Asia Conference 2023: APAC Financials

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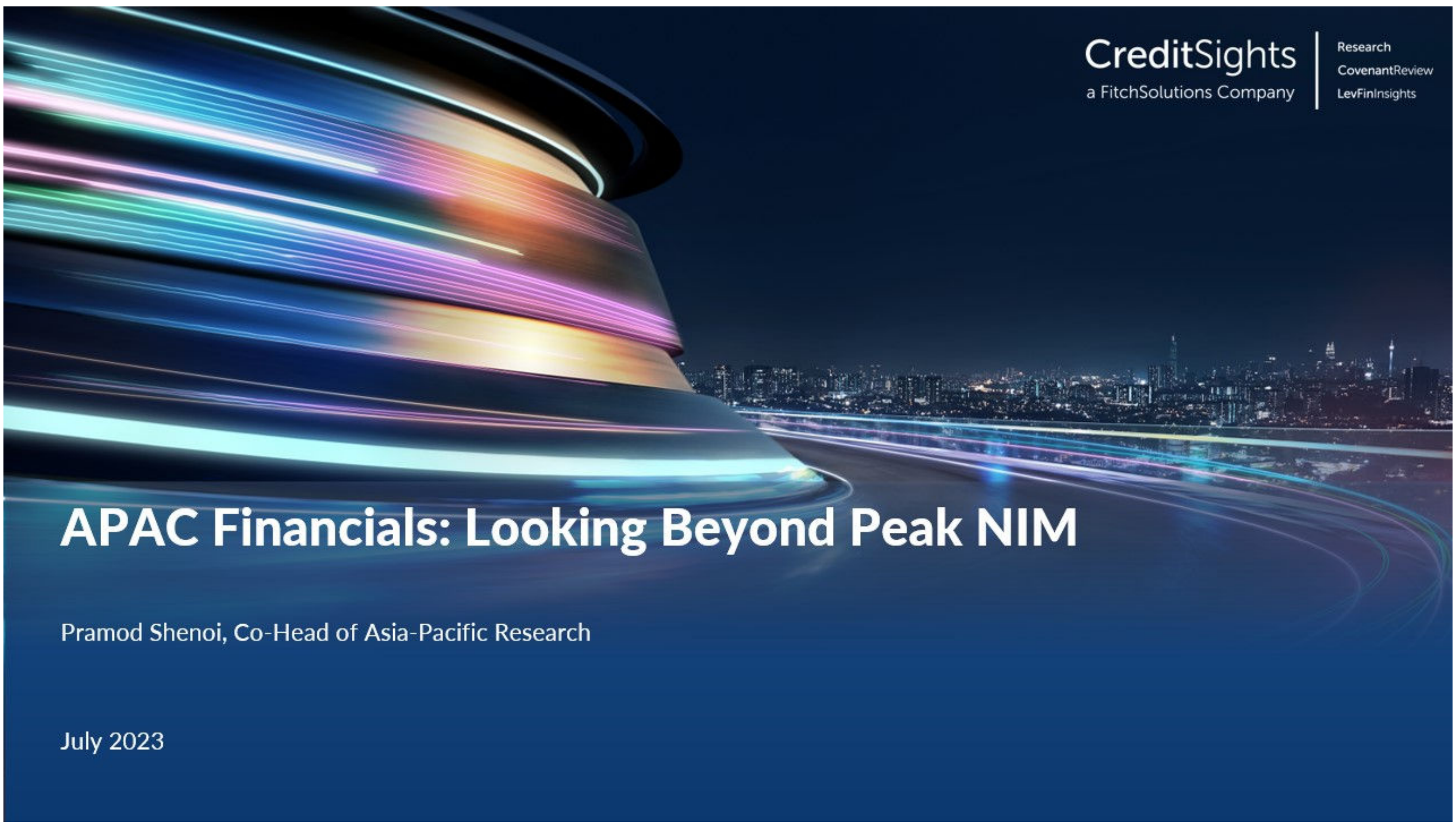
Executive Summary

- **CreditSights recently held its Asia Conference 2023 in Hong Kong and Singapore; this is the transcript of the presentation on APAC Financials, titled "Looking Beyond Peak NIM".**
- **We discussed key trends in the banking and insurance sectors, risks that we are watchful of across the banking sector, and our key picks across senior bonds, and Tier 2 and AT1 capital instruments.**



We break our presentation on APAC Financials into three parts. We first review banks, then move on to the insurance segment, and finally end with our picks and pans for the Financials sector.

APAC Banks: 2023 Trends

Trends	Considerations
Peak NIMs already hit in several markets	• Higher: Hong Kong • Marginally higher: Thailand • Range bound: Japan, Australia, Singapore, South Korea, India, Indonesia, the Philippines, Malaysia • Lower: China
Loan growth is market dependent	• Low-mid single digits: Australia, Hong Kong, Japan, Malaysia, Singapore, South Korea, Thailand • High-single to low-double digits: China, India, Indonesia, the Philippines
Fee income is challenging but should improve	• Wealth / brokerage: Trading activity improving, leverage decreasing • Credit cards: Better spends • Bancassurance: Flat to better • Capital markets and IB: Lower

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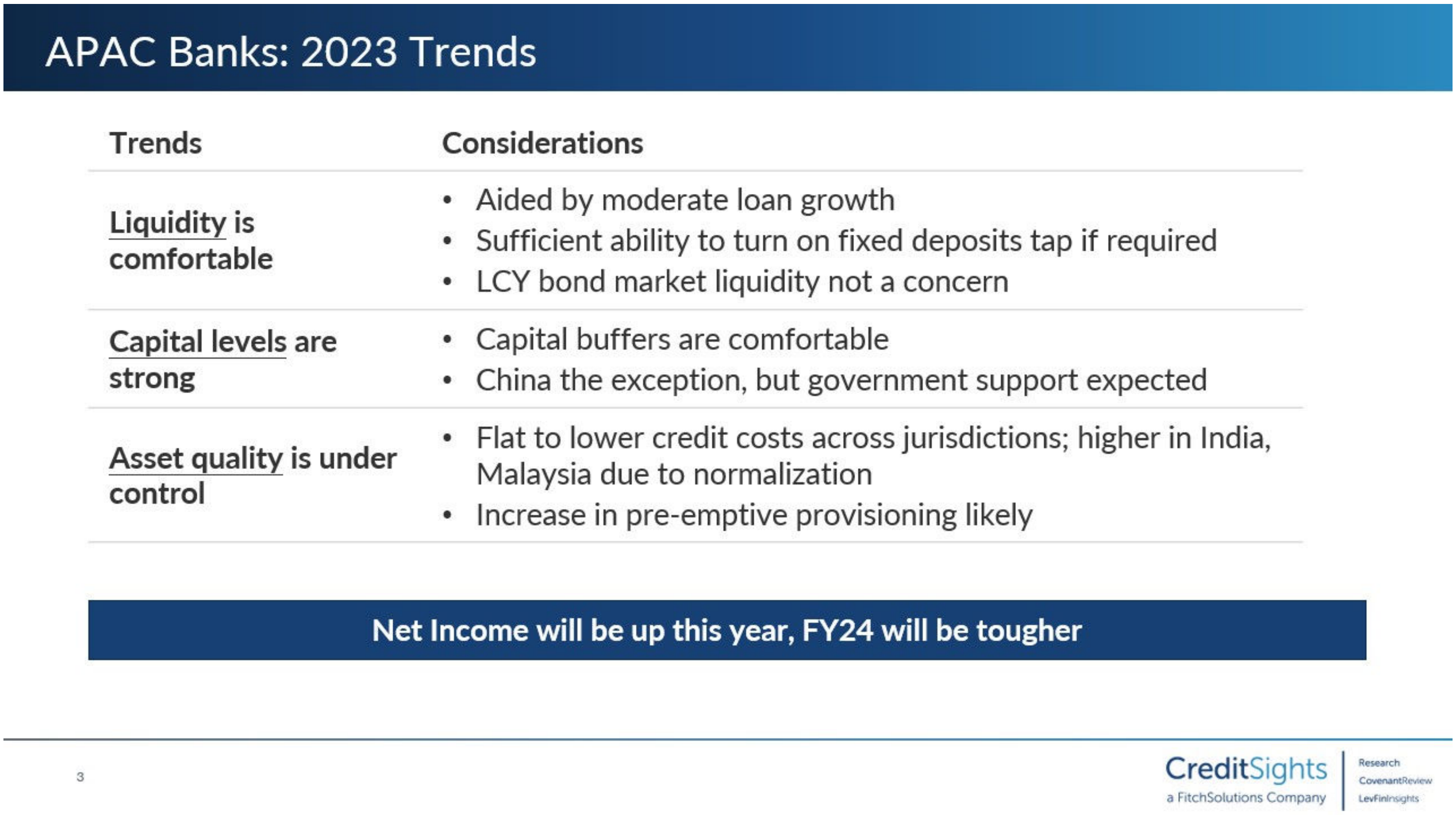
As inflation has come under control in most APAC markets, we don't see further rate hikes coming through in most jurisdictions, with the exceptions being Australia and Thailand. **NIMs have therefore peaked across most markets, and we expect it to be range bound over the rest of the year**. We see higher NIMs in Hong Kong, as a result of HIBOR moving higher, though this is being offset by lower yields on the banks' China exposure. We expect it to be marginally higher in Thailand, with 1-2 more rate hikes expected, and we expect it to be lower in China.

Anecdotally, we are hearing about a slowdown in loan growth in Q2. We see markets divided into two camps – high-single to low double-digit growth in China on the back of government guidance, as well as in India and the Philippines as banks there increase their retail exposure. The story in Indonesia is more individual bank dependent. Conversely, in other jurisdictions, particularly developed markets such as Australia and Singapore, loan growth has been a struggle.

We expect fee income to be challenging but to improve. Wealth management / brokerage saw a strong start to the year before SVB/CS led to slow conditions till May, followed by a marginal pick up. Credit card spends should improve, bancassurance should be flat to better, while capital markets / IB business will be lower in most countries.

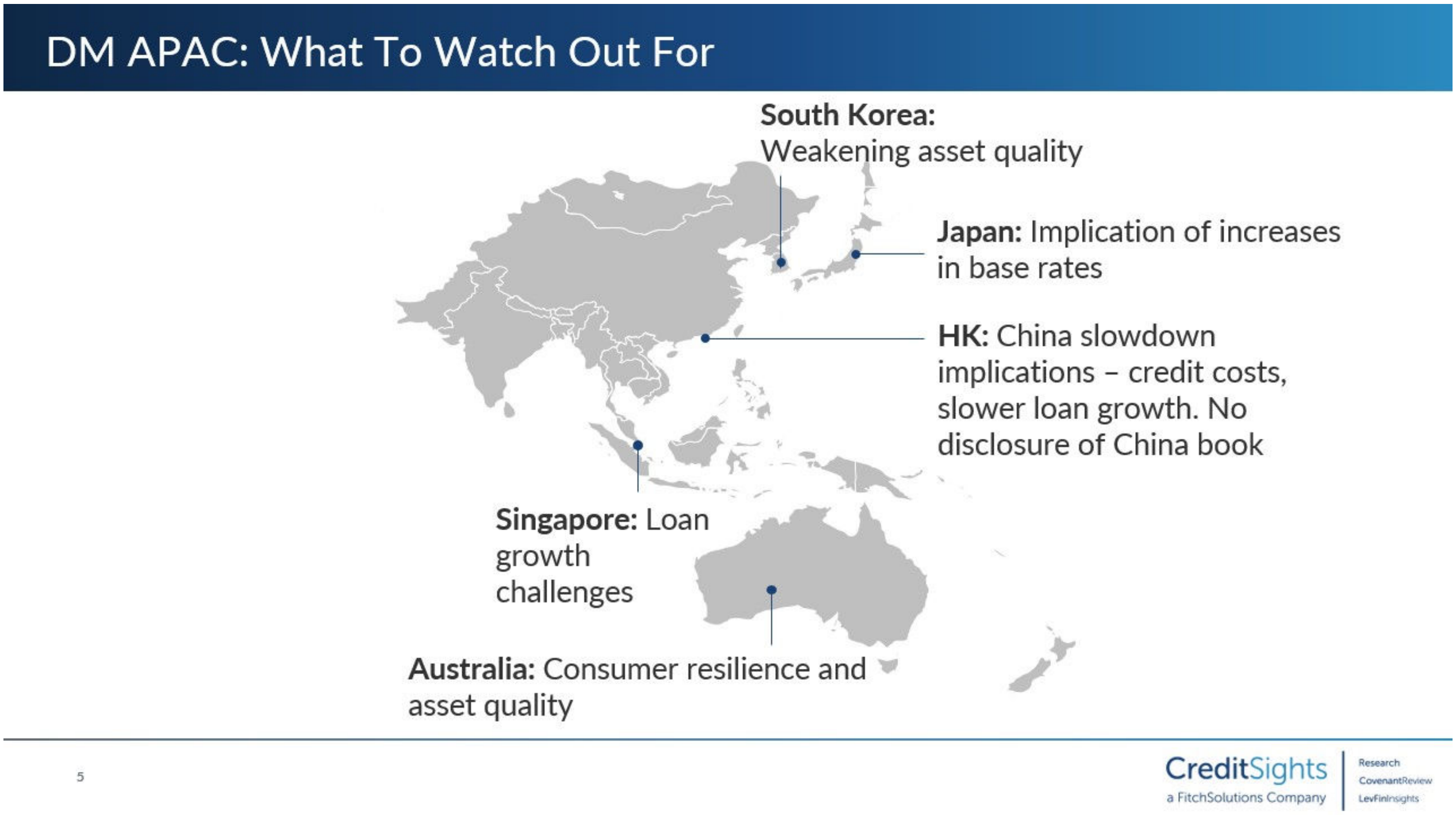


Fortunately, liquidity levels have been comfortable despite the rate hike cycle; some of this has been driven by slower than expected loan growth. Banks have been able to turn on the tap to attract fixed deposits as and when they want, and deposit rates have fallen in some markets because of excess liquidity. We are keeping a close watch on domestic bond market liquidity following the Legoland ABCP default in South Korea in 4Q22 that resulted in the market closing for a few weeks. Conditions in the South Korean bond market have improved subsequently, and we are not seeing the conditions that the market faced in 4Q22 elsewhere.

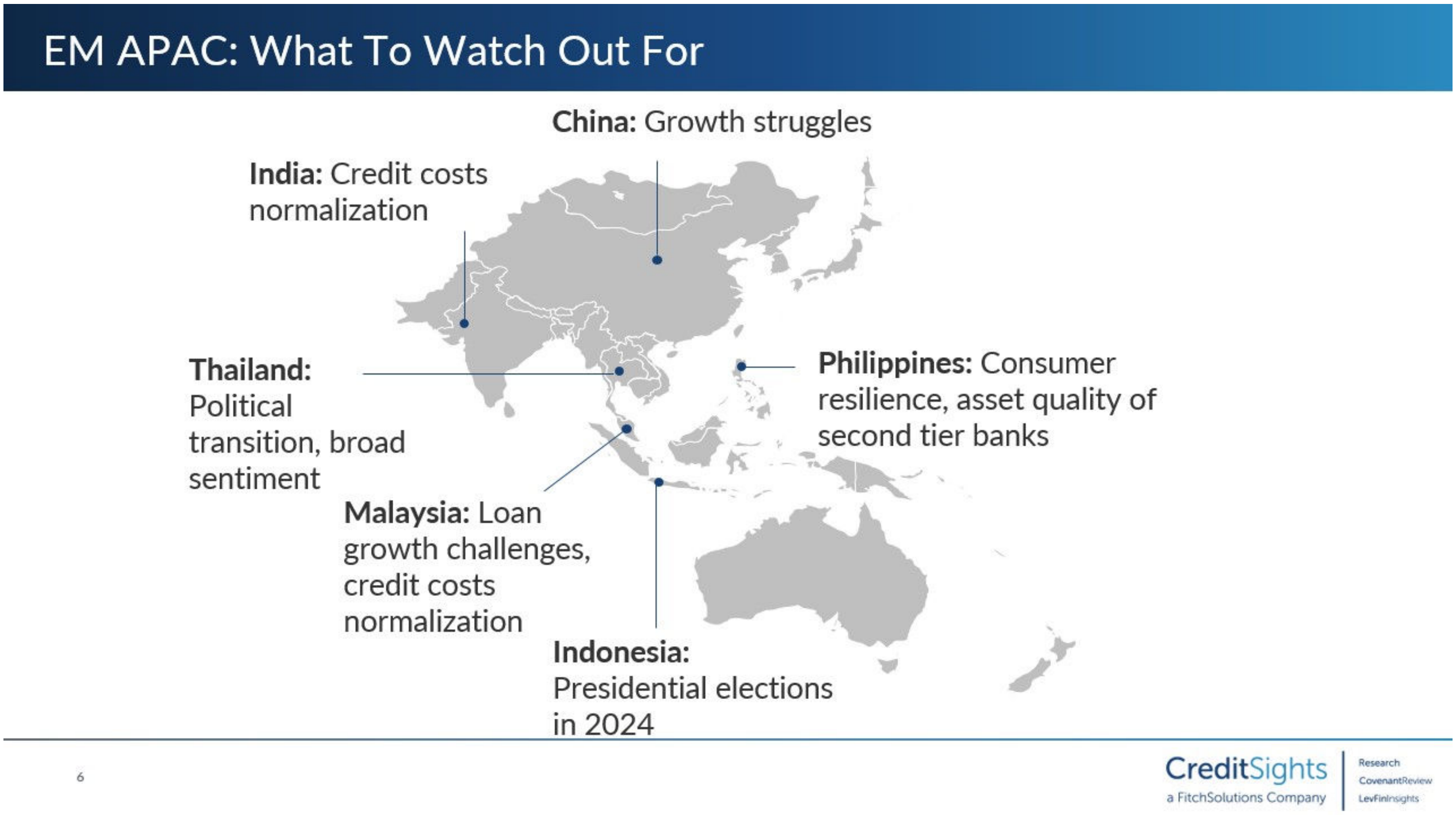
Capital levels are also robust across jurisdictions, with the exception of the non-Merchants Chinese Joint Stock Banks, but here we expect government support to kick in.

Asset quality is also under control, and we expect flat to lower underlying credit costs in most jurisdictions, but higher credit costs in India and Malaysia as a result of credit cost normalization – higher recoveries in the last year meant that credit costs were artificially lower. With more complex economic conditions and an expected slowdown, we expect to see banks increasing pre-emptive provisions, as has taken place in South Korea. Australian and Singaporean banks have extensive general provisions, having continued to maintain the provisions taken during COVID times.

We are mindful of a number of risks though, as highlighted on the page above. **In particular, a sudden slowdown in growth in India / Indonesia / Philippines will increase credit costs well beyond current expectations.** Retail asset quality has held up well because of low unemployment levels in developed markets, but we are watchful of increases. There are risks of issues in the US and Europe affecting sentiment and markets in Asia, although we are not worried about CRE in the APAC region, and don't see any D-SIB coming under stress / an SVB type of situation.



We are watchful about specific risks in different markets. In DM-APAC, we see a mild weakening in South Korean asset quality, which the banks put down to COVID-related support no longer being available. We **aren't concerned about real estate project finance related issues** at the major financial groups. In Japan, the story is more positive with the potential for better domestic NIMs following interest rate increases, although the earliest possibility is in Apr-24. In HK we are looking for the credit implications of a China slowdown, although disappointingly, with the exception of BEA, **the HK banks do not provide a breakdown of their China loan exposure**. For banks like Chong Hing, China loan exposure is ~60% of the loan book. Singapore faces loan growth challenges, and in Australia the consumer has been resilient to large interest rate increases, and we hope that doesn't crack.



In EM-APAC, we are aware of China's growth struggles and expect profitability growth to be very difficult for the banks this year. In the Philippines, **we are cautious about the second tier banks** and their fast-growing exposure to retail (particularly unsecured) and SME lending at this point in the cycle. We have earlier discussed credit cost normalization in India and Malaysia. In **Thailand**, the impact of a longer period of government formation is on a slower passage of the government budget, and the resultant lower spending will likely slow down GDP growth for a quarter or so. We see spread volatility, in case government formation fails, as an opportunity to buy Thai capital securities. In Indonesia, we are watching out for the implications of the presidential elections in Feb-24.

We will provide a short review of the insurance industry in Asia in 2022, and our focus is on the life insurance sector because this is where we have most of our coverage. After that, we will share our view on the sector going forward.

APAC Insurers: FY22 Review – Resilient Balance Sheets

- Rate hikes and equity market declines led to material unrealised losses
- Capital fall - mismatches between the accounting measurements of assets, liabilities
- COVID-19 claims were a hit to earnings but did not affect capital much
- Solvency levels declined but with large buffers above regulatory minimums
- Capital adequacy strong with early adoption of HK RBC and implementation of CROSS-II and K-ICS
- Embedded value increased thanks to the higher value of in-force business
- Fixed-income portfolios are of high quality in most cases

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It was not an easy year for the life insurance industry in Asia in 2022. The sector was hit by a number of adverse developments that were among the most significant risks for insurers. Rate hikes and equity declines resulted in significant unrealised losses. In addition, accounting mismatches, where liabilities were valued at book value while assets were valued at market value, exacerbated the deterioration in capital levels. COVID-19 claims also impacted results; multiple waves of infection across the regions resulted in significant claims in several markets. Meanwhile, there were new regulatory changes such as CROSS II in China, the early adoption of Hong Kong RBC by some companies, and the move to K-ICS in Korea. These should improve the industry in the long term, but could lead to increased pressure on capitalisation in the short term. As a result of these adversities, the solvency ratios of life insurers in the region declined markedly.

However, their solvency still remained quite strong, with good buffers above the regulatory minimums. The solvency ratios of the insurers we cover were also well-positioned compared to their industry averages. This is because their balance sheet strength is underpinned by high-quality fixed income portfolios, the largest investment asset on their books.

In short, 2022 was a challenging year with many headwinds, but life insurers were resilient to these pressures.

APAC Insurers: Forward Looking Catalysts and Risks

Area	Catalysts	Risks
Claims	• COVID-19 claims to decrease	• Other medical insurance claims to rise as frequency of hospital visits increase
Premium Growth	• Border reopenings boost growth • Recovery momentum has continued since 2H22	• Sales of foreign currency policies decline in Japan • Rising lapse rates, higher guarantee offerings to be monitored
Investments	• Improved income on higher interest rates	• Higher hedging costs for overseas investments • Lower interest rates in China = lower yields
Regulations	• Positive IFRS 17 impact on HK, South Korea insurers • Earnings volatility will be reduced	• Disclosure at some companies remains limited - further communication required

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We have a fairly positive view on the insurance sector for 2023, and we remain comfortable with the overall fundamentals. On the claims side, COVID-19 claims have fallen, which will help underwriting results to recover. The increase in elective care and other medical treatment claims is likely to peak this year before stabilising, and will be offset by the absence of large COVID-19 claims. We therefore expect life insurers' underwriting profits to improve. Meanwhile, growth has picked up, especially since the second half of 2022, and the momentum has continued into early 2023. However, a potential deterioration in surrender rates, an important measure of liquidity, needs to be monitored closely, although the statistics so far do not point to any worrying developments. Investment returns will improve as interest rates have risen. Hedging costs continue to be high, but as insurers reduce their exposure to overseas investments, the impact of hedging costs (for foreign exchange derivatives) will be more limited than last year.

After a very long period, the new IFRS 17 accounting standard finally takes effect this year in jurisdictions such as Hong Kong and South Korea. The new accounting standard is expected to reduce earnings volatility and solvency sensitivity to interest rate movements. Earlier concerns about capital pressure arising from the implementation of IFRS 17 have been fairly well addressed by insurers, and partly mitigated by the higher interest rate environment. However, IFRS 17 disclosures are still limited for a number of insurance companies, and market participants will need more time to get used to the new accounting standard and its intricacies.

APAC Insurers: Forward Looking Catalysts and Risks

Area	Catalysts	Risks
Japan Rates	• Further YCC relaxation may shift Japanese life insurers' investments to longer duration JGBs	• Market volatility may rise, triggered by a reduction in foreign asset investments
Solvency	• Solvency remains robust, supported by very high capital buffers and conservative investments	• Moderate exposures to equities and/or alternatives may increase in Japan, Thailand and China • Exposure to infrastructure loans in Korea remains under watch
LCY Liquidity	• Japanese insurers can refinance in JPY • Chinese issuers may refinance onshore given declining funding costs	• Funding conditions in Korea remain unfavourable

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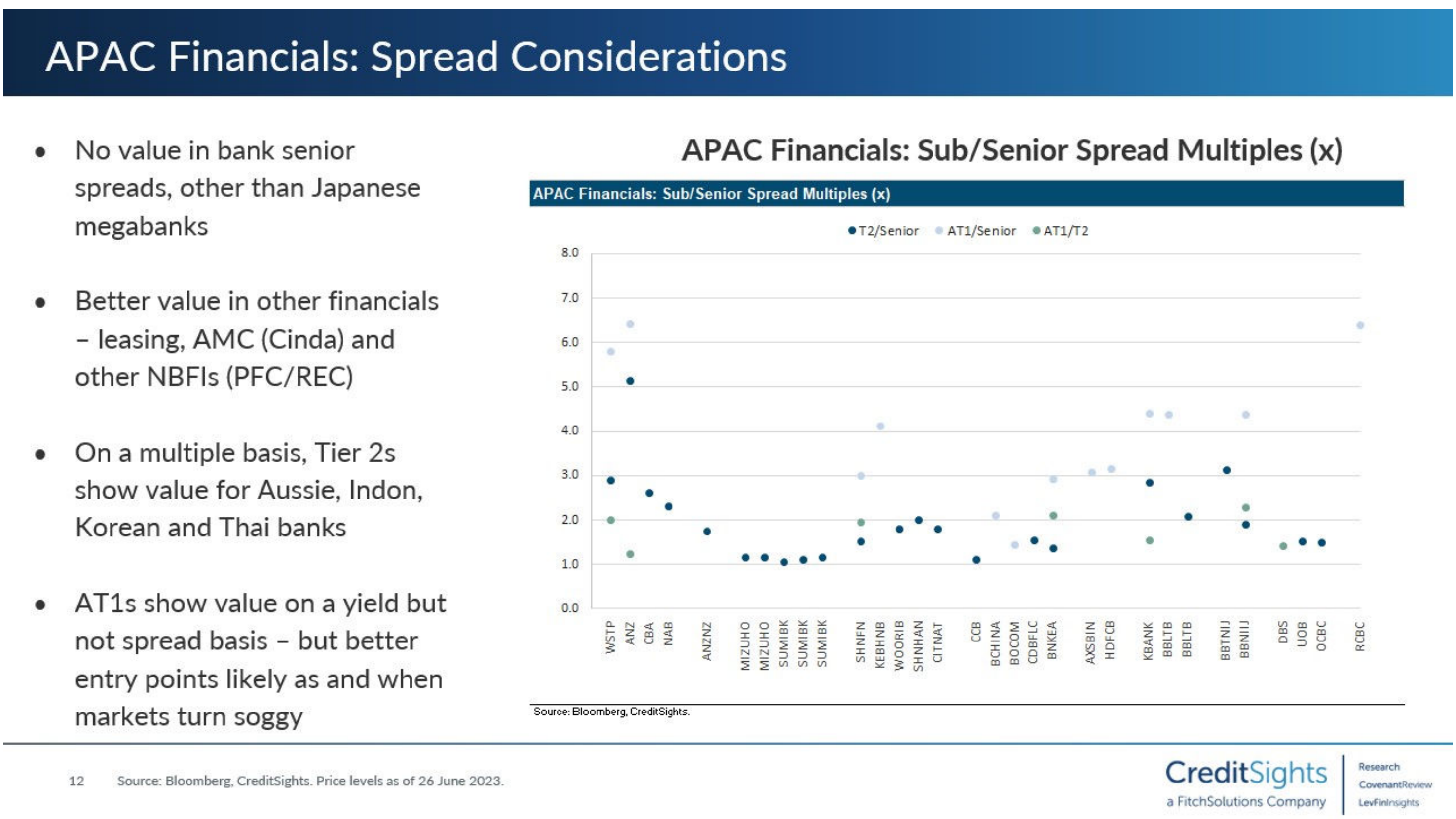
Next, on the easing of the YCC, a surprise move by the Bank of Japan at the end of last year: the impact on solvency ratios has been moderate, but we note that there has been greater investment into Japanese government bonds. This will help life insurers in Japan manage their market risks as the market plans to [adopt the economic solvency regime in 2025](). However, further easing of the YCC may cause market volatility as Japanese institutions switch their holdings of foreign bonds into domestic JGBs; Japan as a whole is one of the largest holders of US and European bonds. We also remain vigilant about equity risk, which is currently at moderate to high levels. However, the major equity indices in Asia have held up quite well this year. We have no major concerns about the sector at present.

Most importantly, we remain comfortable with the credit quality of the insurers we cover. They are well-established companies, typically the largest in their home markets. They have robust solvency ratios, underpinned by high-quality investment portfolios. Insurance penetration in the region remains low by global standards, so long-term growth is promising. Industry profitability is adequate and credit spreads look reasonable. Overall, we see Asian insurers as a set of good credits and a fine source of diversification for bond investors.

We now move to our key picks across the APAC Financials sector.



We see limited value in bank senior spreads, other than those of the Japanese megabanks, where we **prefer MUFG and SMFG to Mizuho**. We see better value in non-bank financials, such as the Chinese leasing companies, **Cinda AMC**, and Indian power sector financiers **PFC and REC**.

Within the bank Tier 2 space, we look for a minimum multiple of 2x for Tier 2/senior spreads, and find these in Australian, Indonesian, Thai and some Korean banks.

There are some AT1s that we like, but equity market conditions have been particularly strong recently, and if there is equity market volatility, there should be better entry points for the AT1 instruments.

APAC Financials: Key Picks

Senior	Tier 2	
• **RECLIN 04/28:** +174 Wide vs. SBI, key policy role • **BNKEA NC 03/26:** +264 Attractive, low risk • **CCAMCL 02/28:** +173 Good spread, bond structure • **FRESHK 10/26:** +365 Decent credit, no more fallen angel risk • **MUFG NC 04/28:** +151 Wide - no bail-in risk • **SMBCAC 05/28:** +180 50-80 bp vs. BOCAVI & SUMIFL • **PRUFIN 04/30:** +130 Should trade <20 bp wider v AIA	• **BBLTB 34 NC 09/29:** +264 ~2.1x T2/senior multiple • **KBANK 31 NC 10/26:** +306 ~2.9x T2/senior multiple • **MUANTH 37 NC 10/26:** +392 Should be flat to inside KBANK T2 • **BBTNIJ 01/25:** +358 100 bp wider than BNI	• **NAB 37 NC 01/32:** +280 & **WSTP 36 NC 11/31:** +292 Low call risk, ~30 bp wider than bullet • **MQGAU 36 NC 03/31:** +343 Good risk management, strong returns, 70 bp wider than bullet • **ASBBNK 32 NC 06/27:** +233 B2 type instrument, CBA parentage, RBNZ oversight • **DAIL Perp NC 07/26:** +204 Strong credit, should be ~20 bp inside MYLIFE and NIPLIF

13 Source: Bloomberg, CreditSights. Prices shown are Bid G-spreads or YTC or YTW as of 26 June 2023.

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Our key picks amongst senior bonds include the recent RECLIN 04/28 - it is trading at a 60 bp+ spread vs SBI although it has seen a significant improvement in its credit quality; we would expect it to trade no more than 30 bp wider. The recent **BNKEA** 4NC3 TLAC issue looks wide to us, and we prefer senior TLAC risk to Tier 2 and AT1 bonds from this issuer. We like the spread offered by Cinda; it is our preferred name in the China AMC space. We have always liked **FRESHK** and have had an Outperform recommendation on the name since we initiated on it in Jan-22; the overhang of an S&P downgrade has now gone away. We like the spread that MUFG's callable senior TLAC bonds offer, as there is no bail-in risk associated with the name given explicit government support. We like the business model and the strong shareholder support that **SMBCAC** has. The **PRUFIN** 04/30's are trading well wider than AIA's; we see the differential as no more than 20 bp.

Amongst the Tier 2's, we like the Thai Tier 2's from **BBLTB and KBANK** as well as the **MUANTH** sub-bond. Investors are being paid for market volatility when it comes to the former two names. We expect spreads to tighten as and when government formation comes through, and would look to add if spreads widen. We also like MUANTH, which has a 38% shareholding from KBANK; it should trade inside the KBANK Tier 2 as it is well capitalised, is doing well in the Thai insurance market, and has none of the SME asset quality risk that KBANK has. We also like the **BTN** Tier 2 for its spread, while acknowledging that liquidity is likely to be low in the name. Amongst the Australian, NZ and Japanese names, we like the 15NC10's from the Aussie banks and are no longer worried about non-call risk; we like ASB Bank of New Zealand whose Tier 2 is a Basel 2 style instrument without loss absorption, is 100% owned by CBA, and has a very conservative regulator providing oversight. We also like the Japanese life insurance sub debt bonds, in particular the **DAIL** NC 07/26.

APAC Financials: Key Picks

AT1

Low non-call risk (high back-end reset/reputational consideration/authority compulsion/available onshore market)	Slightly higher extension risk (no onshore market), but strong fundamentals and capital buffers
• **ANZ Perp NC 06/26:** 7.68% High back-end reset, can refi in AUD • **DBSSP Perp NC 02/25:** 6.87% Capital not required, can refi in SGD • **SHINFN Perp NC 05/26:** 7.71%, **WOORIB Perp NC 10/24:** 7.51% & **KEBHNB Perp NC 10/26:** 7.33% System call expectations, comfortable coverage ratios and pre-emptive provisions • **HDFCB Perp NC 08/26:** 8.64% Reputational considerations, can refi in INR	• **BBLTB Perp NC 09/25:** 7.50% & **TMBTB Perp NC 12/24:** 9.38% Well-run business models, good fundamentals and strong capital, reputational consideration incentivizes a call, TMBTB no longer needs the capital • **BBNIIJ Perp NC 03/27:** 10.09% Strong capital and profitability

14 Source: Bloomberg, CreditSights. Prices shown are Bid G-spreads or YTC or YTW as of 26 June 2023.

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Finally, we come to our preferred AT1 names. We put our preferred names into two categories.

In the first, we put names that have high back-end resets (as these reduce the probability of call risk) e.g. ANZ, have local bond markets in which they can issue to refinance the $ AT1s e.g. DBS and HDFCB, or where there is strong backing from the authorities for a call on the first call date e.g. the Korean banks.

In the second, we put names where there isn't a domestic market to refinance in (the Thai regulator does not allow AT1 issuance in THB and the IDR market has not developed sufficiently to absorb an AT1 issue), but where we are comfortable that the bonds will be called. For example, the BBLTB perp has a high back-end reset and was issued when BBL was acquiring Permata; the bank's capital position has improved and we expect the bonds to be called and potentially not replaced. It is a similar story with **TMBTB**, which issued an AT1 when TMB merged with Thanachart Bank. The issuer says it no longer needs the capital, and we agree. It has bought back some of these bonds and expects to purchase more from the market if prices fall in the future. **BNI** of Indonesia has a particularly strong CET1 ratio of almost 20%, and does not appear to need the capital. While we expect higher dividend payouts to reduce its CET1 ratio going forward, we still see its future capital levels as sufficiently comfortable to call and not refinance the bonds.

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