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Banking Banana Skins 2015

Indonesia Perspectives

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Banking Banana Skins 2015, is a unique survey of the risks facing the banking industry, which has been produced by the Centre for the Study of Financial Innovation (CSFI) in association with PwC. CSFI is a non-profit think-tank, established in 1993 to look at future developments in the international financial field – particularly from the point of view of practitioners. The survey describes the risks currently facing the global banking industry, as seen by a wide range of bankers, banking regulators and close observers of the banking scene around the world. The survey was carried out in September and October 2015, and received 672 responses from individuals in 52 countries. There were 19 respondents from Indonesia. The questionnaire was in three parts. In the first, respondents were asked to describe, in their own words, their main concerns about the financial system over the next 2-3 years. In the second, they were asked to score a list of potential risks, or Banana Skins, selected by a CSFI/PwC panel. In the third, they were asked to rate the preparedness of financial institutions to handle the risks they identified. Replies were confidential, but respondents could choose to be named.

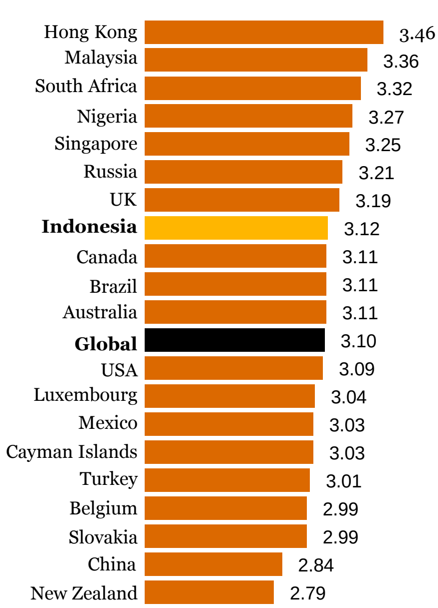
The Banana Skins Index measures the average score given by each country to the 24 risks listed in the questionnaire. The higher the score, the greater is the implied "anxiety level". The Preparedness Index measures the average response given to the question: "How well prepared do you think the industry is to handle the risks you identified?" where 1=Poorly and 5=Well. The higher the score, the greater is the implied level of preparedness. Note that both indices are "self-scored".

This publication focuses on the Indonesia respondents. The full global publication may be found at pwc.com.

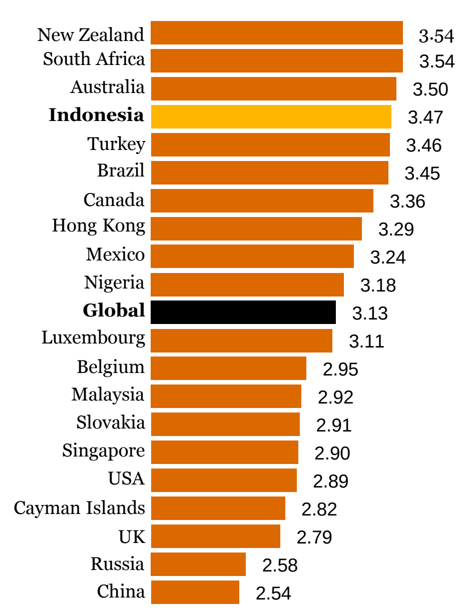
Banking Banana Skins 2015

	World		Indonesia
1	Macro-economic environment	1	Macro-economic environment
2	Criminality	2	Currency
3	Regulation	3	Interest rates
4	Technology risk	4	Credit risk
5	Political interference	5	Conduct practices
6	Quality of Risk Management	6	Criminality
7	Credit Risk	7	Technology risk
8	Conduct practices	8	Political interference
9	Pricing of risk	9	Regulation
10	Business model	10	Liquidity
11	Social Media	11	Quality of risk management
12	Reputation	12	Emerging markets
13	Capital availability	13	Human resources
14	Interest rates	14	Business model
15	Emerging markets	15	Pricing of risk
16	Shadow banking	16	Capital availability
17	Currency	17	Social media
18	Liquidity	18	Derivatives
19	Corporate governance	19	Management incentives
20	Management incentives	20	Reputation
21	Derivatives	21	Corporate governance
22	Human resources	22	Reliance on third parties
23	Reliance on third parties	23	Sustainability
24	Sustainability	24	Shadow Banking

"Anxiety" Index



Preparedness Index



Economic slow-down and volatility

The macro-economic environment and recent economic slowdown is a major area of concern for respondents, both globally and in Indonesia. With projected 2015 GDP growth in Indonesia still being just under 5%, the concern in Indonesia is somewhat different than what may exist in more developed markets, and may have more to do with volatility than with mid or long-term economic prospects.

While bankers in Indonesia agreed on the #1 risk being macro-economic, here is where the similarities end. Of the next four risks identified by Indonesia respondents, none were in the top-5 of risks identified by global respondents, with currency and interest rate risk globally being #17 and #14, respectively.

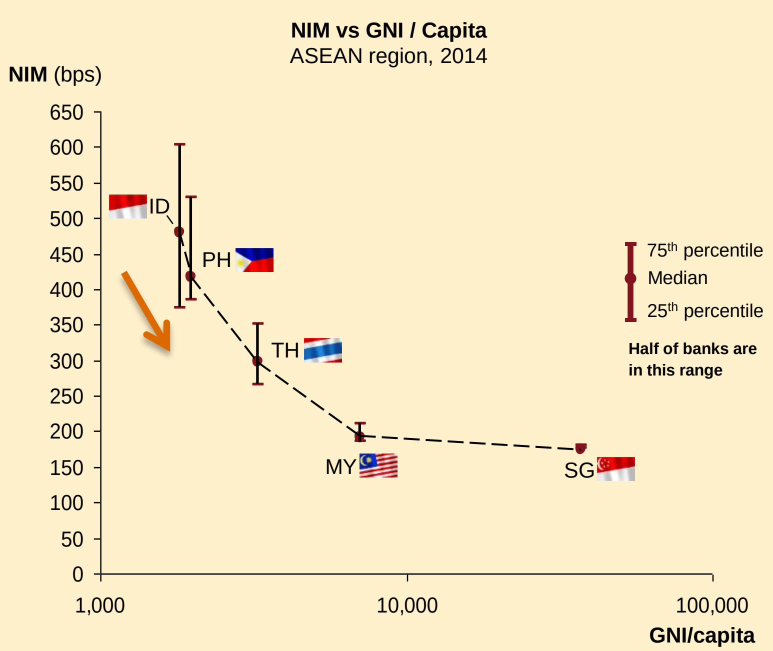
"Rapid increase of non-performing loans in banking industry due to sharp currency depreciation."

"If the Forex situation worsens a delayed macro-economic recovery could result in a liquidity crisis."

Volatility and the impact on profitability and credit risk

Currency risk ranked 15 positions higher than it did globally. and interest rate risks were noted as particularly strong concerns in Indonesia, and this in turn may have influenced the concern about the wider macro-economic environment. The weakening of the Rupiah against the USD and other major currencies has put significant stress on borrowers with foreign currency loans but where revenues are in Rupiah.

One banker noted that liquidity risk is the main worry for many institutions because "low developed local capital markets makes it more difficult to obtain longer term funding, especially in local currency". Liquidity was the 10th highest risk locally, but only 18th globally.



Note: 76 banks with publicly available data are included
Source: Bloomberg, EIU, Strategy& analysis
**USD @ 2005 constant prices*

High interest rates was already noted in our 2015 Banking Survey a year ago as an area of concern that was expected to slow loan growth. On the other hand, margins in Indonesia have been the highest in the region and a key driver for strong profitability. As margins shrink the pressure to reduce cost and improve efficiency is increasing substantially.

Our analysis shows that other ASEAN markets have experienced much lower margins as economies mature and customers become more sophisticated buyers. All things being equal, a 150 basis point drop in margins without a corresponding improvement in efficiency would drive many banks in Indonesia to have cost-income ratios in excess of 100%.

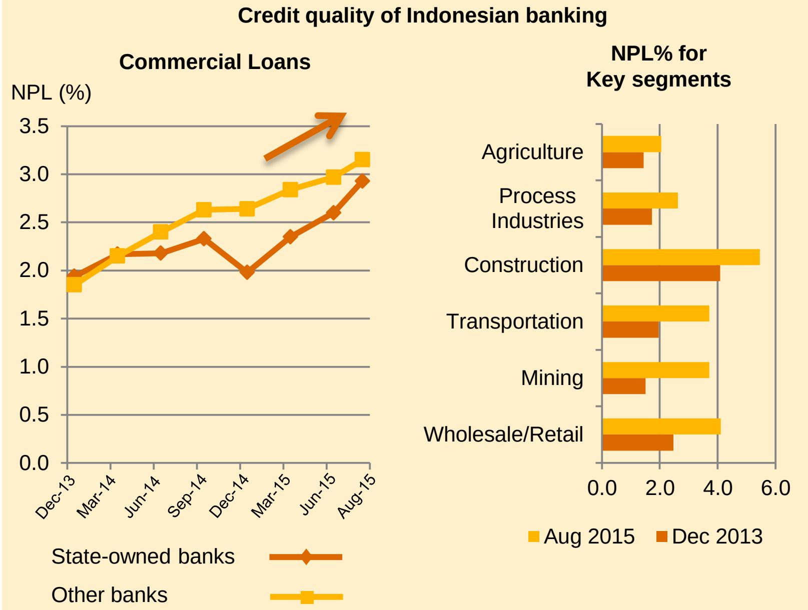
With regards to Credit Risk, global respondents still felt credit risk was a top-10 concern (#7); however in Indonesia the sensitivity was much higher. NPLs have been relatively low in Indonesia post-Asian Financial Crisis, but are now growing across many sectors and many different product areas, in part due to currency volatility but also due to low commodity prices and a slow-down in the economy.

Volatility and the impact on credit risk (cont)

While NPLs on retail loans are still relatively low at less than 2%, there has been a continuous increase in NPL% on commercial loans over the past 2 years, with the sharpest increases in Wholesale & Retail, Mining, Transportation and Construction.

Banks in Indonesia are increasingly focused on how they are managing the increase in credit risk and ensuring that systems and processes are up to the task.

Similarly in our 2015 Banking Survey, 79% of respondents had noted credit risk as the main focus area for 2015, and the results of this Banana Skins survey validate that this continues to be the case.



Source: Bank Indonesia

Risk Management

The quality of risk management was perceived globally to be a greater concern at number 6 compared to 11 in Indonesia. This is not surprising considering the level of risk in developed markets in the years following the global financial crisis and the attention by regulators in those markets. The rise in NPLs in Indonesia will "test" risk management functions under more challenging circumstances, and we may see a growing level of sensitivity and attention to the quality of risk management.

Underestimated technology risk?

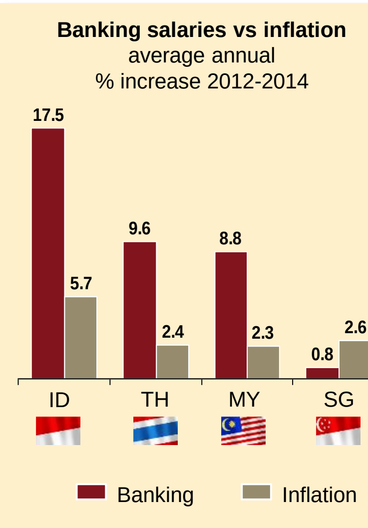
Interestingly, Criminality (ie Cyber-Risk) rocketed to the #2 concern among respondents globally, but was not in the top-5 locally. While it may reflect the relatively lower sophistication and usage of digital channels in Indonesian banking, it may also reflect a gap between the actual and perceived risk that will leave banks unduly exposed.

According to a 2013 report by US-based Akamai Technologies, Indonesia had surpassed China as the leading source of cyber attacks. While Banks in Indonesia are more focused on the immediate economic conditions, a lack of priority around technology and cyber-risk may leave banks to be exposed to ever-more sophisticated attacks. As a comparison, Singapore respondents had Criminality and Technology Risk as the top 2 concerns, and Malaysia rspondents scored them at #4 and #2, respectively. However, some local respondents did criticise "mammoth legacy systems" and warned about "security issues regarding digital banking and rogue employees/vendors motivated by personal benefit or risky incentive systems".

War for Talent

In Indonesia, Human Resources was at #13, compared to only #22 globally. This is consistent with past Banana Skins surveys and the higher level of sensitivity in Southeast Asia, e.g., China has Human Resources at #9.

With the growth in banking in Indonesia in recent years, wage costs have been outpacing inflation and it has been a "seller's market", particularly in specialist areas of finance, risk management and sales.



Source: OJK, ILO, Robert Walters, Strategy& analysis

High anxiety, High perceived preparedness

The "anxiety level" of the Indonesia response was 3.19 on a scale of 1-5, which was higher than the global average of 3.1 and eighth out of twenty countries. This was a similar trend among other Southeast Asia locations, where Hong Kong, Malaysia, Singapore all were among the top 10 in anxiety as well. Clearly there is a feeling among bankers in the region about softness in markets, the slow-down of China, and the increased risk environment.

On the other hand, when asked "How well prepared do you think banks are to handle the risks you have identified?", Indonesia scored 3.47 out of a possible 5, indicating a higher level of perceived preparedness than the world average of 3.13.

"Financial Institutions are highly regulated..."

"The level of capital held gives Indonesian banks sufficient cushion to weather the bad times."

Many parts of the world were more severely impacted after the global financial crisis in 2009, and as such have had many years to adjust. The recent changes being experienced in Indonesia are creating anxiety but the feeling was that the market is much more prepared than in the past. A common feedback from bankers is "we learned from the Asian financial crisis" and regulation has significantly developed over the years.

Regulation, while the number nine Banana Skin in Indonesia, was the number three risk globally. Global banks, particularly in Europe and North America, have seen increased scrutiny by regulators, in respect of loan loss provisioning, capital adequacy and operational risk. This is driving a concern among the industry about high costs of compliance and new capital requirements.

In Indonesia, as pressures on profitability increase, we may see more sensitivity in the future to the amount and cost of regulation.

Concern from Emerging Markets

The anxiety level of the emerging markets of Southeast Asia, Africa, Brazil and Russia were all higher than the global average, with Hong Kong and Malaysia the highest among those surveyed.

US respondents scored emerging market risk at #9, with one banker commenting "Disruptions in the Middle East, North Africa and China will have a significant negative effect on the world economy in 2016."

However, that level of concern was not shared by all, as the UK, Australia and Canada respondents scored emerging market risk fairly low at #15, #19 and #18 , respectively. This may reflect the differences in emerging market exposure among respondents, or there may be a disconnect in perceptions.

Please contact us for a more detailed discussion of the matters covered in this publication:

David Wake

Advisor
Financial Services
david.wake@id.pwc.com
+62 21 528 90800

Jusuf Wibisana

Partner
Assurance
jusuf.wibisana@id.pwc.com
+62 21 528 9600

Lucy Suhenda

Partner
Assurance
lucy.suhenda@id.pwc.com
+62 21 528 91060

Marina Tusin

Partner
Consulting – People & Change
marina.tusin@id.pwc.com
+62 21 521 2901

Chairil Tarunajaya

Partner
Risk Consultancy
chairil.tarunajaya@id.pwc.com
+62 21 528 91136

David Hovenden

Advisor
Consulting – Strategy&
david.hovenden@strategyand.my.pwc.com
+62 21 521 2901

Samuel Ong

Advisor
Assurance
samuel.ong@id.pwc.com
+62 21 528 90480

Margie Margaret

Partner
Tax
margie.margaret@id.pwc.com
+62 21 521 2901 ext 75862

Kees Poelman

Advisor
Risk Assurance
cornelis.p.poelman@id.pwc.com
+62 21 521 2901

Angelique Daryanto

Partner
Assurance
angelique.daryanto@id.pwc.com
+62 21 528 90636

Media enquiries should be addressed to:

Khrisma Fitriasari
khrisma.fitriasari@id.pwc.com
+62 81310200647

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PwC Indonesia
@PwC_Indonesia