The Indonesian banking industry: competition, consolidation and systemic stability

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1. Introduction

A banking crisis occurred in Indonesia following the persistent depreciation of the Indonesian rupiah (IDR) from mid-1997. A number of banks experienced illiquidity and insolvency during the crisis due to a lack of public confidence in the banking system that forced Bank Indonesia (BI) to bail out several systemically important banks. To restore the solvency and the stability of the banking system, the government embarked on a restructuring programme in 1998. However, the government only recapitalised and restructured viable banks. As a consequence, several banks were frozen out of operation or closed in 1998-99 to prevent the financial system and the economy from further disruption.

The restructuring programme has involved:

- the injection of government capital into viable banks through the issuance of recap bonds;
- the introduction of a blanket guarantee;
- the establishment of the Indonesian Bank Restructuring Agency (IBRA);
- corporate restructuring;
- improvement of corporate governance; and
- bringing supervisory and regulatory practices closer to international standards.

The government also encouraged the merger of several small banks into a stronger bank in 2000 and that of four state banks into a new large bank - Bank Mandiri - in 1999. Bank Mandiri is now the largest bank in Indonesia with total assets of IDR 290 trillion (29% of the market) in Indonesia in August 2000. This consolidation strategy, as well as the closure of frozen banks, significantly reduced the number of banks from 241 in 1997 to 153 in October 2000. Nevertheless, the present banking industry remains vulnerable, such that strengthening of the restructuring programme is of the utmost importance.

This paper analyses the dynamics of competition, and consolidation of the Indonesian banking industry before, during and after the crisis, as a basis for policy recommendations. It is organised as follows: Section 2 outlines the forces for change in the Indonesian banking industry after the crisis; Section 3 examines the privatisation of state banks; Section 4 discusses domestic mergers between local banks; Section 5 analyses the role of foreign banks; Section 6 discusses systemic stability in the banking industry; and Section 7 provides a summary and conclusion.

2. The forces for change

The weaknesses in the banking sector could be identified long before the crisis occurred. This section tries to explore the crucial aspects of the banking industry in the period prior to, and after, the crisis. The findings of this discussion will be used as a basis for improving the stability of the banking system in the future.

2.1 History of the banking crisis

The weaknesses that might have led to the banking crisis had been recognised from the late 1980s to the early 1990s. For the sake of a better overview of specific problems, the evolution of the banking industry may be split into three periods: 1970-83, 1983-88 and 1988-97. The periodisation itself can be attributed to the characteristics of banking business, which moved from a distressed financial situation resulting from heavy regulation and limitation, to a more “optimistic” atmosphere due to deregulatory measures adopted by the government.

In the period 1970-83, the economy benefited from the oil boom as the government budget relied heavily on the revenues from oil and gas. BI applied credit ceilings and interest rate controls, and limits on prefinancing credit to contain the inflationary pressures. Under the liquidity support scheme, banks obtained a certain margin of interest for credit extended to borrowers. This incentive, which was given only to state banks and selected private banks which met minimum criteria regarding soundness, became the motivation for banks to mobilise public funds.

In the period 1983-88, initiated by the fall in oil prices in the early 1980s, the government could no longer provide resources at subsidised interest rates. Hence it introduced a number of reform packages, including one covering monetary and banking policy in 1983. Under the June 1983 reform, the government decided to reduce the interest rate subsidies and prefinancing credit except for small and medium-sized enterprises, and simultaneously introduced discount window facilities, Bank Indonesia Certificates (SBI) and Money Market Commercial Paper (SBPU). The SBI was designed to absorb banks’ excess liquidity, while SBPU was to provide an instrument for money market operations and liquidity management for banks. The discount window was intended as a facility for banks to borrow funds from BI in case of liquidity mismatch. Such big changes necessitated banks adjusting to a new policy environment. Due to lack of expertise, in the initial phase, banks mostly relied on funds from the money market to finance their loans; therefore, banks’ profits were very sensitive to the volatility of interest rates.

In the period 1988-97, the government continued to roll out a series of reform packages. These were aimed at improving the effectiveness of banks as financial intermediaries and the stability of the banking system. In general, the reform packages covered the following areas:

- promoting fair competition among banks by allowing new entry, widening the network, reducing segmentation between state banks and private banks, and allowing more independence in decision-making;
- promoting more prudent regulation, such as the adoption of net open position limits, use of the Basel Capital Accord of 1988 to assess the adequacy of capital, and statutory lending limits;
- promoting the effectiveness of money market instruments; and
- shifting from relatively fixed to more floating interest and exchange rates.

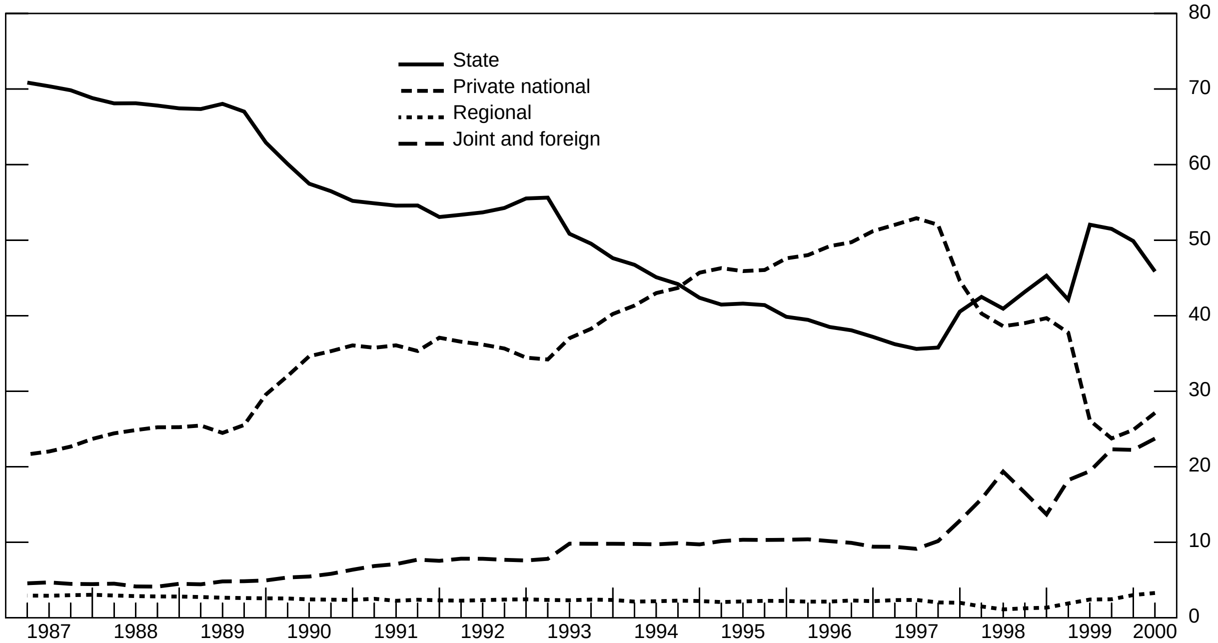
These reform packages were issued in October and December 1988, March 1989, and January 1990.

Prior to the adoption of this series of reform packages, the banking industry had been very restricted and the financial market, in general, depressed. Lifting the barriers to entry encouraged banks to mobilise deposits and hence reduce their reliance on the government. The dominance of state banks also began to decline due to, inter alia, the abolition of the guideline for state enterprises to place deposits with state banks and to borrow from them. Graph 1 shows the evolution of market shares of loans from 1980 to 1999.

After the implementation of those reform packages, applications for new bank licences were soaring, submitted mostly by groups of companies. In just two years, BI granted 73 licences for new commercial banks and 301 for new branches. The rapid growth of banks and branches encouraged banks to be more aggressive in tapping the deposit market, without a clear view of to whom they would lend. Private banks intentionally started to lend their money extensively to related companies without sound credit analysis. These practices led to a high level of non-performing loans (NPLs), which was the root of the worst banking crisis in Indonesian history. The following sub-sections discuss the key issues facing Indonesian banking before the crisis.

Graph 1

Share of loans



Sources: Bank Indonesia annual reports, various issues.

Problem loans

Problem loans had been quite worrisome for many years prior to the crisis. Lack of credit analysis was the main problem for state banks because most of the credit policies were intervened by the government and/or top government officials. NPLs within private banks were normally related to loans within the group, violating the statutory lending limit, which was only minimally enforced by a dependent central bank (the Governor of BI was a member of the cabinet).

In February 1993, Booz Allen & Hamilton forecast that the problem loans of Indonesian banks would be around 5 to 20% of total outstanding credits. The problem loans, which increased gradually from 6% in 1990 to 11% in 1991 and 17% in 1992, were the main sources of bank failure in the 1990s. Annex 1 shows the growth of NPLs from January 1995 to December 1999.

Banking regulation and supervision

Under the existing regulations, the authorities have experienced difficulties in detecting problem banks at an early stage. In our view, banking regulation in Indonesia needs further improvements.

First, risk-based capital requirements, which rely solely on credit risk, fail to assess the true risk borne by banks. Theoretically, bank risks comprise not only credit risk, but also interest rate risk, foreign exchange risk and other risks. Therefore, there is a clear danger of banks failing to pay due regard to those risks not covered in the capital requirements.

Second, BI adopted the "gross approach" to these capital regulations, incorporating the portion of loans which have been covered by provisions for expected losses in the calculation of risk-weighted assets. This approach may discourage banks from monitoring their loans as good-quality loans attract the same risk weights as bad loans in the assessment. The gross system was replaced by a net system in June 2000.

Third, the risk assessment methodology fails to capture the actual performance of management. While other criticisms may be levelled against the BIS proposal (BIS, 1988), we have identified some weaknesses in the current capital adequacy regulations. Therefore, banking regulation in Indonesia calls for further improvement. Nasution (1998) criticised the October 1998 reform for requiring strong legal and accounting systems, which could not be established promptly. Disclosure was poor due to weak implementation of accounting standards. It was reasonable to suspect there were loopholes for bribery and corruption. The government could easily be tempted to intervene in the selection process of lending.

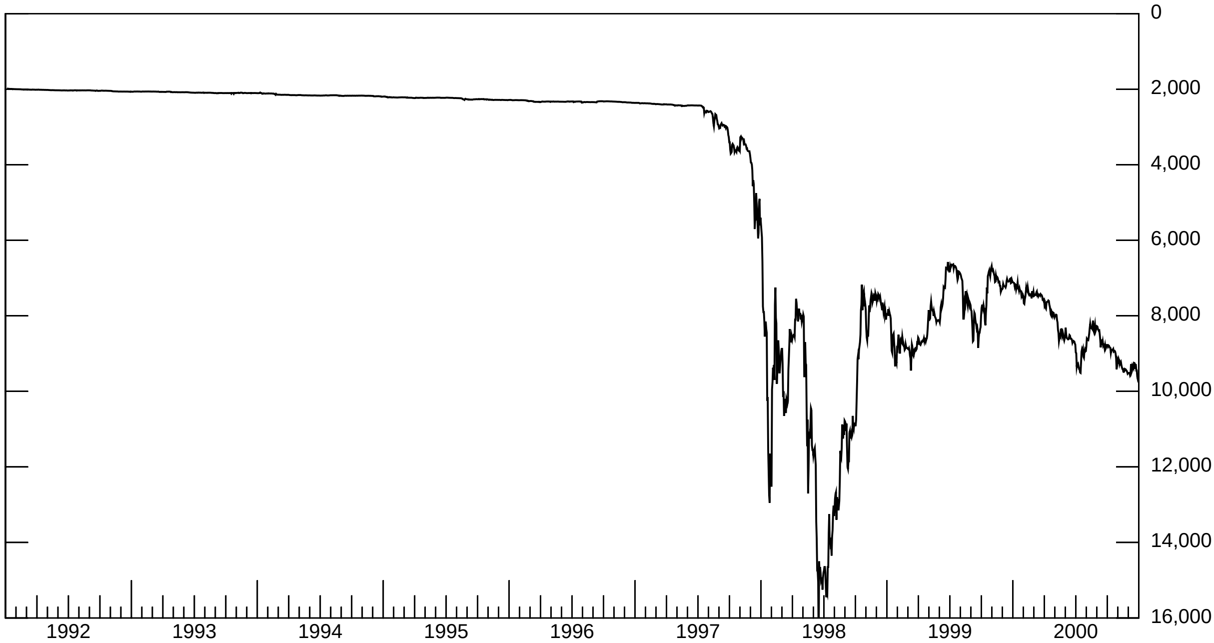
As we have already mentioned, the rapid growth in the number of banks' offices, together with their exposures, on the one hand, and the shortage of professional managers and weaknesses in bank supervision, on the other, were the factors contributing to the banking crisis. In fact, a number of banks had suffered financial problems before the crisis.

Exchange rate environment

The crisis in 1997-98 caused a sharp fall in banks' capital as a consequence of huge losses. The banking crisis in 1997 was triggered by the persistent fall in the IDR exchange rate from July 1997. The USD/IDR exchange rate dropped from IDR 2,450 per USD in July 1997 to IDR 11,000 in March 1998. In response, BI initially widened the spread of its intervention band (ie the difference between BI's buying and selling rate) from 8% to 12% to curb speculation on the IDR. However, this strategy was no longer adequate and finally BI abandoned the band in August 1997. See the plot of the IDR/USD exchange rate in Graph 2 below.

Graph 2

Exchange rate: rupiah per US dollar



Source: Bloomberg.

The managed floating exchange rate policy was an implicit guarantee given to the market by the government. From time to time, the government publicly announced the USD/IDR rate that it envisioned. The players, therefore, could make an accurate estimate of the exchange rate for the forthcoming period. Given this exchange rate policy, market participants prefer borrowing funds from overseas without hedging. However, when the government was unable to maintain the intervention band, the exchange rate plunged and the players, including banks, suffered huge losses.

The exchange rate turmoil negatively affected the weak banks, which had suffered financial problems even before the crisis. Consequently, the government revoked the licences of 16 private national banks on 1 November 1997, and closed seven banks in April 1998 and 38 in March 1999. The level of NPLs reflected the worsening of banks' performance during 1995-99, as shown in Annex 1.

2.2 The structure and the regulatory and supervisory frameworks of the banking system

To address the banking crisis, the government in 1999 introduced the banking restructuring programme, which led to considerable changes in the banking industry in Indonesia.

The Government also formed the Indonesian Bank Restructuring Agency (IBRA) at the end of January 1998 to: (i) verify customer claims under the blanket guarantee scheme; (ii) dispose of assets from banks taken over; (iii) restructure and sell loans transferred from banks; and (iv) divest ownership of recapitalised banks.

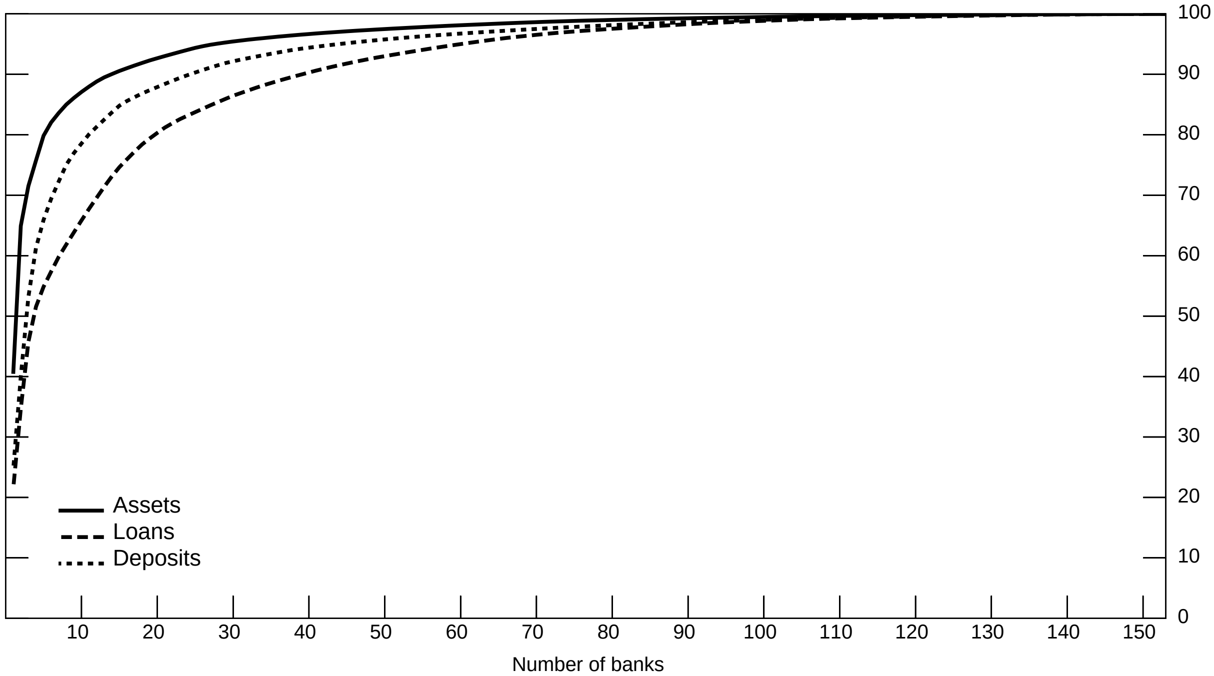
The following discussion shows the current structure and the regulatory and supervisory frameworks of the banking system.

The structure of the banking system

The number of banks in Indonesia has shrunk from 239 to 153 comprising five state banks, 38 private national foreign exchange banks, 45 private national non-foreign exchange banks, 26 regional banks, 29 joint banks and 10 foreign banks. By the end of 1999, the top 20 banks, which included five state banks, accounted for almost 80% of total assets, loans and deposits as shown by Graph 3. The remaining 20% share was shared by 133 small banks.

Graph 3

Market share of deposits, credit and assets



Sources: BI Call Reports, various issues.

Since the regulatory authority (BI) treats all banks equally, large banks with national branch networks have competitive advantages. However, when the crisis struck, these large banks suffered the most while small banks were generally immune. Most of the problem banks were large banks with wide networks because the banks were highly exposed to credit and market risks. One may then infer that the future structure of the banking system may comprise a small number of large banks with wide networks and small unit banks at the regional and district level. However, BI has no plan to intervene by directly reducing the number of banks. Instead, BI will only impose tight requirements on establishing new banks and opening branches, in addition to enforcing the exit policy regulation for insolvent banks.

The regulatory and supervisory frameworks of the banking system

Under the existing regulations, the authorities have encountered difficulties in detecting problem banks at an early stage due to, inter alia, the following factors:

- Some prudential regulations have not been addressed in Indonesia, eg those concerning market risk, country risk and foreign exchange settlement risk. If the market risk regulation had been in place, the impact of the exchange rate and interest rate volatility on Indonesian banks during the 1997-98 crisis would have been more modest.
- Some regulations, such as the minimum capital adequacy requirement and statutory lending and net open position limits, need further improvement at the implementation level as well as in their coverage. The capital adequacy requirement just covers credit risk but still ignores market risk, unlike in most countries. Banks could find loopholes in statutory lending limits through credit swaps with other banks and because the net open position was based on an aggregate calculation (setoff between currencies).
- The approaches to supervisory techniques are conventional rather than risk-based. Conventional approaches normally use ratios to assess the past performance of banks (ex post). However, banks' past performance is less important for stakeholders than their future performance (ex ante). A risk-based supervisory approach is intended to reflect the future condition of banks.
- This supervisory approach for banks in Indonesia is based on solo supervision rather than consolidated supervision. BI is responsible for the supervision of banks while the Minister of Finance is responsible for non-bank financial institutions, including insurance and leasing companies. The stock exchange is under the supervision of the Stock Market Supervisory Board. Any problems at non-bank financial institutions may spark a problem at banks since the former are affiliated with banks. Consolidated supervision could be applied to prevent that from happening.

To improve its supervisory framework, BI has been setting some targets such as improving corporate governance, strengthening banking supervision, and encouraging a sound banking environment.

To promote good corporate governance, BI has introduced several rules, such as:

- enhancing the competence and integrity of bankers by imposing a Fit and Proper Test on each bank's shareholders and management;
- requiring banks to appoint Compliance Directors, responsible for ensuring the bank's compliance with existing regulations;
- maintaining consistent law enforcement by establishing a Banking Investigation Special Unit, to uncover violations against banking rules.

BI is fully aware that the banking crisis stemmed from weaknesses in the performance of banking supervision. In coping with such unfavourable conditions, BI has been focusing on the following aspects:

- harmonising the organisation of bank supervision, particularly regarding structure and responsibility;
- improving bank supervision management including, but not limited to, more efficient and transparent supervision, more competent supervisors, accountability and recognition, as well as reward and enforcement;
- introducing risk-based supervision;
- rectifying prudential regulations with emphasis on risk control.

The efforts to create a safe and sound banking system should be followed by strategic measures to produce a conducive banking environment through:

- the establishment of a deposit insurance programme, expected to come into effect by 2004, as a financial safety net to replace the existing blanket guarantee;
- the involvement of the Public Accountant Firm in banking supervisory tasks so that BI may obtain early and objective information on problems encountered by banks;

- the reactivation of the Bankers' Association, which may partner BI in developing the national banking system and overseeing the conduct of bankers. Such an effort involves training and surveillance of the members of the association, as well as providing needed counsel.

Other efforts have been under way to improve the stability of the Indonesian banking system, such as the introduction of new banking and central banking acts, including the new Banking Act of 1998, which:

- transferred the authorisation for bank licensing from the Minister of Finance to BI;
- relaxed the limit on foreign ownership of Indonesia-incorporated banks, raising it to 99%;
- encourages the development of sharia banking;
- narrowed bank secrecy provisions to cover only the information on deposits (name and amount) instead of total assets and liabilities;
- provides for more comprehensive and stricter criminal sanctions, and determines their minimum level;
- provides for the establishment of a deposit protection scheme by 2004 at the latest;
- provides for the establishment of a temporary special agency to assist with the banking restructuring programme.

Additionally, the government introduced the Act on Foreign Exchange Traffic and the Exchange Rate System in 1999. This provides a legal basis for monitoring the foreign exchange flow and enforcing prudential provisions. The act requires banks to submit to BI a report containing the movement of financial assets and liabilities between residents and non-residents. Complete, accurate and timely information about foreign exchange flows is key to supporting a prompt monetary policy response, primarily directed at maintaining the stability of the rupiah.

2.3 Information technology

The development of information technology allows banks to offer services to customers at lower cost. However, the application of sophisticated information technology may create operational risk related to fraud, the unreliability of information systems and discontinuity of operation. Therefore, rules of conduct in the application of information technology are necessary for banks. The following discussion outlines the regulations on the adoption of information technology and internet banking in Indonesia.

Application of information technology

BI has released regulations requiring banks to report the IT applications used in their products and activities. These reports will be used to monitor the application of IT at banks, particularly in relation to the efficiency of banks and the safety of public funds.

Compared with the development of IT in other countries, the application of IT in Indonesian banks is still relatively low. Based on the survey conducted by the Committee on Payment and Settlement Systems (2000), there is no bank in Indonesia offering services or products related to electronic money (e-money). E-money is defined as stored value or prepaid products in which a record of the funds or value available to the consumer is stored on a device in the consumer's possession. This definition includes both prepaid cards (sometimes called electronic purses) and prepaid software products that use computer networks such as the internet (sometimes called digital cash). These products differ from so-called access products that allow consumers to use electronic means of communication to access otherwise conventional payment services (for example, use of the internet to make a credit card payment or for general "online banking").

Internet banking

To date, six banks have offered internet banking to customers. However, the operation is still at an initial stage, being simply a means of providing communication and information rather than transaction facilities. The development of internet banking in other countries will surely contribute to the spread of internet banking in Indonesia in the future. Consequently, BI is now in the early phase of developing a regulatory framework for internet banking. We at BI are all aware that internet banking calls for special attention from regulatory and supervisory authorities due to the associated risks, such as improper disclosure, fraud, discontinuity of business due to hardware interruption or software failure, etc. Errors in software may lead to incorrect messages being transmitted between banks.

From the banking supervision point of view, an IT supervisory review plays an important role in ensuring that adequate policies and prudential internal controls are in place. Currently, the supervisory authority lacks sufficient expertise in internet banking operations. Therefore, the task of examining the operation of internet banking may be outsourced to external auditors who should be instructed to address any shortfall or imperfection coming to their attention in the course of their assignment. For the longer term, the supervisory authorities should develop their own in-house IT expertise so as to ensure that the application of internet banking can be controlled properly by internal sources.

2.4 Competition from foreign banks

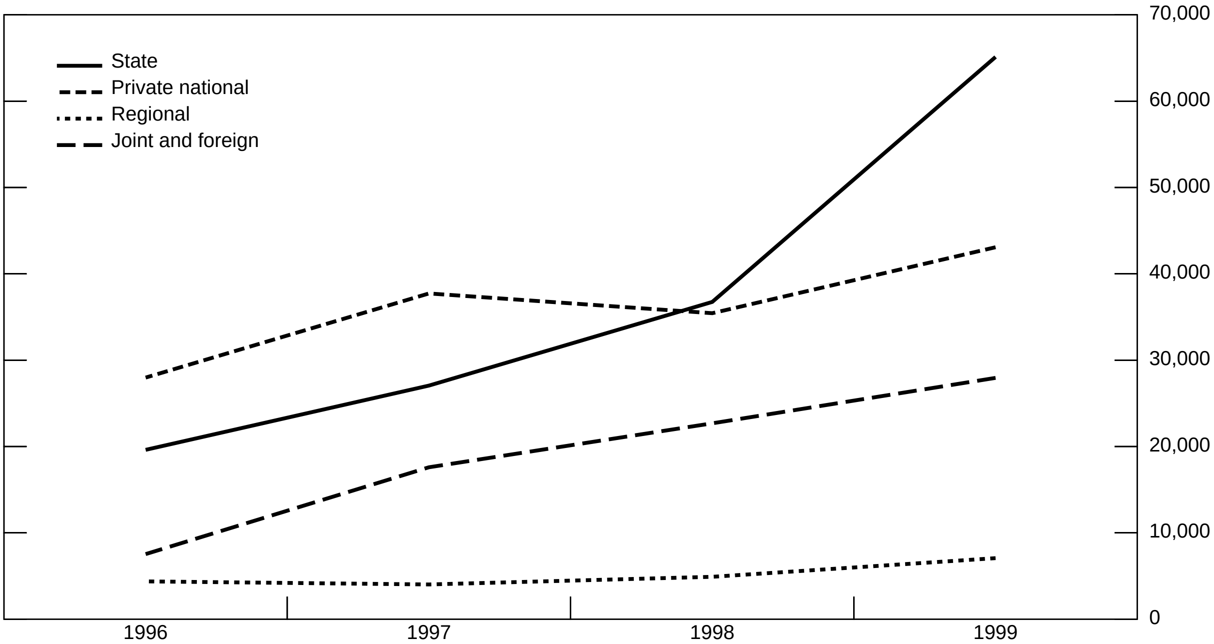
Under the current regulations, foreign banks may open branches or representative offices (but not a subsidiary or entity separate from the head office), but subject to the following conditions:

- the bank should have an international reputation;
- the bank should be ranked among the world's 200 largest banks in term of total assets;
- the initial fund placement should be at a minimum of IDR 3 trillion or equivalent in USD.

Currently, there are 10 foreign banks operating in Indonesia with branches in several major cities. Prior to the implementation of the government blanket guarantee, foreign banks and joint banks experienced a significant increase in demand deposits. However, after the guarantee scheme was adopted, the public returned to state banks. Graph 4 shows the growth of demand deposits by groups of banks.

Graph 4

Demand deposits by groups of banks (in billions of IDR)[1]



[1] Blanket guarantee scheme implemented in January 1998.

Source: BI Annual Report, 1999.

Obviously, the advantages of foreign banks in terms of support from their head offices, skilled human resources and a less regulated environment will pose challenges for national banks in terms of competition within the industry.

3. State banks: privatisation

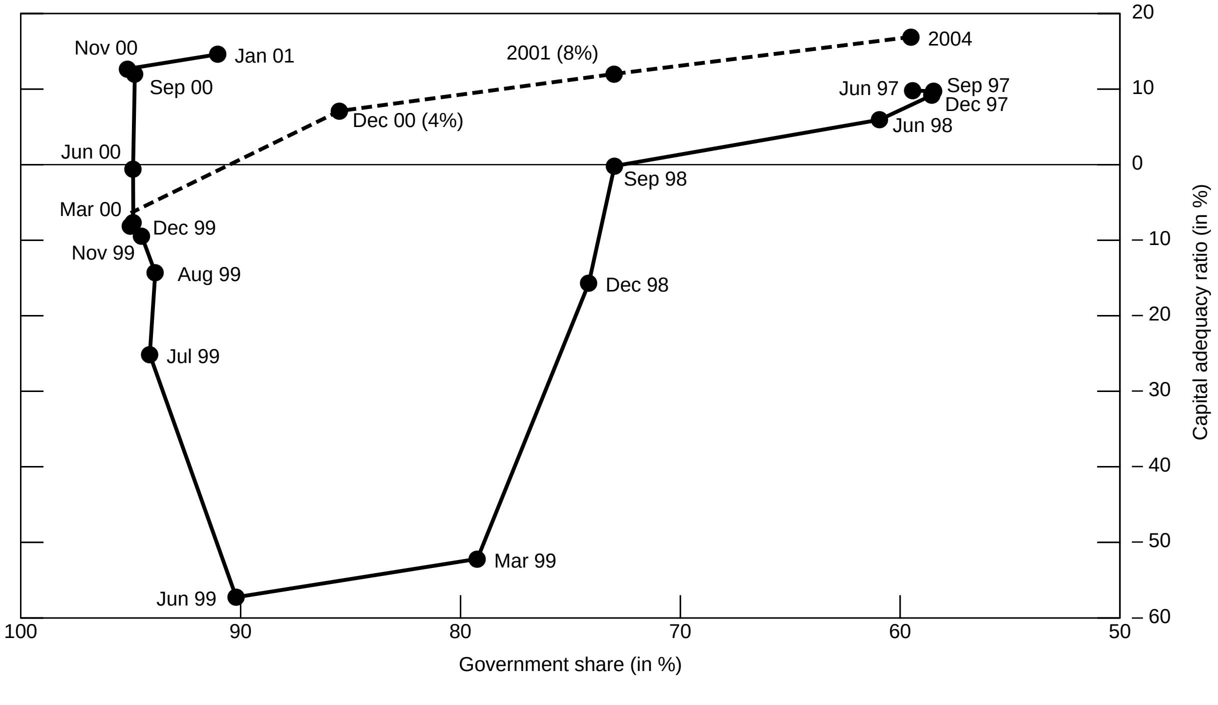
Many countries have a number of state banks, which are established either to achieve certain goals (ie foster development) or for political reasons. When state banks are inefficient, privatisation is often an important element in improving efficiency, especially where these banks have been the primary cause of banking difficulties. State banks in developing countries have generally been marked by less efficient operation, with a large proportion of their loan book consisting of "directed" lending to public-sector enterprises, often large loss-making enterprises. Restructuring of the banks may require restructuring the large public sector enterprises as well. Often state banks are fully backed by the government and, hence, their funding costs are lower. However, the government may not be prepared for the corresponding contingent liability, which may be difficult to meet. This has been the case despite the fact that, in some instances, supervisory standards have been less stringent for state banks (Hawkins and Turner, 1999).

Until the adoption of the reform package in June 1983 and October 1988, state banks in Indonesia commanded a major role in the banking industry (Annex 2). They continued to dominate loans to the public sector even in the period after the crisis, accounting for 83.7%, 86.7% and 86.8% of the market at the end of 1997, 1998 and 1999 respectively.

Prior to the crisis, credit quality had been deteriorating for years. Lack of credit analysis was the main problem for state banks because most of their credit decisions were influenced by the government and/or top government officials. As mentioned above, connected lending limits were weakly enforced and so loan quality continued to deteriorate, even after the crisis, as shown in Annex 1.

Graph 5

The evolution of CAR and government ownership of banks



As part of a government plan to privatise the state banks, the state bank regarded as the most profitable and best managed, offered 25% of its shares to the public in 1996 on the Jakarta Stock Exchange. After the recapitalisation programme had been carried out, the public share stood at 1% in October 2000. The performance of all banks deteriorated during the crisis, including the privatised state bank. In order to maintain financial system stability and public confidence, particularly in relation to the state banks, the government has:

- arranged a merger between four state banks and established a new single state bank;
- established a new state bank specialising in export financing;

- recapitalised a (prospective) new state bank and three remaining state banks to reach a capital adequacy ratio of 4%. These prompt steps were taken to address the negative capital and bad performance in the aftermath of the crisis. The government's recapitalisation programme has changed the structure of ownership of Indonesian banks. The evolution of government ownership is shown in Graph 5. Total government recap bonds accounted for IDR 412 trillion or 60% of GDP in July 2000.

In the future, the government will continue to privatise state banks in order to create sound, modern and well managed banks. Furthermore, the funds raised from the privatisation process will be used to repay the government bonds issued for recapitalisation.

4. Domestic mergers

Domestic mergers and takeovers often constitute the least costly way of restructuring the banking system. In many cases, a consolidation of the banking system may become the authority's choice even without a crisis if the authority considers the industry "overbanked" and some banks are inefficient. Mergers could become remedial steps to isolate problems in small banks. A large and well capitalised bank can absorb NPLs from weak and small banks, and then improve the quality of management. However, it is still questionable whether merging two or more weak banks can create a strong single bank.

The latter question arose when the government arranged a merger between four state banks, each of them having high levels of NPLs. The new problems faced by the new bank are very obvious. While there may be synergies or cost reductions from eliminating overlapping branches, the immediate practical difficulties in merging cultures, linking computer systems, dismissing excess staff, consolidating data and reports, and so forth can be formidable. Therefore, it may be unrealistic to expect mergers to produce the quick cost reductions needed in a crisis.

Since the crisis, 17 private banks and four state banks have been involved in two mandatory government-sponsored mergers and three voluntary mergers. The first mandatory merger took place in July 1999, involving four state banks, which suffered negative capital and huge losses. The merger will make the prospective bank the largest bank in Indonesia, with a 29% market share in loans and 21% in credits. The bank was recapitalised in 1999 with the issuance of IDR 179 trillion government bonds to bring its capital adequacy ratio up to 4%.

The second mandatory merger was in June 2000, involving nine small and medium-sized private banks which were bundled together to form a large private bank. The new bank has kept the brand name of the large banks and most of their managers. However, it will take a while to assess the effectiveness and benefits of these mergers. On the other side, the remaining voluntary mergers involving seven private banks seem to be benefiting from synergy and improved efficiency. However, the prospective bank is still encountering some problems related to the unification of accounting systems and liquidity.

5. Entry of foreign banks

In a systemic banking crisis, the difficulty of finding large and healthy domestic banks has led governments to invite foreign banks to take over domestic banks. Claessens, Demirgüç-Kunt, and Huizinga (1998) suggest that an increase in the foreign share of bank ownership tends to reduce profitability and overheads at domestically owned banks, so the general effect of foreign bank entry may be positive for bank customers. The existence of foreign banks in domestic banking may have other benefits, such as:[1]

- less connected lending;

[1] See Hawkins and Turner (1999).

- improved quality and availability of financial services;
- greater competition, which in turn reduces the costs of banking products;
- new skills and technology;
- faster and cheaper access to international capital markets and liquid funds (via parent banks);
- additional oversight by foreign supervisors, which may make them sounder; and
- meeting entry conditions to international “clubs” (notably the OECD).

However, some governments of developing countries often face domestic pressure to keep foreign banks out. This has not prevailed in Indonesia since the current regulations allow foreign banks to open branches or representative offices and even take over domestic banks with the maximum permitted ownership reaching 99% (only 1% minimum share of domestic partner). So far, however, there has been no strong interest in owning Indonesian-incorporated banks through either direct or portfolio investments. This could be due to the perceived low quality of their assets, even after the government has taken remedial actions such as transferring the NPLs to IBRA and recapitalising the banks with government bonds. Nevertheless, the government has prepared the next steps to divest its ownership in recapitalised banks after five years, in line with the Letter of Intent co-signed with the IMF.

6. Systemic stability

The weak recovery of Indonesia’s economy is due to the slow resolution of three chains in the vicious circle that magnified the depth of crisis. The three chains were: unstable monetary conditions, a weak banking sector, and a heavily indebted business sector (BI Annual Report, 1999).

According to Goodhart et al (1998), there are three basic principles for managing a banking crisis to gain systemic banking stability, namely:

- ensure that the parties have benefited from risk-taking bear a large proportion of the cost of restructuring the banking system;
- take prompt action to prevent problem institutions from extending credit to highly risky borrowers or capitalising unpaid interest on delinquent loans into new credits;
- gather the political will to make bank restructuring a priority by allocating public funds while avoiding sharp increases in inflation.

In systemic crises where a large proportion of the banking system becomes insolvent, the funds prepared to resolve bank failures, such as deposit insurance and emergency central bank credit, are usually inadequate. Hence, public funds often must be used to resolve bank failures. The objective of public policy is to ensure that the transfer is limited to those parties whose protection from bankruptcy is necessary to preserve the integrity of the banking system.

Based on our experiences after significant reform in 1988, the future structure of the Indonesian banking system will most likely comprise a small number of national/multinational banks with national branch networks and international activities and a relatively high number of regional banks operating in particular regions across the country. The performance of large banks (core banks) will be very important as an indicator of systemic stability. Therefore, supervision may be focussed mainly on these banks. The task of improving the regional banks may be delegated to the regional governments.

In order to limit the impact of the crisis, the disadvantage in the funding pattern of domestic banks will be remedied by applying different treatment between national banks and regional banks. The national banks will be subject to more stringent regulation due to their higher exposures to various risks. The supervisory approach will also be improved by adopting risk-based supervision focusing on ex ante assessment, in place of the previous ex post monitoring.

7. Summary and conclusion

The deregulation packages in the 1980s and 1990s might have contributed to the fragility of the banking sector in Indonesia due to lack of prudential regulation, good governance, market discipline and law enforcement. Given the inherent fragility, the industry was prone to a crisis, which was triggered by a sharp depreciation of the rupiah in mid 1997. Experience shows that large banks with wide networks encounter more difficulties than small banks, which are less exposed to foreign exchange rate and interest rate risks.

The rapid growth of banking operations, in terms of the number of banks and offices as well as products, was not fully anticipated by the supervisory authority. It is therefore necessary to bring regulatory and supervisory approaches closer to international standards. Consolidation of banks will allow banking supervision to focus more on systemically important banks (core banks). Consistent law enforcement practices will promote the development of market discipline and good governance in the banking sector.

Privatisation is necessary to ensure that fresh money will be received to repay the recap bonds. However, domestic investors may be unable to absorb all the privatised shares from the government. Therefore, foreign investors will be potential buyers in the market as they are allowed up to 99% ownership in Indonesian banks.

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Annex 1

Classified credits for the period 1995-2000

	1995	1996	Dec 1997	Dec 1998	Dec 1999	Aug 2000
Total credits (trillions of rupiah)	267	331	450	545	277	280
	Classified credits as % of total					
Sub-standard	2.7	2.6	2.6	10.4	10.2	11.5
Doubtful	2.4	3.3	2.5	15.2	12.8	6.0
Bad debt	3.3	2.9	3.2	23	9.9	10.4
	Distribution of classified credits by bank ownership (%)					
State-owned banks	72.7	67	52.7	38.9	52.6	48.2
Private banks	16.3	22.8	42.3	52.7	23.1	26.9
Regional development banks	5.5	4.9	0.4	0.1	1.2	3.4
Foreign and joint venture banks	5.5	5.3	4.6	8.4	23.2	21.5
	Classified credits as % of total credit by bank ownership					
All banks		10.4	8.3	48.6	32.9	27.9
State-owned banks		16.6	4.4	18.9	31.5	28.1
Private foreign exchange banks		3.7	2.8	21.1	35.9	26.4
Private non-forex banks		13.8	0.7	4.5	15.7	6.3

Sources: Data for the period January 1995 to April 1997 were derived from Nasution (1998) and for the period December 1997 to August 2000 from the BI database.

Annex 2

Market share of each group of banks in 1983 and 1987 (%)

	1983				1987			
	Assets	Deposits	Public sector loans	Private sector loans	Assets	Deposits	Public sector loans	Private sector loans
State banks	75.6	81.5	99.3	70.9	71.2	86.7	99.5	61.8
Private FX banks	8.2	6.7	0.2	9.1	11.8	6.6	0.1	15.5
Foreign banks	8.3	11.8	0.1	7.9	6.1	6.6	0.1	6.1
Private non-FX banks	4.6	0.0	0.0	7.6	7.9	0.0	0.1	13.0
Regional dev. banks	3.2	0.0	0.0	4.4	3	0.0	0.3	3.7

Sources: BI Annual Reports, 1983 and 1987.