Deleveraging Asia

August 2021

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About this report
Unless specified otherwise, all the data in the Deleveraging report is based on ongoing tracking and monitoring of deal activity, based on Deloitte practicioners' insidhts into the respective markets together with public and industry sources, notably Debtwire. This combination of sources limits the detail we can provide on individual transactions or identifiable data segmentation.

All data in this report is correct as of March 2021.

Deleveraging Asia 2020

Asia in 2020: The general landscape

Since the publication of our previous Deleveraging Asia report in 2019, non-performing loan (NPL) stocks in the main Asia Pacific (APAC) economies have increased from USD 679 billion to USD 753 billion at the end of December 2020, as national economies in the region were disrupted by the COVID-19 pandemic. This may be the mere tip of the iceberg. Loan asset quality is likely to be obscured by government-led policy responses to the pandemic, such as debt moratoria and regulatory forbearance. Bad debts are expected to increase as these measures unwind, putting banks under pressure to deleverage their balance sheets. These figures do not reflect the potentially large volumes of NPLs sitting on the balance sheets of asset management companies (AMCs) and special purpose vehicles (SPVs) that were established to clean up banks' balance sheets.

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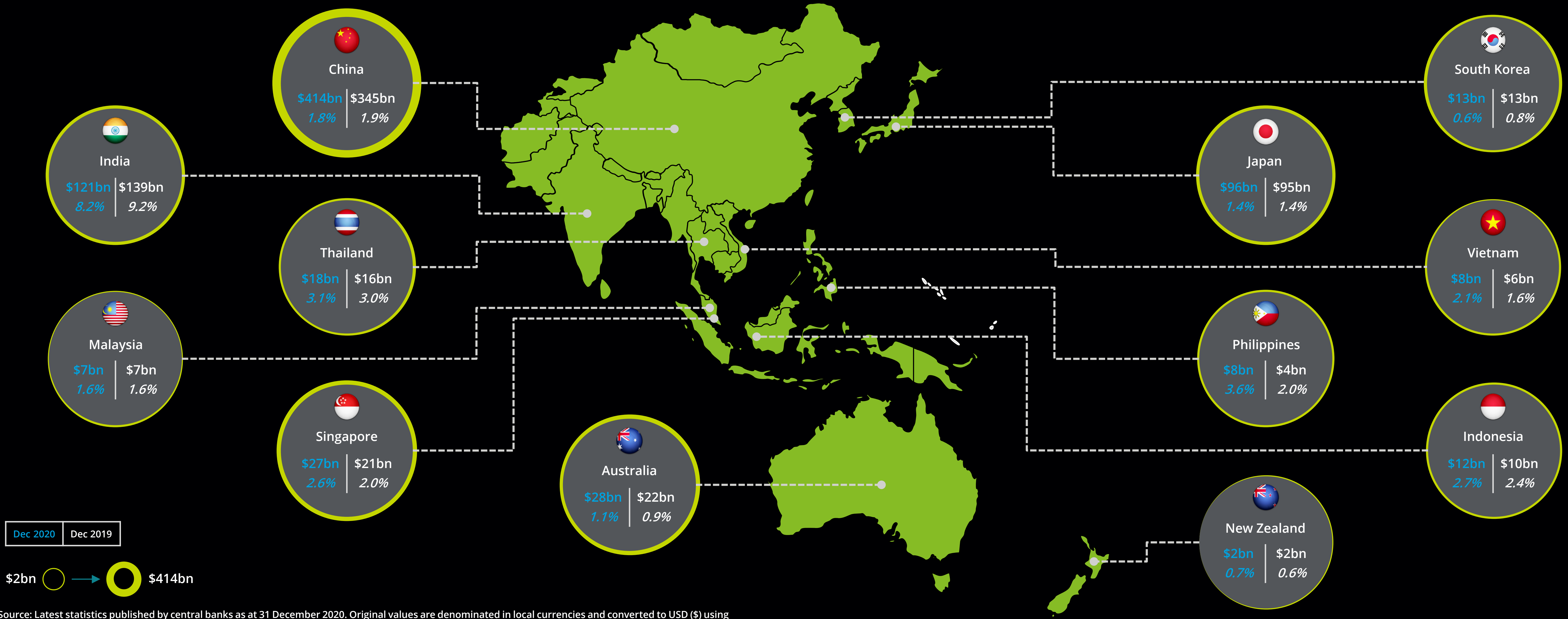
USD 753 billion of NPLs held by banks across APAC at the end of December 2020



Source: Latest statistics published by central banks as at 31 December 2020. Original values are denominated in local currencies and converted to USD ($) using exchange rates at the end of the relevant period.

A year like no other

2020 brought new and previously unforeseen challenges and uncertainty. While we can see some light at the end of the tunnel with positive news on vaccination programmes, an unequal roll-out among countries and the risk from new variants of the virus could still damage the tentative shoots of economic recovery.

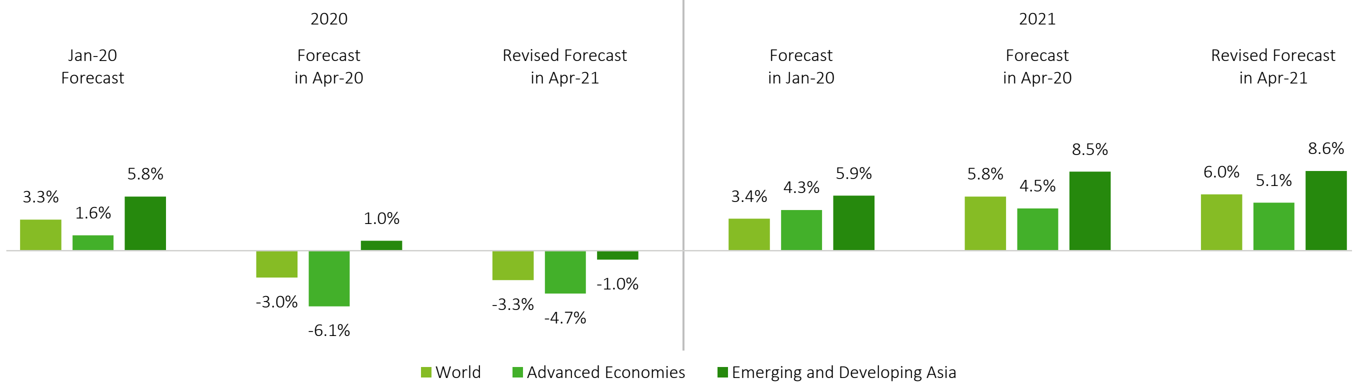
Negative growth followed by a rebound in 2021

At the onset of the pandemic, governments around the world responded quickly to introduce measures to stop the spread of the virus, together with unprecedented stimulus and regulatory forbearance measures to protect businesses and economies from the consequences of the disruption.

According to estimates published by the International Monetary Fund (IMF) in April 2021, the global economy contracted by 3.3% in 2020, but with regional variations reflecting different levels of disruption and support countermeasures. Emerging and Developing Asia (including China, India and the Association of Southeast Asian Nations-5, (ASEAN-5), whose economies are typically more centralised, experienced a smaller reduction of just 1.0% in GDP in 2020 compared to Advanced Economies. Indeed, China and Vietnam still achieved growth in GDP in 2020 (China 2.3% and Vietnam 2.9%), albeit at lower rates than in previous years.

Recent forecast by IMF indicates that the APAC region will recover at a faster rate than elsewhere, with GDP growth of 8.6% in 2021, compared to an average of 6.0% globally and 5.1% for Advanced Economies.

Growth Forecast for 2020 & 2021



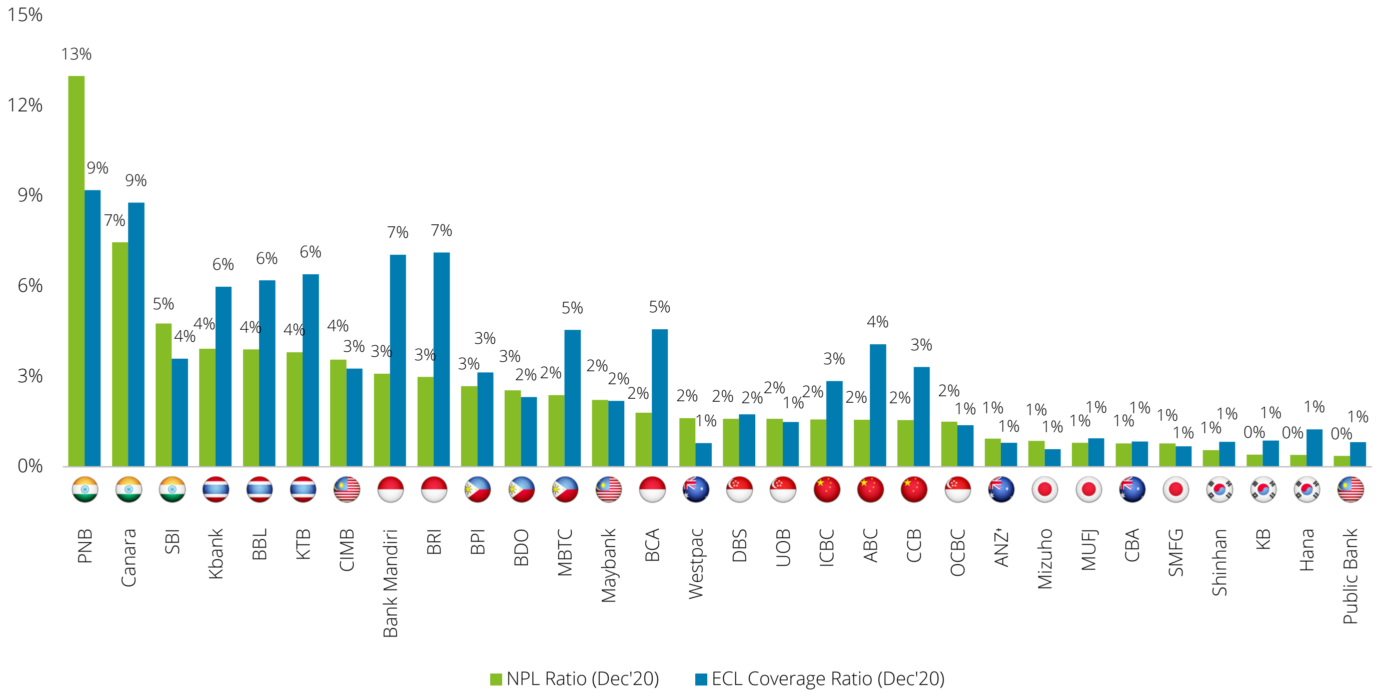
Source: International Monetary Fund (F = forecast), January 2020, April 2020, April 2021

Impact on the banking sector

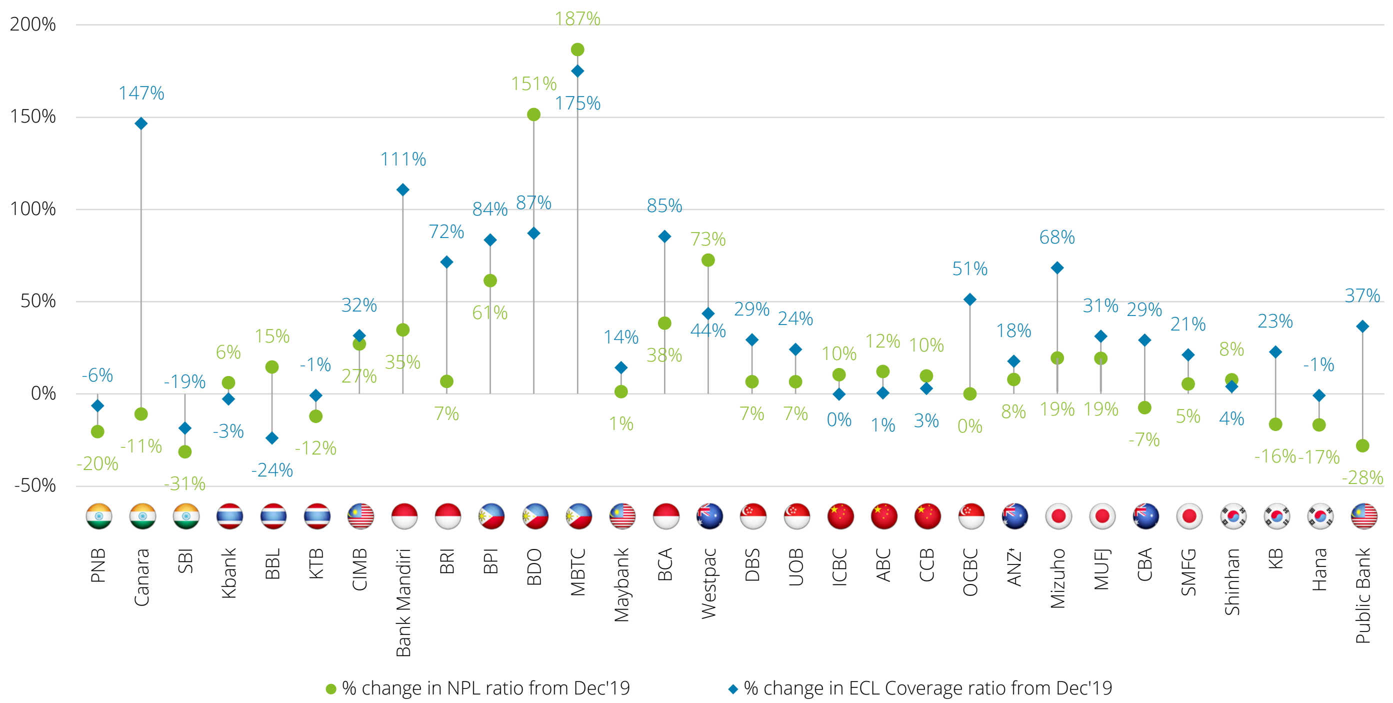
Against a backdrop of an already low interest rate environment, higher loan defaults put further pressure on banks profitability. To date, loan asset quality has not yet been significantly impaired, although with some exceptions (in the Philippines, Australia, Indonesia and Malaysia). As evidenced by the 2020 year-end results of the top banks in APAC as reviewed later in this report, some have started to regain profitability, with a higher net interest margin (NIM) and lower loan impairment costs in the final quarter of 2020 than in the first three-quarters of the year. Provision level has increased across major banks in Asia which resonates with the trends observed in Europe. Some countries, such as the Philippines and Indonesia, are expecting a worse asset quality deterioration than the others, as indicated by the surge in provision and NPLs.

However, the debt moratorium schemes and relaxed risk classification criteria remain a source of critical uncertainty with regard to recognising problem loans. The consequences of much of the pandemic-induced credit risk are yet to emerge.

TOP Banks – NPL Ratio vs. ECL Coverage Ratio as at Dec’20



TOP Banks – % increase in NPL Ratio and ECL Coverage Ratio from Dec'19 to Dec'20

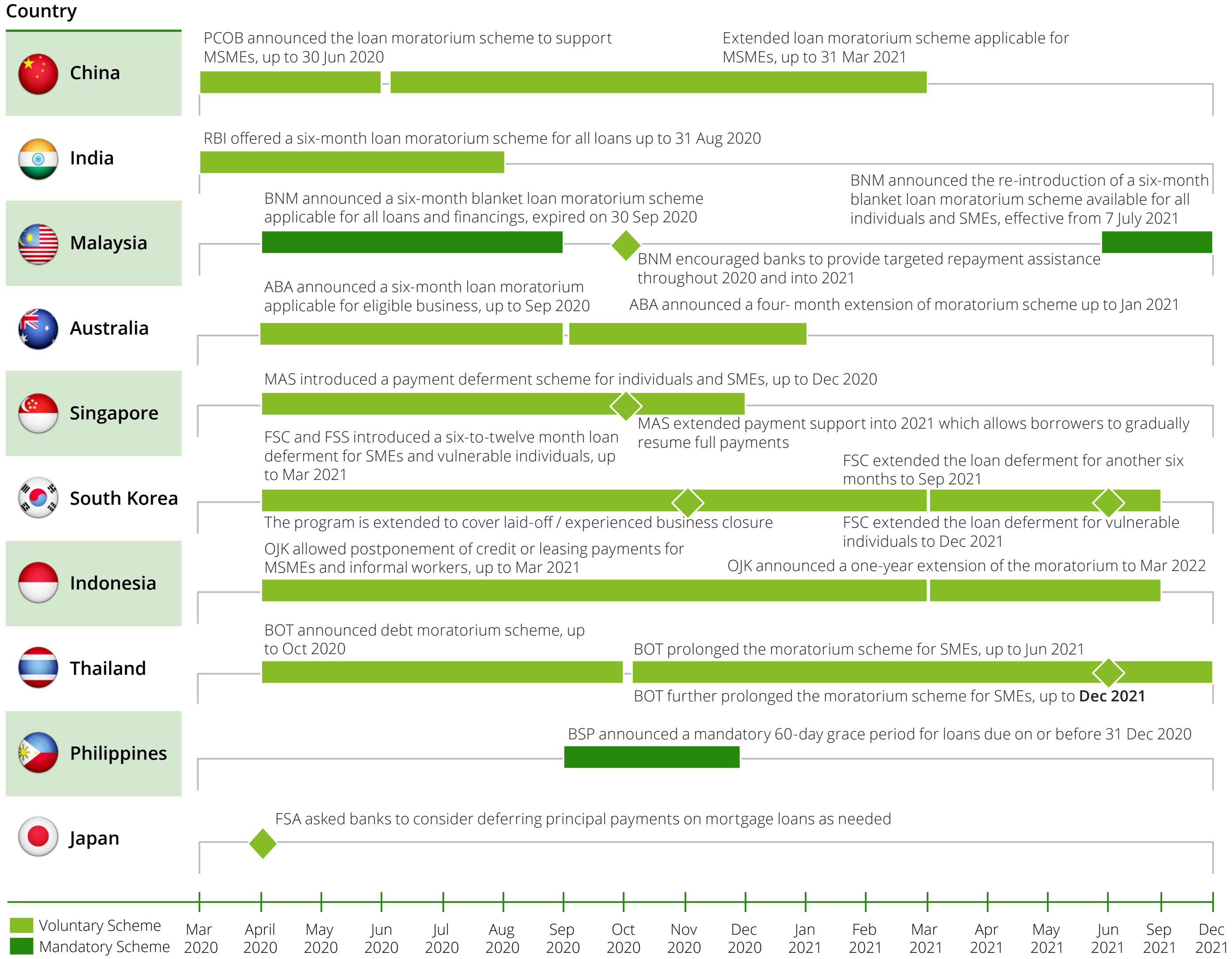


Source: Published financial reports by banks as of December 2020. *Published financial reports by banks as at September 2020.

Government and banking regulators: efforts to prime the pump

To combat the adverse economic effects of the pandemic, governments across the world introduced sizeable fiscal stimulus packages, including healthcare subsidies, employment support measures, loans to SMEs, loan guarantees, tax reliefs and various other schemes targeting the worst-hit sectors. Banks have played a crucial role in channelling stimulus funding to companies and consumers.

Banking regulators implemented various measures to foster the resilience of banks, such as regulatory forbearance and capital reliefs; and as shown in the diagram below encouraged the introduction of loan moratorium schemes and the provision of additional payment support to borrowers adversely affected by the pandemic.



Source: Central Banks, IMF Policy Tracker of Policy Responses to COVID-19 https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19, refreshed in June 2021

But are these measures sufficiently effective to protect the economy and speed up the pace of recovery?

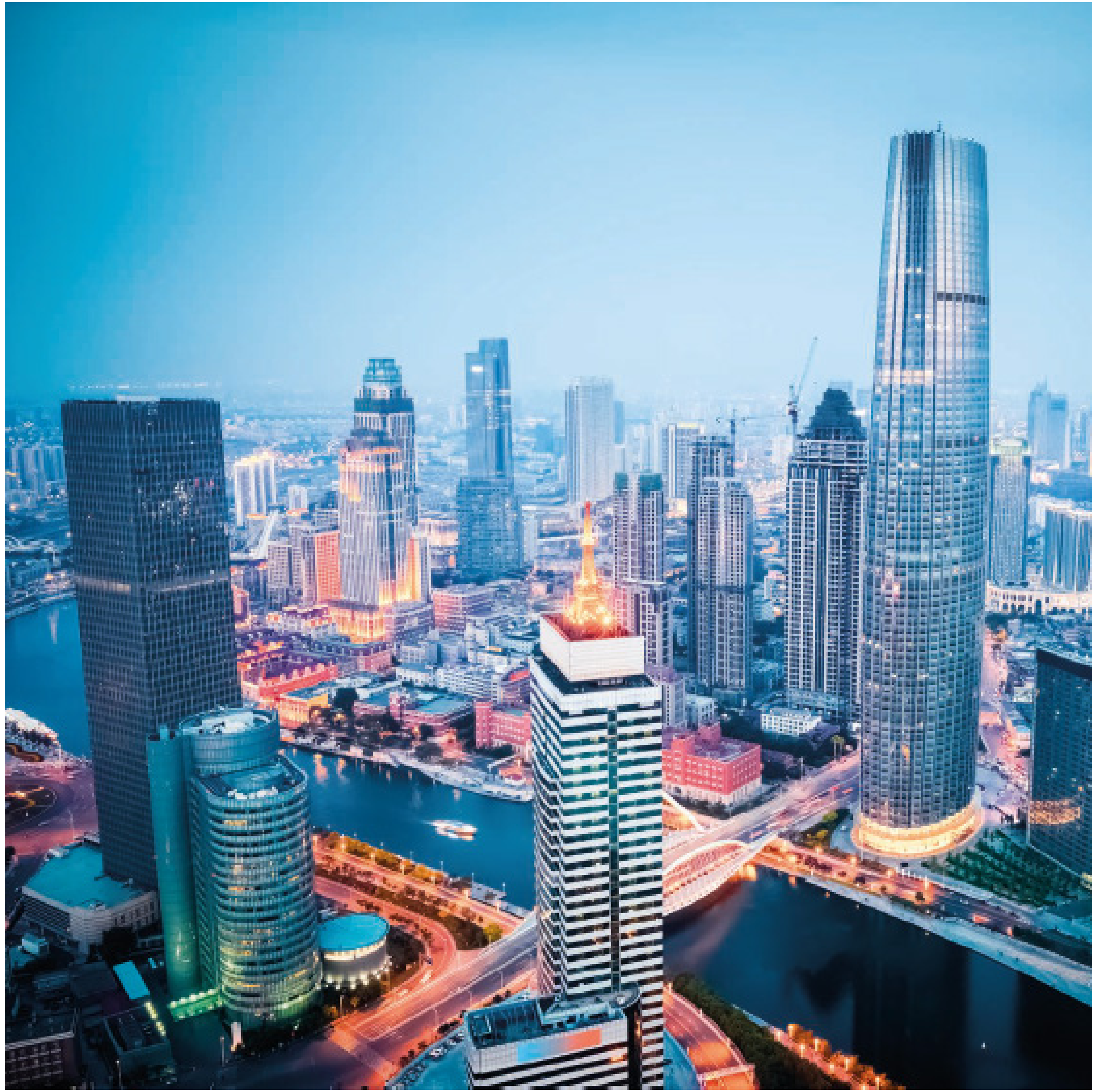
Conditions set for a significant increase in NPL market activity

To date the various policy responses appear to have limited the increase in NPLs in the short term, but the real impact on asset quality may only become apparent in the second half of 2021, when the moratorium schemes start to expire. Although Asian banks are maintaining strong capital positions and have made additional loan loss provisions, the latent credit risk needs to be closely monitored. Moody's[1], the credit rating agency, has forecast that the volume of NPLs will double on average across the major APAC economies by 2022.

So, which markets in Asia will draw the attention of NPL investors?

A survey of 700 central bankers, senior bankers, resolution authorities, financial advisors and asset management companies (AMCs) in Asia, conducted by Deloitte in August 2020 suggested that direct NPL portfolio sales would be the main area of activity for banks looking to address underlying balance sheet issues (57% of respondents), with specific focus on the SME sector. Based on our insights into the NPL markets and recent market sentiment, we anticipate that China, India, Indonesia and Thailand(which have the largest NPL stocks and where distressed investors have been active over the past few years) to continue to be the primary areas of focus for NPL transactions in Asia in the foreseeable future. That said, however, we note that regulators in the Philippines and Vietnam are making efforts to facilitate direct NPL sales as a way of tackling an anticipated wave of distressed assets, which could make these countries the next regional hotspots.

The main features of each respective market are described in the following sections.



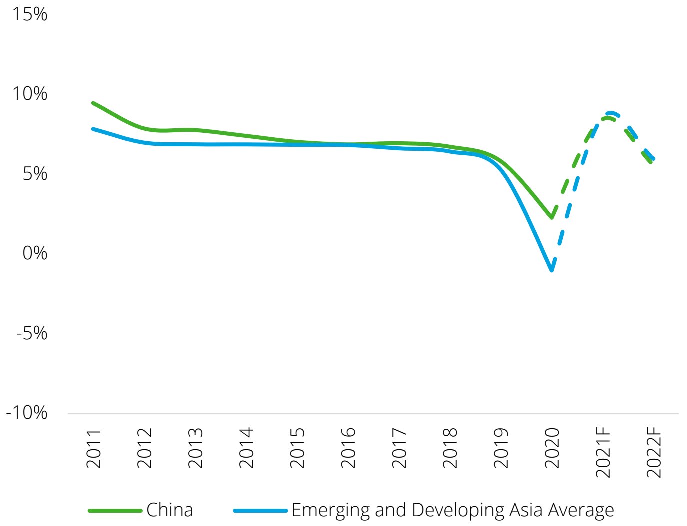
China

Macroeconomic landscape

China was the first country to be hit by COVID-19, and its quick and effective response to contain the spread of the virus made it the first major economy in the world to recover[2].

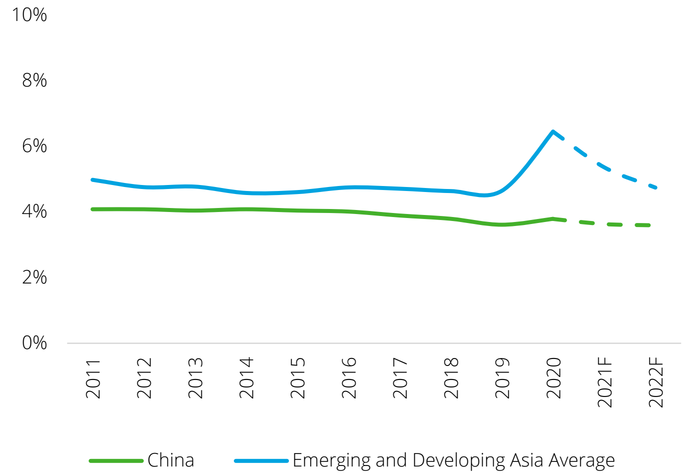
GDP fell sharply in Q1 2020 across all major sectors following the imposition of a nationwide lockdown. As the government's timely measures to combat the pandemic took effect, most industries recovered and the economy bounced back in the second quarter of the year. All major sectors of the economy returned to growth, with an increase in GDP of 4.9% in Q3[3] and growth of 2.3% for 2020 as a whole.[4] The IMF expects China GDP to achieve growth of 8.4% in 2021.[5]

Real GDP Growth (%)



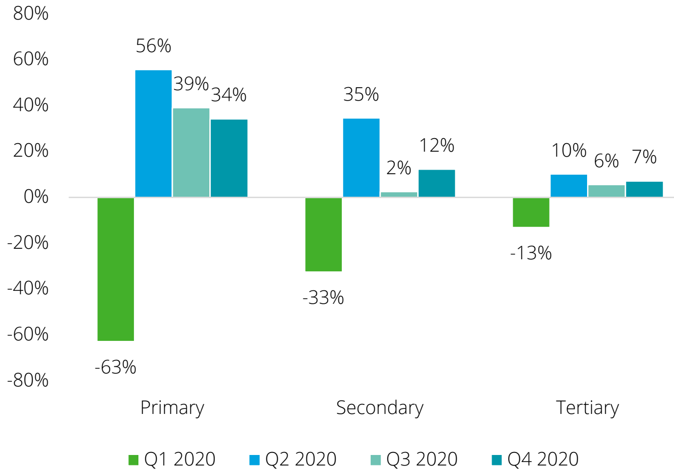
Source: International Monetary Fund (F = forecast)

Unemployment Rate (%)



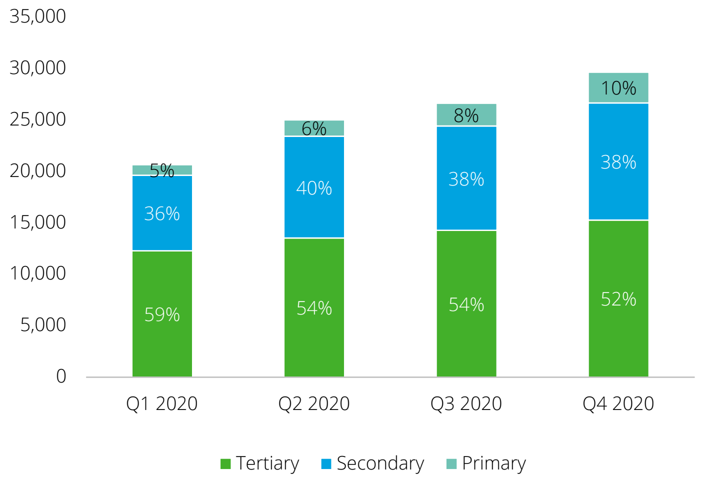
Source: International Monetary Fund (F = forecast)

Key Sector GDP Growth (Q-o-Q %)



Source: National Bureau of Statistics of China

GDP by Sectors (RMB'bn)



Source: National Bureau of Statistics of China

The unemployment rate in China in 2020 is expected to have shown only a modest increase of 0.2% to 3.8% from 2019 – well below the regional average. This is mainly due to the early recovery in business activity in the second and third quarters of 2020.

Although China has emerged from the lockdown, its important trading partners in Europe and the United States have not yet done so. This has affected China's exports at a time when its domestic recovery has remained relatively fragile, given several small-scale outbreaks of the virus and regional lockdowns.

The trade tension between China and the US in the past two years has slowed down economic growth to some extent. In December 2020, president-elect Joe Biden stated that there would not be any immediate moves to lift the tariffs that the Trump administration had imposed, and he expressed concerns about China's practices in relation to technology and intellectual property.[6] Amid these uncertainties, China is strengthening its footprints in Southeast Asia and East Asia.

Government's response to the crisis

China announced fiscal measures estimated at RMB 4.9 trillion[7] (c. USD 750 billion) to counter the economic and social damage caused by the pandemic and introduced a loan moratorium scheme to support SMEs in March 2020, one of the earliest in the region. The scheme was subsequently extended until March 2021.

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Key measures taken by banking regulators

Measures	How?	Outcome
Loan extension and debt restructuring	In March 2020, the People's Bank of China (PBOC) encouraged banks to provide extensions on SME loans and micro credits. The repayment date for principal or interest could be delayed to 30 June 2020 at the latest. However, the loan moratorium was further extended for micro, small and medium-sized enterprises (MSMEs) to 31 March 2021.	As of September 2020, banks in China had granted moratoria on RMB 4.7 trillion of MSME loans.[8] The policy provided temporary financial relief for borrowers, and allowed financial institutions more time to mitigate their potential losses. However, the moratoria also created latent credit risks for banks.
Easing of credit classification requirement	The China Banking and Insurance Regulatory Commission (CBIRC) ordered banks to focus on fundamentals and not to adjust credit risk classifications purely on the basis of short-term cash flow difficulties caused by the virus outbreak.	No apparent movements in loan classifications have been observed among major banks. However this measure may amplify the latent credit risks.
Encouraging bank lending	PBOC cut the required reserve ratio for qualified banks by 50bps-100bps[9]. The central bank approved an RMB 400 billion re-lending quota. It will purchase regional banks' loans granted to small businesses, which the banks then buy back after one year. The intention is to encourage SME lending at lower interest rates.	The cut in reserve ratio has released RMB 550 billion worth of liquidity into the market to shore up the economy. According to the Vice Governor of the PBOC, RMB 2.3 trillion of micro-loans have been approved, representing an RMB 796 billion increase compared to the same period in 2019.[10]

Source: Central banks and Deloitte research of public data

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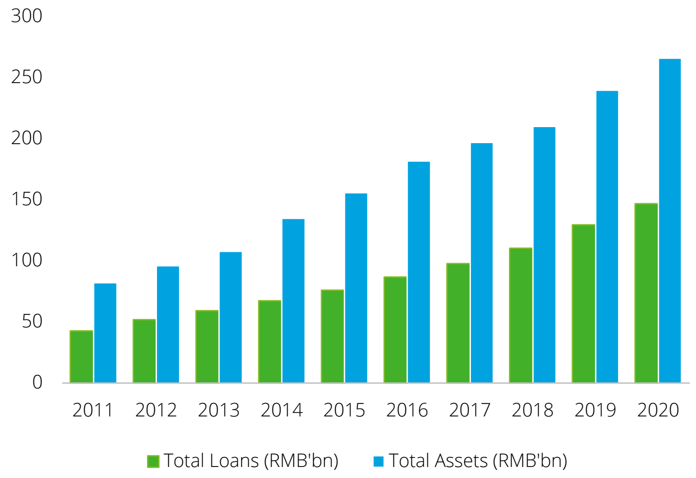
Banking landscape

China's banking sector continues to be dominated by the top state-owned players, namely the big five banks – Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Agricultural Bank of China (ABC) and Bank of China (BOC). The banking sector further consolidated in 2020, with several M&As and partnership arrangements between city commercial banks and rural commercial banks. International banks remain minority players, although they are keen to expand their activities and presence in the Chinese financial services market.[11] Four foreign banks – UK-based HSBC and Standard Chartered, Citibank of the US and Hong Kong-based Bank of East Asia – have developed significant operations and established extensive local networks.

The banking regulator has been gradually easing the policies governing foreign banks to support a greater integration of China's financial sector with the global market. For example in January 2020, CBIRC revised regulations for foreign lenders, allowing them to set up branches and wholly foreign-owned subsidiaries.[12] Nonetheless, the lengthy licensing process and competition from established local players provide strong challenges for international banks seeking to launch fully-owned operations in China.[13]

Between 2019 and 2020, the total assets of commercial banks in China grew by 11% Banks were lending more aggressively at lower rates to support the pandemic-hit economy following the instructions from the government. However as the economy recovers, the regulator may become less concerned about system-wide credit easing and increasing loan volumes.

Commercial Banks Assets (RMB'tr)

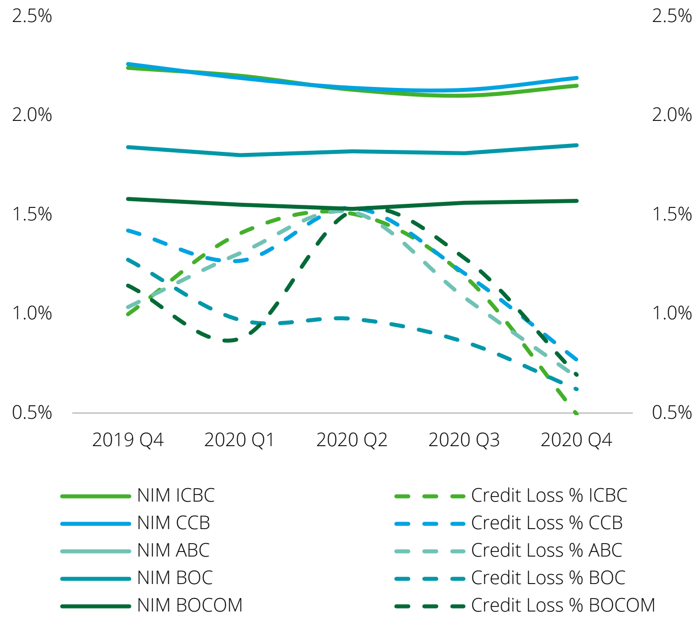


Source: China Banking and Insurance Regulatory Commission

When PBOC cut the Loan Prime Rate (LPR) in March 2020 to reduce the cost of lending, this had an adverse effect on the profitability of banks. Net interest margin (NIM) narrowed slightly for all the major banks, which also made large provisions for future credit losses caused by the pandemic, reducing profitability even further.

Big five banks saw an increase in credit losses in the first half of 2020, with ICBC and ABC reporting 44% and 30% rises in credit costs in Q1 respectively; while CCB, BOC, and BOCOM showed increases from Q2, with BOCOM's credit loss surging by 80%. As banks' performance improved amid recovery, credit losses started to decelerate in the second half of 2020.

NIM & Credit Loss (%) - Top Banks



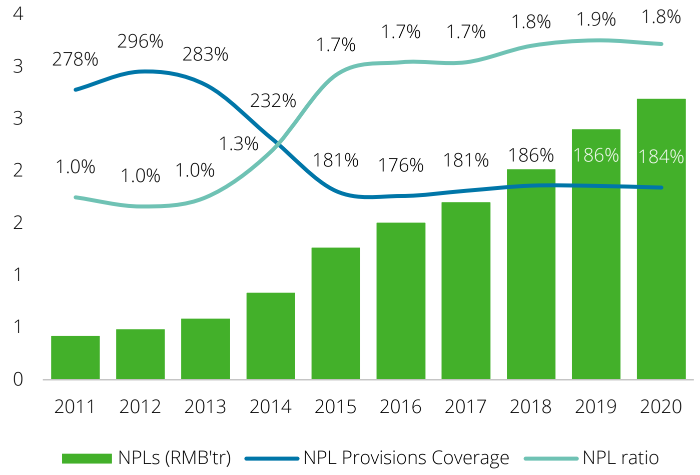
Source: Published financial accounts as of December 2020
*annualised % of gross loans

The NPL stock of the banking sector grew significantly during the first three quarters of 2020, and the NPL ratio reached a decade-high level of 1.96% in September 2020 (subsequently falling to 1.84% in December 2020). The increase in NPLs followed a surge in sub-standard loans (i.e. loans where borrowers are displaying a definable weakness in repayment ability, and their operating income is insufficient to enable full repayment of interest and principal) across all top banks in the first half of 2020, with ICBC and BOCOM recording increases of 52% and 152% respectively during this period. As at year-end 2020, total sub-standard loans in the banking system stood at RMB 1.28 trillion (USD 195 billion)[14], a 26% increase from 2019.[15]

A further increase in NPLs can be expected, since default risks were temporarily hedged by government policies. Bad loans are likely to surge in 2021, particularly among small and medium-sized financial institutions with relatively weak internal controls and low asset quality. CBIRC has ordered banks to implement the following measures prepare for the rebound in NPLs:[16]

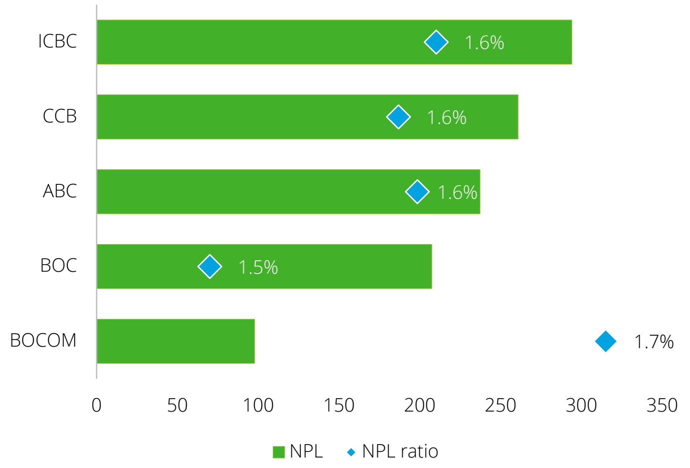
1. Rigorous credit risk classification: Carefully segregate borrowers that have been affected by the pandemic and borrowers with inherent operating risks, strictly following a five-category system to identify non-performing assets.
2. Increase efforts to resolve NPLs: The capital and funds released through the reduction of loan loss provision coverage must be used for NPL resolution.
3. Explore multiple channels to resolve NPLs: Accelerate NPL resolution through various methods such as write-off, collection, loan portfolio transfer, and debt-to-equity swaps.

Banking System NPLs (RMB'tr)



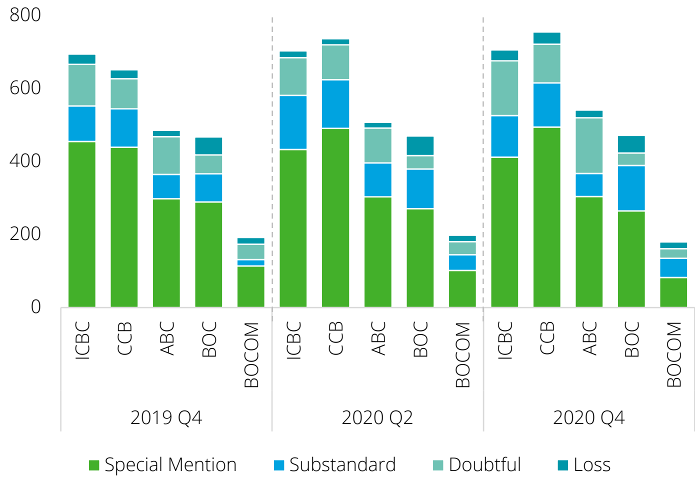
Source: China Banking and Insurance Regulatory Commission

Gross NPLs (RMB'bn) - Top Banks



Source: Published financial accounts as of December 2020

Non-current Loans by Classifications (RMB'bn) - Top Banks

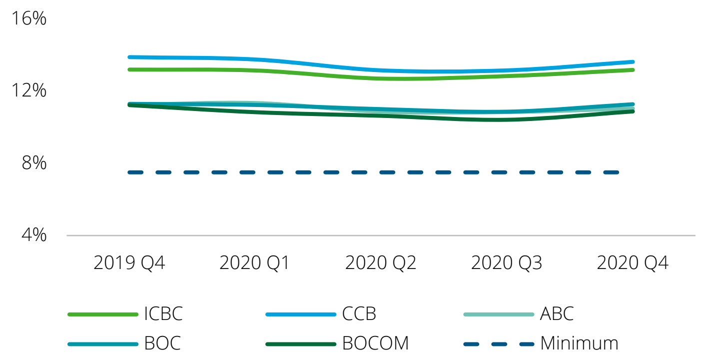


Source: Published financial accounts as of December 2020

The top banks experienced a slight decline in their CET 1 ratio during H1 2020 because of falling net profits coupled with increased lending activities. However, they are still adequately capitalised, with their ratios between 10% and 13% as of December 2020, well above the 7.5% minimum regulatory requirement. On the other hand, the capital positions of many small and medium-sized banks are weaker and are vulnerable to varying degrees of stress, exacerbated by the increase in impairment losses caused by the pandemic. According to Fitch Ratings, three Fitch-rated small and medium-sized banks will see their CET 1 ratio falling just below the regulatory requirement.[17]

China's banking sector remains under pressure to replenish its capital. PBOC and CBIRC issued a draft consultation paper on total loss-absorbing capacity (TLAC) requirements, suggesting that the top banks (G-SIBs) should raise substantial amounts of capital or loss-absorbing debts in the next few years.[18] Banks have relied on profit retention to replenish their capital bases; however, to provide finance to support business development and economic growth, retained profits alone will not be sufficient. Banks are therefore likely in future to tap external sources for additional capital.

CET 1 Ratio (%) - Top Banks



Source: Published financial accounts as of December 2020

During 2020, there were some mergers and restructurings of small and medium-sized banks. For example, Jiangsu Rural Commercial Bank became a shareholder of Zhenjiang Bank; Wuxi Rural Commercial Bank and Jiangyin Rural Commercial Bank jointly established Xuzhou Rural Commercial Bank; and Panzhihua City Commercial Bank and Liangshan Prefecture Commercial Bank jointly established Bank of Sichuan.[19] Mergers and restructurings may speed up the disposal of NPLs; and they will also help revitalise the assets of banks, increase their capital, and enhance their resilience against risks.

The regulator in China is planning improvements in the country's financial sector. CBIRC issued the circular on 'Carrying out the Follow-up Checks for the Rectification of Market Problems in the Banking and Insurance Sectors' in June 2020. This proposed a review of the soundness and effectiveness of the internal compliance systems of financial institutions.[20] In addition, to support the rapid development of the banking sector and facilitate alignment with international standards, PBOC announced the 'Commercial Bank Law (Revised Draft)' in October 2020.[21] The revision closely follows the Basel requirements, focusing on corporate governance, capital and risk management, customer rights protection, and market exit mechanisms.

NPL landscape and market development

In our Deleveraging Asia 2019 report, we highlighted that the size of the NPL market in China is on a par with the most active European markets, with over USD 120 billion traded in either the primary or secondary markets. However foreign investors are under-represented, because the current regulations only allow officially licensed asset management companies (AMCs) to buy NPLs directly from banks. The market landscape may change in future. The Phase 1 U.S.-China trade deal signed in January 2020 specifically addressed the opening up of the NPL market in China. In view of the mounting bad debt problem post-COVID, the Chinese government is even more committed to opening up the NPL market and diversifying the composition of players.

According to the 'China Special Assets Industry Development Report (2020)', non-bank financial companies (NBFCs) will become an important supplier to the NPL market, leading to further diversification in the types of assets offered in the market. NBFCs have also been exposed to risks from non-performing assets. According to incomplete statistics, the supply of non-performing assets from the non-bank sector, such as trusts, wealth management and non-licensed AMCs, was close to USD 115 billion as of August 2020.

AMC market and recent developments

The state-owned AMCs continue to be the dominant players in China's NPL market due to their strong capital bases and lower cost of financing. To mitigate the impact of the pandemic, AMCs have been actively fulfilling their roles of risk mitigation and resolution of NPLs. For example, acquisitions of non-performing assets by China Cinda and China Great Wall in 2020 exceeded RMB 199 billion[22] and RMB 140 billion[23] respectively. Furthermore, China Great Wall carried out online community marketing of non-performing assets as an innovative approach to facilitate trade during the pandemic. With the rising volumes of NPLs and increasing demand for resolution, acquisitions and restructurings of businesses by AMCs are expected to gain momentum in 2021.

The current '5+2+N' model comprises of the five state-owned AMCs, two provincial AMCs per province and many other private non-licensed players in the market. However, the competitive landscape for AMCs is likely to be further diversified, as the regulator in recent years has relaxed its policies on the market participants to support the resolution of NPLs. More types of institutions are participating in the market amid the increasing demand for NPL disposals. CBIRC approved a fifth national state-owned AMC, China Galaxy Asset Management Co. Ltd. in March 2020, the first since the 'Big Four' state-owned AMCs were established over two decades ago. China

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Galaxy Asset Management is authorised to invest in and dispose of non-performing assets of financial institutions and carry out bankruptcy restructuring.

Article 4.5 of the Phase 1 China Trade Deal states that China agrees to allow U.S. firms to obtain regional licences (and national licences as and when new national licences are granted) on a non-discriminatory basis. This agreement is likely to disrupt the current market status quo. Although it is still at an early stage, with no clear guidance around the application process, it is viewed as a key step in opening the NPL market in China.

The first foreign AMC came to the market in February 2020. Although not licensed, Oaktree Capital established a wholly owned entity, Oaktree (Beijing) Investment Management Co., Ltd. with registered capital of USD5.42 million, seeking direct access to the Chinese NPL market. Later in the year, the first licensed AMC with foreign involvement was established in Hainan Province by a subsidiary of the Hong Kong-based New World Development.

Development of the unsecured consumer NPL market

It is expected that unsecured consumer NPLs, including credit card loans, will continue to increase following rapid credit growth in recent years and the economic impact of the pandemic. According to Fitch Ratings, some banks have already reported significant rises in consumer and credit card loan delinquencies since February 2020.[24] PBOC launched a pilot programme in January 2021 where participating banks can transfer their unsecured personal NPLs to licensed AMCs and asset investment companies (AICs). The banks participating in the pilot programme include six major banks and 12 national joint-stock banks. Under the scheme, the transferees are only allowed to recover their NPLs through their own debt collection. They cannot transfer them to other third parties. Given consumer NPLs have not been a focus for AMCs in the past, they are still exploring the implementation of these schemes and may seek partnerships with practitioners who have relevant expertise and experience with unsecured consumer NPLs.

NPL securitisation

As banks face the risk of severe asset quality deterioration in 2021, which the market may not be able to absorb, they are using securitisation as another effective tool to resolve their NPLs on a large-scale. According to Bloomberg China,[25] RMB 28.1 billion of securitisation products backed by NPLs were issued in 2020, the largest amount since the approval of the NPL securitisation pilot programme in 2016. Sixty percent of the issuance was completed in Q4.

Large commercial banks are the dominant issuers in this market, with the AMCs joining the market for the first time. There were a total of 15 issuers during the year, including state-owned banks, joint-stock banks and asset management companies. State-owned banks occupy the leading positions. China Construction Bank was in first place in terms of issuance size, issuing nine asset-backed security (ABS) products in 2020 with a total value of RMB 10.4 billion. It was followed by Industrial and Commercial Bank of China, which issued eight ABS products with a combined value of RMB 5.4 billion. NPL securitisation has become a regular tool for state-owned banks and large joint-stock banks to dispose of NPLs. In addition, with the expansion of the third non-performing ABS pilot, a regional bank, Guiyang Bank, China Orient and Huarong entered the market.

There were three types of NPLs underlying ABS products issued in 2020: personal credit loans, personal mortgage loans and corporate loans. These represented 71%, 14.5% and 14.5%, respectively, of the number of products issued, and 33%, 46% and 21% of the total issuance amount. Bank of China also issued the first non-performing personal auto loan ABS, adding to the variety of NPL ABS products in China.

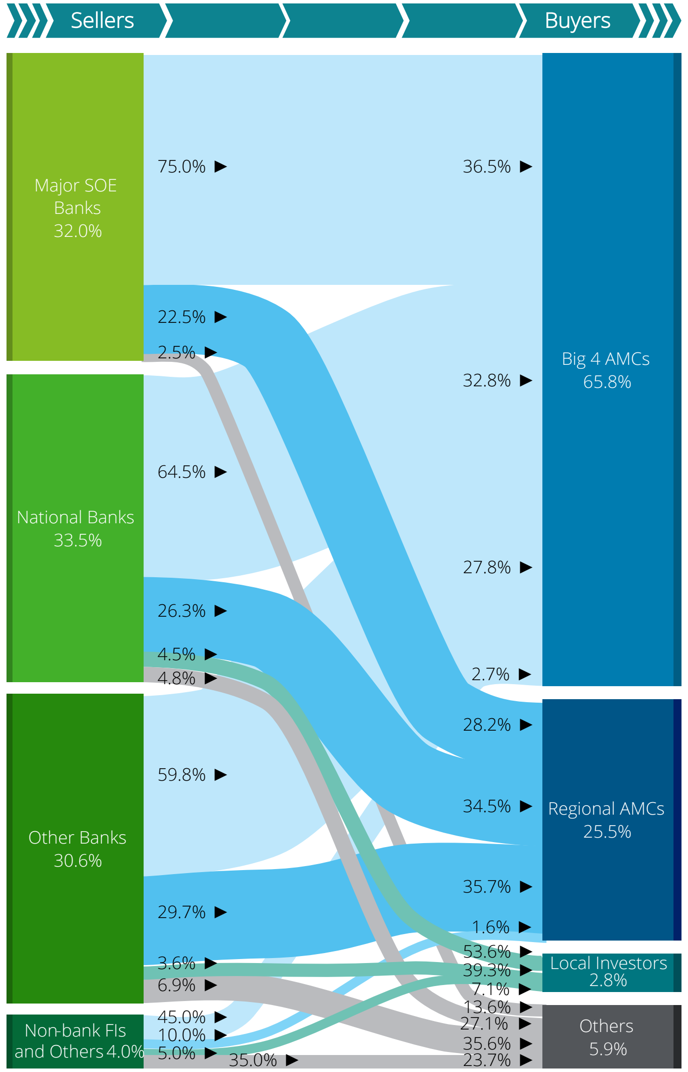
NPL transactions in 2019 and 2020

Total NPLs sold in the primary and secondary markets amounted to RMB 859 billion (USD 130 billion) in 2019, of which about 80% or RMB 681 billion (USD 105 billion) were portfolio transactions. The total amount of NPLs sold in the primary and the secondary markets in 2020 was slightly less at RMB 715 billion (USD 109 billion). This may reflect a general decrease in market activities during H1 2020 as a result of the pandemic, and higher reserve prices for NPLs marketed by commercial banks during Q3 2020 as the market recovered. We have noted the following market features:

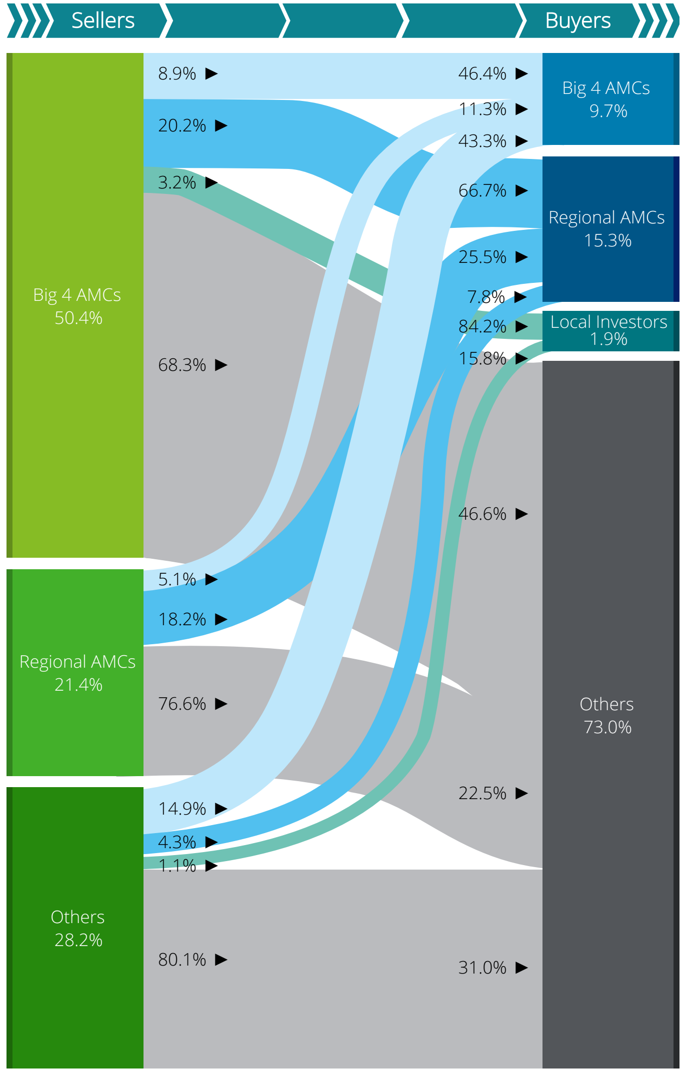
- The most active provinces in terms of transaction values in 2019 and 2020 were Zhejiang, Guangdong, Jiangsu, Henan and Shandong, Transaction values in these five provinces accounted for 57% of the national total.
- The vast majority of the primary market portfolios were sold to national and provincial AMCs who are also the major sellers in the secondary market. Apart from the Big Four national AMCs, examples of top local buyers include Guangzhou Asset Management, China Everbright Asset Management, GOHO Asset Management, Suzhou Asset Management, Jiangsu Asset Management, Zhejiang Zheshang Asset Management, and Ningbo Financial Asset Management.
- The profile of sellers in the primary market has been diversified. Major state-owned banks and national banks sold 84% of the primary transactions in 2018. In contrast, only 65% of primary market NPLs were disposed of by these large banks in 2019. The market share of other banks, including city or rural commercial banks and non-bank institutions, more than doubled between 2018 and 2019.
- The NPLs acquired by international investors comprised just 2% of the RMB 416bn secondary market in 2019, even less than the 4% in 2018. Buyers are mainly local institutional and individual investors.

NPL breakdown by transaction outstanding principal balance (OPB)

Primary market

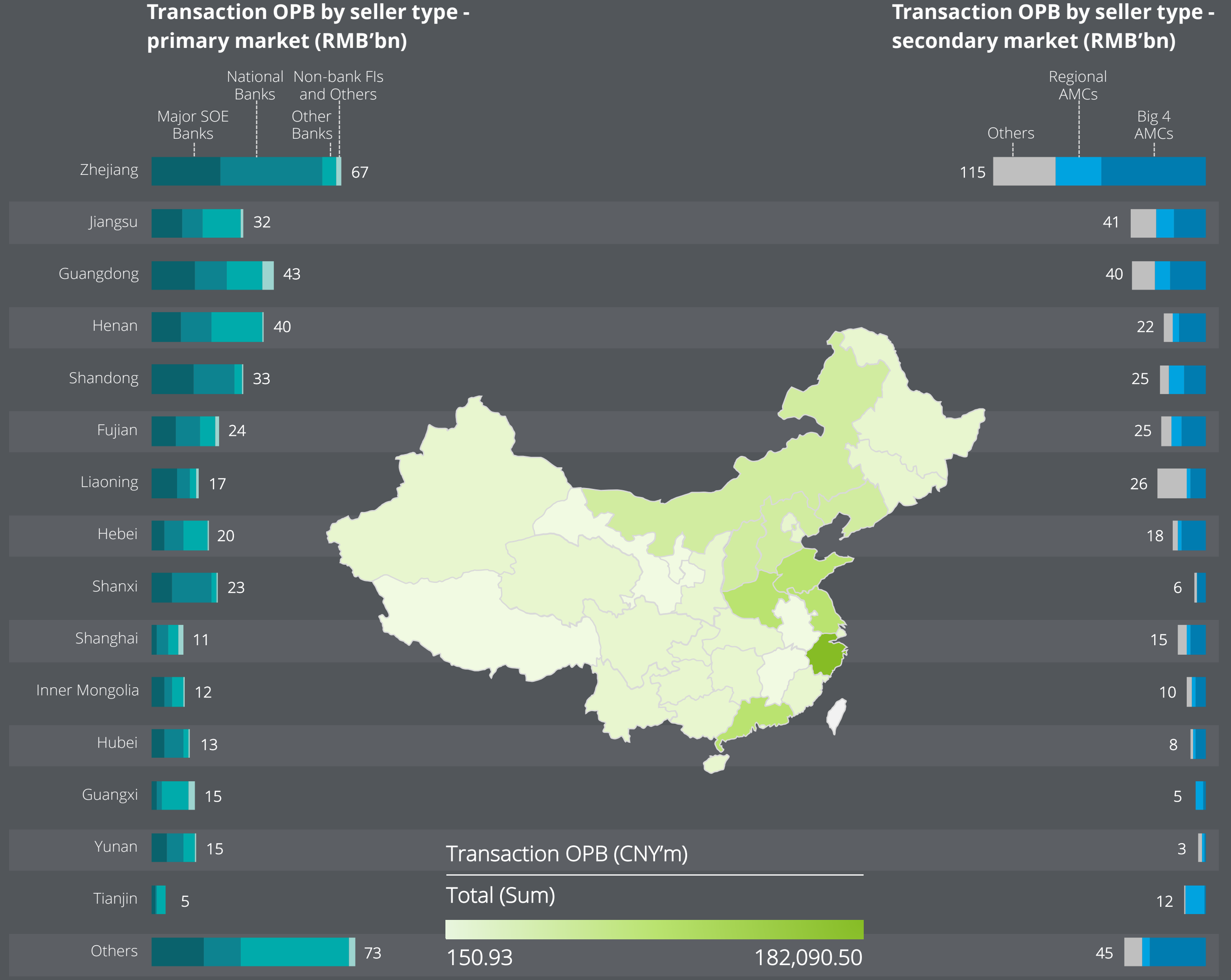


Secondary market



Source: Deloitte research and analysis of public data

NPL transaction activity in Mainland China by province – 2019



Source: Deloitte research and analysis of public data

Key events in the NPL market in 2020

Time	Events
January	**A China AMC executed its very first overseas NPL portfolio acquisition** Huarong International, a subsidiary of Huarong, won the auction for an NPL portfolio held by overseas banks. This marked the first step of Huarong's strategic transformation and exploration of the foreign NPL markets.
February	**Foreign AMC completed the registration process in Beijing** Oaktree Beijing will become the key platform for Oaktree Capital to expand its businesses in China. Its business scope will include asset management and investment management. Establishing its onshore entity is regarded by the market as the first step for Oaktree to apply for an AMC licence in China.
March	**CBIRC issued measures on the implementation of administrative licensing for non-bank institutions, clarifying the conditions for foreign financial institutions seeking to establish AMCs** Conditions include but are not limited to: total assets at the end of the most recent fiscal year shall not be less than USD 10 billion or equivalent; and the balance of equity investment shall not exceed 50% of the company's net assets (including the investment amount). However, it is still unclear whether these conditions apply to establishing national or local AMCs.
March	**Galaxy asset management company, the fifth national AMC in China, was officially approved** This was the first approval of a national AMC in the 20 years since the Big Four AMCs were established in 1999.
June	**The pilot scheme for the transfer of single-name corporate NPLs and retail NPL portfolios was being prepared** CBIRC issued the 'Notice on Conducting the Pilot Work on the Transfer of Non-performing Loans (Draft for Comment)' and the 'Implementation Plan for the Pilot Transfer of Bank NPLs'. In the pilot scheme, banks are allowed to transfer single-name corporate NPLs and portfolios of non-performing personal loans.
August	**The first local joint venture AMC was approved and Hong Kong New World Group won the second AMC licence in Hainan** The Hainan government approved the establishment of Hainan NWS Asset Management Co. Ltd. With its AMC licence, the entity can purchase NPL portfolios held by banks in Hainan province

Key events in the NPL market (cont'd)

Time	Events
October	**Carlyle was reported to be establishing a fund with an AMC in China to speed up its strategic positioning in China's NPL market** It was reported that Carlyle Group is cooperating with the fifth national AMC Galaxy Assets to promote the establishment of the Galaxy-Carlyle distressed asset fund.

Source: Deloitte research and analysis of public data

Access to an established and experienced local servicer remains the key to a successful NPL investment in China. Foreign buyers are teaming up with local servicers to support their expansion in the Chinese NPL market. Our previous two deleveraging reports identified several key issues for the NPL market in China that are still relevant today:

Key considerations for loan sales

Issues	
Restrictions on buyers	Foreign investors are not allowed to acquire NPL portfolios directly from banks. They only have access to the secondary market. Over 90% of portfolios go to national AMCs in the primary market.
Legal enforcement process	The disposal of NPLs is subject to local legal frameworks and environments. As the enforcement process differs between provinces, the timeline for resolution varies, with an average of about two years.
Bid-ask spread	According to research by China Orient, the price of NPL loan portfolios dropped by about 10% in 2019 and is expected to have dropped further in 2020 due to a deterioration in asset quality, with smaller portfolios favoured over larger ones. However, competition from local investors still exists and will compress bid-ask spreads.
Fragmented servicing market	There is a lack of well-established nationwide servicers. Foreign buyers are looking to establish their local servicing capabilities by building up their own in-house team or partnering with local servicers.

India

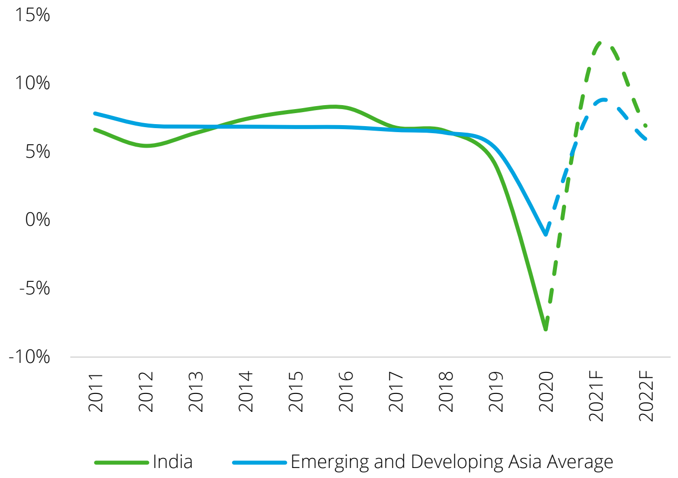
Macroeconomic landscape

Due to the continuing impact of COVID-19, India's GDP contracted by 7.5% in the July – September quarter of 2020 (as a % change over the previous year). However, this was an improvement over the April-June 2020 quarter when GDP contracted by 23.9% (as a % change over the previous year) - the sharpest annual decline in economic activity since India's independence in 1947.[26]

The unemployment rate rose sharply to 9.1% in December 2020 even as economic activity continued to resume post lockdown. According to the Centre for Monitoring Indian Economy, one of the key reasons for the rising unemployment rate was the increase in labour force in December, while the labour markets were not ready to absorb it. The House Price Index in December 2020 rose by 1.1%, relative to 3.3% in the previous year.[27]

With a comfortable parliamentary majority, the government has been keen to move ahead with structural reforms to support economic growth following the COVID-19 pandemic. However its reforms in the agricultural sector in the second half of 2020 sparked large-scale protests by farmers in New Delhi, and opposition could potentially disrupt recovery in the sector. Moreover, the security situation in Jammu and Kashmir remains a concern. A deadly border clash with China in June 2020 has also increased pressure on the government.[28]

Real GDP Growth (%)



Source: International Monetary Fund (F = forecast)

India is now hit by the second COVID-19 wave. The rapid rise in the number of COVID-19 cases and the subsequent imposition of severe restrictions to contain the spread will negatively impact the country's GDP growth forecasts and prolong the pain of already badly-hit sectors, such as retail and tourism. A long drawn-out COVID-19 wave will impact small and midsize enterprises, delay the recovery in banks' loan books result in job losses as well as business closures.

Government response to the crisis

Key measures taken by banking regulators

Measures	How?	Outcome
Loan moratorium	Relief measures were provided to borrowers facing difficulties in paying their equated monthly instalment (EMI) amid the lockdown. Under the terms of the moratorium borrowers were given the option to defer their EMI, and the repayment schedule for term loans was thereby postponed. The moratorium extended to both interest and principal repayment on vehicle loans, home loans, and personal loans, agricultural term loans, crop loans as well as credit card debts.[29]	The moratorium initially provided temporary relief to borrowers until 31 May 2020 but this was subsequently extended to 31 August 2020. The Supreme Court, in an interim order dated 3 September 2020, ruled that accounts that had not been declared a non-performing asset (NPA) before 31 August 2020 should not be declared an NPA till further orders.[30] Subsequently, the Supreme Court lifted the moratorium on March 23, 2021 and indicated that no further extensions would be given and banks could start classifying loans as NPAs[31].
Government guaranteed loans	This is a programme to help SMEs suffering from the pandemic, through USD 40 billion of government-guaranteed loans.[32]	Many entrepreneurs interviewed by Reuters said that the government's measure may not be enough to save many companies. SMEs were already in such difficulty that the demand for taking on new loans remained low. Businesses stated they would have preferred the government to help them by cutting goods and service tax or by means of a waiver of interest on existing loans.
Standstill on asset classification	The RBI[1] announced a standstill on asset classification for standard bank accounts (April 2020), i.e. these could be classified as NPAs only after 180 days, as opposed to the normal stipulated 90-day period.[33]	This measure provided relief to standard account holders. The exclusion of the moratorium period in evaluating NPA classification applies to Non-Banking Financial Companies as well (NBFCs).
Lowering reserve requirement	The Cash Reserve Ratio (CRR) requirement for banks was reduced by 100 bps from 4% to 3%. The minimum daily CRR balance was also reduced, from 90% to 80%.[34]	This reduction in rate improved liquidity in the banking system by about INR 1.37 trillion. This dispensation was available for a period of one year, ending March 2021. The reduction in the daily CRR balance was available up to June 2020.

Key measures taken by banking regulators (cont'd)

Measures	How?	Outcome
One-time restructuring	In August 2020, the RBI announced a resolution framework to mitigate the impact of the pandemic on borrowers and to facilitate revival of economic activity. It provided a window under the prudential framework to enable lenders to implement a resolution plan in respect of eligible corporate exposures without change in ownership, while classifying them as 'standard' but subject to specified conditions (including personal loans)[35].	The framework helped only a few distressed companies get back on track. According to India Ratings and Research, only 5 % of its rated 450 issuers in the mid and emerging corporates (MEC) space had availed the RBI's financial restructuring facility available till December 31, 2020[36].
Emergency Credit Line Guarantee Scheme (ECLGS)	Th ECLGS was introduced with a limit of INR 3 trillion. It allowed companies to borrow up to 20% of its outstanding credit, subject to certain conditions of eligibility. It provided a 100% guarantee to banks and NBFCs to enable them to provide emergency credit facilities to eligible borrowers in order to finance their working capital requirements.	The Scheme came as a relief to MSMEs, which had been grappling with severe liquidity problems, high default risks, supply shocks, a shortage of labour, and non-payment of receivables, all caused by the pandemic. As of 12 November 2020, INR 2.1 trillion of loans had been approved for 6.1 million borrowers[37].
Freeze on actions under the Insolvency and Bankruptcy Code (IBC)	Sections 7, 9, 10 of the IBC were temporarily suspended to provide protection to businesses from bankruptcy proceedings for defaults during the pandemic.	This move, extended until 31 March 2021, brought relief to small businesses. However, the lack of effective recovery mechanisms outside the IBC was a challenge
Bad Bank*	Creation of a bad bank under an asset reconstruction and asset management company structure, in which the ARC will acquire the stressed assets from lender in an aggregate manner, while the AMC will act as a resolution manager and dispose of the assets to alternative investment funds.	The bad loans sold to the ARC will shift from the asset book of banks to their investment book. Once the recovery is complete, the security receipts (SRs) will be redeemed. Any upside, i.e. recovery higher than the price at which the loans were transferred, will be passed on to the banks. This transfer of bad loans by banks to a specialised institution will allow banks to free up their capital to focus on fresh lending. Lenders have so far reviewed 101 NPAs) in the first phase and now plan to transfer 22 accounts amounting to roughly INR 890 billion to the bad bank. The government is expected to provide a guarantee of INR 310 billion for a period of five years for the National ARC[38].

Source: Central banks and Deloitte research of public data
* Details of the functioning of the Bad Bank are yet to finalized

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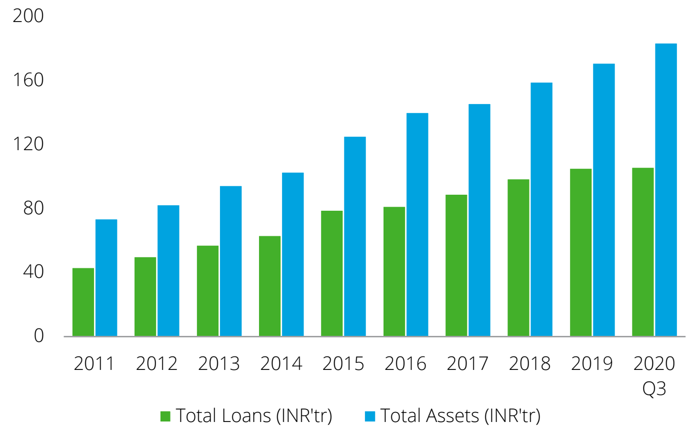
Banking landscape

India is one of the world's major economies, and its banking sector warrants serious concern because it entered the pandemic in poor shape and the scale of the economic damage suggests that it will be hit hard by a growing volumes of defaults.[39] The Indian banking system showed resilience during the 2008 Global Financial Crisis (GFC). Post the GFC, there have been certain concerns in the banking and NBFC system with cases such as Punjab National Bank, Yes Bank, PMC Bank, ICICI Bank, Infrastructure Leasing and Financial Services, and Dewan Housing Finance Corporation Limited coming to light.[40] Further, to prevent bankruptcy, the RBI put a moratorium on Punjab and Maharashtra Cooperative (PMC) Bank in September 2019, on Yes Bank in March 2020, and on Lakshmi Vilas Bank (LVB) in September 2020.[41]

In the central bank's January 2021 Financial Stability Report, year-on-year credit growth among Scheduled Commercial Banks (SCBs) had weakened as shown in the chart below.

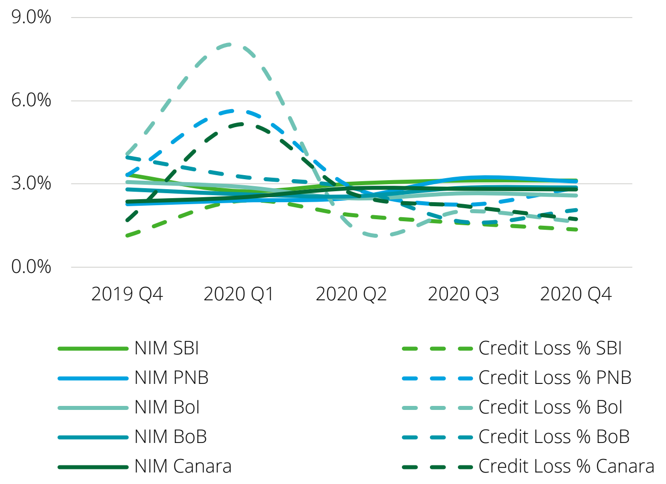
Banking System Assets (INR'tr)



Source: Reserve Bank of India

Net interest margin (NIM) remained stable in 2020 for top banks. The Indian banking system could see an improvement in their NIMs and income as policy rates stabilise and the economy shows signs of recovery. Credit loss for top banks fell sequentially from Q1 2020 following a surge in previous quarter. The loan loss provisioning had been benign in the year on account of various schemes launched by the government to reduce the impact of the pandemic.

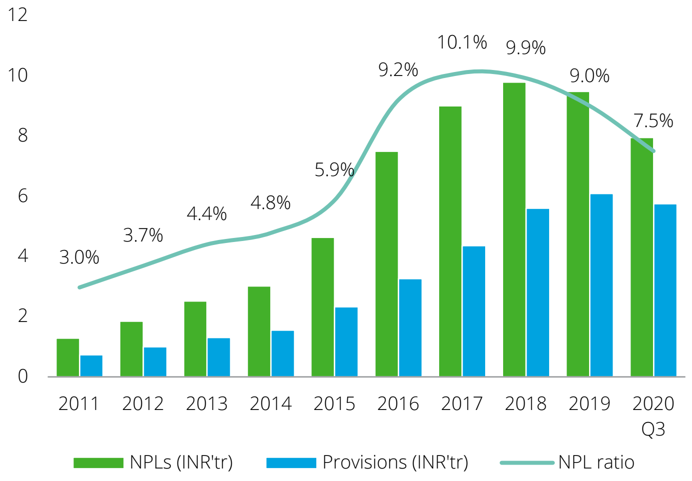
NIM & Credit Loss (%) - Top Banks



Source: Financial statement as at December 2020 *annualised % of gross loans

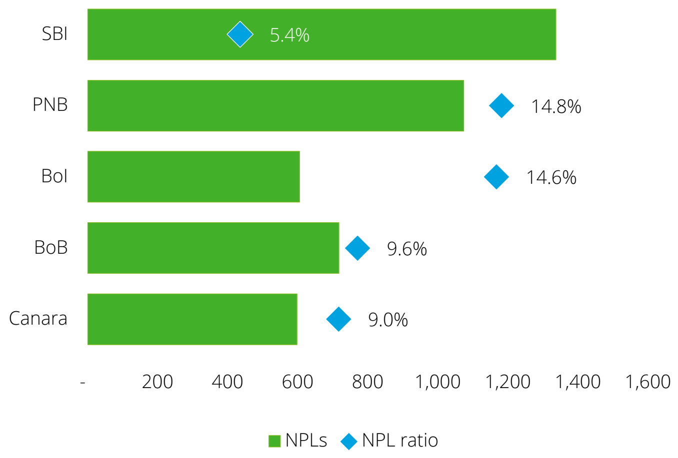
The gross NPA (GNPA) ratio fell to 7.5% from 9.3% and the overall provision coverage ratio improved to 72.4% from 61.5% during the 12-month period ending Septermber 2020.[42] According to the RBI, without any further extension on loan moratoriums, NPAs were expected to increase to 13.5%-14.8% in the following 12 months[43]. In an effort to ride out the pandemic, banks have been strengthening their balance sheets and equity bases, building reserves and creating excess COVID-19 loan provisions.[44]

Banking System NPAs (INR'tr)



Source: Reserve Bank of India

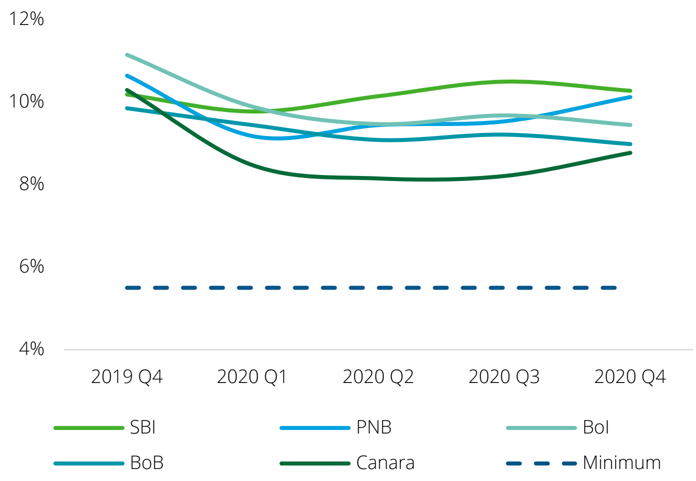
Gross NPAs (INR'bn) - Top Banks



Source: Financial statement as at December 2020

Average CET 1 ratio across top banks is 9.5% as of December 2020, above the minimum requirement of 5.5%. According to S&P, many banks, especially large private-sector lenders, have already raised capital in H2 2020 and have achieved capital adequacy ratios in excess of the regulatory requirements. On the other hand, public sector banks may face greater trouble raising capital amid strained government finances.[45]

CET 1 Ratio (%) - Top Banks



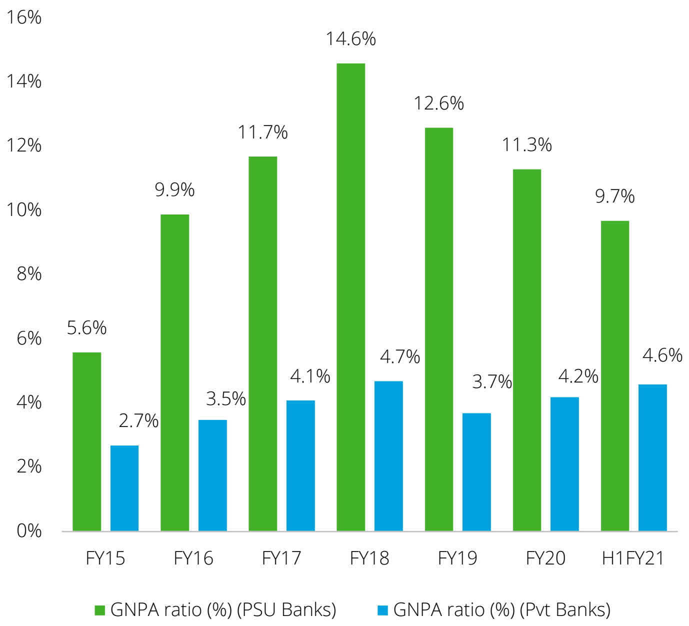
Source: Financial statement as at December 2020

Mergers and acquisitions have been a long-standing theme in the Indian banking sector. Some noteworthy transactions in recent years include the acquisitions of Bank of Madura, Bank of Rajasthan and Sangli Bank by ICICI Bank, and Kotak Mahindra Bank merging with ING Vyasa Bank, Vijaya Bank and Dena Bank merged with Bank of Baroda; and ten public sector banks (PSB) being consolidated into four banks. The mergers in recent years have reduced the total number of PSBs operating in the Indian economy from 27 in 2017 to 12 in 2020.[46]

NPL landscape and market development

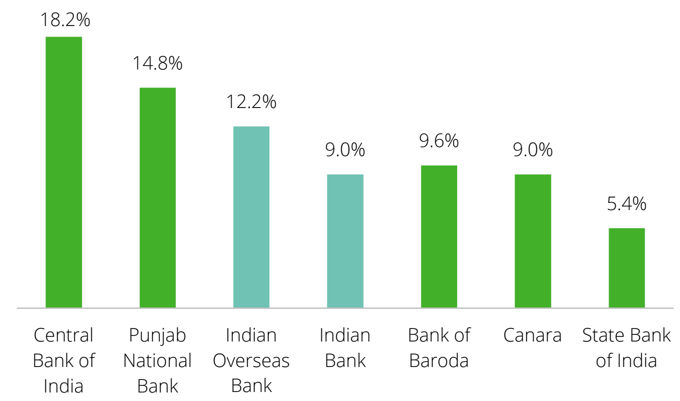
The overhang of bad loans in the Indian banking sector has been a major factor behind the economic slowdown in the country, a problem that pre-dates the public health crisis.[47] An increase in NPAs began with the economic slowdown after the GFC, from a low of ~2% in 2011 to a peak of ~11% in 2017. This ratio then fell slightly but still stood at an ~ 9% in 2019. Historically, NPAs in the Indian banking sector have been concentrated in public sector banks, which together form about 70% of the banking system.

GNPA ratio for PSU Banks is almost double that of Private Banks



Source: Reserve Bank of India
Note: Data in this chart is on proforma basis i.e. assuming the absence of the Supreme Court ruling that bars treating defaulting loans as non-performing assets (NPAs)

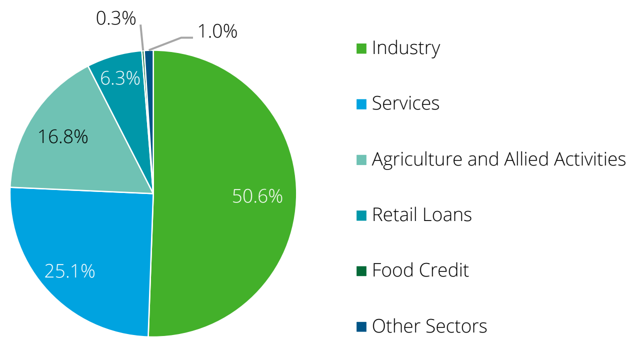
GNPL ratio for Public sector Banks (as of Dec'20)



Source: Reserve Bank of India
Note: Data in this chart is on proforma basis i.e. assuming the absence of the Supreme Court ruling that bars treating defaulting loans as non-performing assets (NPAs)

The GNPA ratio of the NBFC sector fell over successive quarters to December 2019, but increased in the quarter to March 2020. The net NPA ratio was marginally lower in the March 2020 quarter than in the same period in the previous year.

NPAs by Sectors (% Q3 2020)

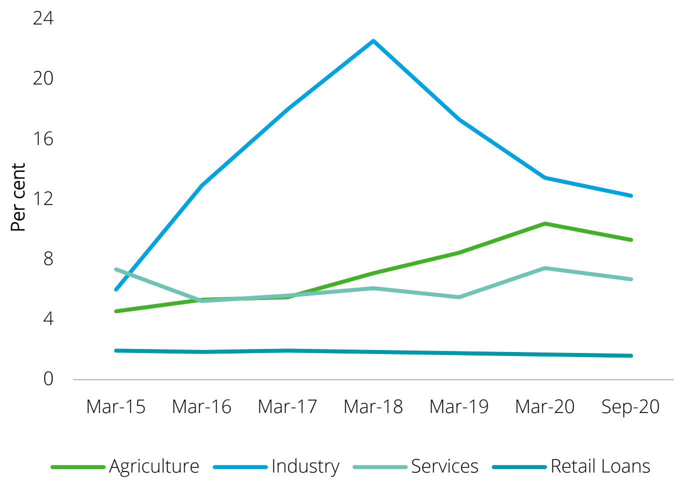


Source: Reserve Bank of India

According to India Rating, stress in retail loans could triple by March 2022 due to a slowdown in income growth and slower pace of job creation in the service sector. It estimated that stressed loans could rise to 4.7% of the total of retail loans by March 2022, up from 1.6% in March 2021, led by non-performing unsecured loans, especially at private sector banks.[48]

Sectoral NPAs of SCBs

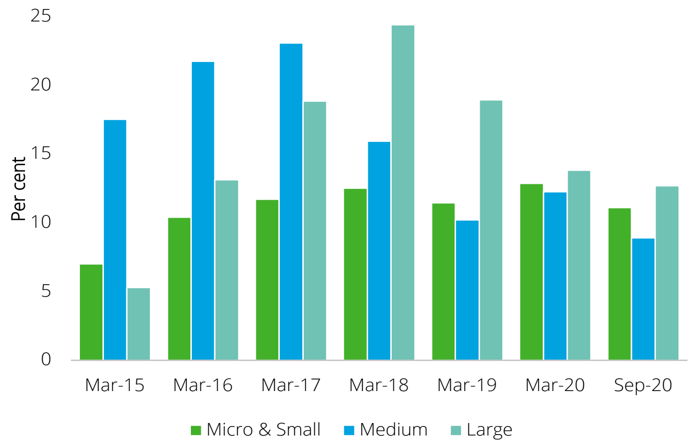
a. GNPA Ratio of Major Sectors



Source: Reserve Bank of India

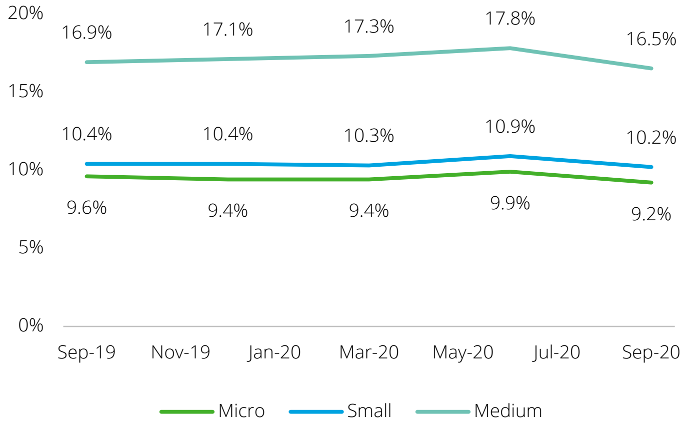
Sectoral NPAs of SCBs

b. Size Group-wise GNPA Ratio in the Industrial Sector



Source: Reserve Bank of India

Segmental NPA rates within MSME



Source - MSME Pulse Report[49],Micro Enterprise Loans (INR 1 million INR 10 million cr.) ; Small Enterprise Loans (INR 10 million – INR 100 million cr.) ; Medium Enterprise Loans (INR 100 million – INR 500 million) ;

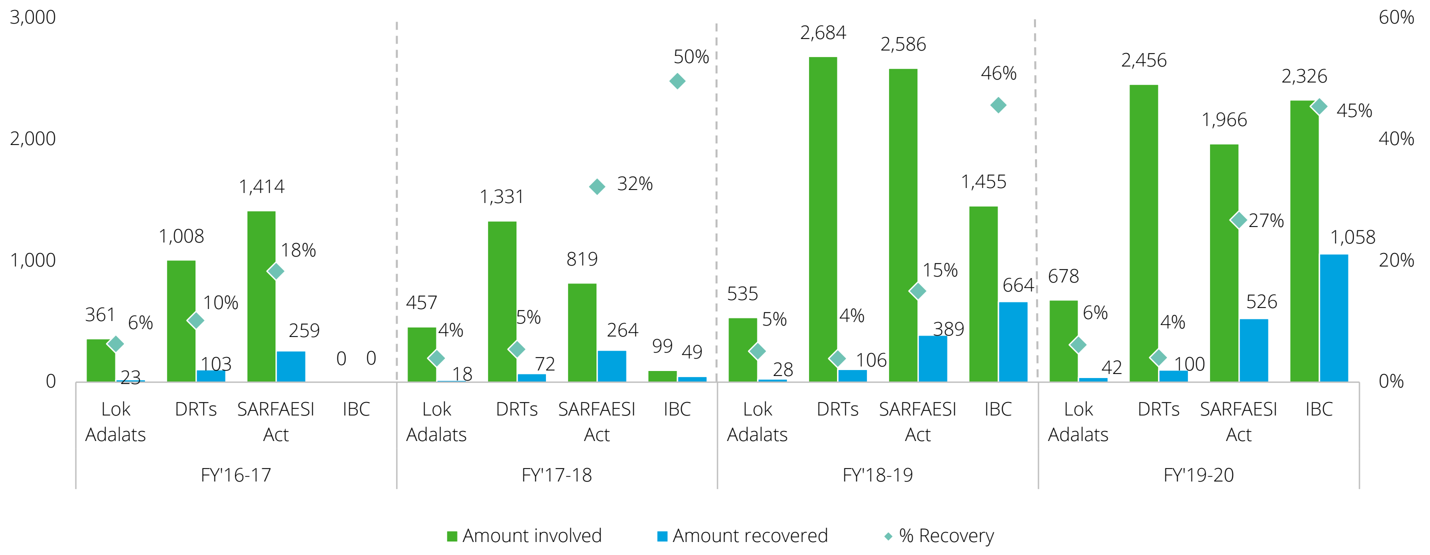
Measures to resolve NPAs

The measures taken to reduce NPAs can be classified broadly into two kinds – first, regulatory means to resolve NPAs (e.g. amending the Insolvency and Bankruptcy Code); and second, remedial measures for banks prescribed and regulated by the RBI for an internal restructuring of stressed assets.

The Insolvency and Bankruptcy Code (IBC) was enacted in May 2016 to provide a time-bound 180-day recovery process for insolvent accounts (where the borrowers are unable to pay what they owe). Under the IBC, the creditor for non-paying loans decide whether to restructure the loan or to sell the defaulter's assets to recover the outstanding amount. If a timely decision is not reached, the defaulter's assets are liquidated. Proceedings under the IBC are adjudicated by the Debt Recovery Tribunal for personal insolvencies, and the NCLT for corporate insolvencies.[50]

The recovery of NPAs by scheduled commercial banks (SCBs) through the Insolvency and Bankruptcy Code has been more effective than other channels. According to the RBI data, of the total amount of INR 1.7 trillion recovered through various channels in 2019-20, the IBC route accounted for INR 1 trillion.[51] As of December 2019, two biggest loan recoveries, Bhushan Steel and Essar Steel India, made up around 49.5% of the overall recovery[52].

Recovery of NPAs by methords (INR'bn)



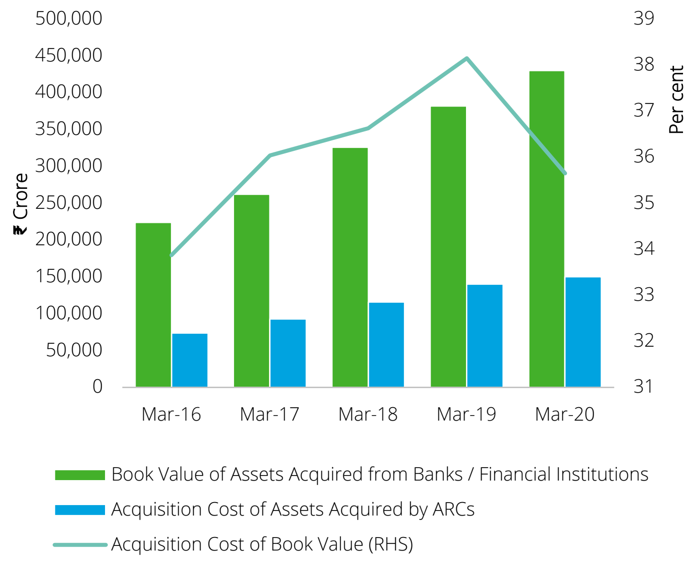
Source: Reserve Bank of India

Between 2017 and 2018, the book value of loans held by asset reconstruction companies (ARCs) increased by INR 667.8 billion to INR 3.2 trillion. As of March 2018, the book value of loans purchased by 27 ARCs in India was INR 3.2 trillion, but the ability of ARCs to clean up bad debts has been slow, largely because banks have been unwilling to take adequate haircuts and are unable to come together and sell 100% of the outstanding loans of an indebted company.[53]

ARC participation increased slightly in the 12 months ended June 2019 when the total of loans classified as non-performing by lenders and held by ARCs rose 17.4% to INR 3.8 trillion. However, the amount of NPAs they bought in the 12-month period was only INR 575.1 billion, as compared to INR 678.3 billion in the previous year.[54]

Stressed Sale to ARCs

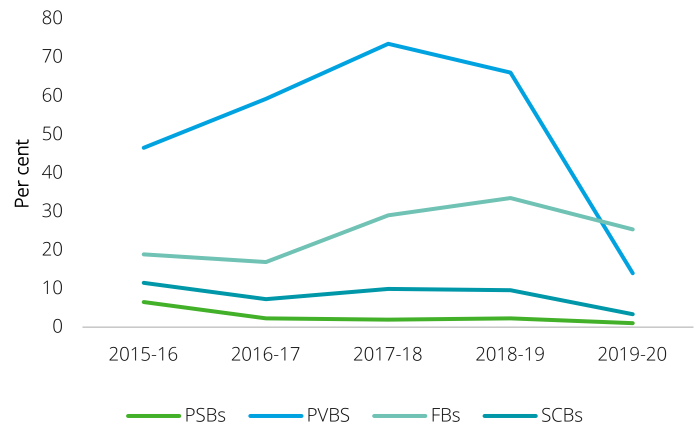
a. Trend in Stressed Assets Acquired and Acquisition Cost of ARCs



Source: Reserve Bank of India

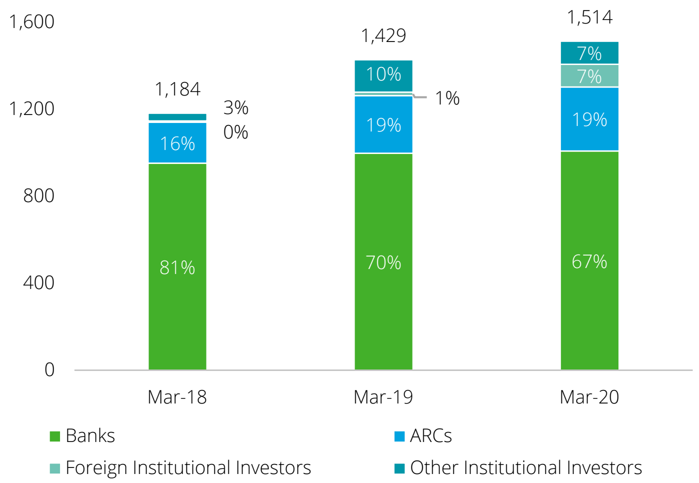
Stressed Sale to ARCs

b. Sale of ARCs



Source: Reserve Bank of India

ARC-issued SRs by investor (INR'bn)



Source: Reserve Bank of India

Few instances of sale of stressed assets to ARC[55]

Year	Description of Transaction
June 2021	SSG together with its arm Acre ARC and locally listed non-banking finance company (NBFC) Authum Investment and Infrastructure submitted bids for the assets of Reliance Home Finance
April 2021	Reportedly, Indiabulls retail assets of c. USD 260 million to be acquired by Ares- backed ACRE
March 2021	Funds managed by Ares SSG, in partnership with asset reconstruction firm ACRE, acquired all outstanding loans and investments of Altico Capital, a realty financier The deal is also the first resolution of a defaulting non-banking financial company (NBFC) outside India's Insolvency and Bankruptcy Code[56]
February 2021	Franklin Templeton Mutual Fund to monetise c. USD 2.3 million of assets as part of winding up its six debt schemes
January 2021	DHFL's committee of creditors approved a resolution plan by PEL's subsidiary Piramal Capital and Housing Finance (PCHFL) for a total consideration of c. USD 4,690 million.
January 2021	Reportedly, HDFC Bank sold loans with a face value of c. USD 275 million.
November 2020	Reportedly, Yes Bank in talks with ARCs to sell NPAs worth over INR 320 billion.
January 2020	Reportedly, Religare Finvest sold loans with a face value of c. USD 97 million to India Resurgence ARC at a discount of 55-60%.

Market Development

Following the outbreak of COVID-19, the distressed asset market showed signs of recovery in Q3 2020. Large banks have lined up a string of legacy NPAs for sale to ARCs. The deterioration of household incomes led banks to consider the ARC route for retail assets, and activity in this segment is now 30-40% higher than before the pandemic. As 2020 drew to a close, the State Bank of India (SBI) and ICICI Bank put out notices for the sale of their exposures to Action Ispat & Power (INR 5.4 billion) and Gammon India respectively. A consortium of lenders to Jindal India Thermal Power (JITPL), led by Punjab National Bank (PNB), has also sought bids for the project. Earlier, Bank of Baroda (BoB), Axis Bank and IDBI Bank had also run processes for NPA sales.[57]

In February 2021, the Indian Finance Minister unveiled a plan in the budget announcement to set up a bad bank, A similar structure for stressed asset resolution was originally proposed by a committee of bankers under the Sashakt scheme in 2018.[58]

The Union Budget 2021-22 proposed the creation of a bad bank under an asset reconstruction and asset management company structure, in which the ARC will acquire the stressed assets from lender in an aggregate manner, while the AMC will act as a resolution manager and dispose of the assets to alternative investment funds.[59] The company will be set up for an initial period of ten years and for an NPA to qualify to be bought by the National Asset Reconstruction Company Ltd, it should be worth at least INR 5 billion. The purchase would be funded by

the ARC, who would pay the lenders at least 15% of the present net value of the loans it buys in cash, while the remaining would be paid in the form of security receipts.

The Ministry of Corporate Affairs (MCA) has proposed a pre-packaged insolvency process (initially for MSMEs) under the Insolvency and Bankruptcy Code (IBC) to resolve the unaddressed COVID-19-related stress resulting from the suspension of certain sections of the code, and to overcome the shortcomings of both IBC and out-of-court restructuring mechanism. As suggested in the draft proposal of the sub-committee of the Insolvency Law Committee, pre-pack is a restructuring plan which is agreed to by the debtor and its creditors prior to the insolvency filing, and then sanctioned by the court on an expedited basis.

It will be an informal arrangement with a debtor-in-possession and creditor-in-control model. Therefore, pre-pack will act as an innovative corporate rescue method that incorporates the virtues of both informal (out-of-court) and formal (judicial) insolvency proceedings. The detailed law around pre-packs is under formation.

In addition to the introduction of bad banks, the Finance Minister announced other reforms to bring the economy back onto a growth path. Some of the key reforms include:

1. **Privatisation of banks:** The Union Minister for Finance and Corporate Affairs, when presenting the Union Budget FY 2021-22 in Parliament, announced that the government has approved a policy of 'strategic disinvestment of public sector enterprises' in all non-strategic and strategic sectors[60]. According to news agency Reuters, quoting government sources, thegovernment has shortlisted four mid-sized state-run banks for privatisation, under a new initiative to sell state assets and increase government revenues.
2. **Recapitalisation of banks:** The Finance Minister has proposed a recapitalisation of INR 20 billion for banks, to increase the financial capacity of PSBs and their ability to lend[61].

Key considerations for sale of stressed assets

Issues	
Restrictions on buyers	NPAs and stressed assets can be transferred to securitisation companies, ARCs, and other investors with adequate capital to acquire the assets, such as other banks, non-bank financial institutions, etc. There are no limits on foreign equity holdings for NPA investors, including ARCs. However, there are restrictions on foreign equity holdings in some key sectors, such as insurance, defence, telecom, etc.
Legal enforcement process	Enforcement framework in India has been improved with the introduction of Corporate Insolvency Resolution Process, enabling either the debtor or their financial or operational creditors to initiate insolvency proceedings. (RBI Circular dated June 2019 outlining the Prudential Framework for Resolution of Stressed Assets). However, the system is still evolving, and some uncertainties remain as to the amendments in the regulations.
Servicing options	• Financial institutions mainly service NPAs in-house. As a result, the independent servicing market lacks development. • The transferor of loans can act as the servicing agent for the loans under a separate servicing agreement, for a fee

Japan

Macroeconomic landscape

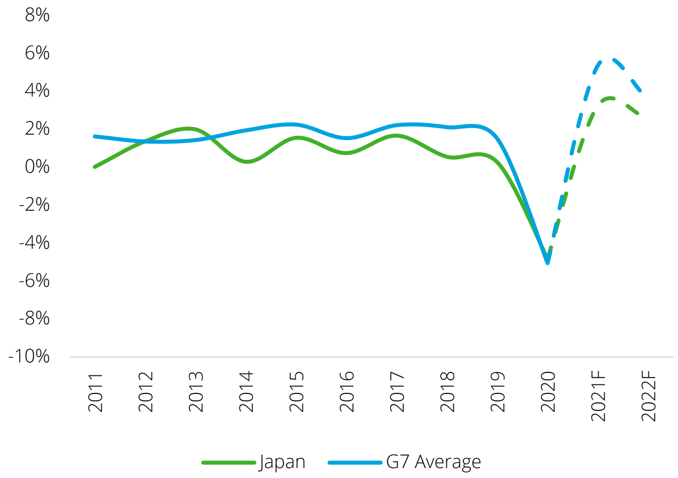
Japan's economy shrank during the first half of 2020 as lockdown measures imposed during the pandemic seriously affected its manufacturing sector as well as consumer spending. In Q2 alone, GDP fell by 8.3%.[62] As expected, production in the manufacturing and transport sectors were among the hardest hit.

Japan has managed to keep a relatively low infection rate compared to other developed economies, which has undoubtedly assisted the recovery. Following three consecutive quarters of contraction, the world's third biggest economy started to show signs of improvement with a quarter-on-quarter real GDP growth rebound to 5.3% in Q3 2020.[63] According to the IMF, the economy is expected to grow by 3.3% in 2021, following a contraction of 4.8% in 2020.

In August 2020, the unemployment rate reached 3%, its highest level since May 2017.[64] Unemployment in Japan was forecast to increase to 2.8% in 2020 from 2.4% in 2019, though this is much lower than the average for the G7 countries (5.8%). It is expected to decline gradually over 2021-2022 to 2.4% as the economy recovers.

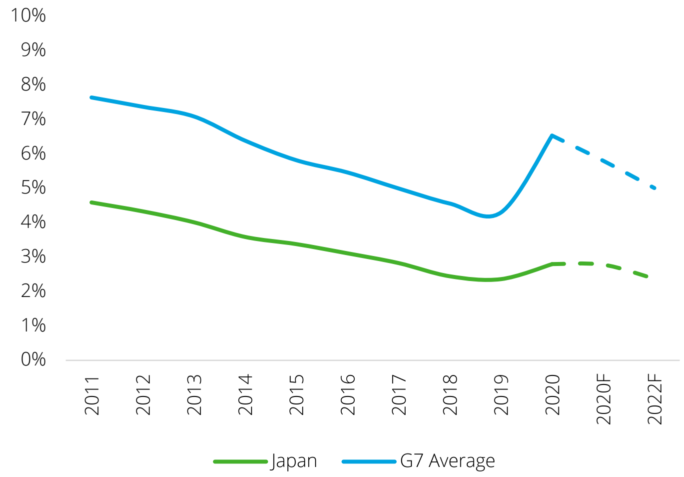
The government is dedicated to bringing the economy back to pre-pandemic levels with the help of stimulus measures next fiscal year starting from April 2021. However, with a second wave of the coronavirus sweeping across the world in late 2020, confirmed cases surged in Japan and pushed the government to declare another state of emergency[65], which would negatively impact the economy and slow down the recovery.

Real GDP Growth (%)



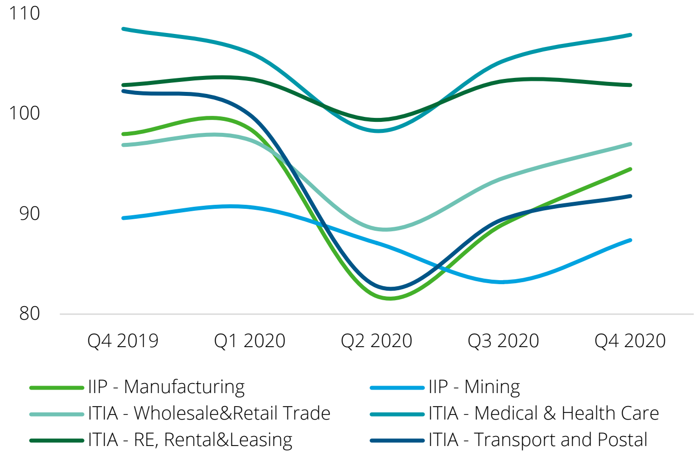
Source: International Monetary Fund (F = forecast)

Unemployment Rate (%)



Source: International Monetary Fund (F = forecast)

Sector Indices by Industry (2015=100)



Source: Ministry of Economy, Trade and Industry (IIP = Index of Industrial Production, ITIA = Index of Tertiary Industry Activity)

Political instability may increase following the departure of Shinzo Abe, the country's longest-serving prime minister. Over the short term the government under Yoshihide Suga, the new prime minister, will focus on minimising the economic fallout from the pandemic. The government will continue to pursue its economic revival agenda in 2021-2025 through a loosened monetary policy and fiscal stimulus. It will also make structural reforms to liberalise trade and the labour market, and promote digitalisation.

Government's response to the crisis

The government rolled out three stimulus packages in 2020 to support the economy. The first package of JPY 117.1 trillion in April 2020 was aimed at protecting employment and businesses, and developing preventive measures to contain the spread of the virus. Key measures included a blanket cash handout and loans to support SMEs. In May 2020, the second package of JPY 117.1 trillion focused on supporting businesses and households. The third and most recent package (of JPY 73.6 trillion) was announced in December 2020 to continue helping affected businesses by extending concession loans and promoting economic recovery.[66] The combined value of all three packages brought the coronavirus-related stimulus in Japan to about USD 3 trillion. The table below lists the key measures relevant to the Japanese banking sector:

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Key measures taken by banking regulators

Measures	How?	Outcome
Deferral of loan repayment	Japan's Financial Services Agency (FSA) has asked banks to consider providing timely and flexible cash flow support for companies and individuals, including concessions on repayments of business loans and deferring principal payments on mortgage loans.	
Loans to support SMEs/corporates	The Ministry of Finance announced an interest-free and unsecured special loan programme to support MSMEs facing severe economic conditions due to the pandemic. The FSA also asked financial institutions to offer flexible loan terms to their smaller corporate clients. The Development Bank of Japan also provided low-cost loans to support large corporates.	As of November 2020, banks had extended the equivalent of more than USD 250 billion in loans under the programme in less than six months.[67]
Assign zero weights to loans guaranteed by public schemes	The FSA allowed banks to assign zero risk weights to loans disbursed under the public guarantee schemes.	More capital can be released to enhance access to loans for borrowers.

Source: Central banks and Deloitte research of public data

Banking landscape

The risk of a banking crisis in Japan caused by the coronavirus pandemic was highlighted in the Bank of Japan's (BOJ) recent semi-annual Financial System Report issued in October 2020. BOJ highlighted three major risks: an increase in credit costs owing to a prolonged economic downturn; a fall in gains or actual losses incurred on securities investments held by financial firms; and a disruption to foreign-currency funding.[68] In addition, in the event of a prolonged pandemic, banks' exposure to middle-risk domestic borrowers and high-risk overseas borrowers, such as energy companies, was seen as having the potential to become problematic. According to the BOJ, the banking system remains sound, although the areas of potential weakness could be exacerbated by bank losses on some risky financial products, such as collateralised loan obligations.

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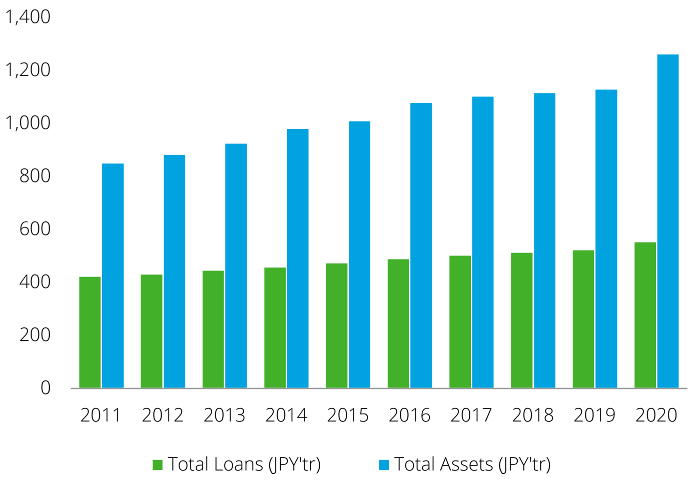
Total assets in the Japanese banking system continued to grow over the past ten years from JPY 850 trillion in 2011 to JPY 1,262 trillion in 2020. The volume of loans shows a steady expansion year-on-year. However, the Economist Intelligence Unit (EIU) expects the demand for loans to decline in the first half of 2021, driven by a recessionary economic environment.[69]

Banking System Assets (JPY'tr)

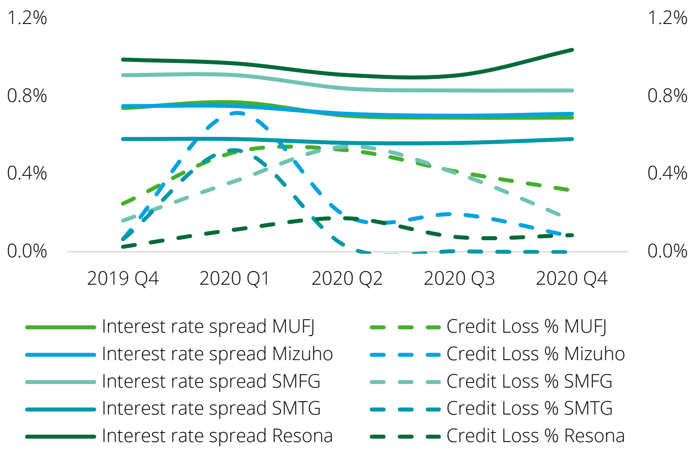


Source: The Bank of Japan

With regard to NIM and credit losses among the top Japanese banks (MUFJ, Mizuho, SMFG, SMTG and Resona), all five saw an increase in credit losses in Q1-Q2 2020, with Mizuho reporting the highest percentage of credit losses to gross loans at 0.75% (annualised). A BOJ board member indicated that Japanese financial institutions may see credit losses rise to the level reached during the GFC if a resurgence of infections hits Japan[70]. Nevertheless, loan loss provisions fell during the second half of 2020 towards their pre-COVID level.

Interest rate spreads across all five top banks narrowed through H1 2020, albeit slightly, impacting each bank's NIM. The BOJ's negative interest rate policy will continue to squeeze interest rate spreads on domestic lending. Japan's bigger banks are relatively well equipped to operate in this environment, given their limited reliance on domestic lending to generate profits. However smaller regional banks are more exposed, and the recession in 2020 may have caused bad loans to jump to levels last seen during the 2008 GFC.[71]

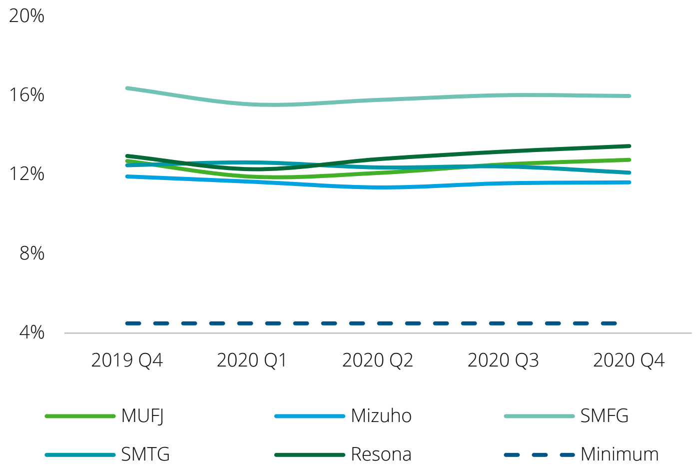
NIM & Credit Loss (%) - Top Banks



Source: Published financial accounts as of December 2020 *annualised % of gross loans

Over the past decade Japan's internationally active banks have improved their capital position. They are on track to meet all requirements under the Basel III standards that aim to strengthen the global banking sector. The average Tier 1 capital ratio for the top five banks stood at 13.2% as of December 2020, well above the supervisory requirements, and is considered sufficient to withstand economic shocks caused by the pandemic.

CET 1 Ratio (%) - Top Banks



Source: Published financial accounts as of December 2020

The BOJ's loose monetary policy will help to maintain the quality of banks' capital during the short- and long-term forecast period, but the persistence of low spreads on domestic lending could reduce the amount of credit available.

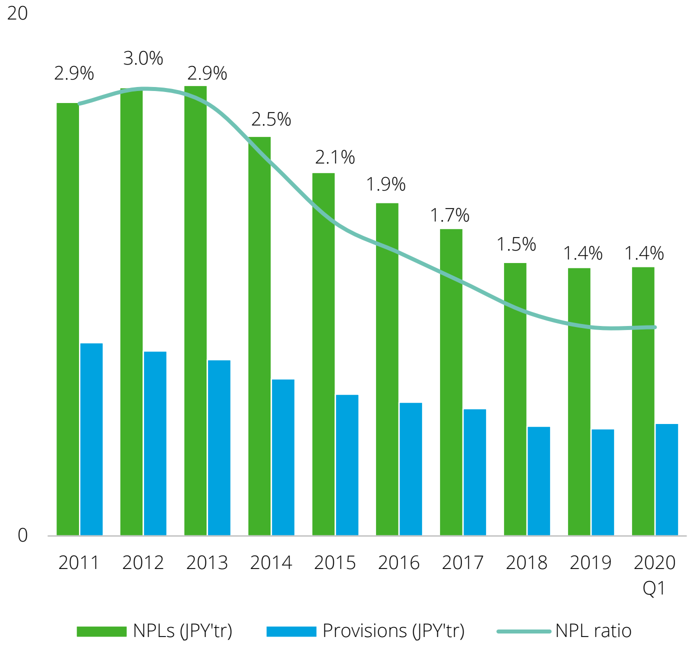
Whereas larger banks are in a better position to withstand its effects, the pandemic is deepening the pain for Japan's regional lenders. The BOJ sees the risk of a crisis emerging for regional banks that had already been suffering before the pandemic from a shrinking domestic economy and years of low interest rates. In November 2020, the BOJ unveiled a scheme to incentivise regional banks to consolidate.[72] Under the scheme lasting until March 2023, regional lenders that opt for a merger will be remunerated. Shortly after the BOJ's policy statement, Resona announced that it would pay up to JPY 66.1 billion to take control of Kansai Mirai Financial Group by acquiring a 49% stake in the entity.[73]

NPL market development

Japanese lenders have traditionally enjoyed a low NPL ratio. Based on data from the FSA, the sector wide NPL ratio stood at 1.4% as of March 2020. Japanese banks have made good progress since 2011 in reducing their NPL ratios since 2011, mainly through the resolution of NPLs internally. However, the pandemic is expected to cause an uptick in default rates and NPL stock, with ratios increasing in 2020.

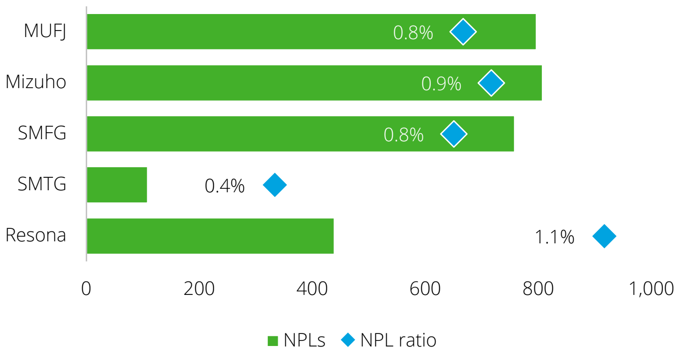
A closer look at the major domestic banks in Japan reveals that their average NPL ratio was 0.8% in December 2020, with Resona having the highest NPL ratio among its peers at 1.1%.

Banking System NPLs (JPY'tr)



Source: Financial Services Agency, reported in March each year

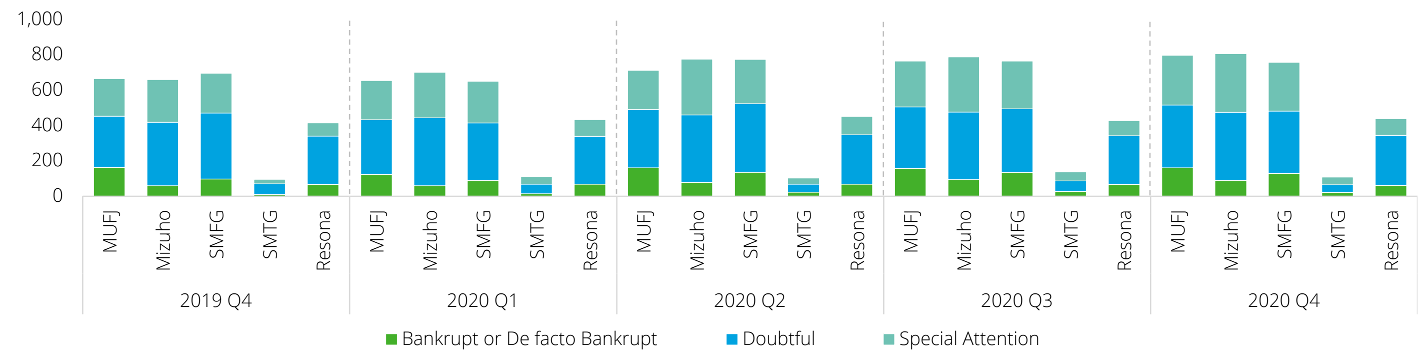
Gross NPLs (JPY'bn)- Top Banks



Source: Published financial accounts as of December 2020

NPLs increased for all of the top five banks during the period (Q4 2019 – Q4 2020), with Mizuho (+22.3%), MUFJ (+19.9%) and SMTG (+14.8%) recording the biggest increases. During the four quarters, the surge in NPLs across the top banks was driven by a rise in 'special attention' loans (32.3%), whilst bankrupt or de facto bankrupt loans increased by about 16.6% and doubtful loans by 4.7%.

Non Performing Loans by FRL (JPY'bn) - Top Banks



Source: Published financial accounts as of December 2020, FRL = Financial Reconstruction Law

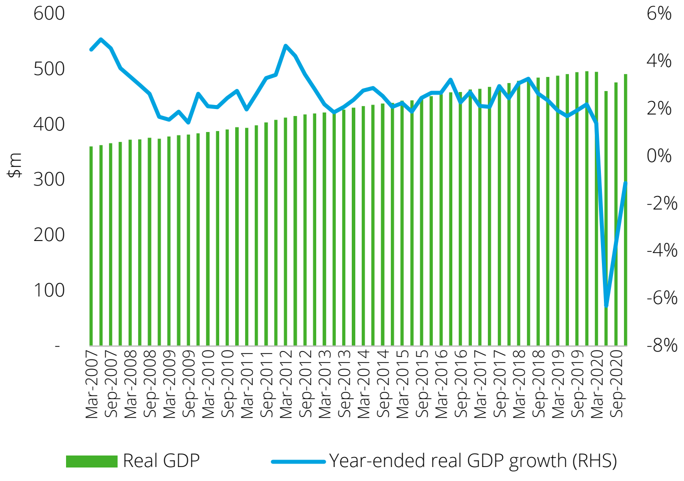
The NPL market in Japan boomed in the late 1990s following the burst of an economic bubble. These NPLs were mostly resolved by 2000. While Japanese banks and other deposit taking institutions still hold the third highest NPL stock in Asia (JPY 10 trillion as of Q1 2020), the market has not been active in Japan for a long time, with sporadic, smaller-scale transactions done mainly by regional banks. NPLs are managed and resolved through internal resolution methods, demonstrating the capabilities of Japanese banks in NPL management.

Australia

Macroeconomic landscape

After enjoying 114 consecutive quarters without a technical recession, Australia recorded the largest peacetime contraction in its economy since the Great Depression due to the COVID-19 pandemic. Despite this contraction, the Australian economy still fared better than most developed economies, with GDP falling in the first two quarters of 2020 but starting to show signs of recovery from the third quarter. Australia reported GDP growth of 3.4% in the quarter to September and further growth of 3.1% in the quarter to December 2020.

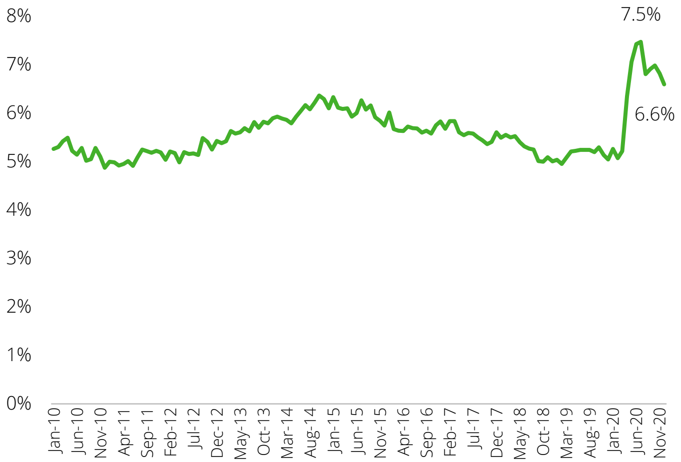
Auatralian GDP



Source: Australian Bureau of Statistics

Australia's unemployment rate peaked at 7.5% in July 2020, ending the year at 6.6% in December, much lower than previous government forecasts of over 10%. The government's response to the pandemic, particularly the JobKeeper wage subsidy scheme which aimed at tying staff to their employer, was the largest contributor to the better-than-expected unemployment rate. Despite the majority of government stimulus tapering off in the first quarter of 2021, the Reserve Bank of Australia (RBA) and the government expect the unemployment rate to continue to fall over time.

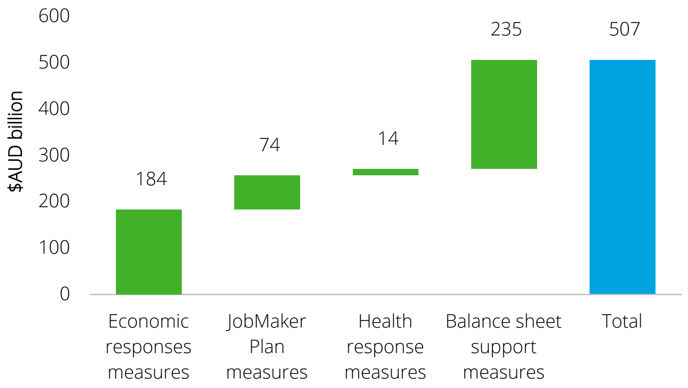
Unemployment Rate



Source: Australian Bureau of Statistics

Fiscal stimulus played a crucial role in supporting the economy in 2020. The Treasury estimated that direct COIVD-19 economic support equalled almost A$260 billion (around 13% of GDP), more than double the fiscal stimulus during Global Financial Crisis. Other responses included health measures of A$14bn and balance sheet measures of A$235 billion (mostly the Term Funding Facility (TFF) of A$200 billion, a source of low cost three-year funding for the banking system). The TFF was established with the aim of supporting the supply of credit by providing an incentive to ADIs to increase their lending to businesses.

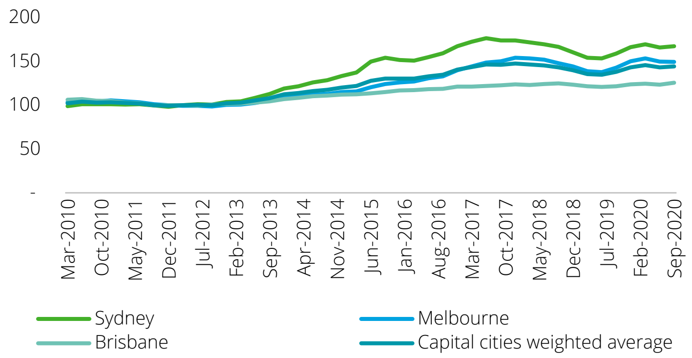
Key fiscal support measures



Source: Australian Treasury (Budget Papers)

House prices fell in mid-2020 but a rebound soon followed, albeit delayed in Melbourne due to an extensive second lockdown in the third quarter of 2020. Major banks and economic forecasts predict the return of double-digit growth in house prices in Sydney and Melbourne and a return to pre-pandemic growth levels in other capital cities.

Residential property price index



Source: Australian Bureau of Statistics

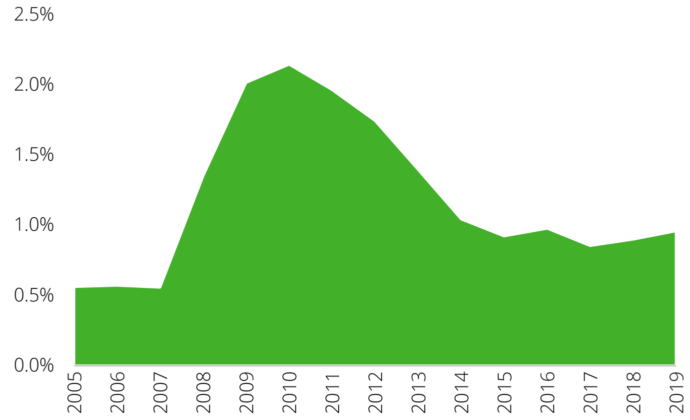
Banking landscape

Australia's banks, and especially the Big Four banks (CBA, Westpac, ANZ and NAB) supported the economy during 2020. A combination of capital buffers, RBA wholesale funding (TFF), and APRA's instruction to defer dividends equipped Australia's banks with the resources to enable them to play a critical support role at the start of the COVID-19 pandemic. The banks offered loan payment deferrals, and the total amounts deferred across lenders reached A$263 billion in June 2020 (around 10% of total loans); this subsequently decreased, reaching A$ 51.2billion (1.9% of total loans) in December 2020.[74] Loans to small and medium-sized businesses accounted for approximately 20% of total loans at the peak, falling to about 10% in February 2021.

The combination of loan payment deferrals and government stimulus helped the banks to prevent an explosion in non-performing loans. The NPL to total loans ratio of most of the Big Four banks is well below the level seen during the GFC. A key reason for the stable NPL ratios of banks is the government's JobKeeper programme, which came to an end in March 2021. The end of this stimulus programme could create the risk of a spike in banks' NPL ratios.

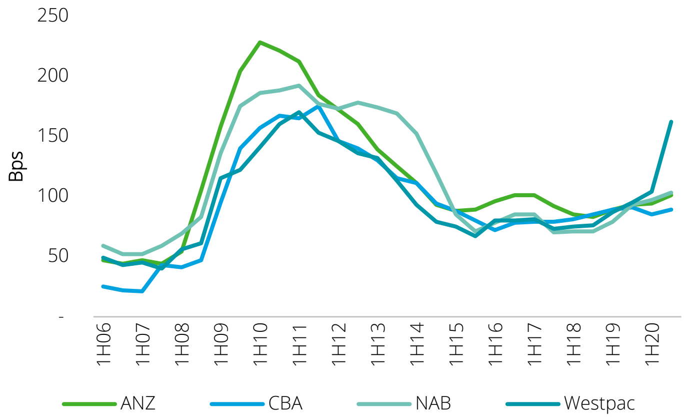
The COVID-19 pandemic has not stopped the banks from pursuing a product simplification strategy, following a Royal Commission into the Financial Services sector in 2019. Some banks have divested non-core assets, like NAB's divestment of MLC Wealth and BNZ Life.

Bank non-performing loans to total gross loans



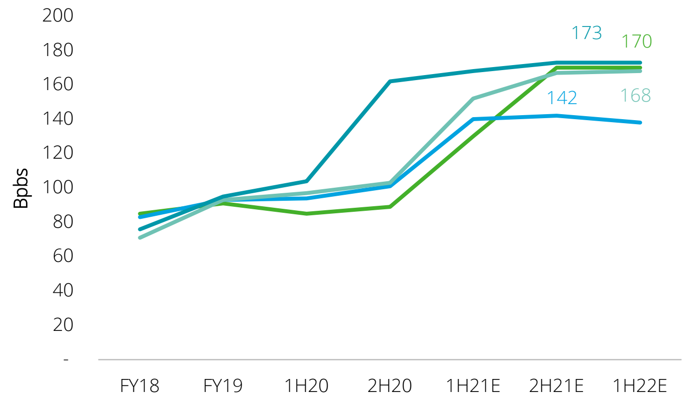
Source: World Bank

Big Four Banks NPLs to Total Loans



Source: Latest public financial information as of December 2020

Big Four Banks NPLs to Total Loans



Source: Latest public financial information as of December 2020, UBS estimates for forecast period

Major Banks ECL Provision

Source: Latest public financial information as of December 2020

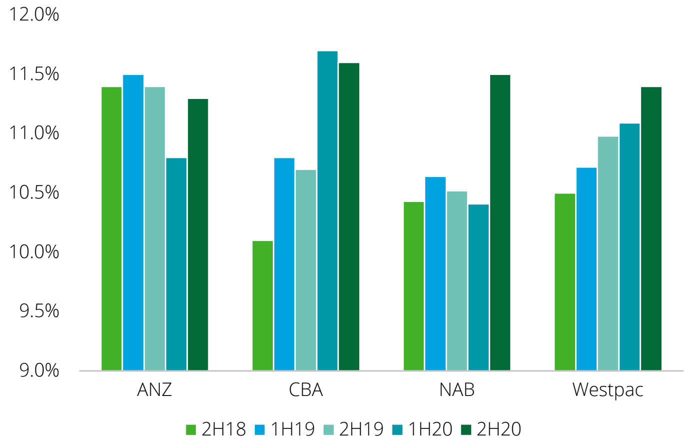
CET1 ratios across the Big Four banks have been strengthened over time in anticipation of higher capital requirements being proposed by the local regulator (Australian Prudential Regulatory Authority or APRA) and in New Zealand by the Reserve Bank of NZ. As a result of the COVID-19 pandemic, APRA has implemented several policies to support the banks including:

- Advising ADIs of their ability to use existing capital buffers below the Unquestionably Strong CET1 benchmark of 10.5% as long as they remain above the minimum legal requirement of 8%. The lowest CET1 ratio (10.4%) was reported by NAB in the second quarter of FY20 but this subsequently increased to 11.7% in the first quarter of FY21
- A deferral of capital framework reform by one year
- An exemption from having to treat loans to customers who have taken up the option of repayment deferral or repayment holidays as in arrears or restructured.

The RBNZ also implemented measures, namely a deferral by 12 months of the start date for increased capital requirements for banks in NZ.

In anticipation of higher capital requirements due to potentially deteriorating loan performance, NAB embarked on a A$ 3.5 billion capital raising to bolster its balance sheet in April 2020.

Big Four Banks' CET1 Ratios



Source: Latest public financial information as of December 2020

The net interest margin (NIM) across all the Big Four banks declined in FY20 compared to the previous year. ANZ in particular has experienced consistent pressures on its NIM since FY16, due to a lower return from its business mix compared to its peers.

Big Four Banks' NIM

Source: Latest public financial information as of December 2020

Singapore

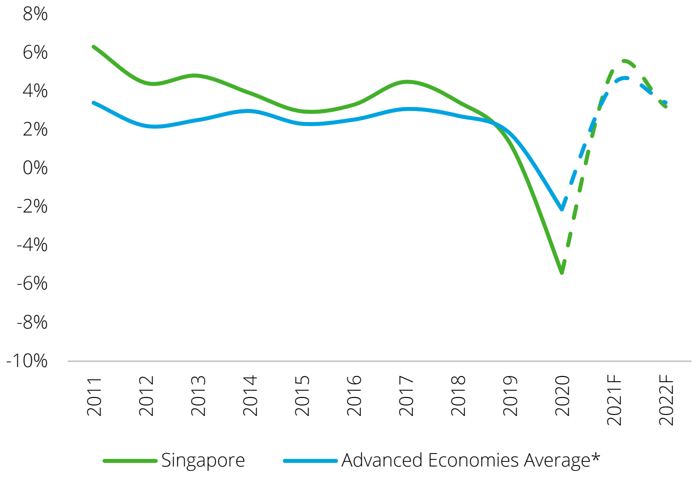
Macroeconomic landscape

In 2019, Singapore's GDP grew by 1.3%, down from 3.5% in 2018. Singapore then experienced its most severe economic downturn since becoming independent. As a result of the COVID-19 pandemic, GDP fell by about 5.4% in 2020. However, a resumption in growth (forecast growth of 5.2%) is expected in 2021, before the economy starts to level out.

According to figures released by the Singapore Department of Statistics, the construction industry experienced a sharp downturn with a decline in output of close to 60% in Q2 2020. With a decline of around 10%, service industries and manufacturing were less severely hit during the same period. However, there was a return to growth in each of these sectors in H2 2020, possibly due to expenditures deferred from H1 2020 by the onset of the pandemic. Other industries experiencing significant disruption are retail and hospitality, which normally benefit from international business tourism. A lasting structural impact may occur with inbound business and tourism-related travel to Singapore, labour force productivity (resulting from the health impact), and changes in both business and consumer spending patterns.

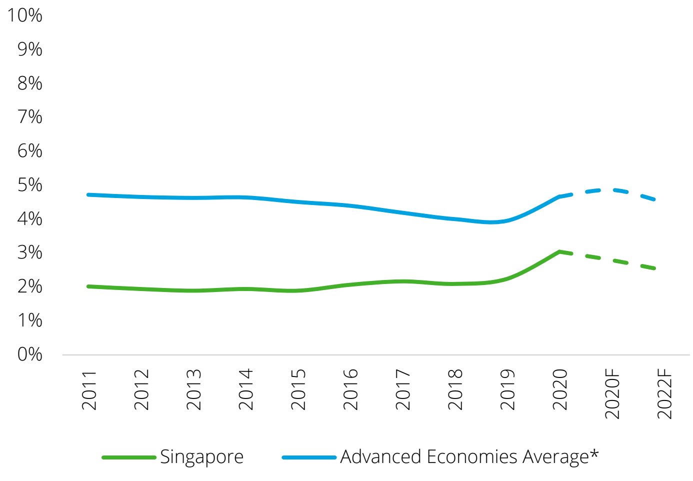
In August 2020, the rate of unemployment rose to 3.4%, surpassing the previous high of 3.3% at the peak of the GFC in 2009. As the economy gradually recovered, the unemployment rate was expected to have fallen to 2.8% as of the end of 2020. House prices in Singapore have remained stable and are forecast to increase in the coming months.

Real GDP Growth (%)



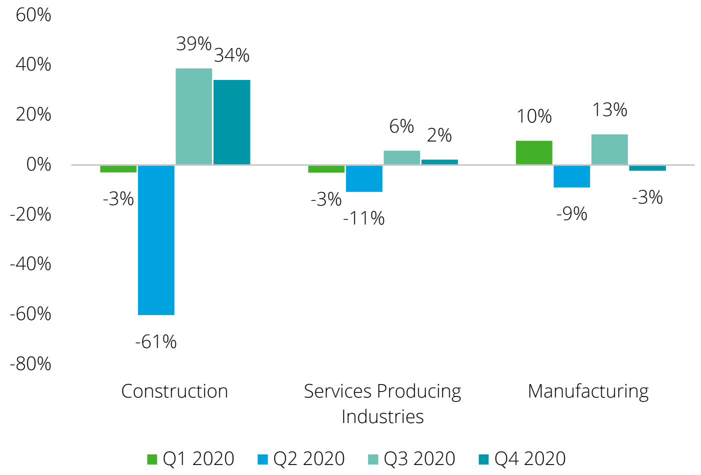
Source: International Monetary Fund (F = forecast)

Unemployment Rate (%)



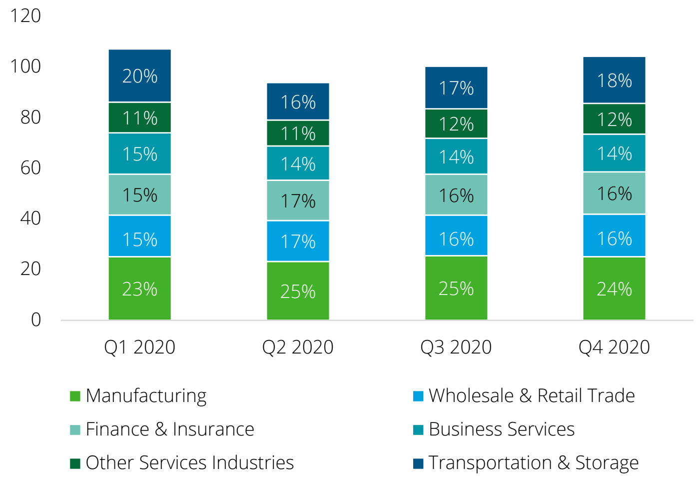
Source: International Monetary Fund (F = forecast)

Key Sector GDP Growth (Q-o-Q %)



Source: Singapore Department of Statistics

GDP by Sectors (SGD'bn)



Source: Singapore Department of Statistics

Government response to the crisis

Government support in Singapore has focused on state-guaranteed loans, with the government assuming 90% of the credit risk. The scheme includes up to SGD 1 million for working capital facilities for SMEs, up to SGD 10 million for trade loans to Singapore-based enterprises, and up to SGD 5 million for one-year bridging loans.

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Key measures taken by banking regulators

Measures	How?	Outcome
Loan repayment extension and restructuring for SMEs	All SMEs could opt to defer principal payments on their secured term loans until the end of 2020. In October 2020, the Monetary Authority of Singapore (MAS) announced a further extension to 2021 for SMEs still in need of relief. SMEs should first consider the Extended Support Scheme - Standardised (ESS-S), whereby SMEs may apply to defer 80% of principal payments on their secured loans as well as, for a certain period, on loans granted under the Enterprise Singapore's Enhanced Working Capital Loan Scheme and Temporary Bridging Loan Programme. The period of deferral varied, e.g. for the hardest-hit sectors such as aviation and tourism the deferral could be up to June 2021. For other sectors, the deferral was up to March 2021.	According to MAS, as of the end of August 2020 there were more than 5,400 applications from SMEs to defer principal payments on secured loans. The total notional amount of loans deferred was over SGD 11.5 billion. Requests for deferment slowed in late 2020 as the cash flows of more SMEs improved with the resumption of business and additional support from various other relief measures.
Loan repayment extension and restructuring for Individuals	**Property loans** Individuals with residential property loans could apply to their respective bank or finance company to defer either principal payments or both principal and interest payments up to 31 December 2020. In October 2020, MAS announced that the individuals could apply for a reduced instalments plan, to benefit from repaying 60% of the original monthly instalment. The plan was granted for nine months but not beyond December 2021. **Unsecured loans** Borrowers with difficulties in repaying their unsecured revolving credit facilities may apply to convert their outstanding balances to term loans at lower interest rates up until 31 December 2020.	As of the end of August 2020, banks had approved about 36,000 applications to defer repayment of property loans until the end of 2020. The notional amount of loans deferred was about SGD 29 billion. Also, there were more than 8,100 applications to convert outstanding unsecured loan balances into new loans with lower interest rates. The notional amount of loans outstanding was over SGD 200 million as of the end of August 2020. By December 2020, the number of converted revolving unsecured credit facilities increased to more than 10,300.

Key measures taken by banking regulators (cont'd)

Measures	How?	Outcome
Adjusting capital and liquidity requirements	Banks are allowed to recognise more of their regulatory loan loss reserves as capital to enhance their capacity to lend. In addition, MAS will adjust the Net Stable Funding Ratio requirement. The amount of stable funding that banks must maintain for loans to individuals and businesses that are maturing in less than six months will be halved from 50% to 25%. The above reliefs will be available until the end of September 2021.	Banks are able to utilise their capital buffers as appropriate to support their lending activity.
Setting accounting loan loss allowances	MAS has provided guidance that in assessing the impact of COVID-19 on future economic conditions in order to estimate loan loss provisions for accounting purposes, banks should also consider the extraordinary measures taken by the government to bolster economic resilience. MAS does not expect banks to maintain higher loan loss provisions solely because COVID-19 relief measures apply to these loans.	According to S&P, banks in Singapore have continued to provide for bad loans in order to build sufficient buffers against any sharp increase in NPLs following the expiry of moratorium reliefs.

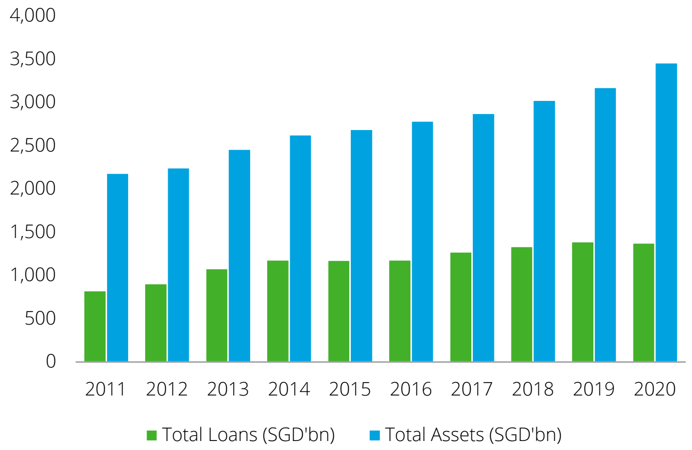
Source: Central banks and Deloitte research of public data

MAS has also delayed the implementation of several updated regulations and standards in line with the recommendations of Basel Committee on Banking Supervision (BCBS). The above measures have provided crucial liquidity and business support during the crisis. However, the consequences of these measures will be tested in 2021: when the economy starts to recover to its normal state, banks will have to return to previous capital requirements and stable funding levels, which is likely to remove liquidity from the businesses that are most in need.

Banking landscape

In November 2019, prior to the outbreak of COVID-19, the MAS released a Financial Stability Report showing the resilience of the Singapore banking sector amid a growing loan stock. However, with the major impact that COVID-19 has had on the credit environment, banks are now facing both operational and regulatory risks, in particular, rising risk-weighted assets and therefore, capital requirements.

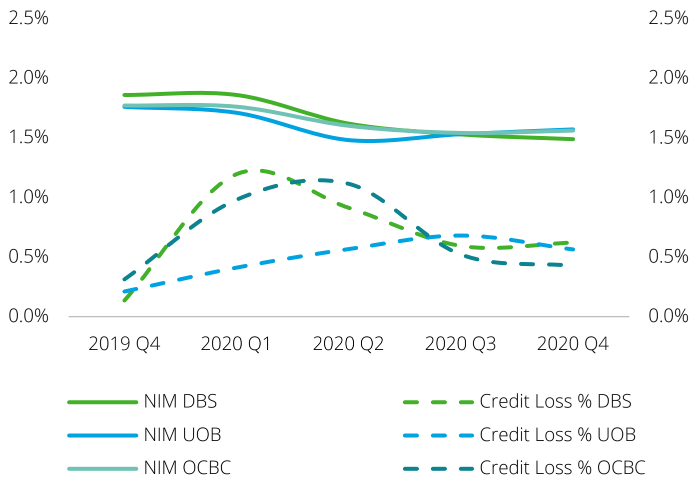
Banking System Asstets (SGD'bn)



Source: Monetary Authority of Singapore (including both domestic banking units and Asia currency units)

Singapore's banking sector has seen a sharp fall in profits and is still facing uncertainty about the future. Among the major banks, credit losses rose sharply for DBS and OCBC in Q1 2020, to 1.2% and 1.0% of gross loans respectively, on an annualised basis. However, as of the year end, these ratios had fallen to 0.6% and 0.4%, suggesting that the banks had overprovisioned for bad loans at the outset of the pandemic. UOB, on the other hand, showed a steady increase in credit losses to 0.7% of gross loans during the first nine months of 2020 and then marginally lowered in Q4 2020. The comparative ratios at the end of 2019 were between 0.1% and 0.3%, indicating the severity of losses from non-performing loans in the Singapore banking sector in 2020. The NIM of the three banks were also squeezed, falling by 20-40 bps during 2020.

NIM & Credit Loss (%) - Top Banks

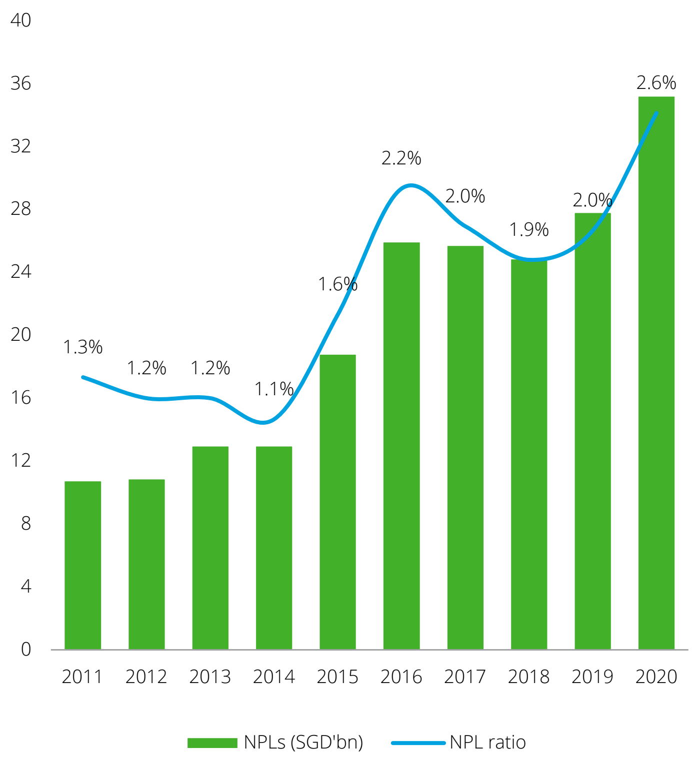


Source: Published financial accounts as of December 2020 *annualised % of gross loans

The NPL ratio for Singapore's banks remained relatively constant between 2016 and 2019, but increased significantly from 2.0% to 2.6% in 2020. Even so, it is still relatively low compared to other countries around the world with more distressed economies, such as Spain and Italy with active NPL portfolio markets. Globally, the NPL market has slowed significantly since the outbreak of COVID-19, and we would not expect any immediate change in NPL activity in Singapore. However, there is the possibility of change in the future, especially if credit quality continues to deteriorate.

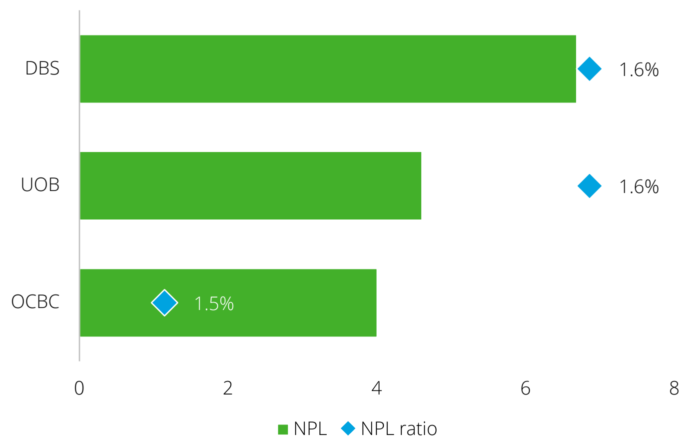
The country's three largest banks – DBS Bank, UOB and OCBC – maintain healthier balance sheets than the national average, each with an NPL ratio between 1.5% and 1.6% in 2020, showing minimum or no change year-on-year. Our previous analysis remains valid, that a significant proportion of banks' NPLs comes from their international exposures, particularly in South East Asia (SEA). This may lead to divestment decisions, but these will be driven by the economic recovery in those SEA countries and the impact on credit quality.

Banking System NPLs (SGD'bn)



Source: Monetary Authority of Singapore

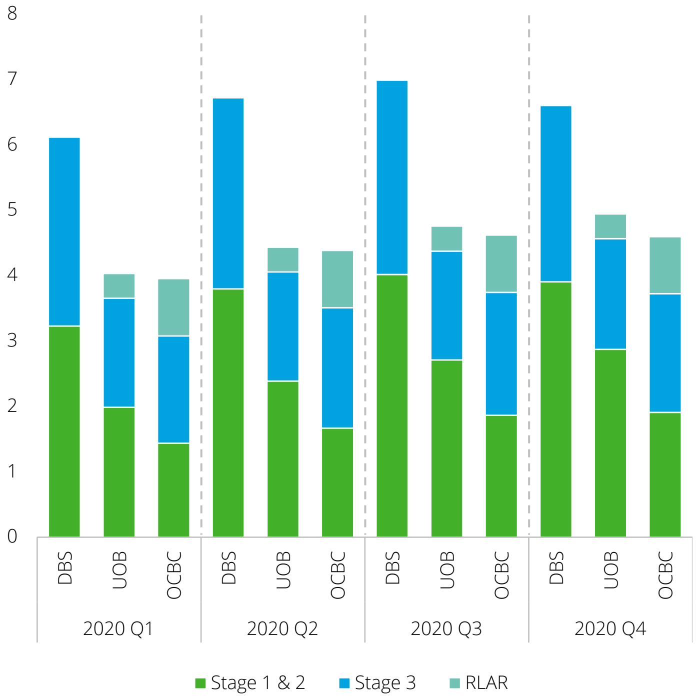
Gross NPLs (SGD'bn) - Top Banks



Source: Published financial accounts as of December 2020 (including both domestic banking units and Asia currency units)

Banks in Singapore have increased their provisioning significantly in recent periods reflecting expected credit losses (ECL) to crystallise. Both Stage 1 and 2 ECL allowances increased across all three major banks in 2020. As government support is withdrawn and available liquidity decreases, a significant amount of these distressed exposures will likely default (and move to Stage 3).

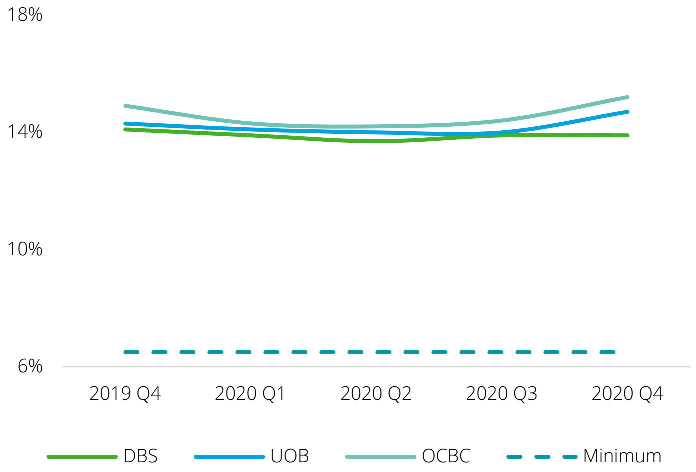
ECL by Stages (SGD'bn) - Top Banks



Source: Published financial accounts as of December 2020

All three major banks have strong capital positions, with CET 1 ratios ranging between 13.9% and 15.2%, significantly above the regulatory minimum of 6.5%. With encouragement from MAS to utilise more of their capital buffers and the ability to hold less stable funding, these ratios may well decline over the coming year. However, with the withdrawal of many support measures due in September 2021, and capital recognition rules returned to normal, these strong positions may come under threat, leading to some deleveraging, as such presenting new opportunities for the already well-established investors in the region.

CET 1 Ratio (%) - Top Banks

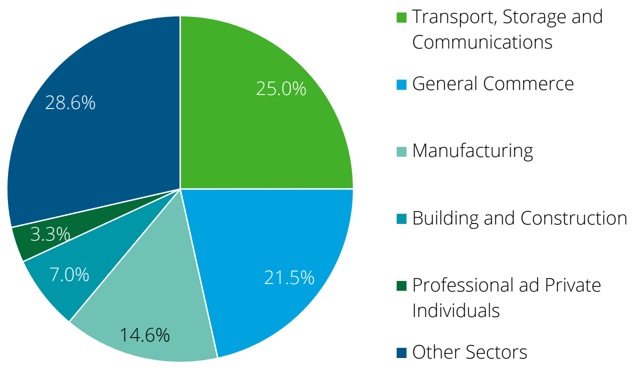


Source: Published financial accounts as of December 2020

NPL landscape and market development

As of December 2020, over 45% of NPLs in Singapore relate to borrowers operating in the transport and logistics sector and general commerce sectors, which were significantly affected by the pandemic. Although the NPL market has not been active in Singapore, as far as we understand, some banks are now considering deleveraging their exposures to NPLs, including some loans to the top borrowers and certain sectors.

NPLs by Sectors (SGD'bn)



Source: Monetary Authority of Singapore (including both domestic banking units and Asia currency units)

Subject to the specific terms in the loan agreement, it is usually possible for a lender to enforce a repossession of the underlying security without the involvement of courts. A mortgagee has a statutory power of sale if the mortgage has been made by deed or registered under the Land Titles Act (Chapter 157). Alternatively, the mortgage document can grant the mortgagee a power of sale. The mortgagee's statutory right to sell arises when the mortgage payments are due. This right is not exercisable until certain statutory requirements are met. Alternatively, a receiver can be appointed without a court intervention once the payment becomes due. Foreclosure, on the other hand, requires judicial involvement and is less common due to legislation protecting the mortgagor's interest.

As outlined in our last two deleveraging reports, the NPL exposures of major Singapore banks are mostly in other markets around SEA and are generally manageable through the usual resolution and workout processes. As a result, Singapore remains an inactive market for NPL portfolio transactions, with banks continuing to hold strong capital positions. Our previous view therefore holds true: any portfolio sales in the near future are likely to act primarily as a mechanism for reducing overseas exposures.

Thailand

Macroeconomic landscape

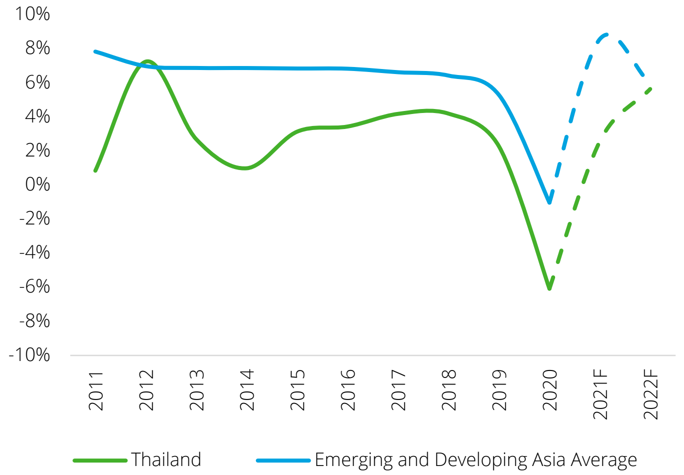
2020 was a challenging year for Thailand. The IMF forecast that there would be a fall of 6.1% in real GDP which is about five percentage points worse than the regional average. This is due mainly to COVID-19 as the Thai economy heavily relies on tourism and its exports sectors. Many sectors have suffered. In particular, GDP in the manufacturing, services and mining sectors all contracted by 10% or above in Q2 2020

With the easing of lockdown and the government's stimulus packages in Q3 2020, GDP growth of 2.6% is expected in 2021 and 5.6% in 2022., following a recovery in private consumption, monetary expansion and an increase in the number of tourists visiting the country.

In 2020, Thailand's unemployment rate reached 2.0%, double the previous year's level , and a high rate of unemployment is expected until 2023. Private consumption fell by about 3% in 2020, and businesses suffered from decline in revenue. Finally, import and export volumes have both fallen by about 16%, negatively affecting businesses across the country.[75]

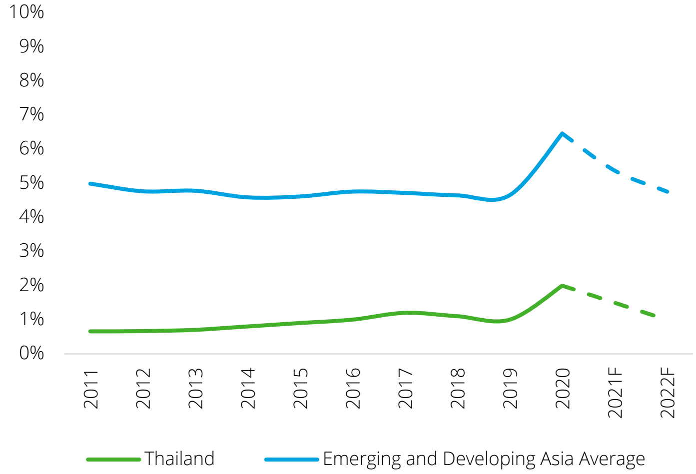
Other factors that may affect economic performance in 2021 include political tensions, an increasing number of bankruptcies and a second wave of COVID-19, which could potentially lead to new lockdown restrictions and affect exports, the tourism sector and the economy generally.

Real GDP Growth (%)



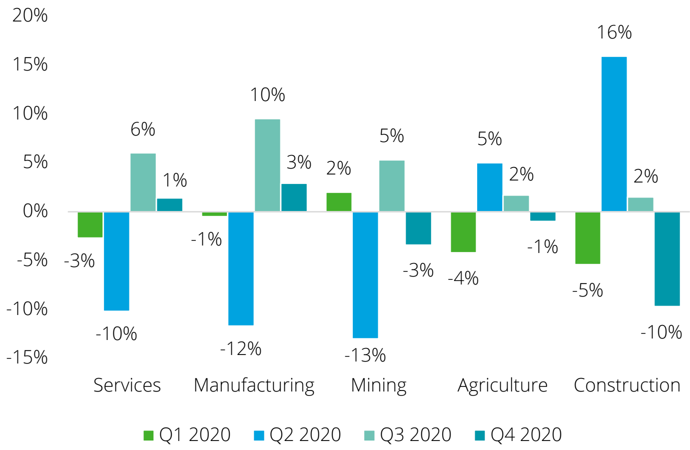
Source: International Monetary Fund (F = forecast)

Unemployment Rate (%)



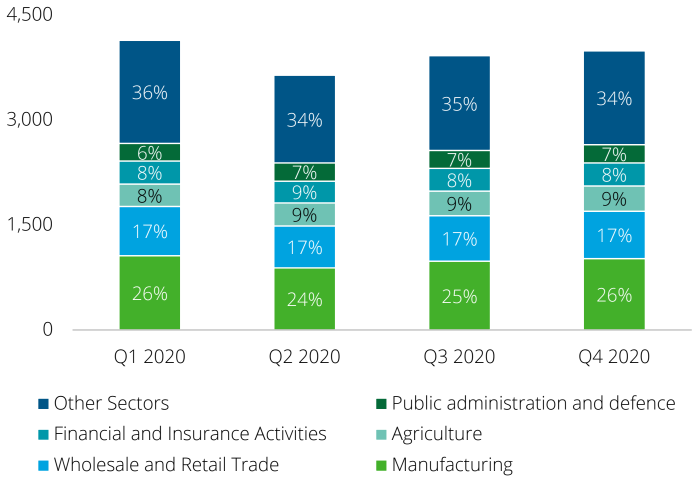
Source: International Monetary Fund (F = forecast)

Key Sector GDP Growth (Q-o-Q %)



Source: Office of the National Economic and Social Development Council, Economic Intelligence Center, and The Trading Economics

GDP by Sectors (THB'bn)



Source: Office of the National Economic and Social Development Council

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Government's response to the crisis

A number of relief measures were introduced by the government and regulators. Below we provide the key steps taken by the Bank of Thailand (BOT).[76]

Key measures taken by banking regulators

Measures	How?	Outcome
Debt relief measures	The BOT announced relief measures including three-six month payment holidays for personal, hire-purchase, leasing, mortgage and SME loans. The blanket moratorium ended in October 2020, but the BOT encouraged banks to provide targeted assistance to SMEs that were unable to service their loans. These targeted measures were set to end in June 2021.	Around 1.05 million accounts totalling THB 1.35 trillion were covered by the initial paymentmoratorium , and loans of approximately THB 6.89 trillion benefited from a reduction in principal, lower interest rates, an extended repayment period or restructuring. [77]
Soft loans	Soft loans at a 2% interest rate were made available for retail and SMEs. SME credit lines capped at THB 500 million were interest-free for six months.	THB 121 billion loans were approved for over 72,000 SMEs.
Reduced compulsory contribution	Compulsory contribution to Financial Institutions Development Fund (FIDF) by banks were reduced from 0.46% to 0.23% for two years.	Financial institutions' costs of taking deposits were reduced.
Financial market stability	Maturing investment grade bonds may be purchased by the Corporate Bond Stabilisation Fund (BSF)	A budget of THB 400 billion has been set aside by the Fund to ensure sufficient liquidity in the bond market.

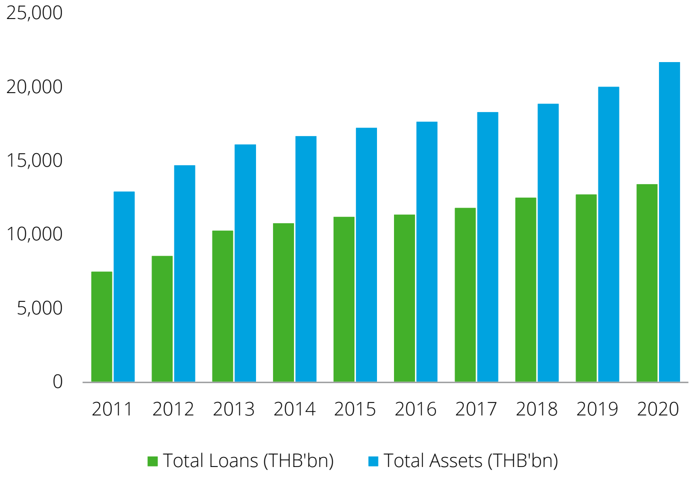
Source: Central banks and Deloitte research of public data

NPLs were not expected to increase significantly in 2020 due to the BOT's relief measures. The banking industry remains resilient, as banks have maintained a high level of capital and an adequate level of loan loss provisions.

Banking landscape

In 2020, lending by banks increased by 5.4% year-on-year as compared to 1.8% in 2019. Corporate loans (64.2% of total loans) grew slowly, as some corporations shifted from bank borrowing to issuing bonds and equities, while others postponed investment projects due to an unstable economic outlook. The volume of consumer loans (35.8% of total loans) grew as a result of government support schemes and the relaxed lockdown in the second half of 2020.[78]

Banking System Assets (THB'bn)



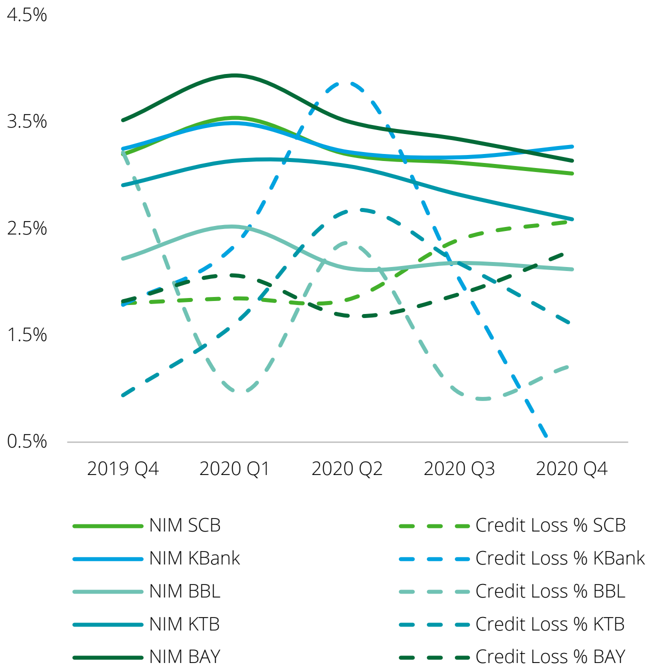
Source: Bank of Thailand

The Thai banking system generated total net profits of THB 146.2 billion in 2020, compared to THB 271 billion in 2019.[79] The fall from the previous year was due to provisioning in response to an expected deterioration in asset quality and a decrease in core revenues, particularly, interest and fee income.

The fall in interest income across commercial banks was a result of a decline in interest rates, and higher funding costs and lending and FIDF fees. The drop in overall net interest margin (NIM) from 2.73% in 2019 to 2.51% in 2020 was due mainly to a decline in interest income from lending together with the high level of provisioning for bad loans. KBank, BBL and KTB reported surges in credit losses during H1 2020 as the banks set aside more reserves amid the uncertainties brought by the pandemic.

**[Expected credit losses include loans, interbank and money market items and debt securities]*

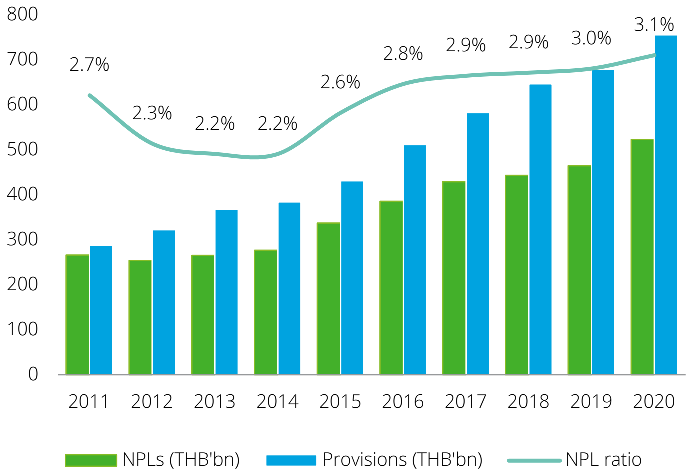
NIM & Credit Loss (%) - Top Banks



Source: Published financial accounts as of December 2020 *annualised % of gross loans

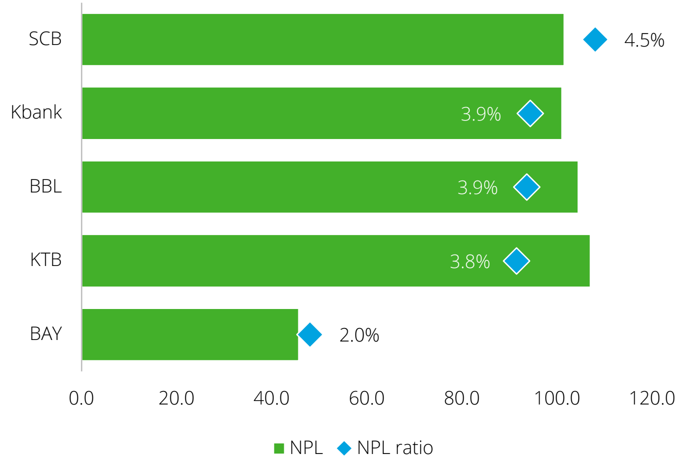
The volume of NPLs grew, reaching 3.11% of total loans in 2020, compared to 2.98% at the end of 2019. Loan loss provision remained high at THB 755.9 billion with NPL coverage ratio at 144.5%. Although NPL figures may seem lower than expected in view of the economic situation, this was due mainly to the BOT's flexible loan classification rules allowing loans restructured under financial aid programmes to be classified as normal, reducing the need to make provisions. At the end of 2020, loans under relief measures amounted to THB 4.83 trillion, approximately 36% of total loans.[80]

Banking System NPLs (THB'bn)



Source: Bank of Thailand

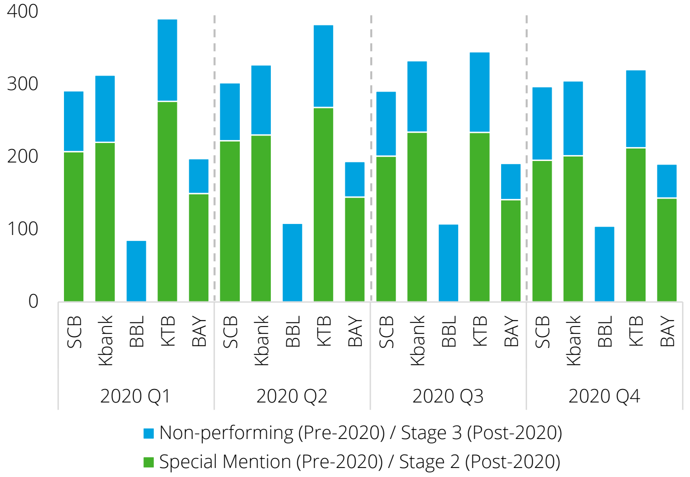
Gross NPLs (THB'bn) - Top Banks



Source: Published financial statements as of December 2020

The adoption of Thai Financial Reporting Standards – (TFRS 9, which is similar to IFRS 9) came into effect on 1 January 2020. Banks have classified some of the previously 'normal' loans as 'Stage 2' to recognise impairment losses at an earlier stage. Some major banks also had a slight increase in gross NPLs (Stage 3) from December 2019, which could be a result of lower asset quality and increased NPL across loan portfolio. Expected credit losses (ECL) are likely to increase as more NPLs are recognised when the debt relief programme ends.

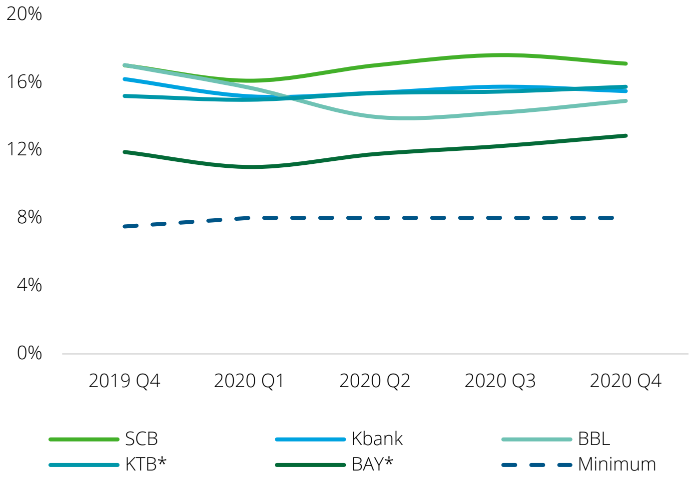
Non-current Loan by Stages (THB'bn) - Top Banks



Source: Published financial statements as of December 2020

Capital funding of the Thai banking system was THB 2.9 trillion in 2020, equivalent to a capital adequacy ratio (CAR) of 20.1%. The average CET 1 ratio for the top 5 Thai banks stood at 15.2% as of December 2020, significantly higher than the BOT's minimum requirement of 8.0%. However, due to uncertainty around the impact of COVID-19, the BOT introduced a preventive measure that dividend payments by Thai banks for 2020 should not exceeding the previous year's payout ratio or 50% of the current year's net profit.

CET 1 Ratio (%) - Top Banks



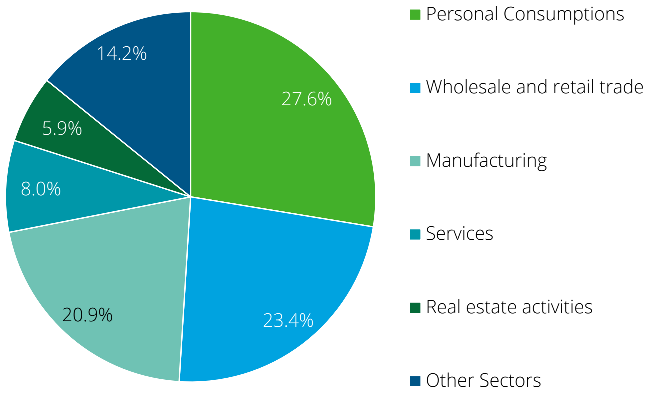
Source: Published financial statements as of December 2020

The THB 156 billion merger between Thanachart Bank PCL (TBANK) and TMB Bank PCL (TMB), Thailand's sixth and seventh largest lenders by assets, was the biggest M&A deal in the Thai banking sector. The combined entity, TMB-Thanachart Bank, will rank the sixth in the country in terms of size. It combines the expertise of of TMB in SME and corporate lending business and of TBANK in auto loans. Thus, the new bank will expect wider-ranging business opportunities, with assets worth THB 2 trillion and a total customer base of about 10 million. After approval granted at an extraordinary general meeting (EGM) in September 2019, theintegration has been proceeding as planned and is expected to be completed by July 2021.

NPL landscape and market development

Personal consumption and wholesale and retail sectors made up more than 50% of the total NPLs outstanding. The higher unemployment rate, and lower consumer spending and import and export volumes impacted by COVID-related containment measures could result in borrowers' inability to pay back the loans.

NPLs by Sectors (THB'bn)



Source: Bank of Thailand

Potential large-scale solution: –Warehousing structure

The BOT has been studying a warehousing concept.It allows borrowers to warehouse or settle their debts without being forced to sell the security at unreasonable market prices amid the sluggish environment. The borrowers can buy back the debts and assets once they recover from the crisis. . This concept could apply to both performing and distressed assets, and with either a new AMC being established or utilising an existing AMC to manage the sold assets. Additionally, the Joint Standing Committee of Commerce, Industry and Banking has also proposed the government should set up an asset management fund to manage assets in the hotelsector that has been severely hit by COVID-19.

The BOT concluded that the national AMC is not needed at this stage, as the risk of an increase in NPLs is currently mitigated by the targeted moratorium scheme, which is scheduled to end in June 2021. At the moment, the majority of banks' clients in the hotel industry have sought debt relief measures and received financial assistance under the BOT scheme. Nevertheless, the BOT implied that it would consider support for the initiative to create an asset management fund based on its overall benefits and feasibility.[81]

Characteristics of the NPL market and legacy issues

The NPL market in Thailand is considered the most mature in SEA. As also mentioned in our previous Deleveraging Asia report, the key considerations for loan sales in the market include the following:

Issues	
Restriction on buyers	Investors seeking to manage NPLs as part of their business model need to obtain an AMC licence, which is covered by the AMC Decree. Typically, foreign investors will partner with a trusted local partner or apply for an appropriate Foreign Business Licence. The process of licensing an AMC usually takes four to six months. However, if the AMC is a Thai majority-owned company, a Foreign Business Licence is not required, and the licensing process will be reduced to around two months. Foreign investors are not permitted to own the title to land in Thailand and are only allowed to hold up to 49% of real estate holding companies. As such, the NPL investors are only able to hold real estate assets if they are acquired via locally owned AMCs.
Legal enforcement process	Collateral for mortgages and asset finance loans can only be enforced after notice has been issued to the debtors, as required by the Thai Civil and Commercial Code (CCC). In comparison, as stipulated by the Business Security Act, enforcement of securities, which does not require court proceedings and is quicker.
Servicing options	There are some established local servicers in the market.

Bangkok Commercial Asset Management (BAM) and Sukhumvit Asset Management (SAM) continue to be the main buyers, but foreign investors have been more active in the NPL market. The market is expected to continue growing annually with regular sales from the largest banks. The portfolio tranche sizes are expected to increase as banks take advantage of investors with larger capital pool who have already entered the market.

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South Korea

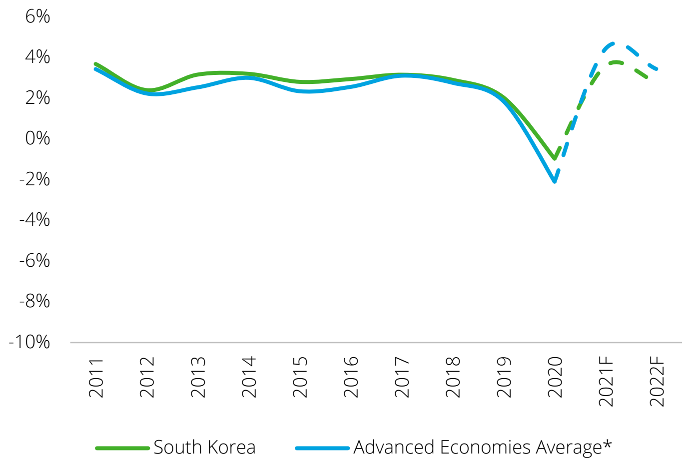
Macroeconomic landscape

Following the global outbreak of COVID-19, South Korea's real GDP fell by 1.0% in 2020, as the country's economy depends heavily on exports. However, the fall was relatively small in comparison with the average contraction of 2.7% in other advanced economies (except for G7 countries). This was the biggest contraction since the Asian Financial Crisis (AFC) in 1997. The business sectors worst affected include tourism, manufacturing, shipping and finance, whereas information technology, e-commerce, and pharmaceutical sectors have been relatively stable. The IMF estimated that the unemployment rate would increase slightly in 2020 by 0.1 percentage points to 3.9%.

Frequent changes to housing policy in order to contain rising prices in the housing market have not been successful. House prices are expected to continue to climb in 2021, and the consumer sentiment index for future house prices published by Bank of Korea (BOK) reached the all-time high in December 2020.[82]

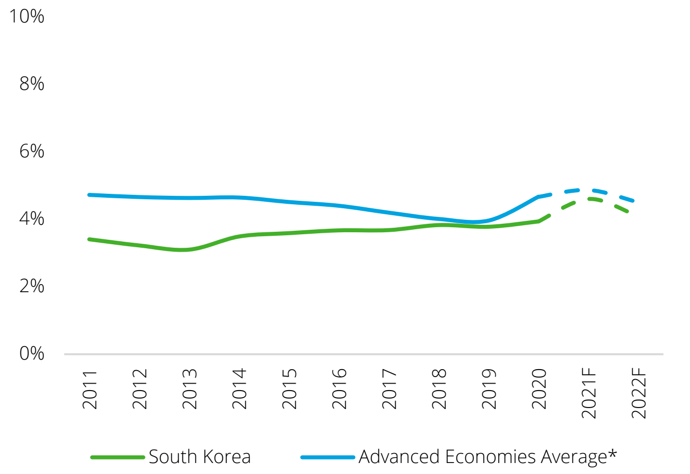
For a long time South Korea has had a tense relationship with its closest neighbour North Korea. Despite efforts made by the South Korean government to bring diplomacy back on track and engage in denuclearisation talks, tensions have continued in 2021. In a post-pandemic economy, South Korea may also seek to improve relations with China, in an attempt to boost its export-reliant economy.

Real GDP Growth (%)



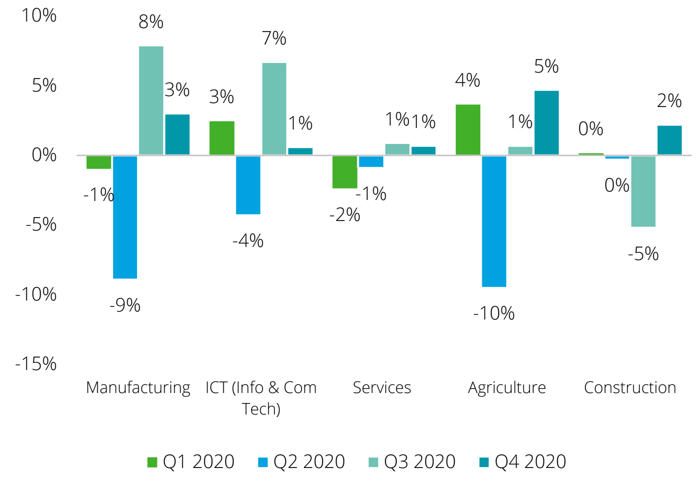
Source: International Monetary Fund (F = forecast)

Unemployment Rate (%)



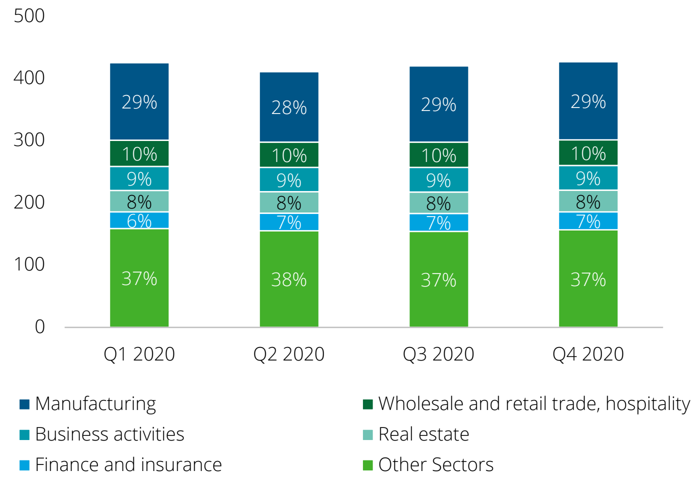
Source: International Monetary Fund (F = forecast)

Key Sector GDP Growth (Q-o-Q %)



Source: Bank of Korea

GDP by Sectors (KRW'tr)



Source: Bank of Korea

In H2 2020 business activity in South Korean returned to growth as major trading partners eased their COVID-19 restrictions and the government rolled out USD 29.6 billion fiscal injections into the economy.[83] The BOK and the state-run Korea Development Institute (KDI) have forecast that the economy will grow by about 3.0% in 2021[84], which is in line with the view of the IMF.

Government's response to the crisis

To stimulate the economy, the Korean Government announced four stimulus packages in 2020, with a total value of over KWR 66.8 trillion (USD 56.4 billion).[85,86] The first package, valued at USD 9.9 billion, was targeted mainly at curbing the spread of the virus. A second package totalling USD 81.6 billion contained measures to help companies.[87] In April 2020, a third package of USD 10.3 billion was approved, to increase spending on job protection schemes, vaccine development, and boosting consumption. In the fourth stimulus initiative for 2020, the government proposed a USD 6.6 billion pandemic relief package, funded mostly by debt. It was reported that this may raise the government's debt-to-GDP ratio to 43.9% in 2020, up from 37.1% in 2019.[88]

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We present the key measures taken to minimise the impact of COVID-19 on the economy in the following list.

Key measures taken by banking regulators

Measures	How?	Outcome (effective?)
Loan repayment moratorium	A six-month moratorium was announced in April to support individuals and SMEs affected by COVID-19. This policy was originally scheduled to end in March 2021. Banks and financial institutions provide a moratorium extension on loan repayments for those affected by the pandemic. In March 2021, the scheme was extended for another six months to September 2021.	Loans with a total amount of USD 115 billion have been under the moratorium so far[89], giving time to ease direct COVID-19 impact on individuals and SMEs.
Credit Counselling & Recovery Service	Credit Counselling & Recovery Service department offers a moratorium on repayment of loans and debt adjustments to those affected by the pandemic.	
Providing low-interest loans	In an effort to revive the economy, the BOK reduced its benchmark interest rate to an all-time low of 0.5%, where it has remained since then. With the reduction in interest rates, banks and credit unions issue loans with low interest rates to individuals and SMEs affected by the pandemic.	This takes some financial pressure off individuals and SMEs affected by the pandemic

Source: Central banks and Deloitte research of public data

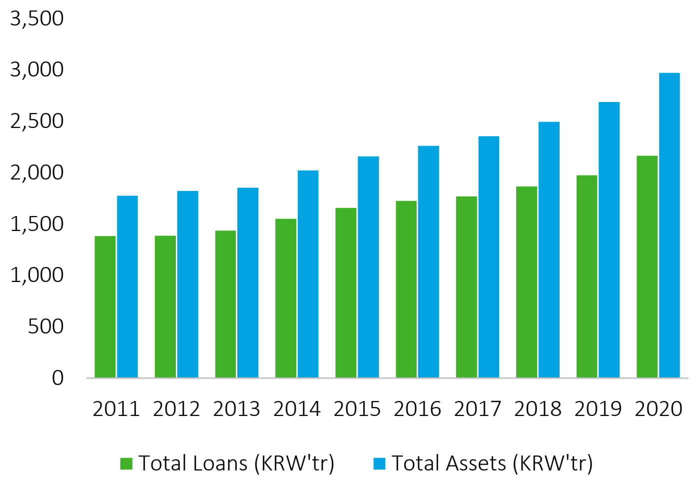
The government's temporary policies to minimise the adverse effects of COVID-19 on the economy have so far performed as intended. Nonetheless, there are concerns over whether these policies have simply delayed the impact of COVID-19 until 2021. In particular, the BOK cautioned that the government's plans for extensive borrowing could lead to bond market imbalances. It also stated that it would continue to use ad-hoc bond purchases to contain yields rather than shift to a policy of quantitative easing.[90]

Banking landscape

The banking system in South Korea consists of a mix of state-controlled lenders, private domestic banks and branches of foreign banks. The commercial banking sector is highly concentrated with a small number of banks competing for market share in a mature market. The ongoing privatisation of Woori Bank, once completed, will mark the end of its history of nationalisation.

In 2020, the government continued to impose strict loan-to-value and debt-to-income ratios, alongside tighter mortgage rules and regulations, to slow down the rapid growth in-house prices. As a result, the total amount of lending has remained relatively unchanged.

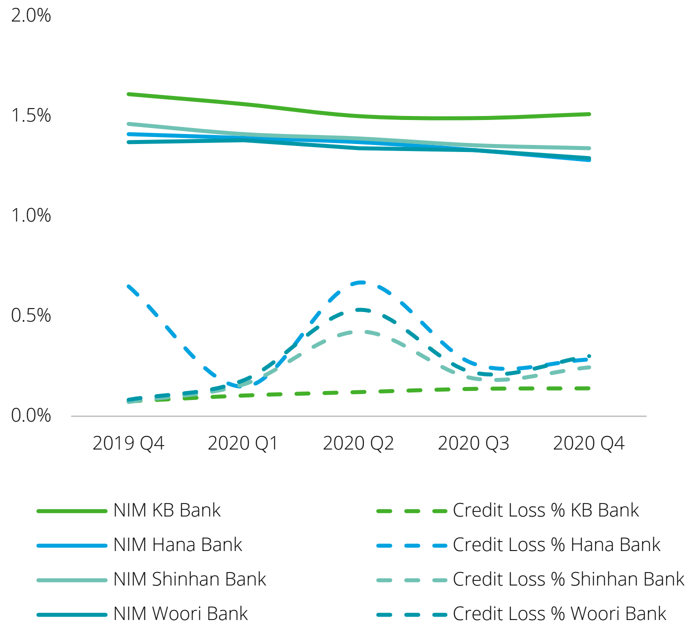
Banking System Assets (KRW'tr)



Source: Financial Supervisory Service (including all domestic banks)

The average return on assets (ROA) for South Korea's four main banks – Shinhan, Hana, Woori and Kookmin – fell to 0.5% (from 0.7% in the previous year) during the first six months of the year. This fall was mainly attributable to an increase in loan loss provisions (LLP) and a contraction in NIM. Based on the earnings reported by the four banks for H1 2020, average cost of risk was about 0.2% of gross loans, of which about 0.1% was due to additional provisioning for bad debts based on an increase in expected losses during the pandemic. The situation improved as the economy recovered in H2 2020. However, the contraction in NIM will continue as it is attributable to the interest rate reduction to 0.5% by the central bank in May 2020.

NIM & Credit Loss (%) - Top Banks



Source: Published financial accounts as of December 2020

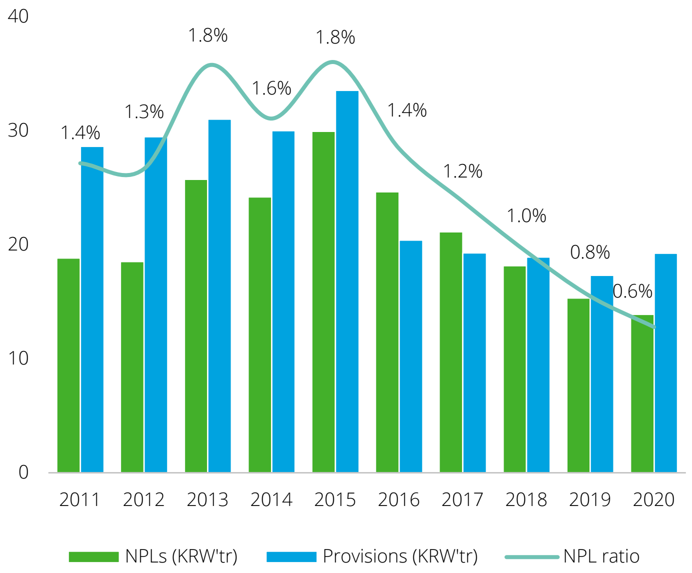
According to S&P, the asset quality of banks remains strong, backed by tighter underwriting standards and reduced exposures to risky segments, such as shipbuilding, shipping, construction and real estate project financing over recent years.[91]

The total of NPLs held by domestic banks in South Korea remained stable stayed at KWR 13.9 trillion (USD 12 billion) as of December 2020, with a 0.7% NPL ratio. This is slightly lower than the total NPL balances at the end of 2019. However the provision for doubtful debts increased by KWR 1.95 trillion (USD 1.67 billion) from 2019, giving a provision coverage ratio of 138.8%. The result suggests that banks in Korea are making more provisions than before, which clearly shows their cautious view about the economy.

The government's stimulus measures have included a loan repayment moratorium, credit counselling and recovery services, and low interest loans. Because of these measures, the total for NPLs balance does not yet reflected the full effects of COVID-19 on the economy. However, this situation is expected to change when the relief measures expire in 2021.

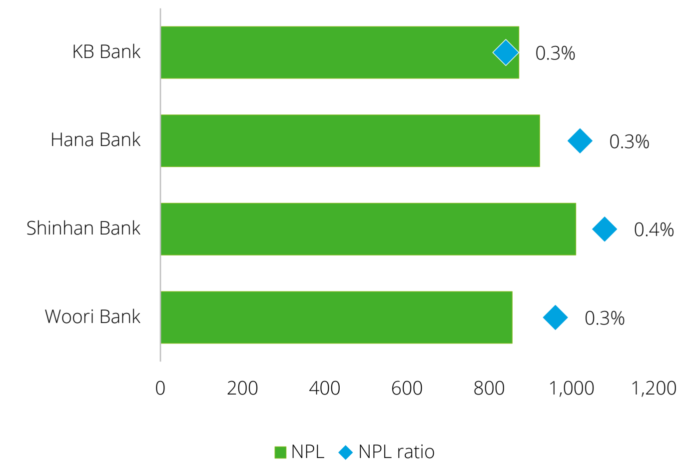
The average NPL ratio for the top four domestic banks improved to 0.33% in 2020 compared to 0.44% in the previous year. The costs incurred by banks on forbearance measures (such as the maturity extension of principal payments on loans to SMEs and unsecured household loans temporarily affected by the pandemic) was modest relative to the total amount of loans. The composition of gross loans by risk categories have remained stable for these four banks.

Banking System NPLs (KRW'tr)



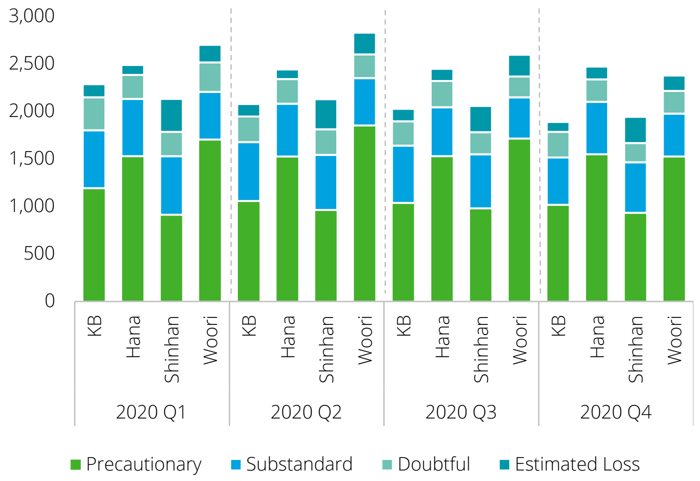
Source: Financial Supervisory Service (including all domestic banks)

Gross NPLs (KRW'tr) - Top Banks



Source: Published financial accounts as of December 2020

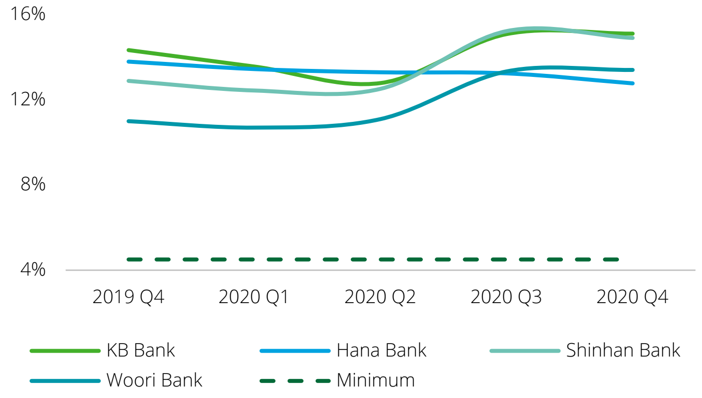
Gross Loan by Stages (KRW'bn) - Top Banks



Source: Published financial accounts as of December 2020

The average capital adequacy ratio (CAR) for South Korean banks rose in Q4 2020 as a result of higher capital and lower risk-weighted assets. The CAR of 19 domestic commercial and state-run banks averaged 15.0%, with and the sector average CET 1 ratio was 12.45% at the end of 2020.[92]

CET 1 Ratio (%) - Top Banks



Source: Published financial accounts as of December 2020

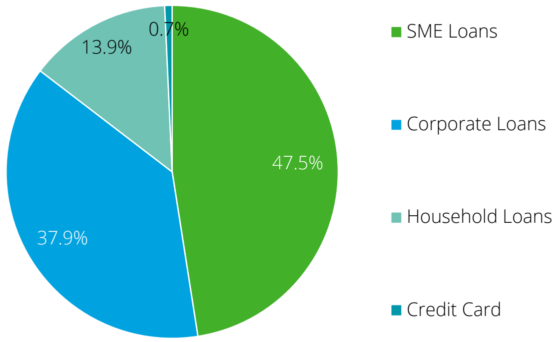
The financial services sector in South Korea is in the process of change, with financial institutions increasingly adopting mobile platforms to deliver their services. Two pure-play internet banks – Kakao and KT banks – were launched in 2017. The latest, Toss bank, received a preliminary licence in December 2019 and will begin operations in 2021.

The pandemic has hastened the pivoting of the sector away from in-person delivery of financial services. Closures of physical branches were already underway, and artificial intelligence (AI) is gradually the human workforce. To support the technological upgrade of the banking industry, the government's post-coronavirus economic strategy – the Korean New Deal – includes full-scale integration of AI into financial services.

NPL landscape and market development

South Korea's NPLs largely comprise of business loans extended to SMEs and corporates. In Q4 2020, SME loans comprised 47.5% of total NPLs and corporate loans made up another 37.9%.

NPLs by Sectors (KRW'tr)



Source: Financial Supervisory Service (including all domestic banks)

The NPL market in South Korea has been active since the AFC, and is among the most mature in the region. A large proportion of the distressed loans is purchased by private investors.

United Asset Management (UAMCO), a privately-owned bad bank, has been operating since 2009, buying and re-selling toxic assets, and is one of the top players in the market. UAMCO has invested in distressed buyout strategies since 2014, seeking the recovery of companies in workouts without the need for court-led insolvency procedures. In February 2020, UAMCO saw its first success in cashing out of a distressed asset investment – Seha, an industrial paper maker.[93] As of September 2020, UAMCO had invested KRW 1.4 trillion in distressed businesses and KRW 2.6 trillion in NPLs. In the coming months, it is intending more exits from its distressed portfolios.

Another major player in the market is the state-run AMC, Korea Asset Management Corporation (KAMCO), established in 1962. It has played a crucial role in resolving asset quality issues in past crises, by acquiring bad debts from banks and disposing of NPLs through methods such as restructuring, loan sales and securitisation.

As a result of of the pandemic, KAMCO plans to create a fund worth over KRW 2 trillion to execute the corporate asset purchase programme initiated by the government. It aims to help companies secure funds to survive the current crisis. KAMCO will also run an information platform to facilitate transactions and promote private investors' participation in the programme.[94] Korean Air was one of the companies to benefit from the programme, receiving financing from a state-run bank to expand its capital by KRW 2 trillion by the end of 2021.[95]

The total balance of NPLs in South Korea is low, but this must be interpreted cautiously because banks tend to sell their NPLs swiftly in the liquid market for distressed assets.

The NPL market shrank sharply in 2020, mainly as a result of the credit support measures implemented by the government in response to the pandemic. According to industry sources, sales of NPLs in 2020 were KRW 3.8 trillion (USD 3.5 billion), down by KRW 600 billion (USD 550 million) from 2019. Among the top banks, Industrial Bank of Korea (IBK) had the most NPL sales, increasing by 7.3% from KRW 1.37 trillion (USD 1.2 billion) in 2019 to KRW 1.4 trillion (USD 1.3 billion) in 2020. However, NPL sales fell in 2020 at other banks such as Korea Development Bank, Shinhan Bank, Hana Bank, and Nonghyup Bank.[96]

Key considerations for loan sales

Issues	
Restrictions on buyers	Buyers must follow certain procedures outlined in "Loan Sales and Purchase Guideline". There is no specific regulation for limiting participation by foreign investors coming in the NPL market. All licensing requirements for buying loans are the same for domestic and foreign investors.
Legal enforcement process	Secured NPLs: Government auction system Unsecured NPLs: Collection agencies, legal action
Regulatory requirements	A newly enacted Consumer Credit Act proposes to establish internal standards to restrict the sale of non-performing loans of individuals.[97] Buyers must be one of the following types of entity: • A financial institution • A Special Purpose Company established for liquidation • Registered with the Financial Services Commission of Korea
Servicing options	In-house or collection agencies

Note: The ruling party of South Korea is pushing ahead with its plan to revise the current credit business law. The revision is expected in early 2021. We anticipate a change in sales and purchase procedures and requirements.

Indonesia

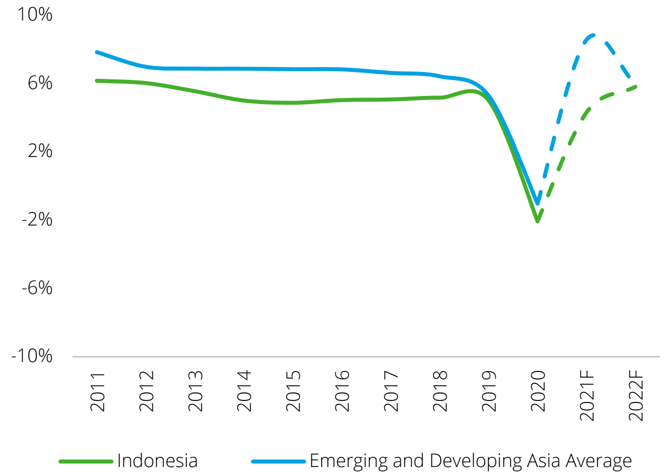
Macroeconomic landscape

The COVID-19 crisis hit the Indonesian economy particularly hard. Despite stimulus measures, the economy slipped into a technical recession for the first time in 22 years[98], with a real GDP in 2020 expected to contract by 2.1%, and a fiscal deficit equal to 6.3% of GDP was forecast, the biggest in decades.[99]

The pandemic affected most of the key business sectors, including manufacturing, wholesale and retail, construction and mining, with negative growth in H1 2020. In contrast with the general trend, the agricultural sector enjoyed strong growth of 16.2% in Q2 2020, supported by the resilience of farmers and a delay in the harvest season[100]. Following a gradual recovery in the economy, the damaged sectors started to show signs of improvement in Q3, but then contracted slightly more than expected in Q4 2020.[101]

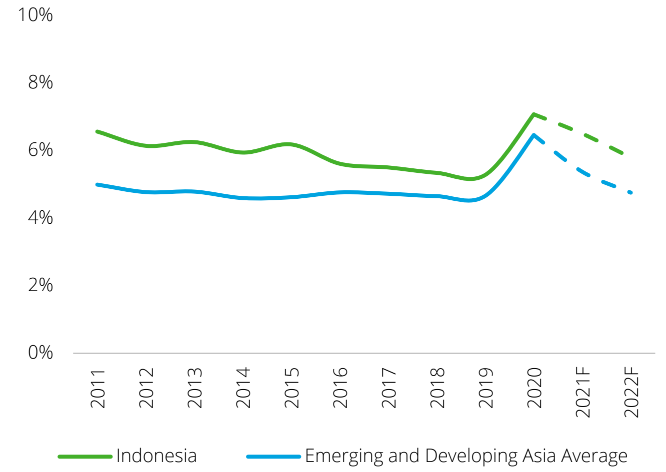
Unemployment rate reached a decade high. It was forecast to be 7.1% for 2020, an increase of 1.8 percentage points from 2019 and 0.6 percentage points higher than the regional average. The numbers of unemployed people increased by 2.67 million to 9.77 million people in August,[102] with the tourism sector suffering the most. The government expects the level of unemployment to remain unchanged in 2021, or even worsen, despite the forecast recovery.[103]

Real GDP Growth (%)



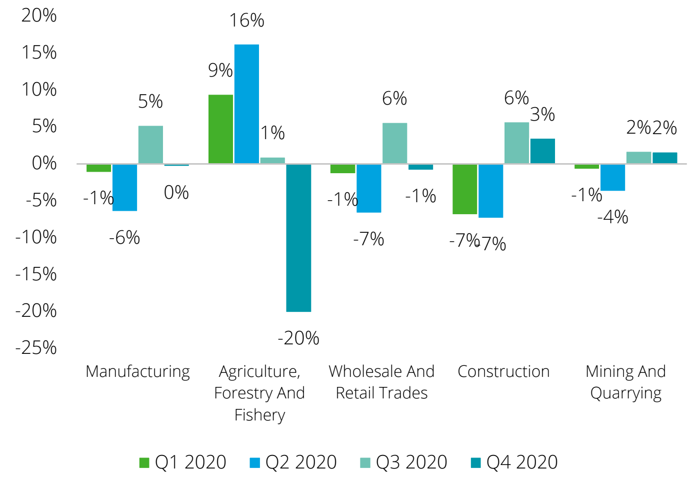
Source: International Monetary Fund (F = forecast)

Unemployment Rate (%)



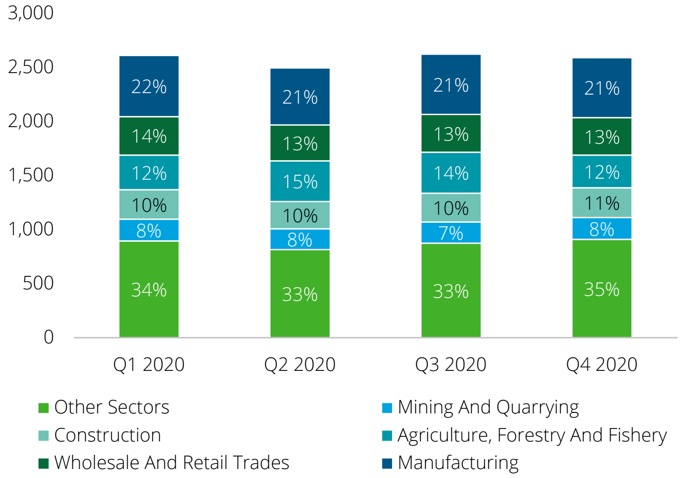
Source: International Monetary Fund (F = forecast)

Key Sector GDP Growth (Q-o-Q %)



Source: Bank Indonesia

GDP by Sectors (IDR'tr)



Source: Bank Indonesia

The IMF expects a gradual recovery of the economy in 2021, with GDP growth of 4.8%. However, growth may be held back by uncertainty surrounding health and the effectiveness of measures to contain the virus, given the continuing rise in cases in the country.

Government's response to the crisis

The Indonesian government put together a number of stimulus measures, including a reduction in the rate of corporate income tax from 25% to 22%, a loan restructuring moratorium for affected micro-loans for businesses, a postponement of loan and lease payments, and accelerated value-added tax refunds.

Key measures taken by banking regulators

Measures	How?	Outcome
Deferral of loan repayment	In March 2020, the Financial Services Authority of Indonesia (OJK) announced a policy of allowing a one-year postponement to March 2021 of payments on loans and leases (for loans up to IDR 10 billion) for MSMEs and informal workers The policy was subsequently extended for another year by the OJK and will apply until March 2022.[104]	The temporary financial relief allows borrowers to ease their cash flows difficulties and provides financial institutions with more time to mitigate and manage potential losses. As of 30 November 2020, the total value of restructured loans under the programme stood at IDR 951.2 trillion.[105]
Easing credit classification / IFRS 9 staging criteria	Restructured loans are allowed to continue to be classified as current.	The incentives have helped keep the aggregate NPL ratio below the regulator's threshold of 5%. However, banks relying heavily on this policy could face a spike in NPLs once it comes to an end.
Lowering reserve requirements	Bank Indonesia has lowered the reserve requirement ratio for banks that provide loans to export-import companies, SMEs, and other prioritised sectors in order to provide more liquidity.	As of November 2020, around IDR 682 trillion had been injected into the banking sector, mainly through the reduction in the reserve requirement.[106]
National Economic Recovery (PEN) programme	In May 2020, the government launched the National Economic Recovery programme to help state-owned entities and the banking sector.	Bank Indonesia allocated IDR 87.59 trillion of funds to several banks to support the MSMEs loan restructuring programme.
Policy rate cuts	Bank Indonesia cut the interest rate five times during 2020 to a record low of 3.75% and urged banks to follow by reducing their lending rates.	The rate cut should boost loan growth and economic recovery. However, the lower lending rates are likely to affect the profitability of banks.

Source: Central banks and Deloitte research of public data

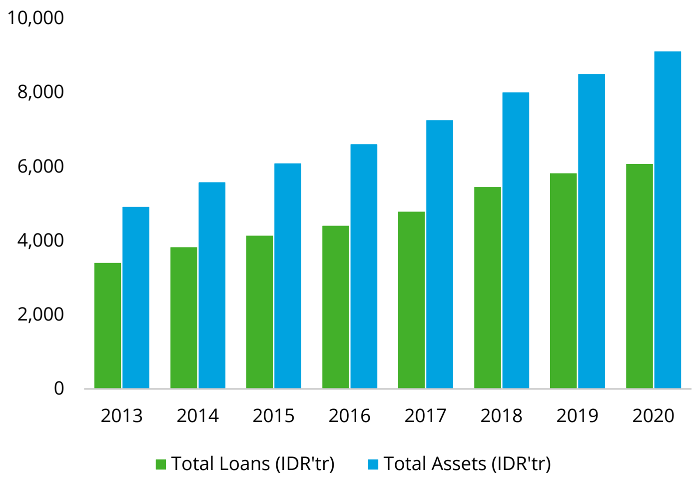
The government's credit relaxation policies and additional have started to pay off: economic performance picked up in Q3 2020. However, the extension of the debt payments moratorium may increase the latent credit risks for some banks once the state support measures are lifted.

Banking landscape

At the end of 2019, there were 109 commercial banks and over 30,700 branches in the Indonesian banking sector.[107] However, more than half of the total banking assets are concentrated in the top five players. To diversify the competitive landscape, the OJK eased its rules in 2019 to allow foreign companies to acquire more than a 40% stake in local banks. The relaxation subsequently led to an uptick in M&A activities, driven mainly by foreign investment.

Loan grew by 4.4% in 2020, however this growth rate is the lowest since 2014. This was mainly due to a weak consumer spending amid the continuing uncertainties during the pandemic. Fitch Ratings forecasted that loan growth rate would recover to 5.0% in 2021, driven by the gradual return to normal economic activity. However, this forecast growth rate is significantly lower than the pre-COVID average annual rate of 14.5% between 2009 and 2019.[108]

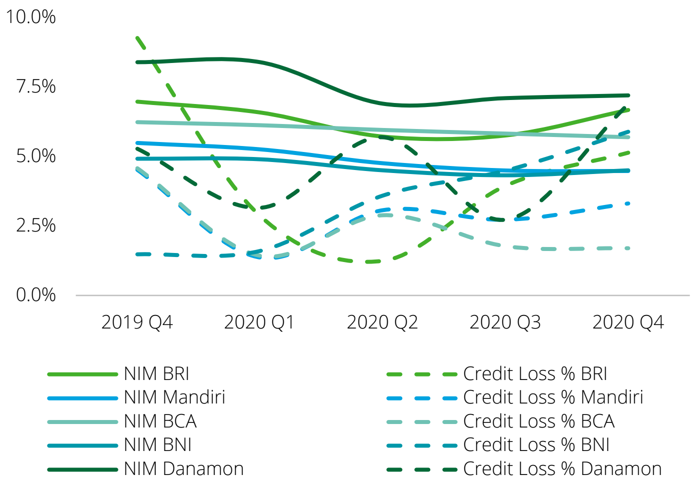
Banking System Assets (IDR'tr)



Source: Bank Indonesia

Indonesian banks rank as the most profitable in the region, with an average NIM of 4.5%[109], although this is lower than the average of 5% in previous years. However, with lower interest rates and slower loan growth, together with increasing credit costs and implementation of the loan forbearance policy, the profitability of the top banks fell throughout 2020, with the biggest fall in Q2. For example, the NIM of BRI fell by showed a 0.9 percentage points in Q2 2020 – the worst among the top five banks. Although the bank's NIM improved slightly in Q3 2020, it was still much lower than its NIM in previous years, which was in the range of 6.5% -7.0%.

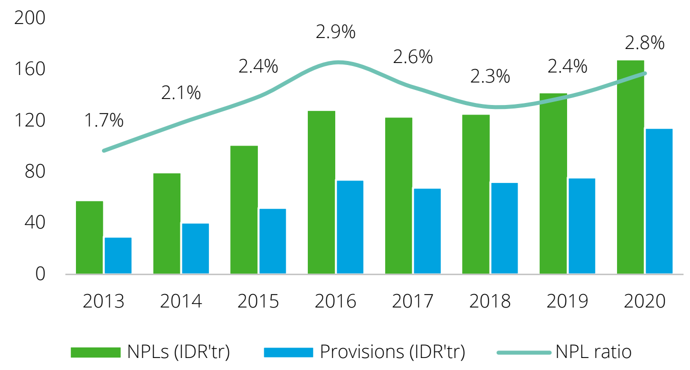
NIM & Credit Loss (%) - Top Banks



Source: published financial accounts as of Nov 2020. * annualised % of gross loans

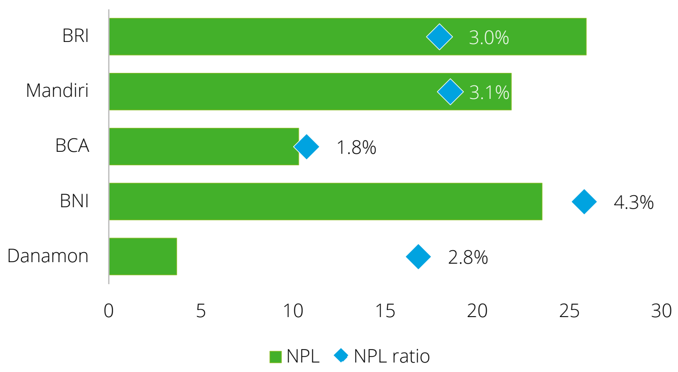
Like other countries in the region, extended state support, relaxed accounting rules and the general uncertainty around COVID-19 have obscured the real financial situation across Indonesian banks.[110] According to Fitch Ratings, the average NPL ratio increased marginally to 3.1% in H1 2020, the highest level since 2013, although it fell back slightly to 2.75% in December, compared to 2.5% at the end of 2019. Credit costs have risen to about 2% of gross loans, up from 1.4% in 2019. Almost 18% of total loans have been restructured following the regulatory forbearance measures (compared to 5% in 2019). The market consensus is that these restructured loan are likely to deteriorate as soon as the government support ends[111].

Banking System NPLs (IDR'tr)



Source: Bank Indonesia

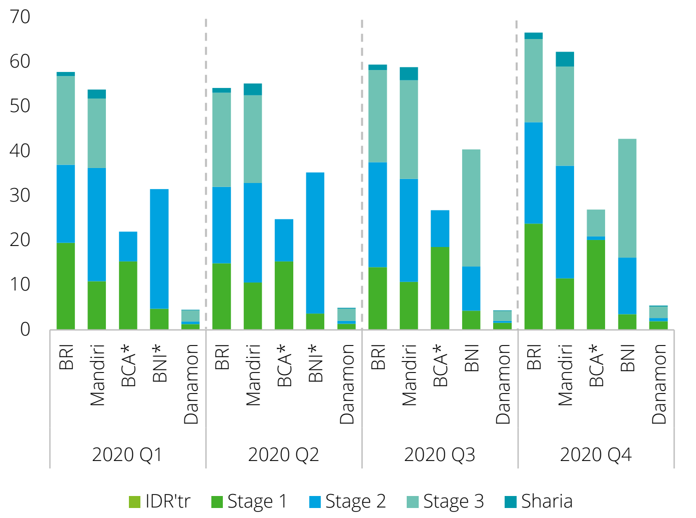
Gross NPLs (IDR'tr) - Top Banks



Source: published financial accounts as of Nov 2020

Due to the relaxation of credit classification rules, the distribution of expected credit loss (ECL) by stages remained largely unchanged for the top banks during the first nine months of 2020, although there was an increase in ECL for Stage 2 and 3 loans for some banks in Q3 and Q4.

ECL by Stages (IDR'tr) - Top Banks



Source: published financial accounts as of Nov 2020 *BCA and BNI only disclose the combined ECL for Stage 2 and Stage 3 since Q1 2020

Banks in Indonesia are generally well capitalised with sufficient capital to absorb potential losses caused by COVID-19. The average CET 1 ratio for Indonesian banks is among the highest in the SEA region.[112] The implementation of IFRS 9 on 1 January 2020 resulted in a one-time reduction in banks' equity and lower capital ratios in Q1 2020.However , the CET 1 ratios of the top five banks are still well above the 12% regulatory requirement. (BCA's ratio, showing the highest at 25.9%, was the highest as of November 2020.)

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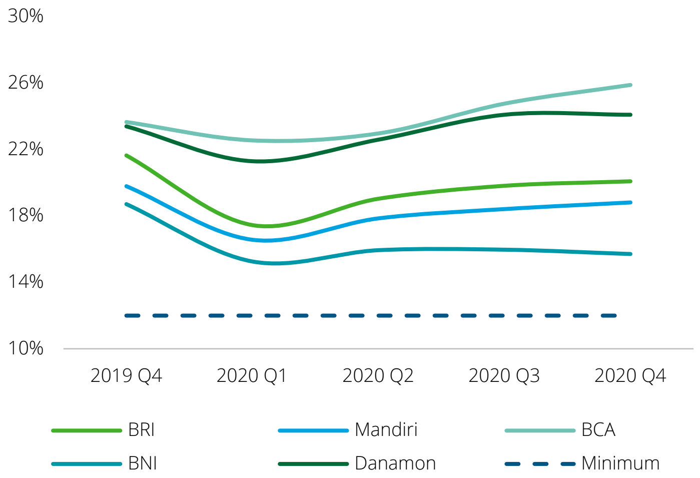
CET 1 Ratio (%) - Top Banks



Source: Published financial accounts as of September 2020

As a result of the government's policy to promote consolidation among banks, M&A activity in the banking sector is increasing following a relatively quiet period between 2009 and 2018. Foreign banks have acquired stakes in several local banks, betting the potential that exists in Indonesian banking. However, some foreign banks are revising their strategies in the market, following unsatisfactory performance. In December 2019 the Dutch lender Rabobank was reported to have sold its local unit to Bank Central Asia, the third-largest bank and the largest private lender in Indonesia.[113] And Taiwan-based Cathay Life Insurance is considering the acquisition of a majority stake in Bank Mayapada to take control, , following the recognition of a USD 298 million loss on the investment.[114]

Further consolidation in the sector is expected following the issue of new rules in March 2020 by OJK on compulsory consolidation in the banking sector to safeguard financial stability amid COVID-19.[115]The rules require all local banks to have Tier 1 capital of at least IDR 3 trillion by the end of 2022. Therefore, smaller banks may be forced into M&A transactions due to the stringent capital rules, as they continue to struggle with liquidity and revenue growth during the pandemic.[116]

Islamic finance

Islamic finance in Indonesia is expected to grow at a faster rate than conventional banking[117], supported by OJK's revamped five-year framework which was introduced in 2019, to strengthen regulations and corporate governance and give a boost to Sharia-compliant products.

As at the end of June 2020, there were 14 sharia commercial banks with over 1,900 offices and 162 sharia rural banks with over 600 offices.[118] Total sharia banking assets amounted to IDR 531.8 trillion, representing 6% of total banking sector assets. Like conventional banks, Islamic commercial banks in Indonesia have a strong capital base. Their average CAR stood at 21.2% as of Q2 2020.

Consolidation is also encouraged in Islamic commercial banking. A three-way merger between PT Bank BRI Syariah Tbk, PT Bank Syariah Mandiri and PT Bank BNI Syariah was completed in February 2021, which has merged to become PT Bank Syariah Indonesia Tbk. ("BSI"). The merger created Indonesia's seventh-largest bank, with assets of around IDR 236trillion[119].

NPL landscape and market development

At the end of Q4 2020 total NPLs stood at IDR 168 trillion, an increase of 18% from Q4 2019. Over half the NPLs for banks were concentrated in the wholesale and retail sector (where NPLs increased by 20.3%) and the manufacturing sector (where NPLs increased by 13%).

As SMEs and corporates face liquidity issues amid the pandemic, more than half of the NPLs related to relatively short-term working capital lending.

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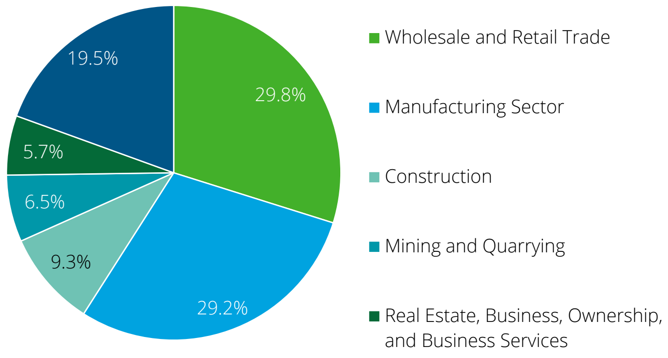
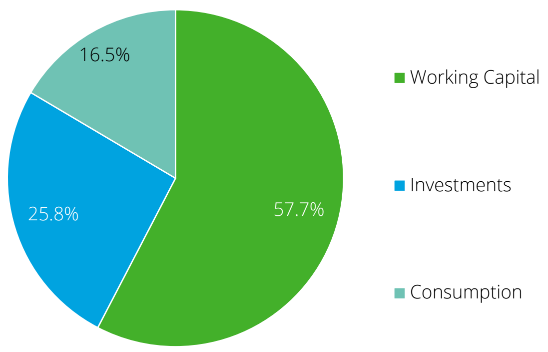
NPLs by Sectors (IDR'tr)



Source: Bank Indonesia

NPLs by Purpose (IDR'tr)



Source: Bank Indonesia

The potential revival of the National asset management company

The first national AMC in Indonesia, the Indonesian Bank Restructuring Agency (IBRA), was established in 1998 during the AFC. It was closed down in 2014, but PT Asset Management Company (Persero) (PPA) was set up to manage the assets of the former IBRA. PPA is now looking to become a national AMC by 2024, leveraging its experience in managing NPLs for banks and through collaboration with KAMCO.[120]

Characteristics of the NPL market and legacy issues

NPLs in Indonesia are held mainly by state-owned banks and loan portfolio sales are subject to certain regulatory restrictions. These are a critical impediment to participation in the Indonesian NPL market. Almost all recently traded loan portfolios were therefore sold by foreign or private banks.

In our last two deleveraging reports, we identified several key issues in the NPL market in Indonesia which are still relevant today:

Key considerations for loan sales

Issues	
Legal enforcement process	Regulators do not provide recommendations on NPL management and approaches to deposition. There is some uncertainty around legal enforcement procedures and portfolio transaction regulations. The two main avenues for insolvency in Indonesia are bankruptcy and suspension of debt payments (known as PKPU). Both are relatively easy to initiate, but due to the lack of a comprehensive legal framework and extended timelines, they are not creditor-friendly in practice.
Regulatory requirements	There are restrictive regulations on the sale of NPLs by state banks – in 2012, the Indonesian Constitutional Court issued a ruling preventing state banks from restructuring or selling NPLs at a discount.
Servicing options	There are limited servicing options in the market due to a lack of specific government guidelines around licensing requirements, which makes it difficult to establish a servicing company.

A continuation of the increase in activity in the Indonesian NPL market in recent years will create more opportunities going forward as banks, especially state-owned and policy banks, look to dispose of their NPLs as they come under increasing pressure for resolution. Since 2019, banks have been exploring alternative options to deleverage. A number of methods have been used by local banks to resolve NPL issues, including portfolio sales, onshore/offshore Special Purpose Vehicles, and AMCs, and investors have shown an appetite for NPLs fuelled by successful transactions in recent years. We expect Indonesia to remain a hotspot in SEA for distressed asset investors.

Vietnam

Macroeconomic landscape

The impact of the pandemic in Vietnam has not been as serious as in many other countries, thanks to countermeasures implemented by the government with strong public support. Estimated GDP growth for 2020 is 2.9%, much lower than the growth rate of 7% achieved in 2019. Although modest, the growth in 2020 is encouraging, considering that Vietnam is one of the few countries to achieve positive growth in 2020: on average, the GDP of its peers in the region fell by 1%.

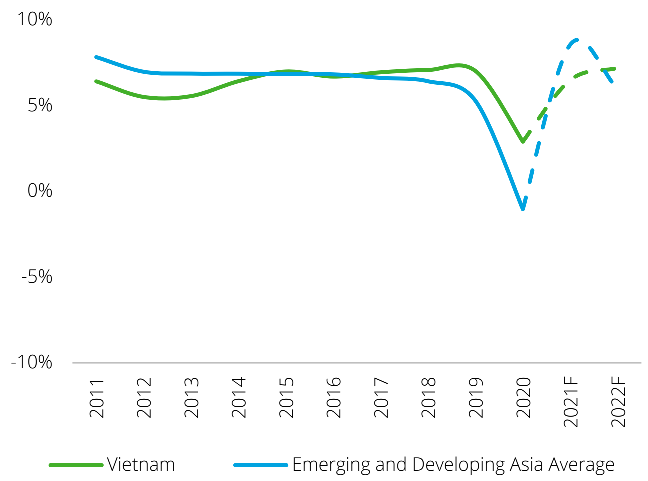
The first known case of COVID-19 in Vietnam was reported in January 2020. The impact on the economy therefore happened relatively early as compared to most of other countries. Initially, major business sectors were severely hit, with the GDP contracting in Q1 2020; but Vietnam was one of the few countries that started to show improvement in Q2 2020, after the government lifted the national lockdown in April. The economy is on track for recovery in its manufacturing, construction and services industries. The main driver of the economic growth is the manufacturing sector, which contributed 18.7% to total GDP in Q4 2020.

The tourism sector was the worst affected in 2020 with business revenues plunging by 58.7%. Even though domestic travel recovered rapidly, continuing restrictions on international travel are expected have an adverse impact. The number of international visitors was down by 80% in 2020 compared to the previous year.[121] In the third quarter of 2020, they accounted for only 1.2% of the total number of tourists: in comparison, in the first quarter of 2020 this percentage was as high as 97.3%.[122]

In 2020, the trade surplus at USD 19.1 billion reached its highest level in five years, making exports a bright spot in the economy. China was Vietnam's largest export market (with turnover of USD 83.9 billion) followed by South Korea (USD 46.3 billion).[123]

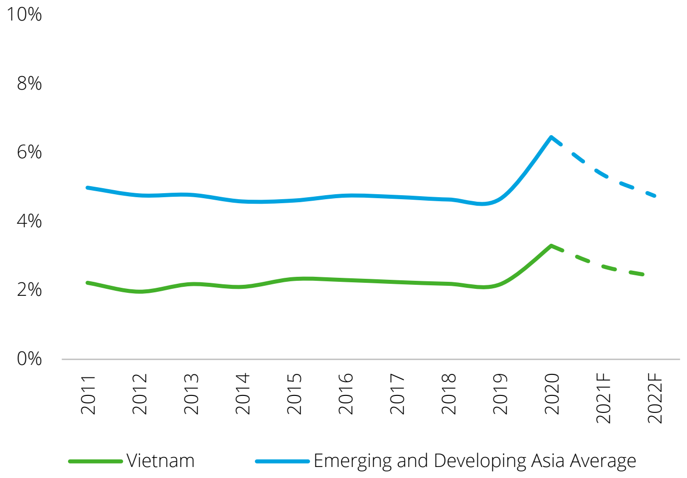
The unemployment rate was affected significantly by the social distancing and lockdown measures imposed by the government to curb the infection rate. According to the General Statistics Office (GSO), in November 2020 the number of enterprises suspending business for a period of time was 44,000, an increase of 59.7% compared to the same period in the previous year.[124] A a consequence of the 32.1 million workers (aged 15 or above) either lost their jobs or had their working hours reduced. The total labour force shrank by 0.8. million in 2020, to 55.1 million.[125] IMF forecasted the unemployment rate in 2020 to be 3.3%, the highest level since 2012, although lower than the 4% target set by the National Assembly.

Real GDP Growth (%)



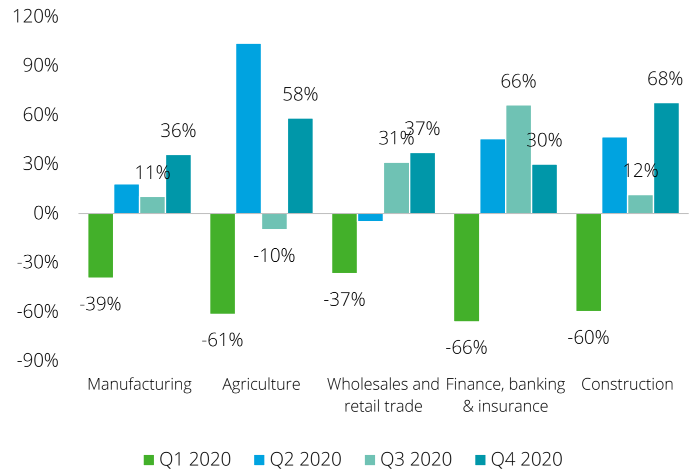
Source: International Monetary Fund (F = forecast)

Unemployment Rate (%)



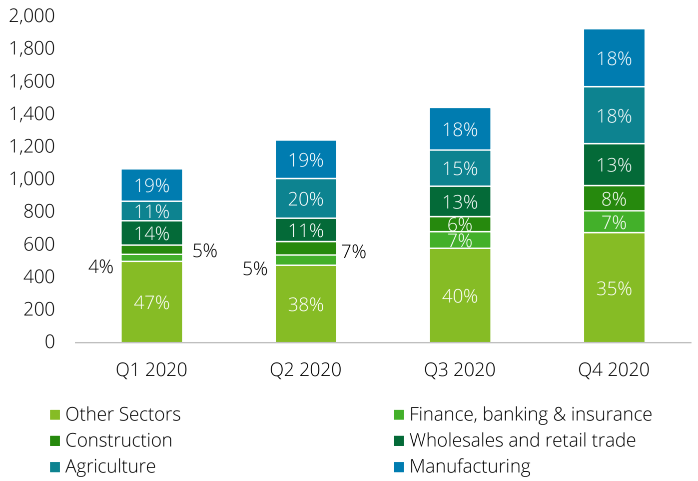
Source: International Monetary Fund (F = forecast)

Key Sector GDP Growth (Q-o-Q %)



Source: General Statistics Office of Vietnam

GDP by Sectors (VND'tr)



Source: General Statistics Office of Vietnam

The IMF forecasts that the Vietnamese economy will recover gradually, with GDP growth of 6.7% in 2021 and 7.4% in 2022, in line with a slow recovery in external demand in its major markets (including tourism services, which will lag behind the recovery in goods exports).

Government response to the crisis

The government issued a first stimulus package in April 2020, targeting households and small businesses as well as to shore up demand in the economy. This package was worth VND 181.4 trillion (equal to 3% of the country's GDP in 2019) and included a fiscal support package (VND 73.1 trillion), a monetary and credit support package (VND 36.6 trillion), a social welfare package (VND 62 trillion) as well as price support for power and telecommunications services. The government has proposed a second stimulus package to focus on the most affected sectors, such aviation and tourism. It has also proposed extensions to previous incentives in the first

package, for enterprises operating in affected sectors, such as delayed tax payments and reduction in land use fees.[126]

The table below presents key measures relevant to the banking sector:

Key measures taken by banking regulators

Measures	How?	Outcome
Loan repayment extension/ restructure loans	The State Bank of Vietnam (SBV) issued Circular 01/2020/TT-NHNN requesting commercial banks to delay, extend deadlines, or reschedule debt payments for loans, and to reduce/waive interest charges and fees, for businesses affected by COVID-19.	As of 14 September 2020, credit institutions had rescheduled debt payments for over 271,000 customers accounting for VND 331 trillion (3.8% of total bank assets), and waived or reduced interest rates for some 485,000 others. Since January 2020, local banks have offered new loans with preferential rates to 310,000 customers.
Interest rate reduction	The SBV cut its policy rate three times in 2020 to boost lending amid slower credit growth due to the COVID-19 pandemic.[127]	Lower interest rates have not had a major impact on the economy as businesses were having troubles accessing credit because they could not prove their repayment capabilities amid the pandemic. According to the SBV, credit growth in the first eight months of 2020 fell to a seven-year low of 4.8%.
Lending cap easing	Under the circular issued in August 2020, the SBV loosened the lending cap for mid-and long-term lending using the short-term funding in order to keep implementing preferential interest rate policies and maintain a stable medium- and long-term debt for customers. The SBV's decision would help banks apply the maximum rate of short-term funding for medium- and long-term loans[128]. The cap rate of 40% is applicable until September 2021.	Up to 30 September 2020, the growth in credit was approximately 6 percentage points less than the originally planned 11-14% for the whole year[129], yet better than the actual growth rate of 2% in the first six months. The SBV estimated that credit growth in 2020 as a whole would be around 8%-10%. Due to the impact of the pandemic, banks are tightening lending standards across the board. Coupled with weakening demand for credit demand, this had the effect of holding back credit growth in 2020.

Measures	How?	Outcome
Relaxation of credit classification	The SBV has allowed banks not to declare debts related to COVID-19 as bad debts. This will therefore delay some provisioning for bad debts until 2021.	Under the relief, few banks have achieved year-on-year pre-tax profit growth of more than 20% for H1 2020 by delaying provisioning for doubtful debts, despite previous forecast that pandemic could adversely impact their profitability[130] The reported performance of banks performance may not be greatly affected in 2020. However, increased credit costs in 2021 will eventually reduce profitability.

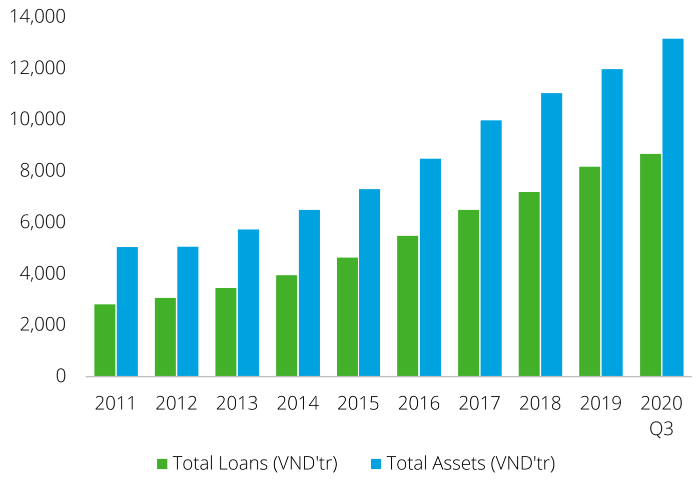
Source: Central banks and Deloitte research of public data

Banking landscape

The Vietnam banking sector is small in terms of loans and deposits, compared to other countries in the region. The four largest state-controlled banks – Bank for Investment and Development of Vietnam (BIDV), Vietnam Bank for Agriculture and Rural Development (Agribank), Vietnam Bank for Industry and Trade (Vietinbank), and Commercial Bank for Foreign Trade of Vietnam (Vietcombank) — are the key players in the local market, together accounting for about 43% of total assets in the sector. The country's joint-stock commercial banks, either listed or private, are mostly smaller lenders. Assets held by these banks were 41.4% of overall banking assets at the end of 2019. Joint-venture and foreign banks are the third main category, comprising 10.7% of sector-wide assets at the end of 2019. The remaining banks are policy banks such as the Vietnam Development Bank, finance and leasing companies, and co-operative banks.

After several years of double-digit growth, the loan growth stagnated in 2020. Outstanding loan balance increased by 4.8% during the first nine months of 2020[131], the lowest in six years and far below the 11-14% target range. Fitch Solutions estimated that credit growth in 2020 would be only 7%, down from the 12-18 % achieved in the previous few years.[132] Despite a short-term dip in 2020 due to the impact of the pandemic, loan growth is likely to continue at a robust pace, with the SBV targeting a growth rate of 12% in 2021.[133]

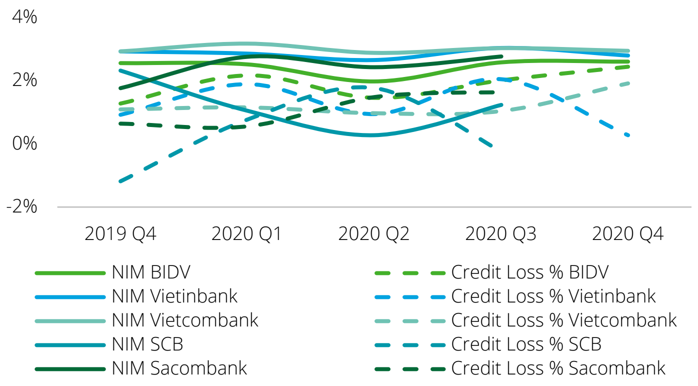
Banking System Assets (VND'tr)



Source: State Bank of Vietnam, as of September 2020

The quality of banks' earnings diminished following outbreak of COVID-19. The NIM of the top five banks in Vietnam fell in H1 2020, but recovered slightly in Q3 on the back of an improving economic outlook, with an average NIM of 2.5% across the top banks. Banks also started to make higher credit provisions in Q3 2020 to reflect deteriorating asset quality on the back of weak economic growth in 2020. However, research suggested that the impact of COVID-19 on provisions has not yet fully materialised, as banks have mostly kept 'normal' loans benefiting from the government's relief scheme.[134]

NIM & Credit Loss (%) - Top Banks

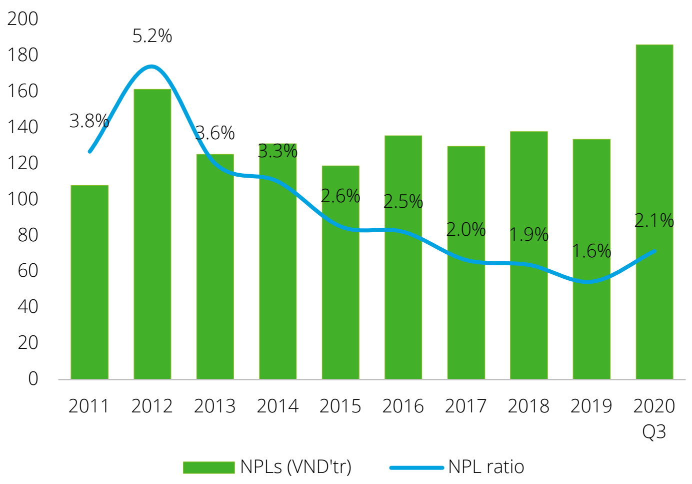


Source: Published financial accounts as of December 2020 *annualised % of gross loans

Agribank, a state-controlled bank, is the second-largest bank in terms of assets. However, as quarterly financial information is not available, it is excluded from our analysis. Year end data not available for SCB and Sacombank

Because of the pandemic, NPLs rose sharply in the first nine months of 2020. According to the SBV, the NPL ratio on the balance sheets of credit institutions in Vietnam increased from 1.63% in December 2019 to 2.14% in September 2020. Rong Viet Securities (VDSC) estimated that the NPL ratio for banks, excluding loans sold to Vietnam Asset Management Company (VAMC), to be about 2.4% at the end of 2020, increasing to over 3% in 2021.[135] The delay in recognising bad debts may keep the NPL ratio below 3.0% in 2020. As of September 2020, the total amount of NPLs in the banking system increased by 26% from 2019 to a decade high of VND 186.1 trillion. 14 out of 16 commercial banks saw their bad debts surge by about 30% in the first nine months, and losses are expected to increase further if the economy continues to suffer from the pandemic.[136]

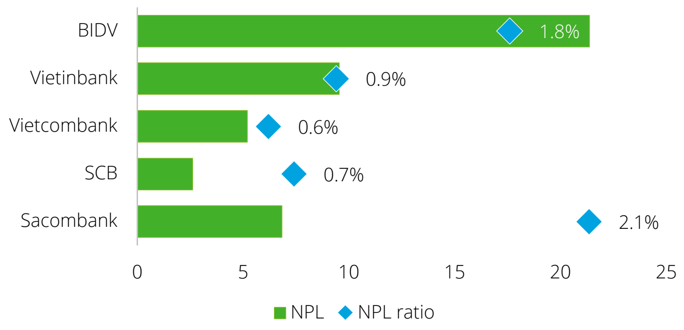
Banking System NPLs (VND'tr)



Source: State Bank of Vietnam, as of September 2020

Among the top banks in Vietnam NPL balances at BIDV, VietinBank and Vietcombank jumped by 34% or VND 12.3 trillion in the first nine months of 2020[137], with the increase particularly large in the third quarter. VietinBank recorded the biggest rise of VND 7.7 trillion, 66% higher than at the start of the year. Overall, NPL ratios across the top banks are below 3%, with Sacombank having the highest ratio at 2.1%.

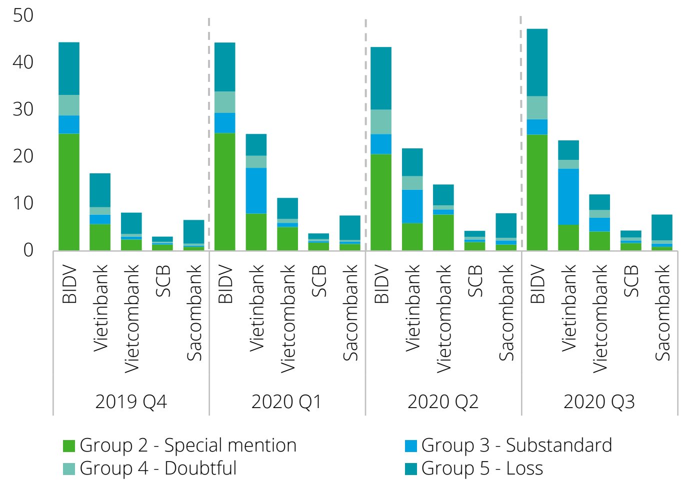
Gross NPLs (VND'tr) - Top Banks



Source: Published financial accounts as of September 2020

The distribution of gross loans by risk classifications across the top banks remained largely unchanged from quarter to quarter in 2020, due mainly to the relaxation of credit classifications for COVID-19 affected borrowers.

ECL by Stages (VND'tr) - Top Banks



Source: Published financial accounts as of September 2020

The SBV has made efforts in the past to encourage consolidation in the banking sector, to use the balance sheets of healthier lenders to support weaker banks. A number of M&A deals were approved in 2015. However, there has not been any significant M&A activity in the sector during the past two years. Nevertheless, some foreign investors are reported to be interested in buying them.[138] The most notable recent deal was the acquisition of a stake in BIDV by the South Korean lender Hana Bank in November 2019. M&A activity is expected to pick up in 2021 as local banks – especially smaller capped ones – are looking for more capital to improve their performance.[139]

NPL landscape and market development

The NPL market is dominated by the state-owned VAMC, which was set up in May 2013 to tackle bad debt issues in the banking sector in Vietnam. To create favourable conditions for VAMC to resolve NPLs, the government in 2017issued the National Assembly's Resolution No. 42/2017/QH14, which granted VAMC more autonomy in operations, and support from SBV and other authorities in the debt resolution process. As a result, the total amount of recovered debt had increased from VDN 29 trillion in 2017 to VDN 126 trillion in 2019.

The accumulated bad debts acquired by VAMC had reached VND 329 trillion as of August 2020.[140] 2020 was the final year for VAMC to resolve bad debts acquired from credit institutions, except for those purchased from weaker banks. 18 out of 27 banks had settled all outstanding NPLs with VAMC in the first nine months of the year.[141]

A number of banks have their own AMCs for NPL resolution. To encourage private sector participation, Decree No. 69/2016/ND-CP (Decree 69) seeks to establish a debt trading company (DTC) that can take part in debt trading, advisory and brokerage, as well as providing debt trading floors. To participate in debt trading, a DTC is required to have investment capital of over VND 100bn (USD 4.4m). Over 50 DTCs were operating in Vietnam in 2020, all locally incorporated and with no foreign capital involved.

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The SBV has recently approved a development strategy for VAMC, aiming to expand its operations as a centre for bad debts resolution.[142] VAMC is tasked with developing a debt exchange to promote the debt trading market in Vietnam. The initiative aims to attract both domestic and international investors who so far have remained reluctant to participate in NPL transactions. These developments present potential opportunities for buyers the Vietnam NPL market.

Characteristics of the NPL market and legacy issues

The table below summaries some issues of interest to foreign investors in the market.

Key considerations for loan sales

Issues	
Restriction on buyers	Foreign investors may be able to purchase directly NPLs and foreclosed collateral from banks, AMCs and VAMC; this is subject to certain land ownership restrictions. Under Land Law (2013), foreign investors are not allowed to own land use rights in Vietnam; but the State can lease rights to foreign-invested entities. Alternatively, foreign investors may buy shares in entities that have been restructured after the exercise of debt-equity swaps. Foreign ownership of companies operating in certain key sectors is capped at 49%. Although Resolution 42 states that the VAMC can sell NPLs to entities and individuals, there is a lack of guidance on the procedures for the purchase of NPLs by foreign investors. With few precedents in the market, the potential restrictions on foreign buyers and regulatory approval process remains unclear.
Licensing requirement	An AMC or DTC has to comply with the minimum legal capital and management requirements in order to register for NPL trading. To purchase NPLs, a foreign bank must register in Vietnam, obtain approval from the SBV, and maintain an NPL to capital ratio below 3%. In addition, foreign investors need an Investment Registration Certificate (IRC) and an Enterprise Registration Certificate (ERC) in order to register their business locally in Vietnam.
Legal enforcement process	Resolution 42 allows the use of expedited procedures on applicable cases for enforcement of security. Nevertheless, it is common for enforcement proceedings to run on longer than the statutory time limits, and a successful foreclosure of collateral through court proceedings can take from several months to several years, at great cost. When foreclosure is not feasible, there will be several rounds of auctions to sell the collateral at the highest price possible.
Lack of servicing capabilities	There are few professional servicers in Vietnam. Banks typically service NPLs in-house or through the use of their own captive AMCs. Foreign investors may need to rely on the originator of the loans for servicing, or co-operate with an established AMC.

Philippines

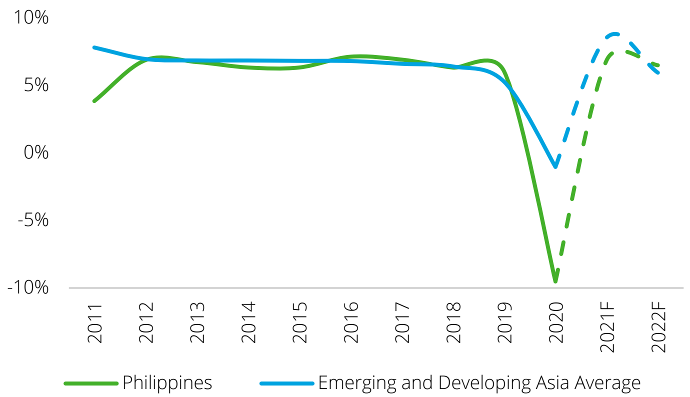
Macroeconomic landscape

The Philippines economy has been badly affected by the COVID-19 pandemic: the country recorded the largest quarterly contraction of 16.9% in Q2 2020 since 1981.[143] In April 2021, the IMF forecast that real GDP would contract by 9.5% in 2020, significantly more than the average contraction of 1.0% for countries in the region.

he country has struggled to combat the pandemic, as various quarantine measures are still in place in many regions. In 2020, all sectors saw a decline in business, except financial and insurance services. Accommodation and food service industries experienced the biggest decline of 63.6% in revenues in Q2 2020, although there was a slow recovery in Q3 and Q4. Manufacturing was overtaken by the wholesale and retail trade sector as the country's largest contributor to GDP in 2020 (PHP 3,300 billion).[144]

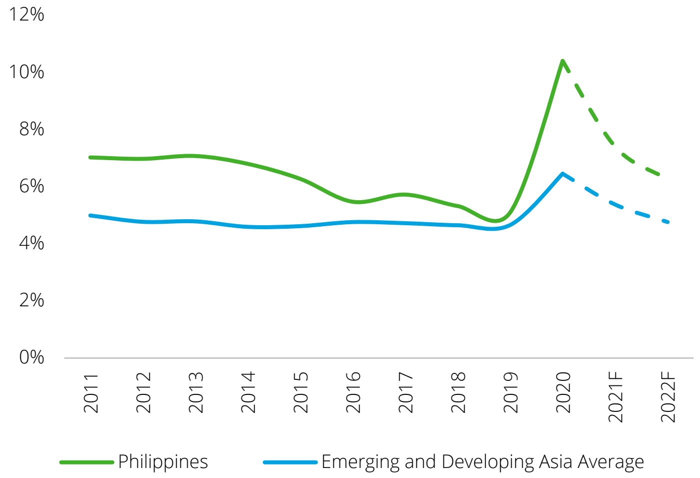
The estimated unemployment rate was 10.4% at the end of 2020, an improvement from 17.7% in H1 2020. However, this is still significantly above the regional average of 6.5%. Unemployment is expected to decline further as quarantine protocols ease, and the economy starts to recover.

Real GDP Growth (%)



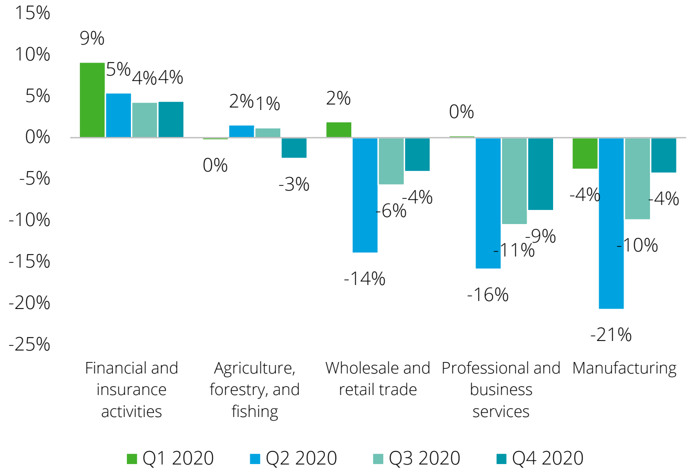
Source: International Monetary Fund (F = forecast)

Unemployment Rate (%)



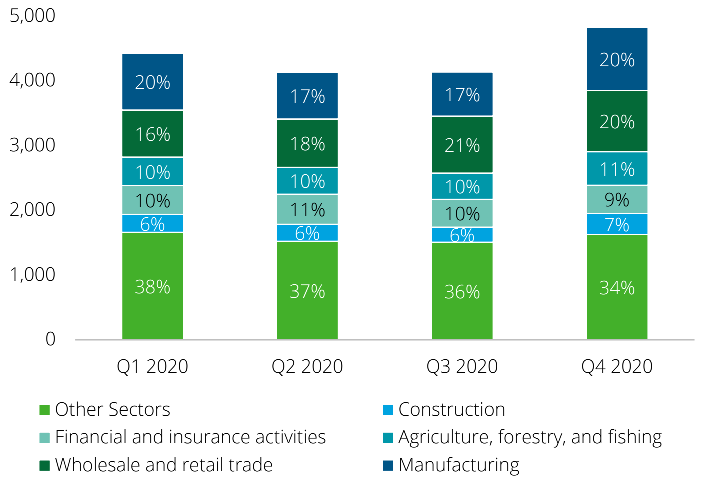
Source: International Monetary Fund (F = forecast)

Key Sector GDP Growth (Q-o-Q %)



Source: Philippine Statistics Authority

GDP by Sectors (PHP'bn)



Source: Philippine Statistics Authority

In addition to the health crisis, the country has also struggled with natural disasters, including typhoons in Q4 2020 which caused widespread damage in several areas. These are estimated to have resulted in a 0.2% reduction in the country's GDP or an economic loss of PHP 90.0 billion.[145]

The Asian Development Bank has estimated that the country's real GDP would contract by 7.3% in 2020, but rebound and grow by 6.5% in 2021, on the assumptions that the COVID-19 pandemic is contained, the economy reopens further, and various government stimulus plans are implemented.[146]

Government response to the crisis

In September 2020, the Philippines government introduced the Republic Act 11494, otherwise known as the Bayanihan to Recover as One (BARO) Act. This sets out various responses and interventions in response to the COVID-19 crisis, including a loan moratorium and the extension of the carry-over period for net operating losses.

Key measures taken by banking regulators

Measures	How?	Outcome
Loan payment moratorium	All financial institutions supervised by Bangko Sentral ng Pilipinas (BSP) should apply a 60-day mandatory grace period to all existing loans, i.e. current and outstanding loans with principal and/or interest, including amortisations, falling due between 15 September and 31 December 2020, without incurring any interest, penalties, fees or other charges. Lenders and borrowers are not precluded from mutually agreeing a grace period longer than 60 days.[147]	Immediate temporary financial relief for borrowers, easing their cash flow difficulties and providing financial institutions with more time to mitigate and manage potential losses. Additional risks for financial institutions, with delayed cash inflows adversely affecting their liquidity.
Extension of carry-over period for net operating losses incurred in tax years 2020 and 2021	Extension of carry-over period for net operating losses incurred in tax years 2020 and 2021 Net operating losses of businesses for tax years 2020 and 2021 to be carried over as a deduction from gross income for the next five consecutive years immediately following the year of loss.[148]	Additional tax incentives and deductions from the gross income of businesses, including financial institutions.
Other regulatory relief measures for banks and other financial institutions	Various regulatory relief measures for banks, including: • Staggered booking of allowances for credit losses over a maximum period of five years • Reclassification of debt securities measured at fair value to amortised costs • Exclusion of eligible loans from being classified as past due or non-performing, until 31 December 2021 • Relaxation of various reporting requirements.[149]	These measures are intended to reduce the impact of losses incurred by financial institutions and strengthen their ability to continue their operations.

Measures	How?	Outcome
Other regulatory relief measures for consumers	Various regulatory relief measures for consumers, including: • Relaxed Know-Your-Customer requirements • Banks encouraged to suspend fees and charges for online banking platforms.[150]	These measures are intended to help ease the burden on consumers and promote continued access to financial services.
Monetary policy measures	The cumulative reduction in policy rates totalling 200 basis points as of November 2020. The rates for overnight reverse repurchase, lending, and deposit facilities are at 2.0%, 2.5%, and 1.5% respectively as of November 2020.[151]	Reduction in rates will promote lending, boost economic activity and strengthen market confidence.

Source: Central banks and Deloitte research of public data

As the country's economy continues to struggle in the wake of the health crisis, the Philippine government has implemented the above measures with the aim of supporting the financial sector and promoting financing activity, while easing regulatory requirements on both banks and consumers. Although measures such as the loan payment moratorium may affect the banking industry negatively through a reduction in cash flows, the government's various initiatives are expected to boost economic growth and help mitigate the adverse impact of the pandemic.

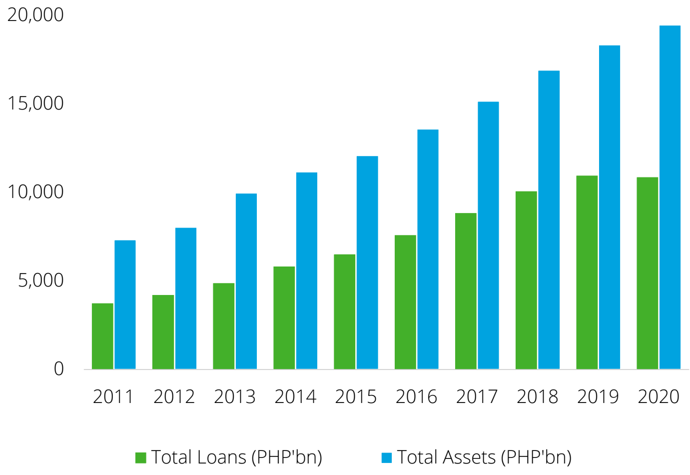
Banking landscape

Despite its relative lack of size and structural complexity in comparison to other countries, the Philippines banking industry was in a healthy financial position before the onset of the COVID-19 pandemic, with strong capital buffers and increasing profits. However, the banking sector was considerably affected by the consequences of the pandemic, with an increase in the number of defaults and reduced consumer and business demand for loans.

Between 2011 and 2019, total loans and total assets grew rapidly, at a compound annual growth rate (CAGR) of 14.3% in loans and 12.1% in total assets.[152] This growth was driven by a low interest rate environment, good asset quality, growth in the wider economy, and structural reforms, supported further by an influx of foreign banks. In 2014 a new law allowed foreign banks to access the Philippines market, with certain limitations. This has led to improved competition and efficiency within the banking sector.[153] As of the 2019 year-end, 29 foreign banks were operating in the country,[154] including the Industrial and Commercial Bank of China, the world's largest bank in terms of assets.

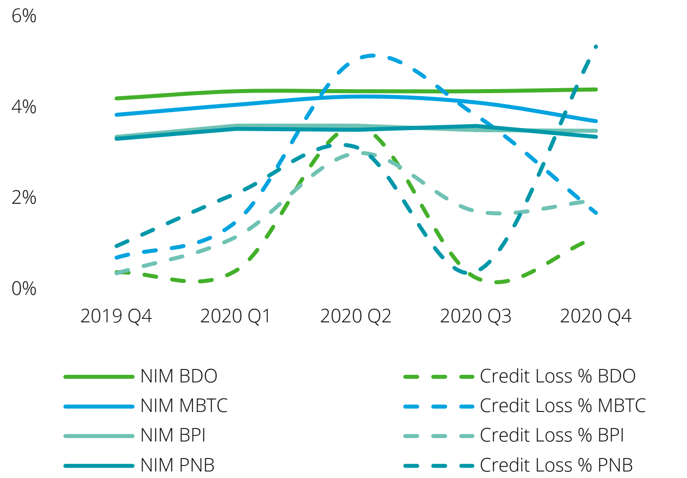
However, total assets growth decreased to 6.1% in 2020 while total loans were lower by 0.9% compared to the end of 2019.[155] This decline was due primarily to the economic recession in the country, along with tightened credit standards and borrower uncertainty.[156]

Banking System Assets (PHP'bn)



Source: Bangko Sentral ng Pilipinas

NIM & Credit Loss (%) - Top Banks



Source: Published financial accounts as of December 2020

In addition to being small in size, the Philippine banking industry is relatively concentrated. The top five banks accounted for 52.4% of total banking assets as of December 2020.[157] These top banks have remained resilient, reporting a similar net interest margins to Q4 2019, and with lower borrowing costs and improved funding mix to offset the lower yields on assets.[158]

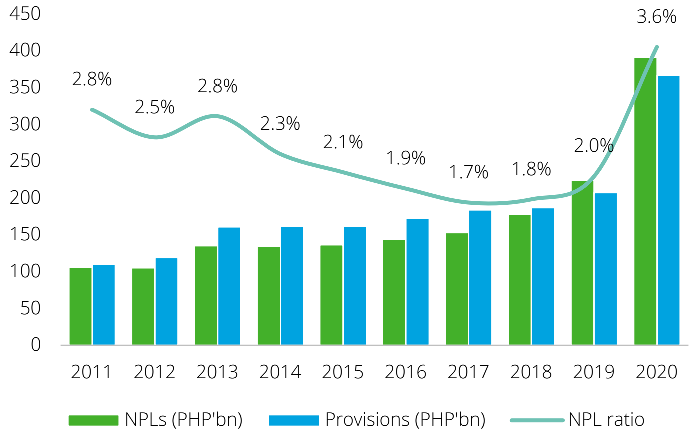
However, loan losses trended upwards during H1 2020. The top two banks in particular reported a surge in loan loss provisions between the end of 2019 and Q2 2020, by 131.7% at BDO Unibank and by 183.4% at Metropolitan Bank and Trust Company (MBTC).[159] The increase reflected macroeconomic forecasts predicting the continuing negative impact of the pandemic and the country's slow recovery. While the top banks reported a decrease in credit losses in H2 2020; Philippine National Bank recorded the biggest increase in credit losses among the top banks in Q4 2020, primarily due to the proactive approach to loan provisioning by the bank.

Total NPLs amounted to PHP 391.6 billion as of December 2020, an increase of 74.8% from the end of 2019.[160] The average gross NPL ratio stood at 3.6% in December 2020 lower than BSP's earlier prediction of 4.6%.[161] The sharp increase in bad loans over 2020 was a result of the economic fallout from COVID-19. Despite the moratorium and other measures implemented to support borrowers, asset quality is expected to continue deteriorating as the overall economy struggles to recover. However, the BSP does not expect the NPL ratio to reach the same level as in the wake of the 1997 AFC, when it peaked at 18.7%, due to the current strong capital position of banks, higher international reserves, and the government's stimulus measures.[162]

The NPL coverage ratio increased to 93% in December 2020, up from 92.6% as at the end of 2019[163] as banks continued to make provisions in anticipation of higher defaults when loan moratoriums expire and borrowers will be expected to settle their debts.

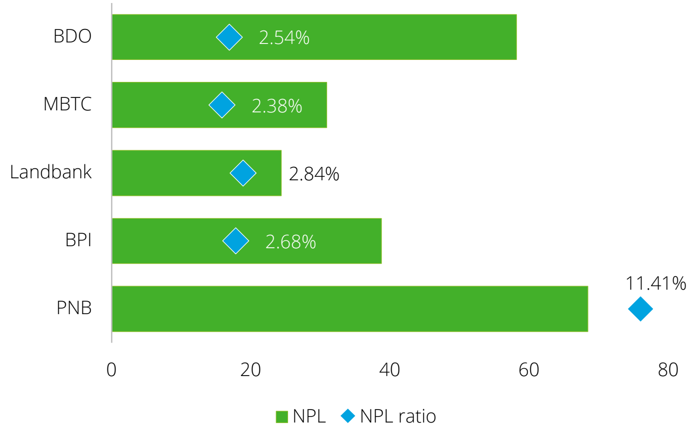
The top banks reported higher NPLs and NPL ratios in Q4 2020, in comparison to 2019.[164]

Banking System NPLs (PHP'bn)



Source: Bangko Sentral ng Pilipinas

Gross NPLs (PHP'bn) - Top Banks

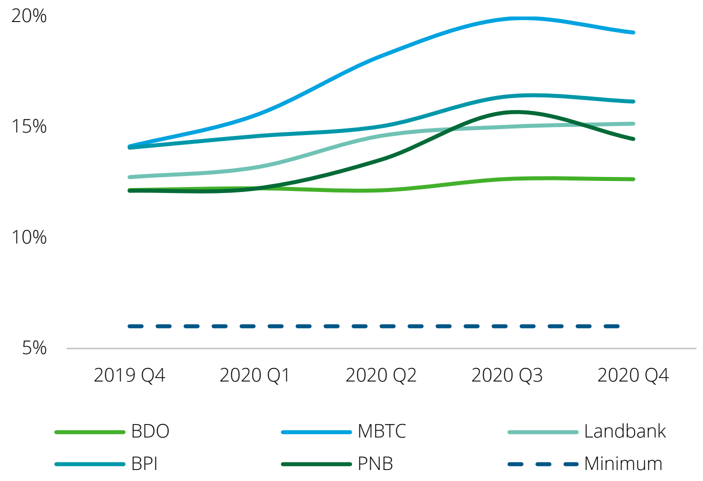


Source: published financial accounts as of December 2020

However, the capital position of the top banks remained strong, with CET 1 ratios ranging from 12.7% (BDO Unibank) to 19.3% (MBTC) as of Q4 2020,[165] well above the prescribed 6.0% minimum. The country's strong capital framework is reinforced by the BSP's strict requirements for a minimum CET 1 ratio of 6.0%, 7.5% for the Tier 1 ratio and 10% for the CAR. International standards only require minimums of 4.5%, 6.0%, and 8.0% respectively. These standards were put in place since as early as 2015.[166]

The banking sector as a whole maintains adequate capital ratios, with a CET 1 ratio of 14.1% and a CAR of 15.4% as of the end of 2019, and a capital to total assets ratio of 12.7% as of December 2020.[167]

CET 1 Ratio (%) - Top Banks



Source: Published financial accounts as of December 2020

In recent years, a trend in the banking sector has been towards the consolidation of many small lenders and rural banks, in an effort to improve financial inclusion, with a fall in the number of banks from 746 in March 2011 to 541 in June 2020.[168] This has been supported by the Consolidated Program for Rural Banks (CPRB), an initiative established by the BSP which ran from 2015 to 2019, with the goal of encouraging mergers and consolidations in the rural banking sector. The programme offered financial and regulatory incentives to banks in the same geographical area that merged. Although the programme was not renewed in 2019, the BSP is now contemplating a similar initiative.[169]

Examples of recent transactions include the merger of Rural Bank of General Trias, Rural Bank of Maragondon, Bangko Noveleta, and Sto. Nino Rural Bank (Ternate, Cavite) in October 2019; Producers Savings Bank merging with seven rural banks in June 2019; Producers Savings Bank acquiring PBCOM Rural Bank in July 2019 for PHP 555.8 million; BDO's subsidiary, One Network Bank, acquiring Rural Bank of Pandi in February 2019; and Union Bank's subsidiary, City Savings Bank, acquiring a 33.7% stake in Philippine Resources Savings Bank in February 2018 for PHP 837.2 million.[170]

NPL landscape and market development

The volume of NPLs is increasing. A surge in the first half of 2020 was driven primarily by borrowers in the real estate and wholesale and retail trade sectors, in addition to consumer loans to individuals and households (particularly, auto loans and credit cards).[171]

Non-bank institutions with quasi-banking functions reported an increase in gross NPLs to PHP 7.4 billion as of March 2020, and a corresponding increase in their gross NPL ratio from 4.7% in December 2019 to 5.4%. This increase was driven by a smaller loan portfolio base, as the industry exercised caution, and by an increase in litigation due to the pandemic. The NPL coverage ratio fell drastically, from 70.8% in December 2019 to 35.3% in March 2020.[172]

Examples of NPL transactions in recent years include restructuring company Collectius acquiring USD 50.0 million worth of credit card NPLs from a leading Philippine bank in June 2020,[173] and a sale by Rizal Commercial Banking Corp of PHP 4.8 billion of NPLs to a special purpose company owned by the International Finance Corporation (IFC) in 2012.[174]

The passage of the FIST Act

The NPL market in the Philippines has been relatively quiet, given banks' strong balance sheet positions and (before COVID-19), and only a few transactions were made over the past decade. However this is expected to change as the impact of the coronavirus has led to a sharp increase in NPL levels. In response to this, the Philippine government introduced the Financial Institutions Strategic Transfer (FIST) Act, which allows for the creation of bad banks known as FIST Corporations (FISTCs) and incentivises the transfer of NPAs and NPLs to FISTCs, and then to third parties. The FIST Act was approved by the Senate and issued in February 2021[175]. Government officials predict that the Act has the potential to protect the financial sector and accelerate the economic recovery.

Characteristics of the NPL market and considerations for loan sales

Below table summarises the key issues of loans sales regarding the NPL market in the Philippines:

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Key considerations for loan sales

Issues	
Restrictions on buyers	FISTCs must be at least 60.0% owned by Philippine nationals if acquiring land, and cannot be incorporated as a one-person corporation In addition, a transferring bank or other financial institution can own only up to 10.0%of a FISTC.
Legal enforcement process	The Securities and Exchange Commission is the primary implementing agency of the FIST Act, and may impose administrative sanctions on offenders.
Regulatory requirements	FISTCs must submit a FISTC plan, to be approved by the Securities and Exchange Commission, detailing investment policies and contribution plans. The transfer of NPAs will be subject to a Certification of Eligibility as an NPA by the appropriate regulatory body.
Tax considerations	FISTCs will receive various tax incentives, such as exemptions from income tax on net interest income, documentary stamp tax, and mortgage registration fees on new loans. The transfer of NPAs is also subject to tax incentives.
Servicing options	In addition to FISTCs that may be incorporated following the implementation of the FIST Act, international restructuring companies such as Collectius and Altus Capital currently operate in the market.

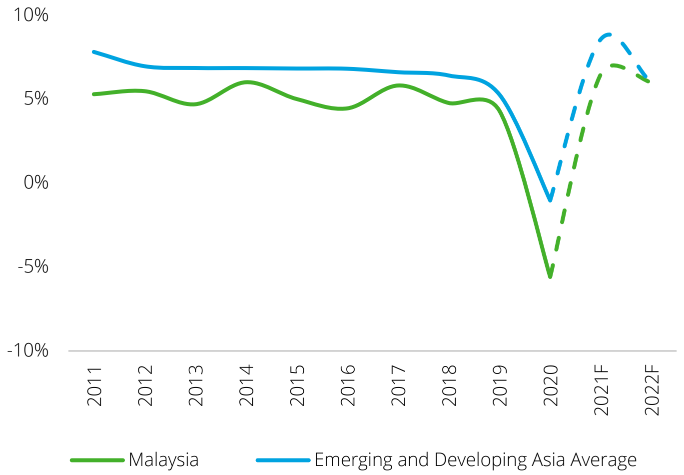
Although the NPL market in the Philippines has been relatively quiet historically, the expected increase in NPLs in the coming months, as moratoria expire and the economy continues to weaken, may trigger a rise in activity in the NPL market. And the implementation of the FIST Act might provide a stronger legal framework and incentive for NPL transactions.

Malaysia

With the continuing impact of COVID-19, Malaysia's real GDP contracted by 17.1% year-on-year in Q2 2020. This was the first contraction in GDP since it fell by 1.1% during the GFC (in Q3 2009).[176] Following the imposition of the government's Movement Control Order (MCO), all business sectors saw a decline in the first half of 2020. The construction sector recorded the biggest quarter-on-quarter decline of 42.2% in Q2 2020. Benefiting from the effectiveness of the MCO, the economy started to recover, with growth of 21.3% in Q3 (and a lower year-on-year fall of 2.6% in GDP). The improvement was evident across all major sectors. In particular, the manufacturing industry experienced a quarterly growth of 3.3% in Q3 and 9.0% in Q4 2020, driven largely by an upturn in trade activity in electricals and electronics.[177] The IMF estimated in April 2021 that the real GDP had contracted by 5.6% in 2020, below the average of 1.0% among other countries in the region.

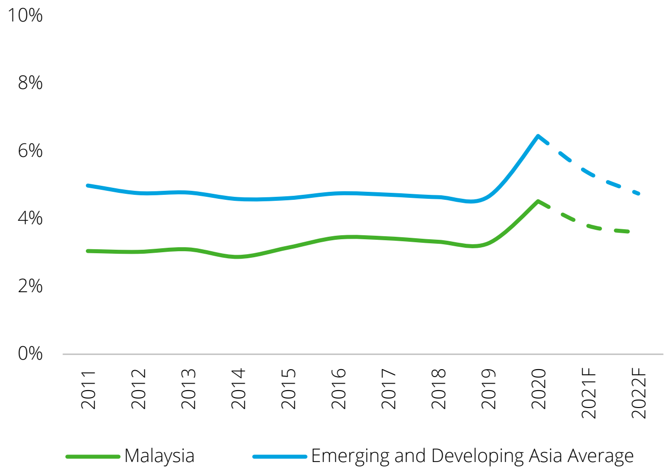
The unemployment rate increased to 5.1% in Q2 2020. This was is due largely to the country's aviation and hospitality sectors being hit badly by travel restrictions.[178] The rate fell slightly to 4.5% in Q4 2020, following a resumption in economic activity following the lifting of the MCO.[179] Any significant deterioration in employment conditions will adversely impact Malaysian banks as the household debt to GDP ratio stands at about 82.2% (about RM1.18 trillion),[180] the highest among ASEAN countries.

Real GDP Growth (%)



Source: International Monetary Fund (F = forecast)

Unemployment Rate (%)



Source: International Monetary Fund (F = forecast)

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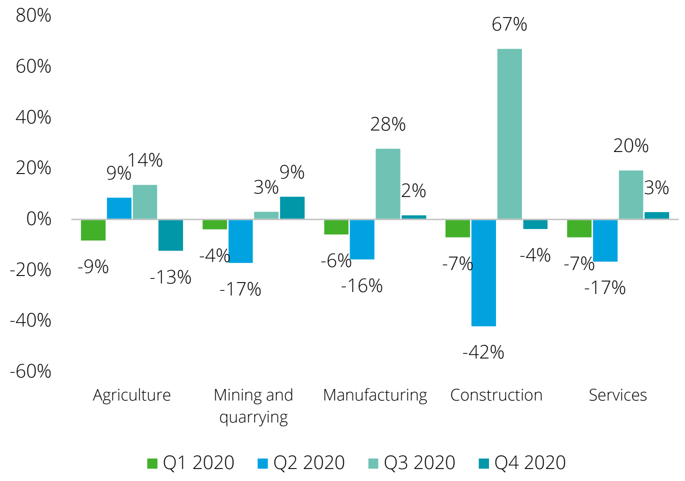
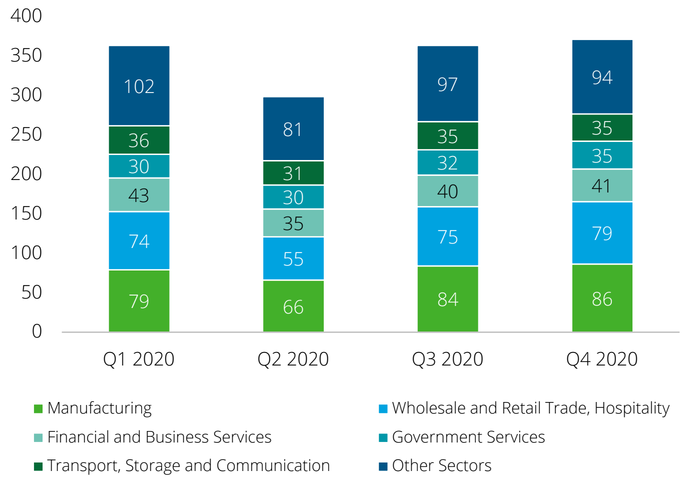
Key Sector GDP Growth (Q-o-Q %)



Source: Department of Statistics Malaysia

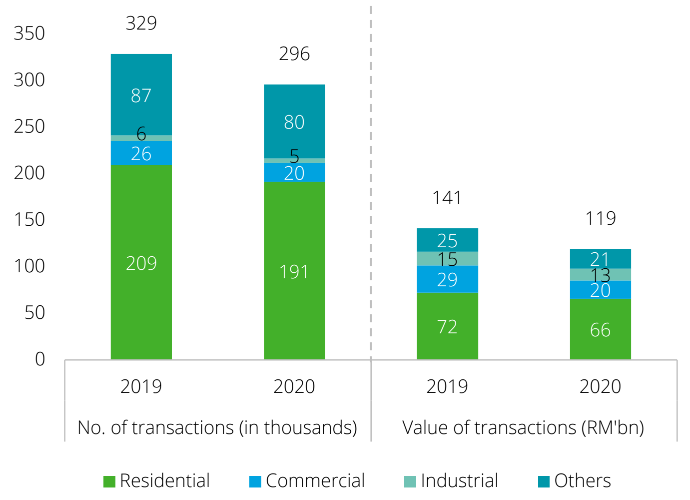
GDP by Sectors (RM'bn)



Source: Department of Statistics Malaysia

The Malaysian House Price Index (MHPI) showed decade-low growth in 2020, at 0.6%.[181] Activity in the housing market weakened during 2020 with both the volume and value of transactions in each type of real estate falling sharply.[182] The deterioration in the housing market poses a risk to Malaysia's financial stability as banks have high exposures to residential loans. The depreciation in values, together with borrowers' cash flow difficulties, increase the likelihood of loan defaults.

Property Sales (%y-o-y)



Source: Valuation and Property Services Department of Malaysia

The EIU expects the economy to recover gradually from 2021, but at a lower rate than before the pandemic.[183]

Government response to the crisis

A number of measures have been introduced by the government and banking regulator in Malaysia to cushion the fallout from the COVID-19 crisis:[184]

Key measures taken by banking regulator

Measures	How?	Outcome
Loan repayment moratorium	A six-month moratorium, from April to September 2020, was introduced to support individuals and businesses whose income had been impacted by the pandemic. Banks will provide a targeted moratorium extension and repayment flexibility after September2020 for borrowers who are still experiencing difficulties.	Immediate temporary financial relief for borrowers to ease their cash flow difficulties and provide financial institutions more time to mitigate and manage their potential losses. By 25 September 2020, about 840,000 borrowers had opted out of the moratorium scheme or resumed their repayments.[185]
Easing credit classification/IFRS9 staging criteria	Staging criteria should not include late payments made under the loan moratorium.	To support the moratorium programme. Banks' ECL model will be less effective under the relief and require adjustments on days past due (DPD) to assess Significant Increase in Credit Risk (SICR).
Lowering reserve requirement	Malaysia's central bank cut its statutory reserve ratio in March by 100 basis points to 2.00%.	RM 30 billion (USD 6.81 billion) of liquidity was released into the banking system, making more funds available for lending.
Reduction of Overnight Policy Rate (OPR)	Bank Negara Malaysia (BNM) cut the OPR four times in 2020 to help the economy to recover. The OPR was kept at a low level, and the effective rate was 1.75% in December 2020.	This reduced the burden of loan payments for businesses and households but reduced interest income for banks. The number of loan applications increased in the low-interest environment.
Establishing additional or enhancing existing financing facilities to provide relief and aid the recovery of SMEs as set out in Budget 2021	BNM announced plans to introduce various relief schemes and loan facilities to SMEs in targeted sectors (including high-tech), vulnerable sectors (including personal services, food and beverages, entertainment) and micro-enterprises covering gig workers and self-employed.	This is to support SMEs affected by the movement control order, and help sustain their business operations, safeguard jobs and encourage domestic economic activity.

Measures	How?	Outcome
Temporary measures under the COVID-19 Act 2020 which came into effect on 23 October 2020[186]	The government introduced temporary measures under this Act to support the Prihatin Rakyat Economic Stimulus Package, the Prihatin SME Economic Stimulus Package and the Short-Term Economic Recovery Plan. It will be effective for two years to mitigate the financial and social impact of COVID-19 . Key measures under the Act are: 1. The threshold for individual bankruptcy has increased from RM50,000 to RM100,000 2. No repossession of goods allowed under hire purchase agreements due to a default on instalment payments between 1 April and 31 December 2020 3. No legal proceedings allowed for recovery of debts under credit sale agreements entered into before 18 March 2020 (provided there were no overdue instalments prior to 18 March) 4. No distress proceedings allowed for rent arrears that occurred between 18 March and 31 August 2020.	This is to provide borrowers and tenants with some breathing space as they continue their day-to-day activities to generate income. It also reduces the number of legal actions taken against borrowers/debtors that have been impacted by the outbreak.

Source: Central banks and Deloitte research of public data

Malaysia's actions are considered pre-emptive measures in response to the pandemic, allowing both borrowers and financial institutions more flexibility to navigate their way through the difficult period. However, the measures had a negative effect on the performance of banks and masked the true extent of deterioration in asset quality. We expect greater clarity when the moratorium comes to an end.

Banking landscape

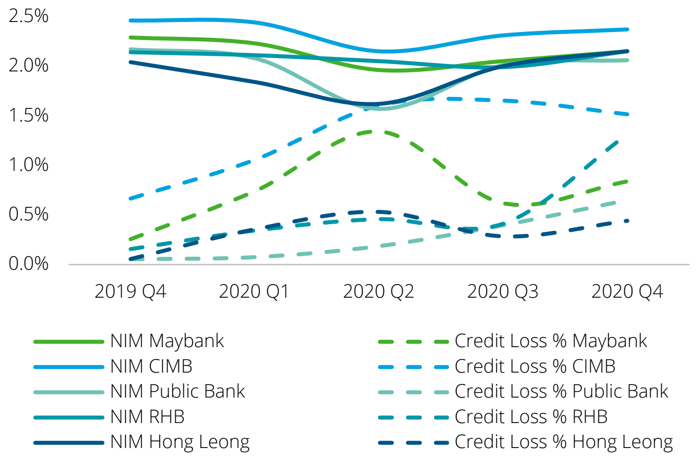
Malaysian banks are fundamentally strong, with low NPL ratios and credit costs, and sufficient capital buffers. However, as the economic conditions remain sluggish, the operating environment of Malaysia's banks has become more challenging with deteriorating asset quality and declining profitability.

Loan growth slowed down in 2019 and the first half of 2020. However growth subsequently picked up and reached a 14-month high of 4.5% [187]in July 2020, amid the attractive low interest-rate environment: this was driven mainly by demand for loans to purchase residential and non-residential properties (as per BNM statistics).

Banking System Assets (RM'bn)

Source: Bank Negara Malaysia

NIM & Credit Loss (%) - Top Banks

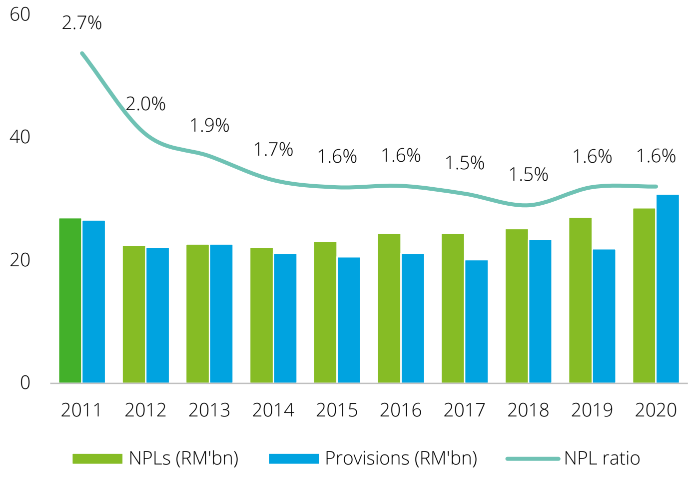


Source: Published financial accounts as of December 2020. *annualised % of gross loans

The top five banks in Malaysia reported a lower NIM in Q2 2020 compared to the corresponding quarter in 2019. This was due to a reduction in the OPR and higher provisions set aside for an expected increase in impaired loans after the moratorium period ends. The ratios climbed back in the second half of the year, however, towards the 2019 levels. Credit losses increased in Q2 across the large banks. For example, quarter-on-quarter increases in loan loss allowances in Q2 2020 were recorded by both Maybank (81%) and CIMB (52%). The spike occurred due to adjustments made for forward-looking assumptions and macroeconomic scenarios forecast in ECL model under IFRS 9, taking into account the continuous impact of the COVID-19 pandemic. BNM expects credit costs for Malaysian banks in 2020-2021 could rise to RM 29 billion.[188]

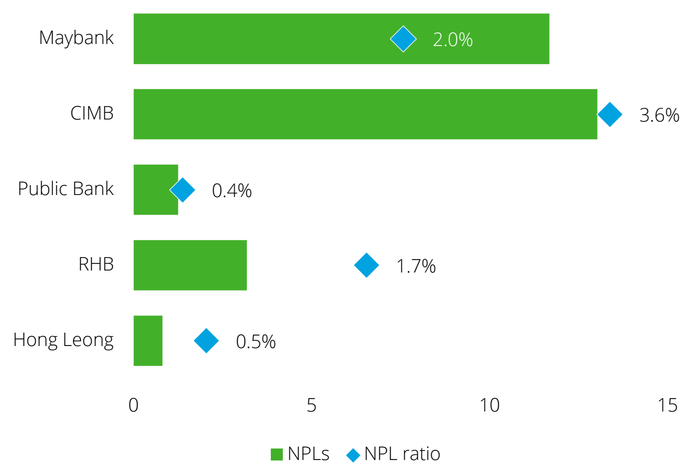
Total NPL volumes in the banking system amounted to RM 28.6 billion (USD 7.1 billion in December 2020 with an NPL ratio on 1.6% and NPL provision coverage ratio of 107.9%.[189] The moratorium relief introduced by the government creates a downside risk from the deferral in recognising problem loans for banks. As a result, NPL numbers were under-reported in the previous quarters in 2020, although provisions were gradually increased as banks have set aside allowances as a pre-emptive measure to avoid a sharp increase in NPLs when the moratorium comes to an end. Maybank, Public Bank, RHB and Hong Leong even reported lower NPL numbers in December 2020 as compared to the end of 2019.Even so, an increase in credit provisioning is expected in 2021, along with an inevitable increase in NPLs.

Banking System NPLs (RM'bn)



Source: Bank Negara Malaysia

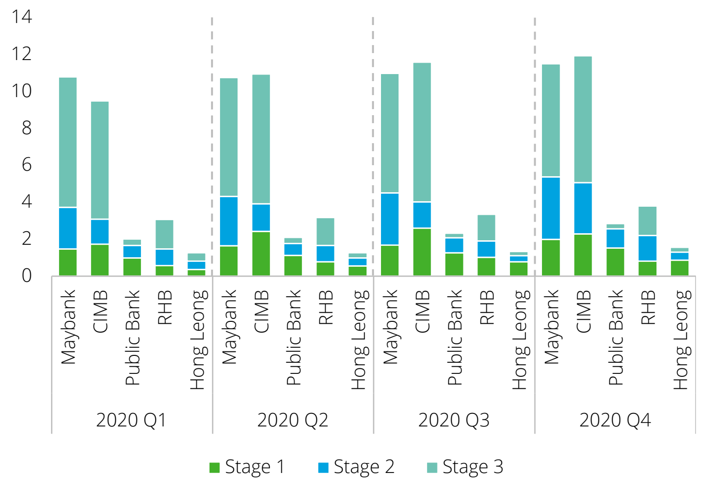
Gross NPLs (RM'bn) - Top Banks



Source: Published financial accounts as of December 2020

In anticipation of higher credit losses, the top five banks have seen large increases in Stage 1 and 2 ECL in 2020. No significant staging migration was observed between Q1 and Q2 as payment arrears taking place during the previous moratorium period did not automatically trigger loan reclassification.

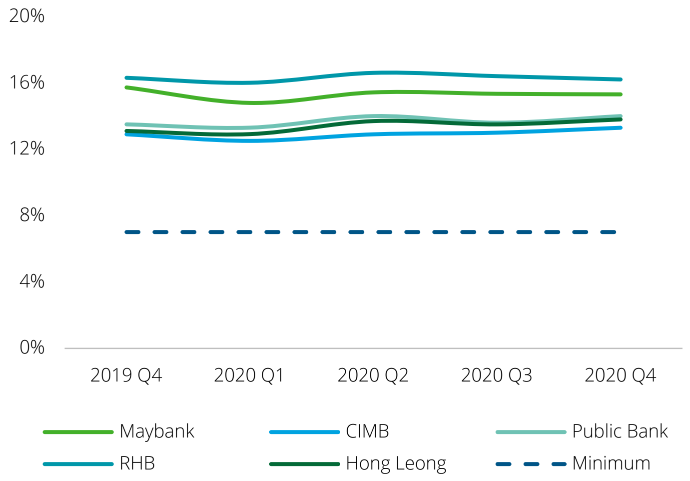
ECL by Stages (RM'bn) - Top Banks



Source: Published financial accounts as of September 2020

According to BNM, Malaysia's banking sector remains well-capitalised, with CAR at 18.3% and an average CET 1 ratio for the banking sector at 14.7% as of December 2020.[190] S&P Global believes that the solid capital buffers of Malasian banks will enable them to partially offset the credit losses from the profound COVID-19 shock to the economy.[191] However, S&P added that further narrowing of net interest margins for banks could pose a downside risks to these buffers.

CET 1 Ratio (%) - Top Banks



Source: Published financial accounts as of September 2020

Islamic Finance

In 2020, the Malaysian Islamic Party (PAS) called for a fresh round of bank's mergers, given the challenges that banks were facing amid a record low OPR and potential liquidity difficulties.[192] It has been difficult to achieve a consolidation among Malaysia's banks in recent years, partly owing to disagreements about pricing and valuations. The most recent merger in the banking sector was between Malaysia Building Society Bhd (MBSB) and Asian Finance Bank in February 2018. A planned merger between Al-Rajhi Bank and MIDF Bhd was aborted recently as the parties could not agree on terms for the deal[193].

A proposed merger among four development financial institutions (DFIs) has also been postponed. Bank Pembangunan Malaysia Bhd (BPMB), Danajamin Nasional Bhd, Export-Import Bank of Malaysia Bhd (Exim Bank) and Small Medium Enterprise Development Bank Malaysia Bhd (SME Bank) were to be restructured and merged into a single entity to strengthen the DFI eco-system.[194] Nonetheless, the proposed merger has recently been revived with the appointment of a new chairman in BPMB in 2021[195].

Malaysia pioneered Islamic finance in the 1980s, and its growth since then has outpaced conventional banking. Some of Malaysia's largest banks have high exposures to Islamic finance; for example, Maybank's Islamic loans account for 62.6% of its total domestic financing as of December 2020. According to Bloomberg, half of Malaysia's banking assets are expected to be Islamic by 2030.[196]

With an aim of ensuring sustainable income and financial resilience in the wake of COVID-19, the ITekad programme has been expanded, with more participating Islamic banks. The programme provides micro-financing, structured training and mentorship through social finance instruments such as zakat, sadaqah and waqf to B40 micro-entrepreneurs. This is in addition to vouchers to purchase insurance and takaful coverage under the Perlindungan Tenang scheme.

The government of Malaysia has also launched the Sukuk Prihatin to fund financing for micro-SMEs, especially female entrepreneurs, supporting grants for research into infectious diseases, and improving connectivity for rural schools. The Sukuk Prihatin has been oversubscribed with total subscriptions exceeding RM 666 million.[197]

NPL landscape and market development

In the past, NPLs in Malaysia were concentrated in household loans and the finance, insurance and business sectors. However, with the impact of COVID-19, NPLs in the manufacturing sector increased by 7.9% in 2020, making it the second-largest sector for NPLs stock. NPLs in household and manufacturing together made up 54.3% of the total stock in December 2020. It is notable that the sectors most affected by COVID-19– wholesale & retail trade, and hospitality – made up only a single-digit percentage of total NPLs.

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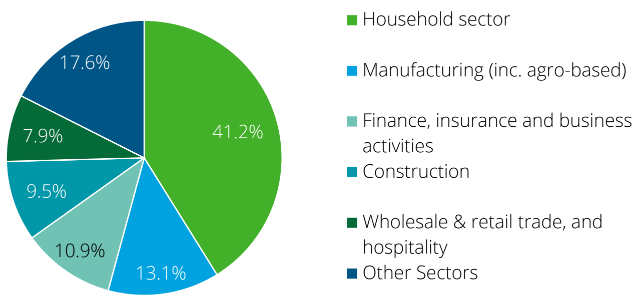
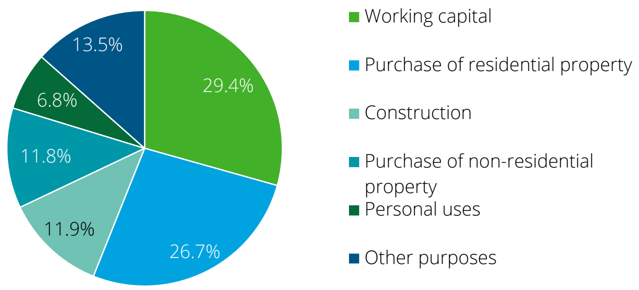
In terms of loan types, over half of NPLs relate to working capital loans and residential mortgages, which accounted for 29.4% and 26.7% of total NPLs respectively at the end of 2020. A weakened property market together with lower incomes to service debts has led to an increase in NPLs. Non-performing residential mortgages increased by 10.5% from RM 6.9 billion to RM 7.6 billion over the course of 2020. Commercial and residential loan portfolios are therefore expected to be a prominent feature of the NPL market over the coming years.

NPLs by Sectors (RM'bn)



Source: BNM Monthly Highlight

NPLs by Purpose (RM'bn)



Source: BNM Monthly Highlight

NPLs are expected to increase in the next two years as the impact of various regulatory measures offered to borrowers, such as the loan moratorium, rehabilitation and restructuring programmes, comes to an end. As of 9 October 2020, more than 640,000 applications for repayment assistance had been received with an approval rate of around 98%.[198]

It has been reported that the government is in discussions to set up an asset management company (AMC) to help banks to deleverage and bail out troubled businesses reeling from the collapse in the financial markets. The concept has a precedent in Malaysia. During the AFC, Pengurusan Danaharta Nasional Bhd was set up in 1998 to warehouse the problem loans to allow the banking sector to resume lending and revive businesses.[199]

Characteristics of the NPL market and legacy issues

Notwithstanding measures to open up the market, the NPL portfolio sale market in Malaysia has remained relatively inactive since the mid-2000s, due partly to strict regulations regarding the process for NPL disposals. While there have been several small-scale unsecured loan portfolio sales by banks disposing of their legacy stocks over the past few years – purchasers have included local and regional DCAs (e.g. Collectius) – few secured NPL portfolios have traded. In 2019, AmBank sold a portfolio of retail and commercial NPLs to SPVs owned by Aiqon Capital for a reputed RM 554 million about 10% of face value, according to news sources).[200]

Our last two deleveraging reports identified several key issues in the NPL market in Malaysia. These are still relevant today:

Key considerations for loan sales

Issues	
Restrictions on buyers	Banks can sell NPLs only to locally incorporated companies where the purchaser is majority-owned by domestic shareholders. Foreign ownership is capped at 49%: this makes it difficult to structure transactions for foreign investors.
Legal enforcement process	A typical litigation process takes 6-12 months depending on the nature of the loans and assets.
Regulatory requirements	Approval from BNM is required at every stage of an NPL sale transaction, including the due diligence exercise. BNM has strict vetting procedures and scrutiny which are usually undisclosed to market participants.
Tax considerations	In Malaysia, transfers of loans to third parties are subject to stamp duty. For transfers of NPLs, there is ad valorem stamp duty up to 4% on the amount due and payable for the NPLs or at the purchase consideration, whichever is higher. If a vesting order under the Financial Services Act and the Islamic Financial Services Act is obtained, purchasers should take note of other potential stamping charges from the land office (for real estate properties) in the event vesting of the charges are required to be stamped too. If a transfer is made as part of an Asset-Backed Security (ABS) structure, the transfer from the seller to the transferee is exempt from stamp duty. Exemption of stamp duty also applies for the issue of ABS or for the ABS transaction documents.
Servicing options	There are limited options in the market and a lack of capabilities. The Debt Collection Agency (DCA) continues to be used as a servicing solution.

The NPL stock has increased as various debt relief measures started to phase out. The well-established regulatory and legal frameworks to support the secondary distressed debt market, if combined with a loosening of restrictions for foreign investors should the regulators allow it, could make Malaysia an interesting NPL market and a potential regional hotspot in the not-too-distant future.

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Deloitte PLAS

Deloitte's Portfolio Lead Advisory Services team ("PLAS") is a global market leading practice, with a dedicated team based in London, specialising in providing clients with end-to-end advisory and assistance across non-core and non-performing loan portfolios.

It has an outstanding market reputation covering deleveraging and strategic advisory, transaction advisory and support and balance sheet advisory.

The core senior team has advised governments, financial institutions, regulatory authorities and global investors on deleveraging and loan portfolio transactions across every major asset class covering over €560bn of assets.

PLAS is supported by a core team of 25 professionals who have worked in advisory, principal investment and banking and by a dedicated network of 140 professionals across the world.

Strategic advisory

Advising financial institutions on loan portfolio analysis; development and implementation of strategic deleveraging options; structural and operational opportunities to maximise value including bad bank establishment, operational carve outs, operation wind-downs and outsourced servicing

Sell-side advisory

Full-service market advisory to financial institutions and sellers of loan portfolios from strategy and preparation to sales execution

Buy-side assistance

Supporting investors with all aspects of due diligence on loan portfolios including analysis, understanding and pricing

Balance sheet advisory

Advising financial institutions on their capital/liability strategies and options, credit risk management and de-risking tools. Comprehensive support in stakeholder outreach

How we can help

We specialise in providing end-to-end support and advice throughout the life cycle of a transaction

Portfolio Lead Advisory Services

01 Balance sheet advisory & capital optimisation

- Capital advisory and solutions, RWA optimisation / asset de-risking / issuance planning and optimisation
- Capital target positioning
- Resolution planning / capital allocation
- Capital performance benchmarking
- Liquidity risk management advisory
- Market intelligence on regulatory, rating agency, and investor developments

02 Strategic deleveraging options

- Identifying the optimal route to disposing of non-core assets

03 Portfolio optimisation

- Helping you identify the optimal portfolio composition to maximise price and minimise P&L and capital impact

04 Data analytics and insights

- Helping you understand the quality and integrity of your data
- We have a very good understanding of the data requirements and expectations of key investors in the loan portfolio market.

05 Market analysis/ Transaction preparation

- Helping you understand the market, buyers and key transaction considerations
- We can assist you in the four main areas requiring preparation:
- Data
- Documents
- Legal due diligence.

06 Portfolio pricing

- Helping you understand the market price of non-core assets

07 Lead advisory execution & transaction support

- Managing and leading the execution of the transaction from preparing marketing materials, advising on process to liaising with investors.
- Assisting you in preparing assets and operations for disposal
- We will provide sufficient resources and co-ordinate all workstreams, ensuring that the transaction runs smoothly with a minimal burden on you.

08 Migration & operational wind down

- Advising and assisting with the transfer of assets and wind down of non-core operations

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