Indonesian Banking Survey Report
2010
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Welcome to the first PricewaterhouseCoopers Indonesia (PwC) survey of Indonesian banks. The survey attempts to gather and synthesize diverse views from senior banking executives from across the banking institutions within Indonesia, whilst at the same time protecting confidentiality of the participants.

When undertaking this survey, we had several key objectives in mind:
1. Understand and share the current views of the banking community with regard to the opportunities and challenges faced by banks in Indonesia in 2010;
2. Provide a platform from which our PwC Indonesia Banking specialists can provide insight and commentary as to what the banking landscape may look like over the next 12 months; and
3. Establish data on industry trends that can be used as a basis of comparison in future years.

The survey was conducted among banking institutions across Indonesia including state owned, local, foreign and regional branches.

The results of the survey are based on completed questionnaires from senior banking executives of banks that represent more than 65% of the Indonesian banking sector (by asset value) and through conducting interviews with senior banking executives.

We focused our survey on three principal areas:
1. Growth outlook
2. Operational matters
3. Risk management, corporate governance and regulation

We would like to express our sincere gratitude to the senior banking executives who participated in this survey whether by questionnaire and/or interview. Without them, this publication would not have been possible.

Going forward the survey will be conducted on an annual basis to allow for more in-depth analysis in the form of year on year movements. In addition, we hope it will keep you abreast of the latest developments in the banking industry in Indonesia.

We trust that you will find the results and analysis insightful.

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

Regulation is more prominent than ever before

Credit risk is the key concern.

According to senior banking executives, the more robust banking and financial systems put in place after the Asian crisis in the late 1990’s has clearly helped Indonesia weather the global financial crisis and provides the foundations for sustained growth in the years to come.

All (100%) of banking executives surveyed forecasted growth for their operations in 2010 with more than three quarters (76%) predicting double digit growth.

The mining, agriculture and telecommunications sectors will continue to fuel the growth in lending, with a mixed response from participants as to how the growth would be funded.

Over half of respondents shared the common view that the principal obstacles for growth in 2010 will be (i) increasingly tough competition; (ii) unpredictable economic conditions; and (iii) the scarcity of human resources.

Given the high amount of competition in the market, it
was unsurprising to see that cost efficiency topped the charts in terms of performance improvement priorities. Most banking executives have plans for adopting vigorous cost-cutting measures over the coming year to expose inefficiencies throughout their organizations and to drive growth.

Despite Indonesian banks avoiding the worst of the credit crisis, it is apparent that there is more regulation to comply with; a wider range of stakeholder expectation; and increased public scrutiny more than ever before. Risk is becoming a fundamental part of the strategic planning process and very much front of mind for banking executives as they evaluate decisions.

Judging by the survey results, there is clearly some way to go in fulfilling the ideal of risk management being an integral part of the business; less than half of respondents consider their risk management activities to be fully integrated into day to day activities.

More than one third of respondents consider credit risk as the key risk for 2010 with liquidity risk a close second. Credit losses often lag behind other risks during a period of volatility and uncertainty and so there was concern from respondents as to whether levels of bad debts had reached the bottom.

Whilst millions of dollars are being spent on Internal Audit departments throughout the banking industry, it is surprising that more than two thirds of respondents do not believe they are getting significant value and insight from their Internal Audit division.

The pace of regulatory and accounting change to date and that scheduled for the coming years has clearly been and will continue to be a focal point for banking organizations with commitments to adopt Basel II and IFRS over the next few years. However, more than half of banking executives believe that further guidance is required to more effectively meet the deadlines imposed.
Growth Outlook

Question: What is your expectation in respect of asset growth in 2010?

Growth confidence

There is no better way to kick off this report than with a unanimous view from all survey participants. All (100%) of banking executives surveyed forecasted growth for their operations in 2010 with more than three quarters (76%) predicting double digit growth.

Existing markets expected to fuel the growth

Views as to which industry sectors would fuel this growth appetite were less than unanimous with a relatively even spread of opinion. The top 3 industry sectors sighted for growth in lending were mining, agriculture and telecommunications.

The mining sector in Indonesia has always been a key contributor to the economy and a global competitive force. With the country’s rich deposits of minerals, many continue to see huge potential for the foreseeable future. Many of the world’s largest mining companies have operations in Indonesia all desperate to feed the demand from China and the rest of the world. It will be particularly interesting to see how this sector addresses the growing importance of factoring in corporate social responsibility into their strategy.
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Respondents predict global demand for crude palm oil (CPO) to increase considerably in 2010 with prices expected to be less volatile than in previous years. Given that Indonesia has recently taken over from Malaysia as the world’s number 1 CPO producer, this is not only positive news for the industry itself but for the banking sector financing the growth.

With more than 220 million people, the market for telecommunications is vast. Whilst the market is considered crowded and dominated by a few providers, it is still considered an attractive proposition for investment especially where there is the necessary capital to increase networks and services. It is widely expected that the banking sector will benefit from this.

The focus will be on organic growth in existing markets

Given the large consensus for double digit growth in the banking sector in 2010, it is interesting to understand how such ambitious growth will be achieved by the banks. Our survey revealed that organic growth continues to be the most preferred option with nearly three quarters of respondents expecting this form of growth strategy to be implemented instead of growth by acquisition.

Such an approach could probably have been predicted with capital and resources in relatively short supply coupled with the macro landscape of global events from the last 18 months continuing to unfold. Undoubtedly there are opportunities to grow inorganically with the right purchase. At the same time, there is a “sense of fear and de facto paralysis” as the risks of making a bad acquisition appear to outweigh those of not making one at all.

A mixed response as to how that growth would be funded

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**Question: Do you have plans to issue more capital within the next 1 - 2 years?**

![Pie chart showing plans for capital issuance](chart.png)

- 33% Will issue capital in 1 - 2 years
- 48% No plans yet
- 19% Wait and see
When asked whether there were plans to issue more capital within the next 1 to 2 years, banking executives gave a mixed response.

Almost half of respondents did not have plans to issue capital in the short-term with almost 20% playing a waiting game. This was surprising to our banking specialists given the low interest rate environment and the consequent desire of investors for strong yielding investment instruments.

This mixed response may suggest that the pace of issuance from prior years in part served to satisfy immediate financing needs over longer term growth-related plans. It may also suggest that business leaders may be reluctant to ‘over-finance’ in the near term. Or simply, such a volatile environment, requires more courage than usual when acting on opportunities.

Cost – benefit approach applied to M&A activity

When one considers there are more than 120 banks in Indonesia, one would naturally expect consolidation in the market through M&A activity. However, the views of those interviewed, highlighted the key factors as to why this is not currently the case in Indonesia.

These key factors include:

- The fragmented nature of the banking industry in Indonesia where less than 10% of banks account for more than 60% of the market. The large divide between the ‘large banks’ and the ‘small banks’, is not considered conducive to natural consolidation of the market particularly when banks are only looking to expand where there are opportunities to increase either their footprint in the market or their product offering/penetration.
- Getting the right balance between risk and reward is difficult – economies of scale do not always eventuate.
- Businesses are notoriously difficult to value with recent transactions being conducted for prices well above their book values.
- Few attractive candidates left - the perception that few banks are ‘available for sale’ leading to non-optimal pricing.
- Challenging post-deal integration processes particularly in areas such as aligning culture, HR processes and incentives and IT systems. This has often resulting in expected synergies not always eventuating as planned.
- Labor and tax regulations are not considered to be as ‘M&A friendly’ as other countries. For example: the ‘Single Presence Policy’ prevents multiple banks being owned by a single shareholder.

One approach adopted by many banks in a bid to expand their product range and improve their consumer focus has been to hire skilled professionals from overseas, whose skills can be leveraged within the organization. This, according to one executive interviewed, was “the key to remaining competitive in the market.”

Obstacles to growth

Whilst almost all banking executives predicted double digit lending growth in 2010, they remained relatively inconsistent in their views as to what factors were the most likely to impact their growth ambitions. Over half shared the common view that the principal obstacles for growth in 2010 will be: (i) increasingly tough competition; (ii) unpredictable economic conditions; and (iii) the scarcity of human resources.

Last on the list (2% of respondents) was corruption. We consider the
impact of fraud and corruption risk later in this report.

We provide commentary as to the possible reasons for these three key obstacles:

**Tough competition**
Few markets, if any, have a greater number of banking participants than Indonesia, with over 120 banks in operation. Naturally, the open market approach adopted by the sector has led to inevitable high competition; competition that will only increase with the recent expansion into the market by the foreign banks over the last decade. Following the nationalization of the banking system and easing of regulations over foreign ownership, foreign banks entered the market, attracted by the country’s vast population and high GDP growth. Coupled with the expertise and experience gained from more developed markets, they regarded Indonesia as an attractive geography in which to expand their Asian operations and product ranges.

With more choice available, Indonesian consumers have an increasing right to place more demands on their banking relationships. They are becoming increasingly price sensitive and demanding of quality customer service. Further, demands for internet and telephone banking services provide participants with an opportunity in which to gain competitive advantage.

**Unpredictable economic conditions**
Looking at the year ahead, many believe that the Indonesian economy will continue to improve throughout 2010 with GDP forecasts in the order of 5% – 6%. Coupled with low interest rates, Indonesia is considered an attractive investment.

However, it is apparent that recent events have made bankers become more cautious; respondents quoted a number of uncertainties remaining for the international financial system and the international economy which add to the risks for the year ahead. Examples include:

- the underlying trade and capital imbalances of the major economies;
- the phasing out of stimulatory packages in many economies; and
- the path of interest rates, which cannot remain at historic lows indefinitely.
Human resources
Our survey shows that more than three quarters of banks will be adding to their workforces (78%) than will be cutting (4%) over the next 12 months.

Question: What are your plans with regard to recruitment over the coming 18 months?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Retrench</td>
<td>4%</td>
</tr>
<tr>
<td>Freeze</td>
<td>18%</td>
</tr>
<tr>
<td>Hire</td>
<td>78%</td>
</tr>
</tbody>
</table>

Although banking executives recognize the need to keep pay under control, they are also keen to attract new talent especially when growth projections are at the high levels expected. People with sound technical knowledge and experience of working in financial institutions that manage billions or trillions of dollars’ worth of assets are at a premium.

However, since the crisis of the late 1990’s; it is believed that fewer graduates are coming through the finance route, opting to study alternative subjects in the hope of moving into ‘more stable’ industries. Competition for such talent is therefore expected to be as fierce as ever as 2010 unfolds. Functions that carry a degree of oversight such as: risk, compliance, HR and treasury are expected to demand greater numbers of specialists, as will customer service. The quicker those banks can find ways to recruit talent, the stronger the position they will find themselves in.

The increasing importance of being environmentally conscious

Question: To what extent has your bank incorporated environmental awareness in its strategy?

![Pie chart showing response distribution]

27% Low extent
29% Significant extent
44% Medium extent

Many in the banking sector have long viewed the efforts to avert climate change as a matter of corporate philanthropy, with no relevance to their corporations’ core strategies. The costs of such activities were seen as detracting from profitability. However that is certainly changing. Whilst the banking sector is not energy or raw materials intensive, it is clear that they have come to understand that their abilities to prosper within a competitive market hinge upon their responses to the challenges of a carbon-constrained world. Such interest is evidenced in the survey with 73% of respondents indicating that environmental awareness played at least a medium part in their strategy.

As an example and in response to this development, the Sustainable Forest Finance Toolkit is being used to support the financial sector in making decisions on the sustainable financing of industries impacting forests. It is likely that supply chains from producers to end users (including their financiers) will be scrutinised further as time passes, and as awareness of environmental issues grows.
Operational Matters

Question: How is your bank tracking against its 2009 budget?

- below budgeted profit > 20%
- below budgeted profit > 10 < 20%
- On budget
- exceeding budgeted profit > 10 < 20%
- exceeding budgeted profit > 20%
- Others

Ahead of the game…

Despite the immediate aftershock of the global financial crisis, it was encouraging to note that only 10% of all respondents have come in under their 2009 budget. More pleasing to note was that almost one in five respondents had exceeded budget by more than 20%. Whether this statistic is more attributable to inaccurate and/or conservative budgeting or a genuine out performance of expectations was not entirely clear. It is probably safe to assume that all of the above were contributors.

In general, bottom line profit was particularly assisted by the growing disparity between the funding rate and the lending rate with banks opting to maintain relatively high lending rates in the wake of volatile markets.
Operational Matters

Question: How is your bank tracking against its 2009 budget?

<table>
<thead>
<tr>
<th></th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>below budgeted profit &gt; 20%</td>
<td>4%</td>
</tr>
<tr>
<td>below budgeted profit &gt; 10 &lt; 20%</td>
<td>6%</td>
</tr>
<tr>
<td>On budget</td>
<td>38%</td>
</tr>
<tr>
<td>exceeding budgeted profit &gt; 10 &lt; 20%</td>
<td>31%</td>
</tr>
<tr>
<td>exceeding budgeted profit &gt; 20%</td>
<td>19%</td>
</tr>
<tr>
<td>Others</td>
<td>2%</td>
</tr>
</tbody>
</table>

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In general, bottom line profit was particularly assisted by the growing disparity between the funding rate and the lending rate with banks opting to maintain relatively high lending rates in the wake of volatile markets.
Cost management: top of the “To Do” list

Question: What areas within your organization demand the most focus from a performance improvement basis?

<table>
<thead>
<tr>
<th>Area</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compliance with regulations</td>
<td>9%</td>
</tr>
<tr>
<td>Human resources</td>
<td>6%</td>
</tr>
<tr>
<td>Risk management</td>
<td>15%</td>
</tr>
<tr>
<td>IT platform</td>
<td>9%</td>
</tr>
<tr>
<td>Competitive pricing</td>
<td>14%</td>
</tr>
<tr>
<td>Brand image</td>
<td>12%</td>
</tr>
<tr>
<td>Cost efficiency</td>
<td>21%</td>
</tr>
<tr>
<td>Marketing</td>
<td>13%</td>
</tr>
<tr>
<td>Others</td>
<td>1%</td>
</tr>
</tbody>
</table>

Given the high amount of competition in the market (refer page 10), it was unsurprising to see that cost efficiency topped the charts as being the focus for performance improvement. Banking executives had plans for vigorous cost-cutting measures to be adopted over the coming year to expose inefficiencies throughout organizations and to drive growth.

Yet, it is important to remember that the secret to cost cutting is to implement sustainable measures and not take quick wins – this will help better protect the business in the long term whilst maintaining employee commitment at the same time.

Other key areas of focus for banking executives in 2010 are risk management and regulatory compliance which are considered in Chapter 3 and IT which is considered below.

IT has a critical role to play

Question: How will your budgeted IT expenditure in 2010 differ to 2009?

It was widely agreed by respondents that IT expenditure represented a significant portion of a bank’s total cost base.

Almost 85% of the respondents expect an increase in their IT expenditure this year compared to 2009.

In order to accommodate the changes in the banking environment meet banking regulations and fulfill client needs, many banks in Indonesia are restructuring their business operations.

Given the high amount of competition in the market (refer page 10), it was unsurprising to see that cost efficiency topped the charts as being the focus for performance improvement.
Data warehousing, system implementation as well as software and hardware upgrades are just some of the factors identified by respondents that are causing banks to increase their investment in IT this year. Another key driver of IT expenditure is the implementation of the new accounting standards PSAK 50 + 55 which has meant banks must update their IT systems to allow them to prepare more detailed analysis of their loan portfolios. These factors are believed to play an important role in the banks’ future operations and hence is seen as one of the major priorities to the bankers.

Tax risk increasing

Question: What priority does the management of tax have within your bank?

- 50% Moderate
- 48% High Priority
- 2% Low Priority
- 32% Have no idea
- 34% Good/better
- 34% Worst

It is widely understood by all stakeholders that the tax regime within Indonesia is developing rapidly with frequent updates to existing tax regulations and the issuance of new tax regulations becoming regular occurrences. This has led to an increase in tax risk for almost all banking institutions and the consequent need for them to devote more resources to manage tax risk.

As tax professionals ourselves, we have certainly seen an increase in the demand for how the market is interpreting these developments and the consequences on their business. It is therefore unsurprising to see that almost half (48%) of respondents consider tax management as a “high priority” with almost all of the remainder deeming it to be a “moderate priority”.

But what exactly is tax risk? According to our tax specialists, tax risk is generally considered to be the risk of an unexpected tax liability including any associated penalties. It is worth noting that the reputational consequences of an unexpected tax liability may often be of more concern that the associated financial cost. We recommend that the audit committee plays a key role in establishing tax risk management practices including helping the organisation define the risk parameters; driving monitoring programs and establishing reporting protocols for tax risk related issues.

Question: How competitive do you consider Indonesia is in terms of managing the tax cost?

When asked about the level of tax competitiveness in Indonesia, we received a mixed response from the banking executives. A third consider Indonesia to be competitive in this area; a third uncompetitive and a third “having no idea”.

Whilst the tax rate has decreased over the last few years, it is important to note that this is just one of the key elements to making Indonesia “tax competitive”. The other key factors are the stability of tax regulations and the ease of which they can be interpreted. Whilst it is acknowledged that much
work has been done on tax reform within Indonesia, there is certainly some way to go to optimise the attractiveness of Indonesia for foreign investors.

Redefining the people strategy

When asked what improvement in human resource management was a key priority, interviewees believed performance measurement and training demanded the most attention.

Significant change to the banks’ people strategy will be required for financial services to become the destination of choice of the brightest young graduates. Generation ‘Y’ is entering the workforce with an alternative view and mindset when compared to the motivations of their predecessors. This is a generation that is believed to better prioritize ethical concerns when choosing a career path. It will also take more than financial compensation incentives to attract and retain them.

In response to this increase in competition for talent, banking executives are becoming increasingly aware that previous people management strategies need to be updated to better match the demands of a changing talent pool.

Question: What will be your key focus in HR after the financial crisis effects are over?

<table>
<thead>
<tr>
<th>Focus</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performance based management</td>
<td>17%</td>
</tr>
<tr>
<td>Culture transformation</td>
<td>6%</td>
</tr>
<tr>
<td>Increase productivity</td>
<td>10%</td>
</tr>
<tr>
<td>Upskilling</td>
<td>9%</td>
</tr>
<tr>
<td>Human Capital Development</td>
<td>23%</td>
</tr>
<tr>
<td>Others</td>
<td>1%</td>
</tr>
</tbody>
</table>
Banking survey
PwC Indonesia

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- Culture transformation: 6%
- Increase productivity: 10%
- Upskilling: 9%
- Human Capital Development: 23%
- Others: 1%

Despite Indonesian banks avoiding the worst of the credit crisis that felled some of the global financial heavyweights, they still face more regulation, a wider range of stakeholder expectation and increased public scrutiny more than ever before. With this, comes the increasing importance of effective risk management and corporate governance frameworks within the sector.

Responses from the survey signal that risk is becoming a fundamental part of the strategic planning process and very much front of mind for banking executives.

More banking executives intend to change their risk management process more than any other element of their strategy, organisation or business model. And we understand that more boards are increasing their engagement with assessing strategic risk than with any other item on the boardroom agenda.

Risk management... a part of daily life

In our view, risk must not only move up the corporate agenda in response to the crisis, but must be seen as something that needs to be embraced by the organisation as a whole.

However, there is clearly some way to go in fulfilling this ideal with 45% of respondents considering that Governance, Risk Management and Compliance (GRC) activities are not fully integrated into day to day activities. This data suggests that many banks have not fully understood the importance of having risk management featuring in the core tasks of managing a business – business management and risk management are one-and-the-same thing.

This may be due to operational culture as GRC functions have at times struggled to get 'buy in' at a senior level. While the importance of integrated GRC has frequently been publicly acknowledged to the outside world of credit-rating agencies, shareholders and regulators, internal politics have often led these functions to be perceived as unnecessary costs to the
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business, and potential inhibitors to further growth. Instead, individuals tend to get caught up in the detail and “ticking the boxes” rather than as a tool to help them distinguish the important risks from all the noise.

Question: How well integrated do you consider your Governance, Risk Management and Compliance activities are in your bank?

<table>
<thead>
<tr>
<th>Integrated Level</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not integrated – run in parallel</td>
<td>6%</td>
</tr>
<tr>
<td>Well integrated – part of daily life</td>
<td>55%</td>
</tr>
<tr>
<td>Some what integrated</td>
<td>39%</td>
</tr>
</tbody>
</table>

Fraud risk – levels remain the same

Interestingly, a little more than half of those surveyed expected the level of fraudulent activity to remain at similar levels to those experienced in 2009. The remainder were equally divided as to whether the number of fraud cases would increase or decrease. This was particular interesting when one normally expects the level of fraud to increase during a period of financial crisis.

Question: In the current economic environment, how do you see the level of fraud risk within your organization?

<table>
<thead>
<tr>
<th>Change in Risk Level</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decreasing</td>
<td>22%</td>
</tr>
<tr>
<td>Increasing</td>
<td>26%</td>
</tr>
<tr>
<td>Remained the same</td>
<td>52%</td>
</tr>
</tbody>
</table>

Just over half (57%) of the banks surveyed had carried out a fraud risk assessment within the previous two years, just under half (43%) had not.

Every Indonesian business is vulnerable to fraud and corruption, some more than others. The level of risk is dependent on a number of factors including; the bank’s size, diversity of business functions, geographic distribution, the extent to which the bank is monitored by other entities or regulators, and the rate of technological change. Whilst there is no foolproof method of preventing fraud and corruption, the risk can be minimised by taking a proactive systematic and considered approach to it’s management. Conducting a structured fraud risk assessment is the first step.

The recent turmoil in the Indonesian and global financial markets has brought into focus the importance of proactive fraud and corruption risk management. In this current financial environment the pressure or incentive to commit fraud is significant. The fact that over 50% of respondents see the level of fraud risk remaining the same may be indicative of a lack of true understanding of the risks facing their banks. Only a quarter of respondents see the risk from fraud increasing, this is surprising.

An additional explanation for this apparent mismatch of responses may be the fact that fraud risk is often only felt, and responded to, once a fraud has been perpetrated and identified. Whilst fraud remains “below the surface” it is possible the priority to address this unknown and unquantified risk is low.

Employee/customer collusion the key risk

A quarter (24%) of respondents saw employee/customer collusion as one of their most significant risks. This is understandable given the
importance of employee integrity together with controls largely being dependent on individual integrity (collusion being a simple way of bypassing controls). The importance of employee integrity supports the need for strong governance ("tone from the top" and ethical policies) together with the wider proactive risk mitigators, the provision of whistleblower services and fraud awareness training. Bribery and corruption (7%) could also be included as a collusion risk.

Funds transfer fraud (21%) was the second most significant risk, possibly due to the fact that it is a well known and understood fraud risk. This risk may be heightened by the increase in popularity of electronic payment options.

The act of “identity theft” (19%) can be used to support a number of other fraud “MOs”, with the relatively easy access to false ID cards increasing the risk even further. There is an additional problem raised by false ID, the anti money laundering requirement to “know your customer”.

The remaining suggested risks were all deemed as low significance by respondents (foreign exchange fraud 10%, trading outside designated levels of authority 7%, IP theft and asset management fraud 2% and FCPA breaches 1%). Whilst this may be the case it is also possible that, because they are relatively complex issues to manage and investigate, then the perceived significance as a fraud risk was artificially reduced.

Credit risk of most concern

**Question: What 2 risk factors do you consider will have the most significant impact on your organization in 2010?**

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategic</td>
<td>3%</td>
</tr>
<tr>
<td>Operational</td>
<td>14%</td>
</tr>
<tr>
<td>Reputation</td>
<td>5%</td>
</tr>
<tr>
<td>Legal</td>
<td>9%</td>
</tr>
<tr>
<td>Market</td>
<td>16%</td>
</tr>
<tr>
<td>Liquidity</td>
<td>17%</td>
</tr>
<tr>
<td>Credit</td>
<td>36%</td>
</tr>
</tbody>
</table>

When asked which risk was of most concern in 2010, more than one third (36%) of respondents answered, credit with liquidity in second place.

**Credit risk**

Credit losses often lag behind other risks during a period of volatility and uncertainty and so there was concern over whether levels of bad debts had reached the bottom. It may perceived by some that the double digit growth expectations in 2010 (as discussed earlier in this report) coupled with the increasing levels of competition may give rise to imprudent or less rigorous lending practices among banks. Or perhaps, given the global financial crisis, bankers are more mindful of risk management and striking the right balance between risk and reward.
This view was taken despite only 20% of respondents predicting that the level of non-performing loans would increase (from 2009 levels).

**Question**: What do you predict will happen to the level of non-performing loans in 2010?

- 24% Significantly decrease
- 16% Decrease
- 0% Increase
- 40% Remain about the same

Perhaps the reasoning behind these conflicting views is due to the increased focus that banks have dedicated to ensuring their credit risk management practices are effective. In other words, Indonesian banks are better prepared today to manage risk than they were pre-Asian Crisis. Enhancements made to risk management frameworks following the Asian crisis include launching of corporate efforts toward the establishment of risk management systems, associated organizational reform and integrated internal control systems.

**Liquidity risk**

Unsurprising, given that a critical liquidity shortage triggered the global financial crisis, banking executives are paying particular attention to liquidity in 2010. In our view, banks will have to become more astute at pricing their liquidity risks and building a better assessment of liquidity risk into their business decisions.

Further, regulations are likely to require banks to maintain higher levels of capital on their balance sheets. This may lead to increased costs being passed onto the end consumer.

We anticipate most banks will take a more conservative view on risk. One consequence of this will be an increased appetite for longer-term savings products in order to reduce the asset-liability mismatch.

**Internal audit – are you getting real value?**

Since the financial crisis in the late 1990’s, the demands on internal audit functions have continued to increase. This has coincided with a shortage of quality resources available in the market. It was against this backdrop that we asked participants whether they were getting real value from their internal audit functions.

It is surprising that 69% of respondents did not believe so;

Whilst in a highly regulated environment, Internal Audit clearly has a role to play in terms of compliance, it is essential that management make the best use from the considerable business knowledge that Internal Audit have.

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.

Pressures are emerging to broaden the internal audit focus on risks. Key stakeholders are starting to reconsider the priorities of the past ten years, and successful Chief Audit Executives will be those who correctly assess their environments and adapt quickly.
Question: To what extent does the internal audit function in your organization add insight and value beyond the compliance type assurance it provides?

Keeping pace with regulation

It is widely considered that the pace of domestic and global regulation is far from releating as the regulators from across the world learn from the mistakes identified from the global financial crisis. Debate as to whether the optimal approach is one of significant refinement to the existing framework rather than wholesale reform continues.

With Indonesia sitting proudly within the G20, it has little option but to fall into line with the ambitious timetable that was set by the G20 in Pittsburg last year. This includes international accounting standard convergence and Basel II implementation.

Basel II

Almost one third (32%) of banking executives required further guidance on Basel II whilst two thirds (66%) categorized their Basel II progress as “well underway”.

Basel II will come into effect in 2011 with banks set to adopt the “Standardized Approach” to credit risk and the “Basic Indicator Approach” to operational risk. Those banks that fulfill the necessary prerequisites will be allowed to move to advanced approaches subject to BI approval.

BI’s expectation is that banks will be adopting the complete Basel II framework by 2014.

PSAK 50 & 55

Two accounting standards that became effective on 1 January 2010 were PSAK 50 & 55 relating to financial instruments.

Despite the effective date of implementing these two new accounting standards coinciding with the deadline of our on-line survey (1 January 2010), it was interesting to see that a little more than half of the banks considered themselves ready and fully compliant with PSAK 50 and 55.

Question How well advanced do you consider the organization’s preparedness to comply with and implement PSAK 50/55?

Our banking specialists had infact expected this number to be lower based on the experience of talking with clients in the market.
However, this lack of progress may not be as critical as perceived given that we understand that more than 70 banks are looking to apply BI’s transition rule on collective impairment thereby effectively allowing them more time to comply with the new requirements.

**IFRS**

To bridge the gap between Indonesian and International reporting standards in time for the 2011 adoption of IFRS, the accounting standard board has recently approved 19 new standards. This is in addition to new interpretations on current standards and withdrawing several old accounting standards.

However, less than half of banking executives surveyed (45%) considered that their IFRS transition project was “well underway” while approximately 55% needed further guidance to be in a position to take their project further.

Given that we believe that, of these changes, there are at least 5 particular standards that will have a considerable effect on the financial statements of the banking sector effective on 1 January 2011, there is little time for banks to enjoy the completion of the FY 2009 financial reporting season.

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**Question**: How well advanced do you consider your organization’s plan to comply with and implement all IFRS standards?
Appendix

The following provides an overview of the respondents to this banking survey.

### Type of Banks

<table>
<thead>
<tr>
<th>Type</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>SOE</td>
<td>10%</td>
</tr>
<tr>
<td>JV</td>
<td>36%</td>
</tr>
<tr>
<td>Foreign</td>
<td>32%</td>
</tr>
<tr>
<td>Local</td>
<td>22%</td>
</tr>
</tbody>
</table>

Source: PwC Indonesia

### Assets

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-5,000</td>
<td>13%</td>
</tr>
<tr>
<td>5,001-20,000</td>
<td>15%</td>
</tr>
<tr>
<td>20,001-50,000</td>
<td>26%</td>
</tr>
<tr>
<td>Above 50,000</td>
<td>46%</td>
</tr>
</tbody>
</table>

Source: PwC Indonesia

Further guidance and socialization required.
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