Welcome to PwC Indonesian Banking Survey 2015!

Jusuf Wibisana
Partner

Over the past five years, PwC Indonesia has asked the views of senior banking executives across Indonesia to gather diverse opinions for our Indonesian Banking Survey. We continue to seek the expert opinions of bankers in 2015.

This year, the Survey covers bankers’ predictions, concerns, comments on regulations, responses to new government initiatives and thoughts on consumer banking trends.

The results of the Survey are based on completed questionnaires from more than 60 senior banking executives working in the Indonesian banking sector, representing more than 75% of total banking assets.*

We would like to take this opportunity to extend our sincere thanks to the respondents for their time and effort in contributing to this Survey. We are confident that this report will provide readers with an understanding of the professional opinions of senior banking executives.

We welcome any feedback you may have on the PwC Indonesian Banking Survey so that we can incorporate it into future surveys and provide you with most relevant information. Do contact us.

*as at 30 September 2014

May 2015

Contents

Overview of 2015 Banking Survey
Executive Summary
01 Macroeconomics outlook and banking business in 2015 | page 10
02 Risk management | page 16
03 Regulations | page 20
04 Infrastructure and maritime industry | page 28
05 Trends in consumer banking | page 34

The report is provided for general and information purposes only, and is not to be taken as exhaustive; nor does it constitute legal or investment advice. In addition, the report is not intended to cover all topics of interest. We make no guarantee or warranty, express or implied, with respect to the accuracy or integrity of the information contained in this report. PwC accepts no responsibility or liability for any action taken or not taken by any individual or organization as a result of reading this report.
Overview of 2015 Banking Survey

A. Survey objectives, target participants and results

This is the sixth year PwC Indonesia conducts Indonesian Banking Survey to gather views from senior banking executives. The survey endeavours to (i) gain insight from bankers into strategies, growth and challenges of the Indonesian banking industry; (ii) share views of bankers on major business areas; (iii) promote mutual understanding and exchange of views between market participants.

The survey was conducted from 8 December 2014 to 9 January 2015. We received overwhelming responses from banks and we are grateful for the bankers’ participation. Without the participation, this survey results would not be possible.

B. Survey respondents’ profile

For 2015 survey, we received survey responses from:

a. 64 senior banking executives of which 38% are CEO and Deputy CEO (or equivalent) of the banks.

b. Banks controlling 76% of total banking assets*, including responses from 9 out of top ten banks in Indonesia. The respondents also cover a cross segment of banks in Indonesia, including:
   (i) 3 out of 4 State Owned Enterprise (SoE) banks in Indonesia
   (ii) 13 out of 25 foreign banks** operating in Indonesia
   (iii) All 4 BUKU*** categories of banks in Indonesia
   (iv) Syariah banks as well as Bank Pembangunan Daerah (BPD)

Banks’ BUKU categories:

- **BUKU 1** – banks with total core capital less than IDR 1,000,000 million. The business activities for banks classified into BUKU 1 are mainly limited to basic funding and borrowing and other banking services in Rupiah. The foreign exchange transaction is limited to the money changer activities.
- **BUKU 2** – banks with total core capital between IDR 1,000,000 million to IDR 5,000,000 million. The business activities for banks classified into BUKU 2 are broader compared to banks classified into BUKU 1 and not limited to services in Rupiah. The banks classified into BUKU 2 can also enter into spot and other plain vanilla derivatives. The equity investment is limited to domestic financial institution with maximum of 15% ownership.
- **BUKU 3** – banks with total core capital between IDR 5,000,000 million to IDR 30,000,000 million. The banks classified under BUKU 3 can enter into all banking activities. The equity investment is limited to domestic financial institutions or other financial institutions incorporated in Asia countries with maximum of 25% ownership.
- **BUKU 4** – banks with total core capital above IDR 30,000,000 million. The banks can enter into domestic or off shore equity investment with maximum of 35% of ownership.

* As at 30 September 2014
** Perhimpunan Bank-Bank Internasional Indonesia (Perbina) members as at 31 December 2014
*** BUKU: Bank Umum berdasarkan Kegiatan Usaha
Executive Summary

The past year 2014 had been a challenging year for the Indonesian economy. Indonesia’s economy in 2014 grew at its slowest pace in five years. Gross Domestic Product (GDP) expanded 5.0% in 2014 compared with 5.5% in 2013.

Since the beginning of 2014, economic growth has been trending down as exports of primary commodities fell, and growth slowed in the international market, especially China. In addition, the high interest rate environment and the weakening of Rupiah had affected the domestic demands as well.

The year 2014 also marked with the legislative and presidential elections. In July 2014, the General Election Commission of Indonesia (Komisi Pemilihan Umum, KPU) declared Joko Widodo (known popularly as Jokowi) and Jusuf Kalla as winners of the presidential election.

With that backdrop, we asked senior banking executives in December 2014 for their views as to how they see 2015 and challenges ahead. Our survey covers bankers’ prediction, concerns, comments on regulations, responses to new government initiatives and thoughts on consumer banking trends.

1. Volatility and uncertainty ahead in 2015

With the new administration under President Jokowi, the majority of bankers surveyed (83% of respondents) believe that the policy direction and economic policies of the new government will have the biggest impact on Indonesia’s economy in 2015.

In addition, the majority of the bankers in December 2014 viewed that the Rupiah exchange rates will continue to be under pressure at ranges between IDR 12,000 to IDR 13,000 and the Bank Indonesia (BI) rate will continue to increase this year. To the surprise of the market, on 17 February 2015, Bank Indonesia’s Board of Governors decided to cut its benchmark BI rate by 25 bps to 7.50%, as it expects inflation to continue easing. In late December 2014, the government cut fuel prices due to falling global prices, which sent inflation lower to 6.9%* in January 2015 from 8.4%* in December 2014.

It should be noted that the slowing growth in China, lower eurozone inflation and falling oil prices have also pushed central banks across the globe to cut rates in 2015 to help their economies, as evident by the central banks’ decisions in India, Canada, Russia (January 2015), China (February 2015), Thailand and South Korea (March 2015).

2. Challenging outlook affecting banking business

Despite pressure to the net interest margin (NIM), nearly half of the bankers expect NIM will remain at the similar levels to 2014. In 2014, the average NIM for Indonesian banks in 2014 was down to 4.2%** from 5.1%** in 2013. About 29% of bankers expect NIM would tighten in 2015.

The majority of the bankers expect the loan growth in 2015 will be around 10% to 20%. Local, sharia and state owned banks are of the view that the growth in the small and medium enterprises (SME), retail and consumer banking are the key targets for growing the loan portfolio in 2015. On the other hand, foreign and joint venture banks are more focused on growing the corporate banking loans in 2015.

Approximately 47% of bankers also expect the non-performing loans (NPL) to increase in 2015 and about 37% believed that they would remain the same. Bankers believe that the increase in NPL would likely arise from corporate and SME loans.

Growing fee-based business is seen as the strongest driver for future business. Banks are developing fee-based income to offset falling loan growth. In addition, bankers also considered the digital channel expansion as the key areas of focus in 2015, especially in the consumer banking space. Nowadays, more and more customers are becoming comfortable using the internet and mobile banking for their transactions, supported by high penetration of mobile, Internet, and smartphones.

3. In driving business growth, the increase in regulatory requirements and margin pressure are seen as main challenges

Our survey question regarding the challenges for growing business in 2015 indicates diverse views. Local, sharia and state owned bankers are of the view that margin pressure as the biggest challenge.

On the other hand, foreign and joint venture banks see the increase in regulatory requirements as the biggest challenge. Today, banks face more regulation, expectations and public scrutiny than ever before.

---

*source: Bank Indonesia

**source: Laporan triwulanan OJK
4. Credit risk continues to be the main risk facing Indonesian banks

Credit, liquidity and operational risks are the top three risks for Indonesian banks.

Nevertheless, consistent with the result in our prior years’ surveys, credit risk remains the number one risk. This is also consistent with the expectations from bankers on the possibility of increase in NPL in 2015. Bankers are of the view that the most important measures to manage credit risk are through the enhancement of the loan monitoring system and approval process as well as limiting exposures to certain high risk industries.

Liquidity concern is also high on the bankers’ list. Bankers put more emphasis on the diversification of funding base (through Current And Savings Accounts (CASA)) to manage the liquidity concerns.

With the increase in the banks’ intermediary role in the financial system, operational risk has also increased. The main emphasis of strategies to manage operational risk are through people development (e.g. training) and automation initiatives to reduce the manual processes. In today’s banking environment, information technology plays a crucial role in supporting the operations of banks.

5. Regulations – Bankers asked for more clarity, especially on Basel III implementation and IT data on-shoring

From the survey results, bankers indicate that there is room for regulator to provide more clarity on some of the regulations. Local, sharia and state owned bankers put more emphasis on capital management considering Basel III implementation, risk management and good corporate governance regulations.

On the other hand, joint venture and foreign bankers are of the view that the regulations related to IT Data Centre need the most attention from the regulators. In addition, bankers from joint venture and foreign banks also need more clarification on the ownership and local incorporation rules.

As a group, half of the bankers indicate that further guidance is required in relation to Basel III implementation, especially in the area of Basel III liquidity requirements, the use of foundation or internal rating based approach and the timeline of Basel III implementation.

6. ICAAP implementation is well underway, but further guidance still needed in area of stress testing

At the end of 2012, Otoritas Jasa Keuangan (OJK) introduced the Internal Capital Adequacy Assessment Process (ICAAP) requirement for banks in Indonesia to continually assess the capital adequacy in accordance with the bank’s risk profile, and the setting of strategy to maintain capital levels.

Although the survey indicated that 68% of the bankers say that the ICAAP implementation in their banks are well underway, 53% of them indicate that further guidance from the regulator is still required, especially in the area of stress testing (e.g. stress testing scenario, severity level and coverage of stress testing).

7. Regarding the implementation of the Integrated Good Corporate Governance and Risk Management, many banks are still at planning stage

We asked in the survey and noted that 72% of respondent bankers indicated that their banks are part of a financial conglomerate and are expected to become the Lead Entity for their respective financial conglomerates as required by OJK Regulation.

OJK require banks to implement and report on Integrated Good Corporate Governance and Risk Management by June 2015 (for banks under BUKU 4 categories) or December 2015 (for banks under BUKU 3 categories). The majority of the bankers indicated that their banks are either currently still in the planning process or in advance planning stage.

8. Local, sharia and state-owned banks have shown interest to participate in Laku Pandai program

In November 2014, OJK announced the Laku Pandai (branchless banking) initiatives.

Laku Pandai is aimed at providing micro access toward savings and loans for rural communities across the country that are mostly unbanked and underbanked. Under the program, participating banks are required to recruit agents, both individuals and legal entities to provide basic saving and loan products to the people.
From the survey, the majority of bankers from local, sharia and state owned banks (62% of respondent) indicate their willingness to participate in this branchless banking initiatives in 2015 and currently this is in the preparation stage. On the other hand, the majority of the bankers from foreign and joint venture banks indicated that they have not put a priority focus to participate in this initiative.

9. Growth seen in infrastructure and maritime financing in 2015 with bankers’ support, especially SoE banks

The new administration under President Jokowi continues to stress the importance of infrastructure to support Indonesia’s economic growth. More than half of the bankers (59%) indicate that their banks currently have exposures to infrastructure financing but the portion is estimated to be less than 10% from their respective loan portfolio.

In the view of those surveyed, transportation and energy will be the key growth for the infrastructure loans in 2015. The complexity of infrastructure projects, regulatory and compliance concerns as well as land acquisition is seen as the key challenge with regards to infrastructure financing.

In addition, President Jokowi also introduced the maritime-axis doctrine as one of the key agenda of his administration. OJK targeted the maritime financing in 2015 to increase by IDR 42 trillion from IDR 85 trillion in 2014. From the survey, the majority of bankers from state-owned banks indicated that their banks are ready to support the Government program on the maritime with focus on the “Sea Highway” program. Bankers from state-owned banks also indicated their interest in the financing of sea port constructions as well as support to fishing industry.

10. Trends in consumer banking indicate bankers see mortgage and unsecured personal loans as key consumer products, and investment in internet and mobile banking is priority in 2015

Strong GDP growth over the past years is seen as the catalyst for a growing middle-class in Indonesia. The growing middle-class leads to positive growth potential in the consumer banking space, especially mortgage loans. More than half of the bankers indicate that mortgage loans will be the key driver in consumer loans followed by unsecured personal loans.

The majority of the bankers also indicate that investment in the internet and mobile banking as their top priority in 2015. Indonesia still lags behind neighbouring countries for internet and mobile banking. From the survey, bankers estimate that currently only up to 25% of the customers transactions are processed through the internet and mobile banking.

2015 Survey’s key findings at a glance

1. Volatility and uncertainty ahead in 2015
2. Challenging outlook affecting banking business
3. In driving business growth, the increase in regulatory requirements and margin pressure are seen as main challenges
4. Credit risk continues to be the main risk facing Indonesian banks
5. Regulations – Bankers asked for more clarity, especially on Basel III implementation and IT data on-shoring
6. ICAAP implementation is well underway, but further guidance still needed in area of stress testing
7. Regarding the implementation of the Integrated Good Corporate Governance and Risk Management, many banks are still at planning stage
8. Local, sharia and state-owned banks have shown interest to participate in Laku Pandai program
9. Growth seen in infrastructure and maritime financing in 2015 with bankers’ support, especially SoE banks
10. Trends in consumer banking indicate bankers see mortgage and unsecured personal loans as key consumer products, and investment in internet and mobile banking is priority in 2015
Macroeconomics outlook and banking business in 2015

Policy direction and economy policies of the new Government is expected to have the biggest impact to Indonesian economy in 2015

The year 2014 was seen as another milestone in the Indonesia’s democratic era marked by two major political events: the country’s fourth democratic legislative elections and the third direct presidential race. In July 2014, KPU declared Joko Widodo (known popularly as Jokowi) and Jusuf Kalla as winners of presidential election.

With this new administration, the majority of bankers surveyed (83% of respondents) believe that the policy direction and economic policies of the new government will have the biggest impact on Indonesia’s economy in 2015.

The bankers also considered the global commodities prices and the fluctuation in Rupiah exchange rates as factors that could significantly impact the Indonesian economy in 2015.

Figure: 1
Q: Which of the following in your view will have a major impact on Indonesian economy in 2015? (choose the applicable ones)

- Policy direction and economic policies of the new Government: 83%
- Fluctuation in Rupiah exchange rates: 40%
- Global commodities prices: 40%
- Slowing growth in export activities: 24%
- Lower domestic economic activities: 21%
- Inbound foreign investments: 20%
- Sustainability of GDP growth: 20%
- Others: 11%
**BI Rate is expected to increase**

Majority of the bankers predict that Bank Indonesia will continue to increase interest rates in 2015, possibly up by 25 to 50 bps. In November 2014, Bank Indonesia hiked its benchmark interest rate (BI rate) from 7.50% to 7.75% in order to mitigate the accelerated inflation and support the Indonesian rupiah exchange rate. Slower loan growth, worsening credit quality and lower profitability are expected by bankers as a result of the high interest rate environment.

In a surprise move, on 17 February 2015 Bank Indonesia Board of Governors decided to lower the BI Rate 25 bps to 7.50%. This new measure is based on the expectation that inflation will remain under control at 4±1% range in 2015.

---

**Bankers predict Rupiah's exchange rate continue to be under pressure in 2015**

An increasingly improving US economy resulted in US dollar appreciation against all global currencies, including Indonesian rupiah. When asked in December 2015, the majority of the bankers predict that the Rupiah exchange rate (against USD) in 2015 will continue to be under pressure between IDR 12,000 to IDR 13,000. We observed that Rupiah has breached IDR 13,000 level in March 2015 and as of April 2015, hovered around IDR 13,000.

---

**NIM expected to remain the same and may tightened**

Indonesia’s net interest margin (NIM) is known as one of the highest in the South-East Asia. Our survey recorded two views in terms of NIMs outlook in 2015. With the current high interest rate environment, 46% of the respondents predict that NIMs in 2015 will remain about the same whilst 29% of the respondents believed that it would tighten. This trend will likely continue as loan demand increases at a slower pace and as depositors search for higher rates.

---

**Fee-based income is now considered as the main area of focus for growth**

With the commodity exports still affected by low global prices and consumer spending threatened by inflation, demand for corporate and consumer loans is set at a slower pace.

72% of the respondents have stressed that growing the fee income is the banks’ main area of focus for growth in 2015. Banks are developing fee-based income to offset falling loan growth, focusing on products such as trade finance, remittance and insurance (bancassurance).

The second and third top areas of focus for business growth in 2015 are growing the loan portfolio and the digital channel expansion.

Investing in technology for digital channel expansion is a key activity. Technology will be a critical factor in reaching new customers without the branch network expansion cost and this will enable banks to be more efficient to meeting customers’ increasingly demanding needs.

---

**Figure: 2**

Q: What is the likely impact to banking industry in 2015 arising from high interest rate environment? (choose the applicable ones)

<table>
<thead>
<tr>
<th>Impact</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Slower loan growth</td>
<td>84%</td>
</tr>
<tr>
<td>Worsening credit quality</td>
<td>65%</td>
</tr>
<tr>
<td>Lower profitability</td>
<td>54%</td>
</tr>
<tr>
<td>Liquidity concern</td>
<td>23%</td>
</tr>
</tbody>
</table>

**Figure: 3**

Q: What is your Bank’s area of focus in growing for 2015? (choose the applicable ones)

<table>
<thead>
<tr>
<th>Area</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growing fee income</td>
<td>72%</td>
</tr>
<tr>
<td>Growing loan portfolio</td>
<td>64%</td>
</tr>
<tr>
<td>Digital channel expansion</td>
<td>55%</td>
</tr>
<tr>
<td>Expanding the banking channels</td>
<td>20%</td>
</tr>
<tr>
<td>Others</td>
<td>3%</td>
</tr>
</tbody>
</table>
**Diverse views when asked about challenges for growth**

Consistent with the results in our 2014 survey, there are two contrasting themes in terms of the focus for growing the loan portfolios depending on the type of banks. Local, sharia and state owned bankers are of the view that the growth in the SME, retail and consumer banking are the key targets for growing the loan portfolio in 2015. Targeting the SME sector is not new. This sector is considered to be the backbone of the Indonesian economy, attracting higher margins. In addition, Bank Indonesia also requires banks to direct at least 20% of their credit portfolio to the SME sector by 2018.

On the other hand, foreign and joint venture banks planned to focus more on growing the corporate banking loans in 2015. Nevertheless, the majority of the both groups shared the same view that the loan growth for 2015 will be around 10% to 20%.

**Non-performing loans expected to increase**

47% of the bankers predict that the NPL will increase in 2015 whilst 37% believed that they would remain the same. The majority believes that the NPL will increase by up to 10% and the corporate and SME loans will become the main source of the increase.

**Driving business growth, increase in regulatory requirements and margin pressure seen as main challenges**

The bankers appear to be divided in views as to what poses the most significant challenge for achieving the loan growth target in 2015. Local, sharia and state owned bankers are of the view that margin pressure is the biggest challenge. On the other hand, foreign and joint venture banks saw the increase in regulatory requirements as their biggest challenge.

Competition for deposits and lending is putting interest margin under pressure, especially for local, sharia and state owned banks as many of these banks put heavy reliance on deposit funding to finance lending. We have seen local, sharia and state owned banks adopting a range of strategies to ease margin pressure, ranging from increasing fee-based products to focusing on higher yield products such as SME and micro loans.

Over the years, Bank Indonesia has introduced and enforced new regulations with the aim of improving banks’ efficiency and strengthening the country’s banking system. These regulations can pose different challenges for foreign and joint venture banks. Some of the regulations which are specifically relevant to the foreign and joint venture banks are the proposed local incorporation for foreign branches, ownership rules and IT data onshore requirements.

However, both groups shared the view that the potential increase in credit risk of loan portfolio and liquidity concerns as the remaining two top challenges.
Risk management

Credit risk continues to be the main risk facing Indonesian banks

Similar with our findings in last year’s survey, credit risk remains the number one risk for bankers. This concern is also consistent with the expectations of bankers and the possibility of an increase in NPL in 2015. With the current high interest rate environment, a weakening Rupiah and slower economic growth, banks may find it more difficult to maintain the non-performing loan ratios at current levels.

Figure: 6

Q: What are your top risk management focus areas in 2015? (choose the applicable ones)

Credit risk 79%
Liquidity risk 56%
Operational risk 42%
Market risk 27%
Compliance and legal risk 21%
IT risk 15%
Others 2%

Majority of the bankers believe that the enhancement in the loan monitoring system and approval process, as well as the limitation to exposures in certain industries will be the key factors to ensuring appropriate credit risk management is achieved.

Liquidity and operational risks are also amongst the top risk areas of concerns for banks

Liquidity risk continues to be listed as one of the top three risks. Triggered by the economic condition in 2014, bankers have acknowledged the tougher liquidity conditions and strong competition for third party funds. Mid-size Indonesian banks are likely to be the most at risk in this regard as they typically have a less diversified funding base and higher cost of funds.

Majority of the bankers believe that the diversification in the funding base (i.e. through CASA) will be the key factor to ensuring the appropriate liquidity risk management is achieved.

Figure: 7

Q: What is your strategy to reduce and manage liquidity risk in 2015? (choose the applicable ones)

Diversify your funding base 77%
Reduce mismatch of assets and liabilities 36%
Obtain bilateral loan facilities 38%
Others 8%
In September 2014, OJK issued a regulation which caps the time deposit interest rates to address the liquidity and pricing concerns. The cap was set at 200 bps above the BI rate for BUKU 4 lenders and at 225 bps above the BI rate for BUKU 3 lenders. No limit has been set for BUKU 1 and 2 lenders. Majority of the bankers believe that this new regulation, to a certain extent, has been helpful to address the above issues.

In today’s world, operational risk has become more complex. Of all the different type of risks banks face, operational risk can be the most devastating and the most difficult to anticipate. If not well managed it can result in a dramatic reduction in the value of a bank.

We asked bankers to indicate their key strategies in managing operational risk. The top three strategies to be taken by the bankers to manage the operational risk are firstly, people development (e.g. training and other development program), secondly automation initiatives to reduce the manual process and lastly, the enhancement of the risk control self-assessment process.

**IT risk is expected to increase in 2015**

As banks’ intermediary role in the financial system becomes more sophisticated, the requirement for supporting infrastructures (including IT) also increases correspondingly.

56% of the bankers predict that the IT risk will increase in 2015 whilst 36% believe that they would remain the same. The three top reasons for the expected increase of IT risk in 2015 are:

1). The increase in the use of IT in all aspects of the Bank’s business;
2). Increase in the number of electronic transactions; and
3). The complexity of the business.

---

**Figure: 8**

Q: What is your strategy to reduce and manage operational risk in 2015? (choose the applicable ones)

- People development: 68%
- Automation initiatives to reduce manual process: 64%
- Enhance risk control self-assessment: 61%
- Review and enhance current policies and procedures: 47%
- Increase compliance checking: 29%
- Increase internal audit function and number of audits to be performed: 26%

---

**Figure: 9**

Q: What are the main factors for the increase in IT risk? (choose the applicable ones)

- Increase in the use of IT in all aspects of the business: 57%
- Increase in number of electronic transactions: 54%
- Complexity of the business: 51%
- Expansion of banking channel: 35%
- Others: 11%
Bankers ask for more clarity on regulations

With the growing volume of regulations, banks are routinely challenged by the need to interpret them correctly. Hence, clarity in regulations are sought by bankers. However, different types of banks placed emphasis on different regulations where better clarity would be helpful to them.

Local, sharia and state owned bankers are of the view that the regulation related to the Basel III need the most attention from the regulators to provide more clarity. In addition, local, sharia and state owned bankers also need more clarification on ownership rules, risk management and good corporate governance regulations.

On the other hand, foreign and joint venture banks are of the view that the regulation related to IT Data Centre needs the most attention from the regulators to provide more clarity. Bankers from foreign and joint venture banks also need more clarification from regulators regarding the Basel III implementation, ownership rules as well as the local incorporation rules.

Figure: 10

Q: In which of the following areas of regulation would you like the regulator to provide more clarity? (choose the applicable ones)

Local, sharia and state owned banks
- Capital management considering Basel III implementation: 63%
- Ownership rules: 51%
- Risk management and good corporate governance: 30%
- Regulatory compliance: 28%
- Information and technology (including IT Data Centre): 23%
- Local incorporation for foreign branch: 21%
- Others: 12%

Foreign and joint venture banks
- Information and technology (including IT Data Centre): 70%
- Capital management considering Basel III implementation: 61%
- Ownership rules: 52%
- Local incorporation for foreign branch: 43%
- Risk management and good corporate governance: 35%
- Regulatory compliance: 22%
- Others: 9%
**BASEL III regulatory changes**

As previously highlighted in our prior years’ banking surveys, Basel III represents the biggest regulatory change that the banking industry has seen in recent times.

Indonesia, as part of the global banking community, is committed to implement this regulatory requirement. OJK, in December 2013, issued a new regulation (PBI No. 15/12/PBI/2013) concerning the Minimum Capital Adequacy Requirement for financial institutions, including an additional capital requirement as a buffer. This new regulation has been applied gradually since 1 January 2014 with the full compliance with Basel III by 2019.

Non-compliance is not an option and work required to achieve compliance is significant. We asked bankers about Basel III implementation as part of our survey and whilst 41% responded that compliance is well underway, another 50% indicated that further guidance is required. This suggests that the capital management guidelines based on Basel III still require more clarity and explanation from the Regulators. Bankers indicated the top three areas where further clarity is needed as below.

1) Basel III liquidity requirements;
2) the use of foundation or advanced internal rating based approach; and
3) the timeline of Basel III implementation.

**ICAAP implementation is well underway but further guidance still needed in areas of stress testing**

When asked about the ICAAP implementation in respective banks, 68% of the bankers indicated that the ICAAP implementation in their banks is well underway.

Although the majority of the bankers indicated that the ICAAP implementation in their banks is well underway, 53% of the bankers also indicated that further guidance from the regulator is still required, especially in the area of stress testing.

OJK as the Regulator will conduct a Supervisory Review and Evaluation Process (SREP) to assess the soundness of a bank’s ICAAP and will then advise the appropriate actions that may be required. Only 35% of the bankers indicated that the ICAAP implementations in their banks have been subject to independent reviews by OJK and the majority of the reviews were done in the last six months.

**FATCA are being implemented by banks**

Foreign Account Tax Compliance Act (FATCA) is a constantly-updated regulation. The United States Internal Revenue Service (IRS) has continually been releasing announcements and updates in order to accommodate the needs and concerns of FATCA’s global stakeholders.

Indonesia has been granted “Model 1 IGA in substance” status since 4 May 2014 which was supposed to expire on 31 December 2014. However, this status has been extended based on IRS announcement. However, according to IRS, the status might be revoked if the jurisdiction does not continue to demonstrate a firm resolve to sign the IGA.
The majority of the bankers (64% of respondents) also indicated that their banks have the complete procedures and already started the US Tax Payers Indentification for the on-boarding customers. In addition, the majority of the bankers (75% of respondents) indicated that their banks already registered with IRS and have a Global Intermediary Identification Number (GIIN).

Indonesian banks must take note of FATCA timeline. The upcoming deadline will be the identification of pre-existing high-value individual accounts, scheduled to be due on 30 June 2015 at the latest.

Additionally, Indonesian banks must also be aware of the possible commencement of Common Reporting Standard (CRS) in Indonesia, anticipated to begin in 2017-2018. CRS, formally named as the Automatic Exchange of Financial Account Information and informally known as GATCA (the global version of FATCA), elevates the “know your customer” requirements for Indonesian banks. Through CRS, Indonesian banks will play the central role on identifying the tax jurisdiction(s) of their customers and reporting their financial data to the respective jurisdiction(s).

**Recently issued OJK regulations**

Regarding the implementation of the Integrated Good Corporate Governance, many banks are still at planning stage.

Corporate governance is centered on setting the right risk direction, exercising proper oversight and protecting the interests of all stakeholders. With this new regulation covering integrated good corporate governance across a banking group, it is expected that the corporate governance functions within a financial services group are better connected. From a governance perspective, the largest entity within a group is expected to lead. 72% of respondents indicated that their banks are part of the financial conglomerate and are expected to become the Lead Entity as required by OJK.

In relation to the implementation status, only 30% of the bankers that indicated that their banks are ready to implement and report on Integrated Good Corporate Governance by June 2015 (for BUKU 4) or December 2015 (for other than BUKU 4), 27% indicated that their banks are still in the planning process, and 24% indicated that their banks are already in advance planning stage and target to be ready by June 2015 (for BUKU 4) or December 2015 (for other than BUKU 4). The remaining portion indicated that their banks are still in the initial stage and may need clarification/assistance.

As with Integrated Good Corporate Governance, mixed results regarding readiness to implement Integrated Risk Management.

Similar with the readiness to implementation of Integrated Good Corporate Governance, we also noted mixed results on the implementation of the Integrated Risk Management.

When asked whether their banks will be able to implement the integrated risk management covering all the risks as required by the regulation by June 2015 (for BUKU 4) or December 2015 (for other than BUKU 4), only 29% indicated their readiness. The other 29% of the respondents indicated that they are still in planning process, 16% indicated that their banks are already in the advance planning stage and target to be ready by June 2015 (for BUKU 4) or December 2015 (for other than BUKU 4), the other 16% indicated that their banks are still in the initial stage and may need clarification/assistance.

As with Integrated Good Corporate Governance, mixed results regarding readiness to implement Integrated Risk Management.

Recently issued OJK regulations

Regarding the implementation of the Integrated Good Corporate Governance, many banks are still at planning stage.

Corporate governance is centered on setting the right risk direction, exercising proper oversight and protecting the interests of all stakeholders. With this new regulation covering integrated good corporate governance across a banking group, it is expected that the corporate governance functions within a financial services group are better connected. From a governance perspective, the largest entity within a group is expected to lead. 72% of respondents indicated that their banks are part of the financial conglomerate and are expected to become the Lead Entity as required by OJK.
Majority of the Syariah Banks already have policies and procedures to implement new OJK regulation on quality of assets

In November 2014, OJK also issued a new regulation on the assessment on the quality of assets of Shariah Bank or Syariah Unit. The majority of the bankers (63% of respondents), indicated that their banks already have policies and procedures in place regarding the above new assessment on the quality of assets.

Figure: 15

Q: Does your bank have policies and procedures in place to implement by 1 January 2015 regarding the assessment on the quality of assets of Syariah Bank or Syariah Unit in accordance with the new OJK Regulation?

- **63%** Yes
- **13%** Not yet but will be ready by 1 January 2015
- **12%** Not yet but in the process and will be ready in 2015
- **4%** I do not know
- **8%** Still in the initial planning process

Local, sharia and state owned banks shown interest to participate in Laku Pandai Programme

In November 2014, OJK announced the Laku Pandai (branchless banking) initiatives with the main objective to provide micro-saving and loan services for unbanked and underbanked people.

One of the requirements set by OJK for the participation in the Laku Pandai programme is the bank must already be operating internet and mobile banking services. These banks can extend their banking activities by recruiting individuals and legal entities as agents.

From the survey, the majority of bankers from local, sharia and state owned bankers (62% of respondent) indicated that their willingness to participate in this branchless banking initiatives in 2015 and currently is in the preparation stage.

On the other hand, the majority of the bankers (83% of respondents) from foreign and joint venture banks indicated that they have not as yet put any focus to participate in the branchless banking initiatives. This could be due to the business models of many of the joint venture or foreign banks do not focus on retail or mass banking.
Infrastructure and maritime industry

The new administration under President Jokowi continues to stress the importance of infrastructure to support Indonesia's economic growth.

In addition to focusing on infrastructure, President Jokowi also introduced the following maritime-axis doctrine:

1. Rebuild Indonesia’s maritime culture.
2. Maintain and manage marine resources, with a focus on building marine food sovereignty through the development of the fishing industry.
3. Provide priority to the development of maritime infrastructure and connectivity by constructing sea highways; establish deep seaports and logistical networks as well as developing the shipping industry and maritime tourism.
4. Through maritime diplomacy, Indonesia invites other nations to cooperate in the marine field and eliminate the source of conflicts at sea.
5. To develop the maritime defense force.

Currently, the majority of the bankers surveyed estimate that the proportion of the infrastructure loans is less than 10% from their total loan portfolio. There is a plenty of room for the banking sector to finance the infrastructure and maritime projects in Indonesia.

Figure: 16

Q: What is your estimate of the proportion of the infrastructure loans compared to your total loan portfolio?

- Less than 5%: 34%
- 5 – 10%: 29%
- 10 – 15%: 24%
- 15 – 20%: 8%
- More than 20%: 5%
Complexity of infrastructure projects is the top challenge in infrastructure financing

The majority of the bankers (63% of respondents) indicated that the complexity of infrastructure projects is the top challenge when undertaking infrastructure financing.

Infrastructure projects are often complex and involve many parties. In addition, many infrastructure investments only generate cash flows after several years resulting in the initial phase of an infrastructure project being subject to higher risks. A typical infrastructure project has several distinct phases, with different risk and return characteristics.

Bankers also highlighted that the regulatory and compliance concerns as well as land acquisition as the other key challenges. Land acquisition has been a serious obstacle for infrastructure projects in Indonesia. Due to land disputes, infrastructure projects can be idle for significant period of time or even be cancelled. In 2012, the then President Susilo Bambang Yudhoyono signed a regulation that set a maximum completion time of 583 days for the land acquisition process for public projects.

Transportation and energy sectors are the key growth for the infrastructure loans in 2015

The majority of the bankers (60% of respondents) predicted that the infrastructure financing for transportation sector will be the key growth for the infrastructure financing in 2015. Between 2015 and 2019, the Government has extensive plans to build more than 2,000 kilometers of new roads, many more airports and sea ports as well as expanding the railways networks. The Government plans to procure ferries to deploy in remote areas and to improve the public transportations in many cities.

54% of respondents also predicted the energy sector will also be one of the key growth in infrastructure financing, consistent with the Government’s plans to build new refineries and upgrade the existing refineries.
State owned banks are set to support the maritime financing

The majority of bankers from state-owned banks indicated that their banks are ready to support the Government program on the Maritime with focus on the “Sea Highway” program. Bankers from state-owned banks also indicated their interest in the financing of sea port constructions as well as to support to the fishing industry.

In addition, bankers from state-owned banks indicated that government support in the form of clear policies and direction, as well as the monetary incentives for the banks, will be the key factors making such financing a success.

Figure: 19

Q: Which of the segments of the maritime doctrine would you be focusing on? (choose the applicable ones)

- Maritime infrastructure – “Sea Highway” 46%
- Fishing industry 42%
- Maritime defense 38%
- Others 8%

Other areas indicated by survey respondents are maritime ports, docking, vessel industry, rail and other supporting industries.

Figure: 20

Q: In relation to the Maritime Axis doctrine, in what area would you like the Government to provide more support? (choose the applicable ones)

- Clear policy and direction 75%
- Monetary incentive for the banks 36%
- One stop solution center and ease of approval for the borrower 30%
- Monetary incentive for the borrower 13%
- Others 9%
Trends in consumer banking

As part of our survey, in view of the growing Indonesia population, thus the need for consumer products, we also asked banking respondents regarding their views regarding trends in consumer banking.

Mortgage loans as the key drive growth in consumer loans

Strong GDP growth over the past years has made Indonesia as one of the fastest growing middle-class in Asia. The growing of middle-class leads to an increase in consumer spending, including housing. The Indonesian property market is now considered as one of the more attractive in Asia.

In 2013, OJK introduced measures to curb excessive demand for housing, particularly when it detected speculative buying in the property sector. Certain measures have been introduced, such as, the progressive policy of loan to value (LTV) ratios for a second home, as well as restrictions on indent house credit applications.

Despite the above measures aimed at slowing down the Indonesia’s property growth, the demand for property, especially for housing is still high. This is consistent with the view from the majority of the bankers, where 56% of the bankers believe that mortgage loans will be the key drive growth in consumer loans and followed by unsecured loans.

Figure: 20

Q: Which product(s) are you principally targeting to drive growth in consumer loans at your Bank in 2015? (choose the applicable ones)

- Mortgage: 56%
- Unsecured loans: 30%
- Credit cards: 19%
- Auto loans: 11%
- Others: 25%


Bankers believe personalised and good services, as well as attractive pricing are key success factors they should focus on

The majority of the bankers believe that the personalised and good branch services are the main reasons for their customers to bank with them.

With the increasing complexity of the customer needs, the banks need to offer suitable personalised services that are customer-centric. Banks can also further enhance the branch services on many levels (including queuing time, quick responses on queries, branch locations and its layouts as well as the friendliness of the branch officers). Equipping branch officers and relationship managers with the right skill sets, tools and knowledge is very important to maintain high quality of services.

Investing in digital channels is a top priority for banks in 2015

Digital banking has become a current business trend. Increasingly of late, more customers are becoming comfortable using the internet and mobile banking for their transactions, supported by high penetration of mobile, Internet, and smartphones. Currently, the majority of the bankers estimated that up to 25% of the customer transactions are processed through the internet and mobile banking.

The majority of the bankers indicated that the investment in the internet and mobile banking is their top priority in 2015. Many customers expect that the transactions they can do at the branch can also be similarly done on their digital channel. Other than the increase in the feature and functionality of the digital channel, the majority of the bankers also see the importance of increasing the digital channel’s security. Digital channels should provide extensive functionality and also maintain a high level of availability, reliability and security in order to meet the customers’ expectation.

The majority of the bankers also indicated that their banks use social media (e.g. Facebook and Twitter) to attract and understand the customers’ needs. With the data collected from the social media, banks can use them in combination with their own customers data to better understand the customers’ profile or segments and thus provide them with the relevant products or services.
Retail banking 2020
Technology Aspects – Digital Banking

In the last few years technology has rapidly evolved and we have reached a tipping point. We are in the middle of a multi-wave trend. In the first wave, digital development is focused on optimising current products and services. The second wave, where enhanced data capture and analysis drives more targeted customer offerings and improved services is underway. Mobile banking will increasingly influence distribution models (e.g. instant videoconferences with product experts) and the payments industry (e.g. P2P mobile payments). Advances in security and verification will enable all aspects of sales, service and delivery to be conducted online. Technology is making bank-interoperability easier, which will drive the third wave, where banks and their partners develop sophisticated profiles on each of their customers.

Innovation will continue, and leading banks will need to enable or leverage this innovation. All of this will accelerate the evolution of leading banks into business focusing on customer-centric information and risk management. In 2020, the following scenarios may have come true:

Every bank will be a direct bank; branch banking will be undergoing a significant transformation.

As technology enables every aspect of banking to go online, and as cash usage falls away, traditional branches will make an evolution. Given their high fixed cost, branches will need to become dramatically more productive, or significantly less costly. Branches will remain, but take many forms, from flagship information, advisory and engagement hubs (offering education, financial advice, full-service capabilities and community offerings) to smart kiosks (offering service, sales, cash and video contact with a range of specialists). Leaders will rapidly improve their footprints, reducing branch size and costs, introducing new models and migrating transactions to low-touch digital channels. Digital capabilities will improve, so that branch service officers and bank customers use interoperable platforms. The human touch will always be available, just much more through digital channels. Banks that are behind this trend will start to struggle, due to structurally uncompetitive economics.

Competitive reach is no longer determined by branch networks, rather by banking licenses, technology and advertising budgets.

When every aspect of banking can be done online, a bank’s target market and competitive arena is no longer defined by its physical footprint, but by its technology, regulatory boundaries and marketing budget. New entrants will no longer have their pace of expansion constrained by the availability of acquisition targets and/or prime retail locations. New entrants could grow rapidly, potentially creating dozens of new competitors and refragmenting the landscape. Further, we will see ever-more competition from non-bank players. Branding and marketing will be more important than ever before.

Banking the unbanked (urban and rural) will become a primary policy objective in both developed and emerging markets.

This objective is defined as governments seek to reap the economic benefits of broader access to financial services for their populace. This push will drive new products and business models, and will become the primary focus of governmental or state-sponsored institutions, particularly where the private sector is unable to fulfil the need. Technology will play an important role for this initiative.

Cyber security is paramount to rebuilding customer trust – winners will have invested significantly in this area.

Recent high-profile security breaches and media commentary surrounding cyber attacks have generated fear and uncertainty, further eroding stakeholder trust. There are now higher expectations about security of information and privacy among clients, employees, suppliers and regulators. Risks range from internal misuse of social media to organised cyber-crime (e.g. mass information theft, or denial-of-service attacks). In our recent 17th Annual Global CEO Survey, we found that 71% of banking and capital markets CEOs consider cyber insecurity as a threat to their business prospects, more than any other sector. Regulation on cyber security is increasing, and regulators are intervening – witness Waking Shark II, the Bank of England-led cyber-attack war-game, simulating an attack on the UK financial system. But simply following regulatory rules won’t allow the business to keep pace with the constantly growing and changing cyber threats. A proactive response is vital. Key priorities include identifying and focusing resources on the ‘crown jewels’ most in need of protection. As a matter of the highest priority, banks should develop cyber-security strategies that are aligned with their business objectives, risk-management protocols and regulatory requirements.
PwC Indonesia
Contacts

Cliff Rees
+62 21 521 2901 ext 90550
cliff.rees@id.pwc.com

Andry Atmadja
+62 21 521 2901 ext 90635
andry.d.atmadja@id.pwc.com

Brian Arnold
+62 21 521 2901 ext 75861
brian.arnold@id.pwc.com

Lucy Suhenda
+62 21 521 2901 ext 76060
lucy.suhenda@id.pwc.com

Margie Margaret
+62 21 521 2901 ext 75862
margie.margaret@id.pwc.com

Samuel Ong
+62 21 521 2901 ext 75480
samuel.ong@id.pwc.com

Jusuf Wibisana
+62 21 521 2901 ext 75600
jusuf.wibisana@id.pwc.com

Angelique Daryanto
+62 21 521 2901 ext 75636
angelique.daryanto@id.pwc.com

Cornelis Poelman
+62 21 521 2901 ext 75683
cornelis.p.poelman@id.pwc.com

Marina Tusin
+62 21 521 2901 ext 75567
marina.tusin@id.pwc.com

Michael Goenawan
+62 21 521 2901 ext 90340
michael.goenawan@id.pwc.com
PwC Indonesia is comprised of KAP Tanudiredja, Wibisana, Rintis & Rekan, PT Prima Wahana Caraka, PT PricewaterhouseCoopers Indonesia Advisory and PT PricewaterhouseCoopers Consulting Indonesia each of which is a separate legal entity and all of which together constitute the Indonesian member firm of the PwC global network, which is collectively referred to as PwC Indonesia.

© 2015 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see http://www.pwc.com/structure for further details.