# Foreclosed assets and their impact on bank performance

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PEFINDO is of the view that the amount of foreclosed assets (AYDA) in the Indonesian banking industry is manageable, despite a gradually increasing portion compared to overall banking assets. At present, AYDA represents less than 1% of the total banking industry's assets. The assessment of a bank's AYDA profile is important for a comprehensive understanding of its asset quality performance, in addition to the conventional assessment method. By managing its AYDA properly, a bank should be able to optimize its asset productivity to serve its financial obligations, and avoid any potential pressure on its profitability and capitalization profiles due to high provision expenses or high capital burden from its AYDA.

Foreclosed assets are non-productive assets obtained by the bank, based on voluntary delivery or authority by the lender as the previous asset owner or on selling of the assets, in the event the debtor cannot meet their obligation to the bank. In giving loans, in some cases banks will require collateral, which is the borrower's pledge of specific assets to the lender to secure repayment of a loan. The collateral serves as a lender's protection against borrower default, and so can be used to settle the loan if the borrower fails to pay the principal and interest satisfactorily under the loan agreement. If the loan is already classified under collectability 5 (loss), the bank will negotiate with the debtor to voluntarily deliver the collateral, which will then be sold either through auction or outside an auction, or the bank can use its authority as stated in the loan agreement to execute the collateral. Accordingly, the loan will be converted into non-productive assets as AYDA. The proceeds of the asset sale will be used to repay the remaining debt to the bank, including fines or arrears and extra costs related to the collateral sale.

**Regulations on AYDA**

Indonesian authorities have focused on how banks should manage foreclosed assets by establishing regulations regarding asset quality assessment, including AYDA for commercial and sharia banks. On October 24, 2012, Bank Indonesia Regulation (PBI) No. 14/15/PBI/2012 was issued regarding assessments of commercial bank asset quality. This was followed by a circular letter from the Financial Services Authority (OJK), SEOJK No. 42/SEOJK.03/2016, on guidelines on risk weighted assets for credit risk using a standard approach for commercial banks. On November 18, 2014, the OJK also launched regulation (POJK) No. 16/POJK.03/2014 regarding the assessment of sharia banks and sharia business units, followed by SEOJK No. 34/SEOJK.03/2015 on guidelines on risk weighted assets for credit risk using a standard approach for sharia banks and sharia business units. The regulations require commercial and sharia banks to define the net realizable value of their AYDA, which is the fair value of the AYDA less the estimated costs of selling the AYDA. The difference between the realized net value and the proceeds from the sale is recognized as profit or loss in the year when it is sold. Banks must use an independent appraiser for AYDA with a net realizable value above IDR5 billion.

There are different methods for commercial banks and sharia banks in assessing AYDA. For commercial banks, AYDA classification or collectability is divided into four categories based on period of ownership: current (up to one year), substandard (one to three years), doubtful (three to five years), and loss (more than five years). Sharia banks only acknowledge two categories: current (up to one year) and loss (more than one year). AYDA in conventional banks has 150% risk weighted assets, stricter than AYDA in sharia banks at 100%. In our view, this differentiation is intended for sharia banks to be more prudent in managing their financing portfolios, as if the bank is forced to convert the non-performing financing into AYDA, it will be penalized by higher risk weighted assets affecting its capitalization profile.

**AYDA profile in PEFINDO's banking portfolio**

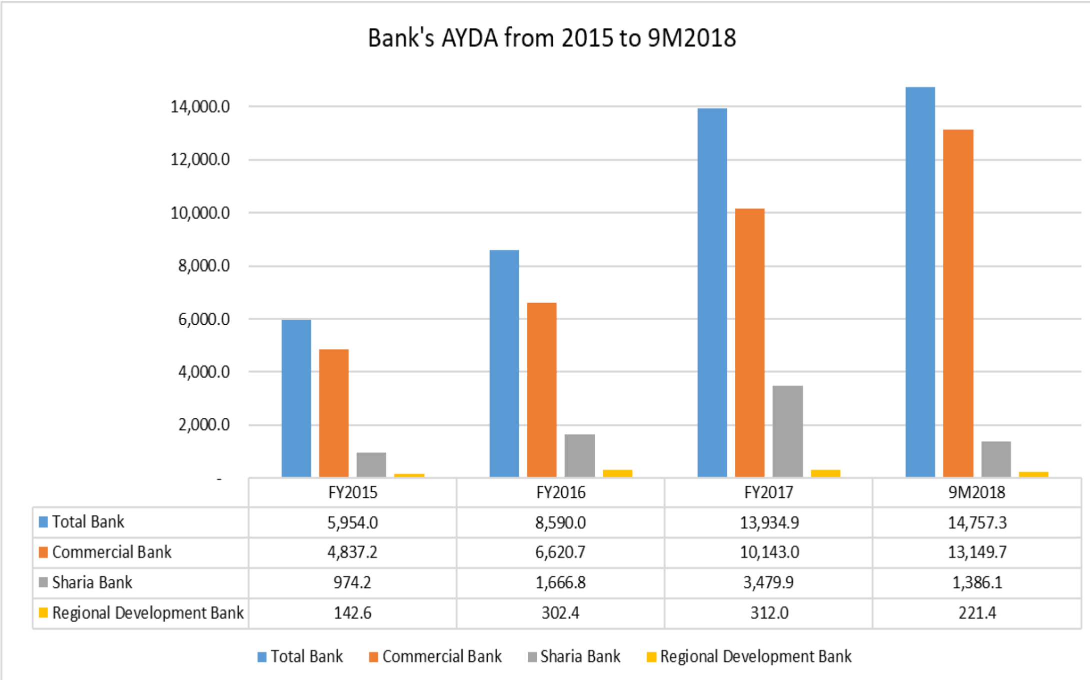
AYDA in Indonesian banks has increased substantially, mostly as a result of the strategy to improve asset quality indicators. In the past five years (2013–2017), the amount of AYDA in PEFINDO's portfolio jumped with a compounded annual growth rate of 75.1% to IDR13.9 trillion as of FY2017 from IDR1.5 trillion as of FY2013. As of September 2018 (9M2018), it increased further to IDR14.8 trillion. PEFINDO's portfolio should represent the overall banking industry as it comprises 24 commercial banks, five sharia banks, and 10 regional development banks (BPD), with total assets of IDR6,481.1 trillion as of 9M2018, or 83.4% of total banking industry assets of IDR7,768.9 trillion in the same period.

AYDA in 24 commercial banks observed by PEFINDO increased by 71.4% CAGR in the past four years (2013-2017) to IDR10.1 trillion as of FY2017 from IDR1.2 trillion as of FY2013, while as of 9M2018 it was IDR13.1 trillion. Amid increasing AYDA figures, the NPL ratio continued to weaken to 3.0% as of 9M2018 from 2.8% as of FY2017. This may reflect room for improvement for commercial banks in their loan origination process and in determining collateral value and liquidity to secure loan facilities. Nevertheless, the AYDA is considered to be manageable as it represents less than 1% of the total loan portfolio.

Contrary to commercial banks, AYDA in five sharia banks in PEFINDO's portfolio decreased substantially to IDR1.4 trillion as of 9M2018 from IDR3.5 trillion as of FY2017. This was mainly due to a significant asset sales transaction by one sharia bank in our portfolio, which sold its assets, including its loans and AYDA. During this period, the NPF of those banks also improved to 4.0% from 6.2%. However, we note the AYDA portion in sharia banks was much higher at 3.9% of the banks' total financing as of 9M2018. AYDA in 10 BPDs also decreased to IDR221.4 billion from IDR312.0 billion as of FY2017, although much higher than FY2013 at only IDR5.5 billion. In the past few years, BPDs have been forced to increase their productive loan segment in line with their purpose of establishment to support regional development and economic activities. However, this was not followed by adequate infrastructure and risk management capabilities, resulting in increasing NPL in the productive loan segment, particularly in the investment loans segment which increased to 7.3% as of 9M2018 and FY2017, respectively, from 5.7% as of FY2013.

PEFINDO is of the view that banks should have clear strategies and specific action plans in managing their AYDA, rather than piling them up to improve their non-performing loans ratio. Banks must optimize their assets to be productive in order to serve their obligations to depositors or lenders, while AYDA is a non-productive asset so does not produce yields, and the amount can be lower due to depreciation. Good AYDA management will optimize a bank's productive assets and reduce the potential burden from AYDA in the form of high provision expenses, declining value, and higher capital charges, which may adversely affect its capitalization profile.

*Figure 1. Bank AYDA in PEFINDO's portfolio (in billion rupiah)*




| | FY2015 | FY2016 | FY2017 | 9M2018 |
|---|---|---|---|---|
| Total Bank | 5,954.0 | 8,590.0 | 13,934.9 | 14,757.3 |
| Commercial Bank | 4,837.2 | 6,620.7 | 10,143.0 | 13,149.7 |
| Sharia Bank | 974.2 | 1,666.8 | 3,479.9 | 1,386.1 |
| Regional Development Bank | 142.6 | 302.4 | 312.0 | 221.4 |

*Source: Bank published financial statements, processed by PEFINDO*