



Bank Loans: Performance in 2010, Expectation for 2011, and Impact on Credit Quality of Banking Sector

Contact:

Haryo Koconegoro
Assistant Vice President
Financial Institution
+62 21 576 1516
haryo.koconegoro@icraindonesia.com

In this commentary, we try to analyze the performance of the Indonesian banking sector using publicly-available data. The focus is on loan growth and quality, taking into account the impact of the reserve requirement ratio rule implemented in late 2010. Based on these factors, we try to gauge how the loans will perform in 2011, given the current economic situation and the guidance for the year. Finally, we assess how all this will impact the overall credit quality of the banking industry.

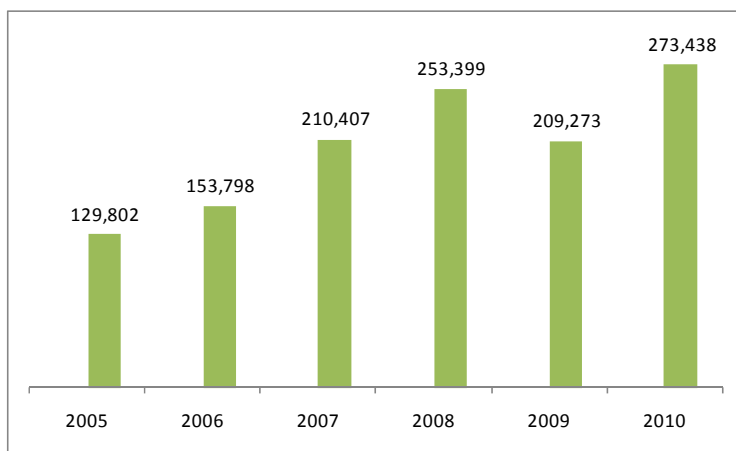
Summary

- Loans grew stronger than our expectation in 2010, but from the liquidity point of view, remained below the banks' potential to lend.
- Despite better macroeconomic expectations, we do not expect loans growth in 2011 to significantly differ from the 2010 level, as banks would be concerned more with overall credit quality than mere growth.
- Banks' overall credit quality should also remain strong going into 2011, as the indicators improved in 2010 vis-à-vis 2009. Further, considering the stronger macroeconomic expectations, we do not see any significant threat of deterioration in banks' credit quality in 2011.
- Some challenges that the banking sector might face include the increasing threat of higher inflation coming from the persistently high world oil price, and the high percentage of undisbursed loans to total loans outstanding which may show that demands for loans are not as strong as what the banks expected. Lack of progress in high-profile infrastructure projects could also undermine any expected significant growth in loans.

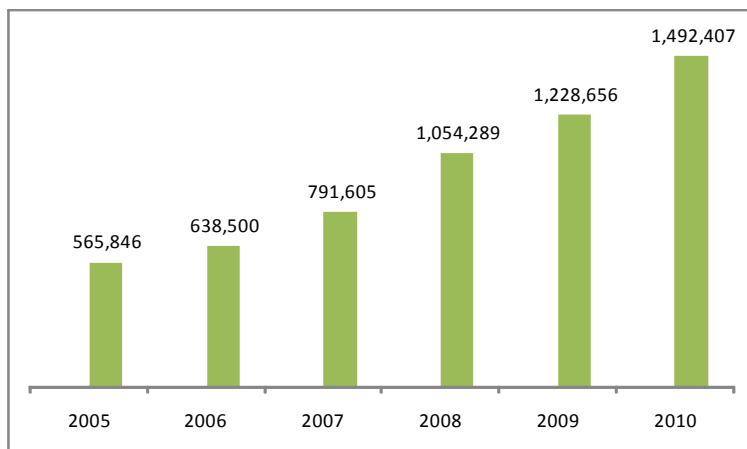
Loan growth (2010 vs. 2009)

Banking loans grew 22.8% YoY in 2010, as against just 10% in 2009. The growth in 2010 was higher than our forecast of 21% YoY (see our research [Assessing the Impact of Bank Indonesia's New Policy](#), published in September 2010). A further breakdown by type of currency indicates that Foreign Currency (FC) loans actually grew 50.2%, or 30.7% in Rupiah (Rp) terms. Meanwhile, Rp loans—which made up some 85% of the total loans outstanding at the end of 2010—grew 21.5% YoY, in line with our expectation. The more subdued growth of Rp loans in 2010 as compared with FC loans was expected; we had indicated in our last research that because of the increase of the reserve requirement (RR) ratio by 3 percentage points (ppt) effective November 2010, about Rp 60 trillion (around 2 months of loan growth) would be absorbed from the industry by way of the RR penalty.

FC loans grew 30.7% YoY in 2010 (in Rp billion)



Rupiah loans grew 21.5% YoY in 2010 (in Rp billion)



Source: Bank Indonesia

Aside from the low base in 2009 because of the impact of the global economic crisis from late 2008 up to early 2009—reflected by the contraction of FC loans by 17.4%—the very strong FC loan growth in 2010 was attributable to:

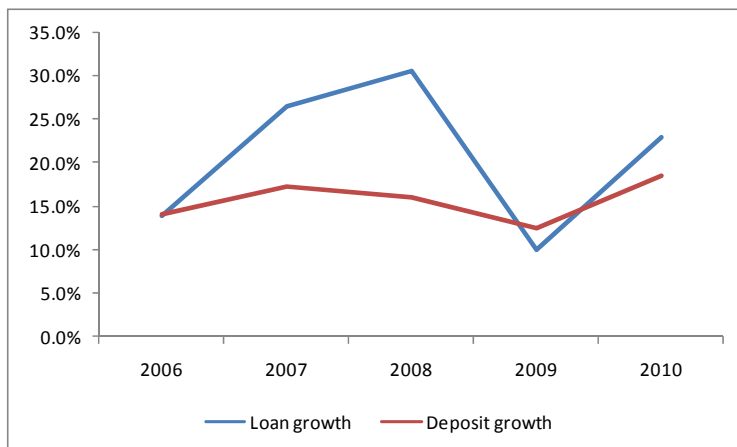
- The improving macroeconomic condition domestically and globally. In the global market, there have been signs of recoveries in the US and some European countries.
- The rise in commodity prices (in particular crude palm oil and coal prices), which have positively impacted the export-oriented mining and plantation companies. Loans extended to these sectors represented some 8.6% of total loans in 2010 and grew by 26.7% YoY that year.
- Quantitative easing (near zero interest rate) measures in some developed countries and a strengthening Rupiah, which have made borrowing in US dollars cheaper; this is good for companies making products with a high-import content.

Comparing 2010 with 2008, FC loans actually grew by less than 8%.

Loan growth outpacing deposit growth (2006-2010)

Since 2005, loans (both Rp and FC) have grown by compounded annual growth rate of 22.8% per annum, outpacing deposits growth of less than 16% per annum. In 2010, deposit grew by 18.5%, bringing system's total loan-to-deposit ratio (LDR) to 75.5%, increasing from 72.9% in 2009.

Loan growth versus deposit growth

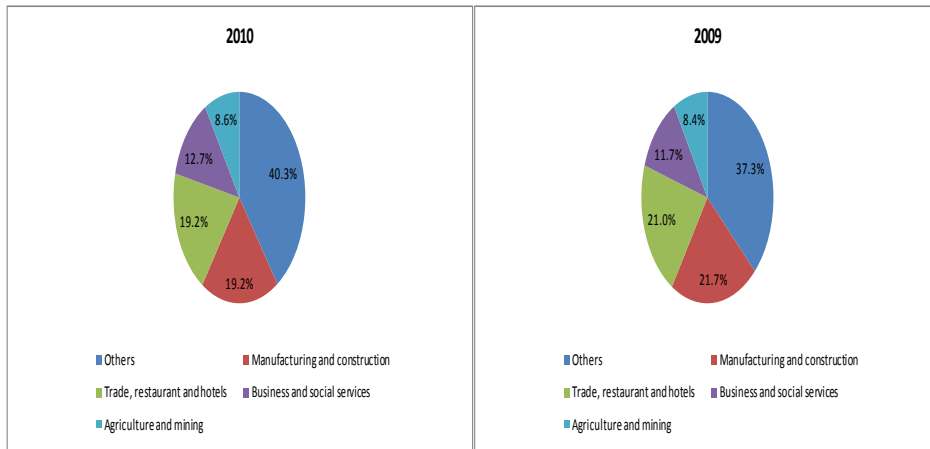


Source: Bank Indonesia

Loans distribution (2010 vs 2009)

Looking at loans distributions by sector, we could see that contribution of favorable sectors such as mining and plantation to total loans got higher in 2010 as compared to 2009. Meanwhile, although still growing, contribution of sectors such as manufacturing and trade decreased in 2010, owing to slower growth relative to other sectors.

Distribution of loans (2010 and 2009)

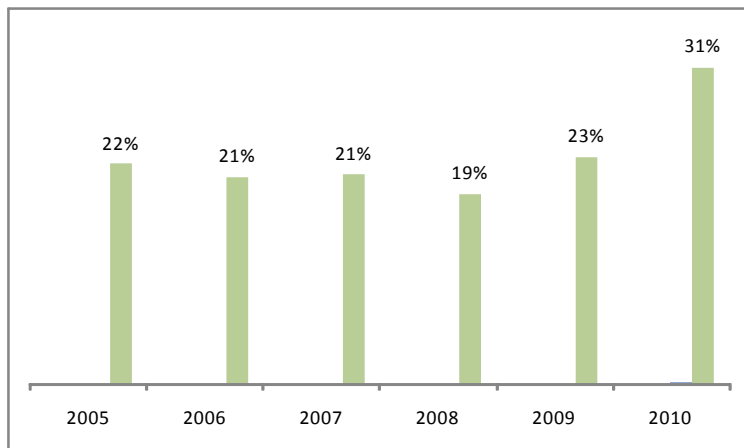


Increasing ratio of UL to total loans (2005-2010)

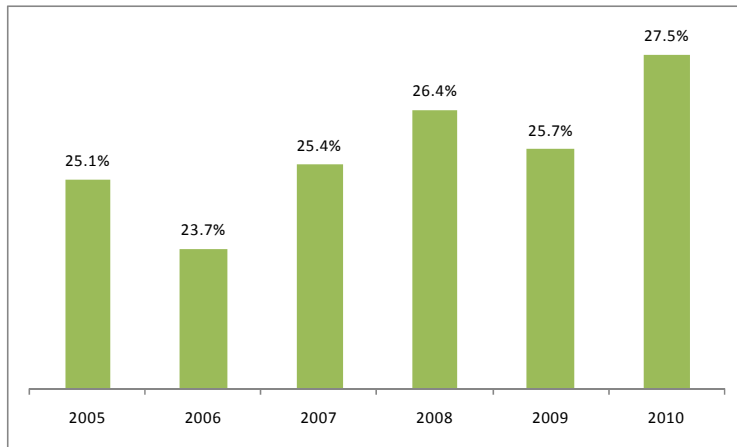
Meanwhile, undisbursed loans (UL) in 2010 reached Rp 555 trillion, up 74% from 2009 and accounting for 31% of the total loans extended. Looking at historical numbers, 31% appears quite high against the average of 20%. While the high percentage of UL might indicate that companies are in a better position than in the past (more financially flexible, given the abundance of bank facilities that they have not withdrawn), this could also mean that banks have tried their best to disburse new loans but the demand was probably not as strong as they had expected.

Nevertheless, looking at the relatively low loan penetration ratio (loan-to-GDP ratio) of 27.5% in 2010, we see potential for further penetration. Still, banks may need to venture into new markets/segments that they might have previously shied away from because of perceived higher risks.

Undisbursed loans to total loans extended



Loans-to-GDP Ratio



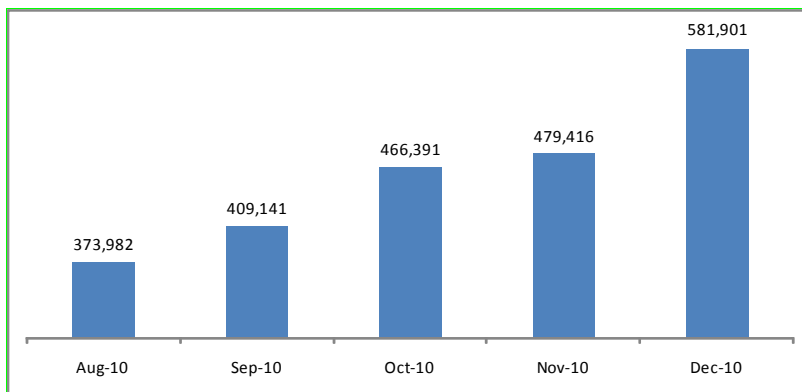
Source: Bank Indonesia

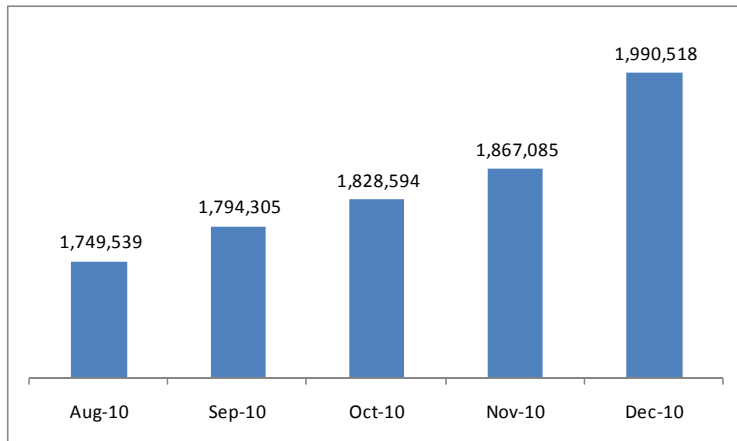
Impact of September 2010 increase in RR ratio on Rp deposits

In our previous research, we had suggested that the 3 ppt increase in the RR ratio would absorb some Rp 60 trillion from the system. Looking at BI's data, we found that placement at BI increased by 46.2% YoY in 2010, much faster than the increase in Rp loans (21.5% YoY) and Rp deposits (20.2% YoY).

Further, month-on-month breakdown revealed that from August 2010 (a month before the RR increase was implemented) to December 2010, the increase in BI placement was a whopping Rp 208 trillion or 55.7% in just five months. This is significantly higher than the increase in Rp loans of Rp 89 trillion or 6.3%, and the increase of Rp deposits of Rp 241 trillion or 13.8%, during the same period.

About 55.7% increase in BI placement in the last five months of 2010 (Rp bn)...



Against 13.8% increase in Rp deposits in the last five months of 2010 (Rp bn)**Loan growth was actually below banks' potential to lend**

To comply with the BI rule, at Rp 1,991 trillion of Rp deposits in December 2010, banks actually needed to place only some Rp 159 trillion with the central bank (refer to following calculation):

| | |
|-------------------------------------|-------------|
| Rp deposit (Rp tn)-Dec 2010 | 1,991.0 |
| RR ratio-old rule | 5% |
| Required amount of RR (Rp tn) | 99.6 |
| RR ratio-new rule | 8% |
| Required amount of RR (Rp tn) | 159.3 |
| <u>Additional RR needed (Rp tn)</u> | <u>59.7</u> |

However, the total amount of placement at BI was Rp 582 trillion, or Rp 423 trillion above the requirement. The reasons for the large excess could include the following:

- Banks may have become more cautious with their liquidity needs in anticipation of the new LDR rule to be implemented in March 2011. This applies especially to those that will be subject to the penalties.
- The debt and equity markets were favorable so that companies had more choices than just bank loans to meet their funding needs. Stocks IPOs and rights issues in 2010 reached Rp 73.5 trillion (2009: Rp 13.0 trillion) while corporate bonds issuance reached Rp 36.6 trillion (2009: Rp 27.2 trillion). This argument can be supported by the higher-than-historical average UL discussed earlier.
- A number of high-profile infrastructure projects which initially were expected to kick off in 2010, still showed no signs of progressing. Given their sizeable assets, big banks usually rely more on large corporate banking deals, such as infrastructure projects, to show meaningful growth on their loan books. Any delays in such high-profile projects would dent these banks' loan growth projections significantly.

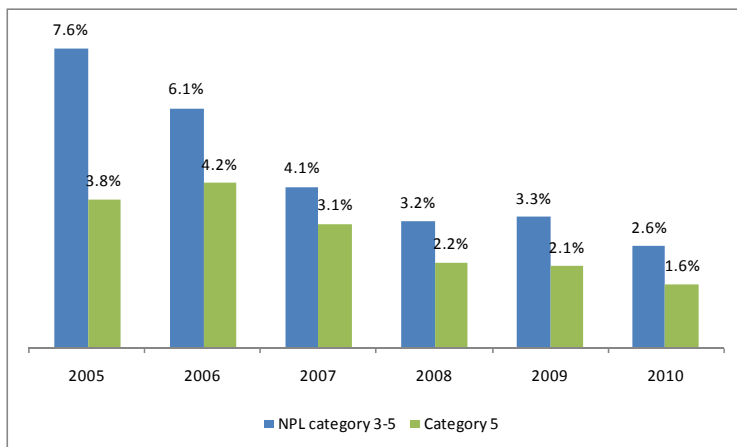
In the light of all this, we take the view that banks will continue to be prudently cautious with their liquidity position in 2011 and may not channel most of any increase in deposits to loans, if they feel the risks of giving out new loans are outweighing the benefits. The focus on liquidity would also be heightened by the RR increase for FC deposits due in March (first phase) and June (second phase) 2011.

If banks were forced to choose, heightened focus on liquidity is likely to prevail over acceleration in loan growth. Despite BI's efforts to encourage more lending by linking RR to LDR and the low loan penetration, banks are likely to rather pay the penalty than force themselves to lend, if the risk-adjusted returns are not worthwhile.

Banks loan quality in 2010

Looking at loans by category (cat) 1 to 5, the quality of loans appeared to have significantly improved over the years (from 2005 to 2010). NPL (cat 3 to cat 5) decreased to 2.6% in 2010 from 7.6% in 2005. Cat 5 loans as a percentage to total loans also improved during the period to 1.6% of loans in 2010 from 3.8% of loans in 2005.

NPL ratio continued to improve during 2005-2010



Source: Bank Indonesia

Considering the gross NPL data above, we may conclude that loans quality in 2010 was better than in 2009. This is hardly surprising, given the challenging macroeconomic situation in 2009. Further, many banks used the more favorable condition in 2010 to clean up their books more aggressively. However, whether credit risk management of banks has improved is a harder question to answer, since we could not say on the basis of these data alone if the decrease in NPL was mostly because of write-offs or because of better credit risk management. Therefore, more conclusive evidence needs to be found before a comment can be made on how improved credit risk management in the industry has so far been.

Performance of top 10 banks

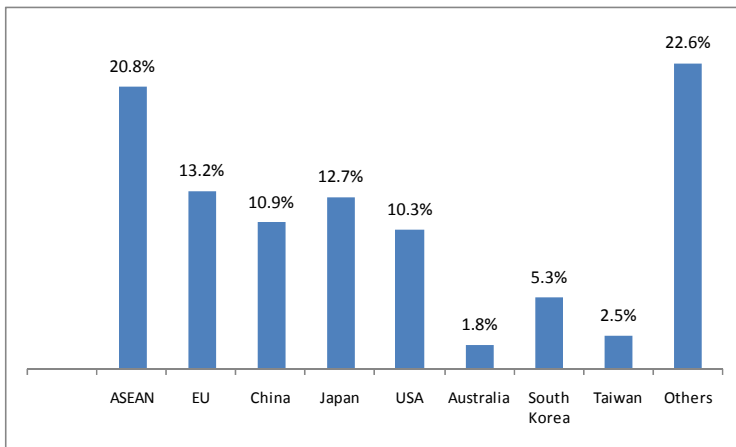
We now look at how the top 10 banks fared in 2010. As with the industry, we wanted to know how the top 10 banks performed vis-à-vis the industry and whether there was some deviation from the industry trend as a whole. The general view was that what happened to the industry as a whole was also experienced by the top 10 banks, which again, is hardly surprising, as in terms of asset size, the top 10 banks accounted for 64.75% of the whole industry. Last year, total loans of these top 10 banks grew by 23.5%.

Performance in 2011

Going into 2011, although FC loans should continue to expand, we see there are a few factors that may constrain the pace of growth:

- *The regulatory increase of the RR ratio from 1% of total FC deposits to 5% in March 2011 and 8% in June 2011.* Given the 78.5% LDR already reached in 2010, an additional 7% of RR would mean that more than 85% of FC deposits would already be utilized. This is only 5 ppt short of the 90% LDR level most banks usually see as the optimal level. The lower interest rate on FC deposits (vis-à-vis Rp deposits) and a strengthening Rupiah have made depositing money in FC unattractive, as evident from the subdued FC deposit growth of 10.1% vs. loans of 30.7% in 2010. As the Rupiah is expected to remain strong in 2011, we are of the view that deposit growth would remain lackluster and exert further pressure on liquidity, which in turn may force banks to decelerate their FC lending.
- *The crippling earthquakes and Tsunamis that hit Japan recently and the political and social unrests across the Middle East.* Revenues from non-oil and gas exports to Japan accounted for 12.7% of Indonesia's total non and gas exports revenue in 2010. Although reconstruction needs and shift in energy sources (from nuclear power to coal and liquefied natural gas) may spike demand for resource-based commodities, negative impacts are likely to be experienced by the more labor intensive industries that Indonesia relies on, such as textiles, aquacultures and furniture. Further, with Japan being one of Indonesia's biggest lenders, there may be projects in infrastructure that were initially planned to be financed by Japanese aid but which run the risk of being postponed or cancelled now. Meanwhile, even as the Middle East region is not a major export destination for Indonesia, the spike in oil price following the unrest there may increase operating costs and weaken purchasing power in some major export destination countries.

Distribution of Indonesia's non-oil and gas exports revenue by countries—2010



Source: BPS

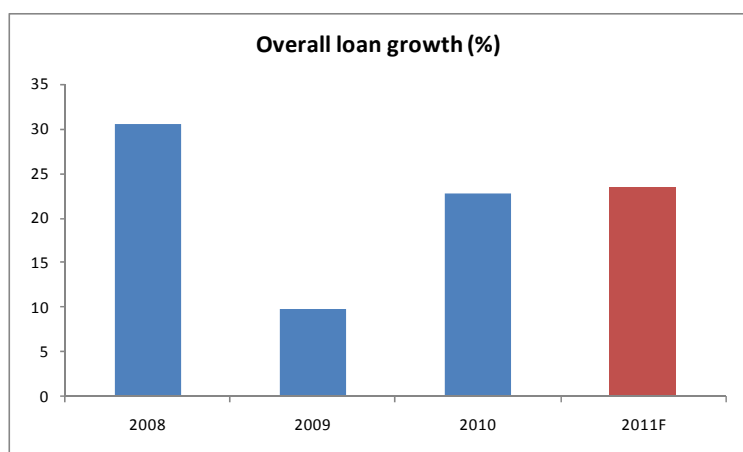
In view of the factors discussed, we believe FC loan growth will not be as strong in 2011 as it was in 2010 and may converge to its average long-term growth rate of around 16% per annum.

Meanwhile, we expect Rp loans growth in 2011 to exceed that in 2010 (21.5%), given the more positive macroeconomic guidance from the government (higher GDP growth, lower inflation and stronger Rupiah), which should support faster growth. However, the difference may not be significant, as banks are facing the problems of increasing UL and slower deposits growth vis-à-vis loans growth.

Using February 2011 data for guidance, total loan grew by 24% YoY in February 2011, contributed by a 22% growth in Rp loans and 39% growth in FC loans. Rp loans showed that the growth for 2011 is on track to beat the increase in 2010. Meanwhile, the high 39% growth of FC loans may be misleading, as the strong growth of FC loans in 2010 started to happen only in the second semester, and so the strong growth in February 2011 came from a low base. Further, in March 2011 we may see constraining pressure on the pace of FC loan growth when the first increase in FC-RR would be implemented (from 1% to 5% of FC deposits).

With higher Rp loan growth but slower pace of FC loan growth in 2011 vis-à-vis 2010, we expect total loan to grow at around 23.5% in 2011, quite similar to the expansion of 22.8% in 2010.

Loan growth estimates for 2011



Source: Bank Indonesia, ICRA Indonesia estimate

Banks' overall credit quality

| (%) | 2010 | 2009 | (%)/ppt |
|--------------------|------|------|---------|
| CAR | 17.2 | 17.4 | -0.2 |
| Gross NPL | 2.6 | 3.3 | -0.8 |
| NIM | 5.7 | 5.6 | 0.2 |
| Net Profit (Rp tn) | 57.3 | 45.2 | 26.7% |
| LDR | 75.5 | 72.9 | 2.6 |

Source: Bank Indonesia

Looking at five basic indicators for banks' credit quality, we see that despite the inclusion of operational risk in the calculation of CAR in 2010, banks are still relatively well-capitalized at 17.2%, only down 0.2 ppt from 2009. This was made possible, among other factors, by the favorable capital markets, which allowed banks to raise more capital. Asset quality (as indicated by gross NPL indicator) also improved; lower by 0.8 ppt, which was in line with improving macroeconomic conditions. Profitability as measured by NIM and net profit also indicated that banks are enjoying healthy profits and margins, thanks to the relatively stronger YoY loan growth and the lower cost of funds (following the declining trend in interest rates).

LDR, which is a liquidity indicator, also shows there is still room for loan expansion and this could be achieved without putting a significant squeeze on the overall liquidity in the system.

Further, with the macroeconomic outlook for 2011 being more favorable—higher GDP growth (2011: 6.4% vs. 2010: 6.1%); stronger Rupiah vs. US dollars (3M11, Rupiah averaged at Rp 8,863/US dollars vs. 2010 average of Rp 9,078/US dollars); sovereign rating upgrades to one notch below the investment grade by three global rating agencies; and postponement of the fuel subsidy quota—we do not foresee any deterioration in banks' overall credit quality in 2011.

Conclusion

Banks loans grew stronger than expected in 2010, but still below the banks' potential to lend. This was evident from the higher-than-required placements at BI and the higher-than-average UL as a percentage of loans outstanding in 2010. The higher-than-average UL may mean that banks were willing to lend, but companies had more flexibility in meeting their funding needs, or the actual demand for loans was not as high as expected because of some constraints.

Despite the better macroeconomic outlook, we do not expect loans growth in 2011 differing significantly from the 2010 level, as banks will be concerned more with overall credit quality than mere growth. Further, the implementation of the RR rule for FC deposits is likely to slow down the pace of FC loan growth, which saw a large (30.7%) increase in 2010.

Banks' overall credit quality should remain intact going into 2011, as the credit quality indicators actually showed improvement in 2010 vis-à-vis 2009. Given the stronger macroeconomic expectations, we do not foresee any deterioration in banks' overall credit quality in 2011.

However, there are some challenges that the banking sector might face. These include the increasing threat of higher inflation, coming from the persistently high world oil price (which may force the government to hike subsidized fuel prices). A rise in inflation may result in slower than expected loan growth as companies may stall expansion plans, hence loans withdrawal, on the back of rising operational costs. Furthermore, the high percentage of undisbursed loans to total loans outstanding may show that demands for loans are not as strong as what the banks expected. Last but not least, lack of progress in high-profile infrastructure projects could also undermine any expected significant growth in loans.

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