Tightening liquidity expected in near to medium term

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PEFINDO projects a potential tightening in bank liquidity profiles in the near to medium term, triggered by the slower pace of growth of third-party funds compared to loans. This will result in an increase in loan to deposit ratio (LDR) to 92%-95%, from historical figures of 90%–92%. The fluctuation of the rupiah places more pressure on bank liquidity as it reduces the interest of investors in rupiah denominated products, and capital outflow from stocks and bonds also adds liquidity pressure.

To anticipate this, regulators Bank Indonesia (BI) and the Financial Services Authority (OJK) issued regulations to maintain bank liquidity at a safe level. BI, as the central bank, raised its policy rate (BI seven-day reverse repo rate) six times from May 2018 through November 2018 in order to maintain deposit stability in the banking industry affected by the volatility in global macroeconomic conditions. BI also issued a new regulation relaxing the average primary reserve requirement for commercial and sharia banks (GWM-P averaging) – a move expected to improve bank liquidity by up to IDR20 trillion.

New regulation related to bank liquidity

The OJK, as the supervisor of banks in Indonesia, released a new regulation related to liquidity in compliance with the Basel III accord – POJK No. 50/POJK.03/2017 on the obligation of commercial banks to fulfill the net stable funding ratio (NSFR). The regulation, which came into effect this year, requires commercial banks to maintain a minimum NSFR – the ratio of available stable funding to stable funding needed – of 100%. It applies to banks categorized under the commercial bank groups (BUKU) III and IV, as well as foreign banks. It complements other recent OJK regulations related to liquidity, such as POJK No. 42/POJK.03/2015 on the obligation for commercial banks to meet the liquidity coverage ratio (LCR).

The use of NSFR is to ensure banks maintain sufficient stable funds adjusted to the composition of their assets and administrative accounts. Banks are expected to reduce their liquidity risks, particularly the needs of medium to long-term funding sources. Thus, banks need to improve the stability of funding by limiting excessive dependence on short-term funding from corporation or institutional depositors. The use of LCR is to ensure banks have sufficient provisions of unencumbered high quality liquid assets (HQLA), comprised of cash or assets that can be easily or immediately converted into cash, with no or little reduction, to meet bank liquidity needs in the period of 30 days under the stress scenario.

BI also issued PBI No.20/4/PBI/2018 on the macro prudential intermediary ratio (RIM) and macro prudential liquidity buffer (PLM) for conventional banks, sharia banks, and sharia business units. In RIM, bank investment in corporate bonds issued by non-bank institutions can be calculated as a component of the liquidity ratio. Under the PLM regulation, banks are allowed to use their marketable securities calculated as secondary reserves as an underlying asset in reverse repo transactions with BI. The application of PLM provides additional options for banks in accessing funding sources to manage liquidity.

We are of view that these regulations are an enhancement approach in analyzing liquidity risks for banks, particularly in the context of the political year ahead. This year, Indonesia held regional head elections simultaneously for the first time, and this will be followed by the presidential and legislative elections in 2019. Under these conditions, we expect the impact on bank liquidity will be minimal. Companies are expected to hold back on making investments and other strategic decisions until after the elections, which may reduce lending activities, resulting in excess liquidity.

National banks' liquidity profile

Bank liquidity has tightened this year, as can be seen from the loan to deposit ratio (LDR) increasing on a monthly basis from 89.1% as of January 2018 to 94.1% as of September 2018. This rising liquidity risk mainly resulted from higher loan growth of 12.7% in September 2018 compared to deposit growth of 6.6% in the same period. The banks' liquid assets ratio (LAR) also declined from 18.2% as of January 2018 to 15.3% as of September 2018. In terms of BUKU bank profiles, BUKU III banks were most affected, as

reflected by an LDR of 103.2% as of September 2018, increasing dramatically from 94.5% as of January 2018. We are of the view this mainly resulted from higher loan growth compared to deposit growth. This was also related to higher forex loans of 15.1% as of September 2018 compared to deposit growth of 4.6% in the same period.

Given BUKU III banks can transact on a forex basis, rupiah volatility has heavily impacted their liquidity profile. Despite LDR also increasing in recent years, we are of the view that BUKU I bank liquidity is still manageable, partially because it is not exposed to rupiah volatility, as all transactions are done in rupiah. As of September 2018, BUKU I bank LDR was 83.9%, down from 86.1% as of January 2018, but still below the maximum regulatory threshold of 92%.

Table 1. Indonesian banking liquidity ratios

Liquidity ratios	Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18	Jul-18	Aug-18	Sep-18
[%] LDR	89.1	89.2	90.2	90.4	92.0	92.8	93.1	93.8	94.1
[%] LDR BUKU I	83.3	80.0	80.1	77.3	79.6	79.8	81.7	84.2	83.9
[%] LDR BUKU II	88.0	87.7	86.8	86.2	87.3	89.3	90.3	91.8	90.9
[%] LDR BUKU III	94.5	94.7	94.7	95.4	98.9	99.8	101.1	102.4	103.2
[%] LDR BUKU IV	86.1	86.2	88.2	88.5	88.9	89.4	89.1	89.2	89.4
[%] LAR	18.2	18.1	17.9	17.4	17.2	16.7	15.6	15.4	15.3
[%] LAR BUKU I	19.5	20.7	21.0	21.7	20.4	21.1	20.7	19.1	16.6
[%] LAR BUKU II	20.6	20.6	21.4	21.3	20.1	20.8	18.7	18.5	19.2
[%] LAR BUKU III	18.2	18.1	18.3	18.2	18.0	17.9	16.4	15.5	15.6
[%] LAR BUKU IV	17.6	17.5	16.8	15.8	15.9	14.9	14.3	14.6	14.3

Source: OJK, Indonesia banking statistics, processed by PEFINDO.

External factors affecting banking liquidity

In our view, banking liquidity may be affected by dynamics in the global economy, resulting in the volatility of the rupiah exchange rate and pressure on interest rates. We expect the trade war between the US and China to continue in the near term, so we are of the view that the potential for the rupiah to weaken or depreciate is still wide open. We are also of the view that rupiah volatility may reduce investor interest in placing funds in rupiah denominated instruments. The lower investor interest can be seen from the higher net sale of stocks and bonds investment from foreign investors in February to June 2018. We predict more investors will withdraw their investment in Indonesia for more stable currency instruments.

The second challenge comes from a potential increase in the US Federal Fund Rate (FFR), which could drive foreign investors to withdraw their investments in Indonesia and place them in US dollar investments. In 2018, the FFR increased three times, with the latest increment on September 27, 2018 at 25 Bps to 2.00%-2.75% from 1.75%-2.00% since June 2018. We project the Federal Reserve will increase again its rate by around 25 Bps by the end of 2018 in order to protect US economic growth. Indonesia is also exposed to commodity price volatility, with the contribution of the mining sector to non-tax state revenue still quite significant at around 50% as of FY2017. Although the coal price continues to rise, we are of the view that any sudden drop in commodity prices could trigger an economic slowdown, resulting in lower inflow of foreign investment in Indonesia. This can be seen from the table below. When the coal price hit its lowest level of $57.51/mt in 2015, foreign direct investment also declined to USD16.6 billion in FY2015, down from USD21.8 billion in FY2014, when the coal price was $70.13/mt.

Indonesia's ease of doing business still needs to be improved, with unnecessary bureaucracy procedures removed, to attract more foreign investors to expand their business in the country. In 2018, Indonesia improved its ranking in the World Bank Ease of Doing Business (EODB) index to number 72, up 19 places from its previous rank of 91. However, it is still far from the government's target of rank 40 in 2019, and from neighbors like Malaysia (24), Thailand (26), and Singapore (2).

Table 2. Net buy (sell) by foreign investors in stock and bond market

	Net buy (sell) by foreign (IDR trillion)		
Date	Bond	Stock	Total
Jan-17	(0.87)	19.70	18.83
Feb-17	(1.19)	6.38	5.19
Mar-17	10.52	31.33	41.85
Apr-17	15.55	22.60	38.15
May-17	0.56	10.33	10.89
Jun-17	(16.93)	14.40	(2.53)
Jul-17	(10.64)	4.99	(5.65)
Aug-17	(6.37)	9.60	3.23
Sep-17	(11.50)	34.23	22.73
Oct-17	(6.20)	(23.17)	(29.37)
Nov-17	(18.62)	34.61	15.99
Dec-17	(7.12)	5.34	(1.78)
Jan-18	2.11	33.62	35.73
Feb-18	(10.59)	(21.55)	(32.14)
Mar-18	(14.91)	10.57	(4.34)
Apr-18	(10.39)	(13.45)	(23.84)
May-18	(6.83)	(11.53)	(18.36)
Jun-18	(26.72)	(3.64)	(30.36)
Jul-18	0.79	9.09	9.88
Aug-18	(2.46)	16.53	14.07
Sep-18	(1.12)	(4.94)	(6.06)

Source: Bloomberg, processed by PEFINDO

Table 3. Comparison of coal price, Fed rate, and FDI

	Unit	9M18	2017	2016	2015	2014	2013	2012
Coal price*	$/mt	114.20	88.42	65.86	57.51	70.13	84.56	96.36
Fed rate	%	2.3	1.5	0.75	0.5	0.25	0.25	0.25
FDI	USD million	15,792	22,028	3,921	16,642	21,810	18,817	19,138

Sources: World Bank, Bloomberg, processed by PEFINDO
FDI: Foreign Direct Investment (Aliran Investasi Langsung)
* Newcastle's coal price

Liquidity profile of banks in PEFINDO's portfolio

PEFINDO's published portfolio contained 38 rated banks as of October 2018, comprising 24 commercial banks, nine regional development banks, and five sharia banks. Overall, we are of the view that their liquidity profile has slightly tightened, reflected by an increment in LDR to 93.3% as of 9M2018 compared to 92.3% in FY2017. In terms of bank segmentation, commercial banks showed a drastic LDR rise from 93.7% as of FY2017 to 100.4% as of 9M2018. We are of the view that this is due to tight competition and high exposure to rupiah volatility. Sharia banks show more stable ratios with LDR of 81.7% as of 9M2018, slightly up from 80.4% as of FY2017, mainly driven by the large portion of Hajj funds in sharia bank deposit portfolios. We are of the view that with this kind of advantage, sharia bank deposits will remain stable in tight liquidity conditions. Regional development bank's (BPD) LDR was strong at 80.8% as of 9M2018, compared to 93.8% as of FY2017. The low ratio in September 2018 was more due to cyclicality, and we are of the view that this should be temporary. However, we expect BPD to be more stable in liquidity as they are backed by high Pemda in their deposit portfolio. We expect banks with large infrastructure,

advanced technology, and a wide variety of products to have a better liquidity profile. These types of banks are expected to have a good capacity to raise funds, particularly low-cost.

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