The Relaxation Impact for the Banking and Financing Industries

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The Covid-19 pandemic has severely reduced business and economic activities in all industrial sectors, including the financial services industry. This is reflected in the contraction of the banking loan of 4.3% year-on-year (YoY) as well as a decrease in financing (combined with joint financing) of 21.1% YoY in March 2021 (1Q2021). The Covid-19 pandemic has yet showed signs of containment despite the launching of the vaccination program. Debtor restructuring has been massively carried out by financial service companies through the relaxation program launched by the Financial Service Authority (OJK) early in the pandemic through the issuance of OJK Regulations (POJK) No.11/POJK.03/2020 and POJK 14/POJK.05/2020. At the end of 2020, OJK amended POJK related to the Covid-19 stimulus through the issuance of POJK 48/POJK.03/2020 and POJK 58/POJK.05/2020 intended to extend the relaxation period to 2022 as well as adding some new features.

Key features of POJK 48/POJK.03/2020

POJK 48/2020, an amendment to POJK 11/2020, is intended to extend the relaxation period to 2022 and to ensure the robust implementation of risk management and prudential principles, as well as policies related to bank capital and liquidity, and relaxation of several ratio requirements. POJK 48/POJK.03/2020 regulates the implementation of risk management where banks need to assess the capacity of restructured debtors, allocate reserves for debtors unlikely to survive during the pandemic, and increase capital reserves. OJK also provides additional relaxations for banks under the category (*Bank Umum Kelompok Usaha or BUKU*) 3 and 4 by lowering the limit of Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) to 85% from 100% and allowing those banks not to meet the capital conservation buffer at 2.5% of the risk-weighted assets.

Key features of POJK 58/POJK.05/2020

POJK 58/2020, an amendment to POJK 14/2020, is intended to extend the relaxation until 2022 and specify the subjects eligible for such relaxation, namely microfinance institutions and fintech lending companies. It also provides more flexibility for debt issuance without public offering, generally referred to as MTN, by reducing the minimum time for reporting the issuance plan from 6 to only 2 months and reducing the minimum equity of the issuer from IDR200 to only IDR100 billion. Furthermore, the issuance of debt securities with a value of up to Rp100 billion has been excluded from the need to obtain an investment-grade rating.

Concerted effort to support the industry

We are of the view that the Covid-19 pandemic has raised the banking and multi-finance risk profile, leading to a substantial business downturn in almost all sectors, resulting in lower demand for loans as well as prompting banks to exercise more caution in their loan approvals. We see the concerted effort as essential to accelerate economic recovery by stimulating both demand and supply sides.

Financial industry has become one of the government priorities, as reflected in the stimulus provided, such as Bank Indonesia's relaxation on the reserve requirement (*giro wajib minimum/GWM*) and the macroprudential intermediation ratio (*rasio intermediasi makroprudensial/RIM*). In early 2021, Bank Indonesia also loosened the loan to value (LTV) and financing to value (FTV) on vehicle and mortgage to 100% for a Bank with an NPL of less than 5%. In addition, the government has exempted the sales tax on luxury goods (PPNBM) for selected cars to boost loan demand amid the Covid-19 pandemic.

We also view that the government's National Economic Recovery (PEN) fund will continue to strengthen the national economy, including the financial services industry this year, with a total budget of IDR924.8

trillion in 2021, an increase from the outturn of the 2020 budget of IDR579.8 trillion, including the budget for MSME, corporate, and bank placements of IDR193.7 trillion. With this stimulus, the sluggish loan growth is expected to gradually recover.

Another type of government support is also evident through the Finance Ministry Regulation (*Peraturan Menteri Keuangan/PMK*) No.71/PMK.08/2020 designated credit guarantee companies under the state-owned insurance cluster (Jamkrindo and Askrindo) to provide guarantees for working capital loans provided by banks to MSMEs. For the non-MSME segment, Indonesia Eximbank (*Lembaga Pembiayaan Ekspor Indonesia/LPEI*) through PMK No. 98/PMK.08/2020 is assigned to provide guarantees for working capital loans, while PT Penjaminan Infrastruktur Indonesia (Persero) (PII) is tasked to conduct loss limit. In implementing the guarantee, the government also maintains the capacity of the assigned SOE through capital participation (PMN) or another risk-sharing mechanism as governed by laws and regulations. This policy is expected to increase the banks' appetite in disbursing loans.

Moreover, the government through PT Sarana Multi Infrastruktur (Persero) (SMI) has extended municipal credit facility (PEN DA) and SOE government investment (IP PEN) with a total fund of IDR20 trillion to assist the Regional Government and also SOEs affected by the pandemic to keep executing their public services.

Impact to the industry

The extended relaxation may prevent a spike in non-performing loans while maintaining acceptable risk management practices. In 2021 the loan restructuring may still be needed, but we expect it to be lower than in 2020 as reflected in the decline in the restructured figures. Still, there is a likelihood that a portion of the restructured loans may deteriorate further to non-performing loans. Accordingly, appropriate risk management is needed to closely monitor the actual condition of those loan accounts. In addition, we also see that the relaxation extended to Bank *BUKU* 3 and *BUKU* 4 provides more room for banks' liquidity and capitalization.

As of 1Q2021, the banking industry's NPL ratio stood at 3.2%, a rise from 2.8% as of 1Q2020, less significant in comparison to the financing industry, with the non-performing financing (NPF) ratio of 3.7% as of 1Q2021 from 2.8% as of 1Q2020, despite a decline from its peak at 5.6% as of July 2020. We consider the manageable pandemic impact on the industry was buttressed by the debtor restructuring process. Overall, total credit restructuring (bank and non-bank) for debtors affected by the pandemic amounted to more than IDR1,000 trillion. If the restructuring largely fails due to the Covid-19, it may undermine the financial system stability and forestall economic recovery.

Through this extension, banks and financing companies may restructure loans to debtors affected by the Covid-19 up to 2022, allowing room for borrowers to manage their cash flows and to organize their business to enable them to fulfill their obligations to their lenders. The extension is an anticipatory step in case the pandemic persists. The relaxation of the restructuring will help debtors affected by the pandemic whose business remain viable, although the improvements take some time. This is also in line with the government's program to deal with Covid-19 on a multi-year basis which is expected to continue to affect the economy after 2021.

POJK 58/2020 has allowed some relaxations in the process regarding debt issuance for financing companies to speed up the process of issuing debt securities, offering the flexibility to obtain additional funding sources, an important feature for independent multi-finance companies, the ones without an affiliation with Brand Holder Sole Agents (ATPM) and banks, which in our view, are significantly affected by the bank selective disbursement amid the pandemic. This is reflected in the bank's declining outstanding loan to the financial sector by 20.5% YoY as of 1Q2021. However, impact of such relaxation is considered limited. Despite a hike in the financing industry's debt issuance by 91.9% YoY to IDR17.7 trillion in 1H2021 from IDR9.2 trillion in 1H2020, the MTN issuance for the financing industry was only recorded at IDR130 billion in the first half of 2021 compared to IDR148.6 billion in the first half of 2020. We view the MTN issuers have not fully taken this opportunity due to the limited demand.

We expect the financial system to remain resilient, as reflected in the stable key figures in the industry. In the banking industry, capitalization has remained strong as reflected in its capital adequacy ratio (CAR) of 24.0% in 1Q2021, and the liquidity has remained sufficient with the loan to deposit (LDR) of 80.9% due to the low loan demand. The profitability starts to improve as reflected in the net interest margin (NIM) of 4.6% in 1Q2021, a slight increase from 4.3% in 1Q2020. However, the loan disbursement contracted 4.3% in 1Q2021 YoY, due to the selective disbursement on the sectors affected by the pandemic and the arrears in the loan repayment. Some sectors less affected by the Covid-19 pandemic, such as agriculture, fishery, food and beverage, and telecommunication still recorded positive growth amid the pandemic.

As was the case in the banking industry, the financing industry recorded a contraction of 21.1% YoY as of 1Q2021. In terms of leverage, the gearing ratio of financing companies was categorized as low at 2x, well below the threshold of 10x. The profitability will likely remain under pressure as reflected in its low ROAA at 1.7% in 1Q2021 compared to 4.6% in 1Q2020.

Future challenges

The challenge for the financial intermediaries is to ensure solving non-performing loans upon expiration of the relaxation in 2022. Prudent loan restructuring is key to the success in maintaining asset quality when the relaxation is lifted, along with the recovery of the business. We see the role of the government is very important since the debtors' improvement in their repayment capacity hinges on the acceleration of the national economic recovery, which has become more complicated due to the resurgence of the Covid-19 reaching daily record highs in Indonesia arising from the emergence of the new delta variant, which is more transmissible. Accordingly, a more stringent restrictions referred as level 3 and 4 restrictions towards community activities (*PPKM*) has been applied.

We view that continuation of the relaxation will still be necessary while the economic recovery gathering momentum. Another challenge is to maintain a strong relationship with banks, given their very selective approach. For banks, determining the actual credit quality of multi-finance companies with significantly restructured loan portfolio presents great difficulty, as the relaxation makes it harder for external parties to identify the actual condition of the quality of the credit. Comparing companies in the same industry will be even more complicated due to the implementation of various restructuring schemes and policies.