INDONESIA

BANKING

SUMMARY

Indonesia's banking sector is currently in dire condition, and a major effort to restructure the sector is beginning to take shape. The economic crisis that swept Southeast Asia starting in July 1997 has nearly paralyzed Indonesia's financial sector. Most bank loans are not being serviced and a collapse in bank credibility has all but shut off the flow of interbank credit. Public confidence in Indonesian banks is also low.

After a decade of banking sector liberalization, the government of Indonesia has found itself forced to issue a sweeping guarantee on bank deposits and other liabilities as the economic crisis deepens. Bank Indonesia has provided a substantial amount of liquidity credits to troubled banks – in effect becoming part owner – after several potentially disastrous bank runs. The government has also established the Indonesian Bank Restructuring Agency (IBRA), charged with supervising and eventually recapitalizing the ailing banks. It is estimated that over 70 percent of banking system assets are under government control.

Against this backdrop, the conditions facing U.S. and other foreign banks in Indonesia are improving in terms of market access and national treatment. In the December 1997 WTO financial services negotiations, Indonesia submitted a far-reaching offer that, among other improvements, guaranteed the ownership rights of existing financial services firms. In addition, partly in response to the banking sector crisis, the government is preparing legislation that would allow full foreign ownership of banks.

DESCRIPTION OF THE MARKET

Structure of the Market

As of April 1998, the Indonesian banking sector consisted of seven state-owned banks, 136 private national banks, 34 joint venture banks, 27 regional development banks, and 10 foreign bank branches. There were also 2,189 Rural Credit Banks and 7,191 other rural financial institutions providing small-scale credit to farmers. In terms of reported assets, private national banks were slightly larger than state-owned banks, due to a rapid increase in the number and size of private banks that began after a deregulation package was released in 1988. Although the number of banks is large, the entire banking sector is small by international standards, with assets totaling less than US$100 billion.

Consolidated Balance Sheet of Indonesian Banks
April 1998 (US$ millions)

	State-Owned	Private National	Foreign	Joint-Venture	Regional Government	Total
Assets						
Cash in vault	308	546	15	4	72	945
Demand dep. at BI	808	920	121	30	52	1,931
Foreign assets	5,557	5,043	928	1,011	2	12,541
Claims on Govt.	49	9	0	7	7	72
Claims on State-owned enterprises	3,449	716	31	47	39	4,282
Claims on private enterprises/ individuals	24,351	25,399	4,159	5,643	828	60,380
other	5,724	8,023	1,656	500	395	16,298
TOTAL	40,246	40,656	6,910	7,242	1,395	96,449
Liabilities and Equity						
Demand deposits	2,062	4,074	591	147	319	7,194
Time/saving deposits	14,107	16,154	874	277	580	31,992
Foreign exchange accounts	3,910	4,168	3,488	1,355	5	12,926
Foreign liabilities	5,856	2,417	1,226	4,155	13	13,668
Government account	1,687	110	11	16	81	1,905
Import guarantees	157	93	13	5	1	269
Borrowings from BI	4,570	6,425	51	459	48	11,554
Capital	2,684	2,639	335	502	153	6,313

	State-Owned	Private National	Foreign	Joint-Venture	Regional Government	Total
Assets						
Cash in vault	308	546	15	4	72	945
Other	5,210	4,577	320	327	194	10,629
TOTAL	40,243	40,657	6,909	7,243	1,394	96,450

Source: Bank Indonesia
Note: Converted at end-April rate of Rp 7970/US$. The end-June rate was Rp 14,500/US$.

The banking sector has historically been fragile, but the economic crisis that began in 1997 has severely weakened many banks, and a wholesale restructuring of the banking sector is underway. It is difficult to predict how many banks will emerge intact from the process. Consequently, the government's role in the banking sector has increased: it has provided direct liquidity support to the banks of over Rp 140 trillion (US$9.4 billion) as of June 1998, or about 20 percent of 1997 GDP, and is concurrently restructuring the banking system (see IBRA). Over the longer term, it appears that foreign banks will be invited to play a larger role in the Indonesian banking sector; legislation allowing unrestricted foreign ownership of banks is currently being prepared.

Regulatory Structure

Bank supervision is carried out under the authority of the Managing Director for Banking Supervision at the central bank, Bank Indonesia. After concerns about the health of the rapidly expanding banking system arose in the early 1990s, Bank Indonesia took steps to strengthen its regulatory control and supervision efforts. Reporting requirements were tightened and more frequent on-site inspections were instituted. Bank Indonesia also merged on-site and off-site inspection teams so that one team would have full responsibility for each institution. In addition, it adopted a "CAMEL" rating approach based on evaluations of capital, asset quality, management supervision, earnings, and liquidity.

Banking regulations were stiffened too. The minimum capital adequacy ratio (CAR) for commercial banks was raised to 8 percent at the end of 1993. (The government, however, lowered the CAR to 4 percent in mid-1998.) In September 1998, the paid-in capital required to establish a new commercial bank, including a joint-venture bank, increased to Rp 3 trillion (US$280 million). Existing banks do not have to meet a paid-in capital requirement. Loan loss provision requirements were raised in 1994, and again in early 1998. Legal lending limits were phased in by early 1997 to control banks' exposure to single groups of borrowers. (A maximum of 20 percent of the bank's capital can be lent to any corporate group, and a maximum of 10 percent of capital to any affiliated group.) Other regulations included a maximum loan-to-deposit ratio of 110 percent; a maximum net

open position for foreign exchange banks of 25 percent of capital; and a prohibition on investing in equities.

Despite a seemingly solid regulatory structure, the financial and economic crisis revealed serious weaknesses in the government's oversight of the Indonesian banking sector. Audits by international accounting firms have revealed that banks routinely circumvented the legal lending limits, and underreported and inadequately provisioned for shaky assets. It is estimated that over 60 percent of bank loans are non-performing. Substantial and unhedged foreign debt by both banks and borrowers has also led to significant financial sector deterioration. It is clear that both the banks and the supervisory and regulatory system need to be overhauled.

IBRA

The government of Indonesia established IBRA in January 1998 to (a) carry out a restructuring of the banking sector; and (b) administer the government guarantee on bank liabilities. Responsibility for the latter has since been transferred to Bank Indonesia. Banks that received a substantial amount of liquidity support have been placed under IBRA supervision. Seven banks under IBRA supervision were "frozen" (closed) in April 1998. As of June 1998, there were 53 banks under IBRA supervision, including the two largest private banks, Bank Central Asia and Bank Danamon. It is estimated that over 70 percent of banking system assets are under government control.

Under the restructuring plan that is being worked out with the assistance of the International Monetary Fund, the World Bank, and the Asian Development Bank, the banks under IBRA supervision are to undergo full portfolio reviews by international accounting firms. An asset management unit (AMU) is also being set up to deal with non-performing assets. Viable banks are to be recapitalized – with foreign participation invited – while non-viable banks are to be closed. The scope of the task, however, is enormous, because worsening economic conditions mean that previously sound banks continue to deteriorate along with the economy as a whole. Many observers believe that most of the banks not under IBRA supervision are in serious financial condition as well. Thus, it is difficult to estimate how many banks will remain after the restructuring process is complete.

U.S. PRESENCE IN THE MARKET

Four U.S. financial institutions – Citibank, Chase Manhattan, American Express, and Bank of America – enjoy grandfather status under Indonesian regulatory system and operate fully-owned branches. Although three of these four banks concentrate only on corporate lending, they are permitted to provide a full range of banking services.

The following eight U.S. banks have representative offices which provide services such as the facilitation of trade financing, but cannot accept deposits or make loans:

Bank of Boston	J.P. Morgan
Bankers Trust	NationsBank
Bank of New York	Republic National
First Union National Bank (formerly CoreStates Bank)	Union Bank of California

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

In 1972, Indonesia stopped issuing new licenses to foreign banks, and no new foreign bank entered the market until after the 1988 financial sector deregulation which permitted joint ventures. (The 10 foreign banks that owned and operated branches, including the four U.S. banks listed above, had been established prior to 1972.)

Recently, the government of Indonesia has reduced the restrictions on the scope of foreign banking activity in Indonesia, though some issues remain.

- Forced Divestiture: The1988 financial reforms permit a foreign bank to form a joint venture with a domestic bank, provided the foreign bank is a "major bank" in its home country, and that reciprocal access is available to Indonesian banks. The local joint venture partner must have an equity interest of at least 15 percent. However, a provision of Indonesian banking law, not yet enforced, requires that the foreign and domestic partners plan to increase the level of Indonesian ownership in the joint venture bank. Concern over this "Indonesianization" provision was allayed by Indonesia's December 1997 offer on financial services in the WTO, which stated that "[n]o transfer of share ownership shall take place without the consent of all parties in the joint venture concerned."

- Discriminatory Capital Requirements: The 1997 Indonesian financial services offer in the WTO also pledged to eliminate discriminatory capital requirements for joint-venture banks by the end of 1998. Under existing rules, these banks must have twice the capital of domestic banks, and regulatory authorities compute capital adequacy ratios and legal lending limits for foreign branches using only capital of the branch and not the capital of the parent bank. These rules restrict the amount of business these banks can do in Indonesia.

- Foreign Ownership: In 1997, the government of Indonesia lifted limits on the foreign purchase of shares in all nonbank firms listed on the Jakarta Stock Exchange, while the limit for foreign ownership of publicly listed banks remained at 49 percent. However, discussions underway in June 1998 indicated that the government was planning to lift all foreign ownership limits on banks, both listed and non-listed, by late 1999 in an effort to attract

foreign capital to the banking sector. The government's June 1998 Letter of Intent to the International Monetary Fund states that "all restrictions on foreign ownership of banks will be lifted as part of the prospective amendments to the banking law."

- Remaining Issues: Foreign banks can offer the same banking services as domestic banks, and U.S. banks operating in Indonesia generally report that they do not feel significantly restricted in their operations. However, there are restrictions on the number of expatriates for whom an investor can obtain work permits. These personnel limits, which apply not only to banks but to all foreign companies doing business in Indonesia, are considered restrictions. In addition, foreign banks are currently limited to opening branches in Jakarta and seven other cities: Bandung, Batam Island, Denpasar, Medan, Semarang, Surabaya, and Ujung Pandang, while domestic banks face no branching limits. As Citibank is the only U.S. bank to have opened branches outside Jakarta, in Bandung and Surabaya, this limitation has not yet become a hindrance. U.S. banks also report difficulties in complying with a government regulation that requires 20 percent of new lending to go to small and medium enterprises – a segment of the economy where U.S. banks have relatively little direct experience.

Exchange Rates Used:

June 1998	14,900 Rupiah/US$
September 1998	10,700 Rupiah/US$