

BPD's credit trend reflects its resilient captive business

Analisis: Hanif Pradipta / Hasnalia Hanifah

PEFINDO views that the overall business profile of Regional Development Banks (BPD) will remain strong in the medium term. This is mainly supported by BPD's strong captive business, in the form of consumer loans to ASN (Aparatur Sipil Negara), which benefited from BPD's status as a regional-owned enterprise (BUMD). PEFINDO also considers that ASN loans will remain important for BPD's business, considering its very good quality as well as the high margins.

The pandemic that occurred in 2020 has raised the overall banking industry risk profile, causing a substantial decline in most business sectors, as well as a decrease in credit and banking services demand. However, we are of the view that the impact of the pandemic on BPD's overall credit profile has been manageable, supported by its main loan disbursement of consumer loans to ASN. ASN loan were not significantly affected by the pandemic since its installment payments are directly deducted from its fixed income. This segment supports BPD's revenue and cash flow amid the pandemic and acts as a cushion against potential asset quality decline.

As of December 31, 2022 (FY2022), there were 27 BPD operating in Indonesia. BPD have recorded total assets of IDR938.3 trillion, total third-party funds (deposits) of IDR723.9 trillion, and total loans of IDR562.8 trillion and represent around 8%-9% of total assets, deposits, and loans of the national banking industry. PEFINDO has assigned ratings to 18 out of 27 BPD operating in the country, at *idA-* and above with a stable outlook. During the pandemic, no BPD experienced a downgrade, reflecting our view of its resilient business model.

Strong market presence in its region

PEFINDO views that BPD has a dominant market share in the region, supported by a captive business from a close relationship with the regional government as a shareholder. This is further reinforced by BPD' role as treasurers for local governments, handling cash management and salary payments for civil servants. These factors have proven to be difficult to replicate or control by other commercial banks, as evidenced by BPD typically commanding over 50% of the credit services to ASN in their respective regions. The synergy serves as an important factor for the strong presence of BPD in their provinces, as reflected in the BPD's loans market share compared to total loans in each respective region, ranging from 10% to 40% in PEFINDO's portfolio.

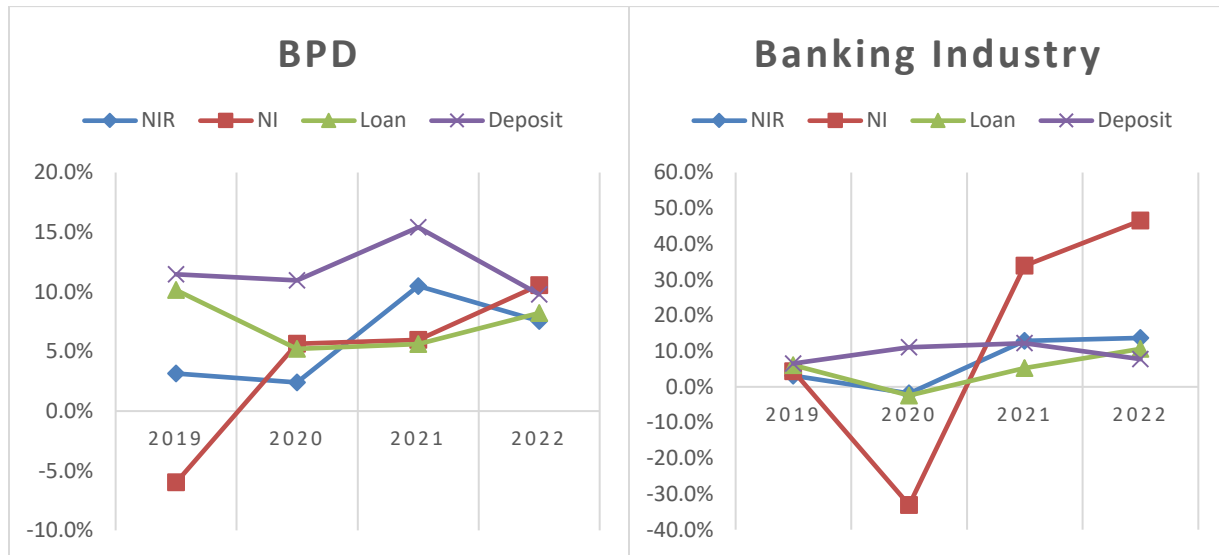
In terms of funding, BPD also benefited from regional governments as its shareholders, considering that regional government funds are a significant contributor to its third-party funds. BPD plays a crucial role as a treasurer for regional governments by managing financial transactions and funds for local governments in their respective regions. This gives BPD a competitive edge as regional government funds are a major contributor to third-party funds throughout the year.

In addition, as shareholders in BPD, regional governments have a personal interest in ensuring the bank's financial performance remains strong. BPD can provide substantial benefits to the region through business synergy, such as financing local development projects and supporting the growth of local businesses, in addition to high dividend yields contributing as a significant contributor to local revenue (PAD). Accordingly, we believe that BPD will continue to maintain its formidable presence in its respective region.

Strong business stability with a sustained growth from its captive business

We view that BPD's earnings quality is strengthened by the stability of its captive business in the form of ASN loans. As of FY2020, the first year of the pandemic, BPD demonstrated its business stability by recording net interest revenue, net income, and loan growth of 2.4%, 5.6%, and 5.2%, respectively. This contrasts with the overall banking industry which contracted by -1.8%, -33.1%, and -2.4%, respectively. BPD's growth during the pandemic was supported by consumer loans, dominated by ASN loans, which grew by 5.7% from 10.1% during the same period.

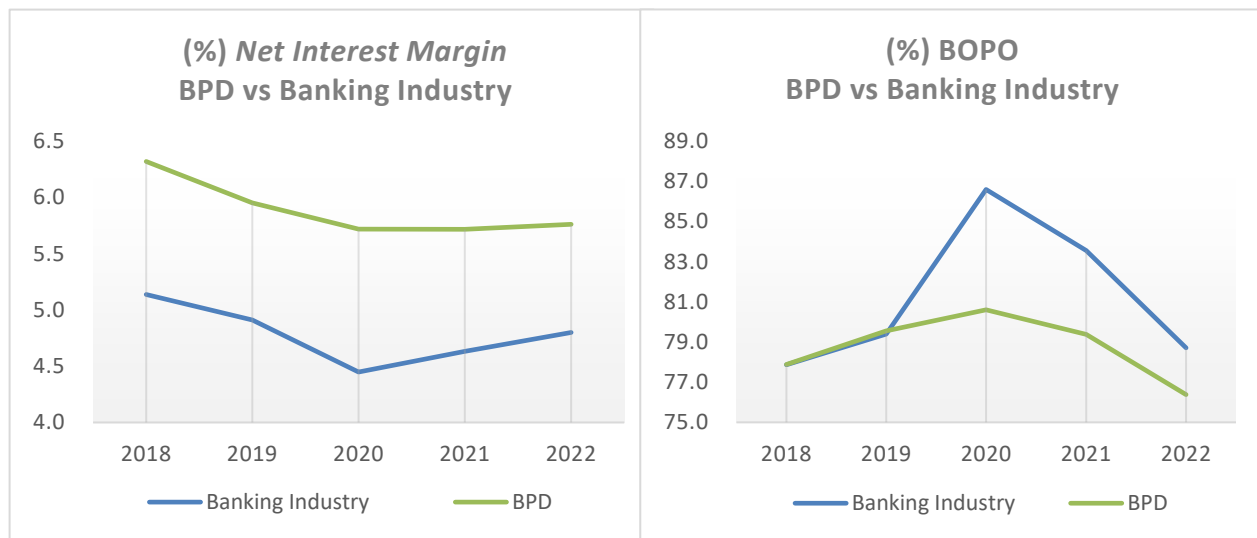
Graph 1. Growth Rate of BPD vs Banking Industry (% YoY)

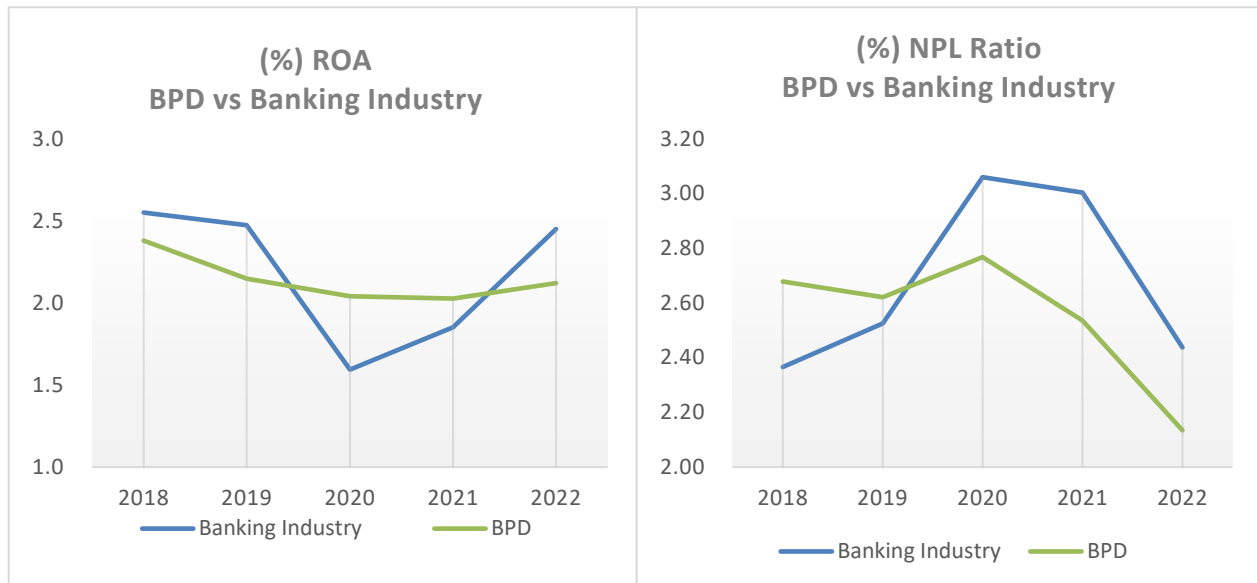


Source: Statistik Perbankan OJK

We also view the growth of BPD’s consumer loans during the pandemic as sustainable, considering its stable asset quality indicators. As of FY2022, its NPL remained stable at 2.1%, compared to 2.5% in FY2021 and 2.8% in FY2020, better than the total banking industry’s NPL of 2.4%, 3.0%, and 3.1% during the same period. In addition, BPD’s restructured loan in the PEFINDO portfolio range from 5% to 15%, lower than the banking industry at the 10%-30% range. Therefore, we view the regulator’s upcoming actions to withdraw stimulus or relaxations which were given in response to the pandemic are unlikely to significantly weaken BPD’s balance sheet.

Graph 2. Financial Indicators of BPD vs Banking Industry (%)





BPD's overall profitability is more favorable than the industry due to BPD's focus on high-margin ASN loans. We also estimate that BPD profitability will improve in 2023 following the economic recovery. BPD was able to maintain a strong net interest margin (NIM) of 5.8% in FY2022 and 5.7% in FY2021, higher than the banking industry averages of 4.8% and 4.6% over the same period resulting on a lower ratio of operating expenses to operating income (BOPO) at 76.4% in FY2022 and 79.4% in FY2021, compared to the banking industry's BOPO of 78.7% and 83.6%. In addition, the return on assets (ROA) for BPD also increased to 2.1% in FY2022 and 2.0% in FY2021, virtually unchanged from pre-pandemic at around 2%.

BPD's business will remain challenged by intense competition in outside its captive market

BPD has a competitive advantage in providing banking services to customers in its local areas, including rural areas which are more difficult for other commercial banks to penetrate. However, this also leads to the geographic concentration of risk. Focusing on the regional business may limit BPD's ability to diversify its loan portfolios, which increases its vulnerability to regional economic conditions. Several BPD have exposure to cyclical industries such as mining and plantations following business concentration in their respective areas, including sectors affected by the pandemic or exposed to ESG (Environmental, social, and corporate governance) risks.

While the risk is partly mitigated by ASN's captive business which dominates more than 50% of BPD's credit portfolio, we are of the view that its effort to expand on the productive segment will be challenged by the competition from commercial banks targeting the same segment. Commercial banks have stronger expertise and infrastructure, which can be a challenge for BPD to attract high-quality debtors. The rise of digitalization efforts by commercial banks may potentially result in easier access in the regions affecting BPD's regional advantage.

Tight competition may force the BPD to reduce their margins and cater to higher-risk segments. This can increase the risk of defaults and problem loans. Additionally, the expansion of BPD' productive loan portfolios can put pressure on their net interest margins, as productive loan borrowers are typically sensitive to interest rates.

Compliance with POJK 12/2020 is still uncertain for BPD with core capital below IDR3 trillion

PEFINDO is of the view that meeting the minimum core capital requirement of IDR 3 trillion by the end of 2024, as mandated by POJK 12/2020, is still uncertain for twelve out of twenty-six BPD as of FY2022. Non-compliance may lead to various sanctions, such as being downgraded to a rural bank, forced merger, or voluntary liquidation. Given the transaction complexities and multi-level bureaucracy of local governments at both the provincial and district/city levels, leads to a significant challenge in obtaining approval for any corporate actions.

Furthermore, given that many BPD are significant revenue sources for regional governments, their existing shareholders may prioritize maintaining this revenue stream instead of injecting capital to meet the minimum core capital requirement, even with the deadline approaches at the end of 2024. This may be due to the regional government's limited financial capacity to inject a significant amount of capital. Additionally, we note that many regional local governments continue to draw dividend payments with a high payout ratio, indicating a low willingness from shareholders to comply with the minimum core capital regulation.

Another feasible solution for BPD to meet core capital requirements is through the establishment of a Bank Business Group (Kelompok Usaha Bank or KUB). Under the KUB framework, an anchor or parent bank must have a minimum core capital of IDR 3 trillion while participating banks only need IDR 1 trillion core capital. However, establishing a KUB is not easy considering the complexity of corporate actions involved. In addition, although not explicitly regulated, we observe that only a number of BPD with core capital above IDR 14 trillion (KBMI 3) are eligible to participate as anchor bank, such as BJB, Bank Jatim, Bank Jateng, and Bank DKI. While regulations allow for non-BPD anchor banks, political issues may arise, as we view that existing BPD shareholders may be unwilling to sell their ownership to private entities that might potentially be acquired in the future by foreign companies in the future.

BPD ratings in PEFINDO portfolio

The ratings we assigned to BPD indicate that BPD have a stronger ability than other Indonesian obligors to meet their long-term financial commitments, although they may be more susceptible to adverse changes in circumstances and economic conditions than higher-rated obligors. Upon revisiting our business risk assessment on BPD by incorporating lessons learned throughout the pandemic, we recognized the strong business stability and competitiveness of BPD due to their close synergy with regional governments. Due to BPD's conservative business, we are of the view that BPD's credit risk profile should be lower compared to other commercial banks which are more exposed to industrial risks and macroeconomic impacts, despite its limited market share and economic scale in its respective areas.

However, this does not mean that the credit risk profiles of all BPD are the same. Reviewing the rating assessment, we appreciate BPD which shows business stability and higher earnings, which, in our view, lowers the probability of default on their financial obligations. Up to May 2023, we have adjusted by raising the ratings of several BPD, namely Bank BJB, Bank Jatim, Bank Sumsel Babel, and Bank Papua.

We expect that there will be further adjustments to the rating upgrades for the other BPD in our portfolio this year, although these upgrades may not necessarily be assigned to all BPD in the portfolio. In addition to the stability of the business and financial performance amid the pandemic, other qualitative considerations, such as meeting minimum core capital, increasing credit underwriting capacity, and corporate governance, will also determine our rating action.

Table 1. Published BPD ratings in PEFINDO portfolio (rating as of June 30, 2023)

Bank	Rating	Assets (IDR billion)	Loans (IDR billion)	Deposits (IDR billion)	CAR (%)	NPL (%)	BOPO (%)	NIM (%)	ROAA (%)
BPD Jawa Barat dan Banten Tbk	idAA	181,241.3	115,755.6	131,189.7	19.4	1.4	80.0	5.3	1.3
Bank Jabar Banten Syariah	idAA-	12,445.8	7,441.2	9,119.6	22.1	4.0	82.7	5.1	0.9
Bank DKI	idAA	78,884.9	48,374.5	65,104.6	24.8	1.7	78.2	4.1	1.3
BPD Jawa Timur Tbk	idAA-	103,031.4	46,196.7	81,767.4	24.7	2.8	73.8	5.1	1.5
BPD Jawa Tengah	idA+	84,493.8	57,256.6	66,841.2	21.7	2.5	67.4	6.6	3.0
Bank Suselbar	idA+	29,653.3	21,803.5	19,548.4	27.5	1.2	67.9	6.3	2.3
Bank Sumsel Babel	idA+	35,299.9	20,899.9	27,338.3	21.5	2.8	76.3	7.7	1.6
BPD Bali	idA+	32,160.7	20,068.3	26,453.0	21.6	2.4	68.9	6.1	2.0
Bank Sumut	idA	40,619.10	27,853.05	31,911.00	20.1	2.6	73.4	6.8	1.8
BPD DIY	idA	16,850.90	9,992.67	12,516.69	31.4	2.9	69.2	5.7	1.7
BPD Papua	idA	29,812.1	18,151.9	24,130.5	23.5	2.9	76.1	6.1	1.4
BPD Nusa Tenggara Timur	idA-	17,032.12	11,815.14	12,799.28	26.9	2.6	80.6	7.1	1.4
BPD Bengkulu	idA-	8,677.76	6,289.04	6,952.32	24.5	1.0	81.6	7.0	1.4
BPD Sulawesi Tengah	idA-	11,963.91	6,267.45	8,145.07	25.9	3.1	65.5	5.6	2.1

All financial information as of December 31, 2022. Total assets, loans, and deposits are stated in IDR billion. The above ratios have been computed based on information from the companies and published accounts. Where applicable, some items have been reclassified according to PEFINDO's definitions.

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