



Assessing the Impact of Bank Indonesia's New Policy: Linking Reserve Requirement Ratio to Banks' Loan-to-Deposit Ratio

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Summary

- To boost lending, Bank Indonesia (BI) recently released a policy under which banks with relatively low loan-to-deposit ratio (LDR) or high LDR but insufficient capital adequacy ratio (CAR) starting from March 2011, will be penalized with higher reserve requirement (RR) ratio.
- A similar policy implemented in 2005-2006 did not work out well, as banks opted to increase their RR instead of loans, given the unfavorable market conditions prevailing at that time.
- Although macro- and micro-economics conditions have improved since 2005-2006, our tests lead us to the view that the affected banks may be more inclined to pay the additional RR than to increase their LDR. Not only the implementation deadline is too close for affected banks to make any significant adjustment, the new rule will not really affect the majority of the banks in the industry (their LDR level is already higher than the minimum stipulated).
- The ineffectiveness of the new policy will be worsened further by the increase of RR by 3%, which was stipulated by BI to take effect in November 2010. Our calculation suggests that about Rp60tn or about two months of loan growth, will be sucked out of the system because of the RR increase.

The policy

The central bank, through a recent press release, announced a new policy/regulation linking a bank's LDR level to its minimum RR in a bid to accelerate system loan growth. However, somewhat more unexpectedly, a new regulation requiring a higher RR to curb inflation was also announced the same day, which we view as counterproductive to the new LDR regulation. In this paper, we try to assess two issues:

- (1) The likely impact of the new LDR regulation on the affected banks
- (2) The significance of the impact of the new LDR regulation on total loan growth in the system

What the new regulation is like

Banks are required to maintain a daily balance with BI equaling a minimum of 10.5% of their Rupiah third party funds (TPF), specified as follows:

- (a) 5% (from previous policy) + 3% (new policy) statutory reserves consisting of a current account balance held at BI
- (b) 2.5% secondary reserves in the form of BI Certificates and/or Government Bonds and/or a current account balance held at BI
- (c) BI will not provide any remuneration (interest) on the first 5% current account balance held at BI, while the additional 3% will be rewarded with 2.5% interest per annum
- (d) Related to point (a), any bank with a balance less than 8% will not get 2.5% interest per annum
- (e) LDR of banks outside the range of 78-100% will need to add RR according to the following formula:
 - (i) If LDR is below 78%, the additional RR = $0.1 \times (78\% - \text{LDR}\%) \times \text{Rupiah TPF}$
 - (ii) If LDR is above 100% and CAR below 14%, additional RR = $0.2 \times (\text{LDR}\% - 100\%) \times \text{Rupiah TPF}$
 - (iii) If LDR is above 100% but CAR is above 14%, no additional RR required.

A lesson from a similar policy in the past

In September 2005, in a bid to accelerate system loan growth, BI implemented an RR regulation related to LDR in addition to the RR regulation that was still effective at that time. The highlights are as follows:

- (a) Banks with LDR >90% will be required to add RR equal to 0% of Rp TPF
- (b) Banks with LDR >75% <90% will be required to add RR equal to 1% of Rp TPF
- (c) Banks with LDR >60% <75% will be required to add RR equal to 2% of Rp TPF
- (d) Banks with LDR >50% <60% will be required to add RR equal to 3% of Rp TPF
- (e) Banks with LDR >40% <50% will be required to add RR equal to 4% of Rp TPF
- (f) Banks with LDR <40% will be required to add RR equal to 5% of Rp TPF
- (g) For these additions to reserve, BI will pay interest on the balance at the rate of 5.5% per annum

Impact of the September 2005 regulation

Loan growth

Loan growth from December 2004 to August 2005 (a month before the RR rule was implemented) reached 19.1%. However, loan growth from August 2005 to December 2005 (after the RR rule was implemented) was only 4.4%.

Current account at BI

Current account at BI contracted by 5.5% from December 2004 to August 2005 (a month before the RR rule was enforced). However, current account at BI from August 2005 to December 2005 (after the RR rule was enforced) grew by 40.3%.

Table I: Loan vs. Current Account Balance Growth

	Loan (Rp tn)		Current account at BI (Rp tn)		
		Growth			
Dec-04	559.5		Dec-04	77.1	
Aug-05	666.5	19.1%	Aug-05	72.9	-5.5%
Sep-05 Implementation of LDR vs. RR			Sep-05 Implementation of LDR vs. RR		
Dec-05	695.6		Dec-05	102.3	
Aug-06	727.9	4.6%	Aug-06	110.7	8.2%
Growth in 3 months after implementation			Growth in 3 months after implementation		
Aug-05	666.5		Aug-05	72.9	
Dec-05	695.6	4.4%	Dec-05	102.3	40.3%

Source: Bank Indonesia

In our view, from 4Q04 to 1Q05, economic conditions were actually quite favorable, supported by the positive sentiment arising from the successful presidential election in 2004. GDP grew by 6.15% YoY in 1Q05 and loans were expected to grow by 20-25% in 2005. However, a dramatic rise in global fuel prices forced the new administration to take the unpopular decision of raising domestic fuel prices twice—in March 2005 (average of 29%) and October 2005 (average of 126%). This caused inflation to shoot up to 17.11%, and GDP growth to report a subdued 5.6% in 2005. BI was also forced to raise interest rates up to as high as 12.75% to contain inflation. Thus, the central bank was actually in a tightening mode at that time. The implementation of the RR rule to boost loans growth during that period therefore appeared somewhat contradictory and poorly timed.

Lesson from the 2005 regulation

BI's drive to accelerate system loan growth by enforcing the RR regulation appears to have been ineffective in the past. More than one year after the implementation of the regulation, loan growth remained lackluster (only 4.6% during the eight-month period since December 2005). The bulk of the loan growth in 2005 was contributed by the growth in the fourth quarter (4.4% from August 2005 to December 2005), which seasonality-wise is normally the best quarter in a fiscal year.

Meanwhile, current account at BI expanded by 40.3% just three months after the RR rule was implemented. The data showed that banks would rather keep their excess liquidity at BI's current account yielding 5.5% per annum (vs. the SBI rate of 10-12.75% per annum) than forcing themselves to extend loans during the unfavorable economic conditions in 2006 as the return would not really be worth the risk. This was sensible as industry-wide the Non Performing Loans NPL ratio during that period reached 8%. This means, with loan provisioning for new loans at 1%, NPL + provisioning were already at 9%, excluding operational cost. As the average loan yield was around 15%, the net yield would only reach 6%, fairly insignificant compared with the 5.5% yield at BI's current account.

Table II: Net Loan Yield vs. BI's Current Account Yield

	Average investment loan yield (%)	NPL ratio (%)	Mandatory provisioning (%)	Net loan yield (%)	Current account at BI yield (%)	Diff in percentage point (%)
	(a)	(b)	(c)	(a-b-c)	(d)	(a-b-c)-d
Sep-05	14.72	7.87	1.00	5.85	5.50	0.35
Oct-05	14.92	7.50	1.00	6.42	5.50	0.92
Nov-05	14.94	7.84	1.00	6.10	5.50	0.60
Dec-05	14.98	7.56	1.00	6.42	5.50	0.92
Jan-06	15.08	7.81	1.00	6.27	5.50	0.77
Feb-06	15.09	8.13	1.00	5.96	5.50	0.46
Mar-06	15.05	8.19	1.00	5.86	5.50	0.36
Apr-06	15.02	8.12	1.00	5.90	5.50	0.40
May-06	15.08	8.38	1.00	5.70	5.50	0.20
Jun-06	15.09	8.33	1.00	5.76	5.50	0.26
Jul-06	15.16	8.42	1.00	5.74	5.50	0.24
Aug-06	15.18	8.35	1.00	5.83	5.50	0.33
Sep-06	15.11	7.95	1.00	6.16	5.50	0.66
Oct-06	15.10	8.25	1.00	5.85	5.50	0.35
Nov-06	15.08	8.09	1.00	5.99	5.50	0.49
Dec-06	14.98	6.07	1.00	7.91	5.50	2.41
Average	15.04	7.93	1.00	6.11	5.50	0.61

Source: Bank Indonesia and ICRA's estimates

Would it be different this time around?

We are aware that the macro- and micro-economic conditions in 2005-2006 were hardly similar to the ones prevailing now. Inflation and SBI rates are much lower at a single digit at present. Banks' asset quality is also much improved. In addition, banks are in a better shape with ample provisioning (>100% of NPL) versus 2005-2006 when at least two of the top 10 banks (Bank Mandiri and BNI) were still struggling under the impact of legacy bad loans. Further, now the government is starting to provide credit insurance (providing compensations for lenders if the loans go bad) for micro loans (KUR), albeit still small compared with total system loans.

We initially did not expect the new ruling would also include increasing the RR, which is somewhat in contradiction with the expansionary motive behind the LDR ruling. For analytical purpose, we will leave out the additional 3% RR rule, which applies to all banks for the time being, and look at the new LDR ruling in isolation. Later on, however, we will briefly look at the net impact of the additional 3% RR rule on the banking system as a whole.

The way we do this is to first look at the top 10 banks by total assets (representing 63.8% of industry as of June 2010) and see who will be affected by the new LDR ruling. Then, we will analyze the affected banks one by one and try to see how they will be impacted.

Table III: Effect of New LDR Rule on Top 10 Banks

Bank	Rupiah LDR (%)	LDR range (%)	Out of the range?	If above range, is CAR below 14%?	Affected?
Mandiri	64.32%	78%-100%	Yes, below		Yes
BRI	93.04%	78%-100%	No		No
BCA	53.10%	78%-100%	Yes, below		Yes
BNI	73.10%	78%-100%	Yes, below		Yes
Niaga	87.62%	78%-100%	No		No
Danamon	102.82%	78%-100%	Yes, above	No. CAR = 15.33%	No
Panin	82.34%	78%-100%	No		No
BII	95.04%	78%-100%	No		No
Permata	91.40%	78%-100%	No		No
BTN	113.90%	78%-100%	Yes, above	No. CAR = 18.71%	No

Source: Company financials and ICRA's estimates

Among the top 10 banks, only three will be affected by the new LDR regulation: Bank Mandiri, BCA and BNI. We try to assess whether these three banks will opt to pay the additional RR, or increase their LDR in accordance with BI's wish.

We will now try to see if the banks' cost of acquiring a new loan will be lower than the cost of paying additional RR. We define the cost of paying the additional RR as the difference between the interest income the banks get from SBI (where they park the excess liquidity) and the interest income from BI's current account, where the banks place the money to pay for the additional RR as penalty for having a lower-than-required LDR. We will also first make sure that the SBI amount already covers 2.5% of the TPF secondary reserve that is required by the central bank.

Table IV: Difference in Interest Income—SBI vs. Current Account

Bank	ldr loan amount (Rp bn)	idr tpf amount (rp bn)	Additional RR (%)	Additional RR amount (rp bn)	SBI owned (Rp bn)	SBI for 2.5% of TPF (Rp bn)	Excess SBI (Rp bn)	Can additional RR be paid by selling excess SBI?	Int income if placed in SBI (6%) - Rp bn	Int income if placed in CA-BI (2.5%) - Rp bn	Difference in interest income
BNI	110,844	151,579	0.49%	743	10,179	3,789	6,390	Yes	45	19	26
Mandiri	180,734	280,983	1.37%	3,844	17,691	7,025	10,667	Yes	231	96	135
BCA	118,973	224,053	2.49%	5,579	60,378	5,601	54,777	Yes	335	139	195

Source: Company financials and ICRA's estimates

As Table IV shows, all the three banks have enough excess SBI that they can re-allocate to pay the penalty (the additional RR) if they have to. The difference in interest income for each of the three banks is less than Rp200bn, with BNI having the smallest amount (Rp26bn) and BCA the largest (Rp195bn).

The next question to answer is whether the cost of acquiring new loans will be lower than the penalty? If the cost of new loans acquisition is significantly higher, it should be safe to assume that the banks will opt to pay the penalty instead, as they will not need to be worried about operational costs, possibilities of loans going bad, weakening CAR, and so on.

Table V: Acquisition Cost of New Loans vs. Interest Income Difference

Bank	NPL (%) of existing loans	Additional loan needed to reach LDR 78%	NPL of new loans (Rp bn)	Provision for new loans (1%)(Rp bn)	Opex of existing loans (Rp bn)	Opex to loans (%)	Opex for new loans (Rp bn)	Acquisition cost of new loans (Rp bn)	int income difference (Rp bn)	Likely to add RR?
BNI	4.30%	7,388.32	318	74	4,537	4.1%	302	694	26	YES
Mandiri	2.18%	38,433.40	840	384	5,773	3.2%	1,228	2,452	135	YES
BCA	0.79%	55,788.31	443	558	5,170	4.3%	2,424	3,425	195	YES

Source: Company financials and ICRA's estimates

Table V clearly shows that the incentive for the three banks to increase their loans is almost nil, given that the cost of acquiring new loans is significantly higher than the lower interest income they have to 'suffer' from having to pay the penalty of additional RR.

The three banks have also been telling the media lately that they plan to increase their lending interest rate to compensate for the lower interest income they get from placing the excess liquidity in BI's current account. We will now try to gauge the extent by which they need to raise their lending rate so as to compensate for the lower yield, and see whether it is possible to do the same without jeopardizing their competitiveness against other banks.

Mandiri and BCA, being relatively heavy in the corporate loan segments, have relatively lower blended lending rates as compared with peers. Further, their cost of funds is also lower by peer comparison because of their strong franchise (people keep their money in Mandiri and BCA mainly for perceived safety and convenience in transactions). This suggests that the three banks should be able to raise their lending rates and remain competitive against peers. Thus, if they opt to pay the additional RR instead of increasing loan disbursements, the banks will actually be able to pass on the additional charges to customers.

Table VI: Lending and Deposit Rates of BCA and Mandiri against Market

Rupiah Investment credit effective interest rate (%)	Rupiah time deposit rate 1 month (%)
Average of all banks 14.3%	Average of all banks 6.5%
BCA 12.8%	BCA 5.3%
Mandiri 13.6%	Mandiri 5.4%

Source: Kontan daily, 8 September 2010

By comparing the rates of investment credit and time deposit of BCA and Mandiri with the industry average, we see that both banks' investment credit interest rates are lower by 70-150bps. Also, given their strong deposit franchise, their time deposit rates are 110-120bps lower than the market rates.

We will now estimate by how many basis points the three banks will need to increase the rate of their existing loans to compensate for the lower interest income because of the penalty. If the increase is of a magnitude less than 70bps as indicated by the above differentials, it may be concluded that the move would be feasible and should not significantly affect their market competitiveness.

Table VII: BPS Increase needed to offset Lower Interest Income

Bank	int income difference (Rp bn)	Existing loans amount (Rp bn)	lending rate increase needed (bps)
BNI	26	110,844	2.3
Mandiri	135	180,734	7.4
BCA	195	118,973	16.4

Source: Company financials and ICRA's estimates

Table VII shows that Mandiri will need to increase the lending rate for its existing loans by only 7.4bps (0.074%) while BCA would have to effect a 16.4bps (0.164%) increase. Given that their blended lending rates are about 70bps to 150bps lower than the market rate, we may conclude that raising the lending rate even by the maximum 16.4bps to compensate for the penalty should not be a problem for either.

These two simple tests then confirm the view that it would be much easier and safer for the three banks—BNI, Mandiri and BCA—to pay the penalty and just pass on the additional RR charge to their customers rather than making efforts to increase their LDRs.

Impact of the additional 3% RR

Along with the new LDR stipulation, BI has also released a new ruling on RR, requiring banks to deposit an additional 3% with BI, so as to curb inflation. Looking at the June TPF position of the banking system as a whole at around Rp2,000 trillion, charging an additional 3% will take out some Rp60 trillion in cash from the system. This makes the new RR rule somewhat counterproductive to the new LDR rule as banks with a tight liquidity position already may need to put a brake on their loan expansion plans.

Bearing that in mind, BI's target of 24-25% loan growth in 2010 may also be at risk of not being achieved. Loans from December 2009 to June 2010 expanded by some Rp148 trillion or about Rp25trillion per month. Assuming the monthly growth rate will stay the same until the end of 2010, loans will expand by Rp300trillion in 2010—a 21% annual increase. Our tests have shown that the new LDR rule is unlikely to "produce" any additional loans. In fact, the new RR rule, which would soak up some Rp60trillion from the system, could actually decelerate loan growth in 2010.

Table VIII: Estimated Loan Growth for 2010

Before new RR rule	
Loans outstanding (Rp tn)- Dec 2009	1,438
Loans outstanding (Rp tn)- June 2010	1,586
Monthly loan expansion rate (Rp tn)	25
Est. loan outstanding - Dec 2010	1,735
Estimated loan growth (%)	21%

Source: Bank Indonesia, processed

Impact of the new LDR rule on loan in 2011

Importantly, implementation of the new LDR rule will take effect only in March 2011. So, it is actually more relevant to see the impact of the new LDR rule on loan growth in 2011. Going by the conclusion we have for 2010, a bank's decision to extend loan or not will still depend largely on the eligibility of the debtors or projects to be financed rather than the disincentive arising from the LDR-RR rule. The factors encouraging banks to increase loans would include economic growth, which Government expects will be a robust 6.3% in 2011 (vs. 5.8% in 2010); low inflation level—expected to remain at 5.3% (vs. 5.3% initially targeted in 2010); and rollout of some infrastructure projects in 2011.

Conclusion

We would expect banks to pay the additional RR rather than increase their LDR in response to the new LDR rule, just as it had happened in 2005-2006, although the rationale was different at that time.

Our view draws mainly on the fact that the new rule will affect only a small number of banks with a specific loan/deposit structure that would make them more inclined to pay the additional RR than to increase their LDR. Besides, the implementation deadline is too close for them to make any significant adjustments to comply to the rule.

In fact, the ineffectiveness of the new policy will be worsened by the accompanying 3% increase in the RR ratio as stipulated by BI. Our brief calculation suggests that about Rp60tn, or around two months of loan growth, would be absorbed from the industry, thereby adding to BI's challenges in realizing its loan growth expectation of 24-25% for 2010. As for 2011, loan expansion that year would be driven more by the readiness and attractiveness of the debtors rather than the new LDR rule.

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