14 May 2014 | Indonesian Banking Sector Update

# INDONESIAN BANKS – Beset by high cost of funds and provisions

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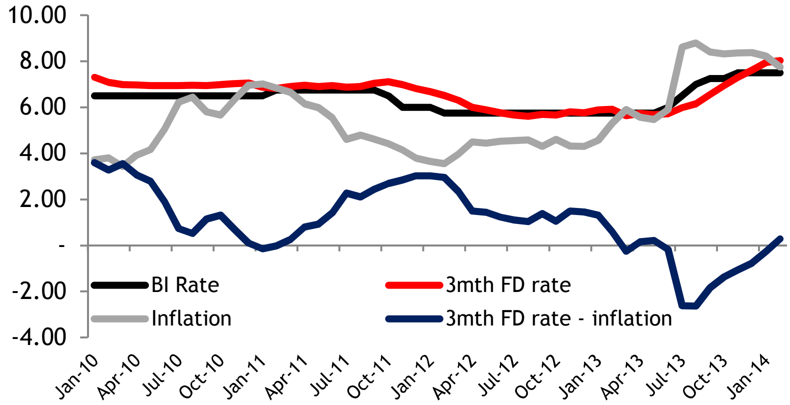
- **Pressure on deposit rates.** Since June 2013, BI rate has risen by 175bp from 5.75% to 7.50%. Correspondingly, deposit rates Indonesia have been repriced upwards. The 3 month FD rate in Indonesia has risen from 5.68% in May 2013 to a high of 8.03% in February 2014. The last 25bp rate hike in BI rate to 7.50% was in November 2013. Interestingly, although the BI rate has stabilised at 7.50% thereafter, FD rates (using 3 month FD rate as proxy) continued to trend upwards. The continued rise in the 3 month FD rate suggests that competition continues to be intensive for deposits in Indonesia. We believe there are 2 key factors contributing to this rise: i) the tightening of liquidity as evidenced by the upward-incline loan-to-deposit ratio (LDR) curve and ii) the lowering of BI's LDR target which has pushed banks above the target band and those smaller banks with relatively weaker deposit franchise to raise their liquidity. We gather that the LDR target band was reduced to 78-92% (previously: 78-100%) by the regulatory authority last year.

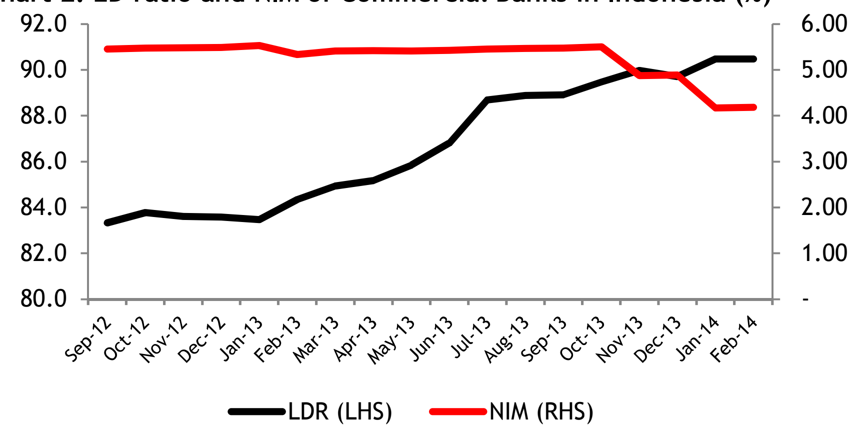
**Chart 1: BI rate, inflation, 3-mth FD rate and spread between 3-mth FD rate and inflation (%)**




Source: BI and MIDFR

- **Inflation pressure subsiding.** Inflation rate rose to a high of 8.79% in August 2013. This compares to 4.30% in December 2012. With the rise in BI rates, inflation has trended lower in the recent months of 2014.

**Chart 2: LD ratio and NIM of Commercial Banks in Indonesia (%)**




Source: BI and MIDFR

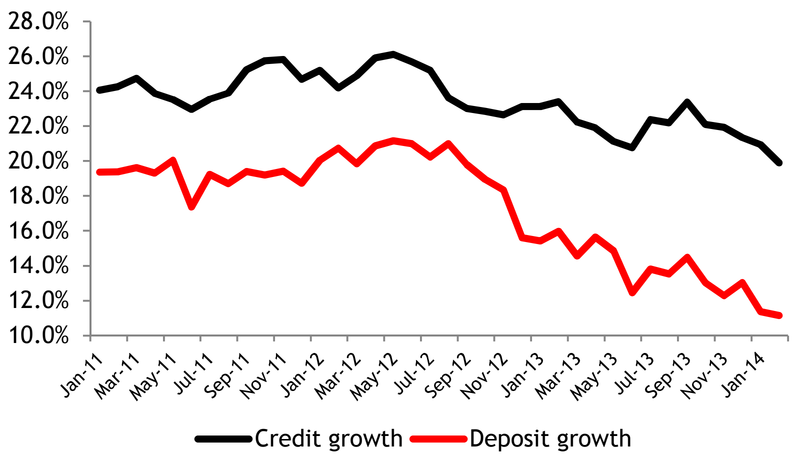
**Table 1: NIM and LDR of Commercial Banks in Indonesia (%)**

| | Jun-13 | Jul-13 | Aug-13 | Sep-13 | Oct-13 | Nov-13 | Dec-13 | Jan-14 | Feb-14 |
|---|---|---|---|---|---|---|---|---|---|
| NIM | 5.43 | 5.46 | 5.46 | 5.48 | 5.50 | 4.88 | 4.89 | 4.17 | 4.18 |
| LDR | 86.8 | 88.7 | 88.9 | 88.9 | 89.5 | 90.0 | 89.7 | 90.5 | 90.5 |

The pressure on higher inflation has abated but is still relative high compared to the rates in 2012. Using the 3 month FD rate as proxy, the real interest rate (3 month FD rate - inflation) has turned positive to 0.28% in February 2014 as compared to -0.77% in December 2013.

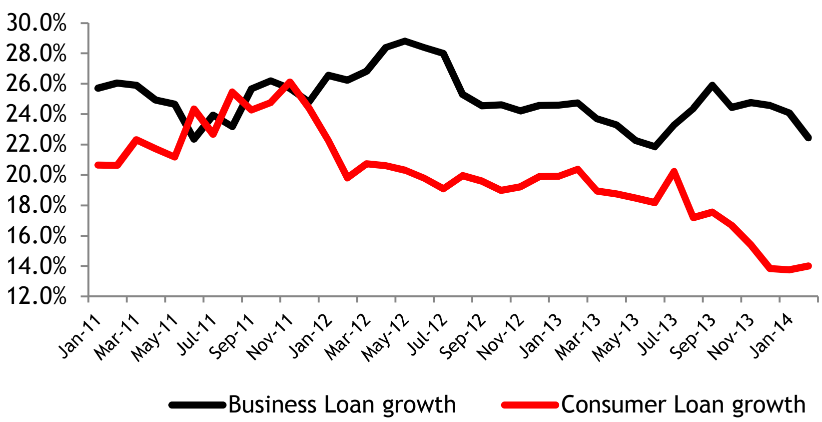
- **Industry LDR risen to 90.5%.** Chart 2 shows that the Industry LDR has risen to 90.5% in February 2014 as compared to 89.7% in December 2013 and 83.6% in December 2012. Credit growth outpaced deposit growth as shown in Chart 3 below and that contributed to the rise in LDR.

**Chart 3: Credit growth and Deposit growth of banks in Indonesia (%)**




Source: BI and MIDFR

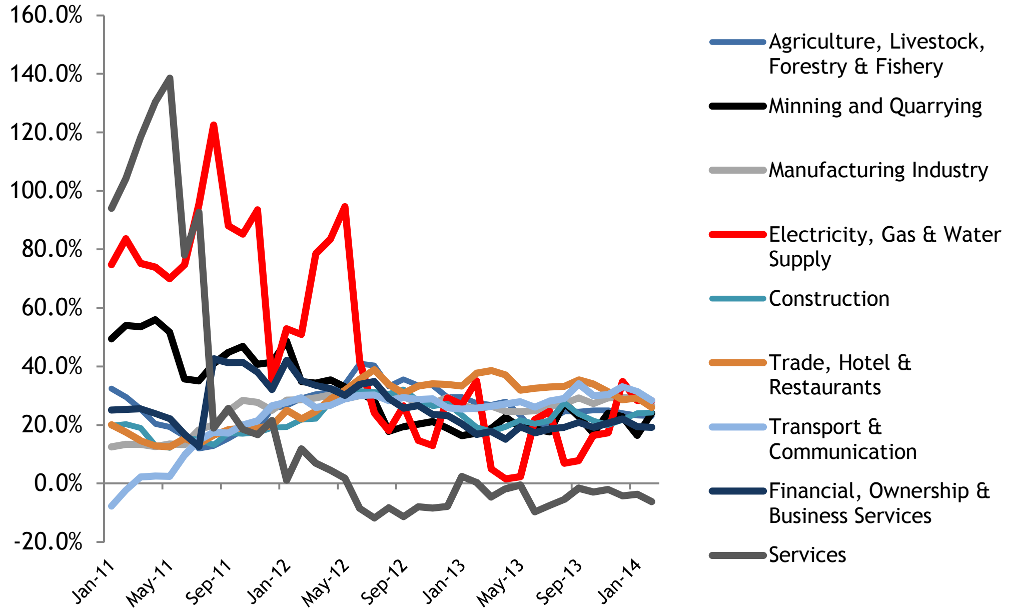
**Chart 4: Business loan and Consumer loan growth of banks in Indonesia (%)**




Source: BI and MIDFR

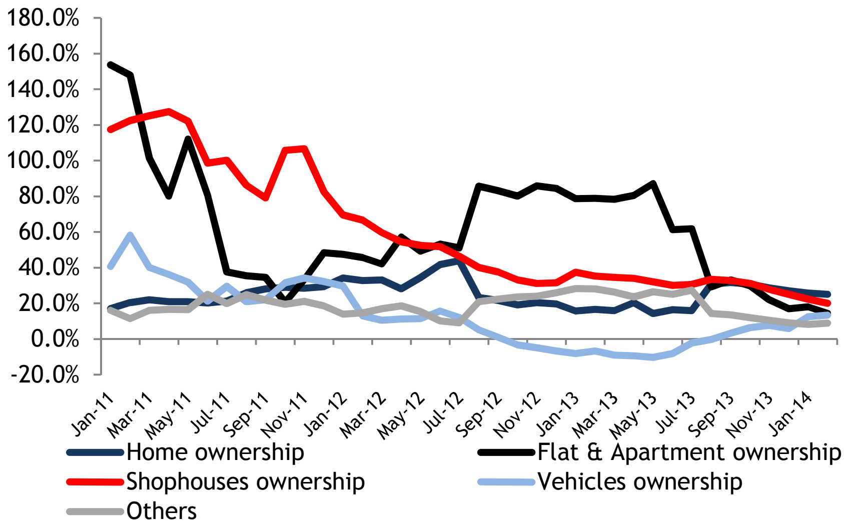
- **Moderation in credit growth.** The rationalisation of subsidy for fuel fuelled inflation and the clearly impacted the growth of consumer loans as seen by the steep decline in its growth rate since August 2013. Also, the economic slowdown in Indonesia has impacted business loan growth. Comparing business and consumer loan growth, we are seeing consumer loan growth moderating at a faster pace, hence contributing to the slowdown in the overall loan growth of banks in Indonesia. Mortgage loans were the key drags for consumer loans while the growth of loans for purchase of vehicles has been rising in recent months.

**Chart 5: Business loan growth by sectors (%)**




Source: BI

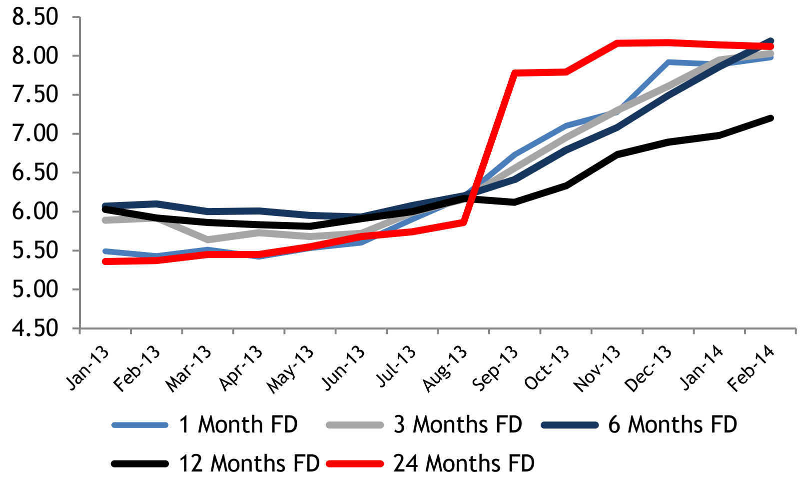
**Chart 6: Growth of key consumer Loans by purpose (%)**




Source: BI

- **Tighter liquidity a cause for concern?** A tighter liquidity scenario due to a higher LDR has pushed up deposit rates as seen from the FD rates offered by banks in the industry. This certainly raises the cost of funding (COF) of banks in Indonesia leading to a compression in net interest margin (NIM) as seen from Chart 2. NIM for Commercial Banks has been compressed to 4.18% in February 2014 from 5.41% in May 2013. With stronger competition for liquidity resulting in rise in FD rates, were are not surprised of some shifts in deposits from CASA to FDs, which may impact banks' CASA ratios. The above factors are likely to continue to compress NIM in 2014 albeit a narrower compression than that in 2013 given that there is now more rationality in pricing for corporate loans.

**Chart 7: FD deposit rates of Commercial Banks in Indonesia (%)**

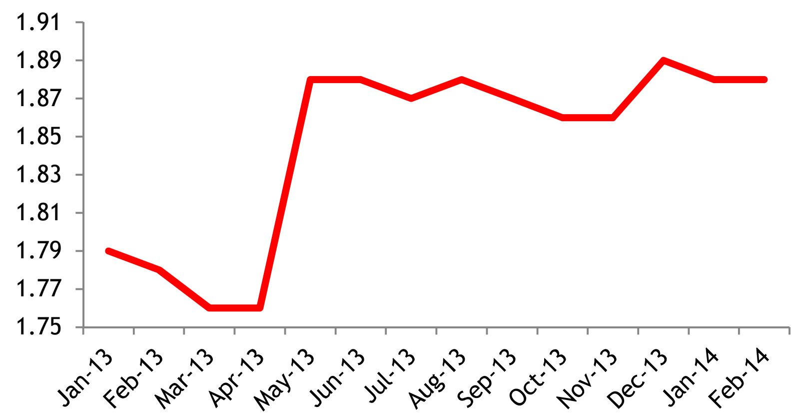



Source: BI

Chart 7 clearly shows the rising trend of the rates for the shorter term FD of up to 12 months. In contrast, the longer tenure FD rates have eased slightly in recent months as evidenced by the 24 months FD rate (see Table 2).

Meanwhile, savings rate of Commercial Banks in Indonesia has been flat. It was 1.88% at February 2014. Pressure on Banks COF's in Indonesia appears to be coming more from FDs and not from savings deposits.

**Chart 8: Savings deposit rates of Commercial Banks in Indonesia (%)**



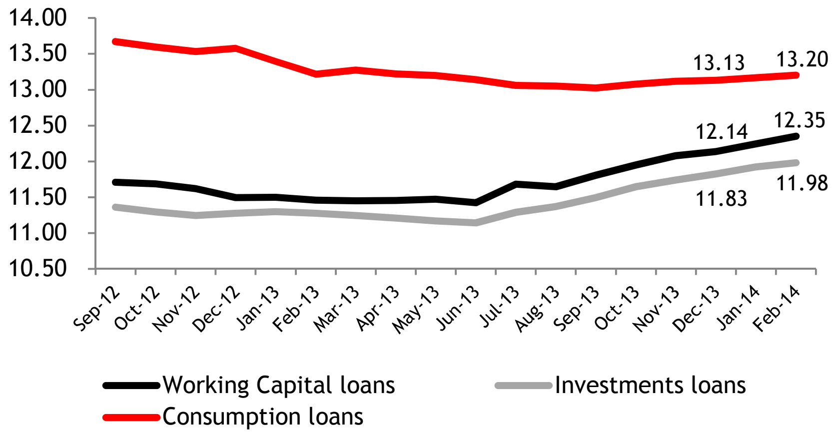

Source: BI

**Table 2: Trend of FD and Savings deposit rates of Commercial Banks in Indonesia (%)**

| | Jun-13 | Jul-13 | Aug-13 | Sep-13 | Oct-13 | Nov-13 | Dec-13 | Jan-14 | Feb-14 |
|---|---|---|---|---|---|---|---|---|---|
| 1 Month FD | 5.60 | 5.90 | 6.19 | 6.73 | 7.10 | 7.28 | 7.92 | 7.89 | 7.98 |
| 3 Months FD | 5.72 | 5.99 | 6.16 | 6.56 | 6.95 | 7.3 | 7.61 | 7.95 | 8.03 |
| 6 Months FD | 5.93 | 6.08 | 6.2 | 6.41 | 6.79 | 7.08 | 7.49 | 7.86 | 8.19 |
| 12 Months FD | 5.91 | 6.00 | 6.17 | 6.12 | 6.33 | 6.73 | 6.89 | 6.98 | 7.20 |
| 24 Months FD | 5.68 | 5.74 | 5.86 | 7.78 | 7.79 | 8.16 | 8.17 | 8.14 | 8.12 |
| Savings deposit | 1.88 | 1.87 | 1.88 | 1.87 | 1.86 | 1.86 | 1.89 | 1.88 | 1.88 |

- **Less pressure on lending rates.** Chart 9 shows that lending rates for working capital, investment and consumption loan rates have been trending up following the rise in BI rate.

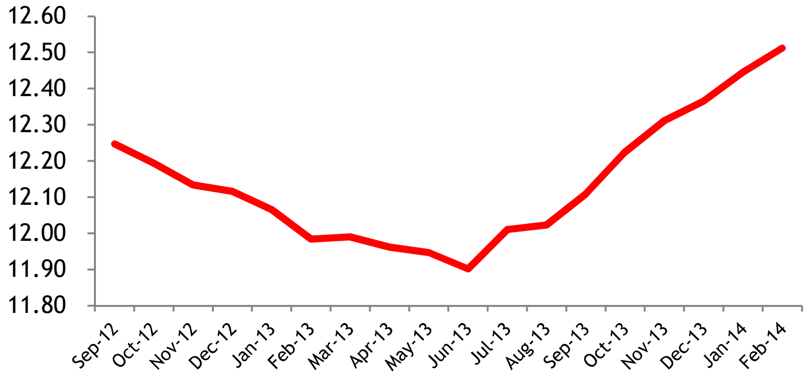
**Chart 9: Lending rates for working capital, investment and consumption loans (%)**




Source: BI

The average lending rate has been on the rise. From our channel checks, we understand that pricing for corporate loans has turned more rational recently and credit terms for corporate lending have more on par among competitors than before. Hence, there is now less pressure on lending rates in Indonesia.

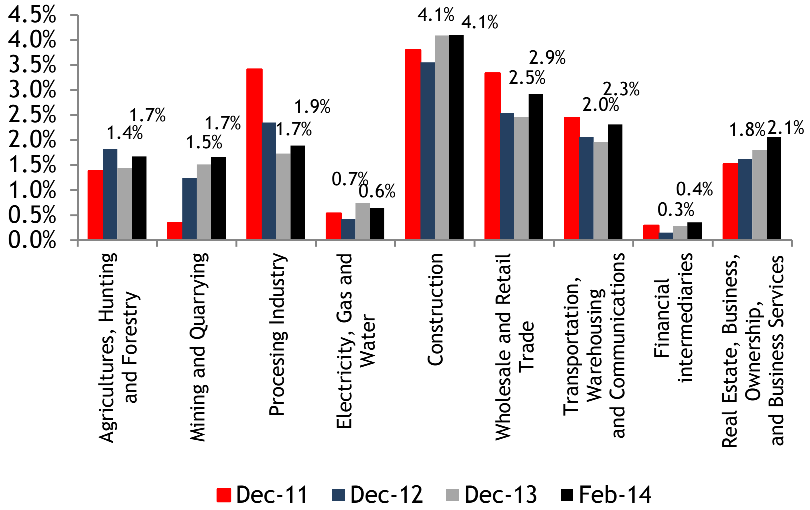
**Chart 10: Average Lending Rate (%)**




Source: BI

- **Some stress on asset quality seen.** With the slower economic growth in Indonesia coupled the inflation effects, we have seen upticks in the asset quality of the banking industry in Indonesia. The overall, NPL ratio for Commercial Banks has inched up to 2.0% in February 2014 (December 2013: 1.9%).
  Chart 11 below, comparing February 2014 to December 2013 for business loans, shows upticks in NPL ratios for the loans extended to: I) Agriculture, Hunting and Forestry, ii) Mining and Quarrying, iii) Processing Industry, iv) Wholesale and Retail Trade, v) Transportation, Warehousing and Communication, vi) Financial Intermediaries and vii) Real Estate, Business Ownership and Business Services sectors.
  The overall NPL ratio for business loans has risen to 2.1% in February 2014 from 2.0% in December 2013.

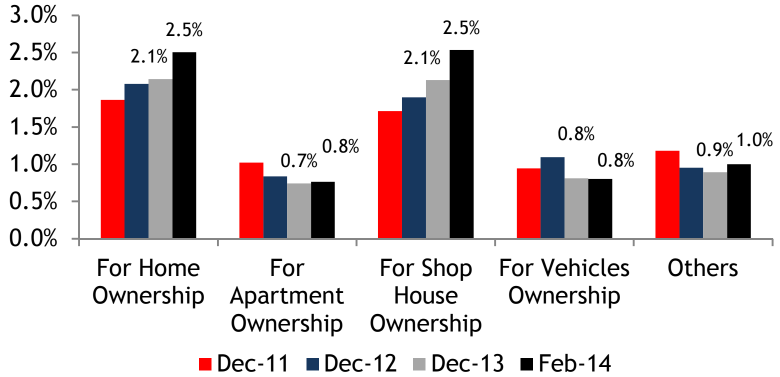
**Chart 11: NPL ratios by key business sectors (%)**




Source: BI and MIDFR

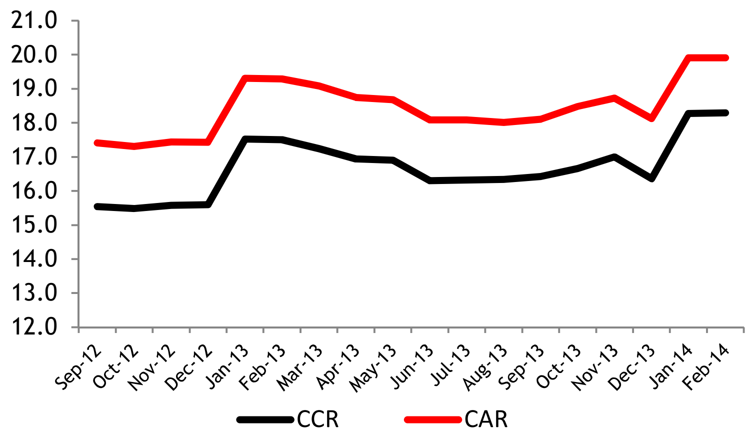
On consumer loans, higher NPL ratios were evidenced for mortgage loans while the NPL ratio for loans extended for purchase of vehicles remained stable. The overall NPL ratio for consumer loans has risen to 1.6% in February 2014 from 1.4% in December 2013.

**Chart 12: NPL ratios for consumer loans (%)**




Source: BI and MIDFR

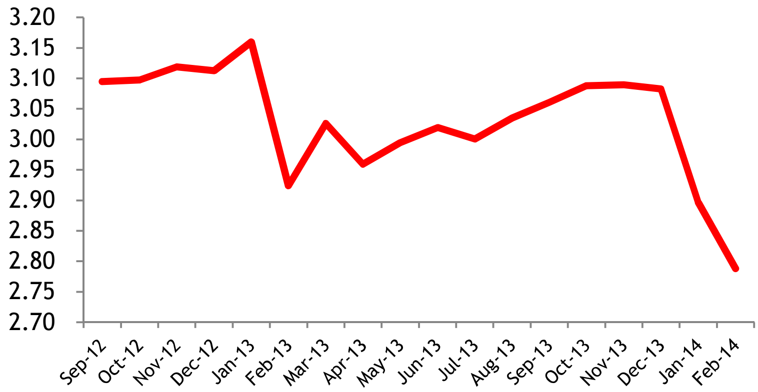
**Chart 13: Core Capital Ratio (CCR) and Capital Adequacy Ratio (CAR) of Commercial Banks (%)**




Source: BI

- **Commercial Banks capital position remained strong.** Commercial Banks' CCR and CAR was 18.3% and 19.9% respectively as at February 2014.

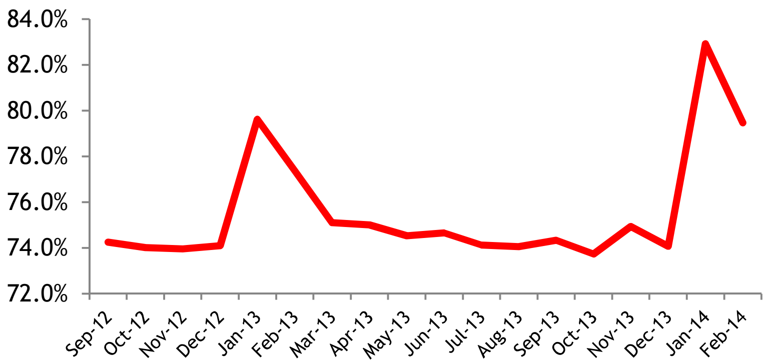
**Chart 14: ROA of Commercial Banks (%)**




Source: BI

Chart 14 shows the declining trend of ROA of Commercial Banks in Indonesia. ROA was lower at 2.79% in February 2014 as compared to 3.08% in December 2013 and 3.11% in December 2012. We believe that the declining trend has been contributed by banks' higher interest expense with an increase in FD deposit cost and lower credit growth due to moderation in economic growth which impacted banks' net interest income. Also, growth in operating expenses has generally outpaced that of operating income leading to a higher CI ratio. Other contributing factors to the drop in ROA include Commercial Banks' higher capital position.

**Chart 15: CI ratio of Commercial Banks (%)**




Source: BI

## CONCLUSIONS

This report provides useful insights into what lies ahead for Indonesian banks. This is especially important as sectoral changes affect CIMB Niaga and BII, hence affecting the earnings of CIMB Group and Maybank which are under our stock coverage. Looking ahead, based on our observations, we expect the following for 2014:

- **NIM pressures not likely to be abate in 2014. Higher COF from the rise in FD rates due to intensive competition for deposits as liquidity tightens will continue to compress Indonesian banks' NIM.** As LDR of the banking system has trended higher, liquidity has tightened. This leads to competition for deposits and hence pressurizing on banks' NIM. Indonesia Banking sector's NIM contracted 60bp in 2013. However, in 2014, we are seeing less pressure on lending rates in Indonesia and NIM pressure will mainly be coming from higher interest expense as deposits turned costlier with banks competing for deposits. FD deposit rates have been trending up as banks are offering higher rates to compete for liquidity. Hence, the margin contraction for 2014 is expected to be lower than 60bp contraction to a NIM of 4.89% recorded in December 2013. Alternatively, banks could raise funding from debt securities to support their asset growth but we think the first preference would still be customer deposits which would be a cheaper source of funding comparatively.

- **Slimmer chance of further rise in BI rate.** Headline inflation has declined to 7.32%yoy in March 2014 from a high of 8.79%yoy in August 2013, helped by the currency appreciation with the rise in BI rate and moderation in domestic demand. With the lower inflation rate and improving current account deficit, chances for further increase in BI rate are looking slimmer.

- **Credit growth in 2014 likely to be lower than 21.4%yoy recorded in 2013.** We had earlier expected 2H2014 to be an improvement over 1H2014 for credit growth. This is on the back of the completion of Indonesia' presidential election providing more certainty in policies for investors and the decline in core inflation in Indonesia which will improve domestic consumption.

  However, with the recent news flow that China, the major trading partner of Indonesia is not likely to implement major stimulus spending and is prepared to slowdown its economy to a more sustainable growth pace, we do not expect business loans to pick up strongly in 2H2014. We believe that the slowdown in Indonesia's trade with a drop in exports to China (mainly commodities) moving forward will continue to dampen the sector's business loan growth. Growth of business loans is likely to continue to be soft with the slower export activities.

  Consumer loans may pick up pace in 2H2014 as the impact of LTV rulings on mortgage and vehicles as well as inflation effects have already slowed down its growth to a very slow pace. Hence, upside potential is looking higher than further downside for consumer loan growth. The overall credit growth for the banking sector in Indonesia is likely to be slower than 2013 with a growth of between mid to high teens for 2014.

- **Loan loss provisions likely to be higher than 2013 on the back of a slower economic growth and high lending rates.** Although inflation rate has come off from the high, we do not expect the BI to lower the benchmark interest rate any time soon as global uncertainties still remain with the need to maintain stability in IDR exchange rate. Hence, the high lending rates are still expected to exert pressure on the asset quality of consumer loans. As seen above, NPL ratios for key consumer loans have inched up. On business loans, NPL ratios for key business loan sectors have trended up with the slower economic growth. Moving forward, we do not expect loan loss provisioning of banks for 2014 to be lower than 2013 due to aforementioned factors.

- **ROA of Commercial Banks trending lower.** We gather that the regulatory authority has imposed a cap on Indonesian banks banc assurance fee income commencing on Mar 2014 and will also cap the credit cards to a maximum of 2 cards per borrower in 2015. On this note, we expect this to add pressure to ROA of Commercial Banks.

- **Indonesia remains a challenging market with NIM compression and high provisions**. Although economic fundamentals for Indonesia have improved with foreign capital flowing back into the country coupled with the attractive valuation for stocks, we think that the Indonesian banking sector will continue to be a challenging market with banks facing NIM compression and trying the manage the high COF while provisions for loan losses is looking no less than that in 2013 with the high interest rate environment and slower trade activities. Banks may need to look at other areas such as managing the operating expenses to counter the higher COF which will impact earnings.

  Although we are remain cautious on the Indonesia, for our local stock coverage, we still maintain a BUY recommendation on Maybank (TP: RM11.00) and a NEUTRAL call on CIMB (TO: RM8.10). This in is view that the profit contribution from BII to Maybank Group is expected to be lower than 10% while that of Niaga to CIMB Group is expected to be in circa 30% which is substantial in contribution in our opinion.

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| MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS | |
|---|---|
| **STOCK RECOMMENDATIONS** | |
| BUY | Total return is expected to be >15% over the next 12 months. |
| TRADING BUY | Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow. |
| NEUTRAL | Total return is expected to be between -15% and +15% over the next 12 months. |
| SELL | *Negative* total return is expected, by -15% or more, over the next 12 months. |
| TRADING SELL | Stock price is expected to *fall* by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow. |
| **SECTOR RECOMMENDATIONS** | |
| POSITIVE | The sector is expected to outperform the overall market over the next 12 months. |
| NEUTRAL | The sector is to perform in line with the overall market over the next 12 months. |
| NEGATIVE | The sector is expected to underperform the overall market over the next 12 months. |