

## BPD embracing KUB

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### Executive Summary

PEFINDO is of the view that regional development banks (*Bank Pembangunan Daerah* or BPD) have a favorable position in their respective regions, particularly due to their status as subsidiaries of local governments, benefitting from the closed ecosystem compared to other competing banks.

On the other hand, BPD's efforts to improve its business position in the banking industry face challenges in the form of dependence on the regional economy and the limited ability of local governments as shareholders to provide capital support, especially to fulfill the Financial Services Authority (*Otoritas Jasa Keuangan* or OJK) Regulation (*Peraturan OJK* or POJK) No. 12/POJK.03/2020 (POJK 12/03/2020) concerning Commercial Banks Consolidation (*Konsolidasi Bank Umum*), one of which requires BPD to have a minimum core capital of IDR3 trillion by the end of 2024. The POJK also regulates the Joint Business Group (*Kelompok Usaha Bersama* or KUB) as a solution for banks struggling to meet the minimum core capital, where banks including BPDs can join other larger banks to be part of the KUB.

### Background and Purpose of POJK 12/03/2020

POJK 12/03/2020 outlines banking consolidation for all types of banks in Indonesia, including commercial banks, conventional banks, and Islamic banks (including Islamic business units in commercial banks). These banks are required to have a minimum core capital of IDR3 trillion by the end of 2023, while for BPDs, the deadline is slightly longer at the end of 2024. For banks that have not met the core capital, the alternative is to go through a consolidation process, by way of (1) merger, consolidation, or integration, (2) acquisition followed by merger, consolidation, or integration, and (3) formation of KUB. The rationale behind this regulation is the fragmented nature of the banking industry. In contrast, industry consolidation is necessary to strengthen the banking structure, enlarge business scale, and enhance competitiveness by improving operating efficiency and encouraging innovation.

The longer deadline for BPDs is considering their important role as an extension of local governments in providing financial services and supporting micro, small and medium enterprises (MSMEs) in their respective regions. However, as they operate individually, BPDs often face capital constraints when competing with larger commercial banks that operate nationwide. In addition to capital and network limitations, BPDs typically lag behind in terms of operational capabilities, such as productive lending and treasury business development.

In this context, POJK 12/03/2020 encourages BPDs to cooperate through KUBs to strengthen their overall competitiveness and resilience, both in terms of business and financial profile. The presence of a KUB parent, which is usually a bank with a strong profile, can strengthen business development efforts and risk management practices by sharing the parent's knowledge and experience that has been built over the years.

### Definition, Provisions, and Implementation of KUB

KUB can be used by all types of banks in Indonesia, but most private banks prefer to raise equity or go through mergers and acquisitions due to the simpler process. The KUB scenario is more in line with the condition of most BPDs that are still struggling to meet minimum core capital requirements. Still, on the other hand, there are challenges in merging or being acquired by other banks due to the reputational factor of local governments as shareholders. In this context, KUB is a cooperation that aims to conduct banking business activities, share services, and use common systems in various aspects, such as risk management, technology resources, and financial services products. The requirements to become a KUB member are :

1. Banks joining the KUB must develop cooperation guidelines approved by OJK. Both KUB leader and KUB participant must first sign shareholder's agreement (SHA), outlining the details of KUB arrangement,
2. Banks in KUB must operate in accordance with standard risk management principles.

Those two principles also apply for BPDs, and the scope of cooperation of KUB includes various fields such as digital banking, asset management, banking product development, and sharing technology infrastructure.

### **Scope of POJK 12/03/2020**

The scope of KUB regulation in POJK 12/03/2020 applicable for BPD KUB can be summarized as follows:

- **Joint Management:** BPDs in a KUB are required to coordinate several banking functions, including risk management, compliance, internal audit, and supervisory functions.
- **Standardization of Products and Services:** KUB enables BPDs to create standardized products so that customers in different regions can enjoy uniform and quality services without significant inter-BPD differences.
- **Information Technology Development:** Under KUB, BPDs are encouraged to share technology infrastructure such as data centers, information security systems, and digital banking applications. We expect this to accelerate technology adoption and reduce technology investment costs in each BPD.
- **Integrated Risk Management:** KUB members are required to have a standard risk management policy, including credit, market, and operational risks, to mitigate potential negative impacts from economic fluctuations or internal risks.

Meanwhile, the implementation and formation mechanism of the KUB begins with the fulfillment of requirements for each BPD that wants to join the KUB, such as the existence of a cooperation plan, agreeing on a banking management policy, and obtaining OJK approval.

OJK acts as a supervisor, ensuring that the implementation of the KUB runs according to regulations and providing guidance in policy adjustments if necessary. The cooperation plan between BPDs is also followed with discussions between shareholders, and the understanding among shareholders still needs to be outlined in an agreement at the bank management level, including leadership issues and management structures.

In KUB, a banking management structure was established consisting of representatives from each BPD. They are responsible for organizing operational strategy, compliance, and governance in accordance with regulations.

Here are some of the benefits of POJK KUB implementation that we see as a positive factor for BPDs:

- **Increased Competitiveness:** Through KUB, BPD can improve economies of scale and become more competitive by having access to greater resources and efficient systems.
- **Operational Efficiency:** KUB allows BPDs to share costs and infrastructure, such as data centers, technology, and employee training.
- **Improved Customer Service:** By standardizing products and services, BPD customers will receive more consistent and quality services. KUB also enables BPD to provide more innovative financial products relevant to the needs of the local market and communities.
- **Promoting Financial Inclusion:** The efficiencies and synergies within KUB support access to financial services for people in remote areas or who have not been adequately served by banks.
- **Regional Economic Growth:** The existence of a stronger funding network between BPDs in one KUB will lead to more competitive loan interest rates to support small and medium enterprises in the region, which can lead to more balanced local economic growth between productive loans and consumptive loans, which are dominated by state civil apparatus (*Aparatur Sipil Negara* or ASN) loans.
- **Acceleration of Digital Transformation:** KUB encourages BPDs to adopt better technology, where the parent KUB is expected to hoist the level of technology used in its member BPDs. This can increase banking inclusion and improve efficiency, allowing manual processes that involve a lot of manpower and physical presence to be automated.

However, this implementation is also not without challenges. The first challenge is a structural issue of coordination and integration. Each BPD has different characteristics, culture, governance, and local priorities. This integration requires time and a high level of coordination efforts to unify a shared vision and mission. It also involves technology and infrastructure adjustments, which require inter-BPD

compatibility, which may have different systems. These technological upgrades and alignments require significant initial investment and a transition process that will take time. Another challenge is that since the KUB system is new and without precedent, there will be a transitional period of regulatory adjustments, data protection issues, and information technology security issues.

### BPD in PEFINDO's Portfolio

As of September 30, 2024, there were 18 BPDs included in PEFINDO's publication list:

BPD	Rating	Equity (IDR trillion)	Asset (IDR trillion)	Loans (IDR trillion)	Deposits (IDR trillion)	Remarks
BPD Jawa Barat dan Banten Tbk (BJBR)	idAA	16.1	207.3	136.1	150.2	Leader
BPD Jawa Timur Tbk (BJTM)	idAA-	11.9	101.2	58.1	81.1	Leader
Bank DKI (BDKI)	idAA-	10.9	82.3	53.6	65.2	Leader
BPD Jawa Tengah (BJTG)	idAA-	10.2	86.5	61.7	71.6	
Bank Jabar Banten Syariah	idAA	9.5	13.1	8.8	8.8	
BPD Kaltimara	idA	8.9	49.4	20.2	35.8	
Bank Sulselbar	idA+	4.7	31.0	22.8	20.6	
BPD Sumsel Babel	idA+	4.5	37.8	24.1	27.1	
Bank Sumut	idA+	4.5	42.0	29.7	34.1	
BPD Papua	idA	4.2	32.5	20.0	26.4	
BPD Bali	idA+	4.1	37.1	22.0	31.7	
BPD Kalimantan Barat	idA	4.0	23.5	15.7	17.7	
Bank Nagari	idA+	3.8	32.4	24.9	26.7	
BPD DIY	idA	3.8	20.2	10.8	14.5	
Bank Aceh Syariah	idA+	3.5	28.7	19.4	24.2	
BPD NTT	idA-	2.6	17.2	12.5	13.1	BJTM
BPD Lampung	idA	1.4	11.5	7.1	9.5	BJTM
BPD Bengkulu	idA-	1.4	9.1	6.6	7.3	BJBR

In this list, only BPD Nusa Tenggara Timur (NTT), BPD Lampung, and BPD Bengkulu are required to join KUBs, given their core capitals have not yet reached IDR3 trillion. BPD Bengkulu has formed KUB with Bank BJB, while BPD Lampung and BPD NTT have formed KUB with Bank Jatim, each by signing a shareholder agreement.

### Consequences of not fulfilling POJK 12/03/2020

The implications if BPD fails to join KUB while its core capital cannot meet the minimum amount of IDR3 trillion are status downgrade and restriction in business. BPDs that do not meet the core capital requirement will likely face operational restrictions and downgraded status to Rural Bank (*Bank Perkreditan Rakyat* or BPR). Rural banks will not be allowed to offer complex financial services and products, including certain types of foreign transactions or investments. If this happens to a BPD, the status downgrade will greatly affect the competitiveness of the Bank's businesses in the region, as well as tarnish the reputation of the regional governments and house of representatives.

## Conclusion

We see that the BPDs in our rating portfolio are generally ready, but the seamlessness of a BPD to enter a KUB with another lead BPD is also determined by its potential business, financial performance, and operational details such as level of ownership, number of management representatives, and extent of collaborations. While the regional economy still offers the business potential to be explored, the efficiency level must be improved considering the vast number of remote areas that require banking services, thus increasing the operational costs. The vision and commitment from the KUB leader are needed to foster its KUB members so that the purpose of this consolidation process can be realized.

POJK 12/03/2020 concerning Banking Consolidation is a strategic initiative from OJK to strengthen the banking industry. One option that can be used by BPDs to address the issue of minimum core capital as required is to collaborate and integrate within the KUB framework. Through this regulation, BPDs are expected to become more competitive and efficient, thereby increasing their contribution to the economy of their respective regions. However, to successfully implement this regulation, commitment and cooperation between BPDs and all stakeholders are required to overcome the existing challenges, including cultural adjustments, governance adjustments, and banking infrastructure development.