S&P Global
Ratings

Global Banking Country-By-Country Outlook Midyear 2020:
More Or Less Resilient To COVID-19 Shocks

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PRIMARY CONTACT

Emmanuel Volland
Paris
+33-14-420-6696
emmanuel.volland@spglobal.com

SECONDARY CONTACTS

Brendan Browne
New York
+1-212-438-7399
brendan.browne@spglobal.com

Cynthia Cohen Freue
Buenos Aires
+54-11-4891-2161
cynthia.cohenfreue@spglobal.com

Osman Sattar
London
+44-20-7176-7198
osman.sattar@spglobal.com

Mohamed Damak
Dubai
+9-714-372-7153
mohamed.damak@spglobal.com

Natalia Yalovskaya
London
+44-20-7176-3407
natalia.yalovskaya@spglobal.com

Sharad Jain
Melbourne
+61-3-9631-2077
sharad.jain@spglobal.com

Gavin Gunning
Melbourne
+61-3-9631-2092
gavin.gunning@spglobal.com

Key Takeaways

- Operating conditions for banks deteriorated abruptly in 2020 due to the COVID-19 pandemic and subsequent oil shock. Although we expect global growth to rebound sharply in the second half of 2020, downside risks remain elevated and include a second wave of infections.
- The outlook bias on bank ratings has turned markedly negative since April 2020.
- Bank downgrades will be limited this year, however, thanks to their strengthened balance sheets, massive support from authorities to household and corporate markets, additional flexibility offered by regulators, and the sustained economic recovery.
- Central bank responses are positive for funding but pressure banks' interest margins. COVID-19 will likely accelerate bank digitalization, trigger another round of restructuring, and push consolidation.
- The pandemic could heighten populism and political risk in several countries. Additional risks stem from U.S.-China trade tensions, the upcoming U.S. presidential election, and a potential "no-deal" Brexit.

The COVID-19 pandemic and subsequent oil price drop have sparked negative rating pressure for global banks in all regions. Although the effects on the global economy will be massive and unprecedented in 2020, we anticipate that bank ratings will be largely resilient in the near term for the following reasons:

- Governments' significant direct support to corporate and household sectors;
- Extraordinary support measures and flexibility from governments and regulators to ensure that banks continue lending. This typically takes the form of liquidity injections, credit guarantees, short-term forbearance, and relief on regulatory capital and liquidity requirements;
- Global banks' generally strong capital and liquidity positions at the onset of the pandemic, supported by a material strengthening in bank regulations over the past decade; and
- Our base-case expectation of a 5.3% rebound in global GDP in 2021 after a sharp contraction by 3.8% this year (see table 1). This contraction and ensuing recovery varies considerably between countries and permanent output losses are generally larger for emerging markets.

Table 1

Global Real GDP Growth Forecasts, June 2020

(%)	2019	2020f	2021f	2022f	2023f
U.S.	2.3	(5.0)	5.2	3.0	2.8
Canada	1.7	(5.9)	5.4	3.1	2.6
Eurozone	1.2	(7.8)	5.5	2.9	2.0
Germany	0.6	(6.2)	4.4	2.6	1.6
France	1.5	(9.5)	6.8	3.1	2.4
Spain	2.0	(9.8)	6.8	3.8	2.3
Italy	0.3	(9.5)	5.3	2.3	1.6
U.K.	1.4	(8.1)	6.5	2.6	2.1
Japan	0.7	(4.9)	3.4	1.0	0.9
China	6.1	1.2	7.4	4.7	5.3
India*	4.2	(5.0)	8.5	6.5	6.6
Australia	1.8	(4.0)	5.3	3.1	2.6
Brazil	1.1	(7.0)	3.5	3.3	2.9
World§	2.8	(3.8)	5.3	4.0	3.9

f--forecast. *Fiscal year ending March. §Weighted purchasing power parity. Source: S&P Global Economics. Oxford Economics.

Our outlooks on bank ratings turned sharply negative earlier this year, as did our trends for economic and industry risk within our BICRAs (Banking Industry Country Risk Assessments). This reflected the fall in oil price in early March and the revision of our macroeconomic forecasts in April 2020, in which our economists materially worsened their assumptions for GDP contraction this year. We now also assume a more gradual recovery in numerous countries, with continued downside risk to this base-case scenario. We acknowledge a high degree of uncertainty about the rate of spread and peak of the coronavirus pandemic. The consensus among health experts is that the pandemic may now be at, or near, its peak in some regions, but will remain a threat until a vaccine or effective treatment is widely available, which may not occur until the second half of 2021. We are using this assumption in assessing the economic and credit implications associated with the pandemic. This is an important element, as banks' creditworthiness is largely a function of the economies they serve. The relative effectiveness of public authorities in curbing the credit impact on customers and supporting a rapid economic rebound once the situation abates will also be a key differentiating factor for future bank rating actions. It will also inform our view of economic and industry risk within our BICRAs.

Generally Resilient, But Not Immune

We have so far lowered our ratings on a smaller proportion of banks than on most other corporate sectors. This reflects the support that banks and their customers are receiving, as well as the fact that bank ratings tend to be higher than most nonfinancial corporates. These higher ratings imply less sensitivity to a deterioration in their operating environment. Added to this, COVID-19 containment measures are hitting the cash flows of a number of nonfinancial corporate sectors very rapidly and very hard. Most banks also benefit from some diversification in their loan books, a stock of loans that continues to provide relative revenue stability, and access to central bank funding.

Chart 1

Outlook Revisions Dominate COVID-19 And Oil Shock-Related Bank Rating Actions

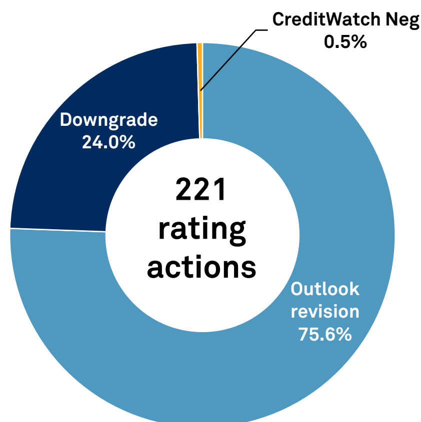
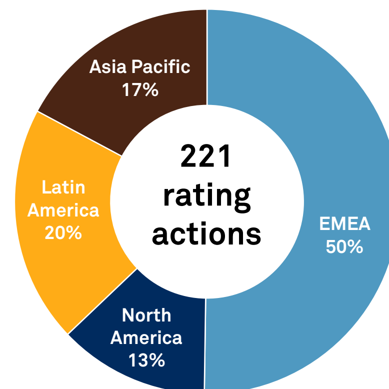


Chart 2

Regional Split Bank Rating Actions Linked To COVID-19 And The Oil Shock



Data as of June 30, 2020. Source: S&P Global Ratings.

The balance of risks remains to the downside, however, as we see ongoing uncertainty on the health, economic, and policy fronts. As such, about 30% of our bank outlooks were negative at June 30, 2020, and we see negative trends for almost one-third of our BICRAs (either on the economic or industry risk score, or both). Of the 221 rating actions we have taken on banks

related to COVID-19 and/or the oil shock from the start of the pandemic through June 30, about 76% were outlook revisions and 24% were downgrades.

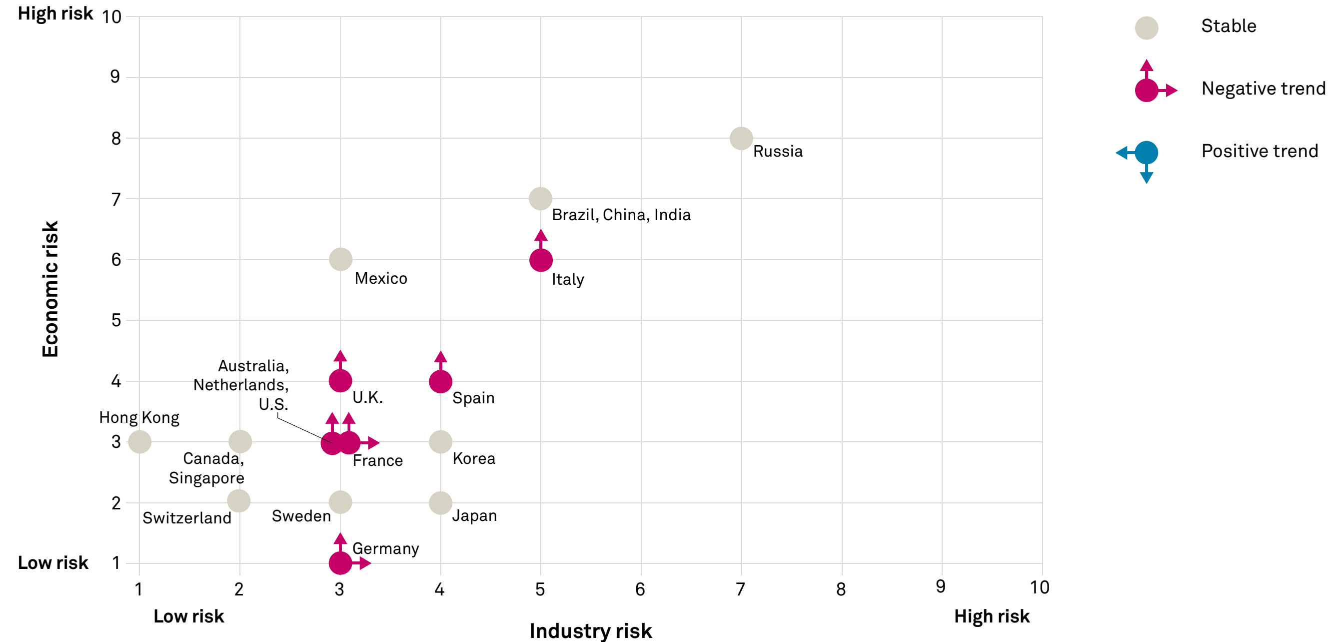
The length and pace of economic recovery will be a function of health and economic policies, the response of individuals and firms, and the condition of the labor market and small and midsize enterprises (SMEs). We also anticipate that the significant liquidity support provided by central banks globally will continue to prove effective in curbing funding and liquidity risks for banks in most jurisdictions.

Most banking sectors have gradually emerged from the financial crisis of 2007-2008 better capitalized, better funded, and more liquid. We estimate, for instance, that the capital base of the largest banks about doubled over the past decade. This comes on top of a material de-risking of a number of banks' exposures during that period. We have seen comparable progress in terms of bank liquidity. Despite these improvements, many banks entered this crisis with ratings already constrained by structurally weak profitability (especially in Europe and Japan) and the expectation, at some point, of a turn in the credit cycle.

Our base-case scenario is that we will not lower our ratings on the majority of banks across jurisdictions in the near term. Indeed, government support packages should help to cushion the impact on households and corporate borrowers. However, risks to our baseline macroeconomic forecast remain firmly to the downside and the shape of the recovery, in particular, is still hard to predict. We have therefore increased the number of banks, and BICRAs, for which we signal material downside risk to our base case.

Chart 3

BICRA Scores And Economic And Industry Risk Trends



A BICRA (Banking Industry Country Risk Assessment) is scored on a scale from 1 to 10, ranging from the lowest-risk banking systems (group 1) to the highest-risk (group 10). Data as of July 8, 2020. Source: S&P Global Ratings.

We could take further negative rating actions if the cyclical economic recovery is substantially weaker or delayed, as this would imply a far more negative effect on banks' credit strength. Actions could also follow negative developments at individual banks. Some downgrades could occur if, for example, a bank's metrics were to sustainably move outside our rating outlook triggers. Ongoing pressure on financial performance will also be a key factor. Once the dust

settles and economies rebound, banks' earnings recovery is unlikely to be as sharp as the increase in GDP. Many banks will face a number of customers that are less viable, a cost of risk that will remain above pre-COVID levels, and rates that are lower for even longer. These factors will likely make a persistent dent in earnings that were already feeble in some regions at the onset of the pandemic. As a result, we expect some banks may be forced to undertake a further round of structural measures to address performance issues, which could act as a catalyst for consolidation.

The long-term effect of the current relaxation of various bank regulations, for example relating to capital buffers and forbearance, will also be a key consideration in our ratings. We note that most regulators have been following the same approach, with very similar measures. In the short term, we see this relaxation as positive for banks, as it should enable them to navigate the worst of the crisis while providing more flexibility to manage the immediate effects (see "Bank Regulatory Buffers Face Their First Usability Test," published June 11, 2020). However, it is too early to predict whether some of these changes could become more lasting. If so, a permanent weakening in banks' capital and liquidity targets, or reduced transparency in recognizing bad debt and delays in adequately provisioning for it, could lead to weaker balance sheets, erode investor confidence, and leave banks less prepared for a subsequent crisis. Weaker prospective capitalization would affect a number of bank ratings over time. We are also likely to see some inconsistency in the way banks report their bad debt in 2020. We are considering less traditional metrics, such as the volume of loan extensions, and compare provisioning levels by lending type and geography in forming a view of banks' relative asset quality and adequacy of provisioning.

The COVID-19 path to recovery varies markedly across countries and is difficult to predict. This in turn will play out differently for banks' financial strength. For example, the GDP shock following the onset of COVID-19 took hold quickly in China, but is now stabilizing. In contrast, it took longer to manifest in India and some Latin American countries, but appears more severe and will test the resilience of bank ratings.

Which Banks Are More Exposed To Rating Actions?

Differences in the proportion of negative outlooks highlight the jurisdictions most likely to see rating actions (see chart 4). To determine whether the rating on a bank is exposed to material downside risk in the present context, we consider the following:

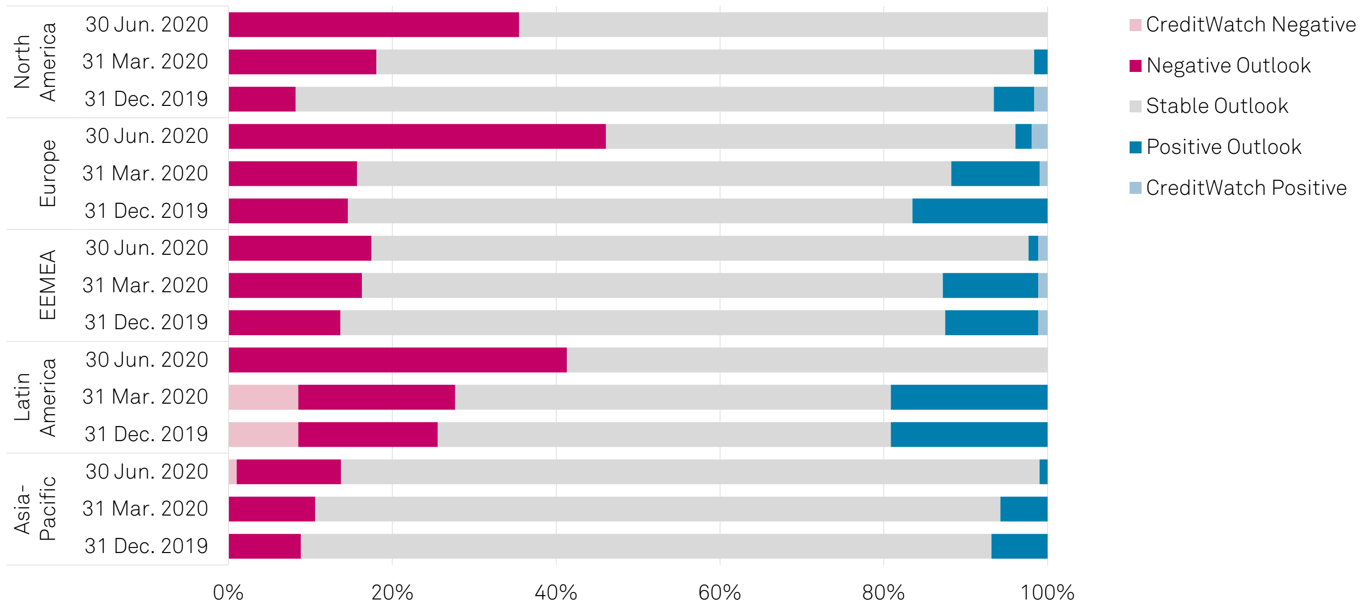
- The current rating level, including to what extent there is room within it for a deterioration in credit metrics.
- The relative exposure of the bank, and the jurisdiction in which it is based, to COVID-19-related risks and the oil shock. This includes exposure to hard hit industries (such as transportation, tourism, oil and gas, gaming, lodging, restaurants) or types of lending (such as SMEs, leveraged loans, commercial real estate, and unsecured consumer loans). Banks' relative exposure to possible fund outflows (as is the case in certain emerging markets) or concentration risk to single-name exposures or particular industries may also exacerbate issuers' vulnerabilities.
- The ability and willingness of the authorities to provide support to their banking systems and banks' customers, and our expectation of the effectiveness of these measures in reducing the short-term impact while laying the foundations for a rapid recovery of the economy.

Given the various links between sovereign and bank ratings (such as government support, strength of the economy, and exposure to sovereign debt), some BICRA and rating actions may follow similar actions on sovereign ratings. This could occur, for instance, in banking systems that receive rating uplift for government support. Our bank ratings may also move

independently from such sovereign actions, especially given the differences in risks that we consider in our sovereign and bank ratings.

Chart 4

Outlook Bias Now Firmly Negative, But Slower Momentum Since Early May



EEMEA--Eastern Europe/Middle East/Africa. Source: S&P Global Ratings Research.

Concentrations in banks' business models and exposures can increase their sensitivity to a weaker operating environment. For example, we have taken rating actions on banks based on geographic or sector concentrations. We could, in a number of markets, see further differentiation in our rating actions between larger and less diversified players. The relative position of banks at the onset of the crisis will also drive some differences in their vulnerabilities to the unfolding stress scenario. In terms of profitability, banks in the U.S. and many in Latin America and Asia-Pacific (except Japan) entered this period in a strong position, better placing them to absorb earnings pressures. Still, even for U.S. banks, ultra-low interest rates will weigh meaningfully on profitability.

Similarly, variations in asset quality at the onset of the crisis may offer some jurisdictions a larger buffer against deteriorating metrics. For example, certain large banks in Asia-Pacific demonstrated consistently stronger metrics at the onset of the COVID-19 pandemic, even if the asset quality of most peers in all regions had been on an improving trajectory in recent years.

Banks In Emerging Markets Face Additional Risk

Most of the rating actions or outlook revisions we initially took on banks were in emerging markets. This reflected generally lower ratings, their economies' higher sensitivity to the oil price drop, and the specificities of some of these banking systems. Following the material downward revision of our macroeconomic forecasts in April, which included many developed markets, and given some of the rising potential second-order effects, the gap in the proportion of rating actions between emerging and developed markets has reduced for now. Nevertheless, in addition to the asset quality deterioration that we expect for banks in developed markets, some banks in emerging markets face additional sources of risk, including:

- Heavy reliance on external funding amid changing investor sentiment (for example, in Turkey);
- Concentration on specific sectors (such as hospitality or industrial or service exports to developed countries) or commodities (such as oil or gas);
- Lack of government capacity to provide extraordinary support, weaker governance, and efficiency of government institutions, as well as a higher likelihood of political and social tensions; and
- For certain emerging market banks, currency fluctuations will likely contribute to the deterioration in asset quality and capital, due to the still-high level of foreign currency loans.

BICRA Economic And Industry Risk Scores And Components

The table below presents S&P Global Ratings' views on key risks and risk trends for banking sectors in countries where we rate banks. For more detailed information, please refer to the latest Banking Industry Country Risk Assessment (BICRA) on a given country. According to our methodology, BICRAs fall into groups from '1' to '10', ranging from what we view as the lowest-risk banking systems (group '1') to the highest-risk (group '10').

Table 2

BICRA Summary Table

				Economic risk			Industry risk		
Country	**BICRA Group**	**Economic risk trend**	**Industry risk trend**	**Economic Resilience**	**Economic Imbalances**	**Credit risk in the economy**	**Institutional framework**	**Competitive dynamics**	**Systemwide funding**
Argentina	9	Stable	Negative	EH	H	EH	H	H	VH
Armenia	8	Stable	Stable	VH	I	EH	VH	H	VH
Australia	3	Negative	Stable	VL	H	L	L	L	I
Austria	2	Negative	Stable	VL	L	L	I	I	L
Azerbaijan	9	Stable	Stable	VH	H	EH	EH	H	VH
Bahrain	7	Stable	Stable	H	H	VH	I	H	H
Bangladesh	9	Stable	Stable	VH	L	EH	EH	EH	I
Belarus	10	Stable	Stable	VH	VH	VH	EH	VH	VH
Belgium	2	Negative	Stable	L	L	L	I	I	VL
Bermuda	5	Stable	Stable	I	VH	I	I	L	I
Bolivia	8	Stable	Stable	VH	H	EH	VH	VH	I
Brazil	6	Stable	Stable	VH	H	H	I	H	I
Brunei	6	Stable	Stable	I	L	H	EH	I	L
Cambodia	9	Stable	Stable	VH	H	EH	EH	H	VH
Canada	2	Stable	Stable	VL	I	I	VL	L	L
Chile	3	Negative	Stable	H	L	I	L	I	L
China	6	Stable	Stable	I	H	VH	H	H	VL
Colombia	6	Stable	Positive	H	H	H	H	I	I
Costa Rica	8	Negative	Stable	H	H	VH	H	EH	H
Croatia	7	Negative	Stable	H	H	VH	H	H	I
Cyprus	8	Stable	Stable	I	VH	EH	H	VH	VH
Czech Republic	3	Stable	Stable	I	L	I	I	I	I
Denmark	3	Stable	Stable	VL	L	I	I	I	I
Egypt	9	Stable	Stable	EH	H	VH	EH	H	H
El Salvador	8	Stable	Stable	EH	I	EH	H	I	VH
Finland	2	Negative	Stable	VL	L	L	I	L	I
France	3	Negative	Negative	L	I	L	I	I	L

Country	BICRA Group	Economic risk trend	Industry risk trend	Economic risk			Industry risk		
				Economic Resilience	Economic Imbalances	Credit risk in the economy	Institutional framework	Competitive dynamics	Systemwide funding
Georgia	8	Stable	Stable	VH	H	VH	H	H	VH
Germany	2	Negative	Negative	VL	VL	L	I	I	VL
Greece	9	Stable	Stable	VH	VH	VH	H	H	EH
Guatemala	7	Stable	Stable	EH	I	VH	H	I	I
Honduras	8	Stable	Stable	VH	I	EH	VH	I	H
Hong Kong	2	Stable	Stable	L	I	I	VL	L	VL
Hungary	5	Stable	Stable	H	H	I	I	H	I
Iceland	5	Negative	Stable	L	H	I	I	H	H
India	6	Stable	Stable	H	H	VH	H	H	L
Indonesia	6	Negative	Stable	H	L	VH	H	H	I
Ireland	4	Stable	Negative	L	H	H	I	I	I
Israel	3	Stable	Stable	I	L	I	I	H	L
Italy	5	Negative	Stable	I	H	H	I	I	H
Jamaica	8	Negative	Stable	EH	I	VH	H	VH	VH
Japan	3	Stable	Stable	L	VL	L	I	H	VL
Jordan	8	Stable	Stable	EH	I	VH	H	H	H
Kazakhstan	9	Stable	Stable	H	VH	EH	EH	VH	H
Kenya	9	Stable	Stable	VH	I	EH	EH	VH	H
Korea	3	Stable	Stable	L	VL	H	I	H	L
Kuwait	4	Stable	Stable	H	I	I	H	I	L
Liechtenstein	2	Stable	Stable	L	L	L	I	I	L
Luxembourg	2	Stable	Stable	VL	I	L	I	I	VL
Malaysia	4	Stable	Stable	H	L	H	I	I	L
Malta	5	Negative	Stable	I	L	H	VH	I	I
Mexico	5	Stable	Stable	VH	VL	H	I	I	L
Mongolia	9	Stable	Stable	H	VH	EH	EH	H	VH
Morocco	7	Stable	Stable	VH	L	VH	I	H	H
Netherlands	3	Negative	Stable	VL	I	I	I	I	L
New Zealand	4	Negative	Stable	VL	H	I	I	L	H
Nigeria	10	Stable	Stable	EH	H	EH	EH	I	EH
Norway	2	Stable	Stable	VL	I	L	I	L	I
Oman	7	Negative	Stable	VH	H	H	I	H	H
Panama	5	Stable	Stable	I	H	I	I	L	VH
Papua New Guinea	9	Negative	Stable	EH	H	VH	VH	H	VH
Paraguay	8	Stable	Stable	VH	I	EH	VH	VH	H
Peru	5	Stable	Stable	H	VL	VH	L	I	I
Philippines	5	Stable	Stable	VH	L	H	H	I	I
Poland	4	Negative	Negative	H	L	I	I	H	I
Portugal	6	Stable	Stable	I	H	H	I	H	H
Qatar	5	Stable	Negative	I	H	I	I	I	H
Russia	8	Stable	Stable	VH	H	VH	VH	H	H
Saudi Arabia	4	Stable	Stable	H	I	I	I	I	L
Singapore	2	Stable	Stable	VL	I	I	VL	L	L
Slovenia	4	Stable	Stable	I	I	H	I	I	I
South Africa	6	Negative	Stable	VH	H	H	I	I	H
Spain	4	Negative	Stable	I	I	I	I	I	I

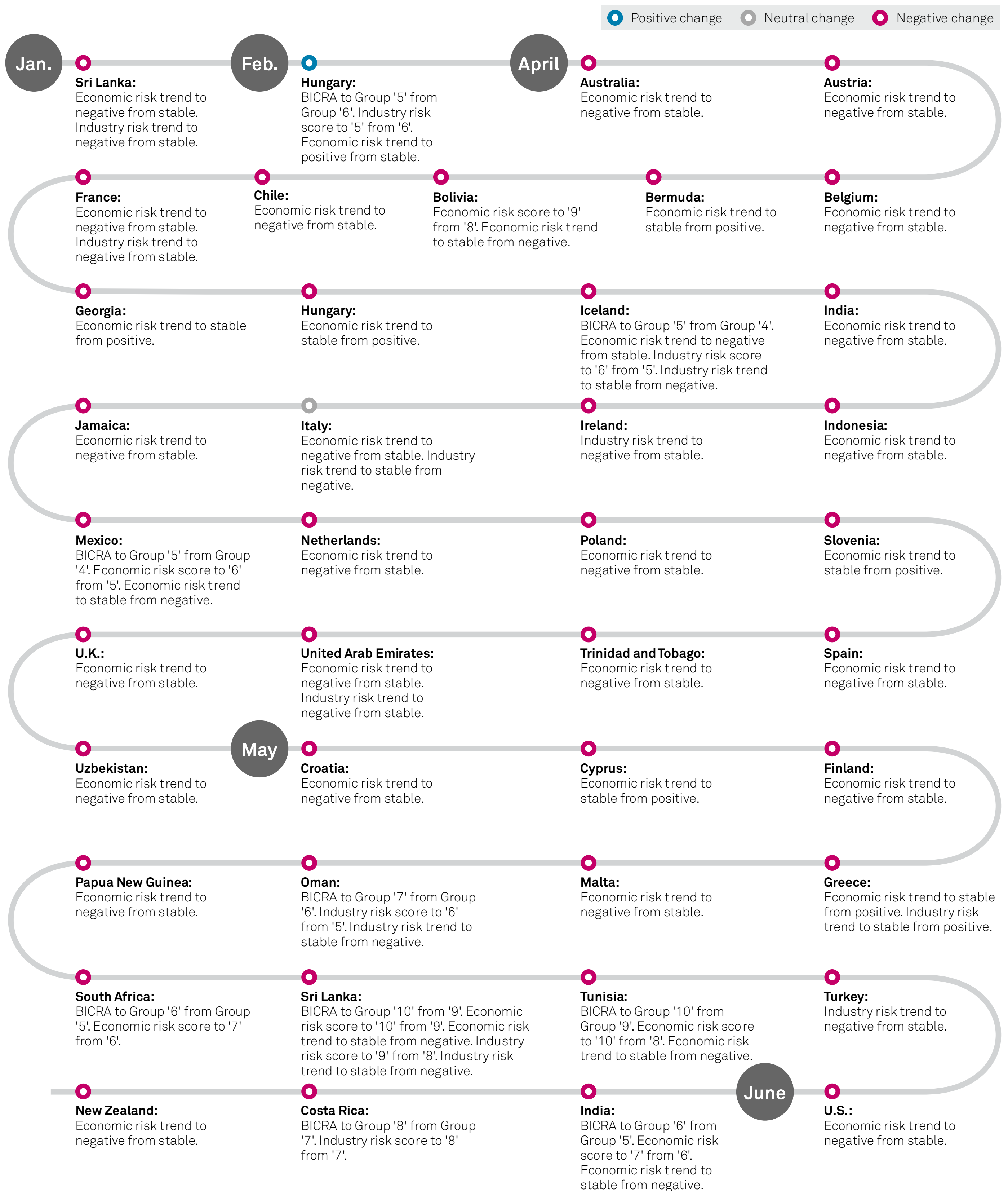
Country	BICRA Group	Economic risk trend	Industry risk trend	Economic risk			Industry risk		
				Economic Resilience	Economic Imbalances	Credit risk in the economy	Institutional framework	Competitive dynamics	Systemwide funding
Sri Lanka	10	Stable	Stable	VH	VH	EH	VH	VH	VH
Sweden	2	Stable	Stable	VL	I	L	I	L	I
Switzerland	2	Stable	Stable	VL	L	L	L	L	L
Taiwan	4	Stable	Stable	I	L	I	I	VH	VL
Thailand	6	Stable	Stable	H	L	EH	I	H	L
Trinidad and Tobago	6	Negative	Stable	VH	I	H	H	H	L
Tunisia	10	Stable	Stable	EH	H	EH	EH	H	VH
Turkey	9	Negative	Negative	H	VH	VH	VH	VH	VH
U.K.	3	Negative	Stable	L	I	H	I	I	L
U.S.	3	Negative	Stable	VL	L	H	I	I	VL
Ukraine	10	Stable	Stable	VH	VH	EH	VH	VH	VH
United Arab Emirates	5	Negative	Negative	L	H	H	I	H	I
Uruguay	6	Stable	Stable	H	L	H	H	H	H
Uzbekistan	8	Negative	Stable	VH	I	VH	EH	H	VH
Vietnam	9	Stable	Stable	VH	H	EH	EH	VH	I

Positive economic or industry risk trend	Stable economic or industry risk trend	Negative economic or industry risk trend

Very low risk (VL)	Low risk (L)	Intermediate risk (I)	High risk (H)	Very high risk (VH)	Extremely high risk (EH)

Data as of July 8, 2020. Source: S&P Global Ratings.

Global BICRA Developments In 2020



BICRA--Banking Industry Country Risk Assessment. Data as of July 8, 2020. Source: S&P Global Ratings.

Country-By-Country Outlook

North America 12

Latin America 16

Western Europe 33

CEEMEA 55

Asia-Pacific 84

Note: 88 countries are included in the report. Countries are listed in alphabetical order by region.

Domestic nonperforming assets are defined as the sum of problematic exposures (including loans and foreclosed assets) due by resident private and public borrowers to a country's resident financial institutions. The general standard is that exposures past due for more than 90 days are classified as nonperforming. In some jurisdictions, this also includes exposures that are up to date in their payment obligations but that run the risk of becoming delinquent. For some countries in Europe, we use Nonperforming Exposure based on the definition of the European Banking Authority. For a number of countries, nonperforming assets of domestic exposures alone are not available. For Canada, Croatia, Denmark, Germany, Hong Kong, India, Indonesia, Italy, Korea, Liechtenstein, Luxembourg, Philippines, Singapore, Slovenia, South Africa, Sri Lanka, Taiwan, Thailand, U.K. and Vietnam, the ratio is on total nonperforming assets, not just domestic.

CEEMEA--Central and Eastern Europe, Middle East and Africa.

North America

BICRA groups: lowest to highest

Group '1' to '10', from lowest to highest risk. BICRA--Banking Industry Country Risk Assessment.
Data as of June 30, 2020. Source: S&P Global Ratings.

Bermuda | BICRA Group: 5

Weaker Economic Outlook Due To Tourism Shock From COVID-19

Primary Credit Analyst
Felix Winnekens
New York
felix.winnekens@spglobal.com
+1-212-438-0313

Key takeaways

- With travel restrictions in place across the globe, the spread of COVID-19 will have a negative impact on Bermuda's tourism sector and on the growth of the financial services sector.
- Bermuda's banks, from a strong capital position, have initially granted borrowers in need three to six months of forbearance because of COVID-19-related headwinds, but we expect to see an acceleration of credit losses and nonperforming assets.
- We believe the pandemic will prolong the correction phase of Bermuda's real estate market, where prices have dropped about 11% since 2008 with an even steeper drop in condo prices, notwithstanding a more recent stabilization.

Key credit drivers

COVID-19. We expect increased pressure on banks' asset quality and limited loan growth in the near term, though banks maintain strong capitalization. The pandemic and the associated travel restrictions have hurt Bermuda's tourism sector, putting pressure on any directly or indirectly affected personal or business loan.

Residential real estate market. Bermuda has gone through a prolonged correction period in its real estate sector that started following the global financial crisis. We expect that the pandemic will prolong the correction phase given near-term economic pressures.

Key assumptions

Relatively shallow recession followed by weak recovery. We project real GDP will decline by 1.5% in 2020 due to the economic shock from the pandemic, while the international financial sector will provide some stability. Real GDP growth will increase steadily in the following two years but remain below 1%.

Continued appeal as an international financial center. We believe the E.U.'s recent whitelisting, confirming that the territory complies with the E.U.'s tax good governance principles, will help Bermuda maintain its appeal as an international financial center.

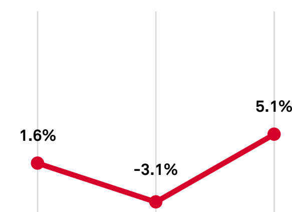
What to look for over the next year

Asset quality deterioration. We expect the shock to the tourism sector in particular will lead to a deterioration in asset quality over 2020. While banks have granted borrowers some short-term relief, the slowness of the recovery and uncertainty around the tourism outlook will keep pressure on asset quality high.

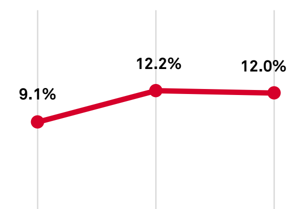
House price development. House prices declined by about 11% since 2008 with an even steeper drop in condo prices. Notwithstanding some stabilization before the pandemic's outbreak, we believe the anticipation of a weak recovery and uncertainty around the outlook of the tourism sector will sustain pressure on real estate prices.

Bermuda

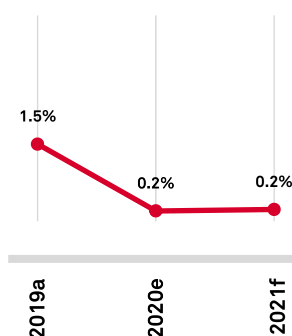
Loan growth



NPA ratio



RoAA



Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming assets as a % of system wide loans.

RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Canada | BICRA Group: 2

Dual Shock From COVID-19 And Oil Price Decline To Test Resiliency

Key takeaways

- The dual shock from COVID-19 and the drop in oil prices will drive up credit losses for Canadian banks, particularly in the commercial and unsecured loan segments, and lead to a decline in earnings from lower interest and fee income.
- Canadian banks entered this period of economic uncertainty from a position of strength with diversified revenue streams, extremely low loss rates, and good liquidity and capital buffers.
- Extremely accommodative fiscal and monetary policy should support the economy and banks in the near term while laying the foundation for a recovery starting in the third quarter this year.

Key credit drivers

COVID-19 and oil price shock. The dual shock from the spread of COVID-19 and the drop in oil prices will significantly affect asset quality for Canadian banks. We expect a jump in nonperforming assets to 1.1% in 2020. However, payment deferral and short-term fiscal support programs will likely delay net charge-offs into 2021.

House price trends. In the near term, the national recession and spike in unemployment may put some pressure on house prices, although a limited number of transactions may distort the picture. In the medium term, we believe fundamental factors, especially supply-demand imbalances, will continue to support house price growth.

Key assumptions

Sudden stop recession. We forecast the Canadian economy will contract by 5.9% in 2020 before gaining 5.4% in 2021. The unemployment rate will peak at 13.7% in the second quarter this year and average 9.2% for the year as whole.

Fiscal and monetary policy will remain accommodative. We believe Canadian authorities will keep comprehensive fiscal and monetary support measures in place for as long as necessary to support the economic recovery.

What to look for over the next year

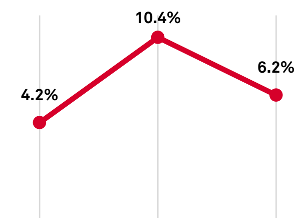
Asset quality deterioration. Payment deferral and forbearance programs coupled with generous fiscal measures will help borrowers in the near term, but asset quality could deteriorate beyond our current expectations when these programs expire.

House price development. We will continue to monitor whether a protracted house price correction will result from the economic recession. This, in turn, could pressure Canada's highly leveraged households. Fundamentally, we believe continued supply-demand imbalances driven, in part, by continued net migration will support house price growth over the medium term.

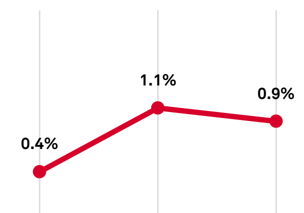
Primary Credit Analyst
Felix Winnekens
New York
felix.winnekens@spglobal.com
+1-212-438 0313

Canada

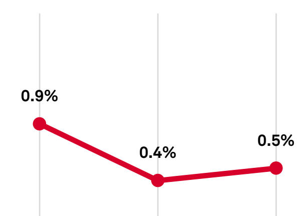
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming assets as a % of system wide loans.

RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

U.S. | BICRA Group: 3

Banks Entered From Position Of Strength, But The Pandemic Is Their Biggest Challenge Since The Great Financial Crisis

Key takeaways

- Banks entered the economic downturn with better capital, liquidity, profitability, and risk management than in many years, helping them cope with stress.
- Earnings will decline sharply this year and capital ratios will likely fall moderately, pressuring some ratings. Still, we expect most banks to remain profitable and avoid deep breaches of buffers over minimum capital requirements.
- However, if the economy performs worse than we expect or government support measures prove to be insufficient, banks could see greater deterioration in asset quality, earnings, and capital, triggering more negative rating actions.

Key credit drivers

The strength of the economy. The duration of the downturn and the strength of the rebound will likely be the biggest determinants of banks' asset quality.

The effectiveness of government support measures. The government and Fed have rolled out many support measures that have boosted market confidence and supported the private sector, such as increased unemployment insurance and lending programs for businesses. While these programs have helped, they will not solve all problems.

Earnings and capital. While we expect a sharp drop in earnings and a moderate decline in capital ratios in our base case, which incorporates loan losses similar to the "adverse" case in the 2019 regulatory stress test, it is conceivable that banks could report bottom-line losses and be forced to cut dividends to preserve capital.

Key assumptions

U.S. GDP will fall 5.0% this year. After a sharp first-half contraction, we expect a gradual rebound with GDP reaching its prerecession level in the fourth quarter of 2021.

Increases in provisions and allowances will begin to abate. Current expected credit losses (CECL), the accounting standard requiring banks to set allowances for lifetime losses, has resulted in U.S. banks taking provisions faster than they would have under the prior accounting standard. Therefore, the rise should abate sooner--likely in the second half of 2020.

Banks will avoid large market-risk-related losses. Banks have not reported major trading or counterparty losses, helped in part by the Fed's market-supporting actions.

What to look for over the next year

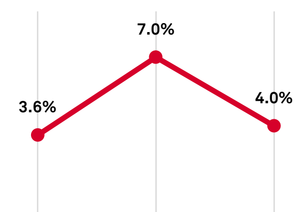
Loan modifications/deferrals. A portion of the loans that banks have extended modifications and deferrals on may turn into nonperforming assets and charge-offs.

Changes in dividends. While banks have generally stopped repurchasing shares, some may also need to cut dividends if capital is under pressure.

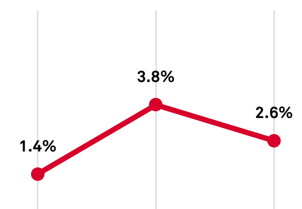
Primary Credit Analyst
Brendan Browne
New York
brendan.browne@spglobal.com
+1-212-438-7399

U.S.

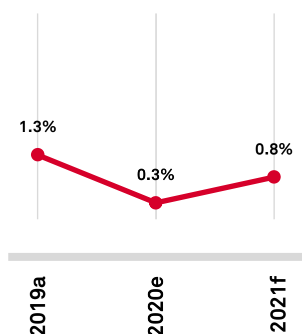
Loan growth



NPA ratio



RoAA



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a--Actual. e--Estimate. f--Forecast.

Latin America

BICRA groups: lowest to highest

Group '1' to '10', from lowest to highest risk. BICRA--Banking Industry Country Risk Assessment.
Data as of June 30, 2020. Source: S&P Global Ratings.

Argentina | BICRA Group: 9

Not All Challenges Stem From The Pandemic

Primary Credit Analyst
Ivana Recalde
Buenos Aires
ivana.recalde@spglobal.com
+44-11-4891-2127

Key takeaways

- Argentina's banking industry has been suffering from volatility that resulted from the last year's election and the sovereign's attempt to restructure its debt.
- These factors have raised the average risk for banks operating in the country. In addition, ratings on banks dropped following the revision of the transfer and convertibility assessment of Argentina in May 2020.
- We expect the pandemic to deepen the GDP contraction, given the prolonged period of lockdowns to mitigate the strain on the health care system. Therefore, high economic risk and imbalances would persist over the next quarters.
- Banks have high liquidity and adequate regulatory capitalization.

Key credit drivers

Significant GDP contraction due to actions to cope with COVID-19. We expect economic activity to sharply contract in 2020 given the impact of actions to contain the pandemic and diminish stress on the healthcare system.

Actions taken by authorities but influenced by limited flexibility. Authorities have implemented direct transfers to support the low-income slice of population suffering from the lockdowns and social-distancing measures amid high levels of poverty and informality. In addition, the regulator focused on increasing lending to help SMEs and individual borrowers, loosened criteria for classifying past-due loans, and established the refinancing of credit card and loan debts. This includes new credit lines to SMEs and healthcare segments at a maximum rate of 24% with reduction in reserve requirements for banks and allowing a higher proprietary position in central bank securities. The government recapitalized the FoGar trust, but scope was limited. These measures lag those some other countries in Latin America that have more financial muscle.

Further deterioration in asset quality. Asset quality metrics will further erode due to the impact of the pandemic amid the already very weak economy, with NPLs at 7%-8% in 2020, up from 5.3% in March .

Key assumptions

Mild GDP rebound in 2021 and depends on developments in sovereign debt restructuring. At this point, we expect a mild rebound in economic activity for 2021, but it would also depend on the developments in sovereign debt restructuring that would influence economic agents.

No real credit growth. Credit penetration in Argentina is the lowest in Latin America, at about 11%, with likely no growth in real terms at best (given inflation of around 40% for the year) and factoring in borrower relief actions that were implemented.

Profitability down. Profitability would take a hit by the implementation of inflation adjustment in the country, mitigated by still high results from the central bank securities and flexibility to transfer changes in conditions due to the short tenor of the loan portfolio. This should help compensate for higher provisions.

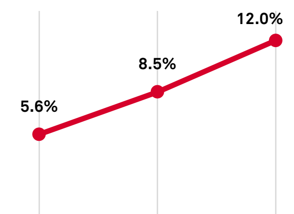
High levels of liquidity and adequate regulatory capital metrics. Despite volatility in deposits in 2019, banks keep high levels of liquidity in cash and central bank instruments amid low intermediation. Capital regulatory metrics present buffer.

What to look for over the next year

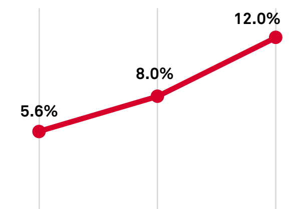
Sovereign debt restructuring and impact on economic performance. Developments in debt restructuring and politics, and economic plans after the pandemic fades away are key for economy and banking system.

Argentina

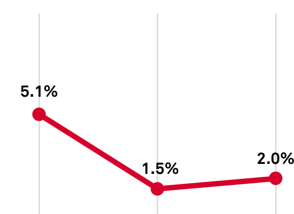
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Bolivia | BICRA Group: 8

Lockdown And Directed Lending Heightening Credit Risks

Primary Credit Analyst
Camilo Pérez
Mexico City
camilo.perez@spglobal.com
+52-55-5081-4446

Key takeaways

- Risks in the domestic financial system have increased due to the economic lockdown resulting from the pandemic.
- Government-directed lending will likely continue to pressure the banking industry's net interest margins and profitability.
- Political turmoil could cause some instability in the banking system next year, but economic recovery should continue fueling credit expansion in the medium term once the situation stabilizes.

Key credit drivers

Weakening macroeconomic conditions are weighing on credit growth and asset quality. The pandemic has increased risks in the Bolivian financial system because the economic lockdown will likely hurt credit growth and pressure the credit losses, profitability, and capital metrics of domestic banks in the following months. Moreover, although the banking system has lessened its exposure to dollar-denominated loans and deposits in recent years, we still believe the deterioration in the country's external conditions could weaken the domestic financial industry during the next two years.

Directed lending is narrowing profits. Government-directed credit is likely to continue producing stiff competition and lessening margins among domestic banks. This is because the law regulates ceilings on lending rates and requires banks to comply with minimum credit quotas aimed at the low-income housing and productive sectors such as agriculture, mining, manufacturing, and tourism.

Key assumptions

Challenging economic conditions. We forecast Bolivia's economy to contract in 2020 as result of decline in global energy prices and lockdowns resulted from the pandemic. However, the GDP growth should rebound during 2021.

Manageable credit losses despite lockdowns. We expect the nonperforming assets ratio to increase at 2.4% by 2021 due to the economic paralysis. Moreover, aggressive lending competition and underwriting standards could widen further credit losses afterwards.

What to look for over the next year

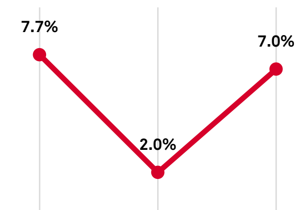
Political uncertainty. Presidential election has been postponed until September 2020 due to the pandemic. The winner will have to confront fiscal and external challenges, primarily due to decreasing exports of natural gas and still large fiscal deficit.

Credit growth to recover after the pandemic. Domestic economy will face some drawbacks as a result of the pandemic, low energy prices, and political turmoil. However, we believe continued levels of investments in strategic sectors of the economy next year will continue laying the foundations for healthy lending growth over the medium term.

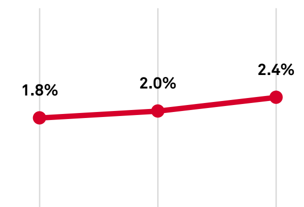
Enterprises' high debt levels and lending concentration. Regulatory lending quotas and interest-rate caps have encouraged rapid credit growth for borrowers in the productive sectors, which could lead to high debt levels. At the same time, Bolivian laws encourage increasing lending volumes, and concentration in cyclical sectors with high loan amounts and longer durations in order for banks to meet targets, which could ratchet up credit risks in the system.

Bolivia

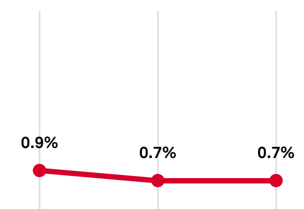
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Brazil | BICRA Group: 6

Regulatory Measures Should Mitigate The Impact of Social Distancing

Primary Credit Analyst
Cynthia Cohen Freue
Buenos Aires
cynthia.cohenfreue@spglobal.com
+ 54-11-4891-2161

Key takeaways

- We expect Brazil's economy to suffer in 2020 before recovery begins in 2021.
- Asset quality deterioration led banks to substantially increase provisions for credit losses, jeopardizing bottom-line results.
- However, we expect credit losses will remain manageable thanks to banks' conservative growth strategies in the past two years and the regulatory measures that help mitigate the impact.

Key credit drivers

One of the emerging markets outside of Asia with the most confirmed cases of COVID-19. We expect Brazil's GDP growth and fiscal performance to suffer in 2020 due to the pandemic and extraordinary government spending, before gradual economic recovery and fiscal consolidation resumes next year.

Regulatory relief measures will help mitigate the impact on banks. Brazil's central bank has introduced a comprehensive set of measures to mitigate the impact of COVID-19 including liquidity support, guarantees on loans, capital and provisioning relief, and others.

Credit cost and net income to sink in 2020. The expected weakening asset quality has led banks to substantially increase provisions for credit losses, jeopardizing bottom-line results. On the other hand, the coronavirus outbreak had mixed effects on credit growth, given that demand in the corporate sector spiked, while that for consumer products such as credit cards, mortgages, and auto loans stagnated. Banks withdrew their growth projections for 2020 due to high uncertainty.

Key assumptions

We expect nonperforming loans to peak in 2021. We expect credit losses to significantly hit the Brazilian banking system and forecast them to be higher than in the last economic crises. However, banks' still high margins and consistently high provisioning coverage will help mitigate the impact on their balance sheets. In addition, banks implemented conservative growth strategies in the past two years that focused on granting payroll deductible loans to government employees, mortgages with conservative loan-to-value ratios, and corporate loans with stronger guarantees.

Recognition of asset quality deterioration will be delayed. The central bank has issued a resolution allowing banks to renegotiate loans while maintaining their credit evaluation prior to the pandemic without requiring additional provisions. As a result, we expect the full impact on banks' balance sheets to be delayed. However, some banks already started to raise additional provisions in the first quarter based on their internal modelling.

What to look for over the next year

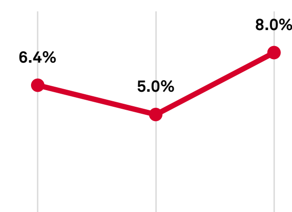
Uncertainty has increased about the country's capacity to advance its structural reform agenda. Ongoing disagreement between the legislative and executive branches, which could become more acute as the pandemic evolves and social pressure increases, could limit the passage and implementation of significant structural reforms during the rest of the administration's term, in our opinion.

Problem loans could heighten. The Brazilian banking system was recovering from the prior economic crises before the pandemic hit, and so a number of corporates entered the pandemic in fragile conditions. If economic activity takes longer to recover, some businesses' sustainability could come under pressure.

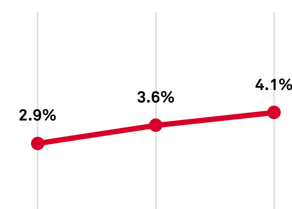
Economic recovery could take longer than anticipated. If the economic recovery is much weaker than we expect after the COVID-19 shock dissipates, banks' operating performance could struggle.

Brazil

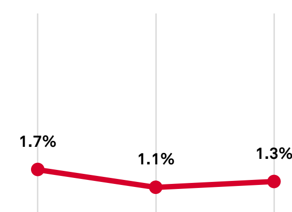
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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RoAA – Sector-average return on average assets.

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Chile | BICRA Group: 3

Rising Risks For Banks Due To Effects Of COVID-19 And Social Unrest In 2019

Primary Credit Analyst
Ivana Recalde
Buenos Aires
ivana.recalde@spglobal.com
+54-11-4891-2127

Key takeaways

- The COVID-19 pandemic and the effects of social unrest in the last quarter of 2019 are pressuring for the operating environment of banks, hampering asset quality and profitability. This is in the context of the population's lower individual income and the country's high corporate debt compared to peers.
- Because of these factors, rated financial entities in Chile have negative outlooks, including the state-owned bank, reflecting the outlook on the sovereign.
- The authorities in Chile took several early actions to ensure banks' liquidity and solvency, as well as measures to buffer the impact of the economic contraction and higher unemployment.

Key credit drivers

Pressures related to the combined effect of the pandemic and last year's social unrest. The expected contraction in GDP in 2020 because of the pandemic, together with the residual effects of last year's social unrest, are augmenting economic risk and stressing asset quality, credit losses, and profitability. Chilean corporates and enterprises also have higher leverage and individuals have lower income versus comparable global peers.

Actions taken by regulator to ensure stability and to buffer impact. Authorities took several actions to ensure liquidity and solvency in the system and to buffer the pandemic's effects.

Key assumptions

Moderate credit growth in 2020 driven by guaranteed lines. We expect credit activity to be at single digit levels and more related to FOGAPE program lines (loans guaranteed by the government) that also involve refinancing existing lines. The increase in credit lines would be driven mainly by SMEs and corporates that are building liquidity cushions to face the pandemic and cover working capital needs.

Worsening asset quality and higher provisions. We expect the deterioration in asset quality to materialize this year, especially in the last quarter, as mitigating measures (introduced in late March and April) start to fade. We forecast nonperforming loans to be 2.8%-3.0% in 2020-2021, in light of contracting economic and consumption activity and increasing unemployment.

Recovery in 2021. Conditions in the country should start improving in 2021, especially in the second half-given better global prospects, especially in China, and higher copper prices.

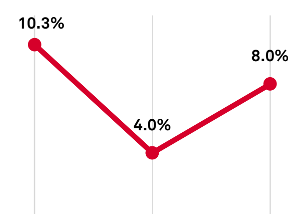
What to look for over the next year

Social issues are still under discussion. Discussions about changes to the constitution are pending in Chile. These were planned for April but postponed due to the pandemic. The evolution of such discussions is important for future consolidation of economic recovery.

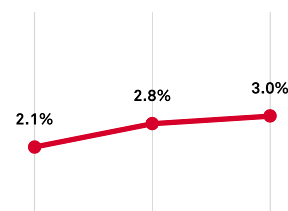
Final impact of shocks still unclear. It will take time to see the final effects of the pandemic, social unrest, and the measures taken to mitigate these on companies and banks' loan portfolios. The SMEs and large corporate groups hurt by the pandemic will also likely in turn affect banks.

Chile

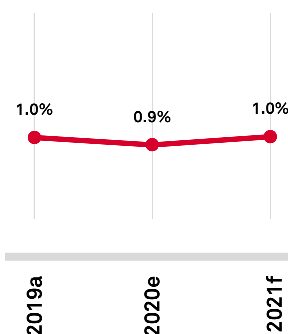
Loan growth



NPA ratio



RoAA



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Colombia | BICRA Group: 6

COVID-19 Will Slow Credit Growth And Hit Asset Quality And Profitability

Primary Credit Analyst
Alfredo Calvo
Mexico City
alfredo.calvo@spglobal.com
+52-55-5081-4436

Key takeaways

- Credit rebound will remain on hold until 2021 because of the coronavirus pandemic.
- A weaker economy, with unemployment entering the pandemic at already high levels, will hurt asset quality and profitability metrics.
- Regulatory improvements would strengthen capitalization and improve funding diversification.

Key credit drivers

The more positive pre-pandemic economic conditions will allow faster recovery in 2021. The government's measures to contain the virus, which include a moderate monetary and fiscal stimulus, will help restore pre-pandemic macroeconomic dynamics, which in turn will support Colombian banks.

Expansion to Central America provides diversification but pressures capitalization. We estimate that one-third of the three largest banks' balance sheets are exposed to Central America. This boosts diversification, but the goodwill related to acquisitions stresses capitalization levels.

Continued regulatory improvements. The adoption of Basel III capitalization rules and measures to assess banks' stable funding ratios could result in higher risk-adjusted capital and improve funding diversification, compared to other banking systems in the region that are aligned with international standards.

Key assumptions

Credit rebound won't occur until 2021. Given the strong link between economic growth and credit expansion, we expect credit expansion won't accelerate until 2021 when we expect the economy to grow 4.5% and total loans to expand about 8%.

Asset quality will worsen due to COVID-19 pandemic. We expect the nonperforming assets to total loans ratio to be 4.00%-4.25% in 2020-2021--fully covered by reserves--while loan loss provisions would represent between 3.5%-4.0% of total loans.

Lowering interest rates and deteriorating asset quality will hit profitability. Since the beginning of the coronavirus outbreak, the central bank has lowered its policy rate by 150 basis points, which along with higher provisions will pressure profitability. We expect return on equity to be about 9% in 2020-2021.

What to look for over the next year

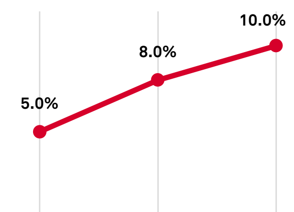
The potential rise in banks' risk-adjusted capitalization and improvements in funding diversification. Implementation of Basel III capitalization rules--resulting in higher risk-adjusted capital ratios--and banks seeking to increase retail deposits in order to strengthen regulatory net stable funding ratios.

Colombia's weakening external profile could bring risks to the banking system. COVID-19 and the slump in oil prices is widening the current account deficit. This could affect banks through higher external funding costs and by the impact on customers who belong to economic sectors sensitive to currency fluctuations.

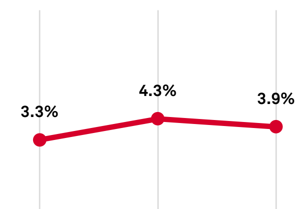
Evolution of nonperforming assets due to COVID-19. Before the coronavirus pandemic, rising unemployment was a concern. As a result of COVID-19, unemployment will keep rising and the impact on banks' asset quality will depend on the severity and duration of the pandemic-related recession.

Colombia

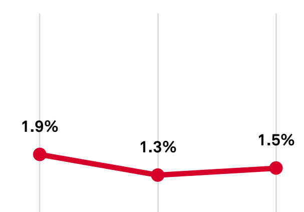
Loan growth



NPA ratio



RoAA



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Costa Rica | BICRA Group: 8

Deeper GDP Contraction And The Pandemic Will Hurt Banks' Asset Quality And Profitability

Primary Credit Analyst
Alejandro Peniche
Mexico City
alejandro.peniche@spglobal.com
+52-55-3500-1249

Key takeaways

- An already declining asset quality will take a further hit from the recession in 2020 and continue weakening throughout 2021.
- Feeble profitability metrics will decline further as interest rates hit historically low levels.
- On June 9, 2020, we lowered our global scale ratings on Costa Rica to 'B' from 'B+', reflecting our expectations of a deeper contraction in GDP and more persistent deterioration of the government's fiscal profile in 2020 and 2021. The negative economic risk trend reflects pressures on the sovereign's political, economic, fiscal, and debt trajectories, exacerbated by the COVID-19 pandemic.

Key credit drivers

Insufficient fiscal reform. Limited fiscal reform is bound to continue weakening public finances, resulting in continued large fiscal deficits and higher debt levels. The economy continues to show resiliency, albeit growth has slowed down in the past two years, and we expect a GDP contraction of about 3.6% in 2020 from the Covid-19 pandemic. However, we expect a growth of 3.3% in 2021 and 3.0% in 2022-2023.

A prolonged correction phase will hurt the banking sector. Credit losses in the banking sector may deepen, given a limited fiscal room to stimulate the economy. We believe the pandemic will deepen and prolong the downside cycle; therefore, banks will most likely face steep credit contraction and higher credit losses.

Distorted competitive dynamics in the banking system bite into profitability. The two largest banks in the country are state-owned and control around 40% of market share in terms of loans, which causes market distortions and depresses profitability (average ROE for the past four years was around 5%).

Key assumptions

Asset quality will deteriorate amid the recession. We expect the nonperforming assets ratio to reach a peak of 3.4% by 2021--fully covered by reserves--while loan-loss provisions would represent 3.5%-4% of total loans.

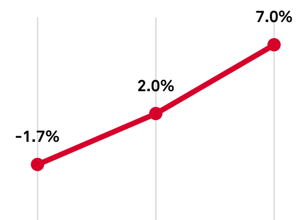
Higher provisions and lower interest rates will dent profitability. For the past couple of years, we observed a steady decline in profitability in the Costa Rican banking system. Due to the pandemic-induced economic shock, we believe that this trend will exacerbate. The declining interest rates towards historically low levels are ratcheting up pressure on net interest margins and active lending rates for core banking products.

What to look for over the next year

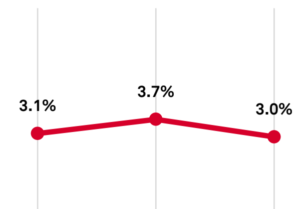
Stagnating consumer loans will drag down the banking system's credit growth. Weak economic activity and higher unemployment will take a toll on the consumer lending segment, but it will be the sole source for credit growth during 2020-2021.

Costa Rica

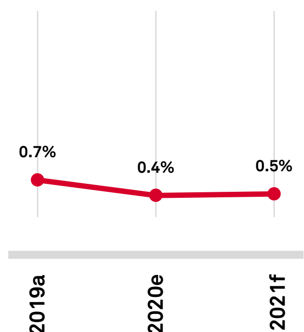
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming assets as a % of system wide loans.

RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

El Salvador | BICRA Group: 8

COVID-19 Severely Impacts The Banking System's Key Figures

Primary Credit Analyst
Jesús Sotomayor
Mexico City
jesus.sotomayor@spglobal.com
+52-55-5081-4486

Key takeaways

- We expect asset quality to deteriorate following the shutdown of non-essential business activities as a response to the COVID-19 pandemic. We also expect delinquency levels to double while profitability to drop below 0.5% during 2020.
- The sovereign's already high debt burden could limit fiscal flexibility under adverse market conditions. We expect funding from International Monetary Fund (IMF), other official creditors, and international markets to provide some liquidity and funding sources to promote a modest GDP growth and credit expansion for 2020 and 2021.
- Despite the country's current economic and political challenges, banking system continues to show relatively stable funding sources and liquidity needs, while continuing to rely on a large and diversified deposit base.

Key credit drivers

Economic stability subject to political consensus. Beyond the pandemic, raising economic growth in the coming years will require reforms to foster competitiveness and investment, supported by sustained measures to reduce crime and the large informal sector, which is estimated to employ about 70% of the working-age population. A divided legislature will continue to be a challenge for policy implementation in order to repair economic growth once the reopening begins.

Credit risk in the economy is rising. Despite manageable delinquency levels and credit losses, modest banking penetration, and diversified loan portfolios, the ongoing pandemic along with the inherent economic, social, and political challenges could harm asset quality metrics going forward.

Room to improve institutional framework. In response to the impact of COVID-19, the regulator allowed banks to undertake voluntary loan restructurings with troubled borrowers. Additionally, it has been proactive in monitoring banks' liquidity, solvency metrics, and credit losses during the pandemic. Still, El Salvador's overall framework remains one step behind those of countries with a Basel III framework, the adoption of which could strengthen bank supervision going forward.

Key assumptions

The economic contraction will delay the government's plans to boost long-term growth. We expect the economy to contract sharply, about 4% in 2020, and growth 23% in 2021. Despite the low per capita income, estimated at about $4,000 for 2020, the country has experienced only moderate economic growth, given that it has suffered from many years of low investment, political gridlocks, weak competitiveness, and high emigration.

Moderate credit expansion. We expect credit to keep expanding modestly in El Salvador, reflecting the country's sluggish economic growth and the highly challenging environment during the pandemic. In this sense, we expect credit to expand 3%-4% in 2020 and 2021 amid modest profitability.

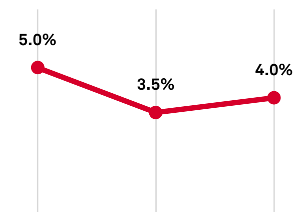
What to look for over the next year

Government's ability to restore investor confidence. Raising potential growth in coming years will require reforms to foster competition and investment, supported by measures to reduce crime.

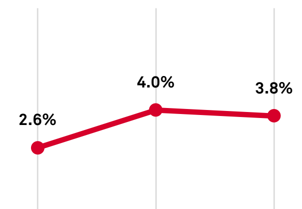
Remittance performance. Remitances account for about 20% of GDP and come mainly from the U.S. As of April 2020, remitances dropped about 40% RTM. This could have substantial impact on household income capacity, and consequently, on the overall economic performance.

El Salvador

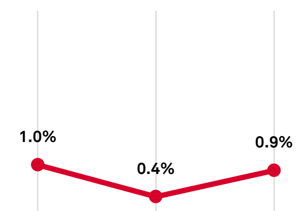
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Guatemala | BICRA Group: 7

Provisioning To Rise Because Of Likely Slow Economic Recovery

Primary Credit Analyst
Erick Rubio
Mexico City
erick.rubio@spglobal.com
+52-55-5081-4450

Key takeaways

- Lower business volumes for Guatemalan banks due to the lockdowns, the reduction in remittances from the U.S., and the drop in the commodities' prices.
- The banking system still lags international standards and we don't expect Basel III to be fully implemented in the next few years.
- We expect nonperforming assets to increase to about 3.5% in 2020 due to the virus-induced economic crisis.

Key credit drivers

Banking system with a stable funding base. Thanks to reliance on a large retail deposit base and to adequate lending and underwriting standards, the financial system is stable with few market distortions. Nonetheless, we expect the higher credit losses arising from the COVID-19 pandemic to hamper the banks' profitability.

Dependence on the U.S. economic recovery. The Guatemalan economy relies heavily on its exports to the U.S. and remittance inflows from it. A prolonged recession in the U.S. would impair the trade activity and the remittances, and consequently, the private consumption.

Low GDP per capita limits household debt. Close to 60% of the population is beneath the poverty level. This, along a large informal sector with low-income levels, result in a low banking penetration that limit the population's debt capacity and access to the financial system.

Key assumptions

Slow economic recovery in 2021. In our view, Guatemala's GDP will contract in 2020 and the recovery will be very gradual, which will lead to a credit growth of about 2.6% this year and about 3.7% in 2021. We expect investor confidence and the volume of infrastructure projects in the country to rise next year.

Weaker asset quality metrics although still manageable. We expect nonperforming assets to increase to about 3.5% in 2020 due to the economic shock caused by the pandemic. However, we believe the largest banks of the country have enough capital to absorb the likely wider credit losses.

Significant lag in implementing Basel III. There are still many international regulatory requirements principles pending; therefore, we don't expect Basel III to be fully implemented in the next few years.

What to look for over the next year

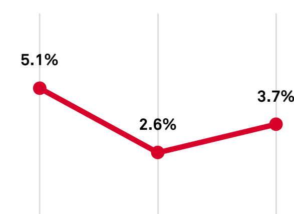
Political climate. The president's capacity to reach agreements with the opposition to carry out the main plans of his agenda will be crucial to boosting legal certainty and investments from the private sector.

Macroeconomic and public finances. Guatemala has relatively stable macroeconomic indicators with low debt and a controlled inflation. However, the expected contraction in economy and rising government fiscal deficit in 2020 could lead to persistently weak public finances over the long term.

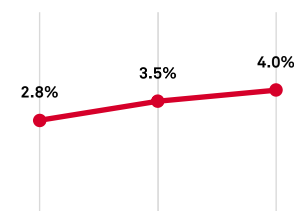
The agriculture industry's recovery. This industry represents more than 10% of GDP. As a result, more than 70% of the SMEs in the sector have faced liquidity strains stemming from the COVID-19 pandemic and lockdowns.

Guatemala

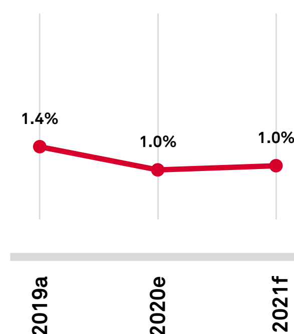
Loan growth



NPA ratio



RoAA



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RoAA – Sector-average return on average assets.

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Honduras | BICRA Group: 8

Economy Is Taking Significant Hit From Downturn In Agriculture And Remittances

Key takeaways

- We expect the Honduran banks' profitability to suffer because of higher provisioning due to the lockdowns and a depressed consumer lending segment stemming from the COVID-19 pandemic.
- Honduras still lags international financial regulatory standards, and we don't expect any significant changes in the short term.
- One of the highest poverty levels in the region with a large share of the population living in adverse conditions, and a significant level of crime and violence, which is reflected in a low GDP per capita.

Key credit drivers

Banking system with a diversified and stable funding base. The biggest banks in the country have a large retail deposit base that provide liquidity flexibility to withstand the current economic turmoil. Additionally, their focus on traditional lending to corporations and mid- to high-income retail borrowers translates into manageable asset quality metrics.

The consumer lending segment is taking the brunt of economic crisis. We expect that the Honduran banks and financial entities focused on low-income borrowers—small- to mid-size enterprises and individuals—will take longer to recover due to higher credit losses and a more pronounced hit on their profitability metrics.

Vulnerability to external shocks, mainly the U.S. Honduras relies heavily on the U.S. economy: exports to this country represent almost 40%, while the remittances from it account for about 22% of the country's GDP. We believe the deep recession in the U.S. will cause both indicators to fall sharply, leading to a very slow recovery in the country.

Key assumptions

Modest credit growth expectation for the banking system. From our view, the credit growth will come mainly from the corporate sector; therefore, it will remain higher than the GDP, which we expect to contract 2.5% in 2020 and slowly recover in 2021.

Weaker asset quality metrics although still manageable for the largest banks. We expect nonperforming assets to increase above 2.5% in 2020 due to the impact of the COVID-19 pandemic. However, we believe the largest banks have enough capital to absorb the potentially wider credit losses.

Large human development needs. Honduras has one of the highest poverty levels in the region and a significant level of crime and violence, which is reflected in a low GDP per capita. In our opinion, these factors limit the households' debt capacity.

What to look for over the next year

Economic recovery pace. We believe the Honduran economy will suffer in 2020 due to the importance of its agricultural sector and its reliance on remittance inflows. A prolonged and more severe economic downturn would weigh on the GDP's trend growth, resulting in deeper fiscal deficits for a longer period.

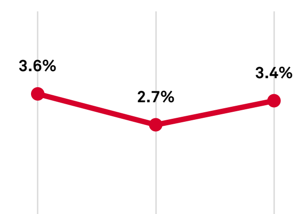
Energy sector. The government-owned electricity company Empresa Nacional de Energía Eléctrica (ENEE) poses a major fiscal weakness. Focusing on reducing ENEE's losses leaves the government with small room in expanding basic services, which require long-term expenditures.

Political climate. The presidential election will occur in 2021, and we believe there could be social tensions and protests if the government fails to address institutional weaknesses in key public institutions and establish clear rules for reelection.

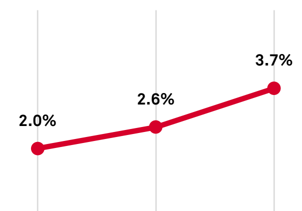
Primary Credit Analyst
Erick Rubio
Mexico City
erick.rubio@spglobal.com
+52-55-5081-4450

Honduras

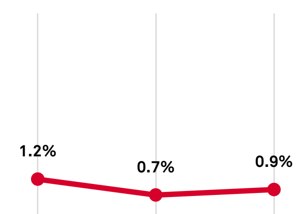
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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Jamaica | BICRA Group: 8

The Pandemic Is Fueling Risks To The Industry While Regulation Helps Mitigate Increasing Cross-Border Risks

Key takeaways

- The temporary halt in Jamaica's economic growth due to the COVID-19 pandemic has increased risks in the domestic financial system.
- As systemic risks rise because of increasing connections between businesses in various Caribbean countries--as a result of mergers and acquisitions (M&As)--Jamaica's banking regulator has made advances toward centralized supervision to mitigate such risks.
- Other initiatives to enhance the banking regulation are in the works, but we don’t expect them to be fully implemented in the short term.

Key credit drivers

Difficult domestic conditions are pressuring the industry's metrics. Jamaica has made progress in achieving economic stability in recent years, mostly thanks to the government's commitment to fiscal prudence and the country's improving external position. Improved economic momentum boosted lending growth in the consumer and corporate lending segments, primarily among the construction, energy, and tourism sectors. However, the pandemic has raised risks in the Jamaican financial system because the economic lockdown will likely hurt the banks' credit growth, and pressure credit losses, profitability, and capital metrics in the following months.

M&As demand centralized oversight. Caribbean conglomerates are undertaking M&As, which could introduce the spillover risks in events of distress because of increased cross-border business links across the region. In our view, it’s crucial that acquisitions move in parallel with strengthened systemic risk management. The Jamaican regulator is leading initiatives to move toward integrated oversight.

Key assumptions

Economy contraction this year. We expect real GDP and employment to decelerate significantly in 2020 due to lockdown, but recovering rapidly during 2021.

Pressures on asset quality. We estimate asset quality to slip during the next two years because of lockdowns. But credit losses would still be manageable under our current base-case scenario.

What to look for over the next year

Lockdowns and global distress will pressure the industry. We will continue monitoring the industry's credit profile as the COVID-19 outbreak and global credit stress play out. Particularly, continued economic paralysis because of the pandemic could impair the sector's growth and profitability, while potentially jeopardizing liquidity in a scenario of volatile deposits. However, the rate of the spread and timing of the peak of the outbreak, and the effectiveness of the government's response to contain the virus, are still highly uncertain, thus the full impact is not totally clear.

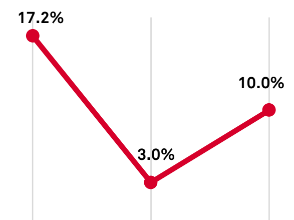
Adoption of strengthened regulations. We expect regulatory bodies to implement initiatives that will help set the basis for a more developed financial industry, which could attract foreign investors in the medium term. For example, an improved and centralized oversight framework is important, given the increasingly interconnected risks across the Caribbean.

Non-regulated players introduce market distortions. The increasing presence of unregulated credit unions, which generate stiff competition through lower lending interest rates, will continue pressuring the system's stability, in our view. However, regulators have started an initiative to supervise these entities formally, which should help lessen market distortions if the initiative goes into effect.

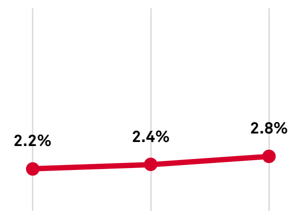
Primary Credit Analyst
Camilo Pérez
Mexico City
camilo.perez@spglobal.com
+52-55-5081-4446

Jamaica

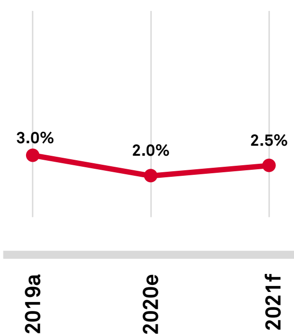
Loan growth



NPA ratio



RoAA



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Mexico | BICRA Group: 5

Weak Economic Recovery In 2021 Will Pressure Operating Performance

Key takeaways

- The recession this year and the weak recovery in 2021 will limit credit growth.
- Asset quality will deteriorate and profitability will slip due to the severe economic contraction.
- Sound capitalization will continue to be a credit strength in 2020-2021, while adequate liquidity will persist, supported by the central bank's measures to alleviate the economic crisis.

Primary Credit Analyst
Alfredo Calvo
Mexico City
alfredo.calvo@spglobal.com
+52-55-5081-4436

Key credit drivers

Economic recovery will take longer in Mexico due to pre-existing economic weaknesses. Low levels of investment and delays in virus containment measures and limited economic policy responses will delay recovery. This will set the stage for challenging operating conditions for Mexican banks.

Mexican banks enter this crisis with good credit fundamentals. Low levels of access to banking--measured by credit to GDP--allow banks to grow with healthy asset quality and adequate profitability, while liquidity and capitalization metrics remain sound.

COVID-19 will hit asset quality and profitability. The pandemic and the collapse in oil prices will exacerbate pre-existing economic weaknesses, damaging Mexico's labor market. Therefore, we expect banks' asset quality to worsen and consequently hamper profitability through higher provisions.

Key assumptions

Credit demand will remain subdued. Mexico's economy will continue to contract this year, and the recovery for 2021 will be weak (about 3% real GDP growth). The damage to the labor market and investment dynamics will result in modest credit demand, about 5% on average, in 2020-2021.

Asset quality will slip amid the recession. We expect the nonperforming assets ratio to peak at 3.4% by 2021--fully covered by reserves--while loan loss provisions would represent between 3.5% and 4.0% of total loans.

Higher provisions and lowering interest rates will hit profitability. Since the beginning of 2020, the central bank has lowered its policy rate by 175 basis points and additional cuts could come in 2020. Moreover, higher provisions will pressure profitability. We expect return on equity to be near 10% in 2020-2021.

What to look for over the next year

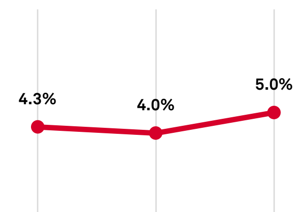
Government's ability to correct pre-existing economic weaknesses and restore economic growth. Because of Mexico's limited economic policy responses thus far, we expect severe damage to the labor market and SMEs that will result in a slow economic recovery.

Severity of the impact on asset quality. The debt moratorium program--approved by the banking regulator--will allow banks to defer recognition of bad loans and their consequent provisioning. Therefore, it's still early to assess the potential damage to banks' asset quality.

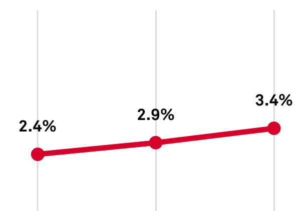
Effectiveness of the central bank measures to alleviate the crisis. These measures focus on providing ample liquidity (in local and foreign currency) and substantial financing resources at more accessible costs to the domestic financial system.

Mexico

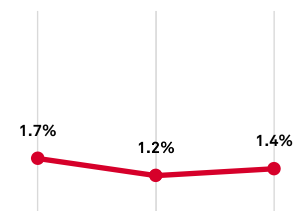
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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Panama | BICRA Group: 5

Relatively Flat Credit Growth This Year With Weakening Asset Quality And Profitability Metrics

Key takeaways

- Asset quality metrics will remain manageable, although they will slip in the next 12 months. Although we anticipate loan forbearance measures, some borrowers won't recover after COVID-19 is under control.
- Profitability levels will be lower than expected and start gradually recovering in2022.
- In April 2020, we revised our outlook on Panama to negative from stable and affirmed our 'BBB+/A-2' sovereign credit ratings. The negative outlook reflect pressures on Panama's economic, fiscal, and debt trajectories, exacerbated by the COVID-19 pandemic.

Key credit drivers

Weakening asset quality indicators, but still manageable. We forecast NPLs and credit losses to reach 2.4% and 1.4% in 2020, respectively, from about 1.9% and 0.9% in 2019. In our view, both indicators still manageable and lower than most of Panama's Banking Industry Country Risk Assessment (BICRA) peers. We believe that adequate lending and underwriting standards, restrained risk appetite, and a diversified loan portfolio will keep the banking system's asset quality resilient during the COVID-19 pandemic.

Lack of lender of last resort. Panama doesn't have a central bank or formal lender of last resort, or an effective deposit insurance system to support distressed financial institutions. To address the economic impact of COVID-19, the regulator allowed banks to use the accumulated dynamic provisioning (about $1.3 billion or 2% of GDP) to absorb the impact of credit losses. It also allowed banks to undertake voluntary loan restructurings with troubled borrowers. Finally, the government has successfully used the public-owned bank, Banco Nacional de Panama (BNP), as the vehicle to provide adequate liquidity to the banking system under stressful conditions through a short-term liquidity facility.

Key assumptions

Economic contraction in 2020, but recovering afterwards. We expect Panama's economy to contract about 2% in 2020 and grow 4% in the following three years. We predict policies to contain the pandemic to severely hurt the construction, tourism, and retail sectors. The ramping-up of Cobre Panama's copper production at a new mine might be slower than expected due to the virus outbreak. Given the importance of Panama's logistics sector, a persistent disruption in international trade would increase downside risks for the country's economic growth, potentially damaging growth prospects. Therefore, we expect credit growth for Panama's banking system to be barely 1% for 2020 and grow to 3% in 2021.

What to look for over the next year

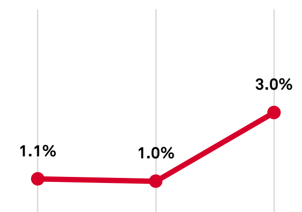
Lower profitability levels for the next 18 months. Profitability levels will be lower than expected and start gradually recovering in 2022. Systemwide returns will represent about 1.20% of the sector's adjusted assets during the next 18 months, compared with 1.34% as of December 2019. The latter reflects lower interest income and fees/commissions, as well as higher loan loss provisions because some borrowers won't recover from the pandemic-induced recession.

Efforts to strengthen the banking system's supervision and institutional framework. The country's financial system regulation continues to improve, reducing the gap with international regulators, although implementation challenges remain. In 2019, the Financial Action Task Force (FATF) placed Panama back on its "grey" list of countries with insufficient preventative measures against money laundering and financing terrorism. The FATF's recommendations for Panama are primarily outside the financial sector, limiting the possibility of a significant impact on the financial system.

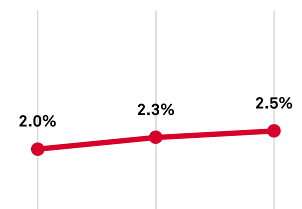
Primary Credit Analyst
Ricardo Grisi
Mexico City
ricardo.grisi@spglobal.com
+52-55-5081-4494

Panama

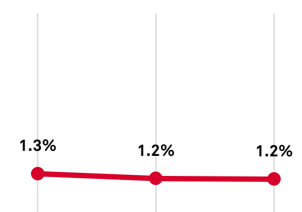
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Paraguay | BICRA Group: 8

Asset Quality Evolution Will Be the Main Factor To Monitor

Primary Credit Analyst
Maria M Cangueiro
Buenos Aires
maria.cangueiro@spglobal.com
+54-11-4891-2149

Key takeaways

- Paraguay had flat economic growth in 2019 and we expect it to contract 2.5% in 2020 due to the impact of COVID-19. Real GDP growth should quickly pick up to 4.5% in 2021.
- We expect that the impact of COVID-19 will continue to slow credit growth this year to 4% in nominal terms, but it should pick up in 2021 once the economy starts to recover.
- Asset quality will weaken in terms of NPAs (nonperforming assets: 60 days past-due loans + stock of repossessed assets), but also in terms of the RRR (renewed, refinanced, and restructured) loan portfolio and under central bank temporary measures that allow some loans to be refinanced.

Key credit drivers

Weaker economy will pressure credit growth and asset quality. Credit growth started to slow in mid-2019 due to softer economic conditions, and we expect it to continue slowing this year because of the pandemic. We predict credit growth will pick up once economic activity resumes, but for asset quality to recover more slowly.

High dollarization and exposure to cyclical sectors. Paraguay's banking system has high levels of foreign-currency lending (almost 50% of the banking system's total lending) and high exposure to cyclical sectors such as agriculture and cattle (34% of the loan portfolio).

Central Bank regulation and supervision. Paraguay's regulatory framework still lags behind international standards and has some weaknesses in terms of oversight. Still, the local regulator has taken several measures--such as liquidity facilities, new set of transitory measures to refinance and restructure loans affected by the pandemic, and programs to provide guarantees to SMEs--to mitigate the impact of COVID-19 on the banking system and the local economy since mid-March.

Key assumptions

Sharp contraction in 2020, but rapid recovery in coming years. In our base-case scenario, the economy will contract 2.5% in 2020, following a year of flat growth in 2019 due to a severe drought, floods, and heightened political uncertainty. We project that the economy will quickly recover in 2021, thanks to better agricultural prospects and a recovery in external demand.

Asset quality metrics to weaken. Asset quality, measured by NPAs, slipped last year due to flat economic growth, partially mitigated by temporary measures issued by the central bank that allowed banks to refinance loans affected by the drought. NPAs will continue to rise, as well as loans in the RRR categories and loans under the new pandemic-related temporary measures.

Profitability and capitalization. We expect the banking system's profitability to decline, pressured by lower margins and expenses related to higher provisioning. Credit losses will increase in 2020 because of worsening credit quality and legacy provisioning deferrals. Banks entered the shock with adequate regulatory capital, but capitalization could decline due to lower profitability despite low asset growth.

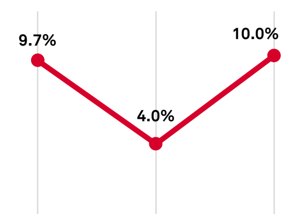
What to look for over the next year

Economic activity. Uncertainty remains about the duration of the pandemic's effects, so we'll keep monitoring Paraguay's economy over the rest of 2020 and in 2021, and the impact of Brazil's economic growth (main destination for Paraguay's exports) and Argentina's still very weak economy. Weather events could also have effects, such as droughts that affect the navigability of rivers, the main export channel.

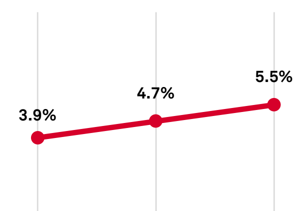
Asset quality and RRR loan portfolio. We'll observe how asset quality evolves in order to monitor potential increases in credit losses in coming years, which could hurt the financial system's profitability and capitalization levels that in turn could limit credit growth once the pandemic impact ends.

Paraguay

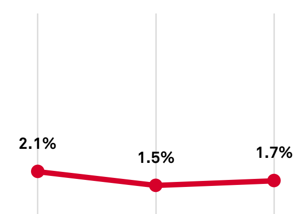
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming assets as a % of systemwide loans.

RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Peru | BICRA Group: 5

Increasing Risk Due To COVID-19 Even With Large Stimulus Package

Primary Credit Analyst
Cynthia Cohen Freue
Buenos Aires
cynthia.cohenfreue@spglobal.com
+54-11-4891-2161

Key takeaways

- We expect the Peruvian economy to sharply contract in 2020 amid the COVID-19 pandemic before recovery begins in 2021.
- However, strong economic fundamentals and ongoing policy stimulus should soften the shock to the economy.
- As a result, we expect credit growth to be driven by loans guaranteed by the government in 2020 and asset quality to significantly weaken, but banks should be able to remain profitable considering their strong margins.

Key credit drivers

One of the most affected countries in Latin America by COVID-19. Despite strong actions taken by the government to contain contagion, the number of COVID-19 cases in Peru has risen rapidly. The limited capacity of the country's health care and sanitation systems complicates the scenario.

Among the largest stimulus packages in the region. To help offset the hit to the economy, the authorities launched a stimulus package, including loan guarantees worth about 12% of GDP. Besides increased health spending, the package includes direct transfers to support the poorest families affected by quarantine, subsidies to informal workers, deferrals of taxes and electricity and water payments, and different initiatives to help small and midsize enterprises mitigate the impact on employment.

Credit losses to surge in 2020. The banking system's NPLs (90-day past-due loans) were about 2.6% in January 2020, and 2.9% for the overall financial system. We expect NPLs to increase due to the effect of the economic contraction to about 3.9% in 2020 and 3.6% in 2021. However, we expect credit losses to increase sharply in 2020 due to the significant economic contraction.

Key assumptions

Economic recovery in 2021. We expect a solid recovery over the following three years, thanks to the comprehensive stimulus package and the expected recovery in China, one of Peru's key trading partners.

Recognition of asset quality deterioration will be delayed. Local regulators are allowing banks to renegotiate loans due to the impact of the pandemic without marking them as nonperforming, so we believe it will take some time for the deterioration to be fully reflected on banks' balance sheets.

We assume broad continuity in Peru's prudent and sound policy framework, despite the uncertainty at this point about the electoral dynamics, including specific candidates, for next year's presidential election. In the coming months, as the shock gradually dissipates, attention will shift to leading potential presidential candidates and their approach to economic policies.

What to look for over the next year

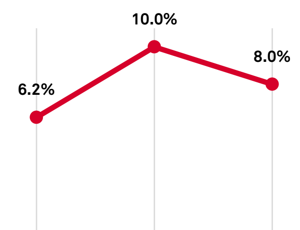
Social unrest could pressure economic recovery. As the number of individuals with COVID-19 has escalated and pressured the fragile health system, social unrest could emerge.

Problem loans could rise. The Peruvian financial system has a meaningful amount of loans offered to cyclical sectors such as small business and middle-market loans (about 27%). If economic activity takes longer to recover, some companies could struggle to remain viable.

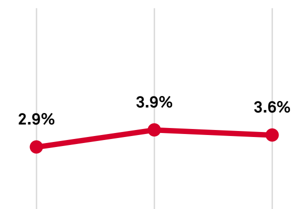
Economic recovery could take longer than anticipated. If the economic recovery is much weaker than we expect after the COVID-19 shock dissipates, banks' operating performance could struggle.

Peru

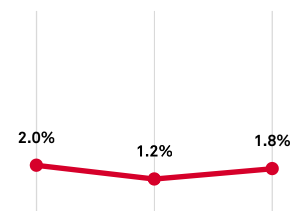
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

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Trinidad & Tobago | BICRA Group: 6

A Double Hit From Lower Hydrocarbon Prices And COVID-19 Outbreak

Primary Credit Analyst
Rafael Janequine
São Paulo
rafael.janequine@spglobal.com
+55-11-3039-9786

Key takeaways

- Pressure on banks' asset quality to surge and business growth to slow as the pandemic-induced drop in trade and lower oil prices contribute to a deeper economic contraction.
- We expect banks' initiatives to provide relief to borrowers in the short term, although the stabilization of lenders' balance sheets will depend on the length of the shutdown of business activity.
- The banking system has posted strong results despite the recession in the past four years. Moreover, banks entered the economic crisis caused by COVID-19 with sound capital and liquidity levels, which should help absorb the economic shocks.

Key credit drivers

Energy crisis. Although T&T's banks are not heavily exposed to oil companies (about 4% of total loans), economy is heavily dependent on the energy sector, which has historically contributed over a third to the government's revenue and the country's real GDP, and accounted for more than 80% of exports.

COVID-19. We expect pressure on banks' asset quality to ratchet up and business growth to slow as the coronavirus outbreak deepens economic contraction. We believe that a consecutive contraction of economy since 2015 will impair companies' finances, while the rising unemployment could hinder the individual borrowers' ability to service their loans.

Sound capital and profitability. Despite the expected reduction in banks' revenues and increase in loan-loss provisions in the next 12 months, the banking system entered the economic crisis with robust profitability (ROE above 20% in the past two years) and strong capital levels.

Key assumptions

Oil prices. Prices for crude oil in spot and futures markets are lower than in 2019. We now assume an average WTI oil price of $25/bbl in 2020, $45/bbl in 2021, and $50/bbl by 2022.

Manageable credit losses. Banks were able to contain the damage to asset quality stemming from years-long recession amid weak energy prices but relatively controlled unemployment and inflation rates. However, the rising unemployment could spike credit losses than we currently expect.

Regulatory relief. We believe the full impact on asset quality will take time to materialize, given the regulatory and banks' measures to lessen the strain.

What to look for over the next year

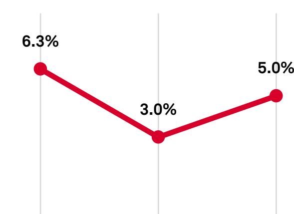
Presidential election in 2020. Difficult economic conditions will continue to challenge the current People's National Movement (PNM) administration. However, we believe that PNM and the United National Congress opposition party share a broadly similar approach to economic policies.

Unemployment. In our view, unemployment is a key leading indicator for a deeper credit stress in the financial system. Household debt service has risen consistently over the past few years and could be a source of vulnerability if economic activity or the labor market softens for a prolonged period.

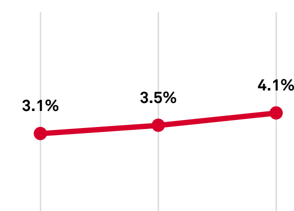
Coverage. Lower loan-loss reserves compared to regional peers while expected credit losses are rising system-wide. We still do not have a clear picture on how banks will manage coverage against non-performing loans during uncertain public health and economic conditions.

Trinidad & Tobago

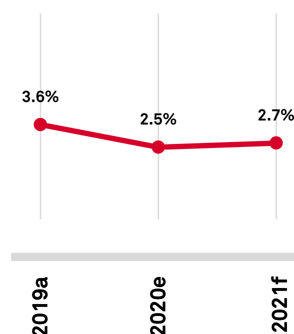
Loan growth



NPA ratio



RoAA



Loan growth – Sector-average growth in loans.

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Uruguay | BICRA Group: 6

Regulatory Measures Should Soften The Impact Of Economic Contraction

Key takeaways

- We project real GDP to contract 3% in 2020, due to the COVID-19 pandemic and global economic downturn, and grow 5% in 2021, supported by infrastructure investments over coming years.
- Pressure on banks' asset quality metrics to surge but will take time to materialize, given the regulatory measures to mitigate the downturn's impact.
- We expect banks' liquidity levels to remain sound, deposit base stable, and solvency levels adequate, despite pressures on profitability and margins.

Key credit drivers

Pressure on asset quality metrics. We believe the world's much more complex economic scenario will pressure the banks' asset quality metrics. However, the impact will be mitigated by the regulatory measures to support the financial system, which include extending maturities of existing loans that are performing without penalties and lowering reserve requirements for loans granted in Uruguayan pesos in order to encourage credit growth in local currency, among others. In this sense, we expect NPLs (past-due loans of more than 60 days) to reach around 4% by 2021 from 3.1% by the end of 2019.

Limited monetary flexibility. High inflation of about 9% and still extensive dollarization continue to limit Uruguay's monetary policy flexibility, because over half of resident loans and more than 70% of resident deposits are in dollars.

High dollarization and exposure to cyclical sectors. Significant dollarization in the economy and some sector and customer lending concentrations increase risks. Loans to the agriculture sector represent about 15% of total loans.

Key assumptions

GDP contraction followed by economic rebound. We expect GDP to decrease 3% in 2020, stemming from a sharp fall in consumption because of the pandemic and weak global and regional demand, together with high unemployment and persistently high inflation. We estimate economy to expand 5% in 2021, as growth in consumption resumes and planned investment projects ramp up.

Flat real credit growth. Private sector's access to credit remains low, at about 28% of GDP, and we expect it will be at the same level in the next 12-18 months, given the weak economy. However, we expect nominal credit growth of 10% in the next two years, influenced by the depreciation of the Uruguayan peso, high inflation, and the economy's rebound in 2021.

Stable and predictable political institutions. We believe Uruguay's broad political consensus and its stable and well-established institutions have anchored--and will continue to anchor--economic stability. In this sense, following the election of President Luis Lacalle Pou, whose administration took office on March, 1 2020, we believe political consensus will be key to implementing needed structural measures.

What to look for over the next year

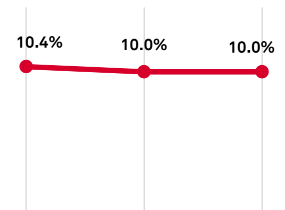
Profitability under pressure. For the next few quarters, we expect banks' profitability to take a hit from lower returns in investment portfolios, given negligible international interest rates, higher cost of risk, and tight margins. The banking system's excess liquidity is allocated in low-risk instruments, mainly U.S. Treasury securities. However, this will be partly compensated by gains in exchange-rate fluctuations due to most banks' active long position in dollars.

Funding base. We expect the deposit base to remain stable despite some expected growth in the nonresident deposit base, which currently accounts for 10% of total deposits, mainly from Argentineans given that country's financial turmoil.

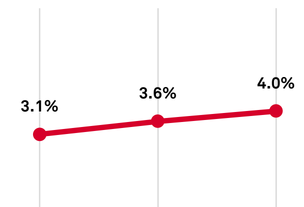
Primary Credit Analyst
Sofia Ballester
Buenos Aires
sofia.ballester@spglobal.com
+54-11-4891-2136

Uruguay

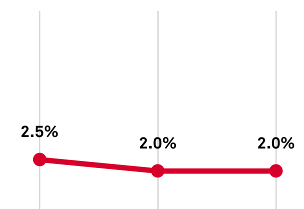
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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Western Europe

BICRA groups: lowest to highest

Group '1' to '10', from lowest to highest risk. BICRA--Banking Industry Country Risk Assessment.
Data as of June 30, 2020. Source: S&P Global Ratings.

Austria | BICRA Group: 2

COVID-19 Impact Calls For Greater Efficiency And Digital Transformation

Primary Credit Analyst
Anna Lozmann
Frankfurt
anna.lozmann@spglobal.com
+49-69-3399-9166

Key takeaways

- Austrian banks are facing the downturn in good shape, with robust capital, liquidity, and asset quality.
- Together with the resilient private sector and large-scale government support programs, this will aid the banking system through the recession.
- In the event of a more-adverse economic scenario, some banks might have little buffer to absorb the spike in risk costs and further decrease in margins. This is because of the high share of interest income, very tight interest margins, and low efficiency at many banks.

Key credit drivers

Strong drop in profitability. Overall domestic risk costs will likely increase sharply in 2020, up to 50 basis points of the total domestic lending portfolio, and domestic return on equity is likely to decrease to a low-single-digit level for most Austrian banks. However, we expect a profitability decrease will not lead to capital depletion or a greater risk appetite, and that banks' lending policies will remain prudent.

Economic downturn requires more efficiency measures for Austrian banks. Despite material progress, the cost efficiency of domestic operations remains a weakness for many Austrian banks, notably because of a still-dense branch network, legacy IT systems, and decentralized structures. We believe these remain the key obstacles to banks' efforts to fully embrace scale benefits and digital opportunities, and to realize the full potential of new technologies to increase efficiency and strengthen revenue-generation capacity.

Key assumptions

Sharp recession in 2020, followed by strong rebound. In our base case, as a result of the COVID-19 pandemic, we expect real GDP contraction of 6.5% in 2020, followed by a 4% recovery in 2021. We expect the Austrian economy to be relatively able to absorb this shock, thanks to its diversity and strong growth in recent years, with real GDP growth averaging 1.9% in the past five years, supported by exports in particular.

Banking sector stability will continue in the downturn. Austrian banks are in a better position to withstand the downturn than during previous crises. Despite the material one-off deterioration of the sector's performance that we expect for 2020, overall sector stability is unlikely to deteriorate, given banks' comfortable capital and provisions, as well as government programs and the social benefits system. The Austrian government was quick to introduce some virus containment measures, and it set up a support program of about 10% of GDP to help the economy through the pandemic.

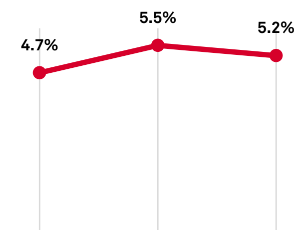
What to look for over the next year

Economic downturn beyond our base-case expectations. There is significant downside risk to our current baseline scenario, owing to the economic effects of the COVID-19 pandemic, which--if more prolonged or deeper than we currently expect--could result in a deterioration of household and corporate sector financial health, particularly given the Austrian economy's focus on service industries.

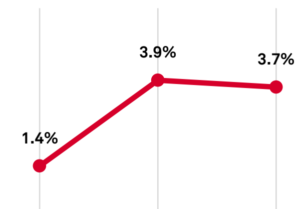
Digital transformation and increased efficiency. In our view, risks to the banking system from tech disruption are contained, mainly because of still-conservative consumer preferences. However, COVID-19 is likely to be a strong catalyst for the transformation of these preferences. Austrian banks' business models will therefore become increasingly reliant on achieving operational efficiency and a lean and modular information technology setup that enables them to respond quickly to changes in trends and expand into adjacent services.

Austria

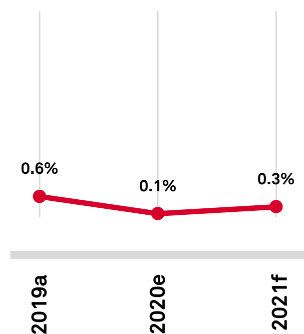
Loan growth



NPA ratio



RoAA



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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Belgium | BICRA Group: 2

Short-Term Profitability Shock In A Resilient Banking System

Key takeaways

- Belgian banks entered 2020 from a high credit standing, owing to a strengthening of capitalization over the past decade, their risk-adverse nature, and ample liquidity from sticky deposits.
- The effectiveness of government measures in response to the COVID-19 outbreak and the pace of recovery will be key in coming quarters. Federal and regional governments, along with the European Central Bank, have implemented significant measures to support the economy. Still, the pandemic will test banks' small and midsize enterprise (SME) and corporate loan books, and their traditional low impairment levels compared with peers.
- Loan provisions will hit Belgian banks' profitability in 2020 and 2021, but longer-term prospects remain sound on the back of continuous efficiency efforts.

Key credit drivers

Comparing domestic credit losses with peer countries' will be key for future ratings. Belgian banks start from a position of strength compared with most countries, owing to decent margins, low credit risk, and ample liquidity. COVID-19 is testing the private sector's risk-averse nature and consequent low impairment levels. New provisions should peak in 2020, before gradually cooling down in 2021 on the back of the assumed economic recovery. Banks' domestic loan books' higher resilience against peers' will be fundamental to maintaining current rating levels.

Domestic credit should remain on the rise. Credit to the private sector has increased faster than GDP over recent years, as households have taken advantage of low interest rates. However, rising indebtedness, on a par now with the European average, is not an immediate concern. This is because net wealth levels in Belgium remain among the highest in Europe. We expect credit growth to stay broadly stable; higher lending volumes to SMEs and corporates in 2020 should offset lower household demand because of COVID-19 lockdowns. Over the medium term, a further material disconnect between credit and GDP trajectories could weigh on the banking system's economic risk.

Key assumptions

We expect Belgium, like neighboring countries, will see a sharp contraction before gradual recovery. In our view, the COVID-19 pandemic will result in real GDP contracting by 7.9% in 2020, with a recovery starting in the second half of 2020, leading to an expansion of 5.3% in 2021. We anticipate the unemployment rate will increase to 6.4% in 2020 from 5.4% at end-2019.

SMEs and corporates will feel the greatest pressure. We believe federal and regional governments' response will support the banking system throughout the downturn. Despite this, we consider banks' SME and corporate loan books could suffer in the next two years because the country has a very open economy. The social security system and general population wealth should limit impairment in the retail sector.

Capital and liquidity should support ratings. Banks' capital strengthening over the past decade will help them bridge the downturn, in our view. The funding profile will remain a key positive factor against peers, thanks to large sticky deposits.

What to look for over the next year

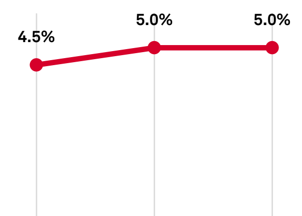
The magnitude and pace of economic recovery. Downside risks to our assumptions remain, and a material downward revision of our macroeconomic forecasts could lead to a downward revision of our BICRA.

Efficiency measures for the future. Until the start of the pandemic, most banks were making efforts to improve their efficiency to mitigate the low-interest-rate environment. The downturn might have shifted managements' focus for some time, but these efforts remain necessary for future profitability.

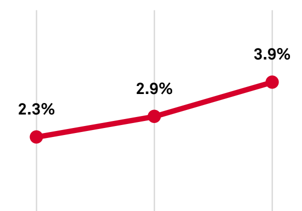
Primary Credit Analyst
Philippe Raposo
Paris
philippe.raposo@spglobal.com
+33-1-4420-7377

Belgium

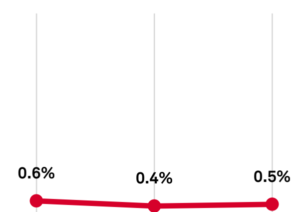
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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a--Actual. e--Estimate. f--Forecast.

Cyprus | BICRA Group: 8

COVID-19 Will Weigh On Banks' Asset Quality And Profitability

Key takeaways

- Cypriot banks are still completing the clean-up of legacy problematic assets from the 2008 crisis, but further disposals are unlikely amid current economic prospects.
- A deteriorating environment, coupled with high private sector indebtedness and potential consequences from changes to foreclosure legal framework, increase downside risks, particularly to banks' asset quality.
- The current economic stress will further hamper banks' profitability, due to ultra-low interest rates, declining transaction volumes, and higher provisioning needs.

Key credit drivers

Already-weak asset quality will likely worsen. The stock of problematic assets is one of the highest in Europe (29.3% of gross loans at end-2019), even after the carve-out of nonperforming exposures (NPEs) outside the banking system and sizable market sales in 2018. Historically embedded poor payment culture and high concentration to the real estate sector (16% of loan book) and tourism (7%) will likely result in higher default rates and delayed recoveries over the coming quarters.

Cost efficiencies are needed to cushion bottom-line results. Banks' ability to further streamline cost structures while investing in digital transformation to become more efficient will be key to accommodating lower revenue resulting from low interest rates, muted lending volumes, and subdued fee income.

Banks' funding profiles will likely remain unbalanced. Funding is almost entirely made of customer deposits, which are still recovering from the 2013 bail-in; and reliance on nonresident deposits is higher than peers' (representing over 20% of deposits). Access to wholesale funding will remain narrow.

Key assumptions

The economy is more vulnerable to external shocks. Due to its small, open nature and high concentration of tourism and real estate, we expect that the Cypriot economy could be materially affected by the fragile economic health of both EU and Commonwealth of Independent States countries, and forecast GDP contracting by more than 7.5% in 2020, before recovering only gradually by about 5.5% in 2021.

Credit losses will push banks into losses. Although supportive fiscal and monetary measures will somewhat cushion the impact on small and midsize enterprises (SMEs) and households, our current credit loss estimates will likely push banks into being loss making in 2020, with a gradual recovery in 2021, although still close to breakeven.

Bank capitalization has some buffer to absorb deterioration. Cypriot banks face this shock with comfortable capital metrics. Common equity tier 1 ratio stood at about 17% at end-2019, on average.

What to look for over the next year

Potential real estate market price correction. Given some banks' exposures to real estate as a result of foreclosure activity in recent years, they run the risk of incurring losses if they are unable to dispose of such assets in a capital-neutral manner.

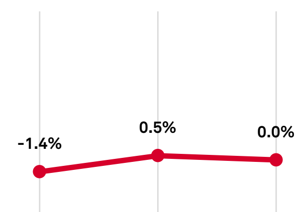
Credit quality after moratoria ends. Given Cyprus' dependence on tourism--a sector which will take longer to recover than many others--government-sponsored moratoria will apply until end-2020, delaying the impact on credit quality deterioration until mid-2021.

Ability to complete market sales of NPEs despite market turmoil. It remains to be seen whether the largest Cypriot banks will be able to complete planned sizable market sales of NPEs that are currently at a standstill.

Primary Credit Analyst
Miriam Fernández, CFA
Madrid
miriam.fernandez@spglobal.com
+34-91-788-7232

Cyprus

Loan growth



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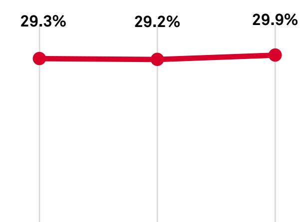
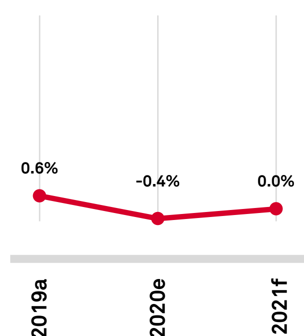


RoAA



Loan growth – Sector-average growth in loans.

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Denmark | BICRA Group: 3

Banks Remain Resilient, Despite Pressure On Profitability

Key takeaways

- A resilient economy and robust welfare system suggest comparably low sector credit losses as a result of COVID-19 in a European context.
- Still, increased provisioning, negative interest rates, cost inflation, and competition are further weighing on earnings.
- While the banking sector relies substantially on wholesale funding, the market shows resilience thanks to market depth and unique characteristics.

Key credit drivers

Relatively low credit loss expectations in a European context. We expect the Danish economy's structure to offer more resilience than those of other Nordic countries amid the COVID-19 pandemic. This resilience, together with the Danish welfare system's robustness and the government's policy response to the COVID-19 pandemic are, in our view, efficient mitigating factors against the potential pressure that the situation creates for banks' asset quality. Overall, we expect bank provisioning needs to peak in 2020 at 35 basis points of the total sector loans, mostly driven by nonmortgage credit exposures toward small and midsize enterprises.

Sector profitability is under pressure, but bank capitalization is robust. Higher credit losses and revenue attrition linked to COVID-19 add to existing headwinds on profitability from negative interest rates, compliance investments, competition, and the cost of already well-advanced minimum requirement for own funds and eligible liabilities (MREL) buffers. Still, we expect that the capitalization of rated Danish banks will remain robust in a European context through 2022, supported by reductions in dividend payments and buybacks.

High dependence on functioning wholesale funding. Danish banks' share of wholesale funding is high relative to other European banking systems. That said, we see this risk as partly mitigated by a deep domestic bond market with a steady flow of mandatory pension savings and the various supporting features of the Danish covered bond framework, not least its soft bullet structure. The government's willingness to ensure liquidity in the system has also supported the market's continued functioning during the turbulence of March 2020.

Key assumptions

A deep recession in 2020, though less severe than in other Nordic counties. We forecast Danish GDP to contract by 5.4% in 2020, before bouncing back to positive 3.2% in 2021. The pharmaceuticals industry materially contributes to the relative stability of GDP compared with other Nordic countries.

Limited correction in house prices. Overall, we consider the Danish housing market to be supported by generally sound supply and demand fundamentals, and we expect a minor house price correction in real terms this year, followed by a return to slow appreciation.

What to look for over the next year

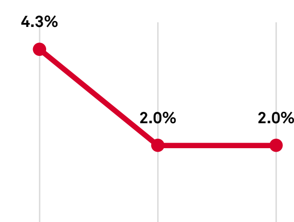
Asset quality trends. We expect COVID-19-related provisions have, to a great extent, been front-loaded in the first quarter of 2020 in Denmark, but we expect actual losses to increase in the coming quarters.

Development in house prices and unemployment. A severe second wave in the pandemic and resumed lockdown are examples of factors which could lead to pressure on house prices and unemployment, pushing credit losses higher than in our base case.

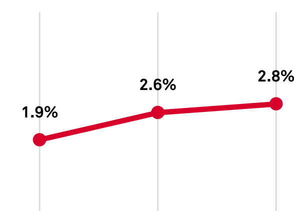
Primary Credit Analyst
Pierre-Brice Hellsing
Stockholm
pierrebrice.hellsing@spglobal.com
+46-84-40-5906

Denmark

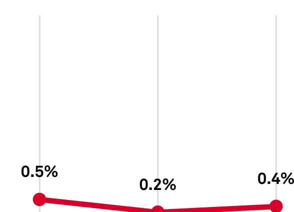
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming assets as a % of system wide loans.

RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Finland | BICRA Group: 2

Resilient Banking Sector But Downside Risks For The Small Economy

Key takeaways

- Finland's banking sector is facing a deep, COVID-19-triggered recession, but government policy measures, strong capitalization, and sound profitability provide some cushion.
- Banks depend on conservative commercial practices which promote stability within the concentrated banking market, but historically high household indebtedness could become a risk if not curbed by additional macroprudential measures.
- Banks respond to the structural funding gap by increasing the share of wholesale funding, which makes them dependent on external funding and investor confidence.

Primary Credit Analyst
Salla von Steinaecker
Frankfurt
salla.vonsteinaecker
@spglobal.com
+49-69-3399-9164

Key credit drivers

Increased economic risks. Finland's economy was already facing structural headwinds entering the COVID-19 pandemic, and will now fall into a severe recession. As a result, we anticipate that asset quality will weaken and the cost of risk for the banking system will materially increase. That said, we expect the banking sector's strong capitalization and sound profitability to mitigate the impact.

Persistent growth in household debt is an ongoing concern. Household debt to disposable income reached an historical high of 129% in December 2019, mainly because of continuous growth in housing loan stock and recently in consumer loans. However, overall debt levels are lower than for Nordic peers, thanks to the Finnish payment culture.

Material share of external wholesale funding is a key weakness. A major part is linked to the largest players, but smaller domestic banks have also expanded funding profiles to covered bonds. Still, we recognize that banks maintain good access to euro-denominated markets, and hold a safe-haven status from foreign investors, suggesting funding stability.

Key assumptions

Significant GDP contraction of 6% in 2020 followed by only modest rebound. With 2.5% expected GDP growth in 2021, recovery is likely to be less pronounced than in other Nordic countries. This reduces the business prospects for the domestic banks.

Increased credit risk. We expect domestic nonperforming assets to increase to about 1.4%-1.5% of domestic systemwide loans in 2020-2021, up from 1.0% in 2019.

What to look for over the next year

Domestic and external recovery from COVID-19. Government support has cushioned the negative economic shock and some effects might only become visible at a later stage. As a small, open economy, Finland is dependent on trade with eurozone members. Consequently, we keep an eye on the external economic recovery, as well.

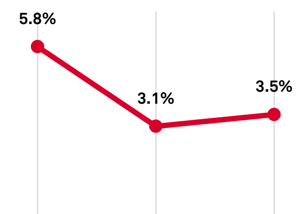
Potentially weaker private sector debt capacity could harm banks' asset quality. Financial distress, especially at small and midsize companies, combined with increased unemployment could lead to credit losses beyond our base case. The introduction of new macroprudential tools to curb household debt is likely to be delayed due to COVID-19.

Finnish banks' focus on digitalization. While large banks' digital agenda is well advanced, we expect the smaller banks' ongoing investments in core banking renewal and digitalization will weigh on profitability.

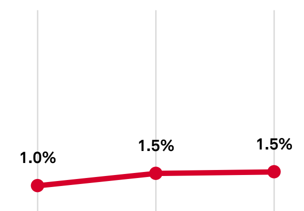
Senior nonpreferred issuance to accelerate. Resolution strategies are taking shape, yet some aspects, such as the subordination requirement, remain open.

Finland

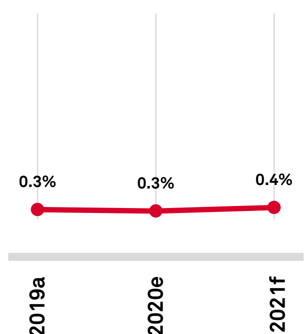
Loan growth



NPA ratio



RoAA



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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

France | BICRA Group: 3

Increased Downside Risks For Banks, With A Rise In Credit Losses

Primary Credit Analyst
Nicolas Malaterre
Paris
nicolas.malaterre@spglobal.com
+33-1-4420-7324

Key takeaways

- Sharp GDP contraction in 2020 will be followed by a recovery in 2021, but not one that would entirely offset damage to the economy and various corporate sectors.
- The downturn comes at a time when the French banking sector was already suffering profitability pressures from low interest rates and heavy cost bases.
- Profitability will weaken in 2020 due to a rise in loan impairment provisions. However, French banks' fundamentals remains sound, with diversified banking and insurance activities and robust balance sheets to support their creditworthiness.

Key credit drivers

The strength of the economic recovery will be critical. The COVID-19 pandemic and its implications will lead to a sharp downturn this year, followed by an expected dynamic rebound in 2021. A deeper and more prolonged economic recession would increase downside risks for French banks, through weaker revenues (derived from net interest margin reduction and lower business volumes) and higher credit losses, resulting in a more significant toll on banks' profitability.

Profitability deterioration to drive cost-efficiency initiatives and pricing discipline. We expect all French banks will target efficiency improvements, while investing in digitalization to meet customers' needs. We also look at banks' pricing in residential mortgages loans, where margins are lower than in other markets, but were slightly up since the end of 2019.

Key assumptions

Sharp GDP contraction followed by recovery. We believe COVID-19 will result in real GDP contracting by 9.5% in 2020, with a recovery in the second half of 2020, leading to an expansion of 6.8% in 2021. The wide-ranging fiscal and related monetary measures have supported the banking system through the pandemic.

Earnings significantly reduced in 2020. Banks' overall profitability has withstood the effects of the low interest rates, thanks to their universal banking model and lower share of interest-sensitive activities than other markets. Increased provisioning for risks will result in the bottom line being more than halved in 2020, but credit losses will not push large banks into losses.

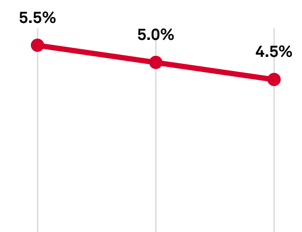
What to look for over the next year

Domestic loan losses will be a key indicator of economic risks in France. We project French banks' credit losses on domestic operations will reach at least 50 basis points this year--double that of 2019, and above the long-term French average.

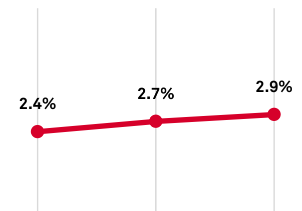
A buildup of economic imbalances and corporate indebtedness. A significant component of the fiscal support package comprises additional indebtedness--for the sovereign, some households, and many businesses, which may result in higher vulnerabilities if the economic recovery is delayed, testing the banks' resilience and balance sheets in a European context.

France

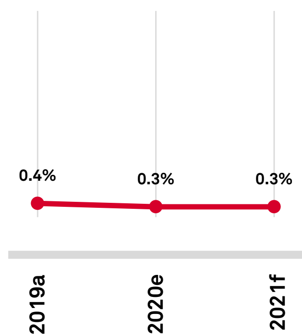
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Germany | BICRA Group: 2

Amplified Economic And Industry Risks On Bank Outlooks

Primary Credit Analyst
Harm Semder
Germany
harm.semder@spglobal.com
+49-69-3399-9158

Key takeaways

- Expected sharp GDP contraction in 2020 followed by rebound in 2021 that will not immediately or entirely offset the damage to the economy, household wealth, and various corporate sectors from COVID-19.
- German's fiscal and monetary measures will mostly mitigate cyclical shock to the economy and help protect the banking sector's stability, although we expect bank earnings, asset quality, and in some cases, capitalization, to weaken.
- German banks entered the crisis already suffering from pressure on profitability, notably due to low interest rates and a heavy cost base.

Key credit drivers

Weaker than anticipated or delayed economic recovery could increase downside pressure. This would imply a far more negative effect on German banks' credit strength and could also follow negative developments at individual banks.

Deteriorating revenue and asset quality will test German banks. COVID-19 is forcing Germany's banking system to demonstrate manageable increases in the cost of risk and sufficient earnings resilience amid greater competition and still low interest rates. This keeps the pressure on banks to cut costs, consolidate, or find new revenue sources.

The pandemic has accelerated disruption risk from fintech and big tech players. Many German banks need to improve their core IT systems. Larger groups need to further optimize costly branch networks, improve cost-to-income ratios to better withstand the crisis, and transform operating models. The lockdowns in response to COVID-19 are catalyzing customers' adoption of digital banking and speeding up the pace of digitalization.

Key assumptions

Strong recovery will offset sharp GDP contraction. COVID-19 will provoke 6.2% real GDP contraction in 2020 versus 7.8% in the eurozone. This will be more than compensated by a strong German rebound with 4.4% expansion in 2021, and 2.6% in 2022.

Substantial, rapidly deployed government support measures. Germany's fiscal and monetary measures will substantially mitigate cyclical shock to the economy, the banking system, and customers, as well as limit German banks' credit losses.

German banks' earnings and asset quality will weaken in 2020, but their financial profiles will remain resilient. Additional pressures on interest margins, loss in revenue, and material increase of credit cost from historic lows could result in much lower bottom-line results for many German banks in 2020.

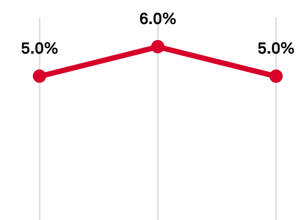
What to look for over the next year

Profitability to suffer in cyclical shock. We expect German banks will need to improve efficiency, invest in digitalization to meet customers' needs, and still maintain prudent underwriting standards and risk adjusted pricing to mitigate difficult credit conditions.

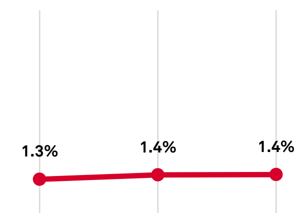
Pressure on asset quality. We project German banks' credit losses on domestic and foreign operations will increase materially in 2021 but remain manageable. We note also that a significant component of the government's fiscal support package comprises additional indebtedness--for the sovereign, some households, and many businesses.

Germany

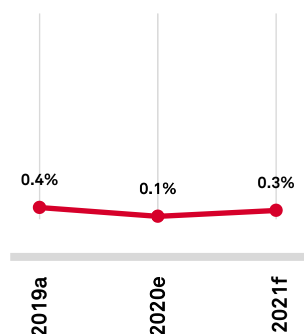
Loan growth



NPA ratio



RoAA



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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Greece | BICRA Group: 9

Pandemic Caught Banks Amid Delayed Recovery

Primary Credit Analyst
Goksenin Karagoz
Paris
goksenin.karagoz@spglobal.com
+33-1-4420-6724

Key takeaways

- The emergence of COVID-19 and measures by governments to contain the outbreak have stopped the positive momentum the Greek economy and its banks were enjoying prior to the pandemic.
- The resulting global economic slowdown and its effect on Greece's tourism, travel, and services sector have diminished the prospects for a faster cleanup of legacy problem loans, where banks were about to make significant progress with the support of some government initiatives.
- We expect these events to temporarily hinder banks from enhancing their precarious earnings and asset quality and from further diversifying their funding profiles.

Key credit drivers

Further weakening of economic prospects, which could lead to nonperforming exposure (NPE) and noncore asset disposals at less profitable terms than banks anticipate. This would only increase the additional cost--notably the reduction in capital--to banks from these sales, forcing them to downsize the planned securitizations. This would particularly harm banks with limited capital buffers.

The pace of the economic rebound, notably regarding the performance of the real estate markets, and unemployment levels. These factors will determine the pace of new problem loan formation, the price and demand for the upcoming NPE securitizations, recovery prospects for the denounced loans backed by real estate, and the collection performance of distressed debt purchasers.

Funding risks, which remain extremely low. Deposits have kept growing, despite the full abolition of capital controls, reflecting increased confidence in the banking system. Moreover, the European Central Bank's (ECB) March 2020 €750 billion emergency bond purchase program allows the purchase of Greek government debt.

Key assumptions

We estimate real GDP will contract 9.0% in 2020, followed by a rebound of 5.5% in 2021, chiefly because of the pandemic's effect on the trade and tourism, travel, and construction sectors. It is likely that prices in the property markets will experience some stress.

We expect credit losses to remain above 200 basis points during 2020 and 2021. This higher cost of risk and limited prospects for new lending will pressure banks' bottom-line earnings and already weak capital formation.

Negative net loan growth due to NPE write-offs and sales. Net interest margins should remain resilient despite the pandemic. Greek banks retain access to the ECB's long-term refinancing lines at attractive terms.

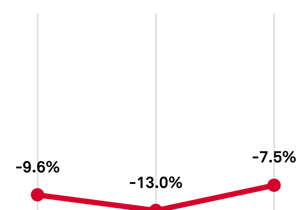
What to look for over the next year

The pace of the new loan disbursements. We do not expect the continuation of the strong first quarter trend vis-à-vis the resumption of new lending during the rest of 2020. The resumption of lending matters more for Greek banks, since their quality of capital and earnings remain weaker after years of weakening interest and fee income generation.

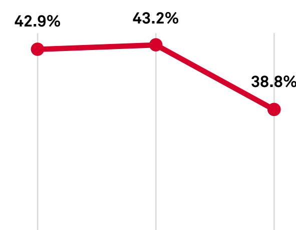
The pandemic's true effect on private sector creditworthiness and property markets. Foreign investments largely determine Greek real estate prices, which were just picking up prior to the pandemic, following a decline of about 40% since 2008. The fallout from the pandemic will determine the pace of the activity in secured debt sales by banks and the payment capacity of indebted households whose net equity has turned negative over the years.

Greece

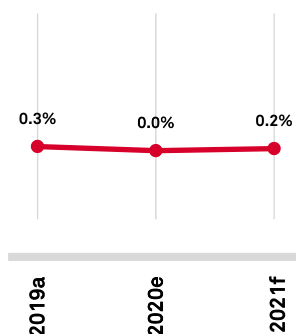
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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Iceland | BICRA Group: 5

Volatile Operating Environment And Weak Profitability Prospects Challenge Banking Sector

Primary Credit Analyst
Antonio Rizzo
Madrid
antonio.rizzo@spglobal.com
+34-91-788-7205

Key takeaways

- Icelandic banks operate in a wealthy economy. However, economic volatility and high concentration in a few sectors such as real estate and tourism, reflected in banks' loan books, expose the banking sector to higher risks.
- We expect the COVID-19 pandemic to exacerbate banks' existing structural weaknesses and put pressure on already modest profitability.
- Unlike the 2008 financial crisis, banks are entering the downturn with comfortable capital and liquidity buffers.

Key credit drivers

Material concentration risks in banks' loan books offset by strong capital. We view the risks to be elevated due to the banks' structural exposures to local small and midsize enterprises--including tourism and commercial real estate--which we see as more vulnerable sectors in the current context. However, the banks counterbalance the risks embedded in the local economy with high capital ratios.

Risk of a prolonged decline in profitability levels. We view the banks' short- to medium-term earnings prospects as bleak given the sharp reduction in economic activity in 2020, the fast decline of interest rates, mounting credit provisions, and fierce competition from pension funds' mortgage lending.

Funding and liquidity positions remain stable. Banks' wholesale funding needs are limited in 2020, which, coupled with the announced additional central bank liquidity facilities and dividend payment cancellations, support liquidity buffers.

Key assumptions

We expect GDP to fall by more than 7% in 2020, followed by a rebound of almost 5% in 2021. The longer and deeper the economic contraction, the more it could impair Icelandic banks' asset quality, increase credit losses, reduce business and revenue generation, and erode capital.

Credit provisions will increase materially as the effects of the COVID-19 pandemic continue. We expect the total amount of nonperforming assets on average loans to exceed 5% in the next two years (from about 3% in 2019).

The privatization of the two state-owned banks is likely to be delayed. We anticipate that banks will put capital optimization and initial public offering discussions on hold until there is greater certainty regarding the effect of the COVID-19 pandemic.

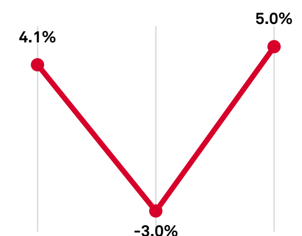
What to look for over the next year

Deteriorating asset quality trend. Economic risks are increasing for Icelandic banks due to growing imbalances in the corporate sector, combined with asset quality deterioration. The duration and longer-term effects of the COVID-19 pandemic, especially on tourism-related activities and real estate, largely determine the asset quality trend, which is on the downside, albeit highly fluid.

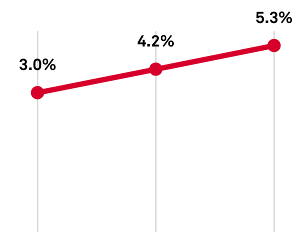
Real estate price developments. GDP dropping, unemployment rising sharply in 2020, and the supply of properties at a sustained level, add uncertainties to real estate prices. This particularly applies to commercial real estate, where prices in recent years have diverged from fundamentals such as construction costs and operating surplus per square meter of property.

Iceland

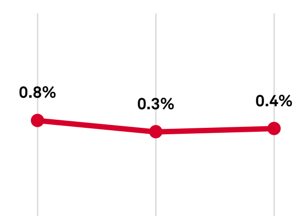
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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a--Actual. e--Estimate. f--Forecast.

Ireland | BICRA Group: 4

COVID-19 Pandemic Adds To Existing Profitability Pressure

Key takeaways

- The COVID-19 pandemic will take a toll on the Irish economy in 2020, with a sharp 10% GDP contraction in 2020, followed by a strong recovery in 2021-2022.
- The shock caused by current crisis will put significant pressure on Irish banks, taking into account structural profitability challenges the banking sector faces.
- We think Irish banks' balance sheets remain robust and should support the banks' creditworthiness through the sharp recession.

Key credit drivers

Economy vulnerable to shocks. As a small and very open economy, Ireland is very sensitive to global developments such as this year's recession. We expect Ireland's GDP in real terms to contract by more than 10% in 2020, after posting one of the strongest growth rates among advanced economies over recent years. The government has put in place a package of emergency measures to safeguard incomes and prevent business closures. These measures, together with Ireland's productive human and physical capital and flexible labor and product market regulations, position the economy well for a strong recovery in 2021-2022, although there remains considerable uncertainty around its timing.

Further pressure on profitability. Irish banks' profitability was not prominent pre-COVID-19 and banks were continuously missing their profitability targets due to their high cost bases. The average cost-to-income ratio of about 70% is higher than that in other European banking systems. Cost reduction remains a challenge as Irish banks continue investing into business transformation and digital capabilities, amid compressing interest margins and lack of business diversity. We expect weaker revenue generation on the back of business slowdown and stiff competition due to high industry concentration and the relatively small size of the domestic economy and bankable population. The inevitable rise in credit losses will further dampen banks' bottom-lines.

Good capital buffers and liquidity cushion. Thanks to years of deleveraging, cleanup of balance sheets, and focus on risk management improvements, Irish banks entered the pandemic with good capital buffers and ample liquidity position. Despite some decreases expected in capital ratios, whether measured by regulatory ratios or S&P Global Ratings metrics, we expect them to remain robust and allow Irish banks to withstand the drop in profitability and absorb unexpected credit losses.

Key assumptions

Rising credit costs. This is despite support and forbearance measures that the government and banks introduced to contain the damage from the pandemic. As of now, we estimate that domestic credit losses could rise to 60 basis points (bps) in 2020 and 50 bps in 2021, from only 21 bps in 2019.

Nonperforming assets to increase, but not massively. Mortgages represent a substantial part of Irish banks' loan portfolios and their quality has improved on the back of nonperforming loan sales, improving underwriting standards, and macro prudential rules imposed by the regulator. We see major risks to asset quality to come from exposures to domestic midsize enterprises and corporates. We are only likely to have better visibility on the quality of banks' loan portfolios and their impact on bank performance in 2021.

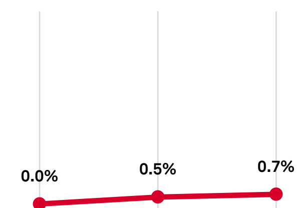
What to look for over the next year

External risks. Pre-COVID-19 concerns related to a disruptive Brexit and an escalation of global protectionism have not disappeared and remain medium-term risks for both the Irish economy and banks.

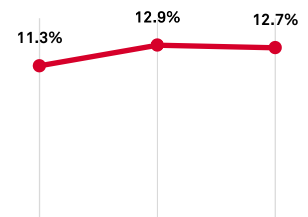
Primary Credit Analyst
Anastasia Turdyeva
Dublin
anastasia.turdyeva@spglobal.com
+353-1-568-0622

Ireland

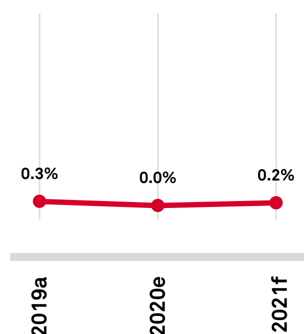
Loan growth



NPA ratio



RoAA



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Italy | BICRA Group: 5

Recession Could Accelerate Structural Sector Changes

Primary Credit Analyst
Mirko Sanna
Milan
mirko.sanna@spglobal.com
+39-272-111-275

Key takeaways

- The sharp contraction in economic activity in 2020 is likely to affect a large number of small and midsize enterprises (SMEs) to which the Italian banks are particularly exposed, in our opinion.
- We think most banks in Italy appear better equipped to deal with a near-term shock than in the previous recession, although the downturn will amplify some institutions' weakness.
- European authorities' supportive measures will mitigate any potential risks arising from Italian banks' exposures to market turbulence.

Key credit drivers

The pace and strength of the recovery. The policy responses taken in Italy might not be totally successful in avoiding permanent economic damage. If the recovery is not as robust as we currently anticipate, this could have a meaningful effect on asset quality, revenue, profitability, liquidity, and potentially capitalization.

Some banks entered 2020 with significant legacy nonperforming exposures (NPEs) and lower capital buffers than peers. As of December 2019, the stock of NPEs net of provisions represented 40% of Italian banks' core Tier 1 capital on average, compared with the 5%-20% we see in higher rated banking sectors.

Key assumptions

Recession to hit hard in 2020. We expect Italy's GDP to contract by 9.5% in 2020, before to growing by 5.3% in 2021, and 2.3% in 2022. The government's flexibility to further adjust its policy to sustain economic growth remains constrained, compared with other countries, by its high level of debt, which is likely to exceed 140% of GDP in 2021.

A steep rise in credit losses. We expect credit losses of 140 basis points (bps)-150 bps in 2020, and 120 bps-130 bps in 2021, therefore at least doubling compared with the 68 bps-70 bps reported in 2019. This will stem from a rapid increase of NPEs we see occurring by the end of 2020, primarily from SMEs. We anticipate that those losses will remain lower overall than those experienced at the peak of the previous double dip recession.

The European Central Bank's (ECB's) enhanced liquidity measures and large deposit base to mitigate refinancing risk. Italian banks' access to affordable unsecured wholesale funding remains constrained by uncertainties about the sovereign's creditworthiness and economic prospects. Still, near- to medium-term refinancing risk has abated, given the abundant liquidity provided by the ECB, the large deposit funding base, and the banking sector's very low external position, with only 5% of reliance on wholesale funding.

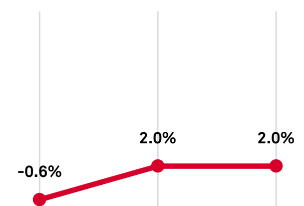
What to look for over the next year

Asset quality trends. The recession will severely test the resilience of the banks' credit quality, and the progress banks have made over recent years in management and underwriting standards. The latter should be a differentiating factor compared with the previous financial crisis.

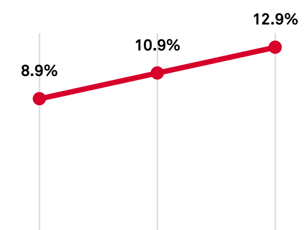
Further consolidation in the banking sector. We anticipate that this recession could further impair the Italian financial system's modest earning capacity and amplify business model sustainability risks for a number of banks, especially the smaller and undiversified ones. In our opinion, the relatively high cost base, compared with the amount of revenue banks can generate, constrains banks' ability to cushion rising business and credit losses. We think this could create more economic incentives for structural changes in the banking sector, including further consolidation over time. As such, the outcome of Intesa Sanpaolo's ongoing takeover of UBI Banca will likely attract investors' attention over the coming months.

Italy

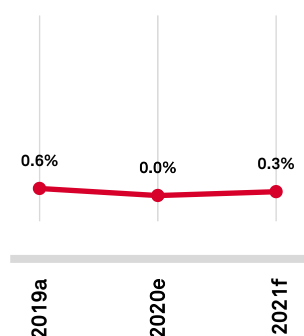
Loan growth



NPA ratio



RoAA



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Liechtenstein | BICRA Group: 2

Strong Bank Ratings With Relatively Little Sensitivity To Recession

Key takeaways

- Ratings are less susceptible to domestic economic swings but exposed to global wealth levels, which depend on capital market valuations.
- Despite a push for global tax conformity over recent years, Liechtenstein's banks have fared relatively well, with only temporary money outflows.
- Extreme market volatility can lead to margin calls and sometimes losses in Lombard lending, despite generally conservative risk management.

Key credit drivers

Banks in Liechtenstein remain vulnerable to reputation risk. Private banks' activities are quite confidence sensitive. We see as the main risks: a major outflow of funds, which could be triggered by tax-code revisions in other countries; reputational damage in the event of any money-laundering allegations; and weak investment performance.

High competition and margin pressure. The recent slump in asset valuation reduced the private banking assets under management and, as a result, the banks' earnings base. This could further intensify competition, in turn leading to continuing pressure on margins. It could also increase the likelihood of further consolidation.

Key assumptions

Lombard lending capacities will play a vital role in new customer generation, especially in Asia. Lombard lending is a key product offered by private banks, complementing the advisory and wealth management business. We assume that banks will not ease their underwriting standards in their quest to attract new customers. Varying degrees of Lombard usage by customers in their asset allocation will, however, lead to volatile lending volumes and related interest income.

Lending will remain low risk. Banks' sound risk management practices, predominantly collateralized low-risk lending, and wealthy customers imply that traditionally low credit losses are unlikely to increase materially in a downturn.

Liechtenstein's open economy is quite resilient to GDP shocks and will quickly recover. This should ensure relatively low credit losses from domestic lending business that is anyway largely collateralized. Based on the banks' low sensitivity to the domestic economy, we do not expect ratings to change as a result of the 2020 recession.

What to look for over the next year

Release of the local minimum requirement for own funds and eligible liabilities (MREL) framework and bank-specific requirements. Material subordination requirements and clear paths to achieve them could provide for additional loss-absorbing capacity buffers for senior unsecured creditors, potentially leading to rating uplift for systemically important banks.

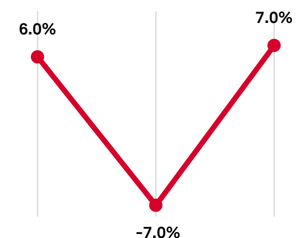
Banks' appetite to increase scale through inorganic growth. Large mergers and acquisitions could temporarily reduce capitalization. COVID-19 and the related expected slump in profitability and continuing margin pressure may push out smaller banks, and could let established players reconsider their private banking footprints.

Continuing pressure from tax-conformity and regulatory initiatives such as the EU's Markets in Financial Instruments Directive, referred to as MiFID II. We expect increasing price transparency and competition will likely continue to weigh on global private banking margins.

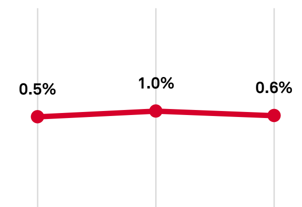
Primary Credit Analyst
Heiko Verhaag
Frankfurt
heiko.verhaag@spglobal.com
+49-69-3399-9215

Liechtenstein

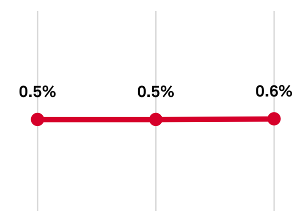
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming assets as a % of system wide loans.

RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Luxembourg | BICRA Group: 2

Prosperous Economy, Transient Cool-Off In Market Dynamics

Primary Credit Analyst
François Monéger
Paris
francois.moneger@spglobal.com
+33-1-4420-6688

Key takeaways

- Luxembourg is a prosperous economy with low government debt and unemployment and a strong economic growth performance, interrupted in 2020 by COVID-19's negative impact; however, we believe that any slowdown in house price growth will be temporary.
- The banking sector enjoys low cost of credit risk, albeit likely to pick-up in 2020, and local banks have strong funding profiles, with domestic deposits exceeding loans.
- Banking supervision is complex, given that most players are subsidiaries of foreign banks and the sizable nonbanking financial sector, while the banking sector has some vulnerability to regulatory and reputational risks.

Key credit drivers

Growth in real-estate prices compared with growth in GDP. Real-estate prices have increased materially faster than GDP for several years. Positively, this was not fueled by credit. Although the rapid price growth was primarily due to the lack of supply and an expanding population, we think that a deterioration in housing affordability could in turn undermine consumption and economic growth. We believe that any slowdown in house price growth in the wake of the COVID-19 pandemic would be temporary. Although not our central scenario, we see a hard landing in house prices as one of the main growth risks.

Domestic credit to the private sector is increasing faster than GDP. Domestic credit growth has been on a marked upward trajectory in the past three years. While we estimate that credit risk in the system is low and underwriting standards were not relaxed during this period, a sustained increase in domestic credit in excess of GDP growth informs our view on economic risks and potential imbalances in the banking sector.

Key assumptions

Luxembourg's economic growth will halt in 2020. We expect real GDP to experience a mid-single-digit decline in 2020--less severe than in most other European countries--and a recovery in 2021.

Real-estate prices will remain high. Real house price growth accelerated in 2019, to average a high 7% over the past four years: we expect the pandemic's impact to curb this trend, albeit temporarily.

Domestic credit will continue growing and we expect a spike in the cost of risk. Over 2020-2021, we forecast low-single-digit annual growth in domestic credit to the private sector, supported by moratoria and the state guarantee scheme for new bank loans in response to COVID-19. We expect sizable increases in credit losses in the domestic retail and corporate markets, although from the very low levels experienced in 2019.

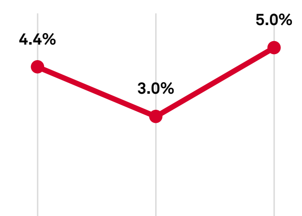
What to look for over the next year

Trends in domestic lending and house prices. Several years of strong dynamics in domestic credit and real-estate prices led us, in January 2020, to see an increased risk of a buildup of economic imbalances. We will continue to monitor over-heating risks, as well as any risk of a hard landing in real-estate prices. The European macro-environment and economic background, and future trends in Luxembourg's GDP, will obviously be underlying key parameters.

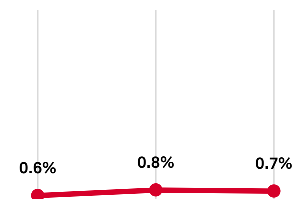
Luxembourg's approach to international tax initiatives and changes to its tax regime. By changing its approach to fiscal competition, with more focus on headline tax rates than on tax exemptions, Luxembourg has engaged in adjusting its tax regime to face pressures from the international community, which includes the European Commission's review of certain rulings under EU state-aid rules. Changes are likely to be gradual, but further measures to adapt to international tax competition and regulation, which would alter the Luxembourg tax regime, could weigh on the economy and, in turn, on banking revenues.

Luxembourg

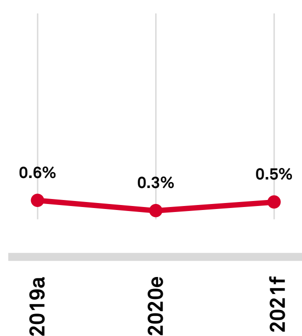
Loan growth



NPA ratio



RoAA



Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming assets as a % of system wide loans.

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a--Actual. e--Estimate. f--Forecast.

Malta | BICRA Group: 5

COVID-19 Will Undermine Banking Sector Performance

Key takeaways

- The 2020 contraction in economic activity will affect the tourism and real estate sectors, which account for an important share of banks' credit exposure.
- Maltese banks' asset quality is likely to weaken and erode the sector's profitability in 2020.
- We expect Malta's regulators will increasingly address supervision shortcomings and strengthen banking sector oversight.

Key credit drivers

Rise in credit risk for Maltese banks. Malta's banking sector has high exposure to tourism-related activities. In addition, we think there is growing risk of a residential property price correction.

Nonperforming exposure is likely to increase. We expect a reversal of the positive momentum that saw nonperforming asset (NPA) reduction reach 4.8% in 2019. However, forbearance measures could delay loans' recognition as nonperforming to 2021.

Malta and its financial sector are still facing high reputational risks. Weaknesses in regulatory financial and anti-money-laundering supervision represent a risk to the sector's macrofinancial stability.

Key assumptions

The Maltese economy will enter a recession in 2020. We expect Malta's GDP to contract by 4% in 2020, followed by a 4.4% growth in 2021, and 3.5% in 2022. Malta's small and open economy, with its large share of tourism, makes it vulnerable to economic slowdown in the eurozone, while tourism is likely to be among the last activities to rebound.

Credit losses will increase substantially. We expect the steps taken by Malta's government and central bank will provide some support to the affected businesses and households, but will not prevent an increase in credit losses in 2020 before a gradual recovery in 2021

Solid funding and liquidity profile. Due to a high level of household savings, the banks enjoy a solid funding base from customer deposits. At the same time, the banks are very liquid, with a system-wide domestic loan-to-deposit ratio of below 60%.

What to look for over the next year

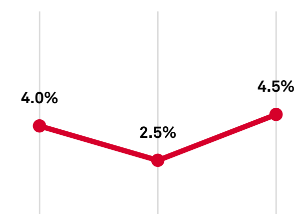
Residential property prices may see a correction. After several years of booming real estate market, largely supported by tourism demand, we now think there is increasing risk of a price correction. Considering 65% of the Maltese banks' lending is to the real estate sector (retail and commercial and residential mortgages), this poses risks to the banking system's financial performance.

Progress in financial supervision. Maltese supervisory bodies are actively working to address deficiencies in financial sector oversight, such as shortcomings in the anti-money-laundering framework. We consider the measures being taken as positive, and expect to see additional progress in this area.

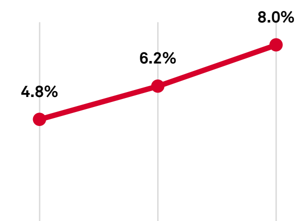
Primary Credit Analyst
Lena Schwartz
Ramat Gan
lena.schwartz@spglobal.com
+972-3-753-9716

Malta

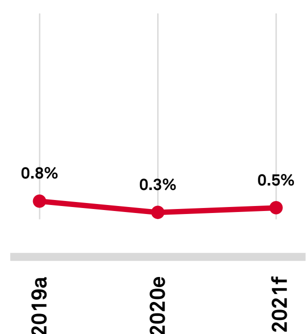
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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a--Actual. e--Estimate. f--Forecast.

The Netherlands | BICRA Group: 3

Resilience, Despite Inevitable Rise In Credit Losses In 2020

Key takeaways

- The COVID-19 pandemic will take a toll on the Dutch economy in 2020, with a close-to 6% contraction expected in 2020, followed by a dynamic rebound in 2021.
- Asset quality will deteriorate in 2020, but the government's support package to the economy should prevent deep and long-lasting damage to the private sector's credit quality.
- Profitability will weaken in 2020 due to a rise in loan-impairment provisions. Dutch banks' fundamentals remain sound, with low risk profiles, healthy capitalization, and cost-efficient models.

Key credit drivers

Recession in 2020. The COVID-19 pandemic and its implications will lead to a sharp downturn in 2020, followed by a dynamic rebound in 2021. The government has implemented a comprehensive package of measures to shield businesses, and employees, from the consequences of the pandemic. Structural features such as the Netherlands' wealthy and diversified economy, strong labor market, net external creditor position, and sizable fiscal space should help prevent longer-lasting damage to the economy.

Short-term pressure on banks' profitability is inevitable. We expect COVID-19 will lead to weaker revenue generation, due to the cumulative effect of business slowdown and payment holidays granted to customers, as well as higher domestic credit losses in 2020. In our view, losses will converge toward 50 basis points (bps) in 2020 before moderately reducing to 34 bps in 2021, from an average of 15 bps in the past five years. Main pockets of risks include export-oriented corporates, small and midsize enterprises, or cyclical sectors such as energy or transportation. Although profitability metrics will weaken in 2020, we believe Dutch banks will remain adequately profitable and with robust balance sheets.

Operating conditions remain fundamentally healthy for banks. We observe supportive price discipline in the competitive mortgage lending segment, a large part of Dutch banks' balance sheets, and favorable dynamics in the property market (structural supply shortage). Due to their well-advanced digital strategies, banks have generally efficient cost bases and lean operating models, which help in an environment of persistently low interest rates and rapidly changing customer preferences.

Key assumptions

An economic rebound in 2021. We expect a 3.9% rebound in 2021, following a 5.9% recession in 2020, thanks to unprecedented policy responses from a 'AAA'-rated sovereign in the form of monetary, fiscal, and regulatory support. The increase of nonperforming loans should be manageable, plateauing at about 3.4% in 2020 and 2021. We expect the sector to stay profitable in 2020, and a gradual recovery in 2021.

Household leverage remains high, on a gross basis. We consider that household indebtedness will continue to reduce over time with the gradual move away from interest-only mortgages, while remaining high in a European context. Still, the substantial savings and financial assets held by Dutch households mitigate credit risks in the retail segment for banks. We do not expect any stress in the residential real-estate market. We expect property price correction to be modest, after years of high-single-digit growth, turning to -0.7% in 2020 and -1.3% in 2021.

What to look for over the next year

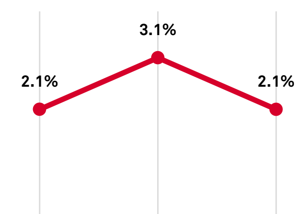
Pre-COVID-19 external risks remain. Concerns related to global trade tensions, and Brexit, remain a lingering risk for the open Dutch economy and its banks.

The banking sector will need to adapt to upcoming regulatory reforms. Banks will have to continue strengthening their balance sheets, adjusting their business models and financial strategies to Basel III regulatory capital changes ("Basel IV").

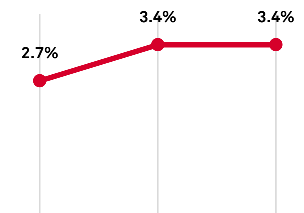
Primary Credit Analyst
Pierre Gautier
Paris
pierre.gautier@spglobal.com
+33-1-4420-6711

The Netherlands

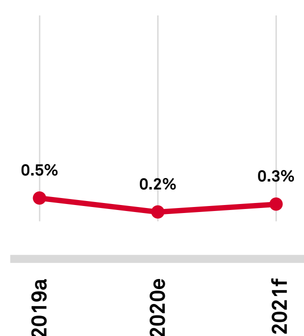
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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Norway | BICRA Group: 2

A Resilient Banking Sector Despite Oil-Price Decline And COVID-19

Key takeaways

- Strong capital and liquidity buffers, a diversified economy, and ample reserves in Norway's sovereign wealth fund, backing strong government support to businesses and households, will help Norwegian banks to withstand the combined pressure from the COVID-19 pandemic and the sharp decline in oil prices.
- Still, the current macro stress will result in intensifying pressure for the banking sector's asset quality, revenue, and profitability over the next two years.
- Despite the traditional reliance of Norwegian banking on wholesale funding, the capital markets show resilience, benefiting the sector's access to funding.

Key credit drivers

Increased economic risks owing to a challenging macroeconomic environment. We expect Norway to undergo a sharp recession in 2020, followed by a rebound in economic growth starting from 2021. This, together with an unprecedented move by the central bank of Norway in cutting the key policy rate to zero in May 2020, will result in a much tougher environment for the banking sector, weighing significantly on banks' margins, asset quality, revenue, and profitability over the next two years.

High household debt levels are a potential concern, although the mortgage portfolio is expected to show resilience. We consider that the residential mortgage portfolio, which accounts for about 55% of total bank loans, will be more resilient to the present stress than the corporate sector exposure, thanks to various government employment and income support measures. That said, we recognize some latent risks to banks from structurally high household debt levels (232% of GDP at end-2019), driven by strong growth in house prices over the past decade, and banks' exposure to the cyclical commercial real estate segment.

Sector profitability is under strain, but robust capitalization and advanced digital transformation will help Norwegian banks weather the stress. The banking sector has accumulated strong capital buffers due to solid profitability over recent years, providing a cushion against the expected deterioration of asset quality. Moreover, Norwegian banks have benefited from being at the forefront of digital transformation in banking. In a context of social-distancing requirements, this should enable banks to continue providing high-quality service to customers and keep their costs under control.

Key assumptions

Significant economic contraction of 6.2% in 2020, followed by a 3.9% rebound of growth in 2021. These forecasts are based on our current expectations regarding recovery in the domestic and international economy, with a potentially longer-than-expected economic recovery representing a downside risk.

Increase in credit risk in the next two years. We expect credit costs to reach 0.3%-0.4% in 2020-2021 compared with 0.15%-0.20% in the previous two years.

What to look for over the next year

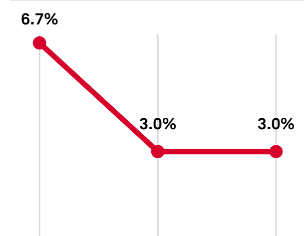
The pace of domestic and global economic recovery is key to recovery. Government support has cushioned some of the negative economic shock, but being a small and open economy, Norway's recovery prospects are closely linked to how fast international trade and global economic growth will recover.

We expect senior nonpreferred issuance to take longer time as the deadline has been extended by the regulator. Following the implementation of a resolution regime in 2019, banks are expected to increase their issuance of qualified instruments; however, the Norwegian regulator has extended the implementation deadline in response to the COVID-19 stress.

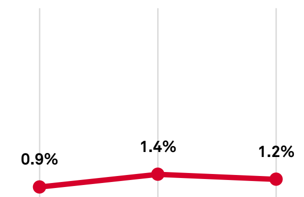
Primary Credit Analyst
Natalia Yalovskaya
London
natalia.yalovskaya@spglobal.com
+44-20-7176-3407

Norway

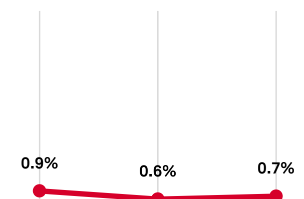
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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a--Actual. e--Estimate. f--Forecast.

Portugal | BICRA Group: 6

2020 Economic Shock Will Delay Convergence Toward Peers

Primary Credit Analyst
Lucia Gonzalez
Madrid
lucia.gonzalez@spglobal.com
+34-91-788-7219

Key takeaways

- This year's severe global recession will hit Portugal's small and open economy hard, particularly the labor-intensive tourism industry, which in 2019 made up 12.2% of GDP.
- The Portuguese private sector faces this crisis with far less debt, after having significantly deleveraged over the past decade, but indebtedness remains high, at about 155% of GDP at end-2019.
- Portuguese banks will continue to benefit from an ample and stable customer deposit base, but their asset quality and profitability will deteriorate from already weaker levels than those of closest European peers as banks' cleanup of nonperforming exposures (NPE) halts, domestic NPEs likely climb above 10% in 2020, and return on equity (ROE) remains below 3% in 2020-2021.

Key credit drivers

Banks enter this crisis with a high ratio of NPEs still on their books from the prior downturn. We estimate the domestic NPE ratio was 8.5% at end-2019, which is higher than European peers', despite significant heterogeneity among the largest players. The current economic shock will hamper banks' efforts to reduce NPEs, and the cost of risk will likely rise significantly this year and next, to 150-175 basis points.

Heightened pressure on already limited profitability prospects. The hit from COVID-19 will aggravate banks' earnings prospects, already pressured by ultra-low interest rates and weak margins. This, together with higher credit losses, will leave the banking system only modestly profitable this year, before recovering slightly in 2021, with ROE below 3% in both years.

Rebalanced funding profiles. Portuguese banks have significantly rebalanced their funding profiles over the past decade, with deposits now accounting for the bulk of their funding structures and fully financing their loan books, while benefitting from ample liquidity.

Key assumptions

The economy will contract significantly in 2020. We anticipate that this year's global recession will hit Portugal hard, with GDP contracting by 7.7%, before expanding by 4.2% in 2021 and 4.0% in 2022, and the unemployment rate surging to about 11.5% from 6.5% at end-2019.

The property market will reverse its increasing trend. Nominal house prices will likely decline by 2.5% in 2020, after having grown by almost 30% cumulatively in the last three years, and recover only modestly by 1.1% in 2021. We anticipate that foreign demand will remain a key driver of the housing market.

Authorities will maintain a supportive stance. The substantial support and flexibility that the banking system receives from public authorities will induce banks to continue lending to households and corporates, and curb banks' funding and liquidity risks.

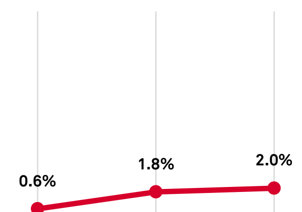
What to look for over the next year

Effectiveness of the government's and banks' measures to tackle the COVID-19 challenges. The economic rebound, which we anticipate will start later in 2020, and the effectiveness of measures implemented will be key in assessing and containing the negative impact on banks' credit profiles.

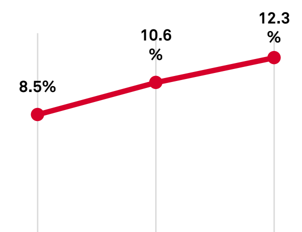
Progress in restructuring Novo Banco. The recession may hinder Novo Banco's plans to restore its financial profile. Of the €3.89 billion the Resolution Fund committed under its contingent capital agreement, only €0.9 billion remains.

Portugal

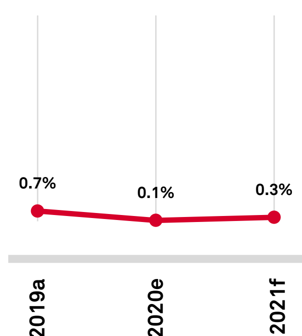
Loan growth



NPA ratio



RoAA



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Spain | BICRA Group: 4

COVID-19 Halts The Good Economic Momentum

Key takeaways

- Spain will enter in an unexpected severe recession in 2020, amid an also complicated political landscape, and will only fully recover in 2022.
- The economy and the banks enter the shock having corrected previous imbalances and with stronger cushions, but still banks' asset quality and profitability are set to deteriorate.
- European and Spanish authorities' massive and unprecedented responses, providing low-interest-rate funding, credit mitigants, and regulatory relief, will help contain the damage.

Key credit drivers

Navigating an unexpected economic shock. Severe lockdown measures provoked a significant contraction of economic activity, which will take time to recover. Unemployment and public debt are set to climb from already high levels, increasing the challenges facing the just-formed minority coalition government. The private sector, however, confronts the shock with manageable debt. Banks had also completed the provisioning of their problematic portfolio left after the previous recession, although there remain high legacy assets on their books (7% of loans at year-end 2019).

Asset quality will deteriorate. Although support measures, from subsidies, to moratoriums, and state-guarantees, will help contain the damage, they cannot completely prevent it. Only by 2021 will we know the extent of the damage. But we expect credit losses will increase to 80-100 basis points in both 2020 and 2021. Spanish banks can absorb the shock with their existing capital cushions, some by only a slim margin.

Profitability challenges will heighten. Spanish banks have proactively tackled their costs. They benefit as well from longstanding relationships with clients. However, their prepandemic returns were not yet consistent with their cost of capital, and now achieving it looks more remote, as higher provisions will add to earnings pressure. This is more of a challenge for midsize banks and sets the ground for another wave of consolidation.

Key assumptions

The economic shock will be severe, but short. The economy will rebound in 2021 (+6.8% GDP growth versus -9.8% in 2020), and recover to pre-COVID-19 levels in 2022. Structural damage will be contained.

The European Central Bank will remain supportive. Banks will not face funding constraints, having access to sizable funding at attractive prices.

What to look for over the next year

Economic developments. If the recession is more severe or lasts longer, or the recovery is milder and longer, it would represent a harsher scenario than the one we are currently contemplating and could negatively affect some banks' ratings.

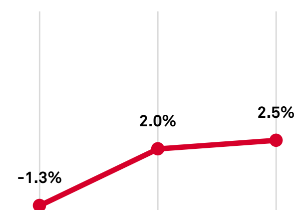
Evolution of banks' risk indicators. Only once the support measures expire will we be able to assess the underlying performance of banks' loan books and their ability to cope with it.

Banks' initiatives to ensure the sustainability of their business models. Banks will have to act decisively to offset further pressure on their net interest income from prolonged low rates, and to transform their operations to better serve clients in an increasingly digital world. This will imply generating more fee income and cutting costs, but also undertaking sizable investments.

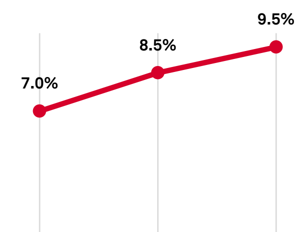
Primary Credit Analyst
Elena Iparraguirre
Madrid
elena.iparraguirre@spglobal.com
+34-91-389-6963

Spain

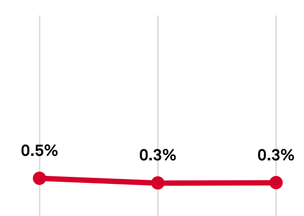
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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Sweden | BICRA Group: 2

Substantial Financial Flexibility Supports Swedish Banks

Key takeaways

- Swedish banks have entered the COVID-19 crisis from a position of strength in terms of profitability, asset quality, and capital levels vis-à-vis the European average.
- The Swedish housing market will remain broadly stable, yet banks remain highly sensitive to property price volatility.
- High private-sector debt in Sweden could pose risks if the pandemic induced recession continues longer than expected.

Key credit drivers

Swedish banks are vulnerable to swings in the housing market. Material exposure to property markets makes banks vulnerable to changes in house prices and households' debt-servicing capacity. Although we do not rule out a moderate price correction, we expect mortgage losses to remain limited.

Banks enter the crisis well prepared. Large capital buffers, digital maturity, and high cost efficiency and profitability should allow the banks to absorb the expected weaker asset quality and increased loan loss provisions in 2020-2021.

High dependence on wholesale funding. The higher share of wholesale funding relative to other European banking sectors increases the Swedish banking sector's confidence sensitivity. Still, the country's deep debt capital markets and the government's willingness to ensure liquidity and a well-functioning domestic covered bond market mitigate this risk.

Key assumptions

A deep recession in 2020. We forecast Swedish GDP will contract by 6.4% in 2020 before bouncing back to 4.8% growth in 2021. That said, the wide-ranging fiscal, monetary, and regulatory support measures will partially mitigate this sharp shock to the Swedish economy.

Some property price volatility can be expected. Although we do not rule out a moderate price correction in the residential housing markets and commercial property in real terms, we believe the impact on banks will be manageable, given the cushion from household wealth and widespread social welfare schemes, as well as banks' cash-flow focus on commercial property transactions.

What to look for over the next year

Asset quality trends. Banks' reporting on expected credit losses was scattered in the first quarter of 2020, with a wide range of assumptions in their provisioning. Hence, the coming quarters will reveal greater certainty on their relative resilience.

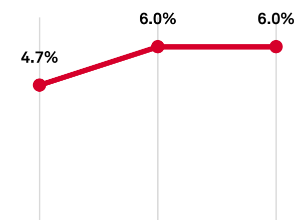
Developments in commercial real estate. Swedish property companies have significant bond maturities in 2020 and 2021 exposing them to refinancing risks, especially given the sector's dysfunctional funding environment for this sector over the past few months. That said, we expect banks will be willing to increase their lending to this sector, which is a mitigating factor.

Senior nonpreferred issuance likely to be delayed. The National Debt Office's recent decision to extend the phase-in deadline for subordination of minimum requirement for own funds and eligible liabilities to 2024 (from 2022) might delay the buildup of additional loss-absorbing capacity buffers at systemically important banks in Sweden.

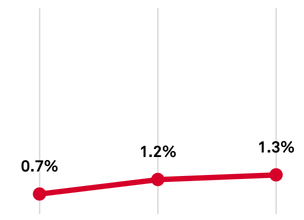
Primary Credit Analyst
Salla von Steinaecker
Frankfurt
salla.vonsteinaecker
@spglobal.com
+49-69-33999-164

Sweden

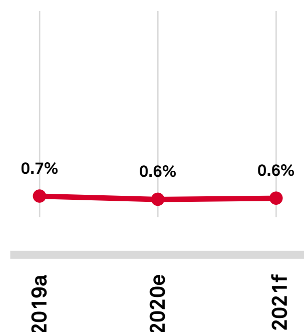
Loan growth



NPA ratio



RoAA



Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming assets as a % of system wide loans.

RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Switzerland | BICRA Group: 2

Banking sector will remain resilient

Primary Credit Analyst
Benjamin Heinrich
Frankfurt
benjamin.heinrich@spglobal.com
+49-69-3399-9167

Key takeaways

- Swiss banks' profitability prospects have weakened and asset quality will deteriorate in the wake of COVID-19, but banks will contain credit losses more than those in most peer countries.
- The Swiss banking sector will remain resilient against this economic shock, bolstered by the superior financial strength of both the household and corporate sector and banks' prudent underwriting standards focusing on collateralized lending.
- Banks' revenue will remain under pressure in a permanent ultra-low-interest-rate environment and political initiatives could further constrain the sector's profitability.

Key credit drivers

A very wealthy household sector. Switzerland's net per capita wealth levels place it among the top countries globally, with wealth evenly allocated among the population. We do not foresee any constraints in Swiss inhabitants' ability to service debt obligations because of COVID-19, thanks to the government's large corporate and household support schemes.

A stress-proof corporate sector. The Swiss corporate sector is significantly stronger than that of other countries. It has proven its resilience to shocks, including the global financial market crisis and the drop of franc's peg to the euro in 2015. The banks' reported nonperforming loans remained low and we saw nearly no increase in corporate bankruptcies following these events, which indicates superior resilience.

Residential mortgage loans dominate most customer portfolios. Switzerland ranks among the countries with the highest share of collateralized lending, mainly residential mortgage loans. Cyclical consumer loans occupy a niche in most Swiss banks' portfolios, which will support the robustness of asset quality during the economic downturn.

Key assumptions

Expectation of a strong economic rebound. We expect Swiss GDP to contract by 6.3% in 2020 because of the COVID-19 pandemic, before rebounding by 4.6% in 2021 and 3.4% in 2022. Government support measures in favor of the corporate and household sectors are substantial and we think Switzerland's economy will rebound swiftly, given its competitive and innovative economy.

Stable housing markets. We expect price growth in single-family housing and owner-occupied apartment segments to slow because demand will remain weaker for some time. The risk for a severe price correction is low, given it would require a significant rise in unemployment, which we consider unlikely. We also expect risks in the investment property segment to remain moderate, although the first signs of a price correction manifested before COVID-19 in some areas after immigration slowed.

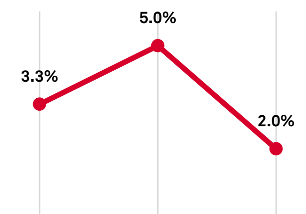
What to look for over the next year

Pressure on banks' profits. Low interest rates are keeping margin pressure on core products. Two political initiatives could further constrain profitability: 1) Abolishing the imputed rental value could decrease the size of banks' loan books and revenue capacity; and 2) Removal of lending restrictions on state-owned Post Finance would increase competition in the domestic market. The success of both initiatives remains highly uncertain, reflecting complex approval processes in Switzerland.

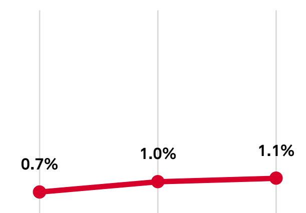
Combating money laundering. The stability of Switzerland's banking sector hinges on compliance with the highest anti-money-laundering-standards. New allegations of serious money laundering could lead us to review the sector's market discipline and the effectiveness of FINMA's supervision.

Switzerland

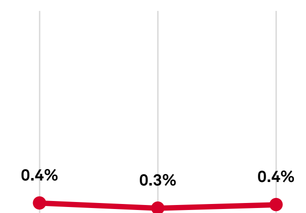
Loan growth



NPA ratio



RoAA



2019a | 2020e | 2021f

Loan growth – Sector-average growth in loans.

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

United Kingdom | BICRA Group: 3

Short-Term Earnings Misery But Long-Term Balance Sheet Resilience

Primary Credit Analyst
Nigel Greenwood
London
nigel.greenwood@spglobal.com
+44-20-7176-7211

Key takeaways

- In 2020, U.K. banks' earnings are facing a triple whammy from a net interest margin squeeze, reduced business volumes, and a sharp spike in loan-impairment provisions.
- The Bank of England and the U.K. government have implemented several significant measures to support U.K. banks, businesses, and households over the coming months.
- We consider that U.K. banks' balance sheets remain robust and should support their creditworthiness through the economic downturn.

Key credit drivers

Systemwide domestic loan losses will show the evolution of economic risk. We estimate that the domestic loan loss rate could rise to 100 basis points (bps) in 2020, which would be about 5x the level we have observed in each of the past six years. In 2021, on the back of the assumed economic recovery, we think that the loss rate could fall to about 67 bps, which we judge to be closer to, but slightly above, the long-term U.K. average.

The pace and strength of the economic recovery will be critical. As with many other banking systems, we currently assume that the U.K.'s economic recovery will commence in the third quarter of 2020. The U.K. has suffered from a surfeit of investor caution, mainly owing to the political impasse after the 2016 EU referendum and lasting through the conclusive outcome of the December 2019 general election, a period when economic growth was lackluster. Failure to conclude a satisfactory new trading arrangement with the EU in the second half of 2020 might delay or dampen the economic recovery.

Cost efficiency will underpin future profitability. With interest rates lower than we had assumed at the start of 2020, we see an even greater focus on lowering operating expense, including reappraisal of property needs. Digitalization and technology investments are inflating costs now, but will ultimately enable incremental headcount reductions and drive permanent efficiency gains.

Key assumptions

Credit losses won't push major banks into losses. Our current credit loss estimates alone should not push the major banks into being loss making in 2020. We note that the absence of payment protection insurance charges in 2020, in contrast to the cumulative £52 billion of provisions over the prior nine years, will provide partial support to year-on-year statutory profit comparisons.

Bank capitalization to remain solid. U.K. banks started the year with comfortable capital metrics, whether measured by regulatory ratios or S&P Global Ratings' metrics. The Bank of England's decision forcing banks to cancel their final dividend on 2019 earnings, as well as interim dividends in 2020, should help banks maintain solid capitalization. Notwithstanding the earnings shock in 2020, we assume banks will be positioned to resume typical shareholder distributions in 2021.

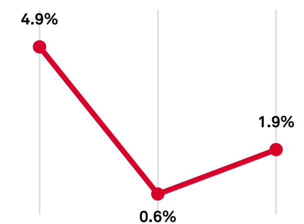
What to look for over the next year

The degree to which housing market activity recovers. The £1.5 trillion domestic residential mortgage market comfortably represents the largest component of U.K. banks' loan books. Advances for house purchase are normally about 60% of gross mortgage volumes, Property transactions, which have been muted since 2008, may need new incentives to recover from their recent extreme slump.

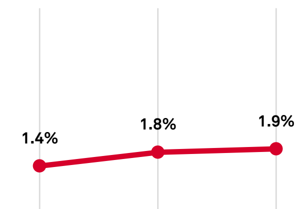
Smaller lenders. More than 20 smaller banks, building societies, and finance companies compete for business, either directly or at the margin, against the dominant banks. For many, the current economic downturn is the first true test of the robustness of their chosen business model.

United Kingdom

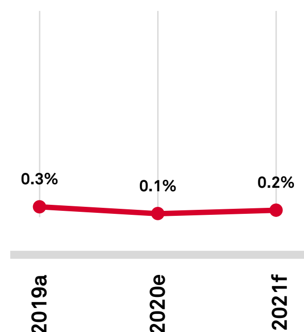
Loan growth



NPA ratio



RoAA



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CEEMEA

BICRA groups: lowest to highest

Group '1' to '10', from lowest to highest risk. BICRA--Banking Industry Country Risk Assessment. CEEMEA--Central and Eastern Europe, Middle East, and Africa. Data as of June 30, 2020. Source: S&P Global Ratings.

Armenia | BICRA Group: 8

Banking System Growth Will Resume In 2021

Primary Credit Analyst
Annette Ess
Frankfurt
annette.ess@spglobal.com
+49-6933-999-157

Key takeaways

- The Armenian economy will be less affected by the COVID-19 pandemic than some other Commonwealth of Independent States (CIS) countries.
- An adequate regulatory response and sufficient liquidity cushion in the banking system will enable banks to weather the current downturn.
- We expect nonperforming loans (NPLs) to increase to 8% and profitability to halve in 2020, with recovery starting in 2021.

Key credit drivers

Depreciation of the Armenian dram could aggravate the deterioration in credit quality due to COVID-19. Extremely high credit risk for Armenian banks reflects the very high share of loans in foreign currency, in particular to unhedged retail borrowers and companies.

Possible outflows of nonresident deposits. We believe that nonresident deposits (mainly from Armenian diaspora), which accounted for about 30% of total domestic deposits at year-end 2019, could be more vulnerable to outflows during times of stress.

Key assumptions

We expect milder economic contraction and higher subsequent growth compared with the majority of CIS countries. We expect the Armenian economy will contract by about 2% in 2020, followed by 4.9% growth in 2021, under the assumption that economic lockdown and quarantine will be eased in the third quarter of 2020.

The banking system will remain highly dollarized. Even though we expect gradual de-dollarization to continue, the dollarization of loans and deposits will remain higher than in peer countries, at about 50%.

The effective regulatory response to COVID-19 will support Armenian banks. We believe that the banking regulator has taken timely and proactive measures to support the banking system during the current stress, including provision of additional liquidity, relaxation of capital and liquidity requirements, reduction of a key rate, and increase in the amount of guaranteed deposits, among others.

What to look for over the next year

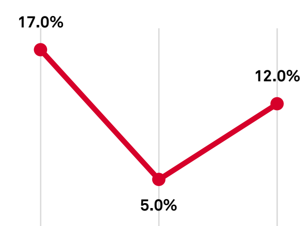
Asset quality will deteriorate but remain stronger than international peers'. We expect that NPLs (loans over one day overdue) in the banking system could increase to 8%-9% in 2020-2021, from 5.5% as of March 31, 2020, and credit costs could increase to 3% in 2020, from about 1.5% in 2019.

Profitability will deteriorate in line with international peers. We expect the banking system will remain stable, with no significant changes to the competitive landscape. At the same time, we expect return on assets to decrease to 0.8% in 2020, from 1.5% in 2019, due to a slowdown in loan growth, pressure on net interest margin, and an increase in cost of risk.

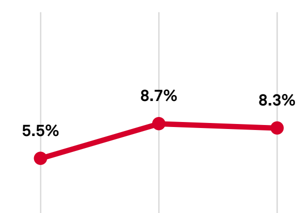
The Armenian banking sector will return to growth after a temporary correction in 2020. We anticipate loan growth of about 5% in 2020, increasing to 12% in 2021, driven by loans to consumers and small and midsize enterprises and loans under government support programs.

Armenia

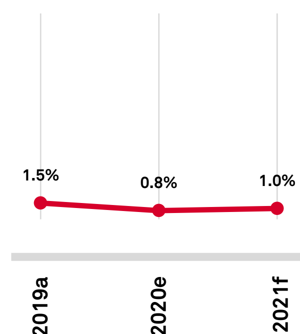
Loan growth



NPA ratio



RoAA



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RoAA – Sector-average return on average assets.

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Azerbaijan | BICRA Group: 9

Deteriorating Economy Will Hit Banks' Asset Quality And Profitability

Key takeaways

- Expected 6.6% economic contraction in 2020, due to the combined impact of the COVID-19 pandemic and a decline in oil prices, will lead to higher credit losses for banks.
- We expect nonperforming loans (NPLs) to double and profitability to erode in 2020, leaving some banks with barely breakeven financial results.

Key credit drivers

High dependence on the oil sector. Azerbaijan derives about 40% of its GDP, 50% of government revenue, and more than 90% of exports from the hydrocarbon sector. Lower oil prices will weigh on Azerbaijan's economic growth prospects. Combined with high sensitivity to potential currency depreciation, this exposes the banking sector to high economic imbalances and short credit cycles.

Operating conditions are weighing on banks' performance. We believe higher risks could stem from the banks' exposures to small and midsize enterprises and unsecured retail lending, which are likely to be hit harder than larger enterprises under the current macroeconomic scenario. For 2020, we expect that Azeri banks' new lending will slow, while credit costs will likely increase to 4.0% of their average loan books (versus an average 3.2% over 2015-2019).

Key assumptions

Sharp GDP contraction followed by gradual recovery. We expect an economic contraction of 6.6% in 2020 followed by a rebound of 2.6% over 2021. Azeri banks face growing challenges to their business growth and earnings prospects, which, along with persisting external vulnerabilities, could ultimately hit banks' capital buffers, asset quality, and funding stability harder than we previously envisaged.

Pressure on asset quality. We assume that NPLs may reach 12%-15% in 2020, compared with about 8% reported at year-end 2019. We believe that the peak in NPLs and the bulk of asset quality deterioration could crystallize only in 2021. Thus, the impact on Azeri banks' profitability from additional provisioning could be deferred over 2020-2021, which could to some extent lessen immediate reduction of capital buffers.

What to look for over the next year

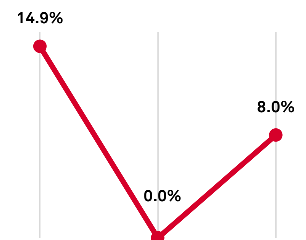
High dollarization of the funding base. Although the banking system has a relatively high level of core customer deposits and no high reliance on external funding, steep depreciation of the Azerbaijani manat over the past few years has led to protracted currency imbalances between banks' assets and liabilities, due to the increased, more than 60% share of foreign currency funding of banks' customer funds. We still view persisting currency mismatches as a high risk for banks. The volatile oil price environment has increased pressure on the manat. In our view, if oil prices remain low for a prolonged period, the authorities could allow the exchange rate to further weaken to avoid a substantial loss of foreign currency reserves, similar to what happened in 2015 when the manat suffered a steep 60% depreciation. Such a case would deal an additional blow to the banking sector.

Rising economic risk. If economic recession is deeper and pandemic containment measures are more prolonged that our current expectations, it would substantially increase risks for Azeri banks, challenging the adequacy of their capital buffers.

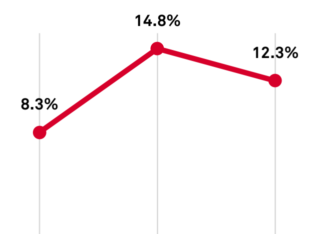
Primary Credit Analyst
Sergey Voronenko
Moscow
sergey.voronenko@spglobal.com
+7-495-783-4003

Azerbaijan

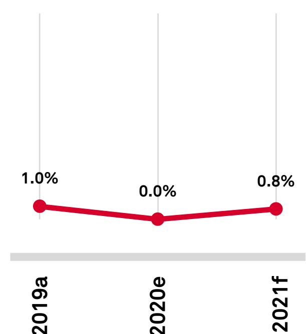
Loan growth



NPA ratio



RoAA



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RoAA – Sector-average return on average assets.

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Bahrain | BICRA Group: 7

External Funding Remains A Key Concern

Primary Credit Analyst
Zeina Nasreddine
Dubai
zeina.nasreddine@spglobal.com
+971-4-372-7150

Key takeaways

- Economic fallout from the COVID-19 pandemic and lower oil prices will weaken bank asset quality.
- We expect weaker profits, given tighter margins and higher credit costs.
- External funding remains vulnerable, though we expect continued foreign shareholder support.

Key credit drivers

External vulnerabilities. Lower oil prices and the COVID-19 pandemic will lead to slower economic growth that could intensify the risks of capital outflows. Bahrain's retail banks are in a net external liability position that could prove vulnerable to domestic or regional stresses. Positively, a portion of external funding comes from supportive foreign shareholders.

Exacerbated real estate pressures. We expect to see higher pressure on the real estate sector, given the economic shutdown. This will in turn weaken bank asset quality, given their high exposure to real estate. We could see an increase in nonperforming loans, from relatively high levels compared with Gulf Cooperation Council (GCC) peers, coupled with an increase in cost of risk, putting pressure on profitability.

Key assumptions

Bahrain's economy to contract. We forecast a 5% contraction of real GDP this year as the COVID-19 pandemic and lower oil prices reduce consumption and investment activities. Bahrain's small economy will also be affected by the slowdown in larger GCC economies, given the close linkages, for instance through the tourism, transportation, and real estate sectors.

Bahrain's funding supported by other GCC countries. Although we do not expect a decline in the oil and gas sector, since Bahrain is a small producer and not subject to OPEC cuts, other large sectors such as financial services and manufacturing will likely slow. The $10 billion of financial support from other GCC sovereigns will partly cover the government's funding needs until 2023.

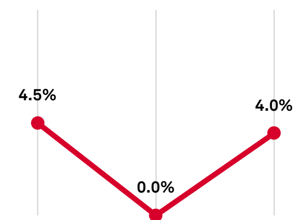
What to look for over the next year

Profitability is likely to weaken. We expect loan growth will reach low-single digits in 2021-2022 as economic conditions gradually improve. Coupled with lower margins and high cost of risk, we expect the overall profitability of the banking system to decline.

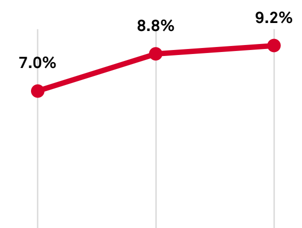
GCC support. We consider that the Central Bank of Bahrain (CBB) has limited ability to maintain the peg of the Bahraini dinar to the U.S. dollar, since the country's reserves do not cover the monetary base. However, support from other GCC sovereigns bolstered the reserve position in 2019 and we expect further support, if needed.

Bahrain

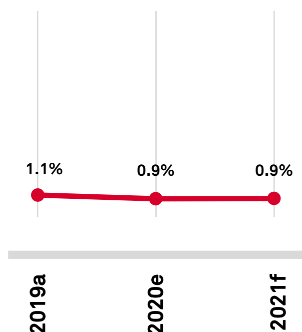
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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Belarus | BICRA Group: 10

High Credit Costs To Persist Amid A Deteriorating Economic Environment

Key takeaways

- We expect asset quality to deteriorate, following Belarus' GDP contraction by 5% this year on the back of deteriorating external trade and financing conditions due to the coronavirus pandemic.
- Foreign currency risk remains significant for the banking system, given a high level of loans and deposits denominated in foreign currency.
- Relatively stable customer deposits will continue supporting banks' funding profiles.

Key credit drivers

Economy sensitive to external conditions. Aggravating Belarus' already weak underlying economic performance in the beginning of the year, most of Belarus' trading partners will be in recession this year, owing to the impact of the COVID-19 pandemic. Therefore, we expect Belarus' economy to contract this year, leading to a deterioration of asset quality in the banking sector. Additionally, Belarus' fiscal and balance-of-payments positions remain vulnerable and characterized by a high proportion of government debt denominated in foreign currency, a heavy debt repayment schedule, and sensitivity to external conditions, including relations with Russia and prospects for economic recovery in Europe.

High exposure to foreign currency risk. High levels of foreign-currency-denominated deposits and loans (61% and 50% of the total, respectively) pose downside risks for the banking system. Although the regulator has introduced a number of supporting measures and most foreign currency-denominated loans are granted to borrowers with foreign currency cash flows, with the now more challenging operating environment for banks, currency risk will likely increase. Specifically, recent weakening of local currency, coupled with the economic recession this year, will likely have a negative impact on the asset quality of the banking sector over the medium term.

Key assumptions

Economic recovery following a sharp GDP contraction in 2020. We expect the COVID-19 pandemic will result in real GDP contracting by 5% in 2020, with a recovery likely to start in the third quarter of 2020, leading to a rebound of 3.5% in 2021. However, if economic recession in Belarus and its key trading partners is deeper or more prolonged than we currently expect, this could result in a further increase in risks for the banking sector.

Rise in credit losses. Significant dollarization, vulnerability of domestic borrowers to adverse economic conditions and lending and underwriting standards that remain relaxed in an international context will likely have a toll on banking sector asset quality over the next two years. Therefore, we forecast credit losses will rise to 4% in 2020-2021 versus approximately 3% in 2019 and 4.5% observed over the previous crisis in 2015.

Stability of customer deposits. Despite some deposit outflow observed in late March and in April, we believe that domestic deposits--the major funding source for banks in Belarus--will remain relatively stable. Fixed-term retail deposits introduced in 2016 that limit withdrawal options but offer slightly higher rates will continue to support the sector's funding stability, as will the lack of investment alternatives.

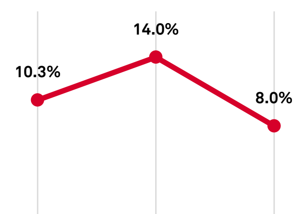
What to look for over the next year

Evolution of economic risk indicators. We think banks might use different approaches in creating provisions and reporting asset quality over the coming quarters, and the full picture of how well the sector copes with the current stress might only become clear toward the end of 2020. Further extension of the prudential requirements relaxation could be an indication of banks' weaker asset quality and lower capital buffers than currently reported under the local standards.

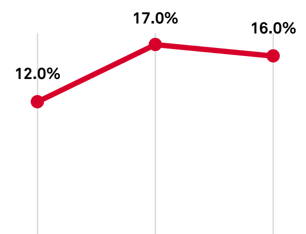
Primary Credit Analyst
Anastasia Turdyeva
Dublin
anastasia.turdyeva@spglobal.com
+353-1-568-0622

Belarus

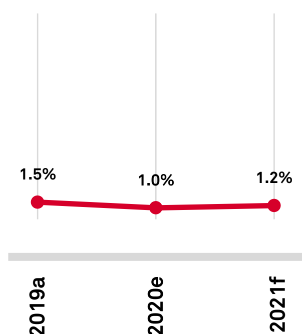
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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RoAA – Sector-average return on average assets.

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Croatia | BICRA Group: 7

Deepening COVID-19 Risks Might Affect Asset Quality

Primary Credit Analyst
Marta Heras
Madrid
marta.heras@spglobal.com
+34-91-389-6967

Key takeaways

- We expect Croatian banks' earnings and asset quality to weaken through end-2020 and 2021, but banks to remain profitable.
- Economic recovery starting in 2021 will help contain credit losses.
- We anticipate that banks will receive capital, liquidity, and operational support from foreign strategic shareholders if needed.

Key credit drivers

Nonperforming exposures (NPEs) are higher than peers'. Croatian banks have made significant progress in reducing their NPEs. At end-2019, the NPE ratio decreased to about 7%, from 17% at year-end 2014. However, we expect this trend to reverse, and asset quality to deteriorate in coming quarters on the back of a contracting economy and reduced tourism activity. Specifically, we forecast NPEs will stand at about 9%-10% in 2020 and 2021.

We believe that domestic banks' profitability will decline. Reduced business and compressed interest margins will likely constrain revenue, which--combined with the growing cost of credit--will affect bottom-line performance. However, we still expect Croatian banks to report positive results and preserve their capital position.

We expect support from foreign shareholders. Foreign strategic shareholders are likely to remain committed to supporting their Croatian subsidiaries. Additionally, we believe that their solid liquidity buffers and the central bank's support measures would be sufficient to offset any unexpected stress.

Key assumptions

We anticipate that the Croatian economy will face a deep recession over the coming months, owing to a sharp contraction in domestic demand and falling tourism receipts. We expect Croatia's GDP to contract by 9% in 2020, followed by a 5.3% rebound in 2021. However, this upturn will not immediately and entirely offset damage to the economy. We chiefly attribute this to the COVID-19 pandemic's impact on the tourism sector (which contributes about 20% of GDP).

The private sector has not fully recovered from the previous recession. Private-sector indebtedness at end-2019 stood at 93% of GDP, one of the highest levels among Central and Eastern European peer countries. Nevertheless, nonfinancial entities are less indebted than they were during the previous financial crisis. We view this as positive, because much of the sector's heavy credit losses came from that segment.

Credit losses will remain higher than peers'. We anticipate that asset quality will remain a key issue for the Croatian banking sector. As a result, we forecast ongoing high credit losses, at around 170 basis points (bps) per year in 2020-2021 from about 80 bps in 2019, despite government support programs.

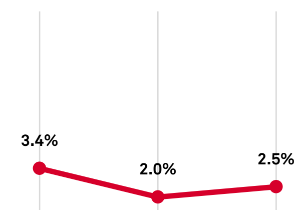
What to look for over the next year

We expect banks will remain profitable, although we anticipate a decline in bottom-line profits. In our view, return on equity will fall to about 5%-6% by end-2021, from 9.9% at end-2019.

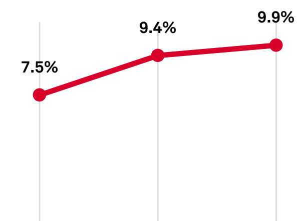
Despite the Croatian government's measures to contain the spread of COVID-19, banks face an unprecedented challenge. We are acutely mindful that our current base case remains subject to significant downside risks. Even under our economic view, the Croatian government's policy responses may not prevent permanent economic damage. Therefore, we expect the effects of COVID-19 to be evident long after the pandemic subsides, mainly through reduced revenue and increased risk costs.

Croatia

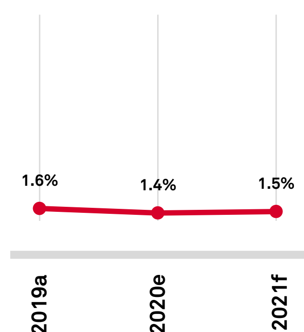
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming assets as a % of system wide loans.

RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Czech Republic | BICRA Group: 3

Czech Banks To Weather Pandemic Better Than Many Peers

Key takeaways

- Sharp GDP contraction in 2020 followed by more robust recovery than other Central and Eastern European (CEE) countries in 2021.
- Timely and proactive regulatory actions and solid financial profile before the pandemic will enable Czech banks to weather the pandemic without material distortions.
- We expect nonperforming loans (NPLs) to double with profitability halved in 2020, before recovery starts in 2021 based on sound economic and banking industry fundamentals.

Key credit drivers

Potential delays in macroeconomic recovery or a more pronounced recession than we currently expect. Either of these factors could increase risks for Czech banks.

Rapid growth in residential property prices. If growth in real estate prices accelerates, this could lead to a buildup of economic imbalances.

Key assumptions

Sharp GDP contraction followed by robust recovery. We think the COVID-19 pandemic will result in real GDP contracting by about 6% in 2020, with a recovery in the second half of 2020, leading to an expansion of 6.5% in 2021. Authorities are using ample fiscal and monetary policy space to cushion the effects of the economic downturn. Materially higher level of interest rates provided more room for lowering the policy rate by 200 basis points to 0.25%.

Effective regulatory response to COVID-19 to support Czech banks. We think the Czech National Bank has taken timely and proactive measures to support the banking system during the pandemic by increasing provision of liquidity to banks, relaxing regulatory capital adequacy requirements and debt metrics, and recommending that banks withhold dividend payments.

Decrease in net external banking sector debt. We think the high level of nonresident deposits at Czech banks will decrease in 2020-2021 due to sharply reduced differences in the interest rate levels in the Czech Republic and the eurozone.

What to look for over the next year

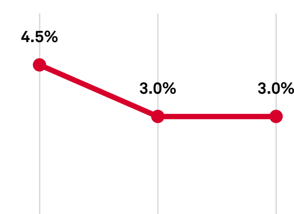
Asset quality deterioration. We think NPLs (loans over 90 days overdue) could rise as high as 5% in 2020-2021 from 2.4% as of end-February 2020. Credit holidays up to six months could relieve the asset quality pressure; that said, they might simply mask asset quality issues until they emerge after the end of the moratorium.

Profitability deterioration. We expect a slowdown in loan growth, pressure on net interest margins, and an increase in cost of risk up to 1% to result in return on assets decreasing to 0.5% in 2020-2021 from 1.1% on average over the past five years. Strong margins and efficiency at onset of the pandemic will provide more of a buffer to absorb this deterioration than for many peers.

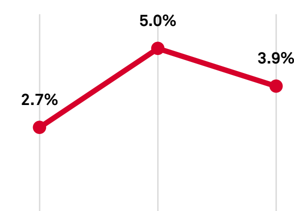
Primary Credit Analyst
Annette Ess
Frankfurt
annette.ess@spglobal.com
+49-69-3399-9157

Czech Republic

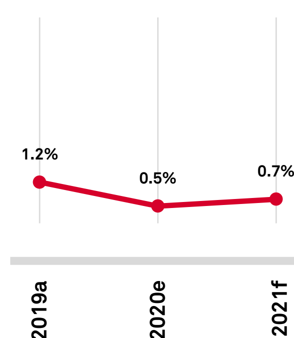
Loan growth



NPA ratio



RoAA



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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Egypt | BICRA Group: 9

Banks' Creditworthiness Is Linked To The Sovereign's

Key takeaways

- We expect higher credit losses for banks as the economy slows down materially.
- The Central Bank of Egypt (CBE) cut interest rates by 300 bps in March 2020 to support the economy.
- Digital banking could enhance financial services' penetration.

Key credit drivers

Banks continue to display high exposure to the government. Significant investments in government securities have supported banks' profitability in previous years, while increasing their link to the sovereign. For some banks, direct exposure to sovereign debt exceeds 30% of total assets. Although we expect customer loans will expand faster than sovereign debt in the coming years, we anticipate the latter will remain sizable.

Banks' asset quality will deteriorate. We forecast nonperforming loans will increase to about 7% by June 2021 because of the negative impact of COVID-19 on exposed sectors, including tourism, small and midsize enterprises (SMEs) and manufacturing.

Good systemwide liquidity buffer. We expect Egyptian banks' liquidity to remain strong, owing to low loan leverage and relatively stable customer deposits.

Key assumptions

We expect COVID-19 to affect economic growth. We forecast a slowdown in real GDP growth to 2.8% in fiscal year 2020 (ending June 30, 2020) and 0.1% in fiscal 2021 (representing a contraction of 1% during calendar year 2020), compared with 5.6% growth in fiscal 2019.

Cost of risk will increase. We forecast increasing credit losses for Egyptian banks in 2020-2021, of 200 basis points (bps)-240 bps, owing to the impact of COVID-19 on private borrowers, particularly SMEs.

What to look for over the next year

The impact of COVID-19 on SMEs. We believe the SME sector, representing about 20% of the largest institutions' lending books, could be more exposed to the direct and indirect economic effects of social distancing measures than large corporates. In our view, the magnitude of the impact will depend on the duration of the pandemic, as well as on the effectiveness of relief measures such as the six-month moratorium on principal and interest announced by the CBE on March 2020 and the subsidized loans granted to SMEs. In addition, we note that some banks, both public and private, have signed agreements with multilateral lending institutions to finance the investments of some SMEs.

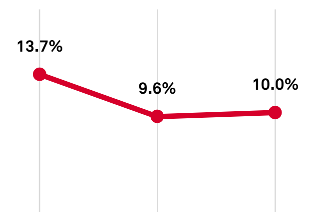
A lower interest rates environment could support lending activities. In our view, depressed consumer spending could lead the corporate sector to further postpone capital expenditure in the near term. That said, we expect economic activity will start recovering in the second half of fiscal 2021, potentially triggering an increase in credit demand. With this regard, we believe that the CBE's decision to cut interest rates by 300 bps in March 2020 could play a positive role by providing additional stimulus.

Digital banking penetration might accelerate. New technologies could support financial inclusion. We understand that, amid the lockdown, Egyptian players are increasingly using digital channels (including phone calls, mobile banking, and ATMs) to interact with their customer bases.

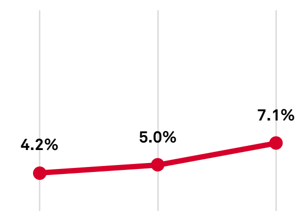
Primary Credit Analyst
Alessandro Ulliana
Milan
alessandro.ulliana@spglobal.com
+39-272-111-228

Egypt

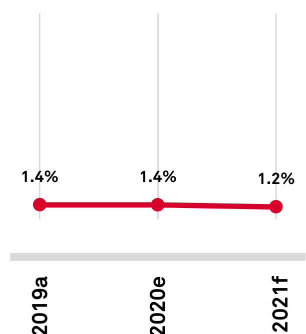
Loan growth



NPA ratio



RoAA



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Georgia | BICRA Group: 8

Banks Will Face A Sharp Increase In Credit Losses

Primary Credit Analyst
Roman Rybalkin
Moscow
roman.rybalkin@spglobal.com
+7-495-783-4094

Key takeaways

- The economy will contract in 2020 by 4% as international travel halts and domestic activity stagnates.
- Cost of risk will increase to about 400 basis points (bps) in 2020 from 100 bps in 2019.
- Recovery of international travel will be key for economic recovery.

Key credit drivers

Better-than-average regulation protects Georgia's banks. The National Bank of Georgia (NBG) has been proactive in addressing increasing risks related to a volatile macroeconomic environment. It started to cool down aggressive growth in retail lending as early as 2018 and has routinely forced banks to keep additional capital buffers for currency-induced credit risk. It also has been encouraging a conservative approach to provisioning, forcing banks to recognize losses averaging 3.4% of loan books as early as the first quarter of 2020.

Dollarization remains high. Despite the NBG's efforts aimed at decreasing dollarization in the banking sector over recent years, banks entered the COVID-19 shock with 55% of their loan books denominated in foreign currency, which will create pressure on the quality of their portfolios.

External funding will remain stable. Net external debt funds about 25% of loans in Georgia, a high level in the international context. We believe that the high share of international financial institutions (40% of banking sector debt) is more stable compared with wholesale funding from capital markets and supports funding stability at times of stress.

Key assumptions

We expect economic growth will rebound in 2021, supporting banking sector recovery. We think that the institutional framework (which we view as better than regional peers'), flexible economy, and international support will allow the banking sector to withstand the current stress and return to strong growth and profitability. We forecast GDP will rebound to 4% in 2021, after a 4% contraction in 2020.

Lending growth will slow down. After years of rapid credit growth (almost 20% per year over 2015-2019), lending will slow in 2020 because banks will revisit their underwriting standards, while the debt servicing capacity of individual borrowers and businesses will be constrained.

Cost of risk will pick up sharply. The COVID-19 pandemic will have a higher impact on asset quality than previous economic crises. An increased burden on borrowers in foreign currencies and a pronounced decline of economic activity could increase cost of risk to 4% in 2020, compared with approximately 1% in 2019. As a result, banking sector profitability will be at about breakeven point in 2020.

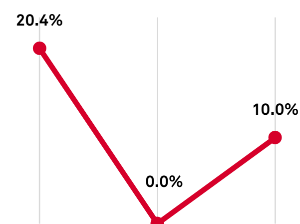
What to look for over the next year

Evolution of safety measures. Tourism is an important contributor to the Georgian economy at about 9% of GDP, with 9.3 million international arrivals in 2019, compared with a population of 3.7 million. Resumption of international travel will be a major driver supporting economic recovery and will depend on how fast international barriers to travel will be lifted.

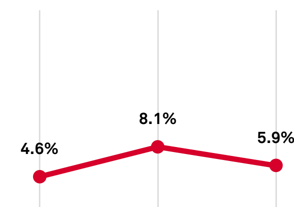
The 2020 elections may affect the policy response. As the parliamentary elections loom, we expect the government's actions will be increasingly tested by opposition in the parliament. We cannot rule out some pressure on the lari coming from political volatility, which may intensify currency risk for the banking sector.

Georgia

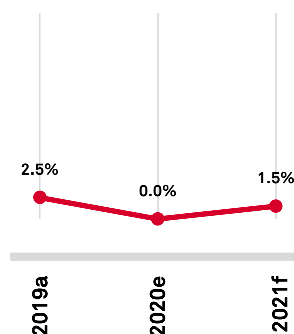
Loan growth



NPA ratio



RoAA



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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Hungary | BICRA Group: 5

Banks Entered The Pandemic In Better Shape Than Past Crises

Primary Credit Analyst
Lukas Freund
Frankfurt
lukas.freund@spglobal.com
+49-69-3399-9139

Key takeaways

- Robust economic growth in recent years provides solid ground for a rebound in 2021.
- High credit growth across all sectors in the past but overall moderate indebtedness of the private sector.
- Good capitalization and liquidity, strong lending margins, and regulators' swift reaction will help banks withstand the crisis.

Key credit drivers

If recovery is delayed, it would increase Hungarian banks' risks. Banks will inevitably suffer a rise in credit losses in 2020 and 2021, but structural economic risks in the economy are lower than during the 2008 financial crisis.

Moderating real estate price growth. Real estate price growth has been very high over the past four years. We do not expect a material house price correction, but price growth will likely flatten due to economic uncertainty, in line with general price corrections among all asset classes. The economic downturn will also have some positive effects, dampening the risk of overheating and preventing the eventual bursting of the real estate bubble. Banks' prudent lending since the last crisis and regulatory measures have reduced overheating risk significantly. The main risk relates to commercial real estate portfolios, especially those with exposure to tourism and transportation.

Swift regulatory actions support financial stability amid very high use of the six-month loan-payment moratorium. The liquidity provision by the Hungarian Central Bank is helping banks withstand the first shockwaves and is improving market liquidity. Bond-purchasing schemes can help banks cushion higher credit losses that may manifest after the moratorium expires.

Key assumptions

Downturn likely to be less severe than for many peers. We expect GDP contraction of 4.0% in 2020, followed by a U-shaped rebound in GDP of 4.7% in 2021. Hungary is well prepared for a solid rebound, given it entered the crisis after a robust expansionary phase. The country's economy was among the fastest expanding in the EU and entered the adverse environment with historically low unemployment, strong wage and credit growth, and very low credit losses.

Impact on the banking sector will remain manageable. Hungary's banks benefited from robust lending margins and low credit costs in recent years, leading to sound levels of profitability and strong capitalization. We expect that, despite a decrease of revenue and increased risk costs, return on equity will remain above many peers', thanks to high demand for credit, comfortable lending margins, and relatively higher interest rates.

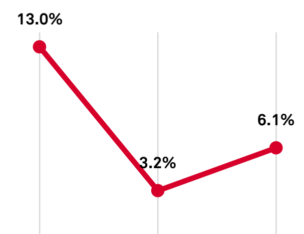
What to look for over the next year

Budgetary discipline. After providing crisis support to individuals and businesses, the Hungarian government must find its way back to fiscal discipline to increase budgetary flexibility in the long term. Further policy pressure on the banking sector in terms of higher taxes to offset expenditure may create market distortions.

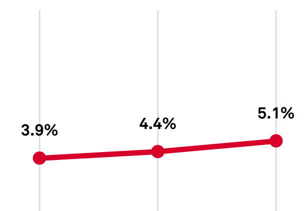
Banking sector consolidation will proceed. Recent merger announcements by three significant Hungarian banks could alter competition in the market. Hungary aims to keep the domestic ownership of the banking sector above 50%, while not directly owning shares. In our opinion, interference by the government or state-affiliated businesses could distort market competition or reduce the banking system's overall stability.

Hungary

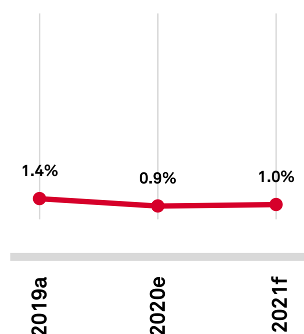
Loan growth



NPA ratio



RoAA



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Israel | BICRA Group: 3

Well-Capitalized And Liquid Banking Sector Should Weather The Shock

Key takeaways

- Israeli banks face gloomier profitability prospects and asset quality deterioration in 2020, but we forecast a strong rebound in 2021.
- We expect the Israeli banking sector to remain resilient to this short-term economic shock, thanks to relatively low private-sector leverage, prudent lending standards, solid capitalization, and ample liquidity.
- The government and central bank have implemented measures to support households and businesses and allowed some reliefs to the banking sector.

Key credit drivers

Strong economic fundamentals and prudent banking sector regulatory oversight. Positive macroeconomic conditions have supported the profitability and asset quality of the banking sector. Prudent regulatory oversight and structural changes in the economy have led banks to reduce their exposures to large borrowers and leverage finance. Banks' capitalization is also solid after several years of profit accumulation.

Reduced risk in mortgage lending. After the regulator applied macroprudential measures more than five years ago, we think the risk in the mortgage portfolio, which comprises 35% of total lending, is now contained. The average loan to value of 54%, as of year-end 2019, is relatively low in global comparison.

Risks remain for profitability resilience. Downside risks to economic recovery, slower-than-expected labor market recovery, and commercial real estate price decline are the key risks for banking sector profitability over 2020-2021.

Key assumptions

Sharp GDP contraction in 2020 and a strong rebound in 2021. We expect a GDP contraction of 5.5% in 2020, owing to lower external and internal demands. Nevertheless, we expect a strong recovery of 6.5% in 2021, based on the recovery of Israel's key trading partners and strong macroeconomic fundamentals, such as a dynamic economy, a not-particularly-leveraged private sector, and a strong external position.

Sizable support package will prevent permanent damage to the country's productive capacity. Our base-case assumption is that the government's programs will support a fast restart of the labor market and relieve the pressure on households and small businesses, which are worst hit by the current crisis.

Housing market stability. The residential property market has stabilized over the past few years, and we do not expect an abrupt house price correction, thanks to strong domestic demand stemming from population growth, and considering supply-side limitations.

What to look for over the next year

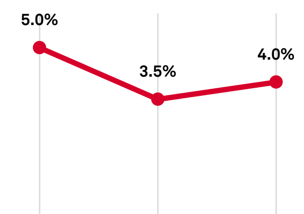
Pressure on asset quality. We expect credit losses to increase in 2020 to 0.8%-1.0%, and to weigh on banking sector profitability before recovering to more normalized levels. A significant share of credit loss provisions is attributed to retail unsecured lending and small and micro businesses.

Efficiency efforts to continue. After several years of implementing efficiency plans, we expect the banking sector to continue improving its operational efficiency and investing in digitalization, as new opportunities arise in the current environment.

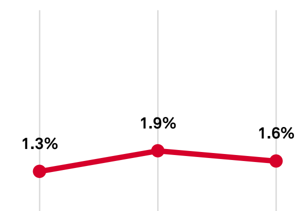
Primary Credit Analyst
Lena Schwartz
Ramat Gan
lena.schwartz@spglobal.com
+972-3753-9716

Israel

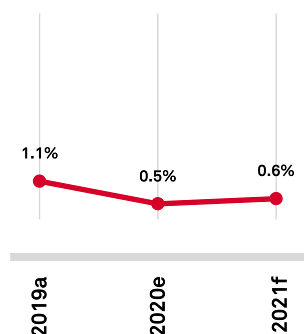
Loan growth



NPA ratio



RoAA



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Jordan | BICRA Group: 8

Asset Quality And Profitability To Deteriorate Amid COVID-19 Outbreak

Key takeaways

- The COVID-19 pandemic erupted in a battered economy already weaken by regional tensions and limited government flexibility.
- This additional shock will lead to a slowdown in economic activity and a rise in problem loans and cost of risk for Jordanian banks.
- Monetary policy easing initiated to mitigate the shock will impede banks' profitability.

Key credit drivers

The COVID-19 outbreak is likely to exacerbate existing problems in Jordan's economy. Flows of refugees from Syrian civil war, trade disruption from Iraq and regional political instability, and slowdown in remittances and foreign direct investments (FDI) from the Gulf region have constrained economic growth in Jordan for the past few years. We forecast Jordan will be in recession in 2020, with its GDP contracting 3%, and will experience only a slight recovery in 2021. Trade, transportation, tourism, and mining will likely be the hardest hit, dragging on credit demand and quality.

Banks have concentrated loan books. Given the small economy and corporate sector, banks have lending concentrations by single name and sector, which inflates risks during recessions.

Pre-crisis credit fundamentals are sound. Banks entered the crisis with sizable buffers to absorb additional credit losses. These include the regulatory capital ratio standing above 17% at year-end 2019, mid-single digit nonperforming loan (NPL) ratios, and still sound profitability with return on equity at 9.4% as of June 2019.

Key assumptions

Deterioration in banks' asset quality. We expect the short-lived yet sharp contraction in domestic output will result in NPL ratios reaching 8%-9% and a spike in credit losses at about 200 basis points in 2020 from 90 basis points in 2019. Because of the loan moratoria in place for affected clients, we believe that the peak in NPLs and the bulk of asset quality deterioration could crystallize only in 2021.

Real estate prices to decline only marginally. Banks are vulnerable to the real estate sector since it accounts for about a quarter of their lending books. However, we do not expect the economic recession will lead to a material correction in real estate prices because residential housing investment is mostly nonspeculative, with prices being flat for several years.

No escalation in the region's political situation. Risks related to domestic political tensions and the Syrian conflict have eased, but remain elevated.

What to look for over the next year

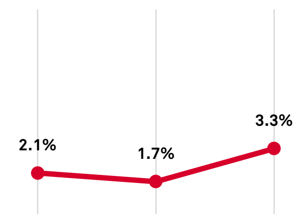
We see rising pressure on banks' profitability. The central bank has cut policy rates by 150 basis points so far in 2020, and further easing remains a possibility. While this will support borrowers' credit quality, the pressure on net interest margins will weigh on banks' profitability, as will higher cost of risk.

Funding pressure is likely to intensify. Jordanian banks are fully funded by core customer deposits, but deposit growth remains sluggish due to low economic and income growth rates in Jordan and across the Gulf, which means tighter liquidity. We believe pressure is intensifying with the COVID-19 pandemic, especially on the smallest banks, since their larger peers benefit from stronger market entrenchment to attract new deposits.

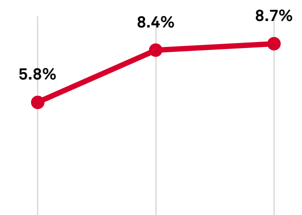
Primary Credit Analyst
Pierre Hollegien
Paris
pierre.hollegien@spglobal.com
+33-1-4075-2513

Jordan

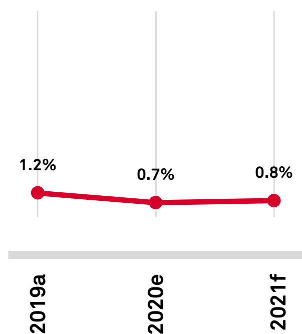
Loan growth



NPA ratio



RoAA



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Kazakhstan | BICRA Group: 9

High Credit Costs To Persist Amid COVID-19 And Economic Pressures

Primary Credit Analyst
Ekaterina Marushkevich
Moscow
ekaterina.marushkevich
@spglobal.com
+7495-783-4135

Key takeaways

- Kazakh banks will continue to experience high credit losses of about 4%-5% of total loans in 2020-2021, amid the depressed economic environment and continued pressure from legacy problem assets.
- We expect that government and shareholder support will partly offset the pressure on banks' asset quality and capitalization.
- Banks' profitability will be low in 2020 and results will differ from one bank to another.

Key credit drivers

Extremely high credit risks remain a key weakness for Kazakh banks. We estimate that Stage 3 loans for the system comprised about 20% of total loans as of June 1, 2020. We anticipate that provisions for credit losses will remain elevated, at 4%-5% in 2020-2021. This results from the additional need to provision legacy problem loans by several banks following the asset quality review completed by the regulator in February 2020 and further deterioration of asset quality stemming from the quarantine measures, oil price decline, and tenge depreciation in the first half of this year.

Government and shareholder support will likely mitigate the pressure to some extent. The government has announced programs to support households and businesses that together amount to about 8%-9% of GDP. This should provide a certain cushion in the context of COVID-19 containment measures and economic contraction. The government has also provided additional five-year guarantees to several banks against their legacy problem loans, while their shareholders have declared their commitment to provide additional capital.

Key assumptions

We expect real GDP will contract by about 3% in 2020, followed by a recovery from 2021. Our forecast takes into account the combination of oil price decline and external and internal demand shock caused by the COVID-19 containment measures. We expect the economy will return to growth in 2021. Consequently, we expect that new lending in the banking sector will slow down in 2020 and return to growth next year.

Banking sector profit will reduce by 50% in 2020. Net profit could decline to about Kazakhstani tenge (KZT) 400 billion for the sector. Small banks' results are likely to be weaker than established players'. In our view, generating sustainable risk-adjusted returns will be difficult for most banks because of narrow margins, elevated credit costs, and increased funding costs.

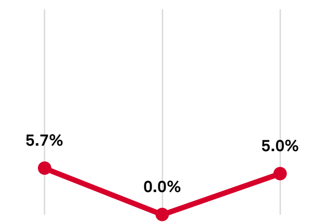
What to look for over the next year

Banking sector consolidation will likely continue. The sector may see further consolidation, with weaker banks leaving the market because it becomes increasingly difficult for them to survive in the challenging environment and keep up with competitive pressure and regulatory requirements.

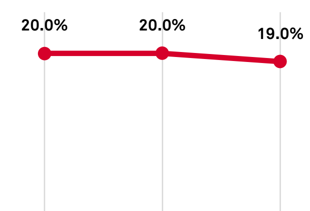
Digitalization trends will increase pace. We have observed an increasing move toward digital transformation at a number of banks over recent years, and the COVID-19 lockdown measures served as an additional stimulus for banks to strengthen their online services. We expect digitalization will increasingly serve as an additional competitive advantage and support banks' cost optimization.

Kazakhstan

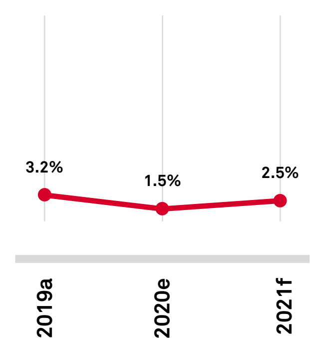
Loan growth



NPA ratio



RoAA



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Kenya | BICRA Group: 9

The Path To Recovery Is Undermined By Fiscal And External Risks

Key takeaways

- Lending growth will be subdued in 2020, despite the lifting of the cap on interest rates.
- Large government debt and vulnerability to external shocks could derail the banking sector's recovery.
- Sector stability will likely continue to be tested.

Key credit drivers

Fiscal performance and external vulnerabilities cast a shadow. Kenya's fiscal deficit will likely widen to 8.7% of GDP in 2020 and funding of the current account deficit will rely on external debt. Combined with Kenya's vulnerability to external shocks, this presents risks to the banking sector recovery.

Credit growth will be subdued, despite the lifting of the cap on interest rates. Domestic credit growth will be tested in 2020, amid the pandemic. We forecast credit to the private sector will expand 3% compared with an estimated 7% in 2019. Consumer lending and small and midsize enterprises (SMEs) will be hit hard, particularly those operating and servicing the tourism sector. We also anticipate that some payment arrears linked to government projects will lead to additional restructuring.

Sector stability will continue to be tested. Midsize banks will continue to face pressure to consolidate to ensure viability of their business model, which has been highly strained by lockdown measures.

Key assumptions

Economic growth slowed by the pandemic. We project real GDP growth will contract to 1% in 2020 and rebound to about 4% in 2021, due to the pandemic's effects. Tourism and travel industries are likely to suffer heavily from the global lockdown. The rebound will be supported by productivity gains from large-scale public- and private-sector infrastructure investments.

Debt will remain high. We estimate general government debt will continue to rise beyond 65% of GDP over 2020-2021 with about half of the stock being external debt. Positively, foreign exchange reserves will be broadly stable under our base-case scenario.

Asset quality will weaken. We forecast the sector's credit losses will average 2.5% in 2020-2021, while nonperforming assets will rise above 12% of total loans in 2020 as the lockdown measures curtail SMEs' recovery.

What to look for over the next year

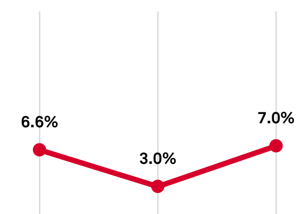
Higher general government debt will constrain banks' effective financial intermediation. The global economic downturn will likely lead banks to increase their exposure to government debt instead of lending. This will counterbalance the impact of credit losses on their net interest margins.

Profitability will decline amid higher impairments. Overall profitability will deteriorate but should still be sufficient to maintain capitalization well above the minimum requirements.

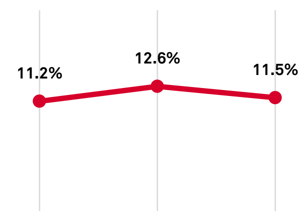
Primary Credit Analyst
Samira Mensah
Johannesburg
samira.mensah@spglobal.com
+27-11-214-4869

Kenya

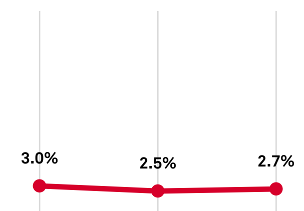
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Kuwait | BICRA Group: 4

Strong Buffers To Absorb Asset Quality Deterioration

Primary Credit Analyst
Zeina Nasreddine
Dubai
zeina.nasreddine@spglobal.com
+971-4-372-7150

Key takeaways

- We expect banking sector risks to remain in check, despite the much weaker macroeconomic environment.
- The banking sector's substantial exposure to real estate and construction remains a concern, especially given current economic situation.
- Compressed margins and higher credit costs will weaken earnings.

Key credit drivers

Manageable impacts from the deteriorated macroeconomic environment. Although we project a severe contraction of the Kuwaiti economy, we consider that risks for the banking system remain manageable because of the system's strong loss absorption capacity and significant amount of provisions accumulated over recent years.

Real estate exposure remains a key risk. We expect pressure on the real estate sector, mainly offices and retail space, given tighter financial capabilities as a result of the economic downturn. The country's banking sector's substantial exposure to real estate and construction remains a concern, especially given the downward trend in real estate prices.

Comfortable funding and liquidity position. We expect banks will maintain high levels of core deposits in their funding base and their liquidity metrics will remain intact, supported by local deposits--notably from the government and government-related entities.

Key assumptions

Real GDP to contract by 6% in 2020 before recovering gradually over the medium term. The economic contraction stems from both Kuwait's participation in OPEC-agreed oil production cuts and the impact of social distancing and lockdown measures on the non-oil economy. We expect that it will take until 2022 for the output in real terms to recover to 2019 levels.

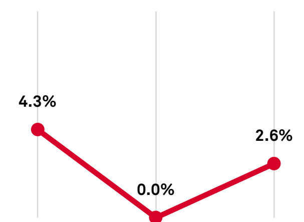
Reform momentum remains slow. We note that Kuwait's reform momentum has been slow in recent years, even compared with other states in the Gulf Cooperation Council. The introduction of taxes has long been delayed, while reforms to diversify the economy and modernize the labor market have achieved limited results. This presents medium-term risks, in our view.

What to look for over the next year

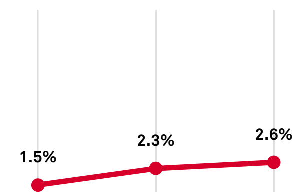
Profitability is at risk. We expect loan growth to be moderate at low-single digits in 2021-2022 as economic conditions gradually improve. Net interest margins will decline on the weaker interest rate coupled with tightening liquidity conditions. We think an uptick in nonperforming asset formation is likely, predominantly because we expect a further reduction in real estate prices.

Kuwait

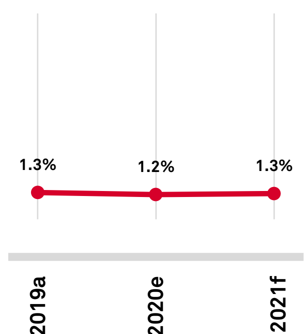
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Morocco | BICRA Group: 7

Expected Deterioration Of Asset Quality

Primary Credit Analyst
Anaïs Ozyavuz
Paris
anais.ozyavuz@spglobal.com
+33-1-4420-6773

Key takeaways

- Following containment measures, Morocco has so far avoided a major health crisis.
- Nevertheless, the COVID-19 pandemic will negatively affect the economy and delay budgetary consolidation.
- Moroccan banks benefit from relatively good profitability and adequate solvency, which should help them withstand the shock over the next two years.

Key credit drivers

A lower middle-income economy, burdened by high social needs. We consider that Morocco's economy is still skewed toward cyclical sectors--particularly agriculture. We believe the COVID-19 pandemic will lead to an economic contraction in 2020 before a gradual recovery during 2021-2023.

The Moroccan banking system is one of the largest and most concentrated in North Africa. Before the crisis, the banking sector reported an average return on equity of 10.8%, with an adequate solvency ratio of 13.8%. This will provide some buffers to absorb additional credit losses.

Expansion in Africa brings diversification benefits but is also a source of risk. Large Moroccan banks have expanded rapidly into the rest of Africa, where risks are typically higher than in Morocco.

Key assumptions

The depressed economic environment will slow credit growth. The government has announced several measures to fuel credit to nonfinancial corporations, including lending facilities, subsidized interest rates, and a partial state guarantee. Still, we expect modest private sector credit growth of about 2% for 2020 because of expected higher unemployment and lower demand.

Central bank intervention. Bank Al-Maghrib has announced supportive measures to the banking sector. It has expanded the range of collateral accepted for repos and credit guarantees, increased refinancing operations to support lending to small and midsize enterprises, and provided foreign currency swaps to domestic banks.

Asset quality will deteriorate. We expect nonperforming assets and credit losses will increase materially over 2020-2021 as several important economic sectors--like tourism, export-oriented businesses (e.g. textile, auto, and aeronautic), and real estate--are affected by this crisis.

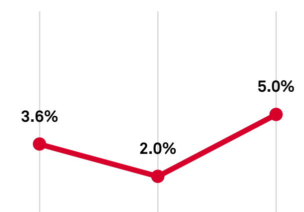
What to look for over the next year

Banks' earnings will suffer. We expect weaker results from the higher cost of risk and lower revenue. We consider banks will suspend dividend payments in 2020, following the central bank instruction.

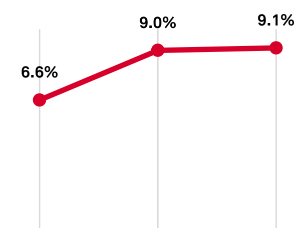
The full impact of the pandemic on the economy is uncertain. The overall outcome remains uncertain since potential long-term effects could include further hindrance of tourism activities and fledgling industries in the auto and aeronautic sectors. In the context of a global economic slowdown, this year's current account deficit will be negatively affected by the decline in inflows of remittances and foreign direct investments, and the fall in tourism receipts. At the same time, the contraction in imports coming from the fall in consumption and significant decline in oil prices will partly offset the above-mentioned developments.

Morocco

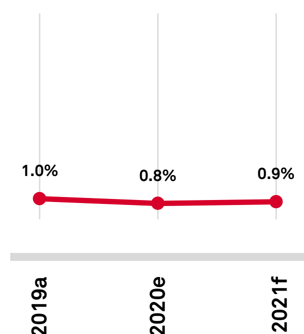
Loan growth



NPA ratio



RoAA



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a--Actual. e--Estimate. f--Forecast.

Nigeria | BICRA Group: 10

An Uncertain Operating Environment In 2020

Key takeaways

- A slow economy amid the oil price shock weighs on the pace of the banking sector recovery.
- Banks are vulnerable to U.S. dollar outflows, given their high net external debt.
- Risks associated with Nigerian naira depreciation could reemerge.

Key credit drivers

High dependence on the oil sector. Nigeria's economy remains largely dependent on the hydrocarbon industry, accounting for 90% of exports and at least half of fiscal revenue. Combined with its sensitivity to currency depreciation and high inflation, this exposes banks to high economic imbalances and short credit cycles.

Loan book concentration exacerbates the risks. The banking sector has high credit risk because of the structure of the economy, and high single-name and sector concentration.

Reliance on external funding. The sector also faces additional liquidity risks because of the dual currency nature of banks' balance sheets, and high net external debt. This could cause pressure on U.S. dollar liquidity if foreign currency reserves drop because of declining oil prices.

Key assumptions

Slow economic growth. We expect GDP to contract by 3% in 2020 and significant pressure on banks' asset quality and earnings because of their material exposure to the oil sector, averaging 30% for rated banks.

Pressure on asset quality. We expect restructured loans will increase to 15%-18% in 2020, from about 10% in 2019, given our lower oil price assumptions. We expect nonperforming loans will rise again to 12.5% compared with an estimated 11.3% in 2019. We forecast credit losses will increase to about 2.5% in 2020.

High external debt. Gross banking sector external debt will remain high, at above 50% of total loans amid the stabilization of the naira. That said, the majority of banks have overcome their short-term liquidity challenges following the introduction of the Nigerian Autonomous Foreign Exchange Fixing Mechanism (NAFEX) window in April 2017.

What to look for over the next year

Declining profitability. Profitability will be weaker on the back of higher impairments and lower net interest margins, due to a combination of weakening asset quality and limited participation in the central bank's securities auctions. However, we still expect top-tier banks' financial performance to be resilient, with return on equity averaging 15%-16% in 2020, and about 8% for mid-tier banks.

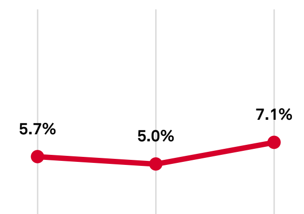
Naira liquidity is manageable. The Central Bank of Nigeria (CBN) has some flexibility to release additional liquidity through the reserve requirement ratio, which sits at 27.5%. Bank credit to the private sector will likely be subdued, despite the CBN introducing a minimum loan-to-deposit ratio of 65% to boost credit growth.

The CBN's predictability is key. Lower foreign currency inflows tied to lower oil receipts are likely to present policy challenges to the CBN with regard to exchange rate and foreign-exchange-reserve policy. We believe that the risk of some banks breaching minimum capital adequacy ratios could re-emerge if the naira weakens by more than 20%, which is higher than our current assumption for 2020.

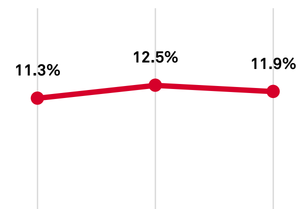
Primary Credit Analyst
Samira Mensah
Johannesburg
samira.mensah@spglobal.com
+27-11-214-4869

Nigeria

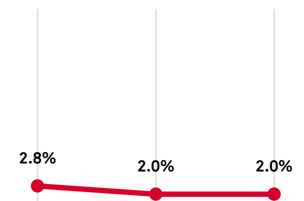
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Oman | BICRA Group: 7

Asset Quality And Profitability To Weaken In 2020

Primary Credit Analyst
Puneet Tuli
Dubai
puneet.tuli@spglobal.com
+971-4-372-7157

Key takeaways

- The economy will contract by 4% in 2020, followed by a mild recovery of 2% in 2021.
- Depressed oil prices and lower economic activity due to the COVID-19 pandemic will lead to higher problem loans and credit losses. At the same time, the government's capacity to support the system has diminished.
- Banks' funding base continue to rely on historically stable public sector deposits.

Key credit drivers

Operating conditions are weighing on banks' performance. Asset quality and profitability will deteriorate in 2020 since we expect the economy to experience a recession, with its GDP contracting by 4%. We expect that slightly higher oil production and a recovery in domestic demand and tourism from 2021 will support real growth averaging 2.1% annually over the next three years.

Banks rely heavily on public-sector deposits. Omani banks are predominantly funded by domestic customer deposits and make limited recourse to external funding. Customer deposits also include funds from the government and related enterprises (more than one-third of total deposits). The government could use some of these deposits to fund its high fiscal deficit. Nevertheless, this risk is mitigated by a long track record of stability.

Key assumptions

Lending book to contract. Given the slowdown in the economy and low demand from domestic corporates, we expect the lending book to contract in 2020, followed by mild expansion in 2021 mainly driven by the household and private sectors.

Private sector indebtedness remains high. Oman's high private sector indebtedness and declining property prices pose risks for banks, particularly in the current economic downturn. Housing prices have moderated in major cities as well as in lower-tier cities. We estimate the price decline at 25%-30% in the past four years nationwide.

The government's capacity to support the banking system has reduced. High fiscal and current account deficits have eroded the government's traditional net asset position, in turn weakening its ability to extend extraordinary support to banks.

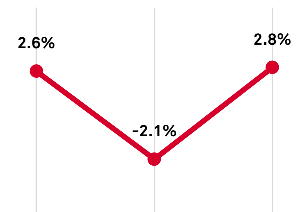
What to look for over the next year

Credit losses will increase. Owing to the less-supportive economic environment, we expect banks' credit profiles will deteriorate in 2020-2021, particularly in the retail and residential real estate sectors, as well as in the manufacturing, utilities, and trade sectors, which are under stress. This will lead to increased nonperforming assets and credit losses. We expect cost of risk to double and stabilize at around 100 basis points (bps) for2020-2021.

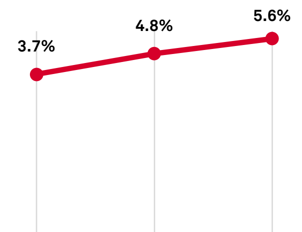
Bank profitability to decline. Margins should tighten as Oman eases its monetary policy in line with U.S. Federal Reserve rate cuts. This could result in a decline of 30 bps-40 bps in Omani banks' average net interest margins. Lower margins, combined with higher credit losses, would lead to a material decline in net profits for banks.

Oman

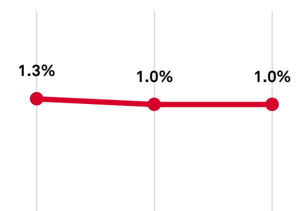
Loan growth



NPA ratio



RoAA



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Poland | BICRA Group: 4

Comparably High Risk Costs Along With Sector Profitability Pressures

Key takeaways

- Profitability pressures owing to a significantly lowered (to 0.1% from 1.5%) rate environment with rising risk costs are accompanied by a government-imposed, balance-sheet based banking tax.
- A sizable legacy Swiss franc mortgage portfolio (23% of the retail mortgage loans as of March 2020) remains the main source of litigation risk and related costs for several midsize banks.
- Poland's broad-based, well-balanced, and flexible economy could experience a smaller 2020 GDP contraction and a stronger 2021 rebound compared with many other European countries.

Key credit drivers

If the recovery were delayed, this would increase pressure on the risk-return profile of Polish banks. Polish banks already reported comparably high, though stable, nonperforming loans (NPLs) and credit losses pre-COVID-19, at about 7%-8% and 70 basis points (bps)-90 bps, respectively. We expect these may almost double at their peak, but will moderate toward end-2021 and in 2022. In addition, historically low interest rates at 0.1%, on top of a government-imposed banking tax, decreases the sector's profitability buffers against those elevated risks.

Legacy Swiss franc mortgage loans portfolio can be a burden for some banks. Banks' exposure to mortgage loans denominated in foreign currency remains high, at 23% of total household mortgage loans as of March 31, 2020. Potential costs, given the 2019 European Court of Justice decision allowing the annulment of some mortgage contracts, is a clear latent risk, despite a low NPL level in that portfolio.

Funding and liquidity remain solid. Poland's banking sector is almost fully funded with deposits, with some marginal issuances of covered bonds or subordinated debt to support comparably strong capital ratios. Foreign funding is decreasing toward 10% and short-term wholesale funding remains marginal.

Key assumptions

Sharp GDP contraction followed by robust recovery. We believe the COVID-19 pandemic will result in real GDP contracting by about 4% in 2020, with a recovery starting in the second half of 2020, leading to an expansion of 5% in 2021. Fiscal and monetary policy space is being used to cushion the recession.

Unemployment will remain elevated at the end of 2020 and beginning of 2021, but will then moderate. We assume unemployment to be one of the key drivers for an increase in banks' risk costs, given the fact that the savings rate or financial assets of Polish households remain among the lowest in Europe.

The regulatory and government response to COVID-19 will be effective. We believe the Polish central bank and financial regulator have taken timely measures to support the banking system, through dividend stoppage, lowering the required capital reserves, decreasing high regulatory capital requirements, or providing liquidity if necessary. Large government programs are supporting borrowers hit by the economic shutdown.

What to look for over the next year

Facing dropping of net interest income in the environment of elevated credit losses. It will be challenging for the banks to further cut operating costs and search for alternative earnings sources in the new-for-Poland, almost-zero-interest-rate environment.

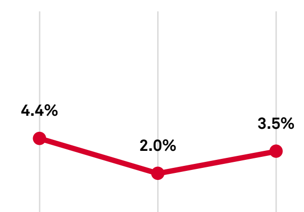
Some consolidation possible. We expect some small or midsize banks to struggle to earn their cost of capital in the post-COVID-19 environment. This may trigger further consolidation of the market.

Postponed minimum requirement for own funds and eligible liabilities (MREL) issuance, until 2024. However, we expect banks to start issuing senior nonpreferred debt and other eligible instruments in 2021.

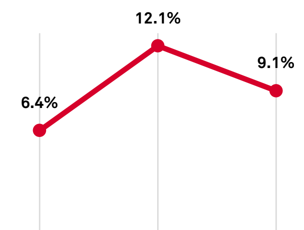
Primary Credit Analyst
Michal Selbka
Frankfurt
michal.selbka@spglobal.com
+49-69-3399-9300

Poland

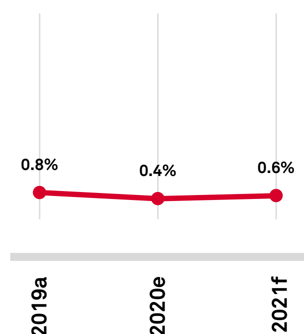
Loan growth



NPA ratio



RoAA



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Qatar | BICRA Group: 5

Damage From COVID-19 Is Likely To Be Manageable

Key takeaways

- We expect credit losses to increase and profitability to fall as both COVID-19 and lower hydrocarbon prices take their toll on Qatar's economy.
- Risks posed by significant external debt will likely remain high, although we expect some moderation in nonresident deposit levels.
- Qatar's government is wealthy and will maintain a highly supportive stance toward the economy and banks.

Key credit drivers

Hydrocarbon prices and government expenditure. The public sector is a key driver of loan growth, with the non-oil private sector contributing only around one-third of GDP. Given low hydrocarbon prices, the Qatari government has postponed some of its discretionary projects, while many infrastructure projects are nearing completion. We therefore expect fiscal expenditure to fall over the medium term, which could be offset somewhat by the development of new gas fields, providing some lending stability.

External funding vulnerability. We see the large presence of public sector deposits as a stabilizing factor. However, we see Qatari banks' dependence on external funding as a source of risk. These flows can be volatile because of market instability as a result of COVID-19 or if geopolitical risks escalate. We expect the government to provide support in case of significant outflows, as it did when a few Arab states imposed a boycott of the country in 2017.

Key assumptions

Economic contraction and slower loan growth. We expect real GDP growth to fall by 5.2% in 2020 before recovering in 2021, with downside risks still significant. Moreover, we expect domestic demand and consumer confidence to remain low.

Asset quality will deteriorate. The significant presence of the government and government-related entities in loan books should somewhat mitigate the extent of asset quality deterioration. However, we still expect that small and midsize businesses, particularly in hospitality and real estate, will add to the formation of nonperforming loans. We expect the system's nonperforming assets to climb to 3.5% by 2021, a figure likely to mask a divergence between those banks with access to high quality, strategically important borrowers and those without.

External funding likely to decline but remain high. We expect that COVID-19-related liquidity concerns will mean that some nonresident deposits will return home. We note the very strong relationship between external liability growth and domestic credit growth.

What to look for over the next year

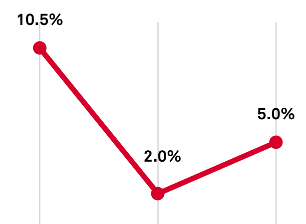
Macroeconomic performance. A second spike of COVID-19 and reimposed restrictions could permanently dent demand and place nonlinear strain on banks with exposures to the most affected sectors, namely real estate and hospitality.

Higher than expected outflow of external funding. Should nonresident deposit outflows become disorderly, funding strains could quickly develop and require government support, such as that extended in the recent past.

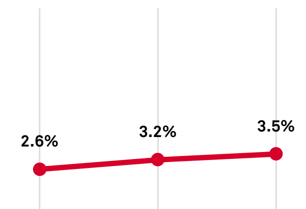
Primary Credit Analyst
Benjamin Young
Dubai
benjamin.young@spglobal.com
+971-4-372-7191

Qatar

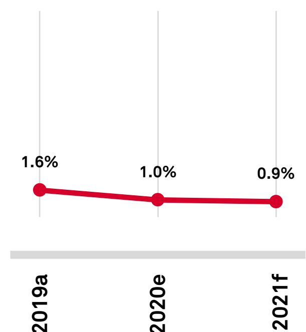
Loan growth



NPA ratio



RoAA



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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Russia | BICRA Group: 8

Elevated Credit Costs Amid Economic Recession And Market Volatility

Primary Credit Analyst
Sergey Voronenko
Moscow
sergey.voronenko@spglobal.com
+7-495-783-4003

Key takeaways

- Expected 4.8% economic contraction in 2020, exacerbated by the pandemic, will lead to increased credit losses.
- Nonperforming loans (NPLs) will likely double and profitability at least halve in 2020, with gradual recovery starting in 2021 on the back of an anticipated economic rebound.
- Banks' sound capital and liquidity accumulated over the past few years will somewhat soften downside risks.

Key credit drivers

Downside risk rests on the economic recovery scenario. If economic recession is deeper and the COVID-19 pandemic containment measures are more prolonged that our current expectations, these would substantially increase risks for Russian banks, casting doubt on the adequacy of their capital buffers.

Asset quality will deteriorate because of pressure from the pandemic and a decline in oil prices. Higher risks could stem from banks' exposures to small and midsize enterprises and unsecured retail lending, which will likely be hit harder than larger enterprises under our current macroeconomic scenario. Retail lending is about to reach a peak of healthy growth and therefore the retail lending credit cycle in Russia is turning. We assume that stage 3-loans may reach 15% by the year-end, compared with the about 8% the largest banks reported in 2019. Consequently, we estimate Russian banking-sector credit losses could reach 2.5%-3% of the average loan book in 2020.

Key assumptions

Sharp GDP contraction in 2020 followed by robust recovery. We believe the COVID-19 pandemic and a decline in oil prices will result in real GDP contracting by about 4.8% in 2020. We think Russia's economy is able to absorb the current shocks and will likely start recovering when the oil price and the global economy do, returning to growth of 4.5% in 2021.

Impact on the banking sector will remain manageable. We expect the system to demonstrate resilience in the face of this short-term event. We consider most large Russian banks better prepared to cope with adverse economic conditions than they were before past recessions. They started 2020 with stronger balance sheets, strengthened by their capital ratios and risk management frameworks. In addition, notably troubled institutions were bailed out over the past few years, which improved the sector's stability.

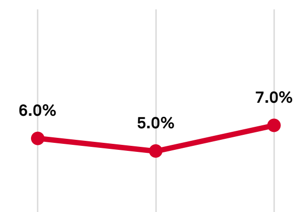
What to look for over the next year

Pace of economic recovery and currency stability. If the COVID-19 pandemic worsens or drags on for longer, it will lead to significantly slower economic recovery than in our forecast, translating to higher-than-expected NPLs and credit losses. Customers' economic stress will, over time, flow through to banks' profit-and-loss statements. The degree to which banks' financial strength can accommodate the dip prior to the expected rebound will be an important rating consideration.

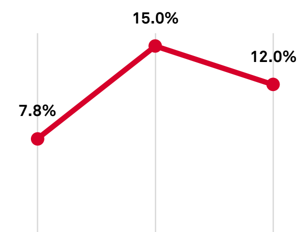
Material variation in future reporting. The next few quarters will likely show significant differences between banks in how they book provisions against future credit losses. The strongest and most conservative banks will likely recognize weaker exposures and provisioning for future potential problems earlier than weaker and less conservative banks. We will probably see great inconsistency in the way banks report their bad debt in 2020.

Russia

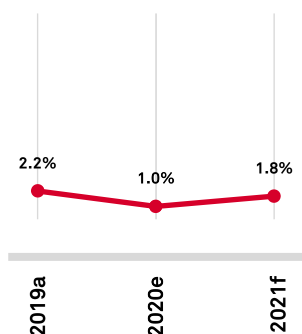
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming assets as a % of system wide loans. Measured as Stage III loans under IFRS classification.

RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Saudi Arabia | BICRA Group: 4

Banks' Profitability Will Suffice To Absorb Higher Losses

Primary Credit Analyst
Roman Rybalkin
Moscow, Russia
roman.rybalkin@spglobal.com
+7-495-783-4094

Key takeaways

- The economy will contract by 4.5% in 2020 as domestic activity stagnates and oil exports and prices remain low.
- The fiscal deficit will rise in 2020 as the government continues to maintain significant spending to support the economy.
- The cost of risk will increase to around 110 basis points (bps)-120 bps in 2020-2021 from 80 bps in 2019.

Key credit drivers

Dependent on the performance of the global economy. The Saudi banking system has largely demonstrated its resilience in a difficult environment of low oil prices and weak economic growth. However, growth depends substantially on the dynamics of the oil market and is vulnerable to global economic and regional geopolitical trends, as well as the non-oil economy.

Credit conditions had just normalized before the 2020 shocks. Muted investment activity of the corporate sector over 2017-2019 resulted in anemic credit growth in the economy (outside the mortgage segment), which only resumed growth in the last quarter of 2019. Banks' prudence in 2017-2019 will protect them in 2020-2021.

Funding profiles remains stable. Despite a recent build-up of external funding, the Saudi banking sector remains predominantly funded by customer deposits that have been stable. While we expect some further increase in external debt, the banking sector will remain a net external creditor.

Key assumptions

Lending growth will slow. After sharp growth in the first quarter of 2020, lending growth will slow abruptly as reallocation of government spending priorities due to COVID-19 and new taxes curb demand from corporates. Growth in mortgages will be resilient, albeit at a slower pace than in the past, given that government support for the sector will remain under our assumptions.

Cost of risk will pick up. We believe that the COVID-19 pandemic will have a higher impact on the non-oil part of the economy than the oil price declines of 2008 or 2014. This will test Saudi banks' credit quality. The contracting industry will suffer, despite write-off of problematic exposures over previous years, and the hospitality and commerce sectors will be hit owing to safety measures and travel restrictions. We expect the cost of risk to increase to 110 bps-120 bps in 2020-2021.

Profitability will stay resilient. Lower interest rates, slow growth, and the higher cost of risk will put pressure on Saudi banks' profitability. We believe, however, that Saudi banks will be able to absorb it and keep a return on average assets of about 1.2% in coming years.

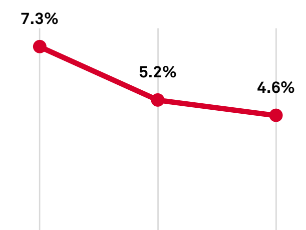
What to look for over the next year

Evolution of safety measures. Travel restrictions have directly affected the Saudi economy through a sharp fall in the number of pilgrims, and indirectly affected it via oil prices. As a result, economic growth will depend on lifting travel restrictions and the scale of the Hajj and Umrah pilgrimages.

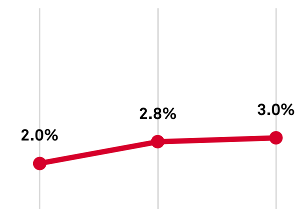
Fiscal response will evolve. As low oil prices strain the government's fiscal position, pushing the fiscal deficit to record high levels in 2020, the government will have to solve the conundrum of preserving fiscal stability while providing sufficient support and stimulus to the economy.

Saudi Arabia

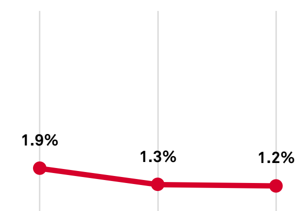
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Slovenia | BICRA Group: 4

Recent Improvements Provide Buffers Against Economic Downturn

Key takeaways

- The recession provoked by COVID-19 will delay Slovenia's further economic convergence with the eurozone average.
- Slovenian banks entered the economic downturn from a position of strength with sufficient capital and liquidity buffers to absorb pressure on asset quality and earnings.
- Significant stress on the corporate sector will push asset quality down and risk costs up, but large-scale government support programs will usher the banking system through the crisis.

Key credit drivers

COVID-19 rapidly halted the country's improving trajectory in income and asset quality. Given Slovenia's reliance on exports and tight integration into European supply chains, weak external demand puts significant pressure on the domestic corporate sector and its credit quality. Additionally, tourism and the close trade relationship with Italy are further areas of concern. However, we believe the setback in Slovenia's economic convergence with the eurozone average will be temporary, and we think the country is well positioned to benefit from the rebound expected in 2021.

Banks are entering the downturn from a position of strength. Private-sector deleveraging and asset quality improvements in past years have provided Slovenian banks buffers to weather the temporary shock better than in previous crises. The banks' comfortable capital and liquidity buffers will likely limit the adverse impact on the banking system and preserve overall sector stability, despite significant pressure on asset quality and earnings. Additionally, stronger governance and underwriting criteria should help limit the rise of nonperforming assets (NPAs) and credit losses.

Key assumptions

Sharp economic contraction followed by a robust recovery. In our base case, we expect Slovenian GDP will contract by 7.8% in 2020 because of the COVID-19 pandemic. Slovenia was the first EU country to lift most pandemic related restrictions, in May. While some precautions remain in place, we think reopening the economy will pave the way for the recovery, and we thus forecast real GDP will rebound by 5.2% in 2021.

Credit pressure on corporate sector. Slovenian banks' asset quality hinges critically on the performance of corporates and small and midsize enterprises, which are still burdened by an NPA ratio that well exceeds the 2.2% average for the country. We expect the banking sector's domestic credit losses will rise to 80 basis points (bps) for 2020, versus our five-year average of 20 bps, and we believe the corporate sector will be the main driver. Mortgage lending will likely not be the main cause in the first wave, because it is supported by government programs, but more stress will accompany rising unemployment.

What to look for over the next year

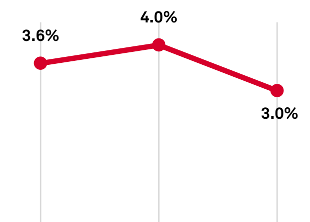
We see risks that our base case could worsen. If the downturn lasts longer or the rebound is more tepid than our economists currently forecast, it could imply a more negative effect on the banking system. Risk costs rising significantly above our expectation, severely deteriorating asset quality, and sustainably weakening profitability could add to pressure on bank ratings.

Loan moratorium will delay loss recognition. Although regulatory forbearance will help weaker borrowers, it can also delay recognition of, and perhaps also adequate provisioning against, NPAs. Borrowers' ultimate ability to meet the terms of the loans will become clear only once the mandatory loan moratorium ends. Because the private sector is generally resilient, with wealth levels being the highest in Central and Eastern Europe (CEE), we expect use of the moratorium will be lower than other CEE countries.

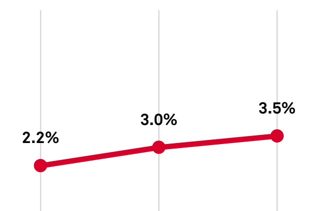
Primary Credit Analyst
Gabriel Zwicklhuber
Frankfurt
gabriel.zwicklhuber@spglobal.com
+49-69-3399-9169

Slovenia

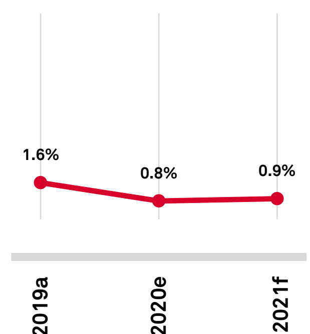
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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South Africa | BICRA Group: 6

High Credit Losses And Weak Economic Growth

Key takeaways

- Weak economic growth, exacerbated by the COVID-19 pandemic, will lead to higher credit losses.
- Retail and small and midsize enterprises will be the most affected by the lockdown, despite support measures.
- Risk of portfolio outflows will persist in the second half of 2020.

Key credit drivers

Total credit will contract. We anticipate total private sector credit (from banks and capital markets) will contract to about 80% of GDP through 2021 because of the sharp economic drop. We forecast credit to the private sector will shrink by about 5% in 2020, followed by low single digit growth in 2021.

Asset quality will deteriorate. Household debt and affordability metrics will come under pressure in 2020, despite lower interest rates. In addition, we expect the strict lockdown and gradual reopening of the economy in 2020 to strain the commercial real estate sector. As a result, we forecast credit losses will rise to 1.8% in 2020.

Risk of portfolio outflows will persist. The combined effect of uncertainties linked to the pandemic and the exit of South Africa bonds from the FTSE Russell WGI index in May 2020 will likely lead to sustained portfolio flow volatility through 2020. Meanwhile, the South Africa Reserve Bank lowered the liquidity coverage ratio to 80% from April 2020 in anticipation of potential volatility of this ratio if outflows persist.

Key assumptions

Sharp economic contraction. We estimate real GDP will contract by 6.9% in 2020, largely due to COVID-19 effects, before rebounding 4.7% in 2021.

Fiscal risks are at the highest. The weak macroeconomic environment will weigh heavily on fiscal revenue. We expect the headline fiscal deficit will widen to 13.3% of GDP in 2020. At the same time, the debt burden will continue to rise.

What to look for over the next year

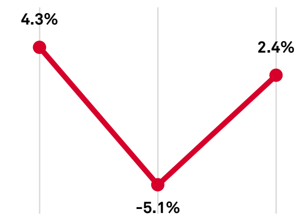
Stable banking sector despite a profitability dip. We expect banks' regulatory capital ratios will remain strong, despite significant pressure on revenue in 2020-2021 stemming from higher impairments.

Reforms will slow. The prudential authority provided capital relief measures. We continue to believe that a deposit insurance scheme, and ultimately an effective resolution regime, will be introduced. However, the timeline has become uncertain in the wake of the current global crisis.

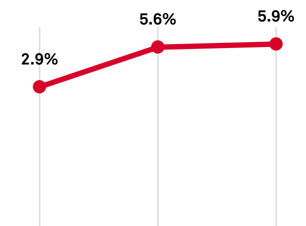
Primary Credit Analyst
Samira Mensah
Johannesburg
samira.mensah@spglobal.com
+27-11-214-4869

South Africa

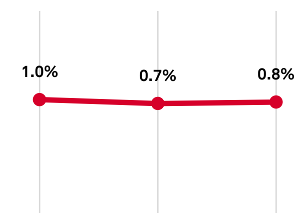
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Tunisia | BICRA Group: 10

Banks' Performance And Capitalization Will Be Severely Hit

Primary Credit Analyst
Anaïs Ozyavuz
Paris
anais.ozyavuz@spglobal.com
+33-1-4420-6773

Key takeaways

- The major economic shock caused by COVID-19 will increase pressures on the already high current account and fiscal deficits.
- This will further undermine Tunisian banks' already weak asset-quality indicators, profitability, and capitalization.
- The Central Bank of Tunisia (CBT) will continue extending significant liquidity support to the system in response to banks' worsening liquidity squeeze.

Key credit drivers

Operating conditions are weighing on banks' performance. We believe the system's asset quality indicators will deteriorate in 2020-2021 because we expect the economy to experience a sharp recession followed by only a mild recovery.

Liquidity profiles remain stretched. The CBT has extended significant liquidity support over the past few years and we expect that to continue in the next couple of years.

Banks funding profiles remain weak. Customer deposits--banks' main funding source--are still insufficient to finance their lending and banks' access to external funding is limited. The shortfall in funding is being covered by CBT support.

Key assumptions

The COVID-19 pandemic will likely have a lasting impact on the economy. We expect Tunisia's economy to contract by around 5% in 2020 and unemployment to rise, followed by a shallow recovery in 2021.

Real estate price correction will accelerate. The real estate sector, which has been facing softening prices since 2016, will suffer an abrupt correction of prices over the coming quarters as increasing unemployment dampens domestic demand and the global recession reduces external demand from Tunisian expatriates.

Credit losses will increase. Banks' exposures to retail, tourism, some exporting industries, and real estate, will mildly increase the cost of risk in 2020 and further in 2021.

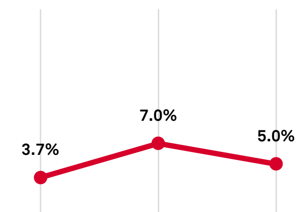
What to look for over the next year

Monetary policy. Further rate cuts and drastic liquidity injections beyond the Tunisian dinar 10 billion announced could lead to local currency depreciation and soaring inflation. Aggressive monetary policy easing could also exacerbate Tunisian banks' unbalanced funding profiles.

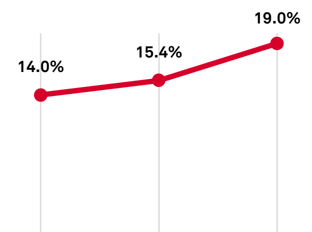
Political instability. Economic recovery will depend on the government's ability to cope with the current crisis, continue receiving support from multilateral institutions, and implementing reforms. Reforms are hindered in our view by the lack of a strong majority and rising social discontent.

Tunisia

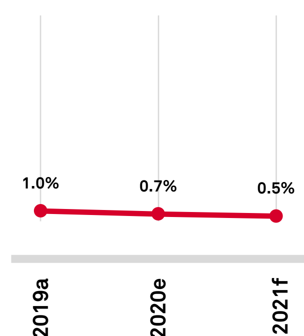
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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a--Actual. e--Estimate. f--Forecast.

Turkey | BICRA Group: 9

Refinancing External Debt And Asset Quality Are Key Risks

Key takeaways

- Maintaining positive investor sentiment is key because of the sector's structurally high reliance on short-term external funding.
- Increasing deposit dollarization is exacerbating pressure on the funding profile.
- Asset quality will continue to deteriorate, adding pressure to already strained profitability and capital.

Primary Credit Analyst
Financial Institutions Ratings Europe
FIG_Europe@spglobal.com

Key credit drivers

Banks are exposed to high refinancing risk. As of April 2020, banks had $76.5 billion of external debt to roll over by March 2021, including about $35 billion of nonresident deposits. In our central scenario, we expect banks to roll over about 80%-90% of their debt and the lira to depreciate by about 12% versus the U.S. dollar in 2020.

Profitability and capitalization are under pressure. We expect banks' capitalization to weaken because of increased credit losses, lower operating revenue, strong lending growth, and the weak lira. The change in calculating regulatory capital adequacy ratios will likely neutralize the effect of the weak lira in the short term, though. Given their strong lending growth, public banks' capitalization will likely face greater pressure.

Public banks will lead lending growth. We expect them to continue gaining market share in 2020. Their lending increased by about 24% in the first four months of this year, but the rest of the sector gained only 11%. We think this divergence is distorting the banking sector's competitive dynamics.

Key assumptions

Economy will contract in 2020. We forecast that Turkey's GDP will decline by 3.3% in 2020 before recovering to 4.5% in 2021. The expected recession follows an already weak performance in 2018 and 2019.

Balance-of-payments vulnerabilities are high. We estimate that Turkey's current account will remain in surplus in 2020, given weak economic activity and import contraction. Still, gross external financing needs are high with the economy needing to roll over about $165 billion (24% of GDP) of debt over the next 12 months. In our view, the central bank has only limited means to counteract exchange rate volatility or meet unexpected external financing requirements.

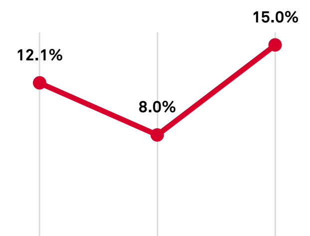
What to look for over the next year/rest of the year

We expect asset quality to deteriorate amid economic recession and a weaker lira. It might take time to become apparent because of forbearance measures and moratoria. We expect the nonperforming loan (NPL) ratio to reach 11%-12% by the end of 2021 and problematic loans (NPLs plus restructured loans) to exceed 20% of total loans. We forecast the cost of risk will rise to 320-330 basis points (bps) on average for 2020 and 2021 from an already high 270 bps in 2018-2019.

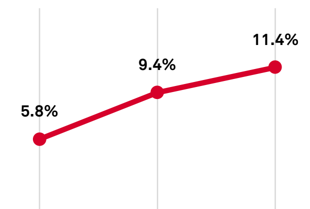
Banks might suffer from the general decrease in confidence. Greater risk aversion from international investors might affect banks' ability to roll over their external debt. Domestic depositors could increasingly convert their savings into foreign currency, adding pressure on the banking sector.

Turkey

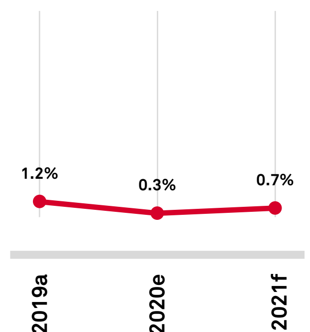
Loan growth



NPA ratio



RoAA



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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Ukraine | BICRA Group: 10

Likely Delay In Resolution Of High Legacy Nonperforming Loans

Primary Credit Analyst
Annette Ess
Frankfurt
annette.ess@spglobal.com
+49-0-6933-999-157

Key takeaways

- Adequate regulatory response and sufficient liquidity cushions will help Ukrainian banks weather this crisis better than they did in 2008 and 2014.
- COVID-19 might delay the legislative amendments to boost resolution of legacy nonperforming loans (NPLs), especially at public banks, which were expected to be adopted in 2020.
- Ukraine's parliament approved a law in mid-May 2020 that stipulates no reversal of PrivatBank's nationalization, mitigating pressure on the bank's stability and boosting depositors' and investors' confidence in the banking sector.

Key credit drivers

Reduction in the very high level of legacy problem loans. Reported systemwide NPLs stood at 49% on March 31, 2020, mostly legacy loans originated many years ago, reflecting very weak asset quality at public banks, high related-party lending, large share of loans in foreign currency, and still-pending mechanisms for orderly NPL resolution.

Privatization of public banks. Four public banks, accounting for about 54% of system assets and reporting the highest NPL levels, distort the system by creating an uneven competitive field for private banks. The state intends to sell PrivatBank and minority stakes in other public banks eventually, which should diminish the distortions. However, we do not expect this to happen in the next two years, owing to unsupportive market conditions.

Key assumptions

The pandemic will cause economic contraction in 2020, as in peer countries. We expect Ukraine's economy to contract by 5.5% in 2020 because of COVID-19 pressures and countermeasures, followed by 5% growth in 2021, assuming the lockdowns will ease in the third quarter of 2020.

PrivatBank's nationalization is final and irreversible. Ukraine's parliament approved a law in mid-May 2020 stipulating that the former owners of PrivatBank may no longer contest its nationalization. This should remove any uncertainty of investors and depositors about the future development of the country's largest bank, as well as support banking sector stability.

Effective regulatory response to COVID-19 to support Ukrainian banks. Ukraine's banking regulator has taken timely and proactive measures to support the banking system in the current stress, including reducing the key rate to 8%, providing additional liquidity, relaxing capital requirements, and recommending dividend suspension, among other measures.

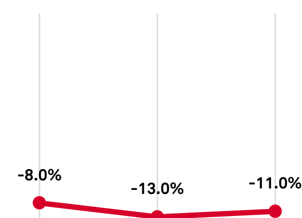
What to look for over the next year

Profitability to deteriorate markedly from 2019's record levels. We expect the return on assets to decrease to below 2% in 2020-2021 from 4.7% in 2019, due to slower loan growth, pressure on the net interest margin, and a marked increase in the cost of risk to about 2.5%-3% from 1.2% in 2019.

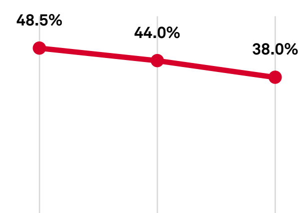
Developments in the hryvnia exchange rate. If the hryvnia depreciates more than the 15% already recorded in 2020, asset quality will suffer, given 48% of corporate loans and 4% of retail loans are in foreign currency. Furthermore, intensified expectations of currency depreciation could lead to a run on banks and/or conversion of hryvnia deposits into foreign currency, thus increasing currency risk in the banking system.

Ukraine

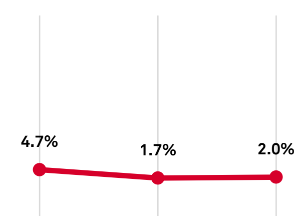
Loan growth



NPA ratio



RoAA



2019a | 2020e | 2021f

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

United Arab Emirates | BICRA Group: 5

Slowing Economy Will Weaken Banks' Asset Quality And Profitability

Key takeaways

- We expect the economy to contract by 8.1% in 2020.
- Lower oil prices, slower economic activity due to COVID-19, and lower interest rates will usher in a rise in problem loans, increase the cost of risk, and dampen banks' profitability.
- The support package of the United Arab Emirates' (UAE's) central bank should help ease the pressure on corporate issuers and small and midsize enterprises, but it will not reduce structural credit risk on the banking system's balance sheet.

Key credit drivers

Operating conditions are weighing on banks' performance. We believe asset quality and profitability will deteriorate in 2020 as the economy experiences a sharp recession with GDP contracting by 8.1%. Growth will return in 2021, helped by the Abu Dhabi government's public sector spending, investments by ADNOC in both the oil and non-oil sectors, and increased economic activity associated with the Dubai Expo, which COVID-19 pushed to 2021.

Relaxation of certain prudential requirements bears risks for the banking sector. To counter the impact of COVID-19, the central bank relaxed certain prudential requirements, which risks eroding banks' capital buffers of banks, albeit from high levels. Relaxation measures include raising the limit on banks' exposure to the real estate sector, increasing the loan-to-value limits for first-time homebuyers, halving banks' required deposit reserve requirements, and reducing regulatory capital conservation buffers.

Key assumptions

Lending growth will slow down. We expect loan growth of about 3% in 2020, driven by the central bank's Targeted Economic Support Scheme for banks to support stressed private sector companies, which included a UAE dirham 50 billion ($13.6 billion) interest-free collateralized funding scheme.

The government will continue to support the banking system. We expect the government to continue supporting the banking system directly and indirectly.

What to look for over the next year

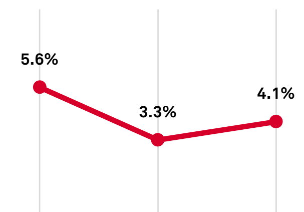
Asset quality to deteriorate. The oil price drop and slowed economy will lead to a rise in problem loans and the cost of risk. This is happening when the real estate sector was already under significant stress and other sectors, such as hospitality and discretionary consumer goods, are experiencing a significant decline in revenue, dragging on their credit quality. Because of the loan moratoriums in place for affected clients, we believe that the peak in nonperforming loans and the bulk of asset quality deterioration could crystallize only in 2021. We expect cost of risk to increase to 140 basis points (bps)-150 bps in 2020-2021.

Bank profitability to decline sharply. Margins should tighten, given that UAE reduces its interest rates in line with the U.S. Federal Reserve. This could result in a decline of 50 bps-75 bps in UAE banks' average net interest margins. Lower margins and higher credit losses would lead to a sharp decline in UAE banks' net profits.

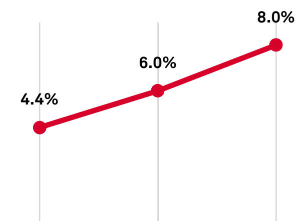
Primary Credit Analyst
Puneet Tuli
Dubai
puneet.tuli@spglobal.com
+971-4-372-7157

United Arab Emirates

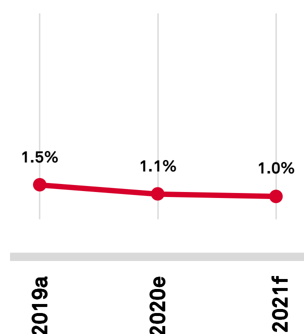
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Uzbekistan | BICRA Group: 8

Higher Credit Costs Amid Slower Economic Growth

Primary Credit Analyst
Victor Nikolskiy
Moscow
victor.nikolskiy@spglobal.com
+7-495-873-4010

Key takeaways

- Economic growth is set to decelerate in 2020 to 1%, driven by the coronavirus pandemic, leading to an increase in credit losses in the banking sector.
- We expect credit losses to grow to about 3%-4% in 2020 and nonperforming loans (NPLs) to 4%-5%.
- We believe that growing economic risks will lead to increasing difficulties for Uzbek banks, especially for smaller players, constraining their business growth, earnings prospects, and funding sustainability.

Key credit drivers

Asset quality will deteriorate, reflecting deceleration in economic activity. We believe that Uzbek banks' credit losses will increase significantly in 2020-2021 to 3%-4%, from 1.6% in 2019, and NPLs will rise to 4%-5% in 2020, gradually decreasing in 2021.

Downside risk relates to the economic scenario. If economic recession is deeper and pandemic containment measures are more prolonged than our current expectations, this would substantially increase risks for Uzbekistan's banks.

Key assumptions

Decreased GDP growth and still-high inflation. We expect GDP growth of only 1% in 2020, reflecting the hit to domestic and external demand from COVID-19 containment measures. We believe that the economy will absorb the current shock and will likely return to growth of 5% on average in 2021-2022. We expect inflation will remain at about 13% over 2020. Growth in public sector wages, continued depreciation of local currency, and loose monetary policy, combined with the liberalization of regulated prices, also add to inflationary pressure.

The impact on the banking sector will be manageable, but smaller banks will feel higher pressure. We expect the system to demonstrate resilience in the face of this short-term event. Solid capital buffers will support the largest banks' profiles. The hit on asset quality will likely be softer for them since these state-related banks have higher exposure to state-owned enterprises (SOEs) and subsidized mortgages, and lower exposure to small and midsize enterprises (SMEs) and private entrepreneurs. We think that SOEs will likely benefit from government support. At the same time, we expect subsidized mortgages will show a more resilient performance than loans to small private businesses and unsecured retail loans. Similarly, we expect funding profiles of large players will be stable, supported by deposits from SOEs and government entities. We expect that smaller banks will report credit costs, NPLs, and restructured loans significantly above the average for the system.

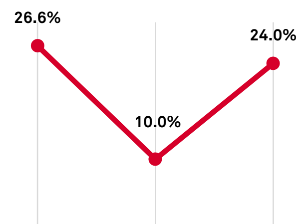
Economic reforms will continue. We expect the government will proceed with its wide reform agenda. The impact of the reforms on SOEs, including banks, could be the most important change for the sector in the medium term. We expect gradual privatization of state owned banks in the coming years to progress, despite a tougher economic environment.

What to look for over the next year

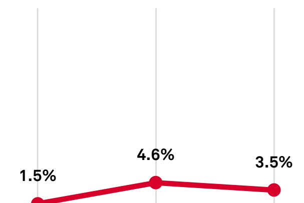
Asset quality dynamics are among the key metrics to watch. The evolution of banks’ asset quality and credit losses in the context of the COVID-19 pandemic and economic deceleration are metrics to watch. At the same time, 2020 full-year accounts are likely to show significant differences between banks in the way they book provisions against future credit losses.

Uzbekistan

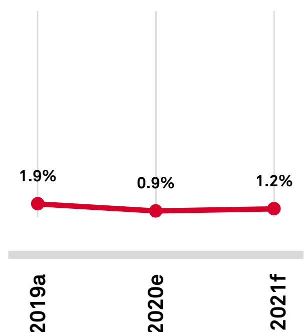
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming assets as a % of system wide loans.

RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Asia-Pacific

BICRA groups: lowest to highest

Mongolia
China
Korea
Japan
India
Taiwan
Hong Kong SAR
Bangladesh
Vietnam
Cambodia
Philippines
Thailand
Sri Lanka
Malaysia
Brunei
Singapore
Papua New Guinea
Indonesia
Australia
New Zealand

Group '1' to '10', from lowest to highest risk. BICRA--Banking Industry Country Risk Assessment.
Data as of June 30, 2020. Source: S&P Global Ratings.

Australia | BICRA Group: 3

Temporary Rise In Economic Risks

Key takeaways

- Australian banks face substantial but temporary increase in economic risks due to the COVID-19 outbreak. We see a one-in-three possibility that the economic hit for the banking sector could be significantly more severe or prolonged than our base case.
- We forecast credit losses to rise to about six times those in 2019 before easing. We also expect house prices to fall by about 10% before resuming modest growth around the middle of 2021.
- Most Australian banks should be able to absorb our forecast rise in credit losses within their earnings despite lower interest and fee income.

Key credit drivers

Fiscal and monetary support should soften the blow from COVID-19 driven recession. We expect the COVID-19 outbreak to drive a 4% contraction in Australia's GDP in 2020 before the economy rebounds with 5.3% growth in 2021. Large fiscal stimulus by the government and moratoriums on loan repayments offered by the banks should cushion the blow for many borrowers. In addition, timely and coordinated monetary support from the central bank has alleviated bank funding and liquidity risks, in our view.

Banks are well placed to absorb increased credit losses. We believe that most Australian banks retain good headroom within their earnings to absorb our forecast sizable increase in credit losses in conjunction with a significant contraction in interest and fee income. In addition, we expect the banks to maintain their capital strength by cutting dividend payments and issuing new capital, if needed.

Key assumptions

Credit losses to rise by six times. A contracting economy, rising unemployment, and weak consumer and business sentiment will weaken the banks' asset-quality metrics. We forecast that the annual credit losses will peak at about 85 basis points (bps) of gross loans by 2021, nearly six times their historical low in fiscal 2019. In line with our broader economic forecast, we estimate that credit losses to ease to about 50 bps of gross loans and advances in 2022.

House prices to fall by about 10%. We expect housing prices to fall by about 10% before resuming modest growth in 2021 on the back of economic recovery. We also anticipate demand for housing to remain muted for the next 12-18 months, as travel restrictions will severely restrict immigration for some time.

What to look for over the next year

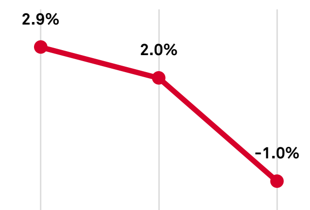
Post COVID-19 path to economic recovery. The effect of COVID-19 on banks' asset quality will become clearer when moratoriums on loan repayments end and the government reduces the fiscal support. A number of households and businesses are likely to struggle to meet their financial obligations at that time, in our view. In addition, we see a one-in-three possibility that the effect of economic downturn due to the COVID-19 outbreak on the banking sector could be significantly more severe than our base case. The banks' capital buffers above minimum regulatory requirements could also erode in that scenario.

Technology-driven changes in the banking industry. The sector is entering a period of significant change as market participants respond to new technologies and increasing customer demand for tech-driven convenience. In our opinion, social distancing measures to limit COVID-19 transmission will increase consumer adoption of financial technologies, accelerating Australia's transition to a technology-driven financial system with a reduced physical footprint. We believe that the major banks are well placed to deal with tech disruptions, given their dominant market positions. Nevertheless, their earnings could compress as technology may intensify competition in some parts of the value chain.

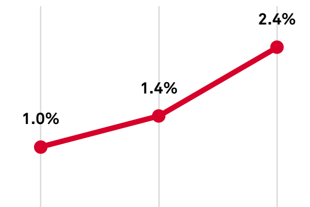
Primary Credit Analyst
Sharad Jain
Melbourne
sharad.jain@spglobal.com
+61-3-9631-2077

Australia

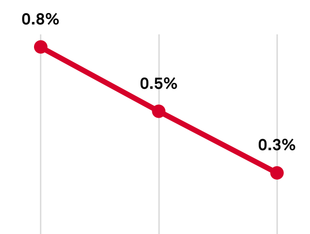
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming assets as a % of system wide loans.

RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Data are for June year-end.

Bangladesh | BICRA Group: 9

Structural Weaknesses Not Going Away Anytime Soon

Primary Credit Analyst
Michael Puli
Singapore
michael.puli@spglobal.com
+65-6239-6324

Key takeaways

- Global economic recession and supply chain disruptions will weigh on the banking system.
- Asset quality risks remain extremely high with the government having little ammunition to boost underlying economic strength and address corporate defaulters.
- Lending rate caps to keep interest margins low and squeeze the already stressed banking system.

Key credit drivers

Nonperforming loans could reach new heights. Deteriorating economic conditions could further exacerbate persistently high levels of stressed assets (including restructured loans), in our view. Revision in loan classification standards in the past two years may result in better headline nonperforming loan metrics but the underlying asset quality is likely to remain weak. These issues will continue to play out with the government's stimulus measures now including existing corporate defaulters.

Weak industry profitability and capitalization will continue. The banking sector is fragmented with about 60 banks; while new banks continue to enter an already crowded market. This fragmentation is one of the many factors that undermine the sector's efficiency and overall profitability, although the average hides the significant gap between good and poor performing banks. While the country is implementing Basel III regulation, progress is slow and frequently takes backward steps. Many banks struggled to meet the minimum capital requirements (including provisioning standards) before COVID-19. The central bank has prohibited banks from distributing cash dividends until September 2020.

Key assumptions

Macroeconomic conditions to remain challenging. The economic slowdown globally will affect Bangladesh's GDP, exports, and remittances, noting its high export reliance. Tempering this is the relatively low cost of labor and production, making it attractive for manufacturers in the region.

Weak asset quality. Bangladesh's banking industry faces structural asset quality challenges due to weak lending standards and foreclosure laws. Regulatory forbearance to reschedule weak loans undermines credit discipline. State-owned banks will continue to hold a large amount of weak assets.

What to look for over the next year

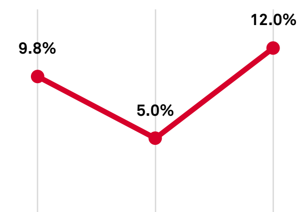
Credit growth to stay muted. We expect credit growth to continue to decelerate as seen in the past few months. Global supply chain disruption and the subsequent fall in trade financing volumes has hurt demand. The central bank, however, continues to take various measures to revive credit growth especially toward small and medium enterprises and the agriculture sector. It also raised the advance-to-deposit ratio for scheduled commercial banks to 87%, reduced the reverse repo rates and cash reserve ratios among others.

Rising pressures on margins. We expect interest income to remain low as loan payments halt during the moratorium. Further, the central bank imposed a lending rate cap of 9% on all loans barring credit cards effective April 2020 and 4% cap on existing and new farm loans. This will likely squeeze bank margins.

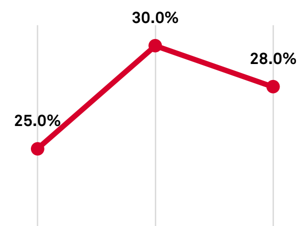
Liquidity pressures for small banks building. Smaller banks could face liquidity crunches as the two-month blanket moratoria for all loans, except credit cards, announced by the central bank brings cash inflows to a near halt. Deposit withdrawals could also rise, as businesses remain shut due to the lockdown. That said, the central bank's policy measures could offer some respite.

Bangladesh

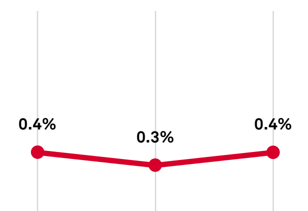
Loan growth



Stressed asset ratio



RoAA



2019a | 2020e | 2021f

Loan growth – Sector-average growth in loans.

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Brunei | BICRA Group: 6

Strong Public Finances And Oil Price Recovery Should Support Banks

Key takeaways

- The decline in energy prices and the COVID-19 pandemic are likely to weaken the economy in 2020. We expect the energy sector and the public health situation to improve thereon.
- Bank profitability is likely to dip as interest margins will decline as global interest rates inch lower while credit costs are likely to rise.
- That said, banks currently have historically high profitability and strong balance sheets.

Key credit drivers

Deterioration in asset quality. We expect credit losses in Brunei's banking system to increase (from a very low base in the past few years) because of tepid economic activity. However, the effect on banks is likely to be limited because the government will support the economy and employment by maintaining counter-cyclical spending.

Moderation in profitability. We expect bank loan books to expand at low single digits in the next few years. On the wholesale banking side, growth is likely to be driven by the government's efforts to diversify the economy and support local firms through contracts from government-linked companies and foreign direct investment projects. Retail activity will remain constrained by total debt service ratio (TDSR) regulations. Bank profitability is likely to reduce as interest margins decline as global interest rates inch lower while credit costs are likely to rise. That said, banks currently have historically high profitability and capital levels. We believe that they are likely to maintain their substantial deposits from a wealthy government and its related entities, and the retail sector.

Key assumptions

Strong fiscal position should insulate the economy from oil price shocks. Brunei's oil and gas industry accounts for more than half of the country's GDP and more than 70% of government revenues. Economic growth will be dampened in 2020 by declines in oil prices and the COVID-19 pandemic sweeping across the world. Energy prices have declined in the wake of weak global demand and initial lack of consensus among major oil producers on production cuts. COVID-19 cases climbed in Brunei since the country registered its first case in early March. However, there are signs of containment. We expect both the energy sector and the public health situation in Brunei to improve from the later part of 2020. We consider that the government's strong net fiscal asset position and oil wealth accumulated over several years should help it to buffer the economy against shocks through countercyclical spending.

Government to remain supportive and funding will remain robust. We expect a high likelihood that the Brunei government would provide timely and sufficient extraordinary support to major local banks if needed. Brunei banks have robust liquidity given the strong surpluses at the country's government and related enterprises, and limited lending opportunities.

What to look for over the next year

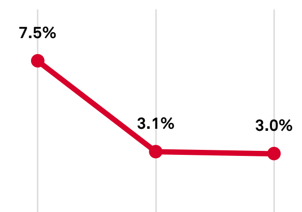
Financial sector reforms. Progress is being made toward establishing a bond market and a stock exchange to create alternative funding routes.

Downside risks. We expect the economy to remain resilient to the effect of COVID-19 and low oil prices owing to ongoing support from the government. Nevertheless, a substantially larger and more prolonged hit to the economy than our base-case forecast could weaken the banking system's stability.

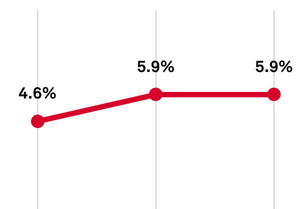
Primary Credit Analyst
Amit Pandey
Singapore
amit.pandey@spglobal.com
+65-6239-6344

Brunei

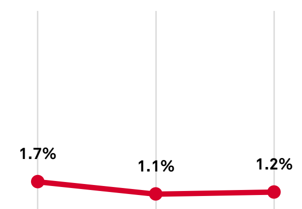
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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Cambodia | BICRA Group: 9

Economic Headwinds Pose Risks To The Banking System

Key takeaways

- We expect the economic slowdown globally and particularly in China to weigh on Cambodia's export- and tourism-dependent economy.
- Credit losses and restructured loans set to increase as economic and bank growth have increasingly relied on tourism, real estate, and construction sectors.
- Central bank's directive on loan repayment moratorium likely to push up restructured loans.

Key credit drivers

High risk of a sharp correction in construction and property segments. The banking sector's high exposure to real estate related activities and use of property as collateral could exacerbate the risks to the financial sector amid the economic uncertainty due to the COVID-19 outbreak. We believe a correction could be triggered by a change in foreign sentiment and investment, particularly from China. Loans to construction and real estate sectors have grown rapidly in recent years; in 2019, loans to these sectors increased by 37%.

High dependence on China. A slowdown in the Chinese economy poses risks to the Cambodian economy and financial system, although China's relative recovery from COVID-19 should also help recovery in Cambodia. In 2019, China accounted for more one-third of total tourist inflows and about 50% of foreign direct investment inflows in Cambodia.

Key assumptions

Global macroeconomic conditions to remain testing. Cambodia's export- and tourism-dependent economy faces risks due to the global downturn. The EU's partial withdrawal of tariff preferences under the "Everything But Arms" (EBA) scheme is expected to take effect in August 2020 and exacerbates weak conditions. This withdrawal effects around 20% of Cambodia's significant yearly exports to the EU.

We expect credit growth to decelerate. We expect borrowing by sectors such as tourism and manufacturing to decelerate reflecting the likely contraction in Cambodia's GDP for 2020. We expect loan growth to resume in 2021 as tourism, appetite for foreign investment (particularly given a movement of low cost manufacturing away from China), and general global economic conditions improve.

What to look for over the next year

Restructured loans to climb up. We expect that restructured loans will rise following the March 2020 central bank directive for banks to restructure loans for borrowers that were impacted by the pandemic in the tourism, textile, construction, and transport and logistics sectors. While headline nonperforming asset levels may not materially increase, we believe asset quality will inherently and understandably deteriorate given underlying economic issues.

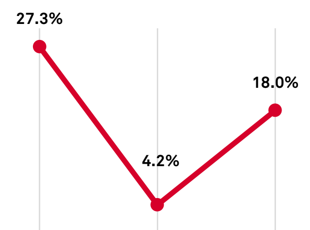
Implementation of capital conservation buffer (CCB) delayed. Similar to many other bank regulators, the National Bank of Cambodia has delayed the implementation of CCB by one year, which should help preserve banks' liquidity and encourage credit growth. We expect that the central bank will remain committed to the path to improve capital buffers and enhance regulatory supervision post COVID-19.

Cashless transactions getting a boost. We expect COVID-19 to accelerate the speed of digital adoption in banking-related services. The central bank has strongly pushed banks and customers to transact via cashless means, which should be a boon for banks with solid digital banking platforms.

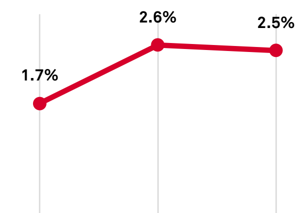
Primary Credit Analyst
Michael Puli
Singapore
michael.puli@spglobal.com
+65-6239-6324

Cambodia

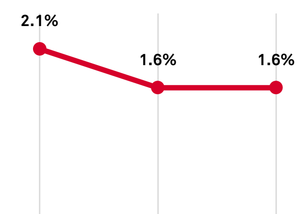
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

China | BICRA Group: 6

Spike In Forborne Loans; Weak Banks Deteriorate Further

Primary Credit Analyst
Harry Hu
Hong Kong
harry.hu@spglobal.com
+85-2-2533-3571

Key takeaways

- China's banking sector has sufficient buffer to absorb the economic blow from COVID-19.
- However, risks remain on the downside and China's regional banks with aggressive risk appetite or high geographic concentration in regions heavily hit by the virus outbreak are most vulnerable.
- Bank profits are likely to remain constrained by net interest margin pressures and new credit provisions even as loan growth stays high.

Key credit drivers

Stable economic risk trend. We see a stable trend for economic risks affecting China's banking sector; these risks are already high, in a global context. We believe the country's banking sector, on average, has the buffer for worsening asset quality due to COVID-19.

COVID-19 effect on the major China banks to be manageable. We believe the largest China banks are adequately placed to manage the effect of COVID-19, while smaller banks with aggressive risk appetite or high geographic concentration in regions hit by the virus could see a material squeeze on their asset quality, performance, and capitalization. Nevertheless, the risk of a banking crisis in China is not high over the next 12 months, in our view. Ample system liquidity should keep acute crisis at bay. Problematic banks may be managed less conspicuously compared to last year as authorities emphasize on financial stability while asking banks to lend more support to the real economy.

Key assumptions

NPA ratio to double. In our view, reported nonperforming loans (NPLs) will only moderately rise, despite widespread loan forbearance. We expect most of these forborne obligations to be classified as special-mention loans or earmarked as normal loans, rather than NPLs. S&P Global Ratings' broader metric for assessing China banks' asset quality--nonperforming assets (NPA)--includes the effect of loan forbearance and shows a sharper deterioration. We project the NPA ratio for China's banks will double to 10% of gross loans and credit losses will rise to about 145 basis points of gross loans in 2020.

Increased policy efforts will alleviate some pain. Credit support to the many small businesses hit by this pandemic should ease near-term downside risk. Nevertheless, we expect credit cards, wholesale and retail trade, transport and logistics, and manufacturing sectors to be the hardest hit.

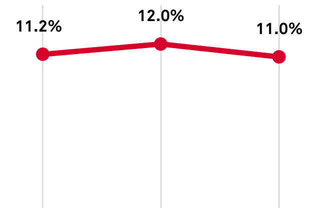
What to look for over the next year

High credit growth but lower profitability and high NPAs. We estimate overall loan growth at about 12% in 2020 and 11% in 2021, buoyed by supportive policies for selected sectors, and looser monetary settings. We expect small business loan growth to be high, while unsecured consumer lending will slow down. Manufacturing and infrastructure investment loans could increase above trend. Nevertheless, higher NPAs from COVID-19 could take years for banks to digest. The speed and magnitude of forborne loans turning into NPA would largely be linked to the strength of China's economic recovery. A significant part of credit cost and profitability hit may be felt for two to three years. While we expect the large banks to continue to make reasonable loan loss provisions, some weaker banks may manage the asset quality and profit impacts over a period of time.

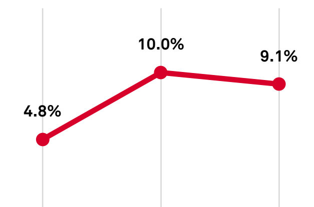
We may see some slippage in "shadow banking" sector reforms. However, the chance of a surge in shadow banking exposures is not high as the overall direction of regulatory tightening has not changed, in our view.

China

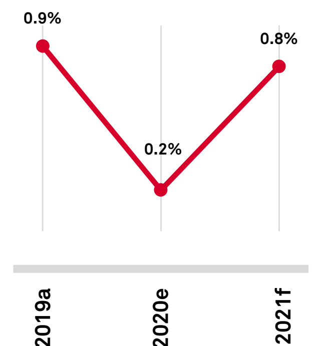
Loan growth



NPA ratio



RoAA



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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Hong Kong SAR | BICRA Group: 2

Headwinds Getting Stronger

Primary Credit Analyst
Shinoy Varghese
Hong Kong
shinoy.varghese1@spglobal.com
+85-2-2533-3573

Key takeaways

- Uncertain operating conditions remain a risk for Hong Kong's banking sector.
- Banks' profitability is under pressure due to elevated credit costs and margins pressure due to low interest rate.
- Prudent underwriting standards, sustainable capital, robust funding and liquidity, together with effective regulatory monitoring should help contain risks to banks.

Key credit drivers

Uncertain operating conditions. Hong Kong's economy has been buffeted by a confluence of the U.S.-China trade tensions, violent social unrests, and the COVID-19 outbreak. Recent disputes between the U.S. and China over the national securities law implementation in Hong Kong has further added to the uncertainty. Several sectors such as travel and tourism, hospitality, entertainment, trade, and retail are under significant strain, dragging on credit quality and demand.

Strong fundamentals. Banking sector's capitalization has strengthened over the past couple of years owing to controlled lending, regulatory additional Tier-1 capital issuances, sufficient internal capital generation, and, in some cases, asset disposals. This provides banks with more buffers to absorb losses. These banks benefit from stable customer deposits and limited reliance on short-term wholesale funding.

Key assumptions

Macroeconomic pressures to ease. We expect the economy to rebound in 2021, supported by various fiscal and monetary policy initiatives, as well as global demand recovery. We forecast GDP to grow by 4.9% in 2021 from the sharp contraction of 4.7% projected for this year. We also expect that unemployment rate will increase to about 4% in 2020-2021.

Low interest rate. We expect the U.S. Fed will keep interest rate at low levels to aid economic recovery from the COVID -19 pandemic, which will pressure banks' net interest margin.

Moderate correction in property prices. We expect a moderate and orderly correction in property prices, with limited effect on the banking sector. Homebuyer demand could likely dampen further and transaction volumes may be affected, in our view. That said, structural housing supply shortage, accommodative monetary policy, and room for policy maneuvering should prevent any steep drop in prices.

What to look for over the next year

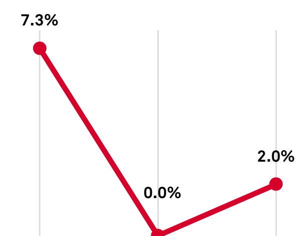
Earnings recovery. While we expect margins pressure to remain next year, profitability should get some support from a moderate decline in credit losses. As economic recovery takes hold, we expect new loan loss provisions to average gross customer loans to decline to about 55 bps from our current forecast of 70 bps for 2020. A pick-up in economic activity will also contribute towards sector's non-interest revenues.

Accelerated pace of digitalization. We expect major banks to continue to lead digitalization. COVID-19 outbreak has accelerated the need for banks to upgrade their technology as more customers go digital and also for business continuity. We expect to see an increasing budget for technology related spending. We also expect more virtual banks to launch services by next year although these may cater to a small and niche segment of the banking sector.

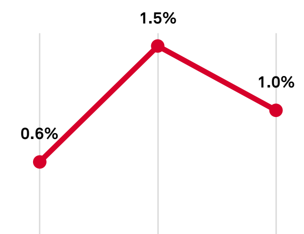
Issuance of LAC eligible instruments. We expect that some banks could issue senior non-preferred debt, a cheaper alternative to the regulatory additional tier-1 and tier-2 capital to meet HKMA's loss absorbing capacity (LAC) requirements.

Hong Kong SAR

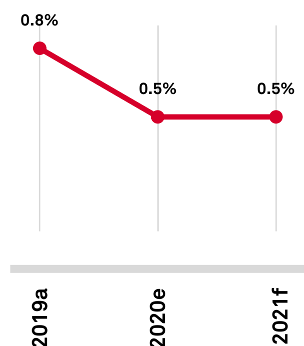
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

India | BICRA Group: 6

Pandemic Will Exacerbate Asset Quality Challenges

Primary Credit Analyst
Deepali V Seth Chhabria
Mumbai
deepali.seth@spglobal.com
+91-22-3342-4186

Key takeaways

- India's economy will contract in fiscal 2021, largely owing to the effect of the COVID-19 pandemic.
- We expect asset quality to deteriorate, credit costs to rise, and profitability to decline due to the challenging operating environment.
- A very high likelihood of government support underpins the creditworthiness of government-owned banks, in our opinion.

Key credit drivers

Challenging operating environment. The COVID-19 outbreak in India and two months of lockdown--longer in some areas--led to a sudden stop in the economy. That means growth will contract sharply this fiscal year (ending March 2021). We have lowered our growth forecast for fiscal 2021 to a 5.0% contraction, leading to heightened economic risk for Indian financial institutions.

Delay in recovery of NPLs. The economic slowdown has interrupted the process of asset quality improvement on the back of the resolution of some big cases under a new bankruptcy law (Insolvency and Bankruptcy Code, or IBC) over the past 18 months. In addition, the government has now announced that no new insolvency cases may be initiated under IBC for defaults occurring in the six-month period (which may be extended up to one year) from March 25, 2020. This is likely to further delay prospects of nonperforming loan (NPL) recovery, in our view.

Key assumptions

The government remains supportive. We expect the government of India to remain supportive of public sector banks, as reflected in its ongoing recapitalization plan. We continue to see a very high likelihood of government support for state-owned banks in India. We expect the government to provide capital support, if required, even though it has not specifically allocated any amount in the budget for fiscal 2021.

Medium-term growth prospects remain strong. We forecast that India's economy will achieve a strong recovery following the deep contraction this year; we forecast real GDP growth at 8.5% in fiscal 2022. The economy's long-term outperformance highlights its resilience. India's wide range of structural trends, including healthy demographics and competitive unit labor costs, work in its favor.

What to look for over the next year

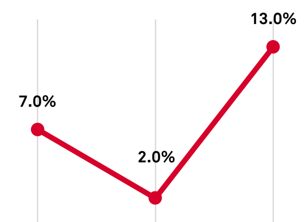
Asset quality stress. Against the backdrop of a likely increase in loan defaults and delayed recoveries, we expect the banking sector's weak assets to shoot up to 13%-14% of gross loans by the end of fiscal 2021 from an estimated 8.5% on March 31, 2020. Moreover, we believe that the banks could be saddled with this huge stock of weak loans next year too and see meaningful recovery only post that.

Performance of the NBFC sector. The nonbank financial companies (NBFC) sector (at 8.8% of the banking system's loans) is another source of vulnerability for banks, in our view. We expect that the current economic downturn will hit a small part of the NBFC sector harder than the banking sector, given some of the NBFCs lend to weaker customers. NBFCs also face accentuated liquidity risks, in our view.

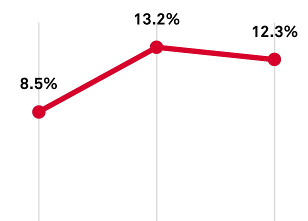
Some banks could make loss and require capital replenishment. We forecast profitability to worsen in the next 12 months, with the banking sector incurring a loss of 0.3% of average assets in fiscal 2021. The increase in credit costs in fiscal 2021 could more than offset the benefit from trading gains amid falling interest rates, a reduction in cash reserve ratio requirements, and a lower tax rate. We expect losses at public sector banks to be higher than at private sector ones, which enjoy better pre-provision earnings. While most of the public sector banks improved their capitalization last year, the loss would necessitate some of them to raise capital to avoid breaching the regulatory minimum requirement and to grow.

India

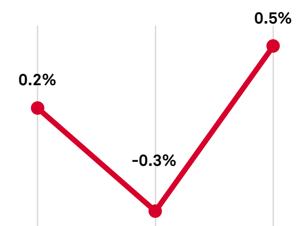
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming loans as a % of system wide loans.

RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Indonesia | BICRA Group: 6

Negative Outlook On Indonesian Banks As Operating Conditions Worsen

Key takeaways

- Negative outlook on banks underpinned by rising economic risk from COVID-19 pandemic.
- Downside risks buffered by strong capital ratios and provisioning build up by banks over several years.
- Economic recovery and currency stability are key credit factors.

Primary Credit Analyst
Ivan Tan
Singapore
ivan.tan@spglobal.com
+65-6239-6335

Key credit drivers

Rising economic risk. The economic risk for Indonesian banks is rising due to the COVID-19 pandemic, which has affected tourism, transport, trade, manufacturing, and investment in the country. The pandemic is also hurting private consumption, which accounts for almost 60% of Indonesia's GDP, given the social distancing measures imposed to contain the outbreak. We estimate Indonesia's economic growth will decelerate to 0.7% in 2020, compared with 5% in 2019.

Ratings underpinned by strong capital and provisioning buffers. Capital and provisioning buffers built up over the years should support Indonesian banks through the economic downturn. The banks' average Tier-1 capital ratio of 20.7% and capital adequacy ratio of 22.3%, as of February 2020, are among the highest in the region. Internal capital generation is likely to support capital positions, despite a likely decline in net interest margins, in our view.

Key assumptions

Decline is a cyclical event and Indonesia's structural growth story is intact. We expect a flattish U-shaped recovery with 6.7% growth in 2021, and the pace of economic expansion to return to 5% levels in the next two to three years. The government's stimulus packages and central bank actions such as rate cuts, reduction in reserve requirements, as well restructuring forbearance should cushion the blow to affected borrowers. Higher loan restructuring may keep reported nonperforming loans (NPLs) and credit costs contained in 2020, but they could spike once the forbearance expires in 2021.

Profitability will be suppressed, return to pre-COVID levels only in 2022. The combination of slower loans growth, low interest rates and restructuring forbearance would crimp the revenues of Indonesia banks up until 2021. In the long run, we believe Indonesia banks will continue to rank amongst the most profitable in the region, reflecting structurally high interest margins and growth potential.

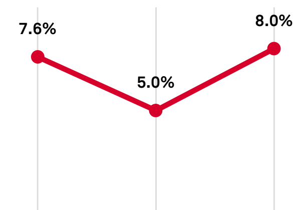
What to look for over the next year

Economic recovery in 2021. Downside risks for Indonesia's banking sector could be exacerbated if the COVID-19 pandemic worsens or drags on for longer, leading to significantly slower economic growth compared with our forecast, translating to higher nonperforming assets and credit losses than we expected.

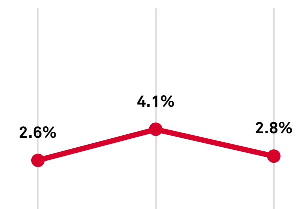
Currency stability. Although the rupiah has shown some signs of stability and strengthening in recent weeks, further depreciation due to the turmoil in financial markets could result in a further weakening of Indonesia's external position or higher delinquencies among corporate borrowers, which may affect banks.

Indonesia

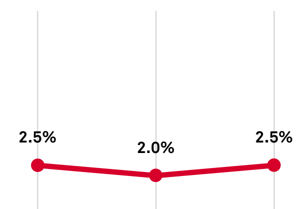
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

NPA ratio – Nonperforming assets as a % of system wide loans.

RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Japan | BICRA Group: 3

COVID-19 Pandemic To Further Compress Profitability

Key takeaways

- COVID-19 will pose further challenges for banks in Japan and constrain profitability in the industry.
- Regional banks face a tough road ahead as operating conditions remain weak.
- Progress in restructuring will be key to the industry's profitability.

Primary Credit Analyst
Ryoji Yoshizawa
Tokyo
ryoji.yoshizawa@spglobal.com
+81-3-4550-8453

Key credit drivers

COVID-19 pressure on profitability. Economic strain stemming from the COVID-19 pandemic points to a squeeze in profitability as credit losses rise due to deterioration in asset quality and an increased likelihood of falls in interest rates globally place pressure on interest margins.

Overcapacity in the banking industry. We view the nation's banking system as vulnerable to risks as a result of a fragmented industry structure. Overcapacity and dwindling interest margins due to competition create an increasingly challenging operating environment for banks and will therefore continue to constrain industry returns.

Evolving asset-liability mismatches. While core deposits comprise significant portions of Japanese banks' funding, we are cautious about their weaker foreign currency funding at a time of increasing overseas exposures to offset low returns from domestic operations. Although the banks are able to exchange ample Japanese currency funding to access non-yen funding, they face increased risk of asset-liability mismatches.

Key assumptions

Recessionary pressure due to COVID-19. We expect the COVID-19 pandemic to hit business cycles in the short term, after which a gradual recovery should take place. We forecast the Japanese economy will grow 3.4% in 2021 after shrinking 4.9% in 2020. A delay in Japan's recovery could heighten economic risks that banks operating in the country face.

Muted contribution to profit from loan growth. Increased demand for working capital from corporates will drive growth in loans. However, a fall in interest margins will counterbalance upside in earnings from growth in credit, leading to muted returns, in our view.

Asset quality will be tested. We expect an economic slump to affect both large corporates and small and midsize enterprises (SMEs). Although Japanese banks had good metrics of asset quality compared with global peers prior to COVID-19, they have limited headroom in their earnings to absorb increasing credit losses.

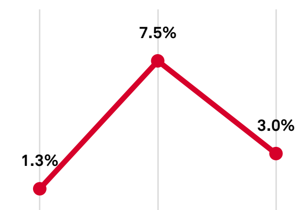
What to look for over the next year

Increase in credit costs. We expect banks' credit costs to total loans to surge to 0.5%-0.6% of gross loans and their nonperforming assets (NPAs) to increase to 2.4% in 2020. We also expect their credit costs and NPA ratio to drop to 0.25% and 1.5%, respectively, in 2021. However, those scenarios are subject to our assumption that an economic recovery will start from mid-2021.

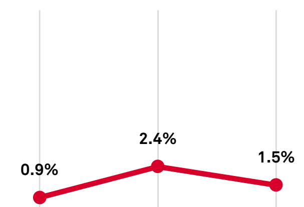
Restructuring of domestic operations to accelerate. Faced with a surge in credit costs and a squeeze on net interest margins, both major and regional banks are being forced to reduce less profitable operations. Also, they simultaneously face the need for new investment in fintech. Accordingly, we expect restructuring of less profitable areas (such as domestic retail operations) to accelerate in 2020.

Japan

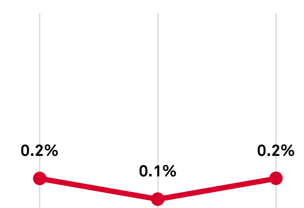
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Korea | BICRA Group: 3

Banks Can Ride Out Economic Strain From COVID-19

Primary Credit Analyst
Daehyun Kim
Hong Kong
daehyun.kim@spglobal.com
+85-2-2533-3508

Key takeaways

- Strengthened risk management enables the banks to manage upward pressure on credit costs amid economic headwinds from COVID-19 in 2020.
- Moderate asset growth will likely support the banks' capitalization despite weakening profitability.
- High private-sector leverage could result in high credit costs if the pandemic prolongs or trade tensions between the U.S. and China significantly intensify.

Key credit drivers

Improved risk management. We expect that the banks will be able to manage some deterioration in asset quality amid the COVID-19, backed by tightened underwriting, built-in additional provisioning, and reduced exposure to weak corporate sectors such as shipbuilding, shipping, and real estate project financing loans. The low loan-to-value ratios of around 50%-55% for mortgage loans, and tightened oversight on borrowers' repayment capability should also mitigate some pressure on household loan quality.

Adequate capitalization despite a weakening of profitability. We expect a large, though manageable, increase in credit losses in 2020, with pressure on the asset quality of export-focused sectors such as shipbuilding, auto, refining and steel and their small and midsize enterprises in the value chain amid tepid global demand. On the domestic front, COVID-19 will exert headwinds on the wholesale, retail, accommodation, and food service industries. The persistent low interest rates will also pressurize the banks' net interest margins. Nonetheless, we anticipate the banks' moderate growth appetite and focus on risk management to support their current capitalization in the coming few years.

Key assumptions

Growth to become moderate. We expect household loan growth to continue to slow down due to the banks' tightened underwriting standards alongside regulatory measures on the property market. Corporate loan growth will also be moderate, in our view, after some pick up in 2020 due to funding and liquidity support for the businesses affected by the COVID-19 led by policy banks and guarantees provided by the government agencies.

Low risk of a sharp correction in property prices. Regulatory measures will likely support the stability of Korea's property market, in our view. Nationwide average housing prices have increased only modestly in real terms over the past decade, and they are relatively low and stable compared with other Asia-Pacific countries such as Hong Kong, Australia, and Singapore.

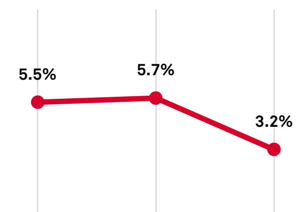
What to look for over the next year

Recovery of profitability. We expect the banks' return on average assets to gradually improve after it drops to around 0.3% in 2020 from around 0.5% in previous years. This will be led by reduction in credit costs as the economy rebounds in 2021 onwards. We anticipate economic recovery next year, supported by a rebound of global demand and the government's fiscal stimulus and market-stabilization measures. That said, a prolonged outbreak of COVID-19 and intensifying trade tensions between the U.S. and China could lead to higher credit losses considering Korea's high private-sector leverage.

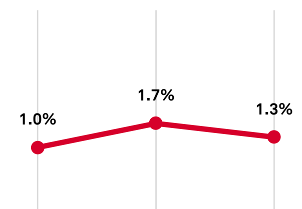
Banks should be able to hold their own against tech disruption. We expect the incumbent banks to sustain their competitiveness backed by their already established online and mobile banking services even as the sector goes more digital. The two internet-only banks collectively comprise only about 0.5% of the loans and deposits at year-end 2019. Fintech companies mainly focus on simple transactions such as money transfers and settlement services, which has not been a major revenue source for banks.

Korea

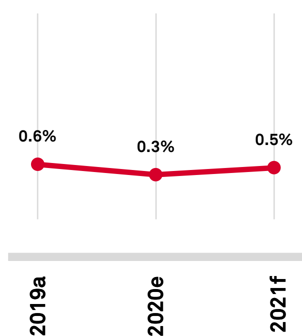
Loan growth



NPA ratio



RoAA



Loan growth – Sector-average growth in loans.

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Malaysia | BICRA Group: 4

Delayed Asset Quality Pains To Continue Into 2021

Primary Credit Analyst
Nancy Duan
Singapore
nancy.duan@spglobal.com
+65-6216-1152

Key takeaways

- We expect asset quality metrics of Malaysian banks to weaken meaningfully only from 2021 owing to the six-month blanket moratorium program extended to all retail and small and midsize enterprise borrowers in the country.
- We expect credit losses to rise to 66 bps in 2020 from 20 bps in 2019 without the moratorium.
- Asset quality risks are partially mitigated by banks' solid capital buffers and prudent risk appetite.

Key credit drivers

Asset quality metrics set to weaken. In our base-case, we expect the sector's nonperforming loan (NPL) ratio and credit costs to increase to 2.9% and 66 basis points (bps) of gross loans by the end of 2020, from historical lows of 1.5% and 20 bps in 2019. The blanket moratorium on loan repayments by all retail and small and midsize enterprise (SME) clients could result in lower NPLs and credit losses compared with our forecasts. However, we expect banks to start front loading provisioning given the significantly worsening economic prospects and business outlook.

Presence of solid capital buffers. We believe Malaysian banks' solid capital buffers (14% common equity Tier-1 ratio) are important mitigants that could partially offset unexpected credit losses from the transitory but acute COVID-19 shock to the economy. However, a likely deep compression in net interest margins could mean additional downside risks to that buffer.

Key assumptions

Solid U-shaped recovery in 2021. We expect real GDP to contract by 2.0% in 2020, followed by a strong recovery of 7.5% in 2021. However, macroeconomic risks could materially increase if the transition period becomes lengthier, containment measures fail, or subsequent infection waves emerge.

Employment conditions to hold steady. The asset quality of Malaysian banks hinges critically on the employment situation in the country, given 58% of banks' loan book is exposed to the household sector. We expect the unemployment rate to remain largely stable--it could increase to 4.9% in 2020 and moderately decline to 4.7% in 2021. Any significant deterioration in employment conditions could weaken the creditworthiness of Malaysian banks.

What to look for over the next year

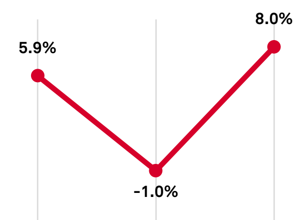
Topline and bottom line to remain constrained. We expect loan growth to stay flattish in 2020 as the moratorium on loan repayments and increase in borrowings by some corporates for their working capital should offset falling credit demand. A combination of anemic credit growth, compressed margin, and volatile capital market means growth in both interest income and non-interest income will likely stay muted. Rising credit costs and limited room for cuts in operational expenses will further weigh on the bottom line, in our view.

COVID-19 asset quality pressures to linger until 2021. We forecast that the NPA ratio will further weaken to 3.9% in 2021, given the likely slow recovery in the job market. We expect a portion of the COVID-19 related borrower defaults to spill over to 2021, despite the business disruptions mainly occurring in 2020.

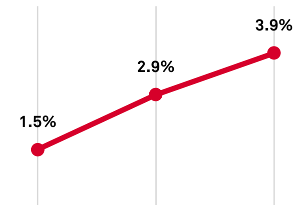
Management prudence key for frontloading of credit costs. We expect Malaysian banks' cumulative credit losses over 2020-2021 to increase to about 128 bps. Management discretion in provisioning will be a key guidepost to apportion the higher credit costs over next two years, in our view.

Malaysia

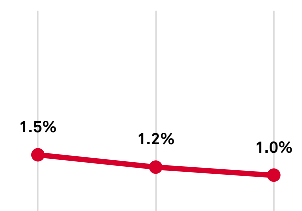
Loan growth



NPA ratio



RoAA



2019a | 2020e | 2021f

Loan growth – Sector-average growth in loans.

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RoAA – Sector-average return on average assets.

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Mongolia | BICRA Group: 9

Forbearance Loans Put Asset Quality Back In The Spotlight

Primary Credit Analyst
Harry Hu
Hong Kong
harry.hu@spglobal.com
+85-2-2533-3571

Key takeaways

- COVID-19 forbearance loans could add pressure on asset quality metrics and further strain profitability as the banking sector looks for a rebound following the regulator's asset quality review.
- Loan growth will be subdued in 2020, but we expect it to resume when the economy largely recovers from the pandemic in 2021.
- The economy remains susceptible to external factors, particularly fluctuations in commodity prices.

Key credit drivers

Susceptible to commodity cycles. Mongolia's economy is heavily dependent on commodities, and its trading partner concentration amplifies the banking sector's susceptibility to acute shifts in commodity prices.

Gaps in regulations and disclosures compared with international practices. Regulators in Mongolia have been taking steps to gradually reduce gaps with international practices in recent years. These include an asset quality review of the banking sector, which contributed tighter loan classification and provision requirements. Banks also have to meet higher capital requirements. These initiatives were also advocated by International Monetary Fund with its support program, which has now concluded. While Mongolian banks' asset quality recognition and provisioning standards have improved in recent years, there are still gaps with international standards, in our view.

Key assumptions

Economic growth will recover in 2021. We expect external uncertainties due to COVID-19 to weigh on Mongolia's exports and hence economic growth, given Mongolia is an export-driven economy. We expect Mongolia's real GDP growth to moderate to around 2.2% in 2020 after 5.1% growth in 2019. We expect growth to rebound to around 8.2% in 2021.

Growth appetite to remain high. While we expect economic headwinds and strengthened regulations to reduce banks' loan growth in 2020, this could rebound sharply if the economy makes a quick recovery in 2021. We note that banks have undergone rapid growth in the past, especially during commodity price upcycles. Although some banks face capital constraints due to the gradual phasing in of conservation buffers, they may look at rebalancing the asset portfolio toward loans to achieve growth.

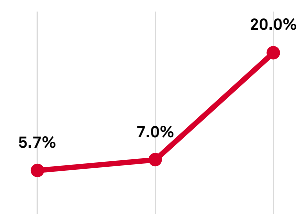
What to look for over the next year

Asset quality to deteriorate. The asset quality metrics of Mongolian banks could deteriorate in 2020 due to macroeconomic headwinds related to COVID-19, particularly when banks adopt International Financial Reporting Standards 9 (IFRS9) at the end of 2020 (delayed from the previously planned implementation in January 2020). These metrics were already hit by the asset quality review, and pandemic-related loan forbearances could add further pressure if slippage is worse than expected. While we expect nonperforming assets (NPAs) to increase, the estimated NPA ratio will benefit from the base effect of higher loan growth.

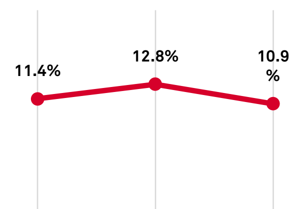
Profitability to remain under pressure. We expect banks' profitability to remain under pressure in 2020. Net interest margins will contract and credit costs will increase due to the various measures implemented by the government to relieve the debt-servicing burden amid COVID-19. We see export-oriented corporates and unsecured retail loans as particularly susceptible to deteriorating asset quality. We expect profitability to recover in 2021, but remain below historical levels.

Mongolia

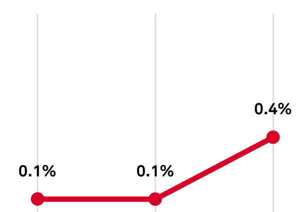
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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New Zealand | BICRA Group: 4

Temporary Rise In Economic Risks

Primary Credit Analyst
Lisa Barrett
Melbourne
lisa.barrett@spglobal.com
+61-3-9631-2081

Key takeaways

- New Zealand banks face substantial but temporary increases in economic risks due to the COVID-19 outbreak. We see a one-in-three possibility that the economic hit for the banking sector could be significantly more severe or prolonged than our base case.
- We forecast credit losses to rise to about 12 times those in 2019 before easing. We also expect house prices to fall by about 10% before resuming modest growth around the middle of 2021.
- Most New Zealand banks should be able to absorb our forecast rise in credit losses within their earnings despite lower interest income.

Key credit drivers

Fiscal and monetary support should soften the blow from COVID-19 driven recession. We expect the COVID-19 outbreak to drive a 5% contraction in New Zealand GDP in 2020 before the economy rebounds with a 6% growth in 2021. The government has announced various stimulus measures, which should support the economy. Moratoriums on loan repayments offered by the banks will also cushion the blow for many borrowers. In addition, timely and coordinated monetary support from the central bank has alleviated bank funding and liquidity concerns, in our view.

Banks are well placed to absorb increased credit losses. We believe that most New Zealand banks retain good headroom within their earnings to absorb our forecast sizable increase in credit losses in conjunction with a significant contraction in interest income.

High vulnerability to external shocks. Risks remain around the funding profiles of New Zealand banks. The banks' significant dependence on offshore short-term borrowing, the country's persistent current account deficits, and its exposures to fluctuations in commodity prices, all make New Zealand vulnerable to external shocks.

Key assumptions

Credit losses to rise by 12 times. A contracting economy, rising unemployment, and weak consumer and business sentiment will affect the banks' asset quality metrics. We forecast that annual credit losses will peak at about 80 basis points (bps) of gross loans by fiscal 2021, about 12 times their historical low in fiscal 2019. In line with our broader economic forecast, we expect that credit losses will ease to about 50 bps of gross loans and advances in fiscal 2022, consistent with our long-term through the cycle expectations.

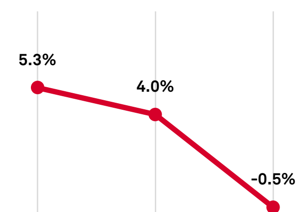
New Zealand bank subsidiaries to remain core to Australian parents. We envisage no change in the four major New Zealand bank subsidiaries' strategic importance to the group strategies of their Australian parents as well as parent ownership structure.

What to look for over the next year

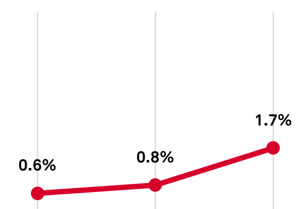
Path to economic recovery. The hit from COVID-19 on banks' asset quality will become clearer when moratoriums on loan repayments end, and the government reduces the fiscal support. We expect that a number of households and businesses are likely to struggle to meet their financial obligations at that time. In addition, we see a one-in-three possibility that the impact of economic downturn due to the COVID-19 outbreak and containment measures on the banking sector could be significantly more severe or prolonged than our base case.

New Zealand

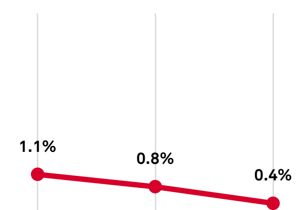
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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RoAA – Sector-average return on average assets.

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Papua New Guinea | BICRA Group: 9

Resource Project Delays And COVID-19 Heighten Economic Headwinds

Key takeaways

- PNG's already-weak economy faces significant headwinds from delays in key resource sector projects, low global energy prices, and COVID-19 containment measures.
- Consequently, asset quality metrics for corporate and SME borrowers are likely to deteriorate. A significant build-up of COVID-19 related payment holidays could also lead to an increase in bad debt.
- Progress on new resource projects could alleviate pressure on corporate and SME borrowers.

Key credit drivers

Small and midsize enterprises (SMEs) face economic challenges. Delays in key resource sector projects and low global energy prices will likely extend PNG's weak economic conditions for some time. We believe that PNG's corporate and SME borrowers will consequently face repayment challenges.

COVID-19 containment measures will add to credit pressures. The impact of the shutdown due to COVID-19 will be widespread across the different sectors in PNG. In our view, this will add pressure on PNG's already-weak economy, especially the SMEs.

Key assumptions

Economic growth to slump in 2020 before making some recovery in 2021. We forecast PNG's real GDP to contract by 0.2% in 2020, followed by a mild recovery with 3.3% growth in 2021.

Credit losses to rise to about 2.2% of gross loans. We expect credit losses in PNG's banking system will rise to about 2.2% of total loans in 2020, above our through-the-cycle loss expectations of about 1.7%, indicating a period of economic hardship.

Private sector credit growth expected to remain flat relative to GDP. We expect PNG's private sector credit growth will remain flat relative to GDP, growing in the mid-single digits in nominal terms. Over the longer term, corporate debt will contribute to growth, particularity if new resource projects begin construction and their operations trickle down to other sectors in the economy.

What to look for over the next year

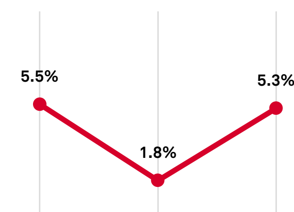
Effect of COVID-19 payment holidays on borrowers. A significant increase in COVID-19 related payment holidays could result in an eventual buildup of bad debt. In our view, certain sectors will be more affected, such as tourism, hospitality, and retail. While headline nonperforming assets may initially not increase materially, we believe other asset quality metrics (such as an increase in payment holidays and credit loss provisions) may deteriorate, given underlying economic issues. We believe single name concentrations also pose risks to the banks, given the large size of certain borrowers relative to the overall banking system.

Progress on new projects could support the economy. The construction of several new resource projects and extensions are expected to lead to a sharp acceleration in economic growth. If these new resource projects get off the ground, they could boost economic growth and the credit quality of corporate and SME borrowers. We expect clarity on the progress of these projects will emerge in the next one to two years.

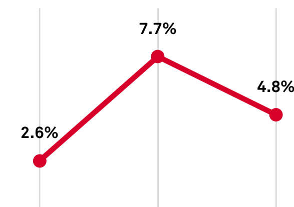
Primary Credit Analyst
Nico DeLange
Sydney
nico.delange@spglobal.com
+61-2-9255-9887

Papua New Guinea

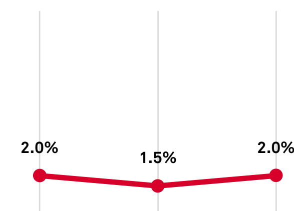
Loan growth



NPA ratio



RoAA



2019e 2020f 2021f

Loan growth – Sector-average growth in loans.

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Philippines | BICRA Group: 5

Resilience Of Large Corporates Will Be Key To Asset Quality

Key takeaways

- Banks will see muted loan growth, rising NPLs and credit costs, and declining profitability in 2020, amid a sharply slower domestic economy.
- Resilience of Philippine conglomerates will be key to containing credit losses.
- Banks' capital and provisioning buffers will help them manage rising risks in the operating environment.

Key credit drivers

COVID-19 will result in a broad-based economic slowdown. We expect the Philippine economy to shrink by 3.0% in 2020, owing to demand and supply shocks caused by the COVID-19 outbreak and proactive domestic containment measures. Consumers and businesses will be hit by the weak economy, rising unemployment, and declining remittances from overseas Philippine workers due to the economic fallout of COVID-19. We are forecasting a flattish U-shaped recovery with 9.4% expansion next year, underpinned by strong growth in investment and exports.

Corporate and household leverage remain relatively low. At 56% of GDP, private sector leverage is moderate, despite rising steadily in recent years. Philippines' household leverage, at 10% of GDP, is among the lowest globally, and lending rates are on a decline, which should support the sector's repayment capacity.

Key assumptions

Credit growth will be muted. We project Philippine banks' loan growth to be in low single digits in 2020 due to the economic slowdown. Credit demand will be driven by the corporate sector as it draws down on bank lines to maintain liquidity and meet working capital requirements.

Large corporates are likely to sustain their credit profiles. Philippine banks' asset quality largely depends on the performance of the corporate sector, which forms 82% of banks' loan books. Large conglomerates with their strong business profiles, diversified revenue streams and solid liquidity buffers will likely come through the challenging operating conditions intact. We expect the banking sector's credit costs to rise to 1.3% of gross loans for full year 2020 compared to the five-year average of 0.4%. We expect the consumer (18% of banking sector's books) and MSME portfolios (7%) to contribute to higher nonperforming loans (NPLs) in the coming quarters.

What to look for over the next year

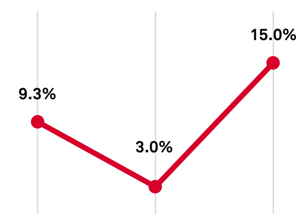
Banks entering the credit downturn from a relatively sound position. The banking sector's good capital position (15% Tier-1 ratio) and sound provisioning (covering about 100% of NPLs) will likely help it manage the rising risks in the operating environment. The sector's profitability will decline in 2020 due to muted growth, margin decline and higher credit costs. Banks will use a combination of cost of funds controls and operating expense management to offset some of the effects of higher provisions. A longer or deeper economic slowdown than our current forecasts could set off a sharper-than-expected deterioration in the banking sector’s asset quality, due to potentially higher large corporate delinquencies.

Regulatory forbearance will delay true recognition. The effect on individual banks in the coming quarters will be uneven, largely hinging on their exposure to vulnerable segments and whether they adopt relaxed accounting and provisioning standards. While regulatory forbearance will provide a breather to weaker financial institutions, it will also delay recognition of NPLs and provisioning in some cases.

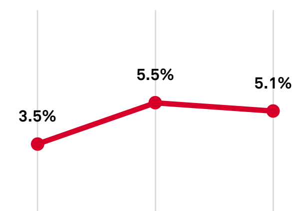
Primary Credit Analyst
Nikita Anand
Singapore
nikita.anand@spglobal.com
+65-6216-1050

Philippines

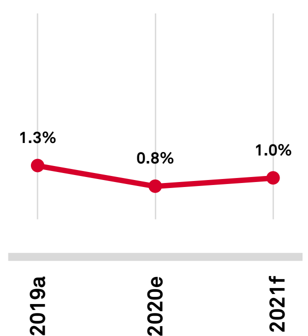
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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Singapore | BICRA Group: 2

Facing Recession From A Position Of Strength

Primary Credit Analyst
Ivan Tan
Singapore
ivan.tan@spglobal.com
+65-6239-6335

Key takeaways

- COVID-19 has pushed the economy into recession.
- Singapore banks are facing pandemic-related hits from a position of strength.
- COVID-19 has accelerated fintech adoption in Singapore.

Key credit drivers

COVID-19 to hit Singapore banks. Banks in Singapore will experience higher delinquencies, credit costs and weaker earnings as the COVID-19 outbreak pushes the economy into recession. As a trade-dependent economy and a major aviation hub, Singapore will be hit hard by the COVID-19 outbreak.

Singapore banks have good financial buffers. The sector is resilient with healthy buffers to withstand shocks and recessions, in our view. The banks have consistently strengthened their balance sheets during good times and maintained healthy Tier-1 capital adequacy ratios of about 15%. The large domestic banks maintain healthy liquidity buffers amid the turmoil, reflecting customer confidence.

Key assumptions

Economy should rebound in 2021. We are forecasting a recession in Singapore with GDP contracting by 5.0% in 2020, followed by a U-shaped recovery in 2021 with GDP growth improving to 6.7%, and then returning to steady state growth of about 2.5% thereafter. We forecast the unemployment rate to increase in 2020 but still remain very low by international comparison at an average of 3.2% (compared with 2.3% in 2019), reflecting robust government measures to protect businesses and save jobs.

Government is highly supportive. We believe the Singapore government is highly supportive of the country's banking system, and will provide timely financial support to ensure stability, if needed. Government stimulus will also buffer some of the downside risks, including an unprecedented stimulus plan worth about 20% of the country's GDP, with the government tapping its vast reserves for only the second time in history.

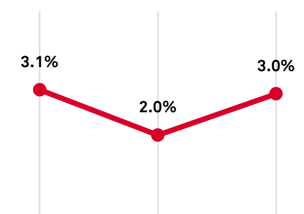
What to look for over the next year

COVID-19 has accelerated fintech adoption. The case for digital banking services in Singapore will become stronger due to COVID-19. A record number of digital banking transactions have taken place during the COVID-19 outbreak, pointing to a strong acceleration in fintech adoption. We believe that consumers who were initially resistant to digital channels are adopting out of necessity.

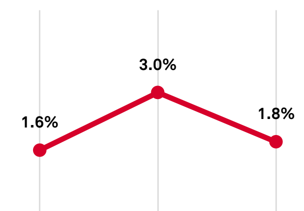
Downside risks if pandemic is prolonged. We expect the economy to remain resilient to the impact of the COVID-19 outbreak and low oil prices because of government support. Nevertheless, a substantially larger and more prolonged hit to the economy than our base case forecast could weaken banking system stability.

Singapore

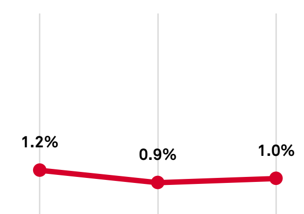
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

Loan growth – Sector-average growth in loans.

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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Sri Lanka | BICRA Group: 10

Economic Woes Could Hurt Banks

Primary Credit Analyst
Deepali V Seth Chhabria
Mumbai
deepali.seth@spglobal.com
+91-22-3342-4186

Key takeaways

- We expect the COVID-19 pandemic to push Sri Lanka's economy into a recession in 2020.
- Deteriorating operating conditions for the country's banks could translate into rising credit costs, lower profitability, and potentially weaker funding profiles.
- The banking system's credit culture could be hurt by frequent forbearance allowed by the regulator.

Key credit drivers

Heightened economic risk. We expect operating conditions for Sri Lankan financial institutions to worsen amid subdued economic activity globally post COVID-19. We expect the pandemic to push Sri Lanka's economy into a recession in 2020, against our earlier expectations of a rebound. Sri Lanka was already facing heightened economic challenges post the Easter Sunday attacks last year. Political instability and the sovereign's weak external and fiscal performance add to the challenge. Barring further unforeseeable exogenous shocks, we forecast the economy to contract by 0.3% in 2020 and rebound to grow 4.6% in 2021, albeit from a low base.

Currency depreciation. Sri Lanka's external position is vulnerable to adverse exchange rate movements and shifts in global credit conditions because more than 40% of the country's public debt is denominated in foreign currency. This could weaken the government's access to external financing. It could also affect the banking sector, although banks in Sri Lanka have limited reliance on external funding compared to the sovereign.

Key assumptions

Profitability to decline. We expect banks' margins to remain under pressure due to low interest rates, subdued business activity, and frequent administrative controls that deter banks from pricing rationally. Rising credit costs emanating from a prolonged economic slowdown and lower margins are set to hurt banks' profitability in 2020. We expect credit costs to double, from 90 basis point in 2019.

Asset quality to weaken. Weak operating conditions are already increasing credit risks for Sri Lanka's banks. We expect these banks' nonperforming loans (NPLs) ratio to rise to 7.6% in 2020 from 4.7% in 2019. The rather high level of Stage 2 loans (loans with a significant increase in credit risk but not credit impaired) signal a much larger incipient problem. Banks' credit losses could shoot up further if the pandemic worsens in Sri Lanka and leads to a deeper and more prolonged economic slowdown.

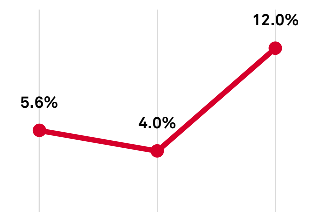
What to look for over the next year

Government and central bank steps to provide some respite. In our base case, we believe steps taken by the government and the central bank--including multiple rate cuts, providing moratorium etc.--should provide some respite for Sri Lanka's banks. The central bank's announcement to allow banks to provide a moratorium on loans affected by the pandemic follows last year's request to banks to grant moratorium on loans related to the tourism industry. Any forbearances by the regulator may delay recognition of bad loans but may not address the problem. In our view, they could hurt the credit culture of the banking system.

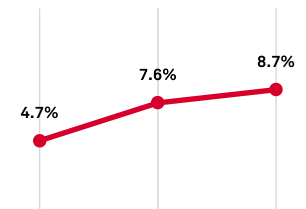
Funding profile could weaken. Sri Lankan banks are already seeing higher pricing for their external funding, which could affect profitability. If the political uncertainty in the country persists, investor confidence may weaken and the risk of funding or liquidity stress for banks may increase.

Sri Lanka

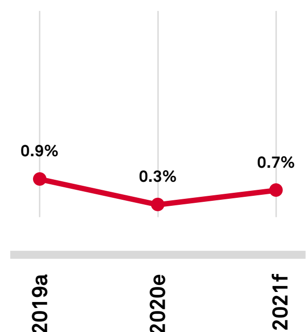
Loan growth



NPA ratio



RoAA



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RoAA – Sector-average return on average assets.

a--Actual. e--Estimate. f--Forecast.

Taiwan | BICRA Group: 4

Solid Capitalization Provides Buffer Against Economic Recession

Primary Credit Analyst
Eva Chou
Taipei
eva.chou@spglobal.com
+886-2-8722-5822

Key takeaways

- COVID-19 causes economic recession in 2020.
- Solid capitalization to provide additional cushion toward higher credit loss and lower profits.
- New virtual banks to speed up fintech development.

Key credit drivers

COVID-19, on top of lingering U.S.-China trade dispute. Given Taiwan's high reliance on exports, weak external demand poses risks for Taiwan. We expect that reduced demand due to COVID-19 and the U.S.-China trade dispute will constrain business growth and weaken asset quality in Taiwan's banking sector.

Lower interest rate globally and domestically. Policy rate cuts in the U.S. and some Asian countries will compress interest spreads on foreign-currency loans. Moreover, Taiwan central bank's rate cut and high competition in Taiwan will continue to strain banks' net interest margin.

Solid capital buffer. Banks have strengthened their capital over the past few years following regulatory requirements, with the average common equity tier 1 (CET1) capital ratio at 12.1% as end of 2019, which would provide an additional buffer to absorb rising credit costs.

Key assumptions

Economic growth should rebound in 2021. We project Taiwan's economic growth to reduce to 0.6% in 2020 before rebounding to 3.2% in 2021, and then returning to growth rate of around 2.5% in 2022-2023. COVID-19 has a lesser impact on Taiwan domestic economic activity compared with peers due to effective containment and mitigation measures. Nonetheless, Taiwan's open economy will still be hit by weak external demand. Accordingly, we expect muted loan growth in 2020, followed by 4.5% growth in 2021.

Government's proactive measures should help. Government relief measures--fiscal stimulus, monetary easing, soft loans, credit guarantees, tax reduction and compensation to virus-hit businesses--will help support borrowers' debt servicing capacity, in our view.

Stable local property market. We expect that domestic property prices will remain mostly stable, given low interest rates in Taiwan and potential fund inflows from Taiwanese individuals and corporates overseas amid continuing U.S.-China trade tension.

What to look for over the next year

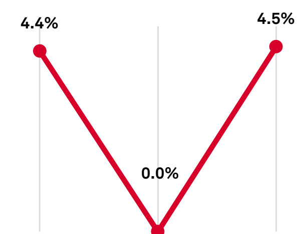
Asset quality metrics to weaken in 2020 and improve by end of 2021. We expect banks' nonperforming assets ratio to double in 2020 from 2019, and improve in 2021 as the disruptions from COVID-19 ease. In our opinion, overall asset quality should remain manageable given the nonperforming assets are increasing from a low base and banks have sufficient provision buffers.

Bottom line to inch lower in 2020 before regaining some strength in 2021. We expect banks' profitability to slash in half in 2020 before recovering somewhat in 2021, largely constrained by enlarging credit costs and policy rate cuts. The volatile capital markets will also add pressure on profitability.

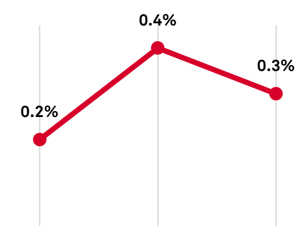
Three new virtual banks to catalyze fintech adoption. COVID-19 has increased digital banking transactions in Taiwan. We expect the three virtual banks, which target to operate in the second half of 2020, will accelerate fintech adoption. Most banks have raised their IT capital expenditure and continue to enhance virtual connections with customers. Nonetheless, we do not expect these developments to change Taiwan's banking sector landscape over the next two years.

Taiwan

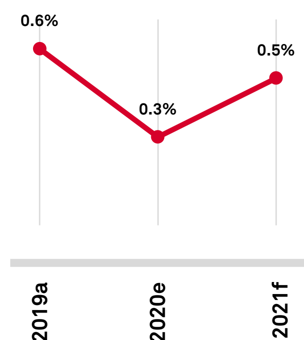
Loan growth



NPA ratio



RoAA



2019a 2020e 2021f

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Thailand | BICRA Group: 6

COVID-19 Will Test The Resilience Of Thai Banks

Key takeaways

- COVID-19 pandemic has pushed the Thai economy into recession.
- Thai banks grapple with double whammy of high household debts and weak SME loans.
- Government relief measures will mitigate, but not eliminate, downside risks.

Key credit drivers

Thailand slips into recession from pandemic toll. The COVID-19 outbreak has exacerbated an economic slowdown already underway due to weak external demand, pushing the economy into recession. We forecast GDP to contract by 5.1% in 2020. The Thai banking sector has been affected by the deterioration in operating environment, particularly given the importance of tourism and small to midsize enterprises (SMEs) to the economy, which we expect will lead to weakened asset quality metrics and profitability. Stage 2 loans for Thai banks rose sharply to 7.7% as of March 31, 2020, from 2.8% at end-2019.

Thailand's high household leverage and banks' SME exposure pose risk. Thailand's household leverage, at 79%, is one of the highest among emerging markets. Economic weakness accompanied by job losses in the tourism and general commercial sectors could lead to higher delinquencies. Export-orientated SMEs are also vulnerable in this challenging environment; those competing on cost are getting squeezed out by more efficient manufacturers in neighboring Vietnam and Cambodia. The Thai economy is also highly exposed to supply-chain disruptions. Electronics, metals, and chemical product manufacturers are particularly exposed to such outages. Thai banks have maintained high provision coverage ratios of upwards of 150%, but they are likely to dip into their provisions this year, in our view.

Key assumptions

Government relief measures will soften the blow to banks. We believe that the steps taken by the government and central bank should reduce the hit to banks. The government has rolled out three rounds of stimulus targeting workers and SMEs, including providing cash handouts and soft loans at zero interest rates. The central bank has made multiple cuts to its benchmark interest rate, which is now at a record low of 0.5%. We note that supporting micro-SMEs has been part of the national agenda since 2014.

Credit losses are set to spike. In our opinion, temporary relief measures are unlikely to eliminate risks for weaker and more vulnerable debtors, although they may lessen the strain and delay recognition of problem loans. We forecast that credit losses will increase to 1.8% of gross loans in 2020 compared with 1.2% in 2019.

What to look for over the next year

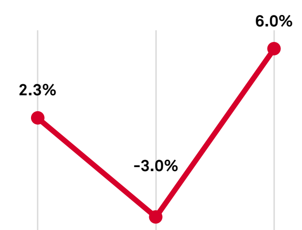
Economic revival is key to credit conditions. We forecast a U-shaped recovery in 2021 with a GDP growth of 6.0%. While relief measures could buy some time for stressed borrowers, a revival of the economy is needed to stabilize credit conditions, in our view. A prolonged delay in Thailand's economic recovery would deepen the downside scenario for domestic banks, given high household leverage and weakness in the SME sector. In our opinion, the creditworthiness of some banks could weaken if we believe their credit costs are likely to rise sharply, loan quality deteriorates severely, or capitalization weakens significantly.

Profitability could decline. We estimate that the banking system's return on assets will reduce below the long-term average of 1% in 2020, driven by pressure on margin and likely rise in credit costs, partially offset by cost control measures. But banks should be able to absorb this dip without any major impact on their good capital levels.

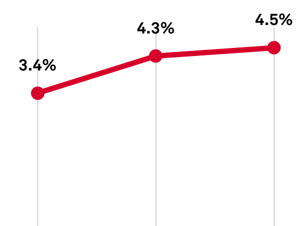
Primary Credit Analyst
Deepali V Seth Chhabria
Mumbai
deepali.seth@spglobal.com
+91-22-3342-4186

Thailand

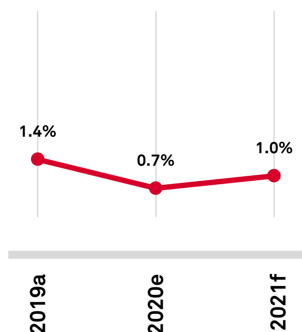
Loan growth



NPA ratio



RoAA



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Vietnam | BICRA Group: 9

Economic Slowdown To Weigh On Bank Balance Sheets

Primary Credit Analyst
Amit Pandey
Singapore
amit.pandey@spglobal.com
+65-6239-6344

Key takeaways

- Vietnam's economy will be hit hard by the COVID-19 pandemic in 2020, but will recover smartly, assuming the pandemic will be contained later in the year.
- Banks' profitability will weaken as margins fall in wake of declining policy rates, lower lending rates to support borrowers affected by the COVID-19-related slowdown, and a rise in credit costs.
- Declining profitability along with thin capital buffers will continue to pose risks for some banks.

Key credit drivers

Deterioration in asset quality. The asset quality of Vietnam banks is likely to decline over the next 12-18 months as individuals and businesses face weaker cash flows amid COVID-19-related weak demand, both externally and domestically (due to social distancing measures). The impact on loan arrears and credit losses could be amplified by Vietnam's open economy, rapid loan growth in recent years, and high private sector debt compared with most other emerging economies. On the wholesale side, small and midsize enterprises are likely to face higher delinquencies, especially in sectors such as tourism, transport, aviation, logistics, construction, construction material, textile, and hospitality. Individuals could face reduced incomes and consumer confidence due to furloughs, wage reductions, or unemployment.

Moderation in profitability. We expect Vietnam banks' earnings in the next 18 months to be hit by higher credit costs and reduced net interest margins as banks reduce interest rates to support borrowers facing difficulties amid the COVID-19 related slowdown. Policymakers are also encouraging banks to pass on the recent rate cuts to borrowers. Growth in non-interest income (export-led trade finance and foreign exchange income, cross sale of retail products such as insurance, and loan processing and card fees) should also reduce sharply owing to lower business volumes.

Key assumptions

Economic recovery to be quick following a sharp downturn. In tandem with the global economy, Vietnam's economic growth will be hit hard by the COVID-19 pandemic and the associated downturn. We forecast real GDP growth of only 1.2% in 2020. However, Vietnam's economy is well-placed to achieve a rapid recovery, assuming the pandemic will be largely contained toward the end of 2020 or the beginning of 2021. Under these circumstances, we expect real GDP growth to rebound to 9.5% in 2021, before settling closer to Vietnam's long-term trend of 6.0%-7.0% growth from 2022 onward.

Credit costs to increase. We expect credit losses of Vietnam banks to more than double to 190 basis points over the next 12-18 months.

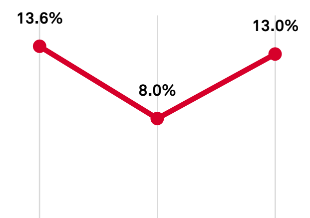
What to look for over the next year

Capital management. In wake of weak profitability, Vietnam banks are likely to conserve capital buffers by lowering growth ambitions, curtailing dividends, and raising capital, in our view. The near-term impact on reported financials including asset quality is likely to be limited due to policymakers' direction to banks to extend debt rescheduling to affected borrowers, and easing of requirements on loan classification and provisioning.

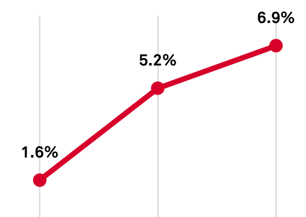
Downside risk. Downside risks for Vietnam banks can emanate from a prolonged reduction in economic activity, which can substantially increase credit losses, especially when the economy has high leverage.

Vietnam

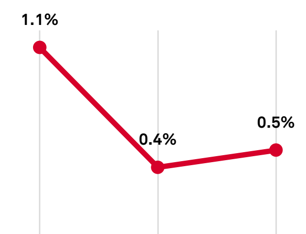
Loan growth



NPA ratio



RoAA



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- European Banks' First-Quarter Results: Many COVID-19 Questions, Few Conclusive Answers, April, 1, 2020

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