Burhanuddin Abdullah: Managing the banking industry within the new dynamics of the Indonesian economy

Speech by Mr Burhanuddin Abdullah, Governor of Bank Indonesia, at the Annual Banker's Dinner 2006, Jakarta, 13 January 2006.

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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,

To begin, I would like to invite all of you to join me in expressing praise and thanksgiving to God Almighty for once again extending us the opportunity to meet in this pleasant and congenial setting at the Bankers' Dinner 2006. For the banking community, the Dinner is an event in which we have established a tradition of taking time to reflect and build our communication with one another, among Bank Indonesia and fellow bankers in Indonesia.

An event like this is an opportunity for reflection, to look at ourselves in front of a large mirror and assess our strengths and shortcomings, make the necessary improvements, and move on to the future. We are reminded of a quote from Chairil Anwar, oft cited at the beginning of each year, "Take a look at yourself in the mirror, but not to get ready for partying". Tonight we shall reflect, self-improve so that we could continue to deliver benefits to the people of Indonesia.

In departure from our tradition of hosting this dinner only for bankers, tonight we are privileged to have with us special guests: The Economic Coordinating Minister, The Finance Minister, and The National Development Planning Minister. Also present with us today are members of the Indonesian Parliament, the Chair of the Indonesian Chamber of Commerce and Industry, economic analysts, and leading media figures. Your presence here this evening clearly signifies that monetary and banking issues are of concern to us all.

Distinguished Guests, Ladies and Gentlemen:

As I start to speak tonight, I am reminded by a night similar to this in early 2005. There, I stood before you ladies and gentlemen as I am now. However, that night was different from tonight as there was a big cloud of worry overshadowing us. By end of 2004, most of us had planned to ring in the coming 2005 with great celebration. To the contrary, at the end of 2004 we saw a massive Tsunami disaster engulf Aceh and Northern Sumatera. We were left aghast and speechless. We all felt sadness. Tens of thousands of our fellow countrymen lost lives and everything they had. We were touched by a sense of shared loss. As the sadness and mourning began to finally ebb, a breeze of hope started to flow. Slowly but surely, optimism towards Indonesia's economic revival was planted in the chests of the people.

And tonight, I would like to ask you to give a momentary look at what we have achieved in 2005, to review our implemented policies and to draw some lessons that can be learned and implemented for the coming years. Subsequently, I would like to convey several steps and thoughts aimed to increase the role of Bank Indonesia and the banking industry in supporting the nation's economic recovery. We hope this effort is inline with the government's policies towards economic recovery. In the end, we find that we all have a common goal: to reach an Indonesian society that is just and prosperous.

Distinguished Guests, Ladies and Gentlemen:

During the first quarter of 2005, optimism ran strong throughout our nation. Economic indicators were on track. Nevertheless, we knew that our economy, having only just pulled out of crisis, still lacked the resilience to withstand external and internal shocks. Excess liquidity, disharmony between strategy and policy implementation, and the lack of economic infrastructure resilience towards external shocks are among the risks potentials our economic stability must face.

This vulnerability became apparent in the second semester of 2005. Global financial imbalances, increases in world oil prices, and hikes in domestic fuel prices in October were followed by an increase in inflation (17.11%) in 2005. The Rupiah depreciated by 8.5% and the Balance of Payments showed a deficit of USD 778 million. This contrasts with 2004's surplus of USD 309 million. The World

Economic Forum stated that Indonesia's competitiveness slipped from 69th position in 2004 to 74th in 2005. This position placed Indonesia in a rung lower than Vietnam. However, despite all the problems, we have to be grateful that our economy was able to maintain a growth of 5.3 – 5.6% in 2005. This growth has helped provide work for only some of those entering the job market and leaving the others adding to the "openly unemployed" statistics.

Distinguished Guests, Ladies and Gentlemen:

From the policy making point of view, 2005 is a year full of challenges. The macroeconomic stability faced great challenges. Faced with the shocks, Bank Indonesia issued several policies which included tightening of the economy's liquidity, taking measures to minimize currency speculation, managing demand and supply of state owned enterprise's foreign currency, and intensifying the commitment to increase provisions of foreign exchange liquidity facilities in order to secure the situation through Bilateral Swap Arrangement mechanisms. These policies proved to be effective in managing the volatile movements of the exchange rate. The exchange rate returned under control and thus remained stable at around Rp9.800 to the US dollar at year's end.

In the midst of these difficult trials and challenges in 2005, we were grateful that the banking industry continued to consistently function well in its service to the public. Credit growth exceeded third party fund growth, with the Loan to Deposit Ratio (LDR) significantly up to 68%. Bank's financing to prospective economic sectors, such as the consumption sector and the Micro, Small and Medium Enterprises (MSME's), remains high at levels exceeding 30%. However, a note of caution is in order here as NPL's tend to move to unfavorable levels.

From the money and capital markets, the increase in interest rates in the second semester of 2005 has triggered redemptions from several financial instruments, particularly so for fixed income mutual funds. The mutual funds industry got a bitter taste of large-scale redemptions after times of boom.

Distinguished Guests, Ladies and Gentlemen:

Based on the 2005 experiences in the economy and banking system, we can ask ourselves what lesson is there to be learned? There are four lessons:

- First, in the midst of a highly dynamic global economic, we must be able to recognize problems immediately and make adequate decisions quickly. Our inability to make a timely policy responds to external developments, such as rising world oil prices and global imbalances, have often caused us to lose momentum, which brings a higher cost consequences to be borne by the economy.
- Second, the collapse of the mutual fund industry after such rapid growth has become a source of financial system instability. In this regard, early warnings from authorities of the financial sector become necessary to prevent the need for sudden and drastic adjustments in portfolios. We also need to continuously improve the coordination between the capital market authority (Bapepam) and Bank Indonesia.
- Third, our relatively thin foreign exchange market that is dominated by large players like Pertamina, is frequently colored by excessive volatility. This relatively high volatility would negatively affect market confidence to the prospects of our macroeconomic stability. This problem would continue if we do not make structural improvements in foreign exchanges liquidity by improving exports performance and capital inflows.
- Fourth, the need to think of ways to lessen our dependency on fuel products. In this regard, the development of alternative energy sources and public transportation with low levels of fuel consumption will become a must in the years to come.

Distinguished Guests, Ladies and Gentlemen:

Stepping into year 2006, it is common that in entering the new year, we would define the expectations we want to achieve as well as identify challenges we hope to overcome within the coming year. In my view, the major challenge we will face in 2006 will be to bring the economy to a new equilibrium.

From the external point of view, several international institutions have projected that the growth prospects for the world economy will not change much. It will remain at around 4.3%, with America and China still as the main engine in the global economic growth. Based on those external conditions, we predict that the dynamics of the 2006 economy will largely depend on coordination between monetary, fiscal, and the real sector's policies. Such coordination needs to be done optimally to manage macro economy stability while promoting economic growth.

- From the monetary side, Bank Indonesia will consistently make efforts to reduce the rate of inflation to a single digits in 2006 to allow interest rates to be gradually lowered in order to boost consumption and private sector investment.
- From the fiscal side, fiscal stimuli through government consumption and investment would provide a strong jump start towards economic recovery, especially if the government could make use of the unrealized 2005 budgeted spending, carry it forward to 2006 and immediately make it realized within the first quarter of this year.
- From the real sector side, economic prospects will be more dynamic if the previously planned infrastructure projects can be realized.

If coordination of these policies is able to be conducted coherently, we will see an improved economic growth supported by the needed investment and consumption levels from the second semester of 2006 Overall, Bank Indonesia projects that the 2006 GDP will reach 5.0-5.7%.

Growth of that level is predicted to be achievable if investment financing sources from both domestic and abroad can be secured. Aside from stimuli provided by government's capital expenditures, I expect the banking industry to continue its role in funding long-term investment projects. An optimistic level of economic growth may be achieved if the banking industry at least maintains last year's level of credit extensions. Foreign sources are also assumed to play a significant role as well. It was noted in 2006 that foreign funding contributed up to approximately 40% of that year's growth level. These foreign sources comprise of Foreign Direct Investment (FDI), portfolio investments, and foreign corporate loans. Therefore, it is apparent that the steps we must take in improving investment climate becomes the keys of success in achieving the level of growth we strive for.

Distinguished Guests, Ladies and Gentlemen:

The dynamics of the macro economy in its path to reach a new equilibrium will in itself impact developments in the banking industry. An example could be seen from the credit market. The increase in interest, the increasing burden carried by the real sector, and lowered purchasing power result to predictions of a lower credit demand. From the supply side, the increase of the real sector's credit risk will cause the banking industry to be increasingly careful in considering the potential debtor's repayment capacity. From the various discussion forums we have held, we are under the tentative impression and conclusion that the banking industry percieves that there are many risks involved in efforts to rejuvenate the real sector. The banking industry holds doubts regading the real sector. Some of these doubts may have come from, among others, the economy's level of competitiveness and and that of several commodities which nearly reached nadir levels, the limited information and the banking industry's limited understanding towards the complexities of particular industries, and unclarity in development direction and development priorities chosen in certain industries in a particular period. All of this exist even though it is understood that clear information regarding to the above issues become a critical navigational tool for banks in allocating their funding.

The opposite occurs in the fund market. The amount of third party funds collected by the banking sector has been continuously increasing. The community in general believes that the banking industry is an institution that is able to provide ease and benefits towards their business activities. It is our prediction that the third party fund growth rate continue towards levels similar to those of in 2005. Despite the positive outlook, deposit growth in 2006 demands our deftness and care in management considering risk factors that are increasingly sensitive. As we understand, starting from 2006, guarantee coverage of the Deposit Insurance Corporation will gradually decrease from Rp 5 billion on March 2006 to become Rp 100 million in March 2007. Taking this into regard, the real competition in deposit taking should be in areas of management and service quality, and banks soundness.

The ultimate effect of the developments I have elaborated are that profit and capital levels are increasingly pressured. Taking that into consideration, for 2006, we view that *a short term pain, while harvesting long term gains* business strategies are a good choice. Bank Indonesia views that the longer run perspective, which puts financial system stability on top of short term profits, should become the option.

Distinguished Guests, Ladies and Gentlemen:

I would now like to convey to you Bank Indonesia's policy steps in banking. We have divided the policy steps into two according to its completion periods, short term and intermediate to long term policy steps. There are four short term policy steps aimed towards providing banks with bigger room to maneuver in performing its intermediary function in 2006, five intermediate to long term policy steps which basically is an elaboration of Indonesian Banking Architecture (API).

As the first short term step, Bank Indonesia will implement temporary adjustment to the regulation regarding the quality of productive assets, while still maintaining the priciples of prudentiality. Regulation 7/2/PBI/2005 issued in 2005 has been successful in bringing about positive changes in the debtor behavior in dealing with banks. With such regulation, debtor's exposures and performance will be tightly monitored by the bank providing its financing. On the other hand, we also realize that the implementation of this regulation during these challenging times will not be easy. Mounting production costs from higher oil prices and cost of capital following increases in interest rates weakens the corporate balance sheets. The uniform classification requires improvements in the operation of the credit bureau, a key part within the banking industry's infrastructure that provides debtor information on a symmetric basis to all banks. At this point, the credit bureau is still on the development process, with full operation expected to begin in the next one or two years.

Considering the abovementioned aspects, this year, we will be making adjustments to Regulation No. 7/2/PBI/2005. This policy is a temporary measure which in essence is a simplification and phasing in of the regulatory provisions. For this reason, the phasing in of these provisions will begin with syndicated loans, which is already supported by adequate means of communication and later to be followed by bigger debtors and debtors of certain amounts.

Second, Bank Indonesia will consider a downward revision in the statutory reserves requirement when the condition of macroeconomic stability permits. The adjustment in statutory reserves requirement will be considered for the first quarter of this year. This consideration is based on the belief that the 2006 macro economy will reach a relatively stable level and thus liquidity of the banking sector can be relaxed.

Third, Bank Indonesia will work steadily to improve public access to sharia banking services. We are preparing a regulation that permits branches of conventional banks with a Sharia Unit to also provide sharia transactions through office channeling. By providing office channeling at conventional branches, banks will no longer need to open Sharia Unit branches in numerous locations to offer sharia banking services.

Fourth, Bank Indonesia will pursue efforts to expand the coverage of banking services with focus on the Micro, Small, and Medium Enterprises (MSME) sector for more equitable outreach extending to all remote areas. We will take several steps to realize this policy particularly by empowering the role and functions of the banking sector in providing the service truly needed by the MSME. The mapping survey conducted clearly shows that the MSME sector has a high resilience level. Profit levels of this sector is in the range of 10 – 50%, and profit levels of 50% is achieved by 30% of business in the MSME sector. It is clear that the MSME sector is prospective in terms of credit and business management, and more importantly, there is a relatively big portion of this sector that is capable to absorb and conduct healthy principles of economics without the need for subsidies. We will continue the mapping survey in 2006 to identify MSME sectors which truly holds potential and capacity to grow and develop. The results of the mapping process will then be synchronized with the Basel II concepts to accommodate the need to finance the MSME sector. Basel II provides special treatment to the retail portfolio by assigning a lower risk weight, assessments toward debtors in this group on a portfolio basis, and requiring a more flexible criteria towards developments in the economy and accommodate financing issues of small businesses. In this regard, we will make adjustments in Risk Weighted Assets for certain retail business, including Risk Weighted Assets calculations for financing the micro and small sector. We hope that through this step, the banking sector will have a regained sense of enthusiasm and more room to provide financing support to various businesses in this sector.

Distinguished guests, ladies and gentlemen: God willing, we will issue regulations regarding to the revision to Bank Indonesia Regulation 7/2/2005. Office Channeling, and MSME this month.

Distinguished guests, ladies and gentlemen

For the intermediate to long term, we will focus all regulations and policies towards the strengthening of banks operational factors and the implementation of prudential principles. Therefore, as a vision, we may expect to see a more complete picture of the banking industry's new shape by the end of 2010. It would be a banking industry with greater resilience, higher competitiveness in the global environment, and contributing towards the development of the nation's economy. To serve these purposes, we will issue the following policies: **first**, to reinforce capital structures in order to accelerate the consolidation process; **second**, to expand the role of foreign banks in the economy, **third**, to build the readiness of the banking system in anticipation of future developments in banking business; **fourth**, to strengthen bank internal management; and fifth, to improve the banking system infrastructure.

First, reinforce capital structures in order to accelerate the consolidation process. During the beginning of 2006, we will conduct an in-depth evaluation of bank business plans through 2008. According to our records, there is at least 27 banks which face an uphill struggle to reach the Rp 80 billion capital requirement by the end of 2007. We view that in order to make the consolidation program effective we will need to focus on the supervision process as follow up steps. By referring to Bank Indonesia Regulation No. 7/15/PBI/2005 regarding to Minimum Tier-1 Capital for Commercial Banks, we will be able to see the effectiveness of the consolidation acceleration process during the first quarter of 2006. This may be done through the evaluation of action plans to be submitted by banks with capital levels under Rp 100 billion.

I should emphasize that Bank Indonesia will not hesitate to take necessary actions to ensure that the regulations regarding to limitations in banking activities is upheld should regulation 7/15 cannot be met by a certain bank. These policies are necessary to ensure that the banking industry develops in the desired direction for the future.

Second, expand the role of foreign banks in the economy. As we know, during the last three years, we have seen steady expansion in foreign ownership. Foreigners now hold 48.51% ownership of the Indonesian banking industry, comparing to the government's decreasing stake of the 37.45%. Amongst Indonesia's 131 banks, 41 are under the ownership control of foreign investors.

Bank Indonesia's policy regarding foreign ownership in banking has been very clear. We have been very open. We realize that with their various strengths, foreign ownership banks have been able to bring added value to the Indonesian banking industry. Their role in channeling capital flows, supporting bonds secondary market activity, supporting international trade, creating product innovations, and transferring knowledge, are decipherable. Foreign banks and foreign ownership of domestic banks has created a positive circumstance for the strengthening of the national banking industry. We convey our sincere thank you for all that have been done.

However, we also have hopes that foreign banks, as part of the national banking industry, increase their roles in supporting financing for the development.

One of our studies indicates that foreign banks, both foreign bank branches and joint venture banks, have a relatively small role in the intermediation process. In the post-crisis period, foreign and joint venture banks moved relatively slowly in restoring their levels of lending. When other banks embarked on credit expansion in mid-2001, lending by foreign banks on contrary declined and even showed a negative credit expansion during the 2002-2003 period. Going forward, I expect and would like to see foreign banks and joint venture banks to participate more in Indonesia's economic revival through its financing activities as often said by their officials.

With the larger presence of foreign banks in the banking industry, it is understandable that the number of expatriate staffs in Indonesia is on the increase. However, to create greater opportunities for local talents, Bank Indonesia will limit the use of expatriate staff in middle management levels, with the exception for positions that cannot yet be filled by the domestic work force. Bank Indonesia will prepare a policy guideline concerning the development of human resources in the banking sector. This policy will take important notice regarding the presence and role of expatriate staff, which presence should be temporary, and during their stay, they are obliged to conduct transfer of know-how to local staffs through various training processes.

Another topic related to foreign banks is regarding to ownership. It may be seen that several foreign banks are owned by the same ultimate shareholder. From the point of view of bank supervision, this is obviously neither effective nor efficient. The same should also hold true for the bank owners themselves. It is not easy to harmonize the business strategy of several banks under their control and avoid unnecessary competition. For this reason, we are looking at the possibility of adopting a single presence policy for banks under foreign ownership control. Under the single presence policy, ultimate shareholders controlling more than one bank in Indonesia will be asked to consolidate their ownership.

Third, Bank Indonesia will build the readiness of the banking system in anticipation of future developments in banking business. Regarding to a global trend in the banking industry, it can be said that consolidation is under way between almost all ownership of major banking institutions and other financial industry corporations (such as insurance, money market, securities, mutual funds, and other related derivative activities). Over time, this has rapidly become widespread practice, producing a change in the nature of a bank's business from conventional operations to the more complex business of universal banking.

Universal banking is a development that we must anticipate as part of the future of the national banking industry. Considering the possible consequences, we will be very cautious and selective in the policy to open the possibility to universal banking activities in Indonesia.

Fourth, strengthen bank internal management. The fast pace development of information technology requires a level playing field in banking activities to enable the global market to be accessible from all corners of the world. This will force us to realign our operational standards in order to survive and to win in the competitive international banking world.

Understanding the importance of this issue, in the coming years, the implementation of best practices in good governance and Basel II should become our focus of attention. It is hoped that when the time comes where the momentum of strengthening shifts to become the momentum of growth, we will be equipped with effective operational capacities which allow us to dynamically move forward in a sustainable manner.

Fifth, improve the banking industry infrastructure. We realize that a strong stable financial system, an efficient and effective operating industry, and consumers that fully understand their rights and obligations will only materialize given that the supporting infrastructure is able to facilitate the developing dynamics.

It is for that reason that improvements of banking industry must receive top priority. In 2006, Bank Indonesia will improve and strengthen infrastructures in five areas, i.e., improving the Financial Sector Safety Net, the establishment of APEX banks for Rural Banks (BPR's), Banking Mediation Agency, Bank Research Institutions in various areas of Indonesia, and the regulation of Card Based Payment Facilities.

Distinguished Guests, Ladies and Gentlemen:

All of this is what I intend to convey to you tonight. It is not hard to imagine the magnitude of problems we must face ahead if we fail to act correctly and quickly. Our economic growth prospect is less than optimal, world oil prices may endure shocks, global imbalances are predicted to rise, and inflation pressure risks remain high. All the while, our time to act is very limited before the effects of those various problems make its way to the banking and financial industry, and ultimately to our daily lives.

This gives us great reason not to delay our actions. It is my hope that the several policy steps I mentioned will be able to fix the various problems within the banking sector.

To take the steps that I have elaborated, it is obvious that many sacrifices must be made. Therefore, we must continue to work hard and rest only when we reach our goals. The banking sector will continuously improve itself while Bank Indonesia will consistently and with strong discipline guard the steps to take towards the improvements. This nation will also continue to work until all that is aspired, a society that is just and prosperous, is achieved.

Once again, I would like to wish you a Happy New Year for 2006. May God Almighty bless us in this new year to take the necessary steps for a better future.