MOODY'S
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Financial Institutions — Emerging Markets

2019 outlook stable overall but rising rates, politics and trade tensions pose some risks

Summary

Slower global growth, rising interest rates, trade protectionism and geopolitical tensions will pose risks for financial institutions in emerging markets throughout Asia, Latin America, Europe, the Middle East and Africa in 2019. Even so, our outlook for banks, insurance companies and asset managers in these regions is broadly stable and reflects a range of buffers that will help these institutions navigate through a more challenging operating environment. Positive credit attributes include resilient balance sheets, steady domestic economic growth and supportive public policies. Still, some issuers, especially those in Argentina, Turkey and other countries with macroeconomic imbalances, could be strained by recession, inflation, currency volatility and negative credit trends including trade tariffs and political risk. In all emerging markets, risks will be higher for issuers that rely heavily on foreign-currency financing. This report is an updated version of our outlooks for financial institutions that were originally included in a broader 2019 global outlook on emerging markets published in November.

» **In the EMEA region, slower but steady growth and improving regulation drive a broadly stable outlook, although tightening global financial conditions, disparate economic output and policy uncertainty hide risks.** Our outlook for banks and insurance companies is negative in Turkey and in parts of Africa but mostly stable for financial institutions in other countries.

» **In Latin America, economic growth will support stable credit conditions across the region.** With the exception of Argentina, growth is recovering from 2016-17 lows and will underpin a stable operating environment for most sectors. We expect policy continuity in Brazil, though congressional support for reforms remains unclear. In Mexico, policy uncertainty is weighing on investor confidence, though banks have financial fundamentals strong enough to withstand deteriorations in the operating environment. The biggest risk to Latin American credit conditions overall is the region's exposure to trade protectionism and rising interest rates. Banks have limited exposure to external market funding, which curbs refinancing risks.

» **Trade tensions are the biggest risk to Asia Pacific's broadly stable outlook, with tightening global liquidity posing another risk.** Most economies will continue to grow at a solid, if slowing pace. But rising trade tensions between the US and China could reduce growth and hurt both consumer and investor sentiment. For financial institutions, tightening dollar liquidity and rising interest rates pose some risks.

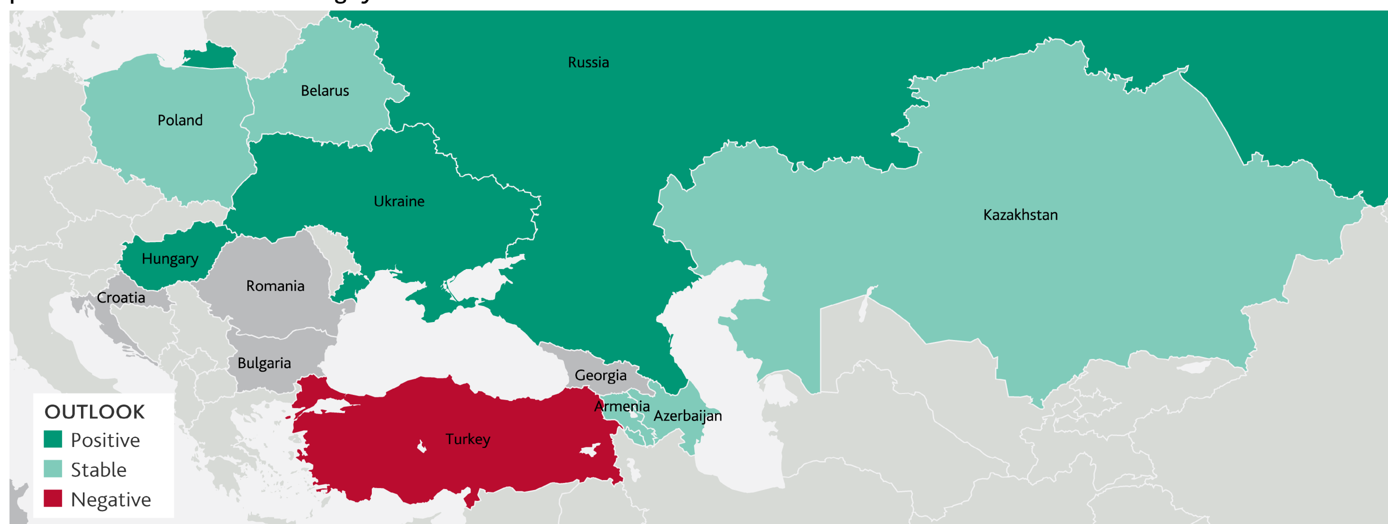
Financial institutions — EMEA: slower but steady economic growth and improving regulations drive stable outlook

Constantinos Kypreos, Senior Vice President

Although tightening global financial conditions pose risks to developing countries, our outlook for most emerging markets in the EMEA region remains stable for financial institutions because of broadly steady — though still below potential — economic growth and improving regulations. The one exception to this is **Turkey**, where a negative operating environment merits a negative outlook (Exhibit 1). Banks in **Africa** also face higher risks because of their exposure to dollar-denominated lending and funding.

Exhibit 1

Turkey is a clear outlier in our mix of stable and positive outlooks in the northern EMEA region. We rate banks in gray countries but do not provide outlooks for their banking systems.



Source: Moody's Investors Service

However, in most of EMEA banks will continue to reduce their nonperforming loan ratios, partly because of tighter regulation and better supervision. This will also improve liquidity management and capital buffers. In **CEE** countries, which are well embedded into the EU supply chain, benign macroeconomic conditions will moderately boost business growth.

Steady oil prices would strengthen lenders in the **Gulf**, where funding and liquidity constraints are easing. Steady oil and commodity prices would also bolster exporters in **Russia**, benefiting its economy and banks. But Russian banks remain exposed to potential geopolitical risks, including new sanctions. If fresh sanctions weakened confidence and investment they could impede banking system growth.

African banks should benefit from a recovery of regional economic growth, especially in East Africa and the West African Economic and Monetary Union (Exhibit 2) and from greater political stability in South Africa and higher commodity prices, helping banks in oil exporting nations such as **Angola** and **Nigeria (B2 stable)**.

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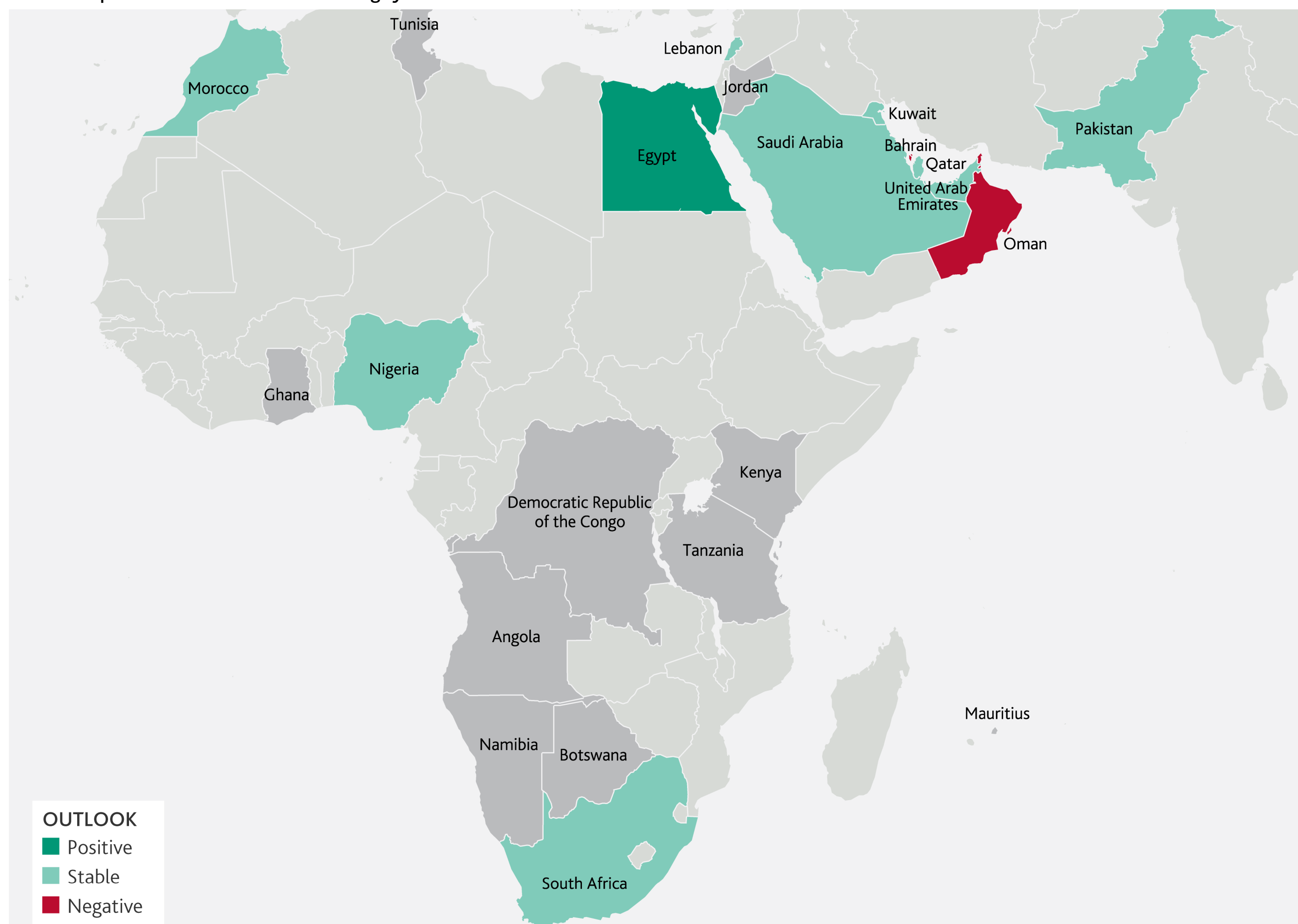
Exhibit 2

Regional economic growth and political stability in South Africa will support banks across Africa. We rate banks and financial institutions in gray countries but do not provide outlooks for their banking systems.



Source: Moody's Investors Service

Nonetheless, tighter global financial conditions could accelerate capital outflows and weaken exchange rates, straining foreign currency liquidity and loan quality. Many African banking systems remain partly dollarised as dollar-denominated loans make up a significant portion of bank balance sheets. As a result, a rise in portfolio outflows and currency devaluations could hurt asset quality for foreign currency denominated loans that are spread out among unhedged borrowers.

In **Turkey,** our negative outlook is driven by a deteriorating operating environment, higher funding risks and our expectation that the solvency of Turkish banks will remain weaker than suggested by reported figures because of regulatory forbearance. Turkish inflation will remain high and we expect economic growth to slow sharply. This, along with a significantly weakened Turkish lira, will worsen loan quality, profitability and capital at Turkish lenders. Turkish banks' heavy reliance on foreign currency funding also increases the risk that they could face a funding squeeze if already weak investor confidence worsened and limited their access to market funding.

Overall, we expect demand for credit to accelerate moderately and for problem loan levels to decline modestly in most EMEA markets. Solid economic growth in the euro area will be particularly helpful to **CEE** banks that are tied into EU trade and supply chains.

Broadly speaking, regulatory improvements will also help banks to strengthen their capital buffers, gradually reduce problem loans and better manage liquidity. Improved supervisory rules include: (1) the gradual implementation of Basel III rules in **Africa** and **Russia**; (2) stricter borrower-based lending criteria and higher capital requirements for specific market segments such as mortgages and consumer lending in **CEE**; (3) limits on related-party exposures and closer regulatory scrutiny of loan collateral management in Russia; and (4)

the implementation of IFRS9 in most countries. We also expect growth in mobile banking to improve financial inclusion and efficiency metrics at **African** banks over the medium term.

Better regulation, enhanced supervision and economic growth also support our stable outlook for the **insurance** sector. Risk-based capital and actuarial reserving requirements have been introduced in major markets in the **Gulf.** This should help improve insurers' sophistication, profitability, capitalisation, asset quality and overall credit quality. Low insurance penetration levels present good growth opportunities, but actual growth may remain somewhat subdued because of intense competition between insurers in these markets which limits their ability to increase pricing.

Financial institutions — Latin America: steady economic growth supports stable outlook for banks, mutual funds and insurers

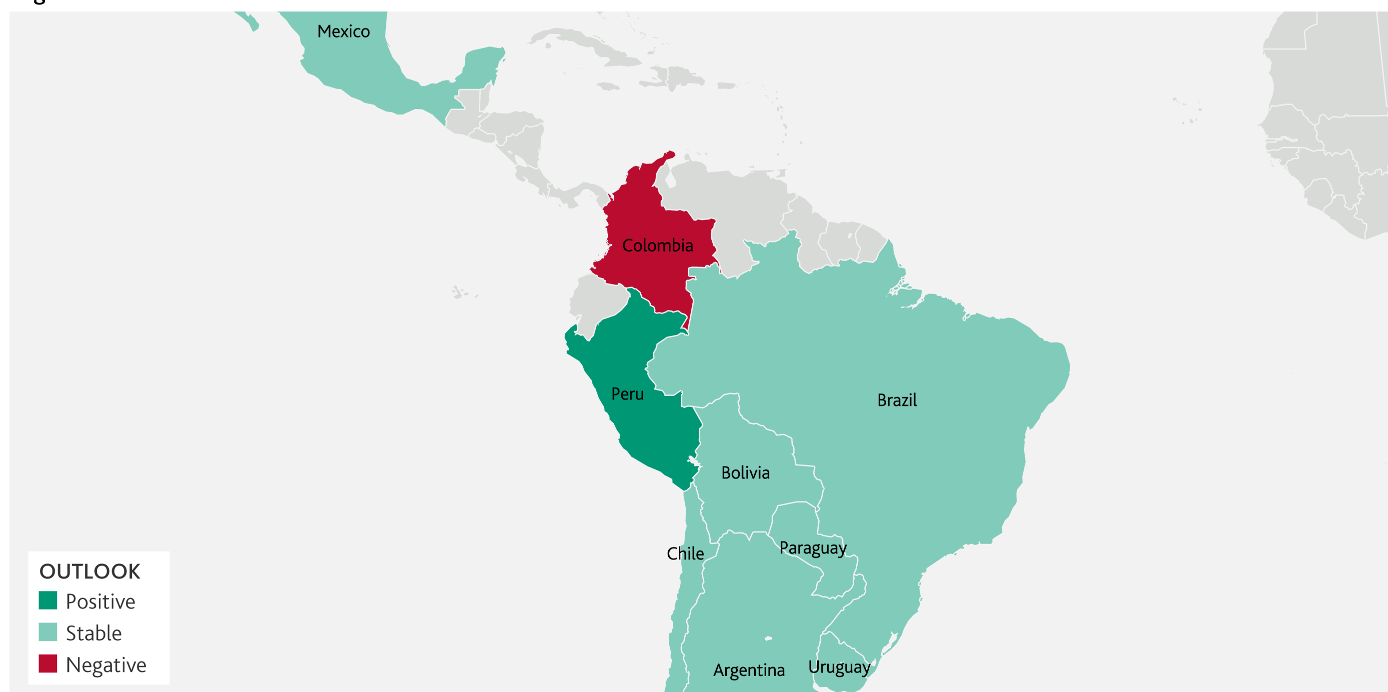
Georges Hatcherian, AVP-Analyst; Juan Bogarin, Analyst & Carlos de Nevares, VP-Senior Analyst

Stable economic growth will help support the operating environment for **banks** throughout Latin America (Exhibit 3), keeping problem loans at bay in most countries. Public policies in the region largely support healthy bank fundamentals, while generally high interest rates and low-cost deposit funding will fuel ample profitability and adequate capital. On average, the nonperforming loans (NPL) ratio will hover at a moderate 3% and return on assets will remain ample by global standards at around 1.5%.

In **Brazil**, President-elect Jair Bolsonaro appears likely to maintain current policies supporting a gradual economic recovery, which will stabilise asset quality and profit as loan growth, fees and lower provisions balance narrowing net interest margins (NIM). In **Mexico,** banks will also post stable asset quality and profitability metrics and maintain good capital buffers, which will help them weather any deterioration in the operating environment. President Andrés Manuel López Obrador has pledged to respect the central bank's independence and maintain the regulatory framework of the financial system for at least three years, contrary to what has been expressed by some members of his coalition.

Exhibit 3

Our outlook for Latin American banks is overall stable. The exceptions are Peru, where the outlook is positive, and Colombia where it is negative.



Source: Moody's Investors Service

In **Argentina**, double-digit inflation and a shrinking economy will raise asset risks and drive a sharp contraction in lending in real terms. The systemwide NPL ratio will double to 4.5% by the end of 2019, driving a sharp increase in credit costs. Although nominal profitability will remain stable, with net income equal to a seemingly robust 2.2% of tangible assets, the return on equity will be negative after adjusting for inflation. Nevertheless, despite the peso's volatility, deposit funding will remain stable and banks have a very limited reliance on cross-border markets.

Banks in **Peru** will continue to post the highest profit in the region and asset quality will stabilise following some recent deterioration. Earnings will be bolstered by strong cost controls and digitalisation efforts, as well as robust NIMs. In **Chile**, robust economic growth in 2019 will support asset quality and profitability. Earnings will also be fuelled by an increased focus on higher-margin retail lending.

Despite **Colombian** banks' good fundamentals and stabilising asset risks, our outlook for the system is negative, which reflects a potential reduction in the government's capacity to support banks if needed.

Despite our stable outlook overall, Latin American banks face risks from rising trade tensions and still difficult global financial conditions. These could curtail economic growth and trigger a deterioration in asset quality, which could potentially erode profitability and capital buffers.

Our outlook for Latin America's **mutual fund** industry in 2019 is also stable, except for Argentina, where the outlook is negative. Low interest rates in **Brazil** should keep fees steady over the next year. Investors there may seek higher returns by shifting into portfolios with higher-yielding asset classes. With most asset managers relying on fixed-income securities, those specialized in equity and alternative investments could have an edge in profitability. A potential pension reform law could also increase demand for new pension funds, adding to already existing retirement plans and funds, which would boost assets under management (AUM) volumes.

Argentina's macroeconomic problems have led to volatile market conditions and returns, driving a sharp decline in investment flows into managed funds, and we do not expect significant improvement in 2019. However, a capital markets law passed in mid-2018 will allow foreign asset managers to enter the Argentine market, which should increase competition when conditions do eventually improve. For **Mexico**, we expect stable market conditions for pension and mutual funds, allowing continued AUM growth.

While we expect steady economic growth throughout most of Latin America to boost business for banks and asset managers, we expect growth in the **insurance industry** to be more restrained. Sharp income disparities, a lack of insurance-friendly tax benefits and a limited range of nontraditional sales channels will continue to impede the industry's expansion despite low market penetration.

In **Mexico**, the full adoption of Solvency II standards indicates that insurers are well placed to keep growing and increase market penetration. Relatively high interest rates will also benefit the industry. In **Brazil**, in contrast, underwriting discipline will be key as lower interest rates reduce investment returns.

In **Peru**, recent updates to mortality tables are credit positive because they will introduce more realistic assumptions used to determine pension benefits and reserves. Finally, in **Argentina**, our outlook for insurers is stable, but they continue to struggle with recession, currency volatility and high inflation, which erodes profitability and capital adequacy for property and casualty P&C insurers. This will continue to limit growth potential for life and annuity insurers.

Financial institutions — Asia-Pacific: stable outlook for banks and insurance despite more difficult operating environment

Eugene Tarzimanov, VP-Senior Credit Officer & Qian Zhu, VP-Senior Credit Officer

For **banks** in emerging Asian economies, slower economic growth in Asia, tightening dollar liquidity and rising interest rates will result in a more difficult operating environment. Nevertheless, banks in the region have solid buffers which will protect their credit quality. For this reason, our overall outlook for emerging market banks in Asia is stable (Exhibit 4)

Our chief concern for 2019 is the escalating US-China trade dispute and the spillover effects that this could have on supply chains and financial markets. Financial conditions in the region have already tightened this year and local currencies have depreciated significantly in **India**, **Indonesia** and the **Philippines (Baa2 stable).** Local central banks have mostly responded by raising interest rates.

Exhibit 4

Slower yet still strong growth underpins our overall stable outlook for banks in most Asia Pacific countries.

Source: Moody's Investors Service

Another risk stems from a decline in dollar liquidity in the region. With foreign portfolio flows reversing out of Asian emerging markets, corporate borrowers will face higher funding costs in dollars. This will create credit challenges for some overleveraged companies with unhedged foreign currency debt and firms that do not benefit from export-related foreign currency income.

Problem and restructured loan ratios remain high in **Bangladesh**, **India**, **Mongolia**, **Indonesia** and **Vietnam** and higher domestic interest rates and weaker regional trade might lead some overleveraged corporate borrowers to default on their debt.

Despite these growing challenges, emerging market banks in Asia have good solvency and liquidity buffers, which should balance the stress on their credit quality. Bank profitability is the first line of defense and totaled 1% (return on assets) in 2017. Loan loss reserves typically cover around 100% of problem assets. Lastly, the capital buffers are good at around 11% in terms of tangible common equity-to-risk weighted assets. Funding and liquidity are also good at Asian banks because they rely mostly on domestic deposits, with a low share of market funding.

Our strong government support assumptions for Asia's emerging market banks will remain intact in 2019. With the exception of **Hong Kong**, Asian regulators have not prioritised the introduction of bank resolution regimes, hence bail-in of senior creditors or depositors is not a tool available to the authorities in most of the region.

Banks also face a mix of other idiosyncratic developments, both positive and negative. In **China**, a gradual approach to deleveraging and more accommodative macroeconomic policies indicate that borrowers will benefit from stronger cyclical support for their repayment capacity, which is credit positive for asset quality at banks. However, nascent signs of a decline in economic leverage during the past year may not continue in 2019.

In **India**, the asset quality cycle is stabilising following massive recognition of problem loans and their gradual resolution and provisioning. However, the recent default of IL&FS, a large infrastructure company and the subsequent liquidity stress in the capital market, has created an emerging risk for banks in the country.

In **Vietnam**, banks have significantly cleaned up their books from legacy problem assets and are set to post higher profit in 2019.

Emerging market banks in Asia will continue to invest in digitalisation and IT transformation to enhance customer experience, reduce client acquisition costs and protect their market positions from new financial technology (fintech) entrants, particularly in retail financial services.

For the **insurance industry**, our overall outlook is stable. Steady economic growth and low insurance penetration in Asia will support demand. Ageing populations and a lack of comprehensive social welfare systems in some Asian emerging markets like **China** and **Thailand** will continue to drive strong growth in private sector health insurance in 2019.

The regulatory regimes in many Asian emerging insurance markets are moving toward more risk-based measurements, including risk-based capital and enterprise risk management frameworks. This will help prevent the build-up of systemic risks and improve capital and financial management.

The industry is also gravitating toward selling less interest-sensitive products to lessen the impact of low interest rates, while providing more protection coverage.

Nonetheless, insurers in Asian emerging markets have been adding riskier assets to their investment portfolio such as infrastructure project investments, trust products and equities to enhance yields. Considering the more volatile economic and capital markets developments in 2019, the investment performance of these insurers could come under pressure.

Technology adoption is most prominent in the insurance industry where it is improving operation efficiency and client experience, but we have not yet seen any transformational changes in terms of insurers' business models.

Moody's related publications

Outlooks:

Funds & Asset Management – Latin America 2019 Outlook

Banks – Latin America 2019 Outlook is stable, supported by favorable operating conditions

Banks – Asia Pacific 2019 outlook

Emerging Markets — Global: 2019 outlook broadly stable; higher rates, politics and trade tensions pose some risks

Cross-Sector - Global: 2019 Outlook - Global credit conditions to weaken amid slowing growth and rising risks, 12 November 2018

Global Macro Outlook: 2019-20: Global growth to decelerate amid tightening global liquidity and elevated trade tensions, 8 November 2018

Sovereigns – Global: 2019 outlook still stable, but slowing growth signals increasingly diverging prospects, 6 November 2018

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Global Emerging Markets Chartbook - September 2018,

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