BSR BANKING SUPERVISION REPORT 2012

BANK INDONESIA

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The Banking Supervision Report (BSR) is the product of Bank Indonesia's transparency and accountability towards the public concerning bank regulation and supervision as stipulated in Act of the Republic of Indonesia No. 23 of 1999 concerning Bank Indonesia, amended by Act of the Republic of Indonesia No. 3 of 2004.

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BSR
Banking Supervision Report
2012

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Foreword

We would like to begin by expressing our gratitude to God Almighty for His mercy and grace in the completion and publication of the 2012 edition of the Banking Supervision Report (BSR). Publishing the Banking Supervision Report represents one form of transparency and accountability undertaken by Bank Indonesia as the central bank to the general public in its task implementation of regulating and supervising banks pursuant to Act no. 23, 1999, concerning Bank Indonesia and amended by Act no. 6, 2009. The discussions contained within this edition of the Banking Supervision Report encompass all types of bank, including conventional banks, Islamic banks and rural banks.

In broad terms, the Banking Supervision Report (BSR) comprises an array of information regarding the number of banks and branch offices as well as the performance of several key banking indicators/ratios for the past year of 2012, which are compared to previous years. BSR also details the direction of banking policy for 2012 as well as the regulations and banking policy instituted in 2012. The various forms of coordination are also reported along with the activities and active role played by Bank Indonesia in conjunction with a number of stakeholders to develop, empower, regulate and supervise the banking sector. In addition, the Banking Supervision Report also describes the banking supervision process performed by Bank Indonesia during 2012 and presents the results as well as follow-up measures to be implemented looking ahead. Furthermore, a number of other salient points relating to banking supervision are also reported, including fit and proper tests, the performance of the information system as well as ongoing investigations and cases of banking mediation. In the final chapter, an analysis of the challenges, prospects and direction of banking policy for 2013 is presented, which is geared towards bolstering bank resilience and efficiency as well as expanding the banks' role in intermediation.

Banking supervision conducted by Bank Indonesia consists of direct supervision in the form of onsite supervision as well as indirect supervision in the form of offsite supervision. Direct supervision is achieved through direct inspections at the respective bank. Meanwhile, indirect supervision includes monitoring all operational activities of the banks through analysis and evaluation of all reports submitted to Bank Indonesia, the outcome of inspections as well as other supplementary information. Based on the results of supervision, at yearend 2012 nearly all conventional commercial banks (98%) achieved the status of Sound and Fairly Sound, which represents an improvement over the position in the previous year (97%). Positive performance was also noted for Islamic banks, with the percentage of Islamic banks rated Good increasing from 55% (2011) to 73% (2012). Meanwhile, the supervision of rural banks in 2012 indicated that the composition of those classified as Sound experienced no change (84%) compared to the previous year.

One of the more salient findings of 2012, with regard to supervision, was that banks maintained positive performance despite the arduous challenges faced (internal and external). Conventional banks, Islamic banks and rural banks all successfully expanded their intermediation function. At commercial banks (conventional and Islamic), the disbursement of credit grew by 23.08% (yoy), the majority of which was funded by deposits, themselves growing by 15.81% (yoy). Despite robust credit growth the banking sector successfully maintained credit quality, as reflected by the lowest level of gross non-performing loans (NPL) in the history of banking in

Indonesia at just 1.87%. Consequently, bank profitability grew by 23.65% on the previous year, thereby buttressing bank capital and evidenced by a level of CAR at 17.32%. Meanwhile, key rural bank indicators showed that credit and deposits at rural banks grew respectively by 21.21% (yoy) and 17.43% (yoy), with solid levels of capital and profitability, as demonstrated by the 27.6% level of CAR and 25.68% (yoy) increase in profit.

It is important to note that this edition of the Banking Supervision Report (BSR) will be the final edition compiled and published by Bank Indonesia because, according to Article 55, paragraph (2) of the Financial Services Authority Act, as of 31st December 2013 the function, tasks and authority concerning the regulation and supervision of financial services in the banking sector will be taken over by the FSA. Therefore, through BSR it is hoped that the reader acquires a broad understanding of the function and tasks of banking supervision and regulation performed by Bank Indonesia during 2012.

In closing, we hope that this edition of the Banking Supervision Report functions as a form of communication to our stakeholders regarding that which was undertaken by Bank Indonesia throughout 2012 in the banking sector, thereby furnishing the readership with more information and greater understanding. We welcome any comments, suggestions and input regarding the BSR publication with the genuine hope that the Banking Supervision Report is beneficial to us all.

Jakarta, 7th May 2013

DEPUTY GOVERNOR OF BANK INDONESIA

Halim Alamsyah

Executive Summary

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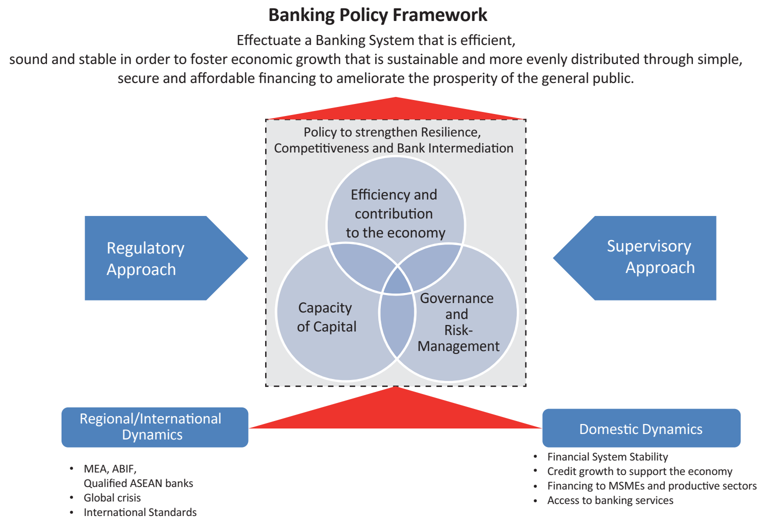
Banks in Indonesia maintained their structure and performed positively during the past year of 2012. Banks consistently strived to reinforce their role within the financial system of Indonesia, among others, by enhancing institutional aspects. Nearly 2,000 additional office units of commercial banks were opened during 2012, including branches, sub-branches and cash offices. In line with the broader service of rural banks to the general public, particularly to micro and small enterprises, the number of rural bank branch offices also increased to 1,329. Meanwhile, the number of conventional banks, Islamic banks (BUS) and Islamic business units (UUS) remained unchanged at 109 conventional banks, 11 BUS and 24 UUS respectively.

The bank intermediation function remained sound amid high volatility in the global economy. Impressive progress in terms of due diligence as well as the application of prudential principals when extending credit helped improve the risk profile of banks. This was further supported by the capital structure of banks, with a stronger core capital that underpinned bank resilience in the absorption of potential risk. Meanwhile, the credit expansion strategy implemented, oriented towards productive sectors, coupled with gains in efficiency had a propitious impact on bank profitability.

Banking policy and regulation instituted in 2012 provided the basis to improve and strengthen the banking supervision function of Bank Indonesia. The regulation of conventional commercial banks aims to strike an optimal balance between boosting competitiveness and strengthening bank resilience, while concomitantly nurturing bank intermediation, including broadening public access to lower-cost financial services (financial inclusion). On the other hand, the regulation of Islamic banks tends to focus on strengthening intermediation to productive economic sectors, product development and the development of Islamic institutional infrastructure as well as promoting good governance and supervision in order to manage risk. Finally, rural banking policy is directed towards developing the capital structure and enhancing competitiveness.

In 2012, Bank Indonesia issued a variety of regulations governing conventional commercial banks, Islamic banks and rural banks. The regulations consist of new regulations, amendments to existing regulations and/or the repeal of previous regulations in the form of Bank Indonesia Regulations (PBI) and Bank Indonesia Circulars. In general, the regulations promulgated aim to buoy economic expansion and catalyse the real sector through domestic financial deepening, the creation of a sound banking system capable of further development, national and international competitiveness, an enhanced banking supervision function, the fulfilment of international standards, improved consumer protection, support for micro, small and medium enterprises (MSME), as well as other institutional and prudential regulations. Concerning the financing of MSMEs, Bank Indonesia focused policy on continuously broadening MSME access to the banking sector and encouraging banks to allocate financing to MSMEs.



Bank Indonesia applies risk-based supervision in order to foster the manifestation of a banking sector that is stable and grows sustainably. Through such an approach, it is possible for bank supervisors to detect significant risks early and take appropriate supervisory actions in a timely manner. From a technical standpoint, risk-based supervision can be explained as a cycle consisting of six stages as follows: know your bank; risk assessment and bank soundness level; supervisory planning; risk-based inspections; updating the risk profile and bank soundness level; as well as the level of supervision and monitoring. Relating to the level of bank soundness, since 2011 Bank Indonesia has refined its risk assessment procedure using Risk Based Bank Ratings (RBBR), which supersedes the CAMELS Rating System. The implementation of RBBR is based on four factors, namely the Risk Profile, Good Corporate Governance (GCG), Earnings and Capital. Furthermore, to supplement the risk-based supervision approach, consolidated supervision is enforced for banks with control over a subsidiary.

As part of the supervision process, especially to help create a solid banking system that can protect the interests of the stakeholders, the implementation of supervision is underpinned by good corporate governance, an adequate information system and consumer protection at the banks. Banks that are owned and managed by those who meet the strict requirements of fit and proper tests support the implementation of good corporate governance in the banking industry. As a first line of defence, Bank Indonesia conducts its selection process through fit and proper tests on any party with a strong influence over a bank's management, for example candidates for the board of commissioners, prospective directors and controlling shareholders. Additionally, in 2009 Bank Indonesia developed a Banking Information System (BIS) to replace the previous Bank Indonesia Banking Sector Management Information System (SIM-SPBI). BIS is expected to accommodate the needs of supervisors in terms of replacing the previous supervision system, which applied an assessment of bank soundness based on the CAMELS ratings and risk profile, with risk based bank ratings (RBBR). In terms of consumer protection, Bank Indonesia continuously strives to enhance bank compliance to prevailing laws and regulations as well as prevent the emergence of structural weaknesses in the banking system that could undermine the national economy. In this context, legal enforcement is an inseparable part of efforts to strengthen the banking supervision system, among others, through investigations and mediation. Mediation is a follow-up measure to the customer complaints procedure that provides an alternative avenue to settle disputes out of court. Mediation aims to provide greater convenience to individual customers through access to dispute resolution with the bank in question using a method that is simple, inexpensive and swift.

Entering 2013, sound economic performance is expected to persist. Nonetheless, uncertainty surrounding the global economic recovery as well as pressures on the domestic economic structure represent the most serious banking challenges. Economic expansion in Indonesia, which is projected in the range of 6.3% to 6.8% in 2013, will continue to stimulate improvements in the performance of banks and other financial institutions. Notwithstanding, in 2013 banks will still face the challenges of external imbalances, ASEAN financial sector integration (MEA) as well as international standards. Domestically, the main challenges consist of governance and risk management, capital, efficiency and economic contribution, financing to MSMEs and productive sectors, access to banking services and financial system stability, among others. In reply to those challenges, Bank Indonesia will continue maintaining financial system stability, including the banking sector, through ongoing policy sustained from previous years. Through a program of financial inclusion, public access to affordable banking services will expand. Meanwhile, through policy requiring banks to publish their prime lending rates for micro credit, complemented by prime lending rate policy issued previously, healthy competition is expected to flourish in the micro segment.

Bank Indonesia is currently in the process of transferring the function, tasks and authority for banking regulation and supervision to the Financial Services Authority (FSA or Otoritas Jasa Keuangan – OJK) while minimising any adverse effects on financial system stability. On 22nd November 2011, the Government and the House of Representatives approved Act no. 21, 2011, known as the OJK Act. This independent financial services supervisor will host a regulatory and supervisory system that is integrated among all activities in the financial services sector, encompassing the banking sector, the capital market, insurance, pension funds, finance companies and other providers of financial services. Based on the OJK Act, the function, tasks and authority for the regulation and supervision of financial services in the banking sector will be transferred from Bank Indonesia to the Financial Services Authority on 31st December 2013. Bank Indonesia has established a task force for the transfer of banking supervision to the FSA in order to support the smooth and effective transfer of authority. The development/progress of the task force is synergised and harmonious with other task implementation at Bank Indonesia in terms of monetary aspects, financial system stability and the payment system.

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Chapter 1
Banking Structure and Performance in 2012

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1.1 Banking Structure

During 2012, banks in Indonesia successfully maintained positive performance despite facing a number of onerous challenges. Amid widespread volatility in the global economy, the banking sector managed to reinforce its role in the financial system of Indonesia, among others, through improvements to institutional aspects. Nearly 2,000 additional new office units were opened during the reporting period, consisting of bank branches, sub-branches and cash offices. In total, there are currently 16,625 bank branches in Indonesia, with 74% concentrated on the islands of Java and Sumatera. In the past year, state-owned banks have implemented an aggressive expansion strategy.

Table 1.1 Total Number of Banks and Bank Branches

Bank Group	2010	2011	2012
State-Owned Banks			
Number of Banks	4	4	4
Number of Branches	4189	4362	5363
Foreign Exchange Banks			
Number of Banks	36	36	36
Number of Branches	6608	7209	7647
Non-Foreign Exchange Banks			
Number of Banks	31	30	30
Number of Branches	1131	1288	1447
Regional Banks			
Number of Banks	26	26	26
Number of Branches	1413	1472	1712
Joint Venture Banks			
Number of Banks	15	14	14
Number of Branches	263	260	263
Foreign Banks			
Number of Banks	10	10	10
Number of Branches	233	206	193
Total			
Number of Banks	122	120	120
Number of Branches	13837	14797	16625
Number of Conventional Commercial Banks	**111**	**109**	**109**
Number of Islamic Banks	**11**	**11**	**11**

1.1.1. Commercial Banks[1]

The number of conventional commercial banks up to yearend 2012 was the same as that in the previous year, namely 109. There were, however, a number of name changes during the reporting period as follows:

1) Here, commercial bank refers to conventional commercial banks and Islamic banks.

1. A change in the business licence of a local enterprise (PD). South Kalimantan Regional Bank was licensed under the name PT Bank Pembangunan Daerah Kalimantan Selatan (South Kalimantan Regional Bank) through Bank Indonesia Gubernatorial Decree no. 14/5/KEP.GBI/2012, dated 1st February 2012.
2. A change in the business license of PT Bank Dipo Internasional to PT Bank Sahabat Sampoerna through Bank Indonesia Gubernatorial Decree no. 14/7/KEP.GBI/2012, dated 22nd February 2012.
3. A change in the business license of PT Bank Agroniaga to PT Bank Rakyat Indonesia Agroniaga Ltd through Bank Indonesia Gubernatorial Decree no. 14/72/KEP.GBI/2012.
4. A change in the business license of PT Bank Liman Internasional to PT Bank Dinar Indonesia through Bank Indonesia Gubernatorial Decree no. 14/75/KEP.GBI/2012, dated 25th October 2012.

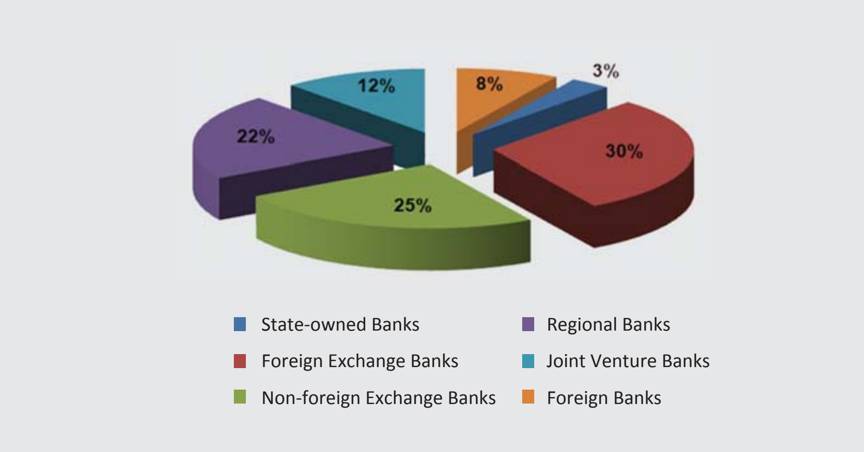
At the end of 2012 there were five more commercial banks with a core capital in the range of Rp1 trillion to Rp10 trillion compared to the previous period and one more bank in the next category with a core capital of more than Rp10 trillion. The increase in core capital was achieved through additional paid up capital as well as through acquisitions by new investors.

Table 1.2 Number of Banks based on Core Capital

Core Capital	2010		2011		2012	
	Number of Banks	%	Number of Banks	%	Number of Banks	%
≥ Rp10 Trillion	8	6,56	9	7,50	10	8.34
Rp 1 T s.d Rp 10 T	40	32,79	44	36,67	49	40.83
Rp100 M s.d < Rp 1 T	74	60,66	67	55,83	61	50.83
< Rp100 M	0	0,00	0	0,00	0	0,00
Total	**122**	**100,00**	**120**	**100,00**	**120**	**100,00**

Based on bank group, the number of banks in each respective group did not change compared to the composition in 2011. Accordingly, foreign exchange banks are the most dominant with 30%, followed by non-foreign exchange banks with 25% and regional banks with 22% (Graph 1.1).

Graph 1.1 Composition of Banks by Group in 2011



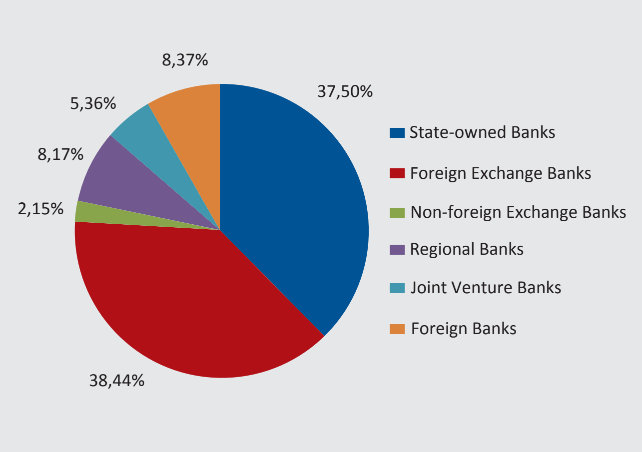
Referring to Bank Indonesia regulations concerning bank grouping based on business activity and core capital, the distribution of commercial banks in December 2012 was as follows:

Table 1.3 Number of Banks based on Business Activity

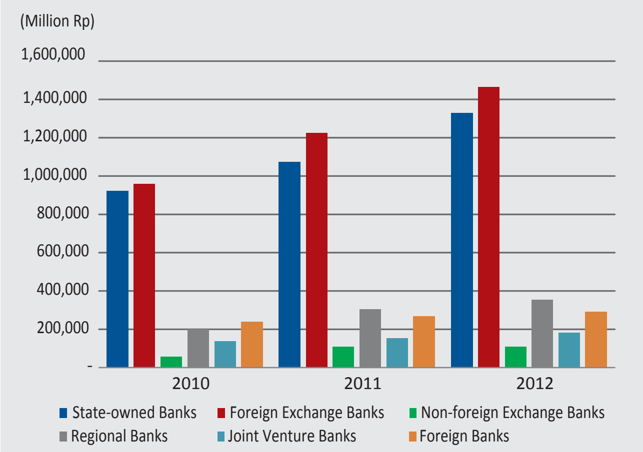
	BOOK 1	BOOK 2	BOOK 3	BOOK 4
	Core Capital < Rp1 T	Core Capital ≥Rp1 T s/d <Rp5 T	Core Capital ≥Rp5 T s/d <Rp30 T	Core Capital ≥Rp30 T
Number of Banks	61	40	14	5

In terms of asset composition nationally, foreign exchange banks account for the largest amount of total assets, followed by state-owned banks that, despite only numbering four banks, control a 37.5% share of total assets in the banking industry (Graph 1.2). In general, all bank groups experienced an increase in their total assets from 2010 until the end of 2012. The most pronounced nominal increase in assets was recorded for state-owned banks and foreign exchange banks, while non-foreign exchange banks enjoyed the most growth as a percentage (yoy) (Graph 1.3).

Graph 1.2 Asset Composition of Banks by Group in 2012



Graph 1.3 Total Assets by Bank Group



1.1.2. Islamic Banks

The number of Islamic banks (BUS) and Islamic Business Units (UUS) operating under sharia principles did not change in 2012 with 11 BUS and 24 UUS respectively, while Islamic rural banks expanded from 155 to 158. The moderate increase in Islamic rural banks (BPRS) was attributable to three new business licenses (BPRS Bahari Berkesan, Ternate; BPRS Magetan, Kediri; and BPRS Saka Dana Mulia, Semarang), one license conversion from a conventional rural bank (BPRS Bakti Artha Sejahtera Sampung, Surabaya) and one business license revocation (BPRS Kafalatul Ummah, Medan).

Throughout 2012, Islamic banks and Islamic business units undertook active expansionary measures through their office networks in order to broaden service outreach. In just one year, the BUS office network expanded by

344 branches from 1,401 to 1,745 and the UUS office network grew by 37 branches from 364 to 401 at the end of 2012. Dramatic expansion in the Islamic banking industry is due to a number of banks undertaking large-scale expansion by opening additional branches. In addition, in 2012 the status of many bank offices changed from sub-branches to branches. The upgrade in branch status aimed, among others, to boost the efficacy of operating costs while enhancing the service provided to the customer.

Table 1.4 Performance of the Bank Office Network

Group of Bank	2010	2011	2012
Islamic Bank (BUS)			
- Number of Banks	11	11	11
- Number of branches	1215	1401	1745
Unit Usaha Syariah (UUS)	23	24	24
- Number of conventional banks with UUS	23	24	24
- Number of branches	262	336	517
Islamic Rural Banks	150	155	158
- Number of Banks	150	155	158
- Number of branches	286	364	401

1.1.3. Rural Banks (BPR)[2]

The number of branches and service coverage of rural banks continued to increase, which is indicated by the growing number of rural banking services available to the general public, particularly micro and small enterprises. The number of rural bank branch offices in 2012 grew by 8.67% on the previous year to 1,329. Meanwhile, the number of rural bank cash offices increased by 12.73% to 1,443.

Table 1.5 Performance of the Conventional Rural Bank Office Network

Office Network	2010	2011	2012
Head Office	1.706	1.669	1653
Branch Office	1.088	1.223	1329
Cash Office	1.116	1.280	1443
Total	3.910	4.172	4425

The establishment of new rural banks outside the islands of Java and Bali continued to increase. In 2012, there were 12 additional new rural banks established with nearly all located outside the environs of Java and Bali. Only one new rural bank was initiated on Java or Bali, which is in line with Bank Indonesia's efforts to continue expanding rural banking services evenly into all areas of the archipelago, namely by applying less stringent regulations for paid up capital in areas outside of Java and Bali. This measure aims to ensure that members of the general public in all corners of the archipelago, in particular micro, small and medium enterprises (MSMEs),

2) Here, rural bank refers to conventional rural banks unless otherwise stated.

feel the benefit of rural banking services. In contrast, three business licenses were revoked in 2012, two from Java and Bali and one from outside Java and Bali.

Table 1.6 The Expansion of Rural Banks

Location of Rural Bank	2010		2011		2012	
	Jumlah	%	Jumlah	%	Jumlah	%
Java-Bali	1.264	74,1	1.208	72,4	1.184	71,6
Outside Java-Bali	442	25,9	461	27,6	469	28,4
Total	1.706	100	1.669	100	1.653	100

Policy to buttress the structure of the rural banking industry went well. Such policy was implemented through advocacy for mergers, namely the amalgamation of two rural banks or more to strengthen the standing of one of the banks, as well as consolidation, namely the amalgamation of two or more rural banks to form a new bank. In 2012, 13 rural banks merged into five and 15 rural banks were consolidated into one.

Table 1.7 Licensing Data for 2012

Area	License			
	In-Principle Approval	Business License	Mergers/Consolidations	
			From	To
Jabodetabek*	1	-	4	2
West Java	-	-	15	1
Central Java and Yogyakarta	-	1	4	1
East Java	-	-	7	2
Bali and Nusa Tenggara	1		-	-
Sumatera	1	5	-	-
Kalimantan	1	4	-	-
Sulampua**	-	1	-	-
Total	**4**	**12**	**30**	**6**

*) Jakarta, Bogor, Depok, Tangerang/Banten, Bekasi dan Karawang

**) Sulawesi, Maluku dan Papua

Based on ownership, of the 13 rural banks engaged in mergers, four were owned by local government with status as a local enterprise, while nine other rural banks were privately owned limited companies. Of the 15 rural banks involved in consolidation, all were owned by local government with status as a local enterprise.

Table 1.8 Mergers and Consolidations in the Rural Banking Industry

Legal Entity	2010		2011		2012	
	From	To	From	To	From	To
Limited Company	26	4	21	3	11	4
Local Enterprise	5	1	34	4	19	2
Cooperative	-	-	-	-	-	-
Total	**31**	**5**	**55**	**7**	**30**	**6**

In line with Bank Indonesia policy to encourage the establishment of rural banks in the form of limited companies, the number of such rural banks has continued to rise. A limited company is an ideal form of legal entity for the banking industry, rather than other types, like a local enterprise or a cooperative. In the context of the rural banking industry, the form of legal entity reflects the ownership composition of the corresponding rural bank. Local government owns rural banks with status as a local enterprise, whereas rural banks in the form of limited companies are examples of rural banks where a private party holds at least a part or all of the shares.

Table 1.9 Number of Rural Banks based on form of Legal Entity

Legal Entity	2010		2011		2012	
	Total	Percentage	Total	Percentage	Total	Percentage
Limited Company	1.384	81,1	1.388	83,2	1.391	84,2
Local Enterprise	288	16,9	247	14,8	229	13,9
Cooperative	34	2,0	34	2,0	33	2,0
Total	**1.706**	**100**	**1.669**	**100**	**1.653**	**100**

In terms of total assets, rural banks can be grouped into four categories. However, based on paid up capital the number of bank groups becomes five. In 2012, the number of rural banks with a level of total assets in excess of Rp10 billion increased to 77, namely from 1,002 to 1,079 with their corresponding share swelling from 60.04% to 65.28%. Based on the amount of paid up capital, the number of rural banks with more than Rp25 billion increased by 36, from 241 to 277 with a corresponding share of 16.75%, up from 14.44% previously.

Table 1.10 Total Assets of Rural Banks

Total aset	2010		2011		2012	
	Jml	%	Jml	%	Jml	%
S.d. Rp1 M	25	1,5	16	1,0	12	0,7
≥ Rp1 M s.d. Rp5M	341	20,0	264	15,8	229	13,9
≥ Rp5 M s.d. Rp10M	433	25,4	387	23,2	333	20,1
≥ Rp 10 M	907	53,2	1.002	60,0	1.079	65,3
Total	**1.706**	**100**	**1.669**	**100**	**1.653**	**100**

Table 1.11 Paid Up Capital of Rural Banks

Paid up capital	2010		2011		2012	
	Jml	%	Jml	%	Jml	%
S.d. Rp500jt	9	0,5	6	0,4	4	0,2
≥ Rp500jt s.d.Rp1M	16	0,9	95	5,7	77	4,7
≥ Rp1M s.d. Rp10M	774	45,4	767	46,0	678	41,0
≥ Rp10M s.d. Rp25M	521	30,5	560	33,6	617	37,3
≥ Rp25M	326	22,6	241	14,4	277	16,8
Total	**1.706**	**100**	**1.669**	**100**	**1.653**	**100**

1.2. Banking Performance

Against the backdrop of a languid global economic recovery, the banking industry in Indonesia performed its intermediation function well despite slower credit growth in the second semester of 2012. A credit expansion strategy oriented towards productive sectors, accompanied by efficiency gains had a favourable impact on bank profitability.

In terms of capital, the banking industry maintained a level of capital well in excess of the minimum threshold with a stronger capital structure. Meanwhile, regarding risk management, the bank risk profile also improved, supported by enhanced credit risk management amid a business environment and macroeconomy marred by the global economic crisis.

Table 1.12 Key Indicators of Commercial Banks

Key Indicator	Dec-10	Dec-11	Dec-12
Total Assets (T Rp)	3,008.85	3,652.83	4,262.59
Deposits (T Rp)	2,338.82	2,784.91	3,225.20
Credit (T Rp)**	1,765.84	2,200.09	2,707.86
CAR (%)	17.17	16.07	17.32
NPL Gross (T Rp)**	2.56	2.17	1.87
NPL Net (T Rp)**	0.26	0.39	0.73
ROA (%)	2.86	3.03	3.08
OER (%)	86.09	85.34	74.15
LDR (%)	75.50	79.00	83.96

* Data covers conventional commercial banks and Islamic banks
** Excluding credit channelling

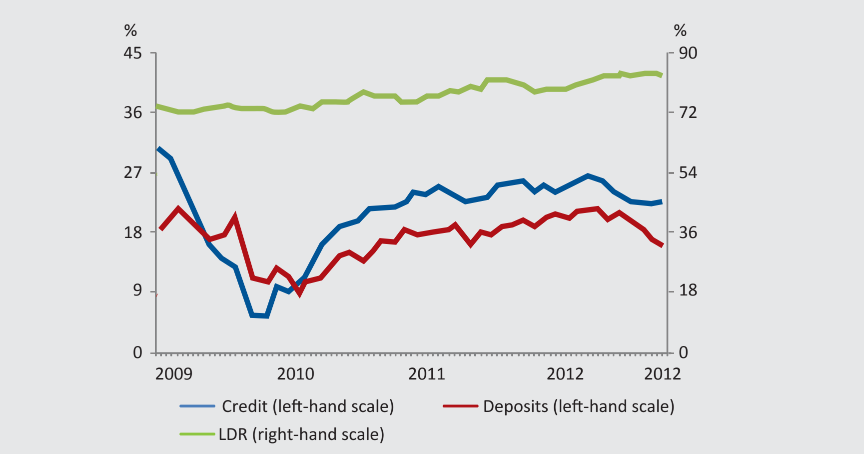
1.2.1. Conventional Commercial Banks

In general, the bank intermediation function continued to improve and was maintained at a level deemed safe for the economy. During 2012, growth in bank credit allocation was 23.08% (yoy), equivalent to Rp507.77 trillion, which is slower than that posted in the previous year at 24.59% or Rp434.25 trillion. The slowdown was driven by, among others, a decrease in consumer loans, especially automotive loans, as well as a decline in domestic corporate performance as a result of persistently widespread uncertainty surrounding global crisis resolution.

Looking ahead, potential credit growth remains high in line with the level of committed and uncommitted undisbursed loans, amounting to Rp267.20 trillion and Rp555.91 trillion. Furthermore, the loan-to-deposit ratio of the banking industry, at 83.96%, is still safe for the national economy and even provides room to expand credit in the future. When compared to other countries in the region, like Malaysia, Singapore, Thailand, Korea and China, the ratio of credit to GDP in Indonesia is much lower. Nevertheless, since 1999 the credit-to-GDP ratio has steadily increased from 20.6% (1999) to around 32% (2012).

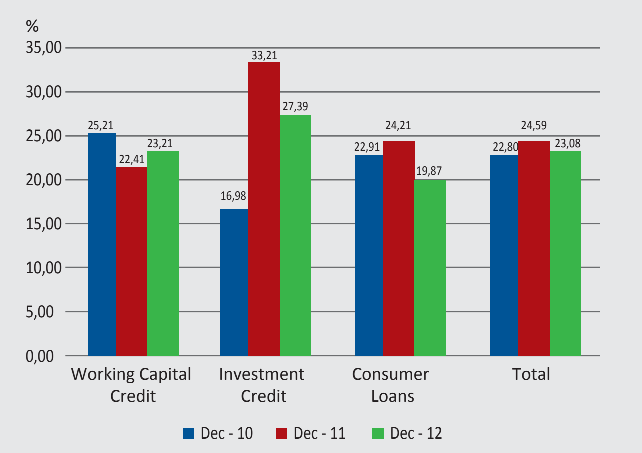
Credit growth in 2012 was dominated by credit allocated to productive sectors, while consumer loans tended to slow. Working capital credit grew by 23.21% (yoy) compared to 21.41% in the year previous. In contrast, investment credit and consumer loans grew respectively by 27.39% (yoy) compared to 33.21% and 19.87% compared to 24.21% in the previous year.

Graph 1.4 Credit in Growth, Deposits and LDR (%)

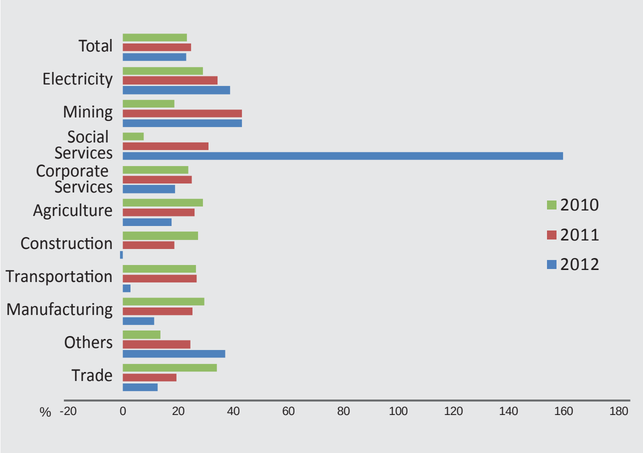


By sector, all productive sectors achieved positive growth compared to 2011. There were a number of economic sectors, however, that experienced a slowdown like mining, social services, others and corporate services. This was primarily due to weaker global demand that led to lower prices for several export commodities from Indonesia. Meanwhile, sluggish growth in consumer loans was due to the introduction of loan-to-value policy as well as mandatory downpayments on automotive loans, which became effective in June 2012.

Graph 1.5 Credit Growth by Type



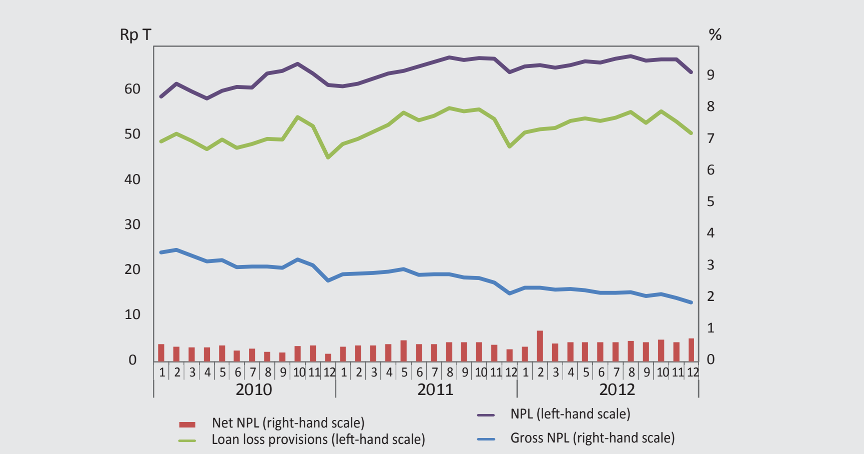
Graph 1.6 Credit Growth by Economic Sector



Bank credit risk was managed well amid robust asset growth bolstered by greater intermediation activity. Although credit growth for the year of 2012 reached 23.08% (yoy), exposure to credit risk tended to ease overall, which was mainly supported by a more selective bank credit allocation process oriented towards productive sectors.

Enhanced due diligence and the application of prudential principles when extending bank credit precipitated a decline in gross non-performing bank loans to just 1.87% (December 2012), which is the lowest level in the history of modern banking in Indonesia. Holistically, risk stemming from credit expansion remains at a level deemed safe, however, threats of rising NPL require vigilance as the nominal NPL level of several sectors, including mining, electricity and construction, are showing indications of growth in excess of that in other sectors despite the low levels.

Graph 1.7 Non-Performing Loans (NPL)



The portion of credit in productive bank assets thrived in 2012 from 64.47% to 70.57%. Shifting the banks' portfolio towards such credit resulted in fewer placements in other productive assets, among others, placements at Bank Indonesia (particularly the deposit facility) and securities (including government bonds – SUN). In this context, in addition to using deposits as a source of financing, banks also began reducing the amount of financial instruments owned, starting with placements at Bank Indonesia (excluding bank checking accounts at Bank Indonesia) in order to expand credit.

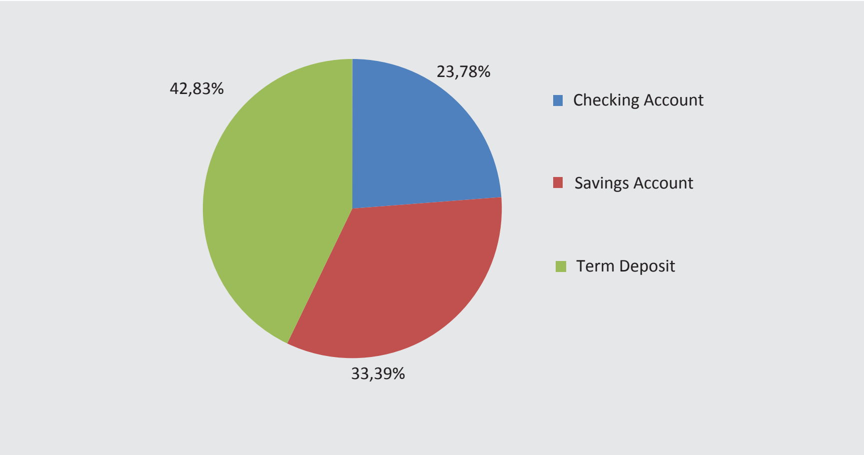
In terms of accumulating funds, the increase in deposits at banks was sufficient to expand credit. The share of deposits as the primary source of bank funds was 91.04%. Meanwhile, interbank-sourced funds and other components of funding were comparatively low at just 3.52% and 5.44% respectively. Based on the type of deposit, term deposits continued to dominate with a share of 42.83% (Rp1,381.3 trillion), followed by savings accounting for 33.39% (Rp1,078.8 trillion) and checking accounts with 23.78% (Rp767.1 trillion). The majority of deposits in the national banking industry are dominated by the deposits held at just 14 large banks with a share of 71.84%.

Of the total deposits amounting to Rp3,225.2 trillion, the majority is owned by individuals with a share of 56.98%, followed by other private companies. Meanwhile, the strongest annual growth was reported for non-residents, namely the central government (46.97%) and private others (31.61%). As a whole, the government has shown the most persistent trend, while 'private' also experienced an uptrend despite a moderate decline in 2012.

Regarding capital, as of December 2012 total capital of commercial banks was Rp510.50 trillion with an average capital adequacy ratio (CAR) of 17.63% for the reporting year (up from 17.16% in the year before). Rp105.80 trillion in supplementary capital at private national and state-owned banks caused the increase, among others. Based on structure, total capital of commercial banks from equity/core capital (Tier 1) was Rp444.54 trillion or 89.51%, followed by Tier 2 capital with Rp52.08 trillion or 10.49% of total bank capital.

A capital structure with a stronger component of core capital is a good indicator of greater bank resilience in terms of absorbing potential risk stemming from the banks' business activities or changes in the business

Graph 1.8 Share of Deposit Components in 2012

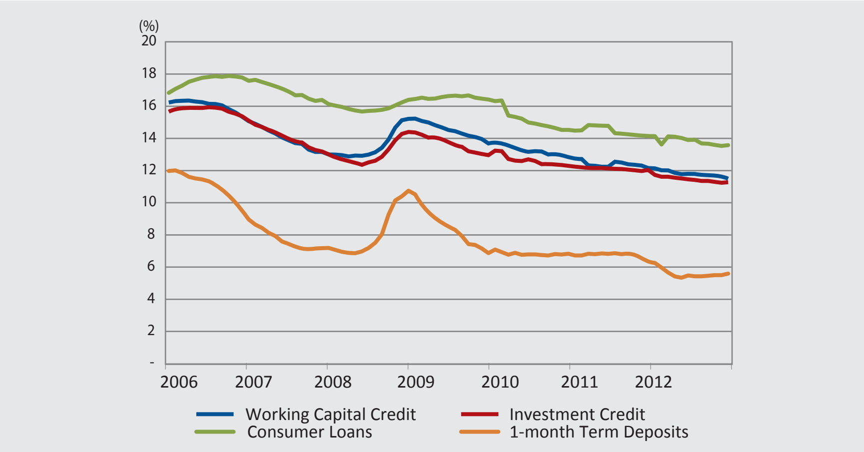


environment. The high level of capital at banks is inextricably linked to Bank Indonesia policy to strengthen bank resilience through aspects of capital. In addition to reinforcing capital, Bank Indonesia also encourages the national banking industry to meet international standards according to Basel in order to buttress bank resilience in the context of overall financial system stability.

Referring to profitability, credit disbursement by banks contributed positively to an increase in profit, particularly operating profit. In 2012, banks booked net profits of Rp92.83 trillion, representing an increase of 23.65% on the previous year at Rp75.08 trillion. The share of interest income from credit reached 51.76% of total bank interest income, followed by operating income excluding interest at 23.30% (primarily dividends, equity method investment gains, commissions/provisions/fees and spot/derivative income).

Amidst the gains in profit, the Net Interest Margin (NIM) narrowed from 5.91% to 5.49%. Despite falling lending rates, the rapid surge in credit volume allocated led to an increase in average Net Interest Income (NII) from Rp14.89 trillion (December 2011) to Rp17.29 trillion. Lending rates dropped in 2012 by an average of 68 bps to 12.06% compared to the previous year. Lower lending rates were partially the result of policy to transparently announce prime lending rates that became effective in March 2011.

Graph 1.9 Average Rupiah Lending and Deposit Rates at Commercial Banks



Average lending rates and deposit rates tended to decline, which reflects the banks' response to policy and appeals from Bank Indonesia to lower bank rates. In 2012, the average 1-month rupiah deposit rate declined by 115 bps to 5.59%. Congruously, rupiah lending rates also declined on all credit types. The average working capital loan rate dropped 60 bps to 11.50%, the investment credit lending rate dropped 66 bps to 11.28% and consumer loan rates by 64 bps to 13.58%.

1.2.2. Islamic Banking

Pursuant to Act no. 21, 2008, Islamic banks are involved with an intermediation function and a social function. The intermediation function covers the accumulation and allocation of the public's funds in order to support national development. The social function is conducted in the form of a treasury institution that receives funds from zakat, donations, alms and grants or other social funds (waqf) and redistributes them through related management organisations.

In 2012, the assets of Islamic banks (BUS and UUS) flourished from Rp145.47 trillion to Rp195.01 trillion, which is an increase of 34.06%. The expanding share enjoyed by Islamic banks in the national banking industry drove asset growth at Islamic banks. In 2012, the share of Islamic banks was 4.61% of the national banking industry compared to 4.02% in the preceding year (up 0.59%).

Asset growth of 34.06% in 2012 was lower than that posted in the previous year at 49.17%, among others, influenced by slower growth in deposits. Nonetheless, the impact of slower deposit growth was offset by additional working capital at Islamic business units (UUS) from their corresponding parent banks in the form of interoffice funds. In 2012, interoffice funds at Islamic business units (UUS) experienced a 97.19% increase from Rp7.11 trillion to Rp14.02 trillion.

Table 1.13 Key Indicators for Islamic Banks and Islamic Business Units

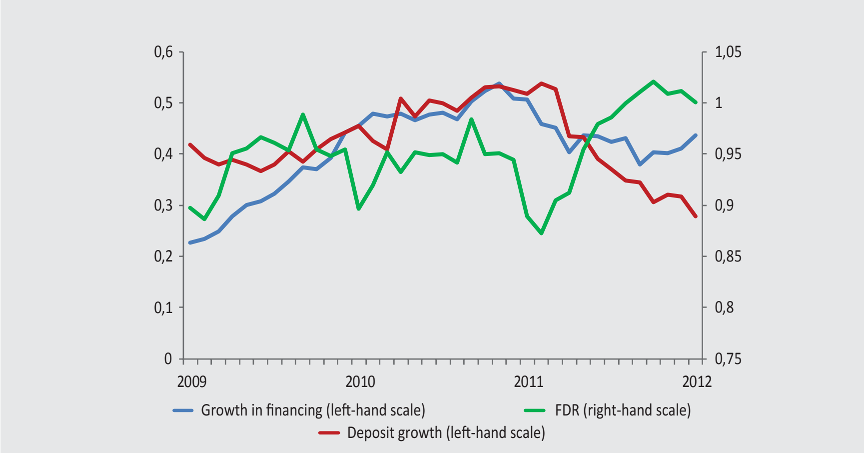
Key Indicator	2010	2011	2012
Total Assets (Rp T)	97,52	145,47	195,01
Deposits (T Rp)	76,03	115,41	147,51
iB Financing (T Rp)	68,18	102,65	147,50
CAR (%)*	16,25	16,63	14,14
NPF Gross (%)	3,02	2,52	2,22
NPF Net (%)	1,6	1,34	1,34
ROA (%)	1,67	1,79	2,14
OER (%)	86,14	85,42	82,51
FDR (%)	89,67	88,94	99,99

Islamic Banks (BUS) and Islamic Business Units (UUS)

Deposits at BUS and UUS in 2012 grew from Rp115.41 trillion to Rp147.51 trillion, or Rp32.10 trillion (27.81%), compared to much higher growth reported in the previous year at 51.80%. The slowdown in deposit growth at Islamic banks (BUS and UUS) was primarily due to lower returns in line with the reduction in deposit rates. The average return (equivalent rate) of deposits (cost of deposits to average deposits) in 2011 was 5.06%, falling to 4.60% in 2012, while the return (equivalent rate) of term deposits in 2011 averaged 7.40% and only 6.40% in 2012. In addition, withdrawals amounting to Rp44.85 trillion on the Haj Fund by the Ministry of Religious Affairs also affected the level of deposits in the Islamic banking industry.

Although deposit growth in 2012 was lower than that in the previous year, Islamic banking financing (BUS and UUS) grew robustly in 2012 by Rp44.85 trillion (43.69%) from Rp102.65 trillion to Rp147.50 trillion. The funding for financing growth originated from additional deposits, liquidity utilisation (Islamic Bank Indonesia Certificates, SBIS and the Bank Indonesia Islamic Deposit Facility – FASBIS) as well as supplementary funds from parent banks to Islamic business units in the form of interoffice funds.

Graph 1.10 Growth in Financing, Deposits and FDR at BUS and UUS

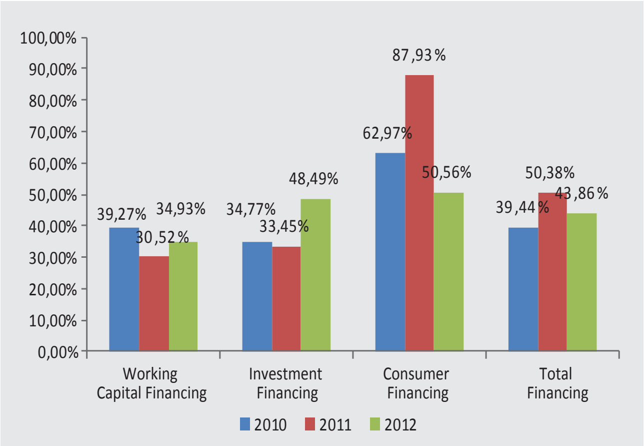


The composition of financing in productive bank assets in 2012 increased with a share of 78.25%, which is larger than the share in 2011 at 72.84%. Other components of productive assets, like placements at other banks and securities (including Islamic tradeable government securities), also experienced a modest increase, while placements at Bank Indonesia decreased.

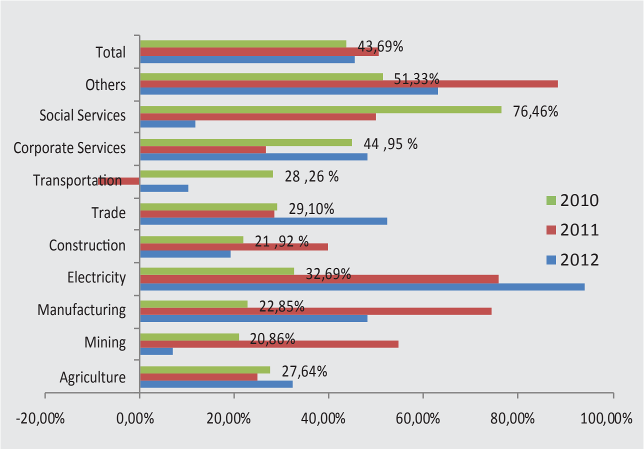
Productive financing, namely working capital financing and investment financing, remained dominant in the reporting year. Islamic banking policy geared towards the development of productive sectors demonstrated impressive results through increases in working capital financing and investment financing in 2012. Working capital financing grew by 34.93% compared to 33.45% in 2011, while investment financing achieved 48.49% growth compared to 33.45% in 2011. Finally, consumer financing grew by 43.86%, the majority of which was used to finance mortgage loans and automotive loans.

Based on economic sector, all economic sectors experienced positive growth in financing during 2012. The highest growth was reported for the social services sector (76.46%), followed by others (51.33%) and corporate services (44.95%). Nominally, most growth in financing was to the others sector, followed by corporate services and social services. In addition, the electricity sector, trade, agricultural, manufacturing, construction and mining sectors all experienced positive growth in financing compared to the previous year.

Graph 1.11 BUS and UUS Financing Growth by Type



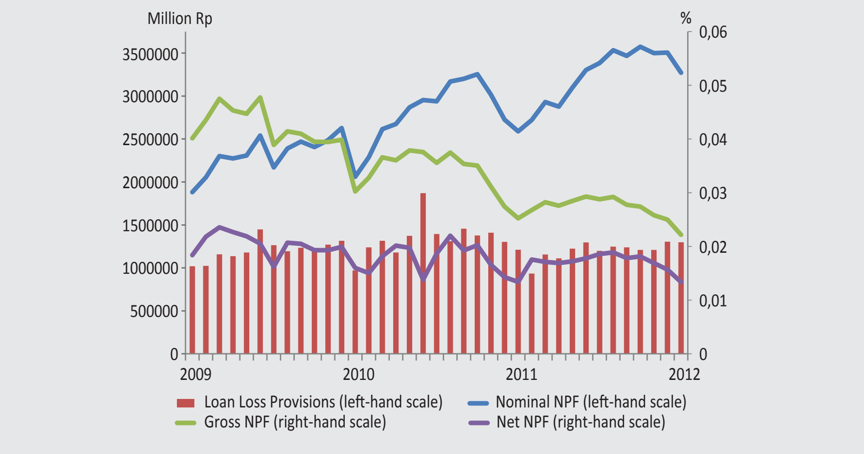
Graph 1.12 BUS and UUS Financing Growth by Economic Sector



Based on type of agreement, Murabahah continued to dominate the financing allocated by BUS and UUS, accounting for 59.66%. In 2012, the portion of Murabahah financing expanded. Conversely, profit sharing financing experienced a decline, albeit insignificant. The growth in Murabahah financing was fuelled by growth in consumer financing, particularly for automotive loans through a channelling scheme in conjunction with multifinance companies. This is the result of introducing a financing-to-value (FTV) ratio as well as downpayments for conventional banks that Islamic banks were not subject to. The average return on profit sharing financing decreased moderately compared to the previous year. In 2012, the average return on Murabahah based financing was 13.96%, down from 14.48% in the previous year. Likewise, the average return on profit sharing financing decreased in 2012 to 14.17% from 14.84% in 2011.

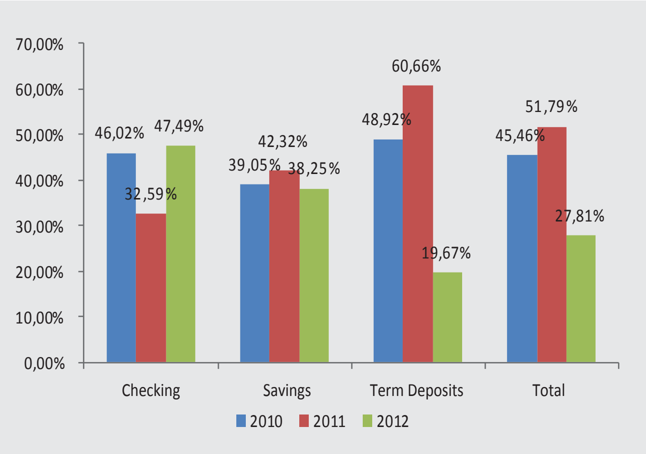
Non-performing financing at Islamic banks tended to ease. The amount of non-performing financing increased from quarter I 2012 until quarter III 2012 but subsequently declined in the final quarter. This trend is congruent with bank restructuring as well as write-offs. At yearend 2012, the ratio of gross non-performing financing (NPF) at Islamic banks was 2.22% (the lowest in ten years) due to improvements in the quality of financing followed by robust financing growth at Islamic banks.

Graph 1.13 Growth in BUS and UUS Non-Performing Financing

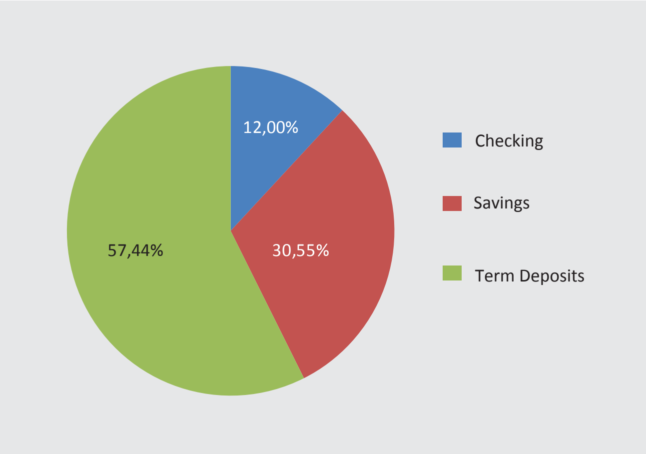


Based on the composition of deposits, term deposits continued to dominate with a share totalling Rp84.73 trillion (57.44%), followed by savings with Rp45.07 trillion (30.55%) and checking accounts with Rp17.72 trillion (12.01%). Nevertheless, growth in term deposits was considerably lower than that in the previous year, namely 19.67% compared to 60.66%. Conversely, the most robust growth affected checking accounts with 47.49%, followed by savings with 38.25%. This is in line with efforts undertaken by Islamic banks to reduce their dependence on expensive funds.

Graph 1.14 Composition of Deposits



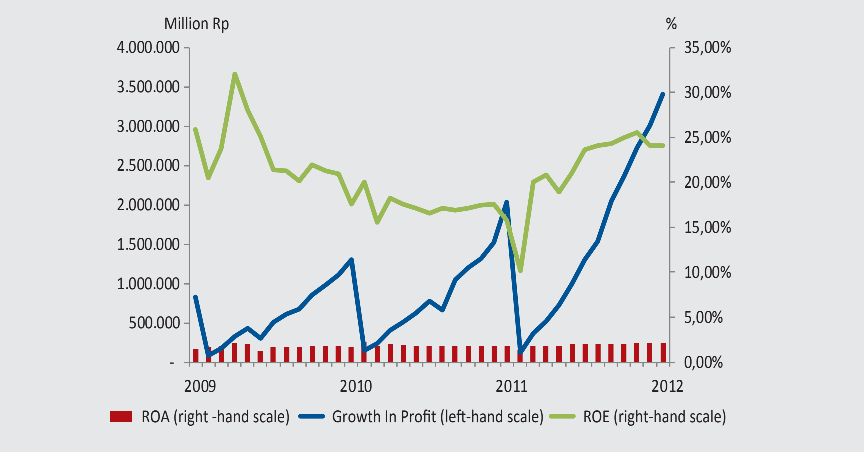
Graph 1.15 Composition of Deposits in 2012



The capital of Islamic banks (CAR) decreased in 2012 from 16.63% in December 2011 to 14.14% at yearend 2012. The decline was due to the increase in risk-weighted assets in line with financing expansion by Islamic banks. Based on structure, Tier 1 capital continued to dominate the capital of Islamic banks, amounting to Rp11.24 trillion or 81.08% of the total, while Tier 2 capital accounted for Rp2.67 trillion or 19.27%.

In terms of profitability, the operating income of Islamic banks (BUS and UUS) in 2012 increased significantly. Operating income was noted at Rp16.85 trillion, which represents an annual increase of 35.27% (yoy). The increase in operating income was driven by significant growth in productive assets as well as more revenue derived from fee-based income.

Graph 1.16 Profitability of Islamic Banks



In 2012, the profit of BUS and UUS grew by 67.33% to Rp3.41 trillion. Regarding the rate of return on assets, the increase in profit precipitated growth in the return on assets (ROA) from 1.79% (2011) to 2.14% (2012). Meanwhile, concerning the rate of return on investment, the rise in profit was accompanied by a corresponding increase in the return on equity (ROE) from 15.73% to 24.06%.

Islamic Rural Banks

The performance of Islamic rural banks during the reporting year indicated satisfactory conditions. Financial indicators demonstrated positive growth, with growth in 2012 outpacing that recorded in 2011. Total assets of Islamic rural banks increased by 33.47% from Rp3.50 trillion (2011) to Rp4.70 trillion (2012). In addition, deposits achieved growth of 40.19%. In 2012, Islamic rural banks maintained a competitive level of profit sharing, thereby bolstering the loyalty of existing customers and attracting new customers. Furthermore, the relatively competitive margin on Murabahah financing helped financing at Islamic rural banks to grow solidly.

Table 1.14 Key Indicators of Islamic Rural Banks

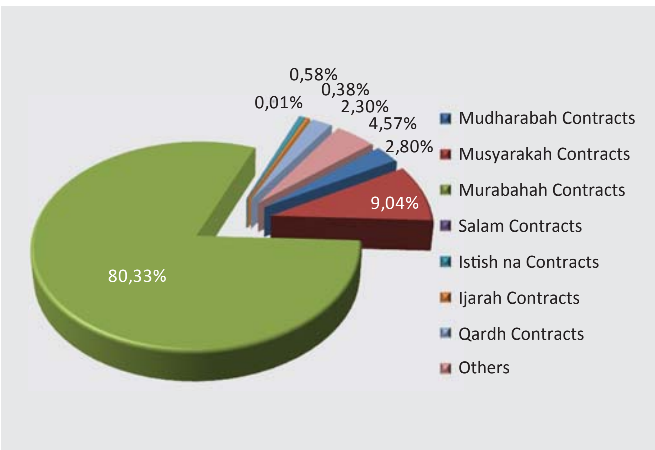
Indikator Utama	2010	2011	2012
Total Assets (Rp T)	2,73	3,50	4,70
Deposits (T Rp)	1,60	2,09	2,93
iB Financing (T Rp)	2,06	2,67	3,56
CAR (%)	27,50	23,50	25,16
NPFs Gross (%)	6,50	6,11	6,15
NPFs Net (%)	5,12	5,14	5,00
ROA (%)	3,50	2,70	2,64
OER (%)	78,10	76,30	86,25
FDR (%)	128,47	127,71	120,96

In terms of allocating funds, Islamic rural banks achieved 33.33% financing growth in 2012, hence the Financing-to-Deposit ratio (FDR) remained high at 120.96%. The high level of FDR was due to business expansion by Islamic rural banks to new financing segments as well as financing expansion funded by loans from Islamic banks (liabilities at executing bank). Financing based on sale as well as financing based on profit sharing were still the favoured transactions of Islamic rural banks. The composition of financing based on Murabahah remained dominant with 80.33%. Meanwhile, Musyarakah and Mudharabah continued to dominate financing based on profit sharing with 9.04% and 2.80% respectively. In addition, multipurpose financing performed well with a 4.57% share. This shows that Islamic rural banks are earning the trust of the general public to fund their needs for services like health, education and religion.

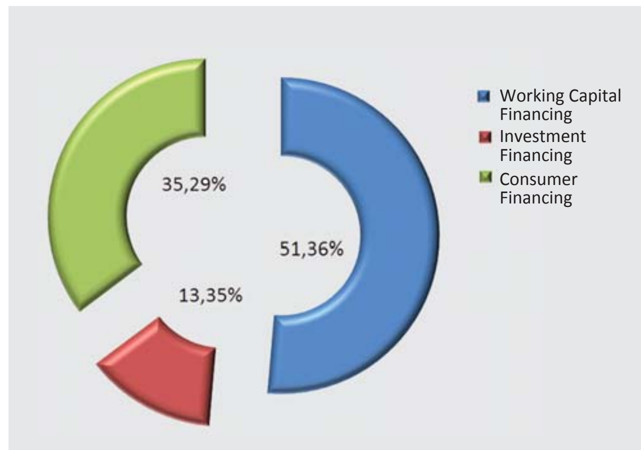
Islamic rural bank financing remains focused on productive financing. Working capital financing continued to dominate Islamic rural bank financing with share of 51.36% in 2012, followed by consumer financing accounting for 35.29% and investment financing with 13.35%. Based upon economic sector, most financing growth was contributed by the mining sector with 217.7% and social services with 147.19%.

Growth in financing was accompanied by an improvement in the net non-performing financing (NPF) ratio from 5.14% (2011) to 5.00% (2012). Notwithstanding, nominal NPF increased in harmony with the current increase in business competition. From an income perspective, in 2012 the operating income of Islamic rural banks increased by 29.00% to Rp271.79 billion, however, operating costs also increased fairly significantly by 42.12% to Rp126 billion in 2012. Consequently, growth in profit was 24.71%, increasing from Rp101.66 billion (2011) to Rp126.78 billion (2012).

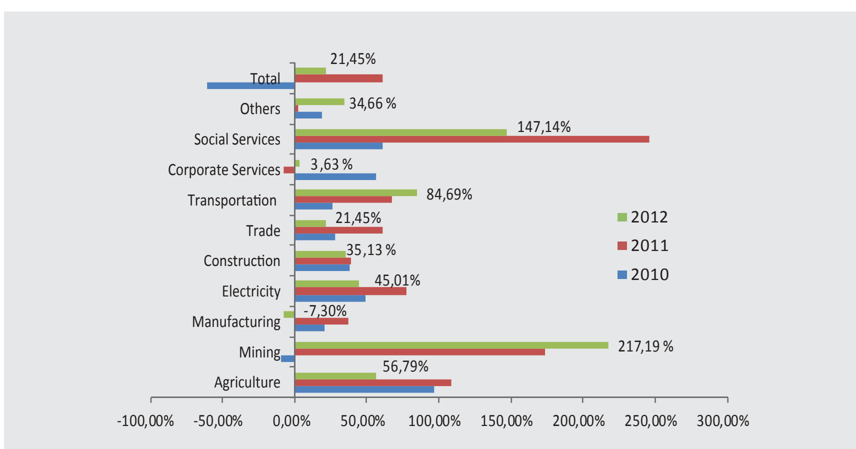
Graph 1.17 Composition of Islamic Rural Bank Financing



Graph 1.18 Composition of Islamic Rural Bank Financing by Type



Graph 1.19 Financing Growth by Economic Sector



1.2.3. Banking Performance based on Business Activity Group (BUKU)

In December 2012, Bank Indonesia issued regulations concerning business activity and office network based on the core capital of the bank[3] in order to boost the resilience and competitiveness of the national banking industry. According to the regulations, commercial banks are categorised into four business groups known as BUKU (Bank Umum Kelompok Usaha or Commercial Bank Business Groups). BUKU 1 is for banks with the lowest core capital as well as the most limited product coverage and business activity. In contrast BUKU 4 is reserved for banks with the largest core capital as well as the broadest product coverage and business activity.

3) For more details on the Bank Indonesia regulation concerning business activity and office network based on core capital refer to Box 2.3.

Based on the BUKU categories and using data for the position in December 2012, in general all four groups performed satisfactorily. There is evidence that increasingly complex product coverage and business activity lead to increasingly positive key indicators. Although only comprising of five large banks, the role of BUKU 4 banks is relatively significant with a share of total assets amounting to 45.2% of total bank assets. From an intermediation standpoint, the four BUKU groups demonstrated a sufficiently high level of LDR in the range of 78.26% for BUKU 4 to 84.58% for BUKU 1. However, the majority of credit allocated (43.7%) and deposits accumulated (46.9%) by banks stems from loans from banks in BUKU 4. The progress of intermediation in the four BUKU groups is offset by adherence to prudential principles, as reflected by the low gross NPL ratio of all four groups. The highest level of non-performing loans was just 2.25% for BUKU 1.

The table of key indicators shows that increasingly complex product coverage and business activity leads to greater profit. The level of profitability, as reflected by ROA, tends to be higher in BUKU groups with a higher level of core capital. This is further supported by a controlled level of efficiency. The lowest BOPO efficiency ratio (68.31%) was found for BUKU 4. In terms of capital, all four BUKU groups maintained a relatively balanced level of capital at around 17%, which is close to the CAR level for the banking industry (17.32%).

Table 1.15 Key Indicators for Commercial Banks based on BUKU*

Indikator Utama	BUKU 1	BUKU 2	BUKU 3	BUKU 4
Total Assets (T Rp)	221.84	844.89	1,270.81	1,925.04
DPK (T Rp)	172.56	607.80	933.68	1,511.15
Credit (T Rp)	145.95	544.62	834.66	1,182.63
CAR (%)	17.71	17.35	17.02	17.46
NPL Gross (%)	2.25	2.11	1.99	1.85
ROA (%)	2.23	2.34	2.65	3.80
OER (%)	81.94	80.24	78.05	68.31
LDR (%)	84.58	89.60	89.39	78.26

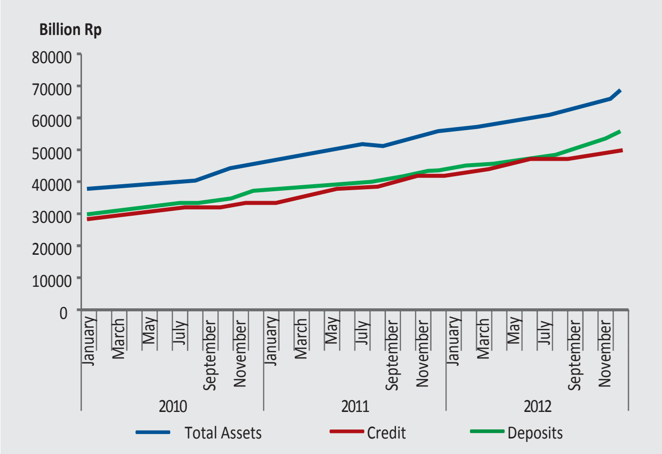
*) Data covers conventional commercial banks and Islamic banks

1.2.4. Rural Banks

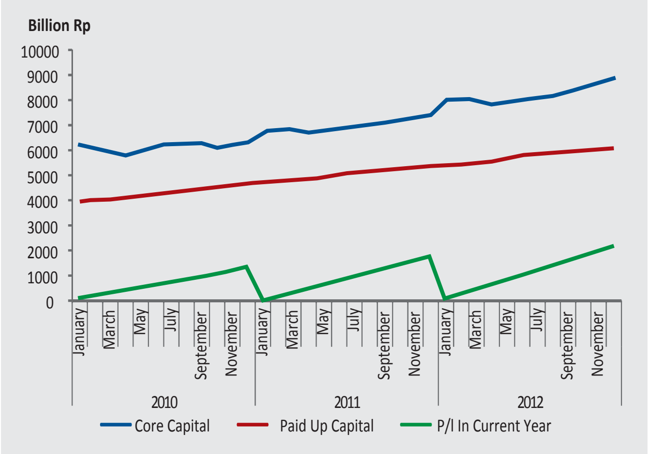
The rural banking industry achieved positive growth amidst flourishing competition. The growth in microfinance agents did not significantly affect the performance of the rural banking industry. In 2012, the rural banking industry grow normally with assets increasing by 20.78% from Rp55.80 trillion to Rp67.40 trillion, credit increasing by 21.21% from Rp41.10 trillion to Rp49.82 trillion and deposits increasing by 17.43% from Rp38.21 trillion to Rp44.87 trillion. Consequently, the loan-to-deposit ratio in December 2012 was 78.63%.

Efforts are required to strengthen the capital of rural banks in order to support further rural banking development looking ahead. Efforts to raise the capital of rural banks, which have been undertaken gradually since 2006, required rural banks to supplement their paid up capital according to the location of the specific bank. As a result, paid up capital increased by 12.87% from Rp5.51 trillion to Rp6.27 trillion in 2012, which led to an 18.10% increase in core capital from Rp8.87 trillion to Rp10.43 trillion in 2012. The growth in capital at rural banks principally stemmed from profit, which soared by 25.68% to Rp475.75 billion. A stronger capital position helped prop up the competitiveness of rural banks, especially in terms of extending financing to the micro and small sector.

Graph 1.20 Performance of Assets, Credit and Deposits

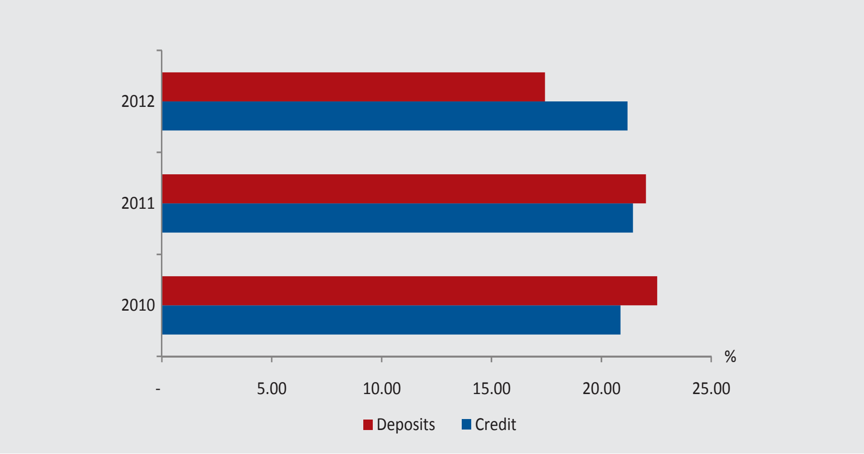


Graph 1.21 Performance of Capital and Profit



The allocation of credit by rural banks primarily focused on micro, small and medium enterprises (MSMEs) as the main market for rural banks. This is reflected by the credit portfolio of rural banks, which is dominated by that extended to MSMEs accounting for 48.10% of total credit. The definition of MSME is in accordance with that stipulated in Act no. 20, 2008, concerning Micro, Small and Medium Enterprises.

Graph 1.22 Growth in Credit and Deposits in 2012



In line with efforts to expand the role played by rural banks in microfinance, the majority of credit allocated by rural banks is used to finance productive sectors in the form of working capital credit. The share of working capital credit reached Rp23.03 trillion (46.23%), followed by consumer loans totalling Rp23.824 trillion (47.82%) and investment credit with Rp2.96 trillion (5.95%). Meanwhile, based on the scale of the business financed, a large part of rural bank credit was apportioned to MSMEs, totalling Rp23.80 trillion, which is 48.10% of total credit at Rp49.82 trillion.

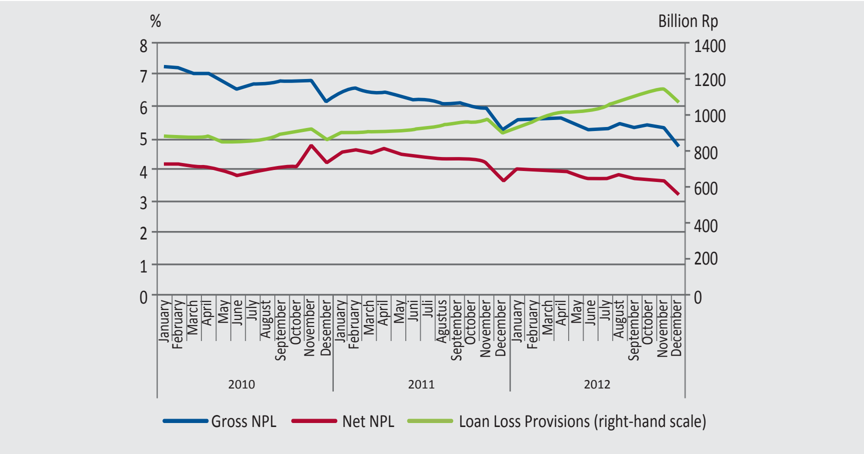
Table 1.16 Credit based on Business Type and Utilisation

Credit Type	Position (miliar Rp)			Growth (%)		Share (%)			NPL (%)		
	2010	2011	2012	2011	2012	2010	2011	2012	2010	2011	2012
By business type*	**33.844**	**41.100**	**49.819**	**21,44**	**21,22**	**100**	**100**	**100**	**6,10**	**5,22**	**4,75**
a. Micro	12.668	14.292	15.551	12,82	8,81	37,43	34,77	31,21	8,61	8,03	7,61
b. Small	3.669	3.795	4.838	3,45	27,48	10,84	9,23	9,71	6,08	5,86	5,70
c. Medium	1.313	2.421	3.408	84,45	40,74	3,88	5,89	6,84	7,20	3,86	4,03
d. Non-MSM	16.195	20.591	26.022	27,14	26,38	47,85	50,10	52,23	4,09	3,32	2,96
By credit type	**33.844**	**41.100**	**49.818**	**21,44**	**21,21**	**100**	**100**	**100**	**6,10**	**6,10**	**4,75**
a. Working capital	16.790	19.557	23.030	16,48	17,76	49,61	47,59	46,23	8,40	7,54	6,69
b. Investment	1.929	2.364	2.964	22,56	25,40	5,70	5,75	5,95	5,06	4,17	4,65
c. Consumption	15.126	19.178	23.824	26,79	24,22	44,69	46,66	47,82	3,71	2,99	2,63

*) For 2010 and 2011 data, the criteria for credit based on business type is in accordance with the MSME criteria stipulated in Act no. 20, 2008, concerning MSMEs.

For the past two years, rural banks have optimally enhanced the quality of their credit. This achievement is based upon a decline in gross NPL of rural banks from 5.22% (2011) to 4.75% (2012). That level of gross NPL is the lowest for the past decade. Low NPL eases the burden of reserves that must be maintained by rural banks, thereby allowing rural banks to concentrate on credit expansion.

Graph 1.23 Performance of NPL and Loan Loss Provisions



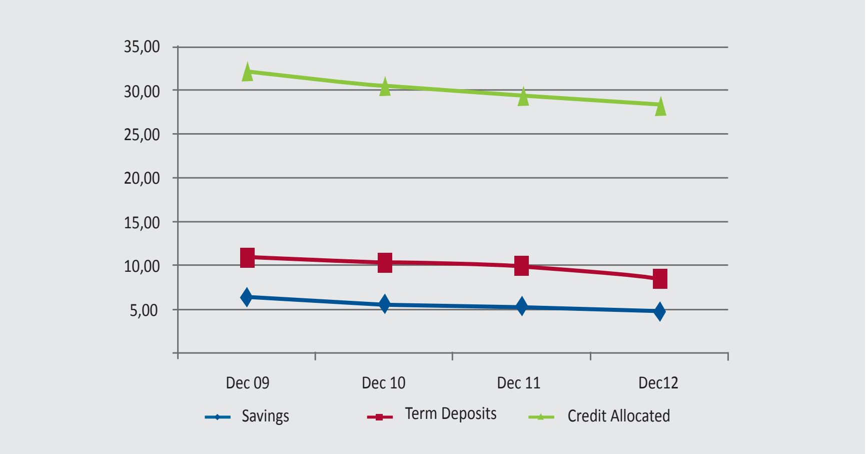
In general, the performance of rural banks tended to improve as evidenced by a number of key indicators. The intermediation function was slightly volatile but remained sound. Assets, credit and deposits all increased. In addition to NPL, the profitability of the rural banking industry also improved, denoted by an increase in ROA from 3.32% (2011) to 3.46% (2012) as well as an impressive 25.68% rise in profit, from Rp1.85 trillion (2011) to Rp2.33 trillion 2012). Gains were also accomplished in terms of efficiency with the BOPO efficiency ratio declining gradually.

Table 1.17 Key Indicators of Rural Banks

Indikator Utama	Des-09	Des-10	Des-11	Des-12
Total Assets (T Rp)	37,55	45,74	55,80	67,40
DPK (T Rp)	25,55	31,31	38,21	44,87
Credit (T Rp)	28,00	33,84	41,10	49,82
CAR (%)	24,17	30,01	28,68	27,55
NPLs Gross (%)	6,90	6,12	5,22	4,75
NPLs Net (%)	3,97	4,25	3,67	3,25
ROA (%)	3,09	3,16	3,32	3,46
LDR (%)	72,90	75,50	79,00	78,63
OER (%)	81,82	80,97	79,47	77,77

Average interest rates at rural banks declined during the reporting year. In 2012, average interest rates were 29.48% (credit), 5.12% (savings) and 9.85% (term deposits). However, such rates are comparatively higher than those offered by commercial banks, which is due to high transaction costs, like marketing costs, as well as tight credit monitoring because of the high number of borrowers and relatively low credit ceiling. Other factors driving high lending rates at rural banks include a high cost of funds and large overheads.

Graph 1.24 Interest Rates at Rural Banks



Box 1.1 Loan-to-Value (LTV) Policy for Mortgages and Automotive Loans

Addressing the persistently strong demand for mortgage loans and automotive loans, Bank Indonesia contends the need to raise prudence in the allocation of such loans. Growth in mortgages, on top of potential risk for the banks, also raises property asset prices that do not accurately reflect true prices, thereby exacerbating credit risk for banks largely exposed to property credit. On the other hand, lenient credit requirements as well as tight competition that led to small, less prudent, downpayments caused excessive growth in automotive loans.

Bank Indonesia uses a countercyclical approach, namely by tightening regulations when credit growth is strong in order to maintain a productive economy and confront future challenges in the financial sector. In this context, regulations were issued in the form of Bank Indonesia Circular (SE) No. 14/10/DPNP, dated 15th March 2012 concerning the application of risk management at banks engaged in allocating mortgage loans and automotive loans. The circular specifies the maximum loan to value (LTV) for mortgages and the minimum downpayment (DP) for automotive loans.

The LTV regulation governs the value of credit that can be extended by a bank in terms of the value of collateral when the loan is disbursed, which is set at 70%. The scope of mortgage loans includes consumer loans for the purchase of a house, including residential flats and apartments but not home offices or home stores, larger than 70m2 (seventy square meters). The regulation is not applicable to mortgages approved through a government housing scheme.

Downpayments on automotive loans are classified as follows: (i) a minimum downpayment of 25% for two-wheeled vehicles; (ii) a minimum downpayment of 30% for four-wheeled vehicles; and (iii) a minimum downpayment of 20% for commercial vehicles of four wheels or more. The definition of a commercial vehicle pursuant to the Bank Indonesia Circular must meet one of the following criteria: (a) a transportation vehicle for people or goods licensed by the relevant authority; or (b) submitted by an individual or legal entity licensed by the relevant authority and used to support the operational activity of the corresponding business.

A lower level of downpayment was imposed for commercial vehicles to favour borrowers who officially use their vehicle for commercial purposes but the regulation still adheres to prudential aspects. LTV and DP policy is based on the value of collateral. The level of LTV for mortgage loans and downpayments for automotive loans will be adjusted from time to time according to prevailing economic conditions.

Mortgage type: Houses of 22m2 to 70m2; Houses >70m2; Houses <21m2, Home office; Home store; Flat/apartment of 22m2 to 70m2; Flat/apartment >70m2; Flat/apartment <21m2; Average growth rate

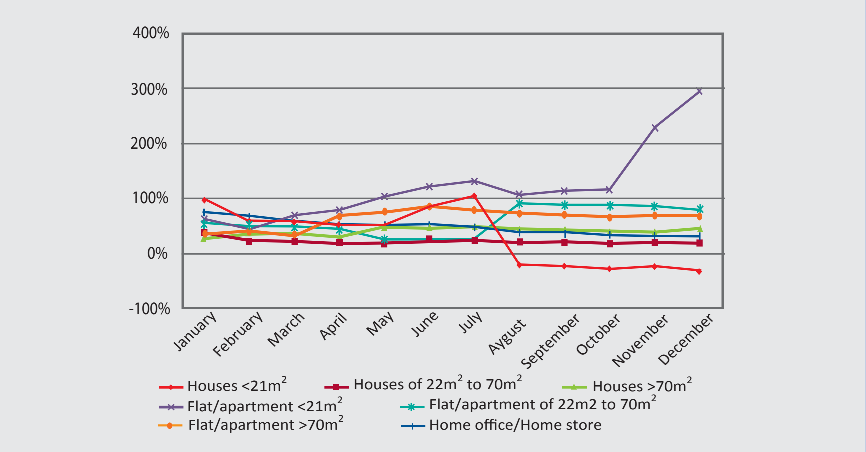
When the loan-to-value regulation was introduced, growth in mortgage loans of houses larger than 70m2 decelerated from 49% (June 2012 yoy) to 39% (November 2012 yoy). Notwithstanding, mortgage growth quickly rebounded at the end of 2012 to 47.2% (yoy) compared to just 27% at yearend 2011. This trend in mortgage growth is in line with the annual cycle of such loans, which tend to spike at the end of

Table 1.18 Growth in Mortgages by Type

Mortgage Type:	Share as of December 2011	Annual Growth (yoy)				
		Dec'11	Mar'12	Jun'12	Sep'12	Dec'12
Houses of 22m2 to 70m2	41%	23%	23%	25%	20%	19%
Houses >70m2	38%	27%	38%	49%	42%	47%
Houses <21m2	9%	57%	58%	86%	-23%	-32%
Home office/Home store	8%	83%	60%	52%	38%	31%
Flat/apartment of 22m2 to 70m2	2%	60%	49%	25%	89%	80%
Flat/apartment >70m2	2%	35%	32%	87%	72%	68%
Flat/apartment <21m2	0,38%	56%	70%	122%	116%	295%
Average growth rate		33%	35%	43%	25%	22%

the year, as reflected by an increase in the number of borrowers and a larger loan size that is influenced by rising land prices and the cost of building materials. In addition, the hike is also attributable to the strategy of several banks to achieve their respective targets after the introduction of LTV policy, among others, by shifting target borrowers away from the small-medium segment towards prime customers seeking mortgages for luxury houses that are not particularly constrained by the size of downpayment.

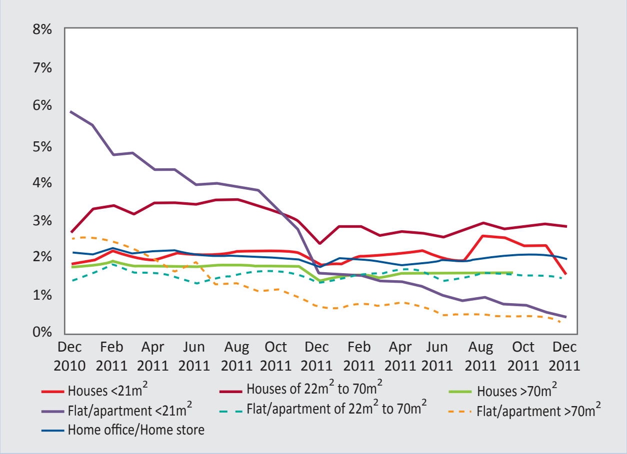
Graph 1.25 Mortgage Growth in 2012



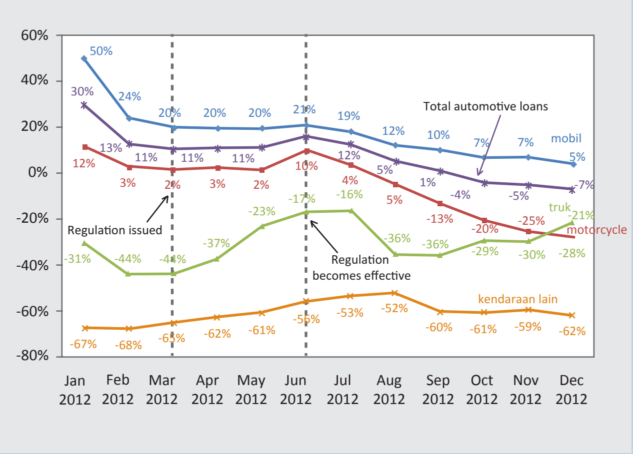
On the other hand, aggregate NPL of mortgages for houses larger than 70m2 is 1.5% (2012), while NPL for flats and apartments decreased to just 0.2% (2012) from around 0.8% previously (2011).

Growth in automotive loans in December 2012 amounted to Rp98.04 trillion, dominated by loans for four-wheeled vehicles (72.5%) and two-wheeled vehicles (26.9%). In 2012, growth in automotive loans tended to slow. After the introduction of DP policy, growth in automotive loans slowed even more to just 7.2% (yoy) in December 2012. The significant deceleration in automotive loan growth affected loans for both two and four-wheeled motor vehicles. Respectively, growth in loans for four-wheeled vehicles slowed from 21% (June 2012, yoy) to 5% (December 2012, yoy), and growth in loans for two-wheeled vehicles slowed from 10% (June 2012, yoy) to -28% (December 2012, yoy).

Graph 1.26 NPL of Mortgage Loans

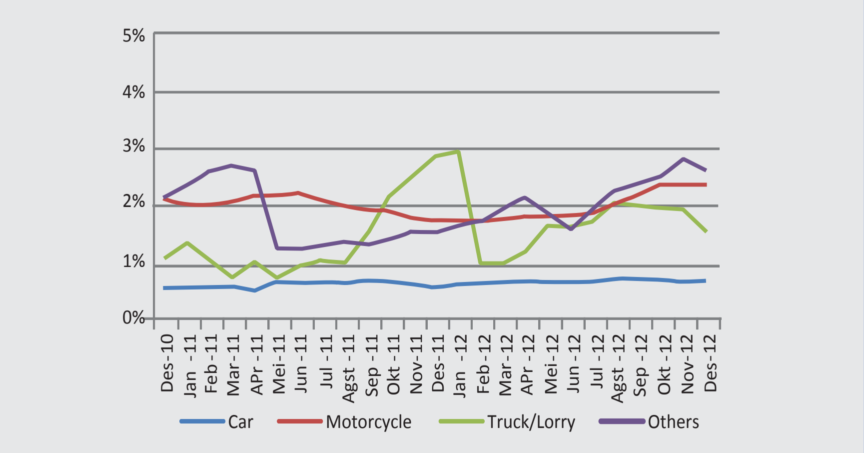


Graph 1.27 Growth in Automotive Bank Loans (yoy)



The NPL ratio for automotive loans was 1.09% in December 2012 (down slightly on previous months). The lower NPL ratio for automotive loans was contributed primarily by the decrease in NPL for trucks/lorries and other vehicles.

Graph 1.28 Non-Performing Automotive Loans



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Chapter II
Banking Policy and Regulation in 2012

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2.1 Direction of Banking Policy

The banking policy adopted by Bank Indonesia in 2012 was directed to strike an optimal balance between boosting competitiveness and strengthening resilience, while concomitantly promoting bank intermediation, including expanding public access to low-cost banking services. Consequently, the general policy direction of Bank Indonesia is as follows:

2.1.1. Conventional Commercial Banks

In 2012, Bank Indonesia set policy direction that can be grouped according to three pillars as follows:

1. **Policy to boost bank competitiveness and maintain financial system stability.** In order to enhance bank competitiveness, the policy to publish prime lending rates will be continued to ensure market mechanisms operate smoothly and policy targets are achieved. As a banking supervision follow-up measure, regulatory enforcement will be achieved by requiring the Bank Business Plan (BBP) to contain targets for efficiency as well as to lower lending rates to normal levels. Bank Indonesia also reviewed the practice of offering deposit rates above the level set by the Deposit Insurance Corporation (DIC), and reviewed limiting the gifts offered to bank customers. Additionally, in terms of financial system stability, Bank Indonesia will continue enforcing LTV policy for mortgage loans and downpayments on automotive loans.
2. **Policy to strengthen bank resilience.** Policy to reinforce bank resilience is instituted by raising bank capital in order to support future economic growth and anticipate changes in the business cycle. Through this policy banks will be better prepared to anticipate a variety of risks thanks to the protection of sufficient capital. Furthermore, Bank Indonesia will continue policy to refine aspects of (prospective) consumer protection. Moreover, in order to improve the quality of bank governance, Bank Indonesia will amend regulations to ensure transparent financial reporting, in particular for condensed financial statements, as well as regulate the public accountants employed by banks. Bank Indonesia will also review ownership policy at banks and multi-license policy in line with the increasing complexity of the banks' business activity.
3. **Policy to promote the bank intermediation function.** Bank Indonesia will continue efforts to advocate financial inclusion, particularly low-cost banking services in rural areas, including ameliorating the quality of the existing TabunganKu (MySavings) program, developing financial education, implementing Financial Identity Numbers and conducting a financial literacy survey. In addition, Bank Indonesia will facilitate intermediation in order to buttress the allocation of financing to various potential sectors in conjunction with a range of relevant institutions. Research will also focus on the constraints to financing in sectors suffering relatively low levels of credit growth. Thereinafter, regarding the financing requirement of sectors that are commercially unattractive to the banking industry but play a strategic role in the national economy, Bank Indonesia will cooperate with the Government to develop a number of supporting financing schemes.

2.1.2. Islamic Banking

Islamic banks are subject to Bank Indonesia's task implementation as regulator of the banking industry in order to develop a banking system based on sharia principles. Islamic banking is still considered an infant industry when compared to conventional banks and the contribution they provide to the national economy.

Therefore, the challenges faced and strategy required by the Islamic banking industry is slightly different from that of conventional banks. In general, Islamic banking policy in 2012 covered the following aspects, among others:

1. **Policy to strengthen Islamic bank intermediation in productive economic sectors.** In order to enhance the intermediation function, Islamic banks are directed towards capacity building to more effectively serve the financing needs of productive sectors and begin redirecting/reviewing the dominance of financing allocated to the services sector and consumption. To this end, Bank Indonesia promulgated a number of regulations that have begun to restrict growth in consumer financing. In addition, Bank Indonesia also facilitates a link-and-match process between Islamic banks and business players in productive sectors, among others, through business matching and hosting focus group discussions between Islamic banks and business players.
2. **Policy to develop products directed at productive economic sectors.** In order to help customer segment diversification, Bank Indonesia prioritises support for the development of products aimed at productive sectors. Support manifests in the form of, among others, product policy, regulatory amendments and the product licensing process. In addition, Bank Indonesia continues to advocate a tripartite system in conjunction with the National Sharia Board (*Dewan Syariah Nasional - DSN*) and Indonesia Charter of Accountants (*Ikatan Akuntan Indonesia – IAI*) in order to expedite the development of new and non-standard products.

   Bank Indonesia also issued regulations to incentivise the use of more varied products and compile a business model for Islamic banking that could be used as a reference and guidelines for the authorities and the industry alike.
3. **Policy to encourage greater synergy with parent banks through the development of institutional infrastructure in the Islamic sphere.** In order to support greater cooperative synergy between conventional parent banks and their Islamic subsidiaries, Bank Indonesia hosts a forum that brings together leaders from the Islamic banking community, directors from conventional commercial banks with Islamic subsidiaries and Bank Indonesia, to reemphasise bank commitment to develop its Islamic business. Reemphasising strategic commitment and policy direction is expected to help Islamic banks converge their level of service with their conventional parents banks, among others, through advances in information technology, office networks and human resources.
4. **Policy to broaden education and communication regarding Islamic banking.** In order to foster Islamic banking development, as in previous years Bank Indonesia actively implements a public communication, socialisation and education program known as the iB Campaign with a central Islamic banking theme that acknowledges diligence, partnerships and equality. The iB Campaign also focuses on communicating parity and the uniqueness of Islamic banking products in order to raise public understanding of Islamic banking products (iB financial literacy).
5. **Policy to enhance good governance and risk management.** Bank Indonesia amended regulations concerning fit and proper tests for Islamic banks and Islamic business units in order to bolster good governance at Islamic banks. Meanwhile, in order to adopt international standards for risk management at Islamic banks, in 2012 Bank Indonesia was actively involved in discussions regarding risk management at international Islamic banks and also reviewed a number of international standards backed by the Islamic Financial Services Board (IFSB).
6. **Policy to improve the quality of the supervision system.** Bank Indonesia developed an Islamic Banking Information System (BIS) and amended the Monthly Report of Islamic Banks (LBUS) in order to boost the efficacy of Islamic banking supervision. Bank Indonesia also compiled an application and guidelines for the

early assessment of supervision at Islamic rural banks. In congruity with the development of supervision for conventional banks, Bank Indonesia also amended the concept of supervision at Islamic banks with the planned introduction of Islamic Risk Based Bank Rating (RBBR-S). Furthermore, Bank Indonesia also regularly organises and hosts training for the supervisors of Islamic banks in order to enhance their competence.

2.1.3. Rural Banks (BPR)

A number of efforts were undertaken in the reporting period to strengthen policy recommendations, develop the capital structure and expand supporting infrastructure for rural banks as follows:

1. **Policy concerning paid up capital and capital structure based on the location of each respective rural bank.** In order to evaluate and refine the requirements for paid up capital as well as to strengthen the overall capital structure of rural banks, particularly the establishment of new rural banks, a number of amendments were required concerning capital at rural banks. Moreover, this regulation has been in effect since 2004. Amending such requirements was motivated by ongoing economic developments that depart from conditions previous, thereby changing the level of income, the prices of goods and services, as well as the funding requirement of rural banks. In addition, increasingly tight competition among financial institutions has led to a stronger capital structure at rural banks as agents of microfinance become more important.
2. **Rural bank lending rate policy.** Although the lending rates offered by rural banks have tended to decline in recent times, they remain comparatively high in excess of 28.29%. In this context, a review of lending rates at rural banks was conducted during the reporting year. The review investigated the determinants of lending rates and other factors that influence lending rates, evaluated normal rates as well as recommended appropriate lending rates for rural banks. Form the results of the review it was found that Bank Indonesia policy concerning transparent lending rates for microfinance extended by rural banks should be determined, thereby boosting efficiency and profit while remaining competitive in the industry.
3. **Amendments to the guidelines for feasibility studies regarding the establishment of new rural banks.** The selection process for the establishment of new rural banks is pivotal to develop a more sound rural banking industry looking ahead. To this end, a number of tools should be prepared that support supervisors when selecting prospective rural banks, thereby ensuring that the establishment of new rural banks can genuinely support the decision to refuse or approve proposals submitted by prospective investors. Therefore, the guidelines for feasibility studies regarding the establishment of new rural banks, which previously merely referred to Economic and Non-Economic Aspects, now adheres to five key aspects, namely Market Aspects, Business Strategy, Human Resources and Infrastructure, Capital and Financial Aspects.
4. **Develop Apex rural banks through a pilot project to advance the electronic credit transfer system for commercial banks acting as Apex rural banks.** Bank Indonesia has policy concerning the formation and development of Apex rural banks in order to expand the role and capacity of rural banks in terms of financing micro and small enterprises. An Apex rural bank is established based on an agreement between a commercial bank, as the Apex, and member rural banks represented by a local rural banking association (DPD Perbarindo). An Apex rural bank has three main functions in the form of pooling funds, financial assistance and technical assistance. Hitherto, six Apex rural banks have been established from five regional banks (West Sumatera, Riau Islands, East Java, South Kalimantan and Central Java) and one commercial bank (Bank Andara). The development of Apex rural banks is also harmonious with the Regional Champion Program for regional banks. To support the three functions of an Apex bank in relation to expanding rural bank

access to the payment system, a pilot project is currently underway for the implementation of an Electronic Credit Transfer System for Apex Rural Banks[4] under the auspices of the Department of Accounting and the Payment System (Bank Indonesia), the Department of Rural Bank Credit and MSMEs (Bank Indonesia) and the Bank Indonesia representative office in Surabaya.

In line with the aforementioned policy direction for 2012, Bank Indonesia also supports efforts towards research and training as well as facilitating MSME development through policy and strategy to "broaden MSME access to banks" and strategy to "encourage banks to finance MSMEs". This policy aims to ensure that MSMEs can enhance their eligibility and capability, hence meeting the banks' requirements (bankable), while simultaneously boosting local economic capacity. In addition, to encourage banks to expand MSME access to their services, Bank Indonesia provides incentives for the banking sector to allocate credit to MSMEs through the promulgation of banking regulations and by strengthening financial infrastructure.

2.2 Banking Regulations

2.2.1. Conventional Commercial Banks

The overriding function of a bank is to accumulate and disburse the public's funds. In the operation of this function and in order to achieve greater banking competitiveness, strengthen resilience and enhance the intermediation function, banks are required to comply with prudential principles. In this context, Bank Indonesia issued the following regulations in 2012:

1. **Bank Indonesia Regulation No. 14/18/PBI/2012, dated 28th November 2012, concerning the Capital Adequacy Ratio of Commercial Banks.**

   The aim of this regulation is to create a banking system that is sound, capable of developing and competitive nationally and internationally.

   The specifics of the regulation include the follow:

   a. Determining a capital adequacy ratio according to risk profile.
   b. Requiring banks to have an Internal Capital Adequacy Assessment Process (ICAAP) to calculate minimum capital according to risk profile.
   c. Reviewing the Internal Capital Adequacy Assessment Process (ICAAP), known as the Supervisory Review and Evaluation Process (SREP), by Bank Indonesia.
   d. Enforcing Capital Adequacy Maintained Assets (CEMA) for foreign bank branches.

2. **Bank Indonesia Circular No. 14/37/DPNP, dated 27th December 2012, concerning the Capital Adequacy Ratio based on Risk Profile and the Fulfilment of Capital Adequacy Maintained Assets (CEMA).**

   This Bank Indonesia Circular is a follow-up measure subsequent to the promulgation of Bank Indonesia Regulation No. 14/18/PBI/2012, dated 28th November 2012, concerning the Capital Adequacy Ratio of Commercial Banks.

   The specifics of the circular are as follows:

   a. Concerning bank ICAAP, Bank Indonesia shall conduct a Supervisory Review and Evaluation Process (SREP) containing an evaluation of the following: (i) the suitability of active supervision of the board of

4) Policy to develop an electronic credit transfer system for Apex rural banks is discussed in more detail in Box 4.1.

commissioners and directors; (ii) the suitability of capital adequacy assessments; (iii) the suitability of monitoring and reporting; and (iv) the suitability of internal control.

b. Minimum CEMA fulfilment shall be implemented incrementally as follows:

   i. All foreign bank branch offices are required to meet a minimum CEMA of 8% (eight percent) of total bank liabilities no later than June 2013.

   ii. In the event that a minimum CEMA of 8% of total bank liabilities is less than Rp1 trillion in June 2013 until November 2013, foreign bank branches are required to maintain a minimum CEMA of 8% of total bank liabilities.

   iii. The minimum CEMA requirement of Rp1 trillion for foreign bank branches as mentioned in point (ii) shall become effective as per the position in December 2017.

3. **Bank Indonesia Regulation No. 14/15/PBI/2012, dated 24th October 2012, concerning the Assessment of Asset Quality by Commercial Banks.**

   The background behind this regulation is as follows: (i) as an appeal to banks to submit financial reports that are accurate, comprehensive and reflect the performance of the bank as a whole; (ii) the need for banks to manage their exposure to risk by maintaining asset quality and asset write-downs (PPA).

   The specifics of the regulation are as follows:

   a. Provisions for unused credit facilities.
   b. Assessment criteria for the quality of interbank placements categorised as loss.
   c. Assessment of credit quality and other funds for MSME borrowers.
   d. Term deposits recognised as cash collateral.
   e. Criteria for a Prime Bank.
   f. Credit restructuring and PPA.

Bank Indonesia also issued regulations in order to bolster **<u>transparent bank financial conditions and performance</u>** as follows:

1. **Bank Indonesia Regulation No. 14/14/PBI/2012, dated 18th October 2012, concerning Transparency and the Publication of Bank Reports.**

   The goal of this regulation is harmonious with the implementation of Basel II according to the development of international standards and accounting standards, as an umbrella for several policies concerning the submission of reports as well as the enhancement of transparency at banks in general.

   The specifics of the regulation are as follows:

   a. Additional information in the Annual Report.
   b. Adaptation of the Quarterly and Monthly Condensed Financial Statements, relating to the grouping of information, as well as the mechanism and schedule for submitting such reports.
   c. Mandatory reports submitted by banks that are part of a business group or banks with a subsidiary. The requirement for banks to publish their Annual Reports and Condensed Financial Statements through their respective websites.

2. **Bank Indonesia Circular No. 14/35/DPNP, dated 10th December 2012, concerning the Annual Reports of Commercial Banks as well as other specific Reports submitted to Bank Indonesia.**

This Bank Indonesia Circular is a follow-up measure subsequent to the promulgation of Bank Indonesia Regulation No. 14/14/PBI/2012, dated 18th October 2012, concerning Transparency and the Publication of Bank Reports. The aim is, among others, to enhance transparency regarding the financial conditions of a bank to the general public and maintain public confidence in banking institutions. The announcement of this regulation is also in line with the implementation of Pillar 3 of Basel II on market discipline.

Bank Indonesia issued the following regulations in order to enhance the **banking supervision** function:

1. **Bank Indonesia Regulation No. 14/12/PBI/2012, dated 15th October 2012, concerning the Head Office Reports of Commercial Banks.**

   This regulation was issued due to the requirement for additional information that was originally reported offline to be reported online in the Commercial Bank Head Office Report System (LKPBU) in order to boost the efficacy of monitoring policy as well as bank efficiency, and in order to harmonise the submission schedule with other reports like the Monthly Report of Commercial Banks and the Periodic Report of Commercial Banks, both of which are submitted online.

   The specifics of the regulation are as follows:

   a. New additional online reports to include cash flow projections, bank activity as a sales agent of non-bank products, e-banking, structured products, executive officers, office network, condensed financial statement and bank employees.
   b. Two additional reporting periods, hence an increase from two to four reporting periods.
   c. A shorter delivery schedule for reports contained in the LKPBU.

2. **Bank Indonesia Circular No. 14/13/DPNP, dated 31st October, concerning the Head Office Reports of Commercial Banks.**

   The publication of this circular was a follow-up measure to the promulgation of Bank Indonesia Regulation No. 14/12/PBI/2012, dated 15th October 2012, issued to create uniformity in the compilation and submission of head office reports by commercial banks.

   The specifics of the circular include amending the guidelines for report compilation and the technical instructions for the reporting application, in particular referring to the following reports:

   a. Cash flow projections.
   b. Bank activity as a sales agent of non-bank products, including bancassurance; mutual funds and international financial products.
   c. Banking transactions through the e-banking delivery channel.
   d. Structured products.
   e. Executive officers.
   f. Office network.
   g. Condensed financial statements.
   h. Bank employees.

Bank Indonesia issued the following regulations in order to create and maintain **rupiah exchange rate stability**, act as **lender of last resort**, anticipate the increasingly complex and uniform nature of bank business activities as well as anticipate the impact of excessive credit growth:

1. **Bank Indonesia Regulation No. 14/17/PBI/2012, dated 23rd November 2012, concerning Trust Management at Banks.**

   The aim of this regulation is to nurture economic agents in their management of foreign exchange using domestic banking services and expertise as well as to support domestic financial deepening.

   The specifics of the regulations cover the following salient points:

   a. Parties that are involved with Trust Management activity.

   b. Principles that have to be met when conducting trust activity.

   c. Trust activity involving a paying agent; an investment agent for conventional and/or sharia-based funds; and/or a borrowing agent and/or a sharia-based financing agent.

   d. The requirements for banks wishing to engage in trust management activity.

2. **Bank Indonesia Regulation No. 14/16/PBI/2012, dated 23rd November 2012, concerning the Short-Term Funding Facility for Commercial Banks.**

   This regulation was issued in order to anticipate potential pressures in the banking system stemming from tighter liquidity, which requires bank access to a short-term funding facility provided by Bank Indonesia as lender of last resort. The reintroduction of a short-term funding facility is expected to garner public confidence in and maintain the integrity of the banking system in particular and the financial system in general.

   The specifics of the regulation cover the following aspects:

   a. Amendments to regulations relating to the requirements for which banks can apply, the requirements for collateral and the interest rates for the short-term funding facility.

   b. Bank requirements were amended to include: a capital adequacy ratio of no less than 8% and fulfilling capital requirements according to risk profile.

   c. Banks eligible to apply for the short-term funding facility are those that meet specific capital requirements and hold high-quality collateral of sufficient value.

3. **Bank Indonesia Circular No. 14/20/DPNP, dated 27th June 2012, concerning Prudential Principles for Outsourcing at Commercial Banks.**

   This circular was issued to further clarify the specifics of Bank Indonesia Regulation No. 13/25/PBI/2011 concerning the application of prudential principles for outsourcing at commercial banks and Bank Indonesia Regulation No. 11/11/PBI/2009 concerning providers of card-based payment instruments, superseded by Bank Indonesia Regulation No. 14/2/PBI/2012.

   The circular explains, among others, the following:

   a. The application of prudential principles and risk management regarding the transfer of power by a bank.

   b. Understanding the core elements and supporting tasks accompanied by examples.

   c. That a bank shall only implement a transfer of power agreement with a Corporate Service Provider (PPJ) incorporated in Indonesia in the form of a limited company or cooperative.

   d. Efforts that must be undertaken by a bank in line with the transfer of power that do not absolve the bank of responsibility to protect the rights of its customers.

e. The submission of work excluded for the transfer of power.

f. Prudential principles when billing for credit cards and managing cash.

4. **Bank Indonesia Circular No. 14/10/DPNP, dated 15th March 2012, concerning the application of risk management at banks extending mortgage loans and automotive loans.**

This regulation was issued because excessive growth in mortgage and automotive loans has the potential to exacerbate a variety of risks faced by banks. In addition, from a macroprudential standpoint, excessive mortgage growth could drive up house prices that no longer reflect true prices (bubble).

The specifics of the regulation are as follows:

a. The LTV regulation for mortgage loans, namely a loan-to-value ratio of no more than 70% for mortgages on residential property exceeding 70m2.

b. The downpayment policy for automotive loans, namely (i) a downpayment (DP) of no less than 25% for purchases of two-wheeled vehicles; (ii) a downpayment (DP) of no less than 30% for purchases of non-commercial four-wheeled vehicles; and (iii) a downpayment (DP) of no less than 20% for purchases of commercial vehicles with four wheels or more.

5. **Bank Indonesia Regulation No. 14/8/PBI/2012, dated 13th July 2012, concerning the shareholdings at commercial banks.**

The enforcement of a maximum limit on shareholdings at commercial banks aims to control the shareholder structure of banks by reducing the domination of shareholders who have an adverse impact on the operation of the bank. Regulating the ownership structure of banks is in line with efforts to foster the application of prudential principles and good governance at banks in order to enhance bank resilience in the face of regional and global economic dynamics. The imposition of a maximum limit on shareholdings is also expected to have a favourable impact on bank consolidation in order to strengthen the national banking industry.

Determining the limit on shareholdings at a bank is based on the category of shareholder, namely in the form of a financial institution, a non-financial institution or an individual. In addition, the restrictions are also based on the relationships of the owners, whether there are any family ties and whether the owners are acting in concert. Imposing such restrictions on shareholdings is in line with the assessment of bank soundness as well as good corporate governance.

The regulation also legislates the maximum shareholding of spin off Islamic banks, the timeframe permitted to meet the new requirements as well as the consequences and sanctions for shareholders in violation of this regulation.

6. **Bank Indonesia Regulation No. 14/26/PBI/2012, dated 27th December 2012, concerning Business Activity and Office Networks based on Bank Core Capital.**

This regulation, concerning the scope of business activity and expanding the office network according to the core capital of the respective banks, aims to bolster bank resilience and boost the competitiveness of the national banking industry. Through this regulation, banks are only permitted to conduct business activity and expand their office network according to the level of core capital maintained. This regulation is expected to raise bank capital in order to anticipate the risk faced in line with the increasing complexity of business activity and the need to expand the office network. Furthermore, the bank intermediation function is also expected to improve optimally, particularly for productive businesses.

Based on core capital, banks are categorised into four business groups (know as commercial bank business groups or BUKU). The scope of products and activities undertaken by each BUKU is governed by the specific

BUKU. BUKU 1 is a category of banks with the most limited scope of products and activities, while BUKU 4 is for banks with the broadest scope of products and activities.

In 2012, Bank Indonesia also amended a number of regulations as follows:

1. **Bank Indonesia Circular No. 14/21/DPNP, dated 18th July 2012, concerning an amendment to Bank Indonesia Circular No. 9/3/DPNP, dated 18th December 2007, concerning Guidelines for the Standard Method of calculating Capital Adequacy at Commercial Banks with Market Risk**.

   This circular was amended in order to create harmony with Bank Indonesia Circular No. 13/6/DPNP, dated 18th February 2011 concerning Guidelines for Calculating Risk-Weighted Assets for credit risk using a standard approach.

   The specifics of this amendment are as follows:

   a. A change in the weighting category for the calculation of specific risk for interest rate risk that is part of the calculation for risk-weighted assets in terms of market risk using the standard approach.
   b. The calculation of specific risk on securities specified by the category of issuer and rating and/or residual maturity.
   c. A change in Form I.a Attachment 2 relating to specific risk.

2. **Bank Indonesia Circular No. 14/8/DPNP, dated 6th March 2012, concerning the second amendment to Bank Indonesia Circular No. 8/15/DPNP, dated 12th July 2006, concerning the Periodic Reports of Commercial Banks.**

   The amendment of this circular represents a follow-up measure to the promulgation of Bank Indonesia Regulation No. 13/19/PBI/2011, dated 22nd September 2011, concerning an amendment to Bank Indonesia Regulation No. 8/12/2006, dated 10th July 2006, concerning the Periodic Reports of Commercial Banks and was issued to adjust the reporting format and supplementary information legislated by other regulations.

   The specifics of the amendment include the following:

   a. Refining the reporting form for the maturity profile.
   b. Adding a form to calculate risk-weighted assets pertaining to credit risk.

3. **Bank Indonesia Regulation No. 14/24/PBI/2012, dated 26th December 2012, concerning Single Presence Policy for Banks in Indonesia**.

   Regulating the return to single presence policy for banks in Indonesia aims to realise a banking structure that is sound and robust in order to enhance the resilience and competitiveness of the national banking industry to better anticipate regional and global economic dynamics.

   This regulation stipulates that any party shall only be a controlling shareholder of one bank with three ways to meet the requirement, namely: (i) perform consolidation or a merger with the banks controlled; (ii) establish a parent company in the banking field; or (iii) establish a holding function. Single presence policy is not applicable to banks in Indonesia when a single shareholder controls two banks that are operated based on different business principles, namely conventional and Islamic. In addition, dispensation is also given to controlling shareholders of two banks when one of the banks in question is a joint venture bank.

4. **Bank Indonesia Regulation No. 14/27/PBI/2012, dated 28th December 2012, concerning the application of the Anti-Money Laundering and Prevention of Financing Terrorism program (APU PPT) at Commercial Banks.**

Refining the regulation for the anti-money laundering and prevention of financing terrorism program is a Bank Indonesia response to national, regional and global dynamics that are accompanied by the development of increasingly complex products, activities and information technology that has the potential to increase the opportunity for criminals to misuse bank products and facilities as a means to launder money and finance terrorism with a more sophisticated *modus operandi*.

The regulation was amended to achieve greater harmonisation with existing laws and international standards. The amendment affected aspects of fund transfers, high-risk areas, simple customer due diligence (to support financial inclusion) and cross-border correspondent banking. The APU PPT program comprises of active supervision of the board of commissioners and directors, policies and procedures, internal control, the management information system and human resources.

5. **Bank Indonesia Circular No. 14/4/DPNP, dated 25th January 2012, concerning Commercial Banks.**

   The specifics of this regulation are as follows:

   1. In order to apply risk management in relation to directors, members of the board of commissioners and executive officers, as well as opening a new branch, change in branch status, change of address and/or closure of a branch, banks are required have in place policies and procedures that cover:
      a. The requirements and procedures for selecting, replacing and terminating members of the board of commissioners, directors and executive officers; and
      b. Planning the opening of new branches, changing branch status, changing address and/or closing a branch office paying due regard to: the vision and mission of the banks, an assessment of economic potential and an assessment of branch performance as well as the realisation of opening new branches, changing branch status, changing address and/or closing a branch office in the previous year.
   2. Banks are required to compile a review as a foundation for planning the establishment of new branches, changes in branch status, changes of address and the closure of a branch using the guidelines contained within this Bank Indonesia Circular. The review must be attached to the Bank Business Plan in relation to planned development and/or proposed changes to the office network as stipulated in the Bank Indonesia Regulation concerning the Bank Business Plan.
   3. Applications for licenses or planned actions and/or the submission of reports as stated in the Bank Indonesia Regulation must be presented by the respective bank to Bank Indonesia using the format and methods specified in this Bank Indonesia Circular. In the event that the format is not specified in this Circular, applications and reports will be submitted to each respective bank.

6. **Bank Indonesia Circular No. 14/8/DPNP/, dated 6th March 2012, concerning the second amendment to Bank Indonesia Circular No. 8/15/DPNP, dated 12th July 2006, concerning the Periodic Reports of Commercial Banks.**

   The specifics of this circular are as follows:

   a. Refine the maturity profile reporting form pursuant to regulations on liquidity risk management and the form for the weekly balance sheet in order to align the format with the new Commercial Bank Report (LBU).

   b. Add a form for the calculation of risk-weighted assets for credit risk in accordance with regulations concerning the calculation of risk-weighted assets for credit risk and a form for the prime lending rate in line with regulations governing the transparent publication of prime lending rates.

2.2.2. Islamic Banks

In 2012, a number of Islamic banking regulations were amended and issued in order to help develop and strengthen the Islamic banking industry as follows:

1. **Bank Indonesia Regulation No. 14/6/PBI/2012, dated 18th June 2012, concerning Fit and Proper Tests for Islamic Banks and Islamic Business Units.**

   The goal of this policy is to create good governance at Islamic banks in order to boost public confidence and ameliorate consumer protection in the Islamic banking industry.

   The technical details of this regulation are contained in Bank Indonesia Circular No. 14/25/DPbS, dated 12th September 2012. The promulgation of this regulation supersedes Bank Indonesia Regulation No. 11/31/PBI/2009 concerning Fit and Proper Tests for Islamic Banks and Islamic Business Units.

2. **Bank Indonesia Regulation No. 14/20/PBI/2012, dated 17th December 2012, concerning an amendment to Bank Indonesia Regulation No. 11/24/PBI/2009, concerning the Short-Term Funding Facility for Islamic Banks.**

   The aim of this regulation is to amend previous legislation concerning the requirements for an Islamic bank to successfully apply for the short-term funding facility as well as the requirements pertaining to collateral. The previous regulation shall remain effective while compatible with the new regulation.

3. **Circular No. 14/7/DPbS, dated 29th February 2012, concerning Gold-backed Qardh products at Islamic Banks and Islamic Business Units.**

   This circular aims to provide a reference for Islamic banks engaged in gold-backed Qardh products and represents the technical guidelines for Bank Indonesia Regulation No. 10/17/PBI/2008 concerning the Products of Islamic Banks and Islamic Business Units.

4. **Circular No. 14/16/DPbS, dated 31st May 2012, concerning gold ownership financing products at Islamic banks.**

   This regulation was issued to provide a reference for Islamic banks involved in gold ownership financing products, representing the technical guidelines of Bank Indonesia Regulation No. 10/17/PBI/2008 concerning the Products of Islamic Banks and Islamic Business Units.

5. **Circular No. 14/33/DPbS, dated 27th November 2012, concerning the application of policy on mortgage financing and automotive financing at Islamic banks and Islamic business units.**

   This circular was issued to provide a reference for Islamic banks and Islamic business units for mortgage financing and automotive financing in order to enhance prudence and expand the role played by Islamic banks in supporting national economic growth through productive financing. This circular contains the implementation of Bank Indonesia Regulation No. 10/17/PBI/2008 concerning the products of Islamic banks and Islamic business units and Bank Indonesia Regulation No. 13.23/PBI/2011 concerning the application of risk management at Islamic banks and Islamic business units.

In conjunction with IAI and the Islamic banking industry, Bank Indonesia discussed material to improve the 2003 Accounting Guidelines for Islamic Banks (PAPSI). The improvements have resulted in two products, namely (i) PAPSI BUS/UUS; and (ii) PAPSI BPRS (PSAK ETAP). The clarification of PAPSI into the aforementioned groups will accommodate the complexity and development of the industry. Furthermore, discussions were held with the industry/IAI/Indonesian Institute of Certified Public Accountants (IAPI) to prepare for the application of PSAK 102 (Murabaha Accounting) and follow-up discussions are planned seeking consensus for the application of PSAK 102 at Islamic banks.

2.2.3. Rural Banks (BPR)

Regulations are required that encourage rural banks to allocate credit to the MSME sector while observing prudential principles in order to expand the role rural banks play in fostering MSME development. Consequently, in 2012 Bank Indonesia issued a number of regulations as follows:

1. **Bank Indonesia Regulation No. 14/9/PBI/2012, dated 26th July 2012, concerning Fit and Proper Tests for Rural Banks.**

   This regulation aims to build public confidence and improve customer protection in the banking industry, thereby necessitating that rural banking management always meets fit and proper requirements in accordance with good corporate governance. The Bank Indonesia regulation covers the scope, the fit and proper testing process, the predicates of the fit and proper test, the sanctions and consequences of not passing and the additional regulations relating to the fit and proper testing process for rural banks bailed out by the Deposit Insurance Corporation (DIC). This regulation supersedes Bank Indonesia Regulation No. 6/23/PBI/2004, dated 9th August 2004, concerning Fit and Proper Tests for Rural Banks.

2. **Bank Indonesia Circular No. 14/36/DKBU, dated 21st December 2012, concerning Fit and Proper Tests for Rural Banks.**

   This Bank Indonesia Circular represents the implementation of Bank Indonesia Regulation No. 14/9/PBI/2012 concerning fit and proper tests for rural banks. This circular supersedes Bank Indonesia Circular No. 6/35/DPBPR, dated 16th August 2004, concerning fit and proper tests for rural banks. This circular contains some amendments, including the parties subject to fit and proper tests, the fit and proper testing procedure as well as clarification regarding the sanction periods.

3. **Bank Indonesia Circular No. 14/26/DKBU, dated 19th September 2012, concerning Policy Guidelines and Credit Procedures for Rural Banks.**

   This Circular is a form of guidelines for rural banks concerning the implementation of each credit activity to fulfil prudential principles and implement sound credit principles as a standard or measure when supervising the allocation of credit at each stage of the credit process individually. The goal of this circular is to ensure that rural banks are consistent and sustainable in their credit risk mitigation as well as to prevent the abuse of authority by a number of parties in the disbursement of credit that could undermine a rural bank.

2.3 Micro, Small and Medium Enterprise (MSME) Policy and Regulation

2.3.1. MSME Policy

Micro, small and medium enterprises (MSMEs) play a vital role in the development and growth of the domestic economy. Bank Indonesia continuously strives to broaden MSME access to banks and encourages the banks to finance MSMEs in order to expand the bank intermediation function. Such policy is directed towards raising MSME eligibility and capability while simultaneously boosting local economic capacity. As part of the efforts to encourage banks to extend financing to MSMEs, Bank Indonesia implemented the following activities:

1. Broadening MSME access to bank financing by strengthening financial infrastructure as follows:
   a. Facilitate the more rapid establishment of Regional Credit Guarantee Companies through a variety of socialisation activities in conjunction with several government ministries.

b. Plan the implementation of MSME credit ratings in preparation for the ASEAN Economic Community (AEC) in 2015. There are currently 323 ratings for 58 MSMEs using the respective methods of rating agencies.

2. Expanding expertise regarding micro, small and medium enterprises.

   A training program, a part of technical assistance, is being run by Bank Indonesia to enhance the competence of human resources in the banking industry, especially small-scale rural banks, which aims to broaden banking expertise with regards to MSMEs. To catalyse bank financing to MSMEs, training is also provided to partner financial consultants (KKMB) in order to accelerate MSME access to the banks.

2.3.2. MSME Regulation

Bank Indonesia issued the following regulations in 2012 in an effort to encourage banks to broaden MSME access to their services:

1. **Bank Indonesia Regulation No. 14/22/PBI/2012, dated 21st December 2012, concerning the Provision of Credit or Financing and Technical Assistance by Commercial Banks in order to Develop Micro, Small and Medium Enterprises (MSMEs)**.

   Through the promulgation of this regulation, conventional commercial banks and Islamic banks are required to gradually allocate at least 20% of their funds in the form of credit or financing to MSMEs followed by the application of incentives/disincentives. Financing can be extended through executing, channelling and joint financing. In addition, through this regulation, the criteria defining MSMEs are now in harmony with those stipulated in Act No. 20, 2008, concerning Micro, Small and Medium Enterprises (MSMEs).

2. **Bank Indonesia Regulation No. 14/19/PBI/2012, dated 30th November 2012, concerning an amendment to Bank Indonesia Regulation No. 5/20/PBI/2003 concerning the Transfer of Bank Indonesia Liquidity Credit Management under the Credit Program.**

   This regulatory amendment was issued to affirm the authority of Bank Indonesia when supervising and assessing the management of Bank Indonesia Liquidity Credit (KLBI) by state-owned banks and the allocation of KLBI by executing banks[5]. In addition, this regulation controls the additional 200 bps hike in the overnight Jakarta Interbank Offered Rate (JIBOR) to replace 1-month Bank Indonesia Certificates as a reference to calculate sanctions for violations of KLBI management as well as to stipulate the delivery schedule for submitting reports regarding the receipt of instalments, adjustments to outstanding credit, reallocation of funds and repayments.

2.4 Coordination and the active role Bank Indonesia plays with Stakeholders

2.4.1 Coordination with the Real Sector

Bank Indonesia strives to boost the efficiency and effectiveness of policy in order to stimulate the national economy in general and the banking sector in particular, as well as to support the implementation of other institutional programs. To this end, Bank Indonesia always coordinates with a variety of parties and is actively involved in an array of programs/activities conducted by germane institutions. In relation to the real sector, Bank

5) An executing bank is a bank that receives the KLBI facility under the credit program.

Indonesia undertakes two distinct activities, namely monitoring sources of vulnerability to the financial system stemming from the real sector as well as nurturing the bank intermediation function.

1. The following actions were taken in terms of monitoring sources of vulnerability to the financial system stemming from the real sector:
   a. In 2012, discussions were held with a number of business associations, like the Indonesian Real Estate Association (REI), the Indonesian Automotive Industry Association (GAIKINDO), the Indonesian Motorcycle Association (AISI), the Indonesian Employers Association (APINDO), the Indonesian Textile Association (API), the Indonesian Footwear Manufacturers Association (APRISINDO), the Indonesian Food and Beverages Association (GAPMMI), as well as the Indonesian Furniture Association (ASMINDO). In general, the following points were discussed at meetings with the aforementioned business associations:
      i. Meetings held with REI, GAIKINDO and AISI in order to monitor the business situation in the housing and automotive sectors prior and subsequent to the introduction of Bank Indonesia Regulation No. 14/10/DPNP, dated 15th March 2012, concerning the application of risk management at banks engaged in allocating mortgage loans and automotive loans.
      ii. Meetings held with APINDO and a number of other associations (textiles, footwear, food and beverages, automotive components and furniture) to investigate the impact of a slowdown in exports due to sluggish economies in Europe and the United States (US), which subsequently spilled over to countries in Asia like China and India. Despite a slight downturn in the performance of exports from Indonesia due to weaker demand from Indonesia's trade partners, including China, India and Europe among others, the national economy of Indonesia remains buttressed by tenaciously strong domestic demand.
   b. In order to identify sources of vulnerability emanating from public and non-public corporations, the corporate performance of each economic sector in Indonesia is monitored through corporate financial statements and other sources for public listed companies as well as corporate surveys for non-public companies that aim to collate more complete information regarding the activities and conditions of non-public companies thought to impact financial system stability.
2. The following actions were taken in order to catalyse the bank intermediation function:

   In 2012, meetings were arranged between the business community and the banking industry with the involvement of related government ministries and institutions in order to expand the bank intermediation function. The activities implemented include, among others, a workshop on financing fisheries as a follow-up measure to the workshop held in 2011. At the workshop, the prospects of the fishing industry were presented and a financing scheme was introduced to the fishermen that would insure their fishing vessels.

MSMEs and the Real Sector

As a form of support to develop the real sector and MSMEs, Bank Indonesia played an active role in cooperation with several relevant parties to strengthen the real sector and MSMEs. The endeavours carried out by Bank Indonesia during the reporting year are as follows:

1. Signed an extension to the Memorandum of Understanding with the Ministry of Marine Affairs and Fisheries (KKP) regarding the development of businesses in the marine and fisheries sector on 27th June 2012. The original MoU was signed in 2009. The objectives of this agreement are as follows:

a. Synergise resources in order to develop businesses in the marine and fisheries sector; and

b. Broaden the access of businesses in the marine and fisheries sector to banking services.

One outcome of the MoU, among others, was joint training for partner financial consultants in the marine and fisheries sector as well as the formulation of a lending model. In addition, Bank Indonesia also cooperated with the Ministry of Marine Affairs and Fisheries in order to enhance Minapolitan Program synergy. The Minapolitan program is a marine and fisheries development program based on regional economic management to drive the marine and fisheries sector in accordance with principles of integration, efficiency and acceleration. The goal of the program is to boost production, productivity and the quality of fishery products as well as to develop Minapolitan regions as centres of local economic growth. In this context, Bank Indonesia sustainably strives to create synergy in the work program with the Ministry of Marine Affairs and Fisheries that is realised through the following activities, among others:

- Mapping farmer/aquaculture groups in terms of their potential for aquaculture financing; and
- Mapping aquaculture systems in order to find the most appropriate form of financing.

2. Signed a Memorandum of Understanding (MoU) between Bank Indonesia and the National Land Agency (BPN) to recognise the legality of assets owned by micro and small enterprises (MSEs). One constraint in the allocation of credit to MSMEs is the lack of legal acknowledgement for MSE assets, which could be borrowed against from the banks. The MoU between Bank Indonesia and BPN, signed on 27th June 2012, is expected to overcome the problems of MSE asset legality, thereby paving the way for more micro and small enterprises to access bank financing, which could be applied nationwide. As a follow-up measure, prospective participants need to be sought with the involvement of relevant government ministries (the Ministry of Agriculture, the Ministry of Cooperatives and MSEs, as well as the Ministry of Marine Affairs and Fisheries) and the banking industry.

Other endeavours undertaken by Bank Indonesia to develop the real sector and MSMEs include the flowing:

1. Create new entrepreneurs. This program aims to mould new entrepreneurs through ongoing training and mentoring in order to create potential customers for the banking industry. Bank Indonesia cooperates with a college to provide entrepreneurial training. In 2012, 'Global Entrepreneurship Week' was held, which is a movement to encourage the youth worldwide to unleash their full potential as innovators and entrepreneurs, with the expectation that they will take the necessary steps toward a future as entrepreneurs who generate new employment opportunities through the innovative businesses they create. In addition to the provision of training and mentoring, Bank Indonesia also provides seed capital assistance to eligible participants.
2. MSME development through a cluster approach comprising of local and national clusters. Specifically for the national cluster program, Bank Indonesia facilitates improvements in quality, regarding technology, culture and the production system, through training and collaboration with relevant stakeholders to enhance aspects of marketing. Meanwhile, for local clusters, leading local commodity clusters are being mapped and supported along with the main contributors to inflation in Indonesia. Clusters are comprehensively mapped to support the formulation of a cluster development model appropriate to the economic conditions in each respective cluster.
3. Strengthening local food security. This program was initiated in order to stabilise domestic prices/inflation for food commodities that have a sufficient impact on inflation.
4. Provide information regarding MSMEs. This activity aims to bridge information gaps between the banking industry and MSMEs in order to encourage banks to allocate more credit to MSMEs. The information provided, among others, is in the form of a lending model for feasible commodities as well as data on the

performance of commodities, products and leading businesses (KPJU) as well as the results of other studies. In addition, MSME profiles are also presented along with MSME centres and cluster development. The information is published through MSME information media in the form of an MSME Info Microsite posted on Bank Indonesia's official website (www.bi.go.id).

2.4.2 Coordination and an Active Role in the Credit Allocation Program

The disbursement of small business loans (*kredit usaha rakyat – KUR*) began in 2007 through six executing banks, namely Bank Rakyat Indonesia (BRI), Bank Tabungan Negara (BTN), Bank Mandiri, Bank Negara Indonesia (BNI), Bukopin and Bank Syariah Mandiri, with two guarantee companies, namely PT Aksrindo and PT Jamkrindo. Currently, all regional banks extend KUR loans and there are two additional guarantee companies, namely Jamkrida Jatim and Jamkrida Bali.

Bank Indonesia's position in the KUR program is as a counterpart of the KUR Policy Committee. In this context, Bank Indonesia has implemented the following actions to support the KUR program:

1. Issue regulations to relax the calculation of risk-weighted assets for MSME credit with specific guarantees.
2. Actively provide input to the KUR Policy Committee regarding any problems with KUR loans related to the banking sector, as well as monitoring the allocation of KUR loans through commercial bank reports and the Debtor Information System (DIS).
3. Facilitate the work program of the KUR Policy Committee and local government to expand the even disbursement of KUR loans, primarily to priority sectors (agriculture, fisheries, forestry and the manufacturing industry) and specific locations.
4. Under the auspices of the Coordinating Ministry for Economic Affairs, in 2012 Bank Indonesia undertook socialisation activities in three cities, namely Gorontalo, Ternate and Samarinda.
5. Provide financial education to prospective immigrant workers regarding the benefits of the KUR program for such workers in terms of entrepreneurship.
6. As the banking supervision authority, Bank Indonesia also plays an active role in coordination and discussions on standard operating procedure (SOP) for KUR supervision.

Based on data from the Coordinating Ministry of Economic Affairs, total disbursements of KUR loans in 2012 reached Rp33.47 trillion (ytd[6]). The target for KUR allocation in 2012 was Rp30 trillion, therefore, 111.57% of the target was achieved. Consequently, the total amount of KUR loans extended by participating banks up to December 2012 amounted to Rp96.89 trillion.

Outstanding KUR loans, based on data from commercial bank reports in December 2012, totalled Rp39.76 trillion, up Rp10.97 trillion (38.13%) in 2012 (ytd). Most KUR loan allocation remains centred on the island of Java (48.73%, followed by Sumatera (22.59%), Kalimantan (10.12%), Sulawesi (11.195), Bali (4.61%) and Papua Maluku (2.77%). Meanwhile, based on allocation by economic sector, most KUR loans are extended to the trade sector (51.19%), while credit to the agricultural sector, including fisheries, accounted for just 19.21%.

6) Year to date.

Food and Energy Security Loans (KKPE), Loans for Beef Cattle Husbandry (KUPS) as well as Loans for Bio-energy Development and Plantation Revitalisation (KPEN-RP)

Bank Indonesia also collaborated with the Ministry of Agriculture through a credit extension program. Through a memorandum of understanding between the Governor of Bank Indonesia and the Minister of Agriculture signed on 16th March 2011, Bank Indonesia facilitates the expansion of credit programs such as Food and Energy Security Loans (KKPE), Loans for Beef Cattle Husbandry (KUPS) as well as Loans for Bio-energy Development and Plantation Revitalisation (KPEN-RP). As a follow-up to the memorandum of understanding, Bank Indonesia has undertaken a number of measures as follows:

1. Facilitate credit program socialisation activities, particularly for KKPE and KUPS in a number of cities like Bogor, Malang, Surabaya and Lampung.
2. Provide input for monitoring and the assessment of credit programs to reveal the constraints, problems and efforts to expand the allocation of program credit.
3. Facilitate the formation of agricultural insurance, in particular crop insurance and beef cattle insurance in order to mitigate financing risk in the agricultural sector, more specifically price fluctuations, harvest failure and the death of livestock.

2.4.3 Coordination with the Deposit Insurance Corporation (DIC)

Close cooperation and coordination between Bank Indonesia and the Deposit Insurance Corporation is required to create and maintain financial system stability as well as to support the implementation of an effective financial system safety net (JPSK). The form of cooperation is stipulated in a joint decree between the governor of Bank Indonesia and the chairman of the Deposit Insurance Corporation (No. 11/55/KEP.GBI/2009 and No. KEP.026/ DK/X/2009). This is further elaborated upon in the implementation guidelines ((Juklak) No. 13/3/KEP. DpG/2011 and No. KEP.011/KE/I/2011) concerning coordination as well as the exchange of data and information in order to support effective task implementation at Bank Indonesia and the Deposit Insurance Corporation, signed on 26th January 2011. The scope of coordination and cooperation between Bank Indonesia and the Deposit Insurance Corporation is prioritized into five salient aspects as follows:

1. Implementation of savings guarantees comprised of updating institutional aspects of the banks, collaborative socialization activities for regulations relating to savings guarantees, follow-up monitoring of bank liabilities as well as determining a normal level of interest in order to make claim payments.
2. The handling of troubled banks that involves coordinated data submission for the bank in question as well as joint inspections by Bank Indonesia and the Deposit Insurance Corporation.
3. Resolution and/or handling of systemic and non-systemic bank failure, the handover of non-systemic failed banks and the handling of bank failure.
4. Follow-up measures for a bank that has had its business license revoked.
5. The handling of other tasks like cooperation in exchanging data and information using information technology, including private and confidential data and information.

In line with the transfer of the banking supervision and regulation function to the Financial Services Authority (OJK) on 31st December 2013, the scope of cooperation between Bank Indonesia and the Deposit Insurance

Corporation will have to be reviewed in light of the respective authority of Bank Indonesia and the Financial Services Authority looking ahead. In addition, effective coordination is also required to realize financial system stability with the involvement of Bank Indonesia, the Deposit Insurance Corporation, the Financial Services Authority and the Ministry of Finance. This coordination mechanism will be achieved through a memorandum of understanding signed by the Minister of Finance, Governor of Bank Indonesia, Chairman of the Financial Services Authority and the Chairman of the Deposit Insurance Corporation on 3rd December 2012.

2.4.4 Coordination and Cooperation with Law Enforcement Institutions

In the execution of its tasks, banking supervision unearths allegations of criminal behaviour in the banking sector (tipibank). However, Bank Indonesia does not have the authority to conduct investigations, therefore, allegations of criminal activity in the banking sector are handled through coordination between Bank Indonesia, the Police Department of the Republic of Indonesia and the Prosecution Service of the Republic of Indonesia. In order to facilitate and expedite the handling of criminal activity in the banking sector, on 19th December 2011 the Governor of Bank Indonesia, the Police Commissioner and the Attorney General signed a memorandum of understanding between Bank Indonesia, the Police Department of the Republic of Indonesia and the Prosecution Service of the Republic of Indonesia to replace and supersede the Joint Decree of the Attorney General, the Commissioner of Police and the Governor of Bank Indonesia, dated 20th December 2004, concerning the Coordinated Handling of Criminal Offenses in the Banking Sector. Coordination is implemented at the central level (in Jakarta and the environs) and at the local (provincial) level through Bank Indonesia Representative Offices, Local Police Departments and the High Public Prosecutors Office. The scope of coordination covers discussions on allegations of criminal activity in the banking sector, reporting allegations of criminal activity, the provision of witnesses, the provision of expertise, freezing accounts, confiscating money and documents, information exchange as well as assessments and other activities.

Bank Indonesia also plays a role in combatting the illegal accumulation of the public's funds. Bank Indonesia's role is played through coordination with a number of relevant institutions in the form of a Task Force to handle alleged unlawful acts in the accumulation of the public's funds and investment management (Investment Task Force). Members of the task force include a variety of institutions, like the Capital Market and Financial Institution Supervisory Board (Bapepam-LK) prior to the switch to the Financial Services Authority, Bank Indonesia, the Commodity Futures Exchange Supervisory Board (Bappebti), the Financial Transaction Reports and Analysis Centre (PPATK), the Ministry of Cooperatives and MSEs, the Directorate General of Domestic Trade (Ministry of Trade), the Police Headquarters for Criminal Investigation and the Attorney General of the Republic of Indonesia. The activities of the task force cover joint inspections and coordinated follow-up handling of unlawful acts, as well as socialization activities for the general public and other activities.

Handling criminal cases in the banking sector also requires coordination with the Deposit Insurance Corporation for banks that have already had their business license revoked. Such coordination refers to the Joint Decree of the Governor of Bank Indonesia and the Chairman of the Deposit Insurance Corporation concerning Coordination as well as the Exchange of Data and Information that supports effective task implementation at Bank Indonesia and the Deposit Insurance Corporation.

In addition, in order to enhance the efficacy of combatting corruption, particularly in terms of using banks as a target or means of corruption, Bank Indonesia also cooperates and coordinates with the Corruption Eradication Commission (KPK) as stipulated in a memorandum of understanding between Bank Indonesia and the Corruption Eradication Commission, dated 8th December 2006, concerning cooperation to eradicate corruption as well as the related guidelines. Cooperation takes the form of reviewing integrated customer data, exchanging information and providing advisory assistance, personnel support, training and socialisation as well as liaison officers.

2.4.5 Cross-Border Supervision Coordination and Cooperation

Experience gleaned from the global financial crisis in 2008/2009 provided a number of valuable lessons for supervisory bodies worldwide. The required response was not only to raise the capital quality of banks as a solid foundation for the creation of a stable financial system but the importance of enhancing the quality of financial system supervision at the local (solo) level by host supervisors and at the consolidated level by home supervisors was also realised.

In the context of Indonesia, where a number of large commercial banks are subsidiaries of international banking groups or branches of a head office located overseas, coordination between home and host supervisors is critical and has become a priority of Bank Indonesia as a host supervisor. This is because foreign subsidiaries and branch offices operating in Indonesia have a significant impact on the domestic banking industry in Indonesia but not as nearly as significant impact on the bank group located abroad. Coordination between host and home supervisors is also a priority when a subsidiary or branch office operates in a host country that represents a financial centre because in this case the subsidiary or branch may have a relatively insignificant impact on the host country but a substantial impact on its bank group.

Minimum Banking Supervision Standards for Banks Operating Internationally

Regarding cross-border banking supervision, the Basel Committee on Banking Supervision (BCBS)[7] issued minimum standards for the supervision of bank groups and the establishment of banks operating internationally. The minimum standards as stipulated in BCBS documents released in 1992 include the following:

1. All banks operating internationally must be supervised by home supervisors in a consolidated manner;
2. The establishment of banks operating internationally must seek initial approval from the host and home supervisors;
3. Home supervisors must have the authority to collate information from the establishment of banks operating internationally (cross-border banking establishment); and
4. If the host supervisor considers that any of the three aforementioned principles are not achieved, then the host supervisor is permitted to apply restrictions or interdict the establishment of the bank in question.

7) BCBS is a cooperation forum for banking supervision. The goal of the forum is to broaden understanding on the main issues associated with supervision and to ameliorate the quality of banking supervision around the world. BCBS also develops supervision guidelines and standards. Some of the BCBS documents that have become references worldwide include, among others, international capital adequacy standards, the core principles for effective banking supervision and a concordat for cross-border banking supervision.

The desired goal of issuing minimum standards for the supervision of banks operating internationally is, among others, as follows:

1. Access information, in order to effectively perform consolidated supervision, home supervisors are required to assess all significant aspects of banks operating throughout the Indonesian archipelago. To this end, home supervisors require access to the information held by all subsidiaries and/or branch offices and must ensure that the information provided is accurate, quantitatively and qualitatively. Access to information is also required by host supervisors in order to bolster effective solo supervision. The information required from home supervisors, in order to boost the efficacy of solo banking supervision, includes: (i) a holistic supervisory framework where all bank groups operate; and (ii) information relating to significant issues that transpire in the parent bank or bank group. This information is required for local entities that have a significant impact on the banking industry.
2. Ensure that banks operating internationally (including all subsidiaries and branch offices) consent to consolidated banking supervision by home supervisors and solo banking supervision by host supervisors.

Cooperation between Bank Indonesia and Foreign Supervisory Authorities

Bank Indonesia performs collaborative supervision and actively exchanges supervisory information with a number of supervisory authorities in other countries in order to enhance the effectiveness of consolidated and solo supervision of banks operating internationally. Collaborative supervision and information exchange is formalised through memorandums of understanding (MoU). Up to the past year of 2012, Bank Indonesia has signed several MoUs relating to cross-border banking supervision with a number of foreign supervisory authorities, including Bank Negara Malaysia, the Monetary Authority of Singapore, the China Banking Regulatory Commission, the Australian Prudential Regulation Authority and the Korean Financial Supervisory Service (FSS), among others.

In general, the memorandums of understanding signed by Bank Indonesia aim to enhance the effectiveness of consolidated as well as solo supervision and contain a mechanism to exchange information, a consultation mechanism, inter-authority dialogue and a variety of other forms of interaction that supports implementation of the supervision function, like joint examinations between the host and home supervisors. With the impending transfer of power to the Financial Services Authority (FSA), the scope of information exchange will expand to not only cover banks but also all financial institutions under the authority of the FSA.

The effective implementation of existing memorandums of understanding is evidenced by the active role Bank Indonesia plays, along with other supervisory authorities abroad, in mutually exchanging supervisory information to enhance consolidated and solo supervision. In addition to direct communication and coordination among authorities, the exchange of information between home and host supervisors is achieved through a range of fora, like (i) bilateral supervisors' meetings between Bank Indonesia and Bank Negara Malaysia, as well as between Bank Indonesia and the Monetary Authority of Singapore to discuss the performance of banks in each respective jurisdiction; and (ii) supervisory colleges[8] of several banks operating internationally.

8) Supervisory colleges are multilateral working groups from several relevant supervisory authorities, seeking the collective goal of sustainably boosting consolidated supervision of a bank group operating on the international stage. Furthermore, referring to BCBS documents concerning good practice principles on supervisory colleges, the primary role of supervisory colleges is to broaden the understanding of members (home and host supervisors) regarding the risk profile of bank groups operating internationally through discussion and information sharing about holistic risk assessment, supervisory concerns and so on. Discussions and information sharing are also undertaken in order to agree planned supervision of a bank group, contingency planning and suchlike.

Coordination between Bank Indonesia and supervisory authorities in other countries is not merely limited to the implementation of memorandums of understanding but also informally with institutions in other countries without the umbrella of a memorandum of understanding. Increasingly intensive coordination between home and host supervisors initiated by Bank Indonesia with supervisory authorities in other countries is expected to boost the quality of solo and consolidated banking supervision, which will ultimately contribute to greater financial system stability.

2.4.6 Coordination with other Authorities under the auspices of the Financial System Stability Coordination Forum

Coordination between related institutions and authorities in Indonesia is required in order to maintain financial system stability under normal conditions as well as during times of widespread uncertainty and in terms of crisis prevention and resolution. To this end, the FSA Act (Act No. 21 of 2011) allows for the establishment of a Financial System Stability Coordination Forum (FSSK) with the involvement of the Minister of Finance (doubling as a member and coordinator), the Governor of Bank Indonesia, the Chairman of the Financial Services Authority and the Chairman of the Deposit Insurance Corporation as members.

The FSSK acknowledges the importance of respecting the authority of each corresponding member of the Forum through a coordinated working mechanism to maintain synchronisation and harmonisation as well as to execute actions that are effective, transparent and accountable with the support of adequate and accurate data. In addition, the need to compile guidelines for the implementation of integrated crisis prevention and resolution nationally through a Crisis Management Protocol for each respective member of FSSK is recognised. Therefore, Bank Indonesia as a member of the Forum concurred with the other members to compose memorandums of understanding between the Minister of Finance, the Governor of Bank Indonesia, the Chairman of the Financial Services Authority and the Chairman of the Deposit Insurance Corporation (No. MOU-8/MK.011/2012, No. 14/2/GBI/DKM/NK, No. 01/NK-1/ DK/XII/2012 and No. MOU.001/DK/XII/2012) concerning coordination to maintain financial system stability, which were subsequently signed on 3rd December 2012. The goal of the MoU is to serve as guidelines for coordinated policymaking and follow-up implementation as well as the exchange of data and information between each respective member of the Financial System Stability Coordination Forum (FSSK) in order to maintain financial system stability and to formulate a national crisis management protocol (CMP) based on the task and authority of each member of the Forum pursuant to prevailing laws and regulations.

Paying due regard to the background and goals of the memorandums of understanding, Bank Indonesia, in conjunction with the other members of FSSK, plays an active role in maintaining financial system stability through the implementation of effective coordination for the activities covered in the memorandum of understanding as follows:

1. Exchange data and information on financial system stability and CMP analysis.
2. Discuss the findings of monitoring the exchange rate, the banking sector, non-bank financial institutions, the capital market, the market for tradeable government securities (SBN) and fiscal risk suspected of disrupting financial system stability by each respective authority, which may or may not affect the national budget.

3. Provide inputs and achieve comprehensive understanding regarding the measures and actions required in order to maintain financial system stability.
4. Harmonise and synchronise the policies of each respective authority necessary to maintain financial system stability.
5. Coordinate the implementation of policies taken to prevent and resolve crises in accordance with the respective tasks and authority of each member institution.
6. Communicate with the general public in order to prevent and resolve crises.
7. Implement and evaluate national CMP simulations.

2.4.7 International Fora

In the wake of the global financial crisis, efforts to overcome weaknesses in the financial system that impact the crisis persist until now. Following up on the G-20's recommendations in the area of global financial sector reform by the Financial Stability Board (FSB) and agencies tasked with compiling international standards, like BCBS, the International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) as well as other national authorities is still the main talking point at a variety of international fora.

The Basel III framework, which was the main issue for discussion in terms of global financial sector reforms throughout 2009-2010, is still the focus of attention today. After the capital and liquidity framework was issued under Basel II in December 2010, BCBS has continued to evaluate the framework in order to ensure that it does not trigger any unwanted side effects. To this end, efforts to refine the Basel III framework are ongoing. The most recent revision took place in January 2013, when BCBS amended the requirements for the Liquidity Coverage Ratio (LCR). Meanwhile, another requirement still in the evaluation process in terms of the liquidity framework is the Net Stable Funding Ratio (NSFR). Currently, BCBS is also in the process of assessing the capital framework under Basel III, in particular the leverage ratio.

Other policies to overcome systemic impacts have also been the topic of intensive discussions since 2009. In November 2011, the FSB and BCBS issued a framework to determine systemic banks on a global scale and a framework for a cross-border resolution regime, both of which are mutually beneficial in overcoming the phenomenon of too big to fail. The resolution regime itself is not only applied to the banks but also the non-bank financial sector and financial market infrastructure. Additionally, in October 2012, BCBS also issued guidelines for domestic systemic banking policy that complements the policy framework for systemic banks globally.

Policy in the area of over-the-counter (OTC) derivatives also received attention. Requirements to standardise OTC derivatives, to implement clearing through central counterparties (CCPs), to trade through electronic trading platforms, to report through trade repositories as well as capital requirements and margins were the policy focus to overcome weakness on the OTC derivatives market prior to the onset of the global crisis. For the banking sector, the application of policy pertaining to the OTC derivatives market will also affect the requirements under Basel III. This indicates that policies advocating global financial reforms are deeply interwoven.

Reinforcing the regulation and supervision of shadow banking is also a key focus of attention. Shadow banking, which is described as entities engaging in credit intermediation and other activities outside of the regular or traditional banking system, is viewed as an integral part of the financial system and plays an important role in supporting the real economy. However, there are concerns that shadow banking could trigger systemic risk in the financial system, particularly if shadow banking involves activities that create leverage like banks, as well as if shadow banking is used by market players to circumvent regulatory requirements.

The aforementioned financial sector policies do not signify that global financial sector reforms are close to complete. The attention of international fora, particularly the G-20 and FSB, remains focused on efforts to ensure agreements in the area of global financial reforms are implemented in accordance with the schedules agreed upon. Furthermore, the focus also lies in evaluating the array of policies issued and proposed in order to ensure that policy implementation does not trigger any undesirable impacts.

The G-20 Leaders' Summit held in Toronto in 2010 announced that global financial sector reform would be built on four pillars, namely a strong regulatory framework, effective supervision, resolution and addressing systemic institutions, as well as transparent international and peer review. A number of policies have been implemented, like the Basel III framework, as follow-up measures to the first Pillar. Notwithstanding, it was acknowledged that a strong regulatory framework will be difficult to implement if not supported by effective supervision.

The Basel II capital framework issued in 2006 introduced three pillars to ensure the realisation of a risk sensitive capital framework based on bank risk profile, where one of the pillars is the supervisory review process (Pillar 2). Strengthening the capital framework (Pillar 1) under Basel III is not intended to undermine the importance of Pillar 2's role introduced under Basel II. The new requirements for a conservation buffer, countercyclical capital buffer and surcharge buffer for systemically important banks (SIBs) do not automatically negate the role of Pillar 2. Although the interaction between the required add-on capital under Pillar 2 and the required buffers under Basel II is still being discussed, the capital buffers under Basel III stipulate that such buffers cannot originate from capital instruments used to meet the add-on capital requirements under Pillar 2. This indicates that the required buffers do not undermine the expectations of the supervisory review process but instead bolster supervisor expectations to ensure bank capital adequacy even after the additional buffers under Basel III. This also stresses the importance of the supervisory review process. Supervisors are considered to play an important role through accurate assessments to ensure a balance between risk taking at financial institutions and adequate capital to absorb risk as well as to intervene when imbalances emerge.

The capital and liquidity requirements under Basel III also evidence the growing importance of supervisors paying due regard to the policies instituted in home and host jurisdictions. For example, supervisors must consider the impact of applying a countercyclical capital buffer in home/host jurisdictions because it affects the capital requirements of banks in jurisdictions with cross-border exposure. The implementation of surcharge SIBs and the Basel III liquidity framework also requires supervisors to assess the potential impact on banks in their respective jurisdictions.

The growing expectation of effective supervision is also noted in other areas of global financial sector reforms, like the cross-border resolution regime. Reforms in this area emphasise the high expectations of effective supervision as well as mutual information exchange and cooperation between authorities across jurisdictions in order to ensure the structured resolution of financial institutions, without incurring losses borne by the taxpayer, as well as without undermining financial system stability in other jurisdictions. The required recovery and resolution plans (RRPs) as well as resolvability assessment requires a collaborative supervision framework and solid coordination, which does not only rely on bilateral and multilateral agreements but also through institution specific cooperation agreements (COAGs) as well as sustainable coordination through Crisis Management Groups (CMG). Imbalances in the flow of information between home and key host jurisdictions of G-SIBs, which is currently incorporated in CMGs with non-key host jurisdictions (non-CMGs), is presently overcome through an information exchange framework between CMGs and non-CMGs. Accommodating the interests of non-key host jurisdictions shows that improvements to effective supervision could be achieved through the availability of adequate flows of information between home and host jurisdictions. Therefore, non-key host jurisdictions can jointly minimise the possibility of disruptions to the financial system. The requirement to compile RRPs in itself demands effective and intensive supervision by the relevant authorities. Furthermore, the requirement to compile resolution plans from an early stage, well before the respective bank is undergoing a phase of resolution and primarily for banks whose failure has the potential to trigger systemic risk, will also require effective and intensive supervision.

Recognising the importance of achieving effective supervision, for the past three years the FSB has issued recommendations to bolster the efficacy and intensity of supervision in order to overcome constraints to the achievement of effective supervision in an array of global jurisdictions, like the mandate and independence of supervisory authorities, aspects of resources (qualitatively and quantitatively), the authority of supervisors, technical refinements to supervision, consolidated and group-wide supervision, sustainable and comprehensive supervision, information exchange between home and host supervisors, macroprudential surveillance and so on. A number of weaknesses have been accommodated through several recommendations by global standard-setters, like BCBS, which revised its Core Principles for Effective Banking Supervision (BCP) 2012 as a minimum reference for financial institutions. A range of guidelines and draft guidelines have also been issued in response to the recommendations offered by the FSB regarding effective and intensive supervision in the areas of risk data aggregation and external auditing. Relating to the recommendations made concerning effective and sustainable supervision, the FSB suggests an organisational structure that reflects the level of importance of a systemic institution, which permits the supervisors of such institutions direct access to senior personnel.

Achieving effective supervision is not easy, especially in terms of supervising systemic banks. In its report on raising the effectiveness and intensity of supervision, the FSB concluded that achieving a balance between the adequacy of resources and risk coverage, or a balance between more intensive as well as intrusive supervision and strategic decision-making by bank management will remain a challenge for supervisors. This will entail competence and volition when taking difficult decisions, a focus on the big picture, forward-looking judgement and involvement in discussions with the bank board and management regarding the business strategy and efficacy of risk governance.

Recognising this, in its recommendations to enhance the effectiveness and intensity of supervision in the area of corporate governance, the FSB emphasises the importance of garnering supervisor involvement with the respective bank's board, the need for a better framework to assess the competence of senior management, the importance of raising expectations regarding the role of CRO and improving internal audits from merely satisfactory to strong, as well as raising expectations concerning the planned succession process at banks. Additionally, expectations surrounding the assessment of risk appetite and risk culture at banks are increasing. Thematic peer reviews in the area of risk governance to FSB members shows that the formulation of an effective risk appetite framework linked to the business strategy, capital planning and fixed budget are still arduous challenges for the majority of banks. Other challenges include that not all authorities currently require an explicit risk appetite statement from the Board within the risk-management framework as well as persistent divergence between the minimum elements in the risk appetite framework. Consequently, the FSB will endeavour to overcome these problems through the formulation of common nomenclatures for the terminology to be used in the risk appetite framework (like a definition of risk appetite, risk capacity, risk limit and so on). In addition, considering that the assessment of risk culture plays an important role in the achievement of effective risk governance, the FSB will explore a mechanism to formally evaluate risk culture in 2013.

The recommendations for financial sector reform, from the standpoints of regulation and supervision, represent a form of commitment that Indonesia is expected to make as a member of the G-20 and FSB. The valuable lessons garnered by the supervisory authority in Indonesia in the face of several crises in recent years are lessons learnt in the further analysis of recommended financial sector reforms that could be applied in Indonesia. Efforts to achieve effective banking supervision, especially that which is integrated with the financial sector in Indonesia, must be continued. The supervisory authority for the financial sector is expected to continue overseeing banks in Indonesia to ensure their competitiveness with other banks in the region as well as to maintain the credibility of the supervisory authority in Indonesia in line with that of global supervisory authorities.

Box 2.1 Policy to Extend Credit and Provide Technical Assistance in order to develop MSMEs

On 21st December 2012, Bank Indonesia issued Bank Indonesia Regulation (PBI) No. 14/22/PBI/2012 concerning the allocation of credit or financing and the provision of technical assistance to develop micro, small and medium enterprises (MSMEs) in order to expand the extension of credit/financing by commercial banks to MSMEs, while simultaneously broadening MSME access to financial institutions.

The specifics of the regulation are as follows:

1. Requiring commercial banks to gradually allocate at least 20% of their funds in the form of credit or financing to MSMEs followed by the application of incentives and disincentives. The credit or financing target to MSMEs can be achieved by commercial banks directly through the provision of credit or financing and/or indirectly through executing, channelling and joint financing.
2. The definition of MSME credit is harmonised with the criteria stipulated in Act No. 20 of 2008 concerning Micro, Small and Medium Enterprises.
3. Expanding the forms and recipients of technical assistance, provided in the form of research, training, the provision of information and facilitation. Meanwhile, eligible recipients of technical assistance include commercial banks, (Islamic) rural banks, MSME finance institutions, service providers and MSMEs. The technical assistance provided by Bank Indonesia aims to enhance the competence of human resources at banks in terms of extending financing to MSMEs and capacity building at MSMEs to meet the credit terms imposed by banks.
4. In the allocation of credit or financing to MSMEs, commercial banks shall adhere to Bank Indonesia regulations concerning the bank business plan; the monthly reports of commercial banks; the monthly and quarterly condensed financial statements of commercial banks as well as specific other reports; the debtor information system; information transparency regarding banking products; and the use of private and confidential customer data.

   In addition, the Bank Indonesia regulation also accommodates the need to strengthen coordination and cooperation with third parties in the advancement of micro, small and medium enterprises in order to create an equitable MSME development program.

Box 2.2 Transparency Policy to Publish Prime Lending Rates for MicroÏnance

Policy was issued by Bank Indonesia in February 2011 to ensure the transparent publication of prime lending rates, which became effective in March 2011. There are four credit segments that must be reported and published by banks, namely corporate credit, retail credit and consumer loans (mortgages and non-mortgages). The aim of this policy is, among others, to enhance good governance and promote healthy competition in the banking industry through improved market discipline. Since promulgation of the regulation, prime lending rates have continued to decline in all segments, primarily attributable to a reduction in the cost of funds for credit and overhead costs.

Table 2.1 Average Prime Lending Rates offered by the Banking Industry (%)

Credit Segment	Sample								qtq	Mar 11-Des 12	Des11-Des 12
	2011				2012						
	Mar	Jun	Sept	Des	Mar	Jun	Sep	Des			
Corporate	10,51	10,72	10,51	10,18	9,86	9,81	9,75	9,69	(0,06)	(0,82)	(0,49)
Retail	11,80	11,91	12,04	11,61	11,23	11,08	11,03	11,14	0,11	(0,66)	(0,47)
Mortgages	11,16	11,38	11,04	10,71	10,61	10,50	10,45	10,41	(0,04)	(0,75)	(0,30)
Non-Mortgages	11,56	11,86	11,88	11,51	11,05	10,99	10,67	10,65	(0,03)	(0,91)	(0,86)

Note: data excludes outliers and is calculated as a weighted average

Based on the results of monitoring performed by Bank Indonesia as well as input from the general public and banking community, the inclusion of a microfinance segment was desirable in the publication of prime lending rates. Based on the data, the nominal share of microfinance to total credit is just 4.06% (December 2012), however, the share of microfinance accounts to total credit accounts in the banking industry is relatively large at 17.48%.

The publication of microfinance prime lending rates is harmonious with the Bank Indonesia regulation that requires commercial banks to allocate at least 20% of their total credit to MSMEs as well as the direction of Bank Indonesia policy in 2013 in the banking sector, namely to broaden public access to more affordable financial services through financial inclusion policy. Bolstering the supply of credit to MSMEs should be accompanied by the availability of competitive microfinance rates, considering that current rates are relatively much higher than the lending rates offered on other types of loans. The definition of micro enterprises in this case refers to the criteria stipulated in the regulation on micro, small and medium enterprises (MSMEs). Prior to the introduction of the amended prime lending rate policy, the 15 largest microfinance providers were approached and surveys were conducted on microfinance customers at the 15 banks. The findings of the discussions with the banks revealed that there remained a clear opportunity to lower lending rates on microfinance through, among others, aspects of transparent pricing. Meanwhile, the results of the survey indicated that the majority of microfinance customers prioritised aspects of convenience and service when seeking credit rather than the lending rate offered. Consequently, there is a need to ensure fairness and protect the consumers of microfinance, hence leading to more normal microfinance lending rates. To this end, Bank Indonesia as the regulator recognised the need to institute policy that encouraged banks to offer more normal microfinance lending rates to the general public. The policy to transparently publish prime lending rates for microfinance is expected to prevent the possibility of exploiting microfinance customers through excessively high or unnatural lending rates set by the banks.

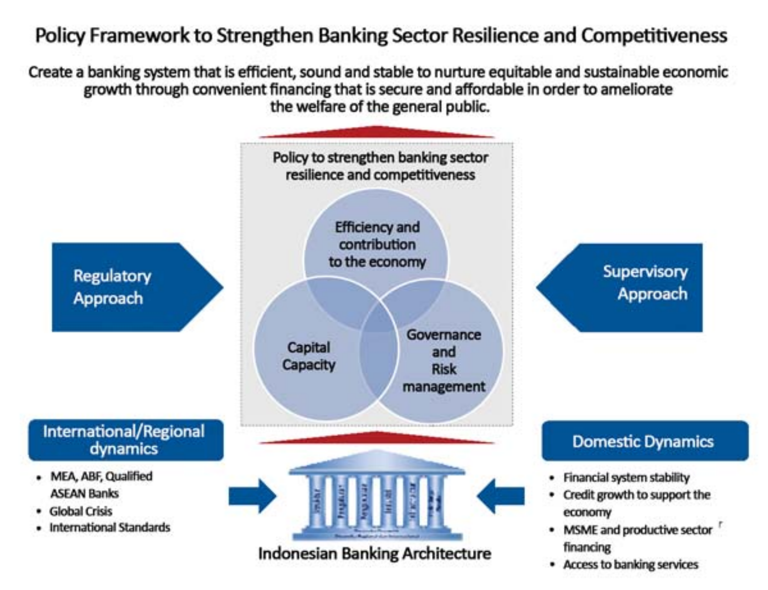
Cooperation with and the support of several parties are required through education socialisation and communication with the public in order to ensure the effective implementation of policy to transparently announce prime lending rates (including microfinance lending rates). Only in this way will such policy be understood quickly by all strata of society, thereby helping task implementation in the banking sector and contributing to national economic growth through credit allocation that is oriented towards productive sectors and priced competitively as well as transparently.

Box 2.3 Multi-licensing Policy

Regional and Global Dynamics

In harmony with global economic and financial dynamics, Indonesia is not immune to the effects of the global and regional economies. Financial system stability in Indonesia is still influenced by the crisis in Europe and languid recovery in the United States, thereby necessitating anticipatory measures that bolster the domestic economy. In addition, planned financial sector integration in the ASEAN region commencing in 2020 will open up numerous opportunities for banks in the region to become Qualified ASEAN Banks (QAB) and therefore operate as local banks in ASEAN member countries, including Indonesia. On the other hand, there remain a number of arduous challenges facing the domestic banking industry. The ratio of credit to GDP is just 32% with economic activity concentrated on the island of Java and parts of Sumatera. In addition, formal financial services are not spread evenly through the Indonesian archipelago, not even reaching half of the population currently, which requires fundamental banking structure policy in order to build resilience and enhance competitiveness.

Bank Indonesia issued the Indonesia Banking Architecture (IBA) in 2004, which remains the cornerstone of banking policy direction in Indonesia. Multi-licensing, as a part of Pillar 1 implementation, is expected to promote banking sector resilience and competitiveness.



Why Multi-licensing?

In broad terms, multi-licensing policy is the regulation of business activity and office networks based on core capital. This policy is expected to help shore up bank capital in order to anticipate risks stemming from the complexity of business activity and the need to expand the office network. In addition, the policy is also expected to optimally enhance the bank intermediation function, especially productive businesses.

Banks operating according to their capacity are considered to have greater resilience because they are able to absorb the risks faced using the capital at their disposal. Furthermore, such banks are more efficient because their business activity focuses on superior products and activities.

Multi-licensing encourages banks to operate according to their economic scale. In order to expand their business activity, banks will achieve economies of scale if their level of core capital totals at least Rp1 trillion. This total increases to around Rp5 trillion if the bank wishes to conduct full business activity according to economic scale. By operating at their economic scale, banks can achieve an optimal level of efficiency as profit becomes determined by the volume of earning assets and not pinned by pricing or the lending rates offered. From a business activity standpoint, multi-licensing is applied by grouping the business activities of commercial banks into four groups, determined in principle by the level of core capital at the respective bank. The groups are known as BUKU 1, BUKU 2, BUKU 3 and BUKU 4.

BUKU 1	• Basic banking services • Core capital of Rp100 billion to less than Rp1 trillion
BUKU 2	• Broader banking services and limited activities • Core capital of Rp1 trillion to less than Rp5 trillion
BUKU 3	• Full banking services and activities • Core capital of Rp5 trillion to less than Rp30 trillion
BUKU 4	• Full banking services and complex activities • Minimum core capital of Rp30 trillion

In line with the level of core capital, the business activity of banks in BUKU 1 tends to be basic banking services. Business activity in BUKU 2 is broader than that in BUKU 1 and so on up to BUKU 4, which covers full and complex banking services.

In order to ensure that the intermediation function is following the desired trajectory and contributing optimally to the national economy, each respective bank group is bound by a target for productive credit that must be met, namely 55% for BUKU 1, 60% for BUKU 2, 65% for BUKU 3 and 70% for BUKU 4. Those targets are calculated based on total bank credit portfolio and include the mandatory 20% allocation for MSME credit.

From the perspective of expanding the office network, multi-licensing is implemented by re-regulating the mechanism for opening new branch offices in order to ensure the even expansion of banking services as well as to promote economic development in unbanked and underbanked areas. There are two main requirements in terms of expanding the office network, namely the level of soundness and allocation of core capital. Stipulating the level of soundness is not a foreign concept in terms of expanding the office network because it was contained in the previous regulation. However, the allocation of core capital is a new concept.

Table 2.2 Allocation of Core Capital by Branch Office Type

Office Type	Allocation of Core Capital for BUKU 3 and 4	Allocation of Core Capital for BUKU 1 and 2
Branch Office	Rp10 Bilion	Rp8 Bilion
Regional Office	Rp10 Bilion	Rp8 Bilion
Sub-branch Office	Rp4 Bilion	Rp3 Bilion
Functional Office *)	Rp4 Bilion	Rp3 Bilion
Cash Office	Rp2 Bilion	Rp1 Bilion

*) Excluding Functional Offices extending microfinance.

The allocation of core capital is not permanent and can be changed periodically in accordance with prevailing economic conditions and public access to banking services.

The allocation of core capital is not permanent and can be changed periodically in accordance with prevailing economic conditions and public access to banking services.

Fundamentally, regulating the allocation of core capital in the expansion of office networks aims to ensure that the establishment of new branch offices is always supported by adequate core capital, thereby avoiding over burdening the respective bank's operating costs. In the calculation of core capital allocation, each type of bank office (branch office, sub-branch office and cash office) is subjected to a different level. To simplify the calculation of core capital allocation, the territory of Indonesia is divided into six zones, starting with Zone 1 for the most densely banked areas with a high coefficient to Zone 6 where the number of banks is small and the coefficient is low.

If a bank wishes to open a new branch, the core capital for the existing office network is calculated first, with the remainder used to determine how many new offices can be opened, in which regions and of which type.

Division of Zones and Determination of Coefficients

Zona I — *Koefisien = 5*
- DKI Jakarta
- Luar Negeri

Zona II — *Koefisien = 4*
- Jawa Barat
- Jawa Tengah
- DI Yogyakarta
- Jawa Timur
- Bali

Zona III — *Koefisien = 3*
- Kalimantan Timur
- Kepulauan Riau
- Sumatera Utara

Zona IV — *Koefisien = 2*
- Riau
- Sumatera Selatan
- Kalimantan Tengah
- Kalimantan Selatan
- Sulawesi Utara
- Sulawesi Selatan
- Papua

Zona V — *Koefisien = 1*
- DI Aceh
- Jambi
- Sumatera Barat
- Bangka Belitung
- Bengkulu
- Lampung
- Kalimantan Barat
- Sulawesi Tenggara

Zona VI — *Koefisien = 0.5*
- NTB
- NTT
- Sulawesi Tengah
- Gorontalo
- Sulawesi Barat
- Maluku Utara
- Maluku
- Papua Barat

The division of zones and size of coefficients will be determined periodically in accordance with local economic development and the scope of public access to banking services.

Incentives to expand the office network will be provided to banks with a proclivity for micro, small and medium enterprises in order to ensure financing services continue to reach productive members of the community.

In addition to an incentive/disincentive program, factors of efficiency and capital accumulation from net profit will also be considered in the expansion of office networks. As such, in addition to using a purely regulatory approach, a supervisory approach is also utilised to ensure office network expansion remains harmonious with efforts to enhance efficiency.

Banking Sector Resilience and Competitiveness

Multi-licensing policy is long-term because it creates a new structure in the national banking industry. Such policy is expected to strengthen bank resilience because banks will operate according to their capacity. Furthermore, such policy in the long term will also boost efficiency and enhance economies of scale because office network expansion and the expansion of business activities can only be attempted if sufficient capital capacity exists. Banking sector resilience and competitiveness will also become a form of capital when competing with other banks in the ASEAN region, both domestically and in neighbouring countries.

Banking consolidation will remain an area of interest, however its implementation will become indirect by urging banks to supplement capital if business expansion is a desired goal. The necessary increase in capital can be achieved through supplementary capital, approaching strategic investors or through mergers and consolidation. In this regard, consolidation must be approached in a wider context, namely through synergy between large banks, whose market is large customers, and small and medium banks, whose market segment is more niche.

The introduction of policy to expand the portion of bank credit used to finance productive activities will undoubtedly help advance the domestic banking industry and new entrepreneurs keen to realise market potential based on a creative economy will be encouraged to develop their businesses, thereby creating employment opportunities. Furthermore, economic potential in local areas untouched by bank financing will become leading regional sectors that contribute substantially to local economic growth and help balance development throughout the Indonesian archipelago.

With the potential outcomes that could be achieved, it is not excessive to state that multi-licensing policy will help the realisation of a banking system that is efficient, sound and stable, hence driving sustainable economic growth in order to ameliorate the welfare of the general public.

Box 2.4 Trustee Policy

Bank Indonesia assumes the task of achieving and maintaining rupiah stability in order to buttress national economic development. In the preservation of rupiah stability, Bank Indonesia faces a number of factors that affect the balance, among others, the supply of and demand for foreign currency on domestic financial markets. Hitherto, sources of foreign exchange (forex) supply on domestic financial markets stem from the financial sector, particularly in the form of foreign portfolio investment that is susceptible to a sudden capital reversal. Meanwhile, the supply of foreign exchange received from export proceeds, which is a sustainable source of funds, is not yet exploited optimally. The benefit of potential sources of foreign exchange, in particular that sourced from export proceeds, is thought to maintain the balance between the structure of supply and demand on the domestic forex market through exchange rate management and domestic forex market deepening.

In line with policy to manage the supply of foreign exchange and policy to expand the role and enhance the competitiveness of domestic banks, Bank Indonesia issued a regulation on 23rd November 2012 that aims to encourage economic agents to manage their foreign exchange using domestic banking services and expertise. This falls under the umbrella of trust management policy and is implemented through Bank Indonesia Regulation No. 14/17/PBI/2012.

Pursuant to the authority of Bank Indonesia to regulate and supervise the national banking industry, the promulgation of this regulation is expected to stimulate and urge the national banking industry to become more attractive internationally. Nonetheless, efforts to enhance the scale of competition in the national banking industry must be offset by adherence to prudential principles considering that trust policy is new and now being regulated for the first time in Indonesia, hence the policy lacks supporting trust legislation.

During the preliminary stage, Bank Indonesia is regulating this activity by setting requirements for banks domiciled in Indonesia and foreign bank branches as follows:

1. Banks: legally incorporated in Indonesia; have a core capital of not less than Rp5 trillion and a minimum capital adequacy ratio (CAR) of 13% for the past 18 consecutive months; have a bank soundness rating of not less than 2 for the past two assessment periods (12 months) and a rating of 3 for the previous period; announce the planned trust management activity in the Bank Business Plan (BBP); and have the capacity to undertake trust management activity based on the results of an assessment conducted by Bank Indonesia.
2. Foreign banks: incorporated in Indonesia not less than three years since promulgation of PBI No. 14/17/PBI/2012; maintain Capital Equivalency Maintained Assets (CEMA) pursuant to prevailing regulations and totalling not less Rp5 trillion with a minimum capital adequacy ratio (CAR) of 13% for the past 18 consecutive months; have a bank soundness rating of not less than 2 for the past two assessment periods (12 months) and a rating of 3 for the previous period; announce the planned trust management activity in the Bank Business Plan (BBP); and have the capacity to undertake trust management activity based on the results of an assessment conducted by Bank Indonesia.

When monitoring the implementation of trust management, Bank Indonesia shall require banks engaged in trust management to meet specific requirements relating to minimum core capital (for banks) or CEMA (for foreign banks), the capital adequacy ratio and soundness level as follows:

1. Banks: have a minimum core capital of Rp5 trillion; a capital adequacy ratio of not less than 13%; and bank soundness rating of 2;
2. Foreign banks: have a minimum CEMA pursuant to prevailing regulations and of not less than Rp5 trillion; a capital adequacy ratio of not less than 13%; and bank soundness rating of 2;

The target and direct benefits expected from the implementation of this policy, at the national level, in the banking sector and in the corporate sector, are as follows:

1. National:
   - Reduce the dependence on short-term foreign funds that could disrupt macro stability.
   - Reinforce exchange rate stability by increasing the sustainable supply of foreign exchange.
   - Activate the financial market, especially the domestic forex market.
2. The Banking Sector
   - Open the opportunity for new business activity with a large potential management value.
   - Expand domestic banking services and competitiveness, as well as encourage banks to build their capacity in terms of capital, risk management, governance, information technology and human resources.
3. The Corporate Sector
   - Expand the availability of trust management activity to meet the infrastructure requirement of exporters and recipients of overseas loans in order to comply with regulations concerning foreign exchange proceeds from exports and foreign exchange from overseas loans.
   - Establish a clear legal framework concerning trust management activity.

   This policy is expected to contribute to meeting the supply of foreign exchange on domestic financial markets, thereby supporting efforts to maintain monetary and exchange rate stability. Bank Indonesia recognises that policy relating to trust management is still embryonic as this represents that first time such activity has been regulated in Indonesia and, therefore, it lacks an explicit legal framework at the judicial level. Looking ahead, laws are required that regulate trust management activity conducted by banks and non-banks. Amendments to the regulations concerning the types and scope of activity, the requirements, risk management, the reporting mechanism and so on will continue.

Box 2.5 Shareholding Policy at Commercial Banks

Background

The economic crisis that befell the Asian region at the end of the 1990s was marked by exchange rate shocks that hit the economy of Thailand, where depreciation in the range of 30% was experienced. The subsequent exchange rate crisis eventually destroyed investor confidence in Asian countries, leading to a massive sudden capital reversal as foreign capital, in the form of foreign direct investment and portfolio investment, took flight to countries deemed more stable.

The fallout from the crisis in the banking sector, as a result of the skyrocketing value of foreign debt due to exchange rate depreciation, was further exacerbated by the dominance of certain shareholders at banks that tended to undertake imprudent banking practices, like credit disbursements to affiliated parties or within their own group, which led to even deeper bank failures. Rupiah depreciation was followed by soaring interest rates as a consequence of efforts to stabilise prices and the rupiah exchange rate, which further undermined borrower performance and led to spiralling non-performing loans. Such circumstances compounded bank losses and eroded capital at nearly all banks.

Overcoming problems with capital in the banking sector post crisis not only relied on domestic sources of funds and bank recapitalisation policy but the government also had to attract capital inflows from foreign parties back into the domestic banking industry. During the crisis period, domestic investors were unable to supplement sufficient capital into the banking sector, while on the other hand, foreign investors faced constraints in terms of limitations on foreign shareholdings in domestic banks, limited to 85% (Act No. 70/1992 concerning Commercial Banks). To overcome this constraint, restrictions were relaxed through the promulgation of PP No. 29/1999 concerning the Purchase of Commercial Bank Shares, which regulated foreign ownership (direct and through the stock exchange) of joint venture banks, limiting ownership to 99% of total shares in a bank.

Nearly one decade after the Asian economic crisis, the global economy received more warnings of a financial crisis on the horizon. This time the onset of the crisis was triggered by a subprime mortgage debacle in the United States but the crisis quickly spread through contagion to financial and banking systems in other countries. The global financial crisis, in part caused by the failure of good corporate governance at banks, led the Basel Committee on Banking Supervision (BCBS) to issue Principles for Enhancing Corporate Governance, which requires supervisory authorities to implement measures to ensure that ownership structure does not inhibit the implementation of good corporate governance in any way.

In addition to problems associated with good corporate governance in the banking sector, the advent of economic cooperation in the ASEAN region also forced the national banking industry to enhance its resilience and competitiveness. Planned ASEAN financial sector integration in 2020 will see the emergence of Qualified ASEAN Banks (QAB) that are free to operate anywhere in the ASEAN region, thereby ramping up the level of competition between national banks and those from the ASEAN region.

Objectives

Reflecting on experience gleaned from the 1997 crisis as well as cases of troubled banks in Indonesia, which in general are owned by specific dominant parties, the need was recognised to regulate the level of shareholding permitted at banks in Indonesia. More evenly distributed shareholdings are a solid foundation in the implementation of good corporate governance, where checks and balances can be put in place among the various shareholders. Such a mechanism could minimise potential abuses in the interest of specific shareholders or parties related to certain shareholders.

The regulation concerning shareholdings at commercial banks limits the size of shareholdings. For example, the largest shareholding is permitted for shareholders in the form of banks and non-bank financial institutions (40% of paid up capital), while the smallest shareholding is applicable to individuals (20% of paid up capital at conventional banks and 25% of paid up capital at Islamic banks). The philosophy behind the difference is that banks and non-bank financial institutions are supervised and regulated, and therefore expected to better steer bank policy in a more desirable direction. On the other hand, considering that no supervisory body is responsible for supervising and regulating individuals, their ownership of bank shares is the most restricted compared to other kinds of shareholder. The other category of shareholder is non-financial institutions, which are permitted a maximum shareholding of 30% of paid up capital.

Although the philosophy of this regulation is to ensure shareholders in the national banking industry adhere to the maximum level set, full implementation will be achieved gradually. The first stage is to enforce restrictions on shareholdings at banks with a soundness rating and/or good corporate governance (GCG) rating of 3, 4 or 5 in December 2013. On the other hand, shareholders at banks with a soundness rating or GCG rating of 1 or 2 in December 2013 will be able to maintain their level of shareholding while the rating is maintained.

By providing special dispensation for shareholders at banks with a soundness rating and GCG rating of 1 or 2 in December 2013 to retain their level of shareholding while the ratings are maintained, banks will have an incentive to improve and maintain their soundness ratings and the quality of GCG implemented. Phasing in this regulation also aims to minimise potential price pressures on the stock market that would occur if all banks simultaneously adjusted their shareholdings within a specific period. In addition to reinforcing bank resilience through a stronger soundness level and better quality good corporate governance, this policy also promotes bank consolidation by providing an incentive in the form of a longer time frame to adjust the maximum shareholding for investors in banks that have merged.

Box 2.6 Policy for iB Mortgages and iB Automotive Financing at Islamic Commercial Banks and Islamic Business Units

iB mortgage financing and iB automotive financing from the Islamic banking industry have mushroomed in the past five years with average annual growth in the range of 53.19%. Such robust growth in recent years has led to iB mortgage financing and iB automotive financing accounting for 13.5% of all financing allocated in October 2012. Similar to the case at conventional banks, excessive iB mortgage financing from Islamic banks drives up property prices so that they no longer reflect true prices (bubble), which could exacerbate credit risk at banks largely exposed to property financing. Similarly, excessive growth in iB automotive financing could escalate credit risk for the banks.

In order to apply prudential principles and expand the role of Islamic banks to support national economic growth through productive financing, in the same way as conventional banks, policy is also required for Islamic banks concerning iB mortgage financing and iB automotive financing. iB mortgage financing and iB automotive financing policy in the Islamic banking industry is issued while paying due consideration to the special characteristics of Islamic banking products, including the fatwa issued by the National Sharia Board-Council of Ulama Indonesia (DSN-MUI). Bank Indonesia policy is set forth in Bank Indonesia Circular No. 14/33/DPbS, dated 27th November 2012, concerning the application of policy for mortgage financing and automotive financing extended by Islamic commercial banks and Islamic business units.

The new guidelines regulate the following: (i) iB mortgage financing under Murabahah or Istishna are subject to a maximum financing-to-value (FTV) ratio of 70% (FTV is calculated as the difference between the value of financing and the value of collateral, where the value of financing is based on the principal amount allocated to the customer as stipulated in the financing agreement, while the value of collateral is based on an assessment performed by BUS or UUS at the start of the financing agreement); (ii) iB mortgage financing under Musyarakah Mutanaqisah (MMQ) is required to limit house/building sharing from the outset by Islamic banks set at 80% of the value of the house/building; and (iii) iB mortgage financing under Ijarah Muntahiya Bittamlik (IMBT) is required to use a deposit that must be deposited by the customer to the corresponding Islamic bank of no less than 80% of the value of the house/building. The deposit will subsequently be counted as payment towards the purchase of the house/building when the IMBT matures. In the event that the customer rejects the option to purchase the house/building that is the object of the IMBT, then the deposit is returned to the customer.

iB mortgage financing under MMQ and IMBT is subject to less stringent regulations than that for Murabahah and Istishna due to the following considerations: (i) contains principles of risk sharing, which is the soul of the Islamic economy; (ii) promotes MMQ and IMBT products in the Islamic banking industry, thereby countering the dominance of Murabahah (policy to promote financing, excluding Murabahah, is already in place through regulations to assess the quality of assets as well as the restructuring of Musyarakah/Mudharabah financing); and (iii) MMQ and IMBT products that could possibly drop in price (repricing) during the financing repayment period provide benefits to the customers and the banks, thereby making such products more competitive.

The scope of iB mortgage financing in this Bank Indonesia Circular covers consumer financing to purchase a house, including flats and apartments exceeding 70m2 but excluding home offices and home stores and does not include iB mortgage financing for government housing schemes.

On the other hand, downpayments for iB automotive financing are applicable as follows: (i) a minimum downpayment of 25% for two-wheeled vehicles; (ii) a minimum downpayment of 30% for four-wheeled vehicles; and (iii) a minimum downpayment of 20% for four-wheeled commercial vehicles. Commercial vehicles as stipulated in this Bank Indonesia circular must meet one of the following requirements: (a) a vehicle to transport people or goods licensed by the relevant authority and used for specific business activities; or (b) a vehicle owned by an individual or business entity licensed by the relevant authority and used to support the operational activity of the corresponding business. The lower level of downpayment applicable to commercial vehicles aims to benefit those who seek formal automotive financing for commercial purposes while still adhering to prudential principles. The level of FTV, sharing, and deposits for iB mortgage financing and the level of downpayments on iB automotive financing will be adjusted for time to time in accordance with prevailing economic conditions.

This circular was issued on 27th November 2012 and becomes effective on 1st April 2013. Consequently, the effectiveness of this regulation has not yet been evaluated.

Chapter 3
Banking Supervision Implementation and Enforcement in 2012

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3.1 Banking Supervision

Consolidated Supervision

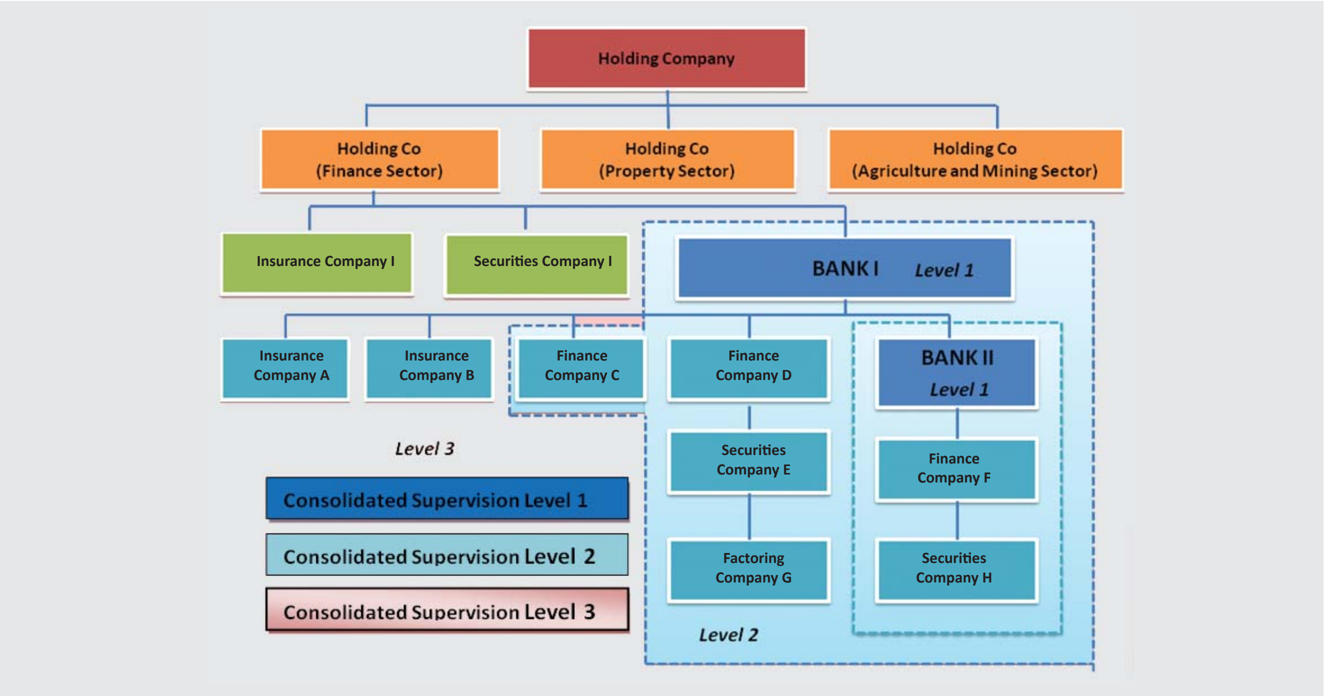
Banks continuously face risks inherent in each business activity. Risks stem from the activities of the bank itself or indeed from businesses related to the bank. Meanwhile, the development of financial transactions during the era of globalisation has led to greater integration in terms of the financial products and services offered by banks. Progressively integrated financial products and services have led to a profusion of increasingly complex risks. Confronting these conditions, banks are required to monitor all risks that directly and indirectly influence business continuity, including risks originating from subsidiaries and the corresponding business group.

Through the promulgation of Bank Indonesia Regulation No. 8/6/PBI/2006 concerning the application of consolidated risk management by banks with control over subsidiary companies, Bank Indonesia requires banks with control over a subsidiary to apply consolidated risk management. The implementation of this regulation is contained within Bank Indonesia Circular No. 8/27/DPNP, dated 27th November 2006, concerning prudential principles and reporting in order to apply consolidated risk management by banks with control over a subsidiary.

Thereinafter, in order to conduct consolidated banking supervision, Bank Indonesia issued Circular No. 14/60/INTERN, dated 12th December 2012, concerning guidelines for consolidated banking supervision of banks with control over a subsidiary. That circular supersedes the previous Bank Indonesia Circular No. 8/76B/INTERN, dated 15th December 2006, concerning guidelines for consolidated banking supervision of banks with control over a subsidiary.

In general, banking supervision is divided into three levels. **Level 1** is supervision of a bank on a solo or individual basis. At this level, banks and non-bank financial institutions are supervised individually. **Level 2** is supervision of a bank as the parent company of a subsidiary (downstream). And **Level 3** is holistic supervision (upstream and downstream) that encompasses the parent company, the bank, subsidiaries and sister companies of the bank. Looking ahead, as bank activities and products become increasingly complex and in order to anticipate the development of bank conglomerates, consolidated banking supervision will be required of the bank, parent company and subsidiary companies, including sister companies.

Figure 3.1 Consolidated Supervision Framework

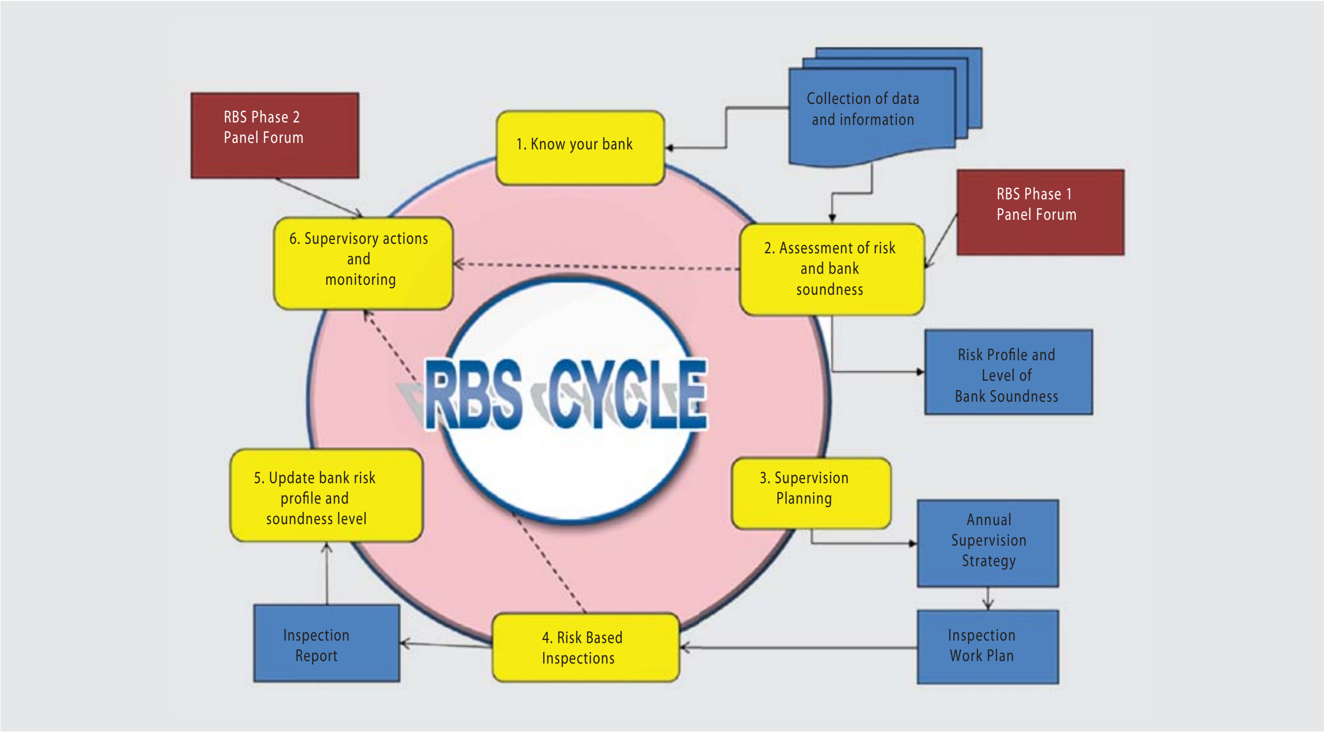


Risk-Based Banking Supervision

Bank Indonesia applies a risk-based approach to banking supervision. This approach utilises a strategy and methodology based on risk that allows supervisors to detect significant risks to the business activity of banks under their supervision early and take appropriate supervisory actions in a timely manner. Risk-based supervision can be described as a cycle made up of the following stages:

- *Stage 1* is understanding the bank (know your bank). This stage is a preliminary measure in the overall risk assessment process and takes the form of understanding internal and external factors that could influence the performance and risk profile of the bank.
- *Stage 2* is assessing risk and bank soundness, where the risk assessment process covers the assessment of inherent risk and the risk control system as well as the determination of bank risk. The results of the risk assessment are an inseparable part of the bank soundness assessment.
- *Stage 3* is supervision planning, which consists of planning annual supervision activity. This includes direct and indirect supervision according to the risk profile and soundness level of the bank.
- *Stage 4* is risk-based inspection, namely the inspection techniques and procedures with a focus on significant risks in accordance with the results of the risk assessment and planned supervision. Aspects of bank compliance to prevailing regulations are also included in risk-based inspections.
- *Stage 5* is periodically updating the risk profile and/or bank soundness level if a significant change occurs in the conditions or performance of a bank based on the results of indirect banking supervision or indeed direct supervision.
- *Stage 6* is supervisory actions and monitoring. Supervisory actions are measures undertaken by bank supervisors in order to resolve the respective bank’s problems based on the results of risk assessment and

Figure 3.2 The Risk-based Supervision Cycle



bank soundness and/or the results of inspections. Monitoring is performed on the implementation of the corrective actions required in line with the schedule set.

To hone the quality of supervision (quality assurance) and thereby advance the effectiveness of banking supervision, quality assurance is implemented to guarantee that the input, process and output of risk-based banking supervision meet international standards. To this end, a Risk-Based Banking Supervision Panel Forum was established that offers recommendations and conducts assessments regarding the quality of banking supervision. The panel forum is convened at two different stages of the RBS cycle, namely during the assessment of risk and bank soundness stage as well as during the stage of supervisory actions and monitoring.

Risk-based supervision has been applied by Bank Indonesia since 2003. In harmony with the implementation of risk-based supervision, Bank Indonesia applied an assessment system for bank soundness, known as the CAMELS rating system in 2004, where bank supervisors assessed bank soundness based on factors of capital, asset quality, management, earnings, liquidity and sensitivity to market risk. Although the implementation of both supervisory systems was sufficient to support risk-based banking supervision, Bank Indonesia recognised the need to refine the prevailing supervision system based on a number of considerations. First, the recent global crisis triggered a global financial reform movement that aims to bolster financial system stability through refinements in the supervision system and the application of risk management by banks. Second, the release of international standards by, among others, BCBS, FSB, G-20 and IFRS (International Financial Reporting Standards) necessitated adjustments to the Bank Indonesia supervisory framework and methodology to ensure compliance with prevailing international standards.

Bank soundness based on risk is the outcome of assessments of bank conditions based on four factors, namely the risk profile, good corporate governance, earnings and capital. Assessments are required by supervisors as well as the banks themselves (self-assessment). The assessment of risk profile is an evaluation of inherent risks and the quality of risk management for eight types of risk, namely credit risk, market risk, liquidity risk, operational risk, legal risk, strategic risk, compliance risk and reputational risk. Good corporate governance is assessed by evaluating a bank's management in terms of implementing the principles of good corporate governance referring to prevailing Bank Indonesia regulations concerning the application of good corporate governance by commercial banks. Earnings are assessed by performance, sources of earnings, sustainability of earnings and the adequacy of earnings management. Assessing capital involves evaluating capital adequacy and how well bank capital is managed.

Banks are required to report their findings from self-assessments of bank soundness, individually and consolidated, to Bank Indonesia in accordance with the deadlines set. Furthermore, banks are also required to update their self-assessment of bank soundness and submit the results to Bank Indonesia at the first possible opportunity when financial conditions deteriorate, or the bank faces problems like liquidity risk or capital shortfalls, or other conditions that, according to Bank Indonesia, require the bank soundness level to be reappraised. Bank supervisors use the results of assessments as the foundation for supervisory planning and supervisory actions for the problems identified in the assessment, including determining the status and exit policy. For the banks, the assessment of bank soundness is used as the basis to determine future business strategy as well as to compile and implement corrective actions on the bank's weaknesses or problems identified in the assessment of bank soundness. If, in its assessment, Bank Indonesia identifies problems or violations that significantly affect or will significantly affect bank operations or business continuity, Bank Indonesia is authorised to lower the composite rating of bank soundness for the bank in question.

Bank Soundness Assessment Framework

Assessing the health of a bank based on risk (Risk-Based Bank Ratings – RBBR), known as assessing the bank soundness level, is a mechanism to evaluate risk and the financial conditions of a bank based on the information obtained by supervisors through on-site examinations as well as information gleaned from bank reports submitted to Bank Indonesia (off-site supervision). The assessment of bank soundness produces a composite rating that is used as a means for bank supervisors to determine strategy and the focus of supervision on a particular bank. Therefore, assessing the soundness of a bank helps bank supervisors to:

a. Detect significant risks early and initiate appropriate and timely supervisory actions.
b. Allocate supervisory resources to the risks with most potential to undermine the health or soundness of a bank.
c. Enhance the application of consolidated supervision through consolidated risk-based bank ratings for bank with control over a subsidiary.
d. Formulate a supervisory plan congruous with the problems identified in the assessment of bank soundness.

Bank Soundness in the Banking Supervision and Regulation Paradigm

RBBR represents a new banking supervision and regulation paradigm for Bank Indonesia, composed if the following characteristics:

a. The Bank Indonesia supervisory framework is increasingly directed towards a **principle-based** approach, namely a regulatory approach that prioritises meeting core regulatory principles rather than formulating rigid regulations in too much detail (prescriptive). Therefore, breathing room is provided for bank supervisors to interpret and apply the substance of Bank Indonesia regulations according to the scale, characteristics and complexity of each respective bank.

b. Using a principle-based approach, Bank Indonesia regulations, especially those relating to the application of risk management and good corporate governance, are a form of **minimum requirements** that the bank or supervisors must tailor to the scale, risk characteristics and complexity of business activity under supervision. Consequently, RBBR assessments are not a one-size-fits-all approach and actually require bank supervisors to apply the same standards but with different expectations for each bank. As the business scale of a bank or the importance of the bank in the financial system increases, or indeed as the products and business activities of a bank become more complex, then supervisors' expectations also increase regarding the risk management and good corporate governance standards to be applied.

c. Using a **holistic** approach to banking supervision and regulation, namely a combination of microprudential aspects in order to create sound banks individually and macroprudential aspects that seek to create a healthy bank industry as a whole.

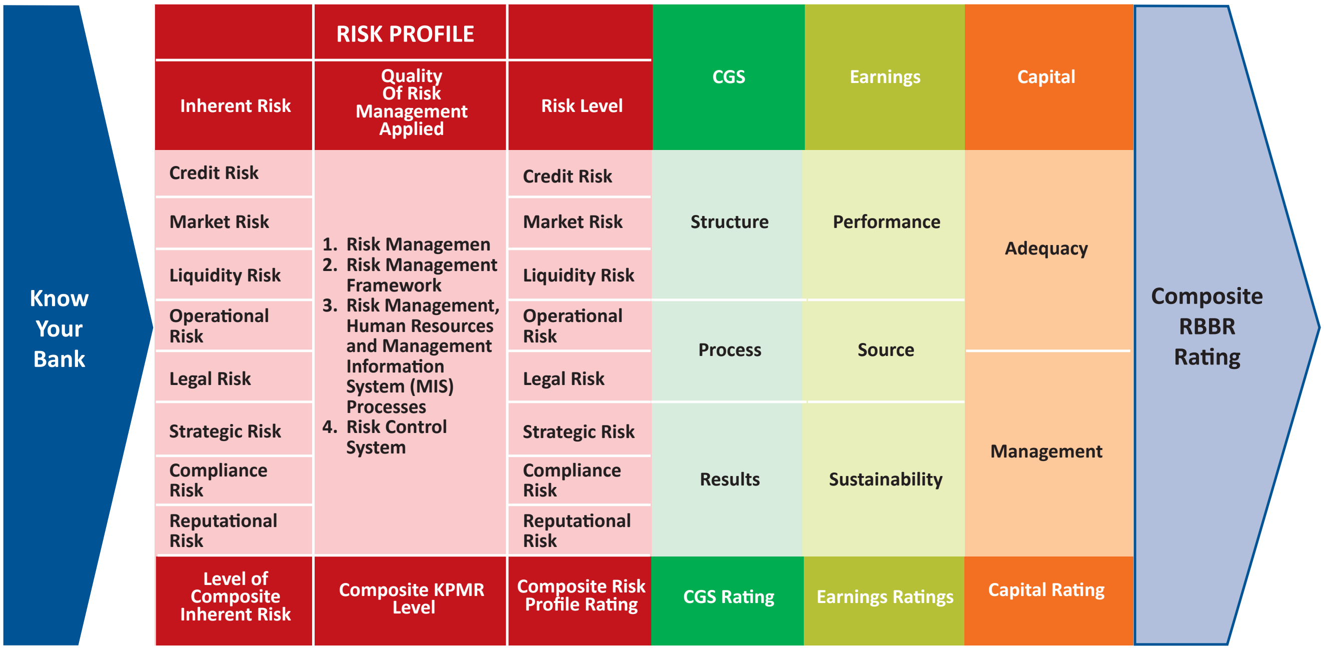
d. Balanced banking supervision and regulation, namely by striking an optimal balance between the application of supervision and enforcement pursuant to prevailing regulations and accompanied by supervisory actions tailored to the problems faced by the specific bank contextually. Therefore, in the case that a specific regulation does not exist, bank supervisors must continue to enforce supervisory actions and request an exit strategy if problems are identified at the bank.

e. Bank supervision is directed towards **identifying problem banks earlier and implementing effective and timely supervisory actions.** Accurate and early identification of the root of the problem is crucial to determining the supervisory actions required. RBBR answers this requirement by providing a comprehensive and structured analysis approach, hence problem banks can be identified more accurately and more effective and timely supervisory actions can be initiated.

f. The bank soundness level, the management of the bank and bank business continuity are the full responsibility of the bank's management. The bank's management is required to maintain and advance the level of soundness through the application of prudential principles in the implementation of business activity. To this end, banks are required to perform regular self-assessments of soundness as well as implement effective corrective actions.

The assessment of bank soundness covers the evaluation of four key factors, namely the risk profile, good corporate governance, earnings and capital as presented in Graph 3.3 (**Bank Soundness Level Assessment Framework**). Subsequently, a composite rating of bank soundness is determined based on the four factors mentioned.

Figure 3.3 Bank Soundness Level Assessment Framework



Bank Soundness Assessed Individually

1. Contextualisation of Know Your Bank

   Risk must be assessed based on an understanding the actual bank itself. In this context, it is critical for bank supervisors to fully comprehend the bank business strategy, the main business activities and supporting activities, the level of risk, the previous level of soundness, the performance of risk management and internal control, as well as the performance of bank earnings and capital.

2. Assessment of Risk Profile

   The risk profile is assessed based on eight types of risk that must be evaluated by all banks, namely credit, risk, market risk, operational risk, liquidity risk, strategic risk, compliance risk, legal risk and reputational risk. Evaluating the aforementioned risks is achieved by assessing inherent risk and assessing the quality of risk management.

   a. Inherent Risk

      Inherent risk is risk that is intrinsic to a bank's business activity, which may or may not be possible to quantify, and has the potential to influence the financial condition of the bank. Consequently, the characteristics of inherent risk are strongly determined by macroeconomic conditions, the industry environment and bank strategy as well as the types of products and services offered by the bank.

      Inherent risk is assessed prior to any consideration regarding the quality of the risk management applied. Therefore, banks with the same level of inherent risk may have differing levels of net risk according to the quality of risk management that is implemented.

      The level of composite inherent risk is the inference of inherent risk from the eight types of risk that must be assessed, paying due consideration to the materiality and significance of each respective risk.

   b. Quality of Risk Management

      Assessing the quality of risk management aims to evaluate how effectively the inherent risks have been identified, measured, monitored and controlled by the board of commissioners and directors of the bank. The ability of a bank to achieve this is primarily determined by the quality of good corporate governance implemented by the board of commissioners and directors; the adequacy of the risk management framework applied, including policies, procedures and limits; the adequacy of the risk management process; the management information system (MIS) and human resources; as well as the risk control system.

The composite quality level of risk management is the inference of the quality of inherent risk management from the eight kinds of risk that must be evaluated paying due regard to the materiality and significance of the elements of risk management.

c. Level of Risk

The level of risk is the inference of the level of inherent risk mitigated by the application of risk management for each respective type of risk.

d. Risk Profile

The risk profile is the inference of assessing the level of eight kinds of risk, the composite level of inherent risk and the composite quality of risk management with due consideration paid to the materiality and significance of each respective risk.

3. Assessment of Good Corporate Governance

The performance of good corporate governance is crucial to ensure effective risk management and bank financial performance as well as to garner public confidence in the business continuity of banks.

Assessing good corporate governance in terms of bank soundness emphasises how the application of good corporate governance principles effectively guarantees the implementation of governance structure, processes and results at the bank. The assessment of good corporate governance involves evaluating the overall management of the bank in terms of general management and risk management. In this context, other relevant information can be used to support the analysis of good corporate governance performance at a bank.

4. Assessment of Earnings

Sound and sustainable earnings are a vital prerequisite for the business continuity of a bank. Sound and sustainable earnings fund asset growth, boost capital and provide an adequate return for the shareholders. Assessing earnings in the context of bank soundness covers evaluating the performance of earnings, sources of earnings, the sustainability of earnings and the management of earnings.

5. Assessment of Capital

Capital for a bank is a source of financial support for the implementation of bank activities, a cushion to absorb unexpected risk and a safety net under crisis conditions. Capital performance transmits important signals regarding business continuity to the stakeholders of a bank, be they shareholders, creditors or depositors. Consequently, capital adequacy and capital management at a bank are crucial in ensuring its financial soundness, its ability to confront future crises and public confidence in the banking system overall. Capital assessment, at the bank soundness level, covers assessing capital adequacy and capital management.

Assessment of Consolidated Bank Soundness

1. Scope of Assessment

Banks with internal control over a subsidiary company are required to assess bank soundness in a consolidated manner. Consolidated bank soundness is assessed based on an evaluation of risk profile, the application of good corporate governance, earnings and capital.

2. Significance and Materiality

   The assessment is conducted paying due regard to the significance and materiality of the share of the subsidiary company against the consolidated bank and/or problems with the subsidiary company that have a significant impact on risk profile, good corporate governance, earnings and capital of the consolidated bank.

   Determining the significance or materiality of the share of the subsidiary company must consider the total assets of the subsidiary company as a portion of total assets of the consolidated bank. In addition to determining the significance or materiality of the share of the subsidiary company, for qualitative risks like legal risk and reputational risk, any significant problems that could influence the consolidated bank must also be considered, even in the case of a subsidiary company with a share deemed insignificant or immaterial in terms of the total assets of the consolidated bank.

3. The Ratings Assessment and Allocation Mechanism

   The assessment and allocation mechanism for bank soundness ratings at the consolidated level refers to the assessment and allocation mechanism for bank soundness ratings at the individual level.

3.1.1. Conventional Commercial Banks

Sustainable and stable growth of the banking industry is the main prerequisite for financial system stability and an optimal role in the national economy. To this end, Bank Indonesia utilises risk-based banking supervision that allows bank supervisors to detect significant risks early and take appropriate and timely supervisory actions.

In practice, the supervision process is performed by Bank Indonesia directly through on-site supervision and indirectly through off-site supervision. On-site supervision is achieved through direct examination and inspection of the bank involved. Pursuant to Act No. 10 of 1998 concerning an amendment to Act No. 7 of 1992 (the Banking Act) Bank Indonesia is mandated with conducting direct on-site supervision at least once per annum for each bank. On-site supervision follows a risk-based method and can be performed through general supervision and special surveillance that aims to illustrate the financial conditions of the bank involved, monitor the level of bank compliance to prevailing regulations and investigate the application of prudential principles at the bank.

Off-site supervision is the monitoring of all operating activities of the bank, achieved through the analysis and evaluation of all reports submitted by the banks to Bank Indonesia, the outcomes of examinations and inspections as well as other pertinent information. Bank reports are submitted periodically (daily, monthly, quarterly and annually) and cover all bank activities, including the Bank Business Plan (BBP) and Financial Statements.

Banks are required to submit their Bank Business Plan no later than at the end of each November, before the start of the new business plan year, in accordance with Article 18 of Bank Indonesia Regulation No. 12/21/PBI/2010, dated 19th October 2010, concerning the Bank Business Plan, which contains information on projections and working targets for the bank for the upcoming three years, relating to financial aspects, the office network and any plans to release or engage in new products and activities. From there, Bank Indonesia analyses and evaluates the bank business plan, referring to the appropriateness of determining targets based on historical data as well as assessing the strategy implemented by the bank. The accomplishments of the bank business plan are monitored on a quarterly basis to ensure that the respective bank is achieving the targets previously set.

Risk-Based Bank Rating

In relation to honing the banking supervision system, in 2011 Bank Indonesia refined its assessment of bank soundness through the introduction of Risk-Based Bank Ratings (RBBR). An RBBR assessment is conducted a minimum of every six months based on four factors, namely the risk profile, good corporate governance, earnings and capital in order to produce a composite rating of bank soundness. The set of predicates for the composite rating of bank soundness are as follows: PK-1 (Very Sound), PK-2 (Sound), PK-3 (Satisfactory), PK-4 (Less Sound), PK-5 (Unsound). In the assessment of risk-based bank ratings, there are a number of overriding and interrelated principles, namely risk-based analysis that must consider the impacts on bank performance overall; proportionality that deals with the characteristics and complexity of the bank's business; and the materiality/ significance of each factor in the assessment of bank soundness, namely the risk profile, good corporate governance, earnings and capital.

When assessing bank soundness, Bank Indonesia requires banks to also conduct a self-assessment of bank soundness using the RBBR method individually (solo) and consolidated no later than 31st July for the assessment of bank soundness conducted at the end of June and no later than 31st January for the position at the end of December. Meanwhile, consolidated self-assessment must be completed by 15th August for the assessment of bank soundness conducted at the end of June and 15th February for the position at the end of December. The self-assessment covers the risk profile, good corporate governance, earnings and capital.

The self-assessments performed by banks are subsequently used by Bank Indonesia as a consideration in the assessment of bank soundness. At the end of January 2013, supervisors had successfully evaluated the soundness level of 109 conventional commercial banks for the position in December 2012. In 2012, 107 banks received a composite soundness rating predicate of Very Sound and Sound, which is a slight improvement compared to the previous year (106 banks). The criteria of banks receiving predicates of Very Sound/Sound reflect bank conditions that are capable or capable enough to confront the significant adverse effects of changes in business conditions or other external factors. The main factors contributing to two banks receiving predicates of Less Sound at the end of 2012 were aspects of good corporate governance, the risk profile and earnings. To the banks with an unfavourable predicate, Bank Indonesia requested the respective management to implement corrective actions and report regularly to Bank Indonesia, which subsequently forms the basis of further evaluation of the bank soundness level and follow-up supervisory actions.

Risk Profile

The first component of risk-based bank ratings is the risk profile, which illustrates risk exposure faced by a bank as a consequence of performance and/or the business strategy. There are eight types of risk, namely credit risk, operational risk, market risk, liquidity risk, reputational risk, compliance risk, legal risk and strategic risk. Based on the outcome of supervision, the most salient types of risk in the national banking industry are credit risk and operational risk. This is a consequence of banking business, the majority of which still relies on extending credit as the cornerstone of banking activity. Furthermore, in terms of credit risk, a number of banks are still required to improve internal policy and internal control. Meanwhile, to mitigate operational risk, the quantity and quality of human capital and well as IT infrastructure must be enhanced. Follow-up supervisory actions undertaken by Bank Indonesia include requesting that the respective bank's management implement corrective actions and report regularly to Bank Indonesia, which is subsequently considered when reassessing the level of bank soundness and determining follow-up supervisory actions.

In line with conditions external to the banks, primarily the crisis in Europe, bank liquidity represents one component of the risk profile that receives the attention of Bank Indonesia as a preventative measure to ease the domino effect on banking conditions in Indonesia. Liquidity risk is the risk that a bank will not be able to meet its outstanding liabilities from cash flow and/or eligible high-quality liquid assets, without disrupting the financial conditions and activities of the respective bank. A number of supervisory actions were implemented, among others, by regularly monitoring bank liquidity (daily, weekly and monthly) and requesting banks to submit several reports that support a more comprehensive analysis of cash flow and certain financial positions. Banks in Indonesia remained liquid in 2012, as reflected by positive projections of rupiah and foreign currency cash flow as well as an average short-term liquidity resilience ratio in excess of 100%.

Good Corporate Governance

The assessment of good corporate governance (GCG), which is the second component of risk-based bank ratings, is based on thee main aspects: governance structure, governance process and governance outcomes. Governance structure covers task implementation and the responsibilities of the board of governors and directors as well as the completeness and implementation of committee tasks. Governance process is the application of the compliance function, the handling of conflicts of interest, application of the internal and external audit function, the application of risk management including the internal control system, availability of funds to related parties and large funds as well as the strategic plan of the bank. Governance outcomes encompasses transparent financial and non-financial conditions, the GCG implementation report that meets principles of Transparency, Accountability, Responsibility, Independency and Fairness (TARIF) as well as internal reports. An adequate level of good corporate governance is required in bank management considering that the human capital invested in running the banking business is a key factor that must have full integrity and competence. Based on the outcome of supervision, one aspect that must be improved upon further is governance process. The supervisory actions implemented include fit and proper tests for all bank management undermining the governance process as well as requesting that banks execute corrective actions on the overall implementation of good corporate governance. From the results of assessing good corporate governance for the position in December 2012, one bank was rated 1, 49 banks were rated 2, 55 banks were rated 3 and four banks were rated 4. This indicates that the majority of banks have successfully implemented principles of good corporate governance and in the event that a weakness is revealed, that weakness could be resolved through a normal action implemented by the corresponding bank's management.

Earnings

With reference to the component of earnings, during 2012 conventional commercial banks maintained a level of earnings described as Adequate. This denotes that the profit accrued by banks exceeded their target and facilitated an increase in bank capital. The supervisory actions taken included requesting that banks improve their ability to generate profit, among others, by expanding business volume while continuing to adhere to prudential principles. In addition, Bank Indonesia also promoted efficiency gains at banks and advocated lower lending rates, achieved through the publication of prime lending rates that began in March 2011. Furthermore, Bank Indonesia also sought bank commitment to improve efficiency ratios, like the BOPO efficiency ratio, in the Bank Business Plan as well as monitor its realisation through an RBB realisation report submitted by the bank on a quarterly basis.

Capital

The component of capital was also evaluated as Adequate during the reporting year. This reflects that the majority of banks have a good quality of permanent capital (exceeding stipulations in prevailing regulations) capable of absorbing losses and that most banks could anticipate nearly all risks. The scale of capital that must be maintained by banks depends heavily upon the severity of the risks faced. In addition, capital is an important aspect of future bank development in accordance with Bank Indonesia Regulation No. 14/26/PBI/2012, dated 27^{th} December 2012, concerning Business Activity and Office Networks based on Core Capital, which relates to the theoretical amount of capital required by a bank to expand its office network. Bank Indonesia also continually urges banks, which are perceived to require additional capital to support their business activity, to instruct shareholders to supplement more capital, seek new investors and/or reduce the dividends paid to shareholders.

Application of Anti-Money Laundering and Preventing Terrorist Financing

The ongoing development and dynamics of the modern banking industry, which is growing increasingly complex, represents an opportunity for unscrupulous criminals to use banks as a source of money laundering activity and to finance terrorism. In order to harmonise prevailing regulations with international standards, Bank Indonesia has formulated policy in the form of anti-money laundering and countering terrorist financing (APU and PPT) through the promulgation of Bank Indonesia Regulation No. 14/27/PBI/2010, dated 28th December 2012, concerning implementation of the APU and PPT program for commercial banks, which includes the following stipulations:

a. Regulating fund transfers;
b. Regulating high-risk areas;
c. Regulating simple customer due diligence (CDD), particularly to support the national strategy and financial inclusion.
d. Regulating cross-border correspondent banking.

The assessment of APU and PTT covers no less than five aspects, namely the active supervision of the board of commissioners, policies and procedures, internal control, the management information system, as well as human resources and training. The assessment of APU and PTT implementation by banks is graded on a scale of 1 to 5 with 1 being the highest rating and 5 the lowest. Based on the results of supervision, most of the banks in Indonesia are rated 3 (three) with the main factors in need of improvement being internal control and an inadequate management information system. One of the supervisory actions implemented during the reporting period was to request that banks enhance internal control and update their APU and PTT system, thereby facilitating the adequate monitoring of bank transactions. The application of the APU and PTT program in the banking industry is implemented by Bank Indonesia under the aegis of the Financial Transaction Reports Analysis Centre (PPATK) in accordance with the agreed Memorandum of Understanding.

Supervision Status of Commercial Banks

Pursuant to Bank Indonesia Regulation No. 13/3/PBI2011, dated 17th January 2011, concerning Bank Status and Supervisory Actions, the supervision status of a bank is either normal, intensive or special surveillance. In 2012, 106 banks remained under normal (routine) supervision status, while three banks were placed under intensive supervision due to problems with the management of good corporate governance. Intensive supervision is required based on measurable criteria, namely financial aspects (capital, liquidity and non-performing loans), the level of bank soundness and risk profile. In accordance with prevailing regulations, Bank Indonesia shall place a bank under intensive supervision for no more than one year from the date of notification by Bank Indonesia. However, when the resolution of non-performing loans/financing is complex, the time frame can be extended once for a maximum of one more year. The supervisory actions implemented by Bank Indonesia for banks under intensive supervision include requesting that the bank submit an action plan of corrective actions that can be closely monitored by Bank Indonesia. In addition, Bank Indonesia could request that shareholders replace the management of the bank involved, or restrict certain activities conducted by the bank through a cease and desist order.

According to Article 52 of Act No. 10, 1999, concerning an amendment to Act No. 7, 1992 on banking, Bank Indonesia can impose administrative sanctions, among others, involving financial penalties, written warnings, lowering the bank soundness rating and freezing certain business activities at specific branches or at the bank as a whole. In the case of financial sanctions, in 2012 Bank Indonesia imposed such penalties on several banks due in large part to erroneous and overdue monthly bank reports and debtor information system reports as well as violations of the reserve requirement. Other forms of sanctions are enforced consistently in line with the level of violation or error committed by the bank.

Financial System Stability Dashboard

Bank Indonesia has a supporting information system that aims to present the latest information from each bank, thereby assisting supervisors to conduct on-site and off-site examinations, including the financial system stability dashboard and the banking information system (SIP). The dashboard application functions as an early warning system of financial stability from a microprudential perspective, divided into a daily dashboard analysis, four-quadrant analysis and an analysis of strategic issues. Supervisors are required to monitor the dashboard on a daily basis if any banks under their supervision have a specific soundness rating. Meanwhile, all supervisors are required to perform four-quadrant analysis and strategic issue analysis on a weekly and monthly basis. Daily dashboard analysis is designed to help up-to-date monitoring of the financial and liquidity conditions of a bank. Meanwhile, four-quadrant analysis and strategic issue analysis function to inform supervisors regarding the general condition of a bank regarding strategic issues and bank soundness rating.

Supervisory Information Exchange

Considering that bank shareholders are often foreign banks (parent bank), supervisors actively engage in information exchange with home supervisors on, among others, the supervisory approach taken, the bank risk assessment method used and bank conditions in order to bolster effective supervision activity. In addition, supervisors also communicate with parent banks as they have a significant influence over the banks under their control. Such communication is initiated if a supervisor raises supervisory concerns that require the attention of or support from the parent bank to resolve. In 2012, information exchange was implemented with nine supervisory authorities in other countries, including the Hong Kong Monetary Authority, the China Banking Regulatory Commission, the Monetary Authority of Singapore and De Nederlandsche Bank.

Bank Indonesia conducts regular training through a certification program and attachment program, among others, in order to enhance the quality of banking supervision and to confront rapid product development as well as future changes in banking supervision. The certification program is phased from level 1 to 7 and is organised by the Department of Human Resources, with speakers from Bank Indonesia as well as external speakers. The topics discussed include the supervision cycle, risk management, banking products and supervision systems/tools. Furthermore, a number of training programs and workshops involved with supervision are also hosted to boost understanding about supervision, with topics ranging from anti-fraud, the capital market, structured products, good corporate governance and application of the APU and PTT program to the supervision of systemic banks.

Another program to improve the quality of supervision is the attachment program run in conjunction with central banks in other countries, for instance the Australian Prudential Regulation Authority (APRA). A number of mutual benefits stem from the attachment program, including augmenting knowledge and understanding of banking supervision, in this case broadening the knowledge of Bank Indonesia supervisors regarding the Australian banking supervision cycle, supervision procedures and techniques, the reporting mechanism and types of bank report, coordinated supervision between APRA and the Reserve Bank of Australia, coordination among specialist bank supervisors as well as IT inspections by APRA. Additionally, participants also observe and review banks using the Advanced Measurement Approach (AMA) to calculate operational risk.

Banking Supervision Assistance (APBU)

There is a work unit at Bank Indonesia known as the Banking Supervision Assistance Unit (APBU) that aims to recover and resolve banks that have been placed under special surveillance as well as to act as liaison officer (LO) and accommodate banking supervision at Bank Indonesia Representative Offices in order to enhance coordination and improve the quality of supervision and human resources. In general, the tasks of the APBU Unit are as follows:

1. Active involvement in formulating corrective actions for troubled banks as well as to identify and map troubled banks.
2. Implement the LO function for bank supervisors located at Bank Indonesia Representative Offices and coordinate banking supervision development at Bank Indonesia Representative Offices in terms of human resources and the supervision system.

3. Prepare items related to organisational structure.

In addition, one task of APBU is coordinator and host of Panel Forums (PF) as part of quality assurance for risk-based banking supervision. The implementation of panel forums involves managing the fora as well as compiling and maintaining the corresponding database. Meanwhile, in line with the function of APBU as liaison officer for banks with a head office at a domestic Bank Indonesia Representative Office (25 regional banks and 13 commercial banks), the Unit periodically assesses the performance of such banks on a weekly and monthly basis.

Looking at the existing dynamics of the banking sector, the APBU Unit has been allocated additional tasks as follows:

a. Implement an Early Warning System for all banks, with a head office in Jakarta or at a Bank Indonesia Representative Office, through analysis of the bank soundness assessment (RBBR).
b. Assist troubled commercial banks with a head office located at a Bank Indonesia Representative Office.
c. Regularly assess constraints in the field relating to technical banking problems and tasks.

APBU is also tasked with active involvement in formulating corrective actions for troubled banks as follows:

a. Assisting banks under intensive supervision status at Bank Indonesia Representative Offices.
b. Assisting the supervisors of commercial banks at Head Office regarding the implementation of RBBR assessments, including good corporate governance, through RBBR Clinics that began in July 2012.
c. Facilitate the supervision of banks at Bank Indonesia Representative Offices utilising coordinated discussions with other work units, among others, through manpower assistance for on-site examinations, discussing fit and proper tests for management and officers embroiled in cases of fraud as well as discussing problems with the Core Banking System at a number of local banks.
d. Mapping bank problems and regular reporting under the EWS framework.

3.1.2. Islamic Banking

The implementation of supervision was directed in 2012 towards strengthening governance and Islamic bank resilience to risk. Bank Indonesia assesses the level of Islamic bank soundness by considering factors of financial and managerial performance (CAMELS: Capital, Asset quality, Management, Earnings, Liquidity, Sensitivity to Market Risk) as well as the risk profile. The level of bank soundness is subsequently evaluated periodically (quarterly) or as required in the case of a significant change that disrupts bank performance. Based on the assessment of risk and soundness level of each respective bank, a strategic supervision plan is compiled consisting of indirect supervision (off-site supervision) and direct supervision (on-site). Supervision of Islamic banks focuses on risks that significantly affect the risk profile overall but also covers aspects of bank compliance to prevailing regulations, including compliance to sharia principles.

The results of risk assessments, determining bank soundness and the results of examinations form the basis of supervisory and corrective actions taken to restore bank conditions. Such measures are subsequently buttressed by monitoring the implementation of commitments that must be met by the bank within an agreed time frame. Administrative sanctions and/or financial sanctions are imposed on banks that violate prevailing regulations.

Based on supervision conducted in 2012, the stability and resilience of the Islamic banking industry were relatively well maintained. All Islamic banks remained under normal supervision status. Risk assessments showed that in 2012, risk at Islamic banks was relatively controlled. The majority if Islamic banks (91%) maintained a risk profile of moderate, while 9% were categorised as moderate to high. Similar to their conventional counterparts, the types of risk most significantly affecting the risk profile of Islamic banks was credit risk and operational risk. Potential credit risk at Islamic banks must be managed more carefully, among others, by refining policies and procedures, strengthening information technology, meeting the requirement for human resources, understanding Islamic contracts, enhancing the control function as well as reducing the concentration of financing allocated to core borrowers and certain economic sectors. In order to mitigate credit risk, Bank Indonesia always monitors the trends of non-performing financing and the concentration of financing to core borrowers and/or specific economic sectors as well as requesting and monitoring implementation of the Islamic bank action plan that tends to exacerbate credit risk.

Operational risk at Islamic banks is influenced by the quality of the information system and the availability of competent human resources. In terms of technology, supervisors have requested that Islamic banks ameliorate the quality of their information systems, specifically the core banking system, in order to compete with conventional banks. Development of a core banking system is a key agenda topic in the business plan of Islamic banks. In addition, to ensure the quality and security of transactions and information, supervisors monitor, examine and develop the application of risk management in the information system. In order to mitigate operational risk stemming from weaknesses in human resources, supervisors monitor measures taken by banks to fulfil the requirement for human resources, among others, covering recruitment requirements and processes, the fairness of remuneration and facilities, including efforts to augment the quality of human capital through education, training and certified risk management.

In 2012, the composite rating of bank soundness improved for Islamic banks. The percentage of banks rated Sound increased from 54.55% in 2011 to 72.73% in 2012. During the 2012 supervision period, no Islamic banks were categorised as Less Sound and Unsound. Such impressive performance in the level of bank soundness is expected to spur further performance optimisation at Islamic banks in upcoming periods.

The capital of Islamic banks was maintained at a level deemed Adequate for business expansion in 2012. In this context, Islamic banks were adjudged to require additional capital, therefore, Bank Indonesia requested that the shareholders supplement capital, seek new investors and/or reduce the dividends paid to shareholders. The expansion of financing by Islamic banks during 2012 was achieved while maintaining non-performing financing in a satisfactory range. Financing growth accompanied by improvements in the quality of financing precipitated gains in profit. The earnings of Islamic banks in 2012 performed favourably, as reflected by the capacity to book profit and advances in efficiency. Bank Indonesia continuously and sustainably encourages the Islamic banking industry to boost efficiency, among others, by requesting that banks formulate an action plan as a from of commitment to Bank Indonesia regarding efforts to improve efficiency through the cost of funds and overhead costs.

The implementation of good corporate governance by Islamic banks was relatively sound in 2012. As many as 81.82% of Islamic banks had a GCG rating of Sound and 18.18% were considered Satisfactory. Pursuant to prevailing regulations, Islamic commercial banks are required to conduct an annual self-assessment of GCG implementation, the results of which are submitted to Bank Indonesia. Bank Indonesia subsequently follows up on the self-assessment through an examination to evaluate the implementation of good corporate governance and ensure implementation is in accordance with the reports submitted by the respective bank to Bank Indonesia, and then to assess the actual application of good corporate governance. Of the 11 aspects of GCG assessment, supervisors noted that Islamic banks still need to improve the function of GCG committees, compliance, internal audit and risk management. In the case of Islamic banks, GCG implementation also regulates sharia compliance. GCG implementation also covers task implementation and the responsibilities of the Sharia Supervisory Board (DPS) to ensure bank compliance to sharia principles in all business activities. DPS task implementation is not merely limited to providing opinion on new products, but also aims to ensure that banks comply with sharia principles in all of their business activities. The supervision function of sharia aspects requires further optimisation by DPS through sharia testing of the transactions processed by the bank. The effective implementation of the Board's function requires greater understanding by DPS of the banks' operational system and an effective communication mechanism between DPS, internal auditors and the compliance division. Furthermore, Bank Indonesia requested that banks take corrective actions to improve overall GCG implementation in order to enhance the quality of good corporate governance.

In the same way as conventional banks, Islamic banks are also required to apply know your customer principles. In addition, Bank Indonesia assesses the implementation of the APU and PTT program by Islamic banks according to five aspects, namely (i) supervision by the directors and commissioners; (ii) policies and procedures; (iii) internal control; (iv) the management information system; as well as (v) human resources and training. Based on the results of supervision, the implementation of the APU and PTT program by Islamic banks was categorised as Satisfactory. The aspects that require further improvement by Islamic banks include internal control and internal audit as well as integration of the management information system to help detect suspicious customer transactions.

In the case of Islamic rural banks, the assessment of bank soundness is affected by financial and managerial performance (CAEL+M: Capital, Asset Quality, Earnings, Liquidity + Management) as well as the results of an assessment of the risk profile conducted by supervisors for the ongoing year. The main determinants of Islamic rural bank soundness are non-performing financing that leads to lower earnings, as well as inadequate loan loss provisions that undermine the capital ratio of the bank. Consequently, Bank Indonesia has taken a number of supervisory and corrective actions to foster improvements in the root of the problem, among others, by requesting that banks gradually lower the level of non-performing financing (NPF). Incrementally lowering the level of NPF is achieved by optimising the collection and settlement of non-performing financing. A number of Islamic rural banks suffering from a low level of earnings were requested to perform measured expansion of financing.

Bank Indonesia is currently in the process of refining the concept of Islamic banking supervision through plans to introduce Islamic Risk-Based Bank Rating (RBBR-S) in a similar way as conventional banks but with two additional risks related to sharia aspects, namely rate of return risk and equity investment risk, in order to enhance the quality of Islamic banking supervision. Bank Indonesia bolstered existing guidelines with the promulgation of regulations to counter gold speculation and the enforcement of FTV and DP policy on mortgage financing and automotive financing extended by Islamic commercial banks and Islamic business units in order to maintain prudential banking while complying to sharia principles. Moreover, Bank Indonesia also strives to enhance the effectiveness of supervision through refinements to supervisory infrastructure. Some of the measures currently underway include development of an Islamic Banking Information System that integrates a number of Islamic banking applications, hence simplifying the procedure for supervisors to access the information required. Bank Indonesia also changed the Monthly Islamic Commercial Bank Report (LBUS) and changed the reporting system from a form-based approach to Extensible Business Reporting Language (XBRL) with the expectation of gains in efficiency and reporting flexibility.

From the standpoint of Islamic rural banks, Bank Indonesia compiled applications and assessment guidelines regarding early banking supervision that was first implemented in 2012 in order to enhance the supervision of Islamic rural banks. Furthermore, the Enterprise Data Warehouse (EDW) application was developed for supervisors to support information availability in terms of industry-wide Islamic rural bank performance (statistical) and the requirement for individual Islamic rural banking data to perform simulations sourced from periodic BPRS, EWS and Simwas reports. This is expected to broaden the capacity and intuition of Islamic banking supervisors in detecting bank problems earlier while aligning the implementation of off-site and on-site supervision. Meanwhile, other supporting supervision infrastructure currently in development includes an RBB reporting system and panel guidelines for the supervision of Islamic rural banks. The RBB reporting system is an upgrade of the Simwas system for Islamic rural banks in the form of providing web-based RBB information (BPRS) and the corresponding level of realisation, which will lead to more accurate and timely information submitted. In addition, the Islamic Banking Supervision Panel Forum is another form of quality assurance for the supervision of Islamic rural banks.

In addition to infrastructural improvements, Bank Indonesia also continued with the regular implementation of training programs for the supervisors of Islamic banks in order to enhance competence at the basic, intermediate and advanced level. On top of regular training activities, special training was also provided in the form of:

- Gold appraiser training to provide knowledge and skills when evaluating gold as this product is trending in the Islamic banking business;
- RBBR training to deepen the concept of supervision; and
- EWS, Simwas and EDW training.

3.1.3 Rural Banks (BPR)

In order to nurture natural growth in rural banks that operate efficiently and are resilient to competition on the microfinance market, a range of policies were introduced to improve the quality and efficacy of banking supervision as follows:

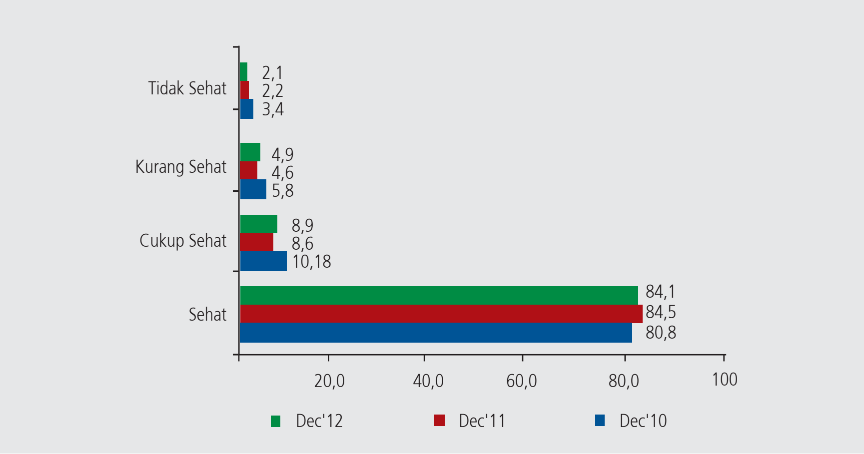
1. Expand special monitoring activity on high-risk rural banks, namely those that meet specific criteria in terms of their financial performance and their potential to experience problems.
2. Implement a Rural Banking Panel Forum.
3. Implement consolidated examinations of rural banks under the same ownership.

In addition to the aforementioned supervision policy for rural banks, Bank Indonesia also routinely conducts direct supervision (on-site) and indirect supervision (off-site). With respect to indirect supervision, Bank Indonesia assesses financial aspects (capital, assets, earnings and liquidity) and aspects of rural bank management. From the results of the assessment, Bank Indonesia performs a general/special inspection and introduces efforts to reinforce and maintain rural bank continuity. As a means and effort to improve the effectiveness of supervision, Bank Indonesia utilises supervision instruments like the level of bank soundness (CAMEL), the handling of troubled rural banks and monitoring high-risk rural banks.

Level of Soundness

From the results of supervision, the soundness level of rural banks decreased slightly, as reflected by the declining share of Sound banks from 84.5% (2011) to 84.1% (2012).

Graph 3.1 Level of Conventional Rural Bank Soundness (%)

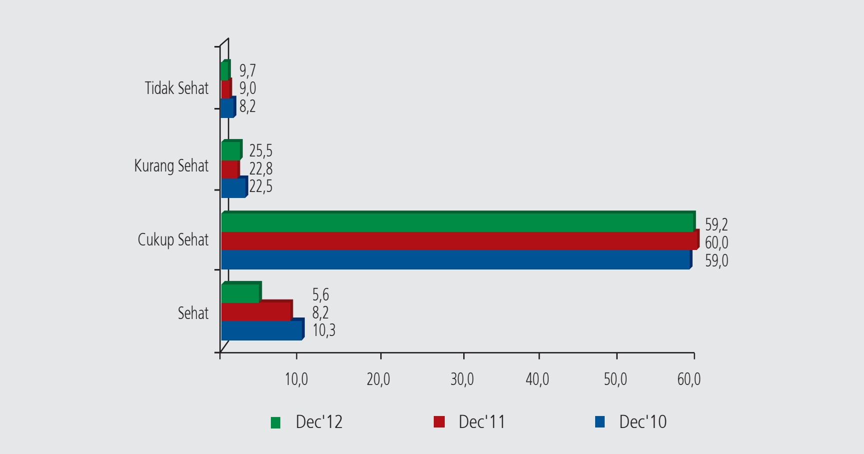


Capital, in 2012 total core capital of rural banks was Rp8,880.38 billion, representing an increase over the previous year of 17.61% from Rp7,550.68 billion. Meanwhile, CAR was 27.55%, down slightly on the previous year by 1.13% as a result of expansive credit growth. Nonetheless, the capital adequacy ratio of the rural banking industry is still considered high.

Asset quality improved during the reporting year, as evidenced by gains in the quality of earning assets (KAP) and NPL (net and gross). In 2011, the KAP ratio, gross NPL and net NPL were respectively 3.58%, 5.22% and 4.17%, improving to 3.25%, 4.75% and 3.25% in 2012.

Management, the assessment of management competence in terms of managing a rural bank begins with fit and proper tests for prospective mangers and owners when the rural bank is established. In addition, fit and proper tests are reapplied if there are any digressions from the basic examination conducted by Bank Indonesia. Aspects of rural bank management are routinely assessed by evaluating components of the soundness level, one factor of which is bank management. The results of inspections in 2012 show a moderate decline in the quality of bank management, as reflected by a corresponding decline in the share of rural banks with a Sound or Satisfactory predicate for management from 68.2% (2011) to 64.8% (2012).

Graph 3.2 Performance of Management Factors



Earnings, the profitability of the rural banking industry was buoyant in 2012, with ROA at 3.46%, up 0.14% compared to 2011. Meanwhile, ROE in December 2012 was 32.63%, up moderately on the previous year from 29.46%.

Liquidity, the liquidity condition of rural banks was well maintained, as evidenced by a Cash Ratio (CR) of 20.04%, which represents a modest 0.95% increase on the preceding year. Furthermore, the intermediation function of rural banks improved in 2012, as denoted by a 78.63% loan-to-deposit ratio (LDR) in December 2012, an improvement on the position in 2011. Therefore, liquidity risk management at rural banks is still relatively safe.

Monitoring of and Coordination with High-Risk Rural Banks

Efforts to enhance rural banking supervision in 2012 were achieved through coordinated handling and monitoring of high-risk rural banks. Rural banks are classified as high-risk if the final risk weighting of several quantitative indicators like CR, CAR, NPL, Bank Soundness and TA exceed 50%. In 2012, high-risk rural banks declined in number compared to the previous year. In addition, the rural banking supervision strategy looking ahead will be implemented through fit and proper tests, rural banking supervision panel forums and supervision on a national scale for large rural banks. On a monthly basis, Bank Indonesia monitors and analyses high-risk rural banks and forwards the results to relevant work units for intensive supervision in order to boost the efficacy of monitoring and handling high-risk rural banks. Thereinafter, an inspection is conducted to reveal the conditions in more detail to ensure that the handling of high-risk rural banks is more effective. Furthermore, special examinations are also performed on aspects of information technology to ensure the integrity and validity of data submitted by rural banks to Bank Indonesia.

Business License Revocation

One form of supervisory action is the revocation of a rural bank's business license (CIU). When a rural bank meets certain criteria it is placed under special surveillance (DPK). At the beginning of 2012 as many as 14 rural banks were under special surveillance. Of the 14 banks under special surveillance, 7 were returned to normal supervision and the other 7 remained under special surveillance as of December 2012. Overall, up to the end of 2012, eight rural banks were under special surveillance. The deterioration in the performance of rural banks was generally caused by fraud perpetrated by a manager/owner and/or a member of staff. If within a set period of time the bank fails to implement the corrective actions then the business license shall be revoked and handed over to the Deposit Insurance Corporation.

In 2012, only three rural banks had their business license revoked. The main contributor was failing to meet commitments in terms of implementing corrective actions within the agreed upon time period after being placed under special surveillance and, therefore, failure to meet the criteria to be removed from special surveillance status.

Implementation of Regulations to Prevent Money Laundering and Terrorism Financing

APU and PTT program implementation was assessed based on four pillars, namely active supervision of directors and commissioners, policies and procedures, internal control as well as human resources and training. The most salient aspect that must be improved by rural banks is internal control, including the information system to detect suspicious transactions. During 2012, 1,440 rural banks were inspected and based on the results, the quality of the majority of rural banks was either satisfactory or unsatisfactory with 888 rural banks (61.67%) and 485 rural banks (33.68%) respectively. Furthermore, 65 rural banks (4.51%) received a rating of 2 and those in categories 1 and 5 accounted for just 0.07% each.

3.2 Fit and Proper Tests

The implementation of good corporate governance is required in the banking industry in order to expedite the creation of a sound banking system, to protect the interests of the stakeholders and to ensure compliance to prevailing regulations. To this end, the banking industry must be owned and managed by those who consistently meet fit and proper requirements. Consequently, as a first line of defence, Bank Indonesia conducts a selection process using fit and proper tests for prospective board members, directors and controlling shareholders because

Table 3.1 Fit and Proper Tests for Conventional Commercial Banks

	Partici-pants	Passed	Not Passed	Partici-pants	Passed	Not Passed	Partici-pants	Passed	Not Passed
	2011			2012			Kumulatif 1999 s.d 2012		
Directors:	127	110	17	109	88	21	2.171	1.786	385
a. Directors	106	95	11	85	73	12	1.712	1.454	267
b. Compliance Directors	21	15	6	24	15	9	459	332	130
Commissioners/Supervisors	89	69	15	86	65	21	1.307	1.111	196
Controlling Shareholders	9	9	0	0	0	0	155	149	6
Total	220*)	188	32	195	153	42	3.633	3.046	587

*) Excluding candidates subjected to only administrative checks (without interview)

those are the people with most influence over the control and management of the bank. Fit and proper tests are performed through administrative research and interviews (as required).

3.2.1 Conventional Commercial Banks

In 2012, a total of 195 candidates took fit and proper tests consisting of 109 directors (including 24 compliance directors) and 86 commissioners/supervisors.

The number of fit and proper tests implemented experienced a slight decline when compared to the previous year. Overall, 83.84% of prospective commissioners, directors and controlling shareholders taking fit and proper tests passed during the period from 1999 to 2012.

3.2.2 Islamic Banks

Bank Indonesia also enforces fit and proper tests on prospective commissioners, directors and controlling shareholders of Islamic banks in order to implement good corporate governance and ensure that Islamic banks are owned and run by those who meet fit and proper requirements. In addition, pursuant to provisions contained within Bank Indonesia Regulation No. 11/10/PBI/2009 concerning Islamic Business Units, all conventional commercial banks with control over an Islamic business unit are required to appoint one of their directors with full responsibility for the Islamic business unit so that Bank Indonesia can arrange an interview with the prospective director of the Islamic business unit. The interview process aims to ensure that the prospective director of the Islamic business unit is highly competent and committed to develop the Islamic business unit of the bank. Furthermore, Bank Indonesia conducts an administrative and interview assessment process for prospective members of the Sharia Supervisory Board (DPS) as well as Islamic business units in order to bolster the effectiveness of DPS' role in supervising bank activity while adhering to sharia principles.

In 2012, Bank Indonesia conducted 36 fit and proper tests for new-entry controlling shareholders, commissioners and directors of Islamic commercial bank and Islamic business units, including heads of foreign banks. Of the 36 candidates, 19 were prospective managers of Islamic commercial banks, 13 were prospective managers of Islamic rural banks, one was a prospective controlling shareholder of an Islamic rural bank, one was a prospective chairman of a representative office and two were prospective directors of Islamic business units. Among the 36 candidates participating in fit and proper tests, three prospective managers of Islamic (rural) banks did not pass. All other prospective candidates passed. In addition, Bank Indonesia also conducted interviews for three prospective members of DPS, all of whom were deemed eligible. Furthermore, two executive officers were transferred without the need for fit and proper tests and seven requests for fit and proper tests were cancelled or not processed further because they were not in accordance with prevailing regulations.

3.2.3 Rural Banks (BPR)

Bank Indonesia implemented fit and proper tests on those individuals deemed to have a considerable influence over the control and management of a rural bank, namely controlling shareholders, mangers and executive officers. Fit and proper tests are conducted to ensure that rural banks are owned, managed and controlled by highly competent individuals with integrity and not looking for personal gain or that for the business group. Fit and proper tests are applied in order to obtain a license for the establishment of a new rural bank or when a change occurs in the management of controlling shareholders of the rural bank or if there are indications of unsound banking practices or violations.

A total of 978 candidates sat fit and proper tests in 2012, comprised of 85 controlling shareholders, 458 commissioners and 435 directors with a pass rate of 77.0%. Fit and proper tests were also given to existing controlling shareholders (96), commissioners (68) and directors (152) with a pass rate of 89.9%. In general, prospective controlling shareholders and prospective managers who did not pass did not meet the administrative requirements, and were listed on the Did Not Pass List and/or on the List of Bad Debt (loss), or did not meet the competence and/or integrity requirements set by Bank Indonesia.

3.3 Banking Information System (BIS)

Bank Indonesia developed a Banking Information System (BIS) to replace the Bank Indonesia Banking Sector Management Information System (SIM-SPBI) in 2009, which is expected to fulfil the requirement of the banking sector in terms of improving the quality of information and implementing the new regulations in the information system (including Basel II as well as the Application of Accounting Standards PSAK 55 and Psak 50). In addition, BIS accommodates the requirement of supervisors regarding the supervision system, which previously based the assessment of bank soundness on CAMELS and risk profile but now uses risk-based bank ratings (RBBR).

In general, the objectives of developing the banking information system (BIS) are as follows:

1. Raise the effectiveness and efficiency of the banking supervision and inspection system.
2. Create uniformity (standardisation) in the task implementation of banking supervision and inspection.
3. Optimise bank supervisors in the analysis of bank conditions thereby raising the quality of banking supervision and inspection.
4. Provide information in the interest of banking research and regulation.
5. Provide information regarding bank publications.
6. Assist the more effective and efficient implementation of investigation activity and banking mediation.
7. Simplify the audit trail for relevant parties.
8. Enhance data and information security and integrity.

Development of the banking information system was carried out over multiple years. Phases I and II have already been implemented and were available to supervisors in the second quarter of 2012. The modules and information developed in Phase I include the BIS framework/platform, the administration module, Know Your Bank (KYB) information, Quality Assurance (QA) and the supervisory plan. Meanwhile, the Risk Assessment module was developed in Phase II, which consists of the Bank Performance Report (BpeR), Risk-Based Bank Ratings (RBBR) and Risk-Based Examinations (RBE). Phase III, the Routine and Non-Routine Financial Data and Administration Report Module, will commence in February 2013. During 2013, further development of the BIS application, namely the BIS Core Data Module, the Individual Banking Information Module and the Islamic Module will proceed.

3.4 Banking Investigation

Bank Indonesia recognises that in line with advancements in the banking industry, the opportunities, quality and complexity of violations in the banking industry also have the potential to increase. Against such circumstances, efforts to enhance bank compliance to prevailing laws and regulations are crucial in order to protect the funds of the general public as well as prevent the emergence of structural problems in the banking system that could undermine the national economy. Furthermore, in order to maintain public confidence, action through legal enforcement represents an inseparable part of efforts to strengthen the banking supervision system to realise a banking system that is sound, stable and growing organically.

In 2012, Bank Indonesia investigated 66 cases of criminal behaviour in the banking sector (Tipibank) that affected commercial banks and rural banks throughout the Indonesian archipelago. Of the 66 cases, 23 incidents linked to 15 banks were referred by Bank Indonesia to investigators.

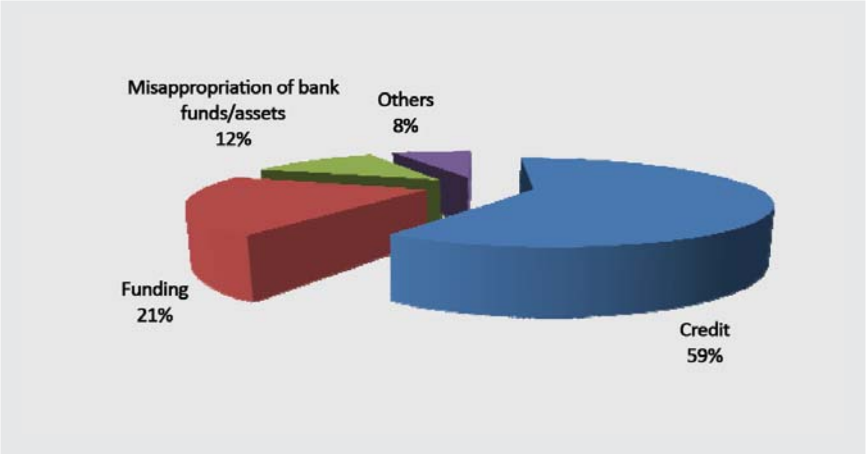
Table 3.2 Investigation Statistics for the period from January to December 2012

Description	Commercial Banks		Rural Banks		Total	
	Cases	Banks	Cases	Banks	Cases	Banks
Number of cases settled by investigation	22	14	44	21	66	35
1. Reported to investigators	6	7	17	8	23	15
2. In the process of being reported to investigators	16	7	27	13	43	20

Note:
1. Cases that have been reported to investigators are cases of alleged criminal behaviour in the banking sector already discussed at the Tipibank Handling Coordination Forum, where consensus is reached to forward the case by Bank Indonesia to investigators.
2. Cases that are still in the reporting process are cases of suspected criminal behaviour in the banking sector that have been settled by investigation or under discussion at the central and local Tipibank Handling Coordination Forum.

Of the total cases settled by investigation, 39 cases (59.09%) are associated with credit activity as presented in the following pie chart:

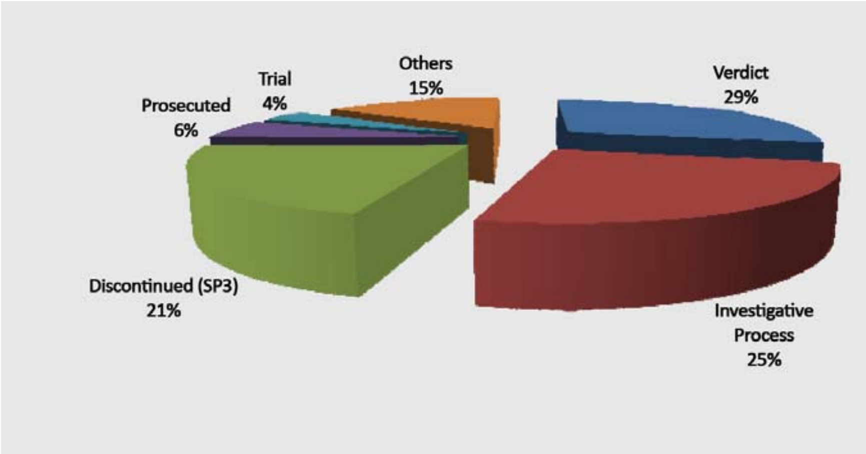
Graph 3.3 Cases of Tipibank by Type in 2012



Within the legal enforcement process, Bank Indonesia only has the authority to impose administrative sanctions on a bank. The imposition of sanctions on violations that contain a criminal element requires a more in-depth investigative process that falls within the remit of law enforcement, namely the police department and the judiciary. Therefore, as part of the efforts to reinforce the implementation of good corporate governance between Bank Indonesia, the police department and the attorney general in terms of coordinated handling of tipibank allegations, the three institutions signed a Memorandum of Understanding concerning the coordinated handling of criminal activity in the banking sector. The scope of coordination covers discussions on alleged tipibank, reporting allegations of tipibank, providing witnesses, providing expertise, freezing bank accounts, confiscating money and documents, information exchange, evaluation and other activities.

With the signing of this memorandum of understanding, cases of suspected tipibank investigated and reported by Bank Indonesia are those that have been discussed and agreed upon at the Tipibank Handling Coordination Forum (FKPT) to be forwarded to law enforcement. Cumulatively from 1999-2012, Bank Indonesia handled 719 cases of tipibank, of which 29% were settled in court and 25% are still under investigation by law enforcement.

Graph 3.4 Handling of Tipibank Cases (1999-2012)



In addition to handling criminal behaviour in the banking sector (tipibank) pursuant to Article 46 to Article 50A of Act No. 7 of 1992 concerning Banking, amended by Act No. 10 of 1998 (the Banking Act) and Articles 59 to 66 of Act No. 21 of 2008 concerning Islamic Banking (The Islamic Banking Act), the scope also covers criminal behaviour as regulated in other laws as follows:

- Act No. 31 of 1999 concerning the Eradication of Corruption, as amended by Act No. 20 of 2001.
- Act No. 8 of 2012 concerning the Prevention and Eradication of Money Laundering.
- The Criminal Code of Indonesia and other regulations that legislate the operation of a bank.

If the investigations conducted by Bank Indonesia reveal criminal behaviour that falls under the remit of a different authority, Bank Indonesia will inform the relevant institution with the authority to follow up. The contribution of Bank Indonesia to support law enforcement is not only in the form of initiating the investigation and reporting allegations of tipibank to law enforcement, Bank Indonesia, in its capacity as bank supervisor, also aids law enforcement by explaining the case, either through the provision of witnesses or experts. In 2012, Bank

Indonesia provided witness and expert testimony a total of 197 times at the behest of law enforcement, at the central level (at Bank Indonesia Head Office) and local level (at Bank Indonesia Representative Offices) with the details presented in Table 3.3.

Table 3.3 The Provision of Witness and Expert Testimony in 2012

Description	HO	Branch Office	Total
Witnesses	50	79	129
Witnesses	48	20	68
Total	98	99	197

In addition to being used in the interest of law enforcement, the results of investigations are also used as input for correction actions imposed on the bank, including administrative sanctions on the bank and/or violators of banking regulations, as well as input to fine-tune the supervision system by Bank Indonesia.

3.5 Banking Mediation

Bank Indonesia has facilitated banking mediation since 2006 in order to provide consumer protection to the customers of banks. Dispute settlement through banking mediation represents a follow-up measure to the customer complaint process that offers an alternative method to settle disputes without going to court. Banking mediation also aims to provide a convenient way for individual bank customers to access dispute settlement with a bank through a simple, inexpensive and quick method.

Through the implementation of banking mediation, Bank Indonesia plays a number of roles in assisting dispute settlement between a customer and the corresponding bank. In 2012, 521 disputes were received by Bank Indonesia, which is up slightly by 2% on the previous year when 510 disputes were received. The moderate increase is due to the proliferation and variety of banking products available as well as more comprehensive understanding by the customer in terms of alternative dispute settlement procedures, including through banking mediation.

Table 3.4 Number of Dispute received by Bank Indonesia in 2012

Type of Product	Number of Disputes		
	2010	2011	2012
Accumulation of Funds	35	47	59
Disbursement of Funds	86	246	280
Payment System	149	206	165
Cooperative Products	2	4	0
Other Products	3	4	6
Not involved with banking products	3	3	11
Total	**278**	**510**	**521**

As presented in Table 3.4, during the reporting year of 2012 the group of products associated with disbursing funds elicited the most disputes received at Bank Indonesia, totalling 280 cases. The Consumer Protection NGO

(LPKSM) forwarded the majority of those disputes (171 cases), which were generally linked to repayment problems and requests to restructure credit, the payment of interest and fees, lack of duplicate credit agreements, as well as objections to the credit billing and collection methods employed by banks.

In 2012, Bank Indonesia mediated 41 disputes and 104 disputes were resolved without entering the mediation process. Meanwhile, 345 disputes did not meet the requirements for settlement through banking mediation as the corresponding disputes were settled by the banks involved or did not meet the requirements for settlement through banking mediation as stipulated by PBI No. 8/5/PBI/2006, subsequently amended by PBI No. 10/1/PBI/2008 concerning Banking Mediation. The majority of disputes failing to meet requirements related to requests for credit restructuring, the majority of which were forwarded by LPKSM.

Bank Indonesia continuously and sustainably organises socialisation and educational activities, either individually or in conjunction with members of the Working Group on Banking Mediation and other relevant institutions in order to raise public and the banks' understanding of customer complaints and banking mediation. The following educational/socialisation activities were conducted during the reporting year:

1. Education and Socialisation through the Media

   In 2012, Bank Indonesia together with members of the Working Group on Banking Mediation visited a variety of print media with the aim of implementing socialisation activities regarding the settlement of customer complaints and banking mediation, as well as to receive input form the mass media concerning the implementation of customer protection by the banking industry, in particular member banks of the Working Group on Banking Mediation. This activity was implemented through visits to three mass media companies.

   In general, the repose from the mass media visits was good. The visits were thought to be relevant and timely in light of the fact that the mass media had received numerous complaints from a variety of readers regarding banking problems. In addition, Bank Indonesia participated in talk shows and welcomed interviews on the topics of customer complaints and banking mediation. Such activities were conducted with the print media and electronic media.

2. Consumer Protection Assistance and Socialisation

   Assistance and socialisation activities regarding consumer protection were organised directly for the general public, bank customers, academics and the police consisting of the following activities: (i) socialisation of banking mediation in South Manggarai; (ii) held a National Seminar on Banking Mediation in Jakarta; (iii) happy cycling activities in Jakarta; (iv) held the 1st International Islamic Financial Inclusion Summit (FIS) in Solo; (v) provided a tour of Bank Indonesia Head Office for the police department; and (vi) socialisation of customer complaints in Tasikmalaya.

3. Banking Bazzar/Expo

   In 2012, Bank Indonesia also attended banking bazaars/expos as a means to disseminate information on banking mediation, namely: (i) the Intermediation Bazaar in Tasikmalaya; (ii) the Banking Expo in Palu, Central Sulawesi; and (iii) the Indonesia Banking Expo in Jakarta.

4. Meetings with Contact Persons at Banks

   Meetings with the bank's contact persons were convened in order to exchange information and provide insight for bank officials/staff regarding banking intermediation. In 2012, meetings with contact persons were arranged in three cities, namely Jakarta, Makassar and Pekanbaru.

Box3.1 **Preparations and the Transition Period for the Transfer of the Supervision Function to the Financial Services Authority (OJK)**

Introduction

On 22nd November 2011, the Government and the House of Representatives passed Act No. 21 of 2011 concerning the Financial Services Authority. This independent supervisor of the financial services sector functions as host of the banking supervision and regulation system that integrates all activity in the financial services sector, which encompasses financial services in the banking sector, the capital market, insurance, finance companies and other providers of financial services.

Pursuant to Article 55, paragraph (1) of the OJK Act, as of 31st December 2012 the function, task and authority for the regulation and supervision of financial services on the capital market, insurance, pension funds, finance companies and other providers of financial services is transferred from the Ministry of Finance and the Capital Market and Financial Institutions Supervisory Agency to the Financial Services Authority (OJK). Meanwhile, based on Article 55, paragraph (2) of the OJK Act, on 31st December 2013 the function, task and authority for the regulation and supervision of financial services in the banking sector is transferred from Bank Indonesia to the Financial Services Authority. Consequently, Bank Indonesia has a transition period of two years (January 2012 until December 2013) to prepare for the transfer of the banking supervision function to the Financial Services Authority. Thereinafter, pursuant to Article 66 (paragraph 1) from the time the OJK Act was passed until the transfer of power on 31st December 2013, Bank Indonesia will continue to perform the function, task and authority of supervision and regulation of financial services in the banking sector.

Measures taken and to be taken by Bank Indonesia in relation to the Transfer of the Banking Supervision Function to the Financial Services Authority

1. Establish a Task Force for the transfer of Banking Supervision to the Financial Services Authority in accordance with Gubernatorial Decree No. 14/17/KEP.GBI/INTERN/2012, dated 26th March 2012, which is an amendment to Kep. GBI No. 14/6/KEP.GBI/INTERN/2012, dated 10th February 2012, tasked with the following:
   - Support a smooth and effective transfer of the banking supervision function from Bank Indonesia to the Financial Services Authority.
   - Recommend sectoral organisation of banking supervision to the Financial Services Authority.
   - Conduct discussions with the Ministry of Finance and/or the Financial Services Authority regarding aspects of organisation, human resources, banking supervision, development, banking regulation and licensing, data and the information system as well as logistics, documents and communication.
   - Prepare personnel and provide input for the Transition Team from Bank Indonesia, responsible for establishing the Board of Commissioners of the Financial Services Authority.

The workflow of the task force assigned with assisting the transfer of the banking supervision function to the Financial Services Authority adheres to an Initiative Charter due to the number of work units involved. Therefore, the performance/progress of Task Force activity can be monitored directly by the Deputy Governor acting as the Initiative Sponsor and DPSHM acting as Initiative Coordinator at Bank Indonesia.

Using Initiatives aims to ensure that Bank Indonesia task implementation in the area of banking supervision up to 31st December 2013 remains in harmony with other task implementation at Bank Indonesia like the monetary sector, financial system stability and the payment system.

2. Bank Indonesia, in conjunction with the Ministry of Finance, compiled the Organisational Structure of the Financial Services Authority, Core Tasks and Function, the Design of Infrastructure and Information Technology, the Human Resources System and Standard Operating Procedures as well as the Work Plan and Budget for 2013. The Board of Commissioners was established on 20th July 2012, comprised of one chairman, one vice chairman and seven members of the board, including two ex-officio members respectively from Bank Indonesia and the Ministry of Finance. The authority of the Board of Commissioners of the Financial Services Authority was effectuated to regulate and supervise the capital market and non-bank financial industry on 31st December 2012.

3. In terms of banking supervision and regulation (commercial banks, rural banks and Islamic banks), Bank Indonesia continuously:

   - Enhances the Prompt Corrective Action response to strategic bank problems.
   - Reinforces the Quality Assurance program, Early Warning System and Supervisory Support.
   - Improves the quality and quantity of banking supervision at Head Office and Representative Offices as the first line of defence in terms of banking supervision.

   Preparing for the transfer of the supervision function to the Financial Services Authority aims to ensure that the transfer process runs smoothly while avoiding the possibility of triggering disruptions in banking supervision and financial system stability. This is achieved by implementing the same pattern of banking supervision at the Financial Services Authority as that which is implemented at Bank Indonesia with several refinements (organisational structure, SOP, compiling a supervision framework for conglomerates in the financial services sector).

4. In terms of regulation, Bank Indonesia has compiled all Bank Indonesia Regulations and Circulars in the banking sector, including licensing, and will subsequently state whether they will remain effective under the Financial Services Authority or whether an amendment is required or even whether the legislation will be repealed.

5. Regarding human resources, in January 2013 Bank Indonesia assigned 78 officials to assist with Operational Support and the Shared Function of the Financial Services Authority in the areas of human resources, IT, logistics, legal aspects, financial aspects as well as education and consumer protection. In addition, 16 officials have also been assigned to the Special FSA Transfer Team for banking supervision and regulation. Currently, preparations are underway for phased implementation of banking supervision at Head Office and domestic representative offices in line with the plan to fill the requirement for human resources at the Financial Services Authority for three years commencing in 2014, including supporting policies.

6. Referring to the information system, Bank Indonesia has mapped all information systems and IT infrastructure at Bank Indonesia, including applications used jointly by Bank Indonesia and the Financial

Services Authority and has initiated intensive coordination and communication with the Financial Services Authority to discuss strategic issues in the area of utilising and managing IT infrastructure.

7. In terms of logistics and documents, Bank Indonesia has prepared warehouses and rooms at the Bank Indonesia Office Complex in Jakarta to work on the shared function with the Financial Services Authority, namely in the areas of auditing, education and consumer protection, and banking supervision as well as preparing rooms at local Bank Indonesia representative offices. Furthermore, Bank Indonesia is currently publishing banking supervision documentation to be transferred to the Financial Services Authority and a joint ministerial decree has been issued concerning the use of Bank Indonesia and FSA assets by the Governor of Bank Indonesia and the Chairman of the Financial Services Authority respectively.
8. In the area of communications, Bank Indonesia conducted socialisation activities in 2012 for all employees at Head Office and Representative Offices as well as to the banking industry and academia. The Financial Services Authority has also performed socialisation activities regarding the FSA for the banking industry, the capital market and other non-bank financial institutions. Joint socialisation activities will be resumed in 2013.
9. Coordination with the Transition Team formed by the Financial Services Authority will shift focus towards preparing the transition of banking supervision to the Financial Services Authority. The majority of members of the Transition Team are also members of the Task Force.

Activities relating to preparations for the transfer of the banking supervision function to the Financial Services Authority will continue until 31st December 2013, when the handover will take place.

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Chapter IV
Banking Outlook and Policy Direction for 2013

4.1 Challenges and Prospects

Impressive economic accomplishments in 2012 are expected to continue and expand in 2014-2014. Nevertheless, an array of arduous challenges also remain that must be confronted stemming from the global and domestic constellations. Internationally, risk factors emanating from widespread uncertainty surrounding the global recovery and commodity prices could undermine the export performance of Indonesia. Meanwhile, dogged domestic demand amid ubiquitous global economic uncertainty will exacerbate pressures on external balances. Domestically, the challenges stem from an economic structure dependent on high imports, particularly imports of capital goods and raw materials, which could expose vulnerabilities to external imbalances as investment activity continues to escalate. Furthermore, growing fuel consumption is juxtaposed against declines in oil production and increasing oil imports, which will aggravate deficit pressures on the current account. Additionally, growing consumption of subsidised fuel in excess of the quota is assumed to compound the burden of subsidies in the state budget, thereby limiting the space the government has to manage its budget, which could affect fiscal sustainability.

In 2013, the global economy is projected to grow more favourably than in recent years, achieving 3.4%. A number of positive developments at the end of 2012 and beginning of 2013, like reaching agreement in the United States regarding a reduction in the budget deficit (fiscal cliff), have bolstered optimism regarding a more propitious global economic outlook in 2013. Notwithstanding, several risk factors remain that will have to be addressed, like negotiations on the debt ceiling and automatic spending cuts in the US, the possibility of restrained economic growth in China, Japan and India, as well as crisis resolution in Europe. Higher projections for global economic growth are accompanied by higher projections for trade volume and commodity prices. Bank Indonesia forecasts that world trade volume will increase by 4.1%, coupled with moderately higher non-oil/gas commodity prices.

Economic growth in Indonesia during 2013 is predicted in the range of 6.3-6.8%, congruous with gradually improving global economic performance. Domestic demand is expected to remain a key contributor to economic growth looking ahead, in terms of consumption and investment. Externally, stronger global economic growth and soaring commodity prices will drive demand for exported products, hence the contribution of exports is expected to grow. Against this promising backdrop, robust investment growth is predicted.

Sectorally, economic growth will be driven on the back of performance in the manufacturing sector, the trade, hotels and restaurant sector as well as the transportation and communications sector. In general, sectoral performance will improve in line with more favourable economic conditions, domestically and globally.

The performance of the financial sector in Indonesia during 2013 is projected to improve with financial system stability maintained. The economy of Indonesia is forecast to grow robustly and therefore catalyse the performance of banks and non-bank financial institutions. The gains in bank performance experienced in 2012, as reflected by growth in credit and profitability as well as lower NPL, are expected to continue into 2013. Looking forward, bank liquidity and capital are projected to remain at levels safe to support further bank credit expansion. This is reflected in the Bank Business Plan (BBP) for 2013, which targets average credit growth of 23.1%.

From a banking perspective, the challenges faced also stem from internal conditions and externalities. Internal challenges, among others, include governance and risk management, capital, efficiency and the economic contribution, MSME and productive sector financing, access to banking services as well as financial system stability. Meanwhile, external challenges stem from ASEAN financial sector integration in the run up to the inauguration of the ASEAN Economic Community in 2015, the development of international standards and uncertainty surrounding the global economic recovery.

4.2 Direction of Banking Policy

4.2.1 Conventional Commercial Banks

Considering the aforementioned challenges and prospects faced, coupled with the continuation of policies instituted in 2012 and in previous years, the banking industry in 2013 will still be urged to enhance resilience, efficiency and its role in intermediation. Bolstering intermediation will be achieved in the form of broadening public access to more affordable banking services through a program of financial inclusion. The financial inclusion program is implemented from two sides, namely the supply side and the demand side. On the supply side, financial inclusion involves expanding public access to affordable banking services as well as creating innovative banking products tailored to low-income earners. Looking ahead, Bank Indonesia will expand access to banking services through non-conventional methods, like exploiting IT, telecommunications and interagency cooperation. This method is more commonly known as branchless banking and it allows banks to reach all strata of society, in particular those who are unbanked and underbanked, without the need to open a physical branch office. Nonetheless, branchless banking must be implemented in a measured way paying due regards to potential risks that could emerge, including their impact on financial system stability. Therefore, in 2013 Bank Indonesia will issue guidelines for the implementation of branchless banking.

Bank Indonesia will also implement efforts to expedite the creation of new entrepreneurs in order to optimise the strength of the flourishing middle class. To this end, Bank Indonesia will coordinate with colleges and private partners to launch an entrepreneurial training program for students, ex-migrant workers and the general public.

Bank Indonesia will also launch a start-up credit scheme for potential entrepreneurs. The scheme will involve the participation of technical institutions and other parties in order to develop, mentor and guarantee the scheme, as well as to process the eligibility of collateral, for instance through a land certification program. Meanwhile, Bank Indonesia is issuing policy that requires the publication of prime lending rates for microcredit in order to complement existing prime lending rate policy.

4.2.2 Islamic Banking

Bank Indonesia recognises the need to develop and implement Islamic banking policy that focuses on the following issues in order to continue nurturing and preserving Islamic banking development:

1. **Directing Islamic bank financing towards productive economic sectors and the wider community**

Similar to policy direction in the previous year, in 2013 the Islamic banking industry will be encouraged to develop its services towards the financing of productive sectors. In this context, Bank Indonesia will bridge the knowledge and skill gap, which remains a constraint to the Islamic banking industry. The support from Bank Indonesia is provided in the form of reviewing the business model of Islamic banks and finalising real sector indices, which produce information that reflects the business accomplishments of the real sector to potentially be financed by Islamic banks. Furthermore, Bank Indonesia shall require at least 20% of the financing portfolio of Islamic banks to be allocated to productive financing, including MSMEs, in a similar way as conventional banks in order to ensure that the intermediation function is more focused on productive sectors and the wider community.

2. **Developing products tailored to the needs of the general public and productive sectors**

According to a number of considerations, like customer segment diversification, expansive growth in market share and a more prominent multiplier effect, Bank Indonesia will prioritise support for product development in productive sectors and prioritise meeting the requirements of the wider community. To this end, Bank Indonesia will review efficiency and the cost structure of Islamic banks, as well as potential further development of an Islamic Microfinance scheme that has hitherto operated in productive sectors but failed to reach the majority of the populace. Bank Indonesia will also continue to refine regulations relating to Islamic banking products. Moreover, in a continuation of policy from previous years, Bank Indonesia will organise a tripartite cooperation forum with DSN and IAI to expedite the development of new and non-standard products. Bank Indonesia will also strengthen product development work units to accelerate the development of assets and accommodate the needs of the wider community.

3. **Transitioning a supervision function that maintains sustainable Islamic banking development**

The year of 2013 represents a crucial time in the preparations to transfer the Islamic banking supervision and regulation function from Bank Indonesia to the Financial Services Authority. Bank Indonesia will revisit the blueprint for Islamic banking in 2013 and contribute to compilation of the Islamic Financial Architecture of Indonesia. Revisiting the blueprint for Islamic banking and the Islamic financial architecture will subsequently be handled by the Financial Services Authority, Bank Indonesia and other relevant institutions for the further financial development of Islamic banks in Indonesia.

In addition, Bank Indonesia will also review domestic and international cooperation with other institutions in line with Bank Indonesia's new role. The review will cover cooperation with the National Sharia Board and the Indonesian Institute of Accountants as well as the Islamic Banking Committee. Meanwhile, relating to ongoing cooperation with international Islamic financial institutions like the Accounting and Auditing Organisation of Islamic Finance Institutions (AAOIFI), the Islamic Financial Services Board (IFSB), International Islamic Liquidity Management (IILM) and the International Islamic Financial Market (IIFM), Bank Indonesia will review the depth of Bank Indonesia's membership within such organisations to reveal whether it remains congruous with Bank Indonesia's new role and is financially beneficial to Islamic banks in Indonesia.

Bank Indonesia will also persist with other efforts to reinforce supervision, among others, through efforts to prepare supervisory infrastructure for Islamic commercial banks and Islamic business units, complemented by the Islamic banking information system (BIS) that applies a new concept to the assessment of Islamic bank soundness (Islamic risk-based bank ratings) through two additional risks associated with Islamic banking, namely rate of return risk and equity investment risk. This will be further supplemented with statistical information as well as efforts to complete the LBUS reporting system through the use of Extensible Business Reporting Language.

4. **Revitalising synergy with the parent bank**

   Similar to previous years, strategy to expand the outreach and assets of Islamic banks will remain focused on cooperative synergy between conventional parent banks and Islamic banks. Through this strategy, Islamic banks are expected to enhance synergy in conjunction with their parent bank in terms of exploiting technological facilities, office networks and human resources. The strategy and measures implemented by Bank Indonesia include, among others, improving coordination in the supervision of conventional banks and Islamic banks as well as considering providing regulatory incentives in order to encourage the provision of Islamic services in the parent bank network.

5. **Enhance education and communication by continuously boosting Islamic banking capacity in productive sectors as well as communicating the parity and distinctiveness of Islamic banking products**

   The socialisation/education program conducted by Bank Indonesia in 2013 will focus more on bolstering Islamic banking capacity in productive sectors as well as communicating the benefits of more varied Islamic banking products and contracts through communication that emphasises the parity and distinctiveness of Islamic banking products in order to maintain growth momentum achieved in terms of those benefitting from Islamic banking products and services (iB Financial Literacy). This program is implemented through a range of media considered effective in promoting the use of Islamic banking services, among others, community-based socialisation activities at media events, Islamic bank participation at banking bazaars/ expos, dialogue with relevant stakeholders (mangers of Islamic banks, industry/business associations, local government, academia, the media, economic and banking observers and public organisations), activities like business gatherings, focus group discussions and business matching as well as above-the-line communication through Public Service Announcements and special rubrics in various print and online media as well as outdoor media. Furthermore, Bank Indonesia will continue cooperation with ICDIF-LPPI through support of the training and education program available to human resources at Islamic banks, required to augment the technical operational skills and competence as well as the capacity to analyse Islamic banking product marketing based on prudential and sharia compliant principles.

4.2.3 Rural Banks (BPR)

Bank Indonesia focused upon the following policy measures during the reporting period in order to boost the competitiveness of rural banks in terms of MSME financing:

1. Encourage rural banks to enhance the quality of human resources and apply better corporate governance in order to improve the performance of rural banks, thereby buoying their contribution to local MSME development.
2. Evaluate paid up capital requirements for rural banks by reviewing paid up capital according to which zone the rural bank is located. Currently, the minimum requirements for paid up capital refer to regulations introduced in 2004, when economic conditions and performance were far different to those experienced today due to tighter competition among financial institutions, hence a stronger capital position at rural banks as agents of microfinance is more important to achieve.
3. Further promote rural banks as community banks for MSMEs and local communities in their area of operation, among others, by amending guidelines for the allocation of credit by rural banks, thus expanding the portion of financing extended from rural banks to the MSME sector.

4. Promote the more aggressive expansion of affordable credit at rural banks through operating efficiency gains at such banks.
5. Enhance the quality of existing cooperation with rural banking associations in order to build the capacity of human capital at rural banks in the form of organising training and providing information that is easy to access by the industry, including information on potential productive businesses that are feasible to finance as well as the latest information required to bolster the competence of human resources.
6. Promote the establishment of new Apex banks, principally from regional banks, which simultaneously nurtures the development of such banks as regional champions.

4.3 Financial Inclusion Framework and Strategy in Indonesia

Introduction

For the past several years, economic performance in Indonesia has remained consistently solid due to high quality economic growth. This is evidenced by the success of the Indonesian economy in terms of overcoming the global financial crisis in 2008 as well as in terms of economic resilience to the crisis in Europe that persists to this day.

Robust economic growth, a level of inflation under control and sound fiscal indicators in Indonesia were recognised by rating agencies. For the first time since the Asian economic crisis befell a number of developing countries in the ASEAN region, including Indonesia, in 1997-98, the country rating of Indonesia was re-affirmed as investment grade by Fitch Ratings and Moody’s. Notwithstanding, in addition to the economic accomplishments achieved by Indonesia, the economic portrait of Indonesia still requires further improvement, particularly in terms of equitable distribution. An equitable economy remains a hot topic of discussion and review because through economic equality the benefits of economic growth are felt by all, as mandated by the fifth principle of Pancasila, namely “social justice for all people of Indonesia”.

One source of problems when striving for economic equality is the lack of access to the financial sector for low-income earners. As is widely accepted, access to financial services creates business opportunities for the general public to ameliorate their welfare. Bank credit, as a source of growth financing to improve welfare, is the preferred means due to the low ratio of credit to GDP.

A body of research shows that one factor significantly affecting the flow of credit to customers/the general public closely relates to the **availability** of access to financial services. In fact, for a number of segments of society, problems with access to financial services are far more important than the often-cited issue of interest rates. Indeed, the general public are often prepared to pay extortionate rates to moneylenders as that remains the only avenue for many.

Accordingly, the topic of financial inclusion has become important to realise and implement. Access to financial services could ease vulnerabilities and financial services are a tool to expand assets and economic capacity, which could ultimately pave the way for communities to escape the poverty trap. Access to financial services represents a crucial step for the Poor to participate more broadly in the modern economy, thus becoming part of the wider economic community.

Another point that requires highlighting is the importance of financial inclusion in terms of reinforcing the financial system by alleviating risk. For the non-poor (especially the large and emerging middleclass) there is the need to diversify investment opportunities and placements for surplus funds in a variety of financial products and services, and in a number of financial institutions that manage the public's funds. Nevertheless, the appearance of multiple investment choices also contains the risk that the funds invested will disappear due to a lack of accountability at investment companies and by fund managers. Therefore, financial inclusion also represents efforts to protect consumers by reducing risk, which will ultimately buttress financial system stability.

Financial Inclusion Approach

Several definitions of financial inclusion are used, including the flowing two:

"A holistic activity that aims to **negate all constraints**, including price constraints and non-price constraints, concerning public access to use and/or benefit from **financial services**." (Summarised from various definitions, including the World Bank, 2008; the European Commission, 2008; McKillop and Wilson, 2007; Leyshon and Thrift, 1993; and Sinclair, 2001).

"A fundamental activity to improve the wellbeing of the Poor and support MSMEs as drivers of economic growth and creators of employment opportunities." (G20 Financial Inclusion Action Plan, 2009).

Based on the two aforementioned definitions, financial inclusion relates directly to broadening access to financial services for all strata of society. This is important in Indonesia, which is geographically dispersed throughout a large archipelago, where access to financial services is often an issue. Furthermore, financial inclusion is also a way to ensure economic equality and broaden the benefits of domestic economic growth, which has remained stable over the past few years, in the wider community.

Based on the National Financial Inclusion Strategy (SNKI), there are three main concepts that mutually reinforce the financial inclusion strategy, namely poverty eradication, financial stability and economic growth. The first component, poverty eradication, is achieved by promoting an increase in class from low-income poor to non-poor, while continuing to consider the special needs of groups like domestic and international migrant workers as well as residents in remote areas. The second component, financial stability, is achieved through the creation of a regulatory environment that supports consumer protection. The final component, economic growth, is achieved by promoting initiatives to spur and empower local economies.

The National Financial Inclusion Strategy is designed to focus on the general public and aims to broaden access to financial services for all segments of society as well as open financial and small business opportunities. This strategy aims to encompass all sections of society but with the distinct understanding that each level of society has a different set of social and financial needs. Furthermore, small businesses represent the largest form of economic activity in Indonesia, thereby requiring special efforts to realise their full potential.

A National Financial Inclusion Strategy that focuses on the general public must be integrated with the national interest and relevant institutions. At the national level, this strategy requires the involvement of all stakeholders in the public and private sectors as well as civil society. The strategy must include consistent and coordinated efforts to achieve the desired level of financial inclusion within the given time frame. Therefore, efforts require a clear common vision regarding the challenges and opportunities offered by the financial system, as well as what could be achieved as a nation looking ahead. This vision also requires national awareness concerning the role financial inclusion plays in creating new opportunities for the most vulnerable strata of society as well as low-income earners. Although the security and stability of the financial system is the overarching concern of the regulator, seeking new ways and new instruments to catalyse existing financial activity represents the foundation of financial inclusion that places the Poor at the centre of attention.

Financial Inclusion Framework

The general framework for financial inclusion is constructed atop six pillars. The six pillars are fully consistent and congruous with the national strategy proposed here and are developed based on input from Bank Indonesia and the Ministry of Finance. The six pillars are as follows:

1. **Financial Education.** This pillar aims to broaden knowledge and raise public awareness of financial products and services that exist on formal financial markets, aspects of consumer protection and risk management. The strategy for this pillar consists of at least three elements: (a) financial product information; (b) consumer protection information; and (c) financial management information. In addition, financial education could also be directed towards assisting low-income and poor households understand the importance of household cash and debt management. The strategy of financial education should refer to the OECD's Recommendations on Principles and Good Practices for Financial Education and Awareness, which contains nine principles and good practices for the implementation of financial education.
2. **Financial Eligibility.** This pillar aims to enhance the eligibility of individuals, particularly the productive Poor as well as micro and small enterprises, that were previously ineligible and, thus, ultimately become bankable and able to access the formal financial sector. This pillar consists of: (a) enhancing individual capacity and boosting public welfare; (b) introducing alternative credit guarantee systems; (c) simplifying the procedures associated with financial services; and (d) identifying potential customers and providing specific financial products and services.
3. **Supporting Policies/Regulations.** The Government and Bank Indonesia, as regulators, are authorised to modify existing policies and regulations, or formulate new policies and regulations as required that broaden access to the formal financial sector and/or eliminate constraints that impede the access of various strata of society to the financial sector. This pillar covers: (a) licensing microfinance institutions and banking agents; (b) compiling regulations that encourage the banking industry to play and active role in providing financial education; and (c) reviewing regulations relating to the mechanism to liquidate corporate social responsibility (CSR) funds from banks.
4. **Intermediation and Distribution Channels.** Intermediation is required to enhance the awareness of financial institutions that there truly remain bankable segments of society. Here there are two fundamental aspects: (1) asymmetric information, namely imbalances in the information between financial institutions and poor segments of society who could potentially be eligible to receive loans; (2) business scale, namely the need to facilitate cooperation between large commercial banks and rural banks, cooperatives and informal financial institutions that operate on a much smaller scale. On the other hand, the distribution channel aims to expand public access to financial services, including seeking alternative methods to broaden the distribution of financial products and services, especially to residents in remote areas, for instance through: (a) agent banking; (b) phone banking; (c) mobile banking/money and e-banking; and (d) other supporting infrastructure.

5. **Public Financial Facilities.** This pillar refers to the capacity and role of the government through direct and indirect financing from the state budget in order to promote public access to the formal financial sector. Nevertheless, allocating state budget funds must adhere to principles of prudence, accountability and expediency as well as remain on target. Public financial policy is implemented though: (a) fiscal incentives; (b) subsidies; and (c) G2P programs (like BLT, PKH and BSM).

6. **Consumer Protection.** This pillar provides guarantees and assurance to consumers in terms of access to the formal financial sector. Broadening public access to the formal financial sector must ensure consumer protection. Here, consumer protection is not only directed towards members of the general public with excess liquidity but also towards those with productive businesses lacking capital. It is imperative for the formal financial system to bridge those two sets of circumstances and provide assurance to both parties.

Bank Indonesia Initiatives in 2012 concerning Financial Inclusion

A number of financial inclusion initiatives rolled out in 2012 will be continued in 2013 as follows:

1. Banking and Financial Education

The following activities were implemented in 2012:

a. Expanding banking and financial education to elementary and junior high school students in four cities, namely Padang, Palembang, Denpasar and Balikpapan.

b. Providing banking and financial education to high school and college students through seven pilot projects.

c. Providing banking education and entrepreneurial training to Indonesian migrant workers in four pockets of migrant worker populations as well as in three placement countries.

d. Providing banking and financial education to certain groups of the general public in specific locales through pilot projects, for instance to fishermen, border communities and civil servants.

As part of the follow-up measures to this program, Bank Indonesia will:

a. Convene preliminary meetings to coordinate with the department of education in each respective region in order to expand education to pupils and students.

b. Coordinate with the Ministry of Manpower and Transmigration in order to expand education services to Indonesian migrant workers.

c. Hold discussions on respective community associations.

2. *TabunganKu* (MySavings)

The results of a survey conducted by the World Bank in 2010 found that more than two billion adults around the world remain without access to formal and informal financial services. Of that total, around 90% reside in Africa, Latin America, Asia and the Middle East. This is similar to the findings of the World Bank survey on Indonesia performed in 2010, where less than half of the populace owned a bank account at a formal financial institution (a bank). Moreover, less than 50% of the Indonesian population held savings at a bank and only 17% had access to bank credit.

The determinants of low public access to financial services include low incomes and insufficient financial education (especially concerning banks). Currently, bank products, particularly savings accounts, do not meet the needs of low-income earners due to high administrative costs and overly stringent requirements to open a bank account. Therefore, Bank Indonesia in conjunction with the banking community designed the *TabunganKu* (MySavings) product as a form of banking education program.

TabunganKu was initially launch nationwide in February 2010 as a follow-up program to the Ayo Ke Bank (Let's go to the Bank) campaign rolled out in 2008. *TabunganKu* is a savings product free from administrative costs and a minimum initial deposit or balance. *TabunganKu* aims to reach unbanked low-middle income earners, while concomitantly advocating a culture of saving that will ultimately raise the welfare of the general public.

TabunganKu was not designed as a current account but specifically as a preliminary savings product that supports a culture of saving in order to pique the interest of the general public. *TabunganKu* is an offline service, meaning that a customer can only deposit and withdraw funds at the branch where the *TabunganKu* account was opened. Since its launch by around 70 commercial banks and more than 100 rural banks, including Islamic rural banks, up to the end of 2012 a total of 3,635,619 *TabunganKu* accounts have been opened.

In 2012, Bank Indonesia under the aegis of the World Bank conducted a survey of the *TabunganKu* program in order to monitor the efficacy and economic impact of the program. The results of the survey show that the program has reached 74% of unbanked customers, encouraging them initially to open a bank account and then to become active users. However, in terms of the total adult unbanked population, only 0.7% is covered.

Regarding usage, it should be noted that the aim of *TabunganKu* as a preliminary savings product that promotes a culture of saving has been achieved, considering that most *TabunganKu* account holders use the service to save (low withdrawals). Furthermore, when unbanked customers that subsequently open a *TabunganKu* account become active users of bank services, the habit of saving is preserved.

A survey of potential and existing customers indicated that the low cost of the *TabunganKu* product (no administrative costs, as well as a low opening and minimum balance) is the most important aspect when customers open a new *TabunganKu* account. Notwithstanding, there is also strong public demand for *TabunganKu* to be expanded and accessible at all bank branches. This new feature is expected to bolster the other key features of the *TabunganKu* product and, therefore, garner more interest in the product.

Impressive *TabunganKu* performance requires additional support from appropriate marketing activities because despite being introduced in 2010, there remain numerous respondents who have still not heard of the program. Consequently, the banks involved are urged to implement further measure to disseminate the program considering the large unrealised potential of the product.

TabunganKu as a form of banking education provided to the general public will be continued. In the near term, the features of *TabunganKu* will be modified, while in the medium-long term, policy will be formulated relating to a Basic Savings Account. In terms of other education programs, banking education in 2013 will be offered to fishermen, border communities and civil servants through a number of pilot projects. Furthermore, the education program will continue for migrant workers, the general public and students. Education for migrant workers will be implemented in four pockets of migrant worker populations and in three placement countries. For college and high school students, the education program will be implemented in various areas as pilot projects. Meanwhile, the education of elementary and junior high school pupils, as implemented in the previous year, will be re-implemented in other areas as pilot projects. The expansion of pilot projects and the implementation of educational activities to new groups, like fishermen, border communities and civil servants is expected to nurture a culture of saving at the national level and continue to promote the financial inclusion agenda.

3. Branchless Banking

As banking services become increasingly sophisticated through greater use of modern information technology, the reality is that many Indonesia citizens still remain unbanked and underbanked. A body of research exists to prove that point, including a survey conducted by the World Bank in 2010 on household access to financial services. The results of the World Bank survey found that of all the respondents, only 68% save and only around half of those use formal financial institutions. From the perspective of loans, households that borrow from banks account for just 17% of the 68% of households that borrow.

There are numerous factors why so many members of the general public remain unbanked and underbanked, including the sheer distance to the nearest bank branch, the exorbitant fees imposed by banks for small transactions, a low level of financial knowledge, products that do not meet the specific needs of local people, low incomes and the long queues that form at local banks. In addition, there remains an image that banks only serve the middle class and up. Furthermore, the imposing nature and grandeur of a physical bank branch can also influence the psychology of rural people and dissuade them from visiting their local bank. Based on the aforementioned factors, an informal approach to providing financial and banking services would be more appropriate when reaching out to unbanked communities in rural areas.

From the banks' perspective, efforts to approach local communities by expanding the office network are not that simple. Establishing a new branch office entails a complex process due to the administrative and financial requirements that must be met as well as the large-scale investment that is required, which serve to undermine the efficiency and performance of the bank. Consequently, efforts the bridge the gap between unbanked people and financial/banking services cannot be achieved through conventional methods.

In the interest of the unbanked, the basic necessities are actually pretty simple, including the ability to transfer funds, deposit disposable income and access additional funds to finance productive business activity. If such requirements are combined with efforts to maintain and enhance bank efficiency in order to curb lending rates, then the solution to narrowing the gap between local communities and banking services is to expand the office network through unconventional means. The most effective way of achieving this is by utilising information technology developed by telecommunications companies together with the retail trade network (agents), which has deep penetration into local communities, that is integrated with banking/ financial services. This is more commonly known as branchless banking.

In principle, branchless banking is a distribution strategy used by banks to expand the provision of financial services to their customers without a physical branch office. Meanwhile, according to the concept of financial inclusion, branchless banking offers payment system and financial services without the need for a bricks and mortar branch office, instead using information technology and/or the services of a third party to serve primarily the unbanked. The technology used in the implementation of branchless banking is cellular telephones, however, the use of other technology like Electronic Data Capture (EDC) is also possible. Cellular telephones are the preferred method due to their widespread adoption by people in Indonesia, even in rural areas. Nonetheless, expanding the financial/banking services network with the involvement of a third party could trigger potential risk for the bank, the customers and third parties working with the bank. Therefore, to overcome that risk, the operationalization of branchless banking must adhere to the following salient principles:

a. Branchless banking aims to promote financial inclusion by expanding the service coverage of the payment system and access to financial services through cooperation with third parties, known as agents, using information technology.

b. Banks engaged in branchless banking are fully accountable for the activities associated with branchless banking implemented by a third party in conjunction with the bank.

c. Banks engaged in branchless banking shall have supporting IT infrastructure that is secure and reliable, adequate risk management and a business continuity plan that covers anticipatory measures in the event that the IT systems fails.

d. Each branchless banking transaction processed through the IT network is real-time and online. In this context, banks shall ensure each transaction is logged accurately and that confidential customer data and information is protected according to prevailing laws.

e. A bank account is the primary media in the application of branchless banking, hence all transactions shall be processed through the bank account as a means to deposit, withdraw and transfer funds.

f. Opening a bank account shall adhere to regulations concerning know your customer principles and customer due diligence with simplified criteria and by observing the limitations stipulated in prevailing regulations concerning anti-money laundering and the prevention of terrorism financing. Consequently, on 28th December 2012 Bank Indonesia issued Bank Indonesia Regulation No. 14/27 concerning the application of anti-money laundering and the prevention of terrorism financing by commercial banks.

g. Banks engaged in branchless banking shall apply principles of consumer protection, including ongoing education to the general public.

Considering that branchless banking is new to the banking industry in Indonesia, its implementation requires a phased approach commencing with guiding principles, pilot projects, complete evaluations and finally full implementation through the promulgation of regulations concerning branchless banking. Bank Indonesia plans to issue the guiding principles of branchless banking in 2013 and implement pilot projects in a number of regions involving certain banks that meet the specific requirements. As an inseparable part of the National Financial Inclusion Strategy and Indonesian Banking Architecture, branchless banking is expected to help expand public access to affordable payment system and banking services as well as to provide banking products that are appropriate to the needs of low-income earners in order to support sustainable and inclusive economic growth.

4. Start-up Credit

In 2012, Bank Indonesia reviewed the allocation of credit for start-up businesses. As a result, Bank Indonesia will formulate regulatory specifications regarding a credit scheme for start-ups and assess the implementation of pilot projects. In this case, Bank Indonesia will coordinate with the banking community and relevant institutions in order to design an appropriate credit scheme.

5. Financial Identity Number (FIN)

In this regard, Bank Indonesia implemented the following measures in 2012:

a. Compiled a FIN database covering the following activities:

- Conducted a baseline survey and a comprehensive survey to compile a database totalling 600,000 respondents and 400 respondents respectively.

- Coordinated with relevant institutions in order to collect and collate data.

b. Constructed the FIN database with data sourced from the baseline survey and comprehensive survey, and developed applications associated with FIN.

c. Signed a cooperation agreement between the Governor of Bank Indonesia and the Interior Minister regarding cooperation when using electronic ID data and census data for banking services at the inauguration of Financial Inclusion Week opened by the President of the Republic of Indonesia on 27th June 2012 in Jakarta.

Follow-up discussions will be held regarding the use of electronic ID data and census data with the Interior Minister in May 2013.

Box 4.1 Policy to develop an Electronic Credit Transfer System

Bank Indonesia implements policy to develop an electronic credit transfer system for Apex banks in order to expand rural bank access to the payment system. The electronic credit transfer system for Apex banks is a means through which payment system services hosted by a commercial bank acting as an Apex bank can meet the requirement of rural bank customers in terms of transferring funds to customers at other banks nationwide. Consequently, it is possible for customers of Apex member rural banks to transfer funds to customers of non-member rural banks or even customers of commercial banks through the national clearing system hosted by Bank Indonesia.

Administrating the electronic credit transfer system for Apex banks represents one function of Apex banks, namely to provide technical assistance to member rural banks in the form of payment system services. The development of an electronic credit transfer system for Apex banks aims to:

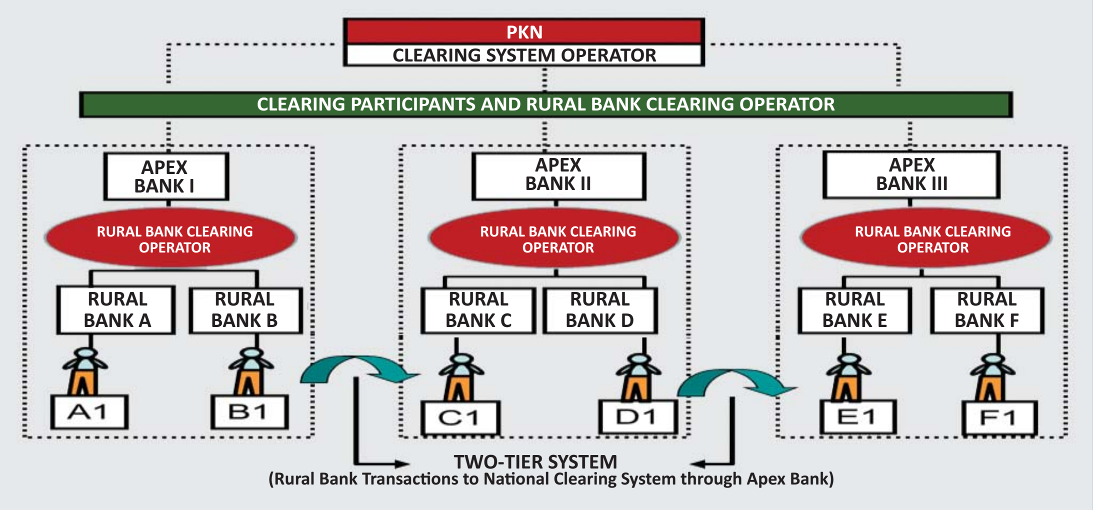
a. Provide secure and affordable fund transfer (credit transfer) facilities to the customers of Apex member rural banks; and

b. Create an inter-rural bank money market among Apex members.

The development of an electronic credit transfer system for Apex banks began in July 2012 through a pilot project in conjunction with Bank Jatim, which is an Apex bank located in East Java, as the host of the electronic credit transfer system. The pilot project involves 18 rural banks as members of the Apex bank out of a possible 278 rural banks located in East Java. After the pilot project, the electronic credit transfer system for Apex banks was officially launched by the Governor of Bank Indonesia on 29th November 2012 in Surabaya.

Currently, only Bank Jatim as an Apex bank in East Java has implemented the electronic credit transfer system for Apex banks. More rural banks are required as members before the facilities of the electronic credit transfer system can be extended and utilised further. Looking ahead, development of the electronic credit transfer system will be continued for Apex banks in other regions, hence the development and implementation of an electronic credit transfer system for Apex banks will successfully meet the requirements of customers from member rural banks to transfer funds to customers at other banks. Ultimately, the implementation of an electronic credit transfer system for Apex banks will enhance the image and boost the competitiveness of rural banks in terms of providing facilities to their customers.

The Mechanism of an Electronic Credit Transfer System for Apex banks



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