

Positive Momentum for Banks in Vietnam and Mongolia, Headwinds in Sri Lanka

Improving operating conditions in Vietnam and Mongolia should continue to strengthen the intrinsic credit profiles of rated banks. Fitch Ratings upgraded the IDRs of two Mongolian banks in July 2018 and four Vietnam banks in February and May 2018. Our assessment of the operating environment in those three jurisdictions are the weakest amongst our covered markets in APAC: 'b+'/'positive' for Vietnam, 'b+'/'negative' Sri Lanka and 'b'/'stable' Mongolia.

Fitch expects the economic environments in Vietnam and Mongolia will remain supported by stable growth outlooks, declining sovereign debt as a proportion of GDP, and rising foreign-exchange reserves. In contrast, Sri Lankan banks face challenges due to slower economic growth and pressure on disposable incomes. Sri Lanka and Mongolia are currently under IMF arrangements, while Vietnam's last IMF facility was in 2001.

We also see progress towards more robust regulatory frameworks in Vietnam and Mongolia, where adoption of international standards has remained slow. Both markets lag Sri Lanka which adopted Basel III in 2017 and IFRS 9 in 2018. Vietnam's regulatory development has trailed its economic progress, and remains hampered by a lack of transparency in financial reporting and regulatory enforcement – often typical in emerging markets.

The Mongolian authorities displayed encouraging rigour during their sector-wide asset-quality review (AQR) in 2017-2018, which could lead to a marked improvement in credibility if resulting bank recapitalisations were made transparent and if Bank of Mongolia (BOM) can sustain its resolve during the subsequent stress-testing exercise.

Bank Ratings Sensitive to Sovereign Ratings

The credit profiles of banks in these frontier markets are typically correlated closely with that of the sovereign due to their systemic importance and strong government linkages, including large holdings of government securities, lending to government and state entities, and direct state ownership. Sovereign support drives the IDRs for most state-owned banks in Vietnam and Sri Lanka as their intrinsic strength remains weaker due to issues of asset quality and capitalisation. In contrast, sovereign support is not a direct rating driver for Mongolian banks.

High Credit Growth Builds Potential Risk

Fitch's Macro Prudential Indicator (MPI) of '2' for Sri Lanka and Vietnam reflects the prolonged high credit growth in the two markets, while Mongolia's recent transition to '1' was a result of 2013 data dropping out of the model. The broadly benign credit environment may obscure any heightened risk appetite by banks amid rapid credit expansion, which could pose a further risk to financial stability, particularly in Vietnam where private credit-to-GDP remains very high.



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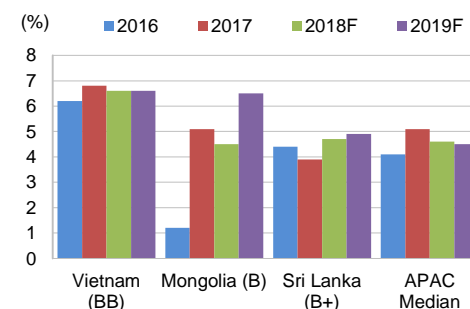


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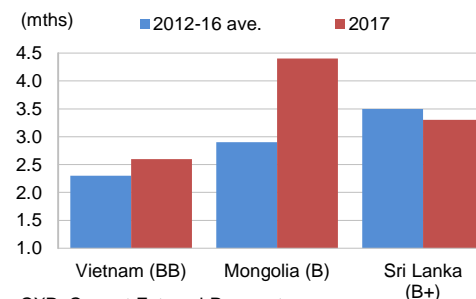
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Real GDP Growth



Source: Fitch

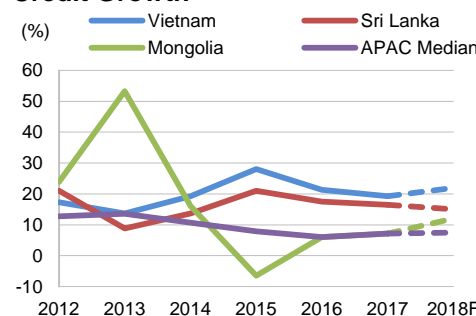
FX Reserve/Months of CXP



CXP: Current External Payments

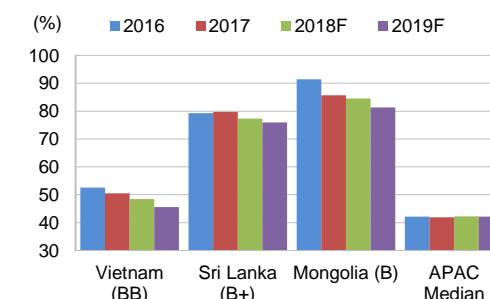
Source: Fitch

Credit Growth



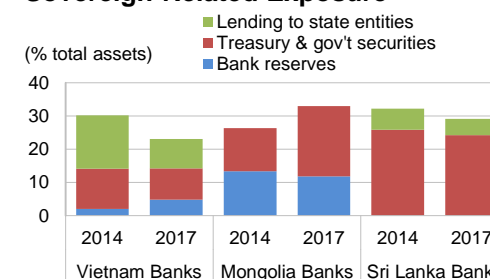
Source: Fitch, banks

General Government Debt/GDP



Source: Fitch

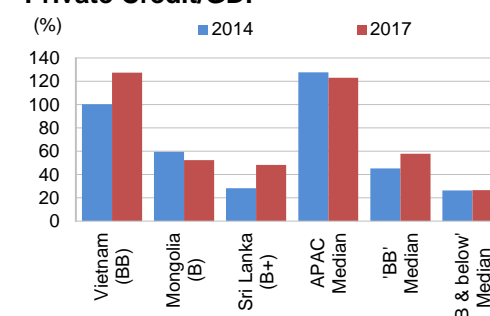
Sovereign-Related Exposure



Exposure to government securities for Sri Lanka banks include bank reserves, no breakdown available

Source: Fitch, banks, central banks

Private Credit/GDP



Source: Fitch

Progressive Banking Reforms Highlight Capitalisation Needs

Vietnam's Basel II implementation, scheduled for 1 January 2020, accentuates the banks' need to boost capital buffers which are thin and have diminished under rapid loan growth. Fitch estimates Basel II will reduce rated banks' capital adequacy ratios (CARs) by up to 4pp, resulting in some state-owned banks being likely to fall short of the minimum requirements. The capital shortfall is further exacerbated by the under-reporting of asset-quality issues.

The completion of the AQR of Mongolia banks – part of the IMF arrangement – indicated that banks' aggregate capital adequacy shortfall was USD210 million or 1.9% of GDP at end-2017. The required capital is likely to be larger, given the likely double-digit lending growth in 2018 and possible requirements from AQR-related stress-testing. The drop in the banking system's CAR to 13.7% by end-2017 from 18.0% at end-November 2017 reflects adjustments from the AQR. IMF requires banks to formally book the adjustments by end-June 2018.

Capital requirements for Sri Lankan banks have also increased due to the implementation of Basel III in July 2017. The banks have bridged most of the capital shortfall in 2017, but Fitch estimates an additional LKR19 billion (USD120 million) of capital will be required by some large banks to meet full compliance by 2019. The shift to SLFRS 9 in 2018 could add to capitalisation pressures through a possible significant one-time adjustment, and drive a structural increase in normalised credit costs.

Vulnerability to Fed Rate Hikes Likely to be Manageable – Barring External Shocks

A measured rise in US rates is not likely to have a significant impact on NPLs as banks' foreign-currency lending is likely to be directed at borrowers with matched cash flows as required by local regulators, but banks with larger holdings of foreign-currency liabilities are exposed to a sharper increase in borrowing costs. Banks are likely to be most vulnerable to a change in investor sentiment resulting in major fund outflows and excessive market volatility.

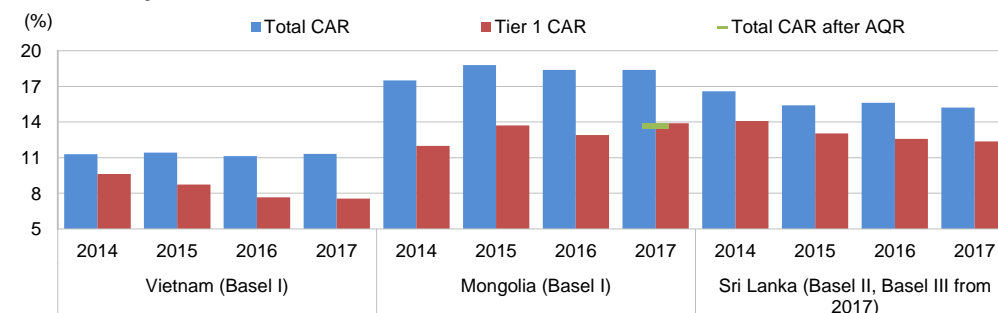
What to Watch:

Vietnam: Relaxation of the 30% foreign-ownership limit will support the system's significant capitalisation needs, especially state-owned banks which are near or at this limit. Challenges over price negotiation may complicate matters.

Sri Lanka: More capital-raising is likely in 2018 to meet the Basel III capital shortfall which could widen under SLFRS 9, although the capital impact could be spread across several periods. The challenging operating environment could also place modest pressure on ratings, unless sufficient loss-absorption buffers are maintained.

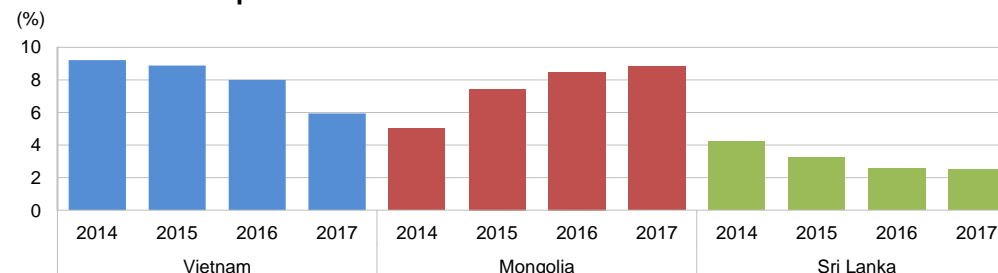
Mongolia: Fitch expects the capital needs for individual banks will become clearer in 2H18 after the AQR results are booked, while the BOM might devise bank-specific capital requirements following the stress-test. A new recapitalisation law, which would allow the government to restructure banks and bail in creditors, will be applicable to banks with regulatory capital shortfalls by end-2018.

Banks' Capital Ratios



Source: Fitch, banks

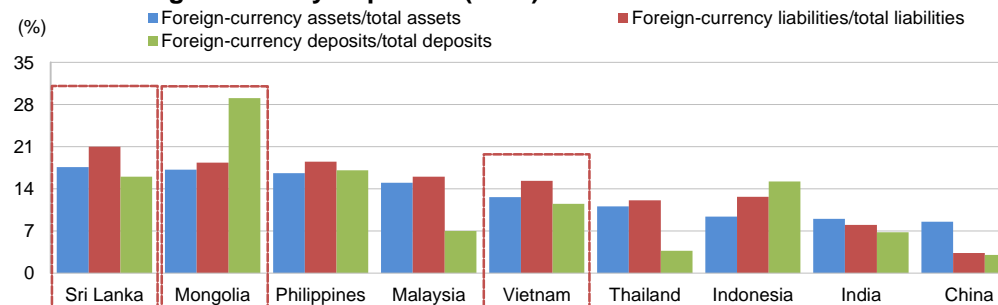
Banks' NPL or Impaired Loan Ratios



Ratio for Vietnam banks refers to weighted average problem loan ratio of major banks. Problem loans include NPLs, SMLs and VAMC bonds

Source: Fitch, banks

Banks' Foreign-Currency Exposure (2017)



Source: Fitch estimates based on national sources. Asset & liability data from major banks; deposit data for system

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