2017 Outlook: Asia-Pacific Banks

Asset-Quality Risks Weigh on Sector Outlooks

Outlooks for 2017

Developed Markets (DM)

	Rating Outlook	Sector Outlook
Australia	Stable	Negative
Hong Kong	Stable	Negative
Japan	Negative	Negative
Macao	Stable	Negative
New Zealand	Stable	Negative
Singapore	Stable	Negative
South Korea	Stable	Stable
Taiwan	Stable	Stable

Emerging Markets (EM)

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

Related Research

Other Outlooks
www.fitchratings.com/outlooks

Other Research
Global Economic Outlook – November 2016
Risk Radar 3Q16 (October 2016)

Analysts

Mark Young (Head of Asia-Pacific banks)
+65 6796 7229
mark.young@fitchratings.com

Ambreesh Srivastava (South and South-East Asia)
+65 6796 7218
ambreesh.srivastava@fitchratings.com

Jonathan Cornish (North Asia)
+852 2263 9901
jonathan.cornish@fitchratings.com

Tim Roche (Australia and New Zealand)
+612 8256 0310
tim.roche@fitchratings.com

More Negative Sector Outlooks: Fitch Ratings' sector outlooks across Asia-Pacific (APAC) have become increasingly negative, with three quarters of the bank systems that we cover being on negative outlook – compared with less than half for 2016. This reflects the likely impact of economic headwinds from China; low commodity prices; and related currency pressures translating into asset-quality and profit pressures as risks crystallise.

APAC bank systems where we have a stable sector outlook reflect overall resiliency to local pressures from an economic slowdown, and a more resilient macro picture for some.

Stable Bank Ratings: All APAC systems are on stable outlook except for Japan and Sri Lanka – both negative, and mirroring the sovereign rating outlook. The stable outlooks reflect: 1) some rating tolerance to sector pressures, and 2) sovereign support where the Viability Ratings (VRs) are lower than Issuer Default Ratings (IDRs). Support still matters in APAC, but credible resolution regimes may see sovereign support eroded for banks in more advanced systems.

Asset-Quality Risks: A cyclical deterioration is underway for most APAC systems, but likely to be manageable – based on earnings and capital buffers. China and India are key exceptions, with the erosion of absorption buffers leading to VR pressures. The main source of risk is the rapid build-up of private-sector debt since 2009 – both corporate and household – which is being tested as growth slows, and amidst low commodity prices and weaker currencies.

China's credit costs will rise further as system leverage expands at an unsustainable pace to support targeted growth levels, with credit/GDP set to hit 274% by end-2017. India's asset-quality recognition process is underway – the focus is now on capital. Other markets to monitor include Hong Kong and Singapore (leveraged to China); Indonesia and 'frontier markets' Mongolia, Vietnam and Sri Lanka (higher currency risks). Thailand and Malaysia have high household debt – as do Australia, New Zealand and Korea with their exposure to mortgages.

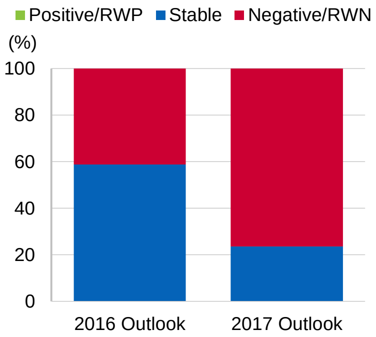
Key Risks – China: Lower economic growth in China and yuan weakness should weigh on regional economic sentiment. Our base case is for Chinese GDP to slow to 6.4% and the yuan/US dollar rate to weaken to CNY7.20 by end-2017. A more severe slowdown would have an impact on open economies such as Japan, Korea, Singapore, Hong Kong and Taiwan. The latter three also have large direct exposure via their financial systems. Weaker commodity prices would also be likely – exposing Indonesia, Malaysia, Mongolia and Australia.

Key Risks – US Rates: US interest-rate normalisation is likely to gather pace, underpinning US dollar strength. A sharper-than-expected rise in US rates – while implying a stronger US economy, and in the context of a weaker China – could push APAC currencies weaker. This would reduce policy flexibility to cut domestic interest rates, with Indonesia and Malaysia more vulnerable due to weaker external positions and greater dependence on commodities.

Key Risks – Politics: Populist anti-globalisation sentiment from national elections has raised uncertainties regarding policy frameworks. The US election has already led to the expectation of higher US interest rates – contributing to dollar strength, which is generally negative for emerging markets (EMs) – while Donald Trump's proposed protectionist trade policies would also raise potential downside risks particularly for emerging-Asia's open economies.

Capital Strengthening: Fitch expects capital levels to improve as global regulatory pressures and slower growth influence trends. Capitalisation and absorption buffers across the region are generally considered comfortable except for the two largest EMs – China and India. Capital levels in Mongolia, Vietnam and Sri Lanka also largely reflect their relatively low ratings.

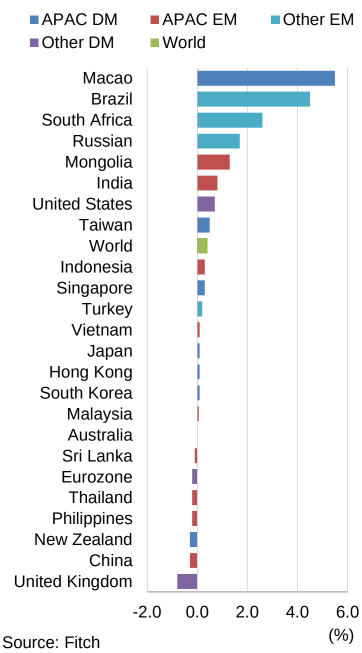
Sector Outlooks



Source: Fitch

Real GDP Growth Rate Change

Change in GDP growth rate: 2017F and 2016E



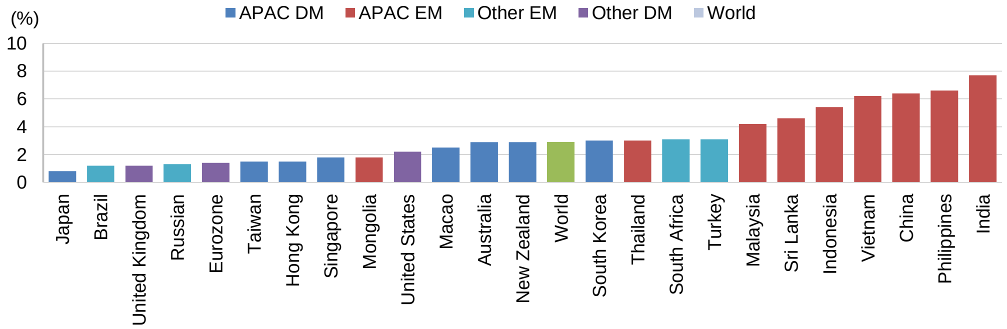
Source: Fitch

Pressures Building on the Banking System

The increased proportion of negative sector outlooks reflects the headwinds faced by most financial systems across APAC. Thirteen out of 17 financial systems are on negative outlook for 2017 compared with seven for 2016. This is notwithstanding EM APAC, in particular, being the fastest-growing region globally, and some higher GDP growth forecasts where markets are coming off recent lows.

Cyclical pressures dominate, and stem mainly from rising credit costs and – by recent historical standards – low credit growth, which we expect to translate into pressure on profit. The rise in credit costs is due to the ongoing crystallisation of credit risks that have built up across the region since 2009 as China continues to slow down, which in turn also translates into a relatively cautious risk appetite across most regional banking systems. Credit demand should also ease off, given the level of leverage which is already high in some markets and a lack of a new economic growth engine – except for some countries where there is infrastructure spending and structural reforms.

Real GDP Growth Rate (2017F)



Source: Fitch

Other pressure points for banks include those affecting business models due to ever-higher levels of regulatory capital as more stringent requirements are phased in; very low or negative interest rates affecting bank margins; and the rapid development of disruptive financial technology ('fintech').

Key Risks

China Slowing; Yuan Weakness

We expect China's decelerating growth (6.4% GDP in 2017) to weigh on economic sentiment across the region, as was the case in 2006. A China 'hard landing' is not Fitch's base case, but a more severe slowdown would add to the challenges and rising risks for banks within China and across the rest of APAC. The Chinese authorities continue to target growth rates that see imbalances increase, and credit is likely to continue to support this growth. Credit (Fitch-adjusted total social financing, FATSF) to GDP is forecast to reach 274% by end-2017 from an expected 258% at end-2016, higher than previous estimates.

The size and complexity of China's credit problem is exacerbated by rising leverage, increased interconnectivity with non-bank financial institutions (NBFIs), and through non-loan credit and rapid mortgage loan growth. The risk built up since 2008 associated with the credit-supporting surplus-capacity sectors is yet to completely manifest itself, and will weigh on the financial system over the short to medium term.

The region's sensitivity to a more rapid slowdown include increased global financial system linkages (see *Mainland China Exposure Data File – November 2016*), trade linkages, as well as reliance on commodities as key exports to China. Further weakness in the Chinese yuan (forecast by Fitch at CNY7.20 to the US dollar by end-2017) could in turn weigh on other currencies in the region. This would hit confidence, adding pressure to the more sensitive emerging markets and those reliant on commodity exports.

Rising US Interest Rates, Dollar Strength

US rates are expected to continue rising in 2017 with the Fed picking up the pace of interest rate normalisation. This is likely to underpin the strength of the US dollar. A sharper-than-expected rise in US rates – while implying a stronger US economy, and in the context of a weaker China – may push APAC currencies weaker, reducing the policy flexibility to be able to cut domestic interest rates. Indonesia and Malaysia would be the most vulnerable due to their weaker external positions and greater dependence on commodities.

Political Risks

The increasingly populist anti-globalisation outcome to recent national elections has meant policy frameworks have become uncertain, thereby increasing the potential downside economic risks – particularly for open economies. The election of Donald Trump has already led to the market expectation of higher US interest rates contributing to dollar strength, which is generally negative for emerging markets. Emerging Asia is also particularly sensitive to protectionist trade policies were these to be implemented. The table to the left highlights the election cycle for APAC over the next 24 months, which together with geopolitical tensions in the region could influence near-term economic sentiment.

APAC Election Timetable

2017 – 2018

Malaysia	By Aug 2018
New Zealand	By Nov 2017
S. Korea	By Dec 2017
Thailand	During 2017

APAC Banks Largely Resilient

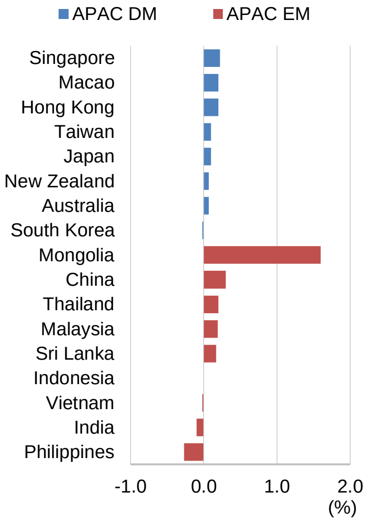
We expect APAC banks to be resilient to a cyclical downturn in most financial systems. We have a stable outlook on the vast majority of banking systems, reflecting generally sound loss-absorption buffers in terms of profitability and capital, supported by stable funding and liquidity. That said, the greatest pressure on bank fundamentals are in the region's largest markets of China and India, with additional risks in the frontier markets of Mongolia and Sri Lanka – both of which are negotiating or implementing IMF programmes. In Japan, unorthodox policies such as negative interest rates have made domestic conditions particularly challenging. This has hurt bank profitability, and also risks undermining the banks' business models.

Asset Quality

Rising NPLs is a theme in APAC, and we expect this to continue across most banking systems in 2017, adding to pressure on profit as lending growth slows. NPLs remain near cyclical lows (except for a couple of markets), and compare favourably with other regions. As a consequence, banks are likely to absorb the risks with only a limited impact on VRs. High financial system leverage or rapid credit growth since 2009 leads us to continue to expect a crystallisation of some of the risks built up – in particular where corporate (or non-bank private sector) external debt faces pressure from a combination of weaker currencies and low commodity prices (despite recent improvements). Some financial systems are also exposed to the risk of high household debt if unemployment begins to tick up or act as a drag to overall economic activity.

Asset Quality

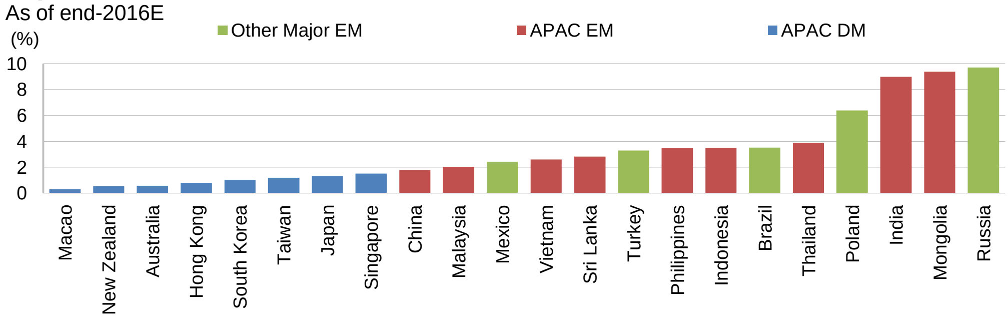
Change in NPL ratio: 2017F and 2016E



Source: Fitch

Impaired Loans Ratio

As of end-2016E



Note: Data for Other Major EM is at June-2016
Source: National Banks and bank regulators, Fitch calculations and estimates

China

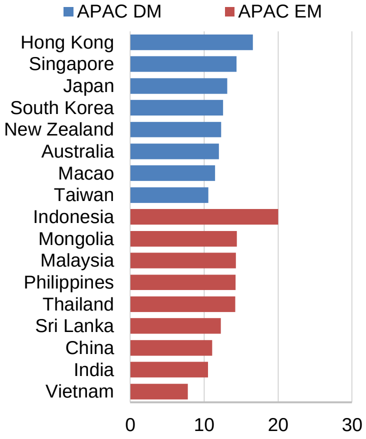
We believe the current reported NPL ratio for the system of less than 2% significantly understates the risks (see *China: Multi-Year Resolution of Problem Credit*), and ongoing rapid credit growth in support of unsustainable GDP growth targets means that potential problems will continue to get bigger. The extent of pressure on VRs will be determined by the erosion of absorption buffers from the realisation of on-balance sheet risks or risks from the 'shadow banking' system – with the mid-tier banks most at risk.

India

Asset quality will remain challenging for the next 12-18 months despite the expected marginal improvement in headline numbers. Following the initiation of the Reserve Bank of India's (RBI) balance-sheet clean-up, stressed assets for the Indian banking system are likely to peak at around 12% during FY17 and then start to improve – but only gradually. This could also have a negative bearing on sector asset-quality trends, depending on the length of the economic disruption relating to 'demonetisation'. The VR pressures are most acute for the public-sector banks, given their high level of stressed assets and low loan-loss reserves. As a result, profitability and capital will remain under pressure (see *Indian Banks' Capital Trigger Risk*) due to the need to lift provisions and meet higher regulatory capital requirements by 2019.

Capital

Tier 1 capital ratio at June 2016



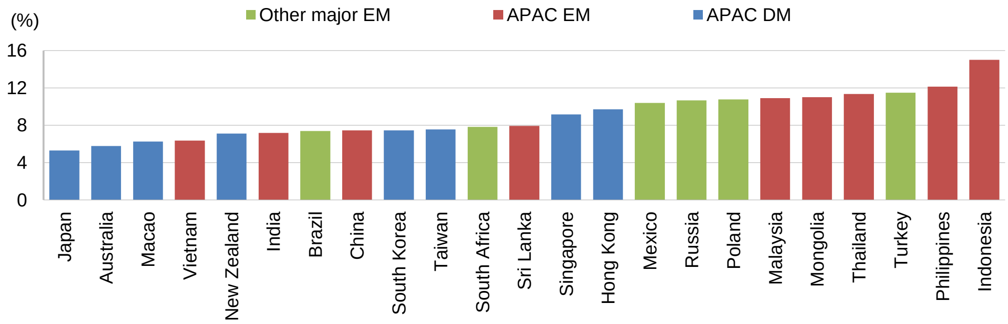
Note: India is at end-Mar 2016
Source: Fitch

Capitalisation

We believe capitalisation and absorption buffers are most under pressure in India and China, given the actual or potential asset-quality issues to which we have referred above. Capital levels in Mongolia, Vietnam and Sri Lanka largely reflect their relatively low ratings. For all other systems across the region, buffers are generally considered comfortable to absorb the sector pressures expected during 2017.

Equity/Assets

As of end-June 2016



Note: Vietnam, Indonesia and India data are Fitch's estimate

Low credit growth in some markets will assist banks in conserving capital, which combined with ongoing regulatory driven adjustments to raise the level of absorption buffers, should support improving regulatory capital trends across most markets. We expect regulatory capital issuance trends split between on- and off-shore markets to be driven by the need for refinancing of legacy instruments and to boost levels in response to additional capital buffers for domestic systemically important banks; adjusting internal risk-weight settings for 'advanced' banks; and also responding to the higher market thresholds set by (in particular) the globally systemically important financial institutions (GSIFIs).

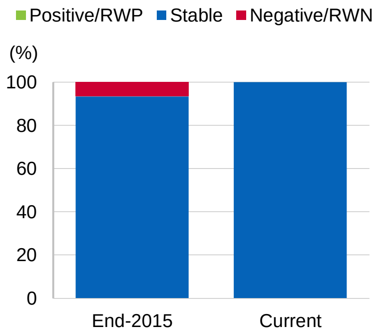
With respect to Total Loss Absorbing Capacity (TLAC) in APAC, this will be largely a Japanese "mega" banks story where we expect the three banking groups to continue to issue qualifying instruments. However, 2017 could also see greater clarity on how the four big Chinese GSIFIs – which benefit from a delayed phase-in – plan to eventually meet their TLAC requirements.

Rating Outlook

STABLE

(2016: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

NEGATIVE

(2016: STABLE)

- High household debt raises macro risks
- Turning credit cycle still manageable
- Profit strong but growth slows

Australia

Rising Financial System Pressure: Fitch's outlook on Australia's banking sector has been revised to negative from stable, reflecting an increase in risks and pressure on profit growth. Household debt is high and rising relative to disposable incomes, making borrowers sensitive to changes in the labour market and interest rates.

Property Key Risk: Fitch expects Australian house prices to remain high relative to peer countries. Growth is likely to moderate, though, as a large number of newly built apartments will come on to the market over the next 12 to 18 months – thereby creating a potential oversupply. Tighter underwriting standards could increase settlement risk, affecting property development exposures – which nevertheless remain manageable for Australian banks.

The build-up of property risk, which has prompted some regulatory intervention, leaves the banks potentially susceptible to some asset-quality deterioration if a more significant price slowdown were to occur, considering their significant exposures to residential mortgages.

Pressure on Profit Growth: Profit growth is likely to continue to slow in 2017, reflecting the low-interest-rate environment, slow asset growth, asset and deposit competition, higher funding costs, and a rise in loan-impairment charges. Improvements in cost-management are likely to be offset by increased investment in technology.

Manageable Asset-Quality Pressure: Asset quality remains challenged in small pockets of the economy – mainly the sectors and regions related to mining and commodity prices. Recent improvements in commodity prices should support asset quality, although exposures continue to be susceptible to price volatility. Banks' exposures to these sectors and regions remain a manageable part of their overall books. Fitch expects the labour market to remain fairly stable, supporting the asset quality of household exposures.

Focus on Stronger Capital: The banks' capitalisation will remain solid, especially in light of further regulatory requirements. Retained earnings are the most likely source of capital; and while we expect profit growth to be challenged, adjustments in dividend policies and the use of dividend reinvestment plans should support strong internal capital generation. Slowing risk-weighted asset growth and the sale of non-core assets could also be beneficial to capital ratios.

Focus on Longer-Term Funding: The banks will remain reliant on offshore wholesale markets, reflecting the lack of customer deposits, in part due to the country's superannuation scheme. However, we expect the banks to continue to focus on improving wholesale maturity profiles as well as growth in core deposits. Improved liquidity should mitigate the risks associated with reliance on wholesale funding markets.

Outlook Sensitivities

Macroeconomic Pressure: An ongoing rise in household debt and house-price growth heightens the banking system's sensitivities to a sharp correction if labour market conditions and interest rates were to change. These scenarios – although not our base case – could jeopardise the banks' strong asset quality and profitability, and weaken capitalisation.

Sharp China Downturn: China growth which is significantly slower than Fitch has forecast could affect Australia's economy as China remains its largest trading partner. This could exert pressure on banks' financial profiles which would in turn place negative pressure on ratings, but this is not Fitch's base case.

Dislocated Funding Markets: A prolonged global funding market disruption could place significant pressure on the banks' balance sheets despite the improvements in liquidity.

Related Research

Fitch: Australia's Major Banks Face More Profitability Pressure (Nov 2016)

Fitch: Fitch Affirms Australia's Four Major Banks (May 2016)

Australian Banks Peer Review (May 2016)

Chart of the Month: Australian Bank Capital Ratios Understate True Position (June 2016)

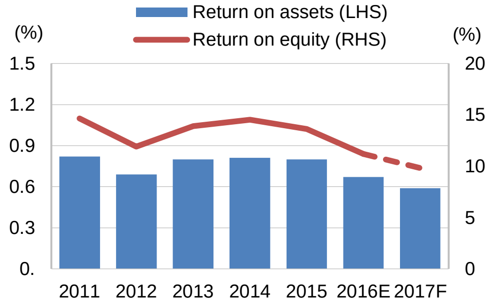
Analysts

Andrea Jaehne
+61 2 8256 0343
andrea.jaehne@fitchratings.com

Tim Roche
+61 2 8256 0310
tim.roche@fitchratings.com

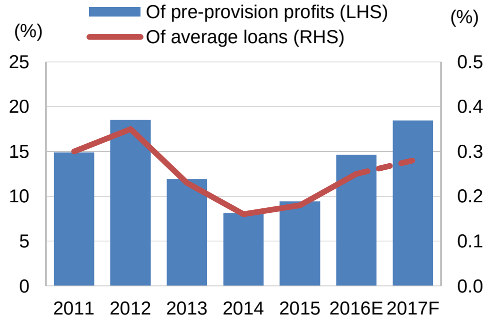
Jack Do
+61 2 8256 0355
jack.do@fitchratings.com

Australia: Key Performance Trends
Return on assets and return on equity



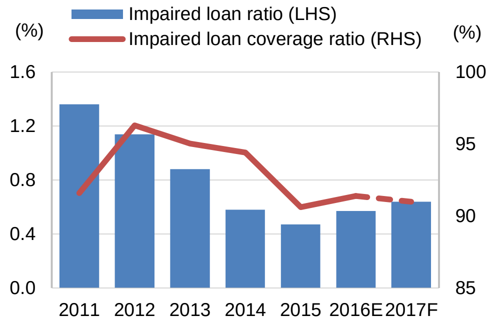
Source: Fitch, Australian prudential regulatory authority (APRA)

Australia: Key Performance Trends
Credit costs



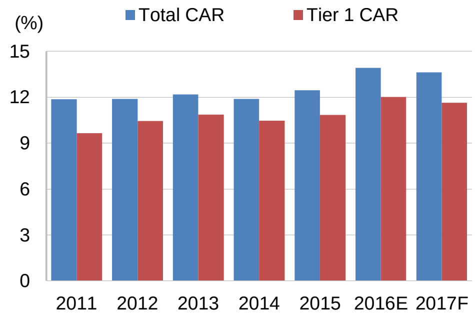
Source: Fitch, APRA

Australia: Key Performance Trends
Asset quality



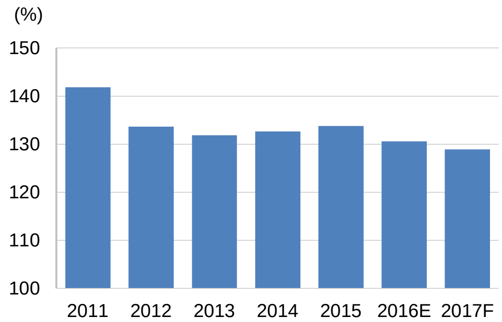
Source: Fitch, APRA

Australia: Key Performance Trends
Capital ratios



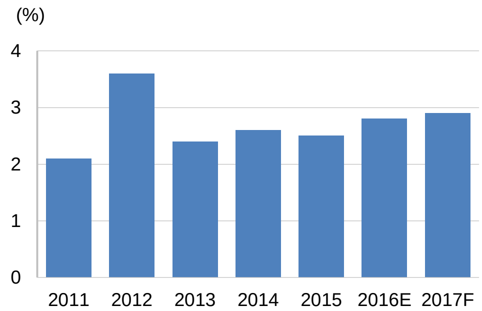
Source: Fitch, APRA

Australia: Key Performance Trends
Loans/deposits ratio



Source: Fitch, banks

Australia: Key Performance Trends
Real GDP growth



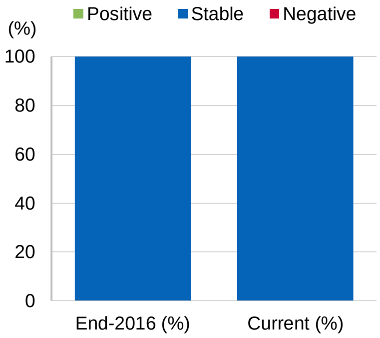
Source: Fitch

Rating Outlook

STABLE

(2016: STABLE)

Rating Outlooks/Watches



Source: Fitch

Sector Outlook

NEGATIVE

(2016: NEGATIVE)

- Reliance on credit to support growth
- Rising interconnectivity with NBFIs
- Increasing regulatory scrutiny

Related Research

Chinese Banks: Impact of Wealth Management Products (November 2016)

China's Debt-For-Equity Swaps Face Implementation Risk (October 2016)

China's Rebalancing Has Not Yet Addressed Credit Risks (September 2016)

China: Multi-Year Resolution of Problem Credit (July 2016)

Policymakers Fuelling China's Mounting Debt Problems (July 2016)

Analysts

Katie Chen
+886 2 8175 7614
katie.chen@fitchratings.com

Jaclyn Wang
+86 21 5097 3189
Jaclyn.wang@fitchratings.com

Jack Yuan
+86 21 5097 3038
jack.yuan@fitchratings.com

Grace Wu
+852 2263 9919
grace.wu@fitchratings.com

Jonathan Cornish
+852 2263 9901
Jonathan.cornish@fitchratings.com

China

State Support Drives IDRs: Fitch's stable rating outlook reflects our expectation of state support, which remains the sole rating driver for Chinese bank IDRs. Our negative sector outlook is underpinned by weakened profitability resulting from higher impairment charges as well as suppressed margins from funding competition and lower borrowing costs to support the economy. Rising systemic risk and pressured risk buffers also contribute to the negative sector outlook.

Rising Systemic Risk: We expect credit growth (based on our revised estimate of Fitch-adjusted total social financing, FATSF) of around 14% in 2017 (2016e: 18%), as policymakers allow strong credit growth (e.g. in property and infrastructure) to meet GDP targets. This implies FATSF/GDP will reach 274% by end-2017 from 258% at end-2016 – higher than previous estimates. The rise in system leverage, increased interconnectivity with NBFIs and through non-loan credit, and rapid growth in new mortgage loans, will add to the size and complexity of China's credit problem.

Flat Earnings: Reported profitability in 2017 is unlikely to change significantly; we expect banks to smooth out their provisioning cycle and report flattish earnings at the expense of further declines in coverage ratios and continued NPL write-offs/disposals. Net interest margin (NIM) contraction should moderate, despite expectations for one more rate cut before end-2017 to keep borrowing costs low. Banks' ability to contain costs and drive fee-income growth will be key differentiating factors.

Pressured Risk Buffer: Asset-quality deterioration, regulatory requirements, and rapid growth in credit exposure will keep pressuring the banks' loss-absorption buffers. In addition, declining ROE, broader economic issues over China's medium-term growth, and volatile market conditions will make capital-raising a challenge.

Corporate Leverage Still Key Issue: Household lending, in particular mortgages, should remain a key loan growth driver for 2017, in spite of further home-purchase restrictions in the higher-tier cities being introduced to cool market prices. The extent that rising real-estate prices further fuel already-high corporate leverage (as borrowers often use real estate as collateral for loans) remains a key risk for asset-quality. Debt swaps alone are insufficient to significantly reduce corporate leverage.

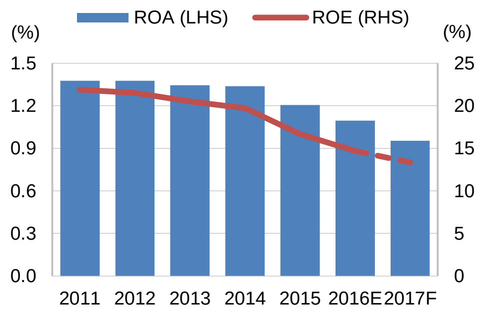
Outlook Sensitivities

IDRs Stable, VR Pressures: Changes to IDRs and reassessment of Support Rating Floors will be tied to shifts in the perceived willingness or ability of the sovereign to provide support, which may be driven by developments in policy/regulation, corporate restructuring and the economy. Rising leverage will increase the potential burden to the state, weakening its ability to support.

Further reliance on wealth management products (WMPs) or other volatile forms of funding; asset-quality deterioration beyond expectations; or sustained/aggressive growth in risk appetite that significantly weakens loss-absorption buffers, could lead to downgrades of VRs. Positive momentum in the banks' VRs is unlikely until China's operating environment stabilises.

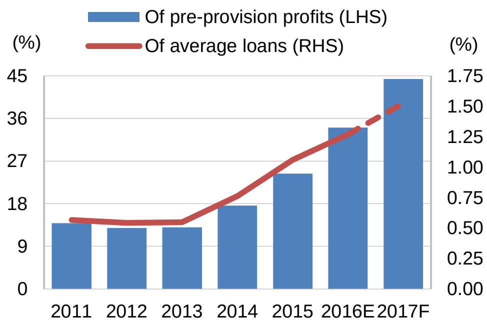
Regulatory Scrutiny: Fitch's projections for 2017 assume that forbearance will continue to drag on asset impairment recognition. However, we expect increased regulatory scrutiny over areas such as WMPs, interbank activities, and investment in receivables. Whether tighter regulations successfully contain systemic risks will depend on the implementation, as previous rules sometimes had the unintended consequences of reducing bank transparency.

China: Key Performance Trends
Return on assets and return on equity



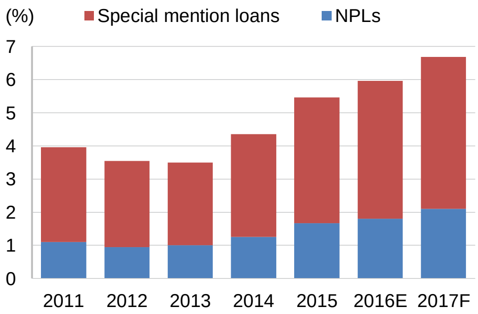
Source: Fitch, CBRC

China: Key Performance Trends
Credit costs



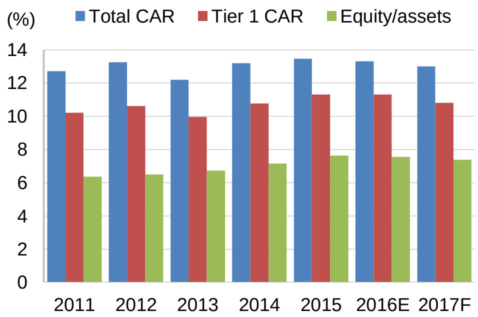
Source: Fitch, Banks

China: Key Performance Trends
Asset Quality - NPL, special mention loan ratios



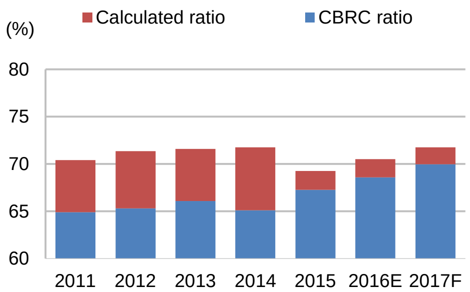
Source: Fitch, CBRC

China: Key Performance Trends
Capital ratios



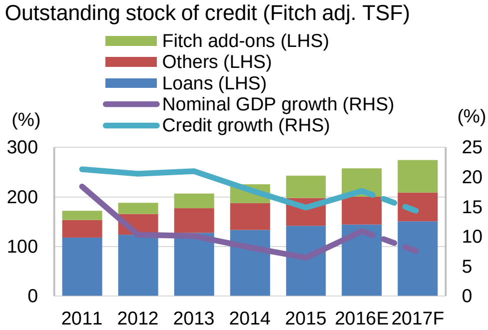
Source: Fitch, CBRC

China: Key Performance Trends
Loans/deposits ratio



Note: Ratios since 2014 represent Renminbi loans and deposits; calculated ratio based on gross loans/deposits
Source: Fitch, PBOC, CBRC

China: Key Performance Trends
Outstanding stock of credit (Fitch adj. TSF)



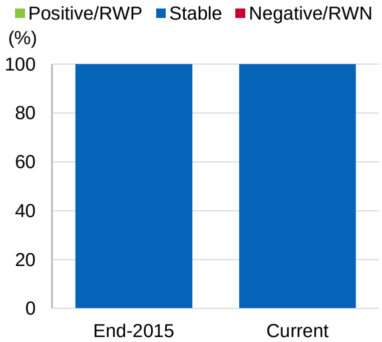
Source: Fitch, PBOC, banks, BIS, HKMA, Wind, CEIC, China Trustee Association

Rating Outlook

STABLE

(2016: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

NEGATIVE

(2016: STABLE)

- MCE most significant concentration risk
- Property risk contained
- Advanced regulatory framework

Related Research

Mainland China Exposure Data File - (November 2016)

Chart of the Month - Hong Kong Banks Risk Survey (September 2016)

Fitch: Hong Kong Resolution Law Will Spur Planning at Banks (July 2016)

Fitch: Hong Kong Banks Can Withstand Severe Shocks, Test Shows (May 2016)

Analysts
Sabine Bauer
+852 2263 9966
sabine.bauer@fitchratings.com

Ivan Lin
+852 2263 9984
ivan.lin@fitchratings.com

Hong Kong

Sound Intrinsic Strength: The rating outlook remains stable, reflecting Fitch's view that banks in the territory will continue to maintain solid fundamentals amid tight regulatory oversight and macro-prudential measures. Vulnerabilities stem from their exposure to China, while we view risks from property lending as contained.

Negative Sector Outlook: Fitch's negative sector outlook reflects our belief that the banks will continue to face asset-quality and profitability pressures from the low-interest-rate environment, and slower economic growth due to spillovers to Hong Kong's open economy from falling Chinese demand. The year 2017 should provide greater clarity over the robustness of banks' lending criteria for China-related activities as loans season.

China Exposure Rising Again: Fitch expects Hong Kong's mainland China exposure (MCE) to continue 1H16's upward trend, as Hong Kong banks become more sophisticated in their China-related activities – which should lead to a pick-up in the onshore activities of Hong Kong banks. Chinese corporates' international expansion will be another growth factor, as this creates opportunities for larger banks to finance them abroad. We believe that MCE will exceed 30% of system-wide assets by end-2017 (1H16: 27.6%, 2015: 27.3%).

High Macro-Prudential Risk: Hong Kong remains the only developed market besides Macao designated an MPI 3 score, which indicates high systemic risk for banks. The score reflects high system leverage and high property prices. Credit/GDP will remain high (2016: 220%) on account of cross-border financing, even though we expect subdued credit growth in 2017.

Property Risk Contained: Fitch believes that banks' property loans will continue to perform well. Loan-to-value ratios are amongst the lowest across Asia-Pacific, and the authorities have the flexibility to soften a potential dip in the property market through unwinding tight macro-prudential measures as well as transaction taxes. Maintaining stability in this key sector is of high priority to the authorities to protect consumer wealth and system-wide confidence.

Cyclical Loan Deterioration: We see a gradual increase in loan-impairment charges in the current environment, with a rising contribution from China-related exposure. Fitch considers that China-related NPLs could rise to above 2% in 2017; but overall, we believe that Hong Kong banks' NPLs will remain moderate at around 1%.

Weakening Profitability: Fitch expects banks' profit to decline moderately due to subdued loan growth, weaker trade flows and higher impairment charges. Gradually rising US and Hong Kong dollar interest rates would benefit the banks, given their large deposit bases.

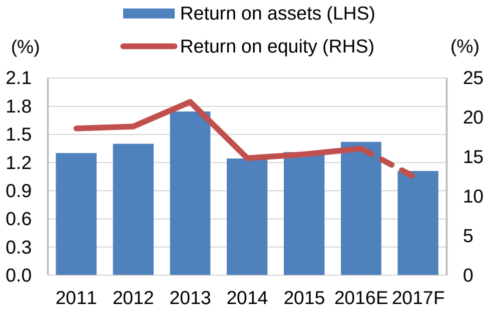
Capital Buffers Phase-in: Banks will continue to phase-in higher capital requirements, specifically the counter-cyclical buffer which applies to banks' domestic exposure (1.25%); and a buffer for domestic systemic importance which applies to the five largest banks (0.5%-1.25%). Recovery and resolution planning will be prioritised for the domestically systemically important banks.

Robust Liquidity: We expect system liquidity to remain robust as the largest banks benefit from strong domestic deposit bases. Sudden withdrawals from less stable foreign sources cannot be ruled out if sentiment towards China and the broader region were to change, but our base case is for the system to remain liquid.

Outlook Sensitivities

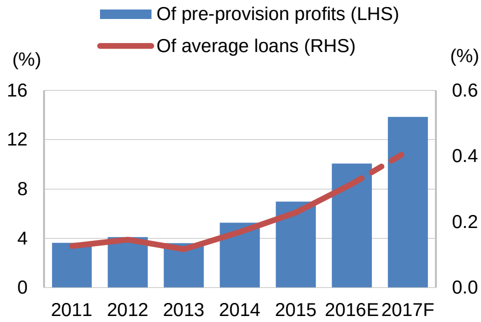
Event Risk Dominates: A disruptive slowdown of the Chinese economy (not our base case) or sudden changes in fund flows could disproportionally hurt the ultra-open economy, and in turn the banking system if its asset quality and liquidity were significantly tested. An unexpected sharp MCE deterioration or aggressive growth could lead to negative rating action.

Hong Kong: Key Performance Trends
Return on assets and return on equity



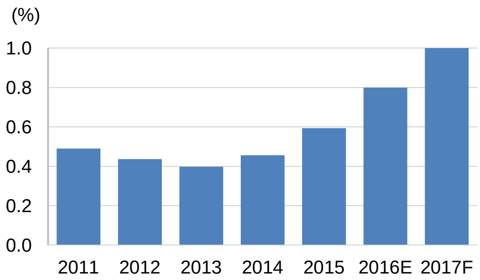
Source: Fitch, HKMA

Hong Kong: Key Performance Trends
Credit costs



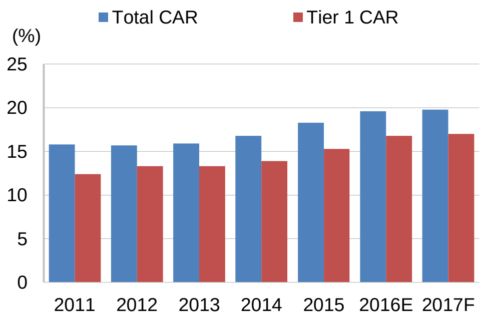
Source: Fitch, rated banks

Hong Kong: Key Performance Trends
Asset quality - impaired loan ratio[a]



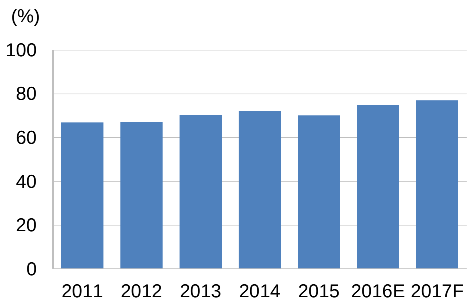
[a] Exposures graded "substandard", "doubtful" or "loss"
Source: Fitch, HKMA

Hong Kong: Key Performance Trends
Capital ratios



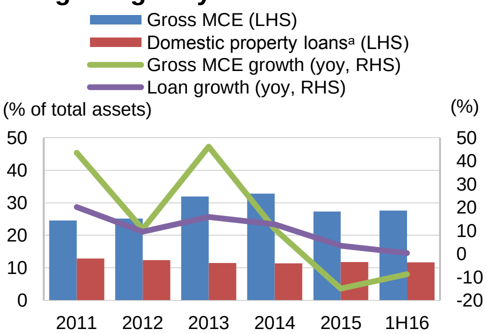
Source: Fitch, HKMA

Hong Kong: Key Performance Trends
Loans/deposits ratio



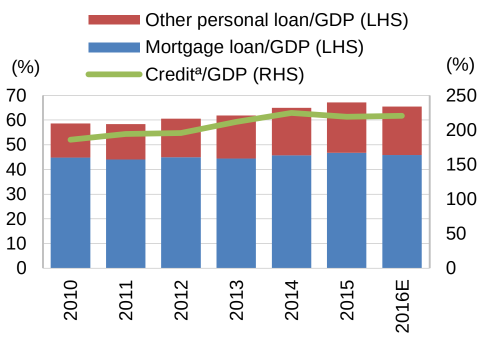
Source: Fitch, HKMA

Hong Kong: Key Performance Trends



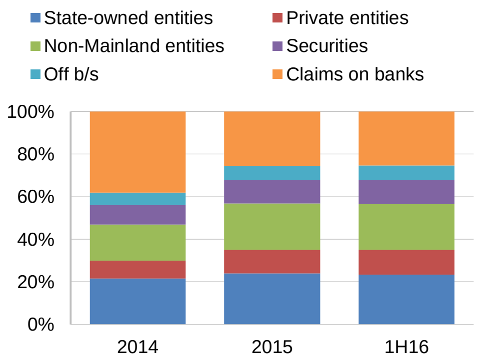
[a] Commercial and residential
Source: Fitch, HKMA

System Leverage



[a] Bank credit to private sector
Source: Fitch, HKMA

MCE by Borrower



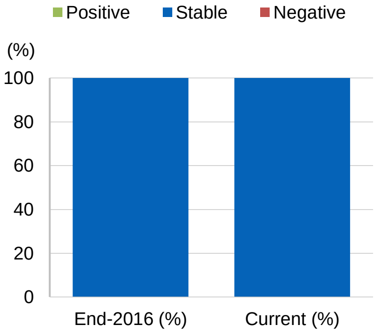
Source: Fitch, HKMA

Rating Outlook

STABLE

(2016: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

NEGATIVE

(2016: STABLE)

- Rising capital pressures
- Weak earnings outlook
- Challenging asset quality

India

Ratings Stable; Sector Negative: Indian banks' IDRs are mostly support-driven (aside from private banks), and are likely to stay stable, mirroring the sovereign rating outlook. The negative sector outlook reflects the fragile standalone position of state-owned banks, and suggests there may be more downside risks for their VRs if the risks of deteriorating asset quality and weak earnings are not offset by larger capital injections. Private-sector banks have better earnings and capital buffers despite rising pressure on asset quality.

Weak Capital; Rising Needs: Capital requirements are set to rise significantly as the Basel III phase-in approaches its advanced stages. Fitch estimates the banks will require around USD90bn in new total capital by the financial year ending March 2019 (FYE19) to meet Basel III standards. This comes when delayed recognition of problem loans and widespread losses have raised standalone credit risks, and added to capital pressure amidst the risk that capital triggers at some state banks may be breached as minimum capital requirements rise.

Eighty percent of the capital needs arise during FY18 and FY19, while more than half of the required new capital will have to be met through core equity; additional Tier 1 (AT1) capital largely accounts for the rest. State banks need the bulk of the capital, and have weak access to equity markets. The government has been a provider of core equity, but the total earmarked sum of USD10.4bn until FYE19 may not be sufficient to address the ongoing capital needs.

Local Market Lacks Depth: Fitch believes it will be very difficult for the domestic market to support the significant AT1 requirement by itself, i.e. without broadening the investor base. Domestic AT1 issuance has risen in the last few months, but overseas activity has been absent since State Bank of India's (SBI, BBB-/Stable) debut AT1 issuance in September 2016.

Weak Earnings: We expect Indian banks' ROA to witness a small uptick over FY16 as losses narrow. However, we expect earnings at most state banks to remain extremely weak, and also for some to incur losses. This is because the pressures of continued loan-loss provisions – for both old and new NPLs – against weak growth will prove overbearing on banks' thin pre-provision earnings, despite a dip in absolute NPL growth.

Asset-Quality Challenges Prevail: Fitch expects the stressed-asset ratio for Indian banks' to increase to around 12% in FY17 (FY16: 11.4%). The asset-quality indicators are possibly close to their weakest levels, but the picture will remain challenging as sectoral stress and slow resolution remain a drag on the pace of recovery. NPLs are likely to slow down, but consistently fast-paced loan growth in retail (including small business) may create vulnerabilities for future asset quality.

Outlook Sensitivities

IDRs Aligned to Sovereign: The banks' IDRs are sensitive to changes in the sovereign rating or outlook. However, private banks' IDRs are also driven by their VRs, and could be downgraded if their VRs are downgraded (except for ICICI Bank Ltd. (BBB-/Stable), where the IDR is at the Support Rating Floor).

Capital Replenishment is Pivotal: Ability to bring in sufficient external capital is critical when prospects for internal generation are weak and capital buffers are at or nearing regulatory thresholds. State banks' VRs have weakened over the years, and could face more pressure if capital inadequacy leads to wider implications such as a breach of capital triggers.

Related Research

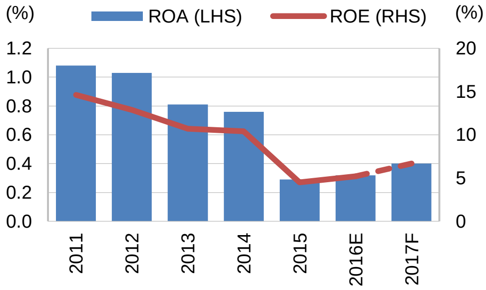
What Investors Want to Know: Indian Banks (November 2016)
India's Bank Resolution Plan Likely to Face Obstacles (October 2016)
Indian Banks' Capital Trigger Risk (September 2016)
First Indian Bank Coupon Skip Shows Capital Pressure (August 2016)
Indian Banks FY16 Report Card (August 2016)

Analysts

Saswata Guha
+91 22 4000 1741
saswata.guha@fitchratings.com

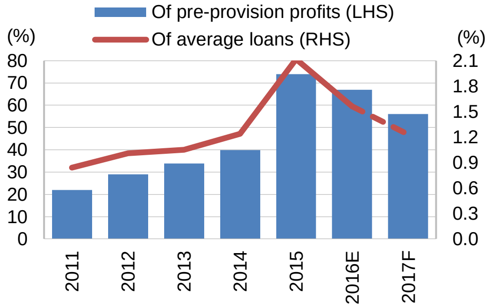
Jobin Jacob
+91 22 4000 1773
jobin.jacob@fitchratings.com

India: Key Performance Trends
Return on assets and return on equity



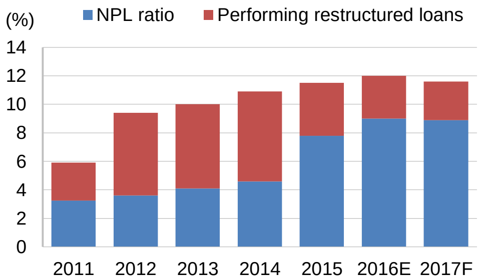
Note: The years represent fiscal year ending March
Projections include govt's announced capital injection
Source: Reserve Bank of India (RBI); Fitch

India: Key Performance Trends
Credit costs



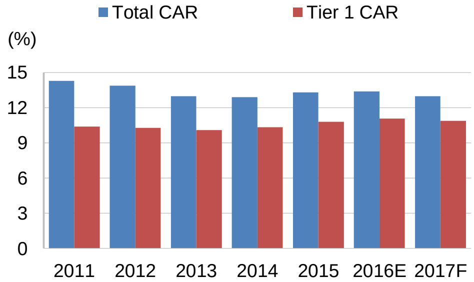
Note: The years represent fiscal year ending March
Source: Reserve Bank of India (RBI); Fitch

India: Key Performance Trends
Asset quality - NPL plus "performing restructured loans" ratio



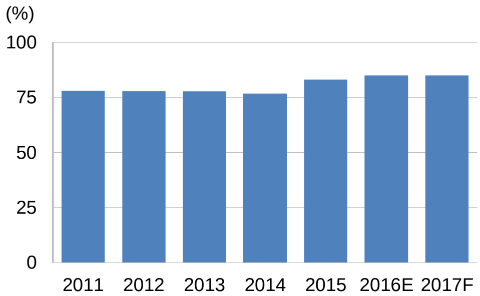
Note: The years represent fiscal year ending March
Source: Reserve Bank of India (RBI); Fitch

India: Key Performance Trends
Capital ratios



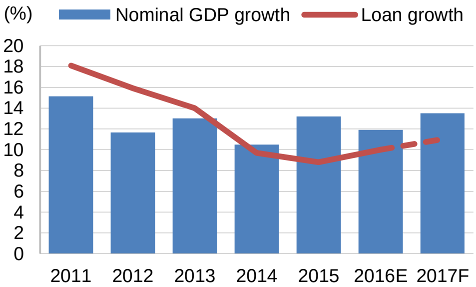
Note: The years represent fiscal year ending March
Projections include govt's announced capital injection
Source: Reserve Bank of India (RBI), Fitch

India: Key Performance Trends
Loans/deposits ratio



Note: The years represent fiscal year ending March
Source: Reserve Bank of India; Fitch

India: Key Performance Trends
Nominal GDP growth and loan growth



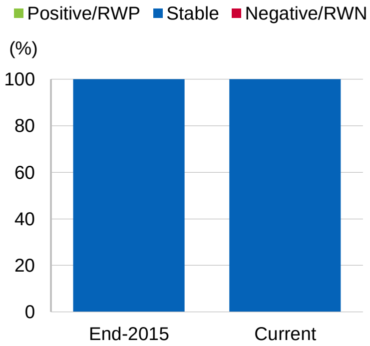
Note: The years represent fiscal year ending March
Source: Reserve Bank of India (RBI): Fitch

Rating Outlook

STABLE

(2016: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

NEGATIVE

(2016: NEGATIVE)

- Weak operating environment
- Asset-quality risks remain
- Capital and profitability strength

Related Research

Indonesian Banks' Stress Test (September 2016)

Indonesian Banks Report Card: 1H16 (September 2016)

Fitch: Indonesia Bank Support Unchanged By New Financial System Law (March 2016)

Analysts

Gary Hanniffy, CFA
+62 21 2988 6808
gary.hanniffy@fitchratings.com

Iwan Wisaksana
+62 21 2988 6807
iwan.wisaksana@fitchratings.com

Indonesia

Weak Operating Environment: Fitch has affirmed its negative sector outlook for Indonesian banks. The operating environment remains challenging, as reflected in weaker credit quality and subdued consumer sentiment, and we expect these conditions to persist into 2017. We forecast GDP to pick up to 5.4% next year (2016: 5.1%), but pressures on the banking system are likely to remain, primarily from risks built up in the previous credit cycle.

Continuing Asset-Quality Pressure: Asset-quality pressure is likely to come from further slippage of already-high levels of 'special mention' and restructured loans, with modestly higher industry loan growth of around 10% (2016: 8%) resulting in the NPL ratio remaining cyclically higher at around 3.5%. The fallout from the commodity-sector downturn filtered through to the general economy during 2016, and should still weigh on trends in 2017.

Stabilising Profitability: We expect credit costs to remain high on incremental NPLs and banks replenishing cover levels, with the average ROA for the top-10 banks estimated to remain flat at around 2.0%. Banks' profitability metrics have declined steadily over the past three years, dragged down by rising credit costs. Yet the profitability of Indonesian banks remains relatively high compared with most of their regional peers, thanks to the banks' strong NIMs.

We expect the top-four banks' profitability to continue to perform better in relation to the medium-sized banks, given their stronger deposit and lending franchises which suggest a greater loss-absorption capability. The lower VRs of the medium-sized banks incorporate their moderate credit-cost tolerance and lower profitability compared with their larger peers.

Well Capitalised: The large banks should remain well-capitalised by end-2017. High core capital, with sector Tier 1 at 20.7% at end-August 2016, along with the banks' relatively high profitability, provides sufficient buffer against significant spikes in credit losses. Common equity comprises the banks' entire Tier 1. The average Tier 1 ratio for the top-10 banks was a healthy 18% at end-June 2016. Most of the large banks would have already met the Basel III requirements if the maximum additional capital charges were applied at end-1H16.

Steady Liquidity: Competition for deposits is likely to remain modestly intense, as pressure for deposits eases with moderate loan demand. A tightening of the interest-rate cap on deposits in March 2016 should help ensure that deposit competition remains healthy. The top-four banks' strong deposit franchises mean they are well-positioned in the unlikely event of a liquidity crunch, with the sector loan/deposit ratio at 89.9% as of end-August 2016. Liquidity coverage ratios (LCRs) at each of the top-10 banks were comfortably above 100% at end-9M16.

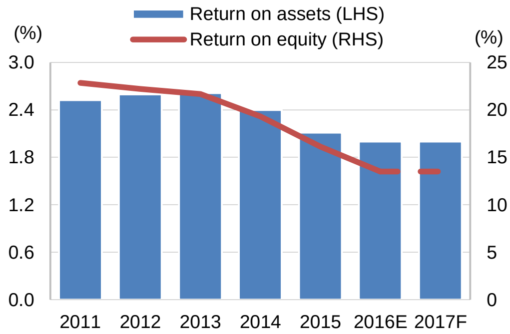
Outlook Sensitivities

Sovereign Rating, Country Ceiling: Any change in the sovereign rating may affect the support-driven ratings of certain banks. A change in the country ceiling, capped at 'BBB', would affect the ratings of most foreign-owned Indonesian banks.

Government Support: A change in the state's ability and willingness to provide extraordinary support would affect the ratings of the state-owned banks. Fitch will review the potential impact on support ratings and support rating floors as further key details and supporting regulations for the Financial System Crisis Prevention and Mitigation Law become available.

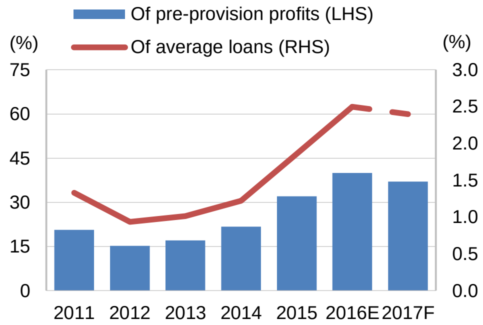
Weaker-than-Expected Environment: Slower-than-expected GDP growth leading to a more prolonged economic downturn would pressure the asset quality profiles of the banks and may significantly affect profitability and increase capital-impairment risk. The banks' VRs are also sensitive to overly aggressive asset expansion and a significant increase in risk appetite.

Indonesia: Key Performance Trends
Return on assets and return on equity



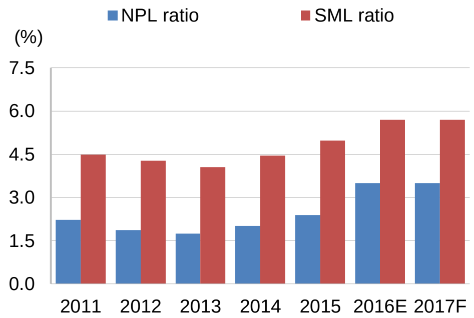
Source: Fitch, 10-largest banks

Indonesia: Key Performance Trends
Credit costs



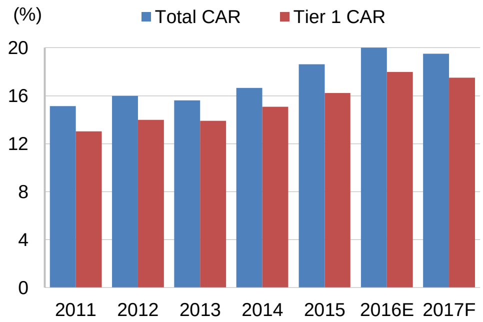
Source: Fitch, 10-largest banks

Indonesia: Key Performance Trends
Asset quality



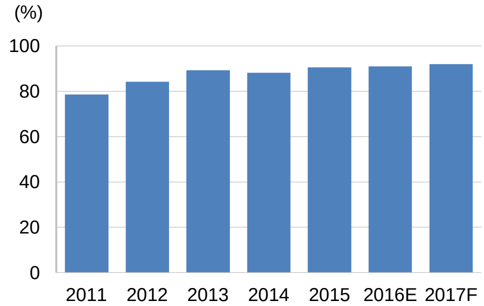
Source: Fitch, 10-largest banks

Indonesia: Key Performance Trends
Capital ratios



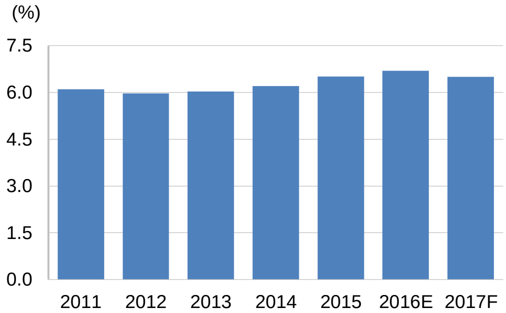
Source: Fitch, 10-largest banks

Indonesia: Key Performance Trends
Loans/deposits ratio



Source: Fitch, 10-largest banks

Indonesia: Key Performance Trends
Net interest margin



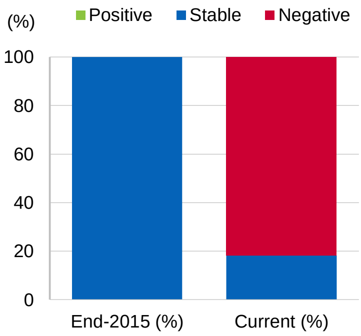
Source: Fitch, 10-largest banks

Rating Outlook

NEGATIVE

(2016: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

NEGATIVE

(2016: STABLE)

- Challenging operating environment
- Pressure on profitability
- Solid financial profiles

Related Research

Fitch Affirms Ratings on Major Japanese Banks (November 2016)

Japanese Banking Sector Update – May 2016 (June 2016)

Analysts

Kaori Nishizawa
+81 3 3288 2783
kaori.nishizawa@fitchratings.com

Naoki Morimura
+81 3 -3288 2688
naoki.morimura@fitchratings.com

Jonathan Cornish
+852 2263 9901
Jonathan.cornish@fitchratings.com

Japan

Challenging Environment: Fitch views the operating environment as negative, with the banks' business models and profitability facing greater challenges. Global market uncertainties and adverse changes in Japan's stock market and currency, and unorthodox policies such as the negative interest rate policy (NIRP) introduced early 2016, are also likely to hinder banks' growth prospects. Real GDP growth remains stable but low (2017f: 0.8%; 2016e: 0.7%).

Japan's subdued domestic environment and NIRP is likely to harm regional banks more than the "mega" banks, which have greater diversification of revenue sources by both product and geography. Nevertheless, their offshore operations also face various headwinds. We expect banks' financial metrics in 2017 to be modestly weaker in terms of profitability, broadly stable in asset quality, with sound capital and liquidity maintained.

Profitability Pressured: Domestic net interest margin (NIM, FYE16 consolidated average: 0.9%) will remain tight over the next 12-15 months, reflecting limited loan growth, low/negative interest rates and tougher competition. Offshore NIM (1.0%) will also face pressure from higher funding costs and competition. New fee-income streams and market-driven trading revenue will see little improvement in the absence of changes in economic policy. We expect lower earnings, with growth in overseas earnings unlikely to fully offset weaker domestic earnings.

Moderating Overseas Expansion: Offshore loan growth will be limited by prevailing economic growth pressures overseas, foreign-currency liquidity management (at a greater cost), and higher regulatory capital standards. Fitch expects asset quality to hold firm, although the banks' higher risk appetite in recent years – mainly in emerging markets – may lead them to reassess risk taking/expansion in light of operating environment headwinds.

Limiting Volatility: The mega banks continue to reduce equity holdings (average: 21% of FCC at end-June 2016) to lower financial volatility. We expect the banks to meet their target levels, but progress will be slowed by lower stock prices and corporate negotiations to reduce cross-shareholdings. Exposure to sovereign bonds (average: 134% of FCC) is around the minimum level required as collateral for liquidity funding needs, so this is unlikely to fall much further.

Liquidity Profile Intact: Strong domestic franchises benefit the mega banks' yen/retail funding, but foreign funding to support their overseas expansion is mostly wholesale in nature (deposits or debt instruments), which exposes them to potential market dislocation. The mega banks have adjusted to changes (eg US money market regulation), and have the Bank of Japan's support as a back-stop in terms of foreign-currency liquidity facilities, in case of need**.**

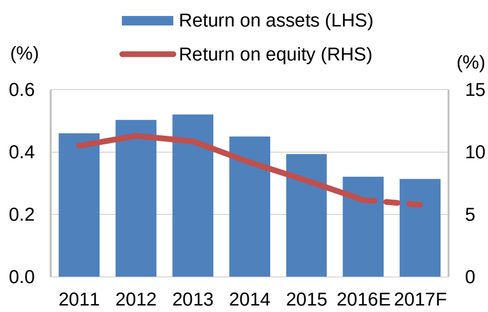
Slower Capital Growth: Fitch expects regulatory capital ratios to remain sound, but they risk falling slightly – due to potential increases in risk-weighted assets from evolving regulations, weaker stock markets, lower profitability, a mostly unchanged dividend policy, and a focus on capital efficiency. Banks' awareness of global developments, including regulations, means they could build additional buffers through issuance of total loss-absorption capacity-eligible bonds.

Outlook Sensitivities

Operating Environment Shock: A substantial deterioration in the operating environment that causes greater volatility in banks' performance, and/or a rising risk appetite without being offset by higher risk buffers, could be ratings negative. An unexpected sharp rise in appetite for risk (market or credit) without adequate mitigation would also be negative.

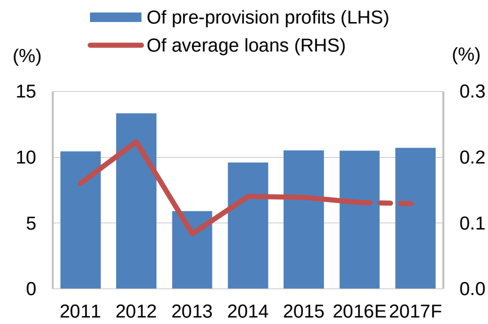
Sovereign Rating: The negative rating outlook is driven by the sovereign rating (A/Negative). A downgrade of Japan's sovereign rating would lead to similar action on banks whose ratings are at the sovereign level or underpinned by sovereign support.

Japan: Key Performance Trends
Return on assets and return on equity



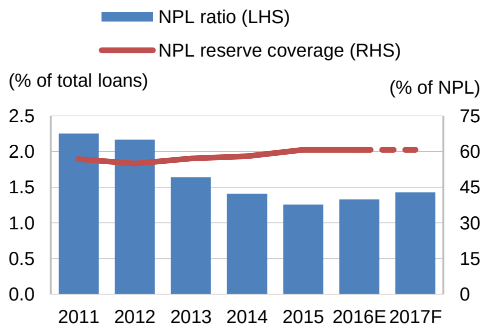
Source: Fitch, banks

Japan: Key Performance Trends
Credit costs



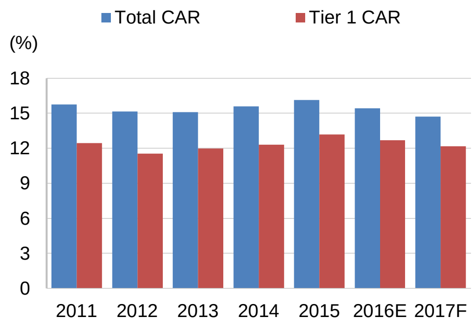
Source: Fitch, banks

Japan: Key Performance Trends
Asset quality - NPL ratio



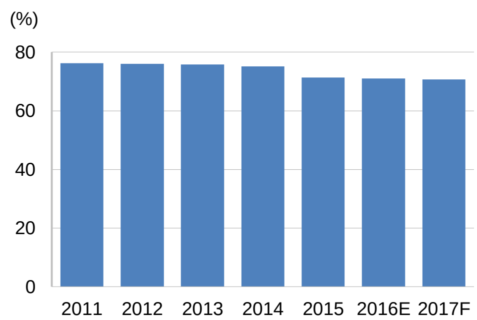
Source: Fitch, banks

Japan: Key Performance Trends
Capital ratios



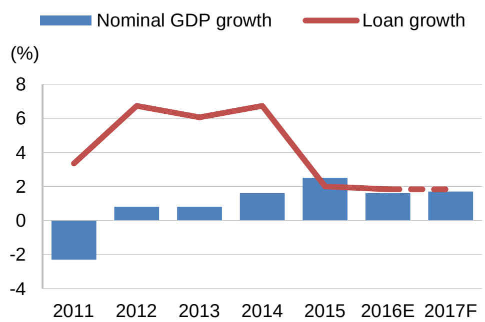
Source: Fitch, banks

Japan: Key Performance Trends
Loans/deposits ratio



Source: Fitch, banks

Japan: Key Performance Trends
Nominal GDP growth and loan growth



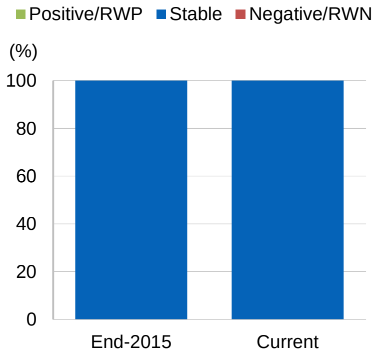
Source: Fitch, banks

Rating Outlook

STABLE

(2016: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

NEGATIVE

(2016: NEGATIVE)

- Concentrated economy key risk
- Weak regulatory oversight
- Parental support drives ratings

Related Research

Fitch: Foreign Banks' China Exposure is Rising Again (November 2016)

Macao Banks Report Card: Outlook on Operating Environment Turns Negative on Property, Gaming Weakness (June 2016)

Fitch: Macao Banks More Vulnerable as Operating Environment Weakens, Loans Surge (March 2016)

Analysts

Ivan Lin
+852 2263 9984
ivan.lin@fitchratings.com

Shanice Lu
+852 2263 9924
shanice.lu@fitchratings.com

Macao

Sector Outlook Remains Negative: Fitch maintains a negative outlook on Macao's banking sector in 2017, to reflect the enduring impact from a slow recovery in the gaming sector, the effect of a China slowdown and property-price corrections on banks' credit profiles. We feel that Macao's weaker-than-peer regulatory framework leaves banks underprepared to withstand risks. Fitch rates two banks in Macao based on institutional support, and the stable rating outlook reflects the credit profiles of their foreign parents.

Economy Recovers: Fitch expects Macao's volatile GDP to expand in 2017 (2016E: -3%, 2015: -20.3%), which should add stability to banks' operating environment. The economy remains concentrated on gaming-related tourism and consumption sectors, and its lack of diversification renders it vulnerable to policy changes in China and shift in consumer sentiment. The debt-servicing ratio is likely to remain low (below 30%), supported by low unemployment (2016E: 1.9%) – benefitting from a flexible labour force of which 40% are foreigners.

High Systemic Risk: Lending to the domestic retail, hotel and property sectors is set to pick up as the economy recovers, in addition to the faster growth in mainland China exposure (MCE) which will further increase Macao's credit/GDP ratio to 117% in 2017F. Macao remains at MPI '3', which implies a high risk of systemic stress.

China Exposure Grows: We see Macao banks' MCE (1H16: 33% of system assets; 2015: 26%) continuing to expand, driven by cross-border financing needs of Chinese and foreign institutions and banks' deepened business integration with these Chinese bank parents. Mainland-related loans, Chinese corporate bonds and off-balance sheet MCE represented 57%, 15% and 14% of banks' assets, respectively, at end-1H16. In contrast, claims on mainland banks and trade finance had declined to 14% and 7% of banks' assets, respectively.

Manageable Gaming Exposure: We believe that the quality of gaming-associated exposure including restaurants and retail sectors (3Q16: 14% of system assets) will be supported by a rebound in gaming-sector revenue. Fitch forecasts a mid-single-digit growth for the latter in 2017 (2016E: -5%, 2015: -34%), due to new casino openings and mass-market visitors.

Large Property Concentration: Property exposure (including loans collateralised by property) should stay above 40% of loans, and its quality should remain adequate, supported by a low average loan/value ratio of around 50%. Infrequent property revaluations entail risks if prices decline fast (-21% since 2Q14). We expect delinquencies to rise from a very low level (3Q16: 0.13%), especially for speculative buyers who are more sensitive to a price decline.

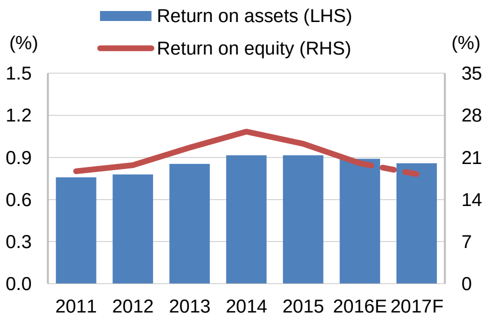
Banks' Performance Largely Stable: We think banks' profitability will hold up, but a reliance on interest income may constrain the upside as loan spreads could narrow on low aggregate loan demand. The steadily growing share of higher-yielding securities will support earnings but also adds market risk. Fitch expects banks' capital positions to remain adequate, in line with just a slight uptick in NPLs (2017F: 0.5%). Liquidity will be supported by large deposit base (2017F loan/deposit: 85%), moderate loan growth and access to liquidity support from parents.

Lenient Regulatory Framework: Macao's macro-prudential measures have somewhat helped to curb the speculative activities in the property sector but bank supervision remains less stringent. There is occasional regulatory forbearance, Basel II capital rules were only implemented in 2015. Recovery and resolution planning is not a priority as over 70% system assets are China-owned.

Outlook Sensitivities

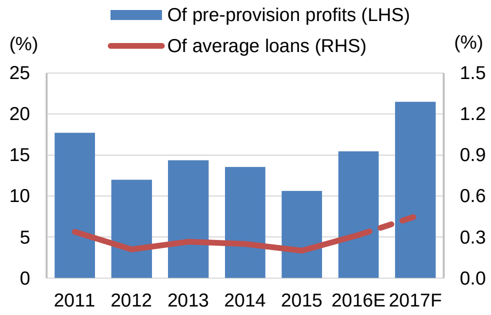
China Risks; Economic Diversification: Revising the sector outlook to stable relies on a recovery of Macao's economy, which is sensitive to China's economy and changes in China's policy towards Macao. The operating environment of Macao banks would improve if Macao could diversify and stabilise its economy through building up non-gaming sectors.

Macao: Key Performance Trends
Return on assets and return on equity



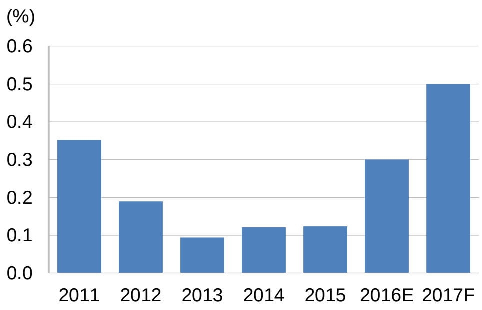
Source: Fitch, banks

Macao: Key Performance Trends
Credit costs



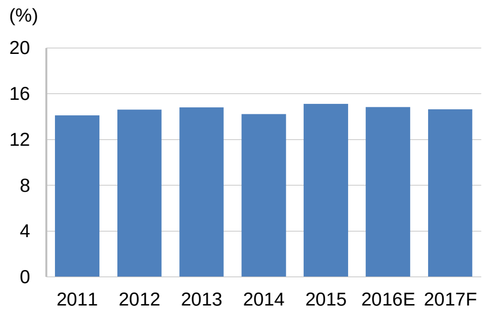
Source: Fitch, banks

Macao: Key Performance Trends
Asset quality - NPL ratio



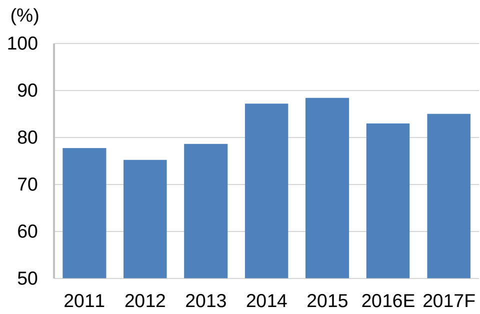
Source: Fitch, banks

Macao: Key Performance Trends
Capital ratios - Total CAR



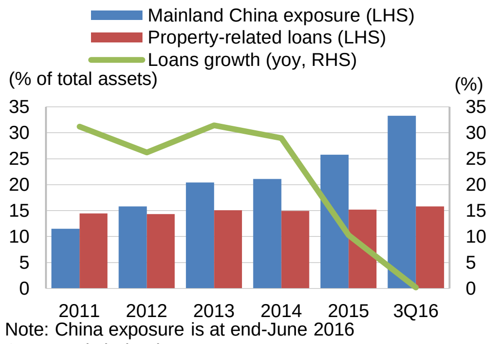
Source: Fitch, banks

Macao: Key Performance Trends
Loans/deposits ratio



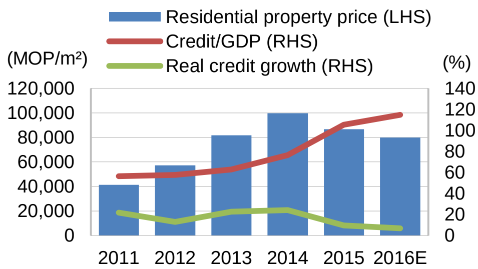
Source: Fitch, banks

Macao: Key Performance Trends
Concentration risk



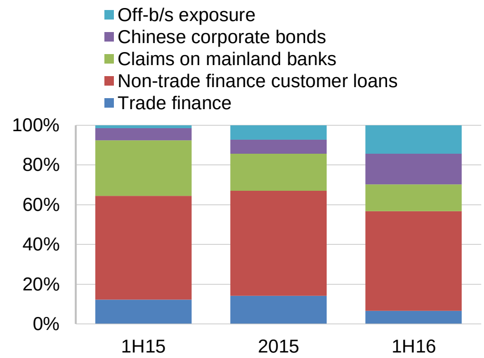
Note: China exposure is at end-June 2016
Source: Fitch, banks

Macao: Key Performance Trends
MPI3 indicators



[a] Real credit growth and Credit/GDP ratio are Fitch estimates; Property price is averaged quarterly transaction price for 1Q16 - 3Q16
Source: Fitch, banks

Macao: MCE Breakdown



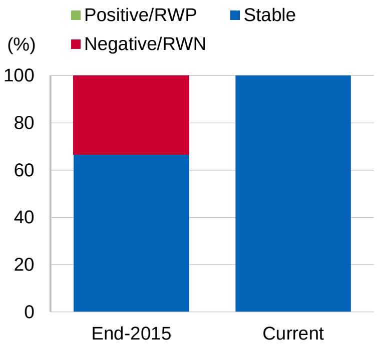
Source: Fitch, AMCM

Rating Outlook

STABLE

(2016: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

NEGATIVE

(2016: NEGATIVE)

- Softer economic conditions persist
- Sound buffers support stable ratings

Malaysia

Conditions Still Challenging; Ratings Resilient: Fitch expects the current environment of lower oil & gas prices and subdued external demand to continue into 2017. Our GDP growth forecast of 4.2% in 2017 (2016: 4.1%; 2015: 5.0%) reflects our expectation that economic expansion will remain below the long-run average, albeit slightly improved – aided by supportive economic policy and modestly higher commodity prices.

We expect a lacklustre economic environment to continue to place moderate pressure on banks' asset quality and profitability, and retain our negative outlook on the banking sector. That said, downside risks to bank balance sheets are mitigated by their adequate loss-absorption buffers, sound funding and liquidity positions, and prudent macroprudential regulation. These factors anchor the stable outlooks on our bank ratings.

Asset-Quality Risks Remain: Gross impaired loans (GIL) have risen among larger banks with significant corporate and offshore exposures, arising mainly from the oil & gas, construction and other commodity sectors. The GIL ratio for the six largest bank groups that we track had climbed to 1.93% by end-September 2016 from 1.76% at end-2015, and we expect the softer economy and a rising cost of living to continue to weigh on asset quality.

We remain watchful for further signs of stress from the oil & gas and construction/property industries, and more vulnerable lower-income households – the latter particularly in light of their relatively high indebtedness (debt/income of 7x) and limited savings. However, the banking system's exposures to the above sectors are modest, and any weakness should be within the bounds of a normal cycle. The oil & gas industry accounts for roughly 2% of credit exposures, while construction and unsecured personal loans each represent 3%-4% of gross loans.

Mild Profitability Pressure: Loan growth should remain muted, and we see higher provisions as the key risk to profitability in 2017. This is especially as loan-loss coverage has fallen – to 78% by end-September 2016 (end-2014: 90%) for the top six banks. We believe corporate and offshore portfolios are likely to pose a greater credit risk. Against this backdrop, we expect banks to manage funding and operating costs carefully. Pre-provision profit should stay sufficient to absorb higher credit costs, with little risk to capital.

System Remains Well-Capitalised: Core capitalisation continues to rise, and the banking sector remains well-capitalised with a transitional common equity Tier 1 ratio of 13.3% at end-September 2016. We expect the banks to retain a more conservative bias in managing capital in the near term, in light of continued economic uncertainty in 2017 and regulatory and accounting updates that may raise capital charges further out.

Outlook Sensitivities

Limited Near-Term Upside: Positive rating action is unlikely in the near term, as Fitch-rated banks are already at the same level as the sovereign, whose ratings are on stable outlook.

Significant Deterioration: A severe downturn – resulting in more pronounced asset-quality, earnings and capital risks – could place greater pressure on bank ratings. This may be triggered by a return to even lower oil & gas prices, or other external shocks. Such a scenario is likely to be accompanied by weak employment conditions – which would in turn hurt household finances.

Excessive Rise in Leverage: Expansionary policies that encourage disproportionately higher private-sector leverage, without a corresponding improvement in debt-servicing capacity, would be negative for the sector. This is important as household leverage is already relatively high in Malaysia (end-2015: 89% of GDP). We believe such policies are unlikely to be widespread, as the regulator remains vigilant against excessive financial leverage.

Related Research

Fitch: Malaysia Budget Signals Stability Despite Low Oil Revenue (October 2016)

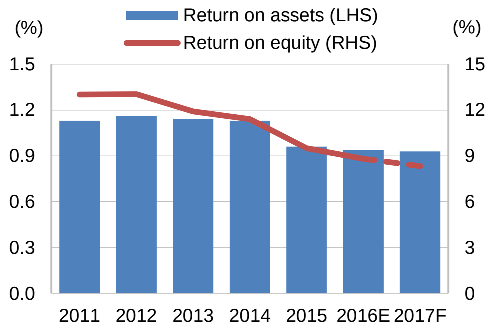
Malaysia (September 2016)

Fitch Affirms Two Malaysian Banks; Upgrades HLBB (August 2016)

Analysts
Elaine Koh
+65 6796 7239
elaine.koh@fitchratings.com

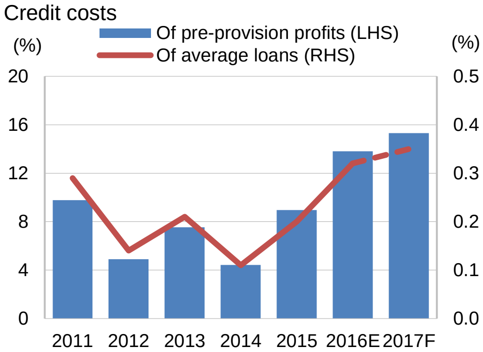
Wee Siang Ng
+65 6796 7230
weesiang.ng@fitchratings.com

Malaysia: Key Performance Trends
Return on assets and return on equity



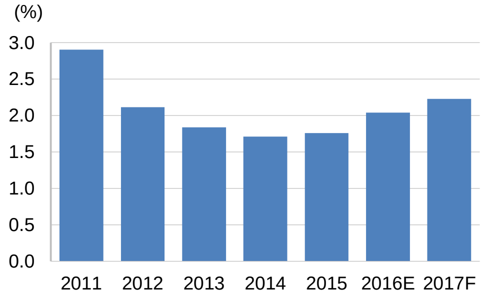
Source: Fitch, Bank Negara Malaysia (BNM)

Malaysia: Key Performance Trends
Credit costs



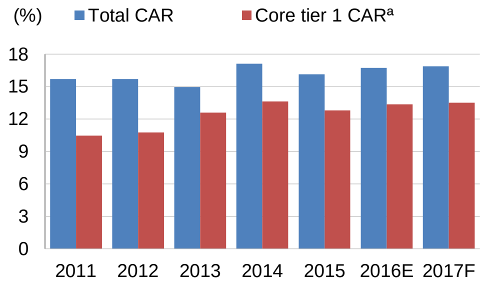
Source: Fitch, BNM

Malaysia: Key Performance Trends
Asset quality
Gross impaired loan ratio - top six bank groups



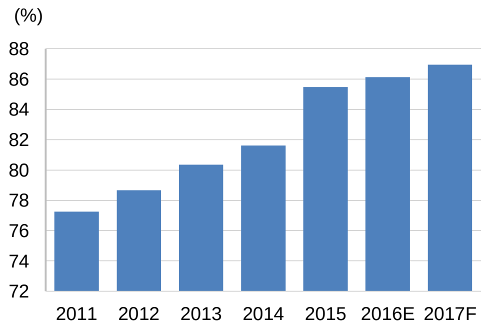
Source: Fitch, banks

Malaysia: Key Performance Trends
Capital ratios



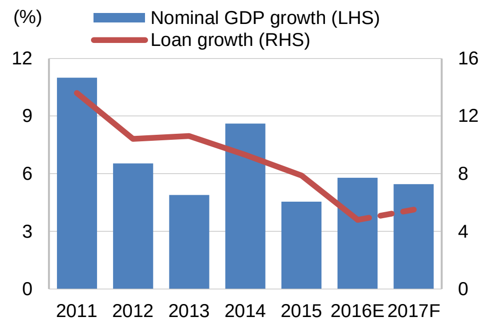
[a] Tier 1 less hybrids till 2012, Basel 3 common equity tier 1 from 2013 onwards
Source: Fitch, BNM

Malaysia: Key Performance Trends
Loans/deposits ratio



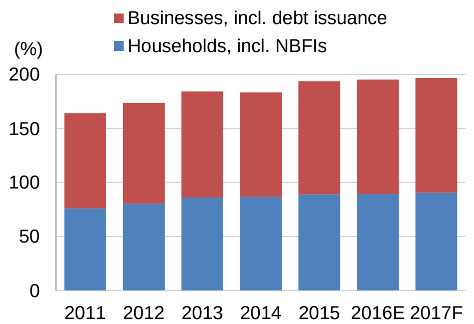
Source: Fitch, BNM

Malaysia: Key Performance Trends
Nominal GDP and loan growth



Source: Fitch, BNM

Malaysia: Key Performance Trends
Credit/GDP ratios



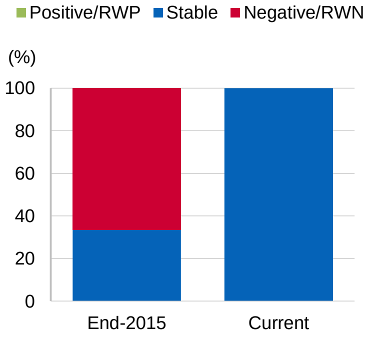
Source: Fitch, BNM

Rating Outlook

STABLE

(2016: NEGATIVE)

Rating Outlooks



Source: Fitch

Sector Outlook

NEGATIVE

(2016: NEGATIVE)

- Heightened sovereign risks
- Difficult environment to persist
- Weak intrinsic strength

Related Research

Fitch Downgrades Mongolia's Khan Bank and XacBank to 'B-'; Affirms State Bank (November 2016)

Outlook and Risks: Mongolian banks (October 2016)

Fitch: Mongolia's Refinancing Risks Deepen as Currency Plummets (August 2016)

Analysts

Ivan Lin
+852 2263 9984
ivan.lin@fitchratings.com

Shanice Lu
+852 2263 9924
shanice.lu@fitchratings.com

Mongolia

Sector Outlook Remains Negative: Mongolia is facing difficult economic conditions, with low commodity prices and a weak local currency. Fitch has revised the rating outlook to stable from negative, following the downgrade of two Mongolian banks on 23 November 2016. The divergence between the ratings outlook (stable) and sector outlook (negative) reflects our view that the volatile operating environment would continue to pressure banks' credit profiles, despite the related cyclical risks having been captured by their ratings.

Highly Interconnected with Sovereign: The sovereign's weakened credit profile (B-/Stable) has a profound impact on the banks, particularly as the banking system has significant direct exposure through holding sovereign and sovereign-related securities – which amount to 26% of their assets on average. The banks use Bank of Mongolia's foreign-currency (FC) swap facility to manage their currency positions, and government funding to conduct subsidised lending.

Potential Liquidity Spillover Risks: Fitch believes banks' funding and liquidity positions are vulnerable to deposit runs if the sovereign were to default on its FC bonds in 2017, but this is not Fitch's base case. We expect bilateral FC funding to remain available. Only one commercial bank had issued FC bonds which fall due 2017 and 2020. We expect further dollarisation and continuous local-currency (tugrik) depreciation (2017F: 12%), which could exacerbate the banks' reliance on the FC swap facility and worsen the quality of FC loans.

Rising Asset-Quality Pressure: We expect the NPL ratio to rise to 11% in 2017 from 9.4% in 2016, due to slower economic growth in Mongolia and China and tight fiscal and monetary conditions. Large commodity exporters and suppliers would be hit the hardest, while pressure on retail sectors is likely to be higher due to their weaker disposable household income. We feel that intensified pressure from the operating environment on banks' asset quality would be broad-based across all sectors, given Mongolia's small and less diversified economy.

Slower Growth Builds Buffers: We view a weaker environment as resulting in slower growth for the banks, notwithstanding their risk appetite could quickly reverse if the environment were to improve. Fitch has classified Mongolia as an MPI 2 country due to faster credit growth in the last few years. The banks are likely to maintain reasonable loss-absorption buffers – including capital, provisioning and collateral – to help mitigate the downside risks. We expect profitability to decrease due to higher credit costs, limited growth and higher funding costs.

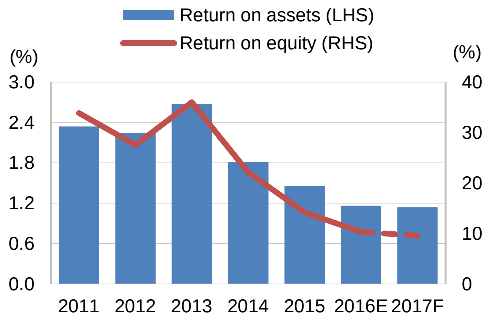
Pursuing Sustainable Development: Fitch expects a stronger commitment from the authorities to market-oriented reforms in 2017, to foster the development of Mongolia's banking industry under the IMF's advice – which could come at the expense of short-term growth. This could help strengthen the supervisory framework, improve governance indicators and bolster banks' provisioning/capital buffers. Credible fiscal and monetary policies could drive more sustainable growth at banks, while ensuring a prudent risk appetite and adequate liquidity.

Outlook Sensitivities

Improving Operating Environment: The sector outlook is sensitive to improvement in the sovereign's external financing conditions; favourable developments of large mining projects; and a pick-up in associated infrastructure investment. The sector outlook would largely depend on steady economic growth, FDI inflows and stabilisation of the banks' financial profiles.

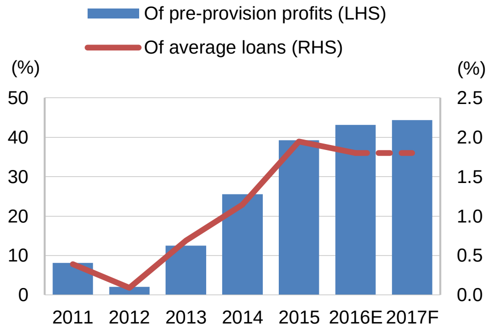
Sovereign Ratings; Intrinsic Strength: The ratings are sensitive to changes in the sovereign rating, the Country Ceiling and Fitch's expectation of the sovereign's willingness to provide support to the banks and; the operating environment and banks' asset-quality metrics. A significant improvement in the latter would be required for any positive rating action on Khan Bank LLC (B-/Stable) and XacBank LLC (B-/Stable), while an upgrade in State Bank LLC's (B-/Stable) ratings is unlikely, given its weaker credit profile.

Mongolia: Key Performance Trends
Return on assets and return on equity



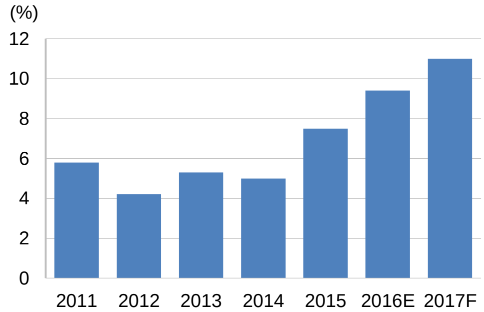
Source: Fitch, banks

Mongolia: Key Performance Trends
Credit costs



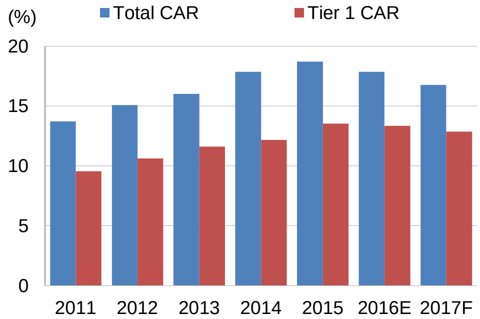
Source: Fitch, banks

Mongolia: Key Performance Trends
Asset quality - NPL ratio



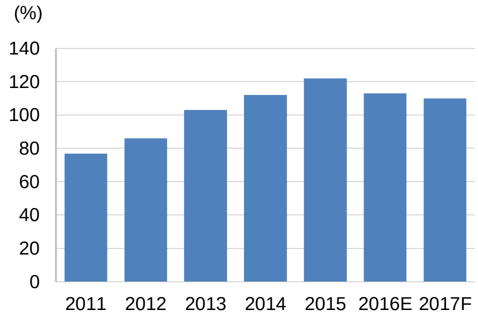
Source: Fitch, banks

Mongolia: Key Performance Trends
Capital ratios



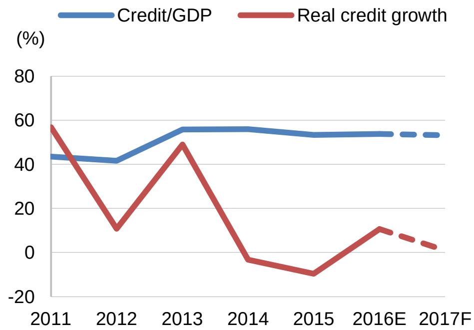
Source: Fitch, banks

Mongolia: Key Performance Trends
Loans/deposits ratio



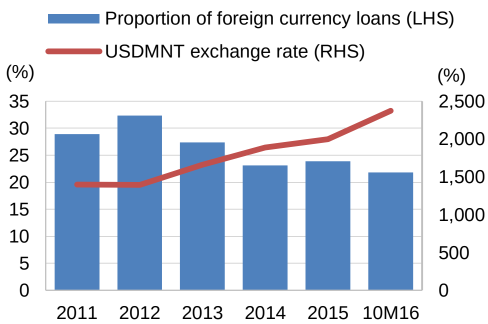
Source: Fitch, banks

Mongolia: Macro Indicators



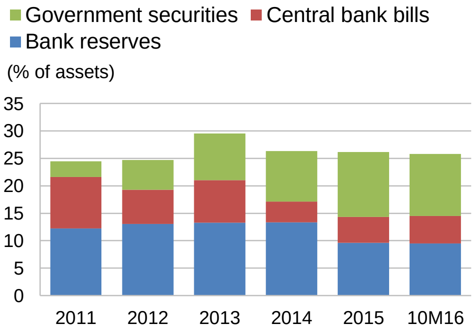
Source: Fitch, banks

Mongolia: Key Performance Trends
Foreign currency loan exposures



Source: Fitch, BOM

Mongolia: Key Performance Trends
Sovereign-related exposures



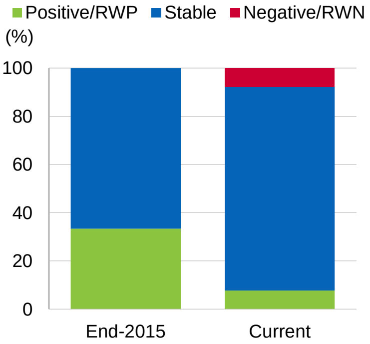
Source: Fitch, BOM

Rating Outlook

STABLE

(2016: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

NEGATIVE

(2016: NEGATIVE)

- High household debt presents threat
- Dairy pressure slowly easing
- Slower profit growth

Related Research

Peer Review: New Zealand Regional Lenders (September 2016)

Fitch Upgrades Co-op Bank; Affirms Four NZ Banks (September 2016)

Fitch affirms New Zealand's Major Banks; Outlooks Remain Stable (September 2016)

Fitch: Tighter Macro-Prudential Rules in New Zealand Support Bank Ratings (July 2016)

New Zealand Major Banks Peer Review (March 2016)

Fitch: Macro Pressures to Persist for NZ Banks Despite Rate Cut (March 2016)

Analysts

Andrea Jaehne
+61 2 8256 0343
andrea.jaehne@fitchratings.com

Jack Do
+61 2 8256 0355
jack.do@fitchratings.com

Tim Roche
+61 2 8256 0310
tim.roche@fitchratings.com

New Zealand

Increasing Macroeconomic Risks: Fitch's outlook on the New Zealand banking sector remains negative for 2017, reflecting the historically high and rising household indebtedness which has become the most dominant risk to the banking system. Fitch expects the asset-quality pressure from the banks' dairy exposures to soften, reflecting a slow recovery in dairy prices since mid-2016.

Housing Imbalances Drive Prices: Fitch believes that house-price growth in Auckland may continue due to strong net immigration and housing-supply imbalances, which is most likely to result in in rising household debt. These factors make the banking system more vulnerable to price corrections hurting banks' balance sheets, as residential mortgages account for the largest lending asset.

The Reserve Bank of New Zealand has introduced several macroeconomic measures since 2013 resulting in tighter underwriting and greater equity buffers of the financed properties. This should limit the effects of a price correction on the banks' financial profiles. However, the longer-lasting impact on the economy could result in weaker asset quality and profitability for the banking sector.

Still Cautious on Dairy: Fitch expects dairy prices to continue to improve steadily, and therefore ease asset-quality pressure arising from the banks' dairy exposures. We feel it would take ongoing tightening of the farmers' operations to withstand the dairy-price volatility.

Profit Pressure Continues: Profitability should weaken modestly but to remain strong relative to international peers in 2017. Profit is likely to decline as a result of potentially higher funding costs and tighter asset spreads – driven by more customers opting for fixed-rate products which are lower-yielding. Loan-impairment charges are likely to increase – although at a slower rate relative to 2016 – reflecting vulnerable dairy exposures and asset growth.

Strong Capitalisation: We expect the banking system's capitalisation to benefit from retained earnings offsetting some risk-weighted asset growth. The banks' strong loss-absorption capacity should offset losses in the dairy book. However, we believe capitalisation could weaken if the banks were to experience a combined event of a sharp house-price correction and softer dairy prices despite the pressure of the latter having eased.

Stable Funding: New Zealand's major banks are likely to remain reliant on wholesale funding despite a greater focus on deposit in preparation of the Net Stable Funding Ratio, as these banks are part of the larger Australian banking groups. Long-term wholesale funding will provide diversification and duration supporting further improvements in their funding profiles.

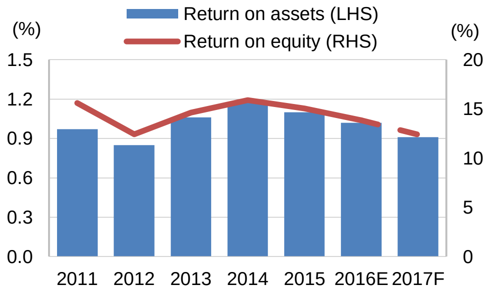
Outlook Sensitivities

Property Correction: A sharp deterioration in the banks' asset quality could be driven by a potential correction in New Zealand's house prices either as a result of slowing net immigration or an economic slowdown driven by internal or external factors. This would weaken the banks' asset quality, profitability and capitalisation.

Sharp China Downturn: New Zealand banks' financial profiles are likely to come under pressure should Chinese economic growth slow sharply. China is New Zealand's second-largest trading partner after Australia, which also relies heavily on China's economic performance. This scenario would place negative pressure on the banks' VRs, but is not Fitch's base case.

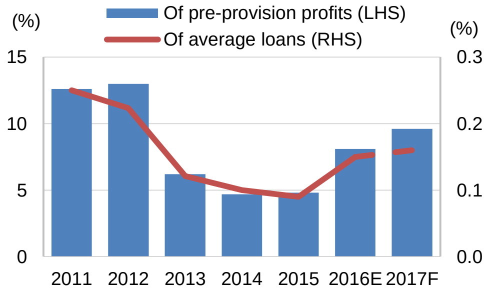
Dislocation of Wholesale Markets: A prolonged global funding market disruption could place significant pressure on balance sheets despite the improvements in liquidity.

New Zealand: Key Performance Trends
Return on assets and return on equity



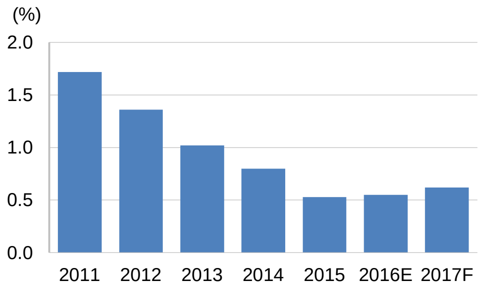
Source: RBNZ, Fitch

New Zealand: Key Performance Trends
Credit costs



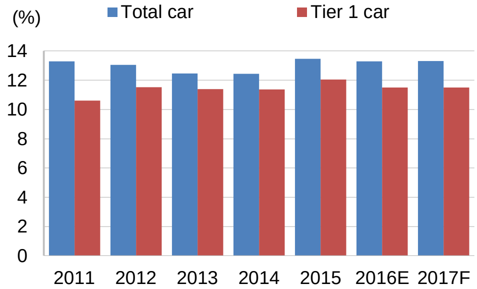
Source: RBNZ, Fitch

New Zealand: Key Performance Trends
Asset quality by NPL ratio



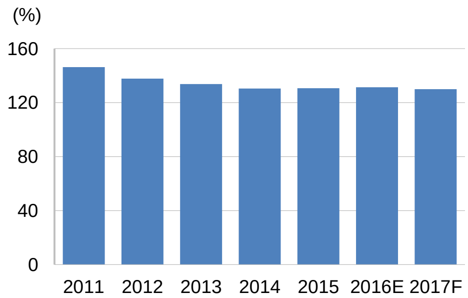
Source: RBNZ, Fitch

New Zealand: Key Performance Trends
Capital ratios



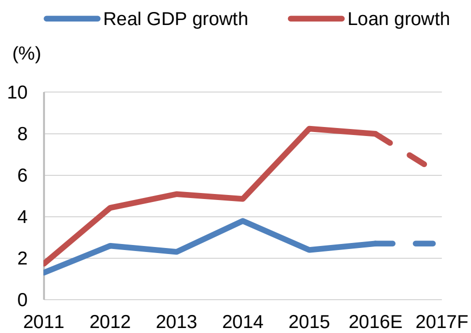
Source: RBNZ, Fitch

New Zealand: Key Performance Trends
Loans/deposits ratio



Source: Fitch, banks

New Zealand: Key Performance



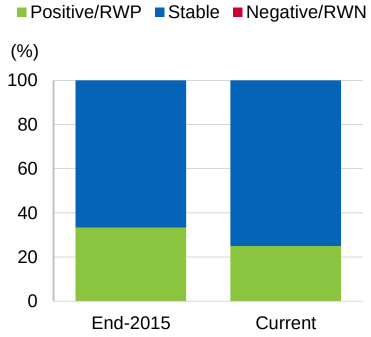
Source: RBNZ, Fitch

Rating Outlook

STABLE

(2016: POSITIVE)

Rating Outlooks



Source: Fitch

Sector Outlook

STABLE

(2016: STABLE)

- Sound economic fundamentals
- Healthy system liquidity buffers
- Strengthening regulatory framework

Related Research

Philippine Large Banks Peer Review (July 2016)

Fitch Upgrades Four Philippine Mid-Sized Banks; Outlooks Stable (July 2016)

Fitch: New Philippine Property Index Adds to Risk Monitoring Kit (June 2016)

Fitch Affirms Two Philippine Government Banks (April 2016)

Analysts

Elaine Koh
+65 6796 7239
elaine.koh@fitchratings.com

Tamma Febrian
+65 6796 7237
tamma.febrian@fitchratings.com

Philippines

Largely Stable Outlooks: The ratings on most Philippine banks are on stable outlook, reflecting our view that most banks' ratings are unlikely to be upgraded again in the near term following the upgrades of five banks in 2016. Exceptions are the two support-driven government banks where the positive outlooks mirror the outlook on the sovereign ratings. The upgrades in 2016 were driven by improved overall credit profiles backed by a robust economy and steadily strengthening regulatory and risk frameworks.

Economic Drivers Intact: Fitch expects domestic demand to remain strong, fuelled by sustained remittance inflows and business process outsourcing revenue; favourable demographics; and continued capital investment needs despite a tepid global economy. Plans by the new administration (elected in May) to accelerate infrastructure spending should also boost growth. We forecast GDP expansion of 6.6% for 2017, among the highest in Asia.

Sustained Credit Expansion: The robust economy will continue to drive brisk loan growth, which we forecast in the mid- to high-teens for 2017. We foresee the bulk of this channelled into infrastructure, real estate and other business investment activities, while strong consumer demand will continue to spur household borrowing. We expect the regulator to stay alert to potential credit and asset bubbles as credit excesses will remain a risk in this environment.

Steady Asset Quality, Profitability: Profit growth will be underpinned mainly by balance-sheet expansion. The gradual shift in loan mix towards higher-yielding consumer and project finance should help offset competitive pressure on margins, while asset quality should remain broadly stable amid supportive macroeconomic conditions.

Comfortable Funding and Liquidity: System liquidity remains healthy, as evident in the low aggregate loan/deposit ratio of 71% (at end-September 2016) and the significant pool of funds deposited with the central bank. Liquidity conditions should remain comfortable in 2017 as existing liquidity buffers, credit creation and foreign remittance inflows help to cushion against debt and currency market uncertainty. We expect banks to continue to prize stable deposits and term funding ahead of Basel III LCR requirements that will be phased in over 2018-2019.

Healthy Capitalisation: Core capitalisation should remain comfortably above local regulatory requirements, which are high by global standards – and rising further for domestic systemically important banks. Risk-weighted asset growth is likely to continue to outpace internal capital generation. We expect the banks to address this by raising fresh capital when needed.

Further Regulatory Strengthening: The Philippine financial stability framework has improved over the last few years, with further enhancements underway – items such as refinements to the central bank charter and local Net Stable Funding Ratio rules have been publicly discussed. We expect these efforts to continue as the financial system broadens and develops.

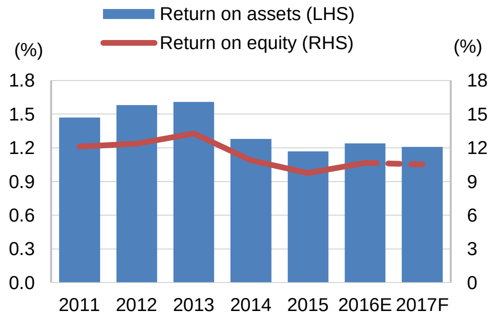
Outlook Sensitivities

Structural Progress: Sustained economic development and further improvement in system regulation and risk management could strengthen banks' overall credit profiles, if they maintain their existing healthy financial metrics and balance-sheet strengths. Conversely, a reversal of recent positive economic and governance trends would hurt banks' profiles in the longer term.

Unexpected Severe Deterioration: A significant economic downturn – leading to weaker domestic demand and large corporate or middle-market enterprise failures – would affect the operating environment and bank ratings, particularly as loan concentration is high.

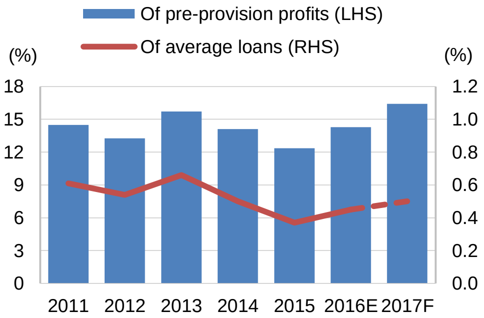
Sovereign Ratings: The ratings and outlooks on the two state-owned banks – Development Bank of the Philippines (BB+/Positive) and Land Bank of the Philippines (BB+/Positive) – are sensitive to movements in the sovereign ratings and rating outlooks.

Philippines: Key Performance Trends
Return on assets and return on equity



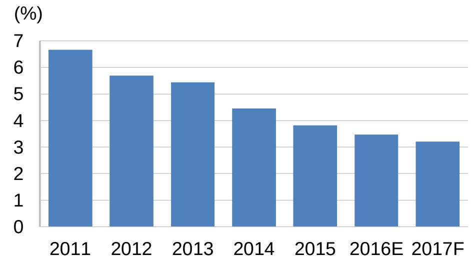
Source: Fitch, Bangko Sentral ng Pilipinas (BSP)

Philippines: Key Performance Trends
Credit costs



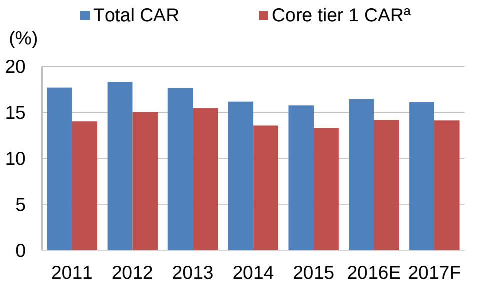
Source: Fitch, BSP

Philippines: Key Performance Trends
Asset quality
NPA ratio[a]



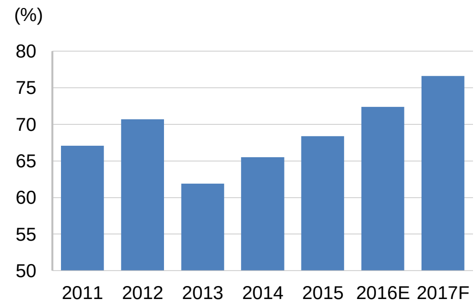
[a] NPAs comprise NPLs and foreclosed properties
Source: Fitch, BSP

Philippines: Key Performance Trends
Capital ratios



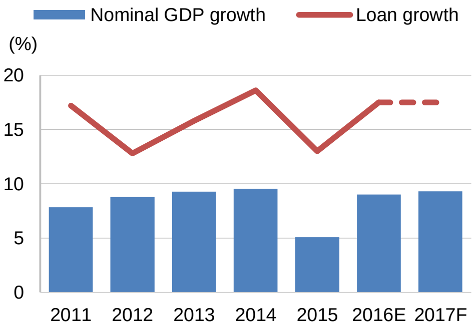
[a] Tier 1 less hybrids till 2013, Basel 3 common equity Tier 1 from 2014 onwards
Source: Fitch, BSP

Philippines: Key Performance Trends
Loans/deposits ratio



Source: Fitch, BSP

Philippines: Key Performance Trends
Nominal GDP and loan growth



Source: Fitch, BSP

Singapore

Challenging Operating Environment: Fitch has revised its sector outlook for Singapore banks to negative, in view of soft macroeconomic conditions that we expect to persist in 2017. This could place broadening pressure on asset quality and dampen earnings over the next year. However, Singapore banks' solid credit profiles – characterised by steady funding and liquidity positions, strong loss-absorption buffers and healthy profitability – support our stable outlooks for their ratings.

Credit-Quality Pressures Remain: Key stress lies in the oil & gas sector which we expect will continue to exert moderate pressure on banks' asset quality in 2017. Prolonged economic weakness could lead to broader asset-quality risks which may also affect small- and medium-sized businesses. However, we believe the downside risks to be manageable. Banks' combined exposure of SGD16.1bn to the troubled offshore support services represented 17% of their core equity Tier 1 (CET1) capital at end-September 2016.

Banks' targeted lending in China – focusing on top-tier state-owned enterprises (SOEs), large corporates, foreign investment enterprises and short-term trade loans – suggests risk from China would be well-contained on the whole. On the housing loan front, we believe proactive macro-prudential measures and strong household balance sheets should contain the risk of a sharp deterioration in loan quality.

Softer Profitability: We expect banks' profitability to weaken slightly in 2017, driven by higher credit costs and a subdued domestic lending environment. This is balanced, however, by their diversified revenue, with core non-interest income forming close to 40% of operating income – of which more than half represented recurring fee income over 2012-2015. Banks should enjoy some NIM uplift from higher short-term rates which tend to track the US Fed funds rate.

Solid Capitalisation: Singapore banks' capital standing remains solid, with fully loaded CET1 ratios ranging between 12.4%-13.5% at end-September 2016. We expect capitalisation to remain stable despite modestly higher risk-weight charges that will affect the banks from 1 January 2017, aided by healthy internal capital generation. Our internal stress tests show that sound capital buffers should enable Singapore banks to weather a significant deterioration in credit quality.

Disciplined Funding: We expect Singapore banks to retain their domestic deposit franchise strengths. Their sound Singapore dollar LCR stood in excess of 200% for 3Q16, and their Singapore dollar loan-deposit ratios had improved to 86.0% by end-September (June: 88.7%, March: 87.2%). The banks' all-currency LCR averaged a comfortable 132% for 3Q16.

Outlook Sensitivities

Greater Risk Appetite: Negative rating action could result from signs of a greater risk appetite such as sustained rapid loan growth, or excessive concentration in riskier sectors or countries, unless accompanied by stronger loss-absorption buffers.

Prolonged Economic Downturn: A prolonged economic downturn that has a severe impact on the property sector and employment conditions may put pressure on banks' ratings. However, this is not Fitch's base scenario.

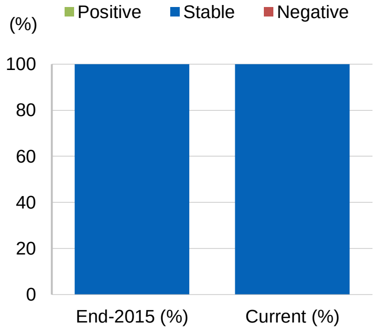
Limited Ratings Upside: Prospects for a ratings upgrade are limited, as Singapore banks are already among the highest-rated banks globally.

Rating Outlook

STABLE

(2016: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

NEGATIVE

(2016: STABLE)

- Macro challenges to persist
- Solid credit profiles
- Strong loss-absorption buffers

Related Research

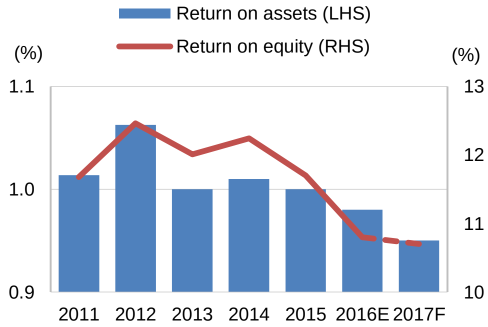
Fitch: Singapore Banks Well-Placed for Asia's Oil & Gas Defaults (October 2016)

Effect of Singapore's Weak Housing Market on Banks (August 2016)

Analysts
Wee Siang Ng
+65 6796 7230
weesiang.ng@fitchratings.com

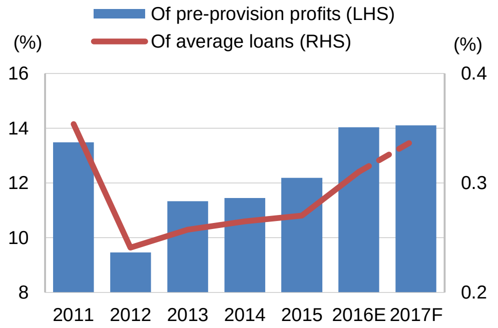
Elaine Koh
+65 6796 7239
elaine.koh@fitchratings.com

Singapore: Key Performance Trends
Return on assets and return on equity



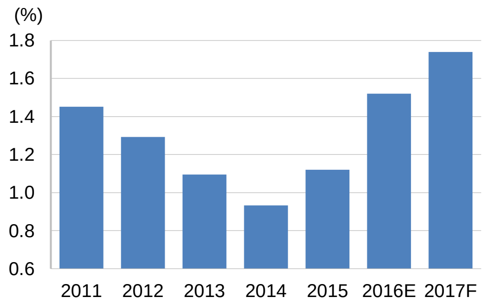
Source: Fitch, banks

Singapore: Key Performance Trends
Credit costs



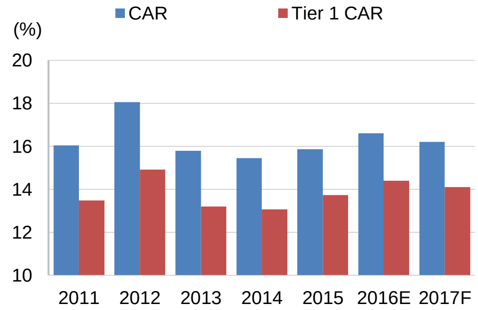
Source: Fitch, banks

Singapore: Key Performance Trends
Asset quality - NPA ratio[a]



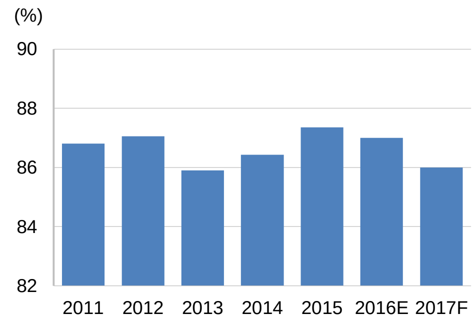
[a] NPAs include NPLs, debt securities and contingencies
Source: Fitch, banks

Singapore: Key Performance Trends
Capital ratios



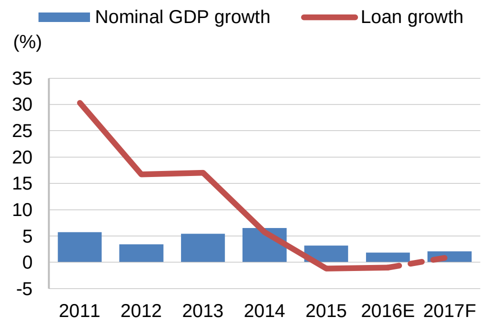
Source: Fitch, banks

Singapore: Key Performance Trends
Loans/deposits ratio



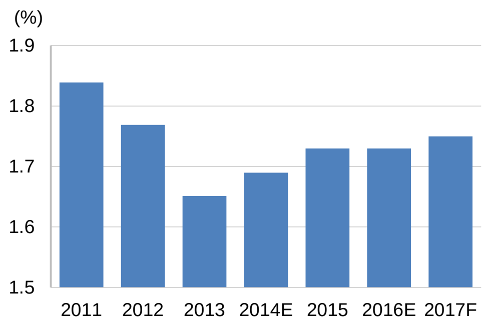
Source: Fitch, banks

Singapore: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch, MAS

Singapore: Key Performance Trends
Net Interest margin



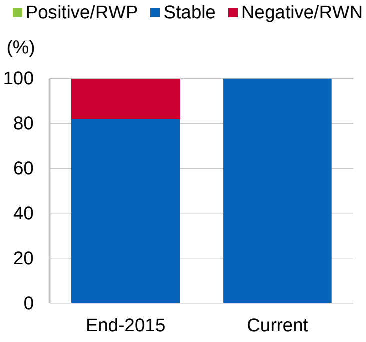
Source: Fitch, banks

Rating Outlook

STABLE

(2016: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

STABLE

(2016: STABLE)

- Heightened political uncertainty
- Property market to lead growth
- Bail-in feature to be seen

Related Research

South Korea Banks Update (June 2016)

Analysts
Heakyu Chang
+822 3278 8363
heakyu.chang@fitchratings.com

Matt Choi
+822 3278 8372
matt.choi@fitchratings.com

Jonathan Cornish
+852 2263 9901
jonathan.cornish@fitchratings.com

South Korea

Mostly Support-Driven IDRs: The bulk of South Korean IDRs are support-driven – five by state support and two by support from foreign parents. VR-driven IDRs are Kookmin Bank (A/Stable), Shinhan Bank (A/Stable), KEB Hana Bank (A-/Stable) and Busan Bank (BBB+/Stable). All IDRs are on Stable Outlook.

Increased Performance Uncertainty: Fitch forecasts a slightly better performance for Korea's banking sector in 2017. However, this comes with higher uncertainty because of potentially large credit costs from the ongoing restructuring, particularly in the shipbuilding sector amid slowing growth in China – the destination for 21% of Korea's exports. The political turmoil arising from the 'shadow president' scandal and the presidential election in December 2017 should contribute to the rising uncertainty in sector performance and regulatory supervision.

Expansionary Measures Support Growth: We think the Korean government has sufficient scope in terms of monetary/fiscal measures and policy financing to support the economy and buffer any unexpected adverse developments, at least for the next few years. We expect Korea's authorities to maintain borrower-friendly measures, including a low policy rate, to alleviate the high household debt burden and support ailing industrial sectors to weather economic headwinds.

Declining Industrial Exposure: We expect slow corporate loan growth, especially among commercial banks. This is due to the weakening corporate sector, a prospective rise in loan-loss reserves when IFRS9 is implemented in 2018, and the potential for a higher regulatory risk-weight for corporate exposures over the long term. Meanwhile, the shipbuilding sector remains a more immediate issue with oversupply of properties a medium-term development.

Property-Driven Growth: We anticipate the property-driven domestic consumption growth to prevail in 2017, extending a run since mid-2014 of the government having relied significantly on the property sector to offset the slowing export sector. This has led to high property supply with surging investment demand, as well as significant growth in mortgages and household loans. We see limited demand from foreigners, an ageing population, and rising household debt as potential restraints for growth in the medium to long term.

Household Debt – a Long-Term Issue: Fitch expects Korea's high and rising household debt (1H16 debt/disposable income: 174%) to become an increasingly serious issue. Nevertheless, we still see this as beyond our rating horizon. In the meantime, Korea has quite robust job security, with strong labour laws. The banking sector's one-month delinquency rate for household loans was just 0.3% at end-3Q16. The average loan-to-value ratio of the banking sector's mortgages – which account for the bulk of the household loans – is around mid-50%.

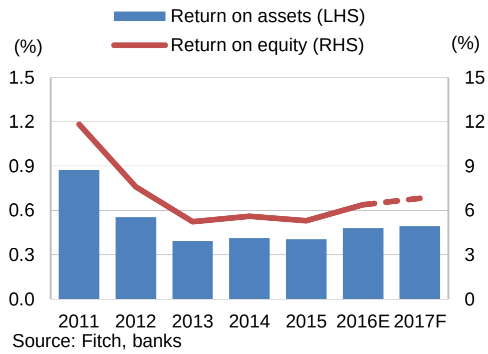
Resolution Framework Revision: We expect a bail-in feature to be introduced to Korea's bank resolution framework in 2017. A reduction in implicit government support available to banks may lead to negative rating action for commercial banks whose IDRs are driven by state support – eg Woori Bank (A-/Stable) and NongHyup Bank (A-/Stable). However, it remains to be seen how strong the language would be, and how feasible to enforce a bail-in in practice.

Outlook Sensitivities

Support Ability/Propensity: A change in the ratings of – or linkage with – the supporting entities may lead to a change in banks' support-driven ratings. A major change to the resolution framework would also trigger a review of bank ratings.

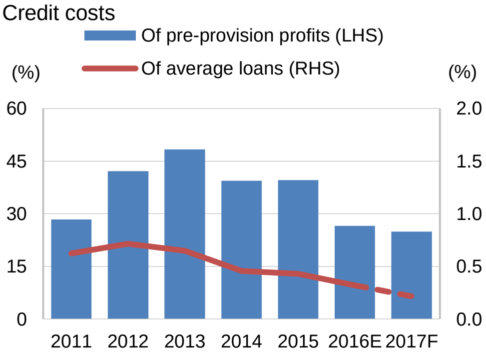
Risk Appetite, Capitalisation: Changes to VRs are most likely to arise where we perceive a bank's risk appetite to have changed significantly without corresponding changes in its loss-absorption buffers, including capitalisation.

Korea: Key Performance Trends
Return on assets and return on equity



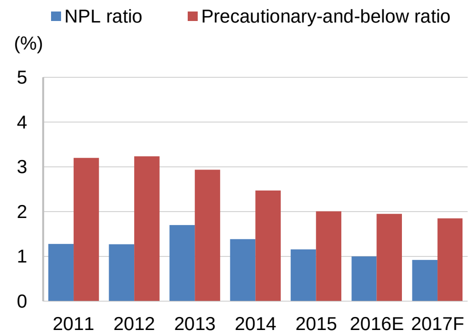
Source: Fitch, banks

Korea: Key Performance Trends
Credit costs



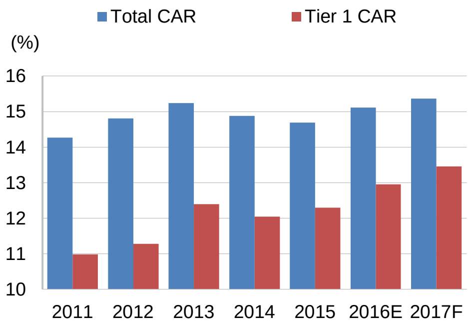
Source: Fitch, banks

Korea: Key Performance Trends
Asset quality



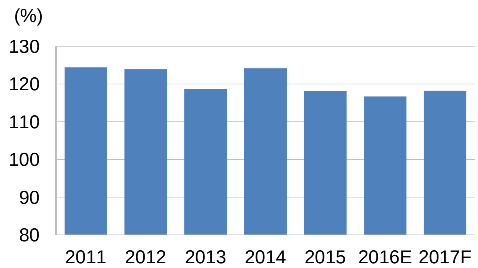
Source: Fitch, banks

Korea: Key Performance Trends
Capital ratios



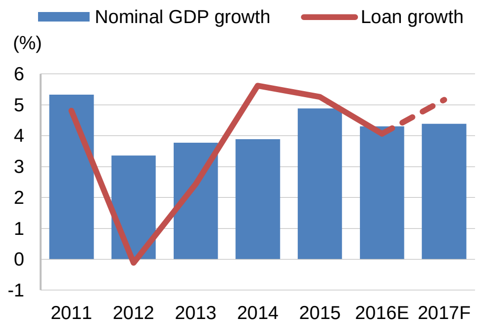
Source: Fitch, banks

Korea: Key Performance Trends
Loans/deposits ratio



Note: The ratio is adjusted for interbank loans and deposits
Source: Fitch, banks

Korea: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch, banks

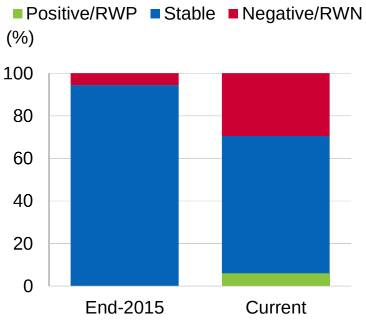
Note: The charts above are for commercial banks only

Rating Outlook

NEGATIVE

(2016: STABLE)

Rating Outlooks



Note: Based on IDRS and National Ratings
Source: Fitch

Sector Outlook

NEGATIVE

(2016: STABLE)

- NPLs to rise
- Capital is an issue

Sri Lanka

Sector Outlook Turns Negative: Fitch has revised its sector outlook for Sri Lankan banks to negative from stable. We believe operating conditions have become more challenging, as signalled by the downgrade and revision of the outlook on the sovereign rating to 'B+'/Negative from 'BB-'/Stable in February 2016. Fitch expects rising macroeconomic pressure to strain banks' credit metrics, in particular asset quality.

Economic Challenges: Fitch expects downside pressure on growth in 2017, and for real GDP growth to be around 5%. Sri Lanka entered into an IMF programme which commenced in June 2016, and could face a period of adjustment that could dampen economic performance in the short term. Sri Lanka also remains susceptible to difficult global conditions.

Negative Ratings Outlook: The negative ratings outlook on Sri Lankan banks largely reflects the impact of the negative outlook on the sovereign and Fitch's approach of generally capping bank ratings at the sovereign rating. This is because bank credit profiles are sensitive to the sovereign's credit profile, and also to risks stemming from the operating environment in the absence of a build-up of adequate loss-absorption buffers.

NPLs to Rise: Fitch expects a deterioration in asset quality to become more apparent in 2017 in the aftermath of lending to more susceptible segments, and for bank NPL ratios to rise amid a more challenging environment. The decrease in the sector NPLs throughout most of 2016 has resulted mostly from a reduction in NPLs from gold-backed lending, and this is not expected to continue to mask incremental NPL formation for the sector.

Moderation in Loan Growth: The continued rise in credit demand throughout most of 2016 prompted a response from the Central Bank of Sri Lanka (CBSL) in the form of rate hikes and higher reserve requirements to curb credit expansion and inflation pressures. Fitch expects these actions to take effect and for lending to moderate in 2017 alongside higher interest rates and reduced consumption demand.

Pressure on Capital: Fitch sees capitalisation as a significant issue facing the sector, stemming from thin capitalisation across state banks and diminishing capitalisation across most non-state banks. The CBSL could impose higher capital requirements, including those via the implementation of Basel III capital standards. Stronger capital buffers are desirable to counterbalance structural balance-sheet issues and to absorb unexpected losses. There has not been much Tier 1 capital-raising, and banks could face challenges in raising capital.

Manageable Profit Pressure: A potential increase in credit costs could offset the benefit of a possible improvement in net interest margin and result in a slight decrease in profitability.

Stable Liquidity Profile: Funding-cost pressures have risen and competition for deposits has increased. Banks' liquidity should continue to be supported through a stable deposit base. Customer deposits comprise the bulk of banks' funding, at about 68% of assets.

Outlook Sensitivities

Impact from Sovereign Rating: The ratings of state-linked banks are sensitive to changes in the sovereign's propensity or ability to provide support. Sovereign rating action could result in similar action on the IDRs and VRs of Sri Lankan banks that are at the same level.

Rising Risk Appetite: Negative rating action could also result from pressure on bank credit profiles through an increase in risk appetite – such as sustained rapid loan expansion and/ or rising exposure to more susceptible segments – unless it is counterbalanced through higher capital buffers and stronger risk management.

Related Research

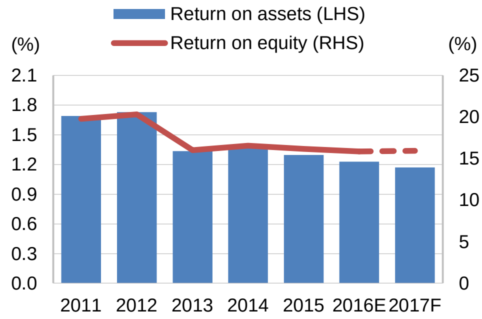
Fitch Downgrades NDB; Affirms 8 Sri Lanka Banks, Negative Outlook on DFCC, Sampath (August 2016)

Fitch Downgrades PABC, Affirms Four Small and Mid-Sized Banks; Revises UB Outlook to Positive (October 2016)

Analysts
Rukshana Thalgodapitiya, CFA
+94112541900
rukshana.thalgodapitiya@fitchratings.com

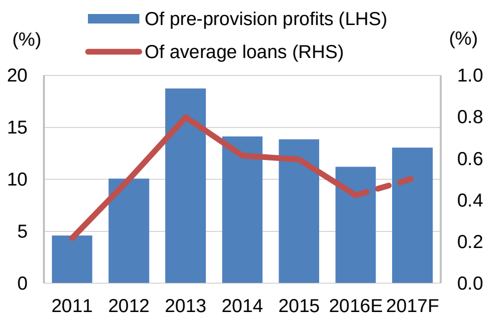
Jeewanthi Malagala, CFA
+94112541900
jeewanthi.malagala@fitchratings.com

Sri Lanka: Key Performance Trends
Return on assets and return on equity



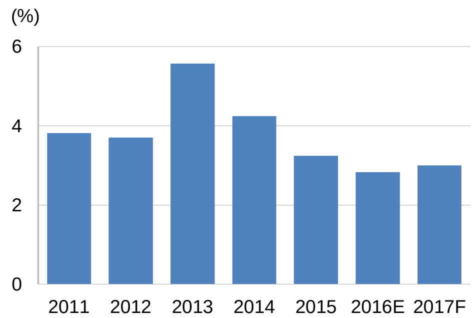
Source: Fitch, CBSL

Sri Lanka: Key Performance Trends
Credit costs



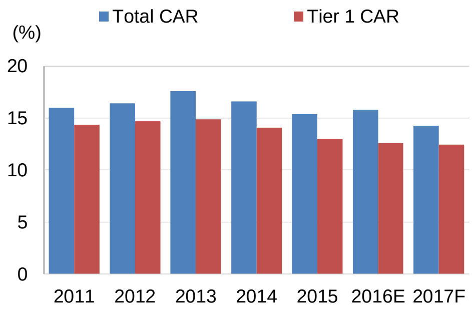
Source: Fitch, CBSL

Sri Lanka: Key Performance Trends
Asset quality - reported NPL ratio



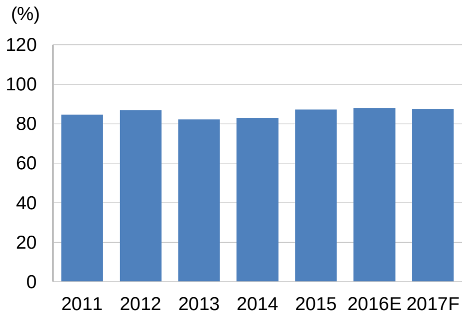
Source: Fitch, CBSL

Sri Lanka: Key Performance Trends
Capital ratios



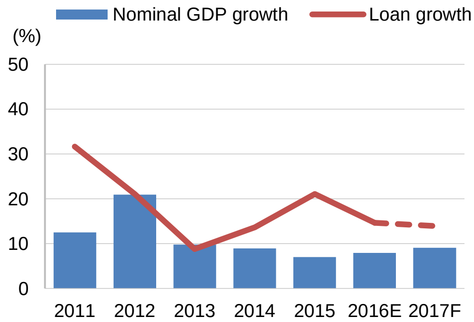
Source: Fitch, CBSL

Sri Lanka: Key Performance Trends
Loans/deposits ratio



Source: Fitch, CBSL

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



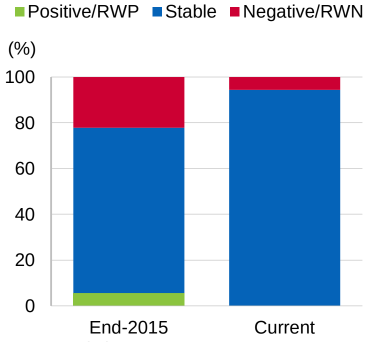
Source: Fitch, CBSL

Rating Outlook

STABLE

(2016: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

STABLE

(2016: STABLE)

- Resilient to growth pressures
- Enhanced risk buffers
- Potential for increase in risk-taking

Related Research

Taiwanese Banks: Regulatory Capital Discretions Add Cushion (May 2016)

Fitch: Recession to Hurt Taiwan Banks' Earnings, Asset Quality (May 2016)

Evolving Taiwanese Financial Groups (August 2016)

Taiwan Banks Report Card (September 2016)

Analysts

Jenifer Chou, CFA, FRM
+886 8175 7605
jenifer.chou@fitchratings.com

Sophia Chen, CFA, CPA
+886 8175 7604
sophia.chen@fitchratings.com

Cherry Huang, CFA
+886 8175 7603
cherry.huang@fitchratings.com

Jonathan Lee
+886 8175 7601
jonathan.lee@fitchratings.com

Taiwan

Mild Economic Environment: The stable sector outlook for Taiwanese banks reflects Fitch's view that they are resilient to challenges stemming from global and domestic economic growth that is below long-term trends. We expect a modest acceleration of real GDP growth to 1% in 2016 and 1.5%-2% in 2017-2018, incorporating a continued mild recovery from the quarterly contraction in 3Q15-1Q16. The central bank has ended its consecutive rate cuts and kept policy rates unchanged, indicating renewed optimism about economic momentum.

Sustained Challenges: Fitch expects the banking sector to face a sustained flat yield curve and low interest rates, as well as rising regulatory costs. Persistent low domestic growth raises the prospects that banks will accelerate their non-organic and offshore expansion strategies and develop a greater risk appetite. The sector is, however, well-positioned on the basis of strengthened risk buffers including rising loan-loss provision and capitalisation, and eased concentration over riskier exposures including technology, real estate and China.

Stable Profitability: We forecast sector return-on-assets to be broadly stable at around 0.6% in 2017-2018. This is based on our view that a tepidly improving interest margin and robust wealth-management fee-income generation would offset a slight rise in credit costs. The banks are likely to strive for earnings momentum by expanding overseas exposure gradually and enhancing deposit structures amid a low-rate environment, while loan demand slowly recovers.

Capital and Funding Healthy: We anticipate the sector's Tier 1 ratio to exceed 11% by 2018, with most banks on track to meet Basel III minimum requirements. Capitalisation compares well with regional developed-market peers, adjusting for Taiwan's higher capital charge for mortgages under the standardised approach. Leverage will also remain lower than in other advanced markets in Asia. We see most banks meeting the Basel III minimum liquidity coverage ratio comfortably, supported by a strong retail deposit base and large holding of government securities.

Loan Portfolios Intact: We expect diversified loan growth in the near- to mid-term and concentration risks to be contained, given the potential shift away from manufacturing industries and lacklustre capital investment opportunities in Taiwan. Stable household leverage, a low likelihood of a sharp rate hike, and adequate collateralisation are to help contain mortgage risks. Taiwan's technology sector helped underpin an improvement in exports in 3Q16 and remains fundamentally competitive, albeit susceptible to an unexpected cyclical downturn.

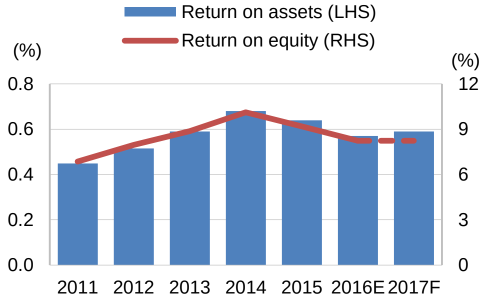
Manageable Asset-Quality Risks: We see loans to individuals and SMEs financing investments, small ventures, and construction projects to be the most vulnerable if the weak growth persists, the property market suffers an abrupt decline, or unemployment rises sharply. However, the latter two scenarios are not our base case. Lower exposure to China, which is likely to remain below 10% of system assets in the near term, should help to mitigate the risks of gradual economic slowdown. Loans to indigenous Chinese corporates have remained very modest.

Outlook Sensitivities

Event-Driven Risks: We see sector and rating outlooks to be stable in 2017. Near-term risks would be more event-driven, likely involving large acquisition but subject to opportunities. This may fundamentally alter the banks' balance-sheet strength, or raise the risks of execution, integration and dilution of management resources and capital.

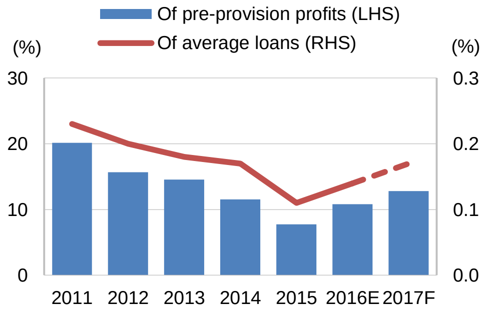
Overseas Growth, China: We see a significant increase in offshore exposure – a key risk to the sector if a sustained low-interest-rate and low-growth environment were to heighten the prospects for banks to become attracted to better-yield emerging markets in Asia. A faster-than-expected slowdown in China would be another threat, undermining Taiwan's economy and trade activities, thereby hurting sector growth, profitability and asset quality.

Taiwan: Key Performance Trends
Return on assets and return on equity



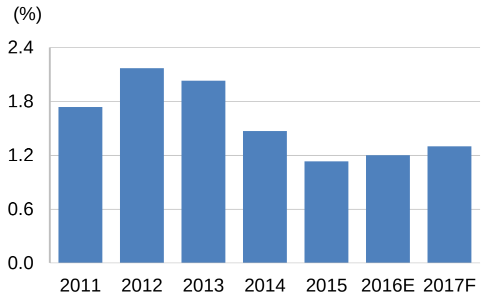
Source: Fitch, Central Bank of the Republic of China (Taiwan) (CBC)

Taiwan: Key Performance Trends
Credit costs



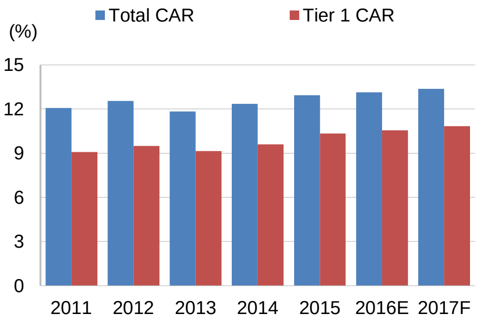
Source: Fitch, CBC

Taiwan: Key Performance Trends
Impaired loan ratio



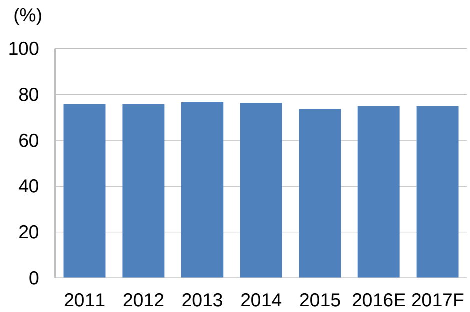
Source: Fitch, CBC

Taiwan: Key Performance Trends
Capital ratios



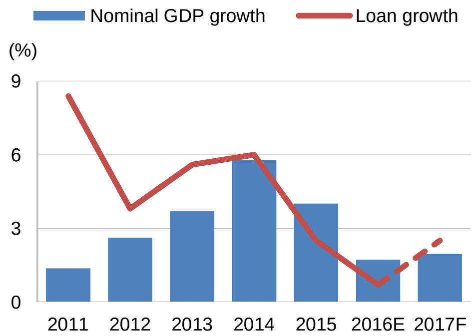
Source: Fitch, CBC

Taiwan: Key Performance Trends
Loans/deposits ratio



Source: Fitch, CBC

Taiwan: Key Performance Trends



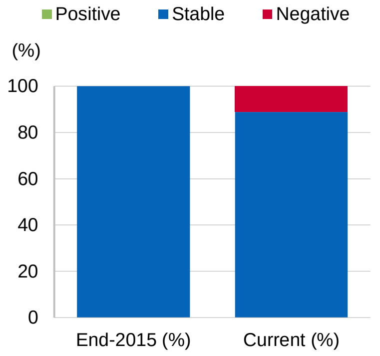
Source: Fitch, CBC

Rating Outlook

STABLE

(2016: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

NEGATIVE

(2016: NEGATIVE)

- Low GDP growth hurts profitability
- NPLs rising; reserve buffers sound
- Banking sector capitalisation solid

Related Research

Thai Large Commercial Banks Peer Review (June 2016)

Analysts
Parson Singha
+66 2108 0151
parson.singha@fitchratings.com

Patchara Sarayudh
+66 2108 0152
patchara.sarayudh@fitchratings.com

Thailand

Sector Outlook Remains Negative: The operating environment constrains the Thai banking sector's financial performance, and is unlikely to become more benign in 2017. Fitch expects that banks' revenue will be hampered by the low-interest-rate environment and limited loan growth. Loan impairments and provisioning requirements are also likely to continue to rise due to sustained low rates of GDP growth.

Asset Quality Weakening Further: Asset-quality risks are particularly present in more vulnerable segments such as SME (which accounts for 39% of sector lending) and unsecured retail loans (9% of sector lending), which are generally affected faster by a weak economy. Furthermore, leverage in the private sector and in households remains high (at 149% and 81% of GDP, respectively, as of 1H16), which adds to potential downside risks.

Fitch expects these asset-quality pressures to remain manageable for most banks – the banking sector has relatively high levels of loan-loss reserve coverage at 127%. Banks have also been reducing loan growth over the past four quarters (in 1H16 loan growth was below nominal GDP growth), and tightening up credit standards in response to the weaker business climate.

Capital Buffers Adequate: Fitch expects that Thai banks will be able to increase their capital ratios despite weaker profitability, due to internal capital generation combined with low growth in risk-weighted assets. The sector Tier 1 ratio was at 14.2% as of 1H16, and should remain an adequate buffer against a worse-than-expected downturn. Key regulatory changes that would affect banks' capitalisation (such as implementation of IFRS9) are not likely to be initiated in Thailand until 2019 at the earliest.

Liquidity Trends Improving: Thai banks' liquidity has been supported by high levels of liquid asset holdings, with the sector Basel 3 Liquidity Coverage Ratio at 173%. The Net Stable Funding Ratio requirement will not be implemented until 2018, but is we do not expect this to have a major impact on most banks' liquidity status. Liquidity pressures have been ameliorated since 2015 by higher deposit growth versus loan growth.

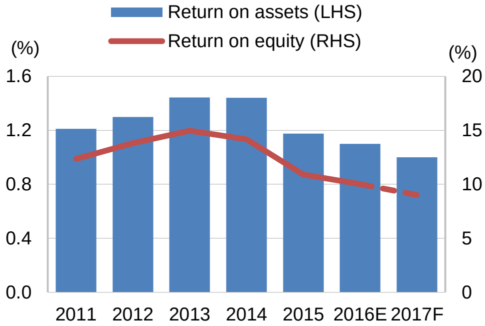
Shifting to E-Payments: The Thai government's initiative to promote electronic payments could lead to some downside to banks' income from transfer fees (which comprises up to 29% of total fee income), and is another potential constraint to banks' 2017 financial performance. There are also near-term operational and cyber risks related to the changes in systems and processes. In any case, greater digitalisation and reduced cash usage could promote cost-savings for the industry over the medium term.

Outlook Sensitivities

Sovereign Rating Changes: Many banks rated in the Thai market are at – or linked to – either the Thai sovereign rating (BBB+/Stable) or the Country Ceiling (A-). Hence any changes to these ratings would be likely to have a widespread ratings impact.

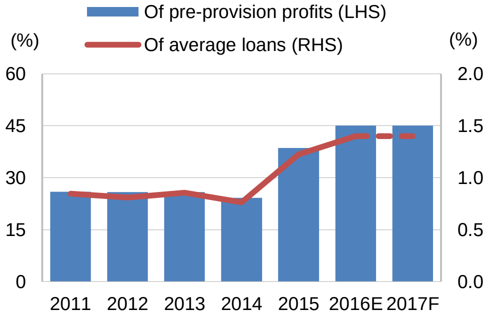
Sustained Weak Performance: Pressure on banks VRs could arise from a larger-than-expected economic downturn, combined with significant and sustained weakness in banks' performance, asset quality and capitalisation.

Thailand: Key Performance Trends
Return on assets and return on equity



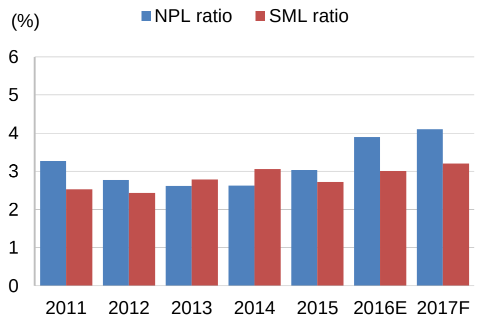
Source: Fitch, banks

Thailand: Key Performance Trends
Credit costs



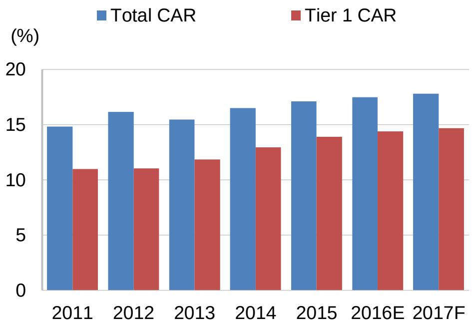
Source: Fitch, banks

Thailand: Key Performance Trends
Asset quality



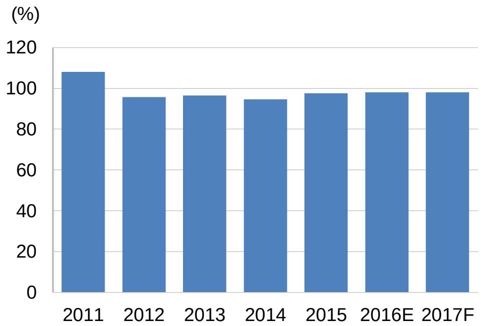
Source: Fitch, banks

Thailand: Key Performance Trends
Capital ratios



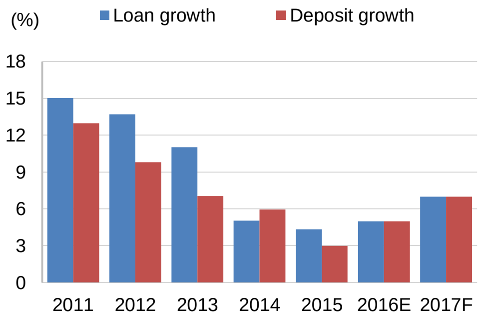
Source: Fitch, banks

Thailand: Key Performance Trends
Loans/deposits ratio



Source: Fitch, banks

Thailand: Key Performance Trends
Balance sheet ratios



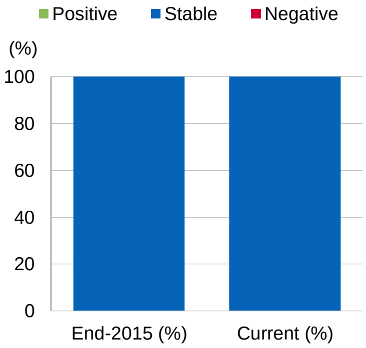
Source: Fitch, banks

Rating Outlook

STABLE

(2016: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

STABLE

(2016: STABLE)

- Structural weaknesses remain
- Large NPL stock, thin capital buffers
- Improving economy helps

Vietnam

Stable Economy to Aid Improvement: An improving macroeconomic environment, characterised by a stable currency and benign inflation, suggests that asset quality and funding and liquidity should remain steady in 2017. However, structural systemic weaknesses remain – as evident from thin capital buffers, a large NPL stock and weak profitability. Fitch expects these structural issues can only be addressed over the long term. Vietnamese banks' ratings – among the lowest in Asia – reflect these structural issues.

Persisting NPL Challenges: We believe the large NPL stock will take time to be resolved due to various legal impediments. The 2.4% weighted-average reported NPL ratio at end-2015, based on the nine-largest banks, understates the actual asset-quality issues. The ratio works out at 9%, after adding NPLs sold to Vietnam Asset Management Company (VAMC) and 'special mention' loans.

Loan diversification away from lending to the inefficiently run SOEs towards small-ticket retail loans may help mitigate the asset-quality pressure. Notably, lending to SOEs had declined to 15% (of total loans of the eight-largest banks in Vietnam) by end-2015 from 19% at end-2011, while retail exposure had increased to 36% from 27%.

Weak Profitability to Stay: Fitch expects banks' profitability to remain soft due to potential compression on net interest margin amid competition for deposits, and regulatory pressures to lower lending rates and extend deposit duration. Higher credit costs from the amortisation of VAMC bonds could be another dampener. However, this could be partially cushioned by strong loan growth, particularly in the higher-margin retail loans.

Low Capital Buffers: Banks' total capital-adequacy ratios (CAR) were low at end-June 2016, at a respective 12.1% and 9.3% for joint-stock commercial banks and state-owned banks. Capital buffers will remain under pressure as Basel II is being phased in at a time when loan growth is accelerating and internal capital generation remains lethargic. However, a sustained rise in foreign appetite for banks may help to bridge significant recapitalisation needs.

Stable Funding Conditions: We expect funding and liquidity conditions to remain stable in 2017. The system-wide average loan/deposit ratio was a healthy 86.6% at end-July 2016. We expect a slightly higher loan/deposit ratio in 2017 – on strong credit growth which is likely to outpace deposit growth.

Outlook Sensitivities

Renewed Macroeconomic Volatility: A volatile operating environment that causes currency gyrations and a sharp deterioration in asset quality – and a loss in depositors' confidence – would be negative for banks' ratings. However, we believe such risks are low in the near term.

Sustained Rapid Credit Growth: A sustained rapid credit growth poses a risk to Vietnam's financial stability, since the credit-to-GDP ratio at 110.5% in 2015 was already extremely high by frontier-market standards.

Credible Reforms, Sovereign Ratings: Effective implementation of key banking reforms and restructuring of SOEs, which enhances asset quality and improves capitalisation, will be positive for the ratings. Positive sovereign rating action would also benefit the support-driven ratings of the systemically important state-owned banks.

Related Research

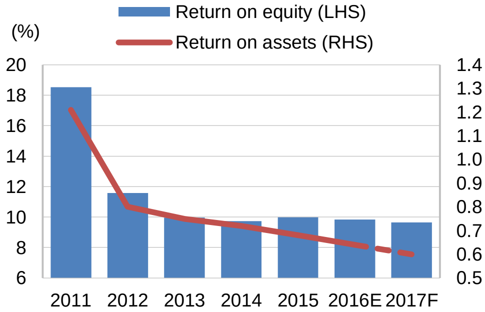
Fitch Affirms Five Vietnamese Banks' Ratings; Outlook Stable (April 2016)

Strong Growth Attracts Foreign Capital for Vietnam Banks (August 2016)

Analysts
Wee Siang Ng
+65 6796 7230
weesiang.ng@fitchratings.com

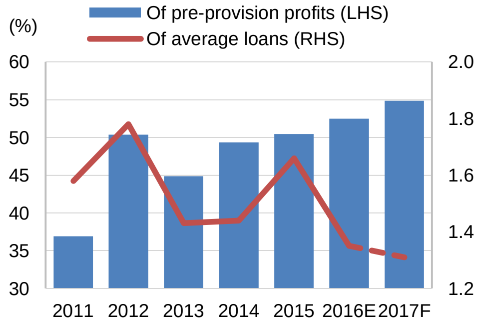
Tamma Febrian
+65 6796 7237
tamma.febrian@fitchratings.com

Vietnam: Key Performance Trends
Return on assets and return on equity



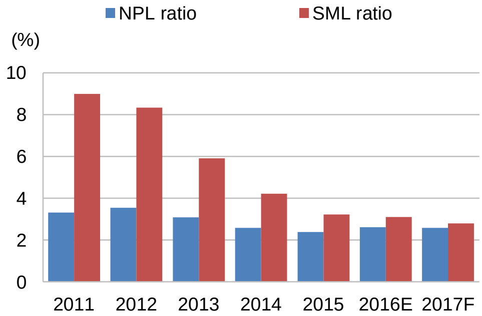
Source: Fitch, banks

Vietnam: Key Performance Trends
Credit costs



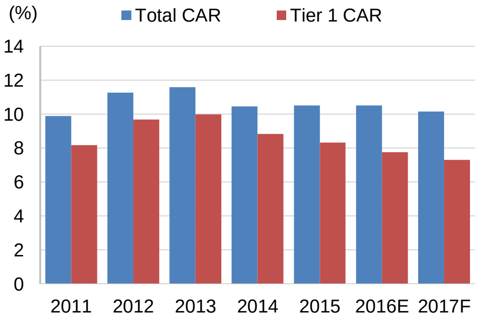
Source: Fitch, banks

Vietnam: Key Performance Trends
Asset quality



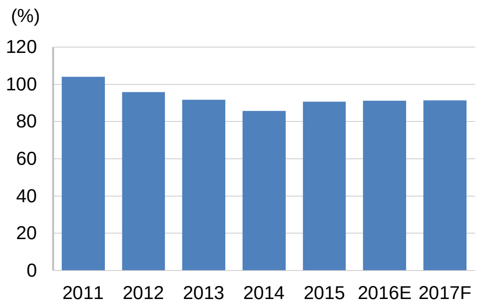
Source: Fitch, banks

Vietnam: Key Performance Trends
Capital ratios



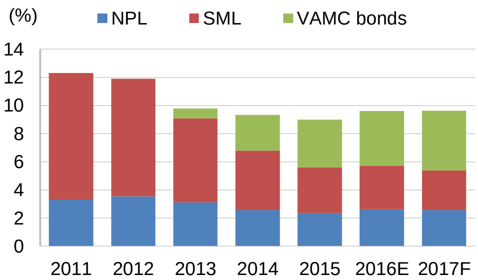
Source: Fitch, banks

Vietnam: Key Performance Trends
Loans/deposits ratio



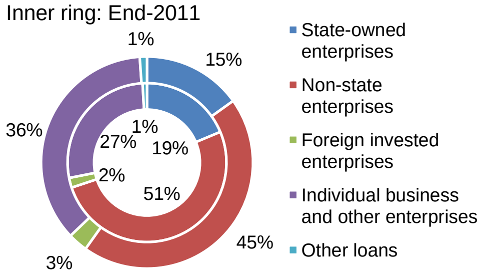
Source: Fitch, banks

VN Banks[a]: Problem Loans
(%) gross loans



[a] Weighted average of Vietinbank, Vietcombank, BIDV, ACB, MB, Sacombank, Techcombank, Agribank
Source: Banks, Fitch estimates

Banks' Lending Breakdown
Outer ring: End-2015
Inner ring: End-2011



[a] Weighted average of Vietinbank, Vietcombank, BIDV, ACB, MB, Sacombank, Techcombank, Agribank
Source: Fitch, Banks