VIETNAM INVESTORS SERVICE

Banking Sector

Frequently asked questions on credit ratings for banks

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Recently, we hosted several seminars to share our insights on our recent bank rating actions, discuss our credit views on the banking sector, and explain how credit ratings can enhance the corporate bond investment process. This report summarizes our responses to the frequently asked questions from the market participants we engaged with, including foreign investors, funds, banks, and financial companies.

What are the key drivers behind the different ratings assigned to banks? In 1H2024, we assigned first-time long-term issuer ratings to three mid-sized banks: Tien Phong Commercial Joint Stock Bank (TPBank) (AA-), Orient Commercial Joint Stock Bank (OCB) (A+), and Fortune Vietnam Joint Stock Commercial Bank (LPBank) (A+), all with stable outlooks. We view TPBank's standalone profile to be relatively stronger than the other two banks, driven by its stronger funding and profitability. TPBank's track record of leveraging digital capabilities to grow its customer base and core deposits is reflected in the bank's low cost of funding and above-industry-average return on assets. OCB has strong capital that partially offsets its higher asset risks. The issuer ratings for all three banks incorporate our expectation of a moderate likelihood of government support during extraordinary times. Government support is a unique rating driver for banks compared to other non-banks and privately-owned corporate entities, driven by their importance to Vietnam's economy and the likely impact of a bank failure on the financial market and economy.

What are the key credit concerns for the banking sector? Governance and liquidity risks are key risks for banks, as illustrated most recently by the deposit run and liquidity crisis suffered by Sai Gon Commercial Joint Stock Bank (SCB) in 2022. The governance issues began when certain individuals who held influential positions in banks and corporate groups – either as shareholders or board members – managed to direct bank resources to serve their own personal interests. These close linkages create significant operational risks for banks and amplify their vulnerability to large corporate failures, shifts in market sentiment, and runs on customer deposits. In addition, banks in Vietnam rely heavily on short-term market funds and have limited liquid asset buffers to withstand liquidity shocks.

How different are domestic credit ratings from global credit ratings? Local bond market regulations require domestic bond transactions to be rated by domestic credit rating agencies. The domestic credit rating scale can provide greater credit differentiation over 21 rating categories, compared with 10 or fewer on the global scale after applying the country ceiling for Vietnam. Local bank regulations allow banks to use domestic credit ratings to assign capital risk weights to their credit exposures and bond investments in other financial institutions.

Are issuer ratings sufficient to assess bond investment risks? Issuer ratings reflect our assessment of an issuer's capacity to meet its debt obligations on time. Bondholders are exposed to issuer risks, as well as risks intrinsic to their specific bond investments. Bond ratings - assigned to individual bonds – incorporate our assessment of transaction-specific arrangements, such as third-party guarantees, and the bondholder's claim priority. Compared to issuer ratings, bond ratings offer enhanced insights for investors to assess investment risks and establish bond pricing.

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What are the key drivers behind the different ratings assigned to banks?

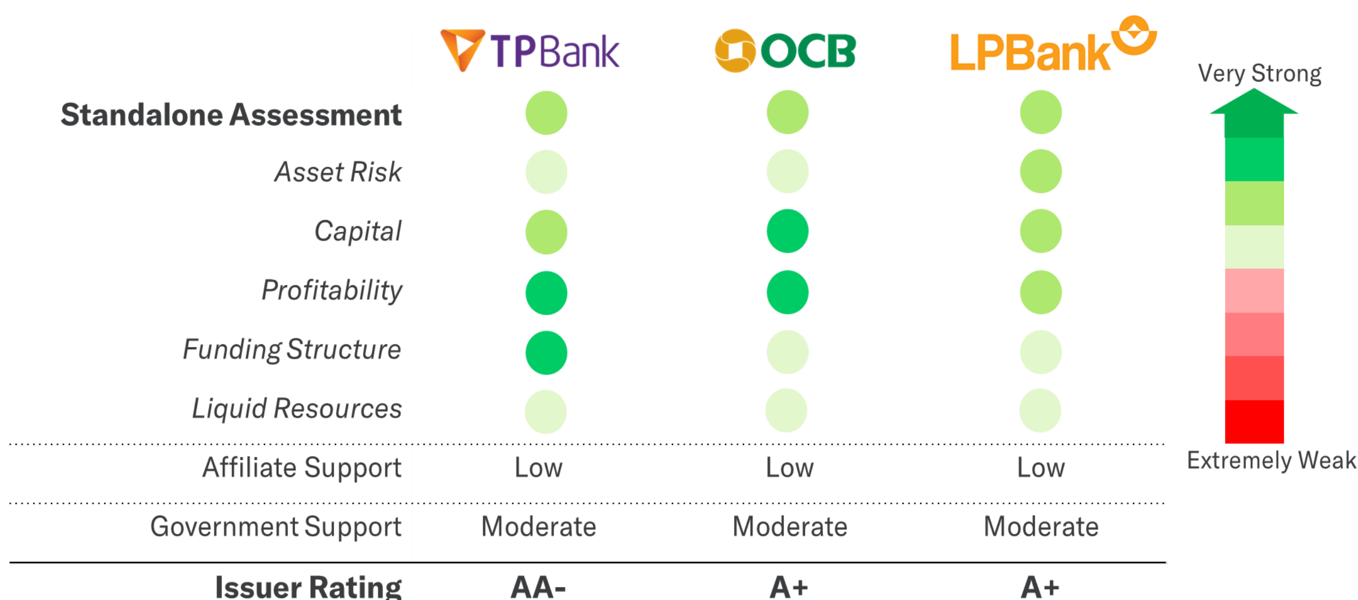
In 1H2024, we assigned first-time long-term issuer ratings to three mid-sized banks: TPBank (AA-), OCB (A+), and LPBank (A+), all with stable outlooks (Exhibit 1).

We view TPBank's standalone profile to be relatively stronger than the other two banks, driven by its stronger funding and profitability. TPBank's track record of leveraging digital capabilities to expand its customer base and core deposit funding base is reflected in the bank's low cost of funding. The bank's above-industry-average return on assets is driven by its strategic focus on higher-yielding customer segments coupled with robust credit growth and a strong funding profile to maintain high net interest margins (NIM).

Similarly, OCB has strong profitability, reflected by its higher-than-industry lending yields and NIM, as well as driven by its ability to manage costs through its digitalization efforts. OCB's stronger capital profile takes into account its strong profitability to generate and retain capital internally to support its asset growth, and the capital infusion by its strategic shareholder, Aozora Bank, in 2020. The bank's strong capital partially offsets its higher asset risk profile, marked by a material increase in retail and small and medium enterprises (SME) loan delinquencies over the past year after a period of fast growth.

LPBank's key strength is its above-average asset quality, underpinned by its track record of maintaining superior asset quality and loan loss coverage metrics relative to the industry average. This is driven by the bank's various measures to tighten credit underwriting and loan recovery practices to tackle the borrowers' weakening debt serviceability, as well as risk diversification across small borrowers and provinces nationwide.

Exhibit 1: Comparison of key rating drivers



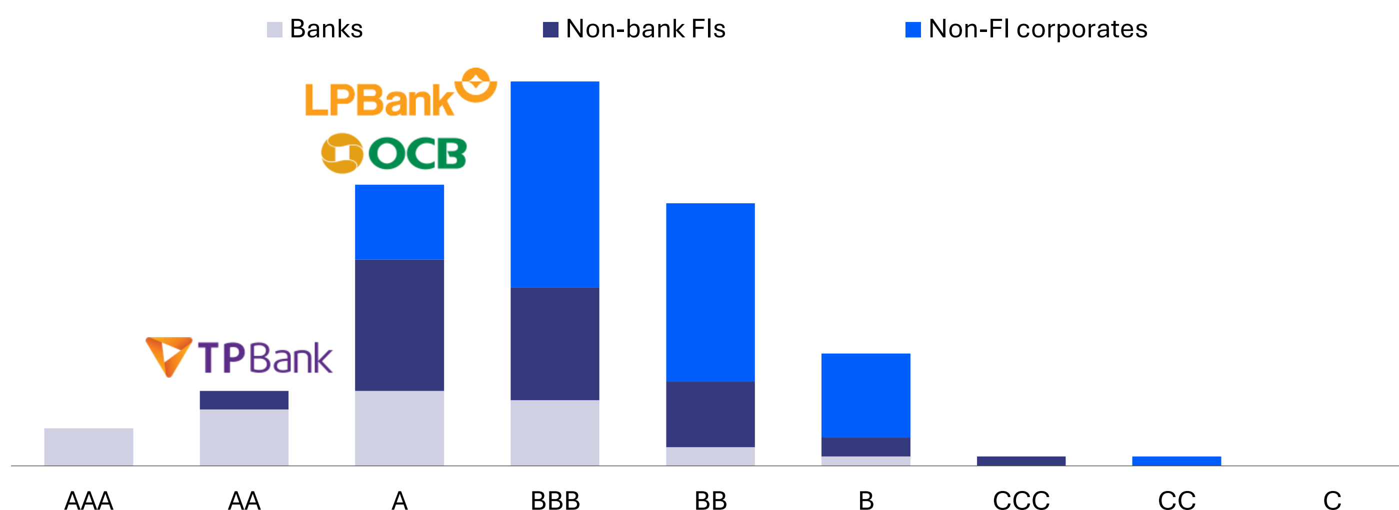
Source: Bank data, Vietnam Investors Service

The issuer ratings for all three banks incorporate our expectation of a moderate likelihood of government support during extraordinary times. Government support is a unique rating driver for banks compared to other non-banks and privately-owned corporate entities, driven by their importance to Vietnam's economy and the impact that a failure of a bank would have on the financial market and economy.

The new Law on Credit Institutions reinforces our expectation of government support for banks. For example, the new guidelines include specific criteria related to a bank's solvency and liquidity position such as deposit runs, that will warrant early intervention by the State Bank of Vietnam (SBV). In addition, the guidelines provide more clarity on the SBV's powers to resolve banks that are placed under special control[1].

As such, bank ratings are among the highest across our ratable universe (Exhibit 2).

Exhibit 2: Preliminary rating distribution for ~130 companies



Source: Vietnam Investors Service
Note: Data for residential real estate and construction sector includes the top 25% of the highest revenue

[1] Refer to our New Credit Institution Law will strengthen risk governance among banks and empower the regulator to act swiftly to maintain financial sector stability (19 Feb 2024)

What are the key credit concerns for the banking sector?

Governance and liquidity risks are key risks for banks, as illustrated by the recent episodes of bank deposit runs and liquidity crises stemming from risk governance issues.

As we have learned from recent incidents, these governance issues begin when certain individuals who hold influential positions in banks and corporate groups – either as shareholders or board members - manage to direct bank resources to serve their own personal interests. These close linkages create significant operational risks for banks and amplify their vulnerability to large corporate failures, shifts in market sentiment, and runs on their customer deposits.

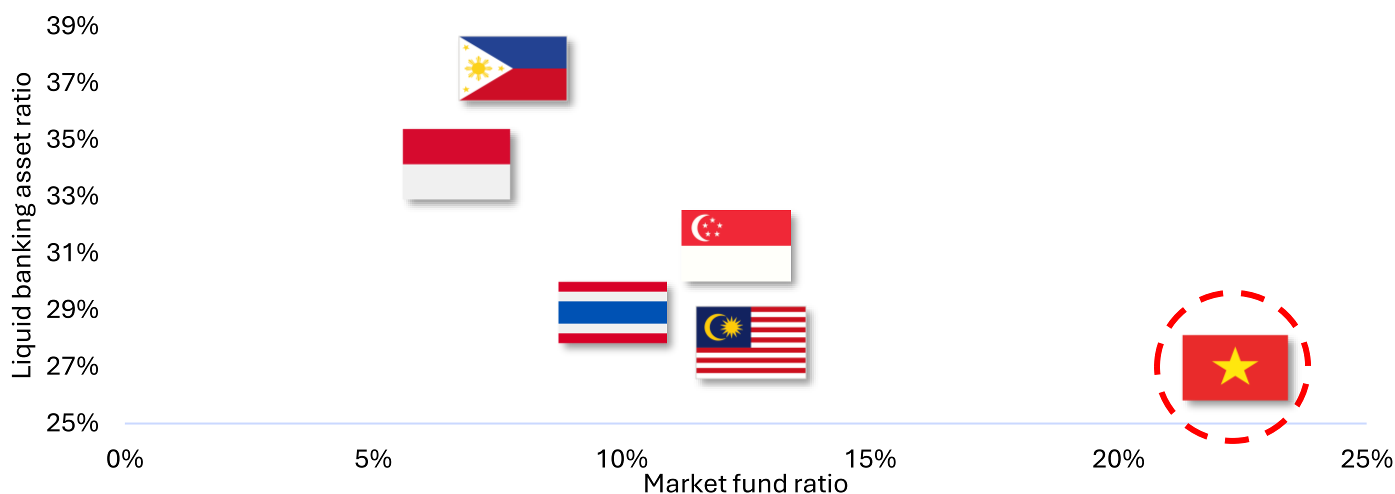
In October 2022, the news of the arrest of the chairwoman of Van Thinh Phat Holding Group Corporation (VTP) for misappropriation of funds drove individual depositors to withdraw their funds from Saigon Commercial Bank (SCB), a bank that is publicly known for its close linkage to the group and its business activities. SCB suffered massive deposit withdrawals over a 5-day period, eventually leading to its downfall due to liquidity issues.

The regulatory investigations into SCB later revealed the fact that VTP's chairwoman controlled over 90% of the bank's shareholding equity and misused bank funds through a complex and myriad series of loan transactions of over VND1,000 trillion in total between the bank and companies linked to VTP and the chairwoman over 10 years. The majority of the loans are now deemed irrecoverable.

The incidents in Construction Bank (CB Bank) and Global Petro Sole Member Limited Commercial Bank (GP Bank) in 2015 were similar to SCB. The bank operations were heavily influenced by a few shareholders, and the banks built up significant credit exposure to real estate developers and projects related to the shareholders. Following the deterioration in the financial health of the shareholders and their projects, the banks landed with significant bad debt and losses that led to their eventual insolvency.

In general, banks in Vietnam are more vulnerable to liquidity risks compared to regional banks. Vietnam banks rely heavily on market funds from the interbank market, which tends to be unreliable and confidence-sensitive. In 2022, deposit runs at SCB also led to withdrawals of interbank funding, a surge in interbank interest rates, and liquidity stress for small banks. Vietnam banks also have limited liquid asset buffers of 27% over total assets – lower than regional peers' average of 31% - to cover market fund obligations (Exhibit 3).

Exhibit 3: Banks in Vietnam with high reliance on market funds are more vulnerable to liquidity risks



Source: Moody's Ratings, Vietnam Investors Service
Note: Market fund ratio is calculated as total market fund divided by tangible banking assets
Liquid banking assets include placements at the central bank, placements at/loans to other financial institutions and securities, which are divided by tangible banking assets for assessment

How different are domestic credit ratings from global credit ratings?

Local bond market regulations require domestic bond transactions to be rated by domestic credit rating agencies. Under Decree 155[2], bond issuers must obtain a local credit rating for their domestic bond issuances if (i) their bond issuance over the last 12 months exceeds VND500 billion and 50% of equity, or (ii) their total outstanding bonds exceed 100% of equity.

In addition, local bank regulations allow banks to use domestic credit ratings to assign capital risk weights to their credit exposures and bond investments in other financial institutions.

For investors using credit ratings for their investment decisions, the domestic credit rating scale can provide greater credit differentiation over 21 rating categories (Exhibit 4), compared with 10 or fewer on the global scale after applying the country ceiling for Vietnam.

Exhibit 4: Domestic credit rating scale can provide greater credit differentiation over 21 rating categories

Rating	Description
AAA	Issuers or debt instruments demonstrate the **strongest creditworthiness** relative to other domestic entities and transactions
AA+ **AA** **AA-**	Issuers or debt instruments demonstrate **strong creditworthiness** relative to other domestic entities and transactions
A+ **A** **A-**	Issuers or debt instruments demonstrate **above-average creditworthiness** relative to other domestic entities and transactions
BBB+ **BBB** **BBB-**	Issuers or debt instruments demonstrate **average creditworthiness** relative to other domestic entities and transactions
BB+ **BB** **BB-**	Issuers or debt instruments demonstrate **below-average creditworthiness** relative to other domestic entities and transactions
B+ **B** **B-**	Issuers or debt instruments demonstrate **weak creditworthiness** relative to other domestic entities and transactions and may be approaching default
CCC+ **CCC** **CCC-**	Issuers or debt instruments demonstrate **very weak creditworthiness** relative to other domestic entities and transactions and are likely in or near default
CC	Issuers or debt instruments demonstrate **extremely weak creditworthiness** relative to other domestic entities and transactions and are typically in default
C	Issuers or debt instruments demonstrate **the weakest creditworthiness** relative to other domestic entities and transactions and are typically in default

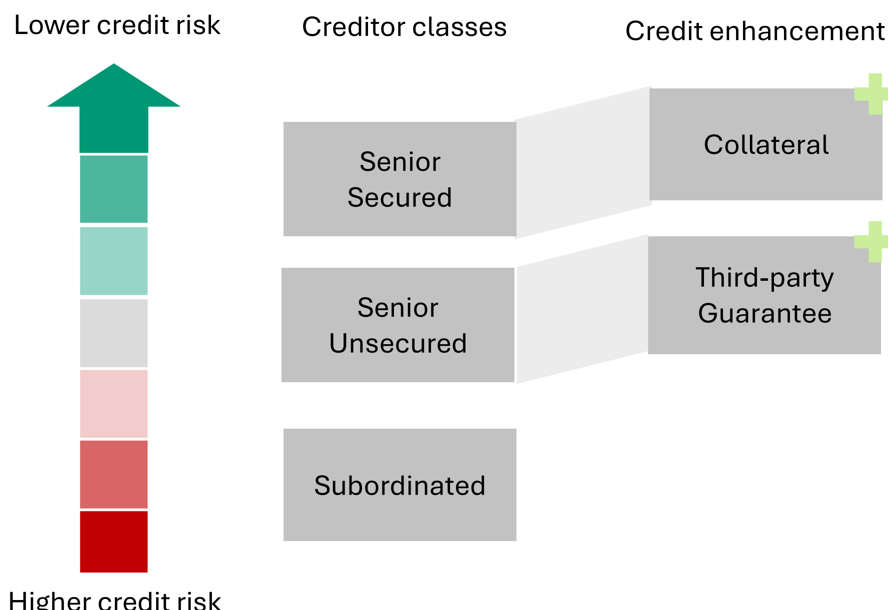
Source: Vietnam Investors Service

[2] Refer to Decree 155/2020/NĐ-CP

Are issuer ratings sufficient to assess bond investment risks?

Issuer ratings reflect our assessment of an issuer's capacity to meet its debt obligations on time. Bondholders are exposed to issuer risks, as well as risks intrinsic to their specific bond investments. Bond ratings - assigned to individual bonds – incorporate our assessment of transaction-specific arrangements, such as third-party guarantees, and the bondholder's claim priority (Exhibit 5). Compared to issuer ratings, bond ratings offer enhanced insights for investors to assess investment risks and establish bond pricing.

Exhibit 5: Using bond ratings to differentiate risk profiles of bonds



Source: Vietnam Investors Service

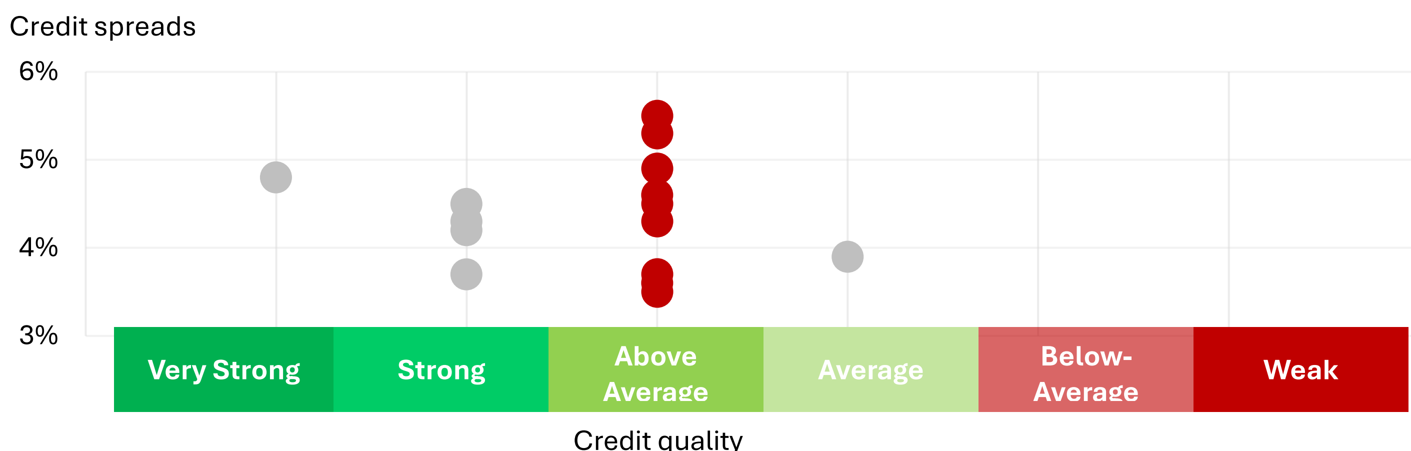
Historical bond pricing in the Vietnam corporate bond market showed that credit risks are not always considered and adequately incorporated in bond pricing.

In principle, for bonds with similar terms and conditions, bonds issued by issuers with stronger creditworthiness should carry a lower coupon rate than those issued by weaker credit quality issuers; bonds issued by issuers of the same credit quality should carry similar coupon rates.

We collected the primary market pricing data for a sample of 3-year senior unsecured bank bonds issued in 2H2023, measured their credit spread with government bonds of the same tenor, and examined whether the credit spreads move in tandem with the bond issuers' credit risk profiles.

Our analysis revealed significant bond pricing anomalies in Vietnam (Exhibit 6). Firstly, bank issuers with stronger credit quality issued bonds at higher coupon rates than those with weaker credit quality. Secondly, bank issuers of similar credit quality issued bonds with significantly different coupon rates even though they had similar terms and conditions.

Exhibit 6: Historical bond pricing did not always correspond with credit quality

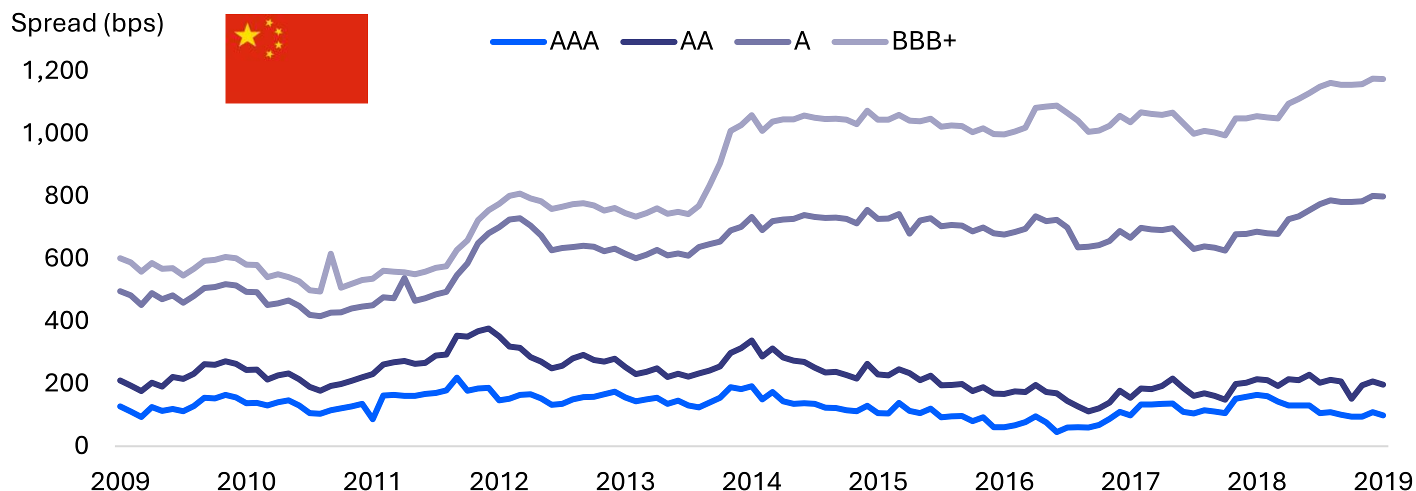


Source: HNX, VBMA, Vietnam Investors Service

As market participants become increasingly familiar with credit ratings and begin to adopt credit ratings in their bond issuances and investments, we expect such pricing anomalies to diminish over time and market efficiency to improve.

In the regional markets, credit ratings support the assessment of relative credit risks for bond investments. Issuers and investors use credit ratings to determine the appropriate bond pricing. As shown in Exhibit 7, corporate bond spreads widen as credit risk increases, and the spreads across different risk and rating categories move in a consistent manner over time.

Exhibit 7: Credit ratings support market price discovery in regional markets



Source: Asian Bonds Online, Vietnam Investors Service

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