

APAC Banks: The Environment Toughens

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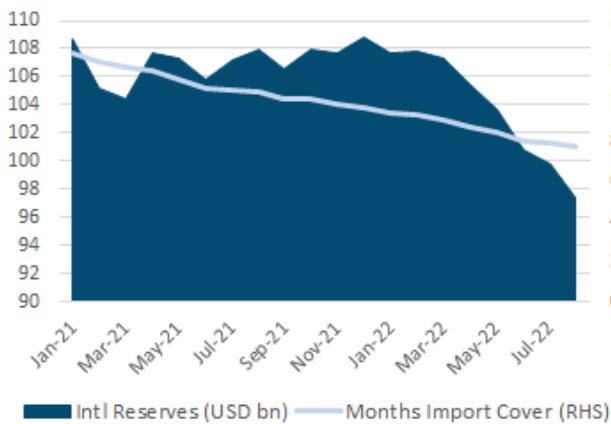
Executive Summary

- **Following a review of the APAC banking sector, we are changing our recommendation on the Thai banks; we move Bangkok Bank, Kasikornbank, TMBThanachart Bank and Siam Commercial Bank to an Underperform recommendation from Market perform, and Krung Thai Bank to Market perform from Outperform.** The Thai economy faces a large number of challenges, and we expect both margin shrinkage and a spurt in credit costs at the banks.
- **It is highly likely that equity markets will continue to correct as earnings deceleration has not been factored into S&P 500 valuations as yet; the credit markets will likely follow, putting stress on EM fund outflows.** This will widen spreads into next year.
- **Amongst the APAC banking sectors, we prefer the developed markets – South Korea, Singapore, Japan and Australia; we also prefer the top tier Chinese banks given the strong domestic bid for these names.**
- **We are also watchful of the impact of an economic slowdown on the Philippines, Indonesia, India, and Malaysia in that order; GDP growth estimates for these economies are still in the 4-6%+ range but we anticipate that these will be scaled back as we progress into 2023.**

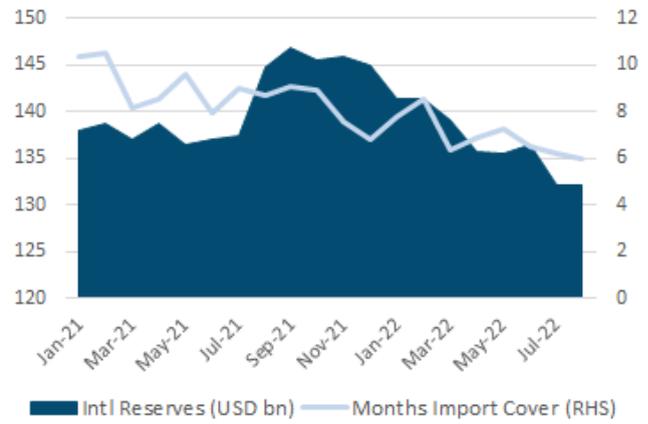
As US interest rates and domestic inflation rise, central banks in Asia are caught between a rock and a hard place. If they don't raise interest rates at a fast enough pace, currency depreciation will result in higher imported inflation. If they do raise interest rates fast, domestic growth will get affected. Most central banks are also becoming more cautious about defending their currencies or reducing volatility as they weaken, as they have seen FX reserves falling sharply in the process.

Drop in International Reserves and Import Cover Across Various South and Southeast Asian (SSEA) Countries

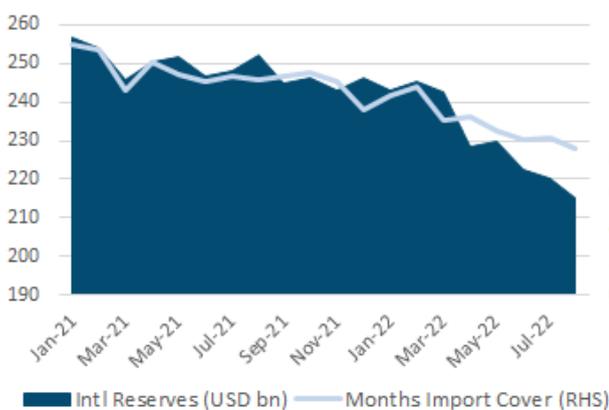
Philippines



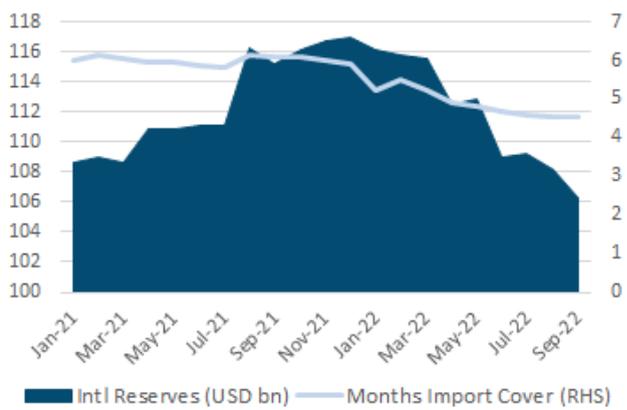
Indonesia



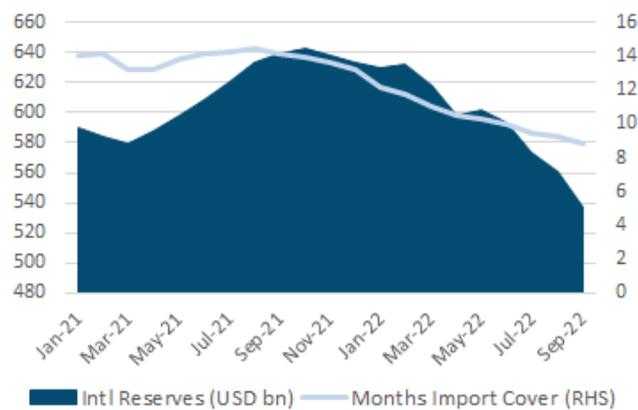
Thailand



Malaysia



India



Source: Bloomberg, CreditSights.

The OPEC+ plan to keep oil prices high is another pain point, as it had largely been expected that slower global growth would result in falling oil prices and therefore bring down inflation levels. This is a particular issue for countries that have twin deficits – a budget deficit and a current account deficit – such as India, the Philippines and Thailand. Indonesia has had a current account surplus this year and last, for the first time since 2011, while Malaysia has had a current account surplus since 1998. Malaysia is also the only oil net exporter out of the group of countries mentioned here.

Over the past few weeks, we have seen a steady widening of Asian EM financials credit; we expect this trend to continue as institutional investors continue to see fund outflows and sell down what they want to first, and later, what they can. HNW investors have been increasing their cash component expecting more market volatility; PB's have been offering good rates on \$ cash to lock in funding. It is highly likely that US equity markets will see much lower levels as the correction to date has largely been a result of higher interest rates on discounting cash flows; it does not take into account lower income levels for companies next year, although downwards earnings revisions have been coming through from analysts. US equity market volatility will lead to a softer environment for Asian credit spreads.

How far can financials spreads widen? The S&P was last in the 3,000-3,500 range in mid-2020; we look at the **APAC RV note from May 2020** to get a better sense of the widening possibilities. In the appendix table at the end of this note, we take some bonds as examples to show the spread differentials, but more broadly, without adjusting for maturity differences, Indonesian and Indian bank bonds were 225 bp wider, and the Thai banks and Philippine banks 150 bp wider. At the other end, Singapore banks have been flat, Korean banks about 70 bp wider, and the Japanese bank TLAC bonds 40 bp wider.

Our best estimate at this stage is for spreads to go 50-100 bp wider into 1Q23 for non-China EM Asia with the Indian, Indonesian and Philippine banks at the tighter end of the range and Thai banks at the wider end of the range, although the spread widening of the Thai bank senior bonds will be tempered by their relatively close maturities for many bonds.

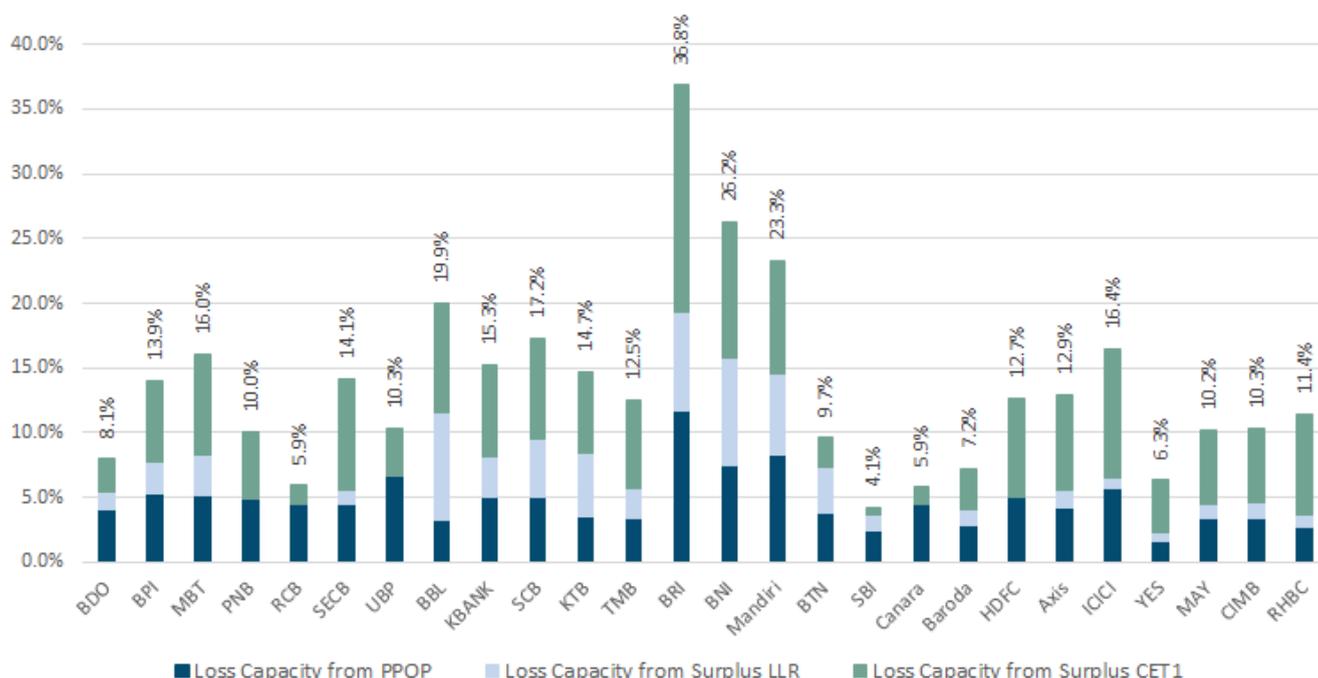
We expect the tightening credit environment to lead to higher credit costs; the consideration is more whether increased net interest income, if applicable, will offset it, as pointed out in our note **APAC Banks: Who Benefits from Higher Rates?**.

In general, geographies where we anticipate banks will be more sheltered are China (thanks to strong top tier banks, the strong domestic bid for short-dated paper, and little supply), Korea and Singapore (high quality financial sectors) and Japan (no impact of rising domestic interest rates). We are also comfortable with the Australian banks, but ongoing supply will continue to be strong, and the Australians will be price takers.

We see Thailand as the economy with particular challenges. For the others, namely the Philippines, Indonesia, India and Malaysia, growth may slow to lower than the 4-6+% range that is being forecast for 2023, but we are comfortable with most banks, other than the second tier Philippines banks.

We have also re-looked at the loss absorbing capacity of banks in India, Malaysia, Philippines, Thailand and Indonesia, measured as how much additional losses these banks can take as a percentage of loans. The strong loss absorbing capacity of key Indonesian banks stood out strongly here, followed by the Thai banks, selected Indian private sector banks and selected Philippine banks. The negative surprise to us here was the low capacity of State Bank of India. However, it is worth noting that for the Thai and Indonesian banks, the estimated loss absorption capacities are slightly skewed in their favour by ongoing forbearance measures.

South and Southeast Asian Banks (ex-Singapore): Additional Credit Loss Absorption Capacities (as a % of loans)



Methodology: Loss absorption capacity above current NPL ratio is calculated as the sum of: (1) Annualized 1H22 PPOP for all except Indian banks (1QFY23), (2) Surplus loan loss reserves (includes both general and specific provisions) above a 75% NPL coverage ratio, and (3) Excess CET1 capital above the minimum capital requirement plus a 1% operating buffer, all as a % of total loans. General provision reserves used for Indian banks are as at 4QFY22. Loss ratio of 75% is applied across all sectors.
 UBP: Est. pro-forma CET1 ratio of 13.5% for Citi acquisition was taken, and net loans were used. SCB: Surplus CET1 capital is pro-forma for THB 61 bn upstream to SCB^x.
 Source: Company data, CreditSights.

We go into greater detail into selected economies below -

THAILAND

We are cautious about Thailand. Given challenging economic conditions, Bank of Thailand has been cautious about hiking rates, with only two 25 bp hikes so far this year, leading to a 13% depreciation in the THB over the past 6 months. Economic growth has been lower than in the rest of EM Asia, and the country has been depending on greater tourist inflows to buoy its reserves. However, with China continuing to remain closed and the rising living and mortgage costs in much of the world affecting discretionary expenditure, we don't anticipate much of a pick-up in tourism. Auto component exports have been affected by supply chain issues. High energy costs and the weaker THB has led to a 7M22 trade deficit of THB 420 bn, the highest in 27 years. This is before ongoing floods and what is likely to be a fraught political environment leading up to national elections next May. The government has asked commercial banks to be cautious about passing rate hikes on to borrowers, and public sector banks have been directed to not pass hikes on. Thai senior bank spreads have widened 5-20 bp in the past month, broadly in line with the market. **While we acknowledge the strong loss absorption capacity of these banks, as a result of the challenging conditions (where we expect narrower margins and higher credit costs), we are changing our recommendation on SCB, KBank, TMBThanchart and Bangkok Bank to Underperform from Market perform, and on KTB to Market perform from Outperform.**

THE PHILIPPINES

The BSP has increased interest rates by 225 bp so far this year to 4.25% and is likely to continue with two more hikes at its next two meetings this year, as its expected FY22 inflation of 5.6% is well above its 2-4% target band. Despite the hikes, the PHP has depreciated by 14.4% over the past 6 months. The BSP predicts a current account deficit of \$20.6 bn or 5% of GDP in 2022. The Philippines does not have much of an exports base to take advantage of a weaker currency, and remittances are likely to increase only by 4% next year. While we are watchful, we don't expect a particularly strong deterioration in the economic environment. GDP growth is still expected to be 6%+ in 2023, we see downside risk there.

The new PHILIP 10/27 is trading at G+110 bp, while the MBTPM 01/26 is at G+123 bp. Taking a 25 bp 3-5Y curve and a 10 bp new issue premium, a new MBTPM would price around G+155 bp; we see a 45 bp spread differential as appropriate. **The first-tier Phil banks (BDOPM, BPIPM and MBTPM) are now trading meaningfully wider than the Thai banks by ~40 bp, but we see this more as the Thai banks that are trading too tight and thus maintain our Market perform recommendation on the first-tier Phils banks. We maintain our Underperform recommendation on UBPPM, RCBPM and PNBPM – the latter two are due to weaker fundamentals, whereas UBP continues to trade very tight.**

INDIA

The Indian Finance Minister, Mrs. Nirmala Sitharaman, said towards the end of September that the RBI had spent \$75 bn in managing INR volatility and that the INR should continue to fall for competitiveness and as the market finds a new level. The INR duly fell to 82.60 vs the \$ from 81 when the statement was made. Fortunately for India, growth seems to be slowing but at a manageable rate; it is still expected to have GDP growth rates of 6%+ in FY23 and 5%+ in FY24. Tax collections have been buoyant this financial year. On the flip side, white collar job vacancies have fallen strongly as corporates tighten belts – we anticipate increasing credit costs in the retail and SME sectors. In general, we see growth as being sufficient to not create particular asset quality issues for the banks. Supply has been another supporting factor for spreads – the Indian banks have effectively stopped issuing senior debt, with the last benchmark issue coming from SBI in Jan-21, if one doesn't take into account the \$300mn 5Y Formosa they issued in Jan-22.

Indian senior bonds have widened 10-25 bp over the past month, in line with Southeast Asian banks (ex-Singapore). **We maintain our Market perform recommendations on the key Indian banks, and our Underperform recommendation on Canara Bank and Bank of Baroda.**

INDONESIA

Indonesia has found itself with a current account surplus this year, for the first time in a decade, thanks to commodity exports. This has led to relatively good IDR stability, with the IDR depreciating by only 6% in the past 6 months. However, its aim to reduce fuel subsidies has led to a jump in inflation from 4.69% in August to 5.95% in September; inflation is expected to continue to be at least 6% till year-end. The higher inflation has led to increases in street protests. We don't foresee issues for Indonesia in the next 9 months or so, with 2023 GDP growth currently expected in the 4.50-5.00% range, but do anticipate that domestic growth and lower commodity prices in time will flip the current account surplus into a deficit again, potentially putting pressure on the currency by mid-next year. Indonesia also has a potential issue regarding policy continuity as elections are due in early 2024, possibly leading to more FX and credit volatility in 2H23. The comfort factor as pointed out earlier is the huge loss absorption capacity of most of the Indonesian banks.

We had moved Mandiri and BRI to Market perform from Underperform in **July** when their \$ seniors were trading at G+140 to 170 bp as we saw the risk premium for vulnerability to swings in global risk sentiment and volatile commodity prices as sufficiently captured at those levels. The seniors have gone on to tighten to ~G+110 bp on 19 September but have since widened out ~50 bp to their present levels. **We continue to maintain our Market perform recommendation on these names and BTN, and our Underperform recommendation on BNI.**

MALAYSIA

Malaysia enjoys a current account surplus, but its slower pace of rate hikes and political instability have led the MYR to decline by 9.5% against the \$ over the past 6 months. BNM has hiked rates thrice this year, each by 25 bp, and a 20 bp hike is expected at its last rate meeting this year in November. Political instability continues as Prime Minister Ismail Sabri Yaakob announced the dissolution of Parliament on 10 October in the hope of securing a stronger mandate. Inflation has not been as elevated as other countries, and consumption and growth momentum were strong in 1H22 thanks to fiscal packages from the government, but such aid is likely to moderate in 2023. The 2023 budget though will need to be re-tabled again after the elections are held. Supporting growth also appears to remain the primary focus with a 2% income tax cut planned in the package, and a budget deficit of 5.5% of GDP being targeted for 2023 - just a slight narrowing from a ~5.8% deficit this year. GDP growth for 2023 was pegged at 4-5% by the dissolved government.

We upgraded the Malaysian banks RHBC and CIMB to Outperform from Market perform and Underperform respectively around **a month ago** when they were trading ~20-40 bp wider than the Philippine banks and ~10 bp wider than the Thai banks. We thought the Malaysian banks should trade through their ex-SG Southeast Asian peers and saw potential for their \$ seniors to tighten by 20-30 bp against them. **Much of the anticipated outperformance has come through now, as the MY banks have widened marginally while the Philippine banks have widened by 50+ bp, but we are keeping them on Outperform as we see room for a further 10-20 bp of tightening relative to the Thai banks and selected Philippine banks such as UBPPM.**

APPENDIX:

Selected APAC Banks: Difference in G-Spread Levels, 10 October 2022 vs. 15 May 2020					
Country	Bond	Current Yrs to Maturity/ Next Call	Current Bid G-Spread (bp)	Bid G-Spread in May-20 (bp)	Chg vs. May-20 (bp)
Thailand					
Senior	BBLTB 4.05% 24	1.4	76	244	(169)
	SCBTB 3.9% 24	1.3	81	236	(155)
Tier 2	BBLTB 3.733% 34NC29	7.0	340	463	(124)
	KBANK 3.343% 31NC26	4.0	334	505	(172)
Malaysia					
Senior	RHBC 3.766% 24	1.4	92	232	(140)
Indonesia					
Senior	BBRIJ 3.95% 24	1.5	151	403	(252)
	BMRIJ 3.75% 24	1.5	156	380	(225)
Tier 2	BBTNIJ 4.2% 25	2.3	442	688	(246)
Philippines					
Senior	RCBPM 3% 24	1.9	132	385	(253)
	UBPPM 2.125% 25	3.0	94	199	(105)
	BDOPM 2.125% 26	3.3	117	207	(90)
	MBTPM 2.125% 26	3.3	115	202	(88)
	PNBPM 3.28% 24	2.0	174	381	(207)
India					
Senior	SBIIN 4.375% 24	1.3	113	306	(194)
	BOBIN 3.875% 24	1.5	116	363	(247)
	EXIMBK 3.375% 26	3.8	156	330	(174)
	ICICI 4% 26	3.4	147	415	(268)
Singapore					
Senior	UOB 1.25% 26	3.5	45	47	(2)
	DBS 1.169% 24	2.1	58	30	28
Tier 2	UOB 3.75% 29NC24	1.5	141	286	(144)
Japan					
Senior (TLAC)	MUFG 25 (TLAC)	2.4	116	177	(61)
	SUMIBK 26 (TLAC)	4.0	134	165	(31)
Tier 2	SUMIBK 4.436% 24	1.5	15	117	(102)
	SUMIBK 3.202% 29	6.9	216	251	(35)
Korea					
Senior	KEBHNB 3.5% 24	1.3	76	167	(92)
	CITNAT 1.75% 25	2.6	90	142	(52)
Tier 2	SHNHAN 3.75% 27	4.9	197	307	(110)
Australia					
Senior	WSTP 3.3% 24	1.4	38	122	(85)
Tier 2	ANZ 30NC25	2.8	239	289	(50)
	WSTP 34NC29	6.8	302	415	(112)

Source: Bloomberg, CreditSights

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RELATED COMPANIES

 Axis Bank

 Bangkok Bank

 Bank BTN

 Bank Mandiri

 Bank Negara Indonesia

 Bank of Baroda

 Bank of Philippine Islands

 Bank Rakyat Indonesia

 BDO Unibank

 Canara Bank

CreditSights

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