Emerging Market Banks: Resilient So Far

By Nada Oulidi, CFA, VP, Senior Credit Research Analyst

KEY TAKEAWAYS

- A key question for EM banks today is whether, despite their foresight and fortitude, they may still face a full-blown banking crisis in 2016. We think not.
- Macroprudential measures, regulatory improvements and higher levels of EM central bank foreign exchange reserves have greatly bolstered EM banks' financial health in recent years.
- Still, major EM banks may face key pressures, including asset quality deterioration, capital and funding pressures and currency depreciation.
- The risk-off episode last summer, when credit spreads significantly widened and prices declined, created some market dislocations and opened up some opportunities.

Conventional wisdom to the contrary, it really should come as no surprise—in general, emerging market (EM) bank credit fundamentals continue to be resilient.

While undeniably EM banks are operating in very challenging macroeconomic and political environments, the fact is that many banks, mindful of past crises, have well prepared themselves for daunting times such as these.

A key question for EM banks today is whether, despite their foresight and fortitude, they may still face a full-blown banking crisis in 2016. We think not. In fact, we think the recent market turmoil, triggered in part by the slowdown in China, plunging commodity prices and EM currencies, and the ever stronger dollar, has turned up some opportunities in EM credit markets.

What Can Explain Such Resilience?

In EM banks' case, the oft-repeated mantra "this time is different" actually holds true. Many major EM banks have built up significant profits, capital, provisioning and liquidity buffers and introduced major regulatory reforms to safeguard financial stability following previous banking crises. They have also tightened underwriting practices, while banking regulators have introduced macroprudential measures aimed at reducing systemic risk in the financial sector.

In addition, most EM banks are still predominantly deposit funded and hence less exposed to the vagaries of wholesale market funding than their European counterparts. Many banking regulators in major EM economies have also introduced Basel 3 capital and liquidity requirements in line with their European peers to beef up capital and liquidity buffers and secure more stable funding. A few have implemented new resolution regimes in line with the Financial Stability Board's recommendations, which seek orderly resolution of financial institutions without systemic disruption and exposing taxpayers to loss. The average capital for Tier 1 across developing country banks is an ample 12.5%,

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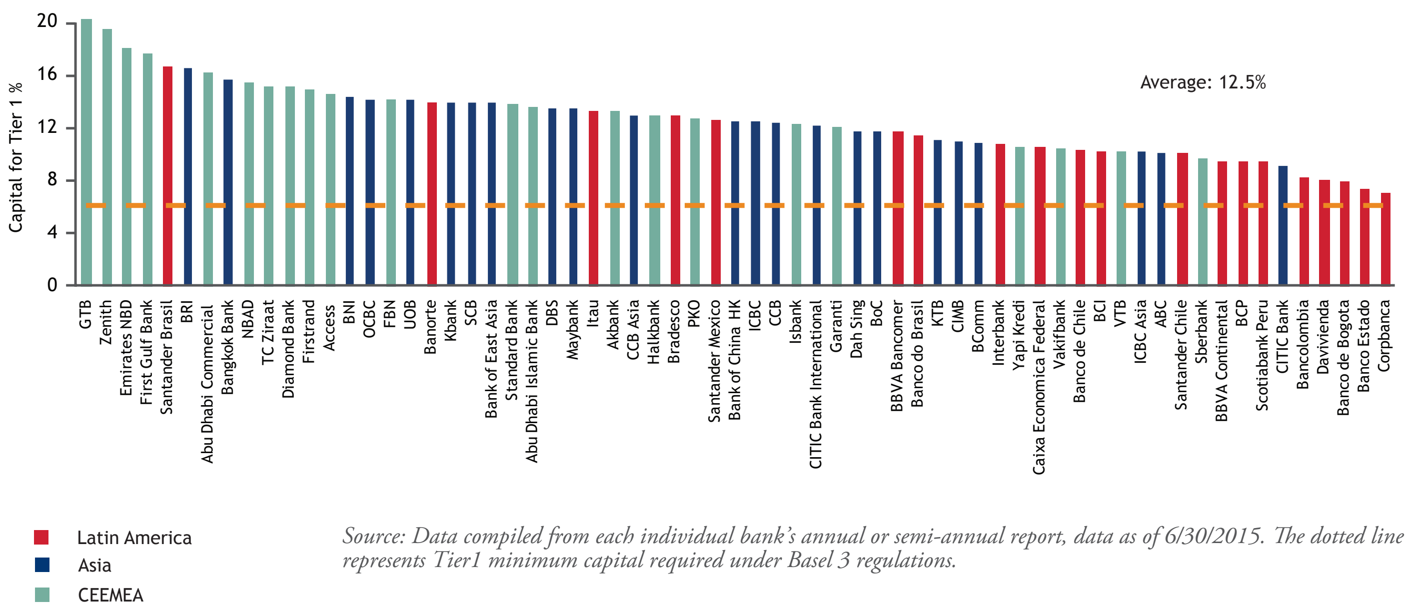
according to banks' financial statements. In addition to these enhancements, according to World Bank year-end 2014 data, EM banks account for only a fraction of GDP in most Latin American, Central and Eastern European, Middle Eastern and African (CEEMEA) countries, making it unlikely that banking system vulnerabilities would topple the economies in these regions.

EMERGING MARKET BANKS' TIER 1 CAPITAL (%)



Source: Data compiled from each individual bank's annual or semi-annual report, data as of 6/30/2015. The dotted line represents Tier1 minimum capital required under Basel 3 regulations.

Is It Too Good to Be True—Pockets of Risk Ahead?

Despite macroprudential measures, regulatory improvements, and higher levels of EM central bank foreign exchange (FX) reserves put in place over the past several years, concerns around the EM banking sector still loom. The Bank for International Settlements (BIS) warned this past September that China, Brazil and Turkey might have a banking crisis in the offing. The BIS said that because of "strong credit growth," the three countries' ratio of credit to GDP was significantly higher than the ratio's long-term trend, indicating the possibility of "serious banking strains."[1]

While we expect many EM economies to enter a challenging phase of the credit cycle as their economies slow, we do not, as we have indicated, forecast a full-blown, systemic EM banking crisis in the year ahead. Rapid credit growth in economies like China, Brazil and Turkey during recent years was concentrated in a few segments and banks, such as quasi-sovereigns and state-owned enterprises, and was generally accompanied by a rise in disposable income. In other economies, credit growth has significantly decelerated during the past year.

[1] *Source: Bloomberg, 9/14/2015.*

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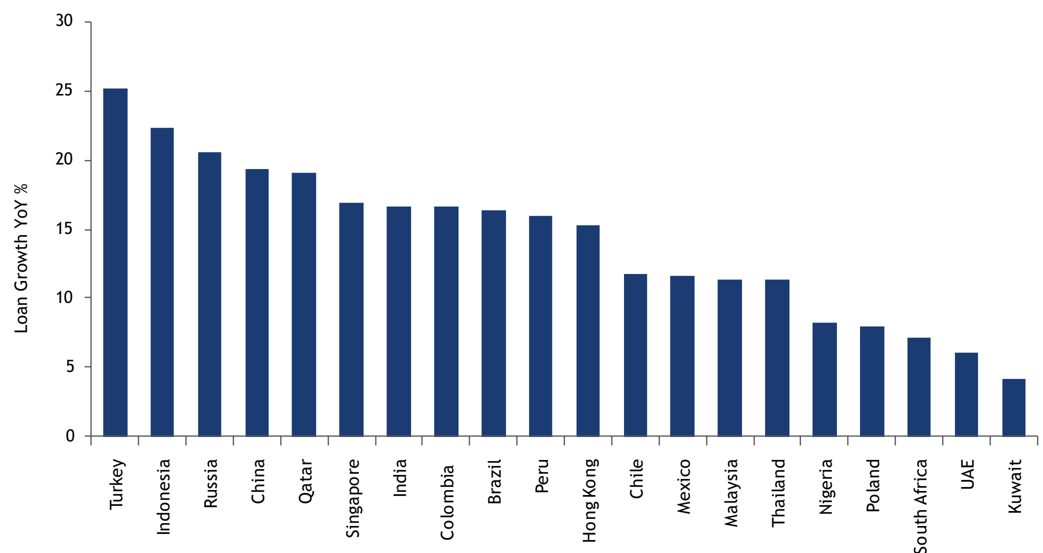
What is apparent to us, however, is that major EM banks could face key pressures, including:

- Fallen angels (borrowers that get downgraded from investment grade to high yield) and credit-rating downgrades following sovereign downgrades.
- Asset quality deterioration from slowing economies.
- Capital pressures from lower profits and currency depreciations.
- Funding and liquidity pressures from capital outflows.

We expect these above risks to be manageable and do not foresee the disorderly, systemic defaults that could lead to a full-blown EM crisis.

EM BANKING SYSTEMS' 5-YEAR AVERAGE LOAN GROWTH (%)

Source: Bloomberg, data as of 12/31/2014.



We are also monitoring pockets of specific risk related to banks that grew recklessly in previous years and/or were used as policy tools to implement countercyclical government populist measures during recent recessionary times; banks in some frontier markets with weak FX risk management ability and lower debt servicing capacity amid depreciated local currencies; and some small- and mid-sized specialized/monoline banks with undiversified loan portfolios in cyclical sectors and slowing economies.

Dealing Productively with Asset Quality and Foreign Exchange Risks

Asset quality has already begun showing signs of gradual deterioration across several EM banks, as evidenced in increased non-performing loans (NPLs), loan renegotiations/restructurings, special mention loans, and NPL sales. In most mature EM banking systems, we do not expect a disorderly surge in NPLs in the year ahead. Working under regulators' auspices, loan workout mechanisms with borrowers facing temporary difficulties have been a welcome, pragmatic measure many mature EM banks have used to spare their balance sheets hefty one-off loan losses. With very few exceptions, EM commercial banks' direct exposure to commodities is limited. Direct exposure is, however, very important to monitor in light of currently low commodity prices and struggling commodity sectors. The indirect impact of low commodity prices is likely far more relevant: slowing economic growth among commodity exporters has implications for asset quality and bank profitability. Unemployment and GDP growth are key factors we monitor, as they would impact banks' asset quality going forward.

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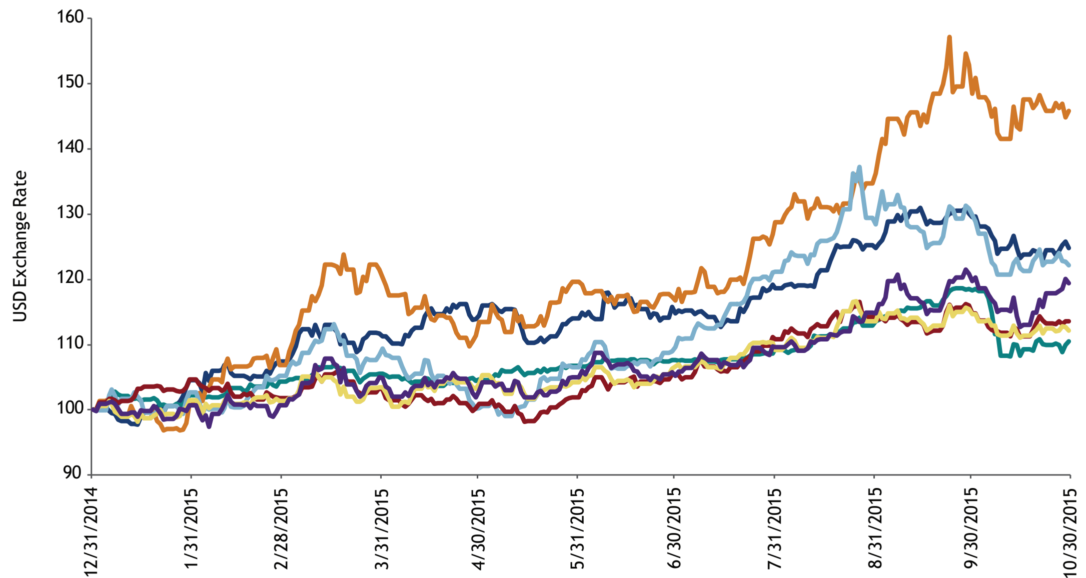
FX lending is another aspect of credit risk we closely monitor in light of material EM currency depreciations this year. Regulatory caps on FX open positions limit FX market risk for most major EM banks, and FX loans have declined as a share of total loans in these EM economies in recent years. In addition, a significant portion of these FX loans (with a few exceptions in Eastern Europe and Latin America) is hedged to large corporate borrowers. Many banks have also increased collateralization of FX loans and are better prepared to deal with currency risks.

EM CURRENCIES PER USD
12/31/14 = 100

Source: Loomis Sayles, data as of 10/30/2015.



That said, no hedge is perfect, and protracted currency depreciation could still lead to asset quality problems in some banks. While profitability has declined on higher loan loss provisions amid expected asset quality deterioration and lower net interest margins, most EM banks have remained well capitalized given the high capital starting levels and strong profitability levels relative to developed market banks.

Can EM Banks Provide Attractive Risk-Adjusted Returns?

Although EM bank bonds have outperformed corporate and sovereigns since 2014,[2] their risk premia have increased as reflected in the increased spread differentials between banks' senior bonds and sovereign bonds, subordinated (sub) and senior bank bonds, and Basel 3 Tier 2 subs and old style Tier 2 sub bonds. The spirit of Basel 3 is to avoid the use of public monies to bail out banks. As a result, Basel 3 securities are "bail-in-able" (either subject to write-down or equity conversion risks), and investors typically demand a risk premium relative to the old style subordinated bonds to hold Basel 3 securities in order to compensate for their loss absorption feature.

We expect EM banks' bond performance to continue to be largely driven by top-down macroeconomic and political stories. However, some decoupling is expected as the negative sentiment toward EM wanes and country and security selection—"the best of the worst"—becomes more prominent.

[2]Source: Barclays EM Index spreads for EM USD Aggregate Corporate, EM USD Aggregate Bank and EM USD Sovereign, data as of 11/10/2015.

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In our sample of "investable" EM banks, Mexican banks continue to be perceived as relative safe havens, and going down the capital structure, subordinated debt can provide meaningful yield pick-up. In our view, the most attractive valuations, however, are currently in EM banks that operate in challenging political and/or economic environments.

The risk-off episode last summer, when credit spreads significantly widened and prices declined, created some market dislocations and opened up some opportunities. However, security selection with a close eye on not only the idiosyncratic characteristics of individual banks and banking systems, but also the macroeconomic backdrop and global interlinkages, will likely remain the optimal way of investing in EM bank credits.

Please see important disclosures on the following page.

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Disclosure

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