Banks are sacrificing profitability to secure liquidity

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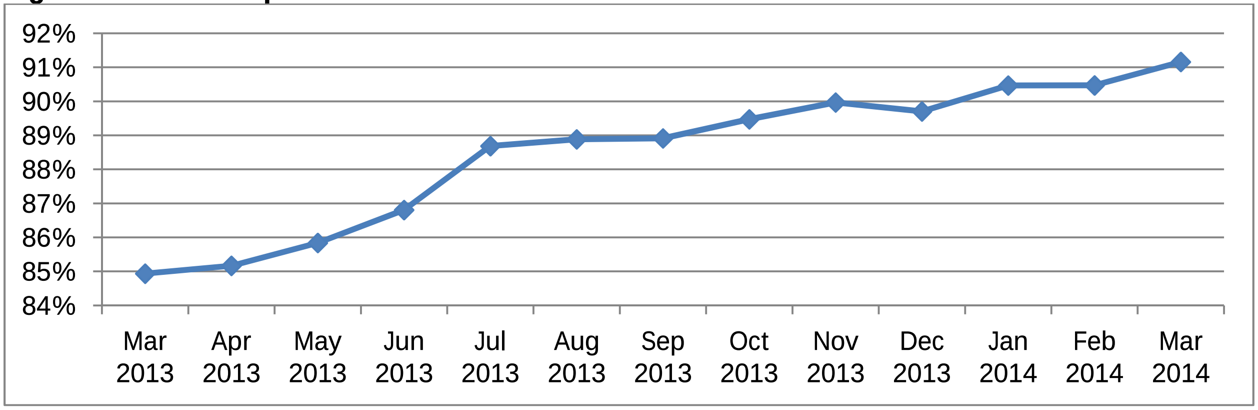
The Indonesian banking industry survived the economic vulnerabilities of 2013, but banks are bracing themselves for new challenges to business growth in 2014 as the economic environment remains tight. The nation's economy grew by 5.2% in the first quarter of 2014 (1Q2014), compared to 5.7% in 1Q2013. This slower pace of growth was due to adjustments in monetary policy, the USD strengthening against all currencies, and elevated levels of inflation and interest rates during 2013.

To date, PEFINDO has assigned ratings to 33 banks in Indonesia, with the highest rating assigned at $_{id}$AAA and the lowest at $_{id}$BBB, with a stable outlook, and one bank with a positive outlook and one with a negative outlook. We revised the outlook on Bank Saudara to positive from stable in March 2014 due to the possible merger with PT Bank Woori Indonesia, which may result in a stronger business position in the industry. As for Bank Sumut, the revised outlook to negative from stable was triggered by its weakening asset quality in almost all loan segments. We expect these banks to maintain their ratings. However, if deterioration in financial performance continues due to a prolonged economic downturn, this could lead to a downgrade, particularly for smaller banks that are more susceptible to economic changes.

Bank Indonesia (BI) has so far increased its benchmark interest rate (BI rate) to 7.5% in an attempt to narrow the gap in Indonesia's current account deficit, and to control inflation. As exchange rates still fluctuate due to the political uncertainty caused by the presidential elections in July 2014, and the US Federal Reserve's tapering, PEFINDO estimates that economic growth in 2014 will be 5.5%-5.7%. We expect demand for loans to soften as commodity prices are affected by global economic conditions, and consumer spending is threatened by inflation. Against this background, banks are striving amid liquidity risks to meet their funding needs.

As of 1Q2014, the industry recorded IDR3,618.1 trillion in total deposits and IDR3,306.9 trillion in total loans, growth of 11.6% and 19.5%, respectively, lower compared to 1Q2013 at 14.8% and 22.2%, respectively. With greater loan growth and fewer funds coming into the banking system, the loan-to-deposit ratio (LDR) increased month by month during 2013 and reached 91.2% as of 1Q2014, almost reaching the maximum level required by the central bank of 92%. Bank Central Asia had the strongest liquidity profile among the rated banks in our portfolio with its LDR at 78.3% as of 1Q2014, in line with BI's targeted minimum level of 78%. The low LDR was supported by its strong brand image, extensive network, and large customer base to penetrate funding. Bank Sumitomo Mitsui Indonesia, which recorded the highest LDR of 204.1% as of 1Q2014, is a joint venture bank that relies more on long-term funding from its parent than retail customer deposits, given its small customer base. We expect the LDR level to ease as loan growth is likely to slow down at 15%-17% in 2014. However, this should also be followed by strong and steady deposit base expansion.

Figure 1.Loan to deposit ratio



Source: Bank Indonesia publication

How do banks manage the liquidity situation?

The current liquidity and funding situations in Indonesia pose challenges for banks to develop future funding. They are spurred to increase their deposit rates, which leads to unhealthy competition as depositors will look around for higher interest rates to protect their savings against inflation. Banks are exposed to deposit withdrawals that may force them to find necessary funding replacements, particularly for smaller banks with less stable deposit bases and weak funding channels. Such exposure will adversely affect banks' asset-liability management and magnify the liquidity risk.

To minimize liquidity issues, banks need to improve their deposit structure. PEFINDO believes that the development of a retail funding base is crucial to support the sustainability of long-term business growth. The enhanced competition for deposits will drive changes to deposit structures. However, it depends on how effective banks are in capturing customers not solely based on pricing. This includes improving brand awareness, providing comprehensive services, and enhancing the quality of distribution channels. PEFINDO believes that strong customer engagement could partly improve funding stability.

Moderate exposure on asset quality

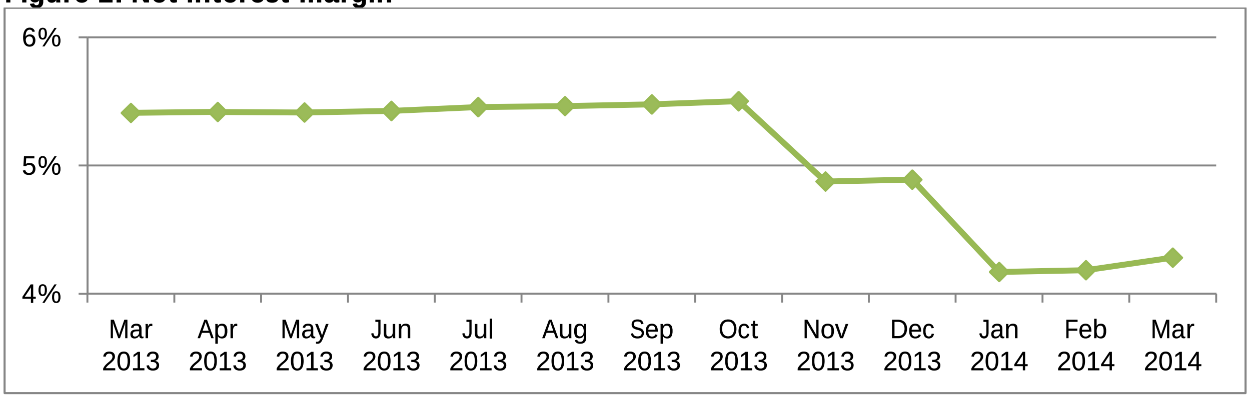
As banks increase their deposit rates, they do not instantly increase their lending rate, which should weigh on their asset quality profiles. Rupiah depreciation has put pressure on Indonesian companies that have an asset-liability currency mismatch. A higher lending rate further weakens the debtors' repayment capability, as reflected by a non-performing loan (NPL) ratio of 2% as of 1Q2014 from 1.8% as of December 31, 2013 (FY2013). Special mention loans (loans up to 90 days past due) or potentially weak loans increased to IDR158.1 trillion as of 1Q2014 from IDR128.8 trillion as of FY2013. Bank ICB Bumiputera had the highest NPL and special mention loans compared to the rated banks in our portfolio of 5.2% and 5.7%, respectively, as of 1Q2014. Bank Sumitomo Indonesia, due to its consistency in improving its credit risk assessment, reported the lowest NPL of 0.3% as of 1Q2014. The lowest special mention loans were held by Bank Sulut at 0.3% as of 1Q2014, as its function as the payment bank for the salaries of regional civil servants allowed it to deduct debt installments from salaries. However, we expect pressure on asset quality to be moderate as we do not expect a significant increase in bad debts as banks are being more selective in loan disbursement.

Ongoing profitability pressure

Banking financial reports showed that time deposits increased to IDR1,653 trillion as of 1Q2014 from IDR1,604.5 trillion as of FY2013, accounting for 45.7% of the banks' total deposits as of 1Q2014, up from 43.8% as of FY2013. A lower share of low-cost deposits (current account and saving account, CASA) saw the banks' interest expenses rise faster at 25%, compared to interest income growth at 16%.

The net-interest margin (NIM) contracted to 4.3% in 1Q2014 from 4.9% in FY2013, attributed to the narrowing spread between deposit and lending rates. Of all the rated banks within PEFINDO's portfolio, Bank Victoria reported the lowest NIM of 2% in 1Q2014, due to its focus on loans to the commercial and corporate segments. Bank Sulselbar generated the highest NIM of 10.7% in the same period through its lucrative captive market in distributing loans to civil servants. Due to economic and political uncertainties, we project that BI will raise its benchmark interest rate in the near term. Therefore, we expect the NIM will continue to fall as higher interest rates will stiffen competition to capture funding and high quality debtors.

Figure 2. Net interest margin



Source: Bank Indonesia publication

In an attempt to deal with thinning margins and anticipate a further profitability downturn, banks are emphasizing cross-selling and focusing on increasing their fee-based income. Fee-based income — such as treasury transactions, bancassurance, and remittances — could partly mitigate further declining profitability. We believe that in the long run, banks will pay more attention to their fee-based income to diversify their revenue streams. PEFINDO believes that these strategies will bode well in the medium to long term, although significant results will take some time. As such, we expect the banks' bottom line profitability figures, as measured by return on average assets (ROAA), to slightly fall in the medium term.

Figure 3.Published ratings of banks

Bank	Rating	Outlook	Total assets	NPL	NIM	ROAA	LDR
Bank Mandiri	$_{id}$AAA	Stable	729,483.0	2.0%	5.4%	2.9%	87.3%
Bank Rakyat Indonesia	$_{id}$AAA	Stable	615,718.6	1.8%	8.2%	3.8%	92.3%
Bank Central Asia	NR	NR	502,187.8	0.5%	6.5%	2.9%	78.3%
Bank Negara Indonesia	$_{id}$AAA	Stable	371,461.1	2.3%	5.7%	2.5%	90.2%
Bank CIMB Niaga	$_{id}$AAA	Stable	218,355.2	2.7%	4.9%	2.0%	95.3%
Bank International Indonesia	$_{id}$AAA	Stable	140,076.5	2.0%	4.4%	0.5%	91.1%
Bank OCBC NISP	$_{id}$AAA	Stable	94,852.0	0.8%	3.9%	1.4%	100.8%
Lembaga Pembiayaan Ekspor Indonesia	$_{id}$AAA	Stable	48,025.6	3.1%	4.1%	2.4%	N/A
Bank Sumitomo Mitsui Indonesia	$_{id}$AAA	Stable	43,714.7	0.3%	2.2%	1.5%	204.1%
Bank Danamon	$_{id}$AA+	Stable	185,919.6	2.0%	7.9%	1.9%	95.6%
Bank Permata	$_{id}$AA+	Stable	167,325.0	1.0%	3.1%	0.9%	94.3%
Bank Syariah Mandiri	$_{id}$AA+	Stable	63,009.4	4.9%	5.5%	1.3%	91.2%
Bank Negara Indonesia Syariah	$_{id}$AA+	Stable	15,611.5	2.0%	7.7%	0.9%	96.7%
Bank Panin	$_{id}$AA	Stable	162,690.9	2.1%	3.6%	1.8%	89.1%
Bank Tabungan Negara	$_{id}$AA	Stable	136,964.2	4.7%	4.3%	1.0%	100.8%
Bank Jabar Banten	$_{id}$AA-	Stable	78,899.3	3.8%	6.2%	1.7%	79.9%
Bank Muamalat	$_{id}$AA-	Stable	54,791.0	2.1%	4.3%	1.1%	105.5%
Bank DKI	$_{id}$AA-	Stable	29,605.6	2.7%	6.4%	3.5%	90.6%
Bank Resona Perdania	$_{id}$AA-	Stable	13,082.7	1.3%	4.0%	2.1%	154.4%
Bank Bukopin	$_{id}$A+	Stable	72,315.6	2.7%	3.7%	1.4%	82.5%
Bank Jatim	$_{id}$A+	Stable	35,464.2	3.6%	9.4%	3.7%	80.4%
Bank Jateng	$_{id}$A+	Stable	33,858.4	0.7%	7.3%	2.8%	78.5%
Bank Sumut	$_{id}$A+	Negative	22,837.2	4.8%	8.5%	2.8%	91.2%
Bank Papua	$_{id}$A	Stable	17,307.0	1.4%	8.7%	2.5%	84.8%
Bank Nagari	$_{id}$A	Stable	17,061.9	2.5%	6.5%	1.6%	92.8%
Bank Sulselbar	$_{id}$A	Stable	10,761.4	1.1%	10.7%	3.9%	83.3%
Bank Mayapada	$_{id}$A-	Stable	25,369.2	2.4%	4.2%	1.7%	86.9%
Bank Victoria	$_{id}$A-	Stable	19,458.8	1.3%	2.0%	0.9%	75.9%
Bank Sulut	$_{id}$A-	Stable	8,644.9	0.5%	8.8%	2.8%	82.6%
Bank NTT	$_{id}$A-	Stable	8,454.3	1.3%	10.0%	3.9%	78.5%
Bank Saudara	$_{id}$A-	Positive	8,239.1	3.0%	5.3%	0.3%	91.0%
Bank Lampung	$_{id}$A-	Stable	5,022.7	0.8%	6.6%	2.5%	77.7%
Bank Capital	$_{id}$BBB+	Stable	7,410.7	0.4%	2.6%	1.0%	62.8%
Bank ICB Bumiputera	$_{id}$BBB	Stable	7,965.1	5.2%	3.2%	-0.7%	83.3%

All financial information as of 31 March 2014.
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. NR: not rated. N/A: not applicable.