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2018 Could Be A Turning Point For Thailand's Bank Credit Downcycle

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2018 is shaping up to be an important turning point for Thai banks. Positive indicators point to a possible end to the long credit downcycle. The economy is expanding at the fastest rate in four years, leading Thailand's central bank to increase its 2017 and 2018 GDP growth forecasts to 3.9% for both years. Bank asset quality is stabilizing, with reported nonperforming loan (NPL) ratios staying around 3% in 2017. This is encouraging after several years of deterioration that started in 2014 due to auto loans going bad followed by loans to small and midsized enterprises (SME).

However, S&P Global Ratings believes the credit turnaround story in Thailand (BBB+/Stable/A-2) could face roadblocks. While headline GDP looks good, the recovery is not broad-based. The external sector continues to do the heavy lifting, with a limited knock-on effect to domestic demand. Overall NPLs have stabilized, but the quality of SME and household loans has continued to deteriorate, albeit at a moderating pace. The SME segment accounts for a third of Thai commercial bank lending, and is more sensitive to adverse credit conditions due to thinner financial buffers than those of corporates.

Overview

- Nonperforming loan ratios have stabilized in Thailand, an encouraging sign.
- Large companies are benefitting the most from the export-led economic recovery.
- Asset quality problems persist at small and midsized companies.
- We expect loan dissemination to rise, but high credit costs will curb profit growth.

We remain cautiously optimistic about the 2018 credit trend for Thai banks. In our base case, overall asset quality will be supported by solid GDP growth. However, the country's economic recovery is not fully entrenched, and the SME sector continues to exhibit weaknesses.

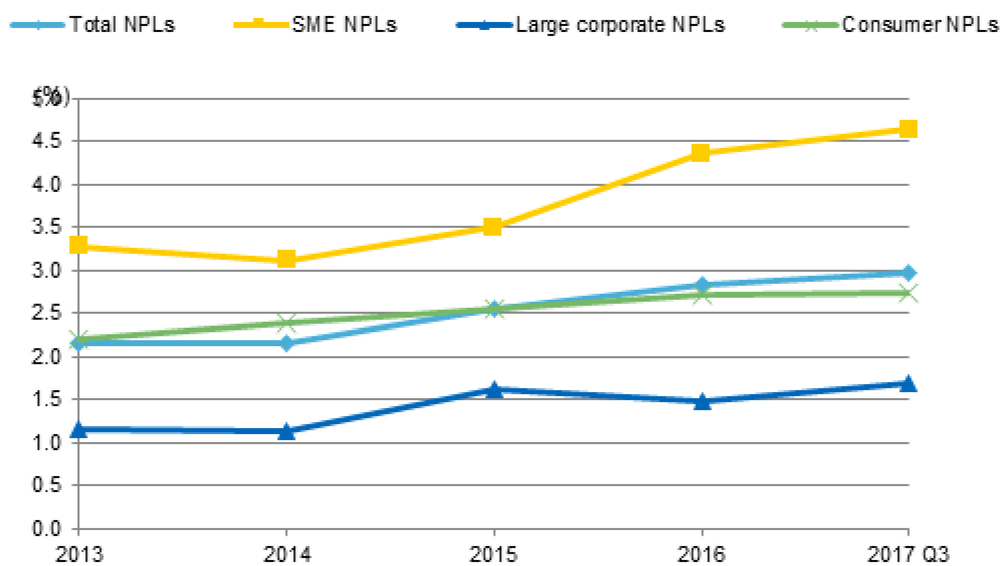
Headline Stability But SMEs Are Still Vulnerable

Despite the stabilization of NPL ratios, a deeper dive reveals ongoing vulnerabilities in the SME sector. The system-wide reported NPL ratio hit 2.97% of total loans at end-third quarter 2017, only marginally higher than the 2.83% recorded on Dec. 31, 2016. Large companies, particularly export-related ones, have been the main beneficiaries of the country's economic pickup. The quality of SME loans, on the other hand, continues to deteriorate. The SME sector's NPL ratio of 4.63% is notably higher than the industry average, and the gap is wide vis-a-vis the corporate sector's ratio of 1.69% (see chart 1).

The issue, in our view, is that many smaller companies are missing out on the economic recovery. Retail-oriented SMEs are geared more toward the domestic economy, whose growth is lagging the external sector. Compared with large firms, SMEs have much lower exposure to electronics, which have led the recent gains in exports. There are also structural constraints at play, including high household debt (78% of GDP in the third quarter of 2017) and an aging population that contributes to weak domestic consumption. Finally, SMEs are also feeling the pinch because of flat agriculture price growth and less-promising farm income, another constraint on purchasing power. Agriculture contributes around 8% to Thailand's GDP.

Chart 1

SME Loans Have Higher Nonperforming Ratios
Nonperforming Loans As A Percentage of Total Loans

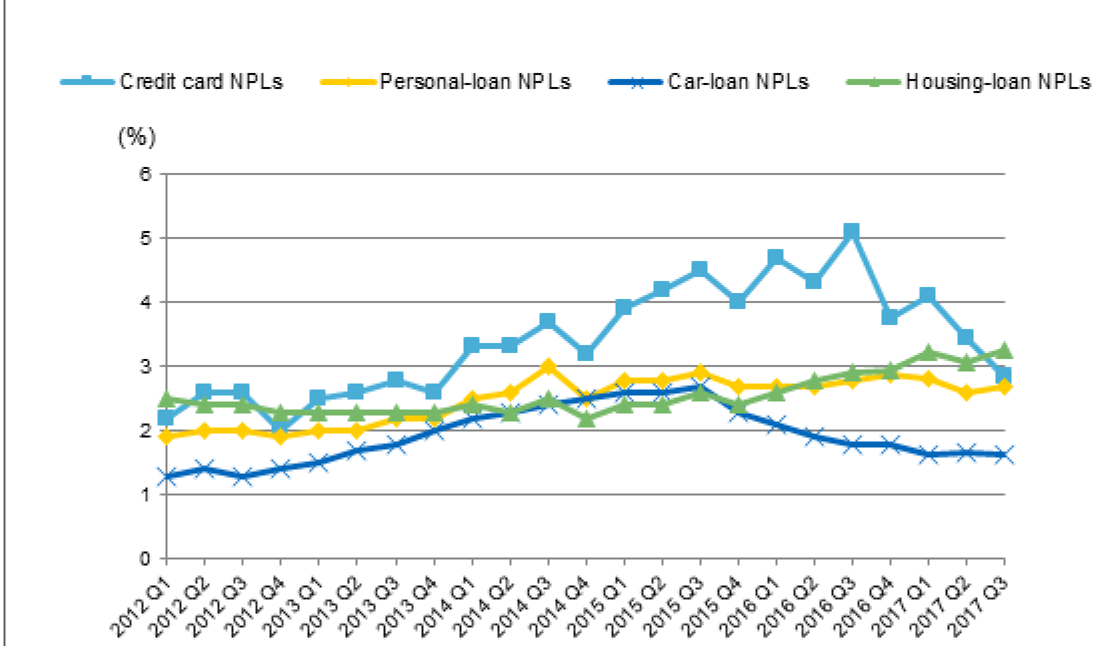


Note: Data includes interbank loans. SME--Small and midsized enterprises. NPL--Nonperforming loans. Q3--Third quarter. Source: Bank of Thailand.

SMEs account for a significant 33% of Thai commercial bank lending, and remain the biggest asset quality problem for banks. Weakness in the SME segment could spill over to consumer loans. Housing loans, which account for about 50% of consumer loans, are seeing a slippage in asset quality. Housing NPLs increased to 3.3% at the end of the third quarter of 2017, from 2.9% at end 2016 (see chart 2). Small business owners in Thailand also borrow from banks in their personal capacity; difficulties in the SME sector could negatively affect their repayment. While there is no country data on consumer loans by SME owners, we believe the increase in housing loans delinquencies could be tied to SME owners.

Chart 2

Housing And Personal NPLs Are Ticking Up
Nonperforming Loans As A Percentage Of Total Loans



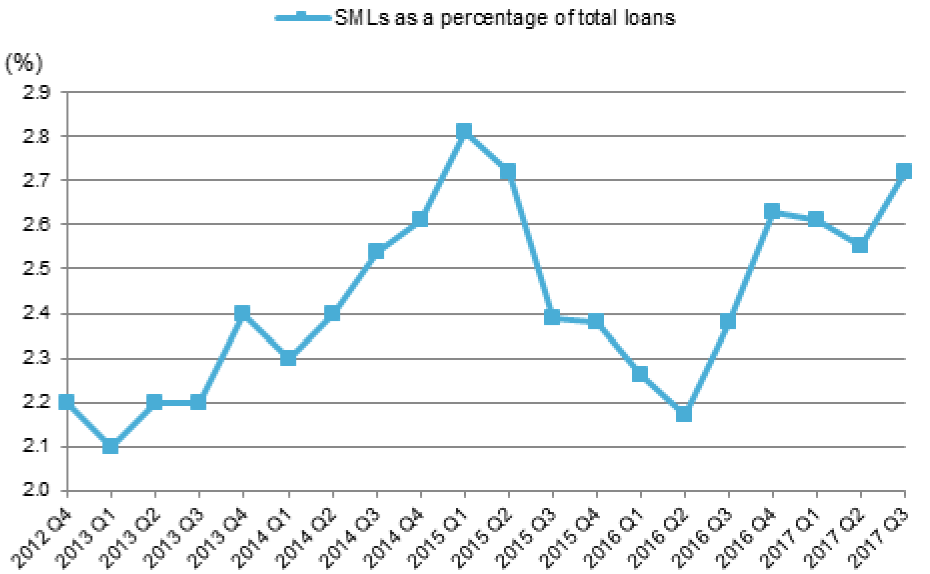
NPLs--Nonperforming loanss. Source: Bank of Thailand.

Is There Light AT The End Of The Tunnel For SMEs?

A consistent increase in special mention loans (loans which have repayment difficulties but are less than 90 days past due) indicates that the effects of Thailand's economic boom has not fully filtered through to all segments. SMLs hit 2.72% at the end of the third quarter 2017, from a recent low of 2.17% in the second quarter of 2016 (see chart 3). Thai banks also have sizable pools of restructured loans (see chart 4). As of Sept. 30, 2017, performing restructured loans accounted for about 2.5% of total loans among the Thai banks we rate. The most common form of restructuring entails extension of tenor, deferment or relaxation of interest, or some combination of both.

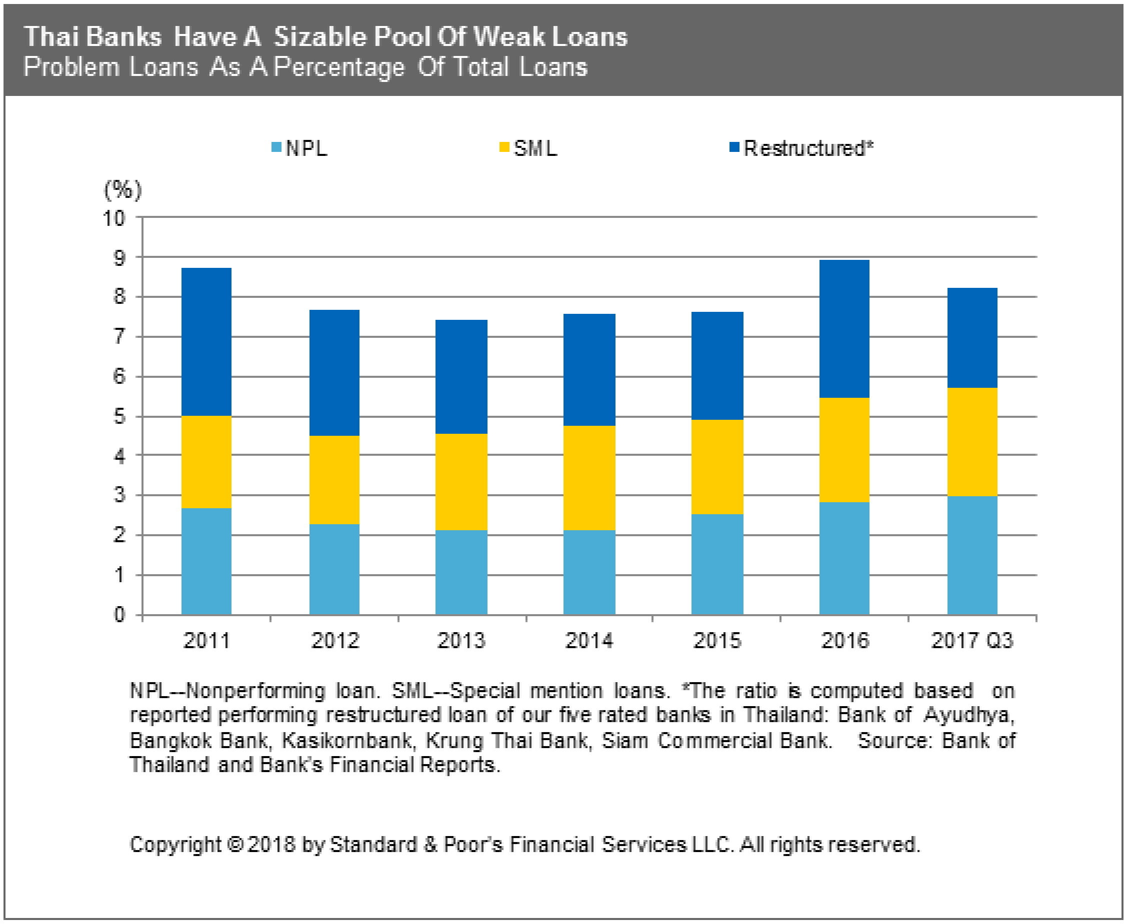
Chart 3

Special Mention Loans Are At Their Highest Rate Since 2015



SML--Special mention loans as a percentage of the total. Source: Bank of Thailand, includes interbank loans

Chart 4



Large corporates have reaped the early benefits of the recovery. We believe that over 2018, the second-order effect from improved sentiment and business confidence will feed into the retail and SME space. The economic measures launched since 2015 to help the SME segment, including soft loans, credit guarantees, and income tax deductions, have cushioned the downcycle. A sustained economic upswing could enhance the effectiveness of these measures.

We believe the buildup of special mention loans could moderate in 2018, accompanied by slower NPL formation in the SME segment. In our view, the turning point in the credit cycle can only happen when there is a sustainable reduction in both special mention and restructured loans.

IFRS 9 Implementation Could Raise Provisioning Costs

The new International Financial Reporting Standard (IFRS) 9, which kicks in from Jan 1, 2019, in Thailand, could raise provisioning costs. IFRS 9 requires banks to make appropriate provisions in anticipation of future potential losses, against the current practice of providing only when losses are incurred.

The standard introduces a new category of "underperforming" loans, in addition to the existing performing and nonperforming loans. A loan is downgraded to underperforming on a significant increase in credit risk; for example if it is more than 30 days past due. Weak loans that are currently on watch lists for potentially turning sour--including special mention and restructured loans--will likely fall into this category. Thailand has a sizable pool of these weak loans, particularly from the troubled SME sector. This is why we think banks might have to deal with potentially higher provisioning.

Banks in Thailand are assessing the extent of asset quality and profitability impact from IFRS 9, and the results won't be available until the first quarter of 2019. However, provisioning decisions will ultimately remain an exercise in judgment. Banks can argue that a restructured loan need not be downgraded to underperforming because of behavioral patterns (such as a weather events temporarily affecting agricultural returns), even if payment is past due.

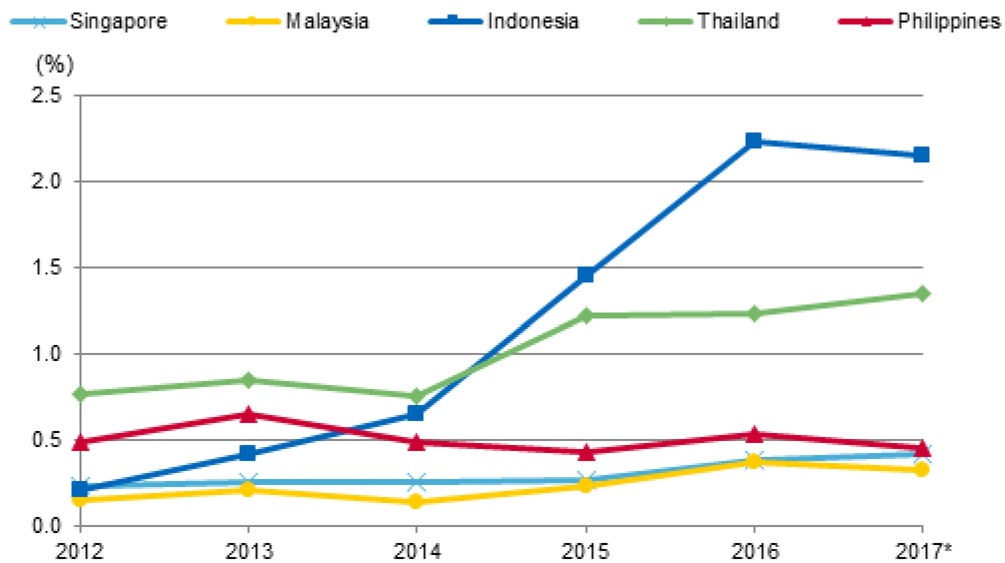
Earnings To Remain Subdued, Loan Growth Could Pick Up

In our view, the 2018 operating outlook for Thai banks is soft with flat earnings growth. In the third quarter of 2017, Thai banks on average recorded an average return on assets (ROA) of 1.04%, lower than the ROA of 1.13% at end-2016 because of increased provisioning expenses. Thai banks have maintained high provisions to buffer against NPLs, especially from the SME sector. Elevated credit expenses since 2015 are the main contributor to lackluster earnings growth, and that will likely continue into 2018 (see chart 5).

Among our rated Thai banks, provisioning coverage averaged 120%-140% of projected losses--one of the highest in ASEAN. We attribute this to a combination of prudent risk management, and regulatory and peer pressure to maintain a sturdy provision buffer in preparation for IFRS 9 implementation. We forecast the sector's credit costs to remain range-bound at around 130-150 basis points for 2018.

Chart 5

Thailand's Credit Costs Are Among The Region's Highest
Credit Losses As A Percentage Of Total Loans



*2017 data is for the first nine months, annualized. Sources: Central banks, bank financial statements, S&P Global calculations.

We expect Thailand's credit levels to expand at a modest rate in 2018, led by export-oriented corporate borrowers. We forecast loans will increase by about 7% this year, compared with an annualized rate of 5.3% as of the end of third quarter 2017. Despite stronger economic growth, banks are still reluctant to lend due to fears about credit risk. We believe banks are taking a circumspect approach given that the cycle is still in the early phases of recovery.

However, upside risk to loan growth emanates from capital-intensive infrastructure projects. The government's infrastructure program includes multiple projects covering rail, roads, air transport, and ports. The Industry Ministry recently revealed that Thailand's Eastern Economic Corridor (EEC) project is expected to see investment in infrastructure projects reach Thai baht 1.5 trillion (US$48 billion) over the next five years. Infrastructure investments on this scale could boost Thailand's economic prospects. Some infrastructure construction activities have already started, and it remains to be seen if the momentum can pick up.

Fintech--Friend Or Foe?

"Fintech" is changing the way banks do business in Thailand. Some of the change is costly; for example, we expect the banking system's fee income could be negatively affected by e-payment mechanisms including PromptPay. On the other hand, we expect banks can lower their operating-costs savings in the medium term by adopting more digital technologies. Banks have been closing branches in the past two years, partly because of increased online customer servicing. In 2017, branches in the system fell by 230, compared with a decline of 45 branches in 2016. In our view, this trend will continue. Siam Commercial Bank Public Co. Ltd. (SCB; BBB+/Stable/A-2) has already announced its intention to reduce branches to 400 by 2020, or shut well over half of the 1,161 branches in operation as of Dec. 31, 2017. SCB is seeking to move away from a large physical footprint and workforce, and to embrace a lighter and more nimble digital organization.

Fintech should also provide banks with new business opportunities. Local banks such as SCB have launched various fintech-focused investment programs and venture capital funds to assist early-stage fintech entrepreneurs. KASIKORNBANK PCL (BBB+/Stable/A-2) has set up Kasikorn Business-Technology Group (KBTG), which will act as a developer and also work in partnership with fintech firms and tech startups to explore financial innovations, aimed at enhancing competitiveness amid changes in global financial technology. The Thai regulator views fintech as an important addition to their financial service ecosystem. Fintech in Thailand is still in the nascent stage, but at this point, we believe that impact on the country's banking sector is supportive rather than disruptive.

Adequate Capital And Provisioning Buffers Underpin Stable Outlook

Thailand's best economic performance in five years has fueled considerable optimism, and the anticipated rollout of major infrastructure plans could deepen the recovery. The export-driven growth bounce has thus far mostly benefitted large corporates. The SME sector remains weak; a lag effect is likely before a better-entrenched recovery would flow to this sector. Nevertheless, downside risks for Thai banks are partly offset by adequate capital levels and provisioning buffers that were built up in earlier years. We expect the Thai banks we rate to maintain Tier-1 capital ratios averaging 13%-15% and provision coverage ratios averaging 120%-140%.

While in our view earnings growth will be constrained by high credit costs, Thai banks will remain profitable enough for retained earnings to keep pace with our estimated 7% loan growth rate in 2018. The banking system's loan-to-deposit ratio of 97% as of Sept. 30, 2017 is high relative to regional peers', but a modest credit expansion is unlikely to create funding pressure. Ratings support from the government should remain high in Thailand, given that regulators in Asia-Pacific, including the Bank of Thailand, are generally not keen to embrace wider bail-in measures.

On balance, positive developments have gained momentum and could signal a reversal of the credit down cycle for Thai banks. 2018 could be a turning point if the economic recovery stays on course.