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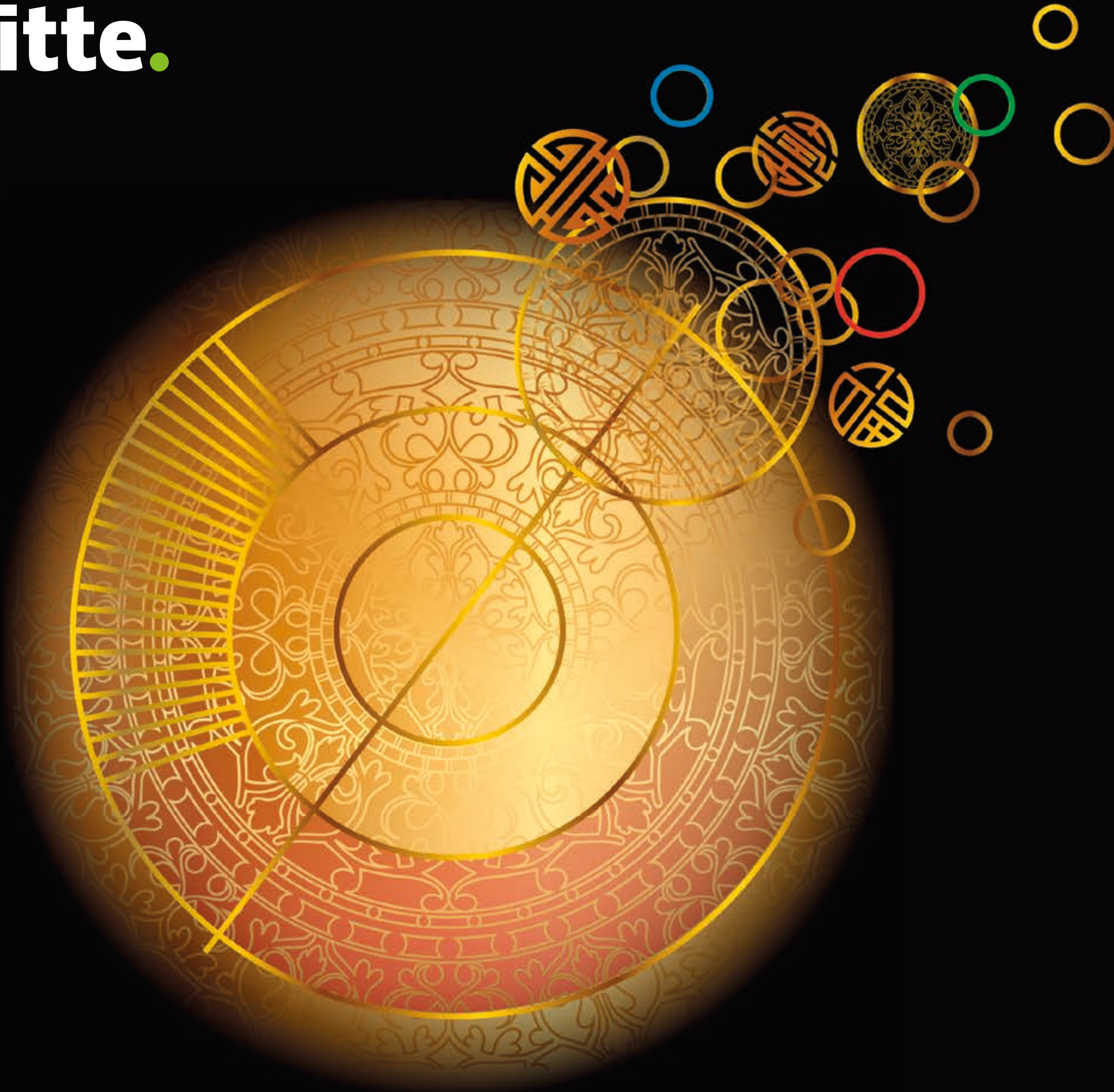

Deleveraging Asia

September 2019

Financial Advisory

Contents

Introduction	**1**
Market overview	**4**
China	**4**
India	**12**
Australia	**18**
New Zealand	**22**
Indonesia	**26**
Thailand	**30**
Malaysia	**34**
Philippines	**38**
South Korea	**42**
Vietnam	**46**
Singapore	**50**
Japan	**52**
Cambodia	**54**
Contacts	**56**
Deloitte PLAS	**57**

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About this report
Unless specified otherwise, all the data in the Deloitte Deleveraging report is based on ongoing tracking and monitoring of deal activity, based on Deloitte practitioners' insights 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 correct as of August 2019.

Introduction

Following the global financial crisis, non-performing loan (NPL) portfolio sales have been largely focused on the European markets. Having reached a record €200bn in loan portfolio sales during 2018, these markets cooled in the first half of 2019, as the measures taken by European banks and regulators have brought NPL levels down to €660bn and reduced the average NPL ratio to 3.1%, down from 3.6% in mid-2018. Investors are now looking to global markets, where the US$640bn NPL stock held by Asian banks – up 23% from the $520bn reported last year – presents a sizable opportunity.

Geopolitical headwinds driving market uncertainty

Macroeconomic uncertainty continues to prevail at both the global and regional levels, with many Asian nations impacted by the global economy's 'synchronised slowdown' and the ongoing trade tensions between the US and China. Early August's foreign exchange market fluctuations are only the latest in a series of economic headwinds over recent months, which has seen gold soar to a six year high as investors shift focus to 'safe haven' assets. Meanwhile Singapore and South Korea's lacklustre economic performance in the first half of 2019 presents a likely indicator of wider malaise, coming from what are considered to be regional bellwether economies.

China and India hold 75% of the region's NPLs

China continues to dominate the Asian NPL landscape with nearly half of the reported stock of NPLs in the region. The scale of the Chinese NPL market is on a par with even the busiest of European markets with over CN¥380bn (US$56bn) traded in the secondary market alone during 2018. Foreign investors remain comparatively under-represented, buying only 4% of these NPL portfolios by value.

India's ₹10.4tn (US$160bn) stock of reported NPLs is the region's second largest. Investors have been establishing Asset Reconstruction Companies (ARC) in the country over recent years to take advantage of the opportunities to acquire NPLs from Indian banks, with sales primarily consisting of corporate loans.

South East Asian banks reported a combined NPL stock of nearly US$50bn as of the end of 2018, and the past year has seen increasing activity across the region as investors take advantage of the opportunity to gain first-mover advantage in markets which are mostly still considered 'emerging', with the notable exception of Thailand's well-established local NPL market.

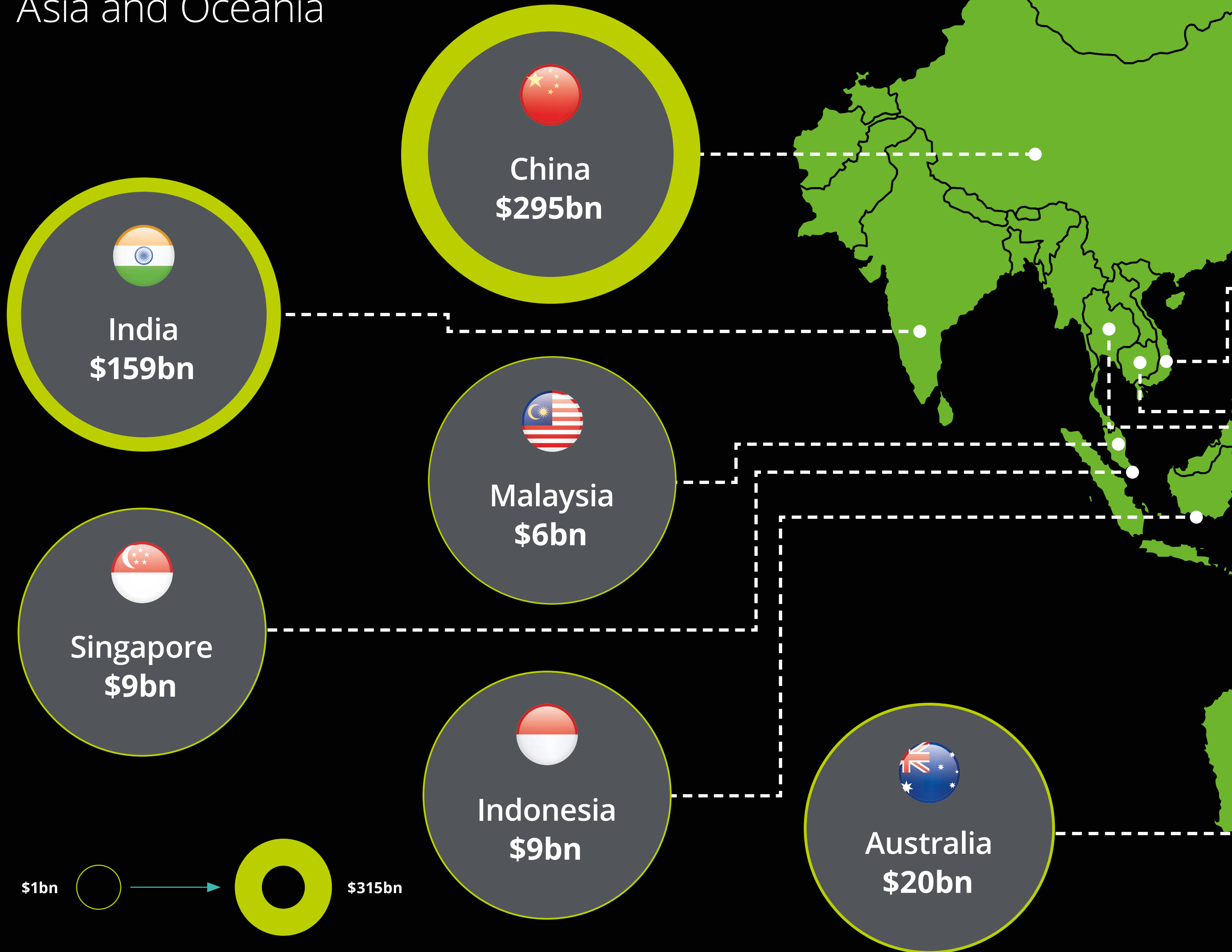
IFRS9 convergence is driving changes to bank balance sheets

Regulatory developments across Asia – notably as local regulators adopt and implement global standards – are renewing banks' focus on the classification of, and provisioning for, distressed assets. With the new standards yet to take effect in some Asian markets, the full commercial impacts of IFRS9 still remain to be evaluated. However the ongoing process has already begun to highlight the balance sheet benefits which could be achieved by many of the region's banks in reducing their NPL exposures.

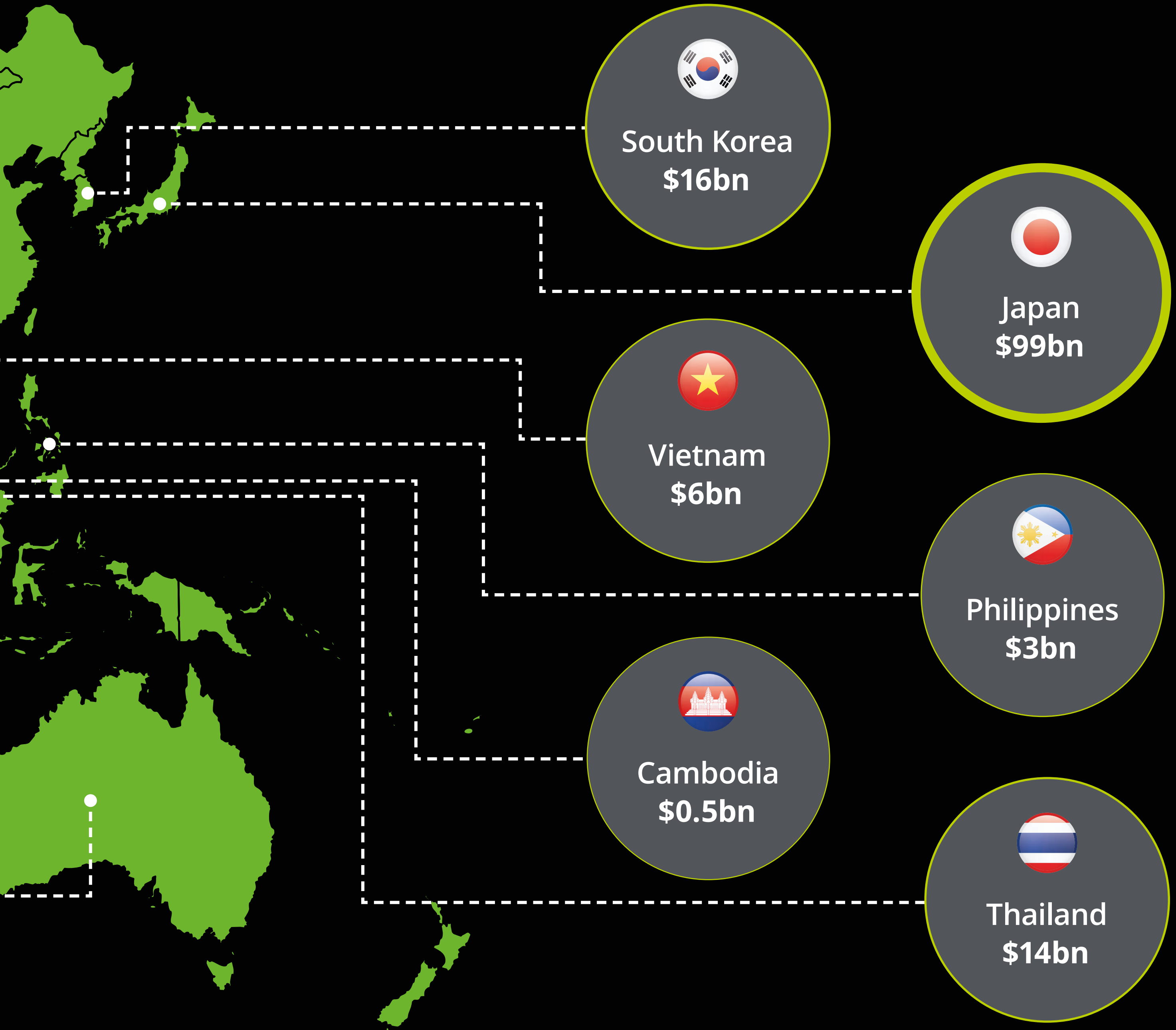
Opportunities in Australia and New Zealand

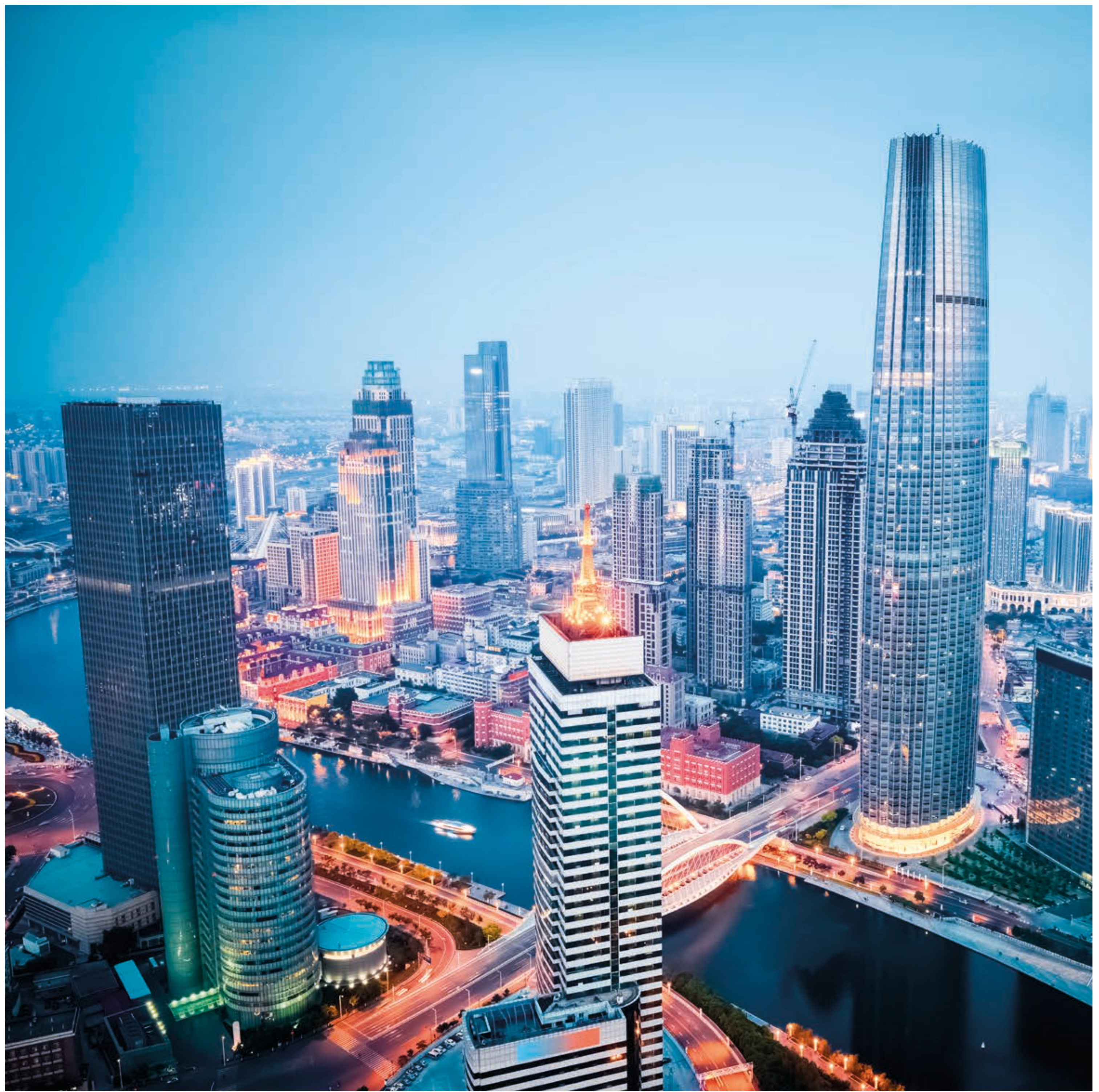
Despite low NPL volumes and ratios, opportunities are also emerging in the Australian and New Zealand markets, particularly in terms of strategic deleveraging efforts and the growing role of non-bank lenders. This has largely been driven by recent regulatory measures, notably as a result of the Royal Commission findings, and follows a similar path to that seen in European markets over recent years, where enhanced regulation and focus on conduct has fundamentally changed the banking landscape.

US$640bn stock of NPLs held by banks across Asia and Oceania



Source: Central banks and regulators, Bloomberg, CEIC. Latest data as of December 2018.


South Korea
$16bn
Japan
$99bn
Vietnam
$6bn
Philippines
$3bn
Cambodia
$0.5bn
Thailand
$14bn



China

Macroeconomic overview

Following two decades of exceptional growth, with real GDP expanding at an annual rate of over 10%, China's economy is transitioning to a 'new normal', with GDP levelling out to a comparatively modest range of 6-7% forecast growth. Aside from the obvious challenges in maintaining previous growth rates for what is now the world's second largest economy, there are certain factors contributing to the dampening of economic growth in the country.

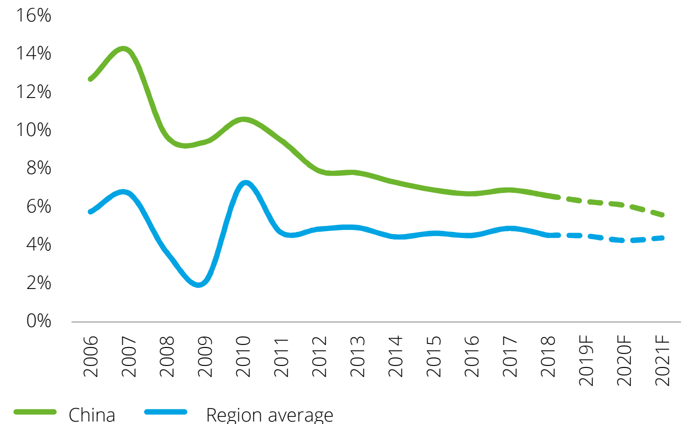
On the domestic front, China's policymakers have publicly expressed concerns about the country's debt levels. This has led to a reduction in access to credit, which has in turn limited growth prospects in the private sector. The reduced availability of credit has also served to intentionally cool China's housing market, alongside moves to discourage property speculation.

At the global level, China's ongoing trade tensions with the US added pressure to its economy in the latter part of 2018 and early 2019, with expectations for this drag on growth to continue throughout the year in the absence of an agreed deal. Nonetheless, the market anticipates a thaw in global trade relations which, combined with domestic stimulus from fiscal and monetary policy and changes to housing restrictions, should sustain GDP growth in excess of 5.5% over the coming years.

Banking landscape

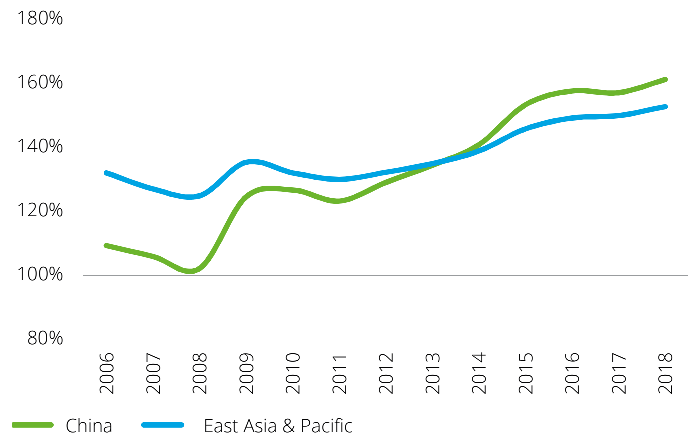
As China's financial sector continues to mature, the banking market remains characterised by a significant concentration amongst a few very large players, including the world's largest banks. China's "Big Four" state-owned lenders – Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Agricultural Bank of China (ABC), and Bank of China (BOC) – were again ranked the top four banks in the 2018 S&P ranking of the top 100 global financial institutions, with a combined US$14tn of assets between them.

Real GDP growth



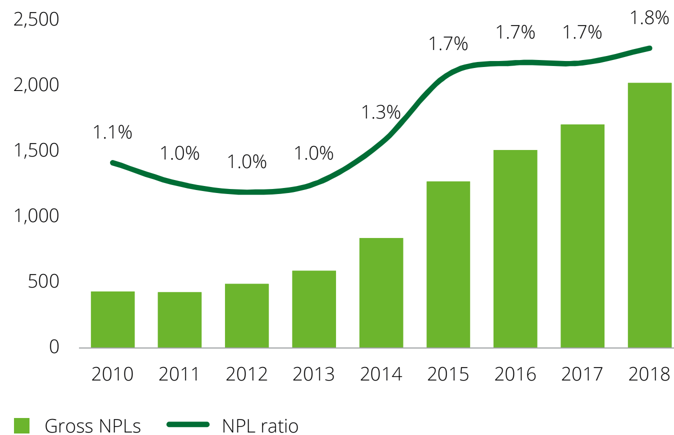
Source: Economist Intelligence Unit (F = forecast)

Domestic credit to private sector as % of GDP



Source: World Bank

Total banking system NPLs (CN¥bn)



Source: CBIRC

Rapid financial innovation and market reforms have transformed the Chinese financial sector over recent years. While banks continue to play the major role in financial intermediation, market liberalisations are increasingly enabling other non-banking financial institutions to provide financial services and credit to Chinese firms and households. Capital markets are thus playing an increasing role in allocating savings and investment within the Chinese financial system. Although China is unlikely to adopt a fully capital market-centric model, Premier Li Keqiang has reiterated this policy direction by emphasising the government's intention to "develop a multi-tiered capital market, and promote the development of the bond and futures markets".

China's financial sector has had limited integration with global markets to date, despite the significant role of the wider Chinese economy within global trade and its integration into supply chains. The next decade is likely to be marked by greater financial sector integration, reflecting China's increasing global footprint. This point was made clear by President Xi Jinping at the Boao Forum for Asia in 2018, where he highlighted China's intention to further open up its financial system. As the country seeks to improve the allocation of savings and investment to better serve the economy, the structure of the financial system is likely to change.

NPL market

The NPL ratio for China's banking system has risen steadily from 1.0% at the end of 2013 to 1.8% in 2018 according to the China Banking and Insurance Regulatory Commission (CBIRC). The total stock of NPLs increased by 18% year-on-year from CN¥1.7tn (US$260bn) in December 2017 to CN¥2.0tn (US$295bn) in 2018. This continued growth of NPLs provides investors with an opportunity to increase their participation in the distressed debt market in China.

Although the largest banks have been steadily working to bring their NPLs under control, a recent report by China's National Audit Office (NAO) has raised concerns about the surge of bad debt held by small banks around the country. This is particularly prevalent among the city commercial banks and rural financial institutions, the combined assets of which account for over 26% of the country's total. In 2019, these were forecast by China Orient to be the bank categories with the highest NPL ratios in China, at 2.17% and 5.17%, respectively.

CBIRC's announcement in May 2019 that it would take over Baoshang Bank, a struggling city commercial bank in Inner Mongolia, with CCB entrusted to handle the bank's operations, suggests that a framework is in place to deal with such situations as they arise.

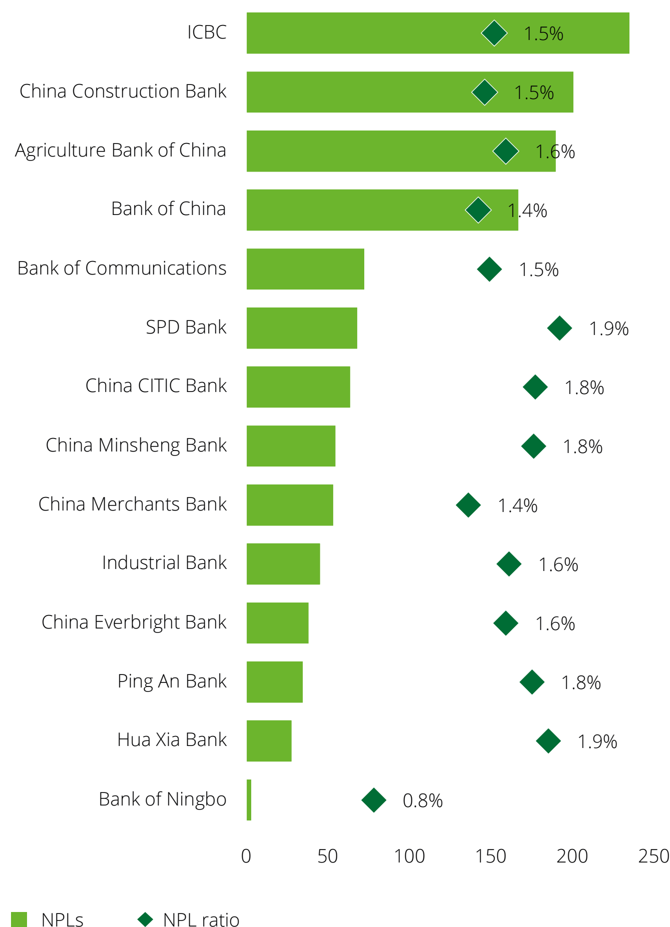
As part of its measures to further clean up the financial sector, the Chinese government implemented its "deleverage" policy in 2018. In the first half of the year, it began to implement strict supervision policies and intensively introduced laws and regulations governing banks, insurance companies, and financial institutions, as well as opening up further avenues for domestic distressed debt resolution. These included a new National AMC and Assets Investment Company (AIC) and encouraging foreign participation in the market.

After an absence from the distressed debt market for the previous decade, foreign investor interest in China has risen over the past couple of years with several high profile buyers entering the market. With increased NPL volumes and an improving landscape for overseas investors, it is no surprise that there has been an uptick in foreign buyer activity. Lone Star, Oaktree, Goldman Sachs, Blackstone, CarVal, and Bain Capital have all been involved in trades in the country during 2018 with overall interest and deal volume increasing. Several international investors are now acquiring subsequent portfolios, which typically focus on the coastal provinces of China such as Jiangsu, Zhejiang, and Guangdong.

Servicing

More so than anywhere else, access to an established and experienced domestic servicer is key to successful NPL investment in China. Foreign buyers are therefore looking to establish strong local servicing capabilities to support their expansion in the Chinese NPL market. Some investors are establishing their own in-house teams, whereas others have chosen to develop local partnerships, such as CarVal with Wensheng AMC, and Oaktree which has done several deals with Alpha & Leader. However, finding strong domestic servicers of scale who can perform to international standards remains a key challenge.

Gross NPLs held by top banks (CN¥bn)



Source: most recent published financial accounts as of December 2018

Key events and regulations affecting the NPL market during 2018

Month	Event
January	**Administrative Measures for Financial Assets Investment Companies issued by CBIRC** • The new rules aim to guide AMCs to focus on their main business of NPLs, and include minimum capital requirements
	Implementation of revised Ministry of Finance accounting standards with reference to IFRS9 • IFRS9 could increase the stock of credit impairment provisions
February	**Regulation on local AMCs** • Unlicensed AMCs will be defined as financial institutions • Local AMCs are not allowed to issue debt financing instruments to the public without approval
March	**Establishment of fifth national AMC approved by the State Council** • The 5th AMC was originally the Jiantou Citic (建投中信) and transformed into a national AMC, renamed China Galaxy AMC (中国银河资产管理有限公司) incorporated in Guangdong province.
May	**The State Administration of Foreign Exchange approved Shenzhen to continue pilot cross-border transfer of NPLs** • The approval cancels the trial period limit
	Guangdong Financial Assets Trading Center was approved for the pilot business of cross-border transfer of NPLs of banks • The first provincial-level asset trading centre approved in China
June	**Loans that are above 90 days overdue are all categorized as "non-performing"** • State-owned banks and joint-stock banks that are directly under the control of CBRC requires that all loans overdue for more than 90 days be counted as "non-performing".
	China Banking and Insurance Regulatory Commission revoked some rules regarding the limitation on shareholding of foreign entities • Relaxation of foreign ownership rules on foreign ownership of financial institutions.
	China Banking and Insurance Regulatory Commission issued "Administrative Measures for AMCs (Trial Version)" • Banks should implement market-based debt-to-equity swaps through implementing agencies. Five state-owned banks (ICBC, ABC, BOC, CCB, and Bank of Communications) to set up AICs.
August	**Big four national AMCs asked to step in to solve P2P issue** • CBRC convened a meeting of the big four AMCs to help resolve the risk of P2P and maintain social stability.
December	**First joint-stock bank to establish an AIC** • The Industrial Bank announced that it plans to invest CN¥10bn to invest in the establishment of Xingyin Financial Assets Investment Co., Ltd. (tentative name).

Key considerations

In order to correctly price assets and evaluate the investment opportunity, it is essential for underwriting teams to have an in-depth understanding of the unique aspects of the Chinese NPL market. In addition to a credible servicing solution, considerations for prospective acquirors of NPL portfolios in China include:

- **Speed of execution:** investors are expected to move extremely quickly once the target portfolio has been formed and price agreed with the seller, with two months being the standard timeframe to complete the transaction.

- **Understanding the AMCs:** prospective investors will also want to have developed a relationship with the seller – or have a keen understanding of the AMCs style – which will not only enable them to conduct investor due diligence ahead of constructing their target portfolio, but also help provide comfort to the sellers of their ability to transact within the expected timescales.

- **Portfolio composition:** portfolios are typically a mix of asset classes and legal status, as sellers look to divest some of their more troublesome and unsecured positions. This means successful buyers will require the capabilities to manage these more problematic positions in order to bridge the pricing gap.

- **Ongoing relationship post-transaction:** the vast majority of portfolio sales to foreign investors will be from one of the state-owned enterprise (SOE) AMCs. As such, successful buyers will typically have an ongoing reliance on the AMC for subsequent approvals or transfers, even after the deal has been completed.

Outlook

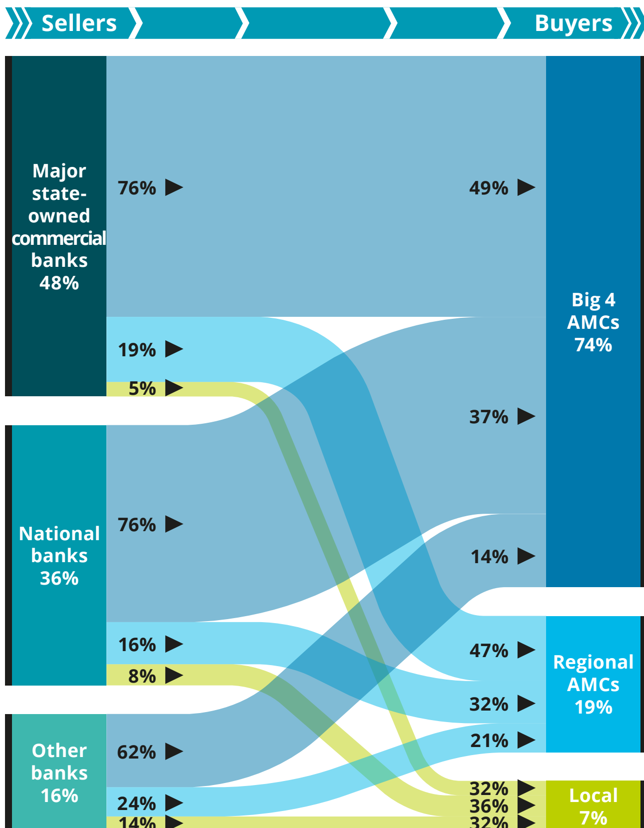
The demonstrable growth in the Chinese NPL market over recent years, in terms of both value and number of deals completed, has shown no signs of cooling during 2019. Investor appetite in the region is expected to continue to grow over coming years, fuelled by the successful transactions by foreign investors. The number of international funds establishing operations in Hong Kong and Singapore continues to increase, as they look to apply international underwriting standards and their global experience to the opportunities in China. There is no doubt that China will continue to be a key NPL market during the coming years.

The Chinese NPL portfolio market

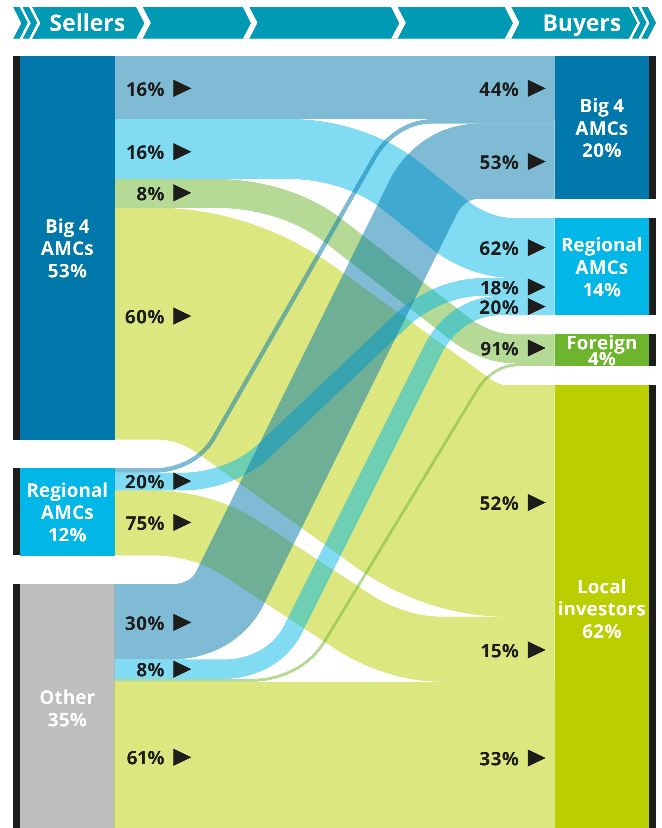
The Chinese market limits the types of buyers who can buy NPLs direct from banks, this means that over 90% of their portfolios are sold to AMCs, the vast majority of which being acquired by the 'Big 4' national AMCs – Cinda, Huarong, China Orient, and Great Wall – which were each originally aligned to one of the 'Big Four' banks, which together with Bank of Communications (BoCom) originate nearly half the loans sold.

The opportunity for international investors lies in the secondary market, which was 44% of the total NPL volume transacted in 2018. However, these are predominantly smaller transactions, with 62% of assets being sold to local investors in over 2,700 transactions at an average deal size of under CN¥90m (US$13m). Compared with the 24 portfolios sold to foreign buyers, worth CN¥17bn (US$2.5bn), which were just 4% of the secondary market.

Deal flows in the primary NPL market – 2018 (CN¥488bn)

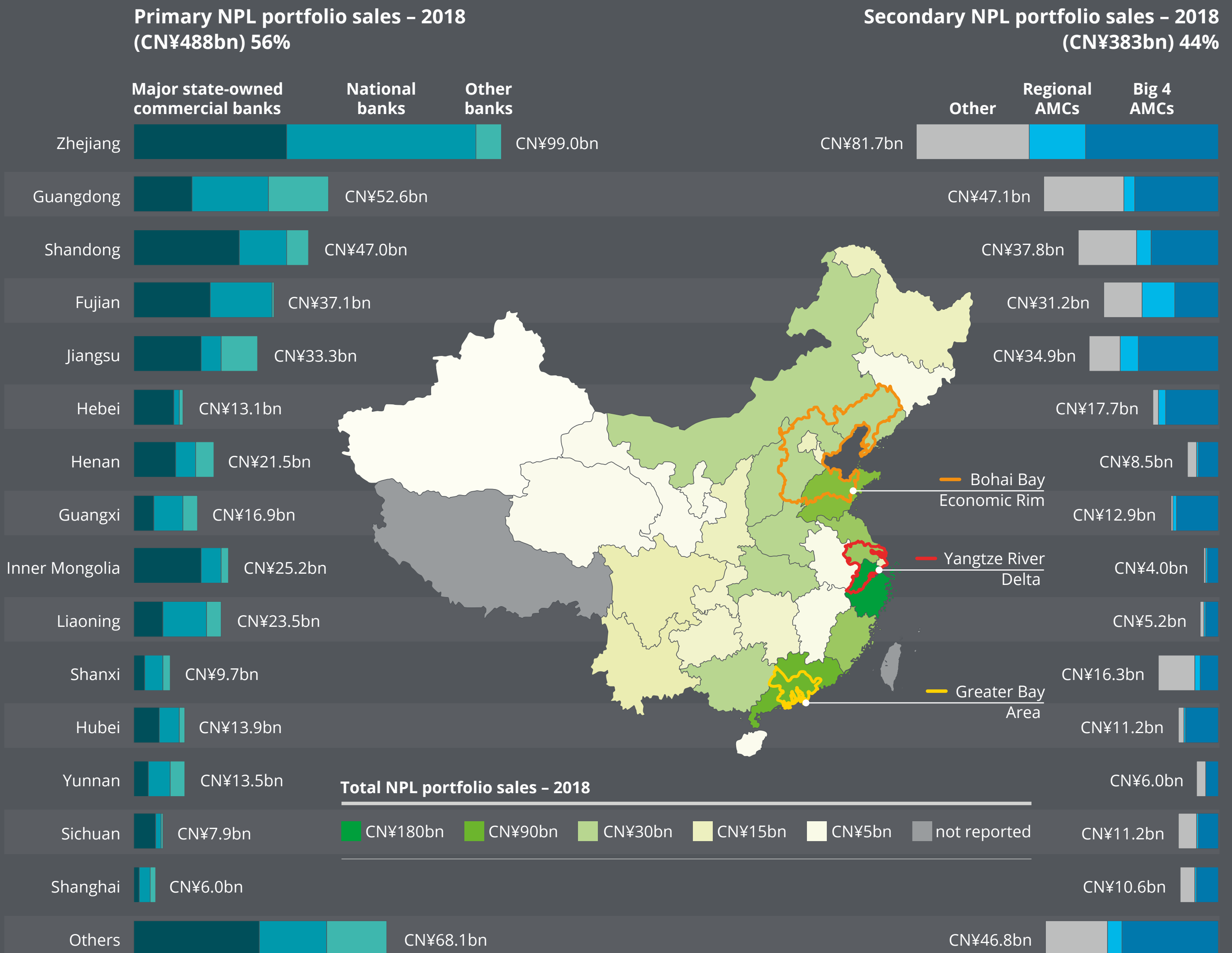


Deal flows in the secondary NPL market – 2018 (CN¥383bn)



Source: Deloitte research and analysis of market data

NPL portfolio activity by province – 2018 (CN¥871bn)



Source: Deloitte research and analysis of market data

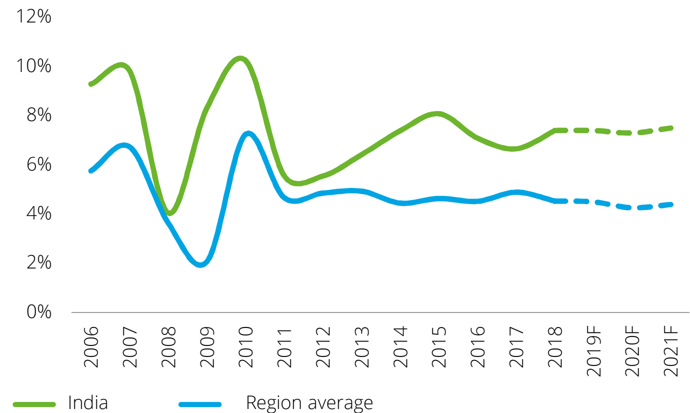
India

Macroeconomic landscape

Indian GDP has continued its impressive growth, rising by 7.2% in 2017-18, putting it on course to become the world's fifth largest economy this year. It is expected to remain one of Asia's fastest-growing economies, despite the recent downward revisions of growth forecasts by India's Central Statistics Office. Growth has been fairly broad-based across industries, with construction and the public sector particularly strong, while agriculture has underperformed. The recent dip in consumer sentiment has seen a decline in credit availability for small businesses.

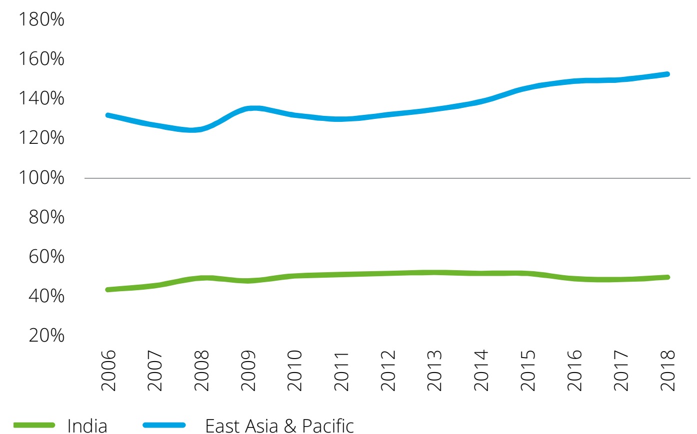
Government efforts over recent years have streamlined tax laws and simplified regulations, improving the country's business environment in the context of an increasingly competitive global economy. These efforts are expected to continue over the coming years, with the May 2019 general election – widely seen as a referendum on the government's policy – securing a second term for Narendra Modi's Bharatiya Janata Party (BJP). In particular, continued investment in developing national infrastructure will remain a priority for the government, as a key factor in driving the country's future growth.

Real GDP growth



Source: Economist Intelligence Unit (F = forecast)

Domestic credit to private sector as % of GDP



Source: World Bank

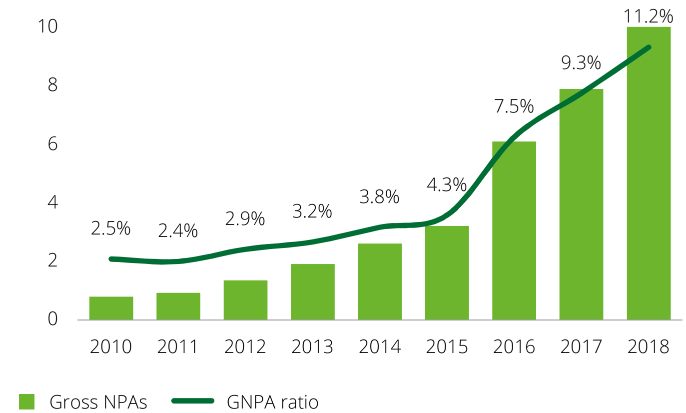
Banking landscape and NPA development

After the contraction of recent years, bank lending in India has returned to growth, with 13% year-on-year credit expansion, driven by 23% growth in private sector bank lending. This growth has seen sharp increases in credit to non-banking financial companies (NBFC) and retail consumer unsecured lending, such as credit cards and personal loans.

The liquidity crisis and resultant nationalisation of Infrastructure Leasing & Financial Services (IL&FS) has had a wider impact on NBFC liquidity, particularly those involved in financing infrastructure projects. With short-term funding restricted through commercial paper and bonds, the Reserve Bank of India (RBI) has responded by easing bank limits on lending to NBFCs, thus the sharp increase in bank lending to the sector is anticipated to grow further still.

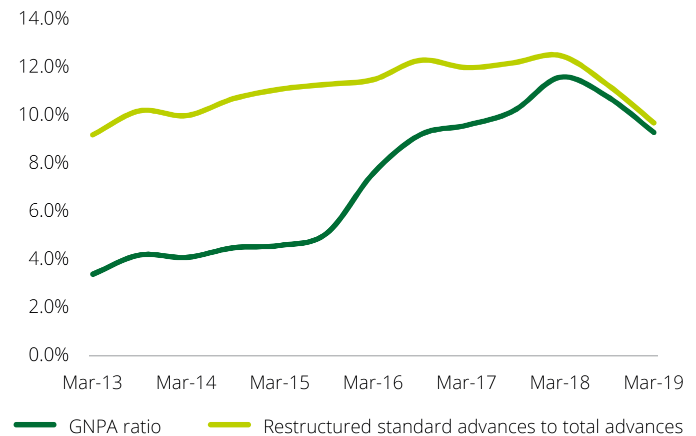
The RBI reports a significant increase in the stock of non-performing assets (NPA) held by Indian banks, with ₹10.4tn (US$150bn) held on the balance sheets of Scheduled Commercial Banks (SCB). The origins of this increase can be found in the rapid credit expansion between 2006-2011 within an environment of relaxed underwriting and monitoring standards. The regulatory response has included the introduction of the Insolvency and Bankruptcy Code (IBC) in 2016, as well as enhanced powers for the RBI to monitor and deal with stressed assets. In addition, measures have been introduced for better NPA recognition on bank balance sheets, including strict Asset Quality Reviews (AQR), quicker reporting, compulsory disclosures of under-reporting, and restrictions on loan restructuring.

Total banking system NPAs (₹tn)



Source: RBI

Stressed advances ratio



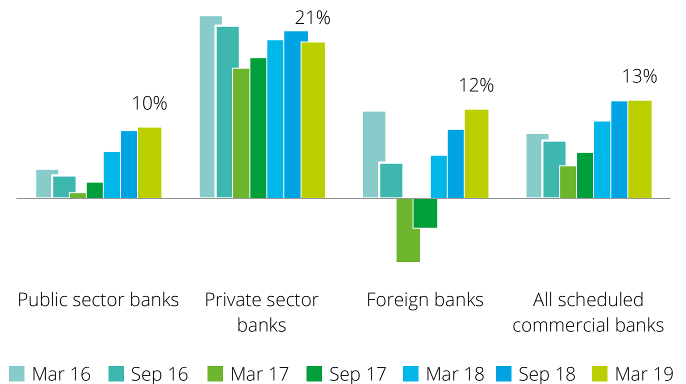
Source: RBI

The Gross Non-Performing Assets (GNPA) ratio for SCBs reached 11.2% as of the end of 2018, up from 9.3% the previous year. This was seen particularly in public sector banks, comprising about 65% of total loans and advances, and 86% of NPAs in the country, whose GNPA ratio rose sharply to rise to 14.6%. Meanwhile foreign banks, with the lowest GNPA ratio, enjoyed a slight reduction to 3.8%.

The Industrial sector saw the greatest GNPA ratio deterioration, reaching nearly 20% in 2018. Agriculture was also negatively affected, with a GNPA ratio of 8%, and has been the subject of political debate through the election cycle, with debt waivers and cash incentives for farmers being considered as measures to gain rural support.

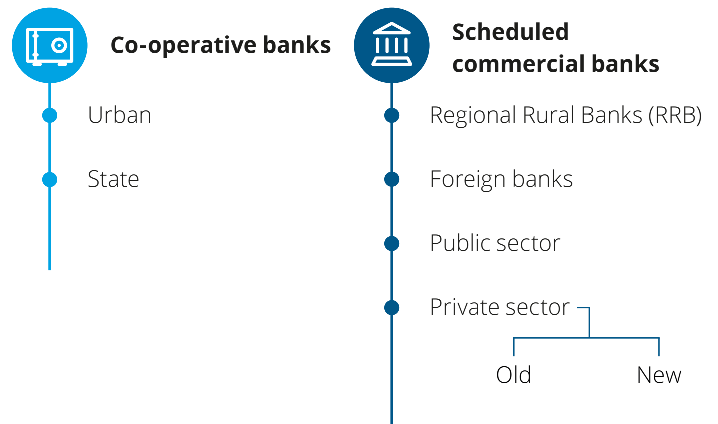
The withdrawal of a number of restructuring schemes has led to convergence of the GNPA ratio with the overall stressed advances ratio, which also includes restructured standard advances. There has also been a reduction in the GNPA ratio during 2019, primarily due to write-offs, with further reductions expected through resolutions of some large NPA accounts, increasing write-offs, and sales of bad loans to Asset Reconstruction Companies (ARC).

Credit growth year-on-year by bank type



Source: RBI, Financial Stability Report (June 2019)

Key classifications of Scheduled banks in India



NPA resolution

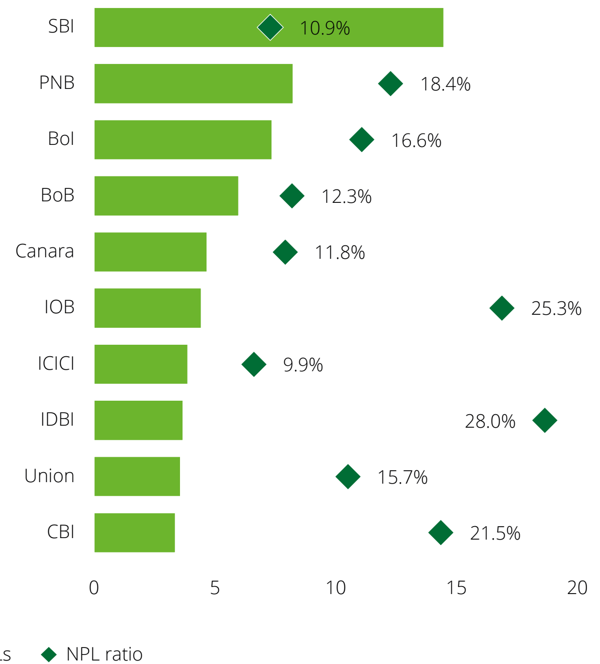
A number of measures have been introduced over recent years to tackle the growing level of NPAs in the country, beginning with the adoption of the Insolvency and Bankruptcy Code (IBC) in 2016, to provide a consolidated framework for resolving insolvencies in an economically viable manner. This was complemented by the 2017 Banking Regulation (Amendment) Bill, giving the RBI new powers to direct banks to initiate proceedings under the IBC.

The June 2019 RBI Circular outlining the Prudential Framework for Resolution of Stressed Assets, replaces its earlier directive, and places the onus on banks to decide on the resolution strategy within 30 days from default, followed by a clear timeframe for conclusion, in order to strike a balance between tight regulatory timelines and excessive delays in resolution. This is providing greater certainty for debt holders.

The Corporate Insolvency Resolution Process (CIRP) was introduced together with the IBC, enabling either the debtor or their financial or operational creditors to initiate insolvency proceedings through an application to the National Company Law Tribunal (NCLT) for corporates and limited liability partnerships, or the Debt Recovery Tribunal for individuals and partnerships. Once approved, an Insolvency Resolution Professional (IRP) will be appointed to replace the board of directors and draft a resolution plan within 180 days, extendable by 90 days.

As of March 2019, a total of 1,858 cases had been admitted into CIRP, of which half were requested by operational creditors, 40% by financial creditors, and 11% by the corporate debtors themselves. Of the cases which have been closed, over half have resulted in liquidation, while the resolution has only been agreed for 94 cases. Of the ongoing cases, nearly a third have already exceeded the maximum 270 days, highlighting the challenges faced in implementing this new process, and leading the Supreme Court to increase the number of benches available to the process.

Gross NPAs held by top banks (US$m)



Source: published financial accounts as of December 2018

Despite the increasing timescales, and in the context of the limited number of resolutions to date, CIRP is already leading to improved recoveries as compared with the previous mechanisms; Debt Recovery Tribunals (DRT), Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests (SARFAESI), and Lok Adalats.

Outlook

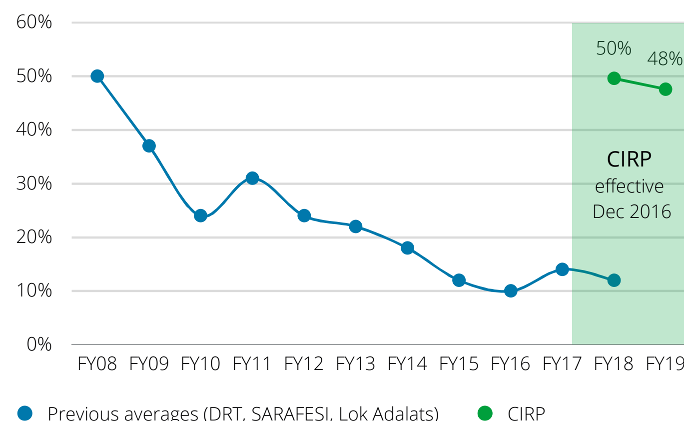
The NPL market in India is continuing to evolve, with increasing interest from investors as the recent enhancements to the country's regulatory frameworks force banks to be more proactive in tackling their stocks of NPAs. Challenges remain for international investors, with the vast majority of the country's reported ₹10.4tn stock of bad loans held by state-backed lenders.

While it remains to be seen how recovery ratios hold up for greater volumes, and as the backlog of ongoing cases is cleared, the improvements under CIRP are providing investors with greater clarity and confidence in both the recovery prospects and time to resolution, thus enabling better market valuations.

Nevertheless, the RBI's push for NPA recognition, and the time-based provisioning regime, is increasing banks' appetite to dispose of their NPAs, and investors are ready to capitalise on the opportunities this presents.

On the regulatory front, there is continuing focus on measures to reduce NPA levels through not only improved resolution processes, but also debtor behaviour. To this effect, a number of government amendments to the IBC have already been introduced, and work is underway by the Insolvency and Bankruptcy Board of India (IBBI) to draft new regulations on insolvency resolution of proprietorships, partnerships, and personal guarantors to corporate debtors.

Recovery rate under CIRP vs. previous averages



Source: IBBI, RBI, market analysis

Cases closed outcome

Appeal/Review/Settled	152	21%
Withdrawal	91	13%
Resolution	94	13%
Liquidation	378	53%
Total	**715**	**100%**

Source: IBBI, NCLT

Australia

Macroeconomic overview

Australia has a diverse, open, and resilient economy, benefitting from a strong institutional setting, monetary policy flexibility, and low government debt. The country has enjoyed stable growth over recent years, with real GDP averaging 2.5% over the past decade and forecast to continue at a similar rate for the coming years.

The unemployment rate at 5.2% has been steadily falling since early 2015, helping to stabilise consumer confidence and encourage consumption despite concerns over low wage growth, stretched household finances, and a weaker housing market.

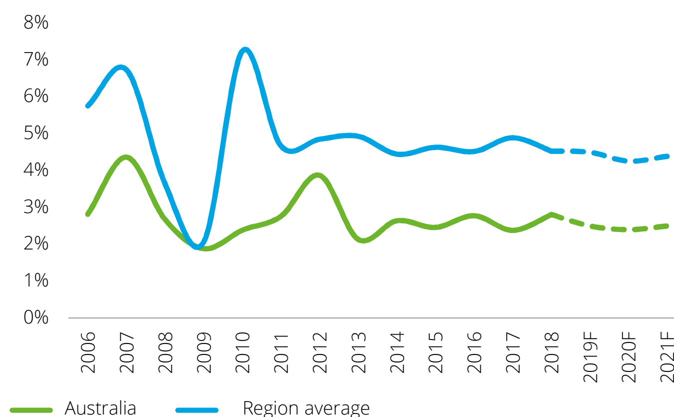
Having experienced unprecedented growth in the five years until 2017, house prices have now fallen by about 7% over the past two years, while housing credit growth has reduced to 5%.

This follows an increased focus on sound lending practices, with regulatory measures introduced to reduce maximum loan size and restrict access to credit for certain borrowers. Investors, who played a large part in the property price growth over preceding years, have been particularly impacted. The shift away from authorised deposit-taking institutions (ADI) has seen lending from non-ADIs grow at over twice the rate of ADIs.

On the supply side, approvals for new dwellings have fallen since the peak in 2016 – with slowing demand from foreign buyers and domestic investors, in part driven by regulatory changes, placing downward pressure on unit prices – although there continues to be a significant number of units under construction in some of the larger markets, notably Melbourne and Sydney.

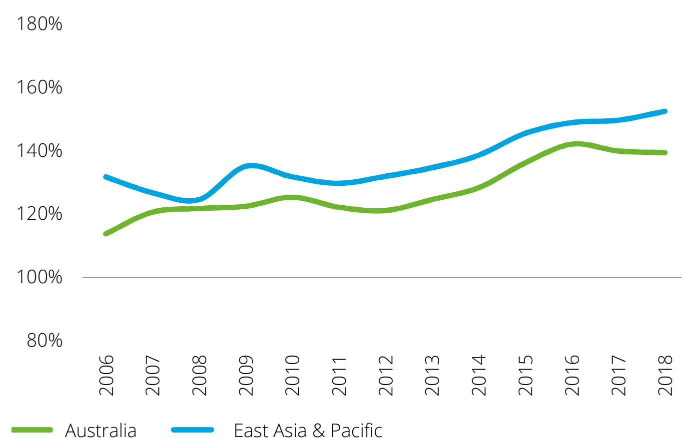
The Reserve Bank of Australia's (RBA) decision to reduce the cash rate by 25bps to 1.0% in July follows steady reductions since late 2011. Further reductions are expected during 2019 which should help to stabilise prices within the housing market.

Real GDP growth



Source: Economist Intelligence Unit (F = forecast)

Domestic credit to private sector as % of GDP



Source: World Bank

Banking landscape

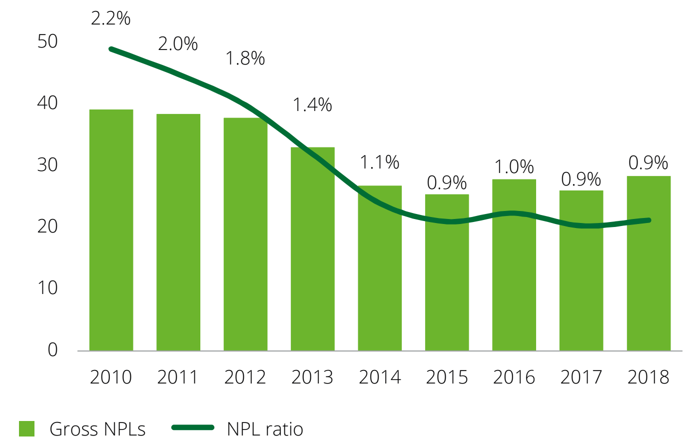
The strength of the Australian banking system was demonstrated during the 2008 global financial crisis, with the country's banks withstanding the crisis better than most. The Australian economy was largely shielded from the downturns seen elsewhere with a booming mining sector, and government stimulus providing an implicit backstop which enabled the major banks to retain their AAA credit ratings throughout.

The acceleration in Australia's housing market following the global financial crisis drove strong credit growth for banks. In particular, the 'Big Four' Australian banks – ANZ, Commonwealth Bank (CBA), National Australia Bank (NAB), and Westpac – were able to capitalise on this growth, increasing their market share over the subsequent decade. Following this sustained period of domestic credit growth, Australian banks are attracting increasing regulatory scrutiny, most recently from the Royal Commission into Misconduct in the Banking and Financial Services Sector.

The changes announced in July by the Australian Prudential Regulatory Authority (APRA) to increase total loss-absorbing capital (TLAC) requirements for the country's systemically important banks, is estimated to require the four largest bank to raise around A$100bn, according to various projections. Coming at a time of tightening margins, rapidly-changing customer needs, and increasing competition from disruptive innovation and open banking, this will increase the economic challenges to holding certain portfolio types.

This is renewing the banks' focus on simplification of their product offerings, in efforts to improve customer experience, reduce risk, and restrain operating costs, while also considering the potential impact of increased market competition on pricing and replacement of income.

Total banking system NPLs (A$bn)



Source: Bloomberg

Outlook

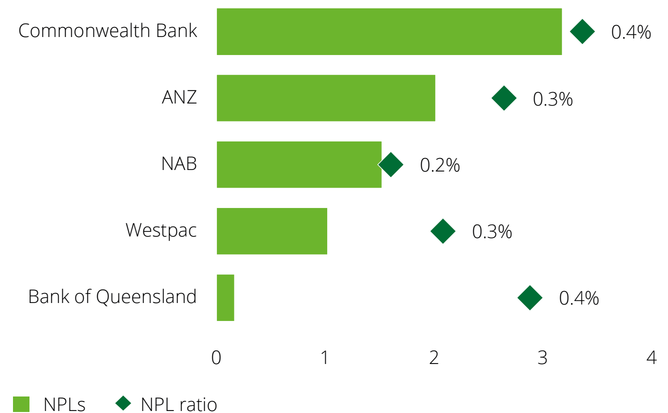
The Australian market for loan portfolios is emerging as ADIs consider potential divestments of non-core assets as part of their response to increasing regulatory pressures, coupled with the lens placed on them as a result of the Royal Commission.

While staple financing could provide the required funding, it limits the banks' ability for derecognition, thus enabling market participants with greater access to leverage to set pricing. European Asset Backed Security (ABS) markets are another potential source of funding, but would require additional compliance with European regulations.

The removal by APRA of the 7% seriviceability buffer for home loans has already led a number of banks to reduce their serviceability rates for borrowers, and is widely expected to revive growth in the housing market.

The anticipated rationing of capital by banks as they focus on core products is creating opportunities in the country for investors looking to enhance returns in the context of diminishing yields. ICE Data Indices reports that the share of global bonds yielding over 5% has fallen from well over half two decades ago to a mere 3% in 2019. This has already led to increased investment in non-bank lending platforms, with ambitions of further expansion over the coming years through organic and inorganic growth.

Gross NPLs held by top banks (A$bn)



Source: latest published financial accounts as of September 2018

New Zealand

Macroeconomic overview

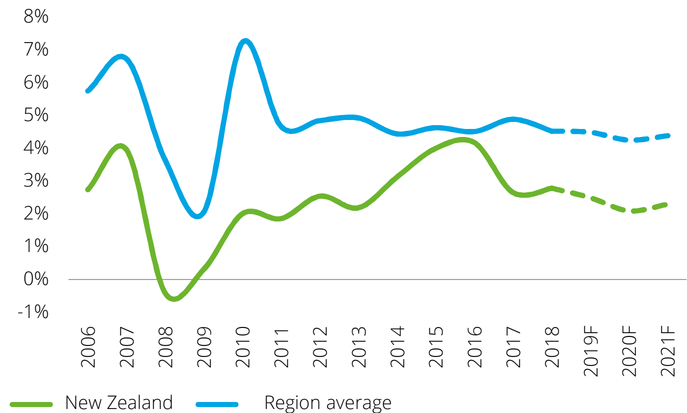
New Zealand has enjoyed steady economic growth over recent decades. One of the least affected OECD member nations during the global economic crisis, it has achieved average real GDP growth of 2.6% since 2008, driven by increasing exports and higher demand from China. Agriculture continues to play a significant role in the country's overall economic output, and exports in particular, although goods-production industries have provided the greatest contribution to GDP growth over recent years.

China is a significant trading partner with whom New Zealand enjoys a widening trade surplus, reaching NZ$5.1bn in the latest year. Tourism and international students account for NZ$3bn of this surplus, while the agricultural sector continues to play a significant role in the country's overall economic output and exports, with meat exports reaching a new high in February 2019.

New Zealand's housing market has enjoyed a period of strong growth, driven in part by foreign investment and strong migration. Housing consents are at a 44-year high, largely focused on urban units (apartments, flats, townhouses) in Auckland, while consents for stand-alone houses have remained broadly flat. A more mixed picture exists across the rest of the country.

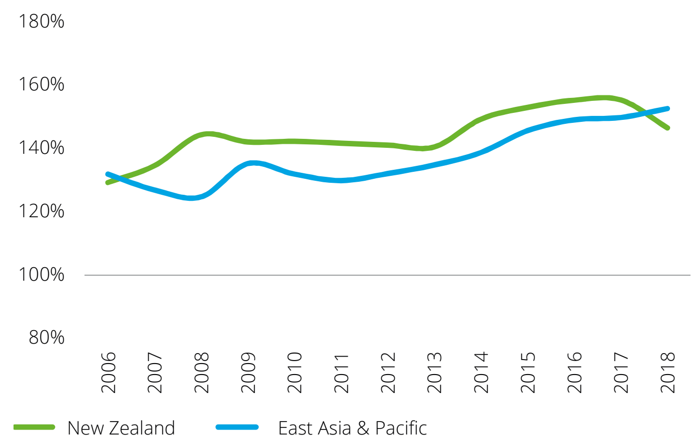
While economic prospects remain positive, there is a forecast easing of growth to 2.1% over the coming years in the context of the wider global slowdown, with domestic household spending and retail sales moderated by sluggish wage growth on the domestic front. Slower Chinese growth and the ongoing Sino-US economic tensions are likely to dampen exports, with China accounting for nearly a quarter of exports.

Real GDP growth



Source: Economist Intelligence Unit (F = forecast)

Domestic credit to private sector as % of GDP



Source: World Bank

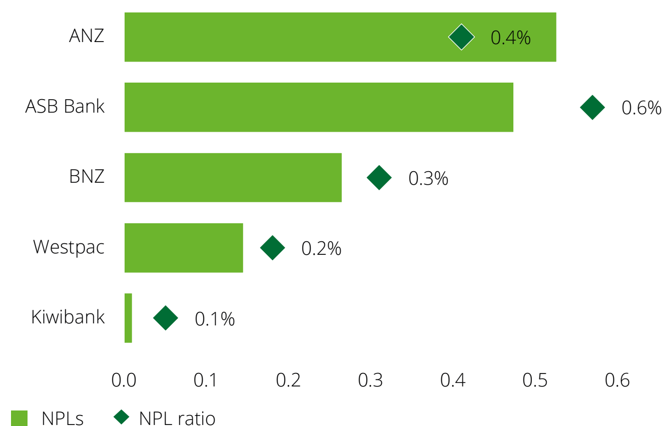
Banking landscape and non-core market

There is a significant overlap between the New Zealand and Australian banking systems, as evidenced by the 'Big Four' Australian banks also comprising the largest banks in New Zealand. The overall banking loan book is dominated by housing loans, representing over 58% of gross loans and advances (GLA), with business loans and agricultural loans a further 38% between them.

Responding to low inflation and the prospect of slowing demand, both domestic and internationally, the Reserve Bank of New Zealand (RBNZ) in August slashed the Official Cash Rate by a further 50bps to the record low of 1.0%, after having held the rate flat for nearly two years.

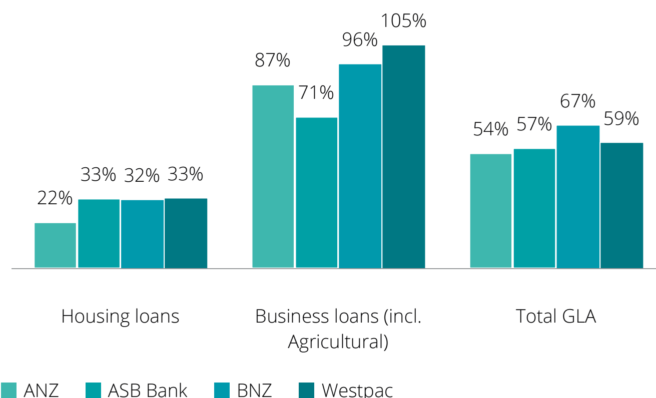
New Zealand's banking sector enjoys low NPL ratios, with the highest ratio reported by the largest banks being 0.6%. However, opportunities remain for strategic divestments at the regional or sector level. The proposed increase to Tier 1 capital requirements as part of RBNZ's comprehensive review of bank capital rules could force New Zealand's banks to increase capital by an estimated NZ$55bn by 2023.

Gross NPLs held by top banks (NZ$bn)

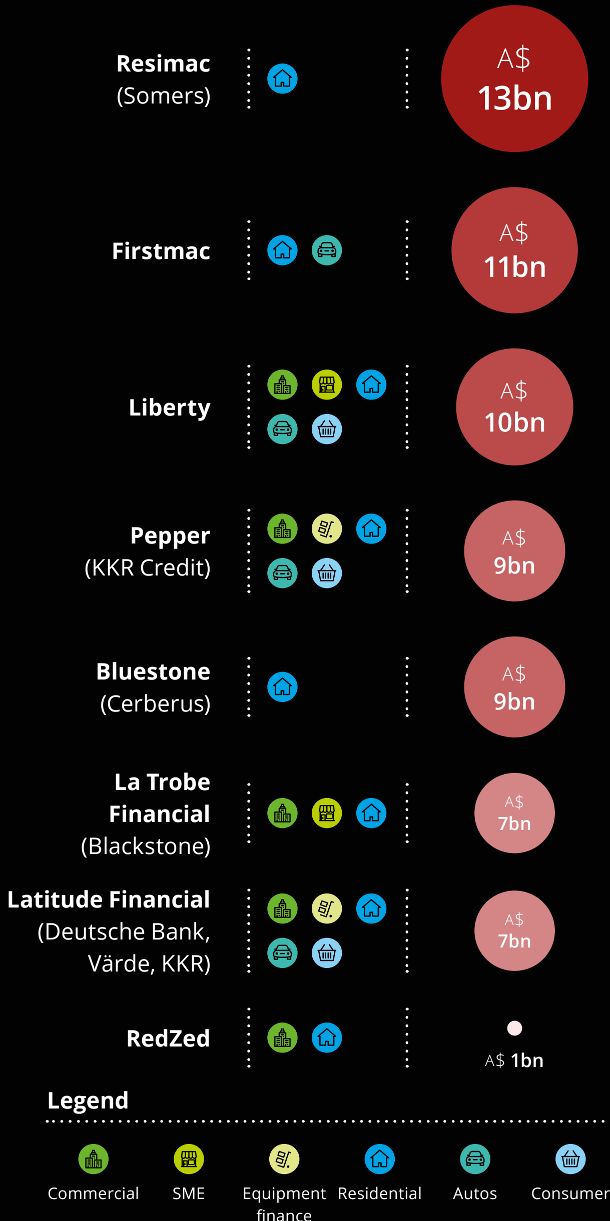


Source: latest published financial accounts as of September 2018

RWA by loan category



Source: RBNZ, bank disclosures as of March 2019



Non-bank lending platforms

Private equity and credit funds have been using M&A to enter the Australian non-bank lending market in recent years, acquiring a number of platforms for future growth. This has been led by the major global funds, which are expanding their global footprint as they seek opportunities for expansion outside of Europe.

Now backed by global capital, these platforms have been able to achieve significant growth, particularly in the riskier asset classes and sectors which are being exited by the main Australian banks, such as SME lending, unsecured consumer credit, and higher-risk mortgage borrowers. The private equity funds also bring teams with extensive knowledge and expertise in managing and growing loan portfolios, gained through experience in the European markets.

These buyers also enjoy the advantages of lower regulatory and capital requirements, and access to global funding sources chasing yield. With the current robustness of Australia's Residential Mortgage-Backed Securities (RMBS) and ABS markets, there is increasing appetite from global investors to expand their presence, further fuelling the platforms' ability to grow their assets under management (AuM).

Asset class	Non-bank lenders
Commercial	Thinktank, Wingate, Chifley Securities
SME	Prospa, Moula, Thinktank, eclipx Business Fuel, Ondeck, Bigstone, Capify, Get Capital, Spotcap
Equipment finance	CSG, Axsesstoday, Silverchef, Flexigroup (Flexi Commercial), eclipx
Autos	eclipx, Metro Finance
Consumer	Flexigroup, Now Finance, Society one, Rate setter, Harmoney, Thincats Australia, Wisr, Easy Street, Financial Services

Regulatory developments in Australia and New Zealand

Australia

The Australian Prudential Regulatory Authority (APRA) have been very active in setting regulation and guidance, which limits Authorised Deposit Taking Institutions' (ADI) abilities to lend to certain pockets of borrowers while also working to establish 'unquestionably strong' capital levels, including:

- ADIs have until January 2020 to meet the new capital benchmarks. The major banks have a benchmark Common Equity Tier 1 (CET1) capital ratio of 10.5%, with some requiring up to 40bps of capital to meet this benchmark.
- Introduction of a countercyclical capital buffer – while this currently remains at zero, APRA may use this lever to require banks to lift capital levels should systematic risk increase.
- Additional capital requirements applied to the 'Big Four' banks in response to their risk governance self-assessments – A$1bn for CBA, A$500m for ANZ, NAB, and Westpac.

New Zealand

The Reserve Bank of New Zealand (RBNZ) released a consultation paper in December 2018 proposing changes to regulatory capital for New Zealand banks. Full compliance would be required by 2023.

- Increase Risk Weighted Assets (RWA) for four internal ratings-based (IRB) accredited banks to approximately 90% of what would be calculated under the Standardised Approach.
- Increase Tier 1 capital requirements to 16% of RWA for banks deemed systemically important; and 15% for other banks – the major New Zealand banks currently average about 13.5%.
- The final revised version of Prudential Standard APS 222, released by APRA in August, limits the capital which Australian ADIs can hold in foreign subsidiaries. This will place further pressure on New Zealand's four largest banks – all Australian subsidiaries – to ration capital and divest non-core assets.

Portfolios impacted

Lending to foreign nationals

A number of measures such as lending limits and responsible lending standards have seen most major banks withdrawing from lending to foreign buyers. This is now a non-core offering for ADIs who are offloading these portfolios to multi-national banks.

SMSF lending / reverse mortgages

APRA recently revised its prudential guide on self-managed super fund (SMSF) loans and reverse mortgages which includes increasing RWA from 50% to 100% for loans with high loan-to-value ratios. Major banks have ceased underwriting, and such portfolios are now in run-off mode. At the same time, platforms are expanding into these products to fill the void left by the majors exiting and remain active in pursuing a trade on such portfolios.

High-risk lending

APRA's measures on responsible lending standard may result in higher RWA requirements and provision levels for riskier lending (such as mortgages which are interest-only, self-certified, or secured with investment properties), prompting banks to consider selling some of these portfolios.

NPLs

APRA may follow the European Central Bank's recently imposed provisions to increase RWA for NPLs.

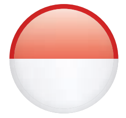
Unsecured retail exposures

APRA proposes to increase RWA to 125% for all retail exposures (except credit cards), an increase from the current requirement of 100% RWA for retail exposures.

Equipment / asset finance

These may also be impacted by increased RWA requirements resulting in banks considering selling such loan portfolios.

Indonesia



Macroeconomic overview

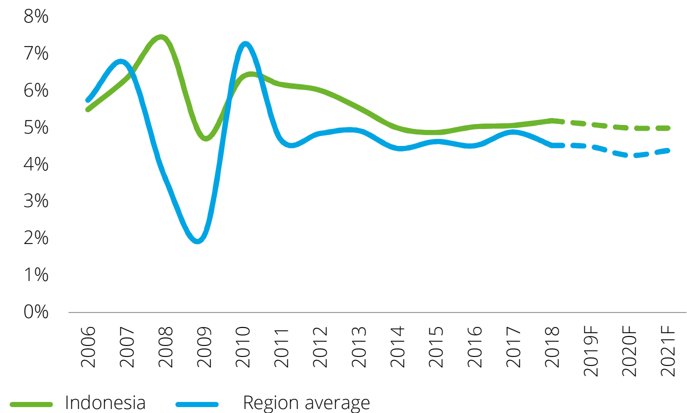
Indonesia's economic growth has stabilised at around 5% over recent years in line with the regional average. Growth is forecast to continue at a similar level for the coming years.

The May 2019 general election saw President Joko Widodo re-elected to a second five-year term. Widodo's presidency has been noted for his commitment to developing infrastructure and expanding social welfare. These policies are expected to continue through his coming term.

The risk of increasingly protectionist policies, particularly in the context of the ongoing Sino-American trade conflicts, presents the most significant challenge for the Indonesian economy over the coming years. Reductions to Indonesian exports since the end of 2018 have further widened its trade deficit, forcing the government to actively pursue new trade partnerships, both regionally, and farther afield.

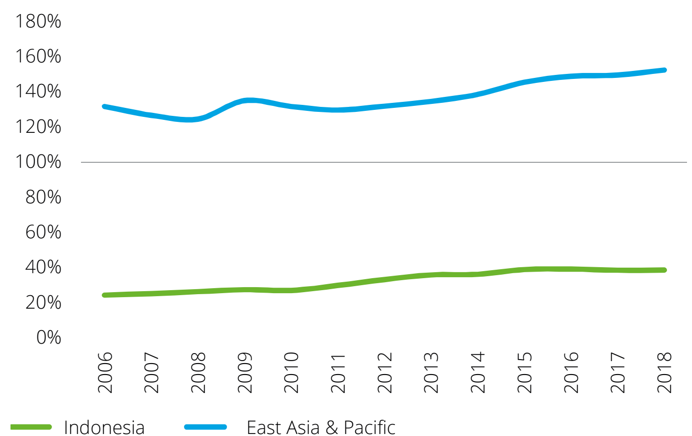
Indonesia's banking sector is exposed to the slowing rate of growth in China's economy, along with the continuing weakness of the Rupiah against the US Dollar. Notwithstanding this, the Bank Sentral Republic Indonesia's (BI) interest rate of 6% still provides attractive yield opportunities in the global context.

Real GDP growth



Source: Economist Intelligence Unit (F = forecast)

Domestic credit to private sector as % of GDP



Source: World Bank

Banking landscape

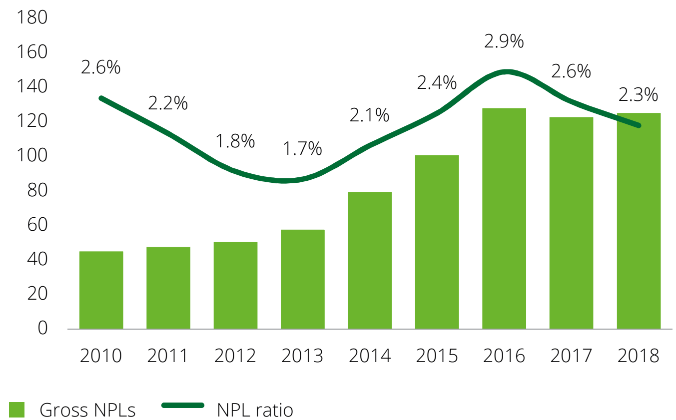
Investment and consolidation have been the key themes in the Indonesian banking sector over the past year. With over 115 commercial banks in the country, the Financial Services Authority (OJK) has actively encouraged consolidation within the sector in the interests of greater stability, and reducing the challenges of regulating such a large number of banking institutions. Supporting this, the OJK has also allowed over 40% ownership by foreign investors in M&A scenarios.

Foreign investment in the sector has come largely from the region, with Japan's Mitsubishi UFJ Financial Group (MUFG) doubling its shareholding in Bank Danamon to over 40% as part of its intended merger with Bank Nusantara Parahyangan (BNP). MUFG is expected to increase its holding to around 75%, pending approvals from shareholders and the OJK. Also from Japan, Sumitomo Mitsui Financial Group (SMFG) is expanding its presence in the Indonesian market, seeking to create the country's 10th largest bank through the merger of Bank Tabungan Pensiunan Negara (BTPN) with its Indonesian subsidiary, Bank Sumitomo Mitsui Indonesia (SMBC).

The Industrial Bank of Korea (IBK) is planning the merger of its subsidiary, Bank Agris, with Bank Mitraniaga, in which it has recently acquired a 72% stake. Meanwhile South Korean investors, Apro Financial, have acquired a 77% stake in Bank Dinar, with a view to merging with Bank Oke, in which they already hold a majority stake.

On the other hand, Standard Chartered is reported to be seeking offers for the 45% share it holds in Permata Bank, which has been deemed non-core.

Total banking system NPLs (Rp'tn)



Source: Bank Indonesia

NPL market

Following significant growth since 2008, the stock of NPLs held in the Indonesian banking sector has stabilised at around Rp130tn (US$9bn). This has brought the NPL ratio down to 2.3% from nearly 3% in 2016.

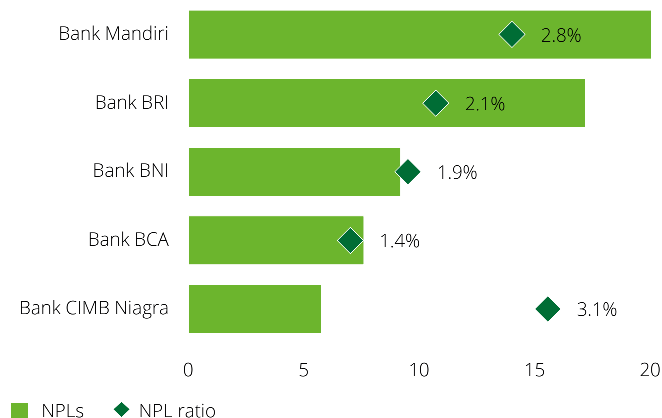
The majority of NPLs in the Indonesian market are held by the country's state-owned banks which are restricted in their ability to dispose of NPLs at a discount. This regulation continues to be a key factor limiting the number of loan portfolio sales in the country.

However, there has been an increase in loan portfolio sales as commercial, regional, and foreign banks work to reduce NPL ratios – notably as a result of capital pressures where the banks have already been required to report under IFRS9 standards – as well as strategic disposals of non-core or underperforming businesses. The regulatory push towards consolidation in the banking sector is also likely to drive further portfolio activity as banks clean up post-merger balance sheets.

Significant asset quality issues have required recapitalisation by Bank Bukopin and Bank Muamalat, with the former securing investment from South Korea's KB Kookmin Bank, and discussions still underway with the OJK to approve the latter's restructuring plans. Ultimately, both will need to resolve their NPLs as part of their overall restructuring. The official implementation of PSAK 72 – Indonesia's adaptation of IFRS9 – in January 2020 is also likely to result in higher NPL levels for a number of weaker banks.

A number of foreign banks have launched NPL disposals over the past year, including HSBC and CIMB Niaga, primarily consisting of corporate assets backed by real estate, as well as commercial and SME loans. Within the unsecured space, Collectius has announced its acquisition of a Rp32trn portfolio with potential forward flow from a bank.

Gross NPLs held by top banks (Rp'tn)



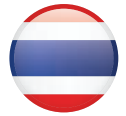
Source: published financial accounts as of December 2018

Outlook

Despite the challenges inherent to an emerging portfolio market, activity has increased since the widely-publicised divestment by Permata Bank of an Rp6.5trn corporate loan portfolio in 2017 to a consortium of CarVal and Macquarie. While this deal has highlighted the challenges for debt holders to enforce on difficult borrowers, it has also provided a case study for investors, demonstrating that portfolio trades can be executed successfully in the country.

Another likely source of NPL portfolios is Indonesia's multi-finance sector, with a tightening of liquidity and slowdown in lending activities following last year's default by Sunprima Nusantara Pembiayaan (SNP) Finance. The OJK has also increased its scrutiny of the sector, leading to a number of licences being revoked or suspended in the sector.

Thailand



Macroeconomic overview

The Thai economy improved over the course of 2018 with full year GDP growing by 4.1%, the fastest expansion in 6 years. Export values grew by 7.7% while private consumption and total investment increased by 4.6% and 3.8% respectively. Average headline inflation remaining positive at 1.1%, along with the current account surplus provide further indicators of this economic expansion.

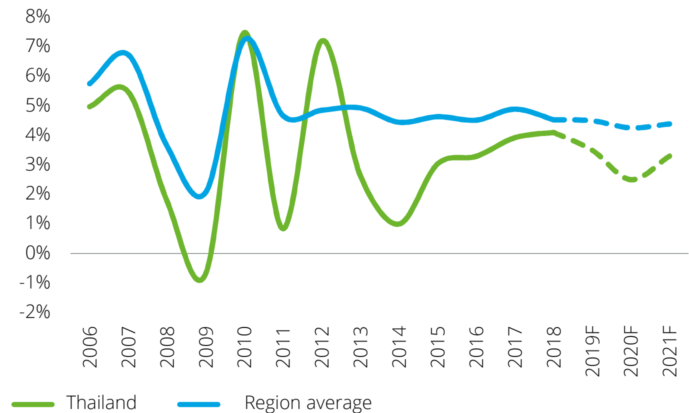
Growth forecasts for the Thai economy from the The Office of the National Economic and Social Development Council (NESDC) and EIU range between 3%-4.5% over the coming years. Further growth is expected to be fuelled by increases in private consumption, tourism, and an acceleration in both private and public investment, particularly through key public infrastructure programmes.

In December 2018 the Bank of Thailand (BoT) raised its key policy interest rate, the one-day repurchase rate, for the first time since 2011, from 1.5% to 1.75%. The BoT is widely expected to maintain an accommodative monetary policy approach over the coming years in order to support economic growth in a low inflationary environment.

Economic revival is expected to remain a high priority for the new government following the national elections in March 2019, with a focus on policies aimed at boosting the country's medium to long-term investment prospects. The primary focus is likely to be ramping up public spending on infrastructure, although measures to boost private consumption are also likely to be included.

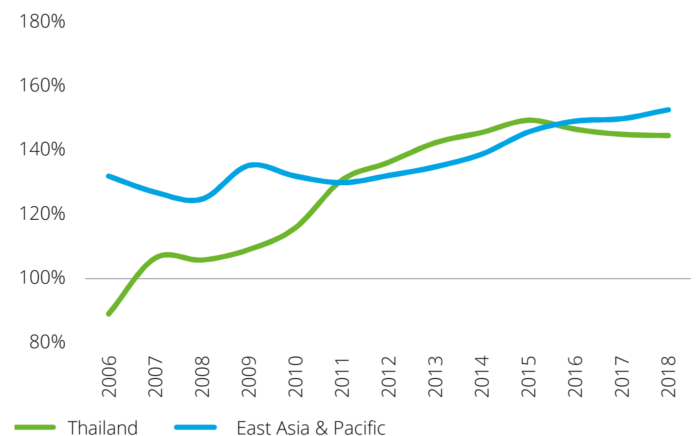
The notable risk to an otherwise positive economic outlook for the country is the potentially negative effect of ongoing Sino-US trade tensions on the country's growth prospects.

Real GDP growth



Source: Economist Intelligence Unit (F = forecast)

Domestic credit to private sector as % of GDP



Source: World Bank

Banking landscape

Thailand's financial sector continues be a significant contributor to GDP attracting foreign investment from Japan, China, and other ASEAN countries. Despite recent increases in the ratio of household debt to GDP, there has been a downward trend since 2016.

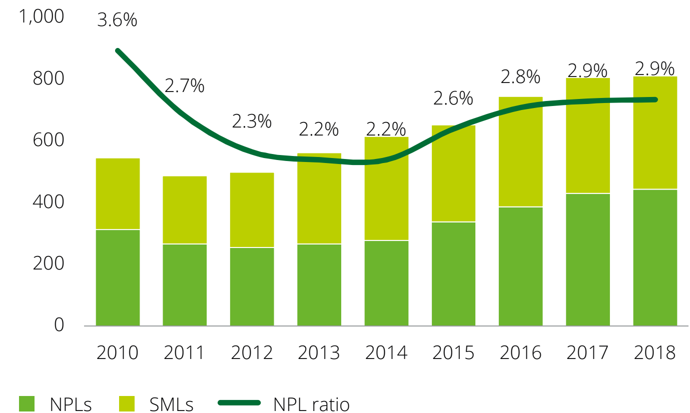
The overall NPL ratio of 2.9% over recent years has been moderated by the active NPL portfolio sale market enabling the banks to reduce their risks through regular divestments. NESDC has reported year-on-year consumer NPL growth of 9% in the first quarter of 2019, separately highlighting the further 2.4% in special mention loans (SML).

There is a high concentration of NPLs and SMLs in the small and medium-sized enterprises (SME) sector, whose NPL ratio of 4.65% remains significantly above the overall ratio, following consistent rises. The economic challenges facing Thai SMEs have been widely reported, including the ongoing regional macroeconomic uncertainty and the disruption caused by expanding e-commerce.

The latest BoT data indicates Thai banks have sufficient capital to weather future volatility, with the total capital and Common Equity Tier 1 (CET1) ratios to risk-weighted assets standing at 18% and 15.1%, respectively, as of November 2018.

The proposed merger of TMB and Thanachart would be one of the largest banking M&A deals in Thailand for some time. Together with the proposed merger of Secondary Mortgage Corporation (SMC) and Government Housing Bank (GHB), it is an example of the theme of consolidation in the sector, both in Thailand and the region more broadly. These follow the government approval last year of tax incentives for financial institution M&A designed to enable Thai banks to compete with larger regional rivals.

Total banking system NPLs (฿bn)



Source: Bank of Thailand

NPL market

The Thai NPL portfolio market is the most mature in South East Asia. It has been active since the early days of the Asian Financial Crisis, and continues to provide an effective mechanism for Thai banks to de-risk their balance sheets. Unsurprisingly, the market has been growing over recent years with regular sales from the largest banks. Sukhumvit Asset Management (SAM), one of the country's two largest buyers of NPLs, estimates over ฿100bn (US$3.5bn) is marketed annually.

Portfolios coming to market continue to be significantly multi-tranched, catering to the large number of smaller local buyers. However this is likely to change as the market attracts more foreign investors to its mix of capital providers. Larger foreign investors – such as Bain Capital, Lone Star, Apollo, SSG, and Goldman Sachs – are becoming more active with the establishment of servicing operations, and are taking market share from local incumbents in both portfolio and single-asset positions.

Residential mortgages continue to represent a significant proportion of the NPLs sold, but an increasing number of real estate-backed SME NPLs have been brought to market recently, which is likely to continue through 2019 with general growth in the SME segment.

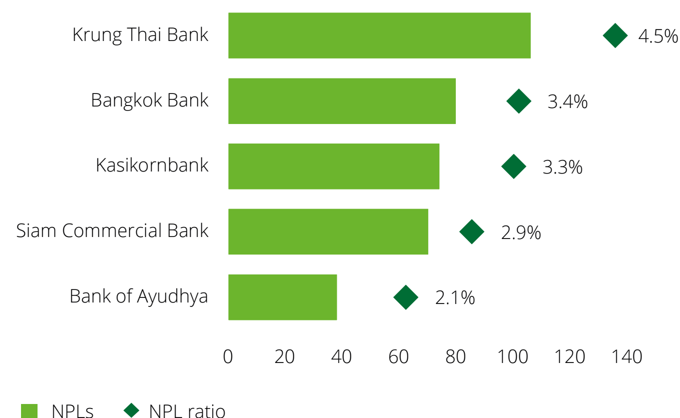
Outlook

With Thai banks now expected to adopt IFRS9 in 2020, the classification requirements of the new regulation are likely to reveal a greater level of distressed assets. While the capital buffers held by Thai banks will afford them time to resolve their NPLs, the uncertain economic outlook could present challenges for them in terms of maintaining the appropriate NPL ratios, driving further NPL sales.

There are likely to be increases to portfolio tranche sizes, which have historically presented a challenge to foreign investors entering the market, as banks take advantage of new investors with larger pools of capital. This would allow investors to build economies of scale faster, and potentially attract leverage, in turn reducing the bid-ask spread.

Recently announced regulatory changes allowing AMCs to acquire unsecured consumer loans from both banking and non-banking sectors are expected to drive an increase of activity in the asset class. This is likely to attract the interest of well-capitalised debt collection agencies.

Gross NPLs held by top banks (฿bn)



Source: published financial accounts as of December 2018

The long-awaited IPO of Bangkok Commercial Asset Management (BAM), announced in August 2019, would leave SAM as the only fully state-owned AMC in the market. This would have a structural impact on the market, particularly in the context of realigned cost of capital for a commercial entity, and is likely to impact the medium term demand-side dynamics.

While the dominance of SAM and BAM are unlikely to diminish in the near future, the changing dynamics in the market could present significant opportunities for both new market entrants, as well as those which have entered the market over the past few years.

Malaysia

Macroeconomic overview

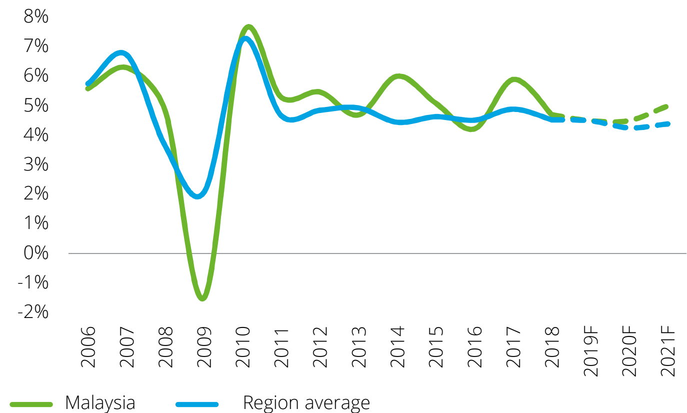
Malaysian real GDP is forecast to stabilise around the regional average of 4.5% over the coming years, a slight slow-down compared with the 5.3% growth achieved in 2018 in the context of the wider moderation of trade globally.

The May 2018 general election ushered in a new government led by the Pakatan Harapan coalition on a platform of economic reform and pledges to tackle corruption in the country. In doing so, they replaced the ruling Barisan Nasional coalition, which had held power in the country for six decades.

A number of the measures introduced, such as the abolition of the Goods and Services Tax (GST) and targeted subsidies to stabilise the price of fuel have helped to moderate inflation, with CPI forecast to be around 1.8% for the coming years providing a benign economic environment.

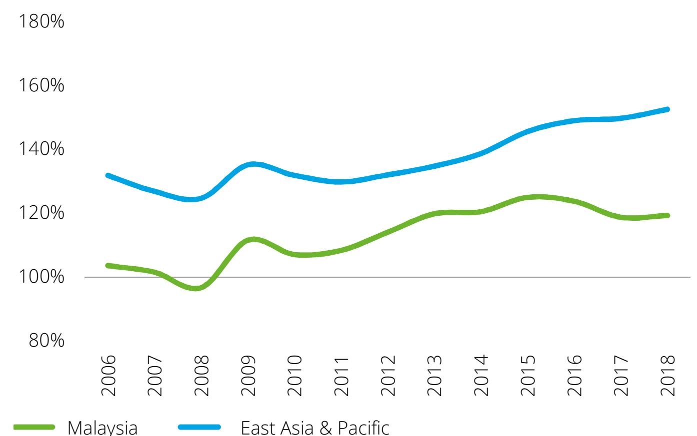
The comprehensive review of megaprojects has resulted in the postponement and cancellation of a number of large infrastructure projects, which is expected to reduce government outlays and help reduce the budget deficit.

Real GDP growth



Source: Economist Intelligence Unit (F = forecast)

Domestic credit to private sector as % of GDP



Source: World Bank

Banking landscape

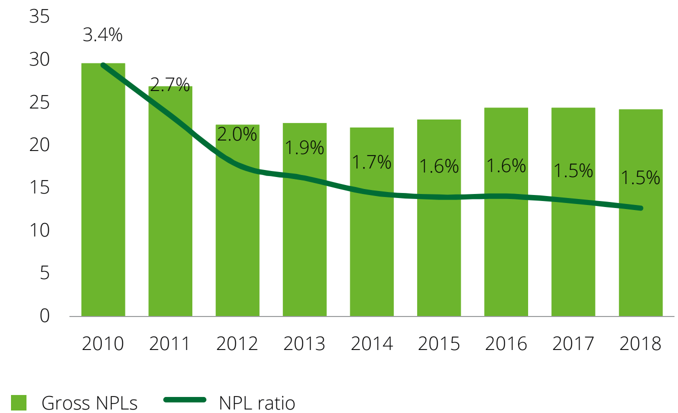
Domestic financial groups continue to be the key players in Malaysia, which typically have a conventional banking unit together with affiliated operations in Islamic and investment banking. Malaysia's Islamic financial system is one of the most advanced in the world, running in parallel with well-developed retail and commercial banking markets.

Overall loan growth of 4.8% in 2018 was driven primarily by the business segment, as well as Islamic financing which increased by 11.5% and 8.9% to households and businesses, respectively. This brought Islamic financing to 32% of the country's overall banking system loans, with a target set by Bank Negara Malaysia (BNM) of reaching 40% by 2020. The growth in personal financing has been significantly moderated since the peak as a result of tighter credit controls and cost-cutting measures over recent years.

Consolidation continues to be an area of focus within Malaysia's banking sector with a number of financial institutions exploring potential mergers over recent years, although not all have managed to produce a successful agreement. These abandoned deals include the proposed three-way merger between CIMB Group, RHB Capital, and MBSB in 2015; and RHB's subsequent merger discussions with AmBank Group in 2017.

MBSB's successful acquisition of Asian Finance Bank saw the consolidated MBSB Bank emerge as a full-fledged Islamic bank. Meanwhile, merger discussions are still ongoing between the Malaysian unit of Saudi Arabia's Al Rajhi Bank and the state-owned MIDF since early 2019.

Total banking system NPLs (RM'bn)



Source: Bank Negara Malaysia

It is understood that a number of foreign players are considering exiting the Malaysian market, and potentially exploring M&A opportunities. However, these may not always be achievable, meaning that deleveraging and managed exits may prove the more attractive approach.

NPL market

BNM reports an overall NPL ratio of 1.5% in the country's banking sector, although a number of the larger banks have higher ratios, which is not unexpected given their scale and exposure to regional markets.

Last year's adoption of MFRS9 – Malaysia's adaptation of IFRS9 – is anticipated to be reflected in the 2019 reports, with CIMB Research forecasting slight deterioration to asset quality, but a 15% increase to loan loss provisions. This could drive increased NPL portfolio activity, as banks look to strengthen their balance sheets.

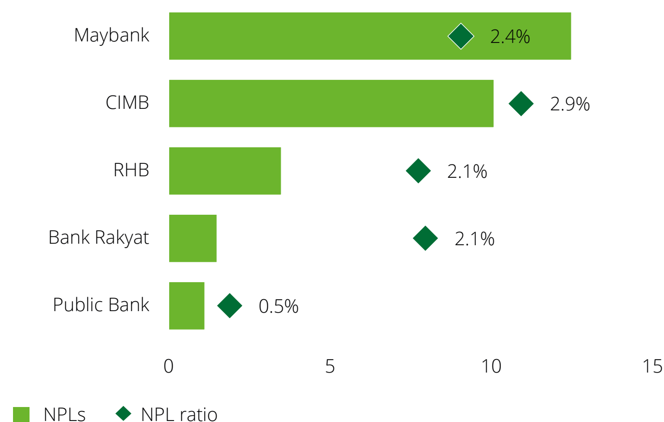
There has been a steady stream of small-scale clearouts of legacy unsecured stock, much of which has already been written-off. Buyers tend to come from the debt collection or servicing community, including regional unsecured debt specialist Collectius, which announced three Malaysian acquisitions during 2018.

A notable exception to this was AmBank's NPL disposal to Aiqon-controlled SPVs in early 2019. The RM554m (US$134m) transaction included both individual and corporate borrowers, separated into two portfolios of Islamic and conventional loans.

Outlook

Malaysia has the classic hallmarks of a developing NPL market, following a pattern which has been seen across a number of now-mature European NPL markets, in which bank sellers begin with disposals of legacy unsecured NPLs, where the high levels of write-offs and impairments allow greater potential upside for prospective buyers.

Gross NPLs held by top banks (RM'bn)



Source: published financial accounts as of December 2018

This trend is likely to continue over the coming year, with a number of deals either already in the market or being considered by banks. However, many of the debt collection agencies which typically bid for these portfolios lack the capital to acquire the larger portfolios. This could present partnership opportunities, and a potential market entry strategy for foreign investors.

Capital optimisation and post-merger activity are expected to lead some banks to consider sales of secured portfolios in the near future. In such an event, portfolios would likely entail substantially larger investments than have been typical in the country, and would also require investors to establish secured servicing capabilities acceptable to the regulators.

Philippines

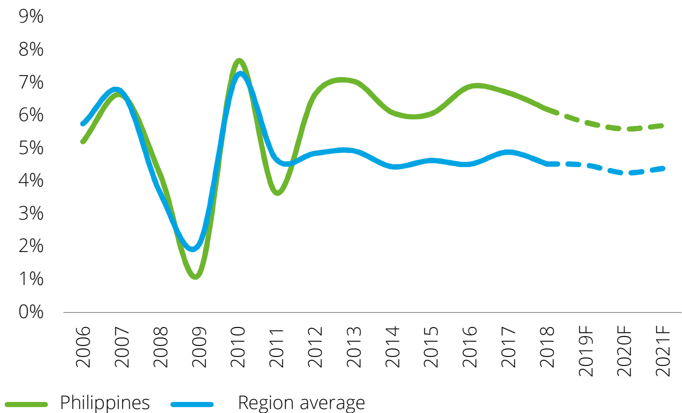
Macroeconomic overview

The Philippines remains one of the region's fastest growing economies, with real GDP growth of 6.2% in 2018. Short term forecasts remain positive due to cooling inflation, with the country's sound macroeconomic fundamentals, continued investment in infrastructure, and improved ease of doing business providing an optimistic long term view. Growth is forecast to continue above 6% over the coming years, representing one of the more robust growth curves in the region.

The economy remains heavily reliant on household consumption which accounted for 68.5% of GDP in 2018. However, investments and government expenditure also saw strong year-on-year growth, largely due to infrastructure related activities. On the production side, the country remains dependent on the services sector, whose gross value added accounted for 57.7% of GDP in 2018. However, it was the industry sector which achieved the fastest growth at 6.8%.

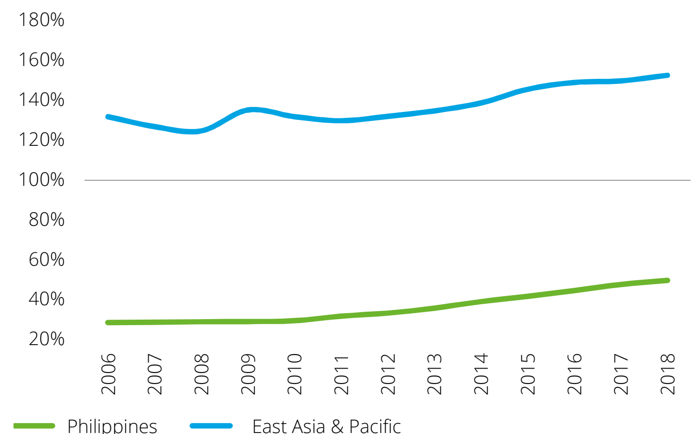
Philippine economic prospects still face external headwinds in the form of the global economy's 'synchronised slowdown', and the potential adverse impacts from El Niño-related weather. Further challenges could result from the delayed effects of policy decisions such as the potential removal of key tax incentives, and the 1.75% increase to the overnight reverse repurchase (RRP) rate during 2018, which is already being reversed by Bangko Sentral ng Pilipinas' (BSP) with reductions in May and August 2019. However, despite these challenges, the overall outlook for the country's growth remains positive.

Real GDP growth



Source: Economist Intelligence Unit (F = forecast)

Domestic credit to private sector as % of GDP



Source: World Bank

Banking landscape

Although the Philippine banking sector is relatively small compared to its counterparts in the region, the outlook is generally positive due to sufficient capital adequacy and ample liquidity. There was a total stock of ₱180bn (US$3bn) NPLs held by Philippine banks, with a gross NPL ratio of 1.8% as of December 2018.

While the overall Capital Adequacy Ratio (CAR) has dipped from 17.4% in December 2012 to 15% in December 2018, this is still well above the regulatory minimum of 10% and provides adequate buffers against unexpected losses. At the same time, the sector's loan-to-deposit ratio reached 79%.

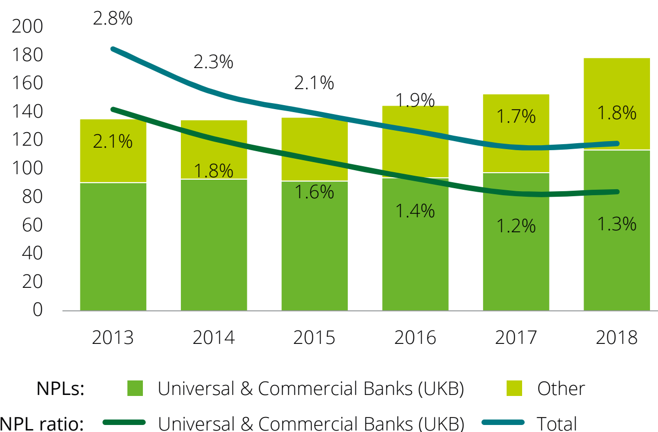
The majority of banking assets are held by universal and commercial banks whose total assets of US$293bn accounted for over 90% of country's total in 2018. There is also heavy concentration, with about half of the sector's assets held by the top four banks – BDO Unibank, Metrobank, Bank of the Philippine Islands (BPI), and the state-owned Land Bank of the Philippines (LANDBANK).

NPL market

The Philippine NPL market originally emerged following the Asian financial crisis of the late 90's when the gross NPL ratio of the country's banks skyrocketed to 17.5%. In response, the Philippine Congress enacted the Special Purpose Vehicle (SPV) Act of 2002 (Republic Act No. 9182), providing tax exemptions and incentives for banks to transfer their non-performing assets (NPA) to SPVs.

Initially granted for a two-year period the Act was extended for a second phase from 2006-2008, enabling a total of ₱180bn to be transferred under the terms of the SPV Act – a significant factor in reducing the country's NPL ratio. There have been relatively few NPL sales in the years since the expiry of the SPV Act.

Total banking system NPLs (₱bn)



Source: Bangko Sentral ng Pilipinas

Recent portfolio transactions have been predominantly limited to unsecured loans. The sale by Rizal Commercial Banking Corporation (RCBC) and Planters Development Bank to an SPV led by the International Finance Corporation's (IFC) Debt and Asset Recovery Program (DARP) was one of the country's most notable transactions in recent years.

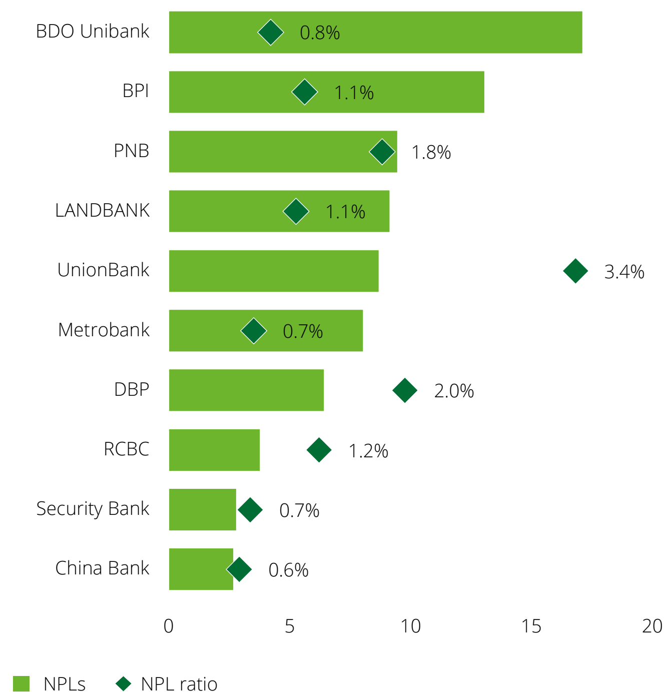
In addition to this, the five M&A deals reported by Mergermarket as being announced in the Philippine financial services sector during 2018 – representing a total deal value of US$175m – would relate to sales of older stocks of NPLs by the banks.

Outlook

Despite the generally high quality of assets held by Philippine banks, there are a number of risks which could lead to increased activity in the country's NPL market. One such risk relates to some of the large universal and commercial banks which are part of conglomerates that also have operations in real estate development. This has raised concerns regarding the banks' exposure to interconnected borrowers and sectors.

Another risk comes from the thrift banking system and rural and cooperative banks which, although a comparatively small part of the overall banking sector, are holding significantly higher levels of NPLs, with ratios of 5.3% and 11.2%, respectively, as of December 2018. This could lead to further NPL portfolio activity in the short to medium term, as these sectors seek to improve asset quality and strengthen capital buffers.

Gross NPLs held by top banks (₱bn)



Source: published financial accounts as of December 2018

South Korea

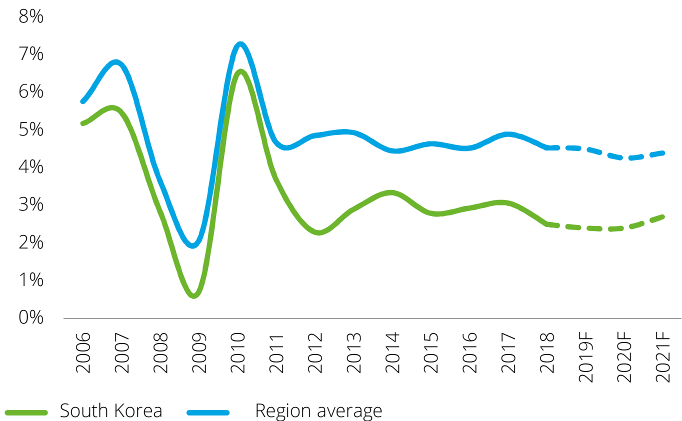
Macroeconomic overview

South Korea's real GDP growth of 2.7% in 2018 was the lowest since 2012, and has been followed by further weakening in economic forecasts, with the latest Bank of Korea (BOK) projection suggesting growth as low as 2.2% in 2019.

Of particular concern is the risk to tech supply chains posed by the ongoing trade tensions between China and the US, as well as economic friction between South Korea and Japan, and all in the context of the global economy's 'synchronised slowdown'.

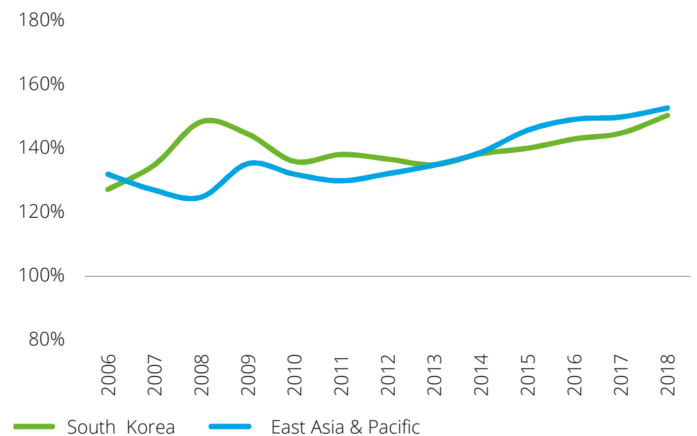
This has led the BOK to unexpectedly cut the base rate of interest to 1.5% in July 2019. Marking a shift in the bank's priority – with a greater focus on supporting economic recovery – and reversing the rate hike of November, when the bank cited record household debt and elevated property prices as factors behind the increase.

Real GDP growth



Source: Economist Intelligence Unit (F = forecast)

Domestic credit to private sector as % of GDP



Source: World Bank

Banking landscape

As part of its policy to stabilise house prices and reduce household debt, the government has introduced a number of measures including strict loan-to-value (LTV) and debt-to-income ratios. This continued in August 2018 with the introduction of a set of regulations to curb speculative real estate demand in key areas, designated "anti-speculation zones" and "overheated zones".

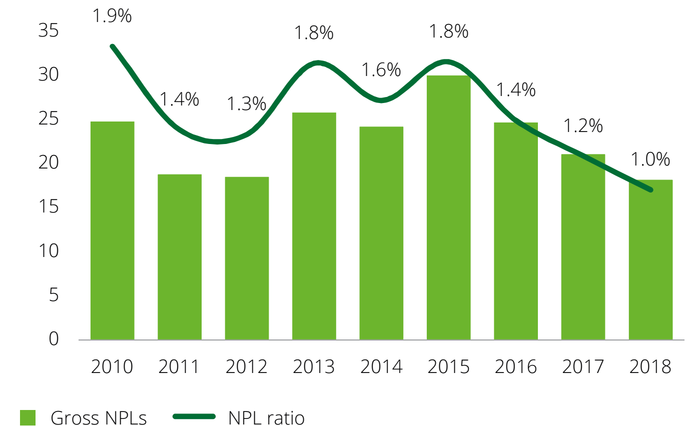
Restrictions include tighter mortgage rules and a maximum LTV of 40% for buy-to-let (BTL) properties. Together with the debt-service ratio targets introduced for the financial sector to manage new loans originated after October 2018, these measures have had some limited success in moderating the growth of household debt and overall house prices.

These stricter lending rules, along with restructuring measures adopted by businesses have achieved consistent reductions in non-performing exposures since 2015. The ₩18.2tn (US$16.4bn) of NPLs held by Korean banks at the end of 2018 brings the overall NPL ratio to below 1%, the lowest levels in a decade.

Business loans comprise the largest part of these loans, with an overall NPL ratio for business loans of 1.4% – 2.1% for large companies, and 1.1% for SMEs – resulting from key industries, such as ship-building, construction, steel, and transportation being considered particularly risky due to their exposure to foreign economies, notably the US and China. This compares with NPL ratios for household loans and credit cards of 0.2% and 1.2%, respectively.

The country's four largest national banks all reported NPL ratios below 0.7% at the end of 2018. Conversely, the latest accounts filed by Korean National Bank (KDB) indicate a further increase in the NPL ratio to 4.2%. Performance has also varied at the regional and bank levels, notably driven by exposures to particularly vulnerable industries.

Total banking system NPLs (₩tn)



Source: Bloomberg

NPL market

The Korean NPL market is mature, with portfolios being marketed across a wide range of asset classes, including commercial real estate, residential mortgages, and shipping finance.

An estimated US$6bn outstanding principle balance (OPB) of NPLs is marketed each year. Buyers are predominantly privately-owned investors, notably United Asset Management Company (UAMCO) and Daishin Securities. Other NPL investors include subsidiaries of larger conglomerates, such as Kookmin (KB) and Hana.

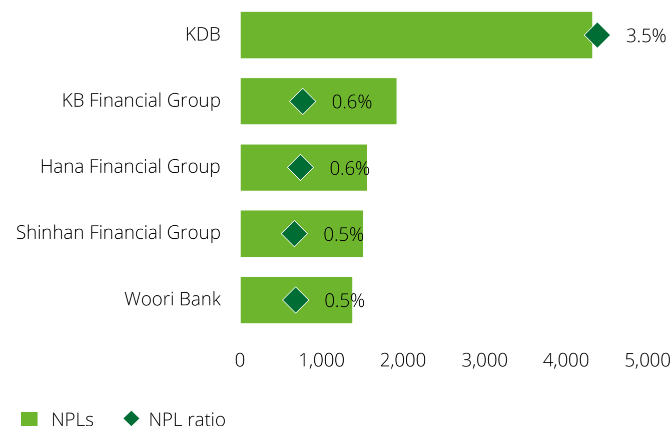
As would be expected in a mature and competitive market, returns tend to be lower as compared with other regional markets, which is a factor to be considered by prospective foreign entrants to the Korean market.

Outlook

There continues to be a steady flow of performing assets from a number of lenders, including insurers and mid-tier banks. This is due in part to the continuing impact of global regulatory standards being applied in the region, which is forcing financial institutions to refocus their business strategies, and divest non-core assets.

The current challenges facing the Korean economy could lead to higher levels of delinquency, increasing stress on capital ratios. This would, in turn, drive further activity in the country's NPL market over the coming year.

Gross NPLs held by top banks (₩tn)



Source: latest published financial accounts as of December 2018

Vietnam

Macroeconomic overview

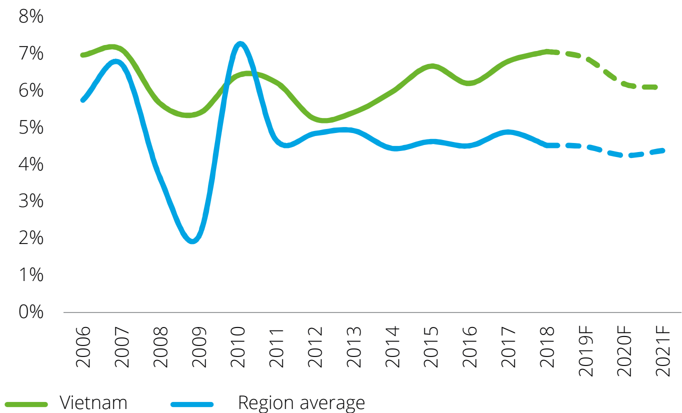
Vietnam has enjoyed consistently strong economic growth with real GDP CAGR of 6.9% since 2000 making it one of South East Asia's fastest-growing economies. Although growth is forecast to moderate somewhat over the coming years, it is still expected to outpace the region with an increasingly attractive macroeconomic environment for both domestic and international investment.

Recent GDP growth has been led by manufacturing growth of 13%, fuelled by strong external demand. Meanwhile, there has been steady expansion in the service sector, with growth of 7% driven by strong retail performance in the context of buoyant private consumption and record tourist arrivals.

As Vietnam emerges as a thriving middle-income economy, the ruling Communist Party is prioritising measures to develop its institutions and infrastructure to sustain future growth and international trade. In particular, it is pursuing deregulation, tackling corruption, and the restructuring of state-owned enterprises.

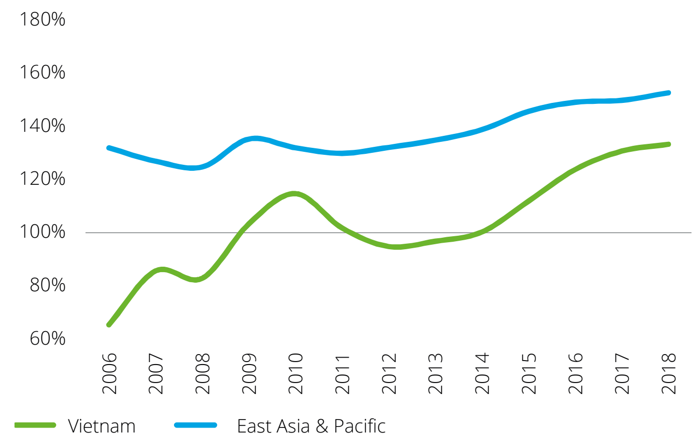
The ongoing US-China economic tensions could prove beneficial for Vietnam's economy, as foreign companies relocate production away from China. This has already led to a 36% surge in Vietnamese exports to the USA in the first half of 2019, making it the eighth largest source of American imports.

Real GDP growth



Source: Economist Intelligence Unit (F = forecast)

Domestic credit to private sector as % of GDP



Source: World Bank

Banking landscape

Vietnam's financial sector is dominated by the four state-controlled banks – Vietcombank, Vietinbank, BIDV, and Agribank – which continue to hold the lion's share of the market in loans and deposits as compared with their private counterparts. This follows the State Bank of Vietnam's (SBV) ongoing programme of restructuring and consolidation over recent years to reduce risk and tackle bad debt in the sector.

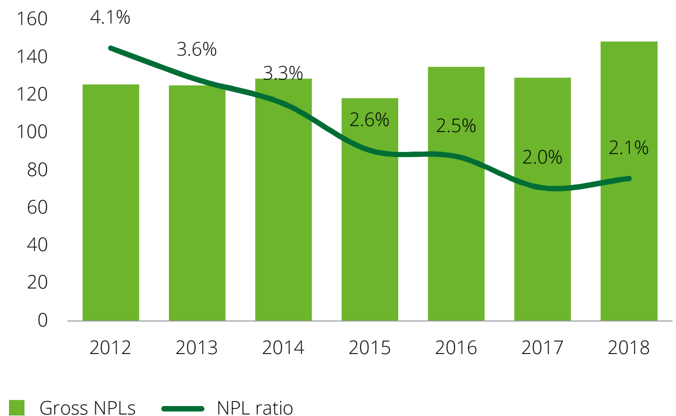
This has led to a significant volume of M&A activity and IPOs in the banking sector including inbound investment into the state-controlled banks. Notable transactions include the US$920m IPO of Techcombank in 2018, and private share placement of US$265m by Vietcombank to Mizuho and GIC (Singapore's sovereign wealth fund) this year. With the acquisition of 15% of BIDV by Korea's KEB Hana for an estimated US$735m announced in July; and the divestment of Petrolimex Group's banking division, PG Bank, to Ho Chi Minh City Development Bank (HDBank) which is still ongoing, and follows the collapse of its proposed sale to VietinBank last year.

NPL market

The overall banking NPL ratio of 2.1% has been reducing since 2012. This has been achieved through the banks' efforts to write off bad debts through enhanced provisioning and an expansion of credit activities, expanding the total lending base by 14% during 2018.

In 2013 the SBV set up the Vietnam Asset Management Company (VAMC) and required any banks with NPL ratios over 3% to sell NPLs in exchange for a special class of bonds. The bonds were provisioned at an annual 20% and could be used as collateral to secure capital from the SBV. By the end of 2017 VAMC had acquired US$12bn of NPLs.

Total banking system NPLs (₫tn)



Source: State Bank of Vietnam

Over the past year, in the context of improving prospects for business and the banking sector, the VAMC's role as a bad debt clearing house has reduced significantly from its 2015 peak.

The introduction of Resolution 42 in 2017 allowed greater autonomy to VAMC in resolving the bad debt portfolio it had accumulated. A key pillar of the resolution was the ability for investors other than domestic credit institutions to be transferrees of security interests granted over immovable property such as land use rights.

As such, it had been widely seen as laying the groundwork for the creation of a secondary debt market, and an opportunity for foreign buyers to enter the market. However, this is contrasted with long-standing restrictions in Vietnamese law, meaning that there is no clear guidance for non-bank investors on their ability to maintain mortgages or enforce claims on these immovable assets.

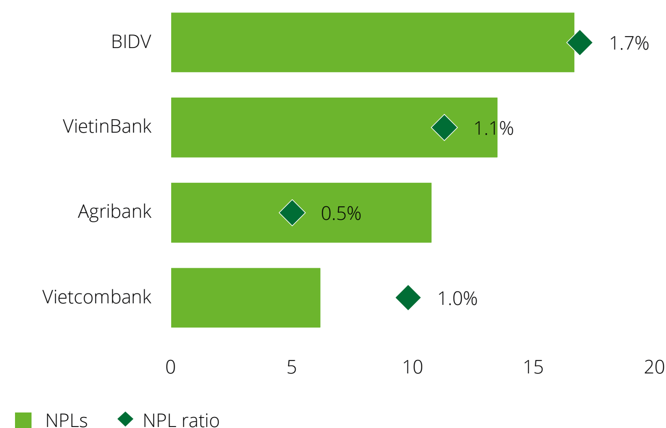
Outlook

Despite the ₫149tn (US$6.4bn) stock of NPLs held by Vietnamese banks, the market for portfolio sales is constrained by the ongoing uncertainty regarding the legal status and enforcement options for foreign investors in the country.

Two years since the removal of legal restrictions on the entities to which VAMC could sell NPLs, it is still unclear whether this opportunity also exists in the context of direct transactions between credit institutions and investors. This could effectively limit the market opportunity for non-bank buyers to the loans marketed by VAMC.

With enforcement options for foreign investors also unclear, there is unlikely to be significant interest in the Vietnamese market until further clarity can be provided.

Gross NPLs held by top banks (₫tn)



Source: published financial accounts as of December 2018

Singapore

Macroeconomic overview

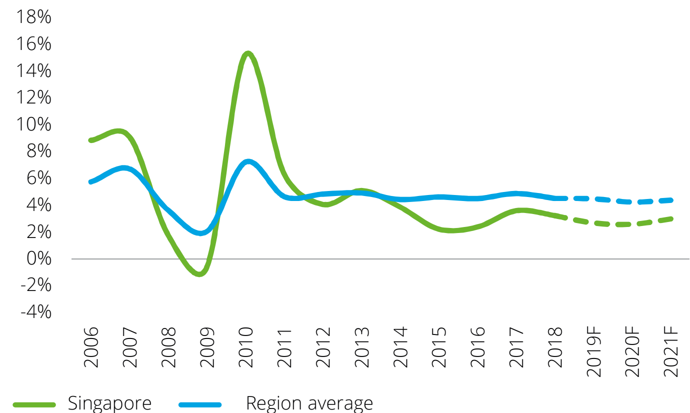
Singapore's economy grew by 3.2% in 2018, which was stable but below the average amongst other Asian jurisdictions. This is expected to moderate over the coming years, with the economic momentum slowing in early 2019 as a result of weaker demand from China and a deepening global tech slowdown.

Factory output contracted year-on-year for the first time since 2017, weighed down by double-digit declines in the electronics and precision engineering clusters. With dominant manufacturing and services sectors, the economy is heavily reliant on exports and global trade to drive growth which leaves it susceptible to further cyclical changes in global demand.

Banking landscape

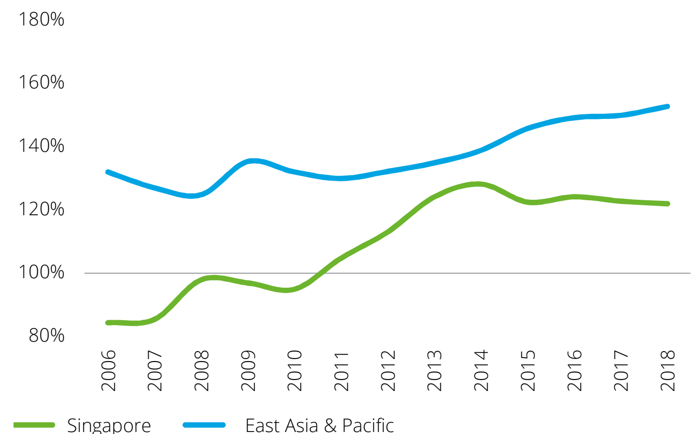
The November 2018 Financial Stability Review from the Monetary Authority of Singapore (MAS), assessed that the nation's banking system remains resilient despite increased uncertainty. The report highlighted four key drivers of external risk from the global macroeconomic environment: tightening financial conditions; global trade tensions; political uncertainty in Europe; and risks associated with technology. Lending by Singapore's commercial banking sector is significantly oriented towards housing (31%) and construction (20%).

Real GDP growth

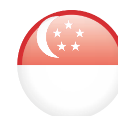


Source: Economist Intelligence Unit (F = forecast)

Domestic credit to private sector as % of GDP



Source: World Bank



NPL market

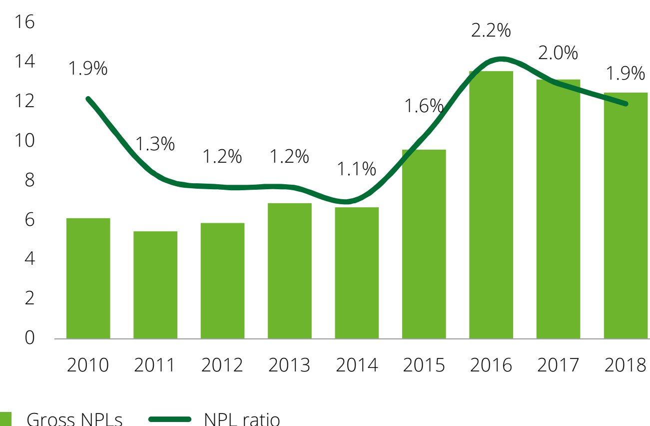
The quality of Singaporean banks' loan books has been improving, while overall lending has remained broadly steady over recent years. Reductions were seen in both the total stock of S$12.5bn (US$9.2bn) and overall NPL ratio of 1.9% at the end of 2018, although they remain significantly higher than the lows of a decade ago.

The country's three largest banking groups – DBS Bank, United Overseas Bank (UOB) and Oversea-Chinese Banking Corporation (OCBC) – maintain healthy balance sheets, with NPL ratios below 2%, and ample provisioning coverage over 190%. However, a significant proportion of the banks' NPLs come from their international exposures, notably in South East Asia, which could result in strategic decisions being made by head office to divest these bad loans.

Outlook

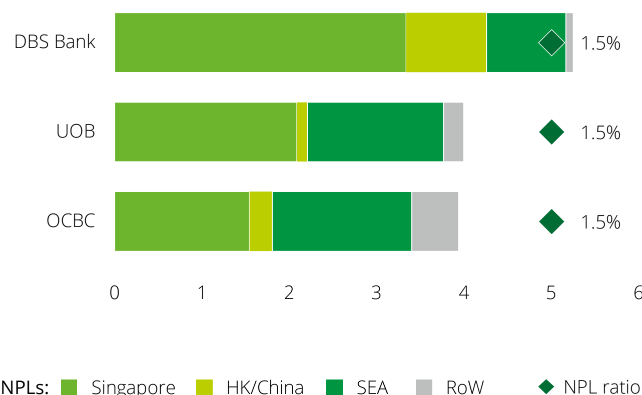
The volume and nature of in-country NPLs held by Singaporean banks are manageable through normal resolution methods, and as such the country has never had an active NPL portfolio trading market, even during the Asian financial crisis. The local banks are well capitalised, so any portfolio sales in the near future are likely to be primarily as a mechanism for reducing overseas exposures.

Total banking system NPLs (S$bn)



Source: Monetary Authority of Singapore

Gross NPLs held by top banks (S$bn)



Source: published financial accounts as of December 2018

Japan

Macroeconomic overview

Japanese GDP growth has largely stabilised at around 1% over the past decade, and is forecast to continue at a similar level for the coming years.

With this rate being significantly below the regional average, the Japanese government is driving efforts to increase domestic investment and raise wages in order to boost demand, stimulate the economy, and escape deflation. The pace of improvement remains subdued, however, owing to the ageing population and significant build-up of public debt over the years.

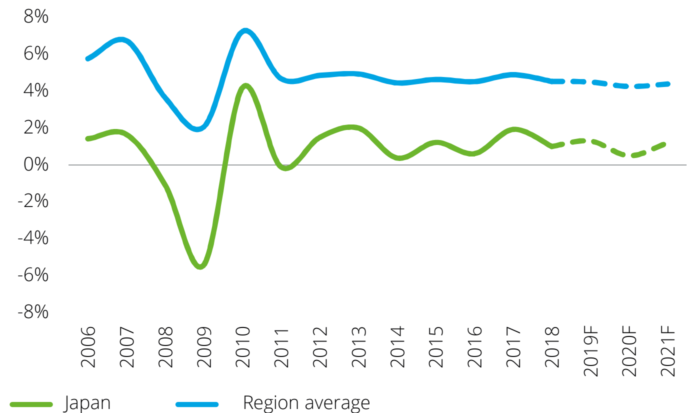
On the other hand, factors which could help stimulate economic growth include an anticipated increase in consumer spending ahead of the planned sales tax hike in October, together with increasing gross fixed investment, due in part to the works in preparation for the Tokyo 2020 Olympic Games.

Banking landscape

Japan's banking sector is mature and largely concentrated on the three megabanks – Mitsubishi UFJ Financial Group (MUFG), Sumitomo Mitsui Financial Group (SMFG), and Mizuho Bank – which between them account for about half of the country's lending, These have each emerged from the consolidation which took place following the Japanese asset bubble of the late 1980's, which also continues to shape their overall lending prudence.

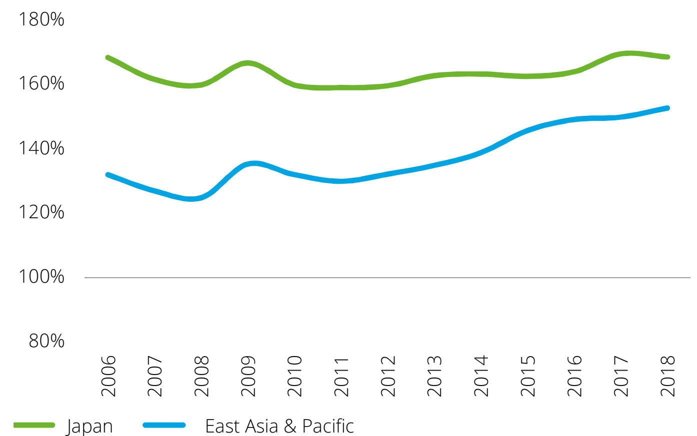
The Bank of Japan's (BOJ) Negative Interest Rate (NIR) policy has seen the key short-term interest rate maintained at – 0.1% since early 2016. This policy, which has seen nearly a decade of interest rates at 0% or below, together with sluggish economic growth, widespread use of financial products, and increasing competition from fintech challengers has seen profitability continue to be the key challenge for Japanese banks.

Real GDP growth



Source: Economist Intelligence Unit (F = forecast)

Domestic credit to private sector as % of GDP



Source: World Bank

The struggle to achieve margins commensurate to their risks has resulted in falling price-to-book ratios (PBR) – with the .IBNKS.T trading at a record low PBR of 0.4 on the Tokyo Stock Exchange in July 2019.

While the larger banks have focused on outward investment for returns, there has been a focus on consolidation amongst the country's 64 chiho-ginko (regional banks) and 259 shinkin banks (cooperative regional financial institutions) to address pressure on their profitability and capital margins. Recent government efforts in this regard have included reviewing antitrust measures to ease M&A restrictions for the regional banks.

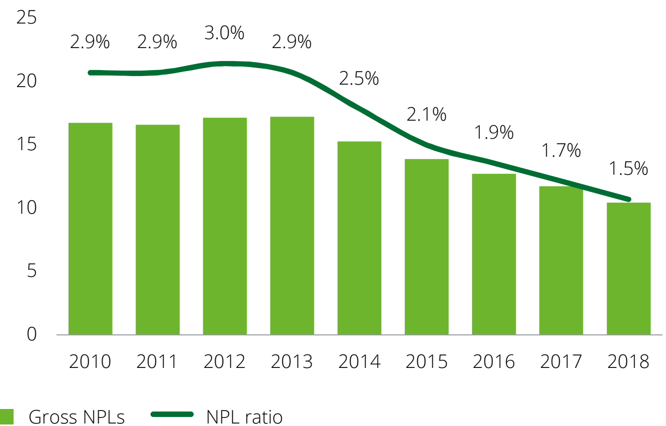
NPL market

The easy supply of money has seen the country maintain consistently-high levels of debt. However, the lending prudence exercised by Japanese banks been largely successful in managing and reducing their NPL ratios. The overall NPL ratio of 1.5% is half that seen a decade ago, and follows six years of consistent reductions. In this context, portfolio sales are not commonplace and the transactions which do take place tend to be small-scale, typically the result of balance sheet tidying-up by regional banks.

Outlook

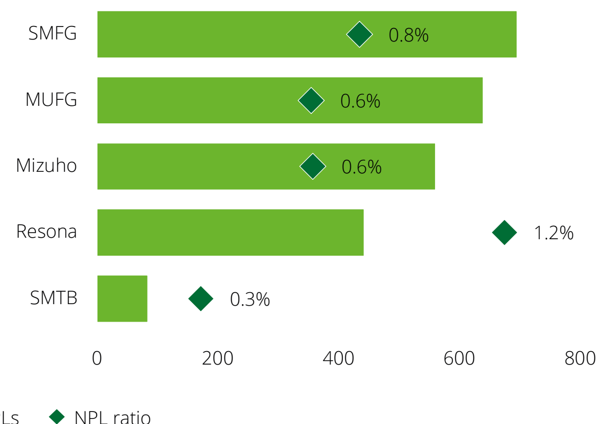
While the JP¥10tn (US$99bn) in NPLs held by Japanese banks is the third-highest in the region, the low ratio and consistent reductions over the past decade demonstrate the banks' ability to effectively manage their NPL ratios through normal resolution methods and without significant NPL portfolio disposal activity.

Total banking system NPLs (JP¥tn)



Source: Financial Services Agency (FSA)

Gross NPLs held by top banks (JP¥bn)



Source: published financial accounts as of December 2018

Cambodia

Macroeconomic overview

Cambodia is one of the fastest growing economies in Asia, having sustained annual GDP growth over 7% since 2011. Growth is forecast to continue around this level for the coming years, with inflation expected to remain at around 2.5%.

Economic growth has mainly been due to strong performance in garment exports, construction, and tourism. There are concerns that a lack of diversification presents a significant risk for the economy, given it's heavy reliance on the garment and construction sectors. Additionally, the country's export and tourism sectors are particularly vulnerable to the global and regional macroeconomic challenges, notably from China, or the EU's recent decision to review Cambodia's status under the Everything But Arms (EBA) scheme.

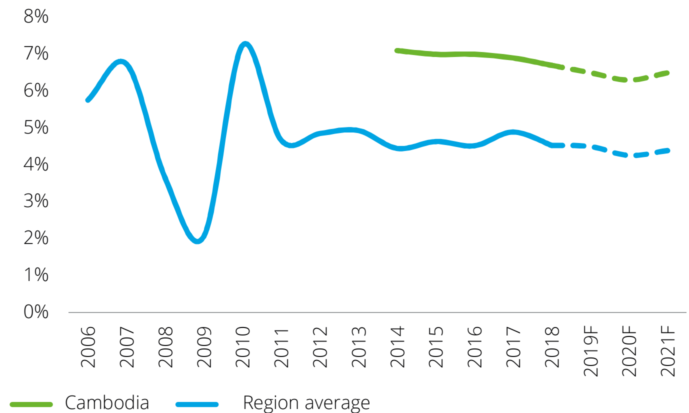
On the other hand, healthy rising disposable income and consumption, alongside an effort to improve the quality of Cambodia's human capital, are seen as positive indicators for economic growth prospects.

Banking landscape

Cambodia's banking sector is saturated with over 43 commercial, 14 specialised, and 80 Microfinance Institutions (MFI) operating in 2018. The total credit in the banking system increased by 19% to US$25bn at end of 2018, with the five largest financial institutions – Acleda Bank, Canadia Bank, Prasac Microfinance, Advanced Bank of Asia, and Cambodian Public Bank – accounting for over 45% of the country's lending.

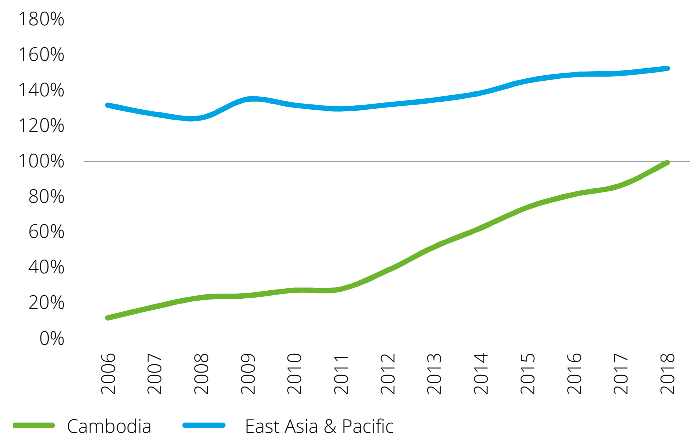
Excluding MFI lending, 30% of credit is to the retail and wholesale trade sectors; followed by owner-occupied mortgages and other real estate activities at 15%; with agriculture, forestry, and fishing at 12%; and construction at 9%.

Real GDP growth



Source: Economist Intelligence Unit (F = forecast)

Domestic credit to private sector as % of GDP



Source: World Bank

NPL market

Cambodian banks have maintained an overall NPL ratio below 3% since 2011. While the total stock of NPLs in the country's banking sector grew to around ៛2tn (US$500m) in 2018, there was still a reduction in the NPL ratio to 2%.

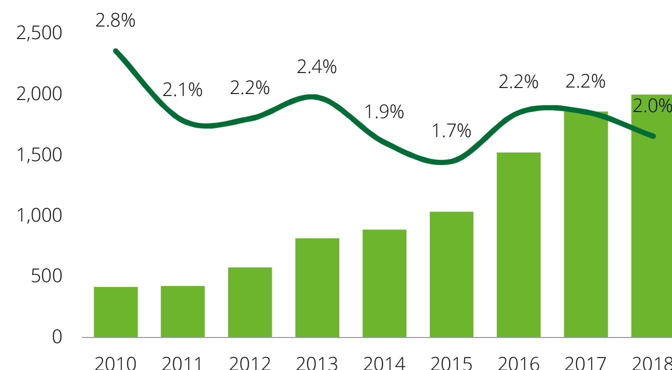
The majority of NPLs are held by commercial banks, which have an average NPL ratio of 2.3%, while the ratio for MFIs is 1.6%. Canadia Bank's 4.1% is the highest of the country's top banks, and accounts for about a fifth of the country's stock of NPLs. At 4.7% Specialised banks have the highest overall NPL ratio, but this is to be expected given the high-risk profile of the sectors to which they lend.

Despite the currently low NPL ratios, significant risks in the sector remain. In November 2018, S&P revised its Banking Industry Country Risk Assessment (BICRA) from negative to stable, while noting that the sector remains high-risk. The main risks are due to high property prices and excessive loan growth – particularly in the construction and real estate sector – as well as relaxed underwriting standards, and a weak regulatory framework. This could lead to a considerable increase in NPLs if there is a decline in the currently-booming property market.

Outlook

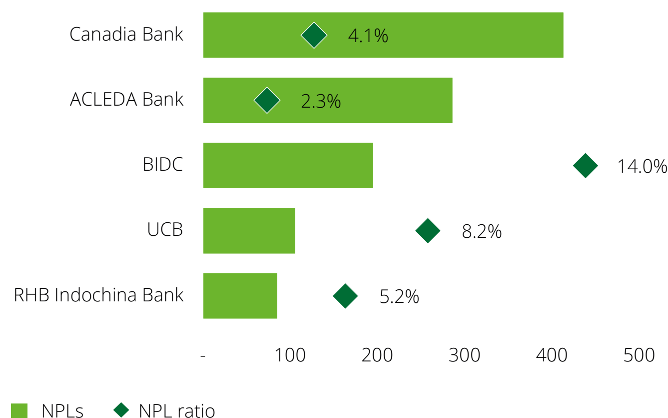
With an emerging economy and developing banking system, the frameworks and ecosystem required to support an active NPL portfolio market are not yet fully established in Cambodia. However, this is expected to develop further over the medium term, as the banks and regulators seek ways to bolster financial stability and manage NPL ratios in line with regional trends.

Total banking system NPLs (៛bn)



Source: National Bank of Cambodia, Bloomberg

Gross NPLs held by top banks (៛bn)



Source: latest published financial accounts as of December 2018

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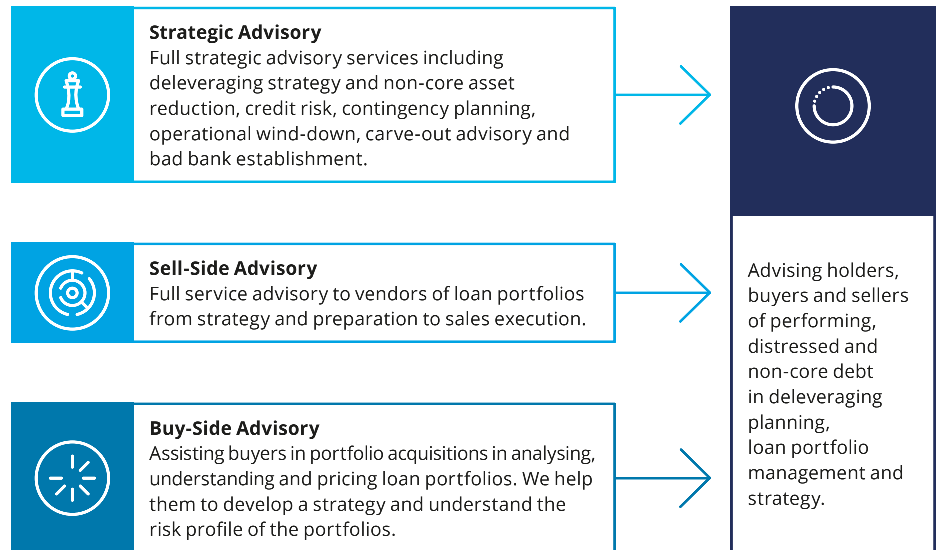
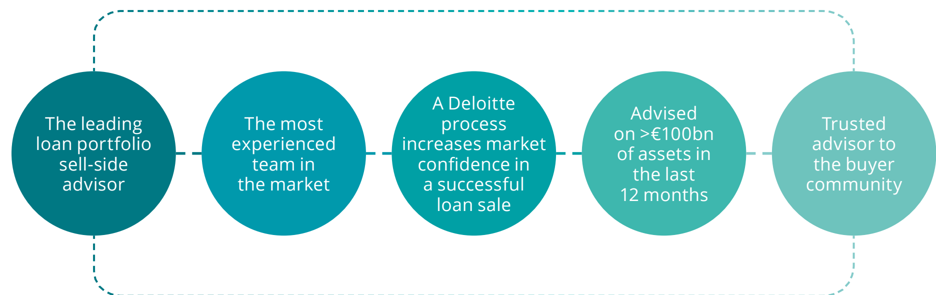
PLAS comprises a core team of 40 professionals with experience in advisory, principal investment, and banking, together with a dedicated network of 150 professionals across the world. This is in addition to extensive resource and expertise available from Deloitte's global network of member firms. The PLAS team are active in nearly every country in Europe, and across Asia and many other emerging NPL markets.

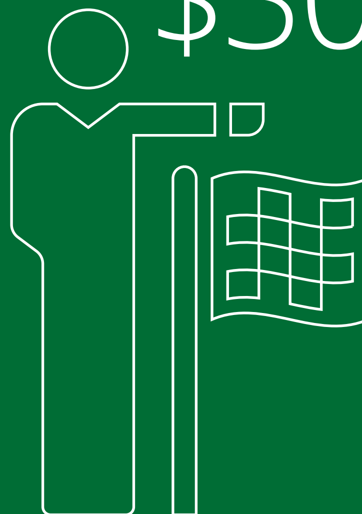




We advise **holders**, **buyers** and **sellers** of performing, distressed and non-core debt in deleveraging planning, loan portfolio management and strategy

Completed deleveraging strategy plans on

$300bn



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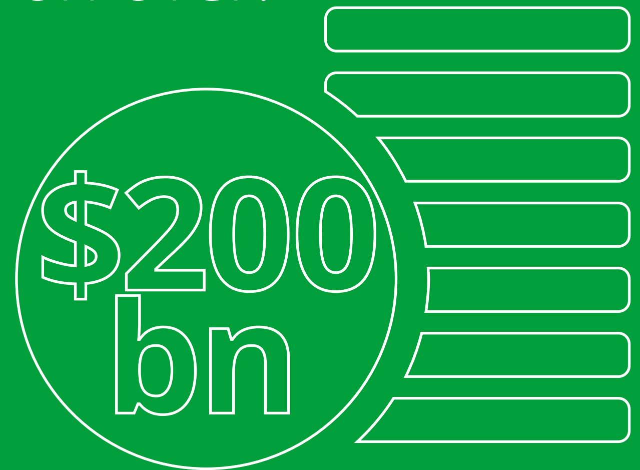
Global leader
in the loan portfolio advisory market

Buy-side advisor on over:



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