Maintaining Stability in Indonesian Banking Industry

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Banking stability in Indonesia is continuously influenced with global and domestic sentiments, such as Brexit, Trump effect, quantum easing taper-off in Europe, and United States' plan to start unloading its balance sheet. Domestically, there is the national state budget deficit issue, slow economic and loan growth, and entering a political year in 2018. In addition, as foreign investors have significant shares in both government bonds and stock market, any sudden flow of funds would cause strain to the stability of Rupiah and interest rate, two of the major factors in Indonesia's banking industry.

Concentration among large banks creates systemic risk

Another factor that contributes to the significance of stability of Indonesian banking industry is the concentration of it, as the top ten banks account for about 60% - 70% of the industry's assets and third party funds. This creates a systemic risk, whereby a failure of one systemic bank will spread into failure of all or many banks in the industry. While it may be easier to supervise only a handful of large banks from an oversight standpoint, it also means that those systemic banks have very little margin of error since the consequences are dire to the rest of the banking industry. Therefore, it is important to understand the nature and causes of this systemic risks and monitor it to avoid the costly and messy process of a bank bail-out.

In fact, in the Law no. 9 Year 2016 passed by the government regarding the prevention and treatment of financial system crisis, the bail-out scheme has been changed into bail-in process, where the main focus is to obtain support from the controlling shareholder first. The government will no longer step in directly to save a distressed bank, but will do so through Insurance Deposit Agency or better known as Lembaga Penjaminan Simpanan (LPS) only after the controlling shareholder proves to be unable to intercede.

Other factors to systemic risk

Aside from the concentration risk, other two factors that could create systemic risk are complexity of transactions and interconnectedness among financial institutions. In our opinion, complexity of transaction is not yet a major factor in systemic risk assessment given that most Indonesian banks are only engaging in plain vanilla transactions as opposed to complex derivative transactions. However, the interconnectedness factor is increasingly becoming more important as financial markets are now globally connected. A major loss of confidence in a systemic bank could drive investors away in a hurry that will spread to other banks.

PEFINDO Methodology

In PEFINDO's view, a bank's systemic risk is embedded in the Banking Methodology as part of the business risk assessment, not as a standalone point. Our analysis of the banks' business position, including market share, and their diversification profile across products, segments, debtors, and funding sources, as well as the quality of infrastructure and management capability, will determine our score of the bank's business rating, and will directly affect the final rating. Although the systemic risk is not directly assessed, the high rated banks tend to have very strong business profiles, and those banks are likely to be considered as systemic banks.

Nevertheless, identifying systemic risk is not always straightforward; while concentration issue is easier to detect, and banks have improved significantly in this area in the last two years (2015) due to pressure of rising NPL ratio, the interconnectedness factor of a bank is harder to determine simply because the supporting data is more difficult to obtain. However, it does not mean this factor is less important, as the trend of banks becoming more interconnected with one another is increasing. A direct correlation between PEFINDO's banking methodology and interconnected factor is the parent support methodology, which is an integral part of the rating of many financial institutions, particularly banks, given its significant impact to the Indonesian economy.

Regulatory initiatives

The attention for systemic risk has been growing, especially since the high profile bail-out process of Bank Century, which garnered many pro and contra opinions. Subsequently, two regulations were introduced: POJK no. 18/POJK.03/2014 regarding integrated management of financial conglomerate, and Law no. 9 Year 2016 regarding the prevention and treatment of financial system crisis.

Table 1. POJK no. 18/2014

No.	Main Highlights	Integrated Management of Financial Conglomerate
1	Main Entity's responsibility	To coordinate integrated governance of the member in the financial conglomerate. Includes establishing guidelines, providing directions, monitoring and evaluating the governance process. It also makes regular reports to OJK.
2	Weakness in the process	As the position of the main entity is also a subsidiary as other members, it has no authority or control over other subsidiaries.
3	Possible solution	The issue is under discussion by OJK. OJK plans to publish a new regulation called Financial Conglomerate Holding (Peraturan Induk Konglomerasi Keuangan atau PIKK). In this regulation, the holding company will have the control and authority to implement integrated governance as it should be.

Source: OJK website, processed by PEFINDO

Table 2. UU no. 9/2016

No.	Main Highlights	Prevention and Treatment of Financial Sytem Crisis
1	Establishment of financial system stability committee (KSSK)	KSSK - komite stabilitas sistem keuangan - coordinates the monitoring and maintenance process of financial system, handles financial crisis, and treats and monitors systemic banks.
2	KSSK membership	Minister of Finance (coordinator, voting right), Governor of Bank Indonesia (member, voting right), Chairman of Board of Commissioner of OJK (member, voting right), and Chairman of Board of Commissioner of LPS (member, no voting right).
3	Conversion of bail-out to bail-in	In a financial crisis, saving a bank will not be undertaken directly by government, but will be focused on the controlling shareholder. If necessary, LPS will take over the failing bank to manage and operate until finding a suitable buyer. The bail-in process must be approved by President of Republic of Indonesia.
4	Impact to rating	More rigorous analysis on parent support application as role of controlling shareholders is becoming more critical.

Source: OJK website, processed by PEFINDO

Indonesian banks are stable in spite of increasing NPL ratio

Indonesian banks are stable, in our view, supported by first and foremost, a very strong capitalization as reflected by average capital adequacy ratio (CAR) of 22% as of June 2017. Aside from the capital conservation and countercyclical buffers that all banks must meet, systemic banks will have to provide capital surcharge that ranges from 1.0% - 2.5%, which will further bolster their capital cushions against risk of insolvency.

Liquidity, as reflected by LDR ratio of 89% as of June 2017, has improved, especially for banks in lower capital category (BUKU 1, 2, and 3), to a range of 90% - 93%, from 94% - 98% range at end of December 2016. In our view, the more concerning issue is the asset quality. The banks' non-performing loan (NPL) and the special mentioned loans (SML) ratios have been increasing in the last two years. At a closer look, the deterioration of quality of banking loans seem to happen across the industry, reflecting sluggish economic condition.

Table 3. Banking indicators

Financial Ratios	1H2017	1Q2017	FY16
Banking NPL %	2.96%	3.04%	2.93%
Banking SML %	5.55%	5.26%	4.51%
CAR %	22.74%	22.88%	22.93%
LDR %	89.31%	89.12%	90.70%

Source: Statistik Perbankan Indonesia, as of June 2017

Challenges in the future

Though the Indonesian banking system is stable, there are still homework to be done to further strengthen the stability of the banking industry. There are challenges such as heightening competition from overseas players, with ASEAN Economic Community around the corner, tighter regulatory requirement standards such as the ongoing Basel 3 implementation, and accounting rule changes of IFRS and PSAK, where we face implementation of IFRS 9 or PSAK 71. The incoming implementation of IFRS 9 or PSAK 71 could result in significant increase to the banking industry's provision expense, hence eroding their profitability.