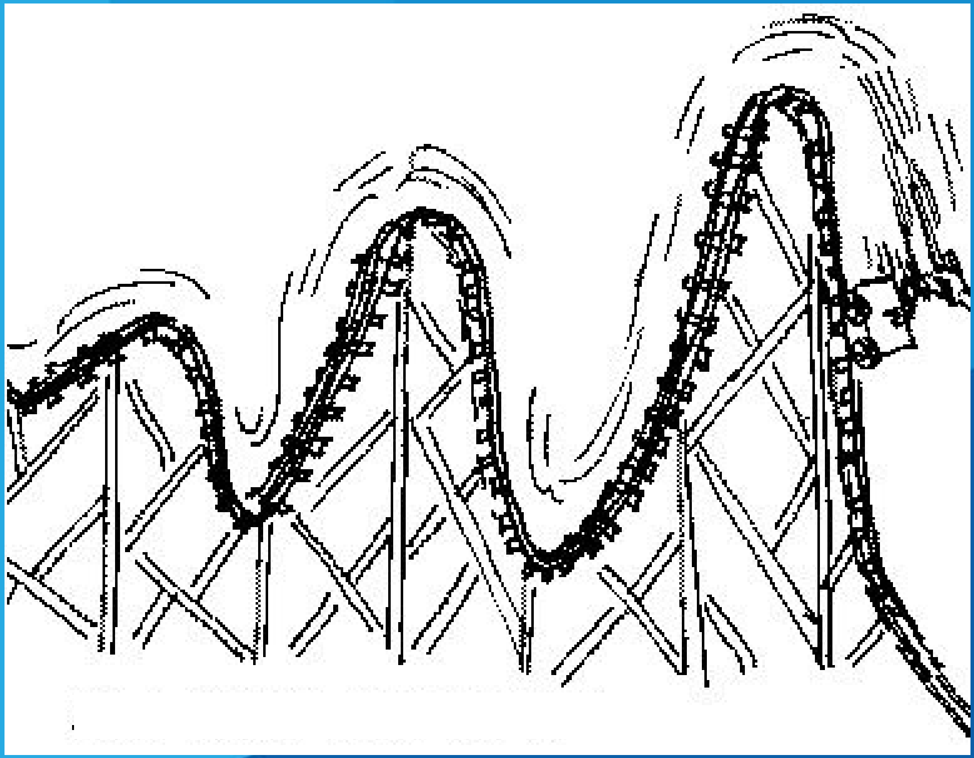
Business Cycle and the Indonesian Banking Sector

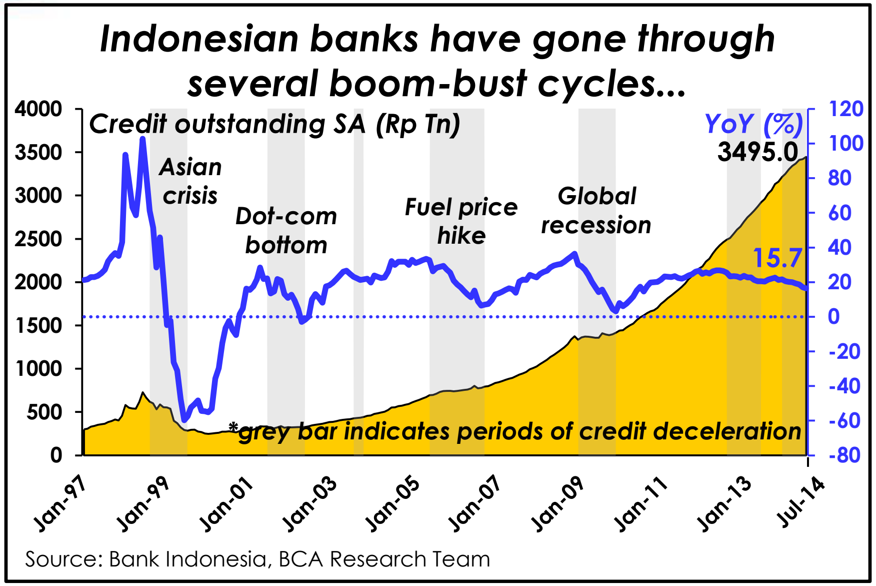


Jahja Setiaatmadja

LPS/IDIC Seminar

Ritz Carlton - Jakarta, 23 September 2014

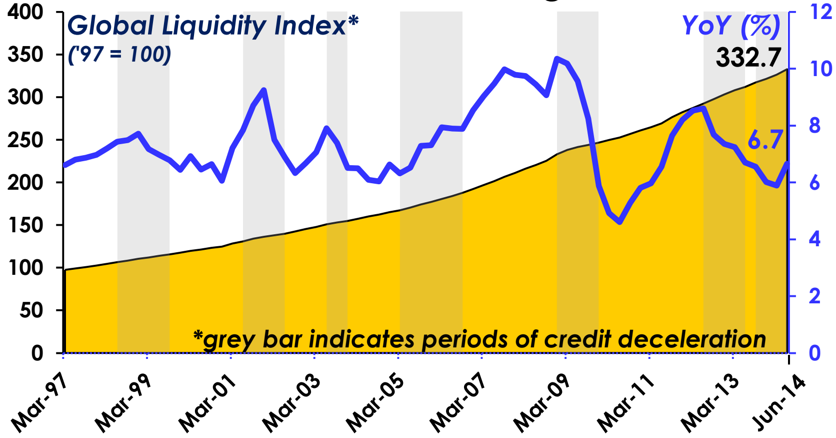
Indonesian banks are becoming more resilient



- **The experience from the Asian crisis led to tighter banking standards**
- **Post-1998 cycles have been milder**
  - **Partly due to better risk management practices**
  - **Partly due to the busts having less impact on Indonesia's growth and BoP**
  - ***Are we getting smarter or just lucky?***
- **Banking sector is still below capacity, low penetration (credit is 36% of GDP)**
  - **Banking shocks are mostly exogenous rather than self-generated**

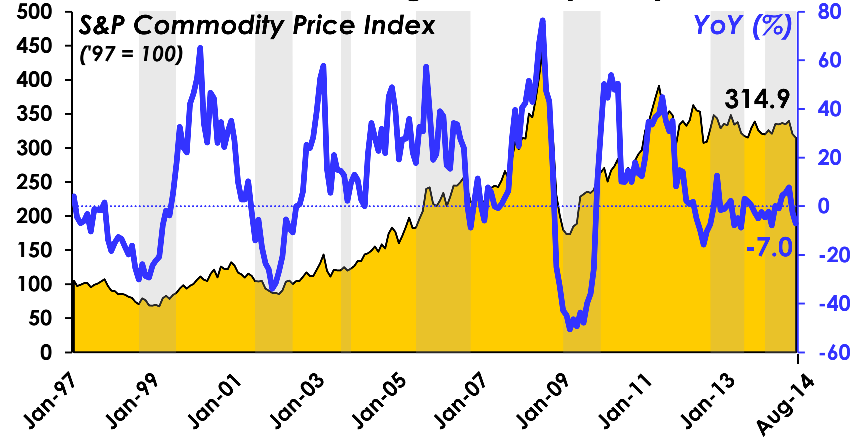
Indonesian banking cycles are governed mostly by global factors

Global liquidity is an important determinant of Indonesian credit growth



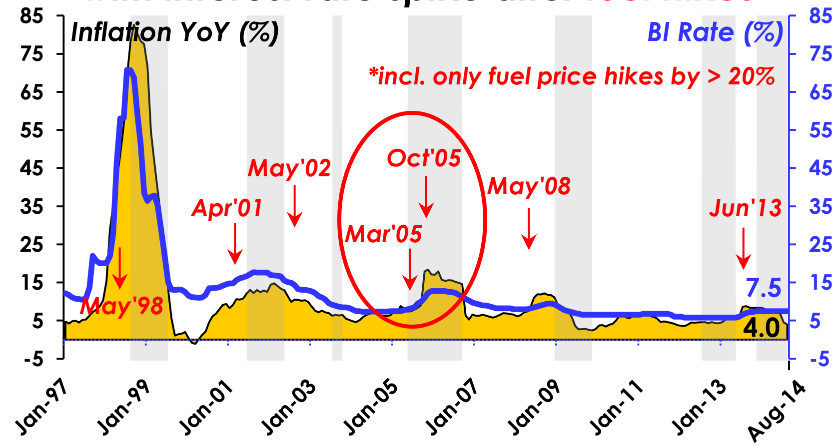
Source: Bloomberg, *calculation by BCA Research Team

Decline in commodity prices crimps export sector and tightens liquidity



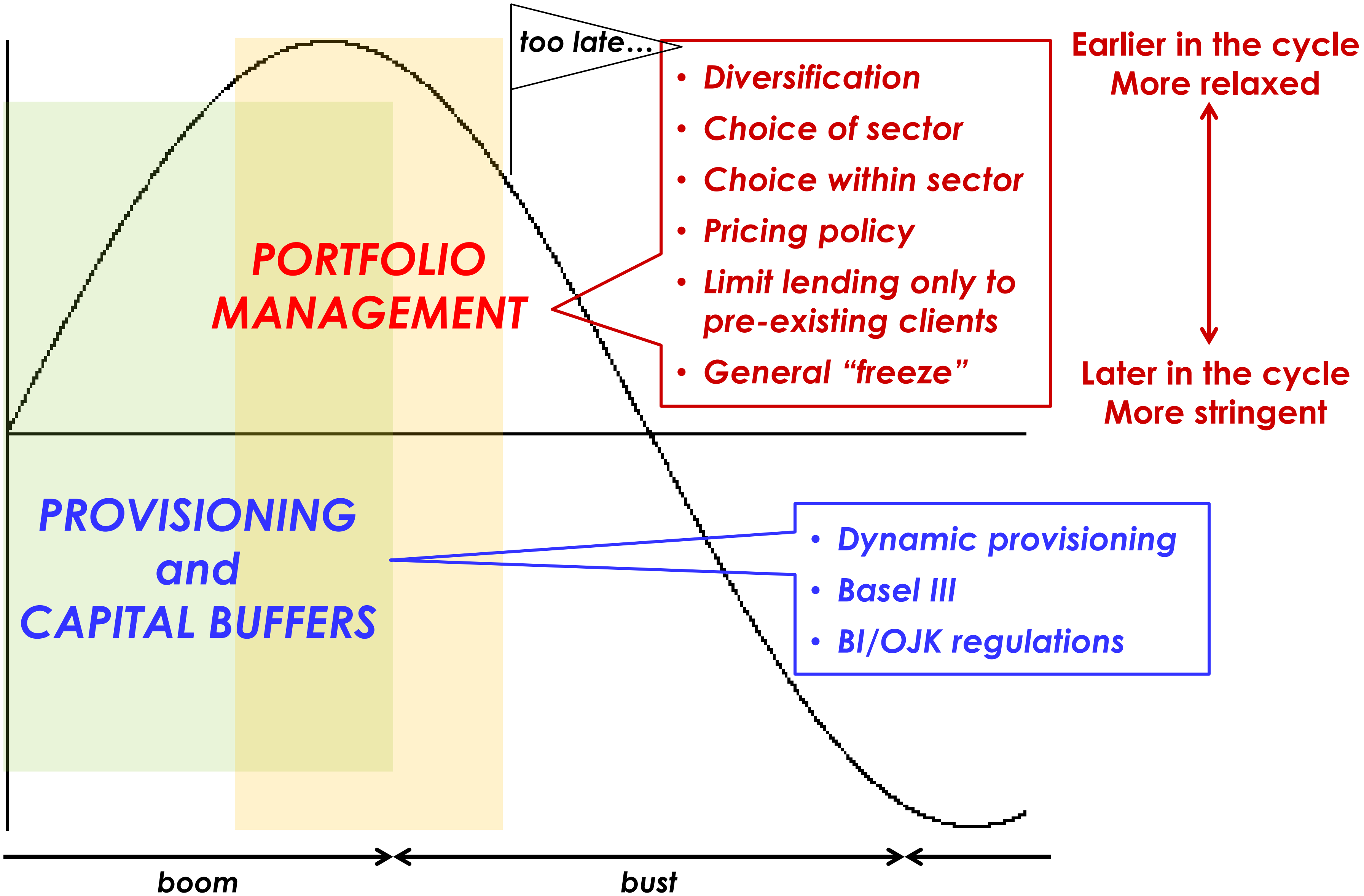
Source: Bloomberg, BCA Research Team

At least one deceleration was associated with interest rate spike after fuel hikes



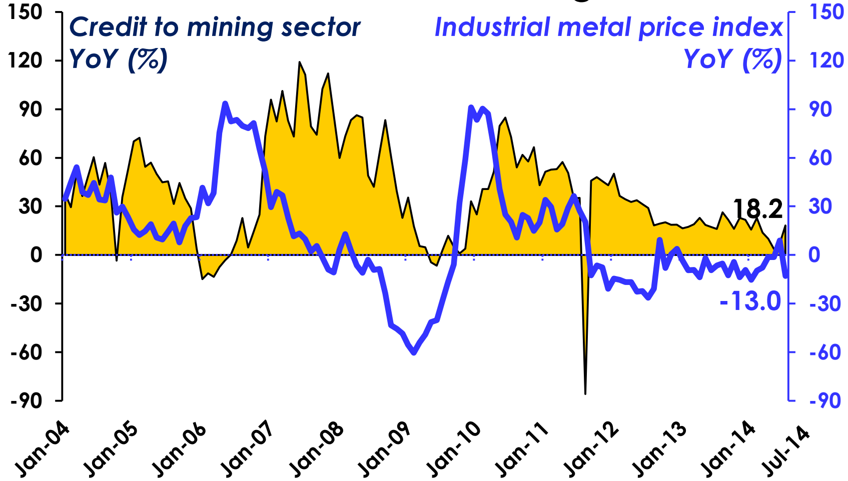
Source: Bank Indonesia, BPS, BCA Research Team

Risk management relies on tried-and-tested methods



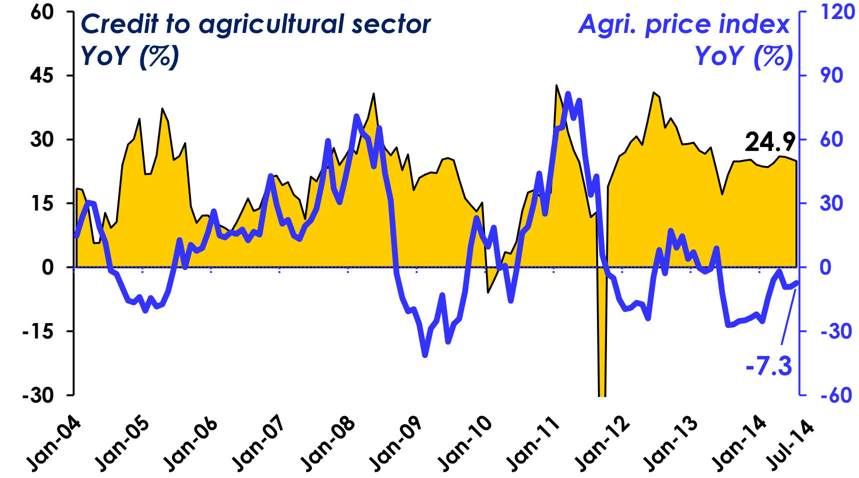
Portfolio management: Bridging the perception gap

Credit allocation tends to lag behind...



Source: Bank Indonesia, BCA Research Team

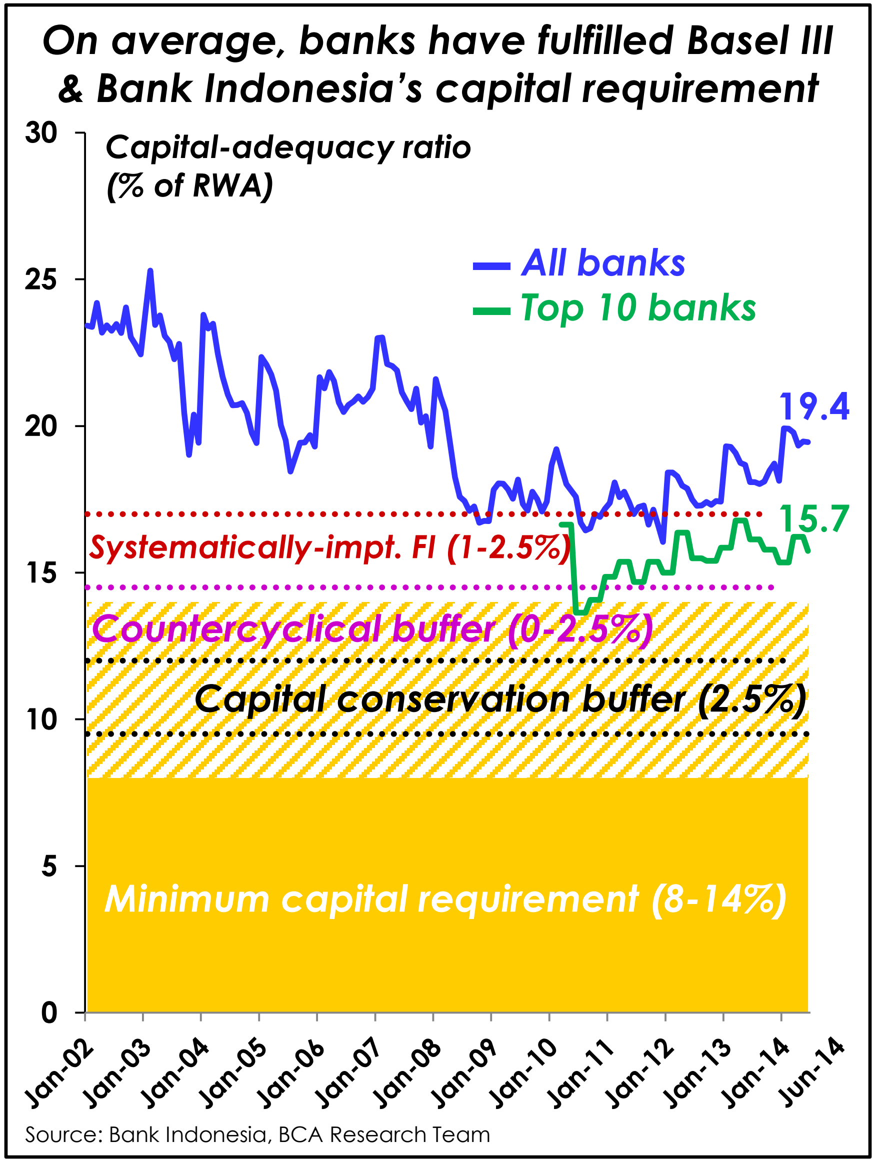
... or coincident with sectoral development



Source: Bank Indonesia, BCA Research Team

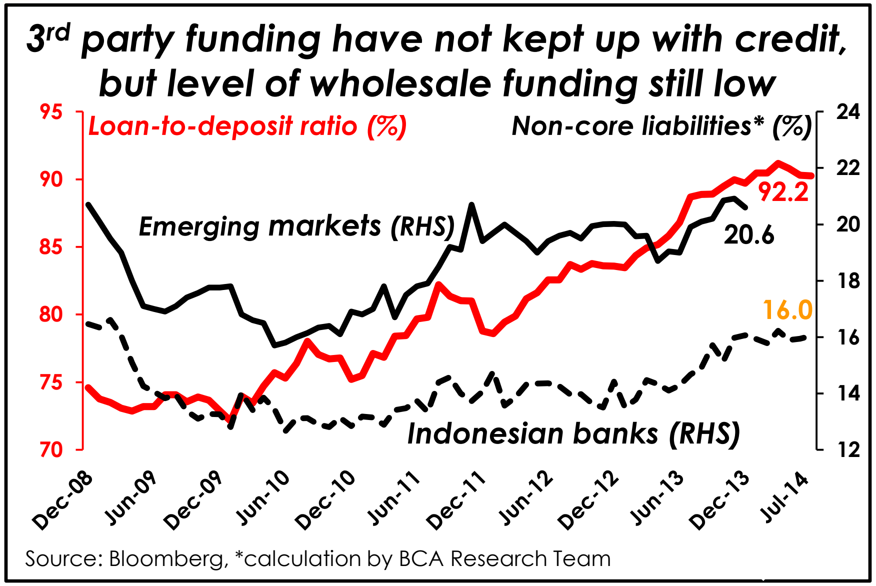
- **Businessmen make investment decisions based on *recent developments & short-term prospects***
- **Financial data is *backward-looking***
- **As such, needs *forward guidance* from management and regulators**
  - ➢ **But regulator must be cautious and not overreact to crises and good times**
- **Needs both broad policy (macro level) + due diligence (micro level)**

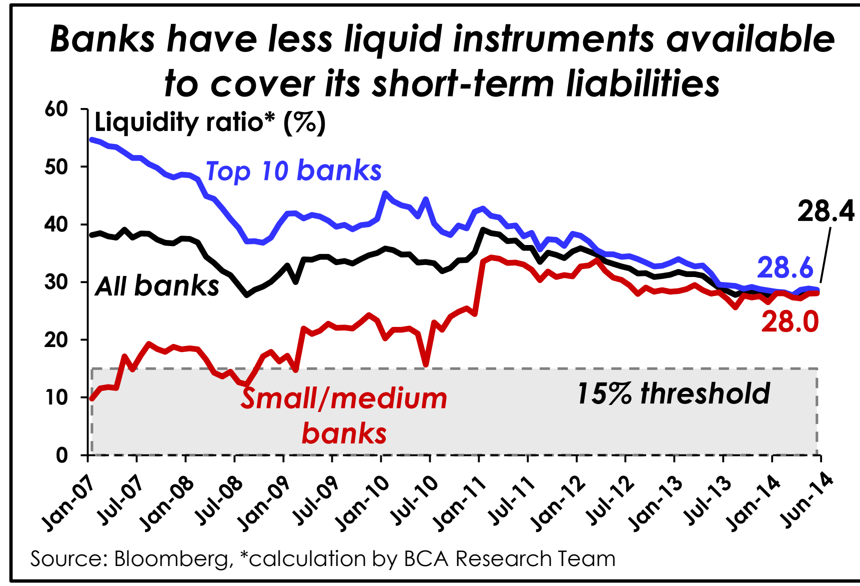
Provisioning and capital buffer: More stringent regime ahead



- **IFRS follows "incurred loss" rather than "expected loss" approach for provisioning**
  - ➢ **Provisioning becomes pro-cyclical and less dynamic**
- **Larger Indonesian banks have lower CAR on average**
- **Basel III phase-in between 2016-19:**
  - ➢ ***If* this coincides with a "bust", credit growth might be crippled further → should be introduced in good times?**

Contemporary concern: Liquidity risk





- **The underlying causes are structural → Current account deficit, low savings rate**
- ***Big danger*: Sudden stop of capital inflow**
- **Sample of steps taken to anticipate liquidity risk:**
  - **Banks: Narrowing NIM, restricting lending**
  - **Regulators:**
    - **Macro-prudential regulations → Secondary RR linked to LDR**
    - **Issuing more liquidity-management instruments**
    - **Improving the functioning of the money market (mini-MRA)**

Financial deepening

In Summary: Responding to the boom-bust cycles

A. Re-regulating

(BI, OJK, LPS, int'l regulators)

- *Monitor and supervise sectoral conditions*
- *Tighten capital standards*
- *Macro-prudential regulations*
- *Financial deepening*
- *Build up reserves → mitigate the effects of capital outflow*
- *Synchronize capital and provisioning regulations*

+

B. Re-orienting

Banks' business process & risk mgmt

- *Dynamic provisioning?*
- *Build up capital buffers*
- *Portfolio management*
- *Measure risks better*
- *Incorporate new scenario-building & stress-testing capabilities*
- *Improve efficiency*
- *Strategic planning & flexible leadership*
- *Rethink business model → Less exposure to cycles*

→

To smooth the effects of business and financial cycles

Thank you

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