We expect loan growth to reduce in most ASEAN economies due to a slowdown in the regional economies (see chart 2).

Chart 2

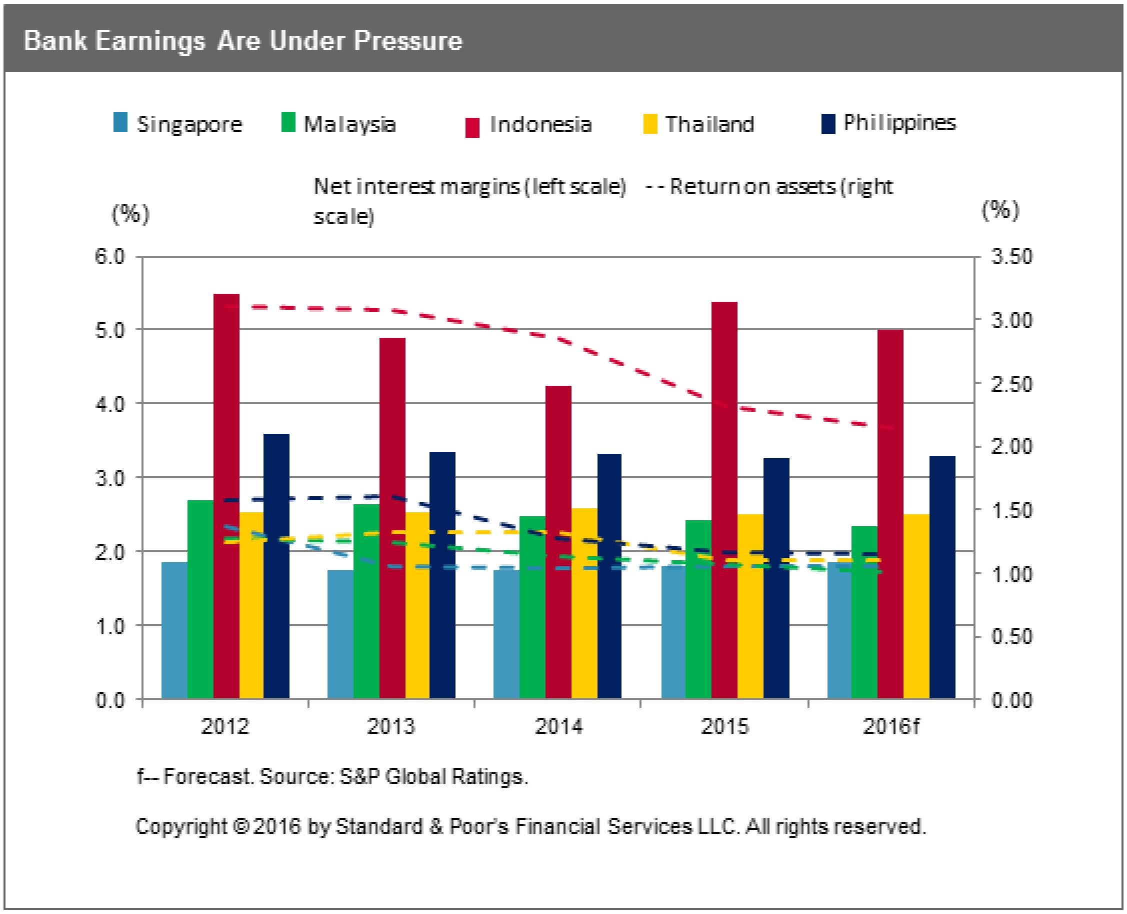


Subdued Loan Growth Across The Region

f-- Forecast. Source: S&P Global Ratings.

We forecast loan growth of 3%-5% for Singapore banks in 2016. For all the three banks that we rate in the country, loan growth was a modest 3.7% in 2015, after adjusting for currency effects, and low single-digit growth will likely persist into 2016. Macro prudential measures to cool the domestic property market have also proven effective, with a corresponding decline in mortgage volumes. This has important revenue implications since interest income from loans accounts for some 60% of revenue in the banking system. Furthermore, if loan growth slows down, non-interest income from loan-related services would also weaken. Muted loan growth could result in pedestrian earnings growth, partially offset by expansion of net interest margins (see chart 3).

Chart 3



Loan growth in the Malaysian banking sector could moderate to 6%-8% in 2016 (five-year average is 10%) amid unfolding external uncertainties about the pace of U.S. Fed rate normalization and the economic rebalancing in China. On the domestic front, compressed commodity prices will soften business sentiment, while consumer spending is crimped by high debt levels and the roll-out of 6% goods and services tax in 2015. We expect net interest margins of Malaysian banks to continue their downward trajectory of 5-10 basis points compression per year owing to continuing strong competition.

In Thailand, we expect the banking industry's loan growth to be a flat 5% in 2016, similar to the 4.4% growth in 2015. Most of the demand will be from tourism-related sectors and government infrastructure initiatives, which is why public spending is essential for growth. Deteriorating asset quality and weaker demand could squeeze Thai banks' earnings this year. We expect the return on assets (ROA) for the banking sector to remain at 1.1% in 2016, with a slightly negative bias.

Credit growth for Indonesian banks will likely remain at 10%-15% in 2016, with a bias toward the lower end of the range if large infrastructure projects continue to be delayed. Our estimate compares with the 10% growth in 2015, and more than 20% for several years before that. Banks' margins would remain under pressure in 2016 due to accommodative monetary policy. The central bank has cut interest rates twice--by 25 basis points each time--to

6.75%. However, Indonesia's banking sector will remain one of the most profitable banking systems globally in 2016, because, even though profitability is declining, it is coming down from a high base. We expect the Indonesian banking industry's return on assets to be 2% for 2016, a very good number by global standards.

We expect loan growth in the Philippines to be 8%-12% per year in 2016. While that number is high compared with regional standards, it is a sharp adjustment from the 19% growth in 2014. In that year, the government introduced measures such as a cap on the value of real estate collateral to cool the property sector, particularly in commercial real estate. Loan growth fell to 13.7% in 2015, compared with a peak of 21.1% in October 2014. Loan growth, particularly to the corporate sector, will likely keep moderating as well unless public infrastructure and development projects kick in under the government's public-private partnership scheme. We expect net interest margins of Philippine banks to strengthen as the proportion of higher-yielding consumer loans rises. However, the increase is from a low base, and the impact on margins will likely be gradual.

Financial Profiles Remain Resilient Despite Headwinds

We stand by our stable outlook on regional banking systems. We expect most banks in ASEAN to maintain their credit profiles in 2016.

Loan-loss reserves of Singapore banks are solid, at more than 100% of problem loans, and provide some cushion against asset-quality pressure. We also continue to factor in a high likelihood of extraordinary government support for Singapore banks.

In Thailand, rated banks entered the economic slowdown with good capitalization, substantial reserves, and a low NPL base, all of which resulted in healthy balance sheets. Banks' resilient capital and strong reserves should enable them to absorb the deterioration in asset quality.

The adequate capitalization of Philippine banks and their sound funding profiles remain a strength that will allow them to deal with rising credit costs. Since 2013, these banks have been actively raising external capital, which more than covers the gap between internal capital generation and growth in risk-weighted assets. Philippine banks also maintain a sizable amount of liquid assets, most of which are in the form of cash and domestic government bonds. Liquidity levels remained stable throughout the global financial crisis in 2008-2009, demonstrating the Philippine banking system's considerable resilience to external shocks.

Our ratings on Indonesia's banks have already factored in the downside risks emanating from choppy operating conditions. These banks also have a comfortable capital cushion against asset quality risks as reflected in a Tier I ratio of about 19.4% and capital adequacy ratio of about 21.9% as of February 2016. In our opinion, the large Indonesian banks we rate will weather the adverse conditions better than their smaller counterparts because of their stronger financial performance, more established deposit franchises, and better risk management.

Malaysian banks' adequate capitalization and liquidity provide a sound footing for them to withstand downside pressure. The Tier 1, total capital, and liquidity coverage ratios of these banks are comfortably above the regulatory minimum. Key downside risks to our base-case scenario are a continued fall in oil prices and a buildup of household debt.

Only a rating committee may determine a rating action and this report does not constitute a rating action.