What Investors Want to Know: Coronavirus Impact on APAC Bank Ratings

Forward-Looking Approach, Ratings Most Vulnerable Where Buffers are Lowest

Sharp Slowdowns, Moderate Recoveries

Fitch Ratings assigns ratings on a forward-looking basis, factoring in forecast macro indicators and bank-specific credit metrics wherever possible. We factor the latest available data into rating decisions, such as Fitch's *Global Economic Outlook* and *Sovereign Data Comparator*. Moreover, we consider baseline and downside scenarios to assess rating tolerance levels and outlook revisions.

We expect a sharp global slowdown, with most major economies – and all in Asia-Pacific – to shrink or slow to multi-year lows before a moderate recovery. However, the recovery in 2021 will see the seven-year average for most economies lagging that to 2019; and in some cases, not recouping the contraction likely in 2020. We will factor any stronger recovery prospects into our ratings.

Impact Greatest Where Buffers are Lowest

Banks with the lowest loss-absorption buffers or headroom at any given rating level face greater risk of negative action, particularly if our forecasts shift closer to downside scenarios. We also consider remediation plans, financial profile deterioration in prior stressed situations and vulnerability to stress, including where we view risk appetite to have increased relative to risk buffers in recent years.

Support Limits Magnitude of Impact on IDRs

Around half of bank Issuer Default Ratings (IDR) in Asia-Pacific are driven by expectations of external support – mainly state support. Among emerging markets, external support underpins two-thirds of bank IDRs. Consequently, downgrades of Viability Ratings (VR) may not necessarily drive downgrades of IDRs. Nonetheless, bank ratings action could mirror action on the supporting entity's rating.

What are Fitch's baseline forecasts?

Is the operating environment affected by COVID-19, and how does it relate to ratings?

Does Fitch rate through-the-cycle; and if so, why not rate through this period of stress?

Where does Fitch expect most downgrades to occur?

Is Fitch taking a different approach to bank ratings in APAC versus other regions?

Will Fitch combine actions on ratings under criteria observation with COVID-19 impact?

Related Research

APAC Banking Outlooks Negative as Coronavirus Heightens Risks (March 2020)

Global Economic Outlook: Crisis Update Late April 2020 (April 2020)

Fitch Ratings Coronavirus Scenarios: Baseline and Downside Cases (April 2020)

Coronavirus DM Bank Buffer Breaches May Not Trigger Downgrade (April 2020)

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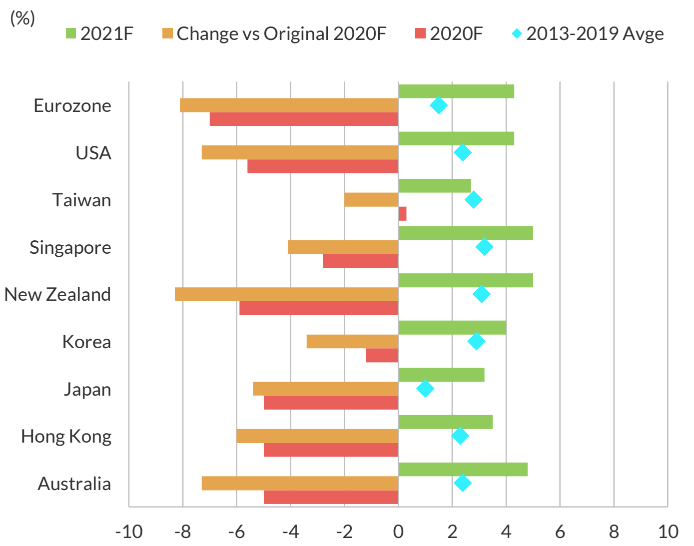
What are Fitch's Baseline Forecasts?

Fitch's macro forecasts for APAC consider stimulus and other measures announced by policymakers. They will be updated by our Economics and Sovereign groups as further data comes to hand. This is also the case for our forecasts on key bank financial metrics.

APAC Developed Market Banking Systems

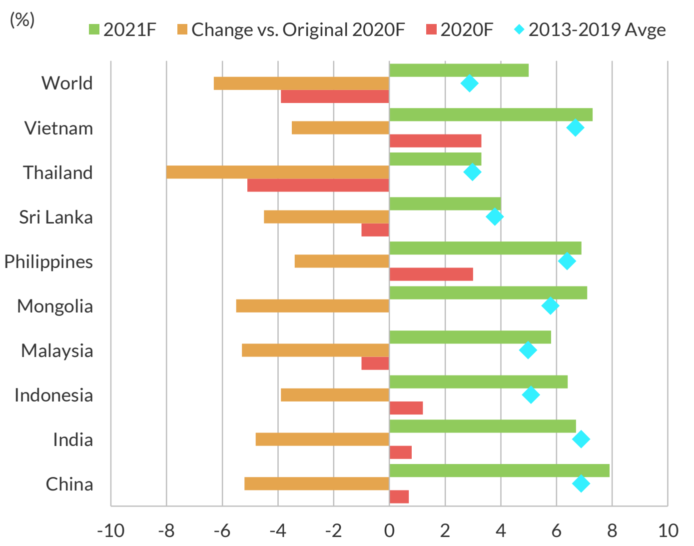
Fitch GDP growth forecasts



Source: Fitch Ratings Global Economic Outlook, Sovereign Data Comparator

APAC Emerging Market Banking Systems

Fitch GDP growth forecasts



Source: Fitch Ratings Global Economic Outlook, Sovereign Data Comparator

Is the Operating Environment Affected by COVID-19, and How Does it Relate to Ratings?

Fitch expects operating environments for APAC banks to be affected to varying degrees – in some cases significantly – over the next two years by COVID-19 through weaker domestic and global economies, lower growth prospects, and asset-quality deterioration.

Prospects are also rising that banking environments will be affected for longer, exacerbated by sustained low interest rates. This is in spite of huge – if not unprecedented – support measures outlined by policymakers which can benefit banks either directly or indirectly. Combined, we expect risks to manifest through greater sensitivity of banks to stress due to lower loss-absorption buffers (eg thinner profitability, weaker capitalisation, higher net impaired loans, and lower collateral values).

For banking systems where the operating environment implied scores (per Fitch's criteria) are lower than an assigned score, we are more likely to lower the mid-point or revise the outlook to negative to reflect systems' weaker resilience to offset any enduring impact of COVID-19.

The impact of lower operating environment scores on bank ratings is twofold: (1) constrained VRs face negative action, with implications for IDRs and instrument ratings driven by or anchored from a VR; and (2) where the new score leads to higher thresholds for bank financial metrics at given VR levels.

Does Fitch Rate Through-the-Cycle; and if so, Why not Rate Through this Period of Stress?

Fitch takes a 'through-the-cycle' rating approach. We assess rating tolerance levels by comparing base-case expectations for banks' financial profiles against stress cases at given scores for operating environments. We also assess whether changes in financial profiles and operating environment scores will be temporary or sustained. The through-the-cycle approach is best evident from our annual sector outlooks for bank performance. The outlook is negative for all 17 systems in APAC, but this is up from seven in January 2020 before COVID-19 had a meaningful negative effect.

In prior years, negative sector outlooks were not highly correlated with negative rating action, as we generally expected moderate or temporary deterioration only in financial profiles in any relevant year – with some exceptions (eg India).

However, we view COVID-19 as more of a shock than a normal cycle, with the potential for longer-lasting effects on bank financial profiles or banking systems' operating environments. We see more banks hitting downside rating triggers, with stressed financial metrics or weaker operating environments being sustained for several years, and not returning within tolerance levels in the next two years (our outlook period). As such, more banks will be downgraded if they hit (or we expect them to hit) rating downside sensitivities – eg structurally lower profitability or weaker capital, particularly in the event of asset-quality deterioration exceeding tolerance levels.

The deeper the shock and the shallower the recovery, the longer it will take for banks' credit profiles to be commensurate with higher rating levels. On the other hand, if we assess any deterioration as likely to be moderate or expect the banks to recover within the next two years, then any ratings action could be limited to negative outlooks. This may be due to the extent or nature of any measures taken by policymakers, and how they benefit banks over the longer term.

Where Does Fitch Expect Most Downgrades to Occur?

IDR downgrades will be more common in three situations where we assess deterioration as unlikely to be sufficiently remediated to mitigate risks in the next two to three years: (1) where our outlook on a bank's rating is already negative; (2) banks whose IDR is underpinned by their VR and constrained by the operating environment score; and (3) where a lower operating environment score implies a bank should have stronger key financial metrics than Fitch expects to be the case.

The risk of negative rating action is likely to increase for banks with thinner buffers or headroom to absorb any meaningful deterioration in key financial metrics at given rating levels, greater exposure to those economies facing the largest shocks – including emerging markets – or where there is significant direct or indirect exposure to the most vulnerable sectors.

Fitch will assess bank remediation plans to return to pre-COVID-19 financial positions, and whether that would be likely within the next two years or longer. Longer timeframes increase the potential for downgrades, which can occur irrespective of banks maintaining compliance with minimum regulatory capital requirements, as we may view capital as inadequate for their perceived risk appetite or asset quality risks.

Among the developed markets, Fitch has already downgraded the IDRs of the major Australian banks (and their wholly owned New Zealand subsidiaries) and some banks in Japan. Among the emerging markets, we have also downgraded banks in Indonesia, Thailand and Malaysia, where we lowered the operating environment scores by a notch.

Is Fitch Taking a Different Approach to Bank Ratings in APAC Versus Other Regions?

Fitch is consistent in our global rating approach, taking into account baseline and stressed cases over the next two years, with forecasts on macro and bank-specific metrics compared with the buffers or tolerance levels we assess at any given rating. However, the effects of COVID-19 will vary across systems, with the weight of ratings action likely to be skewed towards the more vulnerable banks, banking systems or regions. That should be highlighted by rating sensitivities in our Rating Action Commentaries (RACs).

There have already been examples of various bank rating actions in different systems, which we expect to be the case in upcoming portfolio reviews. For instance, rating downgrades may be limited to VRs where we view IDRs as underpinned by external support – sovereign or institutional – as is common in APAC, especially in emerging markets. Ratings action may be limited initially to outlook changes where the impact is less visible to Fitch. Furthermore, outcomes may vary as new information is assessed and Fitch's forecasts are updated.

Will Fitch Combine Actions on Ratings Under Criteria Observation with COVID-19 Impact?

Fitch stated in our RAC dated 4 March 2020 that ratings under criteria observation (UCO) would be resolved as soon as practical, and in any case within six months. Following the updated short-term rating criteria in 2019, we resolved short-term IDRs at the earliest possible opportunity to review the ratings. As we review ratings – whether or not related to the impact of COVID-19 – we intend to resolve ratings UCO at the same time.

As a result, this may lead to T2 debt ratings being downgraded by more than one notch – one notch to reflect our new base case of two notches for loss-severity per criteria, and one or more notches to reflect the extent of downgrade in the anchor rating (typically the VR). That said, we expect VR downgrades to be limited to no more than one notch.