April 22, 2021

ASEAN: The resilience of banks

How ASEAN banks emerge from COVID-19

Not only did ASEAN banks cope well with the COVID-19 induced crisis, but they also helped policymakers tackle problems in the downturn. The dawn of a new economic cycle and the strengthening role of ASEAN in the global supply chain is a favourable environment in which regional banks can prosper in the medium term. Notably, COVID-19 has triggered a new wave of technological shifts in the industry.

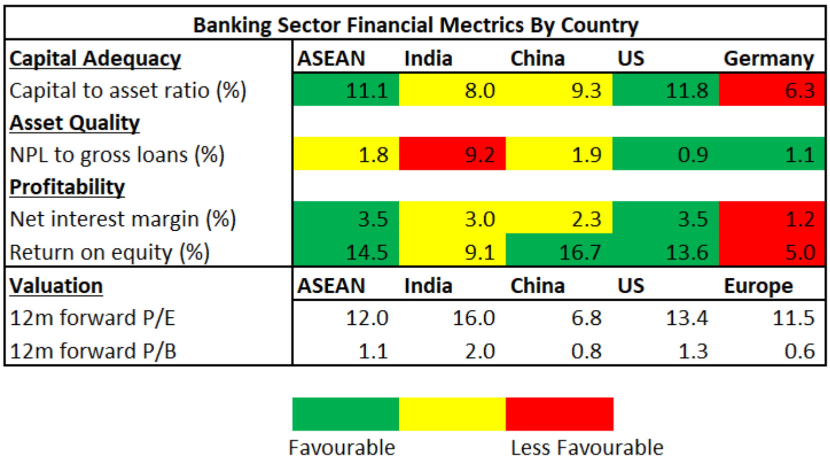
Source: iStock

Banks are at the heart of the economy

In the developed world, corporate credit markets allow firms to raise funding fairly efficiently. Even companies with weak balance sheet metrics can lock in affordable rates in a low interest rate environment on the back of investors' thirst for yield. This is not yet the case in ASEAN where corporate credit markets are still in their infancy, and regional banks maintain their prime position as fundamental sources for lending.

Around 80-100% of corporate funding in Indonesia, the Philippines and Vietnam comes from bank loans. While the statistics look less skewed in Singapore, Malaysia and Thailand due to their more developed debt markets, bank lending remains the dominant financing source in these countries as well. Hence, how effectively banks operate and what risks they are exposed to impact credit cycles and the broad economy directly.

Key financial metrics show ASEAN banks are in good health



Banking Sector Financial Mectrics By Country					
Capital Adequacy	**ASEAN**	**India**	**China**	**US**	**Germany**
Capital to asset ratio (%)	🟩 11.1	🟨 8.0	🟨 9.3	🟩 11.8	🟥 6.3
Asset Quality					
NPL to gross loans (%)	🟨 1.8	🟥 9.2	🟨 1.9	🟩 0.9	🟩 1.1
Profitability					
Net interest margin (%)	🟩 3.5	🟨 3.0	🟨 2.3	🟩 3.5	🟥 1.2
Return on equity (%)	🟩 14.5	🟨 9.1	🟩 16.7	🟩 13.6	🟥 5.0
Valuation	**ASEAN**	**India**	**China**	**US**	**Europe**
12m forward P/E	12.0	16.0	6.8	13.4	11.5
12m forward P/B	1.1	2.0	0.8	1.3	0.6

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Favourable Less Favourable

Source: Latest data available from the World Bank (2019 and 2017), Bloomberg, ZIG

Bank performance also influences the stock markets, particularly in countries like Singapore and Indonesia, where banks are dominant benchmark index components. Around 40% of the Straits Times Index and the Jakarta Stock Exchange Composite Index are associated with banks.

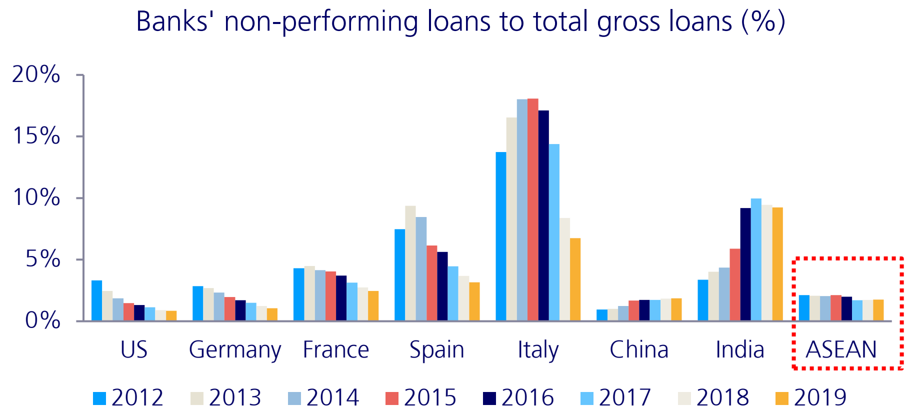
From a macroeconomic perspective, banks are also the key channel for monetary policy transmission. Since the Asian Financial Crisis (AFC), ASEAN banks have established more solid capital bases and disciplined risk management. The COVID-19 crisis showed how banks can be a part of the solution in a downturn.

ASEAN banks are largely in good health

Thanks to major overhauls of the financial system in the wake of the AFC, banks are generally in good shape. The average capital to asset ratios of ASEAN banks was more than 11% on average as of 2019, a ratio similar to US banks and much stronger than European banks (see table 1).

Thanks to a positive economic growth trajectory coupled with a high yield environment, ASEAN bank profitability has been robust, particularly in Indonesia, where banks reported a net interest margin (NIM) of 6% and return on equity (ROE) of 16.6% in 2019, placing them among the most profitable banks in the region. Regarding

Asset quality of ASEAN banks has improved markedly since the AFC



Source: World Bank

asset quality, the non-performing loan to gross loan ratio in ASEAN has improved markedly in the last decade as a result of the restructuring of the banking system since the AFC (see chart 2).

Surviving the COVID-19 stress test

The financial stress on ASEAN banks due to the COVID-19 induced crisis was intense. The economy experienced its worst contraction since the AFC.

Credit growth collapsed as businesses and households scaled back spending. Low interest rates put heavy pressure on net interest margins (NIMs). Foreign investors rushed to withdraw funds from emerging markets (EMs), seeking shelter in safe haven assets.

According to Nikkei Asia, 16 of the largest ASEAN banks saw their non-performing loans (NPLs) rise by around 17% YoY in 2020. Authorities urgently required banks to reduce or suspend dividends. Most importantly, loan moratorium and credit guarantee from governments and central banks helped firms and households avoid financial distress and protected bank assets.

Overall, banks' strong balance sheets, notably in major economies like Singapore, Malaysia and Indonesia along with targeted policy support from governments and central banks helped banks cope well with the COVID-19 recession.

The current concern is the withdrawal of these policy measures will reveal the true picture of non-performing loans, which has been masked by loan moratoriums. This will potentially put pressure on banks' balance sheets. However, ASEAN banks already stepped up their loan loss provisions last year to preserve capital buffers in case of stress. On top of that, the ongoing economic recovery should limit the downside risks.

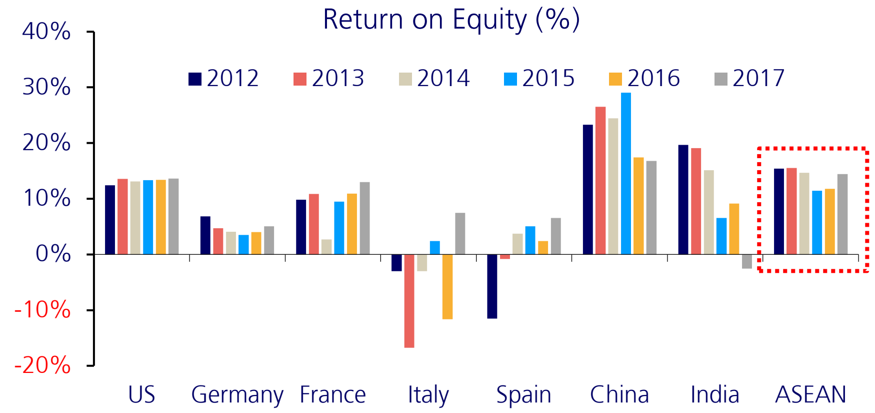
Mind the risks

While ASEAN banks are generally in good health, a closer look reveals some vulnerable spots.

Vietnam's banks are the weakest link in the region. Thin capital bases, which still fall short of the Basel minimum requirement and the still high number of impaired loans, a legacy of the banking crisis in 2011-2012, make local banks vulnerable to economic shocks. Vietnam's rapid rise of household debt to GDP in the last few years is also a concern.

Fortunately, Vietnam was among a few countries in Asia that registered positive growth in 2020 thanks to its early success in containing the pandemic. Therefore, the economic shocks to the economy and the banking sector were limited.

A high yield, strong growth environment supports bank returns



Source: World Bank

It is estimated that the NPL ratio in the Philippines will reach 5% by the end of 2021, scratching the upper levels at which stress tests suggested their banks can resist. The NPL ratio might get worse, given that the country is now experiencing a new wave of COVID-19 with renewed lockdown measures

Elsewhere, Malaysia's low FX reserves relative to short-term debt and Indonesia's high exposure to foreign loans make them sensitive to external financial conditions. However, both countries reported sizable trade surpluses this year, which should reduce their vulnerability to the volatility of their respective currencies to a certain extent.

Lending a helping hand to policymakers

2020 was an unprecedented year for global policymakers. With eye-popping fiscal stimulus worldwide and the arrival of Quantitative Easing (QE) as well as debt monetisation in EMs, a new regime has arrived in which fiscal and monetary policy become increasingly intertwined.

In ASEAN, the enormous outflows of foreign capital in Q2 2020 exacerbated an already critical situation. In response, ASEAN central banks unleashed a vast amount of liquidity into the banking system, mainly through Reserve Requirement Ratio cuts, and guided commercial banks to step in and purchase government bonds dumped by foreign investors.

With public debt rising sharply, banks were also the ones that mainly financed government debt. In Indonesia, for example, banks now hold around half of total government bonds, compared to only 20% in 2019. With still muted foreign appetite for ASEAN bonds, domestic banks should remain the key holders of government bonds in 2021.

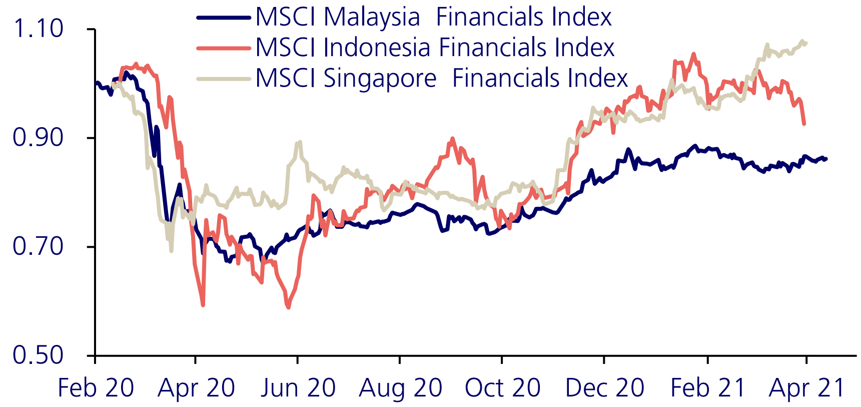
With commercial banks holding such a large portion of sovereign bonds, banks are increasingly exposed to sovereign risks and governments are increasingly exposed to bank risks. In the Eurozone debt crisis between 2011 and 2012, this 'doom loop' was the major source of instability to the financial system.

However, unlike the Eurozone, individual countries in ASEAN independently decide their monetary policy and currency regulations. Also, regional central banks have proved their creditability in ensuring financial stability in the last few years. Overall, the risk of ASEAN countries defaulting on their debt is rather small.

The recovery is underway

From the macroeconomic perspective, the dawn of a new economic cycle should support the recovery of the banking sector. Tech and commodity exports have been robust and should remain so during the global recovery, underpinning bank deposits by export firms. Foreign direct investment (FDI) has shown a positive trend. The supply-chain shift of US and international firms away from China is likely to result in increasing FDI flows into ASEAN in the years to come. Vaccines should encourage the reopening of the

Bank shares rally but volatility is high given currency fluctuations



Source: Bloomberg

economy, bolstering consumption and investment, key drivers of credit growth.

There have been signs of an initial pick up in capex investment among Indonesia's firms and consumer credit demand in Malaysia's property market. We expect this trend to be more visible once vaccine programs gain more solid ground towards the end of this year and earlier next year. This will help bank earnings to recover and NPLs to normalise.

Despite the around 30% rally in bank equities since November 2020, their valuations still look compelling. 12-month forward P/E of major banks are in a range between 10x-12x, a similar level to European banks, but with stronger fundamentals. 12-month forward P/B is trading above one for most banks, except in Thailand and the Philippines where banks look more vulnerable than their regional counterparts due to high NPL ratios.

What does a rise in yields mean for ASEAN banks?

The implications of rising yields for ASEAN are rather complex. Rising yields mean banks would benefit from the widening term premia.

However, given banks' large holdings of government bonds, the drop in bond prices will cause certain unrealised losses in their balance sheets. However, banks still have enough capital to cushion these losses. In fact, they remain active in the bond markets to benefit from higher yields.

Overall, we envisage factors such as improving credit growth, widening term premia, better NIMs and falling NPLs should support banks in the medium term, despite some side effects caused by rising bond yields.

The future of banking is here

An unexpected positive effect of the COVID-19 crisis was the acceleration of digital transformation in all aspects of life. Consumers now prefer shopping and banking online to brick-and-mortar businesses, compelling traditional banks to rethink their operating models.

In ASEAN, banks have embraced Artificial Intelligence (AI), blockchain and biometric technology to enhance consumers' online experience and mobile access.

Regional governments started issuing digital bank licences, allowing new banking businesses to operate entirely on a virtual basis without the need for a physical presence.

In the last few years, fintech firms have proliferated in ASEAN. Many of them target the areas that big banks neglect, such as the rural population and small businesses that lack a credit history to access bank lending. Overall, the prospects for fintech look very promising in ASEAN.

Will there be a survival threat to traditional big banks?

We think this is unlikely. Big banks still have significant competitive advantages, including established customer relationships and a large market coverage. Traditional banks have also evolved by engaging in fintech through acquisitions or partnerships, while investing millions of dollars to enhance their IT capabilities to adapt with the pace of change.

Yet there is no room for complacency amongst traditional banks. With lower barriers to entry, the sector will undoubtedly see more competition. Overall, this shift is likely to create a better future for the banking system by enhancing its efficiency and competitiveness. Most importantly, consumers will benefit from competition in the end.

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