Indonesia Banking Survey 2017

Weathering the rise in credit risk. What’s next for Banks in Indonesia?
Welcome to our 7th Indonesia banking survey! It has been almost 2 years since our last survey and a lot has changed in that time period. We have seen rising volatility in financial markets, weak commodity prices and a sharp increase in NPLs. Brexit and a surprising US election result have added to global uncertainty. Although in our 2015 survey many bankers forecasted a rise in credit risk, the majority underestimated the extent of that risk.

In our 2017 survey, credit risk is clearly still a big concern but the sense is that stability has improved - most now see NPLs on the decrease. Loan growth is lower than in the past, but with more than half of respondents expecting growth of 10% or more in 2017, it should all be viewed in perspective. There are many markets around the world that would envy that sort of growth environment. Overwhelmingly, respondents felt Indonesia to be the most attractive banking market in Southeast Asia, and most feel the market conditions to be improving.

However, the macroeconomic environment is still seen by respondents to be the #1 risk to the industry. There is a pressure on margins, a shortage of talent in key areas, and developing risk management functions. At the same time, the industry – locally and globally – is undergoing a rapid technology transformation, which is driving new and enhanced strategies. That raises the question: What is next for banks in Indonesia? We believe those banks that will be most successful long-term in Indonesia are not only those with a focused overall strategy, but those who also have a focused Fit for Growth strategy and implementation.

We thank everyone who answered to the survey, which was a record response of top management from 58 different banks, which together represent over 87% of banking assets in Indonesia. We hope this survey is useful not only in understanding the views of bankers in Indonesia, but also in raising questions and generating dialogue that helps banks, regulators and the industry as a whole to further develop, grow, and respond to the challenges of tomorrow.
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**Outlook for growth**

Rising optimism, but is it all about credit risk?

Section 2

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Customers are migrating to digital channels while FinTech is disrupting traditional models – do banks have a clear strategy to respond?

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Outlook for growth

Indonesia bankers clearly feel they are in the most attractive market in Southeast Asia. After all, margins are not only good in comparison, they are excellent. The survey highlights that more immediate prospects for loan growth and economic growth are not the main drivers for that attraction, but rather the longer-term upside potential of a large market with low penetration. But in the meantime, high margins make for attractive, profitable banking.

2016 was a more challenging year for many banks in Indonesia in comparison to past years, but bankers feel conditions are improving. While foreign banks are slightly less optimistic, half of foreign banks still believe conditions are improving and almost no banks feel conditions are worse.

During the course of 2015 and the first half of 2016, the government launched a number of major new initiatives to stimulate the economy, namely: 13 deregulation packages for key investment sectors, a one-stop integrated services centre developed by the Investment Coordinating Board (BKPM), and a revised Negative Investment List.

Bankers in our survey largely viewed these actions as a positive step, although the reaction is mixed as to whether they will have a significant impact. Slightly more than half of respondents felt they would have a moderate impact, and almost one-third felt they would have little to no impact at all. Time will tell as it is still early to assess actual impact.

**Figure 1: High margins are a driving attraction for Indonesia**

Q: What are the factors that make Indonesia more attractive than other markets in Southeast Asia?

<table>
<thead>
<tr>
<th>#1 ranked response</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>High margins</td>
<td>31%</td>
</tr>
<tr>
<td>Population size</td>
<td>27%</td>
</tr>
<tr>
<td>Low banking penetration</td>
<td>21%</td>
</tr>
<tr>
<td>Economic growth</td>
<td>17%</td>
</tr>
<tr>
<td>Loan growth</td>
<td>4%</td>
</tr>
</tbody>
</table>

Base: 95% of respondents who believe Indonesia is more attractive than other markets in Southeast Asia

**Figure 2: Banks feel market conditions are improving**

Q: What is your view of Indonesia’s market conditions for Banking in 2017 compared to 2016?

- worse: 4%
- same: 33%
- improving: 63%

The feeling is market conditions are improving and profitability will improve …
Indonesia bankers are expecting profitability to improve in 2017, in large part – as we will see - due to improving expectations on NPLs and credit losses. However, a new dynamic is emerging – NIM compression.

If in past years you were forecasting a decrease in Net Interest Margins, you were in the minority. That is no longer the case – more than half of respondents now forecast a decrease in NIM in 2017. The larger the bank, the larger the expectation that NIM will decrease. For example, 71% of respondents from BUKU 4 banks expect a decrease in NIM, as compared to 44% from BUKU 2 banks. Likewise, none of the BUKU 4 respondents forecast an increase in NIM, however 21% of BUKU 2 banks expect NIM will increase.

For the first time, we also asked respondents to provide their forecast of cumulative NIM change over the next 4 years. Remarkably, in our view, 37% of respondents do not expect NIM to decrease at all over that period. Our view is that NIM is undergoing a wider longer-term decline, and that while there may be a “bouncing-ball” effect along the way, the trend is a downward one. In other words, we believe it is a question of “how much”, not “if”. Smaller banks tended to be less likely to expect NIM compression over the mid-term than larger banks. Smaller banks tend to have higher cost-income ratios and smaller economies of scale, and therefore may be more exposed to future decreases in NIM.

...but challenges lie ahead with NIM compression and credit risk.
Forecasts for loan growth are very close to the recent 2017 estimates by Bank Indonesia. Roughly half of banks expected growth of more than 10%, with 29% expecting growth in excess of 15%. Likewise, roughly half of respondents expect growth of less than 10%

While this level of growth rate is excellent in comparison to many - especially developed - markets around the world, they are clearly lower than they have been in any of our previous surveys. 44% of respondents expect loan growth of less than 10% in 2017; this number in our 2015 and 2014 surveys was 12% and 2%, respectively.

Bankers are more bullish on consumer lending, as we would expect given that most of the concern around NPLs is in relation to corporate and SME lending.

Foreign banks are significantly less optimistic, with only 19% of foreign banks expecting loan growth in excess of 15% as compared to 32% for local private banks and 75% for large state-owned banks.

The state-owned banks are the lead drivers of overall loan growth, and tend to have a stronger push from stakeholders to improve the level of financial inclusion across the country; however, the state-owned banks are also larger and have more expansive networks and access to customers. Many smaller banks are limited by their smaller footprint and higher cost of funds.
Credit risk was overwhelming noted as the top challenge to credit growth in 2017, and this is a trend that has been growing steadily in each of our past 4 surveys. Now almost every banker we surveyed sees credit risk as a top-3 barrier to growth as compared to less than one-fourth in 2013.

Particularly over the last 18 months many banks have been tightening their credit origination standards as credit risk has increased and NPLs have grown. This may be one reason that the primary consumer lending focus is on mortgage loans, which have a stronger collateral base. While credit cards and other unsecured lending can offer good fee-based income and high rates of return, many bankers are hesitant to push harder into this area given the higher credit risk profile. Bank Indonesia has also recently cautioned banks about being too aggressive in sales tactics to attract new credit card customers.

*No correlation noted between expectations of loan growth and views on credit risk*

One interesting result from the survey is that we saw no significant difference in the views about loan growth based on whether respondents expect an increase or a decrease in NPLs in 2017. One might normally expect that if a banker is more optimistic about market conditions and the overall improvement in credit risk, they may be more bullish on loan growth as well. However this was not the case.

This may be an indication that where banks expect further NPLs, they are more concerned about loans that were originated in the past than they are about loans originated in the future. Time will tell whether market conditions and credit risk management has improved, and we explore risk management views further in Section 3 of this survey.

**Figure 8: Credit Risk and Margin Pressure dominate concerns about loan growth**

Q: What are the top three challenges for achieving your loan growth target in 2017?

- Credit risk: 94%
- Margin pressure: 75%
- Weak demand: 30%
- Liquidity: 24%
- Regulations & Talent shortage: 10%
- Sales channels: 8%

**Figure 9: Credit Risk as a barrier has grown steadily over last 4 years**

Q: What are the top three challenges for achieving your loan growth target in 2017?

- 2013: 24%
- 2014: 49%
- 2015: 67%
- 2017: 94%
In our earlier 2015 survey, there was significant concern about rising NPLs with almost half of bankers we surveyed at that time expecting NPLs to increase. Few bankers at that time expected NPLs to decrease. The last two years have followed those expectations with credit losses steadily rising in both 2015 and 2016. In our 2017 survey the views have clearly reversed – now almost half expect NPLs to decrease in 2017. This is consistent with the view that the overall market conditions are improving.

However, there are still a number of indicators of uncertainty in the market. For example, more than one-third of respondents (37%) were either undecided or still felt that NPLs will remain at the same level, including more than half of foreign banks. In addition, there are significant differences in views depending on the type of bank surveyed. Among state-banks, an overwhelming 87% expect a decrease; but among foreign banks this drops to only 28%, with more than 50% expecting no change at all.

In summary, most bankers surveyed clearly feel the situation is not getting worse, but there are varied views on the timing of a turn-around. Judging by responses, the market is in a prolonged recovery, and not everything points to a reduction in NPLs. For example, one-fourth of local private banks surveyed expect an increase in NPLs in 2017.

The key question is whether credit risk management has really improved over the past 18 months, particularly around credit scorecards, origination standards and monitoring.
The highest level of concern for NPLs in 2017 is in corporate/commercial lending, followed by SME. There seems to be very little relative concern with respect to retail lending, and indeed NPL rates have been much lower in this segment for most banks. However, we note that banks in our survey expect much higher growth rates in 2017 for retail lending – 35% expect growth of more than 15%. We also believe this segment has the highest potential for growth, coming from a low base. The challenge will be whether banks are prepared not only on the front-end sales channel, but also with respect to robust lending scorecards, data-analytics, collection and overall risk management systems. PSAK 71 (IFRS 9), which requires an expected-loss model vs the current incurred-loss model, will also put significant added demands on risk function. NPL ratios in the consumer segment are low by comparison to other emerging markets, and we expect over time to see more sensitivity to the credit risk in this segment as activity intensifies.

The overall gross NPL ratio for Indonesia for 2016 compares favorably to many of the other high-growth emerging markets globally. However, we note that caution must be used when comparing such data as one must consider also how well the market has priced in that risk and the variations in credit provisioning regulations. Some markets have taken a more aggressive approach to lending growth which may result in higher NPLs as credit quality is lower in certain segments, but that does not automatically result in an unprofitable sector if the risk is appropriately scored and priced. As mentioned earlier, margins in Indonesia are high and this provides some buffer to manage spikes in credit risk; however margins are decreasing and the need for robust scoring and data analytics will become more and more important to overall credit risk management.
Opportunities for growth – Syariah, Infrastructure & M&A

In our 2017 Survey, we examined views on 3 specific potential areas for growth – Syariah banking, Infrastructure finance and M&A for inorganic growth.

Syariah banking – most bankers see only slightly higher-than-market growth rates to 2025

Syariah banking is currently roughly 5% of the overall Indonesia banking market assets, as compared to 20% in neighboring Malaysia. Considering Indonesia is the largest Muslim population in the world, we asked respondents how they see this percentage developing over the period to 2025. Do they expect to see a very significant growth in Islamic finance and the proportion of Syariah banking to the market overall?

Not really. About half of bankers responded that they see Syariah banking in the 5-10% range by 2025, and almost one-third felt it would still be the same level as it is now. Only 19% felt it would be greater than 10% of the market by 2025. Therefore overall the survey indicates that Indonesia bankers expect Syariah banking to outpace overall industry growth till 2025, but only slightly year by year.

The above results are well under the goal of OJK’s 5-year roadmap for Syariah banking developing in 2015, which targets to triple the market share of Islamic banks to 15 percent by 2023.

Many of the views of surveyed Syariah bankers mirrored the wider industry view, including a positive outlook on market conditions, loan growth (more than half expect loan growth in excess of 15% in 2017), and expected improvement in net income (all). Most – 88% - are focused on organic growth and reported they are unlikely to use M&A in the next 2 to 3 years. Syariah bankers we surveyed had the same views about Syariah market share by 2025 as did the overall industry, expecting growth to outpace the overall market but not to levels set as targets by the regulator or government.

They were somewhat more likely to list capital availability as a risk (#9 overall) for the industry, and likewise were more interested in regulations impacting capital than other banks. Satisfaction with risk management areas was also similar, except in the case of Operational risk where only 13% reported satisfaction.

Mortgage lending was also noted as a focus area for Syariah bankers. One of the most highlighted products launched in 2016 was Griya Swakarya by BNI Syariah, which allows the bank to own and manage its property to be sold to the customers directly. However, new products, particularly where they are not the historical core business of the organization, need appropriate risk mitigation and risk management support.
Infrastructure finance – strong interest to participate

Figure 15: Increased plans for Infrastructure finance

<table>
<thead>
<tr>
<th>Expectation of involvement with infrastructure finance</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Significantly more</td>
<td>15%</td>
</tr>
<tr>
<td>Somewhat more</td>
<td>46%</td>
</tr>
<tr>
<td>Same</td>
<td>27%</td>
</tr>
<tr>
<td>Somewhat less</td>
<td>9%</td>
</tr>
<tr>
<td>Significantly less</td>
<td>9%</td>
</tr>
</tbody>
</table>

Q: What is your expectation for your bank’s lending or involvement with infrastructure finance in Indonesia in 2017?

The Jokowi Government is prioritising infrastructure, but until now it has been very dependent on State-owned Enterprises to deliver the projects. This is set to change. Central Java Power Plant IPP reached financial close in 2016 along with the first four PPPs outside the power and toll road sectors, namely Umbulan Water and three sections of Palapa Ring Broadband Project. The Palapa projects were the first to be transacted with an Availability Payment mechanism.

There are an increasing number of projects in the pipeline or being actively discussed including hospitals, airports, availability payment schemes for toll roads, street lighting, waste-to-energy, education and prisons. Most of these will be Rupiah funded but some may offer scope for US dollar lending.

The recently agreed renewable energy regulations may lead to more lending opportunities in this sector, while the main 35GW programme also continues.

Our survey indicates strong interest to lend on infrastructure projects: 61% of respondents expect an increase in such activity in 2017. This is important as the ambitious government infrastructure development plan ultimately needs involvement from the private sector, including banks. As bank financing on large projects often involves syndication, the survey result helps validate that there is strong interest amongst the local banking industry to participate in infrastructure finance. Issues remain – availability of local currency finance, strong PPP structures, bank teams that understand project finance and the industries involved – but the opportunity is on the upswing.

For a sector-by-sector overview please see our 2016 report on “Indonesia Infrastructure: Stable foundations for growth” at:

In-or-granic growth – to M&A or not to M&A?

There is a very split view on plans for M&A. More than half of respondents said it was unlikely they would engage in M&A activity in the next 2 to 3 years. Of those who felt it was likely, only 12% felt it was very likely. This may also be an indication that there are willing buyers but not many willing sellers. Also, limits on foreign ownership (and uncertainty about future limits) serve to reduce the level of new inbound investment interest.

The strategic drivers for M&A are weighted more towards growth objectives such as expanding channels to customers, than towards internal objectives such as cost management and technical know-how. However, local banks who are considering M&A are more likely to do so for technical know-how (1 out of 3) than foreign banks (1 out of 10), and this is increasingly important as digital transformation occurs in the industry.

Our survey indicates that many banks are re-evaluating their strategies and only 9% of banks have the same strategy over the last 18 months. Therefore the views in the boardroom about M&A may change as these strategies are developed.
Why are many foreign banks less optimistic than large state-owned banks?

As a group, respondents from foreign banks were less optimistic about the current state of the market and the immediate future, especially in contrast to respondents from large state-owned banks. From state-owned banks, 75% expect loan growth in excess of 15%, compared to only 19% from foreign banks. More than one-third of respondents from foreign banks expect profits to be the same or worse, while every respondent from state-banks expect profits to improve. Respondents from state-banks and local private banks were 70% and 50% more likely, respectively, to say market conditions were improving.

One of the key reasons for the less optimistic view is that foreign banks have a much different view on the current cycle of rising credit risk. By and large, respondents from state-banks see the worst behind them – 86% saying they expect NPLs to decrease in 2017. By contrast, only 28% from foreign banks feel NPLs will decrease. We believe one of the other reasons may be that many foreign banks are “mid-size”, and are challenged by the lack of critical mass, funding-base and access that the state-owned banks possess. This can create a vicious cycle if mid-size banks are unable to find their niche or operate in a highly cost-effective manner. This drives a need for mid-size banks to examine their overall strategy, including the leverage of technology, key value drivers and in-organic growth possibilities. Lastly, foreign banks have some particular concerns surrounding data onshoring and ownership limits, which creates uncertainty.

What is the mid-size bank cycle?

- Smaller footprint and smaller deposit base (particularly smaller proportion of CASA funding) can lead to higher funding costs and lower NIM.
- Smaller size limits the bank’s ability to reach economies of scale and cost-income ratios are driven higher. Spikes in credit risk or credit losses have a proportionally greater impact in the short-term.
- Lower profitability can cause a need to seek higher lending rates from customers and challenges the bank’s ability to be competitive. Smaller footprint can lead to concentrations in credit risk and less diversification.
- Overall growth is more limited, resulting in a continuing smaller footprint.
The banking industry in Indonesia is undergoing a significant transformation driven by technology. More than half of respondents said that technology is the main driver of transformation in their bank over the next 3 to 5 years.

7 out of 10 Local bankers said technology was their #1 driver, as compared to 4 out of 10 Foreign banks. It is unclear why this difference exists – possibly it reflects technology investment that has already been made at foreign banks (e.g. via head-office initiatives), or the fact that the foreign banks tend to have proportionately more corporate banking, or simply a less aggressive technology push. Either way, technology is seen by many in the industry – especially mid-size banks – as a way to level the playing field with the larger banks by providing new channels to access customers while driving down the cost of customer acquisition and servicing.

Large banks are not slowing down. In fact, 71% of BUKU 4 banks and 58% of BUKU 3 banks view technology as the #1 driver of their transformation.

Source: PwC Retail Banking 2020 Survey

"59% of global bankers expect the importance of branch banking to diminish significantly as customers migrate to digital channels."

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**Figure 17: Technology is the main driver of Indonesia bank transformation over the next 3 to 5 years**

<table>
<thead>
<tr>
<th>Area</th>
<th>% selecting the area as a #1 driver of transformation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technology</td>
<td>52%</td>
</tr>
<tr>
<td>Changing customer needs</td>
<td>17%</td>
</tr>
<tr>
<td>Operational excellence</td>
<td>15%</td>
</tr>
<tr>
<td>Risk management</td>
<td>6%</td>
</tr>
<tr>
<td>Competition</td>
<td>4%</td>
</tr>
<tr>
<td>Regulation</td>
<td>4%</td>
</tr>
</tbody>
</table>

Q: What is the #1 driver of transformation in your banking business over the next 3 to 5 years?
Most banks are directing their tech investment towards e-banking, with almost half saying this was the #1 priority. Establishing web-based and smartphone-based applications which allow for banking transactions is the obvious entry point for many. In today’s market it is a foregone conclusion that customers expect such options. However, there is a significant opportunity to further leverage tech investment for areas that support growth, efficiency and risk management.

Only 14% of BUKU 4 banks said customer acquisition was a Top-2 priority. This is perhaps not surprising given their already existing expansive physical branch networks. However, there remains a large unbanked population and technology offers a unique opportunity to reach new customers at a low cost, across a wide geography. This is evident in the priorities of BUKU 2 banks, where 50% said customer acquisition was among their top 2 priorities. If this develops, the larger banks will find themselves increasingly challenged by new competitors offering positive customer digital experiences at lower and lower cost points.

On the other hand, larger banks are seeking more to use technology to enhance data analytics and risk management. 62% of the top-10 banks (by asset size) have this as one of their top 2 priorities, compared to only 27% of BUKU 2 banks.

64% of tech strategies are not very clear?

We asked respondents to rank the clarity of their digital strategy. On the positive side, 88% felt their strategy was either ‘very clear’ or ‘somewhat clear’. However, interpreting the difference between “somewhat clear” and “somewhat unclear” may be like deciding whether a glass is half full or half-empty.

Given that only 33% of bankers surveyed felt their strategy was “very clear”, can one interpret this as meaning the remaining 67% are not very clear? In any case, there appears to be room for sharpening and clarifying digital strategies – not only in terms of near term objectives, but also the longer term objectives from a channel, customer experience, and operational point of view. Only then can a successful IT strategy be determined and implemented. Given the speed at which technology is advancing, and the take-up of that technology by customers in Indonesia, having anything less than a very clear digital strategy may be a risky proposition in the long-term.
Only 2 out of 10 bankers surveyed felt very confident about the ability of their IT system to meet both the current and future needs of the business. The result was even lower for respondents from Top-10 banks (13%). As with the question on Digital strategies, it is open to interpretation as to what “somewhat prepared” means. However, banks will need to progress their readiness if they are to be competitive in this digital age.

**Branches still dominate, but customers are rapidly migrating to digital channels**

45% from our survey said at least half of their customer transactions come from traditional branches. This was higher for local banks (55%) than for foreign banks (34%). Similarly, foreign banks appeared to be taking greater advantage of mobile and internet channels: 59% reported that at least one-fourth of transactions are in this channel, compared to 36% for local banks. However, local banks have taken more advantage of ATM-based transactions, with 81% of local banks reporting at least 25% of their transactions via ATM, compared to only 44% for foreign banks.
While branches still dominate among all channels, there is a clear and rapid trend of customer transactions moving to mobile and internet. In our 2015 survey, 75% of respondents said more than half of their transactions were via branches – this is now down to 45% of respondents. Those customers are instead migrating to mobile and internet – in 2015, 27% from our survey said at least one-fourth of transactions were via mobile & internet. This is now up to 48% of respondents.

Interestingly, among BUKU 1 & 2 banks surveyed, more had at least 50% of their transactions via mobile/internet than did the larger BUKU 3&4 banks: 23% vs 17%. This perhaps shows the potential that exists for smaller banks to compete against larger banks through the use of technology.

The larger banks are making more use of ATMs for transactions, although as digital payment systems grow and develop the use of physical ATMs may become less important.

**Figure 22: Clear trend of customer migration from branches to digital channels**

Q: What is your estimate of the proportion of customer transactions processed through branch and internet/mobile banking?

<table>
<thead>
<tr>
<th>Year</th>
<th>Less usage</th>
<th>More usage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>4% 7% 14% 75%</td>
<td>20% 22% 45%</td>
</tr>
<tr>
<td>2017</td>
<td>15% 17% 23% 45%</td>
<td>22% 30% 28% 20%</td>
</tr>
</tbody>
</table>

Source: PwC Retail Banking 2020 Survey

**Millennials are about 50% more likely than their older counterparts (55+) to trust companies with a strong track record of innovation.**
Given the trend towards digital and fewer transactions via physical branches, what are the plans for expanding the number of branches and employees?

Very few banks (8%) plan significant growth in branches, however 45% still plan for moderate growth. The remaining banks surveyed either plan no growth or reduction. While the banks planning growth were varied, those planning a reduction were almost entirely from foreign banks (representing 21% of total foreign bank respondents).

We noted no strong correlation between plans for branches and expectations for loan growth, market conditions, net profit or the level of mobile/internet transactions. In a growing underbanked market with good long-term prospects, there is room for branch growth even as the trend towards digital banking increases. Nonetheless, we believe the survey results show a clear trend that digital banking is on a rapid rise in Indonesia and the level of banking carried out through traditional physical branches will be impacted.

**Figure 23: Evidence of slowing branch expansion**

Q: What are your plans for growth in 2017 number of branches?

<table>
<thead>
<tr>
<th>Growth (53%)</th>
<th>Reduction (12%)</th>
<th>No growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Significant/moderate growth</td>
<td>Significant/moderate reduction</td>
<td></td>
</tr>
</tbody>
</table>

**Figure 24: Mobile and web-based channels expected to grow the fastest over the next 5 years**

Q: From which channels do you expect the largest growth in usage over the next 5 years?

<table>
<thead>
<tr>
<th>Channels in which expect the largest growth in usage over the next 5 years</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mobile application</td>
<td>89%</td>
</tr>
<tr>
<td>Website, web-based platform</td>
<td>78%</td>
</tr>
<tr>
<td>Social media</td>
<td>51%</td>
</tr>
<tr>
<td>Email</td>
<td>22%</td>
</tr>
<tr>
<td>Call center</td>
<td>19%</td>
</tr>
<tr>
<td>Branch</td>
<td>12%</td>
</tr>
</tbody>
</table>

Source: PwC Global FinTech survey 2017 Base: 37 respondents from Indonesia banking, fintech and technology sectors.
FinTech is disrupting traditional banking

Based on Indonesia data from our recent Global FinTech survey, FinTech is seen to be either very important or important by most industry and technology players in Indonesia. However, there are mixed views amongst bankers as to the level of impact already in 2017. The general view is ‘moderate to significant’ impact but responses vary by bank type.

Part of the changes and revisions in bank strategies include how the organization is responding to FinTech. In Indonesia, this response varies from proactive investment in, or partnering with FinTech companies to development in-house solutions to revision of long-term forecasts and stress-testing models to reflect business at risk. Payment systems and funds transfer are seen as the two areas most at risk to move to FinTech over the next 5 years.

“23% of banking business could be at risk due to further development of FinTech, though FinTech companies anticipate they may be able to acquire 33% of incumbent business.”

**Strategies are changing to meet the new demands**

With the rapid pace of change in the market, it is not surprising that many banks are re-evaluating their overall strategy. Only 9% of those surveyed said they had the same strategy in the last 18 months. One-third either have new strategies or are reviewing their strategies, with the remainder having some moderate change. BUKU 3 banks have particularly been re-evaluating strategies, with 42% either having a new strategy or currently re-evaluating their strategy.

Strategies have a better chance of success when everyone in the organization has a high level of clarity and understanding of that strategy. Almost all respondents felt there was at least a moderate level of clarity in their organization. However, only 29% felt this understanding was high. One of the challenges is resource: only 23% of bankers surveyed felt there was good availability of highly skilled talent in strategy-related areas.

Over the last 2 years, as rising credit losses put pressure on profits, there were more and more banks in Indonesia re-examining cost. However, cost-income ratios are still high in the industry, particularly among small and mid-size banks. In our Survey, 21% of bankers said their bank plans to reduce the total number of employees in 2017. Our survey did not address the nature of the strategies and programs that drive those cost reduction activities. However, we often see initiatives where cost reduction is a bank-wide effort that may not be aligned to the overall strategy: for example, identifying 10% savings in all departments, or reducing the footprint of all branches. While these initiatives can have good short-term success and impact to the bottom-line, cost can quickly creep back into the organization soon after. The most effective strategies focus on lasting change that is aligned to the overall bank strategy – reducing the cost in areas that are not strategic priorities and focusing on investment in areas that drive profitable growth. Banks in Indonesia should be asking themselves whether they would really be fit for growth not only today, but also in a lower NIM scenario as already exists in neighboring Thailand, Philippines or even Malaysia.
Winning banks will be those that are Fit for Growth

As we see from our Survey, Banks in Indonesia are in a growth environment, but are experiencing rapid change that is putting or will put pressure on profitability – increased credit risk, NIM compression, rising costs, technology transformation, new disrupters, new compliance requirements. Banks and other financial institutions are realizing that in order to protect and improve the bottom line, they need to focus on managing costs as rigorously as they concentrate on growing revenues. In fact, as with any living organism, there is no profitable growth without equally robust pruning.

Welcome to the New Normal.

To be fit in this way means to be prepared as a growth enterprise. This is not just a matter of innovation prowess, entry into new markets, or acquisition savvy. It means to have your resources, and thus your cost structure, aligned to your company’s overall strategy – deployed toward the right businesses, initiatives, and capabilities to execute your growth agenda effectively. Fit for Growth companies have the right amount of resources they need to compete effectively – no more, no less – at the right places. Companies become Fit for Growth by doing three things consistently and continuously:

1. They focus on a few differentiating capabilities
2. They align their cost structure to these capabilities
3. They organize for growth

There is a clear correlation between how fit a company is for growth according to the Fit for Growth index and its total shareholder returns.

Source: Strategy& “Fit for Growth”

http://www.strategyand.pwc.com/fitforgrowth
Ten competitive technology-driven influencers for 2020 and beyond

It is clear that technology is affecting financial services in a multitude of ways. The following are ten key themes that we believe IT executives in Financial Services will need to address as they begin their strategic planning for 2020 and beyond:

- FinTech will drive the new business model
- The sharing economy will be embedded in every part of the financial system
- Blockchain will shake things up
- Digital becomes mainstream
- ‘Customer intelligence’ will be the most important predictor of revenue growth and profitability
- Advance in robotics and AI will start a wave of ‘re-shoring’ and localization
- The public cloud will become the dominant infrastructure model
- Cyber-security will be one of the top risks facing financial institutions
- Asia will emerge as a key centre of technology-driven innovation
- Regulators will turn to technology as well

Source: PwC publication: “Financial Services Technology 2020 and Beyond: Embracing disruption”

81% of banking CEOs are concerned about the speed of technological change, more than any other industry sector.

Source: PwC’s 19th Annual Global CEO Survey
Technology strategic priorities for 2020 and beyond

The pace of change is increasing and shows no sign of slowing. Financial institutions are looking to the IT organization to do more to help make sure they are well-positioned to succeed in the future. There are macroeconomic trends sweeping the world, and technology-driven influences buffeting the industry. What is the best approach to moving forward?

We see six priorities for success for 2020 and beyond, based on our research and our experience in the field:

1. Update your IT operating model to get ready for the new normal
2. Slash costs by simplifying legacy systems, taking SaaS beyond the cloud, and adopting robotics/AI
3. Build the technology capabilities to get more intelligent about your customers’ needs
4. Prepare your architecture to connect to anything, anywhere
5. You can’t pay enough attention to cyber-security
6. Make sure you have access to the talent and skills necessary to execute and win

Source: PwC publication: “Financial Services Technology 2020 and Beyond: Embracing disruption”
Macro-economic risk and credit risk were by far viewed to be the top risks to the industry, ranked as the #1 risk by 41% and 24% of respondents, respectively. No other risk was selected #1 by more than 7% of respondents.

In our 2015 Banking Banana Skins survey, bankers were also very concerned about macro-economic risk, and in particular about key factors such as exchange rates and interest rates. While those factors are much less of a concern, the economy continues to be viewed as the highest risk.

Credit risk has moved up the rankings since 2015. As mentioned earlier, although bankers believe conditions are improving, there is still apprehension about NPLs. The overall gross NPL ratio for the sector for 2016 was reported by OJK to be 2.93%. This compares well to many high growth emerging markets, but was a rise not seen in the market for some time. Banks have a delicate task of balancing the need for loan growth and financial inclusion with the need to manage credit risk. We believe the key question is not whether a bank’s NPL ratio is 3%, 4% or 5%; but rather whether risk is appropriately scored and priced into credit underwriting decisions and whether risk management and collection functions are up to the task. Capital levels are robust, which is perhaps why capital availability scores low on the list of risks.

Regulation has also risen as a risk since 2015, perhaps reflective of pressures on NPL ratios arising from credit risk, or from pending new regulations such as the draft banking law or data on-shoring (in the case of foreign banks).
**Preparedness – a glass half-full or half-empty?**

Given the level of investment in technology transformation and the impact of technology on the industry, it is somewhat surprising that technology risk was not ranked higher than #6. In our 2015 Banking Banana Skins survey, global bankers ranked this #4.

Another surprising change was that economic crime has moved to the bottom of the list as compared to #6 in 2015. This is closely linked to Cyber Risk and to Technology risk overall.

As we saw in our 2015 Banking Banana Skins survey on banking risks, bankers in Indonesia at that time were very positive about the industry’s preparedness to address risks. Now most respondents told us the industry was “somewhat prepared” for the risks identified, with only 5% being “very prepared”. A further 19% felt the industry was not prepared (28% in the case of foreign banks). Smaller BUKU 2 and BUKU 1 banks were more optimistic, with only 8% feeling the industry was unprepared.

When asked how their own bank is prepared, the response was slightly better with one-fourth of bankers saying their bank was ‘very prepared’. While we did not ask bankers to elaborate further on this assessment, there is a sizeable risk to the sector if more banks do not migrate towards a higher level of overall preparation. Larger banks were more likely to feel very prepared, indicating that smaller banks may be more vulnerable to risk.

It will also be critical for banks to have robust stress testing and contingency planning to be ready to respond to quickly changing market conditions.

Overall, one might interpret the findings as a positive sign – after all, most bankers felt “somewhat” prepared. Alternatively, one might take the view that bankers are less confident since only a relatively small portion felt “very” prepared to address the risks. Again, is the glass half-full or half-empty? Our challenge to banks is to consider whether, in the current, rapidly changing industry environment, anything less than “very prepared” is acceptable.
Respondents tell us that they are most focused on credit and liquidity risk, followed closely by operational risk. Smaller BUKU 2 & BUKU 1 banks were particularly focused on operational risk (e.g. 74% rated it as a top-3 focus as compared to 55% of BUKU 3 and BUKU 4 banks).

Given the technology transformation and related investment which is planned by banks, it is somewhat surprising that technology risk did not rank higher as a focus area. 61% of respondents rated this as the last of the six risk choices.

The fact that operational risk is a higher focus may relate to the fact that with growth can come challenges to manage and control operational risk, and technology implementations can also be disruptive by changing roles, responsibilities and working practices.

With respect to credit risk management, banks expect significant or moderate change in most areas, particularly for loan monitoring. 39% of respondents expect little to no change in exposure limits to particular sectors, which may be an indication that many such modifications already took place.

68% of respondents feel their bank has a clear risk management strategy in place. One-third said such a strategy was “in-progress.”
Do banks have a clear risk management strategy in place?

Figure 34: Larger, state-owned banks are confident about risk management strategy in place

Q: Does your bank have a clear risk management strategy in place?

% who feel they have a clear risk management strategy in place

<table>
<thead>
<tr>
<th>Type</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>State-owned</td>
<td>80%</td>
</tr>
<tr>
<td>Foreign</td>
<td>69%</td>
</tr>
<tr>
<td>Local private</td>
<td>47%</td>
</tr>
</tbody>
</table>

Overall, two-thirds of bankers surveyed felt their bank had a clear risk management strategy in place. A higher portion of respondents from local banks felt their risk management strategy is either in progress (41%) or not clear (12%). However, when earlier asked about how well their organization is prepared to respond to industry risks, local private bankers felt at least as prepared as other bank groups, and in some cases even more so. There may be some disconnect between the “feeling” of readiness and whether there is actually a strategy in place to address those risks or whether risk management is actually operating effectively. Considering the dynamic risk environment, it is essential that banks have clear risk strategies that are understood and implemented throughout the organization.

Overall banker satisfaction levels with the management of specific areas of risk were between ‘moderate’ and ‘satisfied’. Generally, less than 2 out of 10 bankers were ‘very satisfied’ about any particular area, indicating much room for improvement.

The industry average improved slightly across each major risk category from 2015. However, if we compare back to our 2014 survey (prior to much of the increase in NPLs and market volatility), then we see that the average satisfaction levels are lower in each area except operational risk. Credit risk management satisfaction is much lower. The percentage of respondents who are “very satisfied” with their credit risk management (13%) is at the lowest level since we started asking the question in our survey in 2013.

Technology risk scored lower than other areas, again highlighting the need for internal risk management and processes to keep pace with the level of IT transformation and IT risk. Only 7% of respondents were satisfied with the level of technology risk management.

While local banks ranked satisfaction slightly lower across most categories, and foreign banks higher, the differences were not significant.

Overall we believe the survey result indicates a solid foundation for risk management in the industry, but also a clear indication that there is much further room to strengthen and develop risk management, from strategy to implementation.
Liquidity risk management is focused on CASA deposits

The clear focus of bankers when it comes to managing liquidity is diversifying the funding base via a focus on CASA deposits. This is becoming more and more important as expectations for margin compression increase.

There is a strong correlation between CASA Ratios and the size of the bank, and likewise the overall costs of funds. Larger banks with a sizeable CASA funding base have lower overall cost of funds and better cost-to-income ratios. This is one of the main challenges for mid-size banks, considering their smaller footprint and branch network. However, with the increase in technology and less reliance on branches by customers, many banks are seeking to level the playing field by using technology to their benefit.

No local private banks mentioned the use of loan facilities as a means of diversifying the funding base. This compares to 43% of state-owned banks and 32% of foreign banks. Local banks are focused almost entirely on CASA funding and asset-liability management.

83% of Indonesia bankers surveyed felt the regulatory caps on deposit rates was helpful in addressing pricing and liquidity concerns

Source: PwC 2017 Indonesia Banking Survey
As in our 2015 survey, automation initiatives and people development were the top strategic focus areas for the management of operational risk. As mentioned earlier, data analytics and risk management is a bigger driver of technology investment for larger banks than for smaller banks. This is evident in that 42% of BUKU 3 and BUKU 4 banks say Automation as their #1 focus, compared to 26% for smaller BUKU 2 and BUKU 1 banks. Conversely, the smaller banks are more focused on people development (40% vs 26%).

Foreign banks also have a greater focus on automation than local banks. This may be influenced by progressive group-wide investments in automation, as well as burning platform to reduce cost and improve efficiency in order to compete with the largest banks. Local banks (local private, state-owned, and BPD) have a greater focus on people development.
One-third of bankers surveyed expect increased legal and compliance risk in 2017, with KYC and AML being the areas of expected focus. In terms of areas where respondents would like to have more clarity and dialogue with OJK, the new draft banking law tops the list. 34% of bankers surveyed chose this as the #1 area, and 71% chose it within the top 3.

Bank groups were fairly consistent in the main areas for dialogue, with the exception of data on-shoring regulations. One-third of foreign banks said this was a top-3 area where more dialogue is needed with OJK, while almost all other banks listed it as the least of their concerns. As is typical with global or regional cross-border bank groups, many have established data centers, shared service centers, and IT strategies that drive efficiency and service across the whole group operation. Local banks primarily operate only in Indonesia and therefore do not have this issue. Indonesia is the largest economy in Southeast Asia, and this may be a future consideration for larger banks that want to expand cross-border.

Regarding IT and Technology, many banks are moving fast with internal technology investment and implementation of customer mobile and web applications that do not require a wet signature. Many bankers would like to see more clarity on related requirements and regulations. Cybersecurity is also a hot-topic and many banks are keen to have dialogue on how regulations may develop in this area.

Capital levels in Indonesia are relatively robust, but Basel regulations place added burdens and requirements that may impact required capital.

Lastly, PSAK 71 (IFRS 9) is the most significant change to the accounting for loan impairment in many years. For banks it is critical to assess early the potential impact.
Key to the management of risk and the effective implementation of any strategy is a strong level of corporate governance. We asked those surveyed to rate the perceived maturity level of governance in their bank across 8 key components.

Overall, respondents rated their governance fairly high, with the average being 3.7 on a scale of 1 to 5. There is still room for improvement for many banks as approximately one-third of those surveyed rated their governance as moderate (i.e., neither strong nor underdeveloped). Some are realizing that they have disconnects between governance on paper (policies, procedures, directives, structures) and governance in practice (effective operation, minimal overlaps and monitoring/compliance activities that are aligned to strategic priorities). In terms of risk management, the 3 lines of defense are established, but may have inconsistent assessments of risk and/or operate independently.

Scores were noticeably lower for the governance of IT and system infrastructure. This is yet again another red flag for the industry considering the level of planned technology investment.
Risk Culture and Talent

Figure 40: Opportunity to improve risk management through stronger risk culture

Q: What is the level of maturity and strength of the “Risk Culture” throughout your bank?

<table>
<thead>
<tr>
<th>State-owned</th>
<th>Local private</th>
<th>Foreign</th>
</tr>
</thead>
<tbody>
<tr>
<td>Needs improvement</td>
<td>Moderate</td>
<td>Good</td>
</tr>
<tr>
<td>14%</td>
<td>25%</td>
<td>9%</td>
</tr>
<tr>
<td>43%</td>
<td>31%</td>
<td>25%</td>
</tr>
<tr>
<td>19%</td>
<td>23%</td>
<td>9%</td>
</tr>
</tbody>
</table>

A robust risk culture is a key component to successful implementation of the risk management strategy. In this respect there were mixed views. Overall, 54% of respondents felt they had a strong or very strong risk culture throughout the bank. However, 28% felt that risk culture was moderate and a further 18% needing improvement.

Foreign banks were more confident about the strength of their risk culture than local banks. Foreign banks were also more likely to say that there was limited or very limited availability of risk management talent – 44% vs 22% for local banks.

Our approach to establishing an effective risk culture

Maintaining focus on the following six behavioural reinforcers of risk culture is critical to creating and sustaining a healthy approach to risk. An assessment of risk culture identifies the actions and practices in the company that may directly contribute to issues arising in the future. To build an effective risk management culture, organizations need a multidimensional approach that addresses soft skills, policies, and tools. The ability to manage the culture should be supported by a system of levers and controls that are embedded into the approach for assessing and building effective risk culture.

<table>
<thead>
<tr>
<th>Leadership action</th>
<th>Communication</th>
<th>People practices</th>
<th>Global operating norms</th>
<th>Organizational structure</th>
<th>Technology and infrastructure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leaders demonstrate expected behaviors daily, praise and reward positive risk behaviors, enforce disciplinary action for violations, and encourage escalations by all staff levels.</td>
<td>Employees across the organization understand when and how to escalate risks and use appropriate communication channels. Employees fully understand policies and implications of non-compliance.</td>
<td>Compensation and risk adjusted performance are aligned. Risk related objectives are integrated into annual performance goals and the review process; lack of adherence results in lower performance outcomes.</td>
<td>There are consistent global operating norms, policies, procedures, and processes across regions. Process exist to assess issues by understanding how events in one region may impact/trigger risks in another area.</td>
<td>Consider organizational and communication changes that will support stronger partnership between the risk function and business units.</td>
<td>Technology is integrated allowing for real time, end-to-end view of risk information to drive decision making. Leading indicators of culture are identified, assessed, and acted on by management.</td>
</tr>
</tbody>
</table>
Availiability of Talent

Figure 41: Challenges to find skilled talent in key strategy and risk management areas

Availability of talent continues to be a challenge for most banks. In every category, less than half of respondents said that talent had good availability. In the case of Board members, Risk management and Strategy, this was even less.

As mentioned earlier, one-third of banks have either a new strategy or are reviewing their strategy. Only 9% have the same strategy in the last 18 months. However, strategy resource was viewed to be the most difficult to source. Closely related to this is the difficulty in finding highly skilled Board members and Commissioners that have the depth of knowledge and experience to add value to the direction of the organization.

Challenges to find skilled risk management talent, particularly in credit risk management will continue to grow as banks expand into new products and new customer segments with different risk profiles. Future accounting changes from an incurred-loss model to an expected-loss model will require deeper credit risk modelling and data analytics skill sets. Technology risk management and cyber risk management are specialist areas already in high demand, but which will grow as the industry transforms and moves forward Digital strategies.

Only 23% of bankers surveyed feel there is good availability of talent in Strategy related areas.
Further reading

Growth and strategy

Indonesia and Emerging market perspectives

Technology, risk and operations

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