



Banking Sector: Underperforming 2014, NPL Concern and Slight Recovery in 2015

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For the past four years, ICRA Indonesia has assessed the performance of Indonesian banking industry. Last time, we highlighted the slowing growth of the banking industry loans in 2013 on account of unfavorable operating environment earmarked by the high inflation, rising interest rates, trade and current account deficits, and US Federal Reserve's tapering in its stimulus program. The tightened housing loan regulation should be added although the impact is relatively minor despite the drop in property loans.

Albeit all mentioned, the overall credit quality of banking industry in 2013 was still intact with capital adequacy ratio (CAR) of 18.1%, non performing loans (NPL) at 1.8% and net interest margin (NIM) well taken care at 4.9%. Total loans grew by 21.6% year-on-year. In that period, the macroprudential measures taken by the regulator and the banks in general had a vital role in keeping the industry's structure unimpaired despite the unfavourable economic developments.

In this commentary, we do the same for the year 2014 as well as expectations for 2015. Key points are summarized below.

Summary

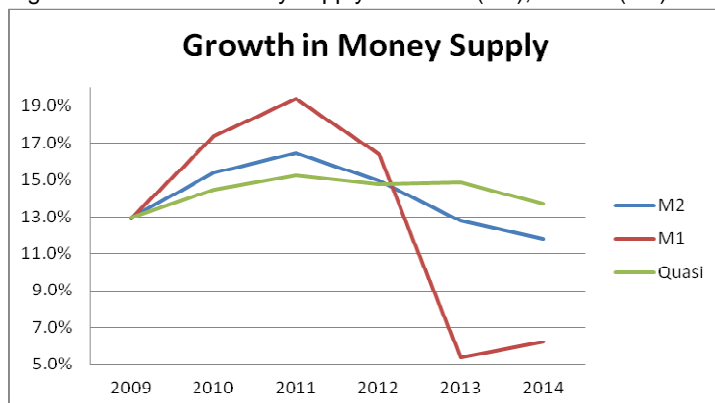
- Bank loans grew by 11.6% in 2014, far below ICRA Indonesia's estimate of 17-19%, to Rp 3,674tn. This growth marks the lowest for the last four years, and much less than 21.6% recorded in 2013.
- Banks have dealt with various challenges in 2014 such as high interest rate environment, slump in business activities with two national elections, rising inflationary pressures, increase in electricity tariffs and minimum wages, and tight liquidity, moreover as US showed continuous improvements in their key economic indicators.
- The banks' credit quality in 2014 are mixed as indicated by even stronger in capitalization as CAR rose to 19.6% (2013: 18.1%) while other key indicators such as non performing loans (NPL) deteriorated to 2.2% from 1.8% and net interest margin (NIM) further suppressed to 4.2% from 4.9%. ICRA Indonesia however views 2014 as underperforming for banks from the perspective of intermediary role, underpinned by significantly lower loan growth than expected.

- In 2015, ICRA Indonesia expects total bank loan to grow by 13-15% taken into account political backdrop has gradually stabilized, ongoing economic reform by new government and the dynamics of global economy, particularly related to recovery in the US. Further, ICRA Indonesia also expects the key structural indicators such as profitability and asset quality to be mildly challenged in 2015, with the lingering impact of unfavourable macroeconomic conditions. Our expectations also include NIM of 4.0-4.5%, CAR of 17-19%, LDR around 89% and NPL of 2.0-2.5% for the course of 2015.
- Key challenges for the banking sector in 2015 would include management of asset quality, especially as businesses have to adjust to policies under new regime, operating efficiency -- the ability to optimize the existing network, products offered and ability to further extract from fee based income as well as acting as an agent of development.
- The capital level is still strong even when viewed from the more stricter Basel III perspective, as the central bank has introduced more conservative approach, requiring banks to deposit additional liquidity reserves.

LOAN GROWTH (2014 versus 2013)

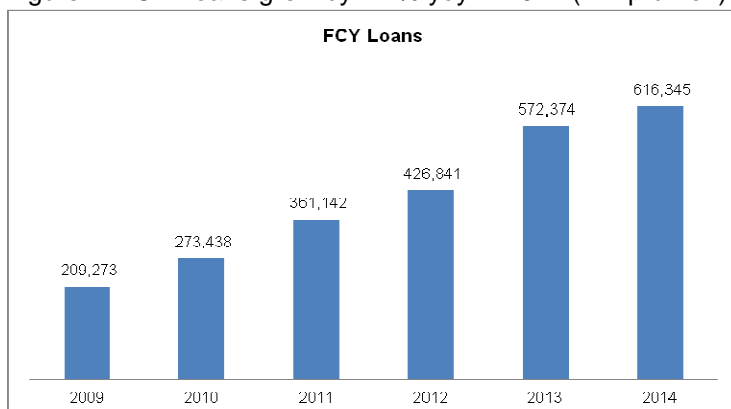
- Total bank loans grew 11.6% year on year (yoy) to Rp 3,674tn as against 21.6% in FY2013 and 23.1% in FY2012.
- As of January 2015, the credit growth stayed at 11.6% yoy. Loan-to-deposit ratio (LDR) further moderated at 88.5% from end year position of 89.3% and CAR strengthened to 21% from 19.6%. Concern in NPL became more prominent after recording a figure of 2.4%, up from year-end position of 2.2%
- The working capital still dominated the proportion, recorded at 47.8% of total loan, lower than last year which can be linked to slower growth in two dominating sectors of wholesale and retail trade industry and processing industry. Consumer loan was at the stable proportion, 27.6% of the total loan; while investment slightly increased to 24.6% from 24.2%.
- Currency-wise, foreign currency (FCY) loans grew by 7.7% in Rupiah (Rp) terms, a huge drop in growth rate from 34.1% in FY2013.
- Meanwhile, local currency (LCY) or Rp loans, which constituted 83.2% of total loans (versus 82.6% in 2013), grew 12.4% yoy, a drop in rate from 19.3% yoy in 2013.
- On the overall picture, the year marred by political activities led to a weak growth in Rp loan. Moreover, the exchange rate situation has raised concern of banks' liquidity in terms of foreign reserves. The government has since established bilateral swaps with major trading partner to overcome the threat.
- M2 and quasi money experienced slower growth in 2014, confirming indication of tightening liquidity. However, unfavorable business environment contributed more to the credit growth slowdown.

Figure 1: Growth in money supply in overall (M2), narrow (M1) and in deposits (Quasi)



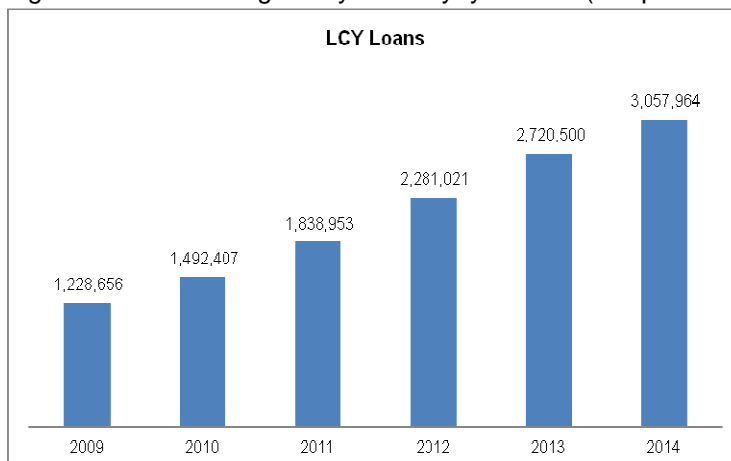
- Closed only 2% weaker at Rp 12,440 at end of December 2014, Rupiah experienced moderate fluctuation against USD during the year, going from as low as Rp 11,271 per USD on April 1st to Rp 12,900 per USD on December 16th and the effect of this swing was not as imminent in 2014 as in a year before. Thus, loan repricing would not be as impactful as in 2013. However, heightened dollar rates and its liquidity hindered businesses from getting forex loan, thus lower loan growth in FCY. Also, slight impact can come from Bank Indonesia (BI)'s new rules to hedge offshore loans, effective from 1 January 2015 -- putting further tightening to future FCY loans.

Figure 2: FCY Loans grew by 7.7% yoy in 2014 (in Rp billion)



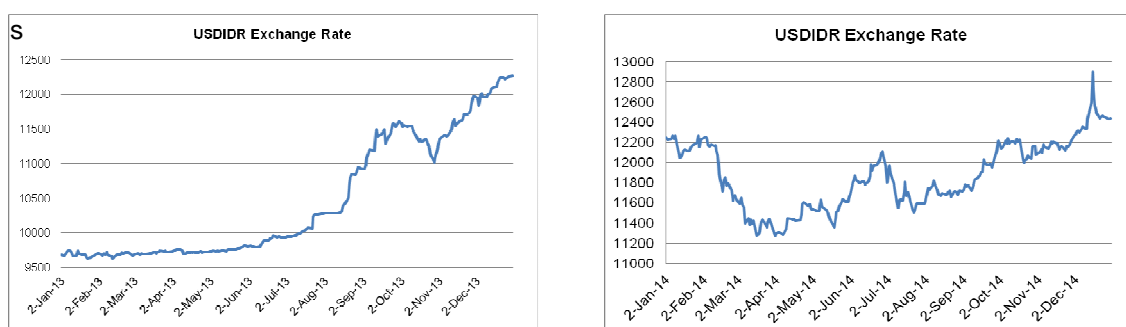
Source: Bank Indonesia

Figure 3: LCY Loans grew by 12.4% yoy in 2014 (in Rp billion)



Source: Bank Indonesia

Figure 4: Rupiah exchange rates against USD during 2013 and 2014



Source: Bank Indonesia

STABLE LDR AS LOAN GROWTH WEAKENED

- The deposit grew 12.3%, lower than 13.6% yoy a year earlier, but higher than credit growth of 11.6%. This stabilized the loan to deposit ratio (LDR) to 89.3% from 89.9% in 2013. This is only 2nd time since 2009 when deposit growth outpaced the same for loans. Overall, ICRA Indonesia views banking liquidity as tight in 2014.

Table 1: Loans growth vs deposits growth

Year	Loans growth	Deposits growth	LDR
2009	10.0%	12.3%	72.9%
2010	22.8%	18.8%	75.5%
2011	24.6%	19.1%	79.0%
2012	23.1%	15.8%	84.0%
2013	21.6%	13.6%	89.9%
2014	11.6%	12.3%	89.3%

source: Bank Indonesia (processed)

- Thus moderated LDR was not the issue of well implemented financial inclusion as planned, but more of a weak growth in loans, the weakest since 2009. Incidentally, 2009 was also a political year but the at that time political issue was not that imposing as the effect of major global crisis stemmed from subprime mortgage meltdown was much stronger. In 2014, political issue was more in the headline despite global macroeconomic backdrop, especially slow recovery in China as one of the major export destination, also not supporting for any headroom in growth. There was also initiation of mineral law implementation that prohibited raw mineral to be directly exported, and the condition has put a sudden brake on export performance.

LOAN DISTRIBUTION

- The top 4 sector contributors stay the same for the periods under observation.
- There was a surge in agricultures, hunting and forestry loans as a result of government initiatives to push agricultural development to pursue self-sufficiency in food supply.
- The LTV regulation in property clearly impacted the industry as the real estate and related loans has seen a drop from #6 in 2011-2013 to #9 in 2014. Percentage wise, in 2013 it was at 5.9% and dropped to 5.0% in 2014. It's one of the biggest losers in 2014, decreasing by 14.3%.

Table 2: Loan distribution by sectors

RANKING				Loans by Industrial Origin	% to total loan			
2011	2012	2013	2014		2011	2012	2013	2014
1	1	1	1	Wholesale and Retail Trade	17.0%	18.4%	19.6%	21.8%
2	2	2	2	Processing Industry	15.7%	16.5%	17.5%	20.1%
5	3	3	3	Others -- household	5.4%	10.3%	8.4%	11.2%
4	4	4	4	For Home Ownership	8.0%	7.8%	8.2%	9.2%
7	7	7	5	Agricultures, Hunting and Forestry	5.0%	5.3%	5.4%	6.4%
3	5	5	6	Non Industrial Origin Others	11.1%	6.7%	6.7%	5.5%
9	9	8	7	Transportation, Warehousing and Communications	4.5%	4.5%	5.0%	5.2%
10	8	9	8	Financial intermediaries	4.8%	4.6%	4.6%	5.0%
6	6	6	9	Real Estate, Business, Ownership, and Business Services	5.3%	5.6%	5.9%	5.0%
8	12	11	10	Construction	3.4%	3.5%	3.5%	4.5%
11	10	10	11	Mining and Quarrying	4.0%	3.8%	3.9%	4.3%
13	11	12	12	For Vehicles Ownership	4.8%	3.6%	3.2%	3.7%

Source: Bank Indonesia (processed)

Table 3: Loan growth by sectors

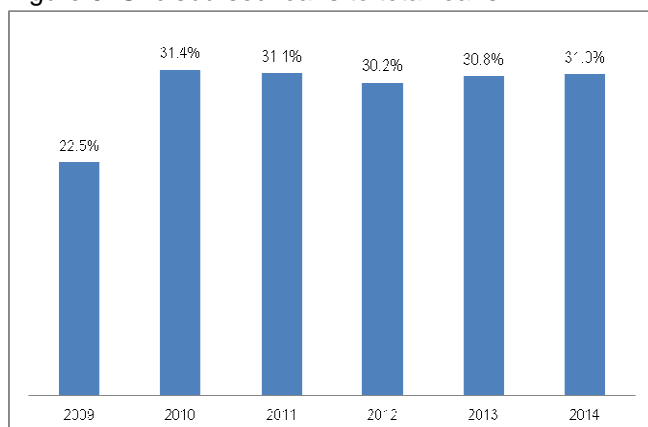
Loans by Origin	loan growth		
	2012	2013	2014
Wholesale and Retail Trade	33.2%	28.9%	11.3%
Processing Industry	29.4%	29.6%	14.3%
Others -- household	132.7%	-0.4%	32.3%
For Home Ownership -- household	19.7%	27.1%	12.7%
Non Industrial Origin Others	-25.9%	22.7%	-18.5%
Real Estate, Business, Ownership, and Business Svc	29.6%	28.3%	-14.3%
Agricultures, Hunting and Forestry	29.7%	24.4%	19.9%
Transportation, Warehousing and Communications	24.8%	33.7%	5.1%
Financial intermediaries	18.8%	21.0%	9.9%
Mining and Quarrying	18.7%	21.7%	11.8%
Construction	27.2%	21.0%	26.9%
For Vehicles Ownership -- household	-6.7%	5.9%	17.9%

Source: Bank Indonesia (processed)

FLAT TREND IN LOAN UTILISATION

- Undisbursed loan (UL) in 2014 grew by 12.2% to Rp 1,138tn, less pacier than 2013 which grew by 24.0%.
- Relative to the loans disbursed, the percentage has not seen any significant movement.
- The indications drawn from UL growth equal to loan growth hinted that overall borrowing appetite has slowed during 2014 and businesses have faced more challenging times, both domestically and globally.

Figure 5: Undisbursed loans to total loans

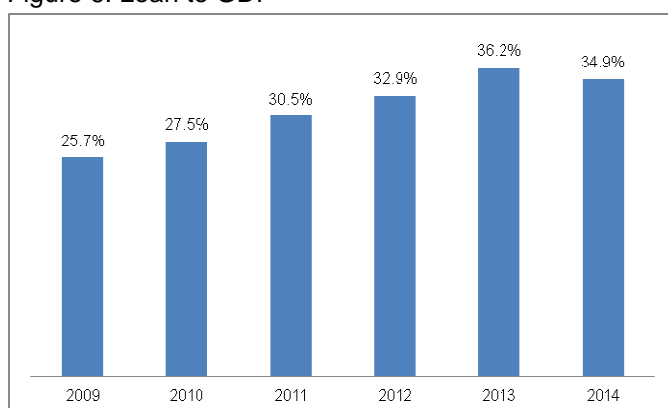


Source: Bank Indonesia (processed)

LOAN PENETRATION

- In 2014, loan penetration (loan to gross domestic products [GDP]) decreased despite efforts to push bank penetration. The figure got lower even when there was a notable slowdown in GDP growth during 2014.
- GDP is estimated to be Rp 10,543tn in 2014, which led to loan-to-GDP of 34.9%, lower than neighbouring countries such as Malaysia (124%), Singapore (128.9%), Thailand (154.4%), Vietnam (96.8%), or similar economy such as India (51.8%). It is about at par with fellow emerging country, the Philippines, of 35.8%^{1, 2}
- This is consistent with our assessment that 2014 is underperforming for banks, from the intermediary role point of view.
- However in light of global economic uncertainties, this low penetration seems to work in our favours since higher loan to GDP also brings the proneness to rapidly deteriorating sovereign credit quality should anything happens against the projected expansion. This was happened in Euro zone, and the repercussion still lingers.

Figure 6: Loan to GDP



Source: Bank Indonesia and IMF (processed)

- Micro, Small and Medium Enterprises (MSME) loan grew at slower pace, despite regulator set a deadline of minimum 20% credit channeled to the sector to be achieved in 2018. In 2014, the aggregated amount of outstanding credit in the sector expanded 10.3% to Rp 671.7tn, as opposed to 15.7% expansion in 2013.
- NPL issue becomes apparent as this sector's NPL has increased to 3.7% from 3.2% a year earlier.

¹ latest data point at 2013

² <http://data.worldbank.org/indicator/FS.AST.PRVT.GD.ZS>

LESS EXCESS IN BI PLACEMENT -- MORE IN LINE WITH BANKS' INTERMEDIARY ROLE

- Total deposits in banking industry of Rp 3,434.6tn and 8% reserve requirement at BI equaled to Rp 274.8tn in absolute amount of reserve requirement for 2014. The actual amount of placement at BI was Rp 569.0tn. That means the amount was in excess of Rp 294.3tn, increasing from Rp 264.5tn in 2013.
- The tighter liquidity and extra prudent stance taken by the central bank during 2014 meant BI requiring additional liquidity tools on top of conventional reserve requirements. For smaller banks, it meant that they had to forego additional lending on the expense of better protection in liquidity. The by-product was the lower margin as placement at BI only yielded marginal interest.
- Externally, the domestic bond market also underperformed in 2014, down further in amount of issuance to Rp 45.3tn after prior year's decrease to Rp 58.6tn. Bond market is considered as alternate interest bearing funding source for businesses, aside from to bank loans.

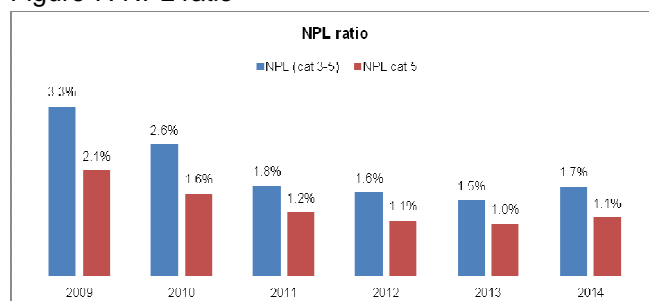
ALERT ON LOAN QUALITY

Looking at the development on the loan quality which categorized as below :

- Category (Cat) 1: Current,
- Cat 2: Special mention,
- Cat 3: Substandard,
- Cat 4: Doubtful,
- Cat 5: Loss,

The quality of bank loans (here represented by earning assets to be exact) has seen deterioration. NPL of earnings assets recorded at 1.7% in 2014, deteriorating from 1.5% prior year. Meanwhile, NPL by total loans was 2.2%, rising from previously 1.8%. This concern is paramount as per ICRA Indonesia's view.

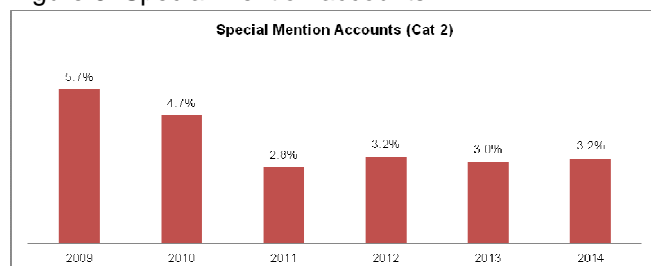
Figure 7: NPL ratio



Source: Bank Indonesia (processed)

- Macroeconomic pressures overspilled to general economic activity purchasing. Slowing business activity on account of cyclical political instability and increasing costs also added to that pressure.
- The same applies to development in special mention (Cat 2) account which saw an uptick in 2014.

Figure 8: Special mention accounts



Source: Bank Indonesia (processed)

- Even as the banks were on conservative stance, both slowing credit growth (which served as fewer denominator) and increasing credit overdues contributed to weaker NPL condition. NPL grew for almost all sectors.
- The tightening in property sectors showed a positive effect as although NPL in real estate related business grew, the same compared to banks' total loan can be kept stable at 0.1%.

Table 4: NPL by sectors (top) and NPL by sectors compared to total loan (below)

Loans by Origin	NPL to its own loan			
	2011	2012	2013	2014
Wholesale and Retail Trade	3.33%	2.54%	2.47%	3.18%
Processing Industry	3.41%	2.35%	1.73%	1.86%
Others -- household	1.18%	0.95%	0.89%	1.00%
For Home Ownership -- household	1.86%	2.08%	2.15%	2.16%
Non Industrial Origin Others	1.83%	1.65%	1.56%	1.11%
Real Estate, Business, Ownership, and Business Svc	1.52%	1.62%	1.80%	2.05%
Agricultures, Hunting and Forestry	1.39%	1.83%	1.44%	1.80%
Transportation, Warehousing and Communications	2.45%	2.06%	1.96%	3.21%
Financial intermediaries	0.29%	0.15%	0.28%	0.94%
Mining and Quarrying	0.34%	1.24%	1.51%	2.52%
Construction	3.80%	3.55%	4.09%	4.61%
For Vehicles Ownership -- household	0.94%	1.10%	0.81%	1.07%

Loans by Origin	NPL to total loan			
	2011	2012	2013	2014
Wholesale and Retail Trade	0.57%	0.47%	0.48%	0.69%
Processing Industry	0.53%	0.39%	0.30%	0.37%
Others -- household	0.06%	0.10%	0.08%	0.11%
For Home Ownership -- household	0.15%	0.16%	0.18%	0.20%
Non Industrial Origin Others	0.20%	0.11%	0.11%	0.06%
Real Estate, Business, Ownership, and Business Svc	0.08%	0.09%	0.11%	0.10%
Agricultures, Hunting and Forestry	0.07%	0.10%	0.08%	0.12%
Transportation, Warehousing and Communications	0.11%	0.09%	0.10%	0.17%
Financial intermediaries	0.01%	0.01%	0.01%	0.05%
Mining and Quarrying	0.01%	0.05%	0.06%	0.11%
Construction	0.13%	0.13%	0.14%	0.21%
For Vehicles Ownership -- household	0.05%	0.04%	0.03%	0.04%

Source: Bank Indonesia (processed)

TOP 10 BANKS AS PROXY

- Top 10 banks are commonly used to serve as a proxy of the overall industry and also as a point to check if there is any material deviation from the general trend or any extraordinary skewness spotted.
- This is based on the logic that as of 2014 the aggregate asset size of these 10 banks represented 62.1% of the system's assets in 2014 (61.6% in 2013).

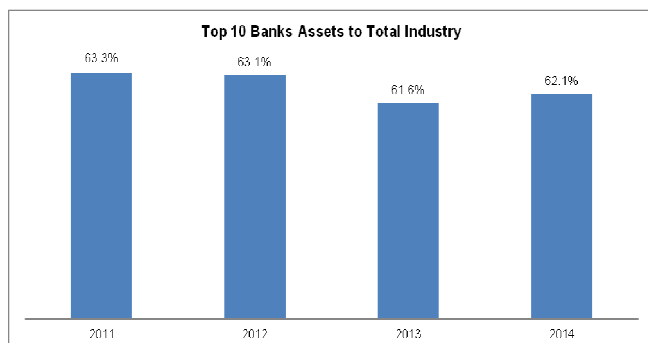
Table 5: Top 10 banks' financial snapshot

		Total Asset (Rp tn)	Total Loans (Rp tn)	Total Deposits (Rp tn)	Net income (Rp tn)	CAR	NPL	LDR	Market Cap (Rp tn)
1	Bank Mandiri	757.0	475.3	576.3	19.4	16.6%	2.2%	82.0%	248.9
2	BRI	778.0	490.4	600.4	24.2	18.3%	1.8%	81.6%	284.5
3	BCA	542.0	347.0	447.9	16.0	16.9%	0.6%	77.4%	320.4
4	BNI	393.5	262.6	299.0	10.5	16.2%	2.0%	87.8%	112.6
5	CIMB Niaga	226.9	170.0	175.0	2.6	15.4%	3.9%	97.1%	20.8
6	Danamon	163.2	109.6	117.2	4.4	17.9%	2.5%	93.5%	42.9
7	Permata	185.1	120.6	135.7	1.6	13.6%	1.7%	88.9%	17.7
8	Panin	159.0	109.6	121.1	2.0	17.3%	2.1%	90.5%	27.8
9	BII	135.1	98.1	102.3	0.4	15.7%	2.2%	95.9%	14.0
10	BTN	144.6	115.9	106.5	1.1	14.6%	4.0%	108.8%	12.6
		3,484.4	2,299.1	2,681.4				85.7%	

Source: banks' respective financial reports

- The gross NPL varies, but overall the levels were rising with 8 of 10 banks experiencing higher NPLs (only BNI and BTN have seen lower NPL).
- BTN normally being the bank with the highest NPL given the special mandate that it carries to finance the national housing needs. However, in 2014, not far behind, CIMB Niaga has seen its NPL almost catch up with BTN to 3.9% from 2.2%.
- The aggregate LDR from the top 10 banks amounted to 85.7%, below the overall industry. It is evident that Bank Mandiri and BCA have enjoyed relatively low LDR as a result of being transactional banks, while BRI has to forego that status despite the high deposit due to the mandate to finance MSMEs. BRI's MSME portion of the total loans led to 43.8% (up 2.1 percentage points from 2013), far higher than all the competitors -- for instance Bank Mandiri only 6.9% and up just 0.3 percentage point from a year earlier. On the other end of spectrum, BTN is the highest in terms of LDR (in addition to the highest in NPL) because of the housing backlog that keeps building up.
- Market capitalization-wise, BCA held the number one spot, far outweighed Bank Mandiri and BRI as it had (and still has) the highest share price and also the second highest shares outstanding after BRI. Being the most funded bank helps BCA to remain cost-effective (its total deposit to total asset reached 82.6%).

Figure 9: Top 10 banks' assets' percentage to total banking industry



Source: Bank Indonesia

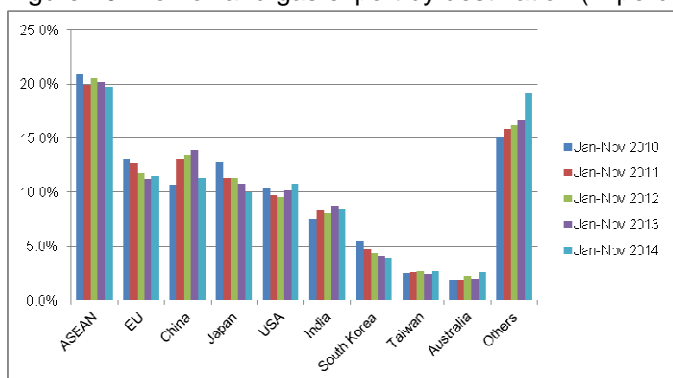
- Total loans of these top 10 banks grew by 11.6% mimicking the industry. This is compared to 21.9% of top ten banks as against 21.6% of the industry in 2013.
- Total deposits grew by 12.2%, also the same as industry. In 2013, it was 14.5% as against the industry's 13.6%. These top 10 banks held 62.6% and 65.2% shares of total loans and total deposits of the industry, respectively, an exact set of portions as in 2013.

EXPECTATIONS FOR 2015

There are several factors that would affect banking sector in 2015:

1. Subdued macroeconomic environment is expected to persist as adjustments to new regime proved to be more time consuming than expected.
2. The threat of weakening Rupiah becomes more apparent. The inflation, however, is expected to be softer than 2014 despite the plan to increase electricity tariff. Thus the threat of significant interest rate step-up is more tentative to external development.
3. Unstable condition of main export destinations, in particular China, has raised concern over the export performance which in the past has been the driving sector of growth.

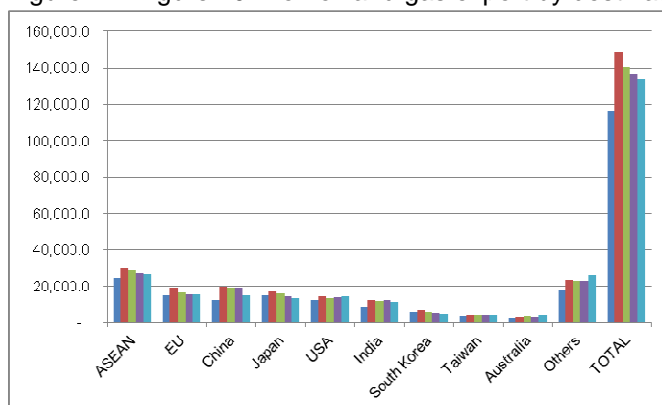
Figure 10: Non oil and gas export by destination (in percentage)



Source: BPS (processed)

The total performance of exports has weakened over the last two years, first as the commodity prices dropped and second as the global economic recovery has not happened quickly. The improvement in US economy has yet to see any sustainability and China has seen its growth expectation to be moderated. Euro zone, meantime, has to deal with Greece issue again. Aside from the exporting point-of-view, the continuing stimulus from Japan plus new stimulus implementation from European Central Bank could shed some light on the domestic investment condition.

Figure 11: Figure 10: Non oil and gas export by destination (in absolute terms)



Source: BPS (processed)

4. We expect the loan growth in 2015 to recover slightly to 13-15%, due to numbers of uncertainties provided that can put most business on the back foot. Domestically, we expect some degree of adaptational phase towards new regime of government and its policies, while global factors such as possibility of Fed interest rate increase, economic and demand pull conditions of major industrial countries and availability of economic stimulus in some other countries or regions, also come into play. LDR therefore would not see a major swing from 89% while NPL can see some pressure to keep at 2.0-2.5% level.
5. Capital adequacy remains in check as central bank closely monitors and can stipulate more liquidity reserve and other macro prudential measures such forex loan hedging. CAR would remain strong at 17-19% while interest margin is expected to stabilise around 4.0-4.5%.

OVERALL CREDIT QUALITY OF BANKING SECTOR

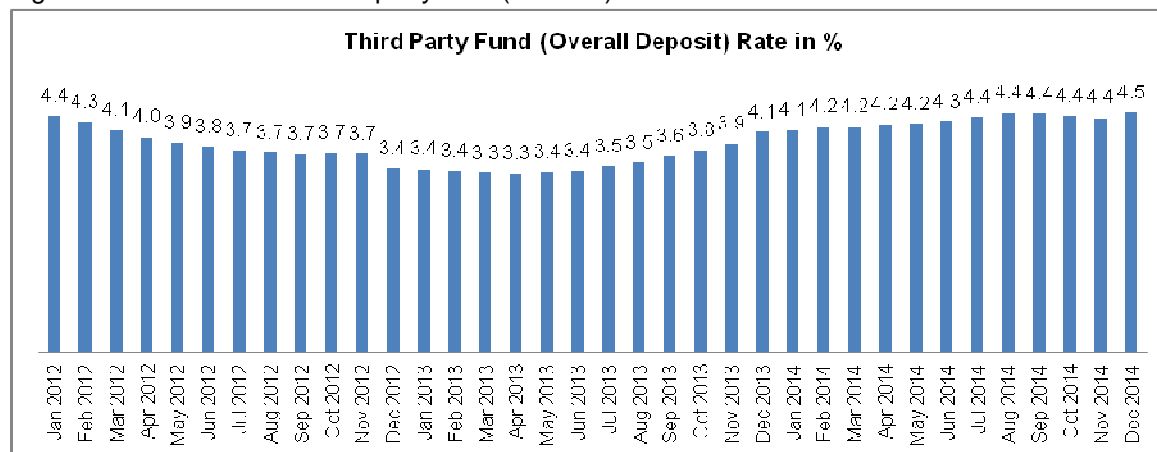
Table 6: Banking industry's indicators

	2009	2010	2011	2012	2013	2014
CAR	17.4%	17.2%	16.1%	17.4%	18.1%	19.6%
Gross NPL	3.3%	2.6%	2.2%	1.9%	1.8%	2.2%
Net interest margin (NIM)	5.6%	5.7%	5.9%	5.5%	4.9%	4.2%
Net profit (Rp tn)	45.2	57.3%	75.1	92.8	106.7	112.2
LDR	73.0%	75.5%	79.0%	84.0%	89.9%	89.3%

Source: Bank Indonesia

Banking industry seems to stumble against strong headwinds in 2014. The profitability got impacted by the squeezed spreads starting in mid 2013. This was a result of increased market interest rate that saw the increase in funding rate cannot be directly matched by the increase in lending rate. Meanwhile, LDR stabilized more on the account of dampened loan growth.

Figure 12: Interest rate of third party fund (blended)



Source: Bank Indonesia (processed)

- The macroeconomic outlook for 2015 seems to be volatile. The headwinds were more impactful than expected in 2014, and it will continue to spill into 2015. The depreciating Rupiah, new policy in setting oil prices, new tax regime and higher operating costs (e.g. increases in electricity tariffs and wages) for businesses would be key challenges for 2015, after 2014 has seen a further depreciating Rupiah, weak trade performance and current account deficit, and market wary during the election period.
- The consolidation in the industry has not happened significantly in 2014, with no significant merger going on. We expect the similar scenario to broadly happen in 2015, given limited incentive and burdens in merger and acquisition process.
- As to the course of regulator to adopt Basel III, current standing in banking industry's capitalization poses no imminent issue. As the overall CAR stood higher to 19% as of December 2014 and 21% in January 2015, the required additional reserve imposed by Basel III would not lead to any difficulty for the banks. However, we would like to see how the actual full implementation of Basel, starting from Basel II play out as the ASEAN Economic Community (AEC) draws closer to the realization. It is also of our concern that AEC issue should lay out the competition map as Indonesia would be the most lucrative market given its demography and consumption appetite.

SUMMING UP

In 2014, bank loans again posted a slower growth, this time in significant fashion, as it fell way below our range of expectation. The effect of 2014 being a political year was more severe to business activities than expected and the problem was compounded with trade deficit which then overflows to the weakening Rupiah.

Table 8: Loan orientation

	2011	2012	2013	2014
Export oriented loans	1.9%	1.8%	1.9%	1.7%
Import oriented loans	1.0%	1.4%	2.1%	1.5%
Others	96.9%	96.8%	96.0%	96.8%

Source: Bank Indonesia (processed)

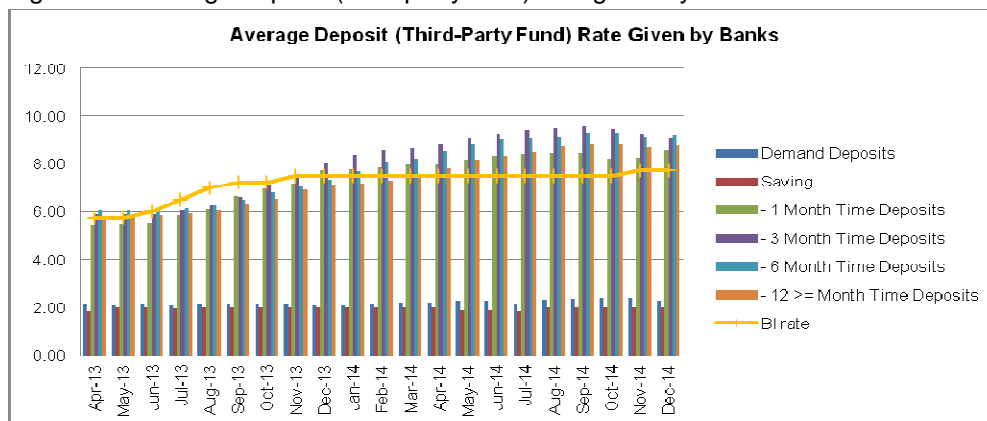
The export oriented loans has decreased in 2014, along with even weaker import oriented ones, due to weakening currency and result of Government's step to imposed stricter import policy, putting higher tax and customs over several items, mostly luxury ones.

However, it is expected that there will be infrastructure development happening in short horizon and import oriented loans that geared towards capital goods' financings can drive up the figure, whereas

exporting activities still seek to find a soft spot in international markets due to slump of price of commodities.

Banks in 2014 faced challenges affecting its NPL and NIM, while CAR and LDR remains strong and at conducive levels. The macroprudential measures, which includes curbing in types of loans, this time added pressure to banks' disbursements as a trade-off to curbing further NPLs.

Figure 13: Average deposit (third-party fund) rate given by banks

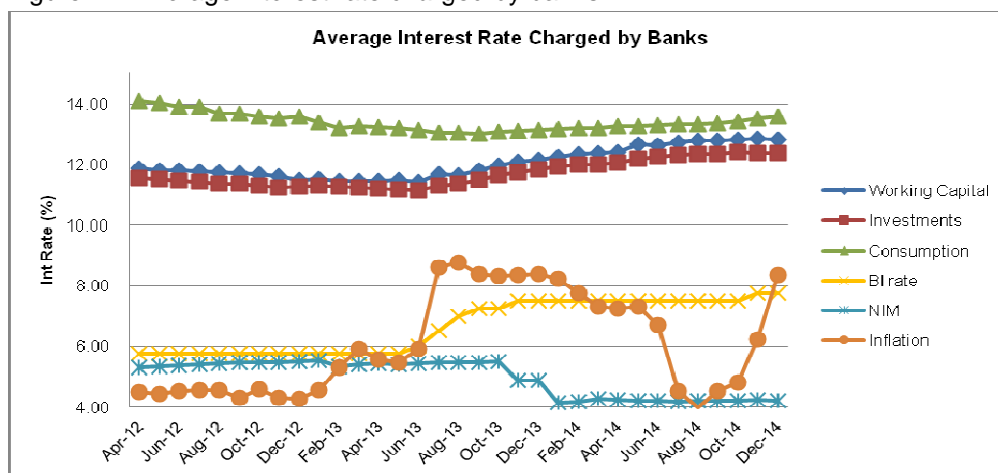


Source: Bank Indonesia (processed)

Deposit rate started to increase rapidly in mid 2013, while demand deposits and savings rate had been more stable, giving way to the top 5 banks (which mainly are deposit attractors by nature) to remain unaffected much. Meanwhile, smaller banks have to deal with higher funding rate which eroded their NIMs

Banks seemed to reduce the effect of inflation by setting stable to lower consumption loan's interest rate. In effect, they compensated it by charging higher to productive sectors' loans (i.e. working capital and investment loans). This increase in charge also to compensate NPLs generated as discussed in the above section.

Figure 14: Average interest rate charged by banks



Source: Bank Indonesia (processed)

Inflation was not the headlining issue in 2014, however heat over political scenes has put a brake on many economic activities. Slowing main export destinations was also not helping to the cause. We had witnessed the same underdisbursement happened in non-banking financing companies also. So both wholesale and retail market got affected the same way in 2014.

The 2015 hopefully would pick up what's relatively dormant in 2014. Our view of growth will take a breather due to the 5-year election cycle, and economic growth is posed to get slowed down in emerging countries, became valid. Moreover, for 2015, we expect no significant growth will occur as the catalyst would be limited. Most of the economic reform will either be still in the draft board or take time before showing any real impact to boost the economy.

Overall, based on the above estimates and assumptions, we expect total bank loans to grow by 13-15%, a slight recovery from 2013. It is expected that domestic consumption will still prevail, investment loans will start to pick up as government repeatedly emphasized on the urgency of infrastructure development. Our expectations also include NIM of 4.0-4.5%, CAR of 17-19%, LDR around 89% and NPL of 2.0-2.5% for the course of 2015. Liquidity will be maintained, with government actively seeking source of funding and bilateral swaps and introducing more integrated repo markets among banks. Central bank can also require additional liquidity tools should the need arise.

However, new fuel price setting mechanism will pose new form of uncertainty as we usually underestimate its effects to the inflation. Increasing wages also poses a challenge to the business, especially SMEs, which in some way becomes contradicting efforts between increasing level of welfare versus keeping level of unemployment low. Relaxation of mineral and mining law along with development of smelters could assist in regulating the trade balance and domestic currency in the mid-term.

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