Indonesia's banking industry: progress to date[1]

Dr. Miranda S. Goeltom[2]

I. Introduction

In the years following the crisis of 1998-99, the Indonesian banking industry achieved significant progress until 2004, as highlighted by various indicators such as credit growth, non-performing loans (NPLs), return on assets (ROA), capital adequacy ratio (CAR), and loan to deposit ratio (LDR; Table 1). This progress was mainly due to the improvement in the overall macroeconomic environment as reflected in the declining trend of inflation (from 77% in 1998 to around *5.8*% in 2004) and interest rates (from 35% in 1998 to 7.5% in 2004) and a relatively stable exchange rate of around IDR 9,000 per USD.

However, soaring world oil prices and natural disasters have begun to affect macroeconomic conditions in Indonesia. The pressure on the rupiah and its pass through effect on domestic prices have heightened inflationary pressures, leading Bank Indonesia (BI) to respond with a gradual increase in interest rates. The recent hike in domestic fuel prices pushed November headline inflation to around 18.9%, while the Bank Indonesia benchmark rate (BI Rate) was raised to 12.75%.

Table 1

Main Banking Indicators

Main Indicators	Pre-Crisis		Crisis		Recovery							
	Dec-96	Dec-97	Dec-98	Dec-99	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Mar-05	Jun-05	Sep-05
Total Assets (T Rp)	506.9	715.2	895.5	1,006.7	1,030.5	1,099.7	1,112.2	1,196.2	1,272.3	1,280.6	1,344.6	1,418.6
Deposits (T Rp)	303.2	400.4	625.3	617.6	699.1	797.4	835.8	888.6	963.1	959.3	1,011.0	1,077.5
Loans (T Rp) *	331.3	444.9	545.5	277.3	320.5	358.6	410.3	477.2	595.1	617.8	664.3	715.3
Earning Assets (T Rp)	387.4	500.5	552.3	853.7	1,007.2	1,048.1	1,023.6	1,072.4	1,146.8	1,128.4	1,239.9	1,283.3
Net Interest Income (T Rp)	-	-	(12.5)	1.1	2.9	3.1	4.0	3.2	6.3	6.0	6.1	5.9
LDR (%)	78.3	82.6	72.4	26.2	33.2	33.0	38.2	43.2	50.0	51.3	53.1	54.2
ROA (%)	1.2	1.4	(18.8)	(6.1)	0.9	1.4	1.9	2.5	3.5	3.4	2.9	2.6
NPLs Gross (%)	6.6	7.1	48.6	32.8	18.8	12.1	8.1	8.2	5.8	5.6	7.9	8.8
NPLs Net (%)	3.9	4.2	35.1	7.3	5.8	3.6	2.1	3.0	1.7	1.9	3.7	5.0
CAR (%)	11.8	9.2	(15.7)	(8.1)	12.7	20.5	22.5	19.4	19.4	21.7	19.5	19.4

Credit growth was targeted to reach 22% in 2005, and at the time of writing this is clearly achievable, as the September figure already shows year on year growth of 20.2%. Consumer loans have experienced the fastest growth, followed by working capital loans, while lending for investment is growing relatively slowly. This, in turn, will drive BI to maintain strong vigilance over loan growth. Despite rising uncertainty and risk exposure, banks are predicted to have the capacity to confront risks as they have ample capital cushions.

Next, I will concisely shed light on major structural changes in the Indonesian banking sector, the nature of current banking risks, and the importance of monetary and financial stability.

[1] Country paper for BIS Deputy Governors' Meeting, Basel, 8-9 December 2005.

[2] Senior Deputy Governor, Bank Indonesia.

II. Evaluation of major structural changes

1. Privatization

After completing the recapitalization of ailing major banks in 2000, the government started to privatize them. So far, the sale of the government's stake in major banks has been successful, with international investors showing significant interest in domestic banks. At the time of writing 15 banks, representing more than 70% of the industry's total assets, have been privatized.

Aside from creating a more competitive banking landscape and raising state revenue, the privatization policy is expected to benefit the domestic banking industry by promoting governance, transfer of technology, and enhanced risk management competencies.

Since 2002, the government's stake in nine domestic private banks has been divested and sold to foreign investors as controlling shareholders. By December 2004, total assets of these nine banks with foreign majority had reached 42% of total industry assets.

2. Mergers and Consolidation

In accordance with the Indonesian Banking Architecture[3], BI intends to create a sound domestic banking structure capable of meeting public needs and to promote sustainable national economic development. Such a sound banking structure could be attained through enhancing the capital base since it is believed that a stronger capital base will allow banks to assume higher risk taking capacity, improve information system technology and expand business scale as well as lending capacity.

As a consequence, in July 2005 BI issued a regulation on minimum capital requirements, which basically requires all commercial banks to have minimum tier 1 capital of IDR 80 billion (equiv. USD 8 million) by end-2007 and IDR 100 billion (equiv. USD 10 million) by end-2010. Within five years, all commercial banks are expected to have minimum capital commensurate with their scope of business and risks. Any banks failing to maintain those minimum statutory levels will be subject to several sanctions; among others, these may include revocation of their licences for foreign exchange operations and closure of branches.

To allow monitoring of their progress towards meeting the minimum capital requirement, banks are required to submit a business plan containing strategies for achieving the required capital levels and current state of progress. Increasingly, BI is sending the message to banks that they will have to prepare to merge or consolidate so as to strengthen their capital base.

It appears that eventually - and sooner rather than later - BI will need to be more proactive in encouraging banks to merge or consolidate, in particular the small banks that are mostly family-owned and family-run businesses, and whose shareholders tend to be very reluctant in giving up ownership.

3. Role of Foreign Banks

Foreign banks in Indonesia may operate in the form of either a branch, a subsidiary (either through direct investment or capital market investment), or a representative office. While representative offices do not conduct business activities, branches and subsidiaries play an active role in the domestic banking industry.

Since the enactment of the 1998 Banking Act, the maximum limit of foreign parties' ownership in domestic banks was raised from 51% to 99%. In addition, since 1999 foreign banks have been allowed to open branches in any location throughout Indonesia, while permission was previously limited to a maximum of 10 big cities. However, it is more attractive for foreign parties/banks to acquire shares in existing domestic banks than to establish new branches, which requires them to provide operating funds of at least IDR 3 trillion (equiv. USD 300 million). This preference is evident as indicated by the recent increasing number of banks coming under ownership of foreign parties as the

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[3] See Section IV.

controlling shareholders. Liberalization has boosted the role of foreign banks in Indonesia; their assets have grown significantly from 7.74% (1996) to 12.75% (2004) of aggregated assets.

III. Nature of banking risks

The Indonesian banking industry continues to confront increasing risks, due to rising interest rates, the rupiah depreciation, and the oil price hike. The increasing trend in credit risks is reflected by the increase of NPLs to 8.8% (gross) and 5% (net) respectively as of the end of the third quarter of 2005. This is mainly due to the impairment of loan portfolios in two of the largest national banks, as they were forced to re-classify their loan quality, as well as the deterioration of the quality of the restructured loans purchased from IBRA (the Indonesian Bank Restructuring Agency). If we exclude these two banks, the gross and net NPLs decline significantly to 5.3% and 2.6%, respectively. It should be noted here that the NPL ratio of credits drawn in foreign currencies greatly exceeds credits drawn in rupiah.

Table 2

NPL level, rupiah vs foreign currency

NPLs, foreign currency loans (as a %)

Banks	Rupiah	Foreign Currency
15 Big Banks	6.8	27.6
Medium	4.2	4.9
Small	3.5	13.6
Joint Venture	2.3	4.9
Foreign Branches	2.5	5.5
Total Bank Industry	5.9	19.3

Market risks also remain high and are tending to increase as banks incur losses due to the falling prices of government bonds in their portfolios. Even though the exchange rate fluctuations have levelled off, the BI Rate is predicted to remain high up to the third quarter of 2006 as the Central Bank is trying to bring down inflation expectations to their medium term path of around 8% by the end of 2006.

Liquidity risks are tending to increase to moderate levels as the limited deposit guarantee scheme is gradually put in place, replacing the blanket guarantee scheme. The gradual implementation of the limited scheme excludes guarantee coverage of inter bank money market transactions as of 22 September 2005.

As mentioned above, rising fuel prices and the weakening rupiah are responsible for pushing inflation to the current elevated levels. BI and the government have taken a number of steps to respond to the situation. BI's reference rate, the BI Rate, has been increased in a gradual and measurable manner. As a temporary measure, the maximum levels permitted for net open positions have been decreased and reserve requirement levels increased according to banks' loan deposit ratios.

The rise in the BI Rate has been followed by a rise in the insurance interest rates of the deposit insurance scheme, which has immediately been reflected in the deposit rates offered by most banks. Several banks are even providing special bonuses and gifts as additional incentives for depositors. These attempts to maintain depositor levels are increasing the banks' cost of funds and putting pressure on their profit margins. Consequently, banks have been left with no choice but to raise their credit interest rates, taking them into a "zone" of higher risks. Such a zone is associated with environments where bank spreads and income margins are severely suppressed, while debtors' ability to repay decreases as their real income becomes severely affected by the soaring inflation.

IV. The importance of financial stability

The recent crisis has shown that Indonesia's banking industry and overall financial system stability need to be improved and strengthened. From an institutional point of view, much remains to be done in establishing an efficient market economy. Moreover, we have learned that it is as important to maintain financial stability as it is to maintain monetary stability.

Recent major initiatives to promote financial stability include, among others:

1. Indonesian Banking Architecture (IBA)

The IBA is a comprehensive, basic framework for the Indonesian banking system and sets forth the direction, outline and working structures for the banking industry over the next five to 10 years. In the Architecture, the policy direction for the future development of the banking industry is based on the vision of building a sound, strong and efficient banking system to create financial system stability for the promotion of national economic growth.

The IBA consists of six major pillars containing the following objectives:

- To establish a robust structure for the domestic banking system, capable of meeting the needs of the public and promoting sustainable economic development
- To create an effective system for bank regulation and supervision in line with international standards
- To build up a strong, highly competitive banking industry, resilient in the face of risks
- To ensure good corporate governance for internal strengthening of the national banking industry
- To provide a complete range of infrastructures to support the creation of a healthy banking industry
- To empower and protect consumers of banking services

2. Basel II Implementation

Basel II will be implemented in phases; implementation will commence in 2008. All commercial banks will be required to meet capital requirements by initially adopting the simplest approaches. Subsequently, any bank capable of making the necessary system changes and meeting all requirements adequately will be allowed to move towards the more sophisticated approaches upon BI's approval. It is expected that by 2010 the Basel II framework will be applied in full scope covering all pillars.

3. Financial Safety Nets

A financial safety net is one of the main pillars of a healthy and efficient banking system, in addition to effective regulation and supervision. In general, comprehensive financial safety nets cover five elements: (i) effective regulation; (ii) effective and independent supervision; (iii) an adequate "lender of last resort"; (iv) an appropriate deposit insurance scheme; and (v) problem bank resolution and adequate crisis settlement.

The government and BI have formulated a policy framework for financial safety nets covering the role, liability and coordinating mechanism of each related institution in this area, namely BI, the Ministry of Finance, supervisory authorities, and the Deposit Insurance Company (DIC). The framework elaborates the 'lender of last resort' and deposit insurance policies to be adopted in the future.

In accordance with the regulations, under normal conditions BI can provide short-term financing facilities for banks undergoing liquidity difficulties due to cash flow disparities. Additionally, it can also provide emergency liquidity assistance (ELA) for banks undergoing financial difficulties that have systemic impact and the potential to cause a crisis in the financial system. The funding for ELA will be provided by the government. BI and the Ministry of Finance have signed a Memorandum of

Understanding regarding the provision of ELA. The regulations concerning ELA provision are currently being formulated by BI and the Ministry of Finance team.

Since 22 September 2005, the DIC has been in operation, performing two main functions: (i) acting as insurer of deposits up to a particular amount; and (ii) handling the resolution and closure of failed banks. The deposit insurance scheme will be gradually implemented up till March 2007, when the maximum coverage shall be limited to IDR 100 million (USD 10,000).

4. Credit Bureau

As a facility for banks to improve their credit quality, a Credit Bureau, a body that will organize and maintain the credit data of banks' customers, is being developed. So far, the recently established Debtor Information System has been helpful in increasing banks' exchange of information regarding debtors' credit standing within the overall banking system. In the future, small and medium-sized enterprises (SMEs) will receive due consideration too. BI will also stimulate the development of rural banks to reach areas which have hitherto not had access to banking services. The linkage programme that has been established with commercial banks will be improved to provide more incentives to commercial banks and rural banks to collaborate. Access to credit for SMEs and the general public will be increased through bond schemes and collaboration with district level government.

Fundamental microeconomic weaknesses also exist as corporate governance has generally been poor. The lack of understanding with regard to the importance of transparency has created a business environment that does not promote adherence to good governance. To make matters worse, legal enforcement has been virtually absent or extremely weak at best, with bankruptcy resolutions being greatly insufficient. With corporate governance and other internal controls left ineffective, it is even more important to foster the development of the Credit Bureau as a way of reducing excessive risks due to incomplete and asymmetric information.

5. Consumer Empowerment

In terms of customer protection, a complaint mechanism is currently being formulated that will accommodate customer criticisms and complaints regarding their banking services. In anticipation of disagreement between banks and their customers in settling disputes, BI plans to form an *independent mediatory institution* or *bank-client ombudsman*.

Subsequently, the transparency standard of banks in promoting their products to customers will be clearly defined, so that customers can make an informed decision on which bank products are suitable and so that provision of misleading information can be avoided. Customer resources will also be used to encourage banks to conduct periodic customer education.

V. Concluding remarks

The twin crisis (in the currency and the banking industry) left us with much to learn. Great lessons have been learned on the importance of financial stability in supporting monetary stability and the economy. By putting economic policies in balance to pursue monetary and financial stability, we can expect to improve our ability to detect possible future crises.

Market discipline, as one of the main pillars of Basel II, should be embedded in the banking industry as well as the financial industry. As the banking industry becomes more advanced, with product proliferation and increasing sophistication, the role of supervisors should be supported by players in the industry to ensure and protect the public interest. This will require a great degree of transparency from the institutions concerned. To increase supervisory effectiveness, regulators should be able to issue high quality researched-based regulations, thus ensuring smooth implementation.

As financial stability requires better coordination and harmonization among related regulatory and supervisory institutions in the country, this issue should be prioritized and continuously strengthened.