10 minutes on recent economic stress in Indonesia

October 2015

Key focus areas for those responsible for governance of Banks in Indonesia

Responding to the Economic Stress in Indonesia

Is there an economic downturn in Indonesia? It is a volatile question in itself – GDP growth is still nearly 5%, banks are still reporting profits, and there is a tremendous upside potential in the market. However, we believe it is reasonable to say that over the last year there has been more and more pressure and stress put into the banking market than has been present in recent years, including:

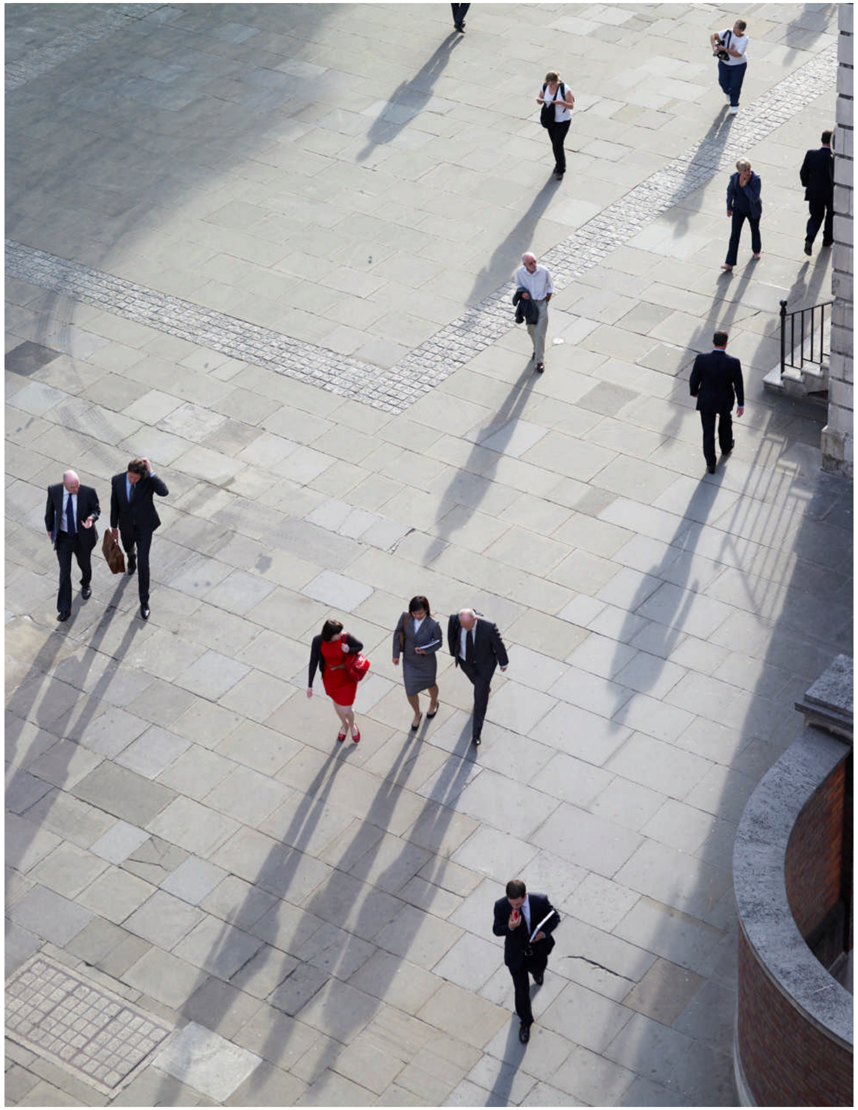
- the impact on borrowers from the collapse of global commodity prices
- A marked decline in the value of IDR relative to USD and other currencies
- A rising level of loan restructurings and NPLs, albeit from a low base
- Rising resource costs and high BOPO levels

Now it is particularly important for those responsible for the governance of Banks and financial institutions in Indonesia to be robustly engaged with their four lines of defense when it comes to managing risk: 1) people, processes and technology; 2) management and oversight; 3) internal audit; and 4) external audit.

A failure to do so can result in unwanted surprises and a lack of preparedness to confront the challenges the Bank faces.

- Are you asking the right questions?
- Is management providing the information you need?
- Are you focused on building trust with stakeholders?
- Are your auditors bringing you the right perspectives?

This short "10 minute" document is aimed at helping Directors, Commissioners and others responsible for governance, to focus on what we believe are the most critical financial reporting and risk issues in the current environment, and the questions you should be asking.



Cash is King

As in any time of economic stress, maintaining sufficient liquidity to meet short-term obligations and withstand shocks is critical. Planning should consider rising costs of funds as emerging markets may be perceived to carry a higher risk.

- Is current and forecasted liquidity sufficient?
- How is liquidity impacted in stress-test scenarios?
- What are the key assumptions underpinning those scenarios?
- What are the most recent deposit trends and maturity profiles?

Know your customers

Is it too early to say that the recent increase in NPLs is the sign of more to come? Perhaps. But we believe there increasingly are a) greater liquidity needs of corporate borrowers, and b) restructurings due to a decline or alteration in expected cash flows from underlying borrower businesses. While certain industries may be impacted more than others (e.g., oil and gas, importers, automotive, real estate), a time of economic stress will have a trickle-down effect to the wider SME customer base.

- What is the level of restructurings, and how are they accounted for? Was impairment necessary due to delinquencies or revised terms?
- Are credit risk and impairment analysis based on most recent borrower financial data, and have their financial forecasts been updated to reflect the new reality?
- Do we need an independent view on the borrower's business plan and projected cash flows? Are historical collateral values still appropriate?
- What is the trend in overdue payments?
- Have related group exposures been looked at collectively?
- Do stress tests consider the differences between the PSAK/IFRS "incurred loss" model and an "expected loss" model?
- How would further changes in interest rates or commodity prices impact the borrower's ability to service debt? Underwriting policies?
- Does the Bank have sufficient work-out resources to manage a possible increase in problem loans?
- In syndicated lending, is it realistic that all participating banks can afford to restructure?

Retail lending – evolving data models

NPLs are already rising in Retail portfolios; the question is whether it is a temporary change or an indication of more to come. Challenging the assumptions used in provisioning models will be key to ensuring provision levels are sufficient.

- What data used in current provisioning models – is that data representative of current trends in overdue payments and losses?
- Is the provisioning model segmented appropriately to consider variations in the Bank's customer base, particularly considering recent growth in new customer segments?
- Is the assumption about recoverability from the sale of loans still valid? Can past rates achieved on sales still be achieved in the future?
- Does the data model consider restructurings?
- Is the Bank's collection department sufficiently skilled and resourced to handle an increased volume of activity?

Stress the stress tests

Globally and in Indonesia, volatility has increased and the Bank's approach to stress testing must reflect the current level of volatility in the market.

- What are the key assumptions in the Bank's stress tests?
- Do stress tests have a sufficient range of variables given current conditions, particularly for interest rates/spreads, foreign exchange, borrower default rates?
- Does the Bank still have the ability to raise capital to meet any shortfalls indicated by stress tests? Do stress tests consider a possible increased cost of capital?
- If rates rise, will assets re-price fast enough to offset the increase in liability costs?
- Do stress tests consider the impact of scenarios on debt covenants, capital adequacy ratios and other minimum statutory requirements?
- How are stress tests reported to the Board of Directors?
- Is there a robust dialogue with OJK/BI on the methods and results of the Bank's stress tests? Does this correlate well to any stress tests done independently by the regulator?
- Do the PSAK/IFRS financial statements have adequate disclosures on sensitivities?

Get the house in order

Organizations with outstanding cost management are able to best adapt to business cycles. In periods of high growth and expansion, an institution may lose focus on cost levels, efficiency and productivity. Banks in Indonesia have benefited from very high margins, and expected compression of those margins will put pressure on profitability and competitiveness.

- Has the Bank performed scenario planning which considers a combination of negative changes: significant margin compression, an increase in cost of risk, and a reduced growth rate? What is the resulting impact on BOPO levels, profitability, capital adequacy and regulatory compliance?
- Is cost reduction based on an overall % target reduction and allocation to departments, or it is based on a deep analysis of costs and a focused plan that will achieve lasting impact?
- How are cost reductions impacting the ability to manage risk?

Pervasive impact of foreign exchange

In addition to the re-measurement impact of the Bank's own assets and liabilities, Rupiah depreciation can have a substantial impact on borrowers, both corporate and retail.

- What are the Bank's policies towards hedging, and are appropriate requirements in place in terms of limits, risk management, approvals and reporting to the Board?
- Has the Bank identified the significant borrowers with the most sensitivity to changes in exchanges rates (e.g., USD loans, importers where costs are largely foreign-currency based but revenues are Rupiah based)?
- What is the Bank's exposure to borrowers with foreign currency borrowings and Rupiah earnings.
- Has the Bank considered the implications of a further currency depreciation?
- Have Bank budgets been adjusted for more recent exchange levels?

Rising levels of economic crime

One of the unfortunate side effects of economic stress is a rise in economic crime.

- Has the bank's fraud prevention policies and procedures been independently reviewed?
- How are Cyber risks and attempted cyber attacks reported to the Board?
- When was the last time that the bank conducting testing of the effectiveness of its disaster recovery plans or business interruption plans?

Counterparty risk beyond loans

If stress increases in the economy, the risk of counterparty default increases, but this is not limited to traditional borrowings.

- What are the policies and requirements for interbank lending? Should thresholds be amended to reflect the increased counterparty default risk?
- Has a Credit Valuation Adjustment been considered for the increased counterparty default risk on derivatives and financial instruments as required by IFRS 13?
- Is there a significant exposure to employee loans that may be impacted by any possible staff reductions?

Decline in asset values

Certain classes of assets may be more sensitive to changes in values during times of economic stress, and can impact the financial results and strategic decision-making.

- Are the Bank's customers experiencing a decline in collateral values?
- Does management still have the ability to hold HTM investments to maturity?
- Is the recognised level of goodwill or other intangible assets impaired when considering current asset values and cash-flow forecasts?
- Are borrower sales and growth forecasts still realistic?
- Has impairment been considered on the value of own-premises or investment property?
- What is the recoverability of deferred tax assets? Are estimated future cash flows still supporting this recoverability?

Build trust with stakeholders

We believe it is critical to maintain a robust dialogue with stakeholders to ensure that the positive aspects of the Bank's performance and approach are recognised and not automatically "grouped" into any wider issues developing in the economy or banking sector. Stakeholders include OJK, BI, rating agencies, customers, employees, bond holders, investors, tax authorities and others.

- Has the Bank engaged in recent dialogue with rating agencies and understand key trigger points for potential rating changes?
- Has the Bank reviewed the robustness of its financial statement disclosures, particularly with respect to the management of risk and development of the credit portfolio?
- Does the Bank's risk management and compliance activity meet the requirements put forth by OJK/BI?
- How does the Bank's approach to Corporate Governance compare to best practice.

Robust auditor dialogue

The external auditor is the last line of defense in the overall management of risk, but provides a crucial source of information and perspective on the Bank's financial reporting and risk management. Always, but particularly in a downturn, there should be a robust dialogue with the auditors at all stages of their work – planning, interim, and year-end.

- Does the auditor present the basis for its risk assessment and expected reliance on controls effectiveness?
- Does the auditor present its plan and approach to reviewing the:
  - corporate loan provisioning, and emerging trends that may impact the level of risk.
  - Retail loan provisioning models, and appropriateness of segmentation and use of historical data.
  - Risk management activities (credit risk, market risk, liquidity risk, etc).
  - Capital adequacy and regulatory compliance.
- Does the auditor involve industry specialists in its work where appropriate? Are valuation specialists involved in the review of borrower collateral? Are key observations resulting from this work presented?
- Does the auditor present the key matters of judgement associated with loan provisioning, the results of the review, significant discussions with management, and areas of sensitivity where provisioning has a risk of understatement?

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