APAC Banks and the Zero Lower Bound

More Asian Markets Adopt Ultra-Low Rates; Effects on Banking Systems Will Vary

The economic shock from the pandemic has prompted a number of Asian central banks to move their policy interest rates to ultra-low levels. Rates are now approaching the zero lower bound (ZLB) for the first time in Australia, New Zealand, Thailand and Korea.

Fitch Ratings says that the experiences of other markets that have operated with rates at or near the ZLB can illustrate the challenges that banking sectors in these four markets may face. However, their experience may differ from those of other markets, based on their specific characteristics.

Generating Income May Become Challenging

Typical challenges that banks face as rates approach the ZLB include dampened interest income and compression of net interest margins (NIM). This can encourage banks to cut costs and increase non-interest revenues, to preserve profitability.

Low interest rates would normally support asset quality, but may be insufficient in the current environment given the scale of the pandemic’s economic shock. Low rates may also lead to further shifts in banks’ funding bases towards longer-term fixed-rate debt and deposits.

Efforts to boost revenue could increase risk appetite: for example, through expansion into overseas markets, short-term consumer lending, a shift down the credit curve, including from government securities to corporate debt, and higher sector concentration.

Most banks are likely to remain focused on containing growth of total risk-weighted assets, but ratings may be adversely affected if the higher risk appetite is not matched by appropriate strategies to manage or absorb credit risk losses.

Effects May Vary by Market

The characteristics of each market’s banking system will determine how ultra-low rates play out. For example, Korean banks have engaged in more personal unsecured lending, which typically has a higher NIM, as rates have moved lower. Meanwhile, Thailand’s banks have a large share of lending going to the SME sector, rendering them more exposed to a slower economy.

Australian and New Zealand banks appear less focused on overseas opportunities than those in some other markets. However, some smaller banks that are more reliant on interest income will be more vulnerable to NIM compression.

Greater Role for Fiscal Policy

Fiscal policy becomes an increasingly important tool for managing economic cycles as rates near zero. Where this affects sovereign ratings, it could have knock-on effects on the many Asian banks whose ratings depend on sovereign support.

More broadly, the lack of experience that most authorities have in wielding monetary policy at the ZLB may increase uncertainty and longer-term risks for their banking sectors.

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Key Points
- Generating interest income becomes more challenging with ultra-low rates. This will encourage banks to cut costs or increase revenue to preserve profitability.
- Low rates support borrower repayment capacity, but this may be offset by the scale of the pandemic shock.
- The impact of ultra-low rates will depend on the specific characteristics of each banking system.

Rates Nearing Zero in More APAC Markets

Policy rates have long been at ultra-low levels in Japan, but the pandemic has prompted monetary authorities in a number of other Asia Pacific (APAC) economies to also cut policy rates to below 1%. Australia and New Zealand’s official policy rates stand at 0.25%, while those in Thailand and Korea are at 0.50%.

Hong Kong’s discount window rate base, at 0.50%, also moved back below 1.00% in 2020. Interest rates in Singapore have dropped to similar levels. Both markets experienced a long period of ultra-low rates in the wake of the 2007-2008 global financial crisis, but saw rates rise in 2017-2019 before the pandemic struck.

Interest rate dynamics in Singapore and Hong Kong largely reflect exchange-rate policies. Movements in Hong Kong’s policy rates are dictated by those in the US, owing to the peg between the Hong Kong and US dollars. Singapore uses exchange-rate management as its primary monetary policy tool.

The effects of ultra-low policy rates are not limited to a narrow range of zero and 1.00% and although the pandemic has led monetary authorities to lower policy rates even further, they were already very low relative to historical levels in many APAC markets before the crisis began.

This means many of the challenges created by ultra-low rates are already factored into our credit assessments of affected economies. However, the additional cuts since the start of the pandemic may compound these issues.

Bank Behaviour at the ZLB

There is a growing body of research into the effects on banks as interest rates reach ultra-low levels, approaching the ZLB. This draws on the empirical evidence provided by markets that have moved policy rates to these levels, including those outside of Asia.

Ultra-low rates may stimulate credit demand, but they can also encourage banks to diversify away from traditional lending as a source of income, particularly where deposit rates are stickier than lending rates, resulting in a compression of NIMs. This can be accompanied by a shift towards fee-based business and trading activity, although rising competition has limited growth in fee income in the past. Overall, banks’ return on assets tends to decline as rates approach the ZLB.

Banks may prefer to increase holdings of other forms of income-generating assets on their balance sheets as lending becomes less profitable, such as equities or bonds. However, they could also opt to hold more cash and liquid assets, partly reflecting the reduced opportunity cost of holding such assets as rates fall.

In terms of funding, the lower interest-rate environment can increase reliance on deposits and longer-term fixed-rate debt, particularly compared with short-term variable interest debt.

Some research has found that the riskiness of bank portfolios, measured by risk-weighted assets as a share of total exposure, tends to decline as interest rates reach ultra-low levels, particularly for banks facing capital constraints. This may be due to lower interest rates being correlated with weaker economic and banking-system growth, tighter regulation, or the possibility that some risks are not fully reflected in risk weights.

Fitch’s view is that ultra-low rates may lead to an increase in risk appetite, even if only selective or incremental, to generate more income when long-term profitability is challenged.

Strategies to Support Income Can Carry Risk

Banks employ various strategies to address the challenge of generating revenue in a low-interest environment. One approach is to expand into faster-growing emerging markets, although this can increase costs, including credit and regulatory compliance costs.

Expansion into faster growing emerging markets can give rise to new risks if entering a weaker operating environment. This may require higher loss-absorption buffers or tighter risk-management processes. Risks often become more apparent when the operating environment is less benign, as at present, making expansion tougher to justify.

Expansion in recent years has raised the prices of potential acquisitions in APAC, affecting the balance of risk and return. Opportunities for near-term cross-border expansion could be further constrained by the synchronised nature of the shock facing regional and global banking systems.

Another strategy banks may employ to support profitability is to increase exposure to sectors that offer better returns, including on a risk-adjusted basis. However, this may increase loan-concentration risk, such as in property.

Other strategies include consolidation to produce synergies and investing in technology to lower costs, access new markets and counter competitive threats from new online-focused financial-service providers. However, these typically take time to deliver results and come with their own execution risks.

The ratings impact of these approaches would depend on the extent to which individual banks take on additional risk, as well as their strategies to manage overall credit risk across their business portfolio, including through higher loss-absorption buffers.

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1 Australia’s cash rate target; New Zealand’s official cash rate; Thailand’s one-day repurchase rate; and Korea’s Bank of Korea Base Rate.
2 We draw, in particular, on the work of Michael Brei, Claudio Borio and Leonardo Gambacorta, published by the Bank for International Settlements.
Pandemic Affects Asset Quality

Asset quality tends to be supported by ultra-low rates, which ease the interest burden on borrowers, although there is a risk of evergreening that may obscure visibility over non-performing assets and dampen prospects for enhancing profitability. This has become more common recently due to the pandemic.

Real GDP (% change)

The usual ameliorating impact of low rates on asset quality may be impeded by the unusually large scale of the shock from the pandemic. Fiscal support, debt moratoriums and other actions by banks and regulators have eased near-term asset-quality pressure associated with the downturn, but Fitch expects pressure to re-emerge once the policies are scaled back in 2H20 and in 2021.

The Japanese Example

Japan presents an interesting case study of a banking system that has operated near the ZLB for many years. Its banking industry continues to face challenges generating revenue, amid persistently low domestic interest rates and high competition. This may have led to some mispricing of credit risk: Japanese spreads for SMES are almost level with those of large corporates.

Japan’s largest banking groups have expanded abroad to support profitability, a strategy that we expect to continue. This may have increased diversification, but it has also heightened exposure to riskier markets. We have also noted previously that they could take higher risks in their securities portfolios to support profitability, although banks’ disclosures do not show a significant rise in investment risk appetites.

Loan Growth in Japan, Hong Kong and Singapore (% change)

The pandemic will add to existing pressure on banks’ business models. The associated deterioration in asset quality will affect domestic lending and emerging-market exposures, translating into higher credit losses and a rise in risk-weighted assets. We expect the rise in credit costs to linger into 2021.

Nonetheless, our base case is for banks to remain profitable, with these trends slowing the pace of capital accumulation, but not eroding capital positions.

Experience of Hong Kong and Singapore

Some of the effects of ultra-low rates in Hong Kong and Singapore in 2009-2016 differed from those usually associated with the ZLB.

Loan growth remained strong in Hong Kong, partly reflecting demand from mainland China-based entities that were expanding abroad. Regulatory tightening ensured that loan concentration in the real-estate sector did not rise significantly, despite rapid house-price growth.

However, near-term prospects for loan growth could have weakened, since Chinese entities face increased barriers to overseas expansion in many key markets. Domestic credit demand is likely to be contingent on confidence in the territory’s future as a centre for international business. There may be potential for fee-based income growth if mainland-based entities continue to list in Hong Kong, supporting local capital markets. However, these benefits are likely to flow mainly to mainland Chinese banks and foreign banks with investment-banking divisions.

Singapore’s post-global financial crisis experience also saw periods of rapid loan growth, although there were dips in 2009 and 2015, the latter driven by a drop in energy prices. The share of non-interest income/total income increased, but only marginally.

Overseas lending growth was strong, partly reflecting the transnational nature of Singapore’s banking sector and the opportunities created by the withdrawal of other global banks in the wake of the financial crisis, as well as a desire to expand abroad to support profitability.

We expect lending growth in Singapore to pick up in the next year or two, but the increase will be tempered, as the pandemic has made banks wary about potential credit exposures and the impact on capital. Banks may increase borrowing costs in response, which, coupled with the lower funding costs associated with ultra-low deposit rates, could support income.

The limited growth potential in the domestic market is likely to encourage Singapore banks to continue pursuing overseas opportunities.

ZLB in Australia and New Zealand

Australia and New Zealand’s banking sectors appear to be responding to an ultra-low policy rate environment in a typical fashion. Deposits have increased as part of the funding mix, while loan growth has slowed.

This is driving an improvement in loan/deposit ratios and consequently easing the systems’ reliance on offshore wholesale funding, which is a source of weakness for local bank ratings. However, we expect banks to remain reliant on offshore funding in the medium-term as deposit growth rates are likely to drop off as pandemic relief schemes are wound back.
Easing funding costs have partly offset the revenue squeeze from NIM compression. Nonetheless, tighter NIMs will add to the strain on bank income over the medium term.

We have revised our outlook on Australian bank earnings and profitability to negative, which will pressure banks’ Viability Ratings, but should not be sufficient in itself to result in rating downgrades. Smaller banks appear the most susceptible to a lower earnings score, as we lowered the scores of the four large banks – Australia and New Zealand Banking Group Limited (A+/Negative), Commonwealth Bank of Australia (A+/Negative), National Australia Bank Limited (A+/Negative) and Westpac Banking Corporation (A+/Negative) – by a notch in April. The large banks also have a greater buffer at their current scores.

We also revised our outlook for earnings and profitability scores for most New Zealand banks and non-bank deposit-takers to negative in April. In most cases, a lower earnings score will not result in a Viability Rating downgrade by itself. However, there may be exceptions for smaller deposit-takers whose earnings are a higher influence in determining their Viability Ratings.

As yet, there is little sign of banks in these two countries moving down the credit curve to offset reduced earnings from lending, and we expect asset quality to be supported in the short term. However, there is potential for an increase in risk appetite over the longer term, including from further concentration in mortgage lending.

**ZLB in Korea**

The process of moving towards the ZLB has been a long one in Korea. Although NIM compression has dampened revenue, this has been partly offset by lower credit costs, with the low rates supporting asset quality. Korean banks have also been able to raise capital at correspondingly low cost – and at longer terms – allowing them to maintain their capital positions and profitability.

The reliance on debt issuance reflects the lower ability of Korean banks to rely on retail deposits as a cheap source of funding than those in some other ZLB markets. Depositors have instead shifted money to funds offering better rates of return.

**Loan Growth in Australia, New Zealand, Korea and Thailand**

(%) change

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Source: Fitch Ratings, Haver Analytics, Reserve Bank of New Zealand, Reserve Bank of Australia, Hong Kong Monetary Authority, Monetary Authority of Singapore

There has also been a rise in personal unsecured lending, a category that carries a higher NIM and has helped to support profitability. Banks have looked to offset the associated rise in risk by improving lending efficiency.

The strength of domestic credit demand has eased the pressure on Korean banks to expand internationally. Nevertheless, the banks retain an aspiration to expand into faster-growing emerging markets and we expect this to be a long-term trend in the sector.

**ZLB in Thailand**

The move towards the ZLB in Thailand has pressured profitability, as deposit costs have been stickier than lending revenue. Low rates have provided some support to asset quality. Nevertheless, loan impairments had been on a gradual increasing trend prior to the pandemic and we expect credit costs to increase in 2020.

Thailand’s banks are heavily exposed to SMEs, with SME loans accounting for around one-third of bank loans. This could make them vulnerable to asset-quality deterioration as the authorities roll back pandemic-related support measures. The larger scale of Thailand’s economic contraction in 2020 relative to other APAC economies will also challenge its SMEs.

Corporate bond spreads remain relatively wide in Thailand compared with markets where issuance costs have tracked policy rates lower. In theory, this could support demand for borrowing, but in practice lending growth is set to remain subdued in the short-term amid broad pessimism about the economic outlook.

The subdued economic outlook has prompted some Thai banks to examine the potential for expansion into faster-growing markets. However, the risks of this strategy are high, since few have experience in acquiring and integrating overseas acquisitions.

Thai banks’ desire to maintain capital levels could be a short-term constraint on expansion. The banking sector’s average common equity Tier 1 ratio was sound at 15.8% as of April 2020. However, in June the Bank of Thailand temporarily barred commercial banks from distributing capital to shareholders, suggesting it could take a negative view towards capital-dilutive acquisitions.

**Direction of Rates**

Authorities in Australia, New Zealand, Korea and Thailand may face rising pressure to consider unconventional approaches should economic growth fail to pick up and if inflationary pressure remains muted, as their rates are approaching the ZLB.

The Reserve Bank of New Zealand has signalled that it is open to negative interest rates and intends to assess banks’ ability to operate with zero or negative rates on certain products and facilities. It has also engaged in quantitative easing (QE) through government-bond purchases, a policy that is likely to continue even if rates are lowered.

In contrast, the Reserve Bank of Australia (RBA) seems warier of taking interest rates into negative territory. Should further monetary policy action be required, it would be likely to take the form of additional government-bond purchases by the RBA, extending their yield curve control targets further down the curve.
The Bank of Thailand appears reluctant to bring the benchmark policy rate to zero, but has said that it is open to using “additional appropriate monetary policy tools, if necessary”. The central bank could also look to intervene more aggressively through QE, which has been relatively modest to date.

Korea policymakers are cautious about taking rates closer to zero amid fears that this could add to financial-system risks, notably by encouraging capital outflow. Lower rates could also aggravate property-price pressures, which have been a source of political discontent. This suggests that the Bank of Korea may also prefer QE to rate cuts should further policy action be needed.

Focus Shifts to Fiscal Policy

The reluctance of some central banks operating close to the ZLB to further lower policy rates, coupled with the increased role of central-bank purchases of government bonds, has meant that fiscal policy is now assuming a more important role in managing economic cycle risks.

This may have implications for sovereign risk, which in turn plays an important role in our bank ratings. In many instances, bank ratings are directly driven by sovereign support.

Nonetheless, the implications are complex. Greater use of fiscal policy to stabilise economic cycles could drive up public debt, putting pressure on sovereign ratings.

However, greater use of QE could reduce the usual costs and liquidity risks associated with increased debt, at least in the short term. Moreover, stabilising the economic cycle is a positive for sovereign risk, making the overall impact on sovereign ratings unclear.

More broadly, the lack of experience that most authorities have in wielding monetary policy at the ZLB may increase uncertainty and longer-term risks for banking sectors, including the associated impact of QE on asset prices. However, the long-term effects of widespread international use of QE have yet to be tested through the economic cycle.
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