Fitch Ratings 2019 Outlook: Asia-Pacific Emerging Market Banks

Trade Tensions, Higher Interest Rates and Market Volatility Creating Headwinds

Fitch's Sector Outlook: Stable

Fitch Ratings' sector outlook remains stable, but the number of negative outlooks has increased slightly from 12 months ago. Some economies and banking systems are showing signs of benefiting less from the tailwinds evident in 2017; we see trade tensions, rising interest rates and slower growth in China as a test for the quality of credit extended in recent years, which had been somewhat elevated in some regional pockets.

Rating Outlook: Stable

Fitch has a stable ratings outlook on all Asia-Pacific (APAC) emerging-market banking systems, which is unchanged from a year ago. Where Issuer Default Ratings (IDRs) are underpinned by Viability Ratings (VRs), we view the banks' loss-absorption buffers as generally sufficient to weather rising pressures in 2019. Around half of Fitch-rated banks in APAC emerging markets have IDRs predicated on expectations of third-party support – whether sovereign or institutional.

Some individual bank intrinsic profiles remain under pressure (such as in markets where we have a negative sector outlook), but where any rating outlooks are still stable, they would likely reflect external support and mirror that of the supporting entities.

Rating Transition and Distribution

Upgrades of bank IDRs are on track to outpace downgrades for the third successive year, due mainly to similar action on sovereign ratings such as in Indonesia, the Philippines, Vietnam and Mongolia. Downgrades also reflect a reassessment of the ability and/or propensity for support to be provided by external parties on a timely basis. Support is most evident among bank ratings in investment-grade jurisdictions, but Fitch continues to assess support prospects in light of the size of banking systems and the perceived systemic importance of individual banks.

What to Watch

- Moderating economic growth; responsive policies supporting relatively robust credit flows.
- Stable financial profiles despite mounting pressures, including a greater risk appetite.
- Headwinds from a potential slowdown in trade, tighter global financial conditions, volatility.
- Influential nature of regulation on bank profiles, property sector.

From left-to-right:

Jonathan Cornish
Head of APAC Banks

Ambreesh Srivastava
South/SE Asia Banks

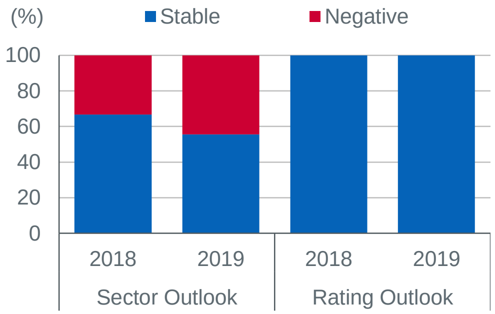
Grace Wu
China Banks

APAC EM Banks: 2019 Outlooks

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

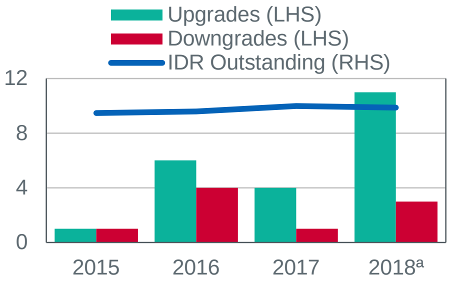
Source: Fitch Ratings

APAC EM Banks: Outlooks



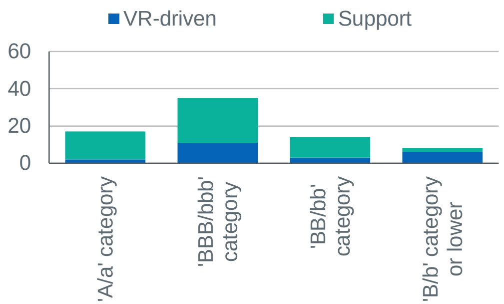
Source: Fitch Ratings

APAC EM Banks: IDR Changes



[a] YTD October 2018
Source: Fitch Ratings, Fitch Solutions

APAC EM Banks: Support



Source: Fitch Ratings, Fitch Solutions

Moderating Economic Growth; Robust Credit Flows

We believe economic growth will moderate in most markets due to a confluence of challenges including tighter global financial conditions, higher debt-servicing burdens, slowing growth in China (to 6.1% in 2019 from 6.6% in 2018E) and, in some cases, political uncertainty (eg elections). Nevertheless, credit growth will be hurt less – if at all – since demand for bank funding remains high to support investment or various government initiatives.

Fitch forecasts credit growth to exceed nominal GDP growth in all markets (except Malaysia), meaning that corporate/household leverage is likely to rise further, and making it more difficult to deal with any deterioration in the operating environment.

Stable Financial Profiles; Mounting Pressures, Risk Appetite

Higher credit costs, investment in digital strategies and risk management, and adhering to higher prudential capital/liquidity standards are pressuring profitability. Risk-adjusted returns on assets should still remain broadly flat, but we see returns on equity falling in most systems, except in Mongolia and India. In the case of the latter two, asset-quality reviews have been conducted, credit costs are likely to moderate from recent highs, and loan growth should pick up.

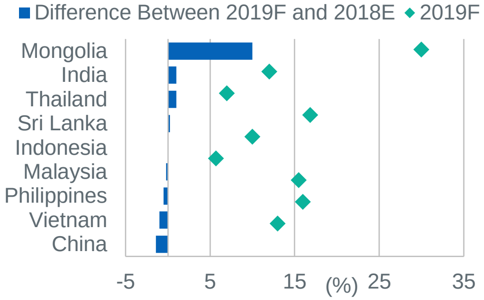
Competition is also challenging profitability. It is unlikely to diminish any time soon – banks often focus on market share and fee-income growth. This attitude has in the past led to additional risk-taking in areas for which banks may not be fully compensated, and this is likely to continue.

Non-performing loan ratios are likely to reflect strategies for resolving legacy portfolios (i.e. India, Mongolia should see fewer NPLs), previous growth records (higher debt-servicing burdens are likely to see NPLs tick upwards in Indonesia, the Philippines) or due to regulation (eg in China, where reported NPLs should rise unless there is further policy easing). We also expect pressure on profitability to cause provision levels to fall in several markets.

We also see little deterioration in the liquidity positions of large banks. Smaller banks face most pressure from competition to fund higher loan growth, and vulnerability to any adverse changes in market conditions. Wholesale funding needs/costs are rising, as are retail deposit costs.

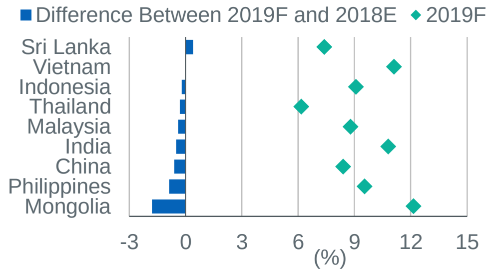
We expect core capital levels to hold up – especially for the larger banks in each system – on account of higher prudential standards (Vietnam, India), capital-raising efforts/capital retention or modest risk-weighted asset growth (Thailand). Capital will be most pressured in higher-growth markets, including China, due to various challenges, including raising capital in a timely manner.

APAC EM Banks: Loan Growth (%)



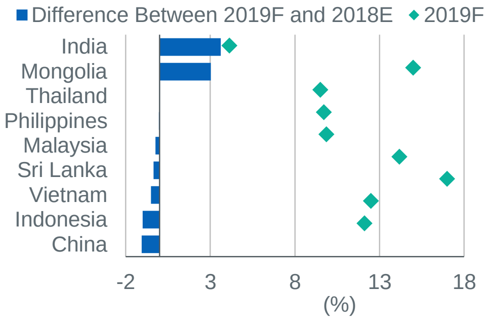
Source: Fitch Ratings, Fitch Solutions

APAC EM Banks:
Nominal GDP growth (%)



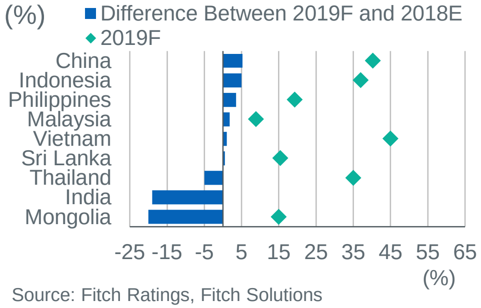
Source: Fitch Ratings, Fitch Solutions

APAC EM Banks: ROE (%)



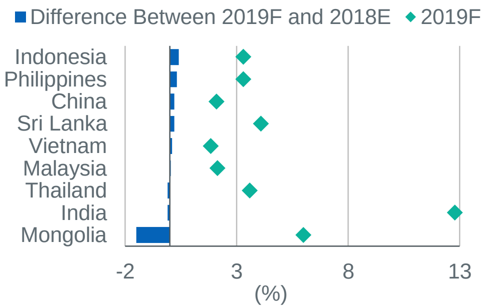
Source: Fitch Ratings, Fitch Solutions

APAC EM Banks
Credit cost/pre-provision operating profit (%)



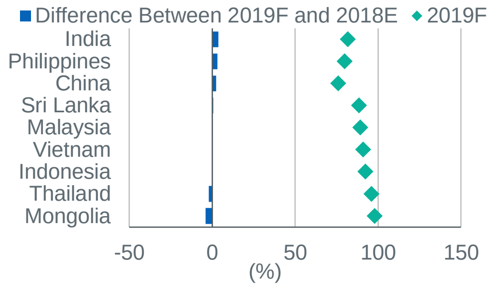
Source: Fitch Ratings, Fitch Solutions

APAC EM Banks: NPL Ratio (%)



Source: Fitch Ratings, Fitch Solutions

APAC EM Banks
Loan-to-deposit ratio (%)



Source: Fitch Ratings, Fitch Solutions

Headwinds from Potentially Slower Trade, Tighter Financial Conditions and Volatility

We expect most APAC emerging-market banking systems to post a stable performance in 2019, but risks remain to the downside in light of tighter global financial conditions and US dollar strength. We see these as negative for capital flows and currencies, and likely to lead to (further) policy rate hikes – notably, in markets with current account deficits such as Indonesia, India and the Philippines. Challenges should be exacerbated in markets where borrowers' leverage has increased the most whilst interest rates were relatively low.

Meanwhile, pressure from US-China trade tensions will also add to emerging-market volatility. These headwinds challenge banks in terms credit, liquidity, and market risk. That said, we see Thailand as less vulnerable than other emerging markets, while Asian policymakers are also generally well-placed to respond aggressively to support growth in the event that such factors threaten to derail recent improvements in the economy and banking system.

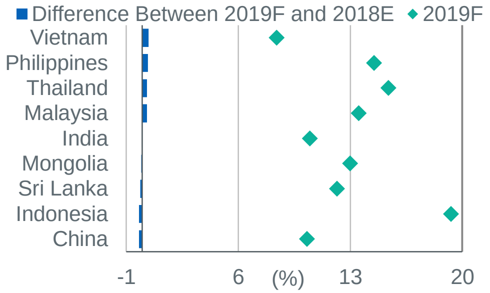
Influence of Regulation on Bank Profiles, Property Sector

The authorities are likely to continue to influence credit growth (stimulate or contain) as well as banks' business and financial profiles, through policy initiatives (including prudential and macroprudential), encouraging investment in digital strategies, higher standards of capital/liquidity, and speed of NPL resolution. For the most part, prudential regulation is likely to follow international standards in fortifying bank balance sheets, but balanced against macro policy, which is likely to remain tilted toward support for higher economic growth.

We also see heightened scrutiny over bank conduct risk – a phenomenon not peculiar to emerging markets, but an area where banks operating in such markets are more vulnerable in the absence of significantly greater investment in strengthening risk controls and enhancing standards of governance (including state-owned banks).

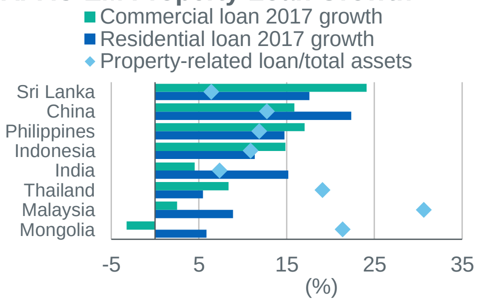
Fitch sees the property sector remaining fairly stable across most APAC markets. Real-estate exposures are generally lower (as a proportion of total loans) in emerging markets, but are just as important for several reasons. Lending remains largely secured on property, LTV ratios also tend to be relatively high, borrowers are more sensitive to higher local interest rates, and banking systems (and economic growth) are often linked to property performance. We see policymakers staying focused on policies that support stability yet prevent risks of overheating.

APAC EM Banks: CET1 (%)



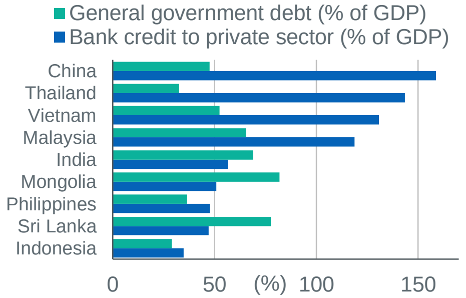
Data for Mongolia, Sri Lanka and Vietnam were T1 ratio
Source: Fitch Ratings, Fitch Solutions

APAC EM Property Loan Growth



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

APAC EM Debt/Credit to GDP Ratio



GDP refers to nominal GDP
Source: Fitch Ratings

Vulnerability to Fed Tightening	
APAC EMs	
China	**Medium**
India	**Medium**
Indonesia	**Medium**
Malaysia	**Medium/Low**
Mongolia	**Medium**
Philippines	**Medium/Low**
Sri Lanka	**Medium**
Thailand	**Low**
Vietnam	**Medium**

Source: Fitch Ratings

China

Outlook

Fitch's Sector Outlook: Negative

Fitch's outlook reflects challenges for Chinese banks as they juggle priorities to reduce "shadow banking" activities and sustaining adequate loan growth – especially to private enterprises – to support GDP as the economy slows. Headline bank performance metrics do not fully reflect the level of interconnectedness and contagion risks within the financial system. *The People's Bank of China's (PBOC) latest financial stability report* suggests to us that around 20%-25% of banks (in terms of assets) would fall below minimum regulatory thresholds in stress scenarios.

Explicit guidance and intervention from authorities over banks' lending also raise medium-term pressures on profitability, if these loans are not managed prudently and priced appropriately.

Rating Outlook: Stable

The IDRs of all Fitch-rated Chinese banks are state-support-driven, and the outlook mirrors that of the sovereign. Ratings are subject to changes in assumptions around support, which could be triggered by news of when/which banks are designated as domestic systemically important.

What to Watch

Bank Capital Insufficient for Aggressive Easing

Fitch believes bank capital levels will significantly constrain more aggressive policy easing. We expect banks to further slow loan growth from 14% in 2018E to 13% in 2019F. The regulatory crackdown may soften in 2019 and we expect the scale of shadow activities will remain stable but decline relative to GDP, given the prominence of China's deleveraging campaign.

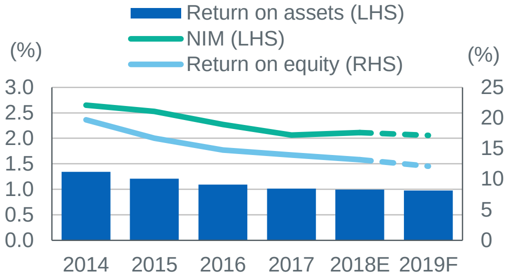
Profitability Boost Unlikely

Reductions in the Reserve Requirement Ratio may benefit NIMs, but overall sector profitability can only sustain capital ratios at the current levels. Capital preservation will remain challenging as banks cope with migration and provisioning of off-balance-sheet exposures. IFRS 9 will kick in for the remaining A-share listed banks and will raise credit costs in 2019.

Acceleration in TLAC Implementation

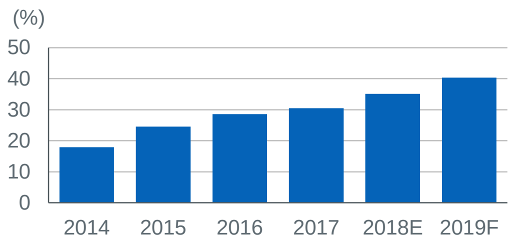
The PBOC signalled potential acceleration in the TLAC implementation for the big four state banks, which we believe would likely require greater near-term issuance of eligible securities. *Bank of Communications (A/Stable/bb-) may also become a G-SIB in the next two years.*

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



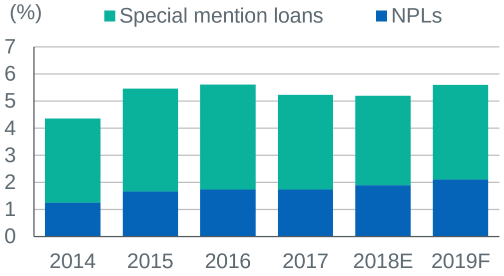
Source: Fitch Ratings, CBIRC

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



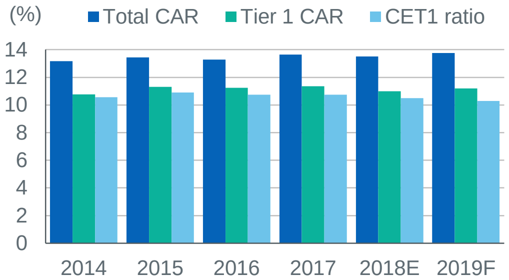
Source: Fitch Ratings, banks

China: Key Performance Trends
Asset quality - NPLs, special mention loans



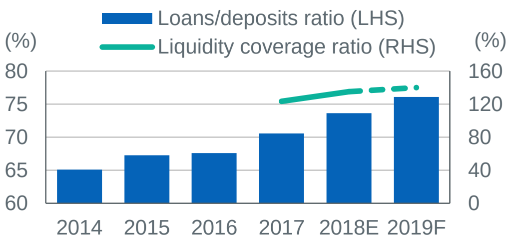
Source: Fitch Ratings, CBIRC

China: Key Performance Trends
Capital ratios



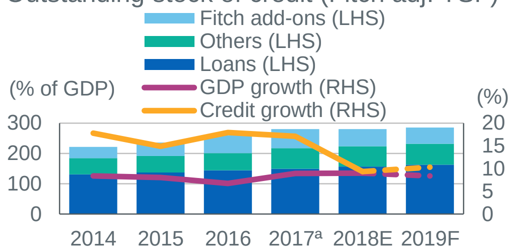
Source: Fitch Ratings, CBIRC

China: Key Performance Trends
Loans/deposits ratio



Note: Renminbi LDR as reported by CBIRC; LCR for commercial banks with asset size >CNY200bn only
Source: Fitch Ratings, PBOC, CBIRC

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



Note: [a] Restated; GDP refers to nominal GDP for all years
Source: Fitch Ratings, PBOC, banks, BIS, HKMA, Wind, CEIC, China Trustee Association

India

Outlook

Fitch's Sector Outlook: Negative

Fitch maintains a negative sector outlook on Indian banks, to reflect the ongoing struggle of state banks with weak core capitalisation amid rising macro headwinds and poor profitability. Indian banks need significantly more capital than that the state has earmarked so far, given the size and complexity of the asset-quality problem and weak earnings outlook. Private banks are likely to recover faster than state banks, which shall remain an overhang for the sector.

Rating Outlook: Stable

The rating outlook for most Indian banks mirrors the Stable Outlook on India's sovereign rating. The IDRs of all Fitch-rated state-owned banks are driven by sovereign support, while private-sector banks' IDRs are governed by their intrinsic profiles, which are expected to remain steady.

What to Watch

More Equity Injection in State-Owned Banks

Fitch estimates that Indian banks will need USD38 billion by FY19 to sufficiently meet minimum Basel III capital standards, achieve 65% NPL cover, and leave some surplus capital for growth. It implies that the state will have to inject the USD11 billion it plans to inject by FY19 as well as an additional USD6 billion it had earmarked as fresh equity issuance from state banks by FY19, with support from asset sales or other sources to comply with minimum Basel III norms.

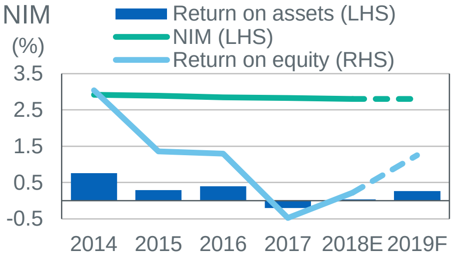
Earnings to Remain Weak

The banks are likely to report weak earnings for (FY19). Some state banks may continue to report losses, albeit slightly better than that seen in FY18. Credit costs have moderated during FY19 but ageing provisions are large enough to absorb the bulk of the weak pre-provision profit. NIMs are a constraint, as both rising interest rates and a capital shortfall affects loan growth.

NPL to Peak, but Uncertain Recoveries

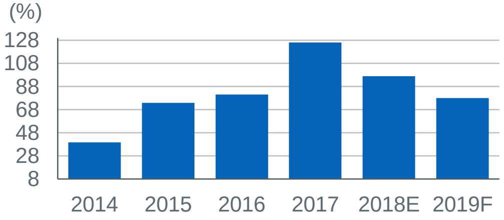
Fitch expects legacy problem loans to peak in 2019, but the size and complexity of the sector's USD140 billion NPL stock will take time to work out. SME and real estate sectors (around 7% of sector loans) can be a risk for both banks and non-banks in the near-term due to tighter liquidity and rising interest rates. Non-banks are a risk given reliance on banks for funding (7% of loans).

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



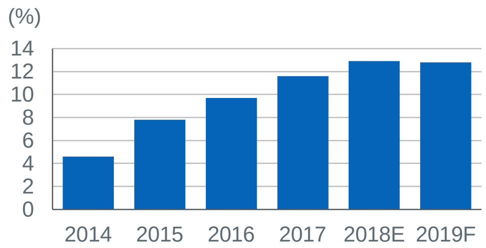
Source: Fitch Ratings, banks

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



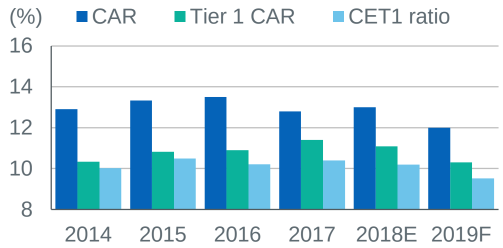
Source: Fitch Ratings, Fitch Solutions, banks

India: Key Performance Trends
Asset quality: Gross NPL ratio



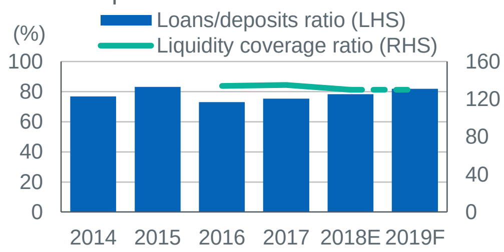
Source: Fitch Ratings, banks

India: Key Performance Trends
Capital ratios



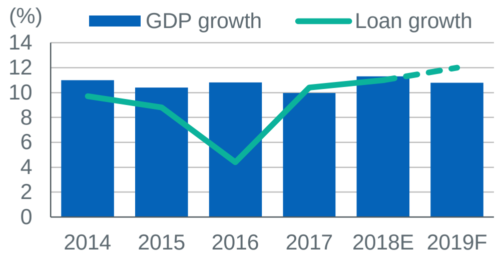
Source: Fitch Ratings, banks

India: Key Performance Trends
Loans/deposits ratio



Source: Fitch Ratings, banks

India: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch Ratings, RBI

Indonesia

Outlook

Fitch's Sector Outlook: Negative

Fitch's revision of the sector outlook to negative from stable reflects our opinion that the sharp rise in domestic interest rates in 2018 (+175bp), and our expectation of further tightening, will filter through to banks' performance in 2019 – leading to tighter margins, higher credit costs and weaker asset quality. Sluggish-but-stable growth could intensify loan competition and exacerbate margin compression, although we expect margins to remain among the widest in the region.

Asset-quality deterioration should be manageable for most banks. Pressure on liquidity, which has tightened slightly, may ease as deposit rates become more attractive.

Rating Outlook: Stable

Many banks benefit from support from the sovereign or higher-rated foreign parent banks whose ratings are stable. The negative sector trends are unlikely to impair the standalone profiles significantly, which are backed by healthy loss-absorption buffers and generally stable funding and liquidity profiles.

What to Watch

Interest-Rate Trajectory

Expected rate hikes by the US Fed in 2019 will be responded to by the Indonesian central bank (BI) in the form of higher domestic interest rates in order to limit rupiah depreciation. However, a more hawkish response by BI would likely lead to lower growth, weaker asset quality, and put greater pressure on profitability than our base case suggests.

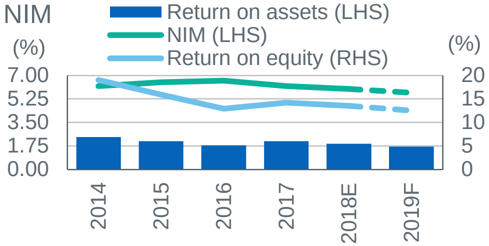
Loosening of Underwriting/Regulatory Standards

Tighter competition amid commodity-price stabilisation could lead to a weakening of underwriting standards, which banks had tightened since the commodity downturn in 2013. Looser regulatory macro-prudential measures to spur growth could also lead to a build-up of credit risk.

Election Impact on Growth

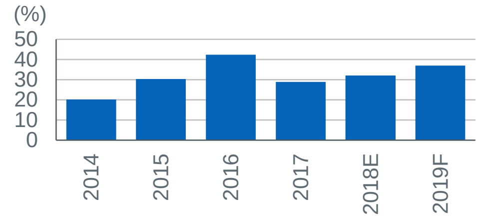
The presidential election in April 2019 could result in uneven growth, with uncertainty leading to muted business activity and loan growth in the first half of the year. We expect loan growth to pick up in the second half, but to remain similar to recent years at around 10%.

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



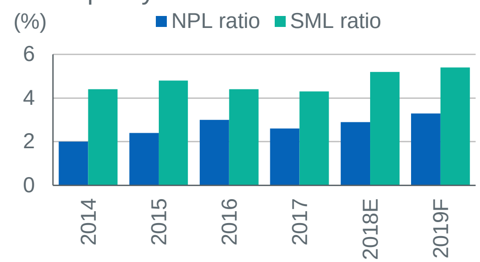
Source: Fitch Ratings, Fitch Solutions, 11-largest banks

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



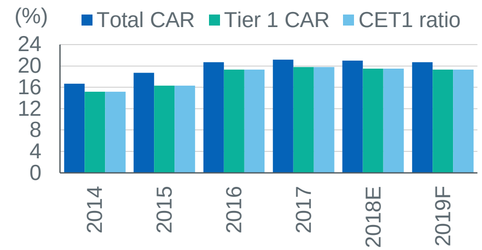
Source: Fitch Ratings, Fitch Solutions, 11-largest banks

Indonesia: Key Performance Trends
Asset quality



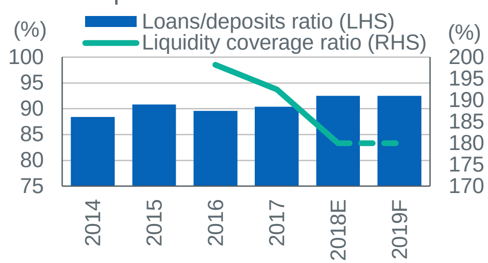
Source: Fitch Ratings, Fitch Solutions, 11-largest banks

Indonesia: Key Performance Trends
Capital ratios



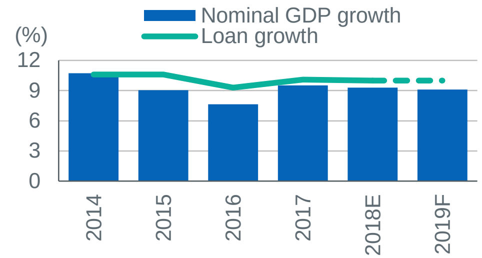
Source: Fitch Ratings, Fitch Solutions, 11-largest banks

Indonesia: Key Performance Trends
Loans/deposits ratio



Source: Fitch Ratings, Fitch Solutions, 11-largest banks

Indonesia: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch Ratings, Fitch Solutions, 11-largest banks

Malaysia

Outlook

Fitch's Sector Outlook: Stable

We expect the credit environment to be generally resilient in the face of modest headwinds to growth in 2019. Credit and GDP growth are likely to remain muted in the absence of a temporary consumption tax holiday and an easing-back of public infrastructure spending. Beyond that, however, government policy and stable employment trends should be largely supportive of growth and asset quality.

We expect sector profitability to hold up well, despite some pressure on NIMs and credit costs from stiff funding competition and softer property and infrastructure construction activity.

Rating Outlook: Stable

The banks' stable rating outlooks are anchored by their adequate loss-absorption buffers, stable funding and liquidity profiles, and satisfactory underwriting standards.

What to Watch

Funding Competition; NIM Compression

We expect careful funding and operating cost management to limit the downside on NIMs and returns due to deposit competition. This is in light of the incoming local Net Stable Funding Ratio rules, whose implementation has been deferred to 2020 at the earliest.

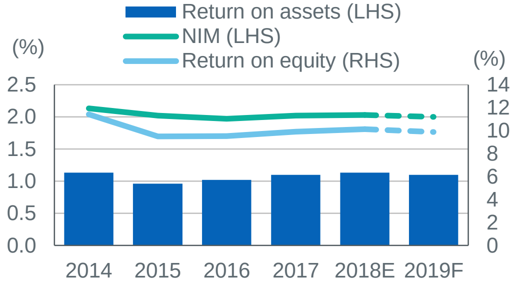
Property-Sector Performance

Property-sector activity should ease with oversupply in some pockets of the market, though loan quality should be supported by the steady economic environment, decent borrower debt-servicing capacity, and banks' more cautious risk appetite in recent years. Recent proposals – if widely adopted – for easier financing options to boost home affordability bear watching, as they may encourage speculation and raise household leverage further.

Global Trade Spillovers, Liquidity Outflows

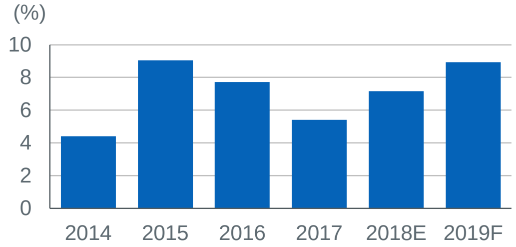
Notwithstanding our expectation of a generally stable operating environment, Malaysia retains a potential vulnerability to more significant capital outflows, given high foreign participation in local bond markets. An escalation in the US-China "trade war" could also pose downside risks in light of Malaysia's open economy, though the country may benefit from supply-chain shifts in the long run.

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



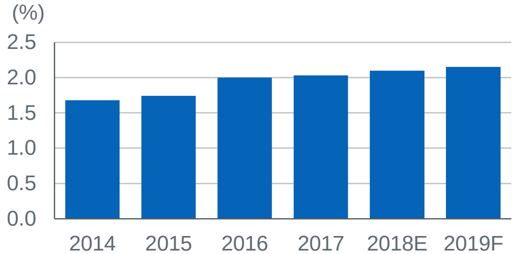
Source: Fitch Ratings, BNM, banks

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



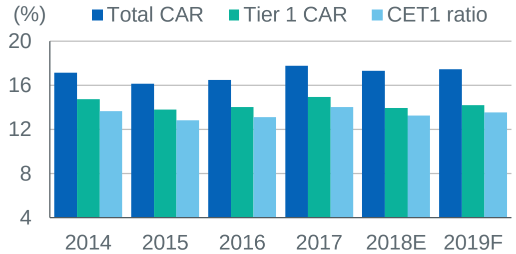
Source: Fitch Ratings, BNM, banks

Malaysia: Key Performance Trends
Asset quality - GIL ratio[a]



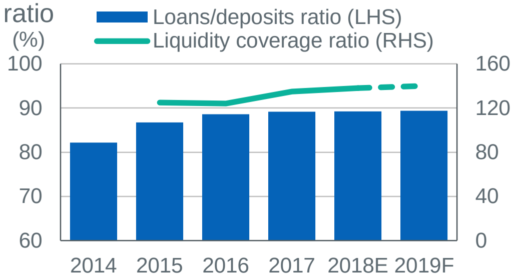
[a] Gross impaired loan ratio, top six bank groups
Source: Fitch Ratings, banks

Malaysia: Key Performance Trends
Capital ratios



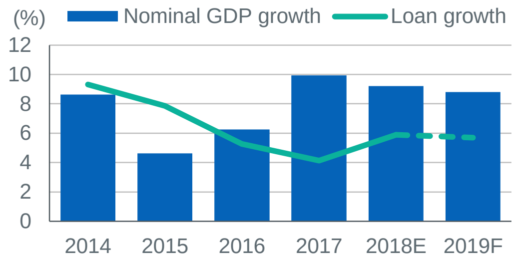
Source: Fitch Ratings, BNM, banks

Malaysia: Key Performance Trends
Loans/deposits ratio and liquidity coverage ratio



Source: Fitch Ratings, BNM, banks

Malaysia: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch Ratings, BNM

Mongolia

Outlook

Fitch's Sector Outlook: Stable

Fitch expects positive developments on profitability and loan quality, while pressure on capital stems from growth. We see continued challenges for the regulator in implementing the enhanced frameworks effectively and ensuring sustainable improvements in loan classification and loss-absorption buffers following the sector-wide asset quality review (AQR).

Rating Outlook: Stable

The ratings of Fitch-rated banks are at the same level as the Mongolian sovereign (B/Stable). The Stable Outlook on Khan Bank LLC and XacBank LLC reflects our expectations of improving profitability and asset quality, which assists in maintaining their intrinsic credit profiles.

What to Watch:

Financing Through Internal Capital, Issuance

Loan growth will pick up in 2019, which will support earnings generation but also test banks' capital management. We expect loans growth could accelerate up to 30% in 2019 and the NIM could widen a little, also considering small increases in domestic interest rates.

Economic Recovery Supports Loan Quality

The high stock of NPLs should come down in 2019, given the recovery in the economy, and Fitch-rated banks should benefit from provision reversals. System-wide NPLs could tick up at end-2018, and we may see more capital-raising as all of the AQR results feed through. Foreign exchange-related risk should remain moderate on disciplined underwriting by the larger banks.

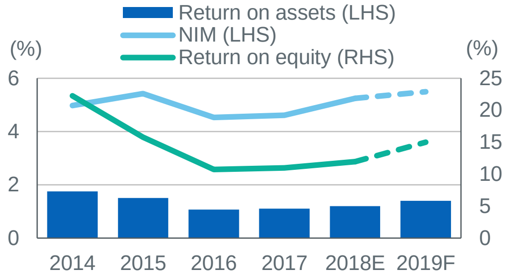
Implementation of Enhanced Regulatory Framework

We expect gradual improvements in the regulatory framework, through implementation of revised rules and regulations. Unsecured lending to individuals has come under scrutiny by the regulator, and higher domestic rates may weigh on borrowers' repayment capacity, however we do not believe that the Fitch-rated banks are overly exposed to risks in that sector.

Other Business: Step-up in Compliance Controls

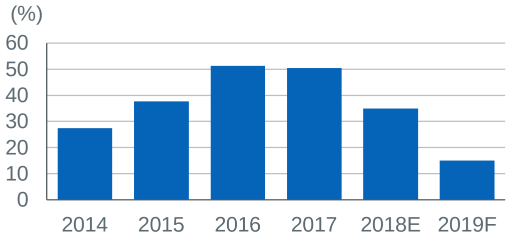
Our base case is for a positive assessment from the Asia/Pacific Group's money-laundering review, which is expected by mid-2019. Banks losing access to US dollar clearing services via international banks is a tail risk.

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



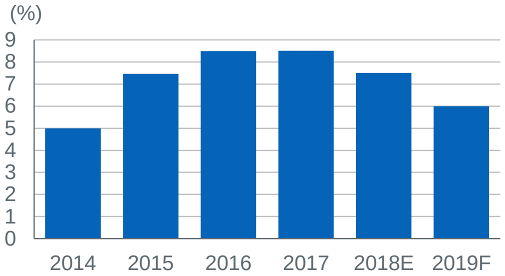
Source: Fitch Ratings, Fitch Solutions, banks

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



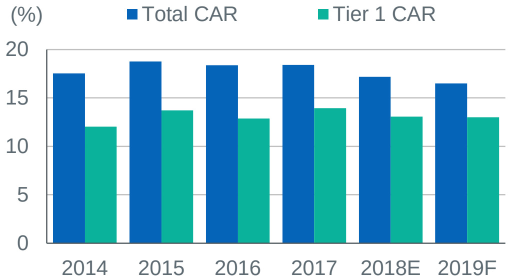
Source: Fitch Ratings, Fitch Solutions, banks

Mongolia: Key Performance Trends
Asset quality - NPL ratio



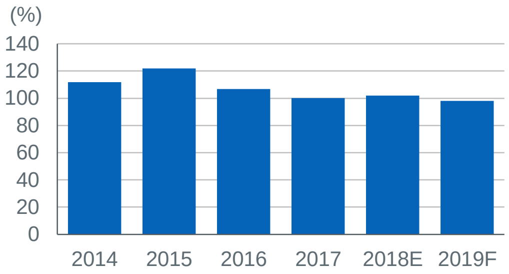
Source: Fitch Ratings, BoM

Mongolia: Key Performance Trends
Capital ratios



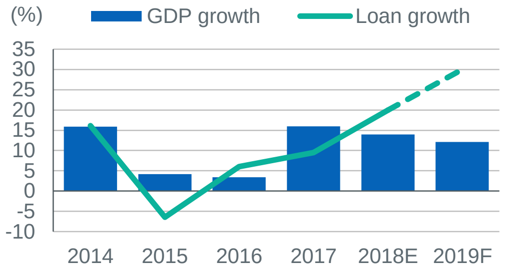
Source: Fitch Ratings, Fitch Solutions, banks

Mongolia: Key Performance Trends
Loans/deposits ratio



Source: Fitch Ratings, BoM

Mongolia: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch Ratings, BoM

Philippines

Outlook

Fitch's Sector Outlook: Stable

We expect banks' NIMs to continue to expand in 2019 as market interest rates rise, helping to maintain stable returns in the face of modest pressure on asset quality, fee income and operating expenses. Economic conditions should remain supportive, as we see GDP growth remaining among the highest in the APAC region. Downside risks to growth and asset quality are most likely to stem from higher-than-expected interest rates and inflation, with policy rates up by 175bp in the year to late-November 2018.

Rating Outlook: Stable

Rating profiles should remain steady, backed by the banks' satisfactory risk controls, adequate loss-absorption buffers, and generally stable funding and liquidity profiles.

What to Watch

Pricing Discipline Counters Tighter Liquidity

Tighter (yet still sound) liquidity will encourage a stronger focus on asset and liability pricing by the banks. This should allow them to better capture the NIM benefits from higher interest rates.

Underlying Demand Strength

The authorities' ongoing infrastructure programme and steady remittance inflows should sustain GDP growth and credit demand in 2019. This will help support asset quality, and we expect credit costs to rise only modestly despite the challenge posed by higher interest rates. An unexpectedly sharp slowdown in activity would pose greater risks – especially in real estate, where many large conglomerates are exposed.

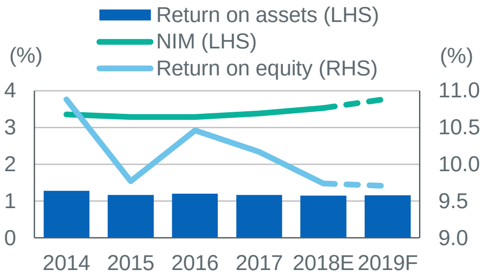
More Wholesale Issuance

Banks will remain largely deposit-funded, but we expect more peso term-debt issuance from programmes filed in 2018, supplementing US dollar debt raised in recent years. This will help banks further diversify their stable funding in light of Basel III NSFR rules taking effect in 2019.

Monetary Policy, Trade Tensions

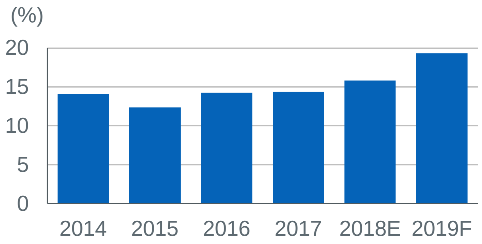
Our base case does not factor in major ramifications from monetary policy or US-China trade tensions, though these remain potential downside risks to bank growth and the sector outlook.

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



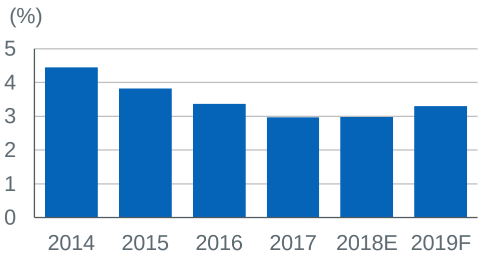
Source: Fitch Ratings, Bangko Sentral ng Pilipinas (BSP)

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



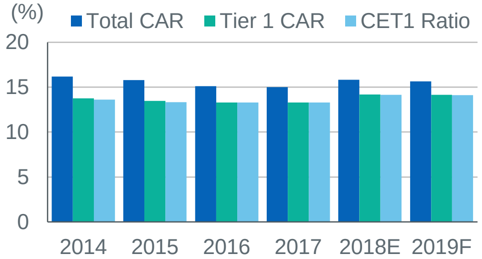
Source: Fitch Ratings, BSP

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



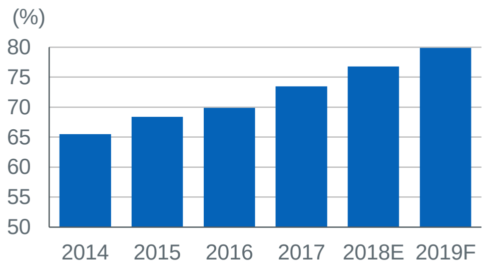
[a] NPAs comprise NPLs and foreclosed properties
Source: Fitch Ratings, BSP

Philippines: Key Performance Trends
Capital ratios



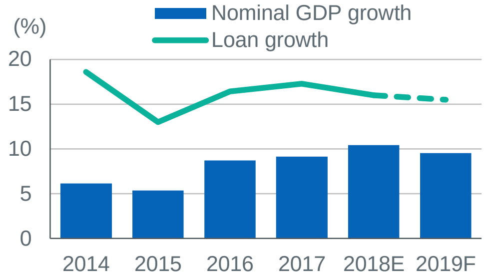
Source: Fitch Ratings, BSP

Philippines: Key Performance Trends
Loans/deposits ratio



Source: Fitch Ratings, BSP

Philippines: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch Ratings, Fitch Solutions, BSP

Sri Lanka

Outlook

Fitch's Sector Outlook: Negative

Fitch maintains our negative outlook, based on our expectations for operating conditions to remain difficult. Economic expansion has remained muted, and this is also likely to be the case in 2019. Sri Lanka faces numerous additional challenges on both the domestic and external fronts, which are likely to affect banks' performance through 2019, mainly on asset quality.

Rating Outlook: Stable

Fitch expects bank credit profiles to remain broadly intact, although it is possible that some modest pressure will be brought to bear on the ratings of some banks in the absence of sufficient buffers against risks. Sovereign rating action could result in similar action on the IDRs and VRs of Sri Lankan banks that are at the same level.

What to Watch

Macroeconomic Risks

Banks are likely to face increased challenges on the macro front. The recent political crisis in Sri Lanka has heightened uncertainties regarding the policy outlook, with the IMF delaying discussions regarding the programme as a result. Sri Lanka is due to enter an election cycle. In addition, the country has large external debt-refinancing needs from 2019-2022 amidst tighter global monetary conditions, with heightened domestic political instability raising refinancing risks. The resulting macroeconomic implications could dampen prospects for banks.

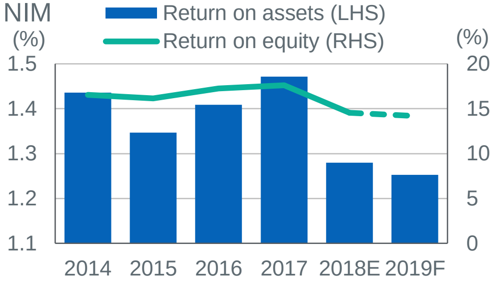
Continued Pressure on Loan Quality

We believe credit risks will linger in 2019, as reflected in a rise in rescheduled loans across banks alongside a surge in NPLs in 2018. Pressures should remain manageable alongside banks' increased focus, although a higher-than-expected level of loan impairments can lead to a re-assessment of these trends.

Ongoing Capital Needs

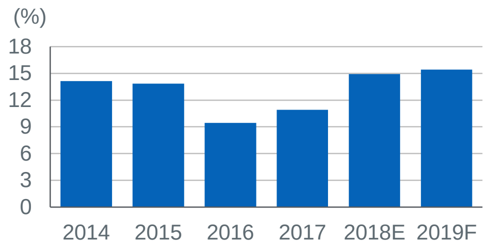
Capital-raising could continue in 2019 among banks that plan to/need to strengthen capital buffers, but banks could face execution risks – given the macro instability. The impact of the implementation of SLFRS 9 is likely to be modest, and the effect on regulated capital ratios is likely to be spread out.

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



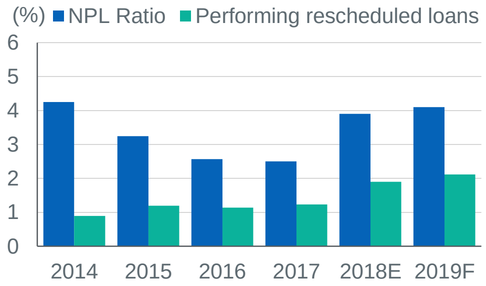
Source: Fitch Ratings, CBSL

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



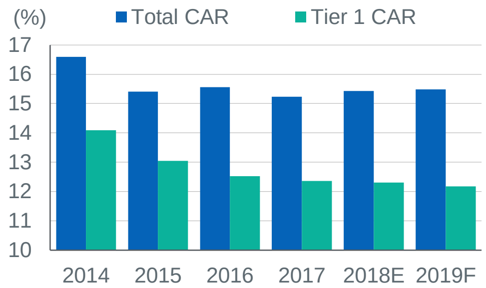
Source: Fitch Ratings, CBSL

Sri Lanka: Key Performance Trends
Asset quality



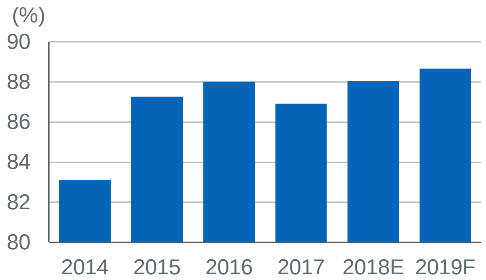
Source: Fitch Ratings, CBSL

Sri Lanka: Key Performance Trends
Capital ratios



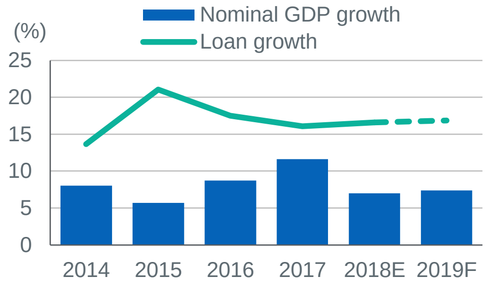
Source: Fitch Ratings, CBSL

Sri Lanka: Key Performance Trends
Loans/deposits ratio



Source: Fitch Ratings, CBSL

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



Source: Fitch Ratings, CBSL

Thailand

Outlook

Fitch's Sector Outlook: Stable

Fitch expects operating conditions in the Thai banking sector to remain relatively stable, as reflected in key financial metrics such as asset quality and profitability. Economic growth has picked up over the past two years, but business sentiment and consumer confidence still appears to be subdued, and Fitch believes that banks will remain relatively cautious.

Rating Outlook: Stable

All 17 banks rated by Fitch in Thailand (on both the international and national scales) are on stable outlook, reflecting stability in their intrinsic profiles or in the ratings of supporting entities.

What to Watch

Asset-Quality Trends Stabilising But Downside Risks Persist

Weaknesses remain such as in the SME segment. Hence there is still downside should economic conditions deteriorate rapidly, particularly as private-sector leverage remains high. The Bank of Thailand has initiated macro-prudential measures on retail lending (on credit cards/personal loans since September 2017, and planned for mortgages starting 2Q19) which are narrowly focused, and appear preventive rather than being a reaction to clear danger signs.

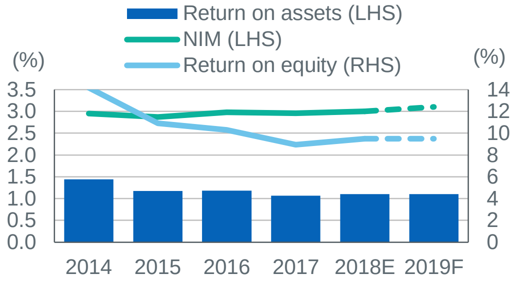
Capital Buffers Will Remain Strong

Fitch expects internal capital generation to remain robust. Many large banks are investing heavily in operations and IT, while competition has forced down retail transfer fees. However, Thai banks have consistently generated profit through-the-cycle, and performance should be supported by declining credit costs and a more benign operating environment.

Loan Growth Rising But Still Muted

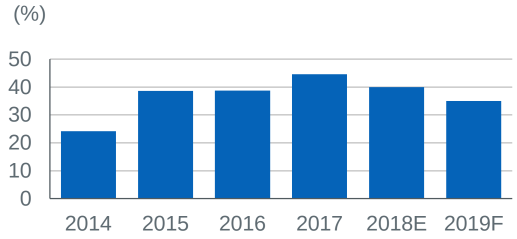
Loan growth is picking up from the very low levels seen in 2016-2017, but remains relatively low compared with nominal GDP growth. This reflects corporate spending which is still weak, as well as a lower risk appetite on the part of the banks. Fitch sees upside to lending growth, should the economic recovery become more entrenched and infrastructure spending rises.

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



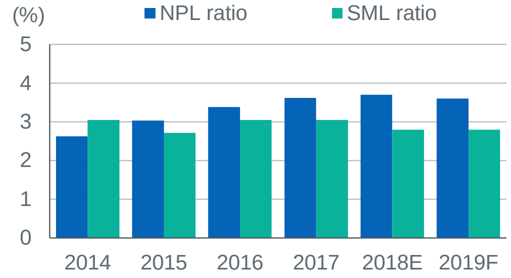
Source: Fitch Ratings, Fitch Solutions, Bank of Thailand

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



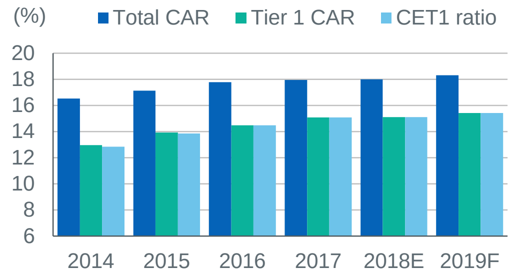
Source: Fitch Ratings, Fitch Solutions, Bank of Thailand

Thailand: Key Performance Trends
Asset quality



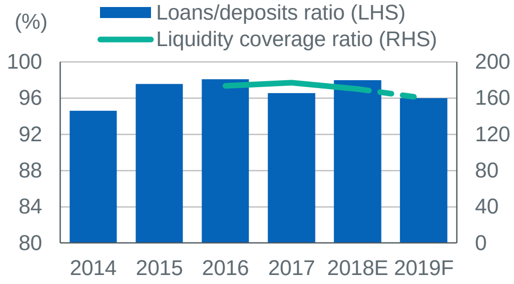
Source: Fitch Ratings, Fitch Solutions, Bank of Thailand

Thailand: Key Performance Trends
Capital ratios



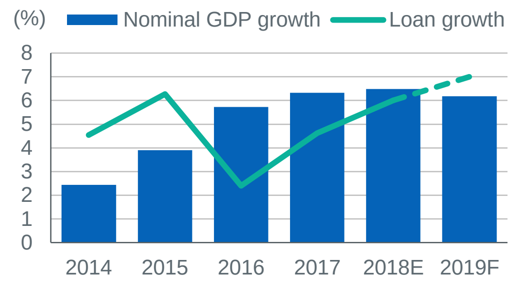
Source: Fitch Ratings, Fitch Solutions, Bank of Thailand

Thailand: Key Performance Trends
Loans/deposits ratio



Source: Fitch Ratings, Fitch Solutions, Bank of Thailand

Thailand: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch Ratings, Fitch Solutions, Bank of Thailand

Vietnam

Outlook

Fitch's Sector Outlook: Stable

Fitch expects Vietnam's strong economic growth and a benign operating environment to prevail in the face of rising external challenges. We see the banks sustaining their positive momentum in financial results in 2019, aided in part by rapid credit growth. Nevertheless, keener competition for deposits and negative knock-on effects from the US-China "Trade War" pose downside risks.

Rating Outlook: Stable

We expect the stable outlook to remain so, given the supportive operating environment.

What to Watch

Further Write-Downs of Legacy Exposures

Rising profit may motivate selected banks to write down their legacy exposures which, along with rapid loan growth, should keep the extent of problem loan ratios steady. That said, we believe the underlying asset quality remains weaker than reported, in light of the system-wide under-reporting of NPLs. We expect banks' profitability to continue to improve, albeit from a low base, propelled in the main by strong growth in high-margin retail loans.

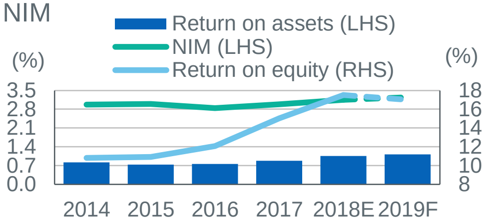
Rapid Credit Growth Could Moderate

We believe banking system credit growth will begin to moderate as the authorities now require banks to adhere to growth targets without exceptions. We view this positively, if executed, as sustained excessive credit growth risks creating further asset-quality problems. However, we only expect a marginal loan slowdown as Vietnam remains a credit-fuelled economy.

Active Capital Issuance

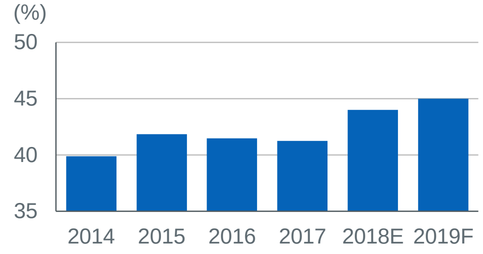
We expect banks to step up capital issuance in 2019 to meet Basel II requirements, scheduled for 1 January 2020. We estimate Fitch-rated banks will require USD6.5 billion in new capital (3% of GDP) if the banks were to target a minimum 8% Tier 1 ratio under Basel II, and raise their allowance coverage to 5% of gross loans and Vietnam Asset Management Company (VAMC) bonds. A relaxation of the foreign-ownership cap would support the significant capital needs, given the lack of depth in domestic capital markets.

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



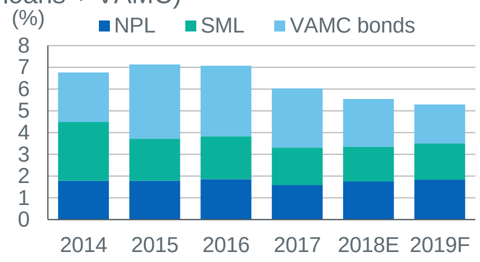
Source: Fitch Ratings, Fitch Solutions, banks*
*Banks refer to weighted average of ten banks (Vietin, Vietcom, BIDV, ACB, MB, VPBank, Techcom, Sacom, SCB, SHB)

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



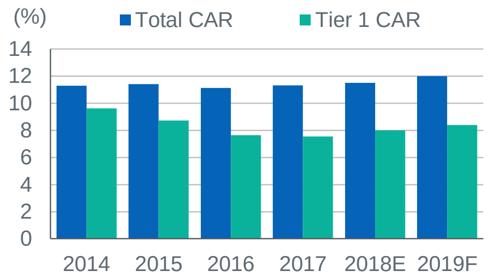
Source: Fitch Ratings, Fitch Solutions, banks*

Vietnam: Key Performance Trends
Asset quality - Problem loans (% gross loans + VAMC)



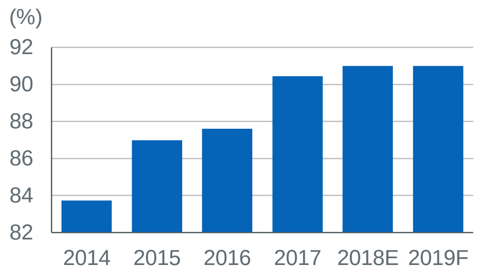
Source: Fitch Ratings, Fitch Solutions, banks*

Vietnam: Key Performance Trends
Capital ratios (Basel I)



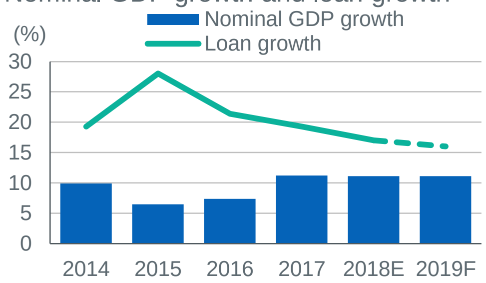
Source: Fitch Ratings, Fitch Solutions, Fitch-rated banks

Vietnam: Key Performance Trends
Loans/deposits ratio



Source: Fitch Ratings, Fitch Solutions, banks*

Vietnam: Key Performance Trends
Nominal GDP growth and loan growth



Source: Fitch Ratings, Fitch Solutions, banks*

Outlooks and Related Research

2019 Outlooks
Global Economic Outlook (September 2018)
APAC Banks Regulatory Compendium – Update (July 2018)
APAC Banks: Implications of Fed Tightening (May 2018)

Analysts

Jonathan Cornish, Head of APAC Banks +852 22639901 jonathan.cornish@fitchratings.com	Parson Singha – Thailand +66 2 108 0151 parson.singha@fitchratings.com
Ambreesh Srivastava, Head of South and South-East Asia Banks +65 6796 7218 ambreesh.srivastava@fitchratings.com	Wee Siang Ng – Vietnam +65 6796 7230 weesiang.ng@fitchratings.com
Grace Wu – China +852 22639919 grace.wu@fitchratings.com	Elaine Koh – Malaysia, Philippines +65 6796 7239 elaine.koh@fitchratings.com
Sabine Bauer – Mongolia +852 22639966 sabine.bauer@fitchratings.com	Saswata Guha – India + 91 22 4000 1741 saswata.guha@fitchratings.com
Gary Hanniffy – Indonesia +62 21 2988 6808 gary.hanniffy@fitchratings.com	Rukshana Thalgodapitiya – Sri Lanka +94 11 2541 900 rukshana.thalgodapitiya@fitchratings.com