Basel Committee
on Banking Supervision

Regulatory Consistency Assessment Programme (RCAP)

Assessment of Basel III risk-based capital regulations – Indonesia

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Contents

Glossary

ABCP	Asset-backed commercial paper
APBN	State Revenues and Expenditure Budget of the Republic of Indonesia
AT1	Additional Tier 1
BCBS	Basel Committee on Banking Supervision
BI	Bank Indonesia
BIA	Basic Indicators Approach
BIS	Bank for International Settlements
BUMN	Indonesian insurance companies with the status of state-owned enterprises
C	Compliant (grade)
CCF	Credit conversion factor
CCP	Central counterparty
CET1	Common Equity Tier 1
CVA	Credit Valuation Adjustment
D-SIB	Domestic systemically important bank
ECAI	External credit assessment institution
FAQ	Frequently asked question
G-SIB	Global systemically important bank
IDR	Indonesian rupiah
IFRS	International Financial Reporting Standards
LC	Largely compliant (grade)
LGD	Loss-given-default
MDB	Multilateral development bank
MNC	Materially non-compliant (grade)
OJK	Otoritas Jasa Keuangan, the Indonesian Financial Services Authority
OTC	Over-the-counter
PFE	Potential future exposure
NA	Not applicable
NC	Non-compliant (grade)
PBI	Bank Indonesia Regulation (Peraturan BI)
PDG	Bank Indonesia Board of Governors Regulation (Peraturan Dewan Gubernur)
PDK	OJK Board of Commissioners Internal Regulation (Peraturan Dewan Komisioner)

POJK	OJK Regulation (Peraturan OJK)
PON	Point of non-viability
PSE	Public sector entity
RCAP	Regulatory Consistency Assessment Programme
RWA	Risk-weighted assets
SE BI	Bank Indonesia External Circular Letter (Surat Edaran BI)
SE DK	OJK Board of Commissioners Internal Circular Letter (Surat Edaran Dewan Komisioner)
SE INTERN	Bank Indonesia Internal Circular Letter (Surat Edaran Intern)
SE OJK	OJK Circular Letter (Surat Edaran OJK)
SFT	Securities financing transaction
SIG	Supervision and Implementation Group
SME	Small and medium-sized entities
SPE	Special purpose entity
SPV	Special purpose vehicle
SREP	Supervisory review and evaluation process
VaR	Value-at-risk

Preface

The Basel Committee on Banking Supervision (Basel Committee) sets a high priority on the implementation of regulatory standards underpinning the Basel III framework. The prudential benefits of adopting Basel standards can only fully accrue if these are implemented appropriately and consistently by all member jurisdictions. The Committee established the Regulatory Consistency Assessment Programme (RCAP) to monitor, assess and evaluate its members' implementation of the Basel framework.

This report presents the findings of the RCAP Assessment Team on the domestic adoption of the Basel risk-based capital standards in Indonesia and its consistency with the minimum requirements of the Basel III framework. The assessment focuses on the adoption of Basel standards applied to Indonesian banks that are internationally or regionally active and of significance to Indonesia's domestic financial stability.

The RCAP Assessment Team was led by Ms Kerstin af Jochnick, First Deputy Governor of Sveriges Riksbank. The Assessment Team comprised eight technical experts drawn from France, Georgia, Germany, India, Mexico, the Philippines and South Africa (Annex 1). The main counterparts for the assessment were the Indonesia Financial Services Authority (OJK) and Bank Indonesia (BI). The overall work was coordinated by the Basel Committee Secretariat with support from staff from Sveriges Riksbank.

The focus of the assessment was on the consistency and completeness of Indonesia's domestic regulations with regard to the Basel minimum requirements. Issues relating to prudential outcomes, capital levels of individual banks, the adequacy of loan classification practices or the OJK's supervisory effectiveness were not in the scope of this RCAP assessment exercise. The assessment relied upon the data, information and materiality computations provided by the OJK and BI by 30 June 2016. The assessment findings are based primarily on an understanding of the current processes in Indonesia as explained by OJK and BI staff and the Assessment Team's expert view on the documents and data reviewed.

The assessment began in May 2015 and consisted of three phases: (i) completion of an RCAP questionnaire (a self-assessment) by the Indonesian authorities; (ii) an assessment phase (January to May 2016); and (iii) a post-assessment review phase (May to September 2016). The second phase included a series of conference calls with the OJK and BI, representatives of Indonesian banks and two consultancy firms, as well as a meeting in Indonesia to discuss the findings. These exchanges provided the Assessment Team with a deeper understanding of the implementation of the Basel risk-based capital standards in Indonesia. The third phase consisted of a two-stage technical review of the assessment findings: first, by a separate RCAP Review Team and the Basel Committee's Supervision and Implementation Group (SIG); and, second, by the RCAP Peer Review Board and the Basel Committee. This two-step review process is a key part of the RCAP, providing quality control and ensuring the integrity of the assessment findings.

Where domestic regulations and provisions were identified as not conforming with the Basel framework, those deviations were evaluated for their current and potential impact (or non-impact) on the reported capital ratios for a sample of large Indonesian banks. Some findings were evaluated on a qualitative basis. The assessment outcome was based on the materiality of findings and use of expert judgment. The Assessment Team also identified areas for follow-up action (Annex 11).

The report has three sections and a set of annexes: (i) an executive summary with a statement from the Indonesian authorities on the material findings; (ii) the context, scope and methodology, and the main set of assessment findings; and (iii) details of the deviations and their materiality along with other assessment-related observations.

The RCAP Assessment Team acknowledges the professional cooperation received from the OJK and BI throughout the assessment process. In particular, the team sincerely thanks the staff of the Indonesian authorities for their role in coordinating the assessment exercise. The series of comprehensive briefings and clarifications provided by the OJK and BI helped the RCAP assessors to arrive at their expert

assessment. The Assessment Team would also like to thank the representatives of Indonesian banks that provided data and information. The Assessment Team hopes that the RCAP assessment exercise has contributed to the sound initiatives that have been undertaken by the OJK and BI and to strengthening further prudential banking regulation in Indonesia.

Executive summary

The Indonesian risk-based capital framework came into force in 2012 (Annex 2). The prudential framework generally applies to all conventional commercial banks, including commercial banking institutions and state-owned institutions. Requirements on market risk capital requirements and the capital conservation buffer apply to a smaller group of banks, but still cover the largest banks in Indonesia that are permitted to conduct international activities. Over time, the Indonesian framework has been periodically updated to include Basel 2.5 and Basel III standards. It was last amended in January 2016, to incorporate the Basel III definition of capital.

During the RCAP, the Assessment Team identified a number of differences between the Indonesian regulations and the Basel framework, which the OJK subsequently decided to rectify. The amendments were passed between July and September 2016. The actions taken by the OJK significantly improved the level of compliance with the Basel minimum standards. The Assessment Team compliments the OJK for its substantial reforms and alignment with the Basel framework. In the absence of these reforms, the RCAP assessment would have generated a less positive result.

Based on the amended regulations issued before the end of September 2016, The Assessment Team finds Indonesia to be largely compliant with the Basel risk-based capital standards. This is one notch below the highest grade.

Six of the underlying components of the risk-based capital framework, on the scope of application, minimum capital requirements, counterparty credit risk, operational risk, Pillar 2 and Pillar 3, are assessed as compliant. The components on the definition of capital, securitisation, market risk and capital buffers were assessed as largely compliant.

The credit risk component was considered materially non-compliant. This is due to two material differences between the Basel framework and the Indonesian framework. The first relates to the risk weight assigned to sovereign or central bank exposures. The Basel framework permits a zero risk weight to be applied to banks' exposures to their sovereign or central bank, provided that the exposures are denominated and funded in domestic currency. In Indonesia, all claims against the Indonesian government and BI receive a zero risk weight, regardless of the currency in which they are denominated or funded. The second difference concerns the risk weight applied to certain loans to employees and pensioners of state-owned enterprises. These loans receive a 50% risk weight in the Indonesian framework, rather than 75% under the Basel framework. Both differences overstate the capital ratios of Indonesian banks compared to the ratio that would apply under the Basel rules, materially so for some banks.

The Assessment Team noted that, in several places, the Indonesian regulations were less specific than the Basel framework, especially with respect to the treatment of complex financial products. This approach contributes to simpler standards, which may be easy to understand for many stakeholders but which do not give detailed guidance on more intricate transactions. The Assessment Team considered this to be appropriate, given the nature of the Indonesian financial system and its focus on traditional banking. As the financial system develops, the Assessment Team recommends reviewing certain parts of the prudential framework to ensure that the level of guidance provided is consistent with the complexity of transactions being conducted (Annex 11). Ultimately it will be important to make sure that risks are measured properly and result in relevant capital charges.

In addition, the Indonesian authorities intend to amend the Indonesian securitisation framework by implementing, by 1 January 2018, a new framework that aligns with Basel standards on securitisation published in 2014. The Assessment Team recommends that a follow-up assessment of the Indonesian securitisation framework be conducted once these standards have been implemented (see also Annex 11).

Response from the Indonesian authorities

The Indonesian authorities welcome the opportunity to respond to the findings and comments of the RCAP Assessment Team on the implementation of the Basel III capital adequacy requirements in Indonesia. We greatly appreciate the professionalism and hard work of the RCAP Assessment Team and its leader, Ms Kerstin af Jochnick. This assessment has allowed us to improve the consistency of our capital framework with international standards and, accordingly, enhance the strength of the framework.

The Indonesian authorities are strongly committed to adopting the Basel capital framework and accept in general the assessment report. Nevertheless, we do not fully agree with and choose not to make adjustments regarding two findings, namely: (i) loans to employees and pensioners; and (ii) treatment of foreign currency-denominated bank exposures to the government. We would like to take this opportunity, for the benefit of the readers, to provide several explanatory notes, as we have done for the assessment team, as to why we do not fully agree.

We believe that loans to employees and pensioners deserve a lower risk weight than that of retail loans. This is because such a category of loans meets requirements that are much stricter than those of retail loans. Loans categorised as loans to employees and pensioners are specifically granted to employees of state-owned enterprises, civil servants and pensioners of both.

For greater clarity, the following is a brief description of the scheme of the said loans. Employees of state-owned enterprises, civil servants and pensioners of both have claims on the government in the form of the salary or pension they receive every month. The government will pay their salary or pension via their respective accounts in appointed banks. Banks that are appointed as agents of salary payments by the government are usually state-owned banks. As these banks act as "salary payment agents", they offer loans that are known as "loans to employees and pensioners". Employees and pensioners have their salary or pension directly deducted as such banks have power of attorney authorising automatic deduction of their salary or pension. Therefore, as long as the civil servants or pensioners are still alive and can still be classified as "civil servants or employee or pensioners of both", the repayment expenses are borne directly by the government budget. Accordingly, the possibility of default only exists when civil servants or pensioners pass away. In such a case, they would be covered by life insurance, which is also one of the requirements for the loan to be classified in this loan category.

It should be noted that not every bank can offer such loans; rather, only banks acting as "salary payment agents" can do so. As can be seen from the materiality test, only one bank was found to have a material impact. This is because that bank is one of the salary payment agent banks described above.

We would also like to provide readers with the same clarification we provided to the Assessment Team regarding the finding on the treatment of bank foreign currency-denominated exposures to the government of Indonesia, for which a lower risk weight is applied. This decision was made based on national economic interest as well as prudential considerations. The reader may wish to note that, as a developing country, Indonesia still requires significant financing to grow. Unlike in developed countries, where markets are active and deep with various financial instruments providing abundant sources of financing, Indonesia's financing sources are limited. Government bonds are one of the main financing sources for Indonesia out of the limited instruments available. Certainly, the decision to apply a lower risk weight was made only after assuring that prudence for banks continues to be upheld. Confidence in upholding prudence has been maintained considering that from a historical perspective, the government has never defaulted on its obligations. This remained true even when the economy underwent the severe 1997–98 financial crisis. Nevertheless, to ascertain that prudence continues to be upheld, the authority closely supervises and monitors banks' foreign exchange exposures by, among others, implementing strict regulations on net open positions. Also, based on current regulations, supervisors have the authority to require banks to increase their minimum capital requirements if supervisors assess that there are risks not captured in the minimum capital requirements calculation. The authorities have closely monitored these exposures, and will continue to do so.

In general, we see the RCAP as an important process as it improves the consistency of banking standards across jurisdictions, whilst providing an opportunity for jurisdictions to better understand the Basel framework. At the same time, the RCAP also enables the Assessment Teams to better understand jurisdictions' characteristics and uniqueness.

1 Assessment context and main findings

1.1 Context

Status of implementation

The Otoritas Jasa Keuangan (OJK) is the main regulatory and supervisory authority for banks in Indonesia. It was established in 2011 by Law No 21/2011 and assumed regulatory and supervisory responsibilities for capital markets and non-bank financial institutions on 31 December 2012. On 1 January 2014, the OJK took over banking supervision from Bank Indonesia (BI), the Indonesian central bank.

The OJK is an independent state institution. Its main decision-making body is the Board of Commissioners, which comprises nine members with equal voting rights. The Commissioners are appointed by the parliament from candidates proposed by the president based on the recommendation of a selection committee. This includes two ex officio members, one from the Ministry of Finance and one from BI. The Board is responsible for determining the OJK's regulations, operational procedures, work plans and budget (the latter subject to parliamentary approval). During the transition from the previous supervisory arrangements, the OJK's operational budget has been funded by the state budget. However, the intention is that the OJK will be financially independent by 2016–17, via the imposition of levies on the financial services industry.

BI implemented Basel II in Indonesia between 2007 and 2012 and subsequently adopted the Basel III capital regulations. The Basel II credit risk standardised approach has been effectively implemented since January 2012, with Pillar 2 and Pillar 3 requirements in effect from November and December 2012, respectively. The final Basel III capital rule was implemented in December 2013, with the capital buffers being phased in from January 2016. The Indonesian authorities do not permit banks to use advanced approaches for credit risk, market risk and operational risk to calculate regulatory capital requirements. Therefore, these approaches were not included in the scope of this assessment. In general, the Basel framework applies to all conventional commercial banks. However, the market risk framework and the capital conservation buffer are only applied to larger Indonesian banks.

Regulatory system, model of supervision and binding nature of prudential regulations

In Indonesia, the Basel framework is imposed on all conventional commercial banks. These comprise over 95% of Indonesian banking assets. The Basel framework does not apply to sharia banks or rural banks.[1] In evaluating the materiality of its findings, the RCAP Assessment Team focused on eight large Indonesian banks, which included the four largest commercial banks. The eight banks comprise about 60% of banking sector assets in Indonesia.

The OJK issues prudential regulations under the powers delegated to it by Law No 21/2011.[2] These regulations are legally binding. The structure of Indonesian regulations is: (i) Law No 23/1999 and Law No 21/2011 establishing the OJK as supervisor; (ii) OJK and BI Regulations; and (iii) OJK and BI Circular Letters. As authority for banking supervision was only recently transferred to the OJK from BI, regulations and Circular Letters issued by BI before the transfer remain valid unless revoked or converted into an OJK Regulation. Table 1 and Annex 2 provide further information on the structure of Indonesian prudential regulations.

1 The regulatory regime followed by sharia banks is similar to the Basel framework. Where there are differences, due to the unique characteristics of sharia banks (eg profit-sharing investment accounts), the OJK follows the standards set by the Islamic Financial Services Board. Rural banks are restricted in their operations, as described in Section 1.2.

2 According to Article 85 of Law No 12/2011 (which concerns the establishment of legislation), the Ministry of Justice and Human Rights formally enacts the regulations by including them in the Official Gazette of the Republic of Indonesia.

The team considers the OJK regulations and Circular Letters as binding by law and therefore within the scope of the assessment. Supervisory letters, through which specific requirements are imposed on individual firms, are considered to have the same force. The team verified the bindingness through an assessment of the RCAP bindingness criteria (Annex 6).

Structure of Indonesian laws and regulatory instruments — Table 1

Laws that empower the OJK as banking supervisor	The establishment of the OJK was mandated by Law No 23/1999 on BI and enacted by Law No 21/2011 on the Indonesian Financial Services Authority. These laws give the regulations issued by the OJK the same legal power as regulations set by other institutions and bodies such as BI. Law No 12/2011 sets out the legal hierarchy of Indonesian laws and regulations. Under this framework, BI and OJK Regulations are recognised and legally binding as long as they are mandated by a law or enacted based on authority.[3]
Supervisory regulatory instruments issued by the OJK and BI derived from the above laws	OJK Regulations (Peraturan OJK, or POJK) apply externally or to the public in general. These are written rules set by the Board of Commissioners. They are legally binding and published in the National Gazette. BI Regulations (Peraturan Bank Indonesia, or PBI) are written regulations set by BI. They are legally binding for all individuals and bodies and are published in the National Gazette.
	OJK External Circular Letters (Surat Edaran OJK, or SE OJK) are written rules set by a member of the Board of Commissioners. They include implementation instructions or technical guidance. BI External Circular Letters (Surat Edaran BI, or SE BI) are written documents that provide implementation or technical guidelines on a BI Regulation. They are published in the National Gazette. Both OJK and SE BI are legally binding on financial institutions.
Internal instruments	A Board of Commissioners Regulation (Peraturan Dewan Komisioner, or PDK) is a written rule set by the OJK Board of Commissioners. It is legally binding within OJK, on those conducting its activities. A Board of Governors Regulation (Peraturan Dewan Gubernur, or PDG) is a written regulation set by BI. It contains provisions on various internal aspects of the organisation.
	A Board of Commissioners Circular Letter (Surat Edaran Dewan Komisioner, or SE DK) is a written rule set by a member of the OJK Board of Commissioners. It includes implementation or technical guidance on POJK or PDK. A BI Internal Circular Letter (Surat Edaran Intern, or SE INTERN) is a written document that provides implementation or technical guidelines on a PDG. Both SE DK and SE INTERN are legally binding.

1.2 Structure of the banking sector

As of June 2016, there are 118 commercial banks in Indonesia and 1,805 rural banks. Total banking assets are around 70% of Indonesia's gross domestic product. Commercial banks comprise 106 conventional commercial banks, to which the Basel framework is applied, and 12 sharia banks. The banking system is dominated by state-owned banks and government-owned regional development banks. Rural banks, while numerous, comprise less than 2% of banking sector assets. These banks are not connected to the

3 BI Regulations are mentioned explicitly in Article 8 of Law No 12/2011. OJK Regulations fall into the same category, but are not cited as an example because the OJK did not exist at the time the law was issued.

payment and clearing system and are restricted in the scope of their operations. There are no global systemically important banks (G-SIBs) based in Indonesia, though a number of G-SIBs have Indonesian branches. There are no designated domestic systemically important banks (D-SIBs) in Indonesia.

Most Indonesian commercial banks have a traditional business model, focusing on retail and corporate banking. There is no investment banking in Indonesia. Banks have limited overseas activities; no bank has more than 10% of its assets as foreign assets. Domestically, Indonesia has seen considerable credit expansion in recent years, in both household and corporate borrowing. However, the proportion of Indonesians with a bank account remains relatively low. According to World Bank data on financial inclusion, 36% of those aged 15 or over had an account at a financial institution in 2014 (up from 20% in 2011).[4] The financial industry in Indonesia is developing, and a growing part of the population is using financial services.

Bank capital is mainly composed of equity. Based on the Basel III standard, the weighted average total capital ratio of the eight sample banks was 20.3% in June 2016. The Common Equity Tier 1 (CET1) ratio was 18.3% (see also Annex 7).

There are 12 commercial sharia banks and 161 rural sharia banks in Indonesia. These banks comprise around 3.5% of Indonesian banking assets. They are not subject to Basel capital requirements.

1.3 Scope of the assessment

Scope

The RCAP Assessment Team considered all documents that effectively implement the risk-based Basel capital framework in Indonesia as of 30 September 2016, the cutoff date for the assessment (Annex 4).

The assessment had two dimensions:

- a comparison of domestic regulations with the capital standards under the Basel framework to ascertain that all the required provisions have been adopted (*completeness* of the Indonesian domestic regulation); and
- whether there are any differences in substance between the domestic regulations and the capital standards under the Basel framework and their significance (*consistency* of the Indonesian regulation).

In carrying out the above, the Assessment Team considered all binding documents that effectively implement the Basel framework in Indonesia. The Assessment Team reviewed translated documents provided by the Indonesian authorities and checked the translation of a sample of paragraphs. Importantly, the assessment did not evaluate the adequacy of capital or resilience of the banking system in Indonesia or the supervisory effectiveness of the Indonesian authorities.

Any identified deviation was assessed for its materiality (current and potential impact, or having an insignificant impact) by using both quantitative and qualitative information. For potential materiality, in addition to the available data, the assessment relied on expert judgment on whether the domestic regulations complied with the Basel framework in letter and spirit (see Section 1.4).

Bank coverage

For the purposes of assessing the materiality of deviations, data were collected from an agreed sample of eight banks. This sample comprised: Bank Mandiri, Bank Rakyat Indonesia, Bank Negara Indonesia, Bank Central Asia, Bank Danamon Indonesia, Bank Permata, Bank CIMB Niaga and Bank OCBC NISP. These banks

[4] See World Bank, *Global Findex Database 2014*, www.worldbank.org/globalfindex.

include the largest banks in Indonesia and hold approximately 60% of total assets of the Indonesian banking system (see also Annex 8). Though none have significant overseas operations, all are permitted to conduct international or regional business. Two of the banks are the Indonesian subsidiaries of Southeast Asian banking groups and another two are controlled by overseas investors.

Assessment grading and methodology

As per the RCAP methodology approved by the Basel Committee, the outcome of the assessment was summarised using a four-grade scale, both at the level of each of the key components of the Basel framework and as an overall assessment of compliance: compliant, largely compliant, materially non-compliant and non-compliant.[5]

The materiality of the deviations was assessed in terms of their current or, where applicable, potential future impact (or non-impact) on the sample banks' capital ratios. The quantification was, however, limited to the agreed sample of banks. Wherever relevant and feasible, the Assessment Team, together with the Indonesian authorities, attempted to quantify the impact based on data collected from Indonesian banks in the agreed sample of banks (see Annex 8). The non-quantifiable aspects of identified deviations were discussed and reviewed in the context of the prevailing regulatory practices and processes with the Indonesian authorities.

Ultimately, the assignment of the assessment grades was guided by the collective expert judgment of the Assessment Team. In doing so, the Assessment Team relied on the general principle that the burden of proof rests with the assessed jurisdiction to show that a finding is not material or potentially material. A summary of the materiality analysis is given in Section 2 and Annex 8.

In a number of areas, the Indonesian rules go beyond the minimum Basel standards. Although these elements provide for a more rigorous implementation of the Basel framework in some aspects, they have not been taken into account when assessing compliance under the RCAP methodology as per the agreed assessment methodology (see Annex 9 for a list of areas of super-equivalence).

[5] This four-grade scale is consistent with the approach used for assessing countries' compliance with the Basel Committee's *Core principles for effective banking supervision*. The actual definition of the four grades has been adjusted to take into account the different nature of the two exercises. In addition, components of the Basel framework that are not relevant to an individual jurisdiction may be assessed as not applicable (NA). See www.bis.org/publ/bcbs264.htm for further details.

1.4 Main findings

A summary of the main findings is given below.

Summary assessment grading

Table 2

Key components of the Basel capital framework	Grade
Overall grade	LC
Scope of application	C
Minimum capital requirements and transitional arrangements	C
Definition of capital	LC
Pillar 1: Minimum capital requirements	
Credit risk: Standardised Approach	MNC
Securitisation framework	LC
Counterparty credit risk framework	C
Market risk: Standardised Measurement Method	LC
Operational risk: Basic Indicator Approach	C
Capital buffers (conservation and countercyclical)	LC
Pillar 2: Supervisory review process	
Legal and regulatory framework for the supervisory review process and for taking supervisory actions	C
Pillar 3: Market discipline	
Disclosure requirements	C

Compliance assessment scale (see Section 1.3 for more information on the definition of the grades): C (compliant), LC (largely compliant), MNC (materially non-compliant) and NC (non-compliant).

Main findings by component

Scope of application

The Indonesian implementation of the scope of application is assessed as compliant with the Basel framework. Basel capital requirements apply to Indonesian banks on a fully consolidated basis, at every tier within a banking group, and to any holding company that is the parent entity within a banking group in order to include all banking and other relevant financial activities conducted within a group containing an internationally active bank.

The Assessment Team identified only one exception to the inclusion of all relevant financial activities in the scope of consolidation. This exclusion is related to companies owned or controlled in relation to credit restructuring. The Indonesian authorities explained that such investments are not treated as equity investments, that they may only (by law) exist on a temporary basis and that there are no such companies currently. This finding is not considered material.

While most of the Basel framework applies to all banks in Indonesia, there are exceptions for market risk capital requirements and the capital conservation buffer. The largest banks in Indonesia, including all the sample banks, are subject to market risk and capital buffer requirements. This is consistent with the scope of the Basel standards, which apply to all internationally active banks.

Minimum capital requirements and transitional arrangements

The Indonesian authorities' implementation of the calculation of minimum capital requirements and transitional arrangements is considered to be compliant with the Basel framework.

The Basel framework requires minimum capital ratios of 4.5% for CET1, 6.0% for Tier 1 and 8.0% for Tier 2, as does the Indonesian framework. Most of the Basel framework has already been implemented in full and many of the Basel III standards were implemented without a transition period. The exception is the framework for Additional Tier 1 (AT1) and Tier 2 capital instruments, which permits instruments issued before 2013 to count towards capital until 2018. However, the OJK has taken supervisory action in individual cases to restrict the recognition of non-Basel III-compliant capital instruments where they comprise a material part of capital resources. This finding is no longer considered material. One other finding, on the treatment of general provisions, is also not considered material.

Definition of capital

The implementation of the definition of capital requirements in Indonesia is assessed as largely compliant with the Basel framework. The Assessment Team identified three deviations between the Basel framework and the definition of capital used in Indonesian regulations. Two of these deviations, although not currently material, are considered to be potentially material should the capital structures of banks change in the future. The third is not material.

In particular, the Indonesian authorities have adopted a different approach to the treatment of investments in financial entities. The Basel framework generally requires deduction of investments in financial entities, though subject to a threshold where the investing bank owns less than 10% of the issuing entity's common equity. The OJK requires full deduction of investments where the investing bank owns more than 20% of the issuing entity's common equity, but no adjustment for investments of less significant holdings (with the exception of investments in insurance companies, which are always deducted in full). The OJK has also adopted a different approach to recognising minority interest though, unlike the findings on investments in financial entities, this is not considered as material.

The Assessment Team has several observations on the regulations for the definition of capital in Indonesia, which do not contain all the detailed requirements of the Basel framework. In many cases, this is because the Indonesian legal context, accounting rules or the interaction between the two and prudential regulations make some requirements unnecessary.

The OJK made several changes to the regulations on the definition of capital during the RCAP assessment. The Assessment Team compliments the OJK for its reforms to align the eligibility criteria with the Basel framework. However, monitoring the implementation of these reforms will be important in ensuring that the quality of regulatory capital in Indonesia remains robust.

Credit risk: standardised approach

The Indonesian regulatory requirements implementing the standardised approach for credit risk are assessed as materially non-compliant with the Basel standards. The two main deviations relate to the zero risk weight applied to government and central bank debt denominated in a foreign currency and the treatment of loans to employees and pensioners of state-owned enterprises.

Under the Basel standards, national authorities may apply a zero risk weight to banks' exposures to their sovereign or central bank, provided that the exposures are denominated in a domestic currency and funded in that currency. Indonesia has adopted this treatment and extended it to exposures to the Indonesian government and central bank debt denominated in a currency other than the rupiah. Under the Basel framework, such exposures would warrant a risk weight of 50%. The deviation is considered material as, based on data provided by OJK, this approach overstates the capital ratios of all the sample banks, and by seven of the eight sample banks by at least 10 basis points. Similarly, the Indonesian regulations allow a 0% risk weight if the collateral is in the form of sovereign securities,[6] whether denominated in rupiahs or in foreign currency. This difference is exacerbated by the fact that the

[6] Government bonds, government sharia bonds, Bank Indonesia certificates and Bank Indonesia sharia certificates.

Indonesian regulations do not require the 20% discount in the market value of the securities prescribed under the Basel standards.

The second material deviation relates to claims included in the regulatory retail portfolios. In particular, loans to employees and pensioners of state-owned enterprises receive a risk weight of 50%, which is lower than the 75% risk weight prescribed under the Basel framework for the regulatory retail portfolios. Although the Assessment Team understands that strict conditions on these loans mean that they will often be lower-risk than other unsecured loans to individuals, the life insurance bundled with the loan is not equivalent to a sovereign guarantee. Therefore, the Assessment Team considers that these exposures should receive a risk weight of 75%. The lower risk weight overstates banks' capital ratios, materially so for one of the sample banks.

Consistent with the provisions of the Basel framework, banks in Indonesia may use assessments by external credit assessment institutions[7] (ECAIs) in determining the risk weights of credit exposures under the standardised approach. The regulations require the use of domestic ratings for exposures denominated in rupiahs and the use of international ratings for exposures denominated in foreign currency. The OJK has accredited one domestic and three international ECAIs. The former uses a domestic rating scale, which may have an impact on risk-weighted assets (RWA) and potentially create an unlevel playing field across jurisdictions absent a sound mapping or conversion of domestic ratings to international scale ratings. The RCAP assessment did not evaluate the propriety or soundness of the mapping of the local ratings against international ratings.

Securitisation framework

The Indonesian securitisation framework was implemented in 2005, before the Basel securitisation framework had been developed. Although the rules differ from the Basel framework in many respects, including with respect to the use of external ratings, the treatment of synthetic securitisations (which are treated as corporate exposures) and off-balance sheet exposures, these deviations would have little to no impact on banks' RWA and capital adequacy ratios. The Indonesian framework is a relatively simple one that the Indonesian authorities consider appropriate for the nature and early stage of development of the Indonesian securitisation market.

Indonesian banks' securitisation exposure is very small, comprising only 0.021% of banking sector assets and 0.04% of the assets of the sample banks. Only two of the sample banks had securitisation exposures at the time of the assessment. For these existing exposures, the Indonesian framework is more conservative. Given the size of the securitisation market and the extremely limited activities of the Indonesian sample banks, most of the findings are not considered to be material. However, one finding, regarding the lack of regulations on implicit support, was nonetheless classified as potentially material, due to the qualitative impact that this finding could have on a bank.

The securitisation market has not expanded significantly in recent years, despite the Indonesian authorities allowing it ample room to grow, and it is not expected to develop rapidly in the short or medium term. The Indonesian authorities have consulted on a revised securitisation framework, aligned to the Basel standards on securitisation issued in 2014,[8] and have committed to implementing the revised framework by the prescribed effective date (1 January 2018).

The securitisation framework set forth in Indonesian regulations is assessed as largely compliant with the Basel framework. In determining the grade for this component, the Assessment Team weighed the differences between the Basel framework and the Indonesian framework against their potential impact on financial stability. It also bore in mind the grades assigned for securitisation in other RCAP assessment

[7] Recognised as eligible for capital purposes by national supervisors.

[8] As these standards do not come into effect until 2018, they were not the basis for comparison in this RCAP assessment.

reports, to ensure that its assessment was consistent with that of other teams. The Indonesian securitisation market is very small. The Indonesian framework produces higher capital requirements than the Basel framework for the current, very limited, securitisation exposures of Indonesian banks. Indonesian asset quality regulations provide a disincentive (though not a prohibition) for banks to invest in exposures that would be treated less conservatively under the Indonesian framework than the Basel framework. The commitment of the Indonesian authorities to implement the revised Basel securitisation framework by 1 January 2018 means that the current Indonesian framework is only likely to be in effect for one more year, during which time the securitisation market is not expected to expand significantly. Taking into account all these factors and using its supervisory judgment, the Assessment Team concluded that the differences do not have an impact on financial stability, are unlikely to do so in the short term and that a grade of largely compliant is appropriate.

The Assessment Team recommends that the Indonesian securitisation framework be reviewed again in a future RCAP, to assess the development of the securitisation market in Indonesia and how the 2014 Basel framework has been implemented.

Counterparty credit risk framework

The counterparty credit risk framework in Indonesia is deemed to be compliant with the Basel framework. The Assessment Team did not identify any material differences between the Indonesian rules and the Basel standards.

Market risk: standardised approach

The Indonesian implementation of the standardised measurement method for market risk is considered to be largely compliant with the Basel framework. The most significant findings relate to the treatment of government paper denominated in a foreign currency, which leads to a material difference in market RWA (though not capital ratios), and the absence of a capital charge for equity index-related products, which is not currently material but has the potential to be so in the future.

The Basel standards allow a lower specific risk charge for government paper denominated in domestic currency and funded by banks in the same currency. Indonesian regulations make use of this possibility, but do not limit it to paper in domestic currency. This means that a zero risk weight is applied to all Indonesian government paper, independent of the currency. Though this is consistent with the Indonesian credit risk regulations, it is not in line with Basel requirements, and hence understates market RWA.

For equity index-related products, the Basel framework requires a further capital charge for index contracts and allows arbitrage strategies to be taken into account. There is no equivalent in the Indonesian regulations, because only securities firms are allowed to deal in transactions related to index contracts. However, as banks may own security firms, the absence of a treatment for banks' capital requirements could lead to a material deviation when consolidated capital requirements are calculated.

Despite these findings, the Assessment Team assessed the Indonesian market risk framework as largely compliant, for the following reasons. Unlike the current Indonesian securitisation framework, the Indonesian market risk framework is similar to the Basel framework in most respects. Market risk accounts for a relatively small part of Indonesian banks' capital requirements, there is no investment banking in Indonesia and banks with trading books mainly deal in plain vanilla products. The Assessment Team considered the differences from the Basel framework to have a limited impact on financial stability and the international level playing field.

The Assessment Team observed that, in several areas, the Indonesian rules were less detailed than the Basel framework, particularly with respect to more complex instruments and trading activities. The Indonesian authorities do not permit banks to trade in instruments for which no approach is included in the regulations. Any bank wishing to trade in such instruments must seek approval from the OJK, whereupon the OJK would consider the request and, if deemed appropriate, develop new regulations for such instruments. While the level of detail in the Indonesian framework appears adequate for banks' current trading activities, the Assessment Team recommends that this be reviewed again in a future RCAP, should markets and transactions have developed to include more complex instruments.

Operational risk: Basic Indicator Approach

The Indonesian operational risk rules are compliant with the Basic Indicator Approach as set out in the Basel framework. There were no material findings on this component.

The Basel framework defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. In the Basel standards, this definition includes legal risk, but excludes strategic and reputational risk. In Indonesia, the definition of operational risk does not explicitly include legal risk or exclude strategic and reputational risk. The OJK explained that the essence of the definition is implicitly captured in the manner it structured the regulations. Overall, the Assessment Team did not consider this deviation to have a material impact on operational risk capital requirements.

The Assessment Team also observed that the items that should be considered in computing gross income as indicated in the Basel framework are not explicitly specified in the Indonesian regulations. The OJK explained that it issued a reporting template for this purpose and that this template already incorporates the adjustments indicated in the standard. While the template is generally compliant with the Basel requirements, the Assessment Team recommends explicitly stating the adjustments to gross income in the regulations.

Capital buffers (conservation and countercyclical)

The OJK's capital framework is assessed as largely compliant with the Basel III capital framework with regard to the capital buffers.

The Indonesian regulations do not specify minimum capital conservation standards in the case that a bank breaches its buffer. The OJK has broad powers to restrict dividends and other distributions, which it could use to impose capital conservation standards on an individual bank. However, the use of these powers is subject to supervisory discretion, and may fall short of the requirements of the Basel standards in individual cases.

Supervisory review process

The Indonesian Pillar 2 framework is assessed as compliant with the Basel standards. The OJK has broad powers to impose additional capital requirements on banks.

Currently, the OJK applies Pillar 2 add-ons by mapping its assessment of a bank's soundness to capital charges. Banks must also prepare an internal capital adequacy assessment, which is discussed with the OJK. However, some of the provisions of the Basel Pillar 2 framework are not fully reflected in the OJK's rating methodology. For example, residual risk and implicit support for securitisation exposures are not covered in the Indonesian Pillar 2 regulations. Nonetheless, the Assessment Team considered that these findings are not material, in the light of the OJK's broad powers to impose capital requirements should it consider it justified.

Disclosure requirements

The Indonesian implementation of Pillar 3 disclosure requirements, disclosure requirements for remuneration and disclosure requirements for composition of capital are compliant with the Basel framework. There are no material differences between the Basel standards and the Indonesian regulations.

2 Detailed assessment findings

The component-by-component details of the assessment of compliance with the risk-based capital standards of the Basel framework are detailed below. Sections 2.1 to 2.5 focus on findings that were assessed to be deviating from the Basel minimum standards and their materiality. Section 2.6 lists some observations and other findings specific to the implementation practices in Indonesia.

2.1 Scope of application

Section grade	Compliant
Summary	The Basel framework applies to internationally active banks on a fully consolidated basis, at every tier within a banking group, and to any holding company that is the parent entity within a banking group in order to include all banking and other relevant financial activities conducted within a group containing an internationally active bank. Additionally, it states that any financial subsidiaries that are not consolidated for capital purposes must be deducted from the capital of the banks that consolidate such subsidiaries, including any capital shortfall for such subsidiaries. In general terms, the Indonesian implementation of the scope of application complies with the above-mentioned provision as it requires all commercial banks to apply the capital framework individually, as well as in consolidation with the financial subsidiary companies they own or control.
Basel paragraph number	24, 26 and 27: scope of consolidation
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Article 1 paragraph 4 and 5
Findings	Under the Basel capital framework, all banking and other relevant financial activities conducted within a group containing an internationally active bank should be captured through consolidation. If they are not consolidated for capital purposes, then the bank's investment in such activities (eg shares of a subsidiary) must be deducted from its capital resources. Any capital shortfall in such subsidiaries must also be deducted. Additionally, as a national provision, the Basel standard states that banks might exclude from the aforementioned deduction, with prior supervisory approval, certain temporary investments where these have been made in the context of resolving or providing financial assistance to reorganise a distressed institution. This provision (in paragraphs 80 and 84 of Basel III) was intended to cover temporary capital injections from one bank to another to avoid the latter's failure. Indonesian regulations exclude from the scope of consolidation all companies owned or controlled in relation to credit restructuring. This applies to all companies, both financial and non-financial, and is subject to prior supervisory approval. Additionally, Indonesian regulations do not require a deduction of such temporary capital participation from capital resources, as would be required for investments in financial subsidiaries under the Basel standards. Instead, exposures to credit restructuring companies are risk-weighted at 150%. The Indonesian authorities permit such exclusions because, according to the Banking Law, these investments may only exist on a temporary basis (for a maximum of five years or until the company has made a profit, if shorter). To obtain supervisory approval, a bank must submit a plan regarding its equity participation in credit restructuring companies. This must include an executive summary; a policy and management strategy; risk management arrangements; information on the bank's recent performance; forecast financial statements (including the assumptions used); forecast ratios and other indicators; a funding plan; a fund investment plan; a plan for the equity participation; capital plans; information on organisational improvements and human resources; product issuance or new activities; planned changes in office networks; and any other relevant information. In the last five years, banks in Indonesia have not had capital participations in such entities. Therefore, the deviation is not currently material. If there is a downturn in credit quality, Indonesian banks' exposure to credit restructuring companies could increase.

	However, given the limited nature of such investments and the requirements around prior supervisory approval, this finding is considered unlikely to be material in the short or medium term.
Materiality	Not material

2.2 Minimum capital requirements and transitional arrangements

Section grade	Compliant
Summary	The minimum capital requirements of 4.5%, 6.0% and 8.0% CET1, Tier 1 and total capital ratios, respectively, have been implemented in Indonesia. The Indonesian authorities have adopted a different approach to the treatment of general provisions, but this is not considered material. Most Basel requirements have been implemented in Indonesia on the timeline required by the Basel framework. However, the Indonesian regulations continue to recognise non-compliant AT1 and Tier 2 capital instruments in full until maturity. The OJK has limited the effect of this deviation for the bank most materially affected by way of individual supervisory requirements; as a consequence, this deviation is deemed not material.
Basel paragraph number	42: general provisions
Reference in domestic regulation	POJK No. 11/POJK.03/2016 Article 20 paragraphs 1 and 2 PBI 14/15/2012 Article 42
Findings	In terms of Basel paragraph 42, general provisions can be included in Tier 2 capital subject to a limit of 1.25% of RWA. This requirement is also found in the Indonesian regulations. In addition, the Indonesian regulations allow the amount of the general provision in excess of the 1.25% limit to be deducted from RWA. The Indonesian regulations require the general provision for regulatory purposes to be no less than 1% of assets classified as current (PBI 14/15/2012 Article 42). In most cases, this amounts to a greater provision for regulatory purposes than what is required for accounting purposes. Therefore, a regulatory adjustment is usually needed to raise an additional provision in order to meet the regulatory requirement. This results in a reduction in qualifying capital. On the other hand, the Indonesian regulations allow the general provision in excess of 1.25% of RWA to be deducted from RWA, which reduces RWA and hence the capital requirement. The impact of this deviation was a 2 basis point overstatement of the capital adequacy ratio for two of the sample banks. It is therefore not considered material.
Materiality	Not material
Basel paragraph number	94 (f) and (g): transitional arrangements
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Article 60; Article 61
Findings	The Basel III transitional arrangement for capital instruments states, among other conditions, that capital instruments issued before 2013 that no longer qualify as AT1 or Tier 2 capital will be phased out from 1 January 2013. Fixing the base as the nominal amount of such instruments outstanding on 1 January 2013, their recognition will be capped at 90% from 1 January 2013, with the cap decreasing by 10 percentage points in each subsequent year. This cap is applied to Additional Tier 1 and Tier 2 separately and refers to the total amount of instruments outstanding that no longer meet the relevant entry criteria. To the extent an instrument is redeemed, or its recognition in capital is amortised, after 1 January 2013, the nominal amount serving as the base is not reduced. Under Indonesian regulations, AT1 and Tier 2 capital instruments that were recognised as capital on 31 December 2013 but that no longer meet the capital criteria may still be fully recognised as capital until 31 December 2018. This permits a greater recognition of non-Basel III capital instruments than the Basel framework, and so may overstate Tier 1 and total capital ratios of Indonesian banks.

	In practice, the treatment of AT1 capital instruments is not material as Indonesian banks do not have any capital components in the form of AT1. However, for one of the sample banks, including certain Tier 2 instruments issued before 2013 would materially overstate its total capital ratio. In April 2016, the OJK issued an individual supervisory letter to this bank which limits its recognition of such instruments to levels that are consistent with the Basel framework (to 60% of the nominal amount of the instrument outstanding on 1 January 2013 in 2016, decreasing by 20% per year thereafter, in a straight line). The OJK has the power to give written orders to financial services institutions under Article 9 of the OJK Law and may impose sanctions for non-compliance under Articles 53 and 54 of the same law.
Materiality	Not material

2.3 Definition of capital

Section grade	Largely compliant
Summary	The Assessment Team identified three gaps between the Basel framework and the Indonesian framework with respect to the criteria for eligible capital instruments, as well as the regulatory adjustments applied to calculate regulatory capital resources. While no individual finding is currently material for the sample banks, the Assessment Team considers that two of the three findings have the potential to lead to material deviations between the Basel framework and the Indonesian framework. These potentially material findings relate to the treatment of investments in financial entities. The third, non-material, finding relates to the OJK's regulations on minority interest. Although the approach is quite different to that included in the Basel III requirements, it is unlikely to be materially less conservative in practice.
Basel paragraph number	Basel II paragraph 25, amended by Basel III paragraphs 62–65: minority interest
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Article 16 (2) PBI No.15/12/PBI/2013 Article 9 (3)
Findings	Paragraphs 62–65 of Basel III deal with the recognition of minority interests in capital resources at the consolidated level. The Basel standards permit the minority interest arising from the issues of capital instruments (CET1, AT1 and Tier 2) of a fully consolidated subsidiary to third parties if: (i) the capital instruments meet all criteria to be considered in the relevant capital tier; (ii) the subsidiary that issued the capital instrument is a bank; and (iii) the minority investments in the bank subsidiary represent a genuine third-party contribution to the subsidiary. Regarding the amount allowed to be recognised as capital in each tier, Basel III states that this should be calculated as the capital issued by the subsidiary to third parties minus the amount of the surplus capital of the subsidiary attributable to the third-party investors. The Indonesian regulations adopt a different approach for minority interests. Under this approach, minority interest may be recognised in CET1 capital if the bank owns more than 50% of the subsidiary and: 1. the subsidiary is a bank; 2. there is relationship or affiliation between the non-controlling shareholders of the subsidiary company (ie the minority interest) and the bank; and 3. there is a commitment on the part of non-controlling shareholders of the subsidiary to support the capital of the bank. Such a commitment must be incorporated in a statement or minutes of a meeting of the shareholders' general meeting of the subsidiary. Based on such criteria, the most important factor in recognising minority interest in the Indonesian regulatory framework is whether or not there is a formal commitment from the minority interest to support the capital of the banking group (eg in the form of affidavit). If there is such a commitment, the whole of the minority interest may be recognised in the bank's consolidated capital position. If not, none of the minority

	interest may be recognised by the bank. This is further supported by the condition that all Indonesian banks own more than 90% of their subsidiaries. The Indonesian regulations only specify the treatment of minority interests in the form of CET1 capital, not those counted as AT1 or Tier 2. Also, unlike the Basel framework, there is no express prohibition against the inclusion of minority interest issued by an SPV. This approach means that there is no Indonesian regulation equivalent to the Basel requirement that the minority interest arising on the issues of capital instruments (CET1, AT1 and Tier 2) of a fully consolidated subsidiary must represent genuine third-party capital contributions to the subsidiary. On the contrary, Indonesian regulations require that non-controlling shareholders in subsidiaries must be affiliated with the bank that consolidates those subsidiaries. Indonesian regulations also require that these non-controlling shareholders must be committed to supporting the bank's capital position. As of June 2015, minority interest (in the form of CET1) represented around 0.25% of the total capital of the Indonesian banks in the sample. Comparing the outcome of the Basel standards and the Indonesian regulations, the amount recognised by the Indonesian authorities was 58% lower than what would have been permitted under Basel III. This means that, currently, the treatment of minority interests in Indonesia is more conservative than the Basel framework (though this may not always be the case). Additionally, the Indonesian authorities informed the Assessment Team that Indonesian banks own more than 90% of their subsidiaries and that there are few subsidiaries owned by banks that have issued CET1 to third parties. Moreover, there are currently no subsidiaries that have issued non-CET1 instruments. For these reasons, the deviations have been deemed as not material.
Materiality	Not material
Basel paragraph number	Basel III paragraphs 80–83: investments in financial entities
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Article 17 (1) (d), Article 22 (1) (b)
Findings	The Basel standards require the deduction from capital of a bank's investment in common shares issued by banking, financial and insurance entities outside the scope for regulatory consolidation, where this investment is not more than 10% of the issued share capital of the entity and subject to a threshold. If the total of all such holdings exceeds 10% of the investing bank's CET1 capital (after applying the regulatory adjustments), then the amount above this 10% threshold must be deducted applying a corresponding deduction approach. The treatment provided by the OJK is different from the Basel requirement. The OJK has not prescribed any treatment for insignificant investments in such entities outside the scope of consolidation, with the exception of insurance companies (all investments in insurance companies must be deducted). Effectively, this means that no deduction is required for investments that comprise less than 10% of the issued share capital of the entity, which is not in compliance with the Basel requirements. The OJK guidelines also do not describe the types of exposures that may be construed as investments. This approach is likely to result in underestimation of the required deductions and hence an overstatement of capital. No banks in Indonesia have a participation of less than 20%, so the difference in treatment is not currently material. However, such participations may arise in the future, as there are no restrictions against this. As such, the finding is considered potentially material.
Materiality	Potentially material
Basel paragraph number	Basel III paragraphs 84–86: significant investments in financial entities
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Article 17 (1) (d), Article 22 (1) (b)
Findings	These Basel paragraphs deal with the deduction requirement where a bank has significant investment in the capital of banking, financial and insurance entities outside the scope of consolidation. This covers investments of more than 10% of the issued common share capital of the issuing entity, or where the entity is an affiliate of the bank. All such investments which are not common shares must be deducted in full.

	As per OJK guidelines, participations at companies or legal entities in which a bank has between 20% and 50% ownership, but no control, are required to be deducted. As such, the threshold laid down by the OJK is higher, at 20%. This does not apply to insurance companies, all investments in which must be deducted. As brought out in the findings in respect of Basel III paragraphs 80–83 on similar but less than 10% investments, the methodology followed for the deduction calculation and non-recognition of such investments between 10 and 20% can result in lower deductions, which can inflate a bank's capital resources. OJK guidelines also do not describe the instruments or types of exposures that may be recognised for this purpose, as provided in the Basel standards. No banks in Indonesia have a participation of less than 20%, so the difference in treatment is not currently material. However, banks may have exposures in the future that represent between 10 and 20% of an entity's common share capital. As such, the finding is considered potentially material.
Materiality	Potentially material

2.4 Pillar 1: minimum capital requirements

2.4.1 Credit risk: Standardised Approach

Section grade	Materially non-compliant
Summary	The Indonesian regulations are materially non-compliant with the credit risk standardised approach of the Basel framework. The Assessment Team's main findings relate to the 0% risk weight of foreign currency-denominated claims on sovereigns, and the 50% risk weight of loans to employees and pensioners of state-owned enterprises.
Basel paragraph number	54: claims on sovereigns
Reference in the domestic regulation	SE 13/6/DPNP item II. E.1.a.1 and II.E.1.b
Findings	The Basel framework states that, at national discretion, a lower risk weight may be applied to banks' exposures to their sovereign or central bank, provided the exposures are denominated in domestic currency and funded in that currency. In Indonesia, all claims against the government of Indonesia, whether in rupiahs or in foreign currency, receive a risk weight of 0%. This covers exposures to the Central Government of the Republic of Indonesia, BI and other governmental liaisons and institutions funded by State Revenues and Expenditure Budget (APBN) of the Republic of Indonesia. Based on data provided by the OJK, this approach overstates the capital ratios of all the sample banks, by at least 10 basis points for seven of the eight sample banks.
Materiality	Material
Basel paragraph no	69–71: claims included in the regulatory retail portfolio
Reference in the domestic regulation	SE 13/6/DPNP, item II. E.8
Findings	Under the Basel framework, claims that qualify under the criteria for regulatory retail portfolio may be risk-weighted at 75%. In Indonesia, loans to employees and pensioners of state-owned enterprises receive a risk weight of 50% when certain criteria are met. The OJK explained that these loans warrant a lower risk weight because: (i) the loans are only granted to civil servants, and employees and pensioners of state-owned enterprises; (ii) these loans are supported by a power of attorney authorising automatic deduction of the loan amortisation from the salary or pension benefit; and (iii) the source of repayment (salary and pension benefit) is drawn from the national budget, and so can be considered equivalent to exposures to government and state-owned enterprises. OJK representatives also mentioned that the exposures are guaranteed with life insurance from insurance companies with the status of state-owned enterprises (BUMN). Nonetheless, the Assessment Team considers these exposures as regulatory retail exposures that should receive a risk weight of 75%. The risk mitigants in place do not

	meet the formal criteria for credit risk mitigation under the Basel standards. Four of the sample banks have such loans, though the difference in treatment is only material for one bank. For that bank, the lower risk weight resulted in an overstatement of its capital ratio by 76 basis points.
Materiality	Material
Basel paragraph number	185: the simple approach – exceptions to the risk weight floor
Reference in the domestic regulation	SE 13/6/DPNP items IV.A.3.c, IV.B.5.a, IV.B.5.c, IV.B.1, II.A.2, II.C.3.a, IV.B.6.a and IV.B.6.c
Findings	Under the simple approach of the Basel framework, a 0% risk weight can be applied where the exposure and the collateral are denominated in the same currency, the collateral is in the form of sovereign securities eligible for a 0% risk weight and its market value has been discounted by 20%. The Indonesian regulations allow a 0% risk weight if the collateral is in the form of government bonds, government sharia bonds, BI certificates and BI sharia certificates, whether denominated in rupiahs or in foreign currency. If banks increase their use of foreign currency-denominated sovereign securities as collateral, this deviation could be material.
Materiality	Potentially material

2.4.2 Securitisation framework

Section grade	Largely compliant
Summary	The Indonesian approach to securitisation transactions differs from that prescribed by the Standardised Approach of the Basel securitisation framework. External credit ratings are not used to assign risk weights (a standard risk weight of 100% is used where applicable) and credit conversion factors are not applied to convert off-balance sheet exposures to on-balance sheet equivalents. High-risk exposures such as credit enhancement facilities are deducted from capital rather than risk-weighted at 1,250%. At the time of the assessment, only two of the sample banks had any form of securitisation exposure. These comprised 0.04% of total assets. Securitisation exposures for the Indonesian banking sector as a whole amounted to 0.021% of total assets. Based on the current securitisation exposures, the alternative capital treatment is not likely to have a material impact on banks' capital adequacy ratios or securitisation or total RWA. The Indonesian authorities indicated that securitisation activity is not expected to grow significantly over the next two to three years. As a result of the insignificant exposure to securitisation of Indonesian banks, the deviations identified were rated as not material. There is one exception, which relates to the finding on implicit support. The Assessment Team is of the view that this finding is potentially material due to the impact that disclosure of implicit support can have on any securitisation transaction and its significance from a supervisory perspective. The Indonesian authorities have committed to issue new securitisation regulations based on the revised securitisation framework issued by the Basel Committee, which becomes effective on 1 January 2018. A Consultative Paper has already been issued, but as it was not effective at the time of this assessment it was not considered for the review.
Basel paragraph number	538: substance over form
Reference in the domestic regulation	Not included
Findings	Paragraph 538 of the Basel securitisation framework states that the capital treatment of a securitisation exposure must be determined on the basis of its economic substance rather than its legal form. Furthermore, the supervisor must look to the economic substance of a transaction to determine whether it should be subject to the securitisation framework. No equivalent requirement could be found in the Indonesian regulations.

Materiality	Not material
Basel paragraph number	540: synthetic securitisations
Reference in the domestic regulation	Not included
Findings	The Indonesian Securitisation Regulations (PBI 7/4/2005) do not apply to synthetic securitisation transactions. The definition of synthetic securitisation in paragraph 540 of the Basel text is not contained in the Indonesian regulations. The operational requirements for synthetic securitisations in paragraphs 555 and 556 are also not included. However, in terms of SE 13/6/DPNP Section II.E.11.c ("Guidelines for the calculation of risk-weighted assets for credit risk using Standardised Approach"), securitisation claims not covered by PBI 7/4/2005, such as credit-linked notes, are to be treated as exposures to corporates for capital purposes. The required risk weights for corporate exposures are less conservative than the securitisation framework for the low-rated and unrated exposures, which could result in lower capital held by banks for synthetic securitisation exposures than what would be required under the securitisation framework. Only one bank in the sample had an exposure to credit-linked notes, of 709 billion Indonesian rupiahs (IDR), which was risk-weighted in terms of SE 13/6/DPNP at 20%. As this is a highly rated exposure, the same risk weight would have been applied under the securitisation framework. There is therefore no impact on RWA. Furthermore, in light of the minimal potential for synthetic securitisation transactions, the Assessment Team is of the view that this deviation is not material.
Materiality	Not material
Basel paragraph number	544 and 574: asset-backed commercial paper programmes
Reference in the domestic regulation	Not included
Findings	The Indonesian Securitisation Regulations do not contain any provisions with regard to asset-backed commercial paper (ABCP) programmes. The Indonesian authorities indicated that there are currently no ABCP programmes in the Indonesian market and no significant growth is expected over the next few years. Moreover, the Basel provisions relating to unrated exposures in a second-loss position or better in ABCP programmes (Basel II paragraph 574) would result in a lower capital requirement for banks. The omission in the Indonesian regulations is therefore not considered material.
Materiality	Not material
Basel paragraph number	545: definition of clean-up calls
Reference in the domestic regulation	PBI No.7/4/2005 Article 1
Findings	The Basel framework states that a clean-up call is an option that permits the securitisation exposure to be called before the underlying exposure or securitisation exposures have been repaid. Where clean-up calls do not meet certain criteria or where they act as credit enhancements, banks must maintain additional capital and make public disclosures on these risks. The Indonesian securitisation regulations define a clean-up call as the purchase by the servicer of all remaining underlying reference assets prior to maturity. The Indonesian definition therefore does not include the purchase of remaining commercial paper. Not classifying the purchase of outstanding commercial paper as a clean-up call means that certain transactions subject to capital and disclosure requirements under the Basel framework are not captured by the equivalent requirements in Indonesian regulations. Nor are clean-up calls found to have served as a credit enhancement captured. This means that the capital maintained for such exposures and the associated disclosures would understate the risks posed by such instruments.
Materiality	Not material
Basel paragraph number	548 and 590–605: early amortisation provisions

Reference in the domestic regulation	Not included
Findings	The conditions for a controlled early amortisation provision in the Basel framework (paragraph 548) are not contained in the Indonesian securitisation framework. The capital requirements for early amortisation provisions have also not been included in the Indonesian securitisation regulations. The Basel provisions require an originating bank that sells exposures into a structure with early amortisation features to hold capital against all or a portion of the investors' interest. The absence of these provisions results in a lower capital requirement for banks that originate such assets, where the special purpose vehicle includes early amortisation provisions. However, there are currently no structures with early amortisation provisions in the Indonesian market. It is considered unlikely that such provisions would play a significant role in the foreseeable future. Therefore, this deviation is rated as not material.
Materiality	Not material
Basel paragraph number	551 and 564: implicit support
Reference in the domestic regulation	PBI No.7/4/2005 Article 8
Findings	In terms of the Basel framework, implicit support arises when a bank provides support to a securitisation in excess of its predetermined contractual obligation. Where a bank has provided implicit support to a securitisation, it must, at a minimum, hold capital against all of the exposures associated with the securitisation transaction as if they had not been securitised. Additionally, banks are not permitted to recognise in regulatory capital any gain on sale. Furthermore, the bank is required to disclose publicly that: (i) it has provided non-contractual support; and (ii) the capital impact of doing so. The definition of implicit support is not included in the Indonesian regulations. The capital and disclosure requirements of paragraph 564 of the Basel text with regard to implicit support are also not specifically included. Although the domestic regulations do not specifically refer to implicit support, they do include capital requirements for credit enhancement that has not been formalised in PBI No.7/4/2005 Article 8 (non-formalised credit enhancement can be seen as implicit support). The capital treatment for such credit enhancement in the Indonesian regulations is as follows: 1. deduction from capital of the total amount of credit enhancement; or 2. the capital charge on the underlying reference assets, if lower. Where the bank providing the credit enhancement is also the originator of the underlying assets, the amount of the credit enhancement is also included in RWA and risk-weighted at 100%. The Indonesian approach to credit enhancement which is not formalised may result in lower capital than the Basel framework requirement for implicit support. In particular, where the amount of credit enhancement provided is less than the capital on the underlying assets, the Indonesian approach would only require capital to the amount of the credit enhancement and not the amount of capital on the underlying assets. Furthermore, the disclosure requirements for implicit support are not included in the Indonesian regulations. The Indonesian authorities indicated that there have been no noted incidents of implicit support. Nevertheless, this deviation is found to be potentially material because of the potential impact that disclosure of implicit support can have on any bank with securitisation exposure and its significance from a supervisory perspective.
Materiality	Potentially material
Basel paragraph number	554: operational requirements for traditional securitisations
Reference in the domestic regulation	PBI No.7/4/2005 Article 5
Findings	The Basel framework contains operational requirements for traditional securitisations. These must be met before the originating bank may exclude the securitised exposures from the calculation of RWA.

	While the Indonesian regulations comply with the requirement that significant credit risk associated with the securitised exposures must be transferred to third parties, the following operational requirements are not included in the domestic regulations: 554 (c) – the securities issued must not be obligations of the transferor. Thus, investors who purchase the securities only have claim to the underlying pool of exposures. 554 (d) – the holders of the beneficial interest in the special purpose entity (SPE) must have the right to pledge or exchange them without restriction. 554 (f) (iii) – the Indonesian regulations specify that the originator shall have no obligation to substitute the financial assets which have been transferred. However, the requirement that the securitisation may not contain any clauses that increase the yield payable to parties other than the originating bank in response to a deterioration in the credit quality of the underlying pool is not included in the Indonesian regulations. As the main requirement of significant transfer of credit risk has been included and the impact of the missing operational requirements is not expected to have a material effect on securitisation at this stage, the deviation is rated as not material.
Materiality	Not material
Basel paragraph number	565: operational requirements for use of external credit assessments
Reference in the domestic regulation	Not included
Findings	The Basel framework includes operational criteria for the use of external credit assessments. Because the Indonesian regulations do not use external credit ratings to determine risk weights, these requirements of the Basel text have not been included in the domestic regulations. As discussed in the finding below on paragraphs 566–76, the impact of not using external credit ratings is assessed as not material due to the nature of the Indonesian securitisation market. Therefore, this finding is also deemed not material.
Materiality	Not material
Basel paragraph no	566–76: risk weights
Reference in the domestic regulation	PBI No. 7/4/PBI/2005 Articles 8, 10, 12, 14 and 15 PBI No. 14/15/PBI/2012 Article 14 (2)
Findings	The Indonesian regulations do not use external credit ratings to determine the risk weights for securitisation exposures. Exposures are included in RWA in a limited number of instances (investment in senior tranches, second-loss credit enhancement facilities and liquidity facilities that meet the eligibility criteria). In these cases, a risk weight of 100% is used, irrespective of the external credit rating. Hence, the table of risk weights in paragraph 567 of the Basel framework is not included in the domestic regulations. Resecuritisation exposures are also not risk-weighted differently to other securitisation exposures. No distinction is made between investments by third-party investors and originators (as required by paragraphs 569 and 570 of the Basel framework). The Indonesian approach may result in a conservative calculation of capital for exposures that have an external rating of A– or better (short-term rating A-2/P-2 or better). However, for low-rated exposures (rated below BBB– and below A– for resecuritisation exposures) or unrated exposures, the domestic regulations appear to be less conservative then the Basel requirement. The Indonesian authorities indicated that the majority of exposures of banks are to senior tranches and that there are currently no resecuritisation exposures. In addition, existing regulations on asset quality reduce the incentives for banks to invest in high-risk securitisation paper. From the data provided, the deviation does not have a material impact on capital adequacy ratios and RWA.
Materiality	Not material
Basel paragraph number	567: off-balance sheet exposures
Reference in the domestic regulation	PBI No.7/4/PBI/2005 Articles 8, 9, 10, 12, 14 and 15

Findings	The treatment of off-balance sheet securitisation exposures in the Indonesian regulations differs from that of the Basel framework. Credit conversion factors (CCFs) are not explicitly used to convert off-balance sheet exposures to on-balance sheet equivalents that can be risk-weighted. Instead of risk-weighting exposures, most off-balance sheet exposures (first-loss credit enhancement facilities, including investment in junior tranches, and some liquidity facilities) are instead deducted in full from capital, or result in a capital charge equal to the capital on the underlying assets (if lower). Second-loss credit enhancements are included in RWA in full. By deducting the full credit enhancement (or liquidity facility) or including it in RWA, an implicit CCF of 100% is applied. This can be regarded as more conservative than the Basel framework, which allows a lower CCF in certain instances. In addition, there are some cases where the bank is the originator of the underlying assets and the Indonesian regulations require both a deduction from capital and inclusion in RWA of the full facility. This makes the Indonesian treatment for these types of exposures more conservative than the Basel framework. In terms of the Basel framework, the risk weight of an eligible liquidity facility should depend on the facility's external credit rating. An unrated liquidity facility would receive a CCF of 50% and a risk weight of 1250%. In Indonesia, if the facility, whether rated or not, meets the eligibility criteria of PBI 7/4/2005 Article 9, it is included in RWA at an implicit CCF of 100% and a risk weight of 100%. While this approach is more conservative for highly rated liquidity facilities, it is less conservative for low-rated or unrated liquidity facilities. At the time of the assessment, none of the sample banks had any off-balance sheet securitisation exposures. Due to the small securitisation market, there is also not an expectation that there will be increased exposures for Indonesian banks in the next two to three years. Therefore, although the approach adopted by the Indonesian authorities is different to the Basel framework, the impact on capital adequacy ratios and RWA is not considered to be material.
Materiality	Not material
Basel paragraph no	578: eligible liquidity facilities
Reference in the domestic regulation	PBI No.7/4/PBI/2005 Article 9
Findings	The Basel framework sets out criteria that must be met for a liquidity facility to be treated as an eligible liquidity facility. An eligible liquidity facility that is unrated can receive a CCF of 50% (instead of 100%). The following eligibility criteria are not included in the Indonesian regulations: 578 (a) – the facility must clearly identify and limit the circumstances under which it may be drawn. While the Indonesian regulations state that the liquidity facility must be formalised in an agreement that stipulates the amount of the facility and the term of the agreement, there is no requirement for the agreement to identify and limit the circumstances under which it can be drawn. 578 (b) – the facility must be subject to an asset quality test that precludes it from being drawn to cover credit risk exposures that are in default. In terms of the Indonesian regulations, the facility may only be drawn if the underlying reference assets are of good quality (ie less than 90 days past due). If the underlying assets are not of good quality, the facility may still be drawn to the extent that the bank has obtained a guarantee for the underlying assets (Article 9 (d) (2)). This is less conservative than the Basel framework. 578 (b) – if the exposures that a liquidity facility is required to fund are externally rated securities, the facility can only be used to fund securities that are externally rated investment grade at the time of funding. This is not included in the Indonesian regulations. It should be noted that, in the Indonesian regulations, the eligibility criteria for liquidity facilities are not used to determine the CCF (as in the Basel framework) but to determine whether the liquidity facility should be included as a component of RWA (as described in the finding on paragraph 567 above) or deducted from capital. The implied CCF in the Indonesian regulations in both cases would be 100%. This is more conservative than the Basel framework. This deviation is therefore not considered material.

Materiality	Not material
Basel paragraph number	581: overlapping off-balance sheet exposures
Reference in the domestic regulation	Not included
Findings	The Basel capital treatment of overlapping off-balance sheet securitisation exposures is not included in the Indonesian regulations. As mentioned above, the Indonesian securitisation market is very small, with very few securitisation transactions. None of the sample banks were exposed to credit enhancements or liquidity facilities at the time of the assessment. The omission of the provisions relating to overlapping exposures would therefore not affect those banks' capital adequacy ratios and RWA.
Materiality	Not material
Basel paragraph no	584: credit risk mitigation
Reference in the domestic regulation	Not included
Findings	The Basel securitisation framework requires the following with regard to credit risk mitigation. First, when a bank other than the originator provides credit protection to a securitisation exposure, it must calculate a capital requirement on the covered exposure as if it were an investor in that securitisation. Second, if a bank provides protection to an unrated credit enhancement, then it must treat the credit protection provided as if it were directly holding the unrated credit enhancement. These requirements were not included in the Indonesian regulations. However, the impact of this deviation is considered unlikely to be material in light of the current limited extent of the Indonesian securitisation market.
Materiality	Not material
Basel paragraph number	585: collateral
Reference in the domestic regulation	Not included
Findings	The Basel framework states that eligible collateral for securitisation exposures is limited to that recognised under the standardised approach for credit risk mitigation. This is not specifically included in the domestic securitisation regulations. The Indonesian authorities indicated that any collateral used to hedge the credit risk of a securitisation exposure would be treated in line with the standardised approach to credit risk mitigation applied for all other credit exposures.
Materiality	Not material
Basel paragraph number	586: guarantees
Reference in the domestic regulation	Not included
Findings	The Basel framework states that SPEs cannot be recognised as eligible guarantors for securitisation exposures. There is no equivalent provision in the Indonesian regulations. However, at the time of the assessment none of the securitisation exposures had been guaranteed by a SPE, so the impact of this deviation is unlikely to be material.
Materiality	Not material

2.4.3 Counterparty credit risk framework

Section grade	Compliant
Summary	The Indonesian counterparty credit risk framework is generally consistent with the Basel framework. Only one finding has been identified, on the treatment of securities financing transactions (SFTs); it is not considered material.
Basel paragraph number	Annex 4 paragraph 3: inclusion of SFTs
Reference in domestic regulation	SE 13/6/DPNP

Findings	Under the Basel framework, over-the-counter (OTC) derivative and SFT exposures should be computed according to counterparty credit risk rules. The Indonesian regulations require this for OTC derivatives, repos and reverse repos, but not for all SFTs. The Indonesian authorities state that there is no SFT business in Indonesia other than repos and reverse repos. Banks must obtain prior approval from the OJK to execute such transactions. Currently there are no such transactions in Indonesia, thus this deviation is considered not material.
Materiality	Not material

2.4.4 Market risk: the Standardised Measurement Method

Section grade	Largely compliant
Summary	Eight deviations were identified by the Assessment Team: one material, one potentially material and six not material. The material deviation is related to the privileged risk weight for government paper when the specific risk charge for interest rate risk positions is calculated. The Basel standards allow a lower specific risk charge for government paper denominated in domestic currency and funded by banks in the same currency. Indonesian regulations do not limit this lower charge it to paper in domestic currency. This understates market RWA. The potentially material finding relates to equity index-related products, where there is no equivalent to the Basel requirements in the Indonesian regulations. Only securities firms are allowed to deal in transactions related to index contracts in Indonesia. However, banks may own securities firms, so the absence of a capital requirement for banks could lead to a material deviation when consolidated capital requirements are calculated. In several areas, the Indonesian rules are less detailed than the Basel framework. This results in several findings that, given the nature of Indonesian banks' current market risk profiles, are not material. However, the Assessment Team recommends that this be reviewed again in a future RCAP, should markets and transactions develop to include more complex instruments.
Basel paragraph number	687(ii) and 688: policies and procedures for trading book exposures
Reference in the domestic regulation	SE 13/23 Appendix 1 II.B.3.b.3)a)
Findings	The Basel framework establishes minimum requirements for the policies and procedures applied to trading book exposures. Not all these requirements have been implemented in the Indonesian regulations. In particular, there are no requirements that trading book policies and procedures cover: 1. the extent to which legal restrictions would impede the ability to liquidate exposures; and 2. the extent to which a bank may transfer risk between banking and trading books, and criteria for such a transfer. This requirement is implemented in Indonesian rules only for transactions for hedging purposes. Furthermore, some minimum requirements for positions eligible to receive trading book capital treatment are missing. In particular, there is no requirement for policies and procedures that include the active management of positions on a trading desk, or that positions be actively monitored with reference to market information sources. It is difficult to quantify the effect of the absence of these qualitative requirements on banks' market RWA. However, given the information received on Indonesian banks' current trading books, the Assessment Team did not consider the absence of these requirements to be material.
Materiality	Not material

Basel paragraph number	689(iv): inclusion of securitisation and nth-to-default derivatives in the correlation trading portfolio
Reference in the domestic regulation	None
Findings	Basel II.5 defines the inclusion in the correlation trading portfolio of securitisation exposures and nth-to-default credit derivatives, when they meet certain criteria. This requirement is not implemented in Indonesia. As regards nth-to-default credit derivatives, banks are not allowed to trade in derivatives other than those mentioned in PBI 7/31/PBI/2005 Article 7. This means that they may only trade in foreign exchange and interest rate derivatives. With respect to securitisation, the Indonesian authorities confirmed that there is currently no securitisation exposure in the trading books of Indonesian banks. Therefore, this deviation is not material.
Materiality	Not material
Basel paragraph number	709(ii), as amended by Basel II.5: specific risk charge for interest rate risk for correlation trading portfolios
Reference in the domestic regulation	None
Findings	The revisions to the Basel market risk framework in 2011 included the need to determine the specific risk capital charge for the correlation trading portfolio. This requirement has not been implemented in Indonesia, because currently correlation trading portfolios do not exist in Indonesian banks. Therefore, this finding is not material.
Materiality	Not material
Basel paragraph number	710 and 711(ii): specific risk capital charges for issuer risk of positions with interest rate risk
Reference in the domestic regulation	SE/14/21 2.4)
Findings	The Basel framework requires the calculation of specific risk charges for issuer risk in the area of interest rate risk. According to Indonesian regulation, a capital charge for specific risk could be assigned to a security that is based not on the risk of its issuer but on the risk of the issuers of the securities that guarantee the security. In consequence, a non-qualifying security may have a capital charge of a qualifying security, if the non-qualifying security is guaranteed with securities issued by a qualifying issuer. In the Basel framework, credit risk mitigation only applies to the credit risk framework, and not the market risk framework. Some positions (eg derivatives) may be subject to credit risk and market risk capital requirements. In these cases, the credit risk component (ie the default risk charge applying to the counterparty) can be mitigated by credit risk mitigation, but the market risk component (ie the risk charge applied to possible price movements) does not take credit risk mitigants into account. The price movement of securities can be influenced by the issuer of the security, but the Basel framework does not foresee any relief in the case that the guarantee or the issuer of the guarantee are deemed to be qualifying. The Indonesian treatment, which takes into account guarantees in determining market risk capital charges, thus may underestimate the risk of the security. However, based on the current trading exposures of Indonesian banks, this finding is not material.
Materiality	Not material
Basel paragraph number	711: specific risk capital charges for government papers
Reference in the domestic regulation	SE/14/21 2.4)a)
Findings	When government paper is denominated in the domestic currency and funded by the bank in the same currency, a lower specific risk charge (eg 0%) may be applied at national discretion.

	The Indonesian regulations use this national discretion, but do not restrict it to paper in domestic currency, ie the lower risk weight is applied to all governmental paper. This is consistent with the credit risk framework in Indonesia, but not the Basel framework. The Assessment Team considers this deviation to be material. Although it has a limited effect on the sample banks' total capital ratios (because market RWA are a small share of total RWA), the effect on market RWA is significant. On average, market RWA under the Indonesian regulations are more than 2.5% less than those produced by the Basel framework. For three banks, the difference is above 5% and for one bank it is more than 12%.
Materiality	Material
Basel paragraph number	711(i): criteria for the qualifying category for specific risk charges
Reference in the domestic regulation	SE/14/21 2.4.c).(1) (a) & (b)
Findings	The Basel standards set out three categories of securities for determining specific risk capital charges for issuer risk: "government", "qualifying" and "other". The qualifying category includes the securities of public sector entities (PSEs) and multilateral development banks (MDBs), as well as securities that are: 1. rated investment grade by at least two credit rating agencies specified by the national authority; or 2. rated investment grade by one rating agency and not less than investment-grade by any other rating agency specified by the national authority (subject to supervisory oversight); or 3. subject to supervisory approval, unrated, but deemed to be of comparable investment quality by the reporting bank, *and* the issuer has securities listed on a recognised stock exchange. Indonesian regulations require an investment grade rating from one rating agency for PSEs, MDBs and banks. This treatment is more rigorous for PSEs and MDBs. However, for banks, this means that a bank's security could have an investment grade rating from one rating agency, but a rating less than investment grade from another agency, and would still be in the qualifying category. The Assessment Team does not consider this deviation to be material. There are likely to be relatively few banks which have one investment grade rating and one rating less than investment grade. Also, Indonesian banks appear unlikely to have significant trading volumes with overseas banks in the short to medium term. For all other securities, Indonesian rules require an investment grade rating by at least two credit rating agencies. The alternative with one rating only is not applied, and is thus more rigorous.
Materiality	Not material
Basel paragraph number	712(iii)–(viii): specific risk rules for positions covered under the securitisation framework
Reference in the domestic regulation	None
Findings	The specific risk of securitisation positions which are held in the trading book is to be calculated basically according to the method used for such positions in the banking book, though there are other risk weights defined if these positions are held in the trading book. This requirement has not been implemented, because there is no securitisation exposure in Indonesian banks' trading books. Thus, this finding is not material.
Materiality	Not material
Basel paragraph number	718(xxv): calculation of capital charge for index-related products
Reference in the domestic regulation	None
Findings	Basel rules require a further capital charge for equity index contracts. These rules are not implemented in bank regulations in Indonesia, because only securities firms are allowed to deal with these products. These companies are regulated under the Capital Market Act.

	However, since banks are allowed to own securities firms, such products can be relevant for the calculation of banks' market risk capital charge at the consolidated level. Thus, the absence of a treatment for such exposures in banking regulation could lead to an understatement of market risk capital requirements at the group level. Currently, bank ownership of securities firms is limited in Indonesia. The other equity-related requirements are implemented in Indonesia to be fulfilled on consolidated level by banks. However, although the deviation from the Basel requirements does not currently have a material impact, this may change in the future (for example, if banks acquire securities firms).
Materiality	Potentially material

2.4.5 Operational risk: Basic Indicator Approach

Section grade	Compliant
Summary	The Indonesian operational risk rules are compliant with the Basic Indicator Approach for computing operational risk capital charges as set out in the Basel framework. There were no material findings on this component.
Basel paragraph number	644: definition of operational risk
Reference in domestic regulation	POJK No.11/POJK.03/2016 Article 1 (14) SE No. 11/3/DPNP Item I.C
Findings	The Basel framework defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. The standard further states that operational risk includes legal risk, but excludes strategic and reputational risk. In Indonesia, the definition of operational risk does not explicitly include legal risk or exclude strategic and reputational risk. The OJK explained that the essence of the Basel definition is implicitly captured in the Indonesian regulations. In particular, the regulation indicates that operational risk is one of the sources of legal risk and defines separately strategic and reputational risk. This approach does not clearly describe the scope of operational risk and appears inconsistent with the Basel standards. However, it does not directly affect banks' operational risk capital requirements in Indonesia and thus is not considered material.
Materiality	Not material

2.4.6 Capital buffers (conservation and countercyclical)

Section grade	Largely compliant
Summary	In Indonesia, all banks are required to maintain a countercyclical capital buffer. All banks with core capital in excess of IDR 5 trillion must apply the capital conservation buffer. The Indonesian authorities have broad powers to restrict distributions and require banks to rebuild capital these buffers are breached. The Indonesian authorities have not implemented automatic distribution restrictions in regulations. Instead, supervisory action would be taken on an individual basis should any bank fall below the level of the buffer. To date, no banks have breached their capital buffers, but it may be the case that in the future this approach leads to materially different outcomes to those envisaged by the Basel framework.
Basel paragraph number	129 and 147: distribution restrictions
Reference in domestic regulation	POJK No.11/POJK.03/2016 Article 8 (2) and Article 54
Findings	The Basel standards set out capital conservation standards that automatically restrict distributions should a bank fall into its capital buffer. The OJK rules do not specify minimum capital conservation ratios that apply when the conservation buffer is breached. It is left to supervisory discretion to enforce distribution restrictions in individual cases. The OJK informed the Assessment Team that it intends

	to restrict distributions entirely should a bank's capital levels fall below the level of the buffers. The Assessment Team acknowledges that the OJK has broad powers to restrict distributions, but considers that the automatic restrictions in the Basel framework are designed to mitigate the risk of supervisory forbearance at the point that a bank breaches its buffer. There is a risk that this deviation could become material.
Materiality	Potentially material
Basel paragraph number	132(d): operating within the buffer
Reference in domestic regulation	POJK No.11/POJK.03/2016 Article 8 (2) and Article 54
Findings	Basel requirements highlight that the supervisor, when exercising its discretion to require a bank to conserve capital, should consider that banks might choose to operate within the buffer range to gain competitive advantage. The OJK rules consider only bank-specific factors such as the size of the capital shortage, the bank's financial condition, the bank's projections for increasing capital and the trend of the bank's business expansion. The rules do not explicitly address the possibility of banks seeking to gain competitive advantage. However, the Assessment Team does not consider this difference to have a material effect on the actions taken by supervisors in requiring banks within the buffer to conserve capital.
Materiality	Not material
Basel paragraph number	143: trading book exposures in calculating countercyclical capital buffer requirement
Reference in domestic regulation	POJK No. 11./POJK.03/2016 Article 8
Findings	When calculating the countercyclical capital buffer, the Basel framework requires banks to look at the geographic location of their private sector credit exposures and calculate their countercyclical capital buffer requirement as a weighted average of the buffers that are being applied in jurisdictions to which they have an exposure. This includes all private sector credit exposures that attract a credit risk charge and equivalent exposures in the trading book. The Indonesian framework does not specify how to treat trading book exposures under the countercyclical capital buffer. This could lead to banks' countercyclical capital buffer rate not being representative of the jurisdictions to which they are exposed. However, this deviation is not material, since all credit exposures of Indonesian banks are banking book exposures, the trading books of Indonesian banks are small and Indonesian banks currently have limited exposures to other jurisdictions.
Materiality	Not material

2.5 Pillar 2: supervisory review process

Section grade	Compliant
Summary	The Indonesian implementation of Pillar 2 provisions is found to be compliant, in light of the OJK's broad powers to impose additional capital requirements. Currently, the OJK applies Pillar 2 add-ons by mapping its assessment of a bank's soundness to capital charges. Banks must also prepare an internal capital adequacy assessment, which is discussed with the OJK. However, some of the provisions of the Basel Pillar 2 standards are not fully reflected in the OJK's rating methodology. For example, residual risk and implicit support for securitisation exposures are not covered in the Indonesian Pillar 2 regulations. These findings are not considered to be material.
Basel paragraph number	738(ii): market risk
Reference in domestic regulation	15/18/INTERN chapter III.1.C.4
Findings	The Basel Pillar 2 framework requires banks to supplement internal value-at-risk (VaR) models with stress tests. In particular, banks should consider the following risks: illiquidity / gapping of prices; concentrated positions (in relation to market turnover);

	one-way markets; non-linear products / deep out-of-the money positions; events and jumps-to-default; significant shifts in correlations; and other risks that may not be captured appropriately in VaR. There are no equivalent requirements in the Indonesian framework. Indonesian banks may use internal models for their own risk management purposes, but are not permitted to use them for regulatory capital purposes. Also, market risk is a small part of Indonesian banks' overall capital requirements, in both Pillar 1 and Pillar 2. Therefore, this deviation has limited impact and is not considered material.
Materiality	Not material
Basel paragraph number	760: capital as a temporary measure
Reference in the domestic regulation	POJK No.11/POJK.03/2016 Articles 2, 8, 46 and Article 45 paragraph 2
Findings	The Basel standards regard Pillar 2 capital charges as a temporary measure in cases where capital cannot mitigate risk. This perspective is not explicit in the OJK's regulations. However, the Indonesian regulations do provide that, where the OJK assesses that the capital of the bank does not reflect its risk profile, it can impose higher capital requirements or mandate improvements in risk management or a reduction in risk exposure. The OJK can also place other restrictions on banks' business models, activities and distributions. Therefore, this finding is considered to have limited impact and not to be material.
Materiality	Not material
Basel paragraph number	Supplemental Pillar 2 Guidance, paragraph 16: coverage of all material risks
Reference in the domestic regulation	5/8/PBI/2003 Article 4
Findings	The Basel framework encourages banks to consider a broad array of risks and requires that senior risk management should establish a risk management process that incorporates all material risks. The OJK Pillar 2 requirements specify a particular set of risks that should be considered, but do not require the assessment of risks that might fall outside those categories. This is different to the Basel Pillar 2 framework, which intends to be broad in nature and not to limit its focus. However, the list of risks in the Indonesian regulations covers all major risk types and is interpreted broadly by the Indonesian authorities, so this finding is not likely to have a material impact.
Materiality	Not material
Basel paragraph number	790–94: provision of implicit support
Reference in the domestic regulation	PBI 7/4/2005, Article 23
Findings	The Basel framework states that when a bank has been found to provide implicit support to a securitisation, it must hold capital against all of the underlying exposures associated with the structure as if they had not been securitised. It should also disclose publicly that it was found to have provided non-contractual support, as well as the resulting increase in capital charge. Furthermore, in paragraph 793, the Basel framework states that the supervisor must take appropriate action when the bank is found to have provided implicit support on more than one occasion. This action may include (but is not limited to) preventing the bank from gaining favourable capital treatment on securitised assets for a period of time to be determined by the national supervisor, requiring the bank to hold capital against all securitised assets as though the bank had created a commitment to them by applying a conversion factor to the risk weight of the underlying assets or by requiring the bank to treat all securitised assets as if they had remained on the balance sheet. As has been noted in the Pillar 1 section on securitisation, the Indonesian securitisation Regulations PBI 7/4/2005 do not specifically include provisions for implicit support. The Indonesian regulations do provide a capital treatment for credit enhancement that has not been formalised (deducted from capital or capital on the underlying assets if lower).

	However, there are no disclosure requirements in the Indonesian regulations with regard to such non-formalised credit enhancement. Therefore, this credit enhancement cannot be seen as equivalent to implicit support provisions included in the Basel framework. Furthermore, while PBI 7/4/2005 Article 23 states that any bank that conducts asset securitisation activities but does not comply with the provisions stipulated in the BI regulation shall be liable to administrative sanctions in the form of: (i) a written warning; and (ii) freezing of specified business activities; these sanctions are not specific to implicit support provided. Nor do they aim to discourage banks from providing implicit support, which is the intention of the Basel Pillar 2 provisions in this area. As stated earlier under Pillar 1, the Indonesian authorities indicated that there have been no noted incidents of implicit support. Disclosure of implicit support can have a significant impact on a bank and as such is significant from a supervisory perspective. However, given the very small securitisation market in Indonesia, the very low level of securitisation exposures by Indonesian banks and the OJK's broad powers to impose additional capital requirements, the Assessment Team did not consider this finding to be material.
Materiality	Not material
Basel paragraph number	795: residual risk in securitisation
Reference in the domestic regulation	Not included
Findings	The Basel framework requires supervisors to review the appropriateness of protection recognised against first-loss credit enhancement. This has not been included in the Indonesian regulations. From the data provided by the Indonesian authorities, it appears that none of the banks in the sample have provided first-loss credit enhancement. Therefore, this deviation would not have affected the supervisory process at this stage. The finding is not considered to be material.
Materiality	Not material

2.6 Pillar 3: market discipline

Section grade	Compliant
Summary	The Indonesian regulations are compliant with the disclosure requirements set forth under Pillar 3 of the Basel framework. The Assessment Team did not identify any differences with the Basel framework.

2.7 Observations and other findings specific to implementation practices in Indonesia

The following observations highlight certain special features of the regulatory implementation of the Basel standards in Indonesia. These are presented for information only. Observations are considered to be fully compliant with the Basel standard and do not have a bearing on the assessment outcome.

2.7.1 Scope of application

Basel paragraph number	20–22: scope of application
Reference in domestic regulation	
Observation	While most of the Basel framework applies to all banks in Indonesia, there are exceptions for market risk capital requirements and the capital conservation buffer. The market risk capital requirements only apply to Indonesian banks that have either (i) business activities in foreign currencies and financial instruments in the form of marketable securities or trading book derivatives of more than IDR 20 billion; or (ii) no business activities in foreign currencies but at least IDR 25 billion of marketable

	securities or derivatives in the trading book; or (iii) total assets of IDR 10 trillion or more; or (iv) a network of overseas offices or subsidiaries. Branches of foreign banks must also calculate a capital charge for market risk. The capital conservation buffer only applies to BUKU 3 and BUKU 4 banks, which comprises all commercial banks with core capital of at least IDR 5 trillion.[9] The largest banks in Indonesia, including all the sample banks, are subject to market risk and capital buffer requirements. This is consistent with the scope of the Basel standards, which apply to all internationally active banks.

2.7.2 Definition of capital

Basel paragraph number	Basel III paragraph 49, footnote 9: loss absorbency requirements
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Article 9 (1) SE No.20/SEOJK.03/2016
Observation	The Basel framework sets minimum requirements to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss. This includes specific standards for trigger events embedded in AT1 and Tier 2 instruments and the conversion or write-off that follows. The requirements apply to instruments issued on or after 1 January 2013. Instruments issued before that date which did not meet these standards but which did meet all other AT1 and Tier 2 criteria are being phased out between 2013 and 2022. Although the OJK's capital regulation (POJK No. 11) included a high-level loss absorbency requirement, the detailed requirements in the Basel framework were not implemented in Indonesia until June 2016. The Circular Letter issued in 2016 implementing the technical loss absorbency standards is silent on the recognition of instruments issued between 1 January 2013 and 21 June 2016. However, the OJK explained to the Assessment Team that the regulation issued in June 2016 applies to instruments already in issue. This is because the high-level loss absorbency requirement has been in effect since 1 January 2013 and the Circular Letter sets out only the specific mechanism for how losses are to be absorbed should a trigger event occur. As such, it applies to instruments already in issue. No trigger events occurred before the Circular Letter was issued.
Basel paragraph number	Basel III paragraph 52: components of CET1
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Articles 11 (1), 12, 14, 16 and 17
Findings	Article 14 (7) of the Indonesian regulations recognises a "capital deposit fund" in CET1 capital. Such instruments are not listed as an element of CET1 in the Basel standards. Capital deposit funds are funds that have been given to the bank by shareholders or those wishing to become shareholders, with the intention of investing in and increasing the bank's capital base. Although the funds for the investment have been paid in full, the capital instruments have not yet been issued to the investors. This could be because certain conditions for issuing the instruments have not yet been fulfilled, for example if a general meeting of shareholders must be held to approve the addition or because the bank's articles of association must be ratified by an authorised agency. These funds are eligible to be recognised as disclosed reserves, and hence may count towards CET1, subject to the following conditions: 1. the funds have been fully paid for the purpose of capital addition; 2. the paid-up value has been placed in an escrow account that does not give earnings yield; 3. the funds may not be withdrawn by the shareholders/candidate shareholders and so are available for absorbing losses; and

9 BUKU is the Indonesian abbreviation for the commercial bank classification used by the OJK. Banks are assigned to one of four categories according to the level of core capital. The category determines the permitted scope of the bank's activities under Indonesian regulations.

	4. any use of the fund has the OJK's approval. In determining that these instruments are eligible to be treated as disclosed reserves, the Indonesian authorities consider the criteria in the relevant accounting standard for a financial instrument to be classified as an equity instrument. These criteria are set out in Article 16 of PSAK 50, which implements the relevant international accounting standard (IAS 32) for financial instrument presentation in Indonesia. In particular, the Indonesian authorities consider that the fact that the funds may not be withdrawn implies that there is no contractual obligation to deliver cash or another financial entity to another entity, and hence that the instruments can be treated as equity. Even if the general meeting does not approve the issue of the instruments, the funds would still stay in the bank and be able to absorb losses. The OJK explained that banks disclose "funds for paid-up capital" under equity in their consolidated financial statements.[10] If capital deposit funds were not classified as equity, then they would not be eligible for inclusion in CET1 capital under the Basel framework. Although none of the sample banks currently have capital deposit funds (nor have they had such funds in recent years), the OJK provided an example of another Indonesian bank which did have such funds in issue and who had accounted for them as equity in its audited financial statements. The OJK also informed the Assessment Team that the classification of these funds as capital deposit funds is generally temporary in nature and under the control of the supervisor.
Basel paragraph number	Basel III paragraph 52: components of CET1
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Articles 11 (1), 12, 14, 16, 17 and 20
Observation	Under Basel III, reserves that form part of retained earnings are generally eligible for inclusion in CET1. The Indonesian regulations refer to "general reserves", "general provisions" and "specific reserves". This nomenclature could be confusing, especially as some elements are eligible for inclusion in CET1 and some only in Tier 2. General reserves are established from retained earnings after the deduction of taxes and the approval of a bank's head office. General reserves are included in CET1, as part of the disclosed reserves on the face of the balance sheet. Article 20 of the Indonesian regulations requires general provisions to be maintained as a provision for asset losses (PPA) on earning assets. These are calculated as the highest amount of 1.25% of RWA for credit risk. They are recognised in Tier 2 capital. Specific reserves are described as reserves established from retained earnings (after tax) for a specific purpose. These are prioritised to offset banks' losses.
Basel paragraph number	Basel III paragraph 52: dividends in CET1
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Articles 11 (1), 12, 14, 16 and 17
Observation	The Basel standards state explicitly that dividends must be removed from CET1. The POJK on the definition of capital does not include this explicit requirement. The OJK has explained that dividends are deducted from equity (and hence CET1) when announced and paid. This treatment is driven by the Indonesian accounting standards, which are aligned to international accounting standards (IFRS) in this respect. Banks in Indonesia are obliged to adopt and comply with accounting standards that are consistent with IFRS.
Basel paragraph number	Basel III paragraphs 54 and 57: AT1 and Tier 2 capital
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Elucidation to Article 11 (1) (b); Article 22 (1) and Article 15 Law of the Republic of Indonesia concerning Limited Liability Companies Article 71 (3) and Article 72 (5) PBI No. 15/11/2013 Article 3

10 See, for example, Bank Mandiri disclosures at media.corporate-ir.net/media_files/IROL/14/146157/QuarterlyFinancials_updates_4162016Q12016-Mei-English.pdf.

Observation	Paragraph 54 of Basel III requires that instruments being included in AT1 must not be simultaneously included in CET1. Paragraph 57 sets out a similar requirement preventing the double-counting of Tier 2 instruments. The OJK regulations do not explicitly prevent AT1 and Tier 2 instruments from being included in more than one tier. However, the OJK requires banks to report capital instruments with a unique code for each instrument. This allows them to check that banks do not include capital instruments in more than one tier of capital.
Basel paragraph number	Basel III paragraphs 57–9: Tier 2 criteria
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Article 19
Observation	The Basel standard states that a bank may only exercise a call and replace a capital instrument if it may do so at conditions which are sustainable for the income capacity of the bank. Alternatively, the bank must demonstrate that its capital position is well above the minimum capital requirements after the call option is exercised. The OJK regulation states that a call may be exercised if the bank demonstrates that, after exercising the call, it will still be above minimum capital requirements. Although the language is slightly different to the Basel standards, the Assessment Team considers that "well above" could be regarded as ambiguous in practice. Therefore, this difference in language is not considered to be an instance of non-compliance with the Basel framework.
Basel paragraph number	Basel III, footnote 17: dividend pushers
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Elucidation to Article 11 (1) (b), Article 22 (1) and Article 15 Law of the Republic of Indonesia concerning Limited Liability Companies Article 71 (3) and Article 72 (5) PBI No. 15/11/2013 Article 3
Observation	Dividend pushers are prohibited under the Basel framework. These can oblige the issuing banks to make a dividend or coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. Such an obligation would be inconsistent with the requirement for full discretion at all times to cancel dividend or coupon payments. Although OJK guidelines do not refer explicitly to dividend pushers, they do contain the substantive requirement that a bank must have full discretion at all times to cancel distributions or payments. Therefore, the Assessment Team considers that dividend pushers are implicitly prohibited by the OJK regulations.
Basel paragraph number	Basel III paragraphs 76–7: defined benefit pension fund assets and liabilities
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Article 14 POJK No. 16/POJK.05/2016
Observation	Under the Basel framework, defined benefit pension fund assets recognised on a bank's balance sheet must be deducted from CET1 capital (net of adjustments for tax liabilities). Under Indonesian regulations, laws and accounting standards, the assets of pension funds must be both separated and managed separately from the assets of its founders. Therefore, banks do not recognise defined benefit pension fund assets on their consolidated balance sheets. As a consequence, there is no explicit provision requiring the deduction of defined benefit pension fund assets in the Indonesian prudential regulations. The Basel framework requires that defined benefit pension fund liabilities, as included in the balance sheet, must be fully recognised in the calculation of CET1. As for defined benefit pension fund assets, there is no explicit provision regarding this in the Indonesia prudential regulations. However, the accounting treatment follows SAK 24, which implements IAS 19 in Indonesia, and requires the recognition of defined benefit pension fund liabilities on an entity's consolidated balance sheet.
Basel paragraph number	Basel III paragraph 78: investment in own shares
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Article 22 (1) (a) Article 36 of the Act 2007

Observation	Basel III requires that a bank's investments in its own common shares are deducted from CET1 (unless already de-recognised under relevant accounting standards). The Basel framework describes the extent to which gross long positions may be offset by short positions and how banks should consider holdings of index securities. These aspects are not covered under the OJK regulation. Similarly, the deduction treatment in context of AT1 and Tier 2 is not laid out in banking regulations. Instead, this treatment is implemented indirectly via company law, which prohibits companies from issuing shares to be owned by themselves.
Basel paragraph number	Basel III paragraph 79: reciprocal cross-holdings
Reference in the domestic regulation	Law of the Republic Indonesia No. 40 of 2007 Article 36 POJK No. 11/POJK.03.2016 Article 22 (1) (b)
Observation	Under the Basel framework, reciprocal cross-holdings of capital that are designed to artificially inflate the capital position of banks must be deducted in full from capital resources. Banks must apply a "corresponding deduction approach" to such investments in the capital of other banks, other financial institutions and insurance entities. This means the deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself. The Limited Liability Company Act states that "Companies are prohibited from issuing shares to be owned by the Company itself or by some other Company whose shares are directly or indirectly owned by the Company". This prevents banks from acquiring reciprocal cross-holdings by way of primary issuance. Indonesian banks may only have cross-holdings where such holdings arise due to the transfer of share ownership by way of the operation of law, grant or bequest. If a cross-holding arises in this way, the shares obtained must be transferred to other parties within one year of the transfer. Article 22 (1) (b) of POJK No. 11/POJK.03.2016 requires the deduction of capital instruments issued by another bank that are recognised as liabilities. For cross-holdings of CET1 or AT1 instruments accounted for as equity and acquired other than via direct issue, the OJK regulations imply a choice for the bank in terms of the tier of capital from which the holdings are deducted. However, this treatment would always be at least as conservative as the Basel requirements.
Basel paragraph number	Basel III paragraphs 87–9: threshold deductions
Reference in the domestic regulation	POJK No. 11/POJK.03/2016 Elucidation of Article 17 (1) (b) and (c)
Observation	Under Basel III, some items receive limited recognition when calculating CET1. Significant investments in the common shares of unconsolidated financial institutions, mortgage servicing rights and deferred tax assets arising from temporary differences may be recognised up to 10% of CET1 capital. The amounts of the items that are not deducted are risk-weighted at 250%. The Indonesian regulations do not grant any recognition to these items. Therefore, all such assets are deducted in full. This treatment is more conservative than the Basel framework.

2.7.3 Credit risk: standardised approach

Basel paragraph number	50: domestic ECAIs
Reference in domestic regulation	
Observation	The OJK regulations require the use of domestic ratings for exposures denominated in rupiahs and the use of international ratings for exposures denominated in foreign currency. The OJK has accredited one domestic and three international ECAIs. The accredited domestic ECAI uses a domestic rating scale. This may have an impact on RWA and potentially create an unlevel playing field across jurisdictions, absent a sound mapping or conversion of domestic ratings to international scale ratings.

2.7.4 Securitisation

Basel paragraph number	547: credit-enhancing interest-only strip
Reference in the domestic regulation	Not included
Observation	The definition of a credit-enhancing interest-only strip is not included in the Indonesian securitisation regulations. The Assessment Team understands, that by not including the definition in the regulation, the Indonesian authorities do not permit such instruments to be used by banks. In practice, this type of credit enhancement is not used in the Indonesian securitisation market and the omission of the definition is therefore not considered to be a deviation from the Basel framework.

2.7.5 Market risk

Basel paragraph number	All market risk paragraphs: level of detail
Reference in domestic regulation	POJK No. 6/POJK.03/2016 Article 14 POJK No. 7/POJK.03/2016 Article 2
Observation	The Assessment Team observed that, in several areas, the Indonesian rules were less detailed than the Basel framework, particularly with respect to more complex instruments and trading activities. Market risk accounts for a relatively small part of Indonesian banks' capital requirements and banks with trading books mainly deal in plain vanilla products. The Indonesian authorities explained that the structure of Indonesian regulations means that banks may not deal in instruments for which no treatment exists in the regulations. Should a bank wish to trade in such instruments, it must seek permission from the OJK. The OJK would consider such a request and, if appropriate, develop appropriate regulations for the particular instruments. Only after such regulations are in place would the bank be permitted to conduct these new activities. This approach reflects the fact that complex products do not currently exist in the Indonesian banking system and the desire of the Indonesian authorities to discourage trading in such products without robust risk management and supervisory oversight. While the level of detail in Indonesian framework appears adequate for banks' current trading activities, the Assessment Team recommends that this be reviewed again in a future RCAP, should markets and transactions develop to include more complex instruments.
Basel paragraph number	701(vi): inclusion of all trades in the capital charge calculation and requirement to establish risk management
Reference in the domestic regulation	SE/9/33/DPNP II.6, SE 13/23/DPNP Appendix I. II.B.3.c.3) a) and II.B.3.d.
Observation	In relation to trading book exposures, Indonesian authorities do not explicitly mention that "window-dressing" is not permitted. Given the less developed markets and the small amount of market RWA compared to credit RWA, this simplification is not deemed to affect the compliance of the Indonesian framework with the Basel market risk standards.
Basel paragraph number	703: treatment of counterparty credit risk in trading book for repo-style transactions
Reference in the domestic regulation	SE 13/6 II. A. 2., IV.B.3.a and IV.B.6
Observation	The Basel rules state that, for repo-style transactions in the trading book, all instruments in the trading book may be used as eligible collateral. If those instruments fall outside the banking book definition of eligible collateral, then a risk weight of 25% must be applied to those instruments. This is equivalent to the haircut at the level applicable to non-main index equities listed on recognised exchanges (as in paragraph 151 of the Basel framework). In the Indonesian regulations, the eligibility criteria for the trading book are the same as those for the banking book, ie collateral that is not eligible according to the banking book criteria would also not be eligible for trading book purposes. As such, this

	collateral must be treated separately from the cash leg of repo-style transactions. This is a more conservative treatment than netting the two legs in conjunction with the applicable haircut, which is required under the Basel rules. In addition, according to the Indonesian authorities, banks are only allowed to have repo-style transactions comprising eligible collateral.
Basel paragraph number	707–8: add-on factors for potential future exposure (PFE) calculation in the trading book
Reference in the domestic regulation	None
Observation	The Indonesian regulations do not implement the add-on factors for the calculation of PFE for credit derivatives and for derivatives in the trading book that are not subject to banking book treatment. Currently, Indonesian banks are not allowed to trade credit derivatives. The Indonesian authorities state, furthermore, that there are no derivatives that do not fall under the banking book treatment. This means that the Indonesian treatment is more rigorous compared to the trading book add-on factors in the Basel framework.
Basel paragraph number	718: treatment of nth-to-default credit derivatives
Reference in the domestic regulation	None
Observation	Currently, trading in nth-to-default credit derivatives is not allowed in Indonesian banks. Therefore, the respective Basel rules have not been implemented.
Basel paragraph number	718(iii): maturity method for general market risk of interest rate risk positions
Reference in the domestic regulation	SE 9/33/DPNP Appendix I. II. 2. c. 8) a) and b), I. II. 2. d 1)
Observation	Under the Basel framework, omitting opposite positions in same issues and closely matched plain vanilla products is allowed under the maturity method. This possibility is not implemented in Indonesia; therefore the Indonesian treatment is more rigorous.
Basel paragraph number	718(xiv): general risk charge for interest rate derivatives
Reference in the domestic regulation	SE/9/33 II.2.d.4)a) and b) and SE/9/33 Appendix I. II.2 b)
Observation	Opposite positions in the same category of instruments can in certain circumstances be regarded as matched and allowed to offset fully. To qualify for this treatment the positions must relate to the same underlying instruments, be of the same nominal value and be denominated in the same currency. Additionally, for futures the offsetting positions in the notional or underlying instruments to which the futures contract relates must be for identical products and mature within seven days of each other. The criteria implemented in Indonesia to offset future positions are more rigorous.
Basel paragraph number	718(xxxv): treatment of interest, other income and expenses
Reference in the domestic regulation	PBI 12/10/PBI/2010 Article 2 (4) and (5), including Elucidations
Observation	Indonesian rules implement the rules to include accrued interest and expenses as positions in the market risk charge calculation, but give no guidance on how to treat expected future interest and anticipated expenses. However, given the volume of trading book exposures in Indonesia and the fact that most transactions are relatively simple, this was considered a simplification in the regulations that was still consistent with the Basel framework.
Basel paragraph number	718(xLi): use of "shorthand method" for foreign exchange risk positions
Reference in the domestic regulation	SE 9/33/DPNP item II.3.c
Observation	Under the Basel framework, the shorthand method for foreign exchange risk positions should be used if no internal model is applied. Indonesian regulations implement the net position in each currency and in gold, but in the calculation of the overall net open position the gross method approach is used, which is more conservative.

2.7.6 Counterparty credit risk

Basel paragraph number	All counterparty credit risk paragraphs: level of detail
Reference in domestic regulation	
Observation	The Assessment Team observed that, in several places, the Indonesian rules were less detailed than the Basel framework. Counterparty credit risk accounts for a relatively small part of Indonesian banks' capital requirements. While the level of detail in the Indonesian framework appears adequate for banks' current activities, the Assessment Team recommends that this be reviewed again in a future RCAP, should markets and transactions develop such that counterparty credit risk becomes more material.
Basel paragraph number	Annex 4 paragraph 9: treatment of exposures against one counterparty
Reference in domestic regulation	None
Observation	Under the Basel framework, the exposure amount for a given counterparty is equal to the sum of the exposure amounts calculated for each netting set with that counterparty, meaning that exposures from transactions within the same netting set can offset each other, at least to some extent. The Indonesian regulations did not implement any rules for netting with the consequence that (bilateral) netting is not allowed. Consequently, the exposures are calculated separately for each transaction and then summed up for each counterparty, ie each transaction is treated as if it were part of a single trade netting set. This is more rigorous than the Basel framework.
Basel paragraph number	Basel III amendment of Annex 4 paragraph 9 and paragraph 105: outstanding exposure at default
Reference in domestic regulation	SE ATMR II.B.5.2)
Observation	In case of an incurred writedown, ie a CVA loss, the Basel framework allows the reduction of the exposure amount against a counterparty by the amount of the CVA loss. This possibility is not implemented in Indonesia. Consequently, exposure amounts for the calculation of the counterparty credit risk default risk charge could be higher, but not lower than the Basel calculation, which does take into account incurred CVA losses.

2.7.7 Operational risk: Basic Indicator Approach

Basel paragraph number	650: definition of gross income
Reference in domestic regulation	SE No. 11/3/DPNP
Observation	The items that should be considered in computing gross income as indicated in the Basel framework are not explicitly specified in the Indonesian regulations. The OJK explained that it issued a reporting template for this purpose and that this template already incorporates the adjustments indicated in the Basel standard. Although the template is generally consistent with the requirements of the Basel framework, the Assessment Team recommends explicitly stating the adjustments to gross income in the regulations.

2.7.8 Capital buffers

Basel paragraph number	132 (a)
Reference in domestic regulation	POJK No. 11/POJK.03/2016 Article 8 (1) and its Elucidation

Observation	The Basel framework describes the list of distributions that are to be restricted, should a bank fall into its buffer. Those items mentioned in the Indonesian standards are less extensive than the Basel framework. For example, share buybacks and staff (as opposed to management) bonus payments are not included. The OJK explained that the items mentioned in the regulations are examples only and that, in practice, restrictions on distributions would cover all the items listed in the Basel framework.

2.7.9 Pillar 2

Basel paragraph number	764: interest rate risk
Reference in the domestic regulation	SE/15/18/2013
Observation	The Basel Pillar 2 framework includes an assessment of interest rate risk. If supervisors determine that a bank is not holding capital commensurate with its level of interest rate risk, they must require the bank to reduce its risk, to hold a specific additional amount of capital or a combination of the two. The OJK Pillar 2 framework incorporates an interest rate stress scenario. However, the OJK only imposes a specific capital charge for interest rate risk if the stress scenario results in the bank breaching its minimum capital requirements (ie 8% of RWA). If a bank has sufficient capital to withstand the stress scenario, no capital is maintained specifically for interest rate risk. Alternatively, if a bank already has a high Pillar 2 charge for other risks, then no interest rate risk charge may be imposed, In this case, the add-on is not specific to interest rate risk. However, the OJK does have the power to require banks to maintain specific additional capital for interest rate risk if the approach above does not produce adequate capital levels.

Annexes

Annex 1: RCAP Assessment Team and Review Team

Assessment Team Leader

Ms Kerstin af Jochnick	Sveriges Riksbank

Assessment Team members

Mr Jonas Bernes	Comisión Nacional Bancaria y de Valores, Mexico
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Ms Alexandra Gebauer	Federal Financial Supervisory Authority (BaFin), Germany
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Supporting members

Ms Katarina Wagman	Sveriges Riksbank
Ms Louise Eggett	Basel Committee Secretariat
Mr Olivier Prato	Basel Committee Secretariat

Review Team members

Mr Neil Esho	Basel Committee Secretariat
Mr Piers Haben	European Banking Authority
Ms Sophie Schiltz	Surveillance Commission for the Financial Sector, Luxembourg
Mr James Watkins	Federal Deposit Insurance Commission, United States

Annex 2: Local regulations issued by Indonesian authorities for implementing Basel risk-based capital standards

Overview of issuance dates of important Indonesian capital rules — Table A.1

Domestic regulations	Version and date
Regulation on Minimum Capital Adequacy Requirement For Commercial Banks	First issued in December 2012, last version September 2016
Circular Letter on Guidelines for the Calculation of RWA for Credit Risk by Using Standardised Approach	First issued in February 2011, last version September 2016
Circular Letter on Guidelines for the calculation of RWA for Operational Risk using Basic Indicator Approach	First issued in January 2009, last version July 2016
Circular Letter on Guidelines for the Use of Standard Method in the Calculation of Minimum Capital Requirement for Commercial Banks Taking Account of Market Risk	First issued in December 2007, last version September 2016
Circular Letter on Minimum Capital Requirement based on Risk Profile and Fulfilment of Capital Equivalency Maintained Assets	First issued in December 2012, last version July 2016
Regulation on Bank Soundness Rating for Commercial Banks	First issued in January 2011, last version June 2016
Circular Letter on Bank Soundness Rating for Commercial Banks	October 2011
Regulation on Risk Management Implementation for Commercial Banks	First issued in 2003, last version March 2016
Circular Letter on Guidelines for Risk Management Implementation for Commercial Banks	First issued in 2003, last version September 2016
Capital Assessment Handbook for Supervisors	First version in October 2011, last version April 2013
Regulation on Transparency and Publication of Banks Reports	First issued in October 2012, last version September 2016
Circular Letter on Transparency and Publication of Banks Reports	First issued in December 2012, last version September 2016
Circular Letter on Rating Agencies and Ratings Acknowledged by OJK	First issued in December 2011, last version September 2016
Regulation on Prudential Principles in Asset Securitisation for Commercial Banks	January 2005
Circular Letter on Prudential Principles in Assets Securitisation Activities for Commercial Banks	November 2005
Regulation on Countercyclical Capital Buffer Requirement	December 2015
Regulation on Determination of Systemically Important Banks and Its Capital Surcharge	December 2015
Circular Letter on Conversion Feature Into Common Stock Or Write-Down For Additional Tier 1 Capital Instruments And Tier 2 Capital Instruments	June 2016
Regulation on The Implementation Of Governance For Commercial Banks In The Provision Of Remunerations	December 2015
Circular Letter on The Implementation Of Governance For Commercial Banks In The Provision Of Remunerations	September 2016

Hierarchy of Indonesian laws and regulatory instruments

Includes only those instruments with relevance to banking regulation

Table A.2

Level of rules (in legal terms)	Type
1945 Constitution	Constitution
Law	Law enacted by Parliament
BI / OJK Regulation (internal or external)	Regulations made by the BI Board of Governors or OJK Board of Commissioners
BI / OJK Circular Letter (internal or external)	Technical or implementation guidelines, made by a member of the BI Board of Governors or OJK Board of Commissioners

Annex 3: List of capital standards under the Basel framework used for the assessment

- *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Basel II), June 2006
- *Enhancements to the Basel II framework*, July 2009
- *Guidelines for computing capital for incremental risk in the trading book*, July 2009
- "Basel Committee issues final elements of the reforms to raise the quality of regulatory capital", Basel Committee press release, 13 January 2011
- *Revisions to the Basel II market risk framework: Updated as of 31 December 2010*, February 2011
- *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010 (revised June 2011)
- *Pillar 3 disclosure requirements for remuneration*, July 2011
- *Treatment of trade finance under the Basel capital framework*, October 2011
- *Interpretive issues with respect to the revisions to the market risk framework*, November 2011
- *Basel III definition of capital – Frequently asked questions*, December 2011
- *Composition of capital disclosure requirements: Rules text*, June 2012
- *Capital requirements for bank exposures to central counterparties*, July 2012
- *Regulatory treatment of valuation adjustments to derivative liabilities: final rule issued by the Basel Committee*, July 2012
- *Basel III counterparty credit risk – Frequently asked questions*, November 2011, July 2012, November 2012

Annex 4: Details of the RCAP assessment process

Off-site evaluation

- Completion of a self-assessment questionnaire by the Indonesian authorities
- Evaluation of the self-assessment by the RCAP Assessment Team
- Independent comparison and evaluation of the domestic regulations issued by the Indonesian authorities with corresponding Basel III standards issued by the BCBS
- Identification of observations
- Refinement of the list of observations based on clarifications provided by the Indonesian authorities
- Assessment of materiality of deviations for all quantifiable deviations based on data and non-quantifiable deviations based on expert judgment
- Forwarding of the list of observations to the Indonesian authorities

Assessment

- Discussion of individual observations with Indonesian authorities
- Conference calls with selected Indonesian banks and two consultancy firms
- Discussion with the Indonesian authorities and revision of findings to reflect additional information received
- Assignment of grades
- Submission of the detailed findings to Indonesian authorities with grades
- Receipt of comments on the detailed findings from Indonesian authorities

Review and finalisation of the RCAP report

- Review of comments by the RCAP Assessment Team, finalisation of the draft report and forwarding to the Indonesian authorities for comments
- Review of Indonesian authorities' comments by the RCAP Assessment Team
- Review of the draft report by the RCAP Review Team
- Reporting of findings to the SIG by the Team Leader
- Review of the draft report by the Peer Review Board
- Approval of the report by the Basel Committee and publication

Annex 5: List of rectifications by the Indonesian authorities

Basel paragraph	Reference to Indonesian document and paragraph	Brief description of the rectification
		Definition of capital
Basel III 49 footnote 9	POJK No. 11/POJK.03/2016 Article 9 paragraph 1 SE No. 2/SEOJK.03/2016	The Basel framework sets minimum requirements to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss. This includes specific standards for trigger events embedded in AT1 and Tier 2 instruments and the conversion or write-off that follows. The requirements applied to instruments issued on or after 1 January 2013. The OJK's capital regulation (POJK No. 11) included a high-level loss absorbency requirement from 2013, but the detailed requirements in the Basel framework were not implemented in Indonesia until June 2016.
Basel III 52	POJK No. 11/POJK.03/2016 Article 14	Previous OJK guidelines included "contributed capital" as one element of CET1. There is no equivalent instrument included in the Basel III definition of CET1 capital. The OJK has amended its regulation to exclude contributed capital from the CET1 element of capital.
Basel III 52	POJK No. 11/POJK.03/2016 Article 14	Previous OJK guidelines listed warrants and stock options as one element of CET1, at 50% of their fair value when certain conditions were met. The OJK has amended its regulation so that these instruments are no longer listed as an element of CET1 capital.
Basel III 53	POJK No. 11/POJK.03/2016 Article 12	The Basel standards set out 14 criteria for CET1 instruments, all of which must be met for an instrument to be included in CET1. Article 12 of the relevant POJK describes the criteria for CET1 instruments in Indonesia. The previous regulations did not cover all of the Basel criteria. The OJK has amended its regulation to address criteria 3, 7, 9 and 12 in Basel III paragraph 53.
Basel III 55	POJK No. 11/POJK.03/2016 Article 15	The Basel standards set out 14 criteria for AT1 instruments, all of which must be met for an instrument to be included in AT1. The OJK has amended its regulation to ensure that it covers Basel criteria 3, 7 and 14.
Basel III 58	POJK No. 11/POJK.03/2016 Article 19	The OJK has amended the criteria for inclusion in Tier 2 capital in its regulations, in particular to cover the criteria 5(b), 5(c) and 9 in the Basel standards.
Basel II footnote 19	POJK No. 11/POJK.03/2016 Article 19	Basel III footnote 19 requires that an option to call the instrument after five years but prior to the start of the amortisation period will not be viewed as an incentive to redeem as long as the bank does not do anything that creates an expectation that the call will be exercised at this point. The OJK has amended its regulation to include this expectation.
Basel III 60	POJK No. 11/POJK.03/2016 Article 20	Basel III recognises general provisions for loan losses in Tier 2 capital but specifically excludes specific provisions ascribed to identify deterioration of particular assets or known liabilities. The OJK has amended its regulation to ensure that specific reserves are not included in Tier 2 capital.
Basel III 76	POJK No. 11/POJK.03/2016 Article 14	The Basel framework requires that defined benefit pension fund liabilities, as included in the balance sheet, must be fully recognised in the calculation of CET1. The Indonesian framework previously prescribed a treatment for the losses that arise on the recalculation of defined benefit pension plans. This created an opposite entry as a liability. However, there was no equivalent treatment in the Basel framework, and the OJK decided to remove it from its regulations.
Basel III 79	POJK No. 11/POJK.03/2016 Article 22	Under the Basel framework, reciprocal cross-holdings of capital that are designed to artificially inflate the capital position of banks must be deducted in full from capital resources. Under Indonesian company law, cross-holdings may only arise in limited circumstances and

		must be transferred to other parties within one year of acquisition. The OJK has amended its regulation to ensure that any such holdings are deducted from capital during this limited period.
Credit risk: Standardised Approach		
Basel II 60-64	SE OJK ATMR RISIKO KREDIT Chapter II.E.2	The OJK has amended the treatment of exposures to export financing institutions, which were previously treated as banks under the Indonesian framework.
Basel II 70	SE OJK ATMR RISIKO KREDIT Chapter II.E.8.a.2	The Basel standards set out a "granularity criterion" for the regulatory retail portfolio. It also defines "aggregate exposure" and "one counterpart" in explaining the granularity criterion. The terms "aggregate exposure" and "one counterpart" are now also defined in the Indonesian regulations.
Basel II 76	SE OJK ATMR RISIKO KREDIT Chapter II.E.8.a.2	The Basel standards require exclusion of past due retail loans from the overall regulatory retail portfolio for purposes of assessing the granularity criterion for risk-weighting purposes. In Indonesia, these past due retail loans were not previously excluded from the portfolio, but the regulation has now been amended to match the Basel treatment.
Basel II 91, 120	SE/13/31/DPNP Chapter II.B	The Basel standards set forth the eligibility criteria for recognising ECAIs. The Indonesian regulations have been amended to incorporate the outstanding criteria on objectivity and the additional disclosure requirements with regard to ECAIs.
Basel II 94	SE OJK ATMR RISIKO KREDIT Chapter III.B.4	The Basel standards state that banks must use the chosen ECAIs and ratings consistently. The OJK has amended its regulation to incorporate these requirements.
Basel II 99	SE OJK ATMR RISIKIO KREDIT Chapter III.B.2	The OJK has amended its regulations on the recognition of ratings where a borrower has an issuer assessment and other unassessed claims.
Basel II 100	SE/13/31/DPNP Chapter II.A.4	The Basel standards provide that all ECAI assessments must take into account and reflect the entire amount of credit risk exposure the bank has with regard to all payments owed to it. This is now included in Indonesian regulations.
Basel II 151	SE OJK ATMR RISIKO KREDIT Attachment II	The OJK regulations now include a haircut for gold used as eligible collateral.
Basel II 185	SE OJK ATMR RISIKO KREDIT Chapter IV.B.5.c.1.a.i	The OJK has amended its regulations to apply a 20% haircut to collateral in the form of sovereign securities eligible for a 0% risk weight.
Counterparty credit risk		
Annex 4 paragraph 91	SE OJK ATMR RISIKO KREDIT II.C.3	Under the Basel framework, SFTs (repos and reverse repos) that are not treated under the internal models method are subject to treatment under the Comprehensive Approach of the credit risk mitigation requirements in the credit risk framework. Previously, the Indonesian regulations applied the Comprehensive Approach only to reverse repos. The Indonesian regulations were amended and now require the Comprehensive approach also for repos, applying the respective haircuts.
Annex 4 paragraph 92(i)	SE OJK ATMR RISIKO KREDIT Appendix 2 Table 2	The Basel rules describe how the replacement costs for OTC derivatives should be calculated under the current exposure method. This includes a table of add-on factors for the calculation of potential future exposure of the transactions. In the case of interest rate contracts with remaining maturities of more than one year, the add-on factor is subject to a floor of 0.5%, which has now been included in the relevant Indonesian regulation.

Annex 4 paragraphs 104 and 105		Under the Basel framework, banks are required to calculate a CVA risk charge based on a standard formula. The Indonesian authorities have now implemented a CVA capital requirement.
		Market risk
718 (Lxiv) and (Lxvii)	SE concerning Guidelines for the Use of the Standard Method in the Calculation of Minimum Capital Requirements for Commercial Banks taking account of Market Risk Associated reporting templates	The Basel rules define a "scenario approach", which can be used for option positions subject to a bank fulfilling certain criteria. The Indonesian authorities had previously implemented the scenario approach for some positions. However, it has now been removed from the Indonesian regulatory framework.
718 (cxi)	POJK No. 11/POJK/03/2016 Elucidation to Article 41 (1)	Under the Basel framework, the close-out prices for stale or concentrated positions should be considered in establishing the valuation adjustments for such positions. Banks must consider all relevant factors when determining the appropriateness of valuation adjustments/reserves for less liquid positions. The reference to these stale or concentrated positions and the need for additional adjustments for these particular positions has been added to the Indonesian regulations.
		Pillar 2
777 (i)-(xiii)	SE 13/6/PNP	The Basel framework expects supervisors to implement particular rules for the risk management of counterparty credit risk, in addition to the general risk management rules. Previously, OJK regulations treated counterparty credit risk as part of credit risk. However, now specific counterparty credit risk management rules have been implemented in Indonesia.
		Pillar 3
Basel II 818		The Basel standards provide that disclosures set out in Pillar 3 should be made semiannually, subject to certain exceptions. They also state that, in all cases, banks should publish material information as soon as practicable and not later than deadlines set by like requirements in national laws. Previously, disclosures required by the OJK were mostly on an annual basis, but the regulation has now been amended to require semiannual reporting (in particular, for Tables 4, 5, 7, 8, 9, 10 and 11 in the Basel standards).
Table 1		The OJK has implemented new disclosure requirements on the differences in the scope of regulatory and accounting consolidation, particularly the exclusion of insurance companies and credit restructuring companies from consolidation for regulatory purposes.
Table 14		The OJK has introduced new disclosure requirements regarding qualitative and quantitative information with respect to interest rate risk in the banking book.
Pillar 3 disclosure requirements for remuneration, paragraph 11		The OJK has amended its disclosure requirements on remuneration to include a description of the ways in which current and future risks are taken into account in the remuneration processes, which should include: (i) a discussion of the ways in which these measures affect remuneration; and (ii) a discussion of how the nature and type of these measures has changed over the past year and reasons for the change, as well as the impact of changes on remuneration. Also, banks are now required to disclose a description of the ways in which they seek to adjust remuneration to take account of longer-term performance.

Annex 6: Assessment of the bindingness of regulatory documents

The following table summarises the assessment of the seven criteria used by the Assessment Team to determine the eligibility of Indonesian regulatory documents. The Assessment Team concluded that the regulatory instruments issued and used by the OJK and BI as set out Annex 2 are eligible for the RCAP assessment.

Criterion	Assessment
(1) The instruments used are part of a well defined, clear and transparent hierarchy of legal and regulatory framework.	The establishment of the OJK was mandated by Law No. 23/1999 on BI and enacted by Law No. 21/2011 on the Indonesian Financial Services Authority. These laws give the regulations issued by the OJK the same legal power as regulations set by other institutions and bodies such as BI. Law No. 12/2011 sets out the legal hierarchy of Indonesian laws and regulations. Under this framework, BI and OJK Regulations are recognised and legally binding as long as they are mandated by a law or enacted based on authority.[11]
(2) They are public and easily accessible.	OJK and BI Regulations are published in the National Gazette. OJK Circular Letters are published on the OJK's website.
(3) They are properly communicated and viewed as binding by banks as well as by supervisors.	Regulations and Circular Letters are binding for banks and supervisors and viewed as such.
(4) They would generally be expected to be legally upheld if challenged and are supported by precedent.	Law No. 12/2011 sets out the legal hierarchy of Indonesian laws and regulations. Under this framework, BI and OJK Regulations are recognised and legally binding as long as they are mandated by a law or enacted based on authority. Regulations issued by the OJK and BI have never been challenged in court. Courts will take into consideration that according to Law No. 21/2011, the OJK was established with a mandate of, among others, regulating and supervising banks, as well as the fact that regulations stipulated in Law No. 12/2011 are binding in nature. An important phase of the rule-making process is the public hearing phase, which underlines the importance of transparency and provides an opportunity for stakeholders to provide suggestions, views and input.
(5) The consequences of failure to comply are properly understood and carry the same practical effect as for the primary law or regulation.	The BI and OJK Act contains sufficient powers for BI and the OJK to ensure compliance with prudential standards and regulations, laws and guidelines. BI and the OJK have full powers to enforce compliance and a range of powers sufficient to address any given situation up to and including revocation of the licence.
(6) The regulatory provisions are expressed in clear language that complies with the Basel provisions in both substance and spirit.	The drafting of OJK/BI Regulations uses the language found in the Basel standards to avoid any misinterpretation and to aid easy enforcement. Additionally, the OJK and BI issue Circular Letters to serve as guidelines to provide more clarity for both the supervisor and banks.
(7) The substance of the instrument is expected to remain in force for the foreseeable future.	Regulations are in force until they are amended or repealed. BI Regulations and Circular Letters issued before the transfer of supervision to the OJK remain valid unless otherwise revoked or converted into an OJK Regulation.

[11] BI Regulations are mentioned explicitly in Article 8 of Law No. 12/2011. OJK Regulations fall into the same category, but are not cited as an example because the OJK did not exist at the time the law was issued.

Annex 7: Key financial indicators of the Indonesian banking system

Overview of Indonesian banking sector as of June 2016

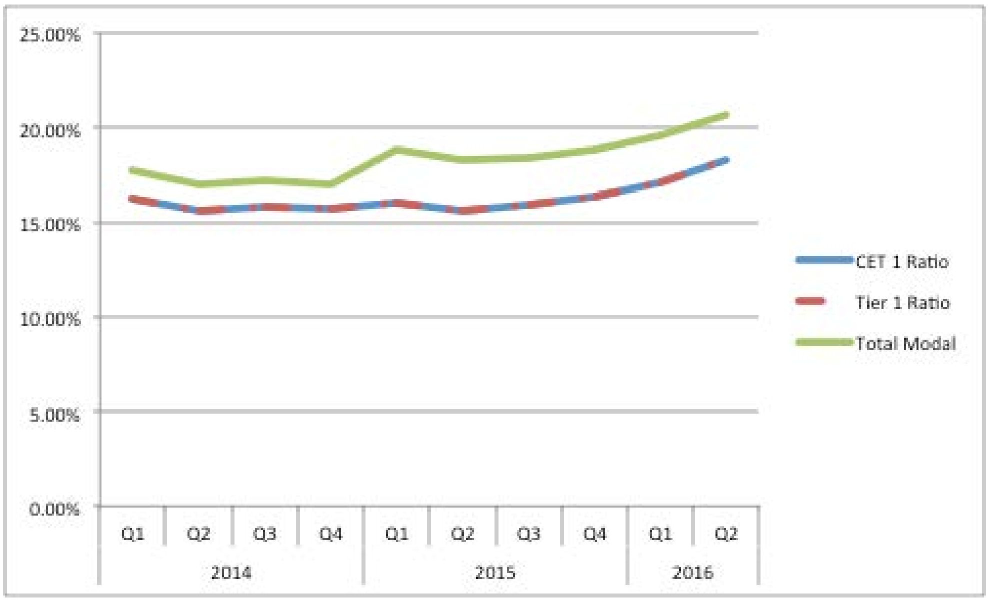
Table A.3

Size of banking sector (IDR billions)	
Total assets of all banks operating in the jurisdiction (including off-balance sheet assets)	7,543,719
Total assets of all locally incorporated internationally active banks	0
Total assets of locally incorporated banks to which capital standards under the Basel framework are applied (ie excludes foreign bank branches)	6,412,888
Number of banks	
Number of banks operating in Indonesia	118
Number of internationally active banks	0
Number of banks required to implement Basel standards (according to domestic rules)	106
Number of G-SIBs	0
Capital standards under the Basel framework	
Number of banks required to implement Basel-equivalent standards	118
Use of advanced approaches by banks	0
Capital adequacy (internationally active banks) (IDR billions and per cent)	
Total capital	552,838
Total Tier 1 capital	448,236
Total CET1 capital	448,236
Total RWA	2,667,517
RWA for credit risk (percent of total RWA)	84.62%
RWA for market risk (percent of total RWA)	0.50%
RWA for operational risk (percent of total RWA)	14.88%
Total off-balance sheet bank assets	419,188
Capital adequacy ratio (weighted average)	20.72%
Tier 1 ratio (weighted average)	18.30%
CET1 ratio (weighted average)	18.30%

Source: OJK.

Evolution of capital ratios of Indonesian banks

Weighted average, in per cent | Graph 1



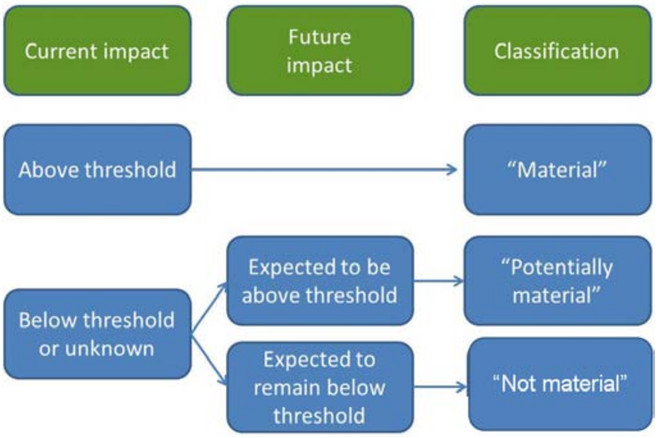
Source: OJK Data.

Annex 8: Materiality assessment

The outcome of the RCAP assessment is based on the materiality of the findings. As per the RCAP assessment methodology, for the assessment of materiality a distinction is made between quantifiable and non-quantifiable findings. For quantifiable gaps, the materiality assessment is based on data where available. For non-quantifiable gaps, the team relies on expert judgment only. Following this approach, an attempt was made to determine whether findings are "not material", "potentially material" or "material".

Classification of quantifiable gaps

Graph 2



Number of findings by component

Table A.4

Component	Not material	Potentially material	Material
Scope of application	1	0	0
Minimum capital requirements and transitional arrangements	2	0	0
Definition of capital	1	2	0
Pillar 1			
Credit risk: Standardised Approach	0	1	2
Securitisation	13	1	0
Counterparty credit risk	1	0	0
Market risk: Standardised Approach	6	1	1
Operational risk: Basic Indicator Approach	1	0	0
Capital buffers	2	1	0
Pillar 2	5	0	0
Pillar 3	0	0	0

Materiality is defined based on quantitative benchmark thresholds (for the quantifiable gaps) and expert judgment (for the non-quantifiable gaps). See Section 2 of this report with the detailed assessment findings for further information.

RCAP sample of banks

The following Indonesian banks were selected for materiality testing of the quantifiable deviations. Together these banks represent approximately 60% of the total assets of the Indonesian banking system.[12] The selection covers the largest Indonesian banks and is a fair representation of the various types of banks operating in Indonesia. The basis of the materiality assessment is the impact on the reported capital ratio (CET1, Tier 1 or total capital ratio) and RWA of the banks constituting the sample agreed between the Assessment Team and the assessed jurisdiction.

RCAP sample banks

Table A.5

Banking group	Share of bank's assets in total Indonesian banking sector assets (%)
Bank Mandiri	15.01
Bank Rakyat Indonesia	13.31
Bank Central Asia	10.99
Bank Negara Indonesia	7.50
Bank CIMB Niaga	4.58
Bank Permata	3.76
Bank Danamon Indonesia	3.25
Bank OCBC NISP	2.41
Total	60.62

Source: OJK.

[12] For this purpose, banking assets include both on- and off-balance sheet assets.

Annex 9: Areas where Indonesian rules are stricter than the Basel standards

In several places, the Indonesian authorities have adopted a stricter approach than the minimum standards prescribed by Basel or has simplified or generalised an approach in a way that does not necessarily result in stricter requirements under all circumstances but never results in less rigorous requirements than the Basel standards. The following list provides an overview of these areas. It should be noted that these areas have not been taken into account as mitigants for the overall assessment of compliance.

Counterparty credit risk

Basel paragraph number	Annex 4 paragraph 9: treatment of exposures against one counterparty
Reference in domestic regulation	None
More rigorous requirement	The exposure amount for a given counterparty is equal to the sum of the exposure amounts calculated for each netting set with that counterparty, meaning that exposures from transactions within the same netting set can offset each other, at least to some extent. The Indonesian regulations did not implement any rules for netting with the consequence that (bilateral) netting is not allowed. Consequently the exposures are calculated separately for each transaction and then summed up for each counterparty, ie each transaction is treated as if it were part of a single trade netting set.
Basel paragraph no	Basel III amendment of Annex 4 paragraph 9 and paragraph 105: outstanding exposure at default
Reference in domestic regulation	SE ATMR II.B.5.2)
More rigorous requirement	In case of an incurred writedown, ie a CVA loss, Basel allows the reduction of exposure amount against a counterparty by the amount of the CVA loss. This possibility is not implemented in Indonesia; consequently exposure amounts for the calculation of the CCR default risk charge could be higher, but not lower than according to the calculation without taking into account incurred CVA losses.

Market risk

Basel paragraph number	703: counterparty credit risk in trading book for repo-style transactions
Reference in the domestic regulation	SE 13/6 II. A. 2., IV.B.3.a and IV.B.6
More rigorous requirement	Basel rules state that for repo-style transactions in the trading book, all instruments that are included in the trading book may be used as eligible collateral. In case those instruments fall outside the banking book definition of eligible collateral, a risk weight of 25% (ie the haircut at the level applicable to non-main index equities listed on recognised exchanges, as noted in paragraph 151) has to be applied to those instruments. In the Indonesian regulations, the eligibility criteria for the trading book are the same as those for the banking book, ie collateral that is not eligible according to banking book criteria would not be eligible for trading book purposes as well and as such had to be treated separately from the cash leg of the repo-style transaction. This would be a more conservative treatment compared to the netting of the two legs in conjunction with the applicable haircut according to the Basel rules. According to the Indonesian authorities, banks are only allowed to have repo-style transactions comprising eligible collateral.
Basel paragraph number	707–8: add-on factors for PFE calculation
Reference in the domestic regulation	None
More rigorous requirement	The Indonesian regulations do not implement the add-on factors for the calculation of PFE for credit derivatives and for derivatives in the trading book that are not subject to banking book treatment. Currently, banks are not allowed to trade credit derivatives.

	Indonesian authorities state furthermore that there are no derivatives that do not fall under banking book treatment, ie the treatment is more rigorous compared to the trading book ad-on factors.
Basel paragraph number	718(iii): maturity method for general market risk of interest rate risk positions
Reference in the domestic regulation	SE 9/33/DPNP Appendix I. II. 2. c. 8) a) and b), I. II. 2. d 1)
More rigorous requirement	Omitting of opposite positions in same issues and closely matched plain vanilla products is allowed under the Basel maturity method. This possibility is not implemented in Indonesia. The Indonesian treatment is thus more rigorous.
Basel paragraph number	718(xiv): general risk charge for interest rate derivatives
Reference in the domestic regulation	SE/9/33 II.2.d.4)a) and b) and SE/9/33 Appendix I. II.2 b)
More rigorous requirement	Under the Basel requirements, opposite positions in the same category of instruments can, in certain circumstances, be regarded as matched and allowed to offset fully. To qualify for this treatment, the positions must relate to the same underlying instruments, be of the same nominal value and be denominated in the same currency. Additionally, for futures, the offsetting positions in the notional or underlying instruments to which the futures contract relates must be for identical products and mature within seven days of each other. The criteria implemented in Indonesia to offset future positions are more rigorous.
Basel paragraph number	718(xLi): use of "shorthand method" for foreign exchange risk positions
Reference in the domestic regulation	SE 9/33/DPNP item II.3.c
More rigorous requirement	Under the Basel framework, the shorthand method should be used if no internal model is applied. Indonesian regulations implement the net position in each currency and in gold, but in the calculation of the overall net open position the gross method approach is used, which is more conservative.

Annex 10: List of approaches not allowed under the Indonesian regulatory framework

The following list provides an overview of approaches that the Indonesian authorities have not made available to Indonesia's banks through its regulatory framework. Where the Basel standards explicitly request certain approaches to be implemented under specific circumstances, the missing approaches have been taken into account in the assessment. However, where the Basel standards do not require jurisdictions to implement these approaches, they have been implicitly treated as "not applicable" for the assessment.

The OJK has not implemented:

- the internal ratings-based approach for credit risk;
- the internal ratings-based approach for securitisation exposures;
- the internal models approach for market risk;
- the scenario approach for option positions;
- the standardised approach for operational risk; or
- the advanced measurement approaches for operational risk.

As indicated above, the Indonesian authorities do not currently permit the use of internal models to determine regulatory capital requirements. However, the Circular Letters on capital requirements for market risk and credit risk include general provisions that market and credit RWA should be calculated using either the standardised methods or internal models. These provisions also expect that initial implementation will follow the standardised approaches. There are no other provisions on internal models within the market and credit risk capital requirement regulations.

The Indonesian authorities informed the Assessment Team that these general provisions do not permit banks to use internal models in calculating regulatory capital requirements. The use of any such model by banks would need supervisory approval and the development of detailed OJK regulations on modelling practices. No such development is anticipated in the next three to five years.

Annex 11: List of issues for follow-up RCAP assessments

The Assessment Team identified the following issues listed below for follow-up and for future RCAP assessments of Indonesia.

Securitisation

The Assessment Team observed several deviations between the current Indonesian rules for securitisation and those in the Basel framework. The Indonesian securitisation market is currently extremely small. Nonetheless, the authorities are taking some steps to encourage the development of commercial paper markets, and this may expand in the coming years. The Indonesian authorities intend to implement a revised framework for securitisation, based on standards issued by the Basel Committee in 2014, by 1 January 2018. The Assessment Team recommends that a future RCAP assesses how this framework is implemented in Indonesia and how the Indonesian securitisation market develops.

Market risk

The Assessment Team observed that, in several places, the Indonesian market risk rules were less detailed than the Basel framework, particularly with respect to more complex instruments and trading activities. Market risk accounts for a relatively small part of Indonesian banks' capital requirements, and banks with trading books mainly deal in plain vanilla products. While the level of detail in Indonesian framework appears adequate for banks' current trading activities, the Assessment Team recommends that this be reviewed again in a future RCAP, should markets and transactions develop to include more complex instruments.

Counterparty credit risk

The Assessment Team observed that, in several places, the Indonesian rules were less detailed than the Basel counterparty credit risk framework. Counterparty credit risk accounts for a relatively small part of Indonesian banks' capital requirements. While the level of detail in the Indonesian framework appears adequate for banks' current activities, the Assessment Team recommends that this be reviewed again in a future RCAP, should markets and transactions develop such that counterparty credit risk becomes more material.

Annex 12: Indonesia's implementation of the Pillar 2 supervisory review process

The supervisory review process has been implemented by the OJK since 2012 and in accordance with the requirements of the Basel framework. The methodology for banks to develop their Internal Capital Adequacy Assessment Process (ICAAP) and the methodology for supervisors in assessing the bank's ICAAP (supervisory review and evaluation process, or SREP) is governed through several regulations.[13] This Annex describes how the OJK's supervisory framework applies the four principles of supervisory review set out in the Basel framework.

Principle 1: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

In relation to the increase of risks resulting from complexity of a bank's products, services and business operations and in line with the development of risk measurement methods and techniques in the financial and banking industry, it is necessary to adjust the calculation of capital adequacy to be able to absorb potential losses arising not only from credit risk, market risk and operational risk, but also from other material risks.

In anticipation of this, Indonesian banks must provide an assessment of their minimum capital requirement based on their risk profile. This not only reflects potential losses arising from credit, market and operational risk, which have been reflected in Pillar 1 capital requirements, but also anticipates potential losses that have not yet been fully incorporated in RWA. These are concentration risk, liquidity risk, interest rate risk in the banking book, legal risk, compliance risk, reputation risk and strategic risk. Banks should also anticipate the impact of stress test scenarios on their capital requirement. In order to comply with the minimum capital requirement based on a defined risk profile, a bank is required to have and implement the calculation process of internal capital requirement or the ICAAP. The ICAAP is a process performed by a bank to determine its capital adequacy in relation to its risk profile, size and complexity and to set a strategy to maintain capital levels.

In Indonesia, ICAAPs must be subject to active oversight by banks' boards of commissioners and directors. This means that the boards of commissioners and directors must at least understand the nature and level of the risks encountered by the bank, assess the adequacy of risk management and associate the risk level with the bank's capital adequacy to anticipate the risks and to support its business plan and strategic plan in the future. They must also ensure that ICAAPs are implemented consistently and integrated in banks' operational activities. Capital management, policy and strategy are also considered to be the responsibility of the boards of commissioners and directors.

When assessing their own capital adequacy, banks must have adequate policies and procedures to ensure that all risks have been identified, measured and reported regularly to the board of commissioners and board of directors. This includes having methods and processes that associate risk levels with the capital level required to absorb potential losses from such risks and being able to adapt these methods and assumptions in response to changes in the business plan, risk profile and external factors. The ICAAP must be well documented, including the methods and assumptions used. Banks are also to have an adequate internal control system to ensure the reliability of the ICAAP, including regular updates and internal independent reviews.

Bank must submit an ICAAP report to the OJK along with a self-assessment on the bank's Soundness Rating.

[13] These include POJK No. 11/POJK.02/2016, SE BI No. 14/37/DPNP, PBI No. 13/1/PBI/2011 or its conversion POJK No. 4/POJK.03/2016, SE No. 15/18/Intern, PBI No. 5/8/PBI/2003 or its conversion POJK No. 18/POJK.03/2016 and SE BI No.s13/23/DPNP.

Principle 2: Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.

Pursuant to OJK Law No. 21 Year 2011, the OJK has the authority to supervise the banking sector. The OJK has extensive powers with respect to the supervision of banking institutions (such as licences for the establishment of banks, bank office opening, work plans, ownership, management and human resources, mergers, consolidations and acquisitions of banks, revocation of business licenses of banks; and business activities of banks, including sources of funds, provision of funds, hybrid products and activities in services); supervision of banking conditions (such as liquidity, profitability, solvency, asset quality, the minimum capital adequacy ratio, the maximum lending limit, loan-to-deposits ratios and bank reserves; bank statements relating to bank's condition and performance; debtor information systems; credit testing; and bank accounting standards); supervision of banks' prudential aspect (which includes risk management; governance; the principles of know your customer and anti-money laundering; and prevention of terrorism financing and banking crimes); and bank examination.

When reviewing a bank's ICAAP, the OJK carries out a SREP which considers the adequacy of the active oversight of the board of commissioners and board of directors; the adequacy of the capital assessment; the adequacy of monitoring and reporting; and the adequacy of internal controls. Based on the results, the OJK can request that a bank correct its ICAAP. The regulations permit supervisors to use a top-down or a bottom-up approach to determine the minimum capital requirement. However, at present only the top-down approach is used. The bottom-up approach is subject to minimum criteria, including that the OJK has implemented advanced approaches to modelling capital requirements (which is not currently the case).

The OJK's handbook of capital assessment considers capital assessment to be a forward-looking assessment of a bank's capital adequacy for covering potential losses resulting from a bank's material risks, earnings volatility and reserve requirements that should be established by a bank on its assets. In this regard, bank supervisors will consider a bank's capital adequacy in relation to its risk profile, access to capital sources (including an assessment of its profitability and policy for distributions) and effectiveness of capital management. Having reviewed these factors, the supervisors assign a capital factor rating.

Principle 3: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Under POJK No. 11/POJK.03/2016, a bank must meet minimum capital requirements in accordance with its risk profile. The lowest levels for minimum capital requirements are shown in Table A.6. In addition, the OJK has the authority to determine minimum capital requirements that are greater than those shown in Table A.6, where the OJK assesses the bank as facing potential losses that require more capital. If there is a difference between the result of the bank's self-assessment of the minimum capital requirement commensurate with its risk profile and the result of the SREP, then the higher minimum capital requirement will be imposed.

Minimum capital requirements according to risk profile	Table A.6
Risk profile rating	Minimum capital requirement as % of RWA
1	8
2	At least 9, no more than 10
3	At least 10, no more than 11
4 or 5	At least 11, no more than 14

Source: OJK.

The average capital ratio of the Indonesian banking industry in December 2015 stood at 21.39%, with the majority banks having a risk profile rating of 2. It means that majority of the banks comply with the minimum capital commensurate with its risk profile.

Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

The OJK employs various on- and off-site supervisory tools to intervene at an early stage to prevent capital from falling below the minimum levels. Where the OJK assesses that a bank does not meet its minimum capital requirement on an individual and consolidated basis, the bank is prohibited from distributing earnings if such distribution would further weaken the bank's capital condition. The OJK can also request that the bank raise additional capital, repair the quality of its risk management process, reduce its risk exposure, limit its business activities and limit the opening of office networks.

In addition, banks that do not meet the minimum requirement commensurate with the risk profile will be subject to intensive supervision by the OJK. A bank under intensive supervision is obliged to undertake supervisory actions as instructed by the OJK, such as writing off non-performing loans and offsetting bank losses against bank capital; limiting remuneration or other similar payments to members of the board of commissioners or directors; limiting payments to or transactions with related parties; restricting payments on subordinated loans; and not implementing plans to issue new products or carry out new activities. Banks are required to submit an action plan to the OJK and report on its implementation.