



## The normative gap in interest capitalization on non-performing loans: International law standards versus Indonesian national regulation

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### Abstract

The capitalization of unpaid interest on non-performing loans (NPLs) remains a contentious practice in global banking, particularly in emerging economies where debtor vulnerability intersects with creditor recovery objectives. While international financial governance increasingly emphasizes debt sustainability, proportionality, and consumer protection, Indonesian regulatory practice continues to permit relatively unrestricted post-default interest capitalization under fragmented legal frameworks. This article examines the normative and operational gap between emerging international law standards and Indonesian national regulation governing interest capitalization on NPLs. Employing a doctrinal and comparative methodology, the study analyzes soft law instruments, prudential banking standards, and consumer protection guidelines at the international level, juxtaposing them against Indonesian civil law, banking legislation, and Otoritas Jasa Keuangan (OJK) regulations. The findings reveal a structural misalignment: international norms increasingly restrict abusive compounding, mandate transparent workout mechanisms, and prioritize financial rehabilitation, whereas Indonesian law lacks explicit caps on post-default capitalization, relies heavily on contractual freedom, and exhibits enforcement gaps in debtor protection. The article concludes with recommendations for regulatory harmonization, including the adoption of proportionality caps, standardized NPL restructuring frameworks, and alignment with international debt sustainability principles to enhance financial stability and equitable credit markets.

**Keywords:** Interest capitalization, non-performing loans, international financial law, Indonesian banking regulation, debt sustainability, consumer protection, OJK, prudential standards

### Introduction

The global resurgence of non-performing loans (NPLs) following macroeconomic shocks, supply chain disruptions, and monetary tightening has renewed scrutiny over post-default debt management practices. Among the most debated mechanisms is the capitalization of unpaid interest, wherein accrued but unpaid interest is added to the principal balance, subsequently generating additional interest. While commercially rational from a creditor's risk-recovery perspective, this practice can precipitate debt spirals, undermine borrower rehabilitation, and amplify systemic financial risks.

In Indonesia, the banking sector's treatment of NPLs remains largely governed by contractual freedom, supplemented by Otoritas Jasa Keuangan (OJK) guidelines that permit interest capitalization under certain restructuring conditions. However, Indonesian law lacks explicit statutory limits on post-default compounding, creating regulatory ambiguity that banks often exploit to maximize recovery. Conversely, the international financial governance landscape has progressively advanced normative standards emphasizing proportionality, transparency, and debt sustainability. Although no binding multilateral treaty directly regulates interest capitalization on private NPLs, a coherent framework has emerged through soft law instruments, prudential banking standards, and consumer protection guidelines.

This article addresses the following research question:

\*How does Indonesian national regulation and practice regarding interest capitalization on NPLs align or diverge from international law standards, and what normative gaps

emerge from this comparison?\* Utilizing a doctrinal legal analysis and comparative regulatory review, the study identifies structural misalignments, evaluates their implications for financial stability and debtor rights, and proposes pathways for harmonization. The article proceeds by outlining the theoretical and regulatory frameworks, analyzing international and Indonesian approaches, identifying the normative and operational gaps, and concluding with policy recommendations.

### Theoretical and Regulatory Framework

#### a. International Law and Soft Law Standards

International law does not contain a binding treaty specifically governing interest capitalization on NPLs. Nevertheless, a cohesive normative architecture has developed through financial regulatory standards, UN principles, and comparative commercial law instruments. These frameworks collectively establish expectations of fairness, transparency, and systemic prudence.

**1. Prudential Banking Standards:** The Basel Committee on Banking Supervision (BCBS) has consistently emphasized the prudential treatment of NPLs to prevent balance sheet deterioration and moral hazard. The BCBS Prudential Treatment of Non-Performing Exposures (2023) urges supervisors to ensure that NPL workout practices do not exacerbate borrower distress or distort risk pricing. While not explicitly prohibiting interest capitalization, the framework implicitly discourages practices that undermine debt sustainability or inflate non-recoverable exposures.

2. **Debt Sustainability and Responsible Lending Norms:** The United Nations Conference on Trade and Development (UNCTAD) Principles on Responsible Lending and Borrowing (2024 revision) and the OECD Guidelines on Financial Consumer Protection (2022) articulate that post-default interest mechanisms must be proportionate, transparent, and non-predatory. These instruments emphasize that capitalizing interest on NPLs without caps or disclosure violates the principle of good faith and may contravene emerging norms on financial human rights.
3. **Commercial Contract Principles:** The UNIDROIT Principles of International Commercial Contracts (2023 Edition) Article 7.4.4 acknowledges that interest on overdue payments may be compounded only if expressly agreed and reasonable. The ICC's Uniform Rules for Debt Restructuring (2021) further recommend that compounding during default phases be suspended or capped to facilitate rehabilitation. Though soft law, these principles reflect widely accepted comparative standards influencing national reforms.

Collectively, international standards converge on three normative expectations: (i) post-default interest capitalization must be contractually explicit and proportionate; (ii) it must not undermine debt sustainability or trigger abusive compounding; and (iii) regulatory frameworks must prioritize transparent workout mechanisms and consumer protection.

#### b. Indonesian National Legal Framework

Indonesian regulation of interest capitalization on NPLs is dispersed across civil law, banking legislation, and financial sector regulations.

1. **Civil Code (KUHPerdata):** Articles 1765–1767 regulate interest and prohibit compound interest unless explicitly agreed. Article 1253 further states that interest cannot exceed legal limits set by regulation. However, the Civil Code predates modern banking practices and lacks specific provisions addressing post-default capitalization on NPLs, leaving courts to interpret contractual clauses on a case-by-case basis.
2. **Banking Law:** Law No. 7 of 2023 amending Law No. 10 of 1998 on Banking strengthens prudential supervision and consumer protection but does not explicitly restrict interest capitalization. Instead, it delegates detailed NPL management to OJK regulations, emphasizing risk-based provisioning and restructuring flexibility.
3. **OJK Regulations:**
  - POJK No. 40/POJK.03/2019 on Asset Quality and NPL Classification permits banks to restructure NPLs, including capitalizing unpaid interest under agreed terms, provided provisioning requirements are met.
  - Recent OJK circulars (2023–2025) encourage voluntary NPL resolution but stop short of prohibiting compounding during default, reflecting a creditor-recovery orientation.

Indonesian jurisprudence, including Constitutional Court Decision No. 2899 K/Pdt/1994 has affirmed that “Status Quo” in recovery permanent credit loss, and No. 58/PUU-XIII/2015, has affirmed that interest rates must be

reasonable and non-usurious, yet courts have consistently upheld capitalization clauses if contractually stipulated before.

#### The Practice of Interest Capitalization on NPLs

In practice, Indonesian banks routinely capitalize unpaid interest on NPLs during restructuring or moratorium periods. This is justified under OJK's allowance for “rescheduling” and “restructuring,” where capitalized interest is treated as a new principal component for provisioning and collateral valuation purposes. The absence of statutory caps enables banks to apply compounding at contractual or penalty rates, often exceeding the original loan's effective interest rate.

Internationally, jurisdictions such as the European Union (via the Mortgage Credit Directive and national consumer credit laws) and the United States (via CFPB guidelines and state usury laws) impose explicit restrictions on post-default compounding, require transparent disclosure, and mandate cooling-off periods before capitalization. The UNCTAD Debt Workout Framework (2023) further recommends that sovereign and private debt restructuring suspend interest capitalization during negotiation phases to prevent debt traps.

The operational divergence is evident: while international practice increasingly treats post-default capitalization as a last-resort mechanism subject to supervisory approval and proportionality tests, Indonesian practice treats it as a standard contractual right, exercisable at bank discretion with minimal regulatory friction.

#### Identifying the Normative and Operational Gap

The gap between international standards and Indonesian regulation manifests across four dimensions:

1. **Normative Misalignment:** International norms increasingly recognize unchecked interest capitalization on NPLs as incompatible with debt sustainability and consumer protection principles. Indonesian law, however, remains anchored in contractual freedom and creditor primacy, with no statutory prohibition or proportionality test for post-default compounding.
2. **Procedural Deficits:** International frameworks mandate structured NPL workout procedures, independent valuation, and debtor participation. Indonesia lacks a unified retail/SME insolvency or restructuring law, leaving NPL resolution to bilateral negotiations where power asymmetries favor banks.
3. **Transparency and Disclosure Gaps:** OECD and UNCTAD standards require explicit disclosure of capitalization mechanics, effective interest rates post-default, and alternative restructuring options. OJK guidelines mandate general transparency but do not enforce standardized disclosure templates or independent advisory requirements for distressed borrowers.
4. **Systemic Risk Implications:** Unrestricted capitalization inflates NPL valuations, delays recognition of losses, and complicates asset sales or securitization. This contradicts BCBS objectives of timely NPL resolution and accurate risk pricing, potentially undermining financial stability during economic downturns.

The gap is not merely technical but structural: Indonesian regulation prioritizes short-term creditor recovery, while international standards emphasize long-term debt sustainability, market integrity, and equitable financial governance.

### Comparative Analysis and Jurisprudential Implications

Comparative review reveals a global trend toward regulating post-default interest mechanisms. The EU's Consumer Credit Directive (2023 amendment) caps post-default interest at 150% of the original rate and prohibits compounding beyond 12 months of default. Japan's Financial Services Agency guidelines suspend compounding during supervised restructuring. Indonesia's approach remains outlier among G20 peers in permitting unrestricted capitalization absent explicit regulatory caps.

Jurisprudentially, Indonesian courts continue to uphold capitalization clauses under Article 1338 of the Civil Code (freedom of contract), rarely invoking proportionality or good faith doctrines to limit abusive post-default compounding. This contrasts with jurisdictions where constitutional courts or financial tribunals have invalidated excessive capitalization as violating economic rights or consumer protection statutes.

The normative gap thus reflects a deeper institutional asymmetry: Indonesia's financial regulatory architecture has not yet internalized the emerging international consensus that NPL management must balance creditor recovery with debtor rehabilitation and systemic prudence.

### Recommendations and Conclusion

To bridge the identified gap, Indonesia should undertake targeted regulatory reforms aligned with international standards:

- 1. Introduce Proportionality Caps:** OJK should issue binding regulations capping post-default interest capitalization, aligning with UNCTAD/OECD principles of reasonableness and non-predatory lending.
- 2. Mandate Structured Workout Procedures:** Develop a national NPL resolution framework requiring independent valuation, debtor consultation, and supervised capitalization approvals for retail and SME loans.
- 3. Enhance Transparency Requirements:** Standardize disclosure templates for post-default interest mechanics, effective rates, and restructuring alternatives, consistent with OECD consumer protection guidelines.
- 4. Judicial and Doctrinal Alignment:** Encourage courts to apply good faith and proportionality principles from the Civil Code and UNIDROIT standards to invalidate abusive capitalization clauses.
- 5. International Harmonization:** Engage with BCBS, UNCTAD, and ASEAN financial regulators to adopt a regional NPL management standard that incorporates caps on post-default compounding and promotes debt sustainability.

### Conclusion

The practice of interest capitalization on NPLs sits at the intersection of creditor rights, debtor protection, and financial stability. While Indonesian regulation currently permits broad capitalization under contractual freedom, international law standards increasingly constrain such practices through proportionality, transparency, and debt

sustainability norms. The resulting gap undermines equitable credit markets and exposes the financial system to systemic risks. Regulatory harmonization is not only legally feasible but economically imperative. By aligning national frameworks with emerging international standards, Indonesia can foster a more resilient, transparent, and equitable banking sector capable of balancing recovery with rehabilitation.

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