Outlook for BPDs remains stable, supported by captive markets

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Regional development banks (*bank pembangunan daerah*, BPD) were established to drive economic growth in the regions, in turn increasing the supply and demand for the flow of funds and lending there. There is a strong correlation between the size of BPDs and their economic activities in their respective regions. Regional areas where the BPDs are operating should also determine the BPDs' size and potential growth. Operating in an economically strong region will facilitate the BPDs to capture business opportunities in the developing sectors to support their growth targets.

To date, there are 26 BPDs operating in the country. As they are owned by the regional governments, these strong relationships are beneficial, providing a captive market to secure funds from regional governments and distribute loans to regional civil servants (*pegawai negeri sipil*, PNS). As of December 31, 2013 (FY2013), BPDs recorded IDR390 trillion in total assets, IDR287.7 trillion in total deposits, and IDR264.5 trillion in total loans. Compared to the banking industry overall, BPDs represented around 8% of total assets, deposits and loans.

PEFINDO has assigned ratings to 12 BPDs, all at $_{id}$A- or above, with a stable outlook and one BPD with negative outlook. These good ratings reflect our view that BPDs have a positive growth outlook driven by economic growth in the regions and strong synergy with their regional governments. We expect rating changes in 2014 to be limited given the increase in regulatory requirements and the intensifying competition in the banking industry.

Growth in line with the banking industry as a whole

The total assets of BPDs steadily grew by a compound annual growth rate (CAGR) of 18.1% during 2009-2013, in line with the banking industry as a whole at 18.3%. This growth was driven by their core business in the consumer loan segment, which targets regional civil servants. However, total loans of BPDs grew at a slightly lower pace with a five-year CAGR of 21.7%, compared to the overall banking industry at 23%. This is due to the limited capital of BPDs to extend its loan portfolio. Nevertheless, PEFINDO believes that BPDs have strong loan growth potential from consumer loans, particularly loans to civil servants. Loans to the productive sector should also drive growth, which is expected to accelerate the regional economy.

On the funding side, total BPD deposits grew 17.3% during the same period, slightly higher than the industry as a whole at 17.1%. Deposits mostly came from regional government funds to finance government projects as part of the regional budgetary revenue and expenditure (*Anggaran Pendapatan dan Belanja Daerah, APBD*) allocation. Whilst BPDs have a stable source of funds from their shareholders and other BPDs, we believe the development of a retail-funding base is necessary to support growth sustainability. To capture retail funding, BPDs face tough challenges to improve their brand awareness in the market and compete with other commercial banks with an already strong presence in the industry, specifically in the retail banking sector.

Figure 1. Regional development banks

(IDR trillion)	5-year CAGR	FY2013	FY2012	FY2011	FY2010	FY2009
Total assets	18.1%	390.0	366.7	304.0	239.1	200.5
Total deposits	17.3%	287.7	278.5	235.4	183.6	152.3
Total loans	21.7%	264.5	218.9	175.7	143.7	120.8

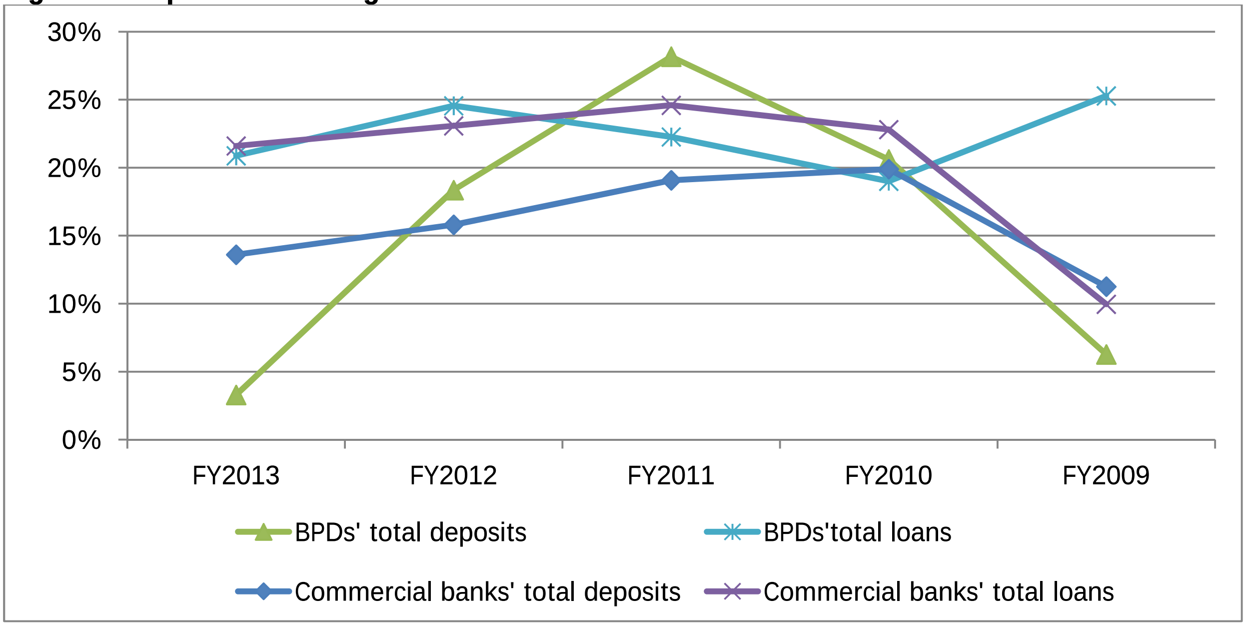
Source: Bank Indonesia publication

Figure 2. Commercial banks

(IDR trillion)	5-year CAGR	FY2013	FY2012	FY2011	FY2010	FY2009
Total assets	18.3%	4,954.5	4,262.6	3,652.8	3,008.9	2,534.1
Total deposits	17.1%	3,664.0	3,225.2	2,785.0	2,338.8	1,950.7
Total loans	23.0%	3,292.9	2,707.9	2,200.1	1,765.8	1,437.9

Source: Bank Indonesia publication

Figure 3. Deposit and loan growth of BPDs and commercial banks



Since BPD activities are focused in their respective regions, they mostly have extensive networks there to deliver banking services to customers, including in rural areas not be easily penetrated by other commercial banks. Supported by their strong synergy with regional governments, PEFINDO expects that BPDs will be able to maintain their strong business position in their regions in the near to medium term. However, strong regional coverage has manifested in a geographical risk concentration. As they continue to focus their distribution channels there, PEFINDO does not expect geographical diversification to change in the medium term.

With the establishment of the BPD Regional Champion Program (BRC) as stipulated by banking regulator, BPDs are expected to enhance their roles under three pillars. The first pillar increases the strong resilience of the institutions by increasing their capital and improving operating efficiency to achieve adequate profitability levels. BPDs as agents of regional development, as stated in the second pillar, should achieve a larger portion of loans to the productive sector, and increase their intermediary function through linkage programs with rural banks (*Bank Perkreditan Rakyat*, BPR) or by becoming an APEX bank. The third pillar mandates the banks to serve the community by providing continual education and understanding in regard to banking services and product awareness. We believe they have executed these pillars, although the prime results have yet to materialize. Financial performance indicators have not all been achieved and consumer loans still dominate their loan portfolios.

Productive versus consumption segments

The BPDs' total loans have consistently majored in the consumer loan segment. As of FY2013, consumer loans accounted for 66.1% of total loans, with the remaining 33.9% from the working capital and investment loan segments. The BPDs have been challenged by the BRC to increase their loans to the productive sector to 60%. This expansion requires large human resources and specialized expertise for the segment's needs.

Through their function making salary payments to regional civil servants, BPDs are allowed to deduct debt installments from salaries. The consumer loan sector is easy business, requiring less effort in terms of risk and cost. In the medium term, we believe that the portion of consumer loans will remain high.

Figure 4. Loan composition to third-party non-banks

Type of use	FY2013	FY2012	FY2011	FY2010	FY2009
Working capital	22.4%	21.0%	20.1%	20.7%	20.9%
Investment	11.5%	11.3%	12.0%	12.0%	10.9%
Productive*	**33.9%**	**32.3%**	**32.1%**	**32.7%**	**31.8%**
Consumption	66.1%	67.7%	67.9%	67.3%	68.2%

Source: Bank Indonesia publication
**Productive = Working capital and investment*

Challenges to keeping asset quality under control

The BRC program, which stimulates the growth of productive loans, has resulted in weakening asset quality. The disbursement of productive loans was IDR87.1 trillion as of FY2013, up from IDR70.7 trillion as of FY2012. Non-performing loans (NPL) from the productive segment rose to 7.5% from 6.1% during the same period. Consumer loans contributed a very low NPL, averaging around 0.5%. To undertake higher risks, BPDs will need improved infrastructure, including qualified and experienced personnel. Scarcity of skilled personnel is expected as all BPDs are targeting the same segment. Their expansion into the higher risk sector must also be accompanied by proper strategies and execution, otherwise, the bottom line NPL will continue to deteriorate.

Figure 5. NPL ratio to third-party non-banks

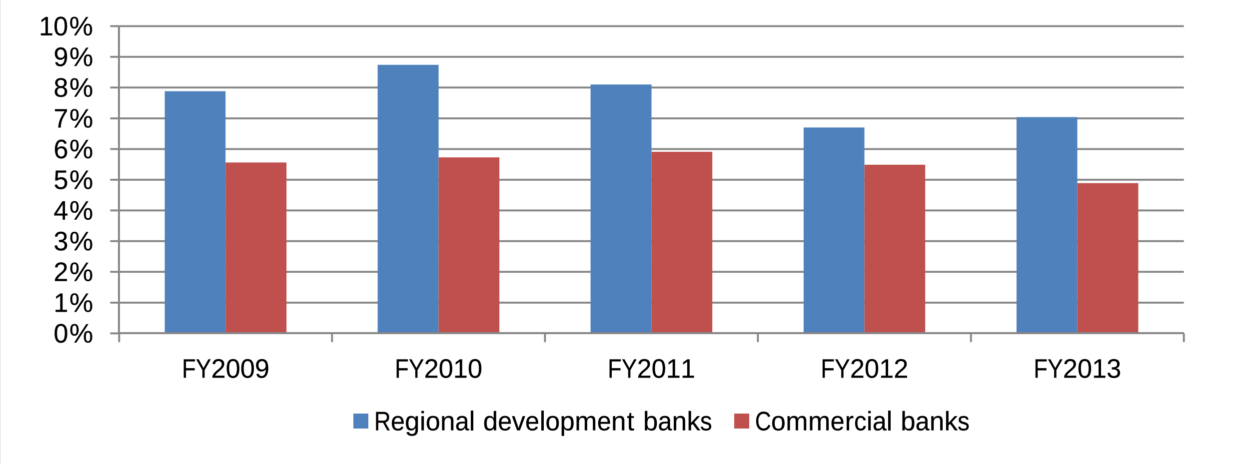
Type of use	FY2013	FY2012	FY2011	FY2010	FY2009
Working capital	8.4%	7.0%	5.5%	6.5%	5.5%
Investment	5.7%	4.6%	2.4%	3.2%	2.7%
Productive*	**7.5%**	**6.1%**	**4.3%**	**5.3%**	**4.5%**
Consumption	0.5%	0.5%	0.5%	0.5%	0.4%
Overall NPL	**2.9%**	**2.3%**	**1.7%**	**2.1%**	**1.7%**

Source: Bank Indonesia publication
**Productive = Working capital and investment*

NIM expected to tighten

Through a significant portion of high-yield consumer loans, BPDs booked a higher net-interest margin (NIM) of 7% in FY2013, compared to the industry's 4.9% for the same period. To maintain efficiency, the banks have been encouraged to reduce their NIM and operating expenses/operating income (BOPO) to 5.5% and 75%, respectively. The table below shows the BPD NIM was consistently higher than the industry as a whole. On the other hand, fee-based income was relatively low, averaging below 5%. This indicates that BPDs heavily rely on high interest rates to generate their revenue. Despite the incremental rise to 7% in FY2013 due to higher interest income from robust loan growth volume and lending rate adjustment in regards to the increment of BI rate, the NIM dropped to 6.7% in FY2012 from 8.1% in FY2011 as a result of a linkage program with rural banks to distribute loans to micro, small, and medium-sized enterprises (MSMEs). The efforts to achieve regional champion status by expanding productive loans to 60% of their total loan portfolios could push down their NIM. Furthermore, tightening competition among the banks should also drive pressure on their margins. PEFINDO projects that the narrowing NIM should be gradual.

Figure 6. Net-interest margin of BPDs and commercial banks



Concentrated funding mitigated by stable funding from related parties

In addition to a high concentration on consumer loans, BPDs are also exposed to a large share of funding from regional government. PEFINDO believes their reliance on regional government funds is inevitable as APBD funds are placed in the banks on a regular basis. Despite a large share of these funds, we view the liquidity risk as a minor factor as it is mitigated by the stability of related-party funds. As shareholders of the BPDs, it is unlikely they will excessively withdraw funds and put the BPDs at risk. BPDs may also obtain additional liquidity support from pooling funds managed by the Association of Regional Development Banks (*Asosiasi Bank Pembangunan Daerah, ASBANDA*), which was established to provide guidance for the BPDs to optimize their roles as financial intermediary institutions and as agents of regional development.

With the rising trend of the BI rate and the USD strengthening against all currencies, the banking industry in Indonesia faces a tight liquidity situation. As the BI rate rose, the industry's loan to deposit ratio (LDR) elevated to 89.7% as of FY2013 from 83.6% as of FY2012. The BPDs' LDR level also increased to 92.3% from 78.6% in the same period. We views that the high BPDs' LDR is attributable to the cyclical nature of regional government funds that show a lower concentration at year-end, and will increase at the beginning of the upcoming year.

Another issue is the influence of the shareholders on the BPDs' capital growth and management profile. Expansion into the productive segment is challenged by need for capitalization. The capitalization level, as measured by capital adequacy ratio (CAR) at 17.6% as of FY2013, was above the BRC capitalization requirement at 15% and so adequate to address the current business risk. Nevertheless, additional capital is essential to support expansion into a higher risk segment. BPDs must go through a lengthy process to raise capital as most have many shareholders and the capital raising process is subject to approval from each regional parliament. In most cases, although they regularly receive capital injections from shareholders, the BPDs also pay a high dividend that counts as regional revenue. We believe that this practice may hold down the BPDs' capital growth and limit their business expansion.

In some BPDs, PEFINDO observes that there is a risk that management faces intervention from the shareholders which results to the management instability. The risk from frequent management change is mitigated by a strong focus in mass market consumer loan products. If the management instability continues to occur, it may affect BPDs' capability to capture potential business.

Resilient growth going forward

Although the BPDs have made their best efforts to achieve indicators as set out in the BRC, PEFINDO believes that not all can be fulfilled given that there are several aspects that are complex for BPDs to achieve, particularly to reach a certain level in the productive loan segment. Taking into account the historical growth of loans and deposits, and the current economic conditions, PEFINDO expects that the loans and deposits growth of BPDs will remain strong, supported by their captive market.

Figure 7. Published ratings of BPDs

Bank	Rating	Outlook	Total assets	CAR	NPL	BOPO	NIM	ROA	LDR
Bank Jabar Banten	idAA-	Stable	75,859.9	16.4%	2.6%	78.0%	6.9%	2.0%	83.7%
Bank DKI	idAA-	Stable	30,643.6	13.9%	2.8%	76.6%	5.6%	2.9%	72.2%
Bank Jawa Timur	idA+	Stable	35,508.8	22.3%	3.1%	65.6%	7.9%	2.8%	75.1%
Bank Jawa Tengah	idA+	Stable	33,726.9	14.6%	0.6%	68.6%	7.3%	2.7%	70.8%
Bank Sumut	idA+	Negative	23,256.8	13.1%	3.9%	70.1%	8.8%	3.2%	88.9%
Bank Papua	idA	Stable	19,888.5	18.2%	1.4%	68.7%	8.1%	2.4%	65.6%
Bank Nagari	idA	Stable	17,057.5	14.0%	2.7%	79.7%	6.9%	1.8%	90.6%
Bank Sulselbar	idA	Stable	11,227.2	21.1%	1.3%	63.4%	10.3%	3.6%	74.2%
Bank Sumsel Babel	idA-	Stable	15,949.1	14.5%	7.8%	76.6%	8.7%	2.1%	80.3%
Bank Sulut	idA-	Stable	8,093.1	13.6%	0.6%	70.9%	10.2%	3.2%	84.3%
Bank NTT	idA-	Stable	8,001.4	16.2%	1.5%	72.8%	9.3%	3.3%	81.8%
Bank Lampung	idA-	Stable	5,624.8	17.6%	0.7%	73.4%	6.4%	2.2%	64.8%

All financial information as of 30 September 2013.
The above ratios have been computed based on information from the companies and published accounts.
Where applicable, some items have been reclassified according to PEFINDO's definitions.
Total assets are stated in IDR billion.