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Asian financials: Bracing for challenges

Financials

While Asian banks are in a stronger position now compared to the 2008 Global Financial Crisis (GFC) period, the longer it takes for economic recovery post Covid-19, the greater the likelihood of consolidation within the sector. Areas of concern include asset quality, profitability and the pace of digitalisation. Operational and financial resilience will be the keys to success.

Covid-19 has impacted many businesses and economies adversely. While economic activity is slowly recovering, a number of sectors continue to feel the pain. The financial sector, for one, has been closely monitored on growing fears that the economic stress will trigger a financial crisis. Cognizant of the risk of dollar funding markets coming under stress, many central banks promptly coordinated with the US Federal Reserve to provide more global US dollar liquidity.

Against the current backdrop, there is heightened focus on the ability of banking systems worldwide to withstand prolonged periods of stress. National authorities have stepped in with measures such as debt repayment postponement, relaxation in nonperforming asset (NPA) criteria, and credit guarantees to support financial institutions and maintain adequate liquidity in the financial system.

However, these measures provide temporary short-term relief. Banks are still required to monitor their asset quality using the usual regulatory standards and build adequate capital buffers over time. This is to ensure that any warning indicators of a financial crisis that eventually leads to a systemic risk can be picked up and addressed promptly.

A TEST OF ASIAN BANKS' VULNERABILITY

The banking sector, globally, has undergone significant structural changes since the 2008 GFC. In general, most Asian banks have built up capital and liquidity buffers and reduced leverage. As a result, prior to the current crisis, Standard & Poor's had a stable outlook on 19 of the 20 Asia-Pacific banking systems. Tier 1 capital ratios were in excess of 11% across the region. See Fig 1. Under the Basel III international banking regulations, banks must maintain a minimum Tier 1 ratio of 10.5% of its risk-weighted assets and a total risk-based capital adequacy ratio of at least 12.5%. Meanwhile, NPAs have also been on the decline for strong banks globally with Asia Pacific banks standing out for the low numbers. See Fig 2.

This view is also echoed by Eastspring's local investment teams across the region. **Eastspring's Shanghai-based research team** expects slight pressure on Chinese banks' asset quality with non-performing loans (NPLs), especially in the consumer segment increasing, as the shutdown in the economy has pushed up the unemployment ratio and weighed on household income. However, as work has resumed, financial institutions should be able to see defaults/ overdues gradually decline.

In any case, the risk can be largely covered by the sufficient capital buffers in the system. The People's Bank of China has injected adequate liquidity and lowered interest rate to support the economy. More importantly, the government has been containing financial leverage over the past few years to mitigate systemic risks.

According to **Eastspring Indonesia**, the country's banking industry is well capitalised, and the regulator has performed Covid-19 related stress tests. In general, capital buffers for systemically important banks (SIBs) are adequate and able to withstand industry-wide NPLs above 7%. Further, the largest Indonesian banks have not cut dividends and the regulator has not issued any advisory for dividends to be cut. This is due to the strong capital positions for the SIBs. Nonetheless there are a number of small and high-risk banks, with already weak capital ratios and high NPLs that may fall significantly below the minimum capital requirements and be forced to restructure or recapitalise.

Meanwhile **Lilian See, Eastspring Malaysia's Head of Research** says that Malaysian banks will see a gradual pace in build-up of NPAs due to Bank Negara's measures that allow banks to provide a 6-month loan moratorium which is automatic for individuals and small and medium enterprises. Larger corporates can also apply to the banks to restructure or reschedule their loans. For now, capital and dividends remain intact based on stress tests.

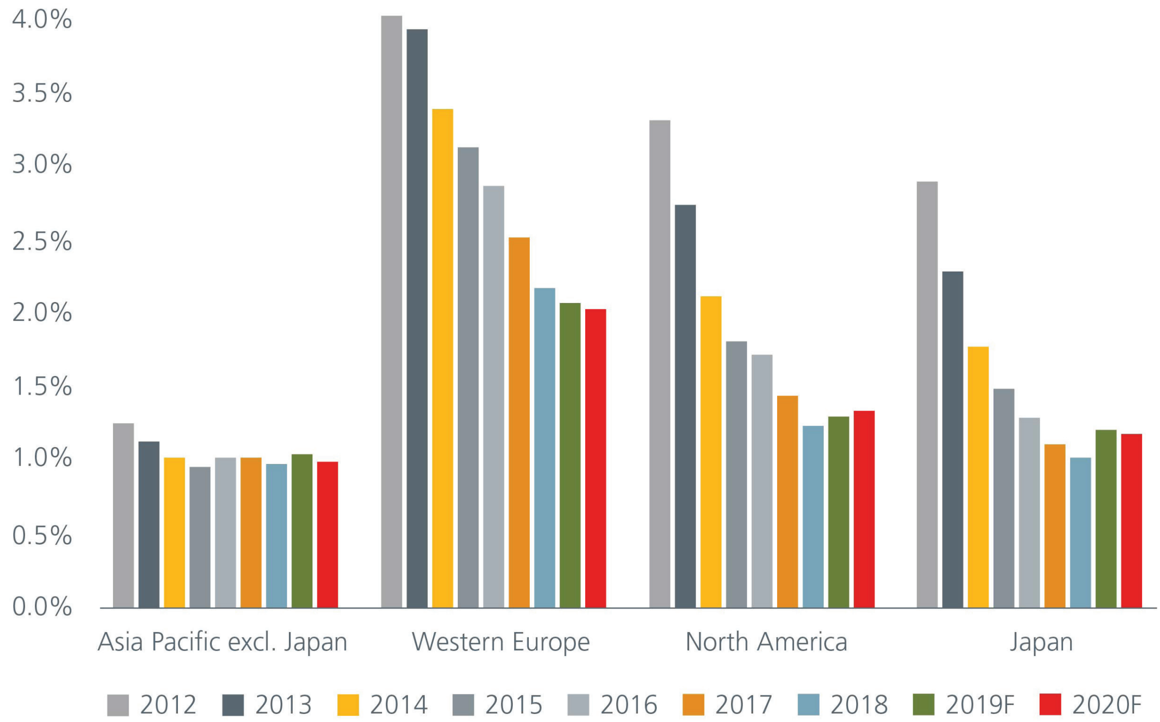
Notwithstanding the above assessments, rating agencies have warned that a prolonged downturn will affect corporates' creditworthiness; rising defaults will cause a spike in the banking sector's NPAs, prompt rating downgrades and trigger another round of tightening financial conditions. Standard and Poor's have reiterated the resilience of banks' asset quality in 2020 hinges on the success of governments' and regulators' policy responses

Fig 1: Capital ratios have risen since 2007

	Tier 1 Capital Ratio				Capital Adequacy Ratio			
	2007	2013	2020	2020 vs 2013	2011	2013	2020	2020 vs 2013
CN	10.3	10.0	13.3	3.3	12.6	12.5	16.3	3.8
HK	10.0	12.2	17.7	5.5	12.2	15.8	22.0	6.2
IN	11.1	12.7	14.4	1.7	14.6	16.1	15.7	(0.5)
ID	15.9	14.8	22.2	7.4	18.3	15.7	23.2	7.4
KR	8.5	11.5	13.5	1.9	12.2	14.0	14.6	0.5
MY	10.3	11.8	14.6	2.8	14.0	14.7	17.1	2.4
PH	11.0	14.0	14.3	0.3	14.5	15.2	15.0	(0.2)
SG	10.0	13.8	15.4	1.5	13.4	16.4	17.0	0.6
TW	9.1	9.5	12.0	2.5	10.5	12.2	13.8	1.7
TH	11.1	11.7	22.3	10.6	14.0	15.4	26.3	10.9
AU	8.9	13.7	15.0	1.3	13.4	16.3	16.7	0.4
JP*	7.1	11.8	15.0	3.2	12.1	15.4	18.2	2.8

Source: Citi Research; Note: *latest data is 2019 for Japan.

Fig 2: Non performing assets show a declining trend



Note: Graph shows average ratio nonperforming assets to gross loans by region for banks within the S&P Global Top 200 Banks that have a stand-alone credit profile assessment in the 'a' category. Source: S&P Global Ratings.

while Moody's believes that Asian governments will likely stand behind the larger, systemically important banks to avert a financial contagion.

PROFITABILITY WOES TO LINGER

The spectre of rising credit defaults is not the only challenge facing banks. The low interest rate backdrop since the GFC has continued to squeeze banks' net interest rate margins. Faced with an even deeper crisis this time, central banks have become ultra-accommodative. With interest rates forecast to stay lower-for-longer, bank profits will be further pressured in the coming years.

Thai banks are at risk of lower operating earnings, i.e. lower loan volumes, lower net interest margins and non-interest income according to **Dr Somjin Sornpaisarn, TMBAM-Eastspring's CEO**. Still, Thai banks, are considered healthier now than during the 1997 Asian financial crisis (AFC). For example, current NPL coverage ratio is higher than 1.4 times, whilst loan-to-deposit ratio was 92.6% at the end of 2019, a much lower level than the 134.8% during AFC.

In addition, the Bank of Thailand has implemented mitigating measures for financial institutions by reducing their Financial Institutions Development Fund's rate of contribution, i.e. fees used to aid troubled financial institutions in times of financial stress, from 0.46% of deposit base to 0.23%. This helps to reduce the operating costs of Thai financial institutions so they can in turn reduce the loan rates for businesses and households. Likewise, the Reserve Bank of India has also put in place measures to support the Indian banking system. Indian banks face challenging times. Economic slowdown has resulted in deteriorating asset quality and low profits even before the Covid-19 crisis struck. The pandemic will add further stress; many expect a sharp drop in transactions and disbursements owing to concerns over rising NPLs.

Declines in profitability can hamper banks' ability to provide loans, thus depriving the economy of much needed credit. Smaller, regional banks that are more focused on domestic loans and deposits, banks with deposit costs that are near zero and cannot lower them further and banks with adjustable-rate business loans will be the hardest hit. The sector will likely see consolidation.

TECHNOLOGY UNDERPINS OPERATIONAL RESILIENCE

Throughout this pandemic, one important feature that has stood out is the operational resilience shown by banks and other financial services providers. Faced with lockdowns, many banks had to ensure staff could work seamlessly from home and continue serving their customers. On the other side, even reluctant customers were forced to embrace digital banking overnight.

Financial institutions that have partnered with technology companies to implement remote customer onboarding, anti-money laundering and fraud detection systems have a competitive advantage. Equally, in this data-driven age, banks that invest heavily in cybersecurity and implement features such as multi-factor authentication, secure applications and biometrics will be winners. Thai financial institutions, for example, use Artificial Intelligence to evaluate customers' credit; those with consistently good payment history can enjoy lower interest loans.

In line with its smart nation initiative, Singapore banks have been investing heavily in their own digital transformation strategies in order to improve customer experience on the front-end and minimise pain points, whilst also updating and transforming their back-end infrastructure in order to be as nimble as possible. Ultimately, financial institutions that undergo a digital transformation are building the blocks for a much higher degree of not only operational but also financial resilience.

THE FUTURE POINTS TO OPEN BANKING

According to a Fintech and Digital Banking report[1], Asia Pacific is expected to see 100 new financial institutions by 2025, a result of market liberalisation and the issuance of new banking licences. Open banking is expected to provide more digital competition and innovation within the sector, and the Monetary Authority of Singapore was one of the first regulators, back in 2016, to put in place guidelines on using application programming interfaces to enable banks to share relevant datasets with FinTechs and non-bank firms. The latest development to Singapore's financial sector digitalisation is the upcoming award of digital banking licences which is expected in 2H2020.

According to **Eastspring Singapore's equity team**, a key advantage that incoming banks will have in Singapore is their already established base of cheap deposits (which can be very sticky) and experience in credit assessment. Incoming digital banks can leverage off their current brands/apps to acquire customers, but it is likely to be more challenging to convert customers into using their new digital bank as their main account rather than a secondary account where less deposits are held. On credit assessment, non-banks will bring alternative data which could give them an edge when it comes to understanding certain niche segments better (e.g. Grab on ride hailing/food delivery).

It helps that people's trust coefficient towards non-bank players continues to improve; McKinsey's Future of Banking Consumer Survey[2] found that most respondents trust BigTech companies to handle their financial needs. The region's digital outlook is optimistic; currently, only 30 percent of Asia Pacific's banking customers actively use digital banking channels. Further, the offerings from non-bank competitors can also extend to the unbanked and underbanked segments, thereby closing the financial inclusion gap and (hopefully) the income inequality gap.

This is the fifth of six articles in our Asian Expert Series which explores the future of Asia post-covid.

Source: [1]Backbase, a company that offers digital banking platform, and the International Data Corp. (IDC). [2]July 2019.

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