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Banking Outlook in 2023: Steady Going Into Election Cycle

Executive Summary

The banking growth in 2023 has been relatively even across all Commercial Banks Group of Core Capital (Kelompok Bank berdasarkan Modal Inti or KBMI), unlike last year which was driven mainly by KBMI-4 banks. Lower-tier banks have been able to post more encouraging growth, attributed to a more stable business environment after the pandemic.

Inflation in United States is expected to moderate, and we expect the Fed to stop raising interest rates, alleviating the pressure on the local policymaker in increasing the Bank Indonesia (BI) 7 days repurchase rate. The decision to maintain the rate is also bolstered by domestic inflation that remains in check. This also partially lifts the risk of a decrease in price for the government bond and central bank instruments that made up the bulk of investment book in the banks. The risk of the ever-increasing interest rate of risk free instruments was evident where The Silicon Valley Bank's default is an eye-opening case where the assumed risk-free instruments still pose liquidity and price risk during the rising interest condition. However, the domestic interest rate movement is still manageable, and therefore we view that the liquidity position of the banking industry is relatively ample, supported by the placement in risk-free instruments such as government bonds, placement in central banks, and moderate loan to deposit ratio.

Concern about asset quality is also moderated by the improvement in general economic condition, assisted by the recovering mass mobility that practically recovered to the level near the pre-pandemic era. President Joko Widodo also stated the Covid-19 pandemic status was over in his speech in June 2023. Credit relaxation is not entirely revoked, giving added breathing room to several lethargic labor-intensive sectors such as footwear and accommodation, as well as micro small medium segment.

Maintained Overall Loan Growth, More Evenly Distributed Across KBMI

Overall loan growth shows a more even recovery compared to last year as shown in the graph below. The deviation becomes narrower between KBMIs. Even though the KBMI-4 banks will continue to do the largest pull in the industry's growth, due to their very large size in nominal, but the trend shows that lower KBMIs were also able to grow their lending portfolio which means the pool of acceptable debtors has gradually become larger.

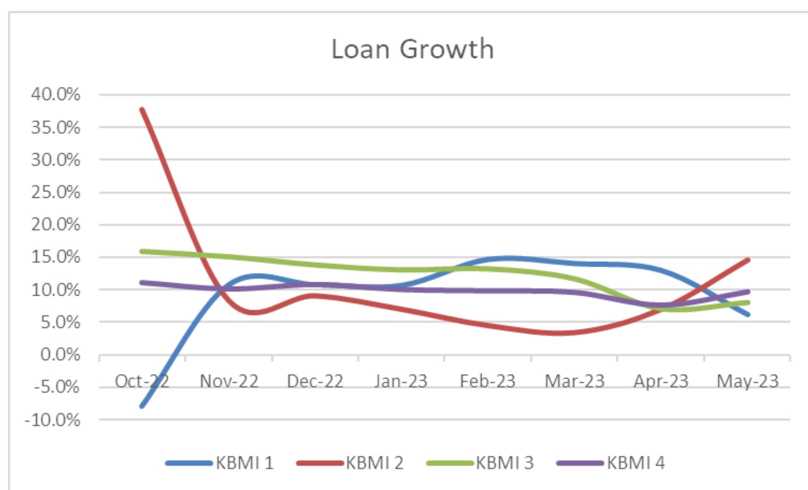

Figure 1 – Loan Growth Across KBMIs (source : OJK statistics)

	Year on year loan growth as of 5M2023
Total	9.4%
KBMI1	6.2%
KBMI2	14.6%
KBMI3	8.0%
KBMI4	9.7%

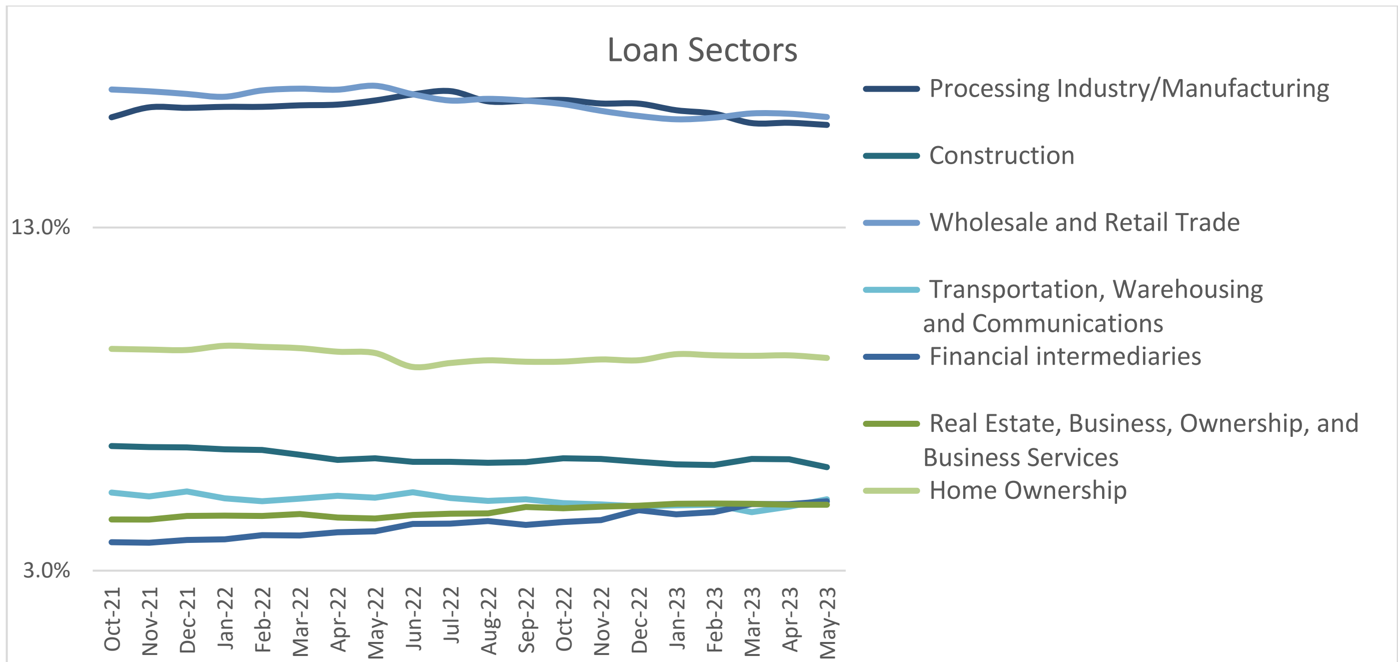

Figure 2 – Sectoral Contribution to Lending as of May 2023 (source : OJK statistics)

In terms of sectors, manufacturing and construction still dominated the overall lending portfolio. We view that going forward the sectoral composition will remain relatively unchanged.

We note several key challenges that are geopolitical and global risks where it send a signal of stagflation that is caused by a number of factors such as political tension in Europe, slow and unstable economic recovery in US, as well as high debt and property bubble in China that impeded its economic growth. In addition, Indonesia's upcoming general election may affect the credit growth moderately, as business owners are likely to hold further major expansion, considering the probability of change in policy that may affect operational aspects of their businesses. However, overall, we view that the risk of loan contraction is limited, given the expectancy of continuous gradual improvement of the domestic business environment in medium term and lesser probability of significant increase in interest rate that at the end should be more direct in its effect to the lending growth.

Ample Liquidity During the Recovery Period
The banking industry's liquidity will likely remain ample in the short term given the banks' selective loan disbursement approach and the significant trust of the corporations and the public to place their deposits in the banks well after the pandemic resides. Banks have also continued to build up their capital base to meet the regulatory requirement of IDR3 trillion in core capital, which is amplifying the banks' liquidity positions amidst the low loan growth period.

A high capital adequacy ratio and a moderate loan to deposit ratio in general means that many banks had an opportunity to recompose their funding profile to manage their cost of fund amid the higher interest rate environment, as well as preparing for the possible of further interest rate increase if that happens.

However, the size of the bank seems to play a part in the ability to collect deposits; even with maximum deposit's interest rate is capped based on KBMI classification, KBMI-3 and KBMI-4 banks still recorded higher deposit growth than KBMI-1 and KBMI-2. Our view that the expected increase in interest rates in 2022 will cause some shift from low-interest-bearing deposits (current and saving accounts) to a more renumerated product (time deposit and capital market instruments) turned out to be just partially true as

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depositors still prioritized safety and comfortable transactional features from banks, resulting in minimum to manageable impact to the banks' liquidity positions.

	% of industry's total deposit
KBMI1	12.6%
KBMI2	11.3%
KBMI3	25.0%
KBMI4	51.1%

Table 1 – Composition of Third Party Deposit as of May 2023 (source : OJK statistics)

Lower KBMI banks (KBMI-1 and KBMI-2) experienced more pressure in their CASA composition, due to higher funding needs to fuel their credit growth.

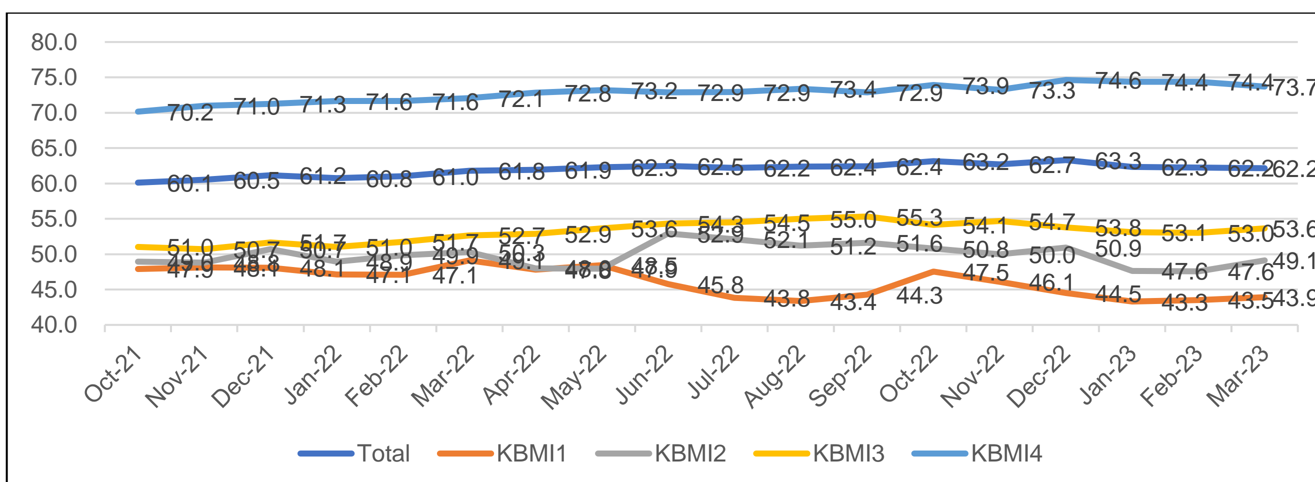

Figure 3 – CASA percentage (source : OJK statistics)

Continued Presence of Ample Capitalization

Despite an improving trend of lending growth rate, we view that banks' capitalization profile remains high and still more than sufficient to absorb risk. The capital adequacy ratio (CAR) was stable at 26.1% as of 5M2023 (compared to 24.7% a year earlier), with CAR tier 1 at 24.5% compared to 23.1% at those periods, partly attributed to the shareholder injection to meet required core capital and recovering bottom line.

Capitalization has continued to solidify the Indonesia's banking industry, and in the past has contributed to the industry's resilience during several crises after 1998. Therefore, despite the expected increase in risk-weighted assets from business growth and risks coming from global issues and domestic election cycle, we expect the maintenance of strong capitalization of the Indonesian banking industry is unlikely to change materially.

Profitability Driven by Funding Costs

Operational costs to operational income ratio (BOPO), which includes provisioning, shows a slight improvement except in January 2023 that showed a hike after significant provisioning following a non-current account of a state-owned construction company.

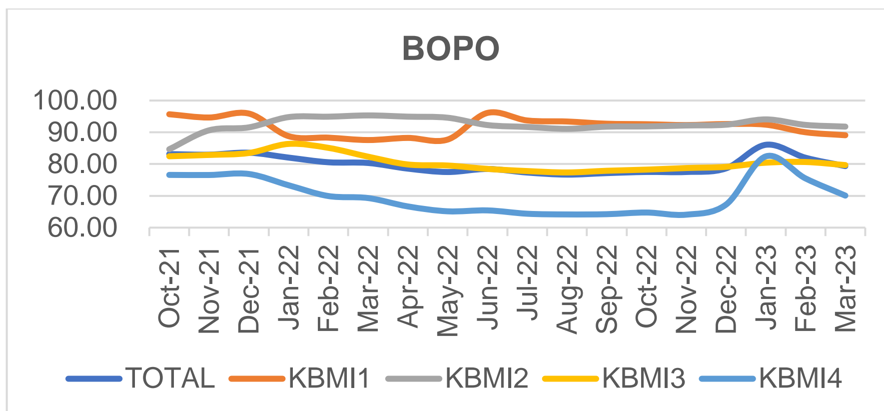

Figure 4 – BOPO by KBMI (source : OJK statistics)

The BOPO ratio trend depicted above shows that the end of relaxation period did not affect the quality of provision significantly, meaning that the Covid-related restructures had largely progressed as planned, in addition to the fact that some sectors and segments are given extension in the relaxation period.

Moreover, despite intense competition, the banking industry generally has continued to generate stable revenue due to the improving overall domestic economy. As such, we expect a stable to slightly better net interest margin (NIM) despite the possibility of further rising interest rate environment. For large banks (mainly KBMI-4 banks), fee revenue will continue contributing significantly to their income profile.

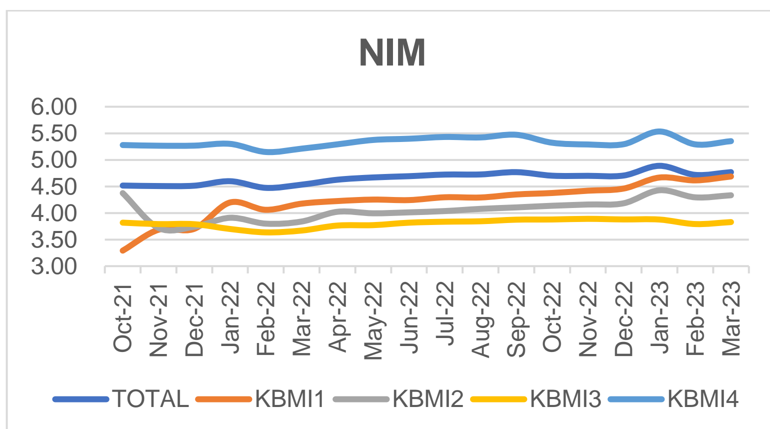

Figure 5 – Net Interest Margin by KBMI (source : OJK statistics)

Despite intense competition to acquire debtors that meet the risk acceptance criteria, the pool of quality debtors or projects is gradually getting more prominent. However, we still maintain our view that the average NIM is still most likely to be around 4.7% in near term, because of the funding cost pressure in non-KBMI 4 banks, and the preference of most KBMI-3 banks to look for quality similar to KBMI-4's target market at the expense of margin.

Improving Asset Quality Despite Less Relaxation

As of 5M2023, the non-performing loans (NPL) ratio of the banking industry has improved notably to 2.5% compared to 3.0% in FY2022 and FY2021, and 3.1% in FY2020, despite the retraction of relaxation of loan classification norms. That retraction excludes specific sectors and segments, such as footwear and accommodation, resulting in a potential increase of NPL ratio upon the planned retraction of loan relaxation in March 2024, as many banks still have notable exposures in those sectors and segments. We note that

accommodation accounted for around 1.9% to 2.0% of total lending portfolio in the industry, and MSME accounted for 20% to 21% of total lending portfolio, while no specific data on footwear sector.

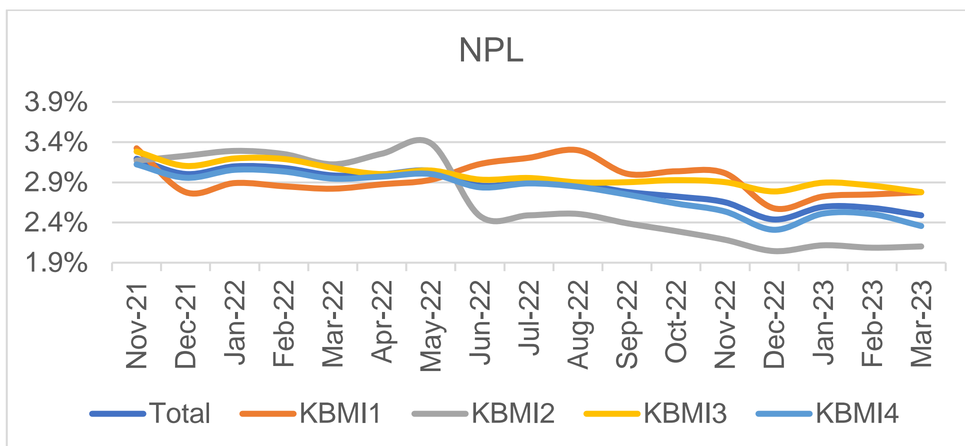

Figure 6 – NPL by KBMI (source : OJK statistics)

We consider the Indonesian government very supportive of the nation's banking system. We believe it is highly likely that the government will provide timely financial support to systemically significant institutions in the country to ensure the financial system's stability. The Financial System Stability Committee (Komite Stabilitas Sistem Keuangan or KSSK), which consists of the Ministry of Finance, BI, Financial Services Authority (OJK), and Deposit Insurance Corporation (LPS), implements policies to support banking industry liquidity, maintain banking performance, and maintain public confidence in the banking industry under their respective authorities.

The authoritative figures provided supportive policies; with BI adopted a moderate interest rate increase policy despite aggressive interest hikes in the US, maintaining stable exchange rate. In addition, OJK issued an extension in restructuring policy for selective sectors and segments, and LPS established a low guarantee rate and eased penalties for late payment of guarantee premiums during the height of the pandemic period.

With the support of these diverse policies, we view that the industry should be able to tread through near term challenges, particularly in the form of election cycle and the global economic backdrop that has yet to instill stability. In essence, we maintain our view that the overall lending growth should be on track to reach around 8% to 10% in 2023.