



BCA

BANKING OUTLOOK

2022

After the Storm

Bank Central Asia – Economic, Banking, & Industry Research

Executive Summary

- The banking sector has weathered the pandemic in relatively good shape, and is ready to expand as the economy recovers. Deposit growth should remain robust, albeit slightly normalized, at 8 – 9% YoY as the stimulus winds down but commodity prices remain elevated.
- The theme for 2022 is an expansion in terms of volume, both for loans as well as transactions. Loan demand has grown stronger both from consumers as well as for working capital, while investment loans remain a wildcard for now. We expect loans to grow by 7 – 8%, driven by a broad-based increase for basic and consumer sectors in addition to some export/commodity-related industries.
- Credit risk remains elevated largely due to the legacy of the pandemic, which means that it may remain rather “K-shaped” in nature, i.e. highest in affected industries such as tourism and transportation. The extent of loan loss provisioning could be a key metric for banks as the end of restructuring relaxation period (Mar-23) approaches.
- The prospect of BI rate hikes this year could curtail loan growth, but it is somewhat buffered by the fact that loan rates have declined faster than corporate profits during the pandemic. The rate hike impact would also be softened by the strong CASA growth (versus time deposit) in recent years.
- The post-pandemic landscape remains most favorable to the larger banks, with high CASA/deposit ratio and strong digital banking franchise – benefiting from growing digital transaction volumes to offset lower fees per transaction. But there are significant challenges in the medium term, most notably (1) the rise of fully-digital neobanks; (2) a mandated increase in SME lending from regulators; and (3) the increased awareness regarding environment/climate-related issues.



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Part I

A promising year

- After what had happened in 2020 and 2021, things should only get better. And most indications do point in the direction of improvement, Omicron notwithstanding. As we mentioned in our *Indonesian Economic Outlook*, growth is likely to accelerate further in 2022, thanks to impetus from commodity boom and pent-up consumer demand.
- The performance of the banking industry would naturally follow in the footsteps of the economy. To be sure, Indonesian banks have stayed remarkably healthy despite GDP contraction earlier in the pandemic. Liquidity, for one, has remained abundant, due to a combination of government stimulus and trade surplus (*Exhibit 1*). Meanwhile, credit risks has been manageable (*Exhibit 2*) thanks in part to OJK's relaxation of loan restructuring rules until March 2023. Finally, bank profits have stayed relatively robust, especially against the backdrop of margin compression. The biggest room for improvement for 2022, then, chiefly concerns loan volumes and transaction volumes, which had shown significant declines particularly at the start of the pandemic.
- There are certainly macro risks that could dampen this incipient boom, which could therefore affect the aforementioned recovery. Arguably the biggest one

Banks have maintained healthy performance amid the pandemic; loan and transaction volumes are set to follow economic recovery

is the Fed's faster monetary tightening, which could spark capital outflows and also potentially curtail commodity prices, thus eating into the export bonanza that has supercharged the economy thus far.

- We do not expect BI to react in a rushed manner towards the Fed's hikes given Indonesia's comparatively strong macro indicators versus other EMs, but it is nonetheless expected to start hiking its own policy rates by H2-22. This should in theory curtail loan volumes, but there is an argument to be made that in the short-term, the prospect of rising rates would incentivize borrowing, especially set against the backdrop of firms' expanding profits.

Corporate profits had declined faster than interest rates in 2014-19; the trend reversed during the pandemic, which may support loan growth

- It is also crucial to consider the longer-term trend here. From 2014 to 2019, the median profit margin of Indonesian corporations declined faster than loan rates ([Exhibit 3](#)), which jibes with the slower loan growth during this period. But the trend was reversed during the pandemic, and – with profitability soaring by Q3-21 – the gap between interest rates

and firms' profit margins are now on par with the 2010-13 period, when credit was growing at double-digit rates. This does not imply that loan growth will necessarily return to those heady days, but it does mean that there is a sizable room (about 100-150 bps) for BI and banks to raise rates without unduly curbing loan growth in the process. Since we expect BI to hike rates by 50 bps in 2022 (or up to 100 bps in an “overheating” scenario), rates may not be the primary impediment to loan growth just yet.

- There is, to be fair, a small risk that rates could rise even faster, mainly due to inflation. As we discussed in our *Indonesian Outlook*, domestic energy prices are misaligned versus global prices, implying a possibility of adjustment that might prompt a spike in inflation (to 5.5% or higher) and necessitate faster rate hikes on BI's part. And even in the absence of such an adjustment, some firms are already seeing an erosion in their profitability due to the rising costs of imported inputs, which may in turn reduce its appetite to expand or borrow.
- But there is one factor that could counterbalance the effects of higher rates – liquidity. Deposit growth have continued to be strong throughout the pandemic, and should remain so in 2022. While the authorities are starting to unwind their stimulus, the still-elevated (albeit slightly normalized) commodity prices mean that the private sector is likely to remain a net saver, and that deposit growth will stay at the relatively healthy pace of 8 – 9% YoY.
- More interestingly, there is also the lack of a shift from checking or saving accounts (CASA) towards time deposits (*Exhibit 4*). Past crises were typically characterized by both increased saving rates *and* flight to time deposits, but the pandemic did not see the latter – which helps explain the decline in cost of funds and loan rates. The strength of CASA vis-à-vis time deposits seems to be the result of three phenomena:

The pandemic has been marked by a shift from time deposits towards CASA rather than vice versa, helping to lower banks' cost of funds

- Monetary and fiscal stimulus

The joint monetary and fiscal expansion led to an increase in money supply, much of which would eventually end up in checking accounts, whether directly for SOE capital injection and SME tax incentives, or indirectly e.g. after being spent by low-income households.

- Shift towards higher-yielding investment products

Low interest rates also made time deposits less attractive, leading to flows into equities or other, more speculative assets. This in turn prompted an increase in the cash reserves of corporations (on mark-to-market basis) and in the transaction volumes of brokers/asset managers – both of which caused further increase in checking accounts.

Increased transaction volumes due to recovery and digital shift should offset the decline in fees from BI-FAST implementation

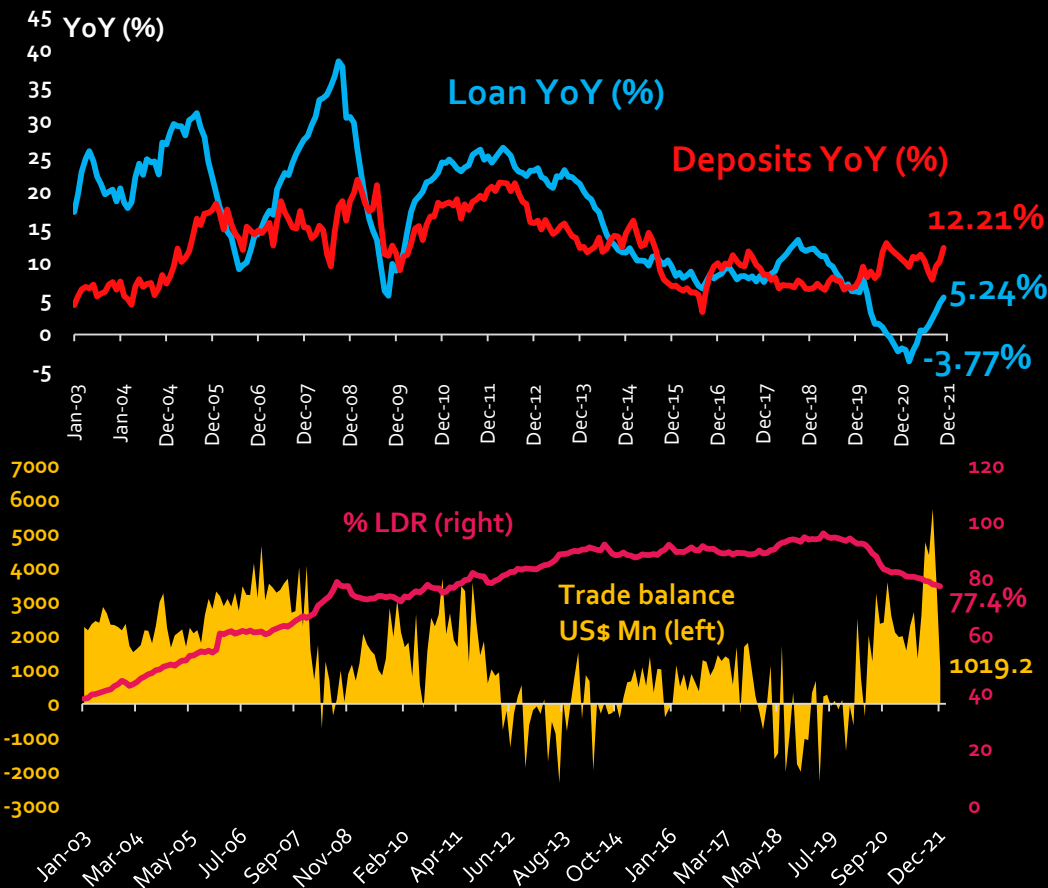
- Shift towards e-commerce and virtual accounts

An emblematic result of the pandemic has been the increasing adoption of digital technology, and with it digital modes of payment such as virtual accounts (VA), which has grown notably rapidly (***Exhibit 5***). As VAs are in essence checking accounts of the VA provider in banks, “parceled out” among numerous user accounts, this further pushes the shift towards CASA and lower funding costs.

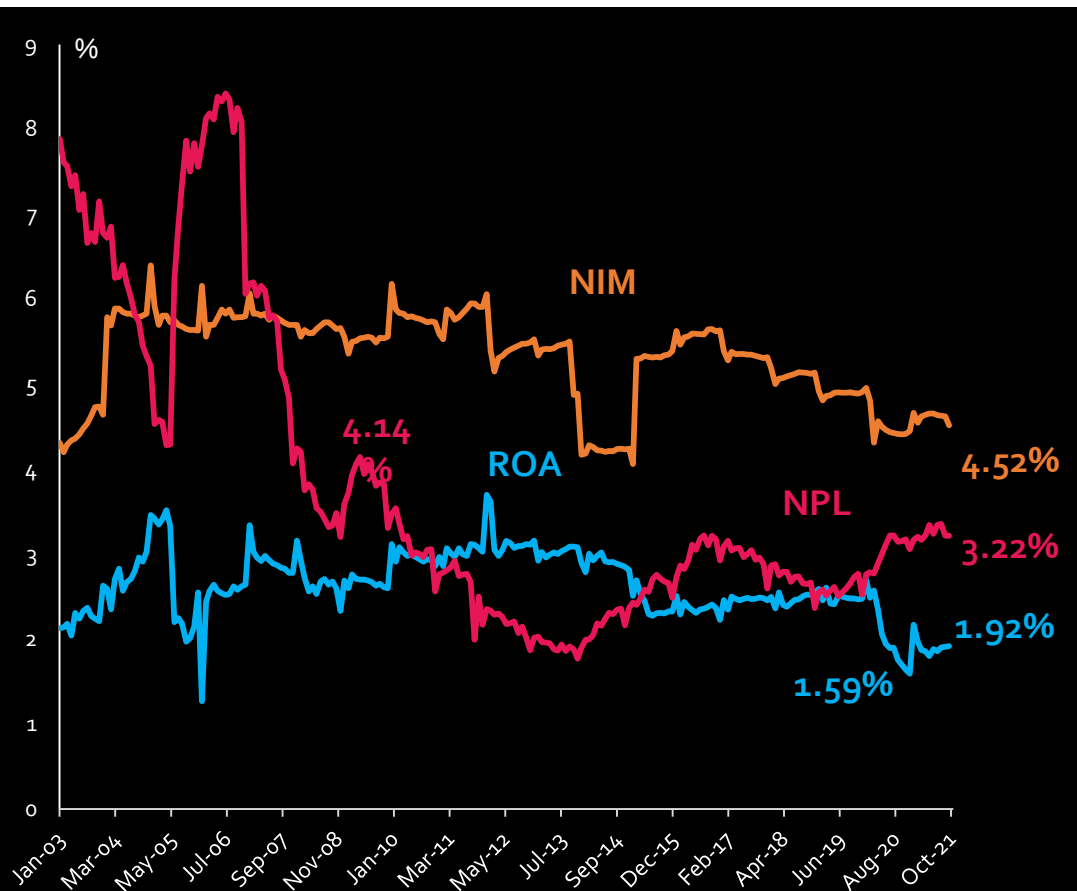


- Of those three drivers, we would expect the first to be less prominent going forward, but the latter two seems to be part of a generational change in financial habits and attitudes that may not easily shift back after the pandemic. As such, with CASA now forming a larger portion of banks' funding – albeit to different extents for different banks ([Exhibit 6](#)) – cost of funds might prove less sensitive towards the rising policy rates.
- Furthermore, the ease of digital transactions (both e-commerce and financial investment) should lead to higher transaction volumes, which in turn drives banks' fee-based incomes. Coupled with the natural increase in transaction due to economic recovery, it appears that the increase in transaction volumes would offset the reduction of fees per transaction due to the implementation of BI's new interbank clearing protocol (BI-FAST). The stage is thus set for a promising year, in terms of both volumes and margins as well as fee-based incomes.

A good starting point: Loans climbing back while liquidity is still supported by the trade surplus

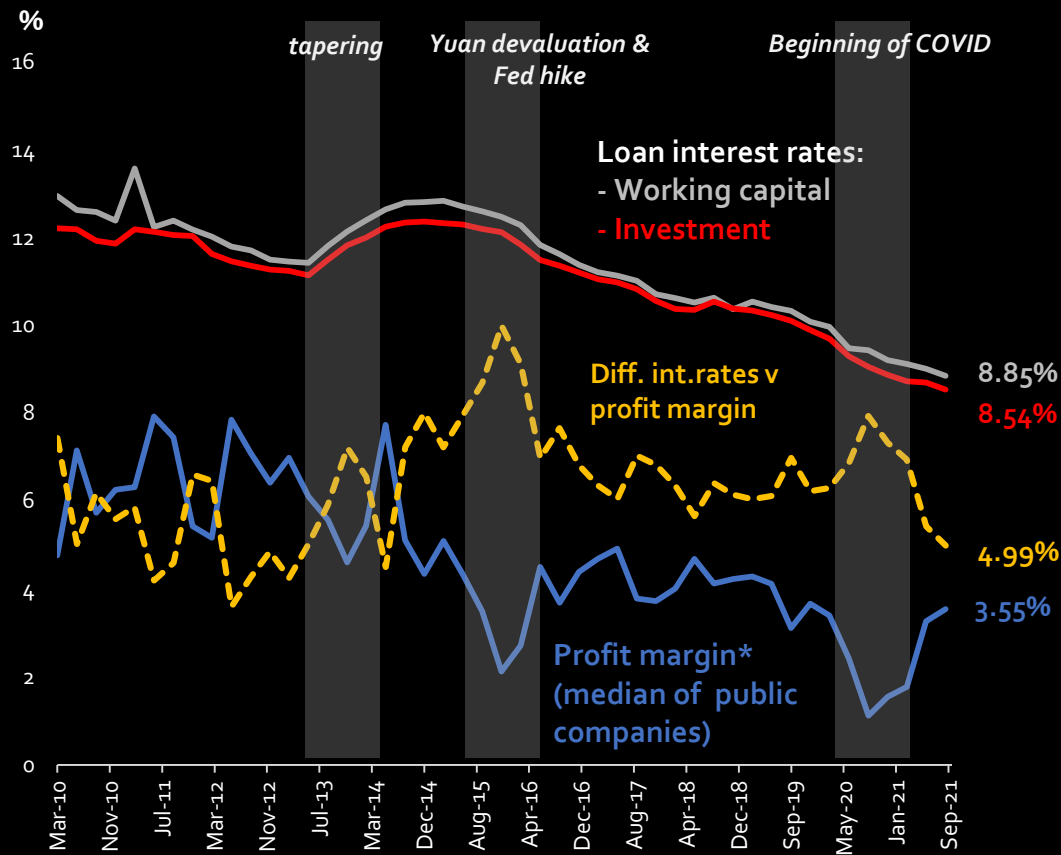


Credit risks has remained manageable while profitability has started to improve



Source: Bloomberg, OJK

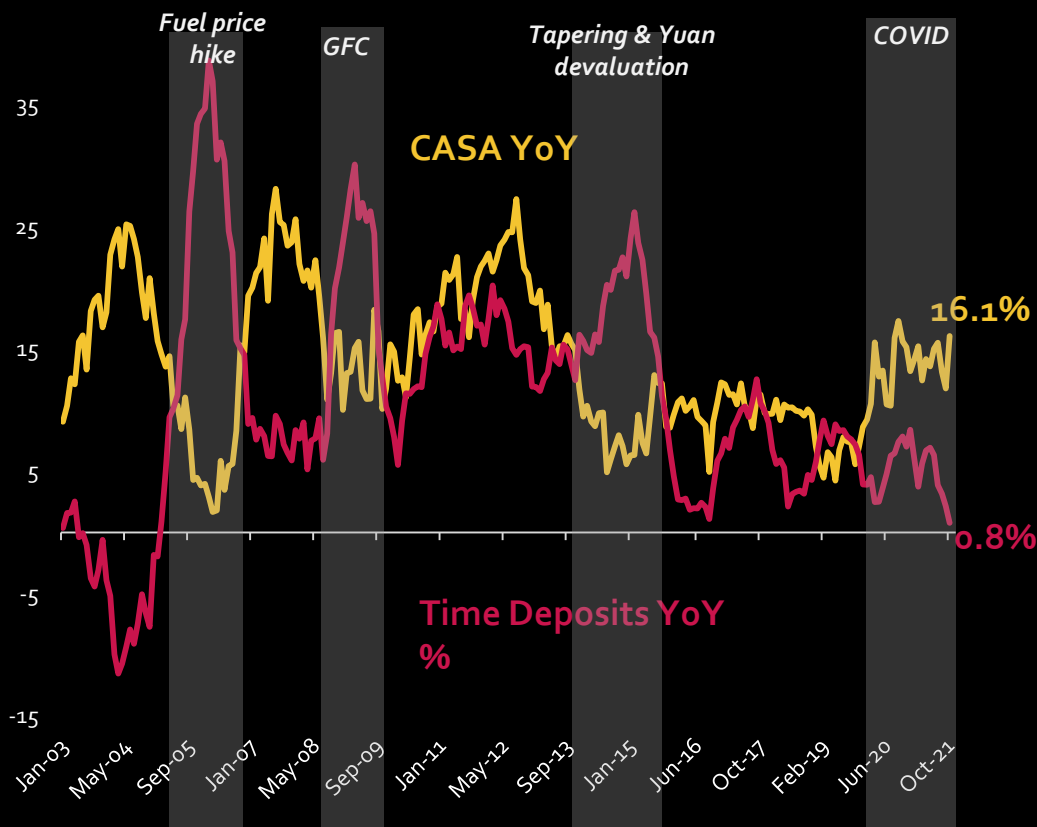
Interest rates have declined faster than profit margins during the pandemic, reversing the trend in 2014-19



Source: Bloomberg, OJK

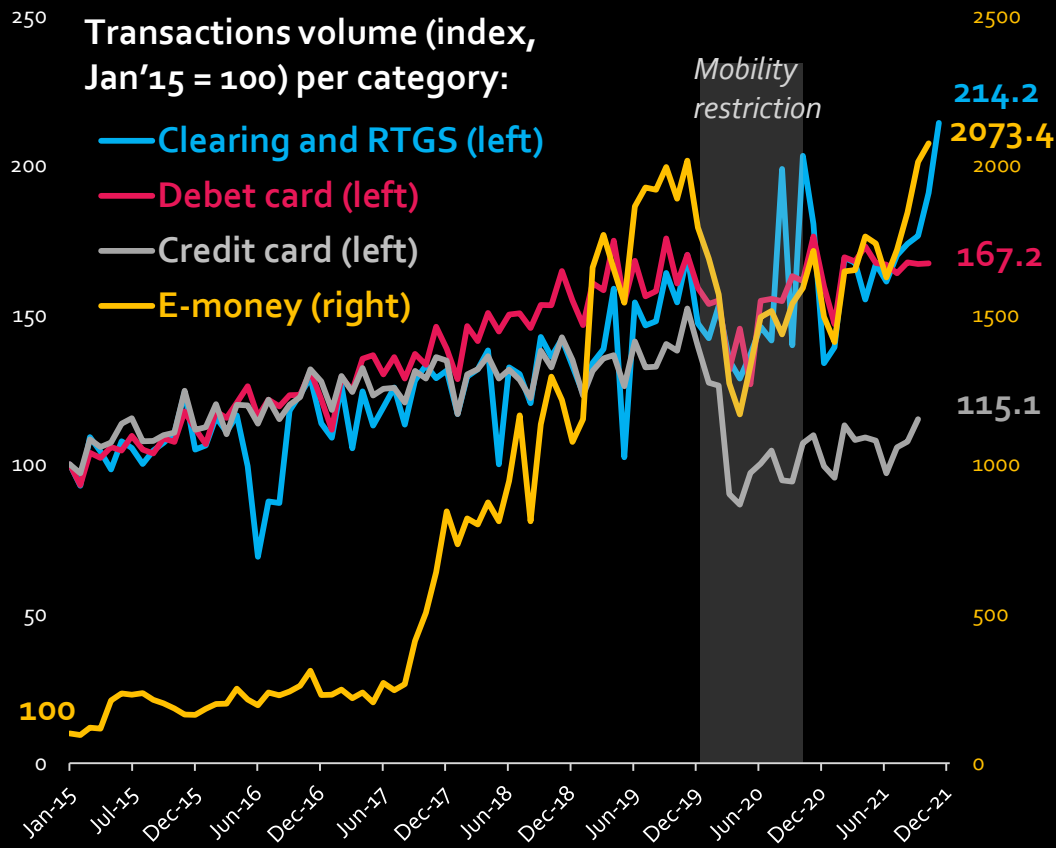
Unlike past crises, the Covid-19 pandemic has seen strong CASA growth vis-à-vis time deposits

Growth YoY %

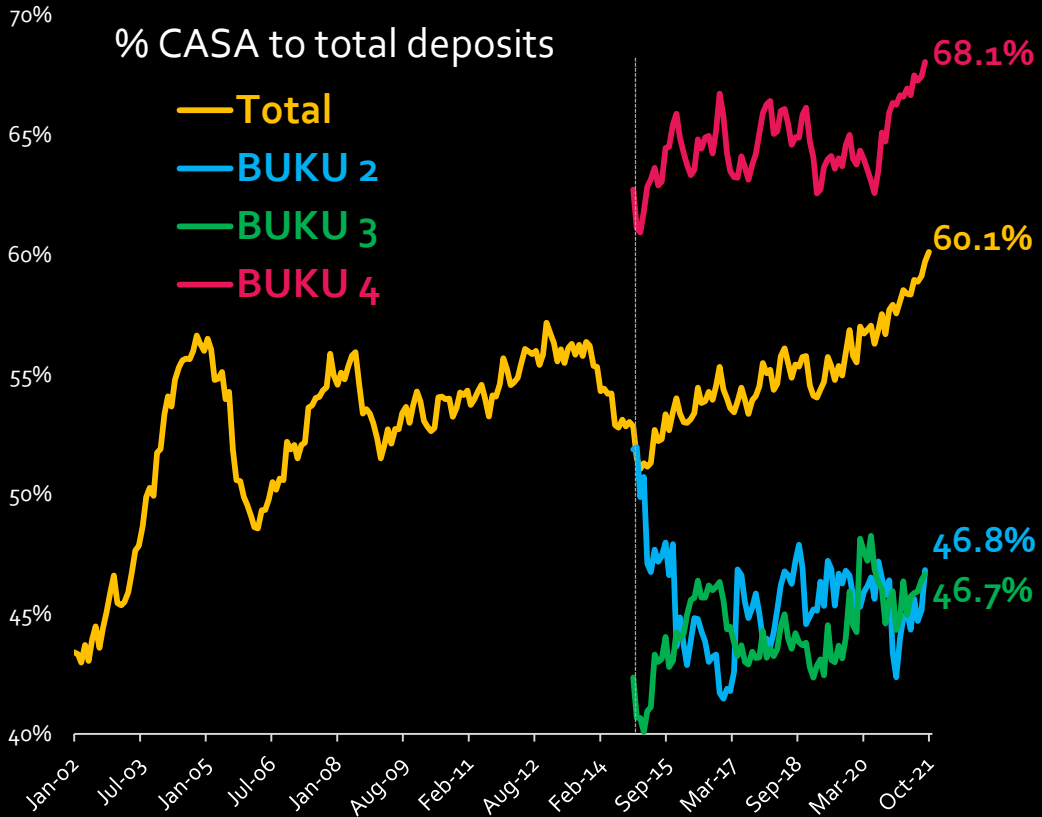


Source: OJK

The growth of e-money (including virtual accounts) has outpaced other transaction channels in recent years



CASA have made up a growing portion of third-party funds, but only for the bigger banks



Part 2

Rebounding and recovering

- The expected recovery in loan volume, however, should not blind us to the uneven ground that still lies underneath. While loan growth has begun to climb up after bottoming out in Q2-21, this growth has been driven mainly by consumer and working capital loans, while investment loans has been lagging behind (*Exhibit 7 – upper panel*). This reflects the relatively rapid recovery in consumption vis-à-vis investment, in part encouraged by the government's decision to stimulate the automobile and property sectors by giving tax incentives and relaxing loan-to-value (LTV) requirements to 0%.

Consumer loans has risen faster than investment loans, but the latter may catch up as industrial capacities approached pre-pandemic levels

- The gap between consumers and businesses spending appetite is also evident from the savings-investment gap data (*Exhibit 8*), i.e. how much deposits have risen in excess of borrowing. Household saving rates spiked early in the pandemic, but began to decline in Q1-21, such that households as a whole are barely a net saver by the end of the year. In con-

trast, the private sector's net savings have remained abundant, which partly reflect the massive windfall from commodity exports, but also apparent cautiousness on the corporations' parts.

- How much loan could grow, then, will depend on whether the private sector will shake off their caution and start expanding again. Since investment loans account for about a quarter of total loans, its recovery (or lack thereof) could be the difference between our optimistic baseline expectations for loan growth (at 8 – 10%) versus a more moderate scenario (6 – 8%).
- One argument in favor of more investment is that industrial capacities had rebounded and even approached normal levels prior to the Delta wave. Now, with global logistical gridlock as well as a demand recovery that has been even stronger post-Delta, it is reasonable to think that CAPEX would start to rise in 2022. Nevertheless, the latest survey data continues to show rather modest appetite for investment, in contrast to the working capital financing which has only grown since mid-2021 ([*Exhibit 7 – lower panel*](#)).
- The extent of business spending recovery – and how much of it would rely on bank loans – may also vary across different sectors. As we can see in [*Exhibit 10*](#), the majority of sectors have recorded positive growth by Q3-21, but at very different rates. Incidentally, the sectors that show the fastest output growths – most notably mining and healthcare – also show weaker than average loan growths. This seems related to the strong earnings in these industries, allowing it to fulfill its financing needs without resorting to banks or the capital market. Indeed, amid the uncertainties of the pandemic, retained earnings have remained far and away the preferred financing source for most businesses ([*Exhibit 9*](#)).

The fastest-growing sectors depended less on bank loans, as retained earnings remain the most preferred financing source amid the pandemic

- For banks, then, capitalizing on the commodity boom may not mean lending to the commodity-producing sectors per se – although there might be increased financing demand from sectors such as CPO, which is in the midst of a replanting cycle, or downstream industries such as ferronickel which are strongly supported by the government. In practice, it would likely mean lending to consumer-centric sectors as retail and real estate, as well as industries that facilitate the economy as a whole such as telco/IT, logistics, and transportation.
- Moreover, there is a case to be made that the domestic growth outlook may be more robust compared to the global growth outlook – at least for 2022. The business cycle in the US, Europe, or China might be “longer in the tooth”, given their faster vaccination rollout and larger stimulus compared to Indonesia. This means that export-oriented sectors might actually face a higher risk of demand slowdown in 2022 relative to domestic-facing ones.

While credit is growing once again, credit risk is likely to remain elevated and resolution of LaR prior to Mar-23 would remain a key concern

- Finally, it is important to note that loan growth prospects might not correlate all that well with credit risks in each particular sector. Credit risk is more of a lagging indicator, and amid this pandemic it probably correlates with the output loss (compared to potential) that has been incurred during the past two years. As we can see in ***Exhibit 11***, some sectors

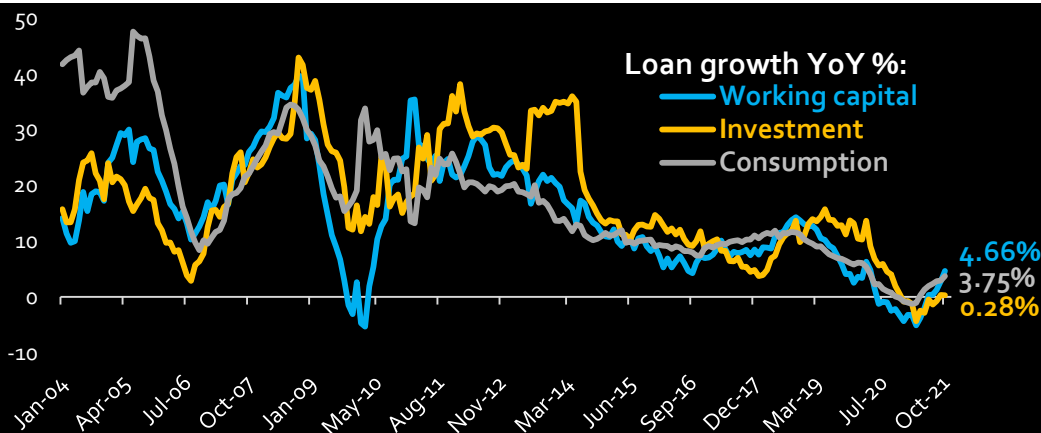
such as restaurants and transportation have seen large output losses, but have also returned to positive growth in 2021. Such sectors should exhibit stronger loan demand, but at the same time might continue to show elevated levels of loan at risk (LaR) and NPL over the medium-term.

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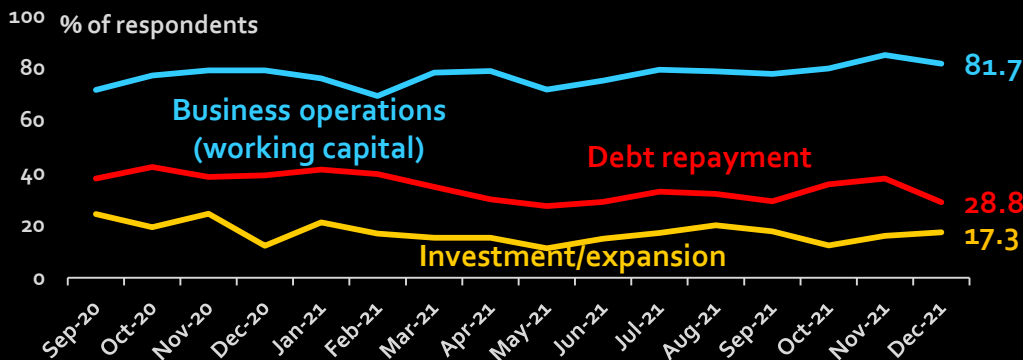
Part 2: Rebounding and recovering

- The lagging nature of credit risk also means that LaR resolution would take on increased importance in 2022, especially as we approach the end of restructuring relaxation period in Mar-23. While LaR is starting to decline ([*Exhibit 12*](#)), Covid-related restructuring still comprises more than 10% of banks' loan portfolio, and some of it would prove to be unsalvageable and eventually has to be moved to the NPL bucket or written off. Fortunately, Indonesian banks have maintained strong capital adequacy ratios and had also increased their levels of provisioning ([*Exhibit 13*](#)) in line with IFRS-9 guidelines.

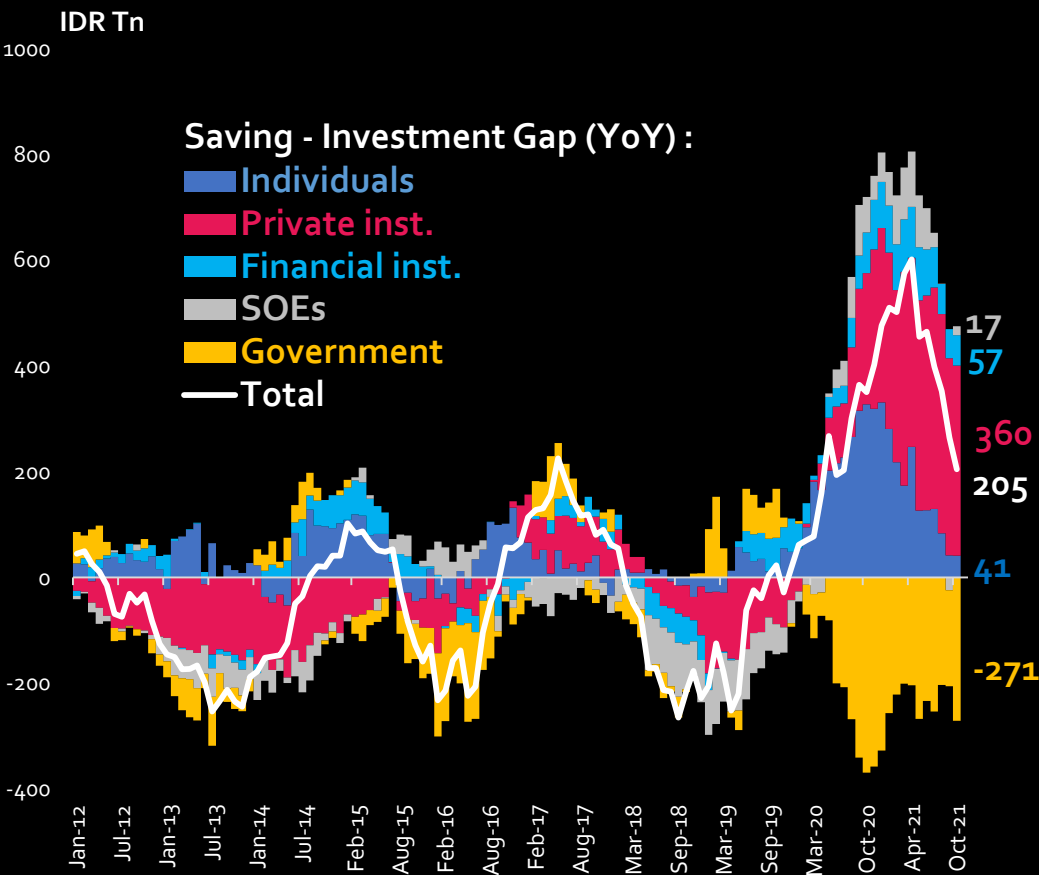
Loans for investment purpose still lag behind working capital and consumer loans



BI Survey : What is the purpose of your financing?

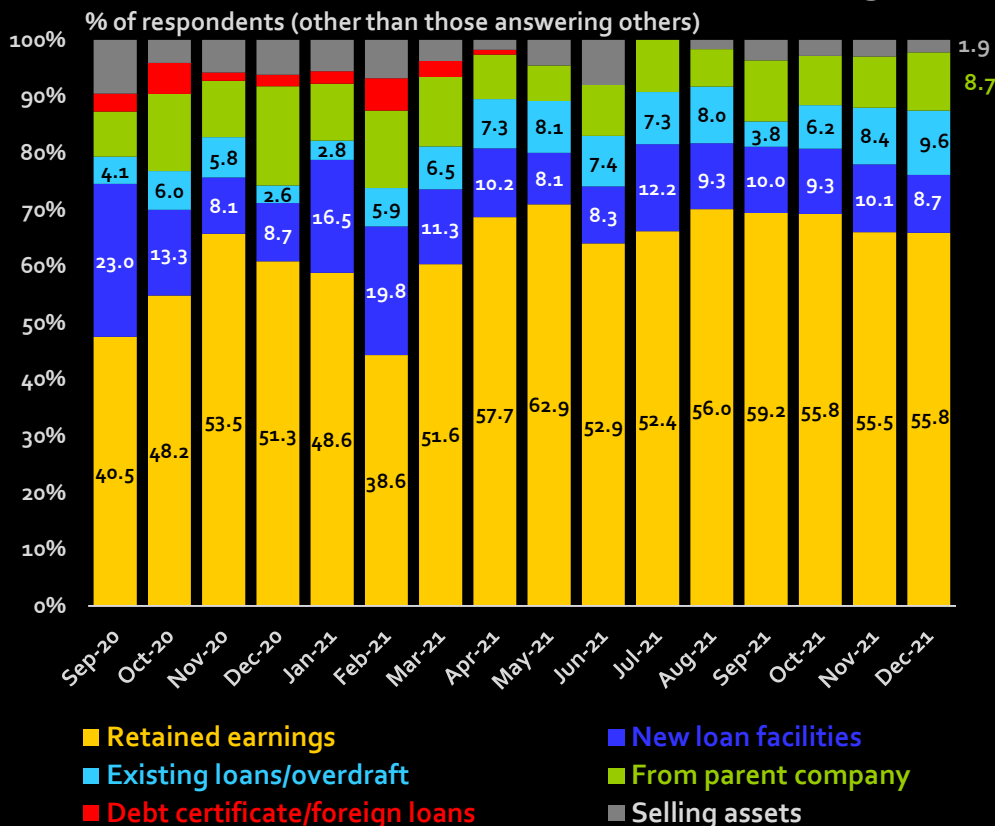


The private sector has maintained large net savings, while those of SOEs and individuals have declined

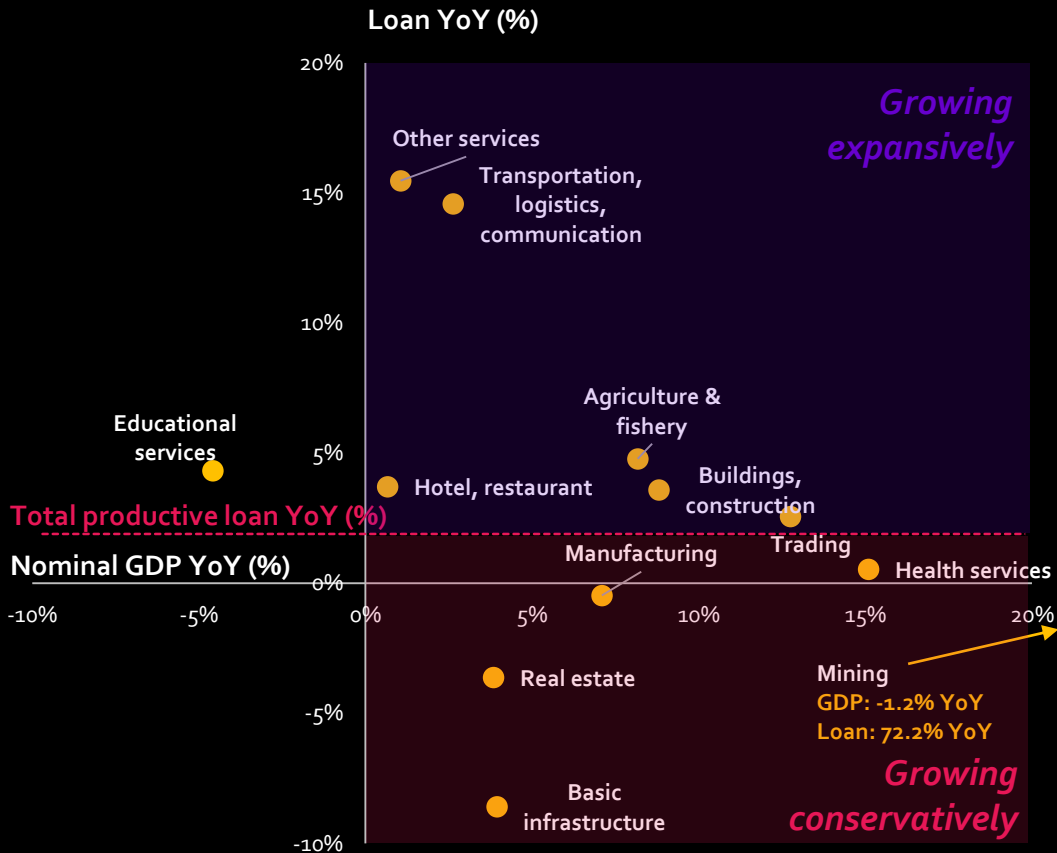


Retained earnings remained by far the most preferred source of financing amid the recovery ...

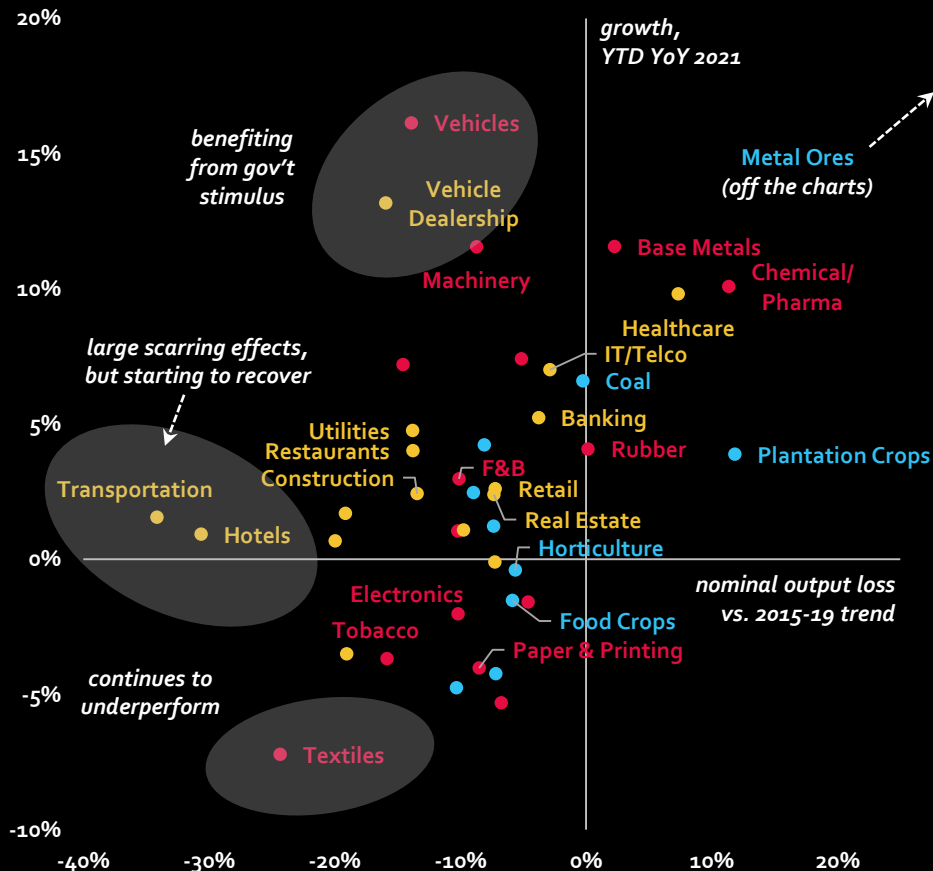
Q : What is your main source of financing?



... and as such, loan growth did not correlate all that well with sectoral growth ...



... and probably not with credit risk either, as it mostly reflects pandemic-related output loss (x-axis)

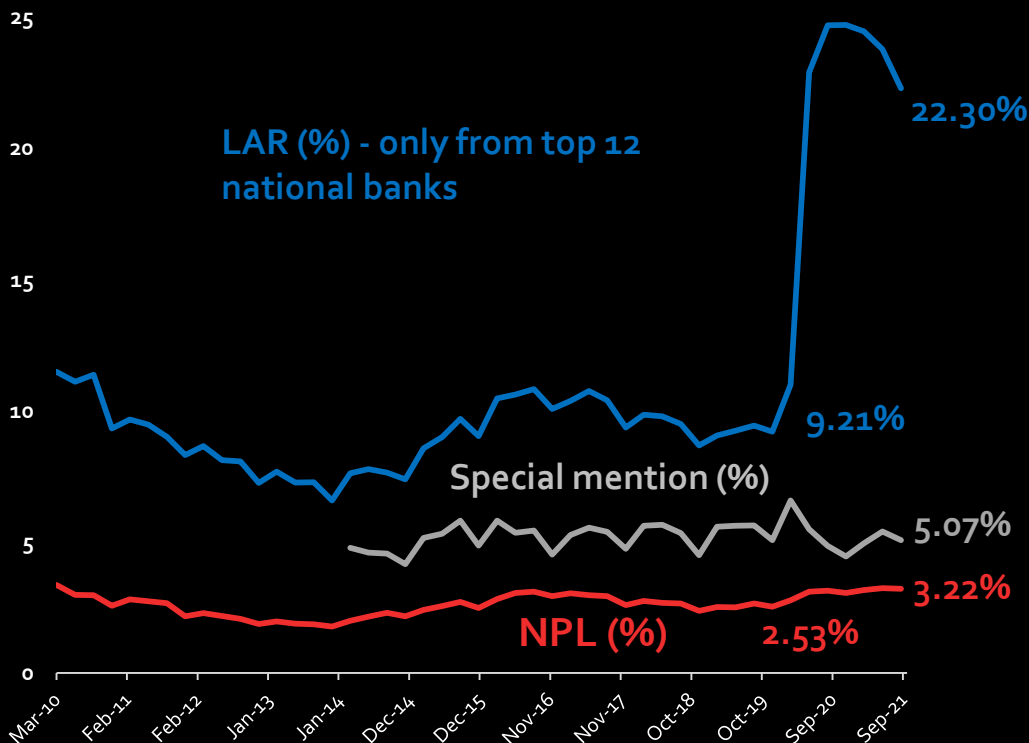


Source : BPS, BCA Economist calculations

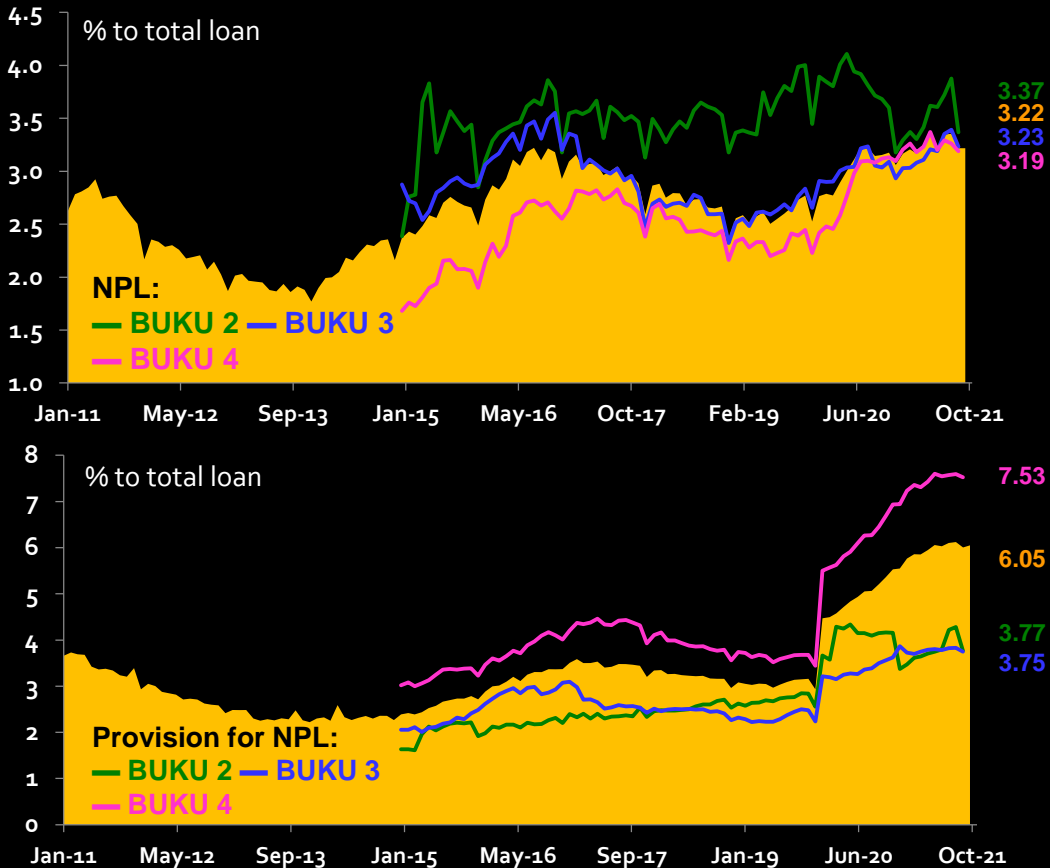
* Light blue = Primary sectors, Red = Manufacturing, Yellow = Tertiary sectors

Loan at risk levels remain elevated, albeit starting to decline thanks to writeoffs or shift into NPL

30 (%) ratio to total loan



Banks, particularly bigger ones (BUKU 4), have increased their loan loss provisioning



Part 3

Merging and diverging

- In the first two chapters, we have discussed how funding from CASA (instead of time deposits) could be a critical factor for banks amid the rising rate environment, while provisioning is key in mitigating the still-elevated LaR levels. If we look closer at both indicators, however, the largest banks (BUKU 4) outperformed the medium and smaller banks by wide margins ([Exhibit 6](#), [Exhibit 13](#)). Such a gap can also be seen for indicators of banking profitability ([Exhibit 14](#)), including fee-based incomes which constitute a growing share of bank revenue ([Exhibit 15](#)).
- Of course, banking has always been a capital-intensive industry with economies of scale and network effects – all of which lend itself towards consolidation. The advent of digital channels may seem at first blush to level the playing fields, but the large amount of CAPEX needed, as well as the rapid pace of technological advance and obsolescence, has only tilted the field even more so towards the bigger banks.
- As it is, the main factors that could potentially shake up the banking business in the medium to long-run comes mainly from the outside, namely (1) the rise of digital banks or neobanks, (2) changing regulatory climate, and (3) the growing trend towards environmentally sustainable financing.

Digital technology, regulatory changes, and ESG awareness constitute the primary long-term challenges to the banking industry

- The years 2020-21 saw an influx of neobanks into Indonesia's banking landscape. These new entrants focus on a new kind of business model to compete with traditional banks, being part of a larger digital ecosystem and also backed by a massive war chest of financing from VC and other tech companies.

Digital banks may have an edge on funding and customer acquisition, but the lending side would need a gradual buildup of capabilities

- As such, while these neobanks are still medium-sized for now, they are looking to grow and acquire customers rapidly through extensive promotions and collaboration with other digital platforms in their respective ecosystems. They thus constitute a contrary trend to the aforementioned consolidation tendency. Still, the large incumbents have been preparing for these new challengers by also embracing a more digital and ecosystem-oriented model, in some cases by spinning off their own digital banking arms.
- It is as yet unclear who will come out on top of this potential shakeup, however a few things are clear in the short-term. First, the trend towards M&A between tech platforms, banks, and other financial institutions would only continue, especially following the issuance of POJK 12/2021 that established level playing field between traditional and digital banks. Second, digital banks – as well as the more adaptive incumbent banks – will probably gain market share in terms of funding, at the expense of the small- and medium-sized traditional banks.
- Thirdly, while an advantage in funding could certainly be leveraged towards the lending side, there are critical “soft infrastructure” that will need to be built up gradually, including customer networks and risk analysis capabilities. The



neobanks' digital savvy and potentially wide customer bases lend them more towards consumer and SME lending rather than corporate loans – which coincidentally seems to align with the new medium-term regulatory goals.

- BI's new regulation, PBI 23/2021, introduced a metric known as the macroprudential inclusive financing ratio (RPIM), which is the ratio of a bank's SME financing to total financing. The regulation specified a gradual increase in the level of RPIM to be fulfilled, from 20% in 2022, to 25% in 2023, and 30% in 2024.
- But while the goals of RPIM are quite narrowly defined, it may arguably accelerate overall loan growth over the next few years. A simple calculation shows that, given the starting point, the banking industry as a whole will have to grow its SME lending by an average of 30% annually if it is to maintain the growth of other loans at reasonable levels (**Exhibit 16**). The alternative is for non-SME loans to either stagnate or contract, something which is likely untenable given the large financing needs of the recovering economy.
- The other challenge associated with RPIM concerns credit risk, since SME loans naturally experience higher NPL levels compared to corporate ones (**Exhibit 17**). Banks that have tended to focus on other types of loans will certainly have to increase their provisioning and also invest in greater capabilities to market and analyze SME loans.

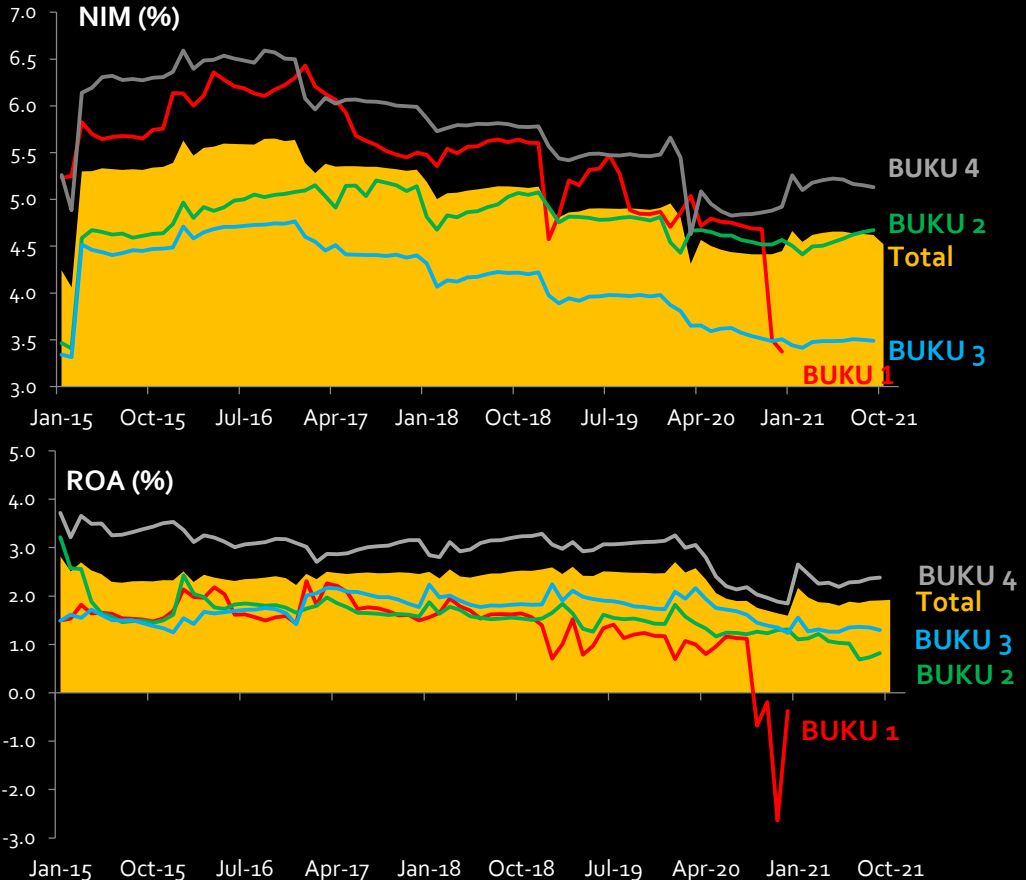
While RPIM aims at spurring SME loans, it may end up accelerating credit growth in general especially amid the post-pandemic recovery

- The third challenge comes from the rising salience of environmental issues, which may affect banks' portfolio allocation as well as the credit risk it faces in several sectors. On one hand, this trend may improve the longer-term prospects for some sectors such as basic metals, whose derivatives are required for electric vehicles (EV) and renewable energy generation.

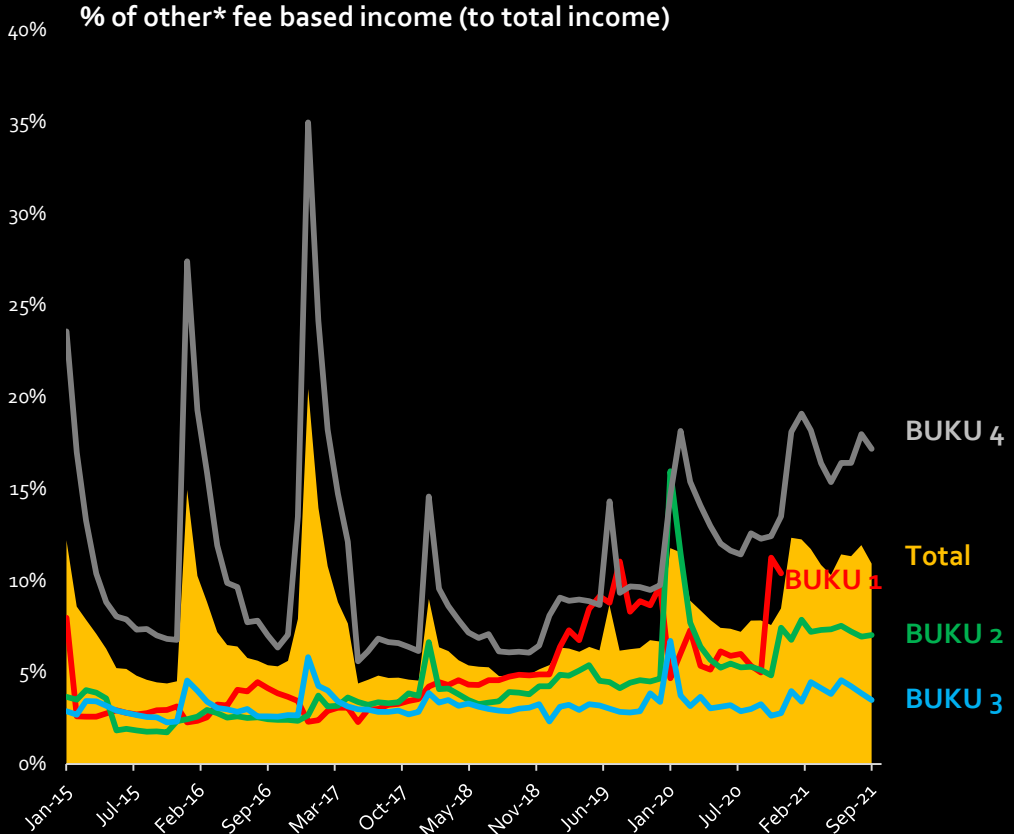
The impact of ESG issues on bank portfolios could be cushioned somewhat by the high commodity prices in the meantime

- On the other hand, it could negatively affect some sectors that have been the mainstays of the Indonesian economy, such as coal and CPO. The pressure on the coal industry seems to be particularly strong going forward, especially as the government has committed itself to the goal of net zero emission by 2060. This is a big change in direction compared to the past decade, when the portion of coal in Indonesia's energy mix increased sharply. Instead, the government is phasing out the construction of new coal-fired power plants and is introducing a new carbon tax.
- Estimating banks' exposure to coal is not an exact science, given the paucity of detailed sectoral breakdown of industry lending data. A broad estimate is between 0.8 – 2.5% of banks' total loan portfolio, but coal certainly has a wider spillover to other sectors ([Exhibit 18](#), [Exhibit 19](#)). In the end, though, we do not expect a sharp increase in loan-related credit risk in the short-term, since the transition is likely to be rather gradual, and its impact cushioned somewhat by the relatively elevated energy prices. Overall, while banks are facing long-term challenges, it still has sufficient room to adapt as well as the momentum from the economic recovery.

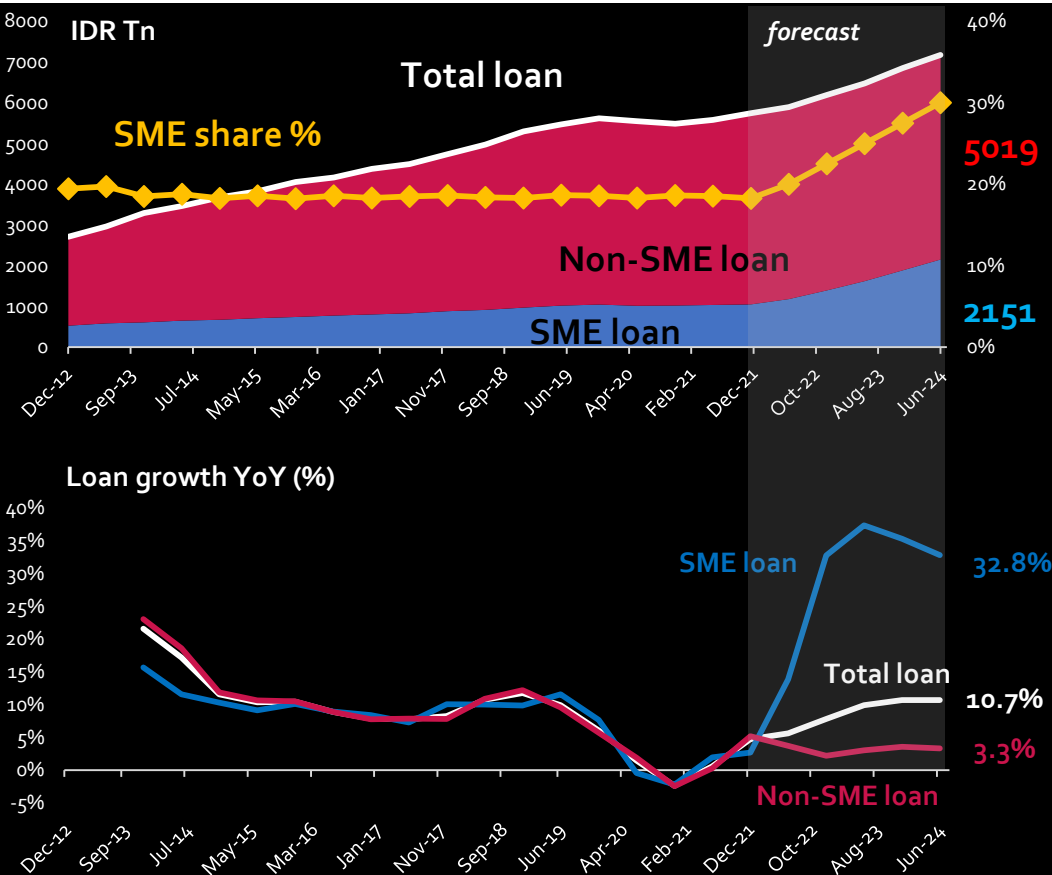
There has been wide – and probably growing – profit disparity between the bigger and smaller banks



The share of fee based income continue to increase, but it is not everyone's game

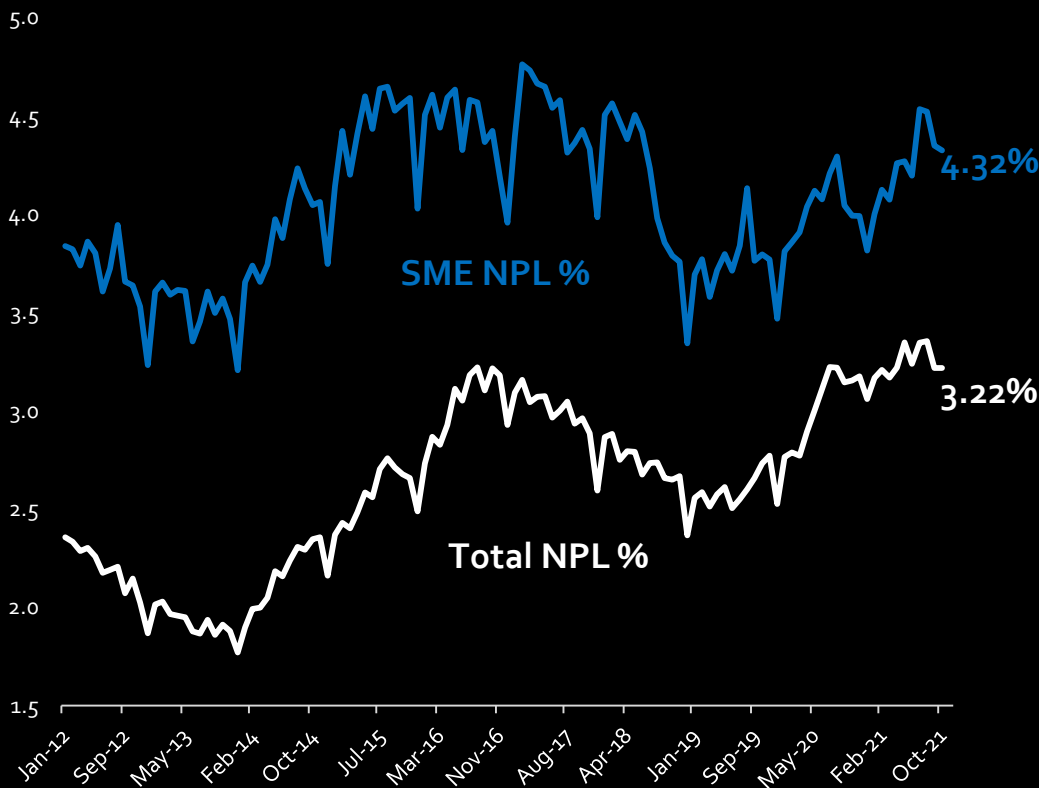


Fulfilling RPIM could mean either faster overall loan growth and/or slower non-SME loan growth



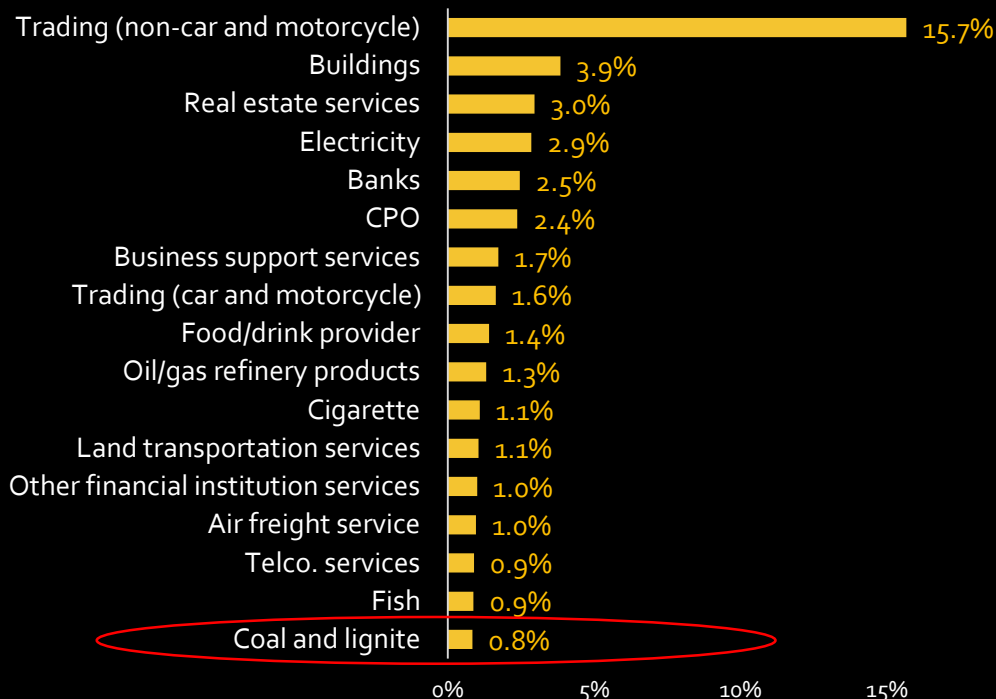
Traditionally, credit risk has been higher for SME loans than other loans in general

NPL ratio %



Estimating the exposure of coal to bank's portfolio? #1

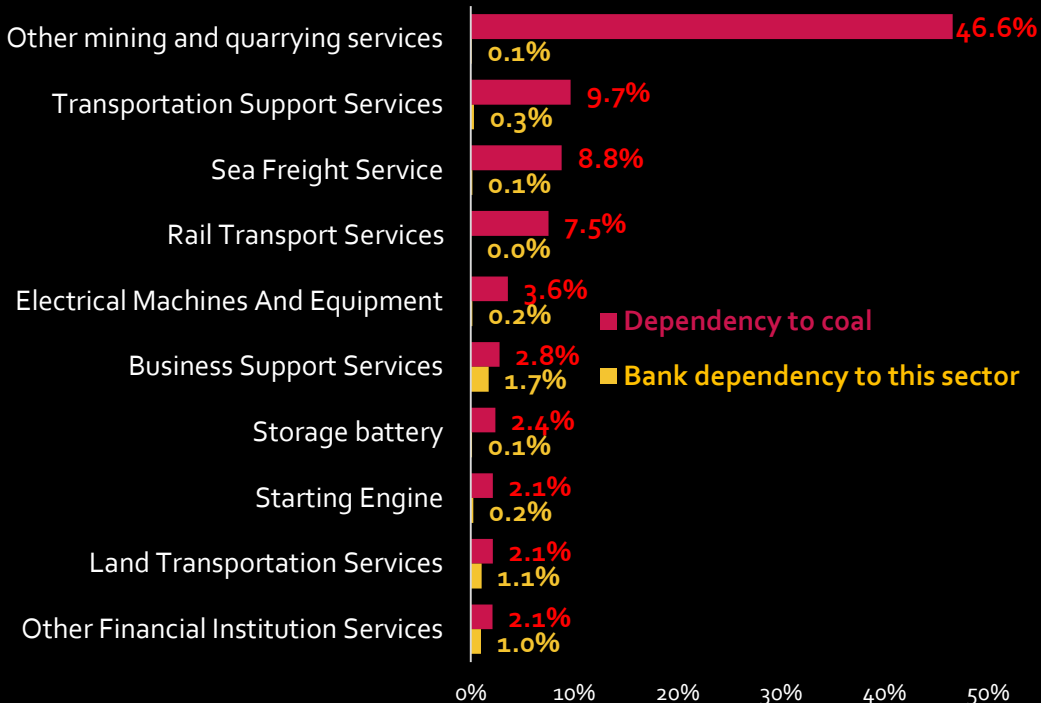
First level (direct) exposure



*) The approximation was calculated using input-output table (2016), from financial institutions (banks only) to other sectors

Estimating the exposure of coal to bank's portfolio? #2

Secondary level (derivatives, only top 10) exposure



*) The approximation was calculated using input-output table (2016), from top 10 sectors that heavily depend on coal sectors, linked to financial institutions (banks only)



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