Burhanuddin Abdullah: Progressing towards a sound, strong banking system for promoting development

Address by Mr Burhanuddin Abdullah, Governor of Bank Indonesia, at the 2005 Bankers' Dinner, Jakarta, 14 January 2005.

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Fellow Bankers in Indonesia,
Senior colleagues at Bank Indonesia, distinguished guests, ladies and gentlemen

Assalamu'alaikum wr.wb,
Good evening, and greetings to you all,

I. Introduction

At the outset, let us first of all express our gratitude to God Almighty that we are still able to gather here this evening in good health to attend the Annual Bankers' Dinner for the year 2005. For us in the banking community, it has been our tradition to gather together for a moment of reflection and communication among us.

Furthermore, on this occasion, allow me, on behalf of the Board of Governors of Bank Indonesia to extend to you our very best wishes for the Year 2005.

Ladies and Gentlemen,

The year 2004 has just ended. As we reflect on the year 2004, we can say that it was a year that was full of events that had meaning. It was a year full of accomplishments but also a year full of challenge. Perhaps we can say that 2004 was a year where we experienced the peak of political transition and in the process we have successfully conducted the general election in a democratic, peaceful, honest, and fair manner. It was a year where our society has succeeded to recompose itself in an accelerated fashion so that our social life can function in more tranquility. We can also note that the year 2004 was also the year where we achieved macroeconomic stability which would provide a stronger basis on which to base the growth of our economy. Exports and investment are beginning to show signs of vitality in order enabling a more broad-based growth to take place. In our external relations, we can also note that the year 2004 was the year that we have regained our place and our role as member of the international community. We have shown we have achieved maturity as a nation and as a democratic society. We have also shown that we are able to deal with the problems we faced in our own way and with our own program. In short, the year 2004 was a year where we are beginning again to show our own identity as a nation and our determination to stand on our own two feet.

With the record achieved in the year 2004 it was natural for us to look to the year 2005 with optimism. However, as we approach the end of the year 2004 a series of serious natural disasters had also occurred that overshadowed the record of accomplishments we achieved. The earthquake in Nabire on the Eastern end of our country and the Tsunami disaster in Aceh and North Sumatera on the Western end of the country had shocked all of us. We have been deeply saddened by the news of the disaster where more than one hundred thousands of lives had been lost as well as property and infrastructure.

In the face of the tragic losses of lives and property I wish to extend my deepest sense of gratitude for the concern and commitment that have been shown by the banking community to help our brethrens in Aceh and Sumatera who suffered from the calamities. Assistance for disaster relief from the banking community coordinated by Bank Indonesia has so far reached Rp. 67.8 billion. I also wish to extend my deepest appreciation to those in the banking community who institutionally or individually have organized the relief efforts on their own, and to who had even delivered the assistance directly on the location in the disaster areas.

Moreover, may I also take this opportunity to express my great appreciation for the strong commitment of the banking community to restore economic activities in Aceh. In my visit together with the group of the Coordinating Minister last week, I am gratified to note that all banks that have had operation in Aceh have again resumed their normal operation.

It is also with great sadness to learn that more than 170 bank employees in Aceh have been reported to have died or are missing in the disaster. More than 120 bank offices have been seriously damaged in Aceh. Under such conditions it is heartening to learn that banks have begun their operation on January 3, 2005, one week after the disaster occurred. Bank clearing operation had resumed on January 5 2005. Thus the payments of salaries to civil servants in Aceh have been made according to the normal process prevailing in the rest of the economy. Up to today, it has been reported that of the 13 banks operating in Aceh, 7 have resumed their operation in their premises, 2 in a newly-rented premises, and 4 operating in premises made available by Bank Indonesia.

Distinguished guests, fellow officials from Bank Indonesia, ladies and gentlemen,

II. Theme: strengthening the banking industry

The theme I have chosen for my address this evening is “Progressing Towards a Sound, Strong Banking System for Promoting Development.” This theme has been deliberately chosen based on the facts and urgency of future developments that challenge us to resolve fundamental problems pertaining to the lifeblood of the industry. In recent years, various efforts have been targeted with emphasis on maintaining macroeconomic stability, with Bank Indonesia’s attention drawn more towards resolving economic and monetary issues. Macroeconomic stability, as I frequently explained last year, is an element of continuity, a matter of essentiality for any economy seeking to progress.

In this regard, we are thankful that in the midst of a multiplied challenges and tests, we have succeeded in building and sustaining macroeconomic stability. The rupiah has been maintained at an encouraging level, despite coming under pressure around mid-year, and the inflation rate is under relative control at a low 6.4%, with the domestic economy growing at about 5%.

With the support of this macroeconomic stability and the fundamental understanding that higher levels of economic growth would require a strong and efficient banking industry, we launched the Indonesian Banking Architecture (API) at the beginning of 2004. This master plan for the future of the banking industry received enthusiastic comments from many quarters. Suggestions, input, and criticisms came from various parties with a concern and interest in our banking industry. All are aware that banking is a key if not the most important industry in turning the wheels of the economy. From that time forth, we have been buoyed with confidence in the ability of our banking industry to proceed with consolidation and institution building by laying down the foundations that will set the course for the banking industry.

Having achieved macroeconomic stability, I envisage two important agenda for 2005. The first is to maintain this stability with focus on sustainability, and the second is that it is time for us to devote greater attention to the systems and institutions in the banking industry in order to build strength and deliver results. The hard-won macroeconomic stability should not be frittered away because of the fragile condition of some banks that could endanger the stability of the system as a whole. On the other hand, the banking sector must be capable of building its strength and capacity so that it does not disrupt the stability that we have in hand and can deliver greater benefits to the public. To this end, banking policy in 2005 will be directed towards efforts to strengthen the banking industry with new measures to reinforce policy and concrete actions to accelerate the bank consolidation process.

The primary objective of consolidation in the banking sector is to strengthen the banking industry in the face of mounting future competition. It is this ability to face competition that will determine the ability of banks to meet the demands of the public. It is for this reason that Bank Indonesia in the period ahead will pay an increasingly serious attention toward banks which are unable to meet the requirements in the process of consolidation. Bank Indonesia will not hesitate to take a firm policy in order to ensure that the process will succeed.

Let it not be that one bad apple spoils the whole barrel. We must not allow the progress we have so far achieved to be endangered by the problem faced by only a handful of banks with problems. The growing momentum of improvements in the banking sector must be safeguarded and supported by continuing corrective efforts.

At our gathering this evening, I will present a number of policies that we will pursue throughout 2005 and in the medium to long term. These are specifically the policies that we will institute to accelerate the consolidation process in the banking industry, as I touched on earlier.

To elaborate and discuss the theme of my speech this evening, I will first explain the present macroeconomic conditions and outlook and the performance and prospects of the banking industry. This section will be followed by the views of Bank Indonesia on key problems and challenges confronting the industry in 2005 and the medium term. In this section, I will also present the various policies that we have developed and now expect to resolve the various problems and challenges and build the Indonesian banking industry as a sound, strong, and efficient banking industry, of benefit to the economy and society. In my closing remarks, I will attempt to present some conclusions by reiterating the key messages that I see as important and deserving of attention from us all. These are points that I expect to become the focus in our efforts to take the development of the banking industry to a new level in support of 7% economic growth in year 2008.

Distinguished guests, fellow bankers, ladies and gentlemen,

III. The macro environment of the banking industry

Before I deal with future policy issues on banking, I wish to take this opportunity to glance at the macro-economic factors that surround the operation of banks. If we examine the development of several key indicators since the crisis, we can note with some satisfaction that they have generally show improvements. Various stabilization efforts undertaken by the Government and Bank Indonesia in the monetary and fiscal fields as well as in bank restructuring have been achieved according to expectation.

Having achieved stability which we will continue to safeguard, we are now confident that the time has come to look ahead. After the initial focus of managing the immediate impact of the crisis had been undertaken, we had subsequently began to deal with the process of recovery by focusing on achieving and maintaining stability. Our next phase is to prepare for the longer-run policy requirement to generate the momentum for a higher and more sustained growth. This shift in the evolution of policy can be seen from phasing out of institutions that was directed at dealing with the immediate impact of the crisis. We have exited from the IMF program and the IBRA is now dissolved.

Improvements in macroeconomic and monetary situation have ushered a more favorable environment to the economy. Stable inflation and interest rates levels have helped the business sector to obtained cheaper funding through both banking system and the capital market. For the banking system, stable interest rates at the level that was relatively low reduces credit risk of banks and hence progressively facilitate extension of credit to real sector. For the public, gradually decreasing of the level of interest rates, increases their access to bank credits and led to the increase in consumption of durable goods. This in turn had a positive impact on the real sector as reflected in the increase of GDP by 5% during year 2004.

Improved macro-economic situation has a salutary impact on the real sector. Although so far growth has been spurt by consumption, it is gratifying to note that investment and exports are begining to show improvements. Growth has taken place across wide spectrum of sectors, with the highest contribution coming from the process industries, trading and transportation. The fact that growth has taken fairly evenly across sectors can also be seen by looking at expenditures when outlays for investments including investment credits have increased. In addition to the domestic factors that has contributed to growth, favorable external situation has also been helpful. The open global economy still provides opportunity for exports and prices of commodities of our interest have been improving.

As we enter 2005, we look forward to continued improvement in the Indonesian economy. I am optimistic that macroeconomic stability will be sustained throughout the years to come. The rupiah is set to remain stable with an appreciating trend, while inflation in overall terms will stay well under control despite some expected pressure. The rupiah is forecasted to hold stable while inflation is predicted to stay on track with the government-mandated inflation target of 6%-7%.

We predict that the Indonesian economy will grow in the range of 5.0%-6.0% while shifting to healthier balance in sources of growth. The year 2005 will be the year of infrastructure. The government commitment to promoting development projects with added value for the economy, such as toll roads, ports, telecommunications and transportation, and the rail network is a key factor sustaining our optimism for improvement in sources of economic growth and especially investment.

Alongside this, non oil-gas exports are predicted to maintain their heartening trend, consistent with the favorable conditions in the international economy, a competitive exchange rate for the Rupiah, and expanding access to international trade financing. Our estimation is that non oil-gas export will continue to be driven by primary products, such as coal, nickel, and rubber, and some manufacturing sectors such as electronics and the food and beverages industry.

Looking ahead, improvement in export performance will be contingent on none other than improvement in export competitiveness. Global imbalances that could potentially push China towards revaluation of the Yuan will indeed create new opportunities for Indonesian exports through substitution. However, given China's high productivity and low labor costs, we will be able to avail this opportunity only if we succeed making improvements in productivity and efficiency. The challenges in penetrating export markets will become significantly harder in 2005 with the elimination of textile export quotas, while so far, almost 60% of our textile and textile products have been sold to quota countries such as the United States and the European Union. With the abolition of quotas, China and India, the world's leading competitors in the textile industry, are predicted to control a 60% share of the global market.

Distinguished guests, fellow bankers, ladies and gentlemen

IV. Performance of the banking industry

Improved macroeconomic condition and stability and growing momentum in growth has had a positive impact on the banking sector. Extension of credits, which is the mainstay of banking activities has gradually increased and it has now reached a significant level. Moreover, what is even more gratifying is the increase in investment credits,which during the crisis had been lagging behind. It is reasonable to expect that bank intermediation will further improve in the years ahead.

On the more microeconomic side, the banking industries have achieved some significant progress in many fronts. A number of measures and programs for internal consolidation and restructuring which have been implemented since a few years ago have continued to show satisfactory progress. This can been seen from the strengthening in the capital structure of banks and from the reduction of credit risks as well as increase in profitability. The Capital adequacy ratio of banks [CAR] has arrived at a more satisfactory level, stabilizing at 20%. Problem credits has been under better control as shown by our figures on net non-performing loans (NPL) of 2.1% and gross non-performing loans of 6.7%. Lower NPLs improves profitability of bank. In fact, the banking industry enjoys one of the highest returns to capital.

Even more impressive is the progress achieved in syaria banking. Rapid growth in this segment of banking can be seen from the rapid increase in banks undertaking shariah banking, their total asset, as well as the amount financing being extended by shariah banks. It is appropriate to note with satisfaction that the intermediation function performed by shariah banks have been high where their FDR had reached 104%. This level of FRD has placed Indonesian shariah banks high in the ranks among shariah banks in any country in the world. This level of FDR is even higher than the level of conventional bank which only reached 50%.

However, with market share still around the 1% mark, sharia banking has not yet reached the point of providing a significant contribution to the economy. Nevertheless, with the record achieved so far shariah banks have demonstrated the viability of alternative financing to the public. However, with the brisk growth achieved in recent years, the sharia banking industry has vividly demonstrated its capacity to offer an alternative avenue for financing to the small and medium-sized enterprises (SMEs). Therefore, it would not be an exageration to anticipate that in the years to come the share of shariah banking will increase significantly, at least comparable to the share in other countries members of the Organization of Islamic Conference.

Looking ahead, it is envisaged that sustained macroeconomic stability will pave the way for the banking system to strengthen the bank intermediary function. This is expected to boost lending in 2005 by 20% or about Rp 106.2 trillion. With the continued overliquid condition of the banking system and the moderate 6% increase in deposit funds, this projected growth is seen as achievable.

Investment credit, which began to pick up in 2004, is predicted to expand further particularly as infrastructure projects get under way. As I mentioned earlier, the banking system can play a key-financing role in the Government plan to accelerate the construction of infrastructure. In this regard, I call on banks to keep a close watch on their funding structure and experience and capacity in project financing. In the consumer sector, credit expansion is predicted to remain strong and will be the first choice for private banks and foreign banks as more banks enter into cooperation with multifinance companies. In the property sector, banks need to exercise greater caution in lending because of the higher risk of default on loans for purchase of apartments and office premises.

In the SME and microenterprise sector, lending soared in 2004 and this trend can be expected to continue in the years to come. For many banks SMEs would remain one of the preferred areas for the allocation of credits. We need to respond positively to the initiative launched by the UN to declare this year as the International year of micro-credit to help SMEs. With the great potential that are available in the SMEs given banks the opportunity to perform their intermediation function.

To extend support to the SMEs, efforts need to be devoted to encourage the Peoples' Credit Bank (BPR), as the financial institution closest to SMEs in their operation, to enhance their capacity to deal with SMEs. The proximity of BPR to SMEs, both physically and "psychologically", is part of the strength of these banks that we will continue to build. Looking ahead at the next 1-3 years, Bank Indonesia will pursue measures to promote institutional and capacity building to enhance the capacity of BPR to perform this function and to assume the function of a community bank that would be the spearhead of micro-credit extension.

Going forward, the banking industry need to examine and develop innovations to assist the development of SMEs. These innovation could extend the scope of financing to SMEs and at the same time reduce the risks of extending credits to the sector. In this connection, it may be noted that since recent time, we have launched a pilot project in cooperation with local governments and ASKRINDO to explore the possibility of creating a guarantee scheme for credits extended to SMEs. It is our hope that the pilot project could be expanded to more regions if it proves to be effective to reduce the credit risk to SMEs that has hitherto represented a major obstacle to lending by the banking sector.

Distinguished guests, ladies and gentlemen

V. Problems and challenges

As I have mentioned, our goal is to develop a banking industry that would be strong and proactive in order to be able to support a sustained growth of our economy. In the years ahead despite the progress we have achieved, we are fully aware that we will continue to face a series of problems and challenges. Given the dynamic nature of the banking industry, it can only be expected that routine, technical, and operational issues will emerge from time to time as we move forward on our journey.

However, we will not be confronting only technical and operational issues. Our lives will *not* be that easy. The multidimensional crisis we have faced has left some deep scars at the level of the systems, institutions, and individuals. Segments in our society have blamed us, the banking industry, for the misfortunes that they have suffered arising from the crisis. At certain stage the banking industry had suffered a loss of public confidence. This highly abstract but fundamental factor that is central to the banking industry, trust, seemed for a while to have been uprooted from the core of the banking community. There was a feeling at some quarters in the public that the banking industry have failed to provide a sense of security. The reverse also took place. The trauma of debtors defaulting on their loan agreements similarly led to a loss of confidence in the banking system in their debtor customers.

Restoring this fundamental building block in the banking business is no easy task. Although we have in general achieved much progress, there are many more things that need to be done in order to regain the trust that had been undermined. We must take steps to regain some of the lost trust by taking steps from the most simple to the most sophisticated. Some the the major challenges we will continue to face and resolve are:

First, the problem of relying excessively on short-term fund leading to the predominance of short term credits

Although on the average in 2004 deposits experienced a modest increase, the composition of deposits have been dominated by those with maturity of 1 month. In the meantime, deposits with longer maturities have gradually declined. They have been subsequently placed in instruments issued by non bank financial institutions such as bonds and mutual funds.

With this composition of deposit funds, the banking system as a whole faces the problem of high volatility of funds. This in turn will hinder the banking system from placing funds in long-term investment financing. The present condition has encouraged banks to seek business in consumption credit or working capital credit carrying relatively short terms in order to avoid difficulties with mismatch between funding sources and placements.

Second, problems with information concerning the debtor soundness have eroded the confidence of the banking industry in the real sector, hampering the intermediary function

We must admit that despite the improvement in the intermediary function over the years, among conventional banks the function is still not operating as it should. This is indicated by the continued high risk premium charged by banks, resulting in the slow decline in lending rates and the tendency of banks to focus their efforts in credit expansion on existing debtors and short-term credit carrying relatively low credit risk. This problem stems primarily from lack of information on the soundness of debtors that would reduce the perception of risk in the banking system regarding prospective borrowers.

Within this context, the challenge is how to improve transparency and accuracy on flows of information on debtors/prospective borrowers and economic sectors with potential for lending. This also includes information on the policy direction in the real sector, how to build the understanding and capacity of banks in assessing risk, and how to improve legal certainty in the resolution of problem loans in order to reduce the negative impact of the cost of problem loans on the risk perceptions of banks.

On the other hand, banks must be able to understand the wide ranging technical aspects and the economic dynamics operating in the sectors where they intend to market their credits. Excessive concentration of credits in certain sector, in the long term will lead to market saturation, which in turn would increase the risk in extending credit to this sector. Accordingly, bank must be more proactive and constructive in providing opportunity of financing in sectors which are productive and which have not so far being touched optimally.

Third, the credibility of the banking system will be contingent on the ability of the banking industry to strengthen good corporate governance, including management of operational risk

During 2004, we witnessed a number of cases generally related to the inability of banks to manage operational risks, particularly in regard to fraud committed by bank owners and management. The incidence of fraud points to bad faith on the part of owners and managers who exploit their banks for dishonest personal gain. Failure on the part of individual banks, if allowed to continue, will undermine trust to the banking system.

Another matter of fundamental importance and calling for urgent attention is the issue of integrity at all levels, including bank employees. The issue of integrity does not stand in isolation, but comprises part of another, larger problem of the deteriorating credibility of the banking system.

In view of these facts, it is time for the focus of our attention to move up to the more advanced level of modern management of the banking industry, the application of good governance principles, and meticulous, scrupulous management of operational risk.

Fourth, implementation of deposit insurance scheme requires banks to strengthen market confidence

As I elaborated earlier, public confidence in the national banking industry at this time is not fully based on objective considerations. For the public, the Government blanket guarantee is a dominant factor in determining their opinion and confidence toward the banking system.

This condition cannot be allowed to persist. Beginning in 2005, the Government blanket guarantee will be phased out and replaced by the Deposit Insurance Agency (LPS). This changeover will place added responsibility on the banking industry to build and maintain public confidence. Without a high level of confidence, the public will quickly move funds from the less trusted banks to sounder banks with stronger capital resources.

To prevent this unhelpful phenomenon, the banking industry must be capable of proving that it exists as a secure, sound industry. In order to adequately functional in this environment, going forward banks soundness would be determined not only by its quantitative prudential indicators, but will be much wider to include a more qualitative assessment. Banks must be able to show their ability to strive in situation of fierce competition. In doing this, must be managed by professionals with high integrity who are able to govern between prudence and the management of risks on the one hand, and aggressiveness and creativity in developing new opportunities on the other hand. All transactions must be conducted quickly, promptly, and accurately by means of an extensive office network with optimum utilization of information technology. Banks ability to implement modernization and to adopt best practices must become a distinct feature of strategic management that has selling value and can always be transparently monitored by the public.

Conversely, banks that are unable to meet the expectation and aspiration of the public as described above would inevitably be abandoned by its customers. Failure to anticipate this means that the banks concerned will inexorably find difficulty in keeping up with normal business, suffer substantial loss or even deteriorating its soundness to the level that may endanger its existence.

Fifth, the banking industry is constantly challenged by competition from non-bank products, such as mutual funds, bonds, and insurance

As I have mentioned in our bankers' dinner last year, banks in 2004 would face an increasingly tight competition both among each other and competition arising from other financial institutions. If we compare the banking and non-banking industries, it is obvious that growth in non-bank instruments such as mutual funds has outpaced growth in bank products. Last year, the level of banks deposit has only increase slightly by 4.5% whereas net asset value of mutual funds increased by an impressive 40%. On the other hand, bank credits during 2004 grew only by 20% whereas the Jakarta Composite Index grew more rapidly, especially during the second half of the year, to close 44% higher at year end.

The higher return in bullish capital market is also a contributing to a tighter competition faced by banks in mobilizing deposit funds. On one hand, the rate of interest offered on bank funds is limited, being tied to movements in the blanket guarantee scheme rates. On the other hand, mutual funds that comprised of fixed income instruments can offer a fixed and significantly higher return as compared to any bank product. Return from investment in the stock exchange was even higher. Moreover, competition also stemmed from insurance company that also offer hybrids of insurance and investment services, known as unit links.

The highly active bonds market in the recent period is expected to escalate in the periods ahead. This in part is attributable to eminent issuance of new bonds by both the government as well as the private sectors in order to finance physical development. The volume of transaction in the bond market is expected to be relatively high would of course influence the decision of the public to place their funds in this instruments.

The increasing trend of types of financial instruments offered to public is expected to continue the period ahead. This condition in turn would have an impact in slowing the growth time deposit especially those deposits with maturity longer than 1 month. On the assumption that interest rates would remain relatively stable, it can be expected that the share of this product in the market would continue to decline while the mutual funds that are sold through banks will experience significant increase.

It is important to note the increasing role of banking industry in the growth of mutual funds. The extent of the involvement can be attributed to the close relationship between banks with security companies which issued mutual funds. The closeness of this relationship makes it difficult to distinguish between activities of banks from those of other financial institutions. This phenomenon in bank operation of the banking system and the coming strengthening of the regulatory framework for collateralized securities products linked to the banking system appear likely to take bank industry to a new dynamic that would lead toward a more universal characteristics of banking practices. In turn, however, this will aggravate the inherent risks in the banking system and lead to a wider contagious effect. This is because instability in the market for one type of product will quickly spread, affecting the overall stability of the banking industry.

It is logical to expect that strategic alliance would continue to develop, as the operation of financial institutions become more integrated and interrelated to one another. Nonetheless, our expectation is that the bank sector would be able to continue to be the driving force in development of these new products. This strategic function can operate directly and indirectly. Directly, banks can serve as the originator of such products. And indirectly, banks can act as selling agent, creditor to financial institutions or as owner of non bank financial institutions such as insurance and security companies.

Distinguished guests, fellow bankers, ladies and gentlemen

VI. Future policy direction

Within the banking industry, we have long been aware of these problems and challenges. Responding to this, we have worked together to map out actions and do what is necessary to ensure the sustainability of our banking system. Our desired objective is for the banking system to regain its place as a reliable, trusted industry capable of promoting national economic growth.

To accelerate this change and respond to the various problems and challenges that lie before us, we have formulated a number of policy directions for the banking system that we believe will set the course for the future dynamics of the national banking industry. These policy direction include the following:

First, accelerate the consolidation process in the banking industry

In the Indonesian Banking Architecture (API), Bank Indonesia has laid out a series of measures to build the soundness and strength of the national banking industry. Under this policy, the banking industry consolidation program is a key initiative that sets the course for the future of the national banking industry. Within the next 10-15 years, the national banking industry must become capable of serving as a sound, strong, and dynamic backbone to the economy and of delivering results. However, as I explained earlier, the present situation and challenges and an array of unexpected events in 2004 have compelled us to adopt a shorter time frame for consolidation of the banking industry.

In this regard, we must realize that to create a sound, robust, strong, and efficient banking industry, the industry consolidation will not be achieved without first going through a process of consolidation at the level of the individual bank. And, it is this process of individual consolidation that we must strive to complete in 2005. The picture is that an industry putting its house in order and striving for growth must first be sterilized of potential systemic risk that could arise from problems at individual banks.

Before the recent launching of the API, Bank Indonesia put together a range of scenarios for the consolidation program for the building of soundness and strengthening of the banking industry as a whole. These scenarios are:

- Market driven consolidation
- Directives consolidation
- Heavy-handed consolidation.

These scenarios are in essence of a sequence of action programs that are mutually complementary, should one of the scenarios earlier in the sequence prove ineffective and fail to deliver the desired results.

Taking into account the developments that have taken place since the introduction of the API in early 2004, Bank Indonesia is now readying itself to apply the second scenario in the consolidation program, which in essence is an acceleration of the consolidation program scenario set out in the API.

The accelerated consolidation cannot be postponed any longer. We all know that pain will continue to afflict us and will be difficult to heal if we persist in concealing a wound. The credo of intensifying competition will sooner or later open up any and every wound suffered by non-competitive banks. For us to restore soundness, we must open the wound and take serious action, including possible amputation. This is the analogy that underlies the thinking on why we must proceed with the consolidation of the banking industry at this time. The choice lies before us, to reduce problems to the minimum and deal with them as early as possible or wait until the condition becomes irreversible. The second choice is clearly undesirable, as it could potentially trigger instability in the overall system.

The consolidation scenario that we are considering for implementation in 2005 will begin with a process of identifying the medium and large banks that are currently in very sound shape and have adequate human resources to expand market share without sacrificing prudential banking principles. Our expectation is that these will become the *anchor banks* capable of stimulating a process of strengthening among other banks whose future ability to compete is reportedly constrained by a range of factors.

In conjunction with the process of determining these anchor banks, Bank Indonesia will also identify the banks that have or are thought to have lost competitiveness because of their inability to build stronger resources and especially capital. These banks will then be grouped with other banks in reasonably good condition but which lack competitiveness because of limited market share and are experiencing downward trends in both assets and deposit funds. Each group of banks will be offered three options: first, acquisition by an anchor bank; second, merger with other banks in the group; and third, a combination of merger between a number of banks and an anchor bank.

In the merger and acquisition process, identification of similarities in operations, market segment, ownership links, and business orientation of the two parties, both the acquiring bank and the bank to be taken over in the acquisition, are key aspects that should form the basis of any decisions taken. It is hoped that with a consolidation mechanism based on the objective condition of each individual bank, the stakeholders will be open and willing to see that the process will benefit all involved. The banking system will be significantly strengthened, because its actors are banks with optimum levels of resilience and competitiveness.

The first scenario for accelerated consolidation described above will naturally be reinforced by a variety of supportive measures, such as provision of incentives for acquisitions or mergers and the issuance of special regulations requiring banks meeting certain criteria to proceed immediately with consolidation. By adopting what are regarded as more concrete policy measures for consolidation, the hope is that the national banking industry will be made up of banks that possess the strong commitment and capacity to play an optimum role in the national development process. Bank Indonesia has taken steps to prepare for implementing this consolidation policy through a series of amendments to the Legal Lending Limit provisions, particularly in regard to restrictions on equity participation, and we will announce the new provisions in the near future.

Second, reorientation of the working mechanisms and procedures of the national banking industry to more effectively accommodate the needs of the national economy

Parallel with the process of institutional consolidations, banks are also required to revitalize their mode of operation. The process of allocating funds that is practiced by banks have been so far relatively passive. Decisions are not based on accurate research information concerning the sectors they are financing. In the years ahead, banks must be able to identified more clearly the various market niches they wish to operate in and must be proactive in seeking the potential clients in those sectors. The human resources in the bank cannot stand by idly, satisfied with their acquired formal education. They must be trained to understand the realities in the market in which they operate.

The banking system cannot keep operating only on a conventional basis. The advantage of having complete information on the condition of a certain business or industrial sector will ease the work of the banking system in carrying out its function. The perception of credit risk in the sector will decline and the competitive atmosphere will improve, because any financing activity undertaken by banks will be based on their strengths. The current phenomenon of disintermediation in the banking system will disappear because banks will no longer have doubts about the condition of a sector that it intends to finance. This revitalization process gained added validity when we all agreed that the SME and microenterprise sector would become the future of our future expansion. Financing in this sector literally demands an in-depth understanding for the potential and productivity of the sector to be developed to the full extent.

Third, take steps to strengthen the financial system infrastructure

A sound, efficient banking system requires adequate infrastructure. In this regard, it is essential to have an adequate financial safety net (FSN). To move towards the establishment of an adequate FSN, Bank Indonesia and the Government have jointly completed the formulation of the policy framework for the FSN that also encompasses the soon-to-be-established Deposit Insurance Agency (LPS). With the establishment of this agency, the responsibilities for management of the guarantee program and resolution of insolvent problem banks will be defined more clearly. To provide assurance of the maintenance of financial system stability in regard to the banking system, implementation of the LPS guarantee will be phased in so that deposit funds will ultimately be guaranteed only to a maximum of Rp 100 million.

In addition, Bank Indonesia has worked untiringly to promote the application of Good Corporate Governance (GCG) at all levels of bank management. Bank Indonesia is currently upgrading the provisions relevant to GCG in the banking system and the new GCG regulations pertaining to the functions of the board of commissioners and board of directors should be ready in the near future. At some point in the future, Bank Indonesia will also consider an intensive study of possibilities for changes to the regulations governing ownership of bank shares.

Because the implementation of GCG requires very strong cooperation and commitment from all parties involved in the banking industry, Bank Indonesia will facilitate the establishment of a banking GCG forum in the near future in cooperation with banking associations and the national committee for GCG. This forum is expected to discuss and set out a regular program for the issues related to governance in the banking system. In this context, I would like to emphasize once again that the responsibility for implementing GCG and management of operational risk does not rest solely with the Compliance Director. All line management and members of the Board of Commissioners must play their part in strengthening and upholding GCG.

In the coming year we must also take stronger action against irresponsible parties who have besmirched our image. Prevention of acts of bad faith by bank owners and management clearly requires coordination and cooperation from parties on many sides. I call on all members of the banking system to be critically vigilant of the practices going on within our community, and also provide input and support for the introduction of adequate legal instruments and stronger law enforcement. We are Bank Indonesia have and will continue to build networks of coordination and cooperation with all concerned, ranging from the banks themselves, associations, and other authorities including law enforcement agencies to work systematically and persistently to bring certainty of law enforcement into banking governance in Indonesia. Bank Indonesia is currently working with the Ministry of Finance in drafting a Joint Decree to strengthen coordination between the two institutions for action against fraud possibly committed by banks and other financial institutions.

On the other hand, we all know that the banking system will also face mounting operational challenges in the future. Rapid advances in technology will increase the complexity of banking business and lead to the emergence of increasingly innovative products. However, as an industry that has just pulled out of crisis, we must recognize that the banking system faces major limitations in its ability to anticipate risks. For this reason, we need measures for planned and systematic improvement in the quality of risk management. Not long ago, Bank Indonesia issued regulations on risk management that apply to all commercial banks as a minimum standard that banks will soon be required to meet.

To build the quality and competence of banking personnel in risk management, Bank Indonesia has introduced the requirement for risk management certification for all levels of bank management. The certification program was launched in 2004 in a program for bank executives, and so far, a total of 252 commercial bank directors have completed their certification. The program will be continued in 2005 for commissioners and also all banking personnel whose work is relevant to the control and operation of risk management.

Furthermore, to strengthen the effectiveness of the bank intermediary function, supporting infrastructure is needed that will enable the lending process to operate more quickly and reduce the potential for problem loans. To this end, Bank Indonesia has initiated the establishment of the Credit Bureau set to commence operation in 2005. We have waited long for the Credit Bureau, and a great many have repeatedly asked me when this plan will come to fruition. We fully understand the urgent need of banks for this supporting infrastructure, not only to improve the quality of decision making, but also for increased quantity of lending. We have completed the various preparations and as an initial step to support the operation of the Credit Bureau, we will soon release the Bank Indonesia Regulation on the Debtor Information System. This regulation in essence requires banks to report information on all debtors, and this information will then be available to banks to support their lending needs.

Fourth, improving bank prudential aspects and intermediary function

In the next few days, as we promised not long ago, Bank Indonesia will issue the "Banking Policy Package" with 3 (three) key objectives that I can mention here:

***First**,* promote the operation of the intermediary function and consolidation of the banking system in productive business sectors, as reflected in the Bank Indonesia Regulations on the Legal Lending Limit, the Debtor Information System, and Asset Securitization;

***Second**,* promote efforts to build bank capacity in credit risk management, application of prudential principles, and sound banking practices that will ensure sustained financial system stability. This objective is clearly reflected in the regulations on Earning Assets Quality, Legal Lending Limit, Foreign Borrowings, and Asset Securitization;

***Third**,* measures to improve consumer protection through certainty in the application of standard, secure, and transparent banking services. This objective will be achieved through the issuance of Bank Indonesia Regulations relevant to consumer protection and transparency of banking products.

Distinguished guests, ladies and gentlemen

Fifth, position the national banking industry on a level playing field

It is naturally our hope that all of the policies, commitments, and measures to be pursued during 2005 will bring our banking industry to a condition that will encourage and comfort our hearts. I believe that it is the aspiration of us all for the Indonesian banking community to stand in par with other banking systems in the region. For this reason, we are working as quickly as possible to apply the best practices now established as international standards.

With this objective in mind and having held intensive discussions with the banking sector, Bank Indonesia envisages the application of the Basel II working framework as a medium term program that we must strive to achieve within a time frame of 3-5 years. Bank Indonesia plans to launch the application of the Basel II working framework for all commercial banks in 2008. This working framework will be phased in, beginning with the most simple approaches. The policy is expected to influence the behavior of banks in risk management. It is also based on the consideration that the Indonesian banking system, and especially the big banks, have become part of the international banking community, and therefore the application of Basel II can no longer be regarded as merely an option.

We believe that the application of the Basel II framework will strengthen the resilience and stability of the banking system and promote better risk management practices. In practice, the application of Basel II framework calls for thorough preparations by Bank Indonesia, the banking industry, and other stakeholders. The scale of comprehensive preparations encompasses effective risk management practices, competent human resources, adequate information technology and databases, and other supporting infrastructure such as accounting standards based on International Accounting Standards (IAS) and credible rating agencies.

In view of the scope of all that we will be required to do, it is clear that we face an array of daunting tasks. To this end, over the next 3 years Bank Indonesia will work on the development and implementation of action plans so that each of the crucial agenda that must be undertaken by us all, including Bank Indonesia, the banking system, and other stakeholders, will be focused and directed towards efforts to comply with all the criteria and conditions required under Basel II.

Then, having put into place all the prerequisite conditions, we can look forward to having a banking industry at the end of 2010 that will be fully capable of applying best practices and most importantly Basel II.

In this process, Bank Indonesia will strive to play a proactive role that is nevertheless proportionate to our mandate. We are strongly committed to continued facilitation of the various needs of the national banking system in response to the problems and challenges that we face in the future. We will keep working to synchronize our banking sector programs with the process of building the resilience and competitiveness of the business sector. Our studies and research will be guided to respond effectively to various problems and challenges. We will make further improvements to the quality of the regulatory framework so that the dynamics of the banking industry will keep moving on the desired course. Our supervisory actions will be more proactive to prevent problems, but will also be given stronger teeth to deal with problems that arise in order to safeguard the resilience and stability of the system.

VII. Summary and conclusion

We are of course aware of the limitations in undertaking the challenging tasks I have described this evening. That is we in Bank Indonesia are grateful for the support that we have enjoyed from many parties. Indeed, a strong and healthy banking industry is an objective that concerns not only the monetary authority. This aspiration is also shared by the general public, investors and owners and managers of banks. Therefore, ultimately a healthy, strong and proactive banking system is in the interest of all in the society.

The various actions, policies, and issues that provide the context as I explained earlier will also inform the recommendations put forward by Bank Indonesia for the drafting of the Amendment to the Banking

Law, likely to be passed in 2005. To ensure that we all have ownership in this Banking Law, the involvement of all members of the banking community in the drafting process will be essential. I will be looking forward to the contributions and criticisms from the banking industry regarding the draft law that is of such importance to us all.

I am deeply gratified that the Government, and in particular, the President of the Republic, has given us full support in the endeavors we are undertaking in Bank Indonesia to strengthen the banking industry. In our meeting with the President, the President had stated that Bank Indonesia should not leave any room for bankers or banks to the disturb the stability of the economy. I am equally gratified to see that members of the banking community have expressed the spirit and intention, as stated in our meetings with Perbanas recently to give stern warning to those bankers for conducts which do not adhere to the principle of prudence and who have violated principles of good corporate governance in at the expense of the broader interest of the banking industry and the public.

As I have mentioned earlier, we have so far achieved significant progress in putting in place the foundation for economic stability and financial system more in line with challenges in the years ahead. However we are also aware that in our path toward achieving the objective of a more satisfactory financial and banking sector requires time. We are entering a crucial period in the process of transition toward a better future of banking system. The process of consolidating the national banking industry is an objective that we cannot compromise if the stability and resilience that we desire for the banking system is to be achieved.

We must all take note, first of all that the coming years will be no time for complacency. Before us lies only one choice, to work hard to fulfill the commitments and sincere intentions to restructure whatever needs to be put right. We should no longer feel comfortable watching as the various problems unfold within our banking industry. In fact, we as the banking authority see that much remains for us to do to be able to meet this demand.

The second point is that in the future, the public will become more discerning and cautious in the selection of banks capable of serving their transaction needs. They will only be willing to deal with banks that provide a sense of security while also offering returns on the funds entrusted to their keeping. They will also select only those banks that understand their needs and are able to provide a wide range of conveniences in their services. These are the criteria that indeed will build and strengthen public confidence.

Much work remains to be done. We must do so systematically with clear design. The years ahead will not be without challenges, in fact we will face many more challenges than today. The days ahead will full of struggle but also full of hope. May God almighty gives us the strength and the resolve in our work to achieve a brighter future. Thank you.