
BY

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A thesis submitted in fulfillment of the requirement for the degree of Doctor of Philosophy in Law

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ABSTRACT

Corporate governance reform in the banking industry became a major concern in Indonesia after the Asian financial crisis 1997/1998. The study is motivated by the performance of corporate governance in Indonesia that has been perceived as not showing any significant improvement after nearly two decades of reform. The study aims to analyze the government responses to the financial crisis and implementation of corporate governance in the banking industry in Indonesia. This research uses doctrinal research which consists of a review of primary data such as law and regulation, and secondary data such as reports, journals and the international standards related to the corporate governance. This research also uses descriptive analysis to elaborate the concept and the model of corporate governance and the case study method to investigate the implementation of corporate governance in selected banks in Indonesia. The main findings of this study are as follows. Firstly, the legal and regulation reforms are designed to cover (i) banking restructuring; (ii) improving banking regulation; (iii) improving corporate governance standards and its implementation to follow the international standards and best practice. Secondly, there has been institutional reform which consists of (i) ensuring independence of Bank Indonesia as the central bank; (ii) the establishment of the Financial Services Authority (OJK); (iii) the establishment of Indonesian Deposit Insurance (LPS). Thirdly, there has been Islamic Banking reform, namely: (i) the establishment of the Shariah Advisory Council (DSN) which is one of the most important institutional reform of the Islamic banking industry; (ii) the establishment of Shariah Supervisory Board (DPS) in each Islamic bank; and (iii) dispute resolution mechanism for Islamic banking. The analysis of implementation of corporate governance in the four selected banks indicates that corporate governance in the banking industry has been improved. Overall, the study concludes that there are significant regulatory and governance reforms and implementation of corporate governance standards in the banking industry in Indonesia. However, some case studies revealed that the implementation of corporate governance needs further improvement, especially on the supervision and law enforcement. Furthermore, the study recommends: first, the banking authority (i.e. the Financial Services Authority /OJK) must increase the speed of adoption and implementation of the corporate governance standards. Second, the quality of supervision and law enforcement at all levels of the governance structure must be improved. Third, there must be cooperative efforts amongst the authorities to improve corporate governance, including cooperation regarding the Komite Stabilitas Sistem Keuangan/KSSK.
خلاصة البحث

قضية إصلاح حوكمة الشركات في الصناعة المصرفية تشكل مصدرًا كبيرًا في إندونيسيا بعد الأزمة المالية الآسيوية التي حدثت في فترة عام 1997/1998. وما يخص الدافع وراء هذه الدراسة فالأزمة الدائمة، فالأزمة المالية في إندونيسيا. يلاحظ فيه أن لا يظهر أي تحسين ملحوظ بعد حوالي عقود من الإصلاح. وهذه الدراسة تهدف إلى تحليل ردود الحكومة على الأزمة المالية وتفسير حوكمة الشركات في الصناعة المصرفية في إندونيسيا، شكلها وتدفقها بجانب القوانين والتنظيم، بالإضافة إلى السياسات التنظيمية مثل التقارير والمحادثات والمعايير الدولية المتعلقة بحوكمة الشركات، كما تستخدم لمنهج التحليلي الوصفي لبيان مفهوم حوكمة الشركات وتوقعها ومناقشتها. وامرأة القطاع والتي تحل في الدراسة حالة هذه الدراسة في تحقيق تطبيق حوكمة الشركات في بنوك مختارة في إندونيسيا. وقد اكتشفت الدراسة النتائج الرئيسية وهي على النحو الآتي: أولاً، تم تصميم معايير حوكمة الشركات وتطبيقها، وتحقيق الثقة في البنوك المركزي. ثانياً، هناك إصلاح قانوني لحوكمة الشركات في البنوك المركزي. وثالثًا، هناك إصلاح في البنوك الإسلامية، والتي تشمل ما يأتي: 1) إنشاء المجلس الاستشاري الشرعي (DSN) في كل بنك إسلامي؛ و(3) آلية فصل النزاعات للمصرف الإسلامي. وتشمل تحقيق تطبيق حوكمة الشركات في البنوك الأربعة المختارة التي تمت حوكمة الشركات في الصناعة المصرفية قد تحدث. وبشكل عام، تستخلص الدراسة إلى أن هناك إصلاحات تنظيمية كبيرة بما في ذلك تطبيق معايير حوكمة الشركات في الصناعة المصرفية في إندونيسيا. ومع ذلك، هذه الدراسة اكتشفت أن بعض دراسات الحالات فيما يتعلق بتطبيق حوكمة الشركات يحتاج إلى مزيد من التحسين، لا سيما فيما يتعلق بالإشراف وإنهاء القانون. وعلاوةً على ذلك، توصي الدراسة فيما يأتي: أولاً، يجب على السلطة المصرفية (أي الهيئة الخدمة المالية/OJK) القيام بزيادة سرعة اعتماد معايير حوكمة الشركات وتطبيقها. ثانياً، يتم تحديث تحسين نوعية الإشراف وإنهاء القانون على جميع مستويات الهيكل الإدارة. ثالثًا، يجب أن تكون هناك جهود في تعاون بين السلطات لتحسين حوكمة الشركات، بما في ذلك التعاون فيما يتعلق بـ KSSK.
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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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*Go Linawati vs PT Bank Mutiara, Tbk* (Formerly Bank Century) and PT. Antaboga Delta Securitas. Supreme Court Decision No 2838K/PDT/2011, 19 April 2012

*Butet Kartaradjasa vs Bank Rakyat Indonesia Syariah* (BRI Syariah), District Court Case Number 42/PDT.G/2013/PN.JKT.PST

Bank Mutiara Indonesia
Bank Mandiri Indonesia
Bank CIMB Niaga
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**International Guidelines**

Basel I, II, III  
International Monetary Fund (IMF)  
The World Bank  
Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)  
Islamic Financial Services Board (IFSB)  
Organization for Economic Co-Operation and Development (OECD)

**Indonesia Regulation**

Indonesia Banking Law No 21/2008 regarding Islamic Banking  
Indonesia Banking Law No 7/1992 with the amendment Indonesia Banking Law No 10/1998  
Indonesia Company Law No 40/2007  
Indonesian Civil Code  
Indonesian Consumer Protection Law No 8/1999  
Indonesian Law no 24/2004 regarding Lembaga Penjamin Simpanan  
Indonesian Good Corporate Governance Code 2001 revised with Corporate Governance Code 2006  
Indonesian Banking Corporate Governance Code 2004  
Indonesian Law No 21/2011 on Otoritas Jasa Keuangan  
Bank Indonesia Regulation No. 1/6/1999 Regarding Designation Of Compliance Director And Application Of The Standards For The Practice Of The Internal Audit Function For Commercial Banks  
Bank Indonesia Regulation No 5/8/PBI/2003 on Application of Risk Management for Commercial Banks  
Bank Indonesia Regulation no 5/10/PBI/2003 on Prudential Principle in Equity Participation  
Bank Indonesia Regulation No.5/25/PBI/2003 10 November 2003 Regarding The Fit and Proper Test  
Bank Indonesia Regulation No. 7/13/PBI/2005 The Minimum Capital Adequacy Requirement For Commercial Banks Based On Sharia Principles  
Bank Indonesia Regulation No. 7/25/PBI/2005 Risk Management Certification for Management and Officers of Commercial Banks  
Bank Indonesia Regulation No. 7/6/PBI/2005 Transparency In Bank Product Information And Use Of Customer Personal Data  
Bank Indonesia Regulation No. 7/31/PBI/2005 Derivative Transactions  
Bank Indonesia Regulation No. 7/7/PBI/2005 with the amendment No. 10/10/PBI/2008) regarding Settlement of Consumer Complaints
Bank Indonesia Regulation no. 8/5/PBI/2006 with the amendment No. 10/1/PBI/2008 regarding Banking Mediation
Bank Indonesia Regulation No. 8/14/PBI/2006 with the amendment Bank Indonesia Regulation Number 8/4/PBI/2006 Regarding Implementation Of Good Corporate Governance For Commercial Banks
Bank Indonesia Regulation No. 8/7/PBI/2006 Amendment To Bank Indonesia Regulation Number 7/13/PBI/2005 Concerning Capital Adequacy Ratio For Commercial Banks Based On Sharia Principles
Bank Indonesia Regulation Number: 10/32/PBI/2008 - Islamic Banking Committee
Bank Indonesia Regulation Number: 10/17/PBI/2008 - Product of Sharia Bank and Sharia Business Unit
Bank Indonesia Regulation Number: 11/3/PBI/2009 - Islamic Commercial Bank
Bank Indonesia Regulation Number: 11/10/PBI/2009 - Sharia Business Units
Bank Indonesia Regulation No 11/33/PBI/2009 regarding Implementation of Good Corporate Governance for Bank Sharia Commercial Bank and Sharia Business Unit
Bank Indonesia Regulation No 13/2/PBI/2011 regarding The Implementation of Compliance Function in Commercial Banks
Bank Indonesia Regulation No 14/6/PBI/2012 regarding Fit and Proper Test for Islamic Bank and Islamic business Units

Bank Indonesia Regulation No 14/18/PBI/2012 regarding Minimum Capital Adequacy Requirement for Commercial Banks revised with Bank Indonesia Regulation No 15/12/PBI/2013
Bank Indonesia Regulation No 16/1/PBI/2014 regarding Consumer Protection on Payment System Services
Sharia Advisor Council MUI No 03/2000 Regarding Implementation Guidelines for Determination of the Sharia Supervisory Board Member on Islamic Financial Institutions.
Indonesia Ulama Council (MUI) No Kep-754/MUI/II/1999 Regarding Establishment of Sharia Advisor Council (DSN)
Otoritas Jasa Keuangan Regulation No 1/POJK. 07/2013 regarding Consumer Protection for Financial Services
Otoritas Jasa Keuangan Regulation No 22/POJK.04/2014 regarding Know Your Customer Principles for Financial Services in Capital Markets
Otoritas Jasa Keuangan Regulation No 1/POJK.07/2014 regarding Alternative Dispute Resolution in the Financial Services Sector
Otoritas Jasa Keuangan Regulation No 21/POJK.03/2014 regarding Minimum Capital Requirement for Islamic Banks
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<td>AAOIFI</td>
<td>The Accounting and Auditing Organization for Islamic Financial Institutions</td>
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<td>Asean Corporate Governance Association</td>
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<tr>
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<td>BEI</td>
<td>Indonesian Stock Exchange (formerly Bursa Efek Jakarta. Now become Bursa Efek Indonesia)</td>
</tr>
<tr>
<td>BIS</td>
<td>Bank of International Settlement</td>
</tr>
<tr>
<td>KNKG</td>
<td>National Committee on Corporate Governance (Komite Nasional Kebijakan Governance)</td>
</tr>
<tr>
<td>KSSK</td>
<td>Financial System Stability Committee (Komite Stabilitas Sistem Keuangan)</td>
</tr>
<tr>
<td>GMS</td>
<td>General Meeting Shareholders</td>
</tr>
<tr>
<td>IFI’s</td>
<td>Islamic Financial Institution</td>
</tr>
<tr>
<td>IFSB</td>
<td>The Islamic Financial Services Board</td>
</tr>
<tr>
<td>LPS</td>
<td>Lembaga Penjamin Simpanan (Indonesian Deposit Insurance Corporation)</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
</tr>
<tr>
<td>OJK</td>
<td>Financial Services Authority (Otoritas Jasa Keuangan)</td>
</tr>
<tr>
<td>PERC</td>
<td>The Political and Economic Risks Consultancy</td>
</tr>
<tr>
<td>YLKI</td>
<td>Indonesian Consumer Foundation (Yayasan Lembaga Konsumen Indonesia)</td>
</tr>
</tbody>
</table>
CHAPTER ONE
INTRODUCTION

1.1. BACKGROUND OF THE STUDY

Many argued that the EastAsiafinancial crisis of 1997, which in turn triggered the economic crisis, was caused by a systemic failure in implementing corporate governance. The World Bank, in its 1999 report, argued that this crisis is a result of the weak legal framework, bad banking practice, inconsistency in accounting and auditing standards, ineffective supervision, and inadequate protection of minority shareholders’ rights. Meanwhile, the Asian Development Bank (ADB) argued that the financial crisis in Indonesia, Malaysia, Philippines, Thailand, and South Korea was caused by high concentration of company ownership, ineffective supervision, inefficiency and lack of transparency in company control, over-reliance on external funding, and inadequate supervision by creditors. The arguments of these reputable organizations support the notion that the root of the financial crisis is a weakness of regulation and implementation of corporate governance.

One of the most affected industry during the financial crisis is banking industry. Among the affected countries, the Indonesian banking industry was the most severely affected by the financial crisis. There was a total of 54 banks which were

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1United Nation Development Programme, “Corporate Governance in Asia: Lessons From The Financial Crisis”, (Malaysia: UNDP, 2002), 74
2ADB is an international development finance institution whose mission is to help developing country members reduce poverty and improve the quality of life of their people. Headquartered in Manila, and established in 1966, ADB is owned and financed by its 67 members, of which 48 are from the region and 19 are from other parts of the globe (www.adb.org)
closed down during the crisis (16 banks in 1998 and 38 banks in 1999) and several banks had to be bailed out from insolvency.

As a consequence, policy responses to the crisis emphasized on governance reforms in the banking sector, in addition to implementing appropriate macroeconomic policies. The banking institutions became a priority sector due to several reasons. Firstly, the banking industry plays a dominant role in the economy of a country through its financial intermediation functions by channeling funds from depositors to creditors. Consequently, banking failure can destabilize the financial system and cause a systemic failure of the economy.⁴

Secondly, banking is a highly-leveraged industry. It is due to the business nature of banks which involves huge funds collected from a large number of depositors compared to its limited capital injected by bank’s shareholders. Consequently, the failure of banks has significant impact on the society as bank’s failure may cause huge monetary loss for the depositors. Hence, strict regulation is needed to protect depositors and the public interest as well as to ensure economic stability.⁵

Thirdly, the biggest cost of the financial crisis is cost of bank restructuring. Bank restructuring is needed to stabilize the financial system and restore public confidence. This restructuring requires massive cost to support bank liquidity, provide a blanket guarantee for depositors, and take over of assets from insolvent banks. In case of Indonesia, the direct cost to restructure the failed banks reached a total of 620.9 trillion Indonesian Rupiah⁶.

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⁴ Hamid Yunis, “Corporate Governance for Banks” in Islamic Finance: The Regulatory Challenge, edited by Rifaat Ahmed and Simon Archer, (Singapore: John Wiley and Sons (Asia), 2007), 296
⁵ Hamid Yunis, 306
⁶ Boediono, Ekonomi Indonesia: Dalam Lintasan Sejarah, (Jakarta: Mizan Pustaka), 2016, 211
As a crisis-affected country, Indonesia initiated a legal reform to improve corporate governance in the banking industry. A comprehensive legal reforms consist of the regulatory framework and governance structure. The regulatory framework deals with the regulations and standards that should be implemented throughout the banking industry as well as the regulatory authority or bodies responsible in making and supervising such regulations and standards. The governance structure refers to the structure and mechanism of corporate governance that should be adopted within banking institutions.

Almost simultaneously with the corporate governance reform in Indonesia, there were also efforts to enhance the corporate governance in banking at the international level. In 1999, the Basel Committee on Banking Supervision (BCBS)\(^7\) published a guidance on “Enhancing Corporate Governance for Banking Organization”. The BCBS is part of the Bank of International Settlements (BIS)\(^8\) in which Indonesia became one of its members. This guidance was intended to assist supervisory authorities and banking organizations worldwide in promoting the adoption of sound corporate governance practices by banking organizations in their countries. This guidance was drawn from the principles of corporate governance that were published by the Organization for Economic Co-operation and Development.

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\(^7\)The Basel Committee, established by the central-bank Governors of the Group of Ten countries (Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States) at the end of 1974, meets regularly four times a year. The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide (www.bis.org).

\(^8\) The Bank for International Settlements (BIS) is an international organisation which fosters international monetary and financial cooperation and serves as a bank for central banks. Established on 17 May 1930, the BIS is the world's oldest international financial organization (www.bis.org)
While the corporate governance principles developed by the OECD were intended for companies in general, the one developed by BIS was focused on the banking institution. This guidance was widely accepted as corporate governance principles for banking organizations and it may be adopted to reform the existing national legislations, regulations or codes of corporate governance in many countries, including Indonesia.

Ideally and theoretically, initiatives on governance reform are expected to improve corporate governance practices in the affected countries. Amongst early study on corporate governance after the crisis was a survey conducted by the Political and Economic Risks Consultancy (PERC) in 2001. Using a scale of 0 to 10 which reflects the best to worst grade, respectively, the survey asked perceptions of expatriate business executives on corporate governance practice in the key Asian economies. As presented in Figure 1.1, the survey puts Malaysia, Singapore and Hong Kong as the best countries for the implementation of corporate governance. On the contrary, Vietnam, Indonesia and China were classified as the worst three countries in the corporate governance practice.

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9 The forerunner of OECD was the Organization for European Economic Co-operation (OEEC). OEEC was formed in 1947 to administer American and Canadian aid under the Marshall Plan for the reconstruction of Europe after World War II. Its headquarters were established at the Château de la Muette in Paris in 1949. OECD took over from OEEC in 1961. Since then, its mission has been to help its member countries to achieve sustainable economic growth and employment and to raise the standard of living in member countries while maintaining financial stability – all this in order to contribute to the development of the world economy (www.oecd.org).

10 PERC was established in 1976 and headquartered in Hong Kong. From this office, PERC coordinates a team of researchers and analysts in the ASEAN countries, Greater China and South Korea. Some of the world's leading corporations and financial institutions regularly use PERC's services to assess key trends and critical issues shaping the region, to identify growth opportunities, and to develop effective strategies for capitalizing on these opportunities.
Another survey to assess the quality of corporate governance in the Asian countries was the survey periodically conducted by the Credit Lyonnais Securities Asia (CLSA) in collaboration with the Asian Corporate Governance Association (ACGA). The results of the survey for the period of 2005 – 2014 are compiled in Table 1.1. The CLSA-ACGA’s survey shows that Singapore and Hong Kong are consistently in the top-two ranking among the surveyed countries with a similar score. Meanwhile, the survey puts Malaysia, Thailand, Taiwan, and India in the middle ranking with scores that tend to improve in the last three surveys. On the other hand, Indonesia is consistently at the bottom of the ranking with relatively no significant

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11 CLSA Asia-Pacific Markets is Asia’s leading, independent brokerage and investment group. The company provides equity broking, capital markets, merger and acquisition, and asset management services to global corporate and institutional clients. CLSA has built a reputation for unrivalled equity research and economic analysis, which are consistently voted as the best in Asia. Founded in 1986 and headquartered in Hong Kong, CLSA has more than 1,500 dedicated professionals located in 15 Asian cities, plus London, New York, Boston, Chicago and San Francisco (www.clsa.com)

12 The Asian Corporate Governance Association (ACGA) is an independent, non-profit membership organization dedicated to working with investors, companies and regulators in the implementation of effective corporate governance practices throughout Asia. ACGA was founded in 1999 and its membership comprises more than 80 global and regional pension and investment funds, financial institutions, listed and unlisted companies, law and accounting firms, and educational institutions operating or involved in Asia. (http://www.acga-asia.org/content.cfm?site_content_type_id=21)
improvement in the corporate governance score. Only in 2007, Indonesia has edged in front of the Philippines.

Table 1.1 Corporate Governance Quality in Asia (2005 – 2014)

<table>
<thead>
<tr>
<th>Country</th>
<th>2005 Total Score</th>
<th>Rangking</th>
<th>2007 Total Score</th>
<th>Rangking</th>
<th>2010 Total Score</th>
<th>Rangking</th>
<th>2012 Total Score</th>
<th>Rangking</th>
<th>2014 Total Score</th>
<th>Rangking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong</td>
<td>69</td>
<td>2</td>
<td>67</td>
<td>1</td>
<td>65</td>
<td>2</td>
<td>66</td>
<td>2</td>
<td>65</td>
<td>1</td>
</tr>
<tr>
<td>Singapore</td>
<td>70</td>
<td>1</td>
<td>65</td>
<td>2</td>
<td>67</td>
<td>1</td>
<td>69</td>
<td>1</td>
<td>64</td>
<td>2</td>
</tr>
<tr>
<td>Japan</td>
<td>-</td>
<td>-</td>
<td>52</td>
<td>5</td>
<td>57</td>
<td>3</td>
<td>55</td>
<td>3</td>
<td>60</td>
<td>3</td>
</tr>
<tr>
<td>Malaysia</td>
<td>56</td>
<td>4</td>
<td>49</td>
<td>6</td>
<td>52</td>
<td>5</td>
<td>55</td>
<td>3</td>
<td>58</td>
<td>4</td>
</tr>
<tr>
<td>Thailand</td>
<td>50</td>
<td>6</td>
<td>47</td>
<td>7</td>
<td>55</td>
<td>4</td>
<td>55</td>
<td>3</td>
<td>58</td>
<td>4</td>
</tr>
<tr>
<td>Taiwan</td>
<td>52</td>
<td>5</td>
<td>54</td>
<td>4</td>
<td>55</td>
<td>4</td>
<td>53</td>
<td>4</td>
<td>56</td>
<td>5</td>
</tr>
<tr>
<td>India</td>
<td>61</td>
<td>3</td>
<td>56</td>
<td>3</td>
<td>49</td>
<td>6</td>
<td>51</td>
<td>5</td>
<td>54</td>
<td>6</td>
</tr>
<tr>
<td>South Korea</td>
<td>50</td>
<td>6</td>
<td>49</td>
<td>6</td>
<td>45</td>
<td>7</td>
<td>49</td>
<td>6</td>
<td>49</td>
<td>7</td>
</tr>
<tr>
<td>China</td>
<td>44</td>
<td>8</td>
<td>45</td>
<td>8</td>
<td>49</td>
<td>6</td>
<td>45</td>
<td>7</td>
<td>45</td>
<td>8</td>
</tr>
<tr>
<td>Philippines</td>
<td>46</td>
<td>7</td>
<td>41</td>
<td>9</td>
<td>37</td>
<td>9</td>
<td>40</td>
<td>8</td>
<td>41</td>
<td>9</td>
</tr>
<tr>
<td>Indonesia</td>
<td>37</td>
<td>9</td>
<td>37</td>
<td>10</td>
<td>40</td>
<td>8</td>
<td>37</td>
<td>9</td>
<td>39</td>
<td>10</td>
</tr>
</tbody>
</table>


In order to review the development of Indonesian’s corporate governance for more details, Table 1.2 reports the results of CLSA-ACGA’s survey based on the categories surveyed.

Table 1.2 Indonesian’s Corporate Governance Score Based on Categories Surveyed

<table>
<thead>
<tr>
<th>Tahun</th>
<th>CG Rules &amp; Practice</th>
<th>Enforcement</th>
<th>Political &amp; Regulatory</th>
<th>IGAAP*</th>
<th>CG Culture</th>
<th>Total Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>39</td>
<td>22</td>
<td>35</td>
<td>65</td>
<td>25</td>
<td>37</td>
</tr>
<tr>
<td>2010</td>
<td>39</td>
<td>28</td>
<td>33</td>
<td>67</td>
<td>32</td>
<td>40</td>
</tr>
<tr>
<td>2012</td>
<td>35</td>
<td>22</td>
<td>33</td>
<td>62</td>
<td>33</td>
<td>37</td>
</tr>
<tr>
<td>2014</td>
<td>34</td>
<td>24</td>
<td>44</td>
<td>62</td>
<td>32</td>
<td>39</td>
</tr>
</tbody>
</table>

Note: *IGAAP stands for International Generally Accepted Accounting Principles and CG stands for Corporate Governance