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Indonesian Banking Survey Report

2011

PwC Indonesia - FY 2011

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Contents

Introduction

Welcome to the second PwC Indonesia (PwC) survey of the Indonesian banking sector. The survey endeavours to gain insights into the strategies, opportunities and challenges of the banking sector from those who know it best. As part of this year's survey, we are delighted to include feedback from Bapak Halim Alamsyah, Deputy Governor of Bank Indonesia following our presentation to Bank Indonesia on the key findings.

Given that we are into the 2nd year of this survey, we are able to draw comparisons with 2010 and share with you how opinions have changed year on year.

In this survey, we focused on three principal areas that we considered of most interest to the banking community:

1. Growth outlook
2. Operational matters
3. Risk management, corporate governance and regulation

The results of the survey are based on completed questionnaires from senior banking executives from state owned, local and foreign banks that represent more than 50% of the Indonesian banking sector (by asset value).

We would like to take this opportunity to extend our sincere thanks to the respondents for their time and effort in making this survey possible. We are confident that this report will provide readers with a comprehensive understanding of the professional opinions of senior banking executives in the banking industry.

We welcome any feedback you may have on the report so that we can incorporate it into future surveys of the Indonesian banking industry.

Feedback from our discussion with Bapak Halim Alamsyah,
Deputy Governor of Bank Indonesia

For the 2012 survey, it would be useful to understand the areas where there are technical / knowledge gaps of staff working in the Indonesian banking sector.

Executive Summary

Growth outlook

A more bullish outlook was provided by bankers than the one shared in the 2010 survey with double digit growth projections for both lending and deposit predicted by almost all (96%) respondents.

With Indonesia now rated just one grade below 'investment grade', there has been renewed interest from foreign investors. However, it's the country's relatively poor infrastructure that continues to be the 'achilles heel' in attracting further investment. As was the case in the prior year, it is an organic strategy, rather than by acquisition, that is the preferred means of growth.

SMEs were forecasted to drive most of the growth in lending (31%) whilst savings accounts were the area of focus for deposit growth for almost half of banks (47%).

Innovation will drive efficiency and lead to competitive advantage in the sector. Investment in technology is one way of capturing both especially when Indonesia lags behind the rest of Asia in providing internet & mobile banking services.

The regulatory environment was considered the number 1 obstacle to growth in 2011, followed by the war for talent and the political environment. In the prior year, it was competition that occupied the top spot.

Operational matters

Consistent with the preference for organic strategy growth and a targeting of the SME sector, the respondents cited the expansion of the branch network as their principal operational focus in 2011, where more than a third (36%) of respondents planned to open more than 25 branches in 2011.

Capitalization and cost efficiency were also high up on the 'To-Do list' of Senior Executives in 2011. Though interestingly, only almost a quarter (24%) expressed difficulty in knowing where and how to make cost savings at their banks. This difficulty may well be one reason why Indonesian banks have a poor efficiency rate when compared to its neighboring countries.

More than half (55%) of respondents shared significant concern around the scarcity of talent within Indonesia to staff the levels of growth projected. Notwithstanding the scarcity of talent, 94% of respondents were looking to increase their workforce in 2011. According to the survey, bankers strongly preferred non-financial means such as training and mentoring programs to attract and retain top talent with only 16% of respondents preferring financial means.

Net interest Margin (NIM) in Indonesia, at just under 6% on average, is currently the highest in SE Asia (where NIMs of 3% or 4% are more common) and well above other emerging economies like China and India. Despite pressure to lower NIMs, almost half of respondents (49%) believe

they will remain at similar levels to 2010. High inflation and the application of a higher risk premium (compared to other SE Asia countries) are regarded as the principal drivers for this relatively high NIM.

Risk management, corporate governance and regulation

Despite gross non-performing loans remaining steady (at circa 3%), credit risk remains as the top risk for bankers to manage. Liquidity risk and operational risk completed the top 3 risks.

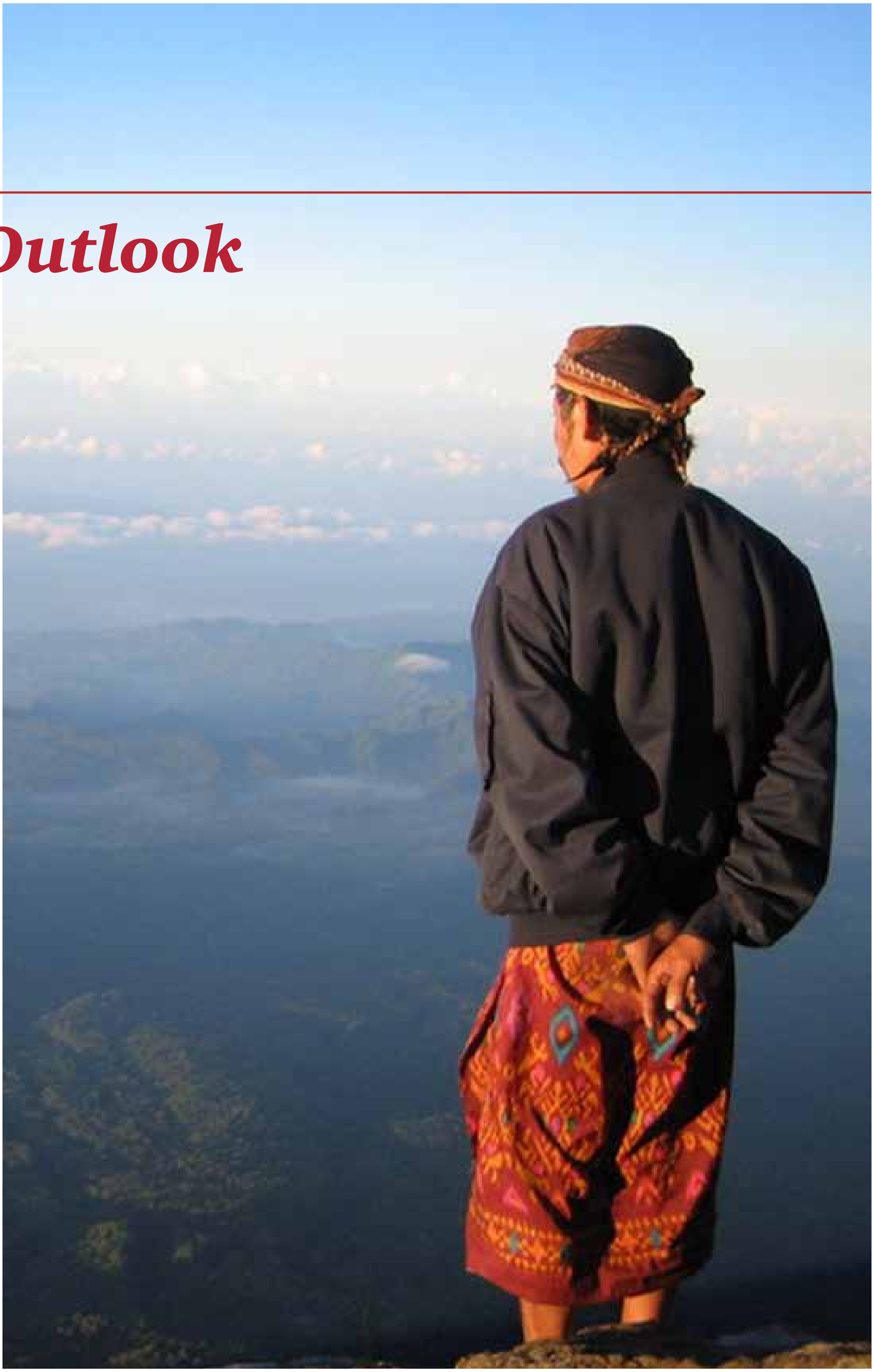
More than half of the respondents to the survey predicted the level of fraud risk will remain the same. Collusion between employees & customers and identity fraud continue to be of most concern when assessing fraud risk.

One of the most surprising results was the number of bankers who did not have a specific view on the current state of regulation in Indonesia – more than three quarters (78%) of bankers had a neutral view with just 8% expressing their support. This was surprising given that the regulatory environment was cited as being number 1 obstacle to growth for 2011.

More than half (57%) of respondents appear to be relatively dissatisfied with the effectiveness of their Audit/Risk Management Committee describing it as only being effective to "some extent".

Internal audit appear to have some way to go before they are managing stakeholder expectations through the provision of valuable business insight from their bank-wide exposure. Only a quarter (25%) of respondents considered they were getting significant insight from their internal audit.

Growth Outlook



Growth confidence sky high

Respondents were bullish in their projections for 2011 with 96% of respondents predicting double digit growth for both lending and deposits . This compares favourably to the 74% that predicted double digit growth in 2010. As was the case in 2010, all were unanimous in the view that positive growth would be enjoyed in the year ahead.

We believe that the country's large domestic market; its large supply of natural resources; and its plans for infrastructure development are some of the key pillars underpinning this level of forecasted growth. The last pillar, infrastructure, is of particular interest. Infrastructure is widely aknowledged by the investment community as being Indonesia's 'achilles heel' and a key reason why foreign direct investment has not reached it's full potential. The banking sector will clearly benefit from the plans for infrastructure development to be shared between the public and private sector.

With Indonesia being rated just one grade below 'investment grade' by the major international rating agencies, foreign direct investors have been returning to Indonesia after a period of somewhat 'modest interest'.

Some predict that Indonesia will have regained its investment grade status in the next 12-18 months – a factor that will surely increase the growth potential of the economy still further. This will complete Indonesia's long journey of recovery from the Asian financial crisis – the late 1990's was the last time that Indonesia was rated as investment grade.

Together with India and China, Indonesia is growing much faster than the world economy - GDP of approx 6% is forecasted. Global strategic decision making is being flexed accordingly.

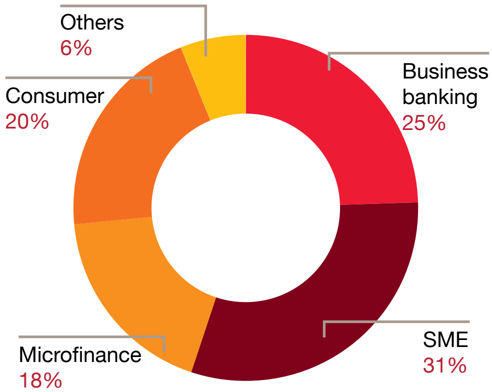
The high level of competition amongst the circa 120 banks continues to intensify with competition for deposits from non-bank sources one area of note.

SME sector targeted

When asked to predict the sector that would attract the highest growth in lending in 2011, the responses were fairly mixed with 31% favouring the SME sector; 25% choosing business banking ; 20% consumer banking and 18% micofinance.

Innovation, in the context of new patterns of demand is a clear strategic focal point for Indonesia banks.

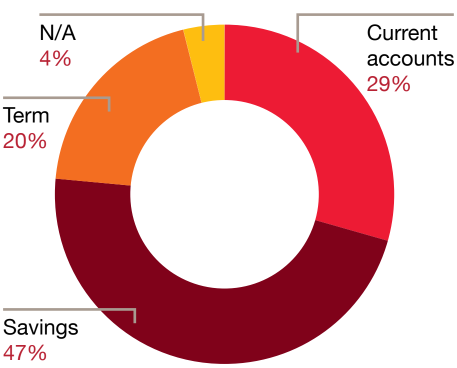
Which banking sector do you expect will attract the highest growth in lending in 2011?



Targetting SMEs is not new. The sector is considered the backbone of the Indonesian economy and attracts high NIMs.

Savings accounts were cited as being the driver of growth in customer deposits in 2011 with 47% of the votes. Current accounts (29%) and term deposits (20%) completed the top 3.

Which product are you principally targeting to drive growth in customer deposits at your bank in 2011?



Continued focus on organic growth

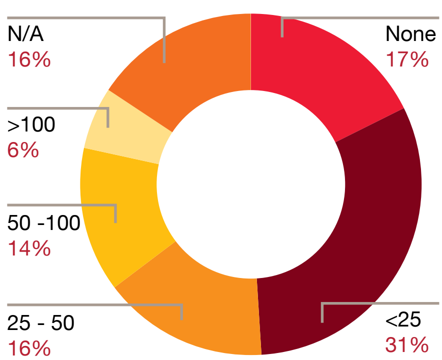
As in the prior year, the bullish growth projections are expected to be met through organic growth; 82% of bankers regarded this as their preferred growth strategy.

The bias for organic growth may well change over the coming years with the new single-owner law and the implementation of the stricter capital requirements of Basel III.

One facet of the organic growth strategy common to most banks is the expansion of the branch network. 36% of bankers revealed that their respective banks were planning to open more than 25 branches in 2011 with just 17% estimating that their number of branches would remain the same.

In fact, expansion of the network was considered the number 1 strategic priority for 2011 for bankers according to this survey. Not a day goes by without us hearing a banking executive talk about the 'power of the network' and 'increasing footprint across the country'.

How many branches do you plan to open in 2011?



No change from the prior year in how that growth would be funded

When asked whether there were plans to issue more capital within the next 1 to 2 years, banking executives gave an almost identical response to the one received as part of the 2010 survey.

Almost half of respondents (48%) did not have plans to issue capital in the short-term with 14% playing a waiting game.

Obstacles to growth

Whilst 96% of banking executives predicted double digit lending growth in 2011, they were more divided in their views as to what were the most likely obstacles to achieving this.

In the 2010 survey, the top obstacle sighted by bankers was competition. Interestingly, competition did not feature in this year's top 3 where the regulatory environment was the number 1 concern, followed by the war for talent and the political environment. With regard to the regulatory environment, recent legislation on bringing IT data centres on-shore; trading in off-shore products and increasing minimum equity capital requirements were considered the principal drivers for this response.

Feedback from our discussion with Bapak Halim Alamsyah, Deputy Governor of Bank Indonesia

Not seeing competition in the top 3 obstacles was surprising.

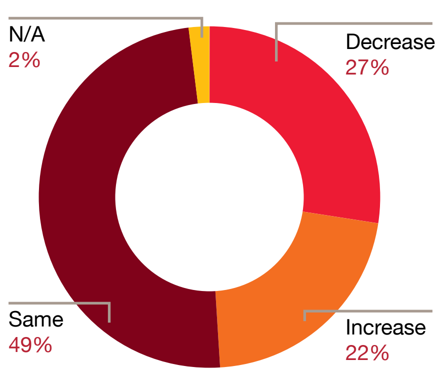
Having the political enviroment in the top 3 obstacles of growth for 2011 was somewhat surprising given the relative political stability in Indonesia. Afterall, Indonesia is the world's third largest democracy and the current president is into his second term. However when we reviewed the top risks cited by other countries' banking sectors (the Banking Banana Skins 2010 survey), we noted that political interference was also the number 1 risk.

We know that the task of managing political risk is not easy. Not only do political changes pose direct risks to banks, but politics is also a component of other external risks. Regulatory changes have the potential to promote or inhibit market competition, social risks often have political bases and responses, and political mismanagement can turn natural or human-made events into catastrophes. Moreover, political risk is often perceived to be outside of management's control, making it difficult to define, predict, and align with objectives. Given the complexity of these issues, it is no wonder that banks often fail to address political risk in a systematic way.

NIM – remains about the same

Opinion was widely divided when asked to predict the movement in net interest margin (NIM) for 2011 with almost half (49%) predicting it would remain the same; 27% predicting a fall ; and 22% estimating an increase.
What is safe to assume however, is that the NIM enjoyed by Indonesian banks (approximately 5,8% on average) will continue to be the most attractive in South-east Asia (where NIMs of 2,5-4,5% are more common) and far in excess of other developing nations like China and India where average NIM is circa 2-2.5%. Naturally there are concerns being raised as to how the relatively high NIM is adversely impacting Indonesia's growth potential. Bankers defend the high NIM's by citing high inflation and having to apply a higher risk premium than other South East Asian countries.

What are your expectations for Net Interest Margin for 2011?



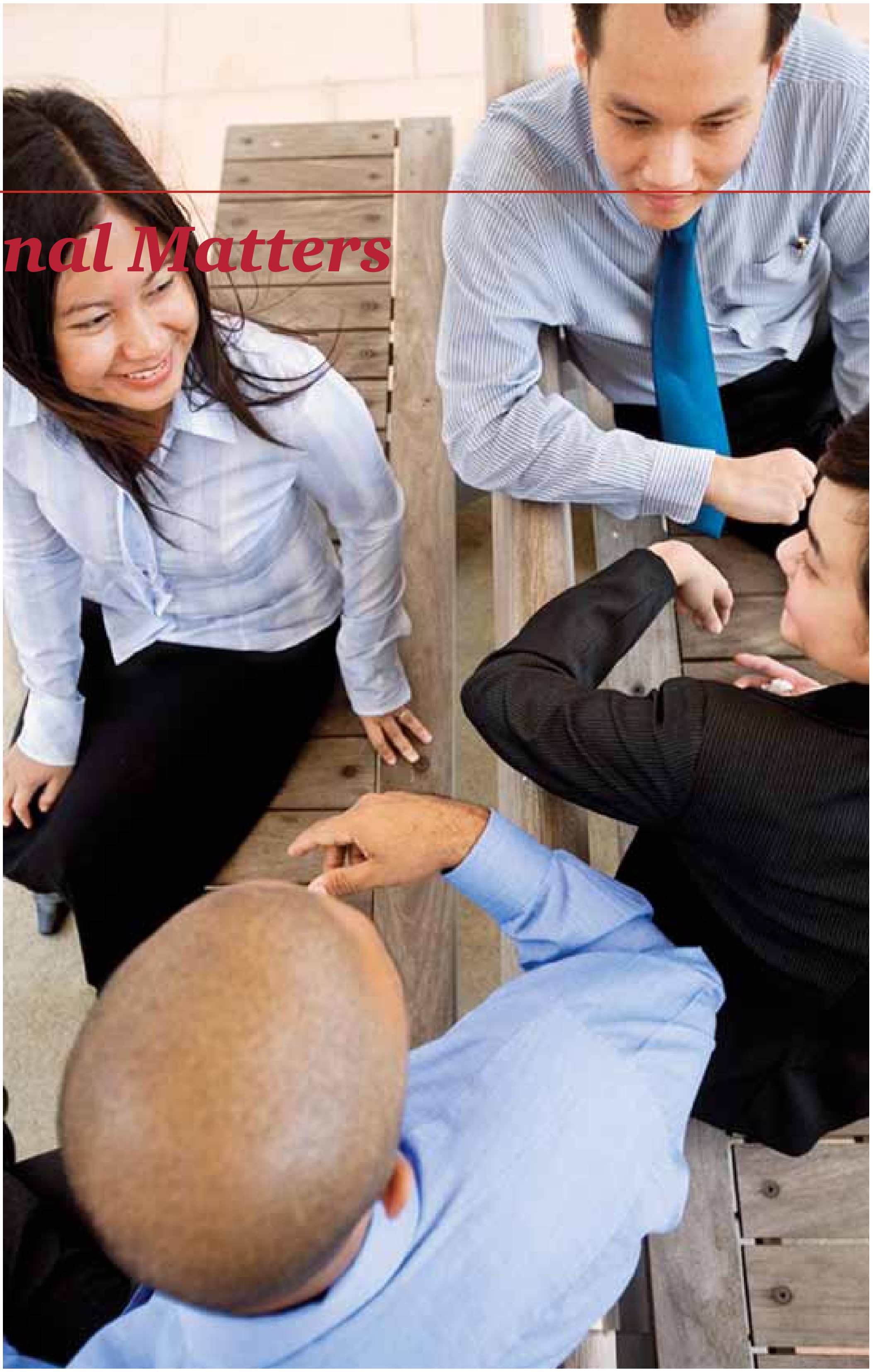
Becoming more environmentally conscious

We reported in the prior year that many in the banking sector may have viewed the efforts to avert climate change as a matter of corporate philanthropy, with no relevance to their corporations' core strategies.

This perception continues to develop – 23% of bankers considered the environmental impact in its decision making to a 'significant extent' with 63% considering it to a 'medium extent'. The latter was a substantial increase from the prior year where just 44% shared the same view.

Whilst banks are relatively low polluters when compared to other industry sectors, it still remains true that for the bank that is prepared, there are opportunities in terms of cost savings and positive reputational advantage. For those who are not prepared, there is the threat of being left behind.

Operational Matters



Only 8% expected to fall below 2010 budgeted profit targets

Despite bullish predictions at the start of 2010 (which one can only assume were somewhat reflected in the 2010 budget), it was encouraging to see that only 8% of respondents predicted they will come in under their 2010 budget.

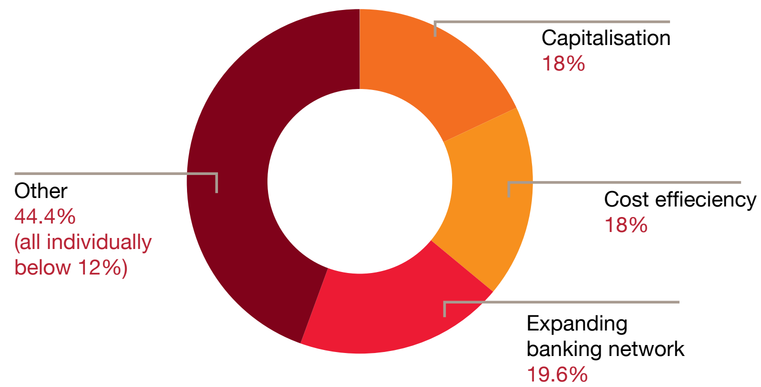
In general, bottom line profit has been particularly assisted by the change in the provisioning levels following the implementation of PSAK 50 & 55 where the BI provisioning levels have been replaced with those derived from the incurred loss method.

Looking ahead to the 2011 year, those predicting budgeted profit would be exceeded by more than 20% dropped from 19% in the prior year to just 6% this year. Whether this is more attributable to more realistic budgeting or a genuine 'scale back' of expectations remains unclear.

The fundamental economic ingredients for growth appear to be in place with a relatively stable rupiah; strong GDP projections; increasing interest from overseas investors; and strong liquidity.

Expanding the network the new #1 on "To Do" list

What is your principal strategic focus for 2011?



As one would reasonably predict having digested the growth projections for 2011 and the target of SME sector, the number 1 strategic priority for 2011 is expanding the banking network. To reach out to Indonesia's large lower to middle income population, banks need to be as close as possible to their customers. This means not only having branches throughout Indonesia but a locally based sales team too.

Whilst cost efficiency remained in the Top 3 for a second year running, it is worth noting that almost a quarter (24%) expressed difficulty in knowing where and how to make cost savings at their banks.

This difficulty may well be one of the main reasons why Indonesian banks have a poor efficiency rate when compared to its neighbouring countries.

Feedback from our discussion with Bapak Halim Alamsyah, Deputy Governor of Bank Indonesia

Given the survey was answered by many of the larger banks operating in Indonesia, the fact that 24% found it difficult to identify cost savings at their banks was concerning.

The skill and value of the finance function when considering cost containment or cost reduction activities cannot be over-emphasised. Any cost reduction initiative needs its context, parameters and desired outcomes to be very clearly understood. Targeted cuts are far preferable to across-the-board reductions. The CFO as an individual, and the function as a whole, have a unique view of the business across its costs, complexity and revenue drivers. This information is fundamental to creating the focus to change the organisation into one that survives and prospers. No one would advocate the execution of a plan based on flawed or incomplete analysis. The finance function, so often the 'controllers' of the business may yet become its saviours.

Level of investment in IT continues

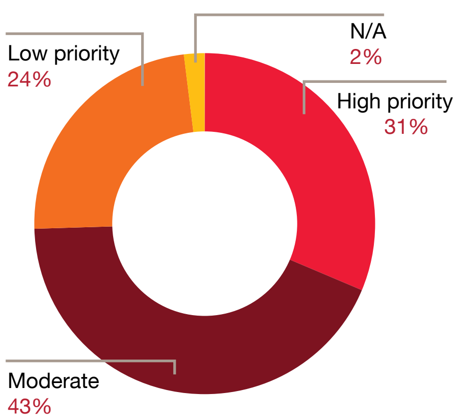
One area where investment continues to be made is in the area of IT. Bankers are in concensus that investment in IT infrastructure must continue to increase with 78% saying that they will boost IT expenditure in 2011 when compared to 2010.

Innovation will drive efficiency and lead to competitive advantage. Technology is one way of capturing both especially when Indonesia lags behind neighbouring countries in internet and mobile banking.

Tax risk is considered to be lower in 2011

Despite it being widely acknowledged that the tax regime within Indonesia continues to develop rapidly with frequent updates to existing tax regulations and/or issuance of new tax regulations, it was surprising to see a shift in how bankers perceived tax risks.

What priority does tax risk management currently have at the leadership level within your bank?



Almost a quarter (24%) of bankers considered tax risk management to be a low priority compared to just 2% in the prior year. Similarly, those classifying it as a high priorty fell from 48% in the prior year to 31% in the current year.

We regard the audit/risk committee as being able to play a key role in establishing tax risk management practices. Their areas of focus may include:

- ensuring there is a framework in place that deals with tax risk;
- helping the organisation define the risk parameters for the management of tax risk;
- driving monitoring programs, including integration with internal audit programs; and
- establishing reporting protocols for tax risk issues.

In driving the implementation of structures and processes for managing ongoing tax risks, the audit committee can be sure their organisation is in compliance with Indonesian tax office requirements.

People – the war for attracting and retaining top talent

The scarcity of talent remains one of the biggest challenges faced by bankers in 2011 as evidenced by it featuring in the top 3 growth obstacles in 2011.

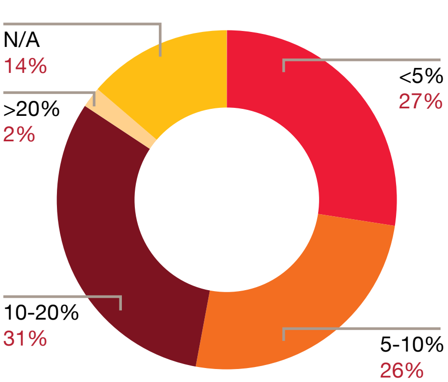
That said, the situation appears to have improved year on year when one considers less respondents described the availability of talented people as being scarce (66% in the prior year, compared to 55% in the current year).

Feedback from our discussion with Bapak Halim Alamsyah, Deputy Governor of Bank Indonesia

It would be useful to understand in next year's survey which levels of staff are the most scarce.

When asked about current staff turnover levels, a rate of greater than 10% was being experienced by one third (33%) of respondents of which only 2% had current turnover rates greater than 20%.

What are your current staff turnover levels?



What are bankers doing to tackle the people challenge? Most plan to use more 'non financial' rewards. These approaches can take many forms but often involve training and mentoring programmes with a closer focus on career trajectories.

48% identified a strategy of more training and development while 32% are seeking innovative resourcing strategies as the preferred means. Interestingly, in what is a highly competitive market, only 16% of respondents were using a rise in their benefits package as a means to attract and retain top talent.

Notwithstanding the scarcity of talent, 94% of respondents are looking to increase their workforce in 2011. Of those looking to add to staff numbers, the majority (50%) are projecting employee numbers growth of between 10-20%.
Set out below are 4 areas where HR may be able to help the bottom line:

1. **Build the brand.** An HR department serves the dual role of supporting the external brand and internally promoting the desired corporate culture. By aligning approaches and practices with how HR wishes to be perceived externally, companies can successfully use HR to enhance corporate reputation.
2. **Align talent and corporate strategies.** HR professionals find the pivotal talent that can help turn strategy into reality.
3. **Develop talent.** By all means, save costs on HR back-office operations. But excellent HR departments add value through talent and leadership development and creation of a performance culture.
4. **Measure success.** The holy grail is for HR to not only measure its impact on business results, but also enable the business to predict talent needs in the right place at the right time.

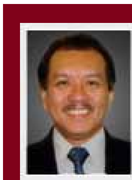
Risk Management, Corporate Governance & Regulation

Risk management... becoming a greater part of daily life

Today's banks face more regulation, a wider range of stakeholder expectations and more public scrutiny than ever before. Capital markets, consumers, pressure groups, employees and governments are a few of those who rightfully hold banking organisations to account for the way in which they define and execute their corporate strategies.

As a result, Governance, Risk Management and Compliance (GRC) have never been higher on the Board's list of priorities. By taking a strategic and holistic approach to GRC, companies can achieve competitive advantage and add significant value to their organization.

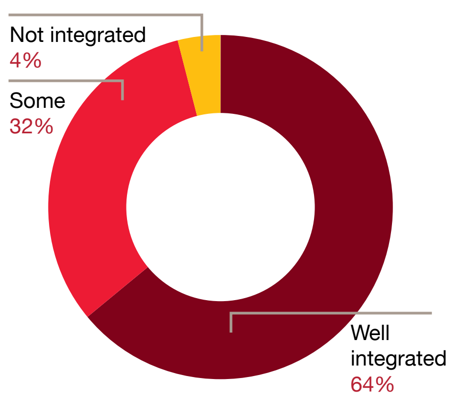
With this context in mind, we are pleased to report that this year's results are more encouraging (than prior year) with 64% of respondents considering that GRC activities are well integrated into day to day activities – up from 55% in the prior year.



Feedback from our discussion with Bapak Halim Alamsyah, Deputy Governor of Bank Indonesia

The greater integration of risk management in the day-to-day operations of the banks is encouraging to see but this will continue to pose a challenge with the growth outlook of Indonesian banks.

How well integrated are Governance, Risk Management and Compliance activities in your bank?

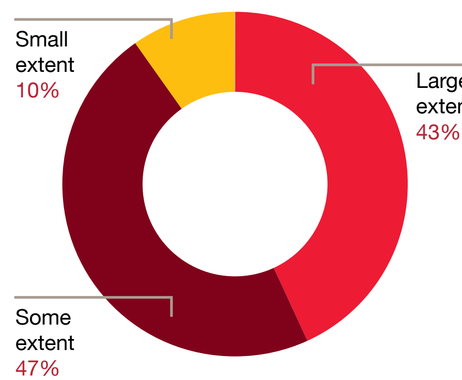


Audit Committees could be more effective

An audit committee may be set up with a constitution in line with good practice, but unless committee members act effectively as a group, the process will add little value to the organization.

Overall, respondents are relatively dissatisfied with their bank's Audit Committee with just 43% describing them as largely effective and the majority (47%) only considering them to be effective to 'some extent'.

To what extent do you consider the Audit Committee at your bank to be effective?



Best practice suggests a regular review of boards and board committees. With all of the extra pressures on an audit committee, a review of its effectiveness is especially useful.
We suggest a review of an audit committee's effectiveness should address the following five areas:

1. The quality and credentials of the members and chairman
2. The scope and clarity of the committee's responsibilities
3. The quality of the information provided to the committee
4. The diligence of members in fulfilling their role on the committee
5. The logistics of committee operations.

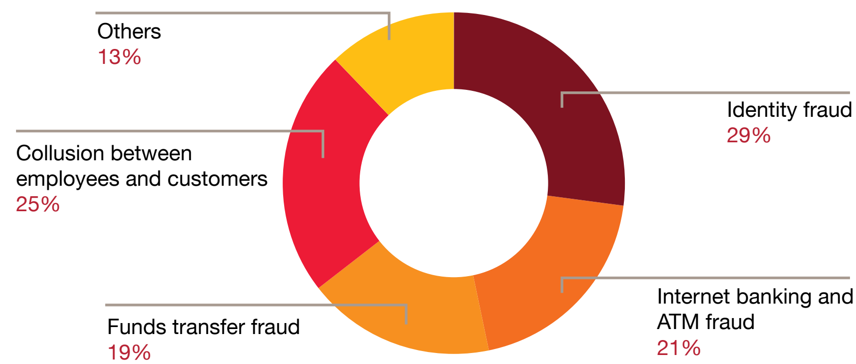
While these areas are often subjective and some of the evidence anecdotal, a carefully structured approach comprising a mix of interviews, document review and benchmarking can provide the objectivity necessary to make an accurate assessment. This is particularly so when the review team brings the experience of working with boards of other Indonesian companies.

Fraud risk

Boards of directors, audit committees, internal audit, management and employees all have a role to play in fraud prevention and detection. In our view, everyone needs to fully understand the risks, accept their responsibility and do what is necessary to reduce fraud risks to an acceptable level.

27% of bankers predicted that the level of fraud risk will decrease in 2011(22% in 2010). Conversely, 22% predict it will increase year-on-year with 51% predicting it will remain the same. Of the fraud risks, identify fraud and collusion between employees/customers draw the most concern.

Which 2 fraud risks are of most concern to your bank currently?

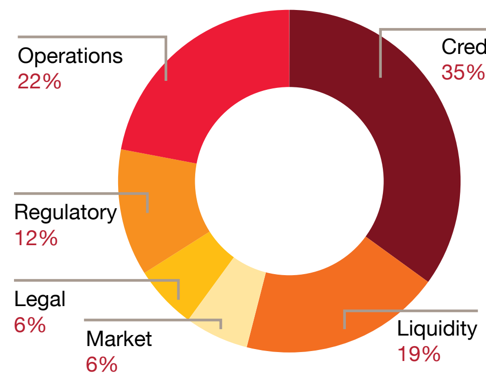


Depending on your track record of risk assessment in relation to fraud prevention and detection, difficult conversations and measures requiring corporate courage may be needed at some or all levels of your organization. Following up when something ‘doesn’t feel right’ is the key. Whilst there is no foolproof method of preventing fraud and corruption, the risk can be minimized by taking a proactive systematic and considered approach to its management. Conducting a structured fraud risk assessment is the first step.

It was therefore encouraging to see an increase in the number of banks conducting a fraud risk assessment in the last 2 years from 57% in 2010 to 69% in 2011.

Credit risk of most concern for the 2nd year running

What 2 risk factors do you consider will have the most significant impact on your bank in 2011?



Despite the level of non-performing loans remaining consistent at an average of circa 3% (across the top 10 banks), credit risk remains the number 1 risk. The challenge remains for the level of bad debts to remain consistent / reduce despite the bullish expectations for lending growth in FY 2011. Sound credit risk assessments and subsequent management will be the key to ensuring this is achieved.

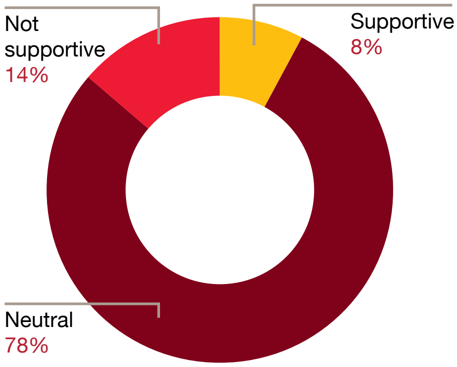
Liquidity risk remains a top 3 risk for banks despite the relatively liquid state of the economy as evidenced by the impressive amount of successful corporate actions over the last 6 months.

A neutral stance on regulation?

One of the most surprising results from this year's survey was the number of bankers who did not have a specific view on the current state of regulation (i.e. amount, clarity and quality) in the banking sector.

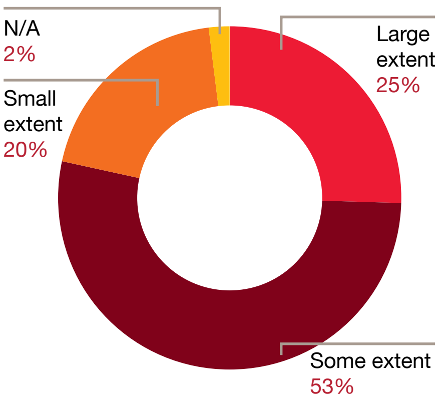
78% of bankers had a 'neutral' view on regulation with just 8% expressing their support and the remaining 14% indicating that they were not supportive. It was also particularly surprising when the same bankers in the same survey identified the regulatory environment as being the single biggest obstacle to the banking industry in 2011.

What are your views on the current state of regulation (i.e. amount, clarity and quality) in the banking sector?



Internal audit – are they providing you with insight?

To what extent does the Internal Audit function in your bank add insight and value beyond the compliance type assurance it provides?



Needs and expectations for internal audit have never been higher and so the key question was asked as to whether internal audit is delivering.

Just 25% of respondents were of the view that they were benefitting, to a large extent, from insight from their internal audit division (compared to 32% in the prior year). This is a low figure when one considers the large investment made in this area and the company wide visibility and mandate to lead their organisations in enhancing capability.

Whilst in a highly regulated environment, Internal Audit clearly has a role to play in terms of compliance, it is essential that it takes the initiative to redefine itself such that it can provide the leadership team with actionable business risk intelligence.

Our survey results may suggest that management may not be completely aware of the business insight and 'value add' that Internal Audit can bring in addition to the results of their day to day procedures. Or perhaps their in - house Internal Audit functions are not adequately trained to provide such business insight and value.

Basel III

Basel III is set to redraw the banking landscape. It will have a profound impact on profitability and force many banks to transform their business models. It will also require firms to undertake significant process and system changes.

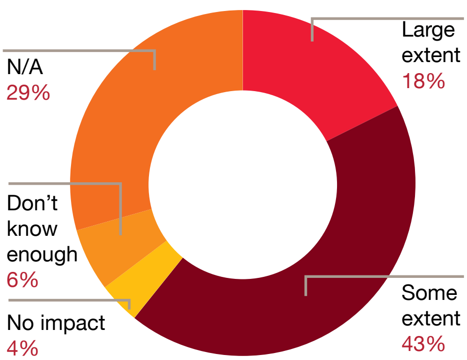
Basel III establishes tougher capital standards through more restrictive capital definitions, higher risk-weighted assets (RWA), additional capital buffers and higher requirements for minimum capital ratios.

As well as rethinking their business models, many banks will need to achieve upgrades in the areas of stress testing, counterparty risk and capital management infrastructure.

The reforms will impact most heavily on banks with large capital markets businesses. Higher capital requirements will primarily come from trading books, securitisations, securities lending and OTC derivatives.

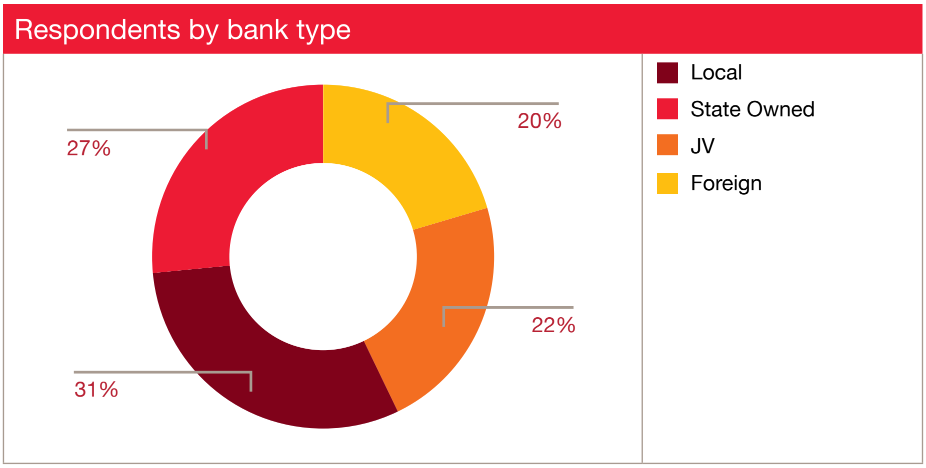
Basel III also establishes new liquidity standards that will drive changes in banks' balance sheet composition to limit illiquid assets, restrict wholesale or unstable sources of funding and manage higher funding costs. These new standards will have a broad impact across most banks, particularly those that focus on commercial and wholesale banking activities.

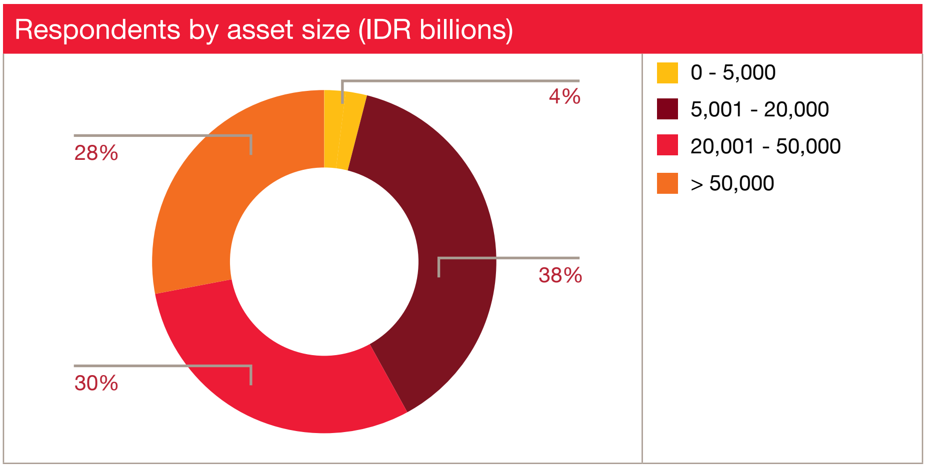
To what extent will your bank be impacted by the recently announced, and more restrictive requirements of Basel III?



It was therefore surprising to see that 29% answered the question, "To what extent will your bank be impacted by Basel III" by selecting the 'Non Applicable' box and 4% saying no impact at all.
The good news for banks is that the Basel III framework does not start becoming effective until January 2013 and its full effects will not be felt until 2019 (assuming Indonesia follows the timetable of other G20 countries), when the new regime's transitional period ends. Nonetheless, it is critical that banks start to reset their business models now to adapt to the new capital and liquidity standards. By doing so, they can not only start to tackle Basel III's many challenges but also keep abreast of the competition.

Appendix


Respondents by bank type
20%
27%
22%
31%
Local
State Owned
JV
Foreign


Respondents by asset size (IDR billions)
4%
28%
38%
30%
0 - 5,000
5,001 - 20,000
20,001 - 50,000
> 50,000

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