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Indonesian banks remain listless amid sluggish growth

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In a bid to revive Indonesia's slumbering economy, President Joko Widodo said in February that he wanted interest rates to "fall, fall, and keep falling". In response to the president's statement, Bank Indonesia (BI) lowered the benchmark rate for the third time in March, with the benchmark rate cut from 7.5 percent in January to 6.75 percent in March. Yet, the economy only grew 4.92 percent YoY in the first quarter, lower than BI's expected target of 5.1 percent. Loan growth also declined to 7.7 percent in April, way below the expected target of 12 to 14 percent for 2016 (see Figure 1). Lack of public spending and private investment accounted for the lackluster growth in the first quarter as government spending has yet to pick up speed while the private sector remains on the sideline.

Interestingly, Indonesia's lending rate remains high despite the central bank's 75 basis point rate cut. The high lending rate is associated with large state-owned enterprises (SOEs) depositing their money in banks that offer higher interest rates. Indonesia's deposit market is unique, in which there are only a handful of big depositors in the market. These depositors, including SOEs and state institutions, are able to negotiate higher deposit rates given their strong bargaining power. This results in higher cost of funds that keeps the lending rate high. The high net interest margin (NIM) in Indonesia also contributes to the high lending rate. Indonesia's NIM is the highest among its peers in the region, indicating inefficiencies in the banking industry (see Figure 1).

In the face of a domestic economic slowdown and a persistently high lending rate, the Financial Service Authority (OJK) is experimenting with a carrot and stick approach in bringing lending rates down to single digits. In March, the deposit rates were capped at 75 to 100 basis points above the BI's benchmark rate. The OJK also reminded banks' executives to stay committed to the deposit rate cap and reduction in their lending rates. Much to the bankers' relief, the OJK chose not to force a cap on the NIM and opted for a carrot approach instead. As a part of the incentives, banks that can lower their NIM and their operating cost to operating income ratio (BOPO) will receive a discount on their core capital allocation requirement upon opening new branches.

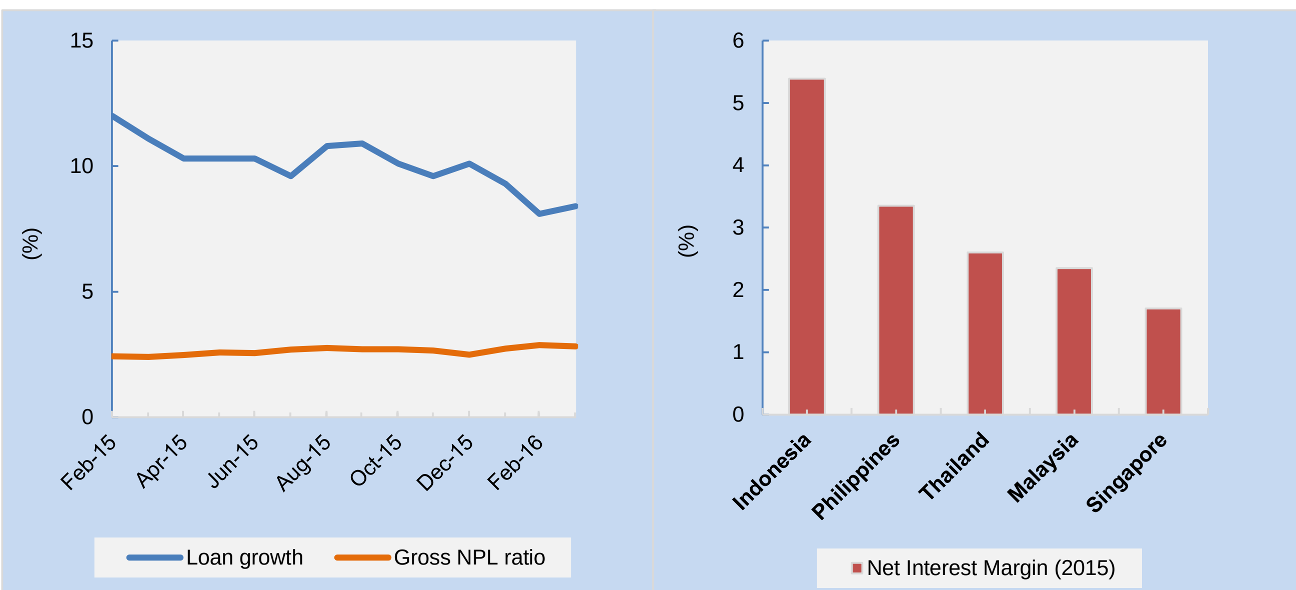

Figure 1: Loan growth and gross NPL ratio of Indonesian banks (left panel); and Net Interest Margin of 5 ASEAN banks (right panel). *Source: Bloomberg, Bisnis Indonesia*

Despite the regulator's push to boost lending, Indonesian banks find themselves in a tough spot amid slow credit growth and fast-rising souring loans. Indonesian banks' NPL to total gross loans had been steadily increasing to 2.83 percent in March 2016 as a result of the global and domestic economic slowdown and exposure to the commodity and natural resource sector (see Figure 1). The aggregate RMI-CRI 1-year Probability of Default (PD) for Indonesian banks has climbed from 38 bps in May 2015 to 66.0 bps on 10 June 2016, reflecting a heightening credit risk of Indonesian banks (see Figure 2). The three biggest lenders by assets, Bank Mandiri (Mandiri), Bank Rakyat Indonesia (BRI), and Bank Central Asia (BCA), also exhibit a similar upward trend in PDs with higher PDs observed in the state-owned Mandiri and BRI. Mandiri and BRI have higher leverage, lower capital adequacy ratios and lower market capitalization compared to BCA. The firms' RMI-CRI Distance-To-Default (DTD) measures are also lower than BCA's DTD. A low DTD is usually associated with a high PD, and changes in DTD are a significant determinant of RMI-CRI 1-year PDs.

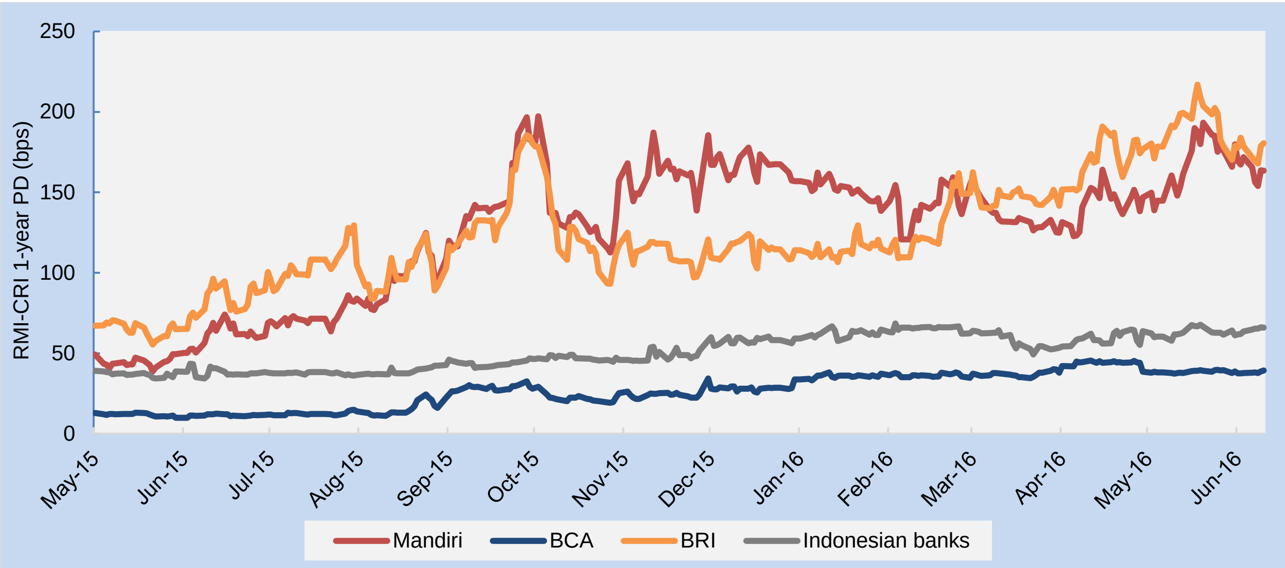

Figure 2: RMI-CRI 1-year PDs for Indonesian banks. *Source: RMI-CRI*

Mandiri, the biggest lender by asset, saw its quarterly profit plunge by 26 percent in the first quarter as its provision ballooned to USD 337mn and NPL ratio increased to 3.2 percent in the first quarter (see Table 1). Mandiri's rising NPL is attributed to its ailing commercial segment that mainly caters to commodity-based businesses. The commercial segment accounted for 75.2 percent of loan downgraded to NPL and 57.6 percent of the NPL in the first quarter. It also revised its loan growth target to 10 to 12 percent, down from its expected target of 12 to 14 percent.

Meanwhile, BCA and BRI reported stronger profit in the first quarter with BRI having the highest ROE among Indonesian banks and BCA second. BRI's strong return is mainly driven by its fast-growing micro loans that grew 20.4% YoY in March while BCA's modest earning is supported by loan growth in the corporate and consumer segments and low funding cost. Nonetheless, the NPL of both banks also increased in the first quarter. Similar to Mandiri, BCA and BRI's NPL mainly happened in the commercial and medium segment, respectively. BCA's management predicted that NPL will still be rising until the third quarter as the economy is still in the process of recovery and the real sector remains sluggish. In anticipation of the rising NPL, BCA's provision increased 22.7 percent YoY in April. BCA revised its loan growth to 8-10% down from its previous target of 11% while BRI is also lowering its profit growth target.

	Bank Mandiri			Bank Rakyat Indonesia			Bank Central Asia		
Quarter	Q3-2015	Q4-2015	Q1-2016	Q3-2015	Q4-2015	Q1-2016	Q3-2015	Q4-2015	Q1-2016
T12 Net income (IDR tn)	20.0	20.3	19.0	24.3	25.3	25.3	17.7	18.1	18.5
ROE (%)	19.2	18.5	17.3	24.7	24.1	24.5	22.0	21.9	20.5
Gross NPL ratio (%)	2.8	2.6	3.2	2.2	2.0	2.2	0.7	0.7	1.1
Provision/NPL (%)	150.5	145.5	131.9	149.5*	150.8*	152.4*	285.4	322.2	235.0
Loan to deposit (%)	87.5	90.0	89.8	81.3	84.1	81.7	86.8	87.9	89.8
Tier 1 capital ratio (%)	15.3	16.2	15.7	16.7	16.7	15.8	18.6	18.1	19.5

Table 1: Financial data for three largest Indonesian banks. * based on RMI-CRI estimates. *Source: Bloomberg, Company data,* RMI-CRI

Against this backdrop, the Financial Service Authority (OJK)'s attempt to lower all lending rates to a single digit might possibly backfire. Rising delinquent loans and sluggish economic condition have turned bankers more cautious in disbursing loans despite the government's attempts to boost lending. The OJK's attempt to increase banking efficiency through NIM reduction can also be counterproductive if a lower NIM is mainly due to a tough business environment. Meanwhile, the reduced deposit rate have turned investor's attention away from banking deposits to sovereign and corporate bonds that offer higher yield, thereby putting pressure on bank's liquidity. With loan to deposit ratio already 89.6% in March, it is uncertain that Indonesian banks can significantly increase lending in light of the tightening liquidity.

In the face of growing troubles, the government is currently banking on a Tax Amnesty Bill that might lead to an expected repatriation of USD 38bn to USD 76bn in offshore assets back to Indonesia. The bill, which will take effect on July 1, will make it easier for tax evaders to declare and repatriate their assets. Income tax on these assets will be capped at 6 percent while those who immediately repatriate their asset will only face 1 to 3 percent tax penalty. Once the bill is passed, the repatriated asset will inject significant liquidity into local banks. Bank Indonesia predicted that the bill can boost credit growth by 2 percent. The increased tax revenue and repatriated asset will help to fund long-term infrastructure projects that underpin Jokowi's economic policy while the increased liquidity is hoped to lower banking's funding cost and boost lending.

Despite the headwinds faced by local banks, Indonesia banks remain fundamentally sound. Indonesian banks are the best-capitalized banks in Asia with BCA leading the pack followed by BRI and Mandiri. Indonesian banks, however, might see rough quarters ahead as the global and domestic economies have yet to pick up speed. While Bank Indonesia is under pressure to further lower its benchmark rate, it is uncertain that banks would be more liberal in lending. With no sign of a strong recovery in the commodity and natural price sector, public investment is likely to play an important role in kick-starting the economy and restoring confidence in the upcoming quarters.

Credit News

IMF sounds warning on China's corporate debt

Jun 12. The IMF warned that China's corporate debt, which was intended to stimulate lending and to boost growth, could be a precursor to a larger crisis if the authorities fail to control it. China's debt grew to a record 237% of gross domestic product in the first quarter. In a released statement, Mr. David Lipton from the IMF, mentioned that the ballooning debt requires immediate attention with commitment to reforms. Further, Mr. Lipton highlighted the potential of a country's economic crisis to "spillover" across the globe. China had begun taking steps against bad debts such as securitisation and debt-for-equity swaps, yet it is viewed by Mr. Lipton and various analysts as having limited results, falling short of eliminating bad debts from the overall financial system. (FT)

Gawker files for bankruptcy, will be put up for auction

Jun 10. Gawker Media Group was placed on auction following a bankruptcy filing that came on the back of a USD 140mn legal dispute involving Terry Bollea. The bankruptcy filing prevented Mr. Bollea from attaining control of the firm and allows Gawker Media to continue operations while it raises funds for appeal. A series of troubles drained the financial resources of Gawker media and the latest trial, costing Gawker USD 10mn. Ziff Davis LLC chief executive Davis Shah, whose company placed an opening bid of USD 90mn for Gawker M, expects the auction to take place at the end of July 2016. The proceeds from the auction would be used to finance further litigation costs and to cover damages. (WSJ)

Korea unexpectedly cuts rate to support debt restructuring

Jun 9. Due to increasing risks to the economy and government's pressure to restructure indebted companies, South Korea's central bank had unexpectedly cut benchmark interest rate to a record low last Thursday. This unanimous decision to cut the seven-day repurchase rate to 1.25% contrasted with other central banks especially with speculations that US rate hikes were likely to be delayed. An expansionary monetary policy could enhance growth, aiding plans by policy makers to reduce capacity and corporate leverage amid persistent declines in Korean exports. South Korea's three year bond yields closed at 1.35% on Thursday. The won closed at 0.1% stronger at KRW 1150.90 per USD. (Bloomberg)

Gardens Regional Hospital files for bankruptcy

Jun 7. The Gardens Regional Hospital and Medical Center Inc., which provides health care to low-income people in the depressed southern Los Angeles neighborhoods, filed for Chapter 11 protection on Monday. The facility generated USD 96,728 per day when it required USD 129,359 in revenue to cover daily costs. The facility suffered decreasing reimbursement payments from the state and federal medical insurance programs leading to an accumulation of more than USD 30mn of debt. Despite an increase in the number of patients with insurance after implementation of Barack Obama's Affordable Care Act in 2010, the increase in insurance money was insufficient to offset the lower payments from government programs. A construction management firm that manages health-care facilities, Naerok Group International Inc., agreed to give a USD 2mn loan to the hospital for restructuring purposes. (WSJ)

Oil field services provider Seventy Seven files for bankruptcy

Jun 7. Oil services firm Seventy Seven Energy Inc. filed for bankruptcy protection inclusive of a plan to wipe off over USD 1bn in debt and handing over control of the business to bondholders. Under the terms of the proposed plan, the company's 2019 unsecured bondholders will receive at least 96.75% equity in exchange for the USD 650mn owed while a second group of bondholders will receive a 3.25% equity stake plus warrants for 15% of the new common stock if they vote to support the plan. (WSJ)

US House passes Puerto Rico debt relief bill (Reuters)

Hastings Entertainment chain said to prepare bankruptcy filing (Bloomberg)

ECB corporate bond buyers ignores default risk (Reuters)

Regulatory Updates

Saudi CMA amends Investment Funds Regulations

Jun 9. The Saudi Capital Market Authority Board had approved the final draft of the amended Investment Funds Regulations, covering the administration, the management and the marketing of foreign funds in the Kingdom. The new rules aim to build out the country's regulatory framework for investment funds, and provide further protection to investors. Under the new rules, fund managers are required to provide greater disclosures and ensure the independence of the funds' custodians. The amended regulations would come into effect from 11 June 2016. (CPI Financial)

Sovereign debt rule changes threaten EU bank finances

Jun 8. European banks are required to raise up to EUR 170bn of extra capital or sell almost EUR 500bn of sovereign debt if regulators commit to plans to break the "doom loop" tying lenders to their government. Top Eurozone regulators have been constantly raising the importance of breaking this link, following the 2011 European debt crisis which highlights the risks of banks holding large amount of debt issued by the governments. Eurozone regulators have been considering methods to introduce capital charges for banks holding sovereign debt, which has been conventionally viewed as risk-free. Expected changes to regulation may lead to a 30% increase in capital requirements for the main EU banks. (FT)

China hints at bankruptcy rules for finance sector (SCMP)

MAS simplifies regulations for securities-based crowdfunding platforms (CNA)

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