Banking Industry Performance Amid COVID-19 Pandemic

Analyst: Hanif Pradipta

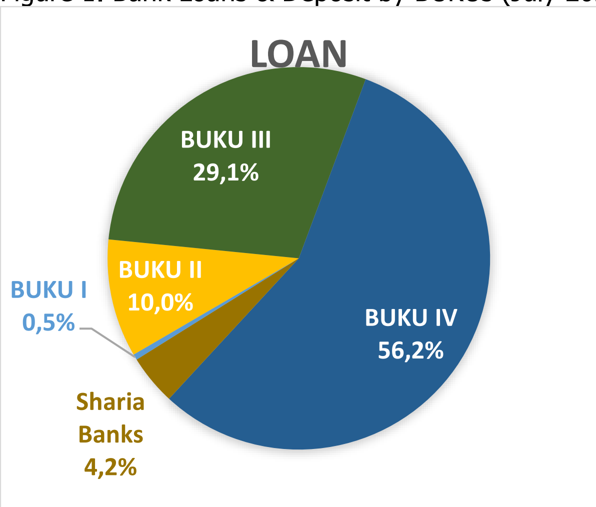
COVID-19 pandemic has had a significant impact on the overall economy and has caused a substantial business slowdown in almost all sectors. This is reflected by the quarterly economic contraction of 5.32% in the second quarter of 2020 (2Q2020). The pandemic has also affected banking loan growth, which only reached 1.5% year-on-year (YoY) as of July 2020, compared to 6.1% at the end of 2019. Nevertheless, we view the impact of the pandemic on the banking industry to be moderate, as it is supported by strong capitalization, stable third-party funds, and adequate liquidity cushions. This supports banks' credit profile stability compared to other sectors. However, we also note that financial performance in the banking sector is weakening, particularly in terms of asset quality and profitability.

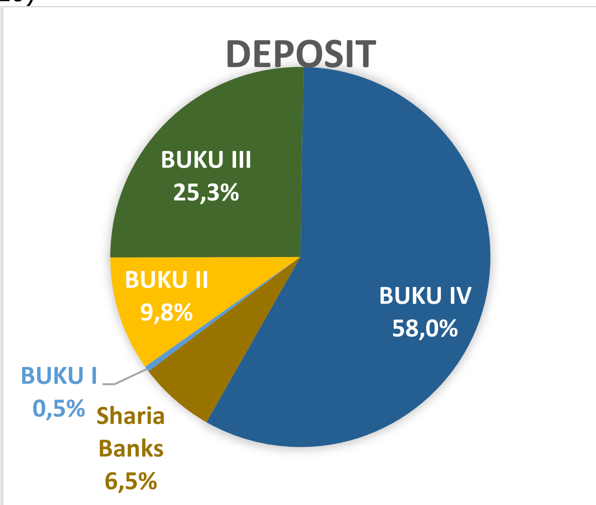
Lessons from Past Crises Helped Prepare Banking Industry

One of the reasons for the moderate COVID-19 impact on the banking industry is that it is more experienced and well-prepared in dealing with crises, particularly in managing liquidity. The industry's active asset-liability management, strong regulatory framework and oversight — including the introduction of relaxation measures — as well as the government's vigorous efforts in maintaining the rupiah's stability, have played key roles in maintaining confidence in the banking sector and the stability of banking deposits, which are the life blood of banking activities. Public trust is critical, as it is directly correlated to the stability of third-party funds and, thus, to the overall banking industry. Apart from liquidity pressures on a few banks, the risk of third-party fund withdrawals was not found to be prevalent. Another important factor is shareholder and parent support. Shareholders or parent companies with strong financial capabilities can support their banking subsidiaries in times of financial difficulties to offer more assurance to the public, despite a higher overall industry risk profile amid the pandemic.

PEFINDO acknowledges that the pandemic has affected most banking segments, although the impact varies from one bank to another. Banks in Indonesia are categorized into four business activities "BUKUs" based on their core capitalization (as regulated in Bank Indonesia Regulation No. 14/26/PBI/2012), with BUKU IV being the highest rank with a minimum core capital of IDR30 trillion. Typically, larger banks in higher BUKUs have advantages in terms of capital, funding, or parent support, which help them become more resilient to the impact of the pandemic, despite some exceptions. We note that though most regional development banks (BPD) are in BUKU II category, the impact of COVID-19 on their credit profile is less significant compared to other banks, as majority of their loan portfolio are supported by their core products of civil servant (PNS) loans. The PNS loan segment and its asset quality profile are the least impacted by the pandemic, due to their salary deduction scheme.

Figure 1. Bank Loans & Deposit by BUKUs (July 2020)

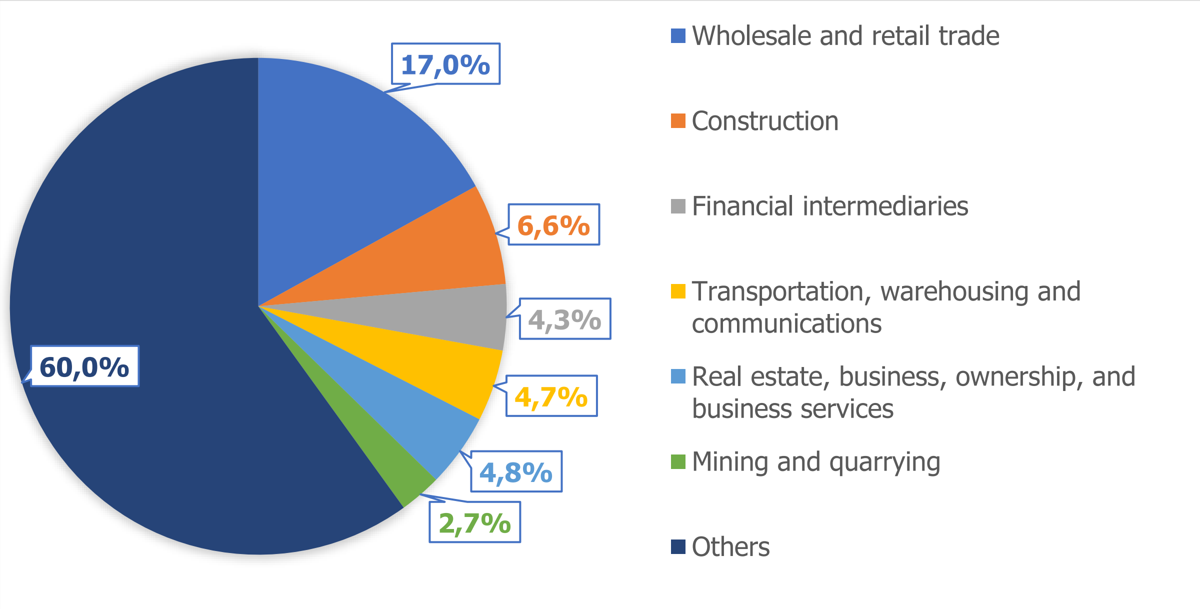




Source: Indonesia Banking Statistic

Going forward, we expect banks to continue to be selective in their lending expansions, due to their substantial exposure to sectors highly affected by the pandemic. PEFINDO has classified a few sectors to be highly affected by COVID-19 — such as trading, household, construction, financing, transportation, airports, tourism, hotels and restaurants, real estate, and mining — which account for around 40% of the banking industry's loan portfolio. Given the wide range of sectors impacted, banks are likely to concentrate their loan growth strategies on select debtors with track records of on-time payments, especially private companies supported by strong shareholders, and SOEs with good fundamental performance. The decline in business activity, although not always reflected in the banks' balance sheets, certainly weakens the ability of debtors to pay their obligations, and has resulted in deteriorating financial ratios, particularly in terms of asset quality and profitability. However, as long as the deterioration of those ratios are contained, and liquidity remains sufficiently available, we are of the view that the impact to banks' ratings should remain moderate.

Figure 2. Bank Loans by Sector (July 2020)



Source: Indonesia Banking Statistic

Financial Performance: Focus on Liquidity, With an Eye on Asset Quality

As stated above, maintaining stable liquidity during the COVID-19 pandemic is crucial not only for the survival of the banking industry, but of other real sectors as well, given the key role of banks in providing financing services. We are of the view that the banking industry's liquidity ratios remain adequate, with liquid assets/third party deposits (LAR) at around 15% - 20%, and majority of liquid assets placed in low-risk and highly liquid instruments such as government bonds or with Bank Indonesia. The average LDR was at 88.1% as of July 2020, having improved from 94.5% in July 2019, as banks made adjustments to their loan sizes while deposits never really left, though there was a flight-to-quality trend as depositors moved their funds around. As such, while the liquidity resilience of each bank may vary, the overall banking industry's liquidity remains solid. In addition, banks also strived to obtain a portion of instalments/interest payments during the restructuring period, to minimize the impact on their cash flows.

In terms of asset quality, the loan restructuring activities due to COVID-19 have been significant at IDR904.3 trillion as of September 2020, or around 15%-16% of total banking industry loans. This indicates the potential bad debt in the future, especially at the end of the COVID-19 restructuring period around the first quarter of 2021. If the debtors fail to recover at the end of restructuring period, or if the restructuring period is extended — which will also increase the industry's risk profile — that will certainly have an impact on the banks' financial performance. PEFINDO will continue to closely monitor the impact of the pandemic on the banking industry's performance and overall credit profile.

Profitability Suffers in the Short Term, While Capitalization Remains Stable

Another significant impact is on profitability, as the instalments paid by debtors are reduced, while banks try to secure liquidity by maintaining their third-party funds. This has pressured banking margins, with the average net interest margin (NIM) declining to 4.4% in July 2020 from 5.0% in December 2019. In addition, provision costs have spiked due to weakening asset quality, as reflected in a BOPO ratio of 85.1% in July 2020 from 79.4% in December 2019. In terms of capitalization, the banking industry's indicators remain strong and stable, with its capital adequacy ratio (CAR) even increasing to 23.0% in July 2020 from 22.8% in January 2020. This ratio has taken into account the impact of implementation of PSAK 71. Even the lower end of the range of CARs was at around 20%, well above the minimum regulatory requirement of 8% - 14% in POJK 11/2016.

Strong Industry Oversight

We view the government's oversight of the banking industry as strong, as seen from some of the stimulus provided, such as a decrease in reserve requirement ratio (GWM) and macroprudential intermediation ratio (RIM) to relieve liquidity pressure. POJK 11/2020 was also issued to ease the COVID-19 burden on debtors' ability to repay their banks loans, while at the same time helping other business sectors. In addition, the government's *Penyelamatan Ekonomi Nasional* (PEN) program is also expected to aid many productive sectors, both MSMEs and corporations, which eventually will benefit the banking industry as well. We are of the view that active policymaking and oversight remain crucial in helping banks manage their overall financial performance and impact on real sectors. However, while restructuring processes help debtors and maintain banking stability in the short term, the cash flow impact of these strategies in the long term may cause an excessive burden on the banking industry. This may affect depositors' and investors' confidence in the banking industry as a whole, which cannot happen as the industry plays a very important role for the national economy.

In response to the impact of COVID-19 on banking system stability, Law No. 2/2020 increased the flexibility of the Indonesian Insurance Deposit Agency (Lembaga Penjamin Simpanan or LPS) to support the industry's liquidity if needed, without placing any additional burdens on the stability of the sector. According to Law No. 2/2020, LPS' role is to prepare for and intensively monitor bank solvency issues together with the Financial Services Authority (OJK), including placing funds in banks prior to their failure. Previously, LPS can only act after a bank has declared bankruptcy, as regulated under Law No. 9/2016 (*Pencegahan dan Penanganan Krisis Sistem Keuangan*). LPS' superior liquidity is also supported by its policy to strictly invest in government bonds, which as of June 2020 stood at IDR122.4 trillion. With the gradual recovery of the economy and assuming the availability of vaccines which equally distributed by the end of 2021, the performance of the banking industry also will gradually improve along with lending growth. Thus, bank failure risk, especially for systemic banks which must be rescued by LPS, should reduce.