Fitch Ratings 2020 Outlook: Asia-Pacific Emerging Market Banks

Risk Appetite, Policymakers Support Broadly Stable Environment

Fitch's Sector Outlook: Stable

Fitch Ratings' 2020 sector outlook for emerging banking systems in Asia-Pacific (APAC) remains stable. The number of negative outlooks on individual systems has fallen slightly, with most central banks shifting course towards looser monetary policy and financial conditions. For those systems where Fitch has a negative sector outlook, we believe any deterioration in key financial metrics will only be moderate in the coming year.

The operating environment remains challenging, yet stable. We downgraded India's midpoint in 1H19, while China's midpoint is low relative to the sovereign rating, which we believe captures the degree of systemic risk in those key markets adequately. Nevertheless, downside potential looms in most markets – external (eg global growth, macro issues) and internal (eg risk appetite) in origin – which policymakers are warding off through measures to support near-term stability.

Rating Outlook: Stable

The outlook has been mostly stable for several years, and is unlikely to change soon, despite the prospect of weaker financial trends. Over half of APAC Issuer Default Ratings (IDRs) are underpinned by external support (institutional or sovereign), with the outlooks mirroring those of the support-providers, including Vietnam and Thailand where several banks are on positive outlook.

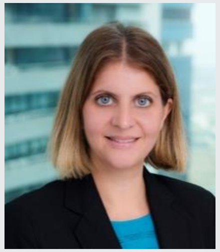
For those banks with IDRs driven by their intrinsic credit profiles (i.e. Viability Rating (VR)) and the outlook is stable, we view their loss-absorption buffers as generally sufficient to weather the likely challenges. Any deterioration in financial metrics is likely to be modest, but we would emphasise the potential for external challenges to expose banks' levels of risk appetite.

Rating Transition and Distribution

The number of VR downgrades has increased in recent years, but so too have IDR upgrades – for different reasons. VR downgrades have been concentrated mostly in India, where the environment remains challenging, but the state banks' IDRs remain stable as we believe the state's propensity to provide support has not diminished. Upgrades in China were due to assumptions around support. Otherwise, rating changes have largely followed similar action on sovereign ratings.

What to Watch

- Rising risk appetite to offset pressures on profitability
- Support from the authorities buffering near-term vulnerability to macro risks
- Exposure to higher leverage exacerbating vulnerability to headwinds
- Capital constraining acceleration of credit growth


From left-to-right:

Jonathan Cornish
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Tania Gold
South/SE Asia Banks

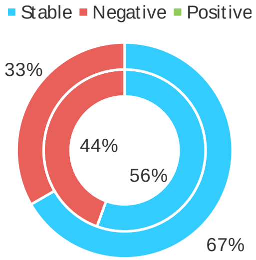
David Wong
North Asia Banks

APAC EM Banks: 2020 Outlooks

	Rating Outlook	Sector Outlook
China	Stable	Negative
India	Stable	Negative
Indonesia	Stable	Negative
Malaysia	Stable	Stable
Mongolia	Stable	Stable
Philippines	Stable	Stable
Sri Lanka	Stable	Stable
Thailand	Positive	Stable
Vietnam	Positive	Stable

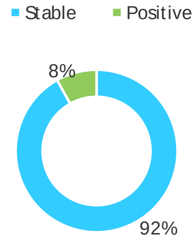
Source: Fitch Ratings

APAC EM Banks Sector Outlook



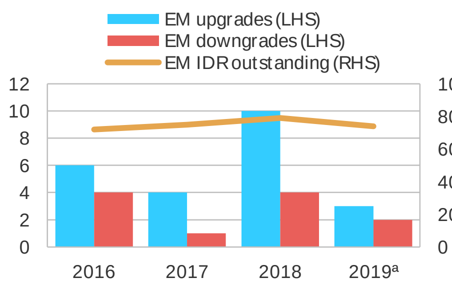
2019: Inner ring
2020: Outer ring
Ratings outlook as of Oct-19
Source: Fitch Ratings

APAC EM Banks Rating Outlook



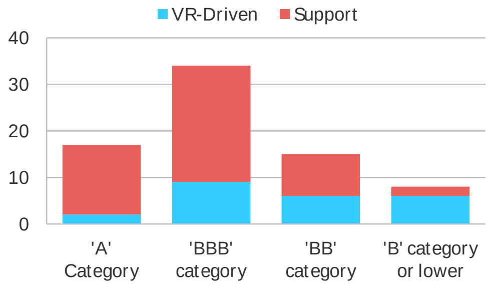
Note: All individual bank outlooks (not system)

APAC EM Banks: IDR Changes



[a] YTD October 2019
Source: Fitch Ratings, Fitch Solutions

APAC EM Banks: Support
Distribution of IDRs at Oct 19



Source: Fitch Ratings, Fitch Solutions

Rising Risk Appetite to Offset Pressures on Profitability

Net interest margins (NIMs) and/or overall profitability – even though not bad – have been under pressure for several years, and we expect that to continue in the foreseeable future. In our view, most banks have taken on incrementally higher risk (even if only selectively) to stem the pressure.

This is the most significant credit trend that Fitch is focused on, as we expect it to be common to most rating actions – whether negative or holding back positive action – on VRs, in the short term. However, the discreet nature of some risk-taking means that it may not become apparent until such time the environment turns for the worse and/or risks crystallise on bank balance sheets. That said, we view banks in Indonesia as generally having among the largest buffers.

Rising risk appetite is appearing through various channels, but largely related to credit. That said, some banking systems remain highly exposed – or are becoming more exposed – to liquidity risks (China, Vietnam). Operational risk also remains common to emerging markets. Within credit risk, we see a greater number of banks shifting down the credit curve (into higher-yielding sectors such as consumer finance and weaker SMEs), which tend to be more vulnerable as the economy softens.

Banks are also raising their exposure to property, both directly and indirectly through non-bank financial entities (although China is somewhat bucking the trend). Meanwhile, we see competition also having an impact on underwriting standards in other ways, including finer loan pricing and collateral coverage. Moreover, some trends are likely to be perpetuated by policymakers' efforts to ease the burden on borrowers or stimulate broader credit growth.

Support from Authorities Buffering Near-Term Vulnerability to Macro Risks

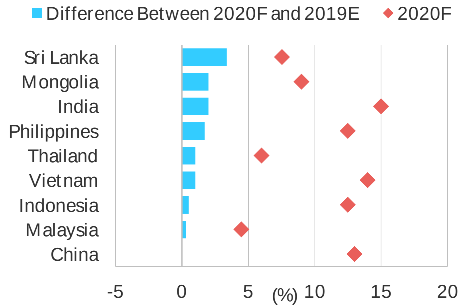
Most emerging markets remain vulnerable to varying degrees to trade protectionism as well as slower capital flows and economic growth, including slower growth in China. Furthermore, several markets should see flat-to-lower GDP growth in 2020, albeit any slowdown should not be dramatic. This is because policy actions – macro and macroprudential – have buffered downside threats to near-term economic and stability in the financial system.

We expect an easing bias towards monetary policy and looser financial conditions in 2020 – after having anticipated tighter conditions just 12 months ago – including a strong US dollar to challenge banks in emerging markets where the competition is most fierce. The primary policy reference rate in every APAC emerging market in our coverage, except Mongolia, is now lower than at the start of 2019. We see this as supportive for borrowers, but less so for NIMs.

Several governments have already accelerated (or are likely to boost) infrastructure investment to support their economies – such as China, Indonesia, Malaysia, Thailand, and the Philippines. This should also support private-sector demand in related areas, but potentially at the expense of rising dependence on ongoing public-sector support for the economy, particularly as leverage rises.

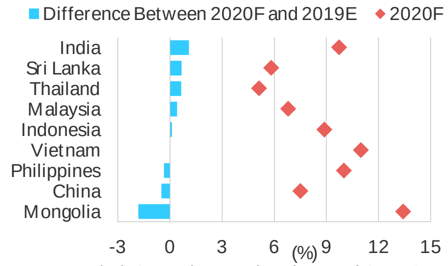
Regulation has influenced credit profiles, often to enhance resilience. Now that uncertainties have increased, many authorities have implemented initiatives to ease pressures by way of liquidity injections, lower funding costs, fewer lending restrictions and capital relief, so that banks can extend more credit. We expect similar initiatives to be implemented in 2020. However, this risks fuelling dependence on such indriect support and on increasing leverage.

APAC EM Banks: Loan Growth (%)



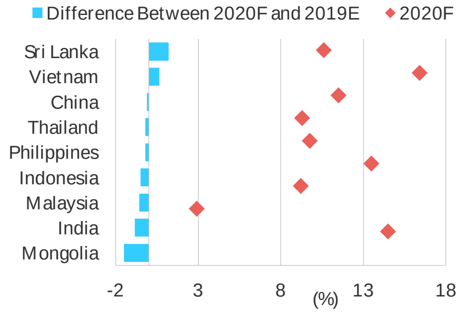
Source: Fitch Ratings, Fitch Solutions

APAC EM Banks: Nominal GDP Growth (%)



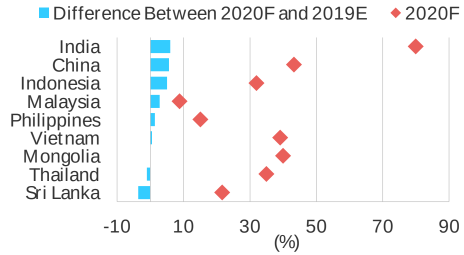
Data per Fitch Sovereign's estimation as of Sep-19.
Source: Fitch Ratings, Fitch Solutions

APAC EM Banks: ROE (%)



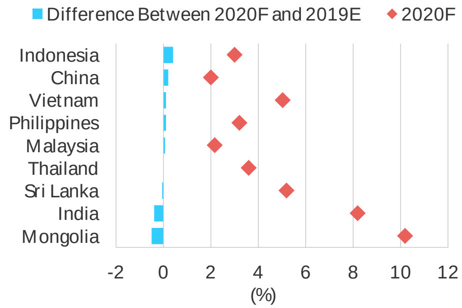
Source: Fitch Ratings, Fitch Solutions

APAC EM Banks Credit Cost/Pre-Provision Operating Profit (%)



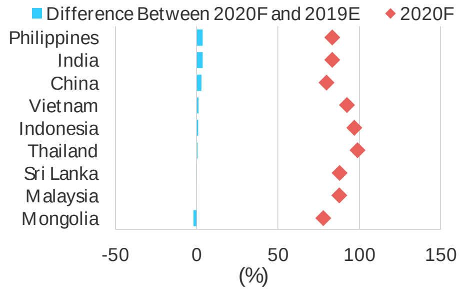
Source: Fitch Ratings, Fitch Solutions

APAC EM Banks: NPL Ratio (%)



Source: Fitch Ratings, Fitch Solutions

APAC EM Banks Loan-to-Deposit Ratio (%)



Source: Fitch Ratings, Fitch Solutions

Exposure to Higher Leverage Exacerbating Vulnerability to Headwinds

Leverage should rise generally over the next few years as nominal credit growth exceeds that of GDP. This is most acute in China (we estimate Fitch-adjusted total social financing to GDP will be around 275% by end-2019), where corporate leverage remains high, but household leverage is set to continue expanding as the country relies increasingly on domestic consumption to support economic growth.

Household debt is likely to remain stubbornly high in Malaysia (around 82% of GDP at end-18) and Thailand (79% – although Thailand's mortgage lending restrictions have tightened in 2019), but we expect it to grow more swiftly in Vietnam (58% at end-2018) and China (53% at end-2018).

We see higher leverage as rendering banking systems more susceptible to any future tightening of policy settings and more vulnerable to external growth headwinds, including a slowdown in China. For example, we see general linkages between higher leverage and relative vulnerability to our theoretical scenario of a sharp slowdown in China's growth, with the main transmission channels being a less benign economic environment and global market volatility.

High corporate and household leverage and high reliance on credit to support growth will render banking systems more vulnerable to faster deterioration in asset quality and liquidity conditions if and when economic growth slows – if not act as a catalyst for such a slowdown in the first instance.

High growth typically exhibits a loosening of underwriting standards in more benign times, as seen in asset-quality cycles in Asia over the past decade – such as in China, Vietnam, Mongolia, Sri Lanka, Thailand, and most recently India. We see such risks remaining prevalent in China and India, with the Philippines (where bank credit is concentrated among conglomerates and lending has fuelled economic growth) yet to be tested by any meaningful change in operating conditions.

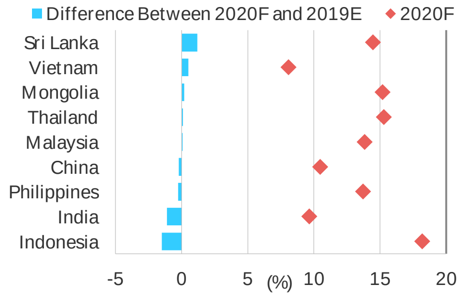
Capital Constraining Acceleration of Credit Growth

Some banking systems face more difficulty than others in boosting credit supply. This is due to capital constraints, despite efforts by the authorities to encourage a greater flow of bank credit in challenging times.

It is the case for many Chinese banks (including the state banks, four of which face minimum total loss-absorbing capacity (TLAC) requirements from no later than 2025), state banks in India (Fitch estimates a further USD7 billion of equity is required to provide an adequate buffer above the regulatory minimums – even more under stress our scenario), as well as Vietnam (where the larger banks need to boost capital to meet new Basel 2 requirements from the start of 2020).

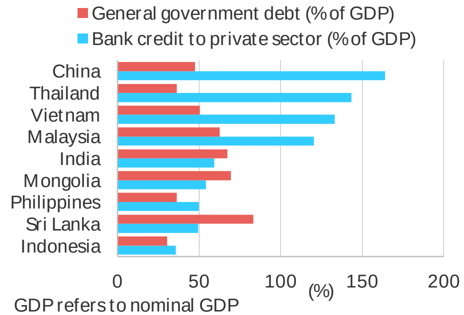
This renders the two largest banking systems in APAC less able to support the troubled non-bank sector, which has until recently grown at very high rates and spurred economic growth, but poses contagion risk for many banks. Consequently, we see the banks as less capable of supporting non-banks, which could exacerbate downside risks for the sector and for economic growth.

APAC EM Banks: CET1 (%)



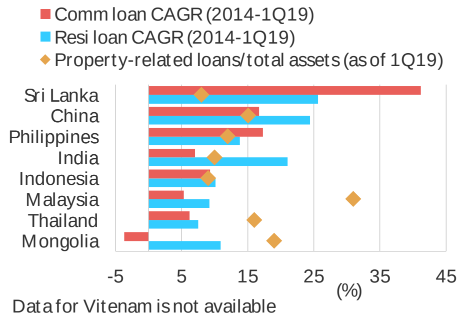
Data for Mongolia, Sri Lanka and Vietnam were T1 ratio
Source: Fitch Ratings, Fitch Solutions

APAC EM Debt/Credit to GDP Ratio



GDP refers to nominal GDP
Source: Fitch Ratings, Fitch Solutions

APAC EM Property Loan Growth



Data for Vitenam is not available
Source: Fitch Ratings, banks, central banks

Relative Vulnerabilities to a Severe China Slowdown

		Channels		
	Overall Vulnerability	Direct Mainland Exposure	Economic Environment	Global Market Volatility
Malaysia				
Indonesia				
Sri Lanka				
Thailand				
India				
Philippines				
Vietnam				
High vulnerability				
Low vulnerability				

Source: Fitch Ratings

China

Fitch's Sector Outlook: Negative

Fitch revised the outlook on China's operating environment to stable from negative in October, reflecting our view that the 'bb+' mid-point adequately captures systemic risk for our rated banks despite operational challenges remaining in terms of capitalisation and asset-quality pressure. We continue to hold a negative sector outlook on Chinese banks more broadly, as trade tensions and weakening economic growth may result in greater asset impairment and earnings volatilities.

These risks have been manifested through increased vulnerabilities reported at smaller banks since early 2019, reiterating our view that the sector as a whole remains undercapitalised. Smaller banks will continue to face greater operational challenges against a weaker economy. We may consider a stable outlook if evidence shows system contagion risks can be resolved without sacrificing loss-absorption buffers, or if system leverage shows signs of more sustainable declines over time.

Rating Outlook: Stable

The stable ratings outlook reflects our expectations that sovereign support for China's banking sector remains intact, especially for the large, systemically important banks. Our support ratings for individual banks may be affected by our assessment of the spirit and likely implementation of a resolution framework in China, if and when such details are announced, but we expect the authorities will continue to favour support to the larger banks based on their systemic importance.

What to Watch

Bank Stimulus, TLAC Challenges

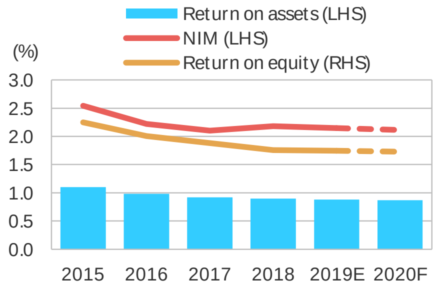
Fitch does not envisage an aggressive easing in credit policy, in light of the authorities' concerns about the build-up of medium-term financial risks. The authorities resisted an aggressive bank stimulus even as China faced escalation in trade tariffs from the US during 2019, and we expect this regulatory commitment to continue in 2020. A reversal in policy stance which favours rapid acceleration in growth (both on- and off-balance-sheet) would be credit negative for the banks' credit profiles as this would raise leverage further.

Bank capital is also a significant constraint against easing, in light of pressures to meet higher capital requirements. The four global systemically important banks (SIBs) may face acceleration in their total loss absorbing capacity (TLAC) conformance to January 2024, which would limit their ability to accelerate growth to support the economy. Other Chinese banks may also face higher capital requirements if they become designated as domestic SIBs.

Adoption of Loan Prime Rate

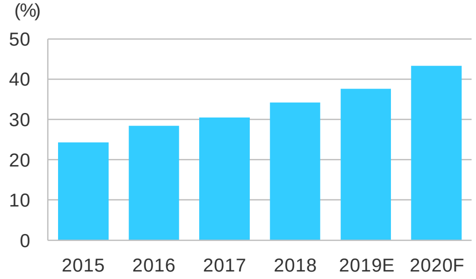
The authorities have instructed banks to adopt the Loan Prime Rate (LPR) by March 2020 in pricing new loans. We do not expect a big fall in quoted LPRs, which may create large pricing gaps against existing loans (which are referenced to official benchmark rates), while the regulatory aim to reduce bank lending rates will continue to pressure NIMs in the long run. We expect such pressures on profitability to be mitigated by additional reductions in RRRs, and a potential reduction in allowance coverage ratios.

China: Key Performance Trends
Profitability



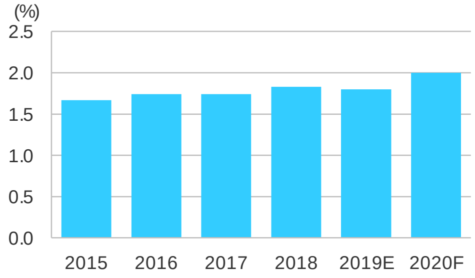
Source: Fitch Ratings, Fitch Solutions, CBIRC

China: Key Performance Trends
Credit costs as % of pre-provision operating profit



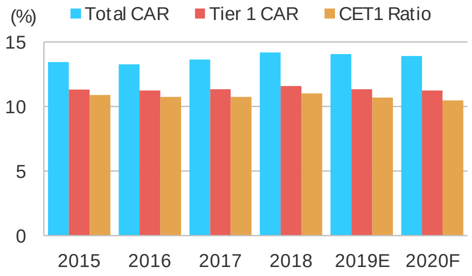
Source: Fitch Ratings, Fitch Solutions, Banks

China: Key Performance Trends
Impaired loan ratio



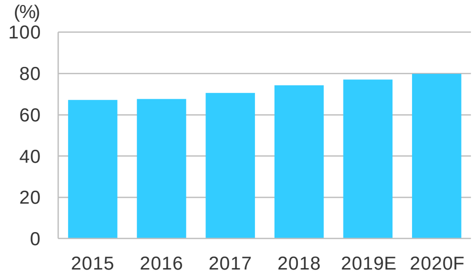
Source: Fitch Ratings, Fitch Solutions, CBIRC

China: Key Performance Trends
Capital ratios



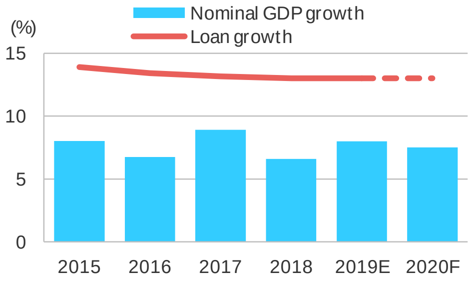
Source: Fitch Ratings, Fitch Solutions, CBIRC

China: Key Performance Trends
Loans/deposits ratio



Source: Fitch Ratings, Fitch Solutions, CBIRC

China: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch Ratings, Fitch Solutions, CBIRC

India

Fitch's Sector Outlook: Negative

Fitch maintains a negative outlook on Indian banks, based on our expectations of continued weak performance despite trends showing this could be past the trough, and ongoing capital requirements. Non-bank stress coupled with rising macro headwinds pose further challenges for asset quality, particularly at state banks which continue to experience capital constraints, delays in bad-loan recoveries, and poor earnings. More capital is needed to insulate the banks' weak balance sheets and to sustain loan growth.

Rating Outlook: Stable

The rating outlook for most Indian banks mirrors the Stable Outlook on India's sovereign rating. The IDRs of all Fitch-rated state-owned banks are driven by sovereign support, while private-sector banks' IDRs – which are lower than the sovereign rating – are governed by their VRs.

What to Watch

More Fresh Equity in State-Owned Banks

Fitch estimates that Indian banks will require an additional USD7 billion of equity by FY21 to support loan growth, achieve 75% NPL cover, and build a buffer over the minimum Basel III capital standards. State banks will require most of this capital as the USD10 billion being injected into banks in FY20 will go mainly towards bridging regulatory capital gaps, providing for ageing impaired loans, and absorbing the costs of merging 10 state banks into four by April 2020.

Macro Headwinds Could Pressure Asset Quality

A slowing economy could exacerbate asset-quality tensions for a sector which is already grappling with weak recoveries and ageing provisions. The improvement in the impaired-loans ratio in FY19 is unlikely to be sustained if stresses on non-banks, real estate and SMEs remain unresolved, due to both tight liquidity and the macroeconomic slowdown.

Margin Pressure; Vulnerable Earnings

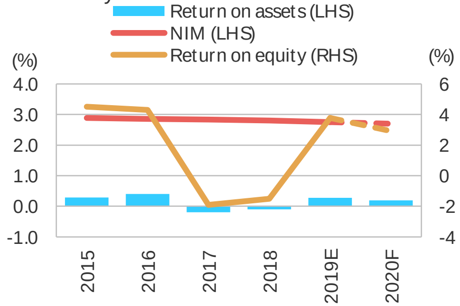
NIMs are likely to face pressure as floating-rate loans have to be linked to external benchmarks in a bid to ensure effective monetary transmission. This will cause a further narrowing in state banks' income buffers which have declined in recent years due to poor asset quality and lower growth, leaving both earnings and equity vulnerable to higher-than-expected credit costs.

Indian Banks Have Thin Buffers Against Systemic NBFC Stress

Systemic stress across non-banks would deal a significant setback to recovery in the banking sector, reversing recent improvements in performance, pressuring VRs, and posing solvency risks to banks with the thinnest buffers. Fitch conducted a *stress test* to examine the potential impact on banks of pressures on NBFCs developing into a broad crisis. We estimate that the scenario would leave banks with an aggregate shortfall of USD10 billion to meet regulatory minimums, and USD50 billion below the level that we believe would provide an adequate buffer.

India: Key Performance Trends

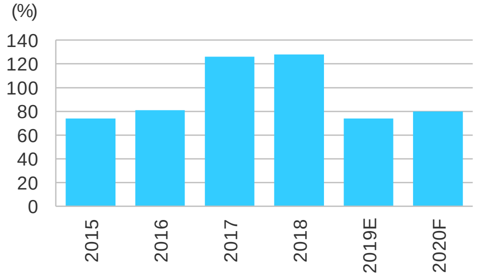
Profitability



Source: Fitch Ratings, Reserve Bank of India, Fitch est

India: Key Performance Trends

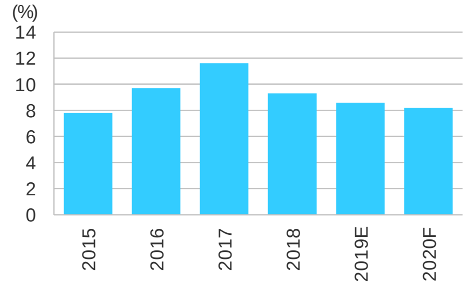
Credit costs as % of pre-provision operating profit



Source: Fitch Ratings, Reserve Bank of India, Fitch est

India: Key Performance Trends

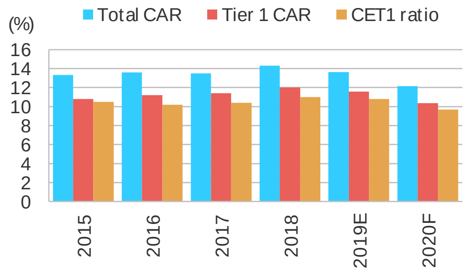
Impaired loan ratio



Source: Fitch Ratings, Reserve Bank of India, Fitch est

India: Key Performance Trends

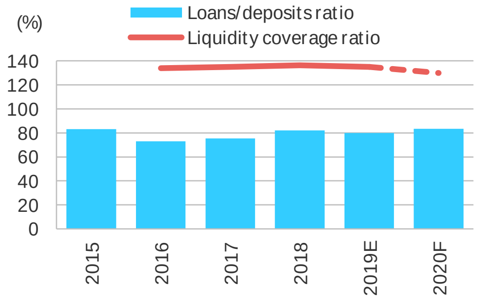
Capital ratios



Source: Fitch Ratings, Reserve Bank of India, Fitch est

India: Key Performance Trends

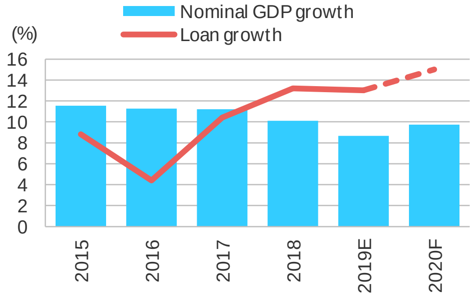
Loans/deposits and liquidity coverage ratio



Source: Fitch Ratings, Reserve Bank of India, Fitch est

India: Key Performance Trends

Nominal GDP growth and loan growth



Source: Fitch Ratings, Reserve Bank of India, Fitch est

Indonesia

Fitch's Sector Outlook: Negative

Fitch maintains a negative sector outlook on Indonesian banks, reflecting rising risks to asset quality amid tighter funding conditions and intensified competition, which will remain a steady headwind against profitability. External risks are also rising – as characterised by weak commodity prices, a slowing Chinese economy, and increasing global trade frictions.

Rating Outlook: Stable

Most of Indonesia's largest banks benefit from support from the sovereign or higher-rated foreign parent banks whose ratings are predominantly stable. Standalone credit profiles are unlikely to be affected significantly by the negative sector trends, but in any case they typically have headroom at current rating levels based on healthy loss-absorption buffers in earnings, reserves and capital.

What to Watch

Loan-Quality Pressure

We see rising risks to credit quality as slower GDP growth and lower commodity prices have pressured weaker borrowers. This impact is visible in cyclically high ‘special mention loan’ ratios and significant asset-quality deterioration at a number of small banks. We expect asset-quality weakness to filter through to the large banks in the near term, but their better underwriting standards and risk controls should ensure that such deterioration remains manageable.

IFRS 9 Impact

Indonesia's banks are scheduled to implement IFRS 9 accounting standards from 1 January 2020, which we expect to result in a one-off deduction to capital and higher credit costs on an ongoing basis. However, the largest banks are well placed to manage the impact as they benefit from some of the widest capital and earnings buffers in the region, which we expect to continue under the new standard.

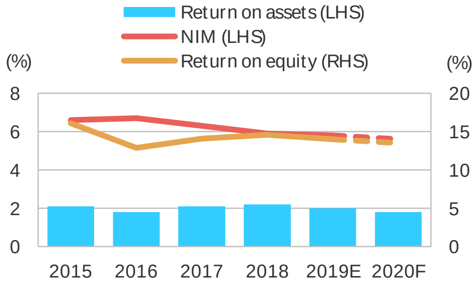
Funding to Remain Tight

Loan growth for Indonesia's largest banks is likely to remain steady at around 12% in 2020, helped by further significant government spending on infrastructure projects. However, deposit growth is likely to continue to lag, which should result in further wholesale issuance and LDRs remaining elevated on prior years. This will ensure that competition for deposits remains keen, despite monetary easing by Bank Indonesia, leading to further gradual tightening of Indonesian banks' wide margins. Liquidity should remain ample, as reflected in liquidity coverage ratios above 150%.

M&A Activity

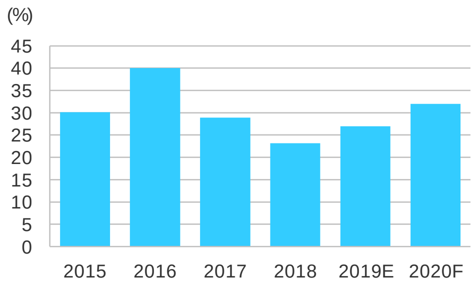
The recent uptick in consolidation in Indonesia's banking sector is likely to be sustained in the near-term, helped by attractive industry returns, some shareholders seeking exits, and a regulator that is open to consolidation. Foreign entrants, particularly large banks in the APAC region, will likely be at the forefront of consolidation, lured by Indonesia's favourable medium-term growth prospects and better profitability than can be generated in their home markets. However, any M&A activity is unlikely to change the industry landscape significantly in the short-term.

Indonesia: Key Performance Trends
Profitability



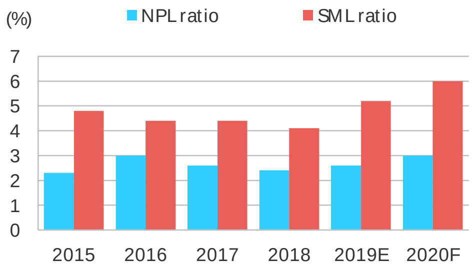
Source: Fitch Ratings, Fitch Solutions, 12-largest banks

Indonesia: Key Performance Trends
Credit costs as % of pre-provision operating profit



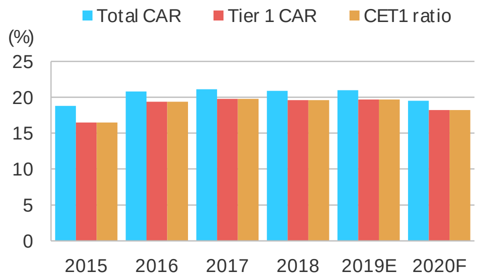
Source: Fitch Ratings, Fitch Solutions, 12-largest banks

Indonesia: Key Performance Trends
Asset quality



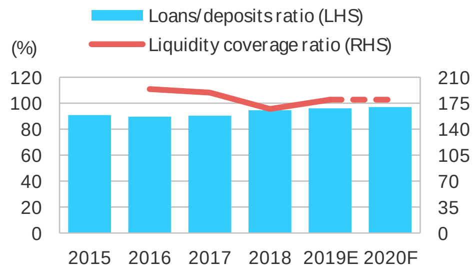
Source: Fitch Ratings, Fitch Solutions, 12-largest banks

Indonesia: Key Performance Trends
Capital ratios



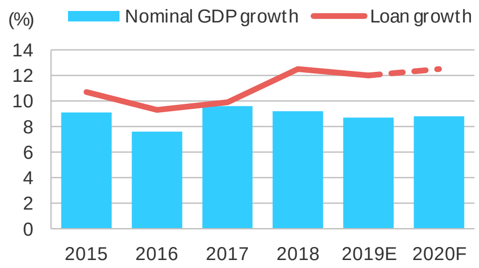
Source: Fitch Ratings, Fitch Solutions, 12-largest banks

Indonesia: Key Performance Trends
Loans/deposits ratio



Source: Fitch Ratings, Fitch Solutions, 12-largest banks

Indonesia: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch Ratings, Fitch Solutions, 12-largest banks

Malaysia

Fitch's Sector Outlook: Stable

Fitch expects the operating environment to be broadly steady in 2020, though sustained external headwinds cloud the outlook. Loan growth is likely to remain muted, but with potential upside in the event of a stronger-than-expected pick-up in infrastructure spending. Moderate growth and more cautious risk appetites in recent years should mitigate downside risks to the banking sector. Nonetheless, bank profitability is likely to face modest pressure from a normalisation in credit costs and margin compression.

Rating Outlook: Stable

The rating outlooks are stable across all rated banks, anchored by their intrinsic credit profiles which include healthy loss-absorption buffers, satisfactory credit standards, and stable funding and liquidity profiles.

What to Watch

Margin Pressure

Bank Negara Malaysia (BNM) has cut benchmark rates by 25bp year-to-date, and we see room for a further cut in 2020 in light of heightened external risks. This, along with competition for loans and deposits, is likely to continue to exert downward pressure on NIMs. However, lower interest rates should ease borrower debt-servicing capacity somewhat and temper asset-quality risks.

Pockets of Weakness

We see potential for loan-quality weakness in pockets of the property, construction and plantation sectors. However, we expect any deterioration to be manageable in light of sustained economic growth and supportive measures targeting these sectors in the 2020 budget.

Household loan quality should remain broadly stable. Lower-income households are likely to be more vulnerable to a weaker economy, but government policy is likely to help mitigate excessive downside risk.

Liquidity Environment; Regulatory Developments

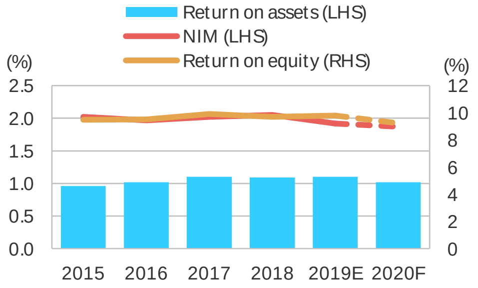
We expect domestic funding conditions to remain competitive, but the authorities are likely to stand ready to counter any bouts of liquidity tightness. Most banks already meet upcoming net stable funding ratio (NSFR) requirements effective July 2020, and compliance is likely to improve further as the published rules were loosened slightly from initial reporting requirements. The planned introduction of a virtual banking licence framework by mid-2020 may stoke greater industry competition, although this is likely to pan out over the longer term.

Trade Tensions; Liquidity Outflows

A more severe impact on Malaysia from slowing global growth, resulting from an escalation in global trade tensions, could have negative spillover effects on loan growth, credit quality and liquidity conditions. This may be partially offset by mitigating factors such as trade diversion, in particular towards the electronic sector.

Malaysia: Key Performance Trends

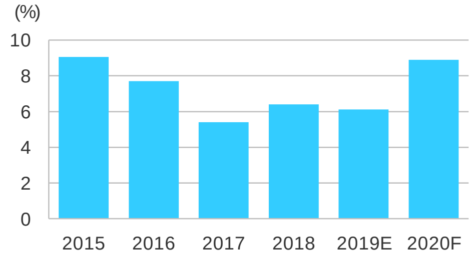
Profitability



Source: Fitch Ratings, BNM

Malaysia: Key Performance Trends

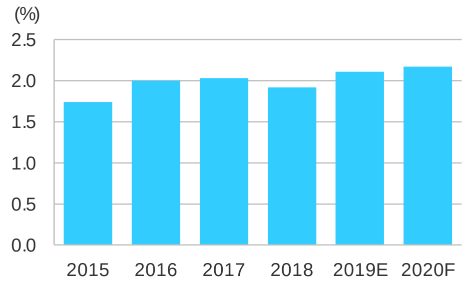
Credit costs as % of pre-provision operating profit



Source: Fitch Ratings, BNM

Malaysia: Key Performance Trends

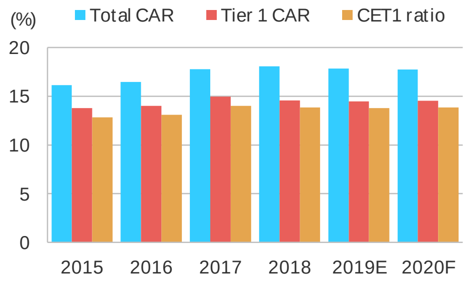
Impaired loan ratio - top-six banks



Source: Fitch Ratings, BNM, banks

Malaysia: Key Performance Trends

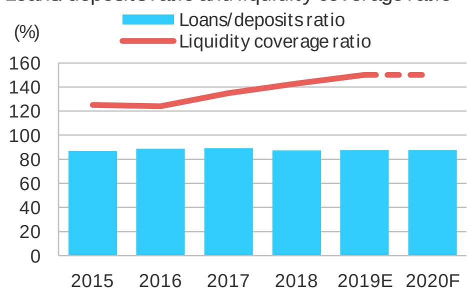
Capital ratios



Source: Fitch Ratings, BNM

Malaysia: Key Performance Trends

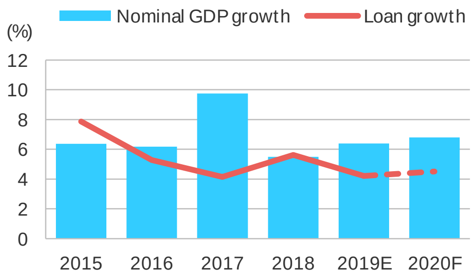
Loans/deposits ratio and liquidity coverage ratio



Source: Fitch Ratings, BNM

Malaysia: Key Performance Trends

Nominal GDP growth and loan growth



Source: Fitch Ratings, BNM

Mongolia

Fitch's Sector Outlook: Stable

Mongolian banks' financial performance is likely to be broadly steady in 2020. A slight narrowing in interest margins amid intense competition and lower interest rates would result in moderately lower returns on assets and capital. We forecast only slightly stronger loan growth, due to higher capital requirements for the largest banks than in 2019. Loan growth has declined sharply in 2019, due mainly to the macro-prudential measures on unsecured individual loans.

The NPL ratio, as per the Bank of Mongolia's (BoM) categorisation, is likely to improve moderately amid strong, sustained economic growth. We expect modest improvements in banks' Tier 1 capital ratios and LDR ratios as we anticipate system-wide loan growth to be well below the nominal GDP growth rate and for the tighter capital requirements to constrain loan growth.

Rating Outlook: Stable

The Stable Outlook on Khan Bank LLC and XacBank LLC reflects our expectations that their intrinsic credit profiles will be maintained amid relatively stable prospects for the economy. Our IDRs and Outlook on Development Bank of Mongolia LLC are equalised with the sovereign (B/Stable).

What to Watch

Economic Policy Change Following Election

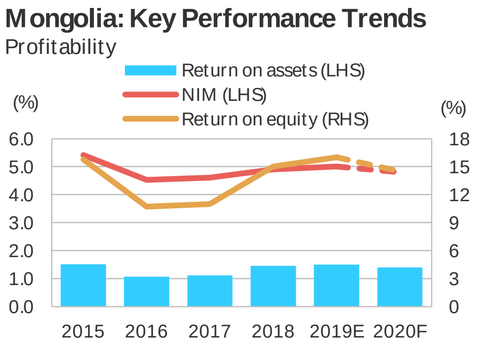
The parliamentary election scheduled for June 2020 may lead to a significant change in economic policy that could spur substantial credit growth in certain segments in the short to medium term. The economy and banking system have seen repeated cycles of boom-and-bust, due to the nation's substantial reliance on the mining industry and undisciplined execution of previous economic policy – especially in election years. That said, Mongolia has demonstrated a more disciplined approach to its economic and fiscal policies under the current IMF support regime.

Forensic Audit on Six Banks' Capital

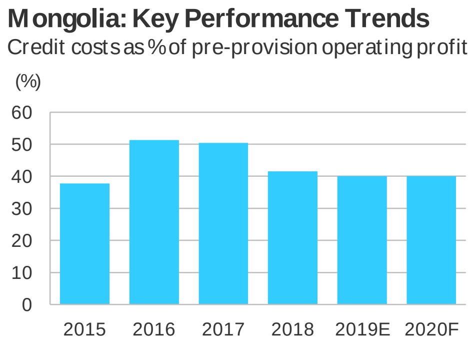
The outcome of the forensic audit of the capital raised related to the Asset Quality Review (AQR) could lead to significant changes in competition or franchise. At worst, a negative finding could be detrimental to the capital or reputation of some of the six banks under the audit, which Fitch does not rate. Capital-constrained banks are likely to see market share eroded in the rapidly evolving system. The IMF-supported Extended Fund Facility has been pending, subject to the forensic audit, and BoM is committed to action to ensure banks raise all capital requested as part of the AQR.

Improvement in Regulatory Enforcement

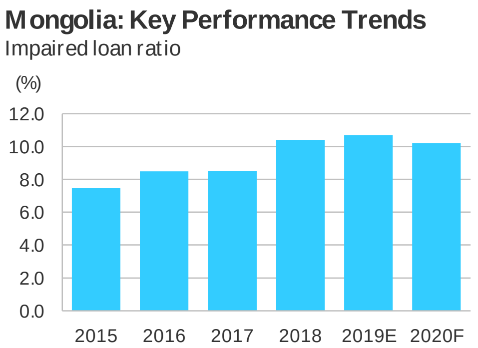
A stronger legal and regulatory framework, combined with a sovereign-rating upgrade, could lead to positive rating action for some Mongolian banks. BoM has implemented numerous banking regulations in the last few years, including a requirement to provide timely loan-loss allowances based on expected losses under the IFRS9 effective from 1 January 2020. However, it remains to be seen if these are promptly enforced, given the poor track record. For example, the AQR follow-up is still pending, although it was supposed to be completed in late 2018.



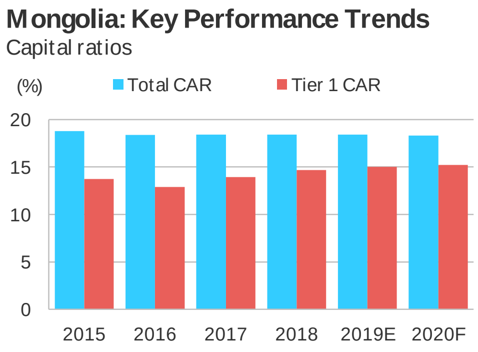
Source: Fitch Ratings, Fitch Solutions, Banks



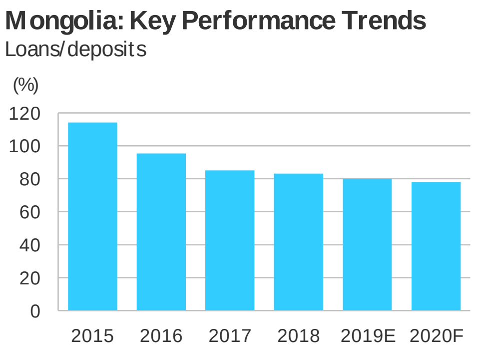
Source: Fitch Ratings, Fitch Solutions, Banks



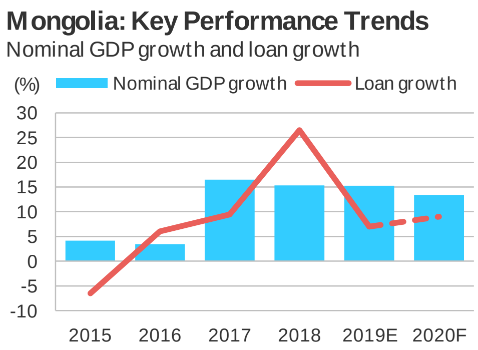
Source: Fitch Ratings, Bank of Mongolia



Source: Fitch Ratings, Fitch Solutions, Banks



Source: Fitch Ratings, Bank of Mongolia



Source: Fitch Ratings, Fitch Solutions, Bank of Mongolia

Philippines

Fitch's Sector Outlook: Stable

Fitch expects operating conditions to be generally supportive of loan growth and credit quality. A recovery in government infrastructure spending should lift GDP growth in the coming year, but banking sector profitability is likely to moderate after a stronger 2019. We believe NIMs have peaked in line with market interest rates, while credit costs are likely to continue to normalise as loan books season. Nevertheless, sustained economic growth should help to cushion against major downside risks.

Rating Outlook: Stable

The rating outlooks are all stable, reflecting the benign environment and supported by the banks' adequate loss-absorption buffers, satisfactory profitability, as well as broadly steady funding and liquidity profiles.

What to Watch

Loan Growth Recovery

We expect a pick-up in government infrastructure spending to spur broader investment activity, amid sustained consumer demand. This should bode well for loan growth, especially after several rounds of policy easing in recent months that partly reversed earlier tightening measures.

Incremental Growth in Higher-Margin Loans

Lower benchmark rates will place pressure on asset yields, but the banks are likely to continue to pursue higher-yielding loans in a bid to maintain margins. The banks have targeted consumer, SME and increasingly microfinance lending for several years, and we expect this to intensify.

This is likely to entail higher credit risk, but the effects on asset quality should be felt only gradually – these segments still form a minority of most banks' loan books, and the new loans will take time to season. Lower funding costs should also help to offset NIM pressure – given efforts to target current and savings accounts – as will rising loan-to-deposit ratios as reserve requirements fall.

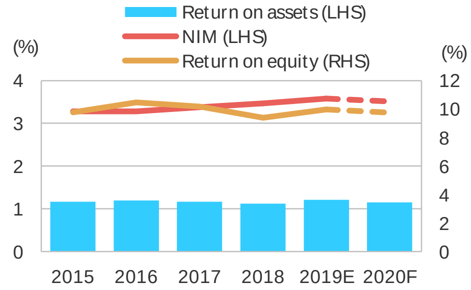
Asset-Quality Normalisation

Asset quality has weakened moderately with higher interest rates over the past year, along with a one-off corporate impairment. We expect further normalisation as loans season. However, any deterioration should be manageable as easing interest rates and strong economic growth should continue to support debt-servicing capacity despite rising leverage in recent years. This assumes no major weakness among the largest exposures – top-20 borrower concentration is high in the Philippines, and any such impairment would have a significant impact on asset-quality metrics.

Easing Capital Buffers

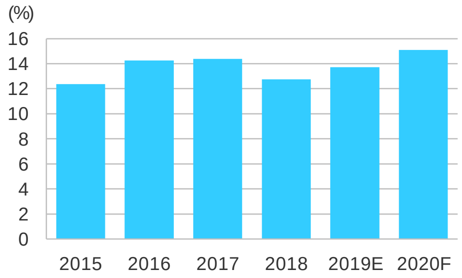
We expect downward pressure on capital adequacy ratios as loan growth picks up once more. The regulator has eased domestic systemically important bank (DSIB) buffer requirements for the largest banks, leaving room for their capital positions to drift lower. However, we expect any erosion to be mild, and capital buffers should remain adequate.

Philippines: Key Performance Trends
Profitability



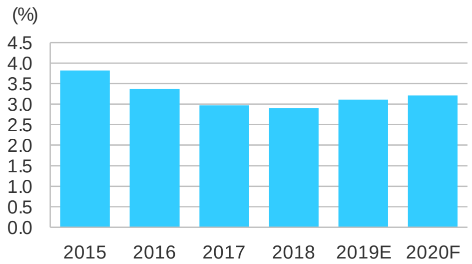
Source: Fitch Ratings, Bangko Sentral ng Pilipinas (BSP)

Philippines: Key Performance Trends
Credit costs as % of pre-provision operating profit



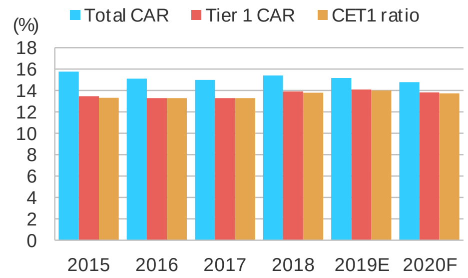
Source: Fitch Ratings, BSP

Philippines: Key Performance Trends
Non-performing asset ratio[a]



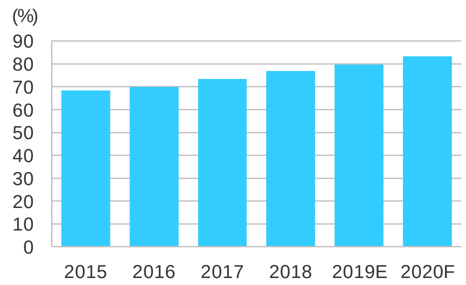
[a] Includes foreclosed assets
Source: Fitch Ratings, BSP

Philippines: Key Performance Trends
Capital ratios



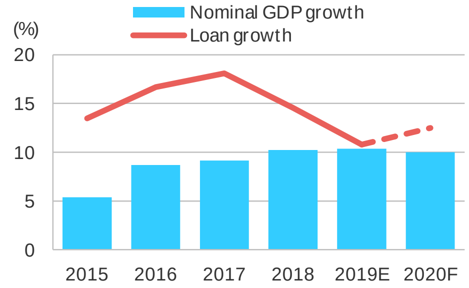
Source: Fitch Ratings, BSP

Philippines: Key Performance Trends
Loans/deposits ratio



Source: Fitch Ratings, BSP

Philippines: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch Ratings, BSP

Sri Lanka

Fitch's Sector Outlook: Stable

Fitch has revised the sector outlook on Sri Lankan banks to stable from negative, to reflect our expectation that operating conditions – although still challenging – should start to improve. In turn, the pressure built up on bank profiles is likely to moderate. The anticipated increase in economic expansion and credit demand – despite remaining subdued – should be supportive of loan expansion and asset quality, which would ease the pressure on profitability.

Rating Outlook: Stable

The outlook on almost all Sri Lankan banks remains stable. Negative sector trends have affected bank performance through higher credit costs, depressed profits, muted lending and rising impaired loans, but thus far have not resulted in negative rating actions, based on our assessment of the deterioration being more cyclical in nature, and banks largely having sufficient headroom to weather the degree of deterioration we had expected and witnessed.

The ratings on some banks could come under pressure should loss-absorption buffers become mis-aligned with perceived risk levels. Sovereign rating action could result in similar action on the IDRs and VRs of Sri Lankan banks that are rated at the same level as the sovereign.

What to Watch

Impact of Upcoming Elections on Growth

The presidential and parliamentary elections are likely to result in lending remaining stilted through most of 1H20. We see greater prospects for loan expansion to pick up in 2H20, supported by an improvement in private-sector sentiment and demand, but it is still likely to remain relatively moderate.

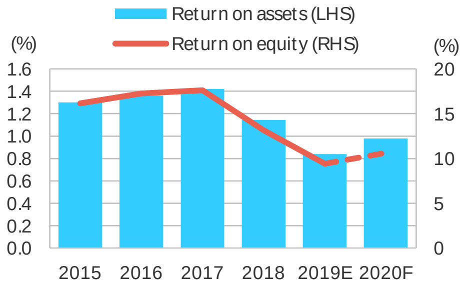
Asset-Quality Trends to Stabilise

We expect the pace of NPL accretion to decelerate from the significant increase recorded in 2019, alongside the potential improvement in borrower-repayment capacity. Asset quality could remain weak, though, with potential risks reflected in higher restructured loans across banks. The unwinding of NPLs is likely to extend beyond 2020 on account of challenges faced in the recovery of collateral, and the resolution of NPLs in certain sectors.

Pressure on Capital Buffers to Ease

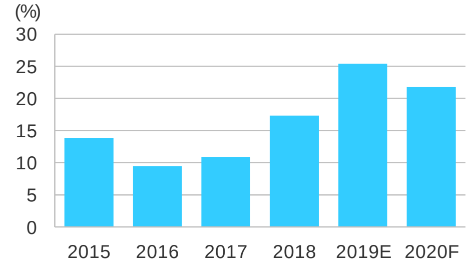
The pressure on capitalisation is likely to subside due to the moderation in NPL build-up and tepid loan expansion relative to prior years. Capital issuance is likely to continue into 2020, in particular for the smaller banks that need to raise capital to meet regulatory requirements. Securing equity capital could continue to remain challenging and face execution risks.

Sri Lanka: Key Performance Trends
Profitability



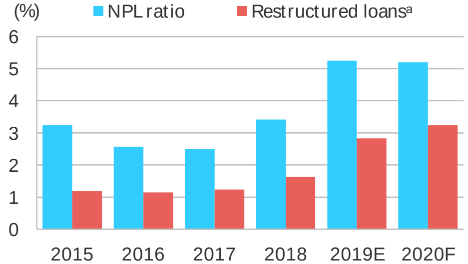
Source: Fitch Ratings, CBSL

Sri Lanka: Key Performance Trends
Credit costs as % of pre-provision operating profit



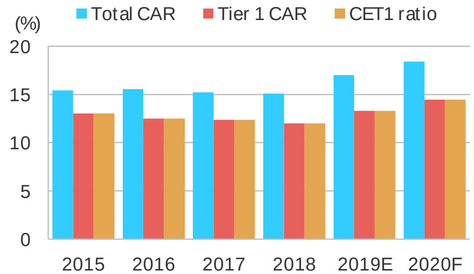
Source: Fitch Ratings, CBSL

Sri Lanka: Key Performance Trends
Asset quality



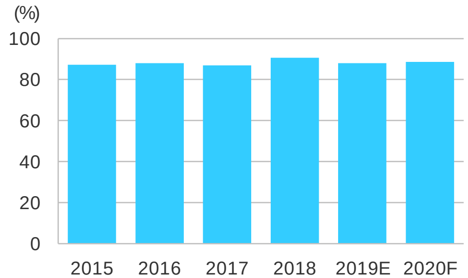
[a] As reported by Fitch rated banks
Source: Fitch Ratings, CBSL

Sri Lanka: Key Performance Trends
Capital ratios



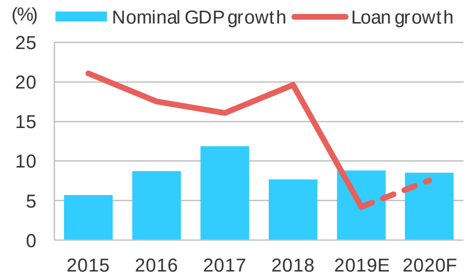
Source: Fitch, Ratings CBSL

Sri Lanka: Key Performance Trends
Loans/deposits ratio



Source: Fitch Ratings, CBSL

Sri Lanka: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch Ratings, CBSL

Thailand

Fitch's Sector Outlook: Stable

Fitch expects performance in the Thai banking sector to be broadly stable over the next one to two years, despite the relatively weak phase of the business cycle. Slower economic growth and muted business activity constrain upside prospects. Fiscal spending on infrastructure projects has been slow, and is only gradually supporting investment activity and credit growth.

Rating Outlook: Positive

Our positive outlooks are due to bank-specific factors, rather than emanating from improved sector performance. Fitch-rated state-owned banks are on positive outlook, mirroring the Outlook on the Thai sovereign. Meanwhile, TMB Bank Public Company Limited (BBB-) is on Positive Outlook as its profile is likely to improve meaningfully after its merger with similarly sized Thanachart Bank Public Company Limited. On the other hand, Bank of Ayudhya Public Company Limited (A-) is on Negative Outlook, which is driven by the Outlook at its parent MUFG Bank, Ltd.

What to Watch

Limited Upside to Earnings

There are near-term challenges to earnings growth, with NIMs to be constrained by sustained low interest rates and weak fee income prospects due to economic conditions and stiff competition. Meanwhile, credit costs should remain substantial. However, many banks are investing heavily in digitalisation initiatives to take advantage of future revenue growth channels, and to manage cost growth.

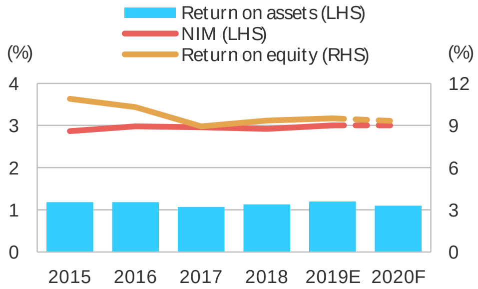
Asset-Quality Pressures Manageable

Fitch does not expect significant pressure from new loan impairments. Loan growth has been limited, and the central bank's macro-prudential measures have reduced risk-taking in retail segments such as mortgages and unsecured consumer finance. Asset-quality risks are mitigated further by high levels of excess provisioning, which also positions the banks for IFRS9 implementation in 2020. Nevertheless, there is downside risk in banks' SME portfolios, should the government fail to maintain economic growth.

Capital Buffers Stabilising at High Levels

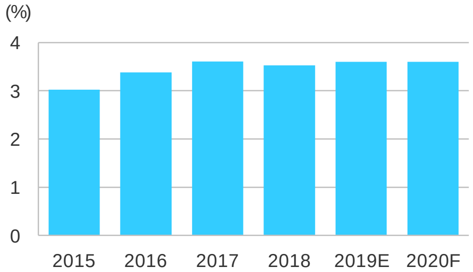
Core capital levels have risen gradually over the past few years, leaving the banks with capital buffers that are well above minimum requirements. Fitch expects limited further growth in capital ratios over the next two years, due to weak earnings prospects, a slight uptick in loan growth, and a one-time moderate impact from IFRS9 implementation.

Thailand: Key Performance Trends
Profitability



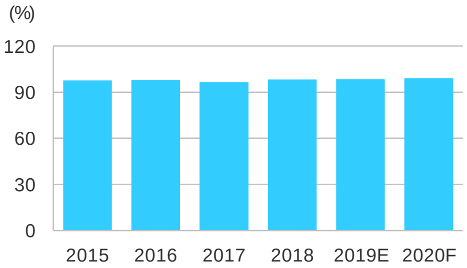
Source: Fitch Ratings, Bank of Thailand

Thailand: Key Performance Trends
Impaired loan ratio



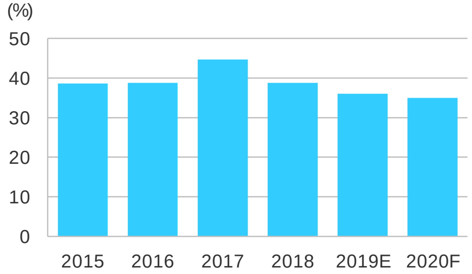
Source: Fitch Ratings, Bank of Thailand

Thailand: Key Performance Trends
Loans/deposits ratio



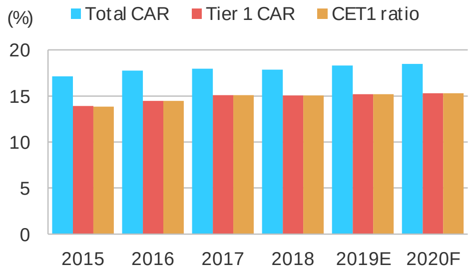
Source: Fiitch Ratings, Bank of Thailand

Thailand: Key Performance Trends
Credit costs as % of pre-provision operating profit



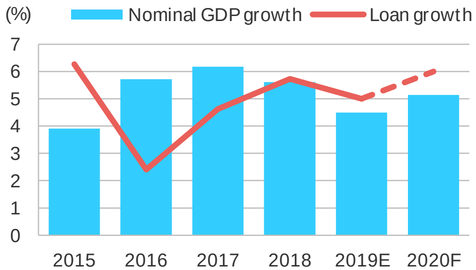
Source: Fitch Ratings, Bank of Thailand

Thailand: Key Performance Trends
Capital ratios



Source: Fitch Ratings, Bank of Thailand

Thailand: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch Ratings, Bank of Thailand

Vietnam

Fitch's Sector Outlook: Stable

Fitch's outlook reflects sustained earnings momentum in 2020 for Vietnam's banking sector, with continued strong growth in higher-yielding retail loans likely to offset modest increases in credit costs as loans season. Rapid loan growth could lead to future asset-quality issues in the event of a less-benign environment. Nevertheless, we expect economic growth to remain healthy, which should contain downside risk to the banks' asset quality.

Rating Outlook: Positive

Vietnam's state-owned banks are on positive outlook, in line with the sovereign outlook. This reflects our expectations that there is a growing ability on the part of the sovereign to provide extraordinary support to the banks, if required, and no diminished propensity for the state to support the larger banks. Beyond this, we believe that the rating profiles should continue to be supported by robust economic growth in the near term.

What to Watch

Further Write-Downs of Legacy Exposures

Certain banks may continue to write down legacy exposures, taking advantage of rising profitability and sustained improvement in the operating environment. This should help keep the reported problem-loan ratios relatively stable. Nevertheless, we believe that system legacy NPLs remain under-reported, with potential asset-quality issues also masked by high credit growth.

Rising Risk in Consumer Lending

Consumer lending has been growing rapidly in recent years, and has become an area of potential future stress. Some smaller banks have also been active in the unsecured and micro-consumer loans segment, where borrowers tend to be higher risk than traditional banking clients. Sustained rapid credit growth could present new asset-quality issues in the event of a less robust economy.

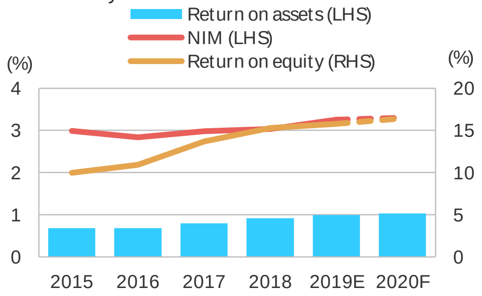
More Capital Issuance Likely

Capital issuance has risen as banks prepare themselves for Vietnam's Basel II standards. We expect this trend to be sustained in light of the thin capital buffers and persistently high credit growth. However rising total capital adequacy ratios might not be a sign of increasing buffers if the Tier 2 that is raised is not fully loss absorbing. Basel II could exert pressure on the banks to price risk and manage capital better, but this is likely to pan out over the longer term.

Credit Growth Uptick; Stable Liquidity Conditions

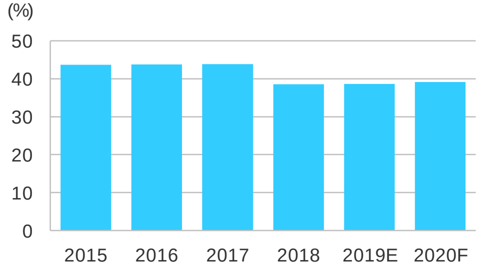
Credit growth has moderated in recent years, due in part to the impending adoption of Basel II. We expect loan growth to be slightly stronger in 2020 – at 14%, from a projected 13% in 2019. Retail lending should remain the key driver. This should push up the system loan-to-deposit ratio slightly, but liquidity conditions should remain generally stable in 2020.

Vietnam: Key Performance Trends
Profitability



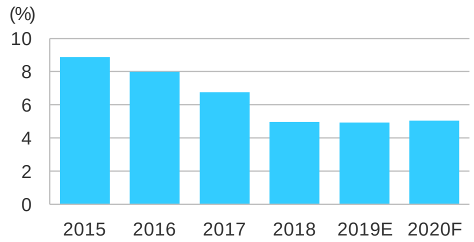
Source: Fitch Ratings, banks

Vietnam: Key Performance Trends
Credit costs as % of pre-provision operating profit



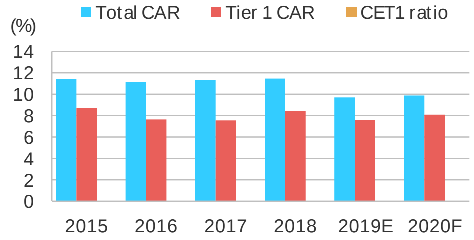
Source: Fitch Ratings, banks

Vietnam: Key Performance Trends
Problem-loan ratio[a]



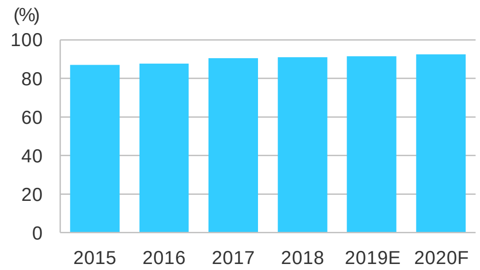
[a] Comprising reported NPLs, SMLs, and VAMC bonds of major banks
Source: Fitch Ratings, banks

Vietnam: Key Performance Trends
Capital ratios[a]



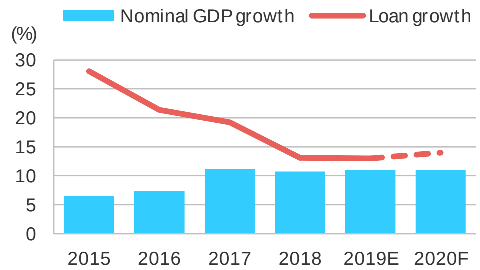
[a] Basel I for period from 2015-2018. Basel II from 2019
Data based on Fitch rated banks only
Source: Fitch Ratings, banks

Vietnam: Key Performance Trends
Loans/deposits ratio



Source: Fitch Ratings, banks

Vietnam: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch Ratings, SBV

Outlooks and Related Research

2020 Outlooks
Global Economic Outlook (September 2019)
What Investors Want to Know: EM Banks (November 2019)
China's Merger Plan May Support Clean-Up of Small Banks (November 2019)
Indian Banks Have Thin Buffers Against Systemic NBFC Stress (October 2019)

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