

## Sharia banking outlook: strong business growth but financial profile will remain moderate

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### Small presence in banking system, but strong growth potential

PEFINDO views the outlook of Sharia banking in Indonesia to be stable, given the potential business growth in the near to medium term amid a small asset base. Nevertheless, the growth may not be as high as in previous years due to the unfavorable macroeconomic condition and the tight liquidity in the banking industry. PEFINDO rates three Sharia banks (Bank Umum Syariah or BUS) and all of them have a “stable” outlook. PEFINDO also rates a number of conventional banks that have Sharia business units (Unit Usaha Syariah or UUS).

**Table 1: Published ratings of Sharia banks and top conventional banks which have UUS**

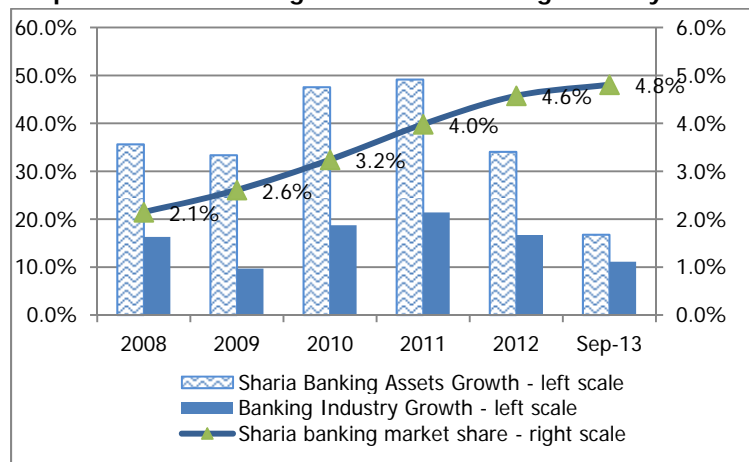
Company	Rating	Outlook
Bank Syariah Mandiri	idAA+	Stabil
BNI Syariah	idAA	Stabil
Bank Muamalat Indonesia	idA+	Stabil
Bank Niaga*	idAAA	Stabil
Bank International Indonesia*	idAAA	Stabil
Bank Permata*	idAA+	Stabil
Bank Danamon*	idAA+	Stabil
Bank Tabungan Negara*	idAA	Stabil

\*Conventional Banks that have UUS

Source: PEFINDO database

Sharia banking assets, which include Sharia banks and Sharia business units, have grown rapidly in Indonesia with a 5-year compound annual growth rate (CAGR, from 2008-2012) of 31.5%, far above the 13% CAGR of the national banking industry's assets during the same period. Nevertheless, the penetration is limited; Sharia banking assets totaled IDR228 trillion at the end of September 2013, or about 4.8% of the national banking industry's total assets of IDR4,737 trillion (see graph 1). The ratio is low compared to other Islamic countries in Asia, such as Malaysia, Saudi Arabia, and Kuwait, where Sharia banking has an average market share of above 15%.

**Graph 1: Sharia Banking vs National Banking Industry**



Source: Bank Indonesia's Banking Statistics

### **Focusing on consumer and retail segments**

The Sharia banking sector has high customer potential in Indonesia, which is the world's most populous Muslim country with a population of 240 million people. The government and Bank Indonesia, as the regulator, have also shown support for the expansion of the Sharia banking industry. The regulator has removed a number of obstacles to Sharia banking, such as double taxation for murabahah transactions and permission to use the networks of parent groups or firms to obtain third party deposits. Leveraging on the networks of parent groups will be beneficial to the Sharia sector, given that its presence is relatively limited compared to conventional ones. The Sharia banking law issued in 2008 also encourages the spin-off of Sharia business units or the establishment of new Sharia banks. Consequently, the number of Sharia banks has increased to 11 as of September 2013 from only three in 2007.

We believe that the demand for Sharia banking – and consequently its share of the national banking industry – will continue to grow. The key driver of growth will be the consumptive sector, which makes up more than 40% of Sharia financing's portfolio. Consumer financing has grown at a compounded annual rate of 46% from 2008 to 2012, compared to 22% for working capital financing and 27% for investment financing. Indonesia has favorable demographics that are supportive of further Sharia consumer-finance demand.

Largely due to a small base effect, growth in Sharia deposits has been more than double that of conventional banks with CAGR of 32% against 13% for the latter. Sharia banking is more reliant on time deposits, which comprise about 60% of total deposits, compared to saving accounts (30%) and current accounts (10%). Current accounts for businesses represented a small share due to the sector's focus on the retail segment and business transactions are still in early development. One advantage the Sharia sector has over its conventional banking counterparts is that its predominantly variable deposit rate is based on a profit sharing scheme, contrasting with the conventional banks' fixed rate deposits. The sector is able to offer higher deposit rates, increasing its attractiveness in terms of fund raising activities.

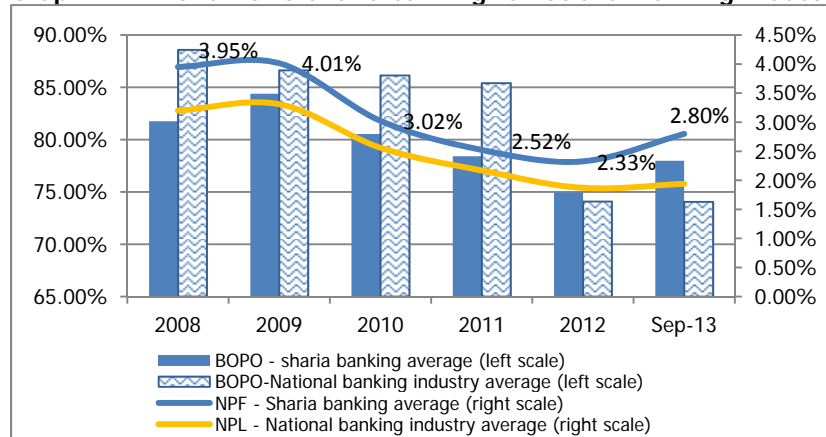
We also note that the recent Ministry of Religious Affairs Regulation No. 30/2013 on hajj fund deposit beneficiaries may have a positive impact on the Sharia banking industry. The regulation states that hajj funds should be managed by Sharia banks or national banks that have Sharia business units. Hajj funds placed in the banks represent around 10% of total Sharia deposits. These funds will be migrated to Sharia banks in 2014. We believe that those funds are relatively stable and will slightly improve the Sharia banking sector's funding mix in the medium term.

From 2008 to September 2013, the total equity of Sharia banks has grown to IDR15.8 trillion from IDR3.1 trillion. Nevertheless, the number is relatively small compared to the national banking industry, which has a total equity of IDR585.3 trillion at the end of September 2013. None of the Sharia banks operated in the BUKU 3 (Bank Umum berdasarkan Kegiatan Usaha) category, defined as having a core capital of more than IDR5 trillion. In the BUKU 3 category, banks are allowed to carry out their entire operations both in Indonesian rupiah and foreign currencies. BUKU 3 banks are also allowed to place equity investments in Indonesia or abroad, limited to the Asian region. We believe that to achieve sustainable growth, Sharia banks should be supported by a strong capital base to allow them to widen their business activities and increase flexibility in corporate actions.

### **Challenges in improving financial indicators**

In spite of the high growth potential, Sharia banks is facing some challenges, particularly in managing financial profiles. In terms of asset quality indicators, Sharia banks fell below the national banking industry average during the past five years. As of September 2013, non-performing financing (NPF) in Sharia banks stood at 2.8%, compared to non-performing loans (NPL) in the national banking industry of 1.9% (see graph 2). About 60% of Sharia financing is disbursed to the micro, small, & medium enterprises (MSME) segment, which has a relatively higher customer risk profile. We are of the view that maintaining good asset quality through a period of rapid growth is a challenge for the sector as well as a potential vulnerability to the industry in the event of an economic slowdown.

**Graph 2: NPF and BOPO Sharia banking vs National Banking Industry**

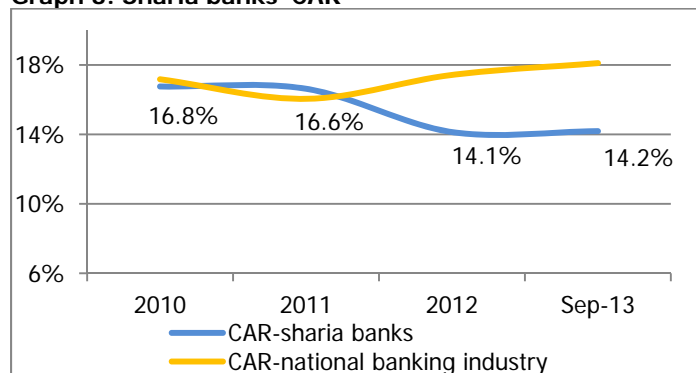


Source: Bank Indonesia's Banking Statistics

Despite Sharia banking's high yield business model, the sector is still struggling to improve its cost efficiency. The high growth strategy adopted by banks in the sector requires them to commit to significant investments to expand their distribution networks. In addition, higher loss provision expenses caused by rapid financing growth has also been a drag on profitability. While the national banking industry is showing an improvement in its operating expense/operating income (BOPO) ratio, the Sharia banking sector's average BOPO is showing an upward trend. The sector's average BOPO ratio stood at 78.0% in September 2013 and 75.0% in 2012, higher than the national banking industry's average of 74.4% and 74.1%, respectively. We expect it will take some time before network expansion will lead to improvements in Sharia banks' earnings profiles and achieve the desired economies of scale.

Another challenge in the Sharia banking industry is its moderate capitalization. Over the past four years, the average capital adequacy ratio (CAR) of Sharia banks ranged from 16.8% (end 2010) to 14.2% (September 2013). A lower CAR indicates that the Sharia banks' rapid expansion came at the expense of capital buffers. These CAR figures are also lower than the national banking industry average, which ranged from 17.2% to 18.1% over the same period (see graph 3). Strong capitalization is highly critical to support rapid financing growth, as average financing to deposit ratio (FDR) has reached more than 100%. Except for Bank Panin Syariah that was listed in January 2014, no other Sharia banks are active in the capital markets, and therefore their capitalization mainly depends on capital injections from their parent groups or sub-debt issuance. This may not be an issue for the Sharia banks owned by strong parent groups that have the financial capacity to support their capitalization. However, we believe it will require a higher capital base to maintain the Sharia banking sector's strong growth.

**Graph 3: Sharia banks' CAR**



Source: Bank Indonesia's Banking Statistics, only including Sharia banks (BUS)

### **Stable outlook for the Sharia banking sector**

We view the outlook for Sharia banking to be stable over the medium term. We expect growth in the sector to outpace the overall banking industry as it is supported by high customer potential. However, growth may be hampered by the economic downturn and intensifying competition. In our opinion, the financial profile of Sharia banks will continue to remain moderate compared to conventional banks, given their financing focus on the MSME segment and limited access to low-cost funding.

We are of the view that the key success factors that would allow Sharia banks to compete in the banking industry are the availability of sophisticated products over conventional products, the expansion of Sharia distribution networks, and regulatory support. On the other hand, Sharia banks should watch out for the tight liquidity condition in the banking industry and a potential weakening asset quality due to the current economic condition.

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