Financial System Stability and Deepening in Indonesia: challenges amid regulatory capital reform under Basel III

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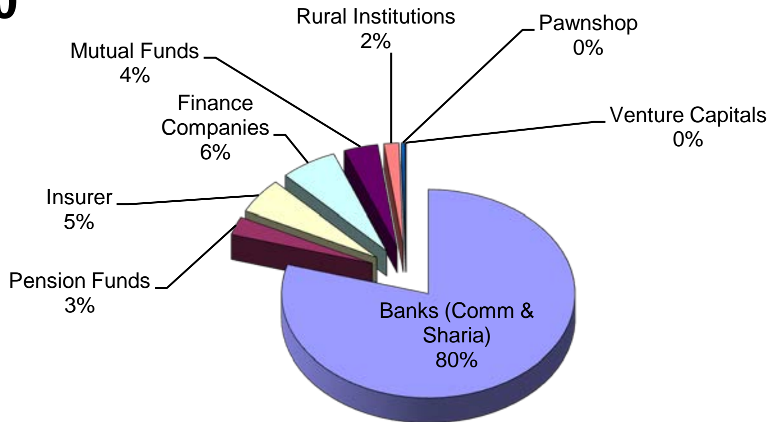
COUNTRY PARTNERSHIP STRATEGY FOR INDONESIA FY2009-2012
Investing in Indonesia's Institutions
for Inclusive and Sustainable Development

What do we mean by Financial System Stability and Financial Deepening?

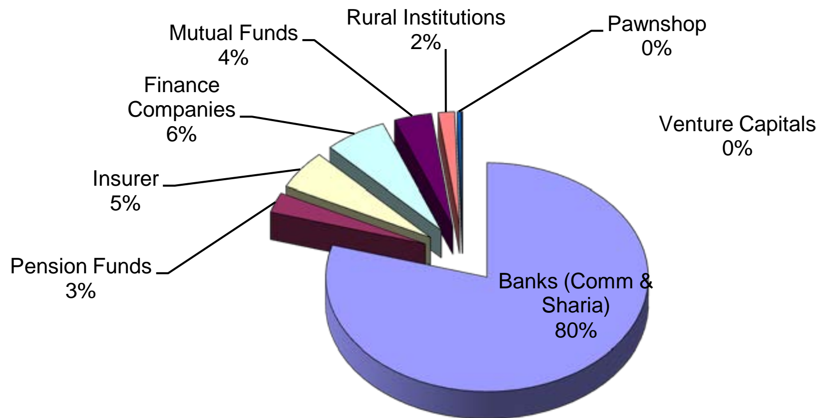
- There is no single definition of financial system stability nor financial deepening.
- Financial system stability is a condition represented by a strong financial system capable of withstanding economic shocks, one that is able to ensure intermediary function, settlement of payments and diversification of risk.
- Financial deepening, sometimes is known as financial development, refers to the increased provision of financial services with a wider choice of services in the economy <u>or</u> an increase in the size of the financial system and in its role and pervasiveness in the economy.

Financial Stability in Indonesia depends on financial soundness of the banking sector

2000



2010



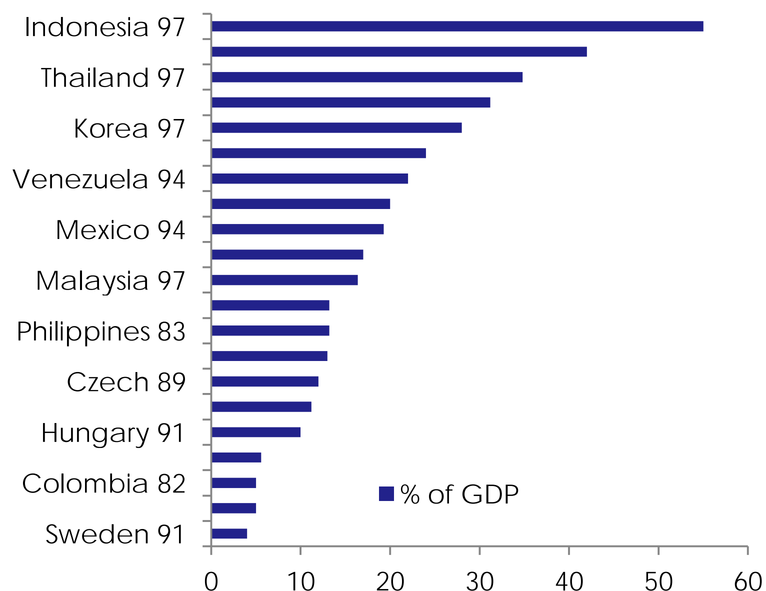
Source: BI, Bapepam LK, WB estimates

- **Highly concentrated - banking sector dominates**, recording stronger asset growth compared to that of the non-bank financial institutions.

- The top three state-owned commercial banks account for one third of all banking sector assets and deposits.

The economic cost of a failure to maintain financial soundness of banks is high

- **The 1997/1998 banking crisis was costly. It wiped off 50% Indonesia's GDP.**
- **Fiscal costs of the 1997-1998 crisis were the highest recorded.**
- **Since then, serious reforms and efforts have been taken to restoring and maintaining financial system stability.**



Source: Honohan and Klingebiel, 2000.

Sustained efforts for maintaining financial system stability have been paying off…

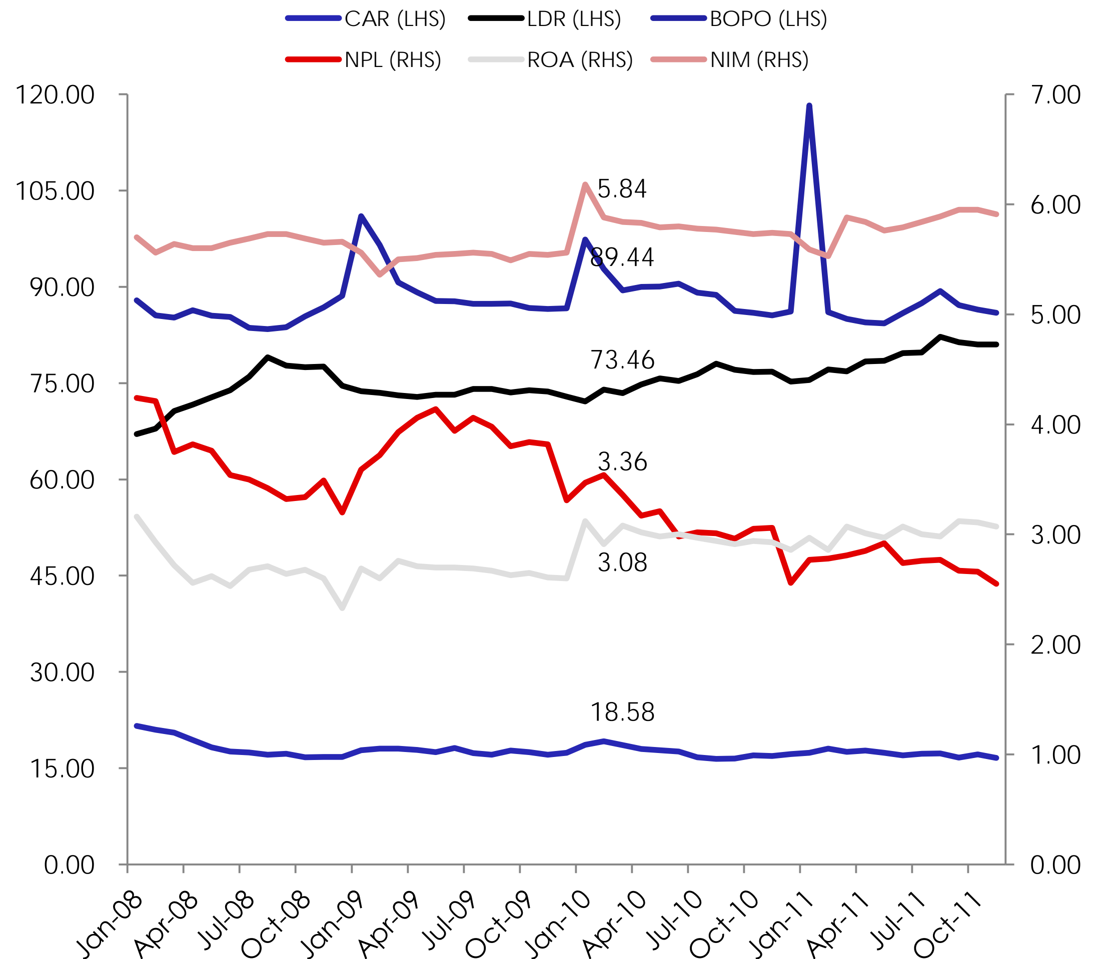
•Banking sector **NPL ratio largely unaffected** by 2008 crisis and continues to improve.

•In 2011 **NPL ratio maintained low level** of 2.7% (vs 2007 6%).

•**CAR consistently strong** and 17.2% 2011, high level of Tier 1 capital.

•**ROA, ROE and NIM had increased** to 3.1%, 18.8% and 5.9% in 10/11 respectively compared to 2.9%, 19.2%, 5.7% 12/10.

•**High level loan provision** consistently over 100% minimum level required. As of 10/11, the ratio increased to 194% from 131% in 12/10.



Source: Bank Indonesia

Banks Intermediary function has improved, with significant lending share to SMEs.

•Maintained **low operating efficiency** measured by the ratio of operating expenses to operating incomes - increased slightly from 85.9% in 10/2010 to 86.4% by 10/2011.

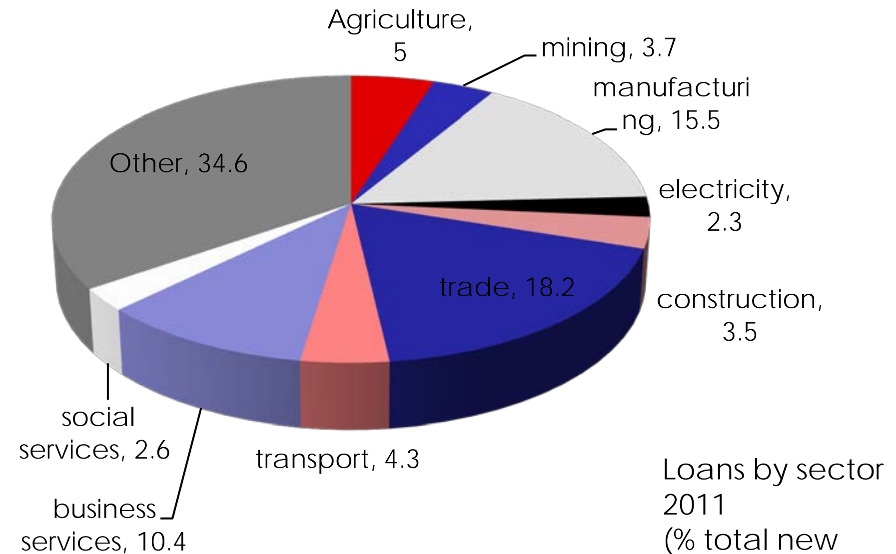
•The **deposit and lending rates stable** at 6.5% and 12% over 2011.

•**Domestic credit to private sector** slight increase **28.8%** (v 25% 2006).

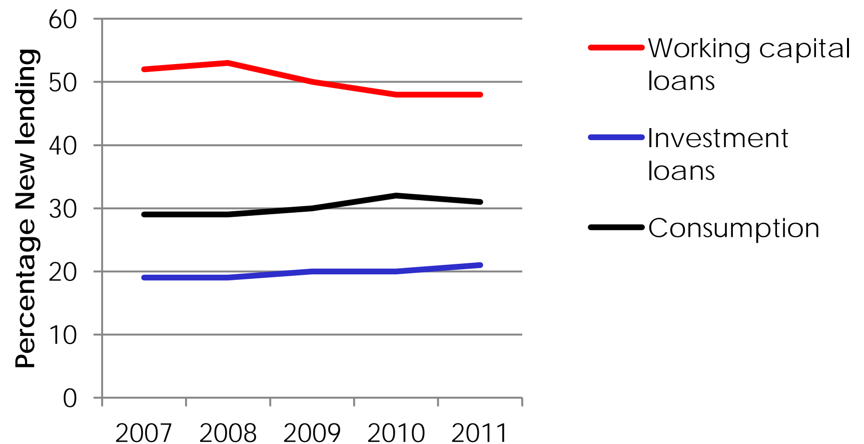
•**Loan to deposit ratio increasing 81% 2011** (75.2% 2010, following regulation on minimum LDR 75%).

•Loans increased 20% with SME lending increasingly prominent - o**utstanding SME lending increased to 53%** (52.4% 2010, 50% 2008).

•Majority bank lending for working capital (48%) but over past five years shifting to investment loans (21%) and consumption (31%), the latter also capturing MSME lending.



Loans by sector 2011
(% total new



Stress Testing and Vulnerability: Lessons from FSAP

- **From October 2009 until March 2010, a joint IMF-WB team conducted the Financial Sector Assessment Program (FSAP) for Indonesia. As part of the FSAP, a bank stress testing was conducted.**

- **The stress test involved scenario analysis and sensitivity analysis. The scenario analysis was used to infer banks' vulnerability to credit risk, while the sensitivity analysis focused on banks' vulnerability to a range of market risk shocks. Both top down and bottom up methodologies were used.**

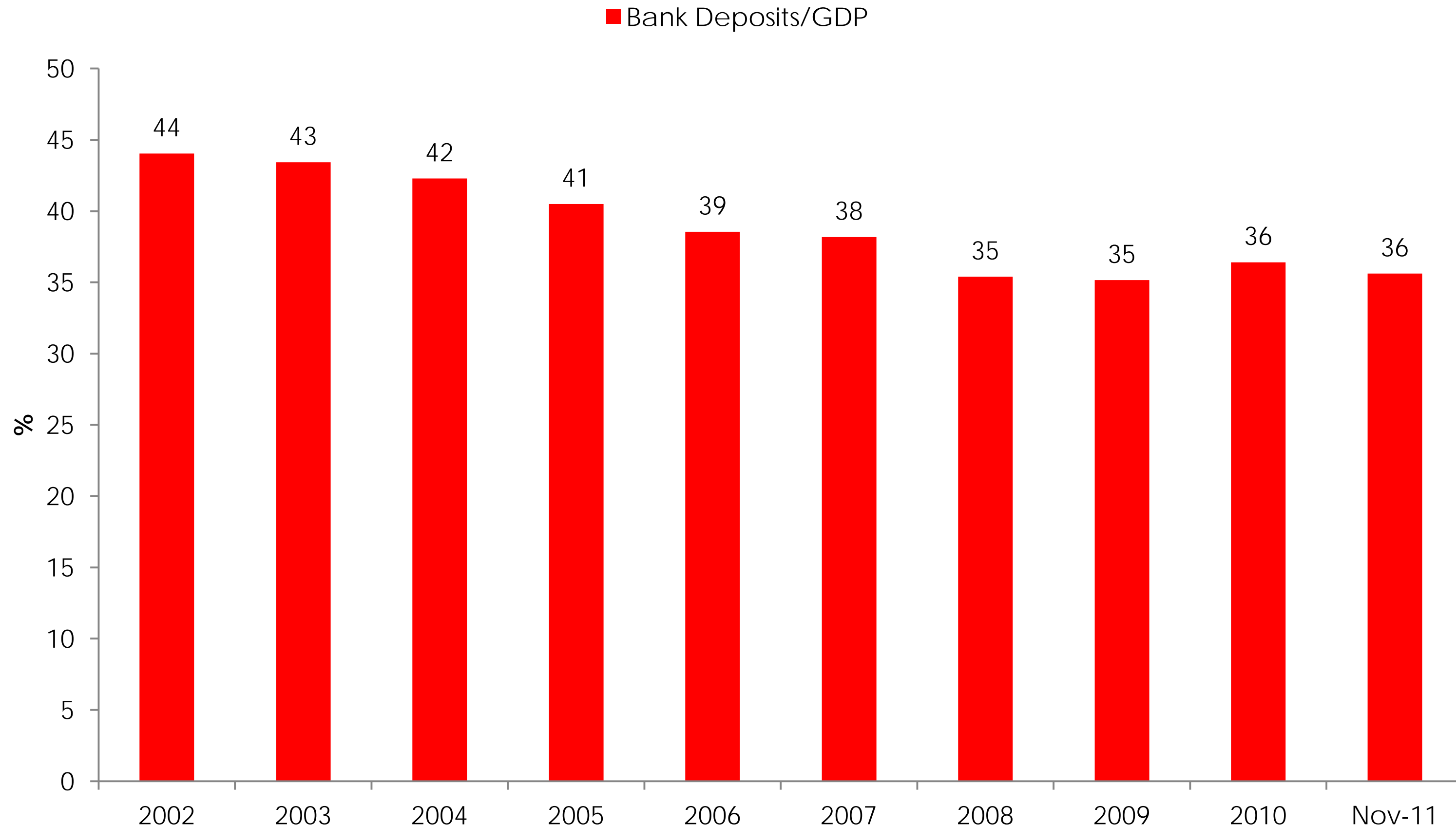
- **Key findings:**
  - **Credit risk is the main source of risk facing the Indonesian banks.**
  - **Indonesian bank are relatively resilient to market shock. They are most sensitivity to interest rate shock on their banking book but can withstand other type of market risk.**
  - **Banks have limited exposure to interest rate on their trading book.**

Stress Testing and Vulnerability: Lessons from FSAP

- **Key findings (continued):**
  - Smaller sized banks are most vulnerable to liquidity risk whilst the largest banks are vulnerable to concentration risk.
  - Contagion risks through the interbank market are not significant due to small size of the interbank exposures.
  - There is a wide diversity of stress testing capacities among the participating banks (12 banks). Most were able to undertake meaningful sensitivity analysis. They were able to also assess their exposures to concentration risk arising from the failure of their largest borrowers.
  - However, a few banks were able to fully evaluate the adverse macro-economic scenario that was chose for the FSAP. In particular, there were significant shortcomings in the methodologies used by many of these banks to assess credit risk regardless whether these were models based on/or incorporated expert judgment.

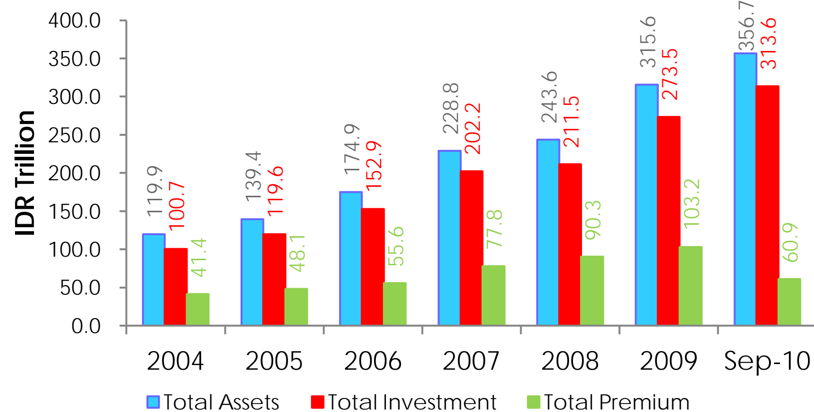
However, financial deepening appears to be a challenge…

- **Bank's size to GDP is low compared to Thailand 97%, Malaysia 129%, Philippine 54%.**

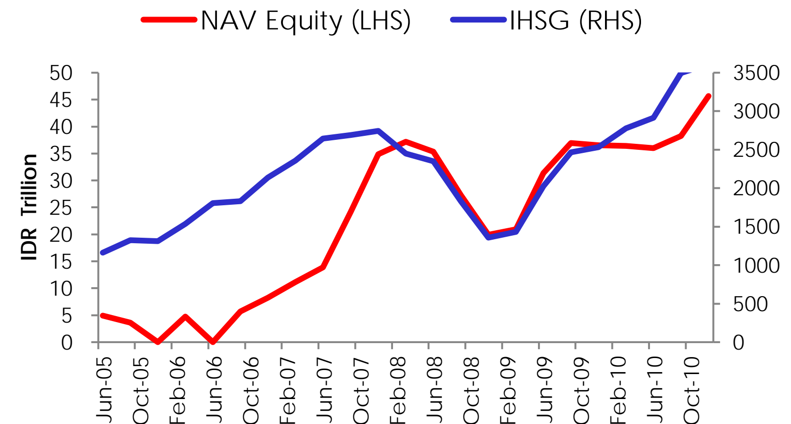


NBFIs are growing strongly but still small.. (1)

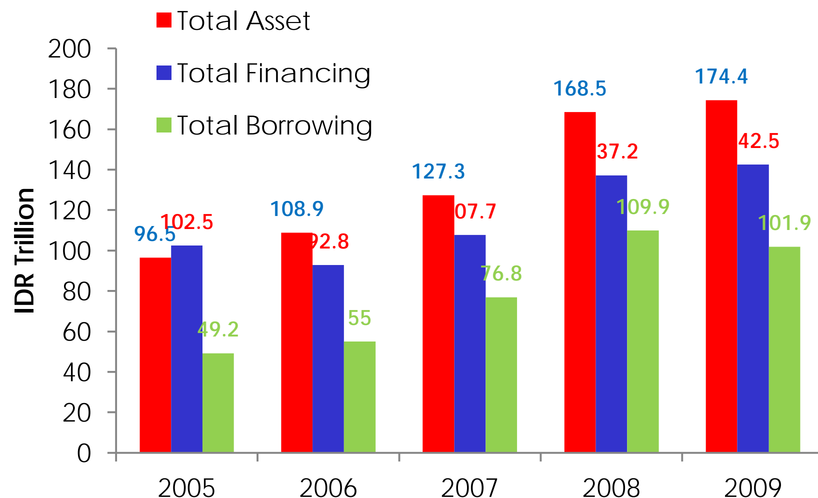
Insurance



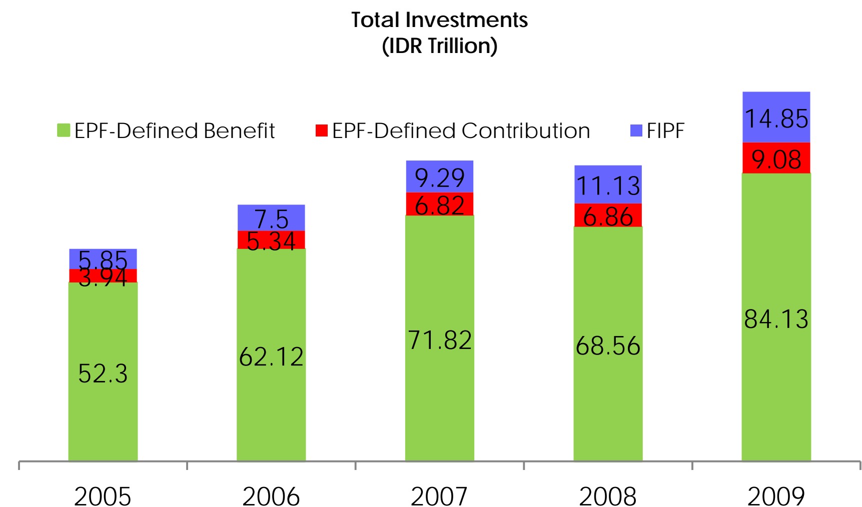
Mutual Fund



Multifinance

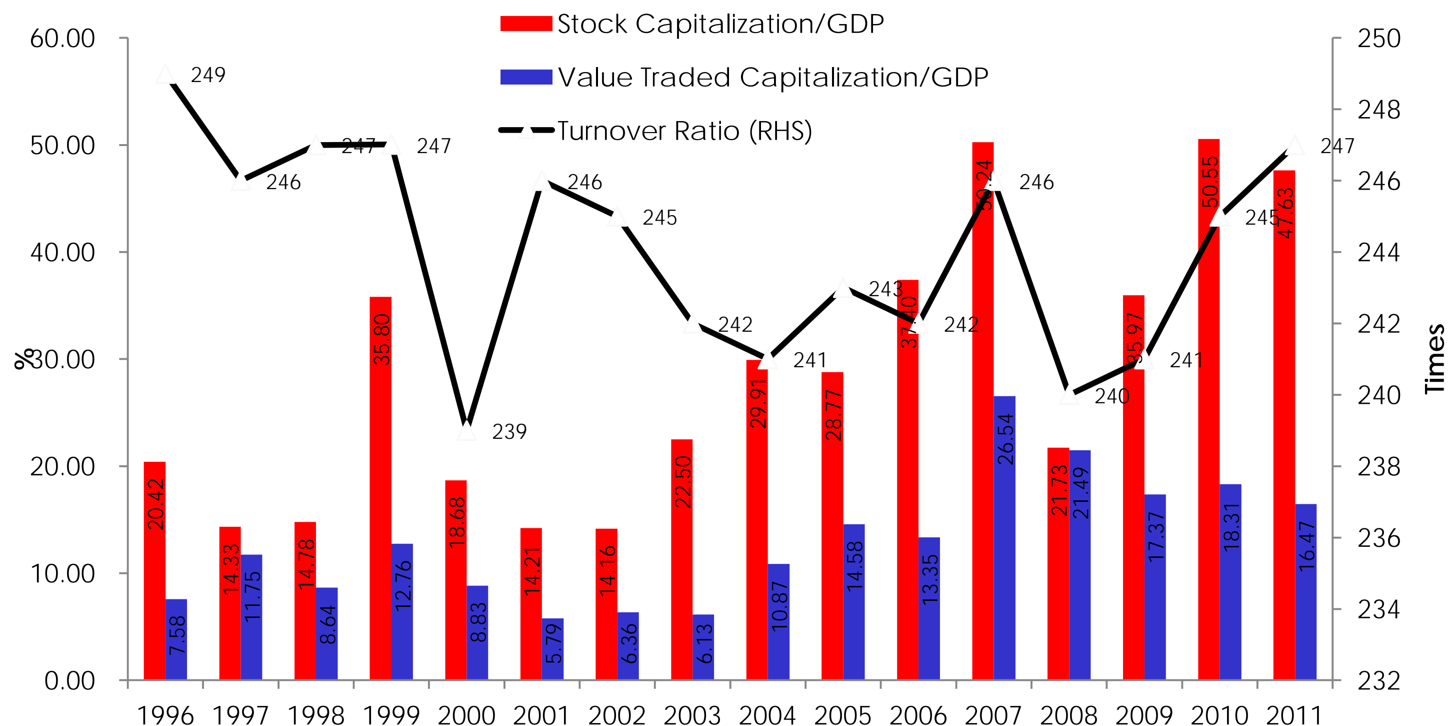


Pension Fund



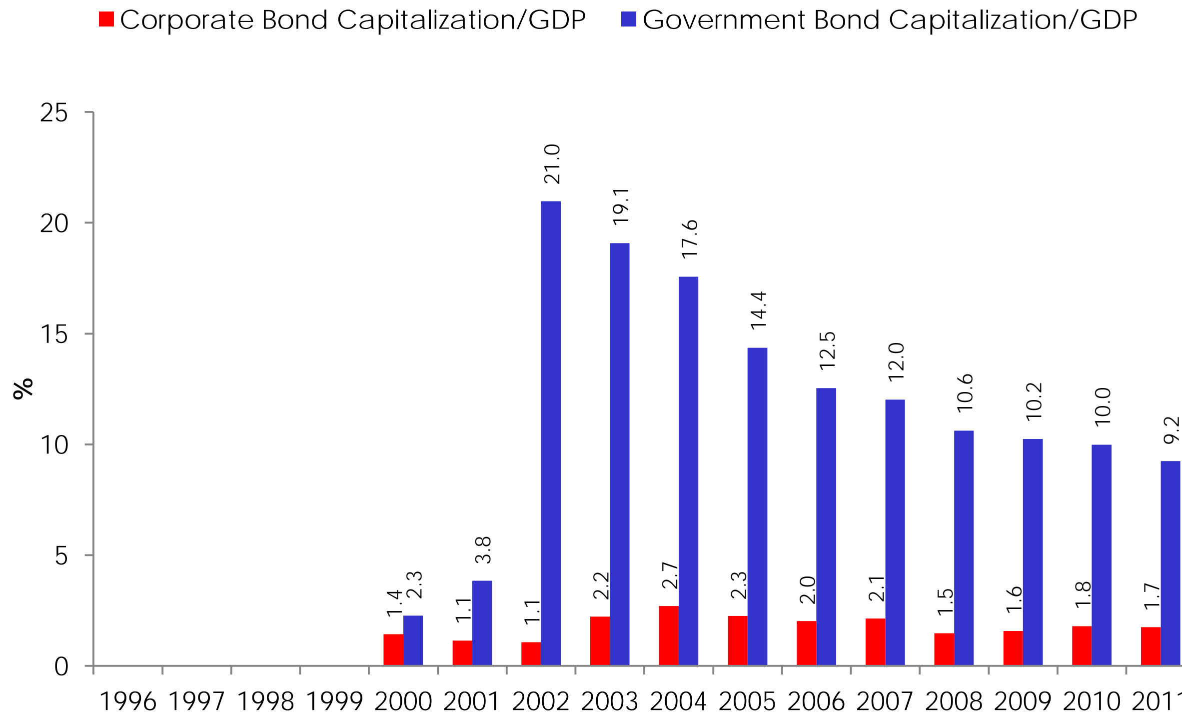
NBFIs are growing strongly but still small… (2)

- **Stock market capitalization trending up, hovering around 48% GDP.**
- **Low compared to region- Thailand 74%, Malaysia 139%, Vietnam 35%.**

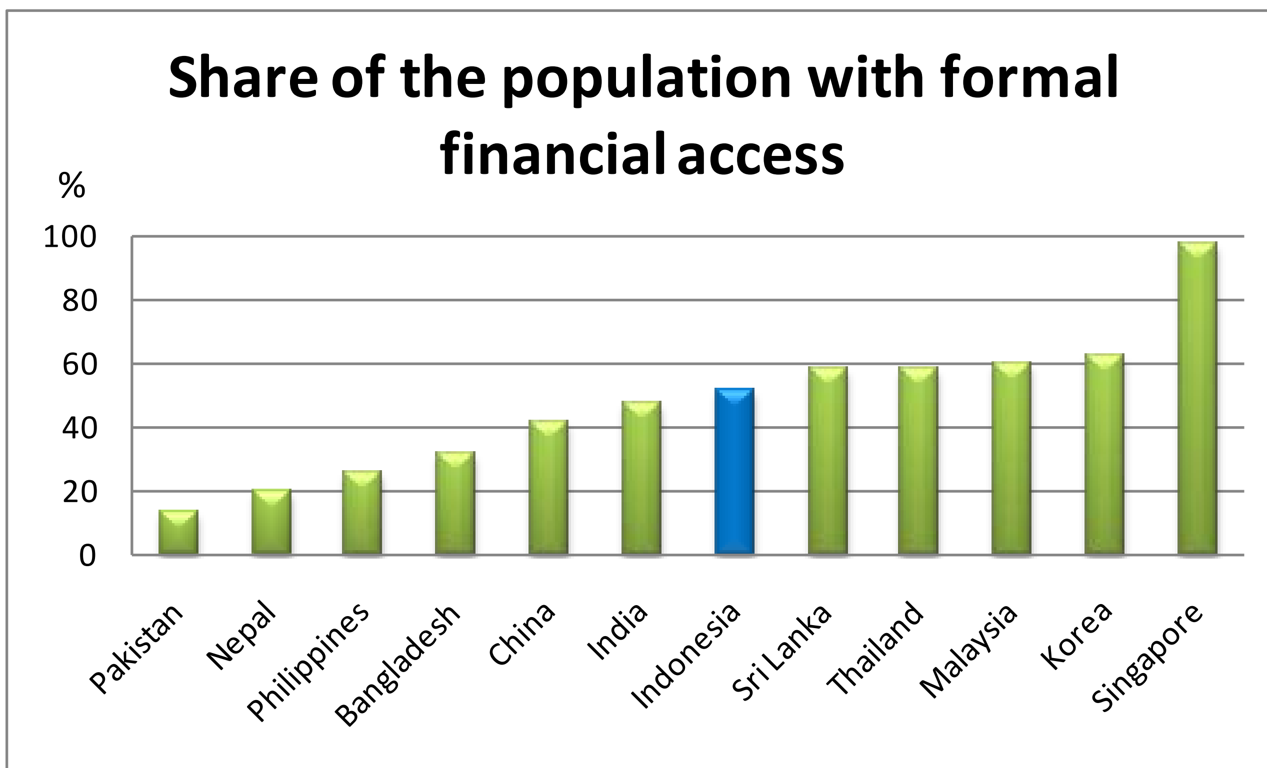


NBFIs are growing strongly but still small… (3)

- **Bond market capitalization is small though growing:** Approx. 13.4% of GDP (2011) compared to 12% (2010).
- **One of the lowest in the EAP region:** Thailand 65% GDP.

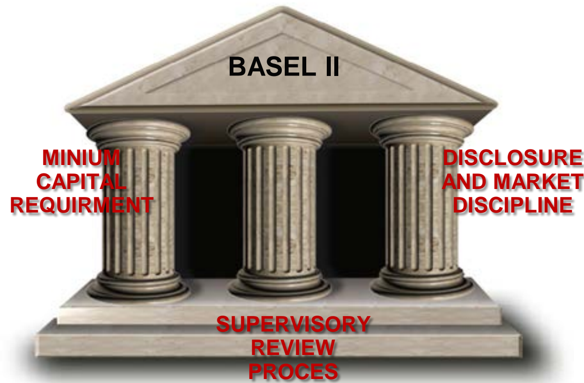


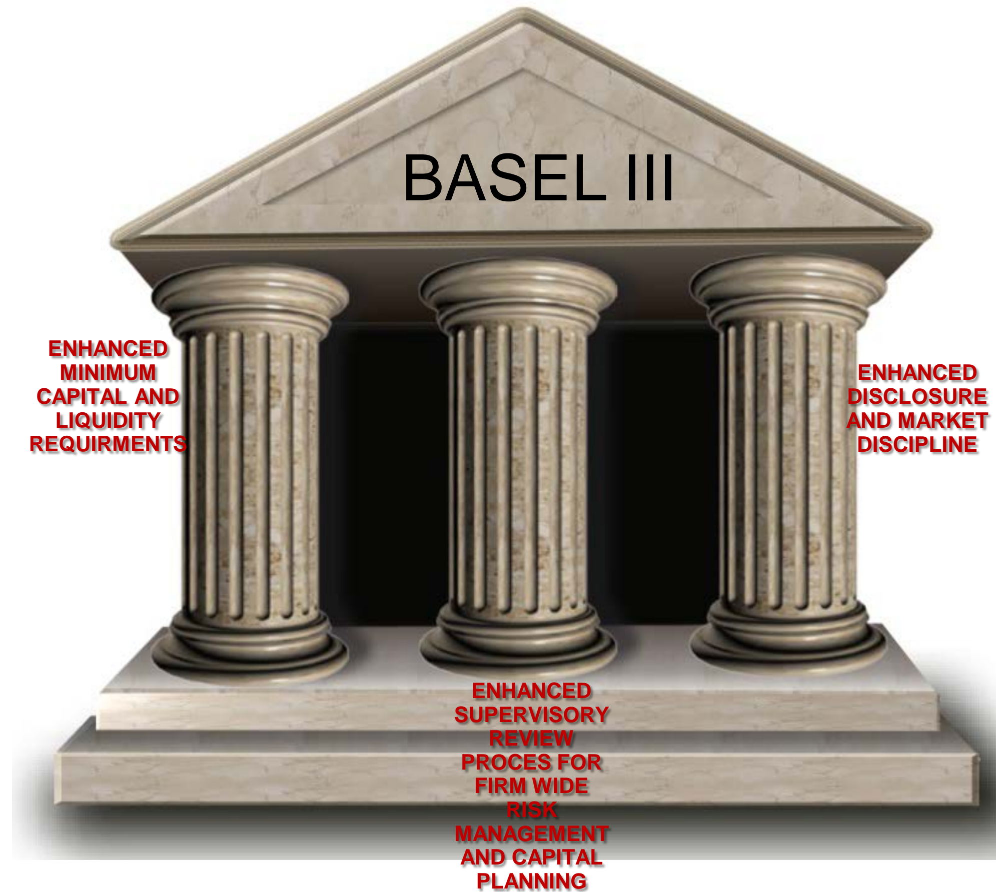
Access to financial services is limited for a significant portion of population…



Source: World Bank 2010

The regulatory capital reform for banks: from Basel II to Basel III

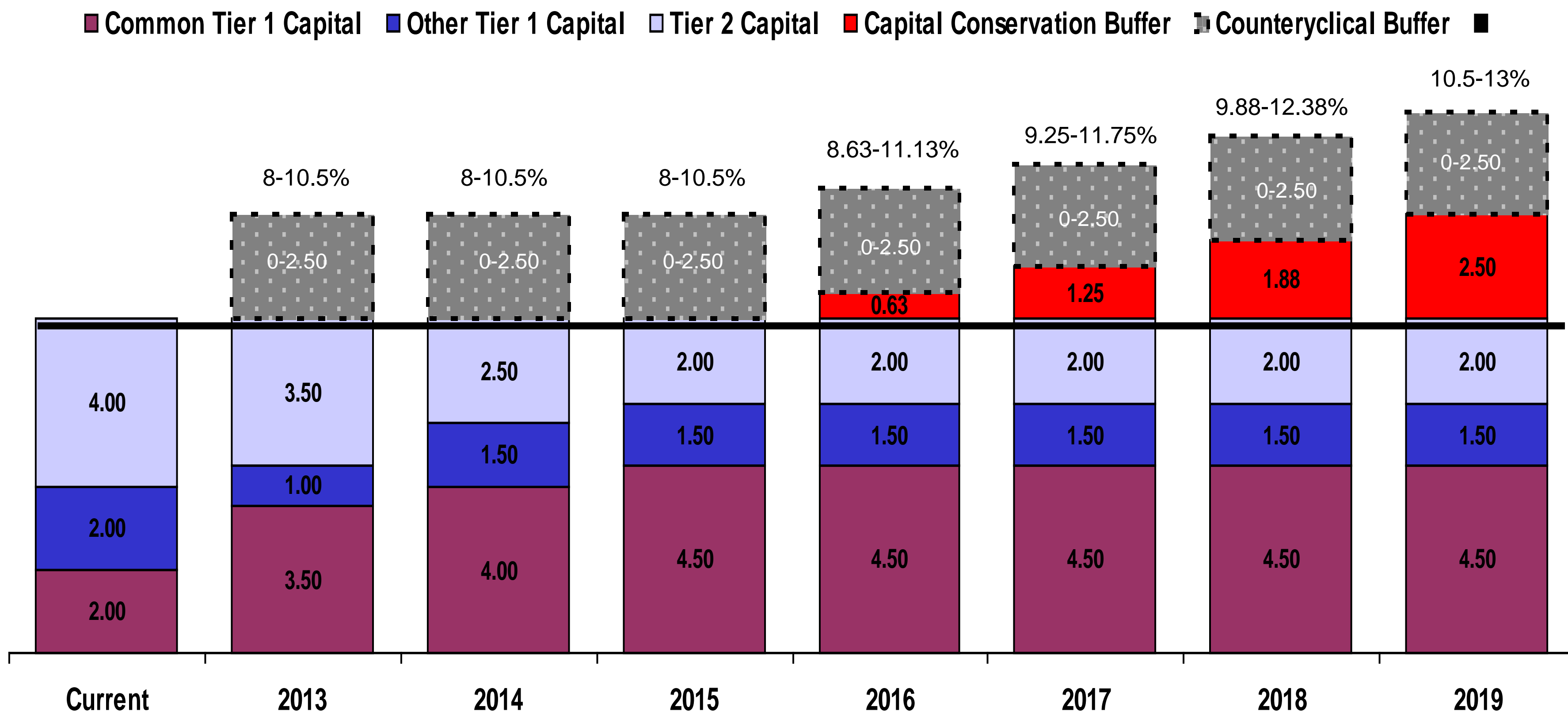




In essence Basel III is an evolution rather than a revolution. Basel III was developed from the existing Basel II framework, and the most significant differences for banks are the introduction of liquidity leverage ratios, and enhanced minimum capital requirements.

SOURCE: PWC, Moody's Analytics, WB

Basel III: Minimum Pillar 1 Capital Ratios*



* Ratios DO NOT include potential capital surcharges for SIFIs or Pillar 2 charges.

Phase-in Arrangements of Basel III

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Leverage Ratio - 3% level	Supervisory monitoring		Parallel run					Migration to Pillar 1	
Leverage Ratio - Disclosure					Introduce Disclosure Guidelines				
Definition of Capital									
Minimum Common Equity Capital Ratio Levels			3.50%	4.00%	4.50%	4.50%	4.50%	4.50%	4.50%
Capital Conservation Buffer Level						0.63%	1.25%	1.88%	2.50%
Minimum common equity plus capital conservation buffer			3.50%	4.00%	4.50%	5.13%	5.75%	6.38%	7.00%
Minimum Tier 1 Capital			4.50%	5.50%	6.00%	6.00%	6.00%	6.00%	6.00%
Minimum Total Capital	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
Minimum Total Capital plus conservation buffer			8.00%	8.00%	8.00%	8.63%	9.13%	9.88%	10.50%
Countercyclical Capital Buffer	0% - 2.5%	0% - 2.5%	0% - 2.5%	0% - 2.5%	0% - 2.5%	0% - 2.5%	0% - 2.5%	0% - 2.5%	0% - 2.5%
Total Capital including 2 Buffers	8% - 10.5%	8% - 10.5%	8% - 10.5%	8% - 10.5%	8% - 10.5%	8.625% - 11.125%	9.125% - 11.625%	9.875% - 12.375%	10.5% - 12.5%
Non-qualifying instruments			Phased out from 2013-2022 - 10% of 2013 value per year						
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Liquidity									
Liquidity coverage ratio	Observation period				Introduce minimum standard				
Net stable funding ratio		Observation period						Introduce minimum standard	

Potential impact on emerging markets*

- **The focus so far has been on the potential impact on developed economies.**
- **Less attention is paid on the potential impact on emerging markets, perhaps because of the belief that they will not be severely affected by the reforms since most emerging market banks already have high level and quality of capital.**
- **However, this is a static accounting view. Taking on a more dynamic view reveals that the global regulatory reforms could potentially have an adverse impact on emerging markets through 2 channels:**
  - **Direct channel – impact on availability and cost of credit in emerging markets.**
  - **Indirect channel – impact on capital flows to emerging markets and on the growth in developed economies.**

Adopted from Andrés Portilla (Institute of International Finance) presentation at the World Bank's FPD Forum , April 2011.

Potential impact on emerging markets

Direct channel

- Characteristics of emerging markets' financial systems.
  - Financial intermediation is mostly done by banks.
  - Relatively underdeveloped capital markets.
- Hence, any reforms that limits the ability of banks to provide credit to the economy will hamper growth. The new capital and liquidity standards could potentially limit the volume and tenor of bank lending:
  - The stricter capital rules will force banks to decrease lending in order to meet the capital requirements.
  - The new liquidity rules will make it less attractive to lend long-term.
- In the long run, the reforms may also have implications on efforts by emerging markets to increase penetration of financial services in their economies.
- Finally, the reforms may also be a bane to emerging markets' efforts to develop their capital markets.
  - Since the Basel rules are designed specifically to increase the amount of capital to support banks' capital market activities, this could hinder the growth of capital markets in emerging markets where banks are the main players.

Potential impact on emerging markets

Indirect channel

- **Structurally, most emerging economies have to rely on foreign capital, i.e. they have more consumption than savings.**
- **However, the reforms may limit the amount of funds from international lenders that goes to emerging markets. Restriction on lending to emerging markets could result from any or both of the following:**
  - **Stricter capital rules (international lenders may limit lending to emerging markets because it would require more capital to support)**
  - **New liquidity rules (the liquidity rules limit banks' ability to lend long term (NFSR) and international lenders may prefer to lend to highly rated sovereigns so it would qualify as a liquidity buffer (LCR)).**
- **The slower economic growth in developed economies that would result from the financial reforms may also have an impact on emerging markets, which rely on the developed economies as markets for their exports.**

Other emerging market issues on specific elements of Basel III

Countercyclical buffer

- **Emerging markets are expected to be the first to be bound to build the countercyclical buffer as credit in these markets continue to expand due to large capital inflows.**
- **However, part of the emerging markets' credit growth considered excessive by the Basel methodology is but a natural consequence of their financial development.**
  - **For example, the still increasing penetration of bank services in emerging markets may lead to a very significant expansion in credit.**

Capital

- **Many emerging markets do not have established markets enabling banks to raise the quantities of additional going concern Tier 1 capital and Tier 2 capital that are envisioned by Basel III.**

Closing words…

- **Implementation of Basel III will help fostering financial system stability in Indonesia but may bring additional challenges in efforts deepening the system.**

- **Given current profile and condition of Indonesian banks, it seems there is no immediate concern about the implementation of Basel III.**

- **Finally, this leads us to reflect on the words of the Greek philosopher Socrates (Athens, 469 BC - 399 BC), who wisely said *that if a man is proud of his wealth, he should not be praised until it is known how he employs it.***

- **Likewise, a national financial system that is proud of its stability and of its resilience to crisis should not be praised until it is known whether that system efficiently provides financial intermediation that contributes to economic growth and the greater welfare of the nation.**

Thank you