Indonesian Banking: An Exercise in Reregulation of Deregulation

Alex Low *

INTRODUCTION

In recent years, there has been a trend throughout Asia towards the deregulation of financial systems. Unlike other Asian countries, Indonesia deregulated at a much more rapid pace, and paid the price with bank collapses. Other countries deregulated more cautiously. Taiwan, for instance, amended its banking law in 1989 to allow the setting up of new private commercial banks and in 1992, when private banks were first established, they were required to retain 30% of their earnings in reserve and could not pay more than 15% of earnings as dividends.[1]

The Indonesian government's efforts at deregulation of the banking system and consequent lessons for other developing countries are examined in this paper.

THE DEREGULATION EFFORTS

In Indonesia, deregulation in the banking industry commenced in June 1983. The banks were free to set their interest rates on both loans and deposits, and there was a diminished role for such activities by the central bank (Bank Indonesia). A significant turning point was signaled by a series of measures, known as 'PAKTO '88'.

The Indonesian Government's policies of banking deregulation were all part of a general economic deregulation process pursued throughout the 1980s. The deregulation policy, which had been supported by the Asian Development Bank and the World Bank, began in 1983, when the sharp decline in crude oil prices caused Indonesia's economic planners to re-evaluate the structure of the country's largely oil dependent economy.[2] The banking deregulation package, known as 'PAKTO '88' relaxed the restrictions on the establishment of private and foreign-owned banks as well as those on existing banks opening new branches.

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* BEc, MEc, LLB NSWIT Dip Lab Rel & the Law Syd; Macquarie University School of Economic and Financial Studies, Sydney

1 See C Y Huang and M H Sterling, 'New Amendment Liberalises Taiwan's Banking Sector', *East Asian Executive Report*, August 1989 at 8 and also J Kaufman Winn, 'Banking and Finance in Taiwan: The Prospects for Internationalisation in the 1990s', 25 *International Lawyer* No. 4 1991 at pp 907 and 935.

2 In 1983 oil and gas accounted for approximately 80% of Indonesia's export revenue.

In response to this package there was a rapid proliferation of banks. A further series of measures known as 'PAKFEB '91' imposed new prudential requirements on banks. Under 'PAKFEB '91' the Indonesian Government stressed that in the face of deregulation, and to be in line with international practice, banks and financial service providers should above all conduct their businesses prudently. 'PAKFEB '91' provided a series of requirements and sanctions on banks and other financial services to enforce the new prudential regime.

However, the transformation from an inefficient financial system consisting of State-owned banks to a dynamic framework which encouraged competition between State and private banks has not been easy, for deregulation brought with it attendant problems which cast a shadow over the banking system.

As examples, Bank Summa, a private bank, owned by the Sveryadjaya family, one of the wealthiest in Indonesia, went into liquidation after amassing more than $US700 million in non-performing loans. Bank Summa was one of the largest banks in Indonesia, yet over 70% of its loans were non-performing and a large proportion of the loans were command loans made on an unsecured basis to other members of the Summa Group, and were never expected to be repaid.[3]

In a later 1994 case, financial problems arose for the State-owned Development Bank of Indonesia (Bapindo) when it extended a $US430 million unsecured letter of credit issued to a conglomerate called Golden Key.[4] The letter of credit was to be used to build a petrochemical plant in West Java. However, Golden Key altered the letter of credit so that payment was made to the head of Golden Key rather than to the equipment suppliers and the money was then diverted to Hong Kong instead of being used to buy equipment for the plant.[5]

There were three main incidents:

(i) Corrupt activities were alleged against company officials leading to the arrest of a number of the Bank's executives. The Minister for Finance, Johannes Sumarlin and the Minister for Political and Security Affairs, Admiral Sudomo were implicated as both had provided references whilst still on the Board of Bapindo.[6]

(ii) Loans of $US200 million were made to PT Kannalo Prima Perkaea (Kanindo), a part of the Kanindo Group owned by Robby Tjakjadi, a former convict who was gaoled in the 1970s for smuggling luxury cars.[7]

As in the Golden Key Affair, funds were diverted to the company's textile arm instead of using the money for the purchase of real estate, which was the original intention of the loan. Political influence was also used to ensure the success of the loan.

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3 See S Aznan, 'Father Knows Best', *Far East Economic Review*, 25 June 1992 at p 62 and by the same author 'Sold at Last', *Far East Economic Review*, 28 June 1993 at p 54.

4 'Golden Key Hole', *Economist*, 30 April 1994 at p 84.

5 R Barsuk, 'Jakarta Says Foreign Bank Should Help Guide Bapindo', *Asian Wall Street Journal Weekly*, March 28, 1994 at p 24.

6 J McBeth, 'The Year of Doing Business', *Far Eastern Economic Review*, 1 September 1994, p 70-71.

7 M Saragosa, 'Indonesian Whispers Turn to Shouts', *Financial Times*, 13 September 1994 at p 7; and S Sinaga, 'Banks Set to Move on Group Linked to Bapindo', *Straits Times*, 3 September 1994 at p 19.

(iii) Loans were also made by Bapindo to Johannes Mulia who used forged documents to obtain credit.[8]

These illustrations of mismanagement by banks and lack of oversight by the government show a deep-rooted problem in banking exacerbated by deregulation.

It can also be said that property development lending has spurred consumption and an unhealthy increase in land prices. Experience in Australia would support the view that lending to consumers and for commercial real estate is riskier than lending to other sectors. Indeed, the 1990/91 tight money policy, instituted in part to slow overall credit growth, took the steam out of the property market and led to difficulties for some banks, including the bankruptcy of a newly formed bank with large real estate loans, Bank Summa.

Again, the insolvency and subsequent liquidation of Bank Summa, the tenth largest private bank with over $US1 billion in assets, demonstrates the problem not only of concentrating lending on real estate, but also of lending to related parties. A major portion of Bank Summa's loans were made to affiliated companies and the poor performance of these companies further weakened the bank.

Indonesia, with all its major private banks controlled by conglomerates, is particularly exposed to the risks of related lending. For this reason adherence to prudential standards requiring that no more than 30 per cent of equity be lent to any group is critical if financial soundness is to be achieved.

Between 'PAKTO '88', when deregulation was introduced, and 'PAKFEB '91', when a new prudential package was introduced, bank credit had increased by 158%.[9] This increase can be attributed to the liberal lending policies of both the state and private banks. Most of these loans were non-performing, for example, 21% of the loans at the end of 1993 made by the larger State banks were non-performing, compared with 6% at the end of 1990.[10]

The types of imprudent lending practices of the banks were:

(i) Not checking on the financial background of borrowers;

(ii) Not looking at the repayment ability of a borrower, and requiring proof of such;

(iii) Not ensuring borrowers used the loan for the designated purpose; and

(iv) Loans made on the recommendation of a high political official (memo lending).

Such practices are not uniquely Indonesian. In Australia, following a period of high interest rates and the failure of offshore loans, banks were made more accountable, thus forcing them to refine and reform their lending practices. Repayment ability is now paramount.[11]

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8 See: 'Bapindo Target of Another Government Probe into Fraudulent Loans', *Straits Times*, 9 October 1994, at p 15; see also the same publication, 15 October 1994 at p 16.

9 W Keeling, 'Jakarta Struggles to Control its Deregulation', *Financial Times*, 9 June 1992 at p 4.

10 G Field, 'Banks Refocus on Making Profits', *Euromoney*, September 1993 at p 253 and M Habir, 'Private Treatment', *Far East Economic Review*, 28 April 1994 at p 54.

11 Interview with Bank Manager, Mr Frank Wells, National Australia Bank, Bankstown

Memo lending however, is not an issue in Australia, unlike in Indonesia, where the culture among senior bank officials is to believe their jobs depend on loyalty to the politicians who appoint them and not on a stable and reliable loan portfolio.[12]

Obviously the deregulation package was meant to generate economic development by making the banking sector more competitive and dynamic where it was previously controlled by poorly managed and inefficient state banks.

Competition, the government did introduce, but it failed in maintaining economic stability in the banking system. A striking example is the capital adequacy requirements for private banks. Capital adequacy is a key indicator of how well a bank can cope with financial difficulties. It shows how the bank can absorb unanticipated losses and a banking collapse which could result in a run on the banks due to lack of confidence.[13]

Capital alone does not make a bank attractive to investors, but earnings do. Earnings generally result from a sound lending policy and practice, taking into account the purpose of the loan, the amount involved, the length of the loan, the source of repayment, the profitability of a transaction and the security offered.[14]

Indonesian banks largely adopted unrestricted lending practices. Many of the new banks were established by industrialists who then proceeded to use the bank as a cash cow for the conglomerate. Additionally, much of the money was used for speculation in real estate.[15]

THE REGULATION OF INDONESIAN BANKING

There have been three Banking Laws that have regulated Indonesian banking.

(i) Basic Banking Law, 1967

The foundation statute is the Basic Banking Law of 1967, effected by various implementing regulations and decrees. In addition, banks transacting business in Indonesia are subject to Indonesian laws and regulations of general application, including the Indonesian Civil and Commercial Codes, which contain provisions on the law of contracts, securities, guarantees and commercial papers.

Branch. This Branch is one which has a high ethnic content, particularly customers from South East Asia. Mr. Wells has stated that whilst the Bank has said repayment ability is something foremost in the Bank's mind he has some discretion and he states he exercises this discretion constantly for he states that none of his Asian clients ever reach the situation where the Bank has to foreclose.

12 H Sender 'Nor a Lender Be', *Far Eastern Economic Review*, 1 September 1994 at pp 73 and 74.

13 The minimum paid up capital for private banks in Indonesia was $US5 million. Contrast this with, say, Taiwan's deregulation in 1989 which required $US370 million! See Article by T Shale, 'Top Level Shakeout Needed to Amend the Financial System', *Euromoney* June 1993 at p 56 and also L. S. Liu, 'Financial Developments and Foreign Investment Strategies in Taiwan - A Legal and Policy Perspective', 25 *International Lawyer*, 1991 at p 69.

14 H J Milne, *Banker and Customer*, London, Pittman, 1986.

15 T Shale, *supra* n 13 at p 56 and also R. Borsuk, 'Indonesia's State Banks are in Precarious Shape', *Asian Wall Street Journal*, 20 October 1994 at p 4.

The principal authorities authorising the establishment of banks are the Ministry of Finance and Bank Indonesia. In order to establish and operate a bank, or to open a representative office in Indonesia, it is necessary to obtain a licence from the Ministry of Finance.[16]

The Basic Banking Law establishes three types of banks, categorised according to the sources from which they obtain funding and the type of credit they may extend. Apart from Bank Indonesia, these categories are general banks, saving banks and development banks.[17] General banks offer facilities for short term loans to the public. Savings banks obtain funds from savings accounts and extend credit by purchasing commercial paper. Development banks obtain funds from term deposits and the sale of medium and long term commercial paper. Their principal business activities are to extend medium and long-term credit in the so-called development sector.

Each type of bank is further distinguished and regulated according to whether it is organised as a governmental, cooperative or private bank, and whether it is domestic or foreign owned.

The activities of Bank Indonesia, as the central bank for the banking system, include current deposit transactions,[18] purchase and sale of securities and bills,[19] the granting of loans to banks for the purpose of increasing productivity,[20] or extending loans in emergencies as the lender of last resort.[21]

Deposits accepted by Bank Indonesia are used for clearing the transaction balances of the banks and for the remittance of funds.[22] Bank Indonesia may also lend on important development projects to both public and private entities. In practice, this is still subject to approvals from relevant departments. In its supervising role, Bank Indonesia is empowered to issue regulations binding on banks operating under or established under Indonesian law.

Article 34(1) of the Basic Banking Law provides that Bank Indonesia undertake Government payment operations. Thus all Government revenue, including tax receipts, is deposited in the Government's account at Bank Indonesia. The Bank extends loans to the Government,[23] subscribes to and underwrites short term Government securities, which are of a temporary nature and maturing at the end of the fiscal year. The Government must report all overdue loans and subsequent repayment schedules to the House of Representatives within three months of the end of the fiscal year.[24]

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16 As stipulated in Chapter III of *Basic Banking Law*, establishment and management of a bank are subject to Minister of Finance approval with prior consideration from Bank Indonesia.

17 *Id*, Article 3.

18 *Id*, Article 41(1).

19 *Id*, Article 41(4).

20 *Id*, Articles 29(1)(2), 32(2).

21 *Id*, Article 32(3).

22 Clearing Regulation, Article 10, *Bank Indonesia Circular Number* 2/470 UPPB/PbB of 19 September 1969.

23 Basic Banking Law, Article 35.

24 *Id*, Article 35(5).

These activities are carried out in the context of the bank's function to maintain a stable monetary environment essential for the development of the national economy.

Bank Indonesia also assists the Government in setting monetary policy through the Bank's Monetary Board.[25] The Monetary Board is comprised of three people, the Governor of Bank Indonesia and two representatives from Government, usually Ministers in the financial and economic areas. The Board is chaired by the Minister of Finance.[26] Whilst monetary policy is a matter for the government, through its participation in the activities of the Monetary Board, Bank Indonesia has a significant role.

Bank Indonesia's Board of Directors, excluding the Governor, consists of between five and seven directors.[27] The Governor and directors are appointed by the President of the Republic of Indonesia on the recommendation of the Monetary Board for a period of five years subject to further reappointment.

Bank Indonesia being the country's central bank, is principally responsible for implementing the government's monetary policies by controlling the money supply, credit and foreign exchange policy, and interest rates.

There is also a group of senior government economic advisers, called the Monetary Council, responsible for advising the President and other government officials on monetary policy. The Monetary Council can request reports from Bank Indonesia on any monetary policy issue.[28]

In addition, Bank Indonesia is responsible for the supervision of the banks and the daily regulation and administration of the banking system.

(ii) Banking Law, 1992

The principal current statute regulating banking, is the Banking Law of 1992 (the Law).[29] This statute regulates banking activity including the categories of banking and their activities (Chapter III), licensing subject to requirements such as composition, capital ownership and business plans (Chapter IV), ownership of banks including the level of foreign ownership (Chapter V), supervision by Bank Indonesia (Chapter VI) and management requirements such as the composition of Boards of Directors (Chapter VII).

The 1992 statute resulted from the view that the legal framework set out in the Basic Banking Law of 1967 was inadequate to cater for the dynamic pace of change in Indonesian financial development.[30]

The law restructured the banking industry by:[31]

(i) decreasing the types of banks;

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25 *Id*, Article 9.

26 *Id*, Article 11.

27 *Id*, Article 15.

28 W A Sullivan, 'International Banking: Indonesia', *International Financial Law Review*, September 1992 at p 21.

29 Law No. 7 of 25 March 1992.

30 C Mitchell, 'The New Indonesian Bill', (1992) 207 *New York Law Journal* at p 3.

31 PDD. Permawan, 'Bank System to be Restructured', *International Financial Law Review*, September 1991 at p 44 and by the same author, 'Indonesia's New Banking Law: the Status of State Banks', *International Financial Law Review*, June 1992 at p 14.

(ii) detailing the licensing and ownership requirements for the banks;

(iii) providing more exact government control over bank lending and capital adequacy policies;

(iv) requiring an education and training program for bank officers and directors; and

(v) the establishment of two kinds of banks, general commercial banks and rural credit banks.

The general commercial banks may buy, sell and underwrite certain security instruments including bank bills not exceeding one year, short term commercial paper, Bank Indonesia certificates, Indonesian Treasury paper and government guaranteed certificates and bonds. They also provide custodial services and issue credit cards.[32]

The rural credit banks do not have the range of activities of the general commercial banks as they are restricted to basic lending functions such as receiving deposits and extending loans. The government is very supportive of Islamic banking, including profit sharing in Islamic finance. The trend is evidenced by the government's approval of Bank Muamelet Indonesia, an Islamic Bank.[33]

To further stabilise the banking sector, the Law required that the legal vehicle of banking used by commercial banks was that of either a state-owned or a privately owned limited liability company, a provincial government company or a cooperative. Before the Law, state-owned banks were not subject to Indonesian commercial laws and were not required, for example, to increase their capital requirements, except if the Indonesian government brought down specific legislation dealing with each bank.[34]

Each state-owned bank became a stated-owned limited liability company pursuant to special regulations promulgated on 29 April 1992 under Article 54(1) of the Law. Conversion was completed under the special regulations and at the same time stripped the bank of all its rights, obligations and assets and transferred its employees to the new state-owned limited liability bank. The inaugural Board of Directors and Commissioners were appointed by the Minister of Finance.[35]

The new Law also placed higher standards upon banks regarding licensing, ownership and lending policies, aimed at giving integrity to the banking system.

In addition, administrative regulations such as periodic decrees, decisions and circulars were issued by the Minister of Finance and Bank Indonesia. Matters such as lending limits, capital requirements, asset evaluation, software security and electronic data processing have all been particularised in circulars issued by Bank Indonesia.

The purpose of a lending limit is to minimise the bank's exposure to credit risk. The principle behind the lending limit is the protection of a bank's capital from

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32 Sullivan, *supra* n 28.

33 O Mohamed Ali, 'Making Sense of Islamic Banking', *International Financial Law Review*, June 1992 at pp 30-31.

34 Sullivan, *supra* n 28 at pp14 and 21.

35 See PDD Permawan *supra* n 31 at p 41.

undue risks. An excessively large loan to a single customer represents a concentration of risk, whilst the making of smaller loans to several different customers diversifies the risk.[36]

In Indonesia, the old basic law for banking[37] sets no lending limits. However, lending limits were instituted through Directives issued on 27 October 1988,[38] by a Decree of the Board of Directors of Bank Indonesia. Under these Directives, the maximum percentages of funds available to any one borrower from bank and non-bank financial institutions were:[39]

- twenty percent of capital for a loan to a single debtor; and
- fifty percent of capital for a loan to a group of related debtors.

In this context, capital includes paid-up capital, retained earnings, general reserves and subordinated loans.

A Bank Indonesia Circular[40] provided detailed implementation of this Decree and applies the lending limit to related persons.

For the purposes of the Decree and the Circular, any of the following are defined as related persons:

- companies in which 35% or more of each company's shares are owned by a family[41] or by a company;
- companies with the same board of directors or supervisory board (Komisaris); and
- a company borrowing from or lending to another company or whose loan is guaranteed by another company.[42]

The Indonesia regulations concerning electronic data processing contain provisions relating to software security.[43] In conducting electronic data processing banks are required to:

- submit a proposal involving the integrated implementation of the system;
- appoint and authorise officers to be in charge of and to operate and develop the system;
- provide an adequate supervisory system;
- provide and maintain hardware; and
- provide a back-up contingency.

Where a bank appoints another party to conduct its electronic data processing, in addition to the above requirements, there must be:[44]

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36 *Bank Indonesia Directors Decree* No. 21/50/Kep/Dir of 27 October 1988.

37 *Basic Banking Law* No. 144 of 1967.

38 *Bank Indonesia Directors Decree* No. 21/50/Kep/Dir of 27 October 1988.

39 Article 2 of *Bank Indonesia Directors Decree* No. 21/50/Kep/Dir of 27 October 1988.

40 Circular No. 23/13/BPPP of 28 February 1991 is a part of 'PAKFEB '91' under the heading, Prudent Banking Activities.

41 The term family includes all persons with relationship to the second degree, from grandparents to grandchildren and their spouses.

42 Part II.3 of the Bank Indonesia Circular 23/13/BPPP of 28 February 1991.

43 Article 3 of *Bank Indonesia Directors Decree* No. 23/73/Kep/Dir of 28 February 1991.

- an appraisal of the ability and capability of the appointed party; and
- an agreement between the bank and the party appointed to maintain bank secrecy and to permit access by an auditor.

The current Decree on electronic data processing by banks operating in Indonesia was contained in the February Package ('PAKFEB '91').[45] Under the heading electronic data processing, this Decree broadly referred to a system using computers to assist banks in processing data. As in other Decrees and Circulars of the February Package, the term bank also included non-bank financial institutions.[46]

According to the Decree, electronic data processing can be performed either by the bank itself or another party.[47] Where a bank wishes to establish, or in certain cases even confirm the use of electronic payment systems, sixty days notice in writing from the date of the Circular must be given to Bank Indonesia.[48] Non-compliance with this provision renders a bank liable to a fine of 1,000,000 rupiah (approximately $US500m), or exposes it to the risk of being given a bad record rating by Bank Indonesia.[49]

Decrees of Bank Indonesia also subject banks to the capital adequacy requirements of the Bank for International Settlements and to the need to cooperate with the World Bank in its directives on limiting credit growth.[50]

Bank Indonesia is the sole supervisory authority over banks operating in Indonesia and so capital adequacy is of paramount importance.[51] Its principal concern is with the liquidity and solvency of each institution so as to protect creditors, based on the proposition that public trust and confidence in the safety of financial institutions is essential for a sound economy.[52]

The authority for the implementation of capital adequacy requirements is in regulations made by Bank Indonesia.[53] This Decree was part of PAKFEB '91. One part of the Package focussed on aspects of the Bank's supervisory role and guidance, another part deals with prudential requirements.

Many of the terms used, for example "capital" and "minimum", are not explicitly defined in the Decree. However, a Bank Indonesia Circular[54] has provided guidelines and detail for the application of the Decree. Although this Circular does

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44 Article 4 of *Bank Indonesia Directors' Decree* No. 23/73/Kep/Dir dated 28 February 1991.

45 Article 1 of *Bank Indonesia Directors Decree* No. 23/73/Kep/Dir dated 28 February 1991 (hereinafter Decree).

46 Decree, Article 1(a).

47 Decree, Article 2.

48 Bank Indonesia Circular No. 23/16/BPPP dated 28 February 1991 (hereinafter Circular), Part III(1)(2).

49 Article 7 of the Decree, and Part IV of the Circular.

50 J J Norton, 'The Work of the Basle Supervisors Committee on Bank Capital Adequacy and the July 1988 Report on International Convergence of Capital Adequacy Measurements and Capital Standards' in 23 *International Lawyer* No. 1, Spring 1989 at p 249.

51 *Basic Banking Law* No. 14 of 1967, Articles 30-31.

52 A Greenspan, 'Commercial Banks and the Central Bank in a Market Economy', *Economic Review*, November 1989, p 6.

53 *Bank Indonesia Directors Decree* No. 23/67/Kep/Dir of 28 February 1991. This Decree deals with a bank's minimum capital requirements.

54 Bank Indonesia Circular No. 23/67/BPPP of 28 February 1991.

not enjoy the status of law, it is a strong indication of how the Bank will interpret the Decree. In addition, Part 4 of the PAKFEB '91 concerning Assessment of Banks and Sanctions gives Bank Indonesia authority to suspend a bank or, in extreme cases, revoke its licence.[55]

In Australia, capital adequacy requirements apply to all banks holding banking licences.[56] State banks (which are governed by State legislation) comply with the guidelines on a voluntary basis. Whilst the requirements do not apply to Australian merchant banks, many of those banks which are subsidiaries of overseas banks are themselves subject to similar overseas requirements.

For the purposes of these requirements, as previously stated, a bank is defined differently in Indonesia. Bank Indonesia stipulates that the new capital adequacy requirements are to be adopted generally by all banks which by definition include non-bank financial institutions.[57]

This widened category indicates that the government recognises that the non-bank financial institutions are also part of the finance industry, and are therefore subject to the same requirements as traditional banks.

Capital adequacy requirements are not new. In Indonesia, the new standard replaces the previous formula.[58]

(iii) Commercial and Civil Codes

Banking activity is also subject to Indonesia's Commercial and Civil Codes, which are modeled on Dutch law. Both the Commercial Code and the Civil Code contain provisions applicable to banks. The Civil Code, for example provides for the creation of mortgage security interests in, and foreclosure on, collateral pledged to secure the payment of a debt. In addition, Article 1365 of the Civil Code, which imposes liability for the loss of the property of another, could be the basis of a lender liability claim, although this has not yet been tested as a basis for such a claim.[59]

The government also recently established a third regulatory body in response to the high percentage of non-performing loans held by Indonesian banks. In 1993, government officials formed a credit supervision committee, comprised of senior officials from both the Ministry of Finance and Bank Indonesia, to monitor the status of problem loans.[60] This committee works in conjunction with the Indonesian Attorney General's office to identify significant non-performing loans

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55 See also the *Basic Banking Law*, Article 31.

56 L Saunder, 'Capital Adequacy Rules: an Overview', a paper given at a seminar, 'Banking Law Challenges & Changes', Sydney, 22 May 1991; see also D J Keller, 'The New Capital Adequacy Guidelines for Australian Banks', *Reserve Bank of Australia Bulletin*, January 1898, p 6.

57 Decree, Article 1 and see also Circular, section General Elucidation . This category of bank should be read together with the *Finance Minister's Decrees*, No. 792/MK/IV/12/1970 and No. 280/KMK/01/1989 of 25 March 1989 concerning Financial Institutions and Non-Bank Financial Institutions. In addition to banks, two other kind of financial institutions may be established: so called non-bank financial institutions and leasing companies. Non-bank financial institutions provide merchant and investment banking services; leasing companies provide lease financing.

58 Originally in Bank Indonesia Circular No. 19/6/UPPB of 27 May 1986.

59 Sullivan, *supra* n 28, at page 26.

60 See M Habir, 'Withdrawal Symptoms', *Far East Economic Review*, 6 October 1994 at p 58.

and to investigate allegations of fraud and negligence on the part of bank officers and regulators.[61]

DEREGULATION MODELS IN SOUTHEAST ASIA

Governments throughout Southeast Asia took the approach that banks and resultant monetary policies were instruments that they could use to intervene in and to maintain control over their respective economies.[62]

In particular, Southeast Asian governments, either by owning banks or by influencing lending decisions of private banks, have used banks to channel domestic savings to favoured borrowers, often at below market interest rates.[63]

As a result of protectionist policies which prevented foreign and domestic banking competition combined with government directed lending, there grew throughout Southeast Asia a network of inefficient banking sectors.

Since the pace and extent of deregulation differed from country to country, such as Hong Kong where the banking sector is all but deregulated,[64] it is useful to look at different deregulation models.

Vietnam

Prior to 1990, the banking system serviced only State enterprises. Vietnam is still in the process of creating a banking system available to citizens and small businesses. Traditionally Vietnamese banks charged high fees, paid interest rates on deposits that did not keep up with inflation and were inefficient. Instead of deposits with banks, most citizens hoarded gold, bought real estate or foreign currency.

To create a more efficient and more strongly capitalised banking system, the Vietnamese Government is currently attempting to encourage savings being put into the banking system by restricting the use of foreign currency and the establishment of joint ventures with up to 30% foreign ownership in the hope of attracting foreign capital and expertise.[65]

Taiwan

Taiwan opened up its State-controlled banks to private competition in 1989. The monopoly held by government-controlled commercial banks ended in January

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61 See M Habir, *Ibid* at p 58.

62 Anon, 'The Luck of the Bankers', *Economist*, 12 November 1994, p 5.

63 Domestic savings rates are on average much higher in Southeast Asia than in developed Western countries. Expressed as a percentage of GDP, the domestic savings rate as of late 1994 was 48% in Singapore, 38% in Indonesia, 37% in Thailand and 31% in Malaysia, as compared with 28% in Germany, 19% in Canada and 15% in both Great Britain and the United States. See 'Business: The 1994 Bottom Line', *Asia Week*, 23 November 1994 at p 157.

64 Anon, 'Hong Kong Banks: Consuming Interest', *Economist*, 5 March 1994 at p 87.

65 M Vatikiotis, 'Vietnam: Foreign Help Wanted', *Far East Economic Review*, 6 October 1994 at p 55.

1992, when Grand Commercial Bank and Dah Aan Commercial Bank opened as the first two private commercial banks.[66]

Prior to deregulation, the government instituted conservative fiscal policies which restricted bank financing to priority sectors such as large industrial borrowers[67], meaning that small business had no access to finance. To cater for their needs there developed a thriving black market consisting of a loan shark system and clubs where an association of people regularly contributed to a common fund and drew from it in turn.[68] It has been estimated that 40% of Taiwan's businesses obtain their financing from this underground sector.[69]

It should also be noted that in Taiwan, paying by cheque is like being granted credit, that is, business people would post date a cheque and thereby obtain extended credit. Because post dating was a way of life, there developed a discount market in post dated cheques.[70]

Private banking not only increased competition but above all provided finance for small business and also more efficient customer services. State banks in particular realised that customer liaison was now of great importance and one of the State banks began running courtesy classes for its employees.[71] In addition, the private banking sector also replaced underground financing and this led to increased stability for Taiwan's financial system.

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66 J Friedland, 'Law for the Jungle', *Far East Economic Review*, 7 May 1992 at p 52 and L Mudle, 'Private Banks Start to Open in Taiwan', *Financial Times*, 28 January 1992 at p 4.

67 W W-Y Wang and J T-Y Yang, 'Financial Institutions in Taiwan: An Analysis of the Regulatory Scheme', (1990) 4 *Journal of Chinese Law* at p 3.

68 Such credit clubs or credit associations are well known throughout Asia. Every country has a version of it. The Vietnamese system is a variation of the Chinese system where clubs have a manager/banker who begins the club and brings together interested members. Each member knows that if they contribute regularly, they will eventually be entitled to a sum of money which they could put to whatever use they wished. In addition, each member has the opportunity of bidding for a loan instead of waiting for their turn. The person who makes the highest bid takes the pot of contributions. These credit clubs have their foundation in a scheme attributed to a Neapolitan banker Lorenzo Tontin in France about 1633. The Tontin scheme was one in which subscribers to a common fund shared an annuity with the benefit of survivorship, the shares of the survivors being increased as the subscribers died until the whole goes to the last survivor.

69 J Friedland and L Kaye, 'Pennies from Heaven', *Far East Economic Review*, 25 January 1990 at p 54.

70 Taiwan had in place a *Negotiable Instruments Act* in the mid 1950's which stated that demand cheques, even if presented before the date marked on the cheque had to be paid or be subject to criminal sanctions. These sanctions were abolished in 1987. This extended the benefit of the Act to the discount market, see P Ghate, *Informal Finance*, Oxford, OUP 1992 at p 33.

71 J Friedland, 'Customers Come First', *Far East Economic Review*, 7 May 1992 at p 72 and S-C J Chen, 'Following the Clients', *Far East Economic Review*, 6 October 1994 at p 50.

Malaysia

Malaysia has made a number of reforms to its banking system which are indicative of its commitment to internationalisation.[72]

Three important reforms were:

(i) The creation of a regional offshore banking centre at Labuan, an island off the Malaysian State of Sabah. The island had a low tax regime and it was encouraged as a financial centre. However, there is a cloud on the horizon, for losses by Malaysia's Berjaya Group on derivative trading by financial institutions operating out of the Labuan Financial Centre could well lead to a reassessment of the government's deregulation in Labuan;[73]

(ii) Deregulation of interest rates by giving banks discretion to set their own base lending rates and allowing banks to open up branches throughout the country; and

(iii) The creation of a two-tier banking system for foreign exchange. Only first tier banks could open foreign currency accounts for Malaysian residents. Seven banks were given this status.[74]

THE DEREGULATION MOVEMENT IN INDONESIA

The economy through macroeconomic eyes

A basic tenet of economists is that to maintain growth and to develop, an economy requires complementary growth of a country's financial system. Indonesia attempted just that by putting into effect major policy packages in 1983, 1988, 1990 and 1991. Whilst economists argue that the timing of financial packages is essential for success, they generally agree that macro-reform can be achieved through financial reform.[75]

How successful have these financial reforms been?

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72 See S Jayasankaran and G Silverman, 'At your Service' *Far East Economic Review*, 31 August 1995 at p 56.

73 S Astbury, 'Malaysia to Set Derivative Rules', *Australian Financial Review*, 10 January 1995, at p 20.

74 Bank Bumiputra Malaysia, Bank of Commerce (Malaysia), Development and Commercial Bank, Hong Kong Bank Malaysia, Malayan Banking, OCBC Bank (Malaysia), and Public Bank.

75 A Krueger, 'Interactions Between Inflation and Trade-Regime Objectives in Stabilisation Programs' in W. Cline and S. Weintraub, (eds) *Economic Stabilisation in Developing Countries*, Washington: Brookings Institute, 1981.
I Little, T Scitovsky and M Scott, '*Industry and Trade in Some Developing Countries: A Comparative Study*', Oxford: Oxford University Press, 1970.
C Mayer, 'Myths of the West: Lessons from Developed Countries for Development Finance', *World Bank Working Paper*, 1980.
R McKinnon, 'The Order of Economic Liberalisation: Lessons from Chile and Argentina' in K. Brunner and A. Meltzer, (eds) *Economic Policy in a World of Change*, Carnegie Rochester Conference Series, Amsterdam, North Holland 1982.
M Michaely, 'The Timing and Sequencing for Trade Liberalisation Policy' in A Choksi and D Papageorgiou (eds) *Economic Liberalisation in Developing Countries*, London: Basil Blackwell 1986 pp 41-59.

Throughout the 1970s, government revenue was used to promote key domestic industries behind tariff barriers. At the same time, inflation raged and Indonesia countered by developing the exchange rate. However, this was in vain as there was continued appreciation of the rupiah. The government also introduced a policy of direct control involving a ceiling on credit and interest rate control.[76]

In the 1980s Indonesia was a high growth/low income country dependent on oil. Oil accounted for up to 80% of exports, kept the country's current account in the black and accounted for as much as 70% of the revenue from Pertamina, the State-owned oil company.

Indonesia's external environment improved in 1984-85 and then worsened considerably, with the 1986 plunge of the price of oil and the appreciation of the yen both pushed the current account into the red.[77] As in 1983, the Indonesian authorities responded with a combination of exchange rate and fiscal policies to restore the balance of payments. Real current government expenditures were cut through a salary freeze, subsidies were reduced and capital spending slowed. Another sharp devaluation was announced in September 1986, lowering the value of the rupiah by 50 per cent.[78] In response to the stabilisation program, Indonesia was also able to step up its aid program, with large amounts of the balance of payments support coming from the World Bank, the Asian Development Bank and Japan.

Unlike the 1983 crisis, stabilisation efforts were coupled with trade reform measures. This began in 1985 with a reduction in the dispersion of tariff rates. More reforms accompanied the 1986 devaluation, setting a pattern of replacing non-tariff barriers with tariffs which were subsequently lowered. In an effort to attract foreign investment, licensing requirements were simplified in 1987. By 1991, a series of almost annual trade reform packages succeeded in sharply lowering export bias and variance in the trade regime and broadening the scope and ease of foreign direct investment.

Stabilisation and trade reform left the Indonesian economy in a different position in 1988 than it had been at the beginning of financial reforms in 1983. Inflation had been kept under 10 per cent, helped by the trade reform that created more effective competition from imports. Strong efforts to reform the domestic tax system and increase collections, coupled with austere spending, also helped keep the fiscal deficit below 4 per cent of GDP despite a decline in oil revenue.[79] Strong export growth had reduced the dependence of the trade account on oil.

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[76] An earlier devaluation in 1983 was a devaluation of the rupiah by 38 per cent in March 1983, which brought the real exchange rate back to its 1978 level, when the last devaluation had occurred. This was undertaken to spur non-oil exports, which had responded well to the 1978 devaluation, and to increase rupiah revenues in the budget. It was in response to the fact that by 1982, the worsening price of oil and world wide recession had undermined Indonesia's balance of payments and fiscal balance, thus prompting a series of macroeconomic adjustments. The current account deficit had reached 7.8 per cent of GDP, while oil tax receipts had fallen 13 per cent in real terms during the fiscal year (April to March).

[77] Anon, 'Indonesia: Gaining from Oil Glut', *Economist*, 24 September 1983 at p 30.

[78] G Fane, 'The Sequencing of Economic Deregulation in Indonesia', in R H McLeod (ed) *Indonesia Assessment*, Institute of Southeast Asian Studies, ANU, 1995, at pp 111-112.

[79] M Pangestu, 'Recent Economic Developments', in R H McLeod (ed) *Indonesia Assessment*, Institute of Southeast Asian Studies, ANU, 1995, at pp 31-32.

Nevertheless, the debt burden had increased, both because of yen appreciation and because of larger current account deficits.[80]

When the Indonesian government began to restructure its economy in the period of the mid-1960s, the Indonesian monetary system was marked by a high level of inflation and an uncontrolled money supply.[81] The government was aware that economic stability would not be maintained in such an environment. Thus the government tried to rehabilitate and stabilise the economy by restraining money supply. The principal aim was to lower the inflation rate or at the very least maintain a stable rate.

In the 1970s, the surplus of funds resulting from the oil boom led the government to introduce a policy of direct control, involving a ceiling on credit and interest rate control.[82] As a result of the reduction in the rate of expansion of the money supply, there was a severe decline in savings deposited with the banks and thus a reduction in the funds needed to finance development.

Official recognition that the banking system was essential to the development of the Indonesian economy was hastened by the decline in the international price of oil. In 1982-83 Indonesia's earnings from oil exports fell by 24% which at the time represented 70% of the country's total export earnings.[83]

FINANCIAL RESTRUCTURING THROUGH DEREGULATION

Indonesia's financial system at the beginning of the 1980s was typical of most developing countries.[84] Finance was dominated by commercial banks, which accounted for 95 per cent of financial assets.[85] Banking was dominated by five State commercial banks which, along with the Bank of Indonesia, which has the concurrent roles of a central bank and a commercial bank, accounted for 80 per cent of the banking system's financial assets. State banks had a number of advantages, including extensive branch networks, access to Bank Indonesia, and the exclusive right to receive public enterprise deposits.

The other 15 per cent of the banking system's assets were in the hands of 21 banks authorised to operate in foreign exchange (11 foreign and 10 domestic), 60 private domestic banks limited to rupiah operations and 29 development banks. While private banks had grown during the 1970s, they were hampered by restrictions on branching and access to public enterprises.

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80 G Fane, *supra* n 78 at pp 107-108.

81 B Kesowo, 'Perspectives and Practice of Licensing and Technology, Transfer in Indonesia', paper presented in a Regional Seminar on Licensing and other Technology Transfer Arrangements, Seoul, October 1987.

82 *Bank Indonesia Directors Decree* No. 7/64/Kep/Dir/UPPK of 26 August 1974 and No. 10/12/Kep/Dir of 17 May 1977.

83 *Supra* n 77 at p 90.

84 V Sundararajah and T J T Balino 'Issues in Recent Banking Crises in Developing Countries', *IMF Working Paper* 1988 and A Nasution, 'Financial Institutions and Policies in Indonesia', Singapore Institute of Southeast Asian Studies, 1983.

85 See Bank of Indonesia Annual Reports for 1982, 1988 and 1991.

A realisation developed that an efficient banking system was necessary for the country's economic development, making it dependent on foreign borrowing. With this in mind the government introduced three reforms in June 1983 which:

(i) Eliminated Bank Indonesia's control over interest rates on deposits and loans;

(ii) Abolished credit ceilings for State banks; and

(iii) Recapitalised State banks by funds provided by the World Bank.

This meant that there was now an independent body overseeing credit growth. The hope of these reforms was to create a market oriented banking system that would attract local funds. This hope became reality with the freeing of interest rates on deposits, thus drawing funds into the banking system and, by the end of 1983, just 6 months later, the amount of money held in fixed term deposits was about 90% higher than at the end of the previous year.[86]

State-owned banks now had to compete directly with privately owned banks for alternate sources of funding. Faced with competition, the State banks had no choice but to modernise, and become more efficient and provide better customer services.

Further liberalising reforms were introduced in October 1988, once again at a time of falling oil prices,[87] and once again the reforms were to mobilise further domestic funds to bolster the non-oil sectors of the economy. It can be said, however, that the economy has become less dependent on oil since the early 1980's when oil accounted for approximately 80% of the country's export earnings. By 1994 it had fallen to 26%.[88]

These reforms were part of the 'PAKTO '88' package which made numerous changes to the regulatory structure of the banking industry and dramatically reduced entry barriers to financing. This was effected by a series of Finance Minister and Bank Indonesia Directors' Decrees.

The prime objective of this package was to foster the growth of non-oil exports by means of mobilising funds, increasing the efficiency of financial markets and other innovations in the financial markets.

The principal significance of 'PAKTO '88' to investors and foreign bankers was that it enabled the establishment of joint venture banks in Indonesia, subject to the condition that the foreign partner was classified as a major bank in its home country and reciprocity existed for Indonesian banks.

Other requirements were that each joint venture bank had a paid up capital of at least 50 billion rupiah with the Indonesian partner supplying at least 15 % of that amount. Export credits also had to equate to at least 50% of the bank's total loan portfolio within one year of the establishment of the bank.

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[86] K Cooke, 'Indonesia: Moves to Mobilise Domestic Funds', *Financial Times*, 29 May 1984 at p 27.

[87] J M Brown, 'Indonesia Makes Sweeping Reforms of Banking Sector', *Financial Times*, 28 October 1988 at p 6.

[88] J McBeth, *supra* n 6 at p 71.

New private banks could be established subject to a paid up capital of 10 billion rupiah ($US5m). Existing local State or private banks could provide full service branches throughout Indonesia provided they could show they were financially sound for the preceding 24 months.[89]

Prior to these reforms, State enterprises could only place their funds with State banks. Now State enterprises could invest up to 50% of their funds with both foreign and domestic private banks, with up to 20% placed in any one bank. It is estimated at the time of introducing 'PAKTO '88', 5,000 billion rupiah was available for deposit.[90]

The liquid reserve ratio for banks held by Bank Indonesia was also reduced from 15% to 2% which facilitated banks becoming licensed foreign exchange dealers. Previously such licences had to be renewed each year. With the passing of 'PAKTO '88', licences once issued became indefinite.

Lastly, the promotion of competition was coupled with improved prudential supervision. 'PAKTO '88' listed the maximum percentages of a bank's capital that could be lent to various borrowers.[91]

Having dealt with banking, the next reform package ('PAKDES', in December 1988), focused on stimulating the capital market and other financial institutions. The government issued new regulations covering the establishment of multi-finance companies empowered to engage in leasing, factoring, venture capital, credit card operations and consumer credit. The same activities were made available to banks. The government issued new regulations governing securities trading, including prohibitions against insider trading. A major disincentive to investing in shares was eliminated when domestic deposits were subjected to a 15 per cent withholding tax, the same tax levied on dividend payments. New regulations also opened the market to foreign investors.

Bank Indonesia, continuing with the reforms, introduced a further package in March 1989. This was aimed at refining the prudential regulations announced in 'PAKTO '88'. This was known as 'PAKMAR', and it eliminated the ceilings imposed on the amount of offshore borrowing by foreign exchange banks. This allowed banks to borrow freely offshore so long as they lent domestically in foreign exchange. Henceforth these banks were required to maintain no more than 25% of shareholder's equity. As at 1 September 1989 the Ministry of Finance had

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89 Anon, 'Deregulating Indonesia: It's the Bank's Turn', *East Asian Executive Report*, 15 November 1988 at p 18.

90 J Friedland, 'No More Coddling: Indonesia Opens up Banking Sector to Competition', *Far East Economic Review*, 10 November 1988 at p 68.

91 A single borrower could be lent at 20%; to an affiliated group of companies, 50% of the bank's capital; to a member of the bank's Board of Directors or supervisory board who is not a shareholder of the bank (or to a company owned by such a board member), 5% of the bank's capital; to a member of the bank's Board of Directors or supervisory board who is not a shareholder of the bank and to an affiliated group of companies owned by such a board member, 15% of the bank's capital; to a shareholder of the bank or a company owned by a shareholder, 10% of such shareholder's equity holding in the bank; to a shareholder of an affiliated group of companies owned by a shareholder, 25% of such shareholder's equity holding in the bank; to directors or employees of the bank, various percentages based on the individual's remuneration from the bank and the individual's ability to repay, *supra* n 89 at p 18.

granted approval to sixty-four percent of the applications for the establishment of private commercial banks. Additionally, the Ministry announced that they had approved 91 out of the 98 applications for these private banks to open branch offices and 95% of the applications for State banks to open up branch offices. In addition, the implementation of the Deregulation Package had increased the value of the stock market: the average value of stock traded through the stock exchange rose from 21 million rupiah ($US10,500) per day in 1987 to 122 million rupiah ($US61,000) per day in 1988.

In January 1990, Bank Indonesia enacted PAKJAN, an additional package which instructed banks to allocate at least 20% of their credit portfolios to small scale business lending, mainly in the farming and foodstuff sectors.

These three packages combined were a dynamic impetus for growth in banking, not only in the number of banks but in the amount of credit extended by the banking industry. Now, not only were there new banks but also expansion of branches by existing banks, leading to rapid growth in private banks. Between 1988 and 1992 the number of private banks increased from 126 to 134.[92]

Many of the private banks were a result of Indonesian industrial groups viewing banks as an efficient way to fund the groups' own business activities. Two of the largest banks, Bank Central Asia (BCA) and Bank International Indonesia (BII) owed their birth to the industrial group Sinor Mas Groupage.[93]

The granting of credit also grew by 53.8% in 1989-90 and by 40.3% in 1990-91. This was due to the increase in the number of banks and the lowering of the liquid reserve ratio to 2% of bank capital, meaning there was more capital available for immediate lending.[94]

This credit growth was mainly due to private banks which increased outstanding credit from 23% to 42%, whilst the share of State banks decreased from 71% to 52%.[95]

It should be noted that while the reforms increased the presence of foreign banks in Indonesia, those banks played little or no part in the banking sector, preferring to concentrate on corporate business and servicing global clients, and not on local retail business, although they did provide custodial services.[96]

Deregulation was now in full swing.

EFFECT OF DEREGULATION AND SUBSEQUENT REREGULATION

The aggressive growth of banking and credit between 1988 and 1990 caused the overall loan quality of the Indonesian banking system to deteriorate. Bad and

92 J Leung, 'Indonesia's Banks Taste Sour Side of Deregulation', *Asian Wall Street Journal Weekly*, 21 December 1992 at p 1.

93 Shale, *supra* n 13 at p 55.

94 Leung, *supra* n 92 at p 5.

95 Indonesia: Banking, US Department of Treasury, National Treatment Study (1994) at p 323.

96 M Habir, *supra* n 60 at p 60.

doubtful loans made by banks increased more than 50% in 1991 from a base of 5.9% the previous year.[97]

Poor loan quality affected both State and private banks alike. Neither kind of bank had properly trained staff in credit analysis. State banks made loans on a political basis and not for sound financial reasons. Borrowers did not feel obliged to repay these loans. Private bank debts arose from lending to shareholders. Conglomerates (who established banks) used the banks as a source of inexpensive capital. Such banks were captive lenders and often did not carry out proper credit checks. Lending limits were exceeded, contrary to those set out in 'PAKTO '88'.[98]

Responding to this financial chaos, the government took action on the monetary front in an attempt to stop credit growth and reduce bank liquidity. As a result, interest rates soared to over 25% per annum by January 1991.[99]

This only drove borrowers to go offshore to seek funds, causing this initial monetary policy to fail. Each year between 1988 and 1991 offshore borrowing grew; from 0.4% in 1988 to 4.5% in 1991.[100]

The government therefore took additional steps to stop credit growth. State banks were forced to purchase Bank Indonesia certificates (SPI's). In so doing the government succeeded in withdrawing approximately 8,000 billion rupiah ($US4B) from circulation.[101] State enterprises were also required to withdraw funds from State banks.[102]

Offshore borrowing was also controlled. A new government department known as the Foreign Commercial Debt Management Coordinating Team (FCDMCT) set a maximum on the aggregate amount of funds that could be raised by offshore commercial loans within any particular year. FCDMCT consisted of 10 Ministers and the Governor of Bank Indonesia. The annual ceiling was set at $US500M on private banks and $US1 billion for State banks.[103] FCDMCT approval was also required.

In addition to these monetary administrative controls, the Indonesian Government imposed a regime of stricter prudential standards on banks in a number of areas. These were the February 1991 'PAKFEB '91' measures with the stated aim of controlling credit growth and strengthening central bank control over State and private banks through prudential regulations. New professional standards were set for bank directors. Loan loss provisioning standards were overhauled, now

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97 W Keeling, 'Indonesian Banks Face Pressures', *Financial Times*, 3 June 1992 at p 4. A commentator, Hendo Suwito opines that Bank Indonesia underreported the extent of the problems with their non-performing debts and that the actual percentage of bad loans was much higher. (H Suwito, 'Indonesian Banks Trapped by Bad Debts', *Asia Pacific Business Reports*, 28 June 1993).

98 See Leung *supra* n 92 at p 5 and Field *supra* n 10 at p 253.

99 T Shale, 'Top Level Shakeout Needed to Mend the Financial System', *Euromoney*, June 1993 at p 55.

100 Standard and Poors, Asian Pacific Region: Asean Banking Profile - Indonesia, available from Melbourne Office (Indonesian Banking Profile).

101 Anon, 'Paving the Way for Growth', *Institutional Investor*, 29 November 1992 at p 6.

102 Indonesian Banking Profile.

103 D H Cornwell and D L Huber, 'Indonesia Restrictions on Offshore Borrowing', *International Financial Law Review*, October 1991 at p 45.

involving a financial analysis of customers rather than simply a check of whether their payments were current.

The intent of the policy behind 'PAKFEB' was to maintain public trust in the banking system and to implement the new Bank for International Settlements capital adequacy requirements. The package also included a series of Finance Minister and Bank Indonesia Directors' Decrees, implemented by Bank Indonesia Circulars.

The Package has the following objectives:

(1) to establish operational rules and regulations for banks;

(2) to improve the supervisory system so that it efficiently acts as an early warning system;

(3) to develop a method by which a bank's financial condition can be determined objectively;

(4) to establish an effective guidance mechanism for banks;

(5) to sanction implementation and a problem-solving alternative for banks experiencing difficulties; and

(6) to improve the support systems to achieve increased efficiency in the banking system.

Although neither a Bank Indonesia Directors' Decree nor a Circular has the mandatory force or effect of legislation, in practice, the banking sector complies with the letter and the spirit of each decree or circular.

One of the aims of financial deregulation is to reverse the decline in the market share of banks, and to re-establish banks at the leading edge of the financial system.[104] This erosion of the banks' relative position in financial markets is a source of concern both for the banks and for the regulators. Nevertheless, the introduction of risk-weighted capital adequacy guidelines for banks (which in Indonesia is also applied to non-bank financial institutions) could be the beginning of a further decline.

Rapid developments in the financial environment consequently altered the impact of regulations on the financial sector. The result was a weakening in the competitive position of regulated financial institutions leading simultaneously to a reduction in the ability of monetary regulators to control the growth of total financing. This also led to a view among regulated institutions that the costs of a regulated status outweighed the benefits.[105]

Thus the banking system became more removed from the marketplace in which banks were supposed to function.[106] Non-bank competitors, which were free of the restraints that govern banks, could exploit the opportunity to replace the bank's

[104] R Ackland, and I Harper, 'Financial Deregulation in Australia: Boon', a paper given at a *Symposium on Developments in Banking, 19th Conference of Economists*, 24-27 September 1990.

[105] *Id.*

[106] H H Loring and J M Brundy, 'The Deregulation of Banks' (1985) 42(2) *Washington and Lee Law Review*, pp 380-381.

position. When this happens, the profitability of banks and the soundness of banking declines.

Apart from stimulating the growth of existing banks, it is believed that financial deregulation would encourage the establishment of new banks.

There is another school of thought which maintains that banking should never be deregulated.[107] 'PAKFEB' could be categorised as following this school in that the deregulation provides for even more stringent restrictions than the previous legislation.

Thus PAKFEB and later Bank Indonesia decrees and directives could be interpreted as reregulation. It could also be argued that in any event when deregulation takes place, Bank Indonesia's supervisory activities will be expanded.

Perhaps this process is a necessary complement to deregulation rather than to reregulation.[108] Those who argue this conclusion submit that the stability of an economy is linked to both the solvency of the financial institutions and the degree of public confidence in those institutions.

It is argued that economic stability cannot be maintained in an environment of currency crisis, or an uncontrolled money supply. Thus, to achieve a necessary financial and economic stability, an appropriate regulatory framework is said to be the best safeguard.[109]

In Indonesia, the adoption of 'PAKFEB' can be described as a product of this viewpoint. After severe examples of bank management failure and unhealthy competition among Indonesian banks between 1988 and 1990, the regulators were determined to adopt a stringent regulatory framework for banks, while relaxing other aspects of the system.

'PAKFEB' and resultant decrees should not be interpreted as meaning deregulation was a failure. It was economically correct to open the banking system and expose inefficiencies in the banking system to competition.

However 'PAKTO '88' and later liberalising packages did not have enough regulatory safeguards in place. For example, it was relatively easy and cheap to set up a private bank, as only $US5M in paid up capital was required. In addition, the liquid reserve ratio required was only 2% of a bank's capital. This clearly was not enough of a safeguard for a bank to guarantee its loans.

The response was to impose controls and prudential standards needed of a sound banking system. In so doing the government had to ensure that the public did not lose confidence in the banking system and, at the same time, had to avoid bank failures.

To do this Bank Indonesia in 1993 relaxed certain standards imposed by 'PAKFEB' when it was clear many banks would not be able to meet its targets. It dealt with this by either extending target dates or lowering targets. For example, to

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107 J B Wynne and S S Spagnola, 'The Myth of Bank Deregulation: For Every Action there is an Equal and Opposite Reaction' (1985) 42(2) *Washington and Lee Law Review*, pp 383.

108 C J Thompson., 'Directions for Prudential Supervision in the 1990's', *Reserve Bank of Australia Bulletin*, May 1991, page 7.

109 Wynne, and Spagnola, *supra* n 107 at p 384.

ensure that banks would meet the risk weighted capital ratio requirement, Bank Indonesia amended its risk weighting guidelines in May 1995.[110]

State-owned banks were a problem in themselves; they were weakened by high levels of non-performing loans, low capitalisation and declining earnings,[111] and no doubt played no small part in Bank Indonesia's decision to relax standards.

Yet one cannot sheet home all the problems to the deregulation of the late 1980s, for two of the main reasons for the weak loan portfolios of the State-owned banks were politically motivated lending practices and the lack of credit checks. Superimposed upon these two reasons is the fact that prior to deregulation, State owned banks were protected from competition and were used in funding government economic development.

Deregulation only accelerated the deterioration of the banking system and its bad debt problems, highlighted by rapid credit growth, new undercapitalised banks, increased competition among banks and lack of regulatory safeguards.

However, when awareness of debt problems increased, the government recognised that an ill banking sector could become a threat to the country's entire financial system. So whilst deregulation was the main goal of the banking authorities in the late 1980s, controlling credit growth and ensuring bank stability was the main concern of the 1990s.

MEASURES TO STABILISE CREDIT GROWTH

In January 1995 Bank Indonesia adopted four policies which tightened its control on State and private banks:

Firstly, banks were required to draw up annual working programs, which had to include projections on savings, deposits and lendings. Banks were required to submit to Bank Indonesia an annual working plan no later than one month from the beginning of a new calendar year. These plans had to contain projections as to the mobilisation and distribution of funds, the expansion of branches, and the development of a human resources scheme for employees.

The second policy set out rules as to who may be involved in the banking industry. Persons or groups that had been involved in fraudulent activities or fraudulent collusion could not become shareholders, directors or employees of a bank. There were also malpractice tests specified and shareholders or directors had to meet this standard.

The third policy regulated the exchange of confidential customer information between banks. A request by a bank for information on one of its customers had to be in writing and had to clearly state the purpose for which the information was to be used.

The fourth policy related to auditing and publication requirements of banks. Banks are required to submit their annual financial statements to be audited by a chartered accountant and then sent to Bank Indonesia. Financial reports had to be

110 Indonesian Banking Profile.
111 *Id.*

prepared bi-annually and the report had to refer to any overseas branches of the bank.

In September 1995, Bank Indonesia adopted two more policies. The first concerned the legal lending limit; in order to encourage banks to spread their risk and not be centred on a small number of debtors for large amounts, Bank Indonesia set maximum limits at which banks were allowed to provide finance to debtors or groups of debtors. Companies would now be regarded as independent and thus not forming part of a group of debtors where not less than 50% of their shares were traded on a stock exchange, provided that that proportion is not controlled by a related company or one of its group companies. The second policy set new rules on the procedure for non-foreign exchange banks to become foreign exchange banks. A commercial bank could now engage in foreign currency business activities only after it had obtained a letter of approval from Bank Indonesia.

Commercial banks which had not yet had approval could successfully apply provided they could prove to Bank Indonesia that they had been solvent for the previous twenty-four consecutive months, had a paid up capital of not less than 150 billion rupiah ($US75m), had a capital adequacy ratio of 10% in the latest month (ie the month immediately preceding the month in which the application is made), and were adequately equipped in terms of internal organisation and procedures to be engaged in foreign currency transactions.

On 13 October 1995 Bank Indonesia allowed banks in need of liquidity to sell their Bank Indonesia certificates, although they had not matured, to Bank Indonesia on the basis of a repurchase agreement. Bank Indonesia would purchase the certificates if four conditions were met:

(1) the certificate was at least one month old;

(2) the maximum amount which could be obtained from the sale of the certificate was the difference between the amount to be cleared by the bank and the bank's accounts with Bank Indonesia;

(3) the certificate would be subject to a discount rate of 1% above the cut-off rate of seven days; and

(4) a limit of four sales transactions per month.

This move was aimed at strengthening the soundness of the banking sector.

INDONESIA: A UNIQUE MODEL

Comparing Indonesia's deregulation with the general Southeast Asian trend, it can be said that Indonesia does not fit in with the general Southeast Asian model and is unique for a number of reasons.

Indonesian banking deregulation has proceeded at a much faster pace. The rapidity at which new banks were established is evidence of deregulation. Between 1988-

1992 there were 100 new banks established,[112] compared to Taiwan where only 15 private banks were established since banking was deregulated in 1989.[113]

One important indicator of bank profitability is the difference between the rate of interest that banks pay to obtain funds and their lend out rate. Banking liberalisation in Southeast Asia has generally not reduced the high interest rate margins maintained by banks in those countries,[114] but margins in Indonesia have declined since deregulation in 1988, due in no small measure to the high number of non-performing loans.

The overly rapid pace of deregulation in Indonesia provides a warning to its Southeast Asian neighbours that caution and patience is the better approach if banking scandals and collapses are to be avoided.

Generally with deregulation, banks were used as a tool for business. However, the Lippo Bank is a distinct example of the opposite. It was initially set up as a bank to supply banking business to retail customers. It was set up by the Rady family and friends (Chinese name: Lee Wun Chan). The founding father, Mr Lee, was a businessman who had an interest in banking, being initially associated with the Bank of Panin. He then moved to Bank Central Asia where he further honed his skills before setting up the Lippo Bank. Lippo Bank was listed on the Jakarta stock exchange and then followed the creation of other business sectors such as insurance, manufacturing and real estate development. These were set up as different entities under different management. Lippo Bank then set up branches overseas in Singapore, Hong Kong, Australia and New Zealand.

Earlier in 1996 there was a rush on the bank due to perceived problems in the conglomerate's real estate arm. However, the bank was able to withstand this rush on funds and investor confidence was restored.[115]

It can be said that deregulation was not entirely in the public interest. As a result of deregulation, crony capitalism thrived. The Industrial Development Bank, for instance, is owned and controlled by a daughter of the President and shareholders in Bank Central Asia and Lippo are associates. It can be seen, therefore, that deregulation only partially develops the economy whilst at the same time benefits friends and relatives of the controlling groups.

But there is a positive side for Indonesia. The establishment of private banks has lessened the dominance of the State banks, making for a far more competitive banking environment.

Competition has also resulted in improved banking services for customers such as automatic teller networks throughout Indonesia, access to credit cards and telephone banking.

Modern technology has converted what was the backroom recording of customer accounts into a modern payment system operable in any place without the restraint of time. The new technology has permitted the development of new services for

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112 Habir, *supra* n 60 at p 58.

113 J Baum, 'Bankers Abroad', *Far Eastern Economic Review*, 11 July 1991 at p 35.

114 For example, by mid-1994 in Malaysia interest rates were at an 8 year high. See Jayasankaran *supra* n 72 at p 64.

115 The above mentioned material is based on interviews with a prominent member of the Lippo Bank in Sydney, in May 1996, who wishes to remain anonymous.

customers in a most competitive environment. Changes in the payments system have given consumers a greater choice of methods of payment. Hence, the use of electronic techniques has made it more convenient for consumers to carry out transactions. The advent of this system has permitted almost instant access to funds. A whole range of issues has been raised such as the relation between technological developments and operational efficiency, as well as prudential controls and risks in the event of failure.

Whilst Indonesian law at present only provides guidelines for the solution of the many potential legal problems, which may arise from the system, many of these could be resolved by a written contract between the bank and its customer. In Indonesia, the relationship between a banker and a customer is governed by the general law of contract. The Indonesian Civil Code provides that damages may be payable in a proper case for breach of contract, non-performance or negligent performance thereof.[116]

International technological developments will no doubt be further adopted in Indonesia. Yet, there is a need to develop an appropriate regulatory framework to establish and clarify the rights and obligations of the parties.

INFORMAL FINANCE SECTOR

Underneath the tormented and strained formal financial structure sits a thriving and comfortable informal finance structure which the masses turn to when requiring money for small investment projects.

It may be argued that this sector provides support to the economy when the formal structure is under strain such as when the government tightens monetary control.

It is contended that the informal finance structure provides a prop to the economy which is vastly underestimated and must be looked at if we are to appreciate a complete picture of the Indonesian financial sector.[117]

It appears the following are the means of informal finance:

(1) Loans from parents and relatives;

(2) Loans from itinerant traders (Mendrings) and Money Lenders;

(3) Rotating Savings and Credit Associations;[118]

(4) Co-operatives or peoples' lending banks;[119]

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116 Art. 1366.

117 There is very little official statistical information that can be relied upon and indeed very little has been written. See Ghate *supra* n 70.

118 In Indonesia these are known as Arisans. There is a pooling of contributions to a common fund which goes in turn to every member of the association, the sequence of rotation being determined by consensus, lottery or a system of bidding in each round, with the bidder who offers the highest discount becoming the borrower in that round.

119 There are currently about 9,000 of these banks (Bank Perkreditan Rakyak (BPR)). They operate at either: (i) The village (kecamatan) level with a paid up capital of 50 million rupiahs ($US5m). (ii) The district (kabupaten) level with a paid up capital of at least 10 billion rupiahs (US1B). They must be companies or cooperatives and subject to legal

(5) Group finance arrangements (sempan-pinjames or traditional credit unions); and

(6) Semi-formal institutions in rural areas like the BKK.[120]

In Indonesia, most of the money supply is in bank notes. This sector is outside the purview of the central bank, and as a result government initiatives such as credit controls and monetary policy have only a marginal effect as an anti-inflationary or deflationary weapon. It is not surprising, therefore, to find a fairly large money market existing outside the banking system which may be described as the informal finance market. This market has little connection with the formal finance market. The two markets are completely separate from one another.

The market consists of individual money lenders of Chinese, Arab and Indonesian nationality operating with their own personal capital in the cities, villages, and provincial areas. Small producers, farmers and merchants depend on the informal market, because they are unable to obtain credit through normal banking channels, for to obtain bank credit, a time-consuming credit investigation must be undertaken, and sufficient security collateral offered.

Credit can easily be obtained from the informal finance market, which does not have any requirements concerning security or solvency and credit is given without the signing of any formal written contract. Rates of interest range between 2 percent and 10 per cent per month, the exact rate depending on personal relationships between the creditor and the borrower, such as prestige and family ties.[121]

There is a marked difference in the attitude of writers to the formal and informal sectors, such that it is rare to find anyone advocating the latter. The literature is also replete with references to the 'exorbitant' interest rates in the informal sector and the 'malpractices' of money lenders.[122]

It has also been said that the informal finance sector creates a pattern of interest rates which weigh heavily on those least able to bear the explicit or imputed costs of borrowing and perpetuate forms of behaviour not conducive to social discipline and responsibility.

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lending limits although no licence is required for opening branch offices in the same village or district. They operate from door-to-door on a daily repayment basis and are distinguished from the commercial banks (Bank Umum) by being excluded from the cheque clearing system. They are referred to in 'PAKTO'88' as people's banks. 'PAKTO '88' provided for the setting up of small rural banks to carry out savings and credit operations and could be financed from Bank Indonesia.

[120] The Badan Kredit Kecamatan (BKK) was a rural financial institution to provide financial services to people in rural areas. This was a program set up by the government in Central Java in the early 1970's to provide credit for village people who were short of capital for their business enterprises.

[121] From an interview in April 1996 with Mr L Homarwidjaja, an Indonesian businessman in Australia. He states that in his personal experience and noting what has happened to friends in his business circle, they mutually receive financial help from their own family and friend initially and then self finance from the business' growth. As reputations increase the formal financial sector then comes into play.

[122] International Labour Office, 'Sharing in development: a program of employment equity and growth for the Phillippines', Geneva, 1970 at p 241.

Yet despite the higher costs of borrowing, investors find the informal markets attractive for a number of reasons. These include speed and simplicity of transactions, more flexible collateral requirements and a strong predilection for keeping loan dealings confidential.[123]

The informal rural credit system (ljon)[124] existing in Indonesia illustrates, following a study of Partidireja,[125] that it plays an important part in the financing of the rural economy and to stop it would do more harm than good.

It may be argued that the informal finance sector is reactive in that it develops in response to regulations operating in the formal sector. This means that it grows and contracts in a contra cyclical manner to financial repression and liberalisation in the formal banking and finance sector.

It is part of the overall financial structure of Indonesia and it has been recognised by the government as of some importance in PAKTO'88.

CONCLUSION

The winds of deregulation sweeping throughout Southeast Asia reached the Indonesian shores and deregulated not only the banking industry, but also finance at large.

The Indonesian government's deregulation efforts in the late 1980s put the country's banking system under a great deal of pressure. The collapse of Bank Summa in 1992 and the behaviour involving Bapindo are the most obvious examples of this strain.

Deregulation created a more competitive banking environment and increased credit availability throughout the country. However, the lack of effective regulatory safeguards left much of the banking sector, particularly the State-owned banks, burdened by non-performing loans after deregulation.

Huge losses and the failures of some banks have raised arguments about the implications of deregulation. Whether inefficient regulation might confine the growth of banking or even be responsible for imprudent bank transactions resulting in loss is a lively issue. The intention had been that deregulation would lead to heightened efficiency and an improvement in the quality and productivity of the financial sector.

Under deregulation, reliable and sound banking practices have been of primary importance. Learning from the experience, Indonesia adopted a policy to attain such standards.

Deregulation in Indonesia began on 1 June 1983. Banks were then empowered to set their own interest rates on loans and deposits. The role of Bank Indonesia with respect to such activities was diminished. Responding to the effects of the October

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[123] A A Rozenthal, *Finance and Development in Thailand*, (Praeger: New York, 1970) at pp 10 and 352.

[124] This is a Javanese word meaning green and involves the sale of a standing crop such as a paddy of sugar cane three to four months before it is ready for harvest.

[125] A Partidireja, 'Rural Credit: The Ljon System', (1974) 10 *Bulletin of Indonesian Economic Studies*, at pp 54-71.

1988 deregulation, a comprehensive deregulation package aimed to encourage the growth of financial, monetary and banking sectors was developed. The February 1991 Package was adopted to emphasise prudential banking activities. This was more in the nature of reregulation than deregulation.

Banking in Indonesia was often combined with other family-controlled businesses, which invited questions on the safety of depositors' funds. In an attempt to resolve this problem, lending limits establishing the maximum level of borrowings a bank may extend to certain categories of borrowers were imposed. The protection of bank finance has been recognised as the principal aim of the lending limits rules.

Although the long-term effects of banking liberalisation may well be positive, the immediate future of the banking sector is unclear. After the large influx of domestic private and joint venture banks between 1988 and 1992, the number of banks appears to be stabilising. One commentator predicts that the total number of banks may soon decline, as smaller, undercapitalised banks either fail or are acquired by stronger institutions.[126] Bank Indonesia would prefer the latter alternative and is actively encouraging healthier private banks to acquire ailing banks in hopes of avoiding further collapses.[127] This, however, could pose other risks for the banking system. Even the strongest private banks in Indonesia are not well capitalised by international standards.[128] Furthermore, the financial health of any private bank could be seriously threatened by absorbing a bank with a weak loan portfolio.

Generally, the larger private banks have been more aggressive and innovative than the State-owned banks in modernising their operations and introducing new banking products and services.[129] The private banks have been particularly active in the retail sector. The State-owned banks traditionally have relied on government entities, such as State-owned enterprises and government pension funds, for their deposit base. Although their near monopoly over deposits from the government sector has been one of the strengths of the State-owned banks, it has also forced the private banks to look to corporations and individuals as their source of deposits. At present, for example, middle-market banking (encompassing second-tier and growing corporations, medium-sized and small businesses and the rapidly growing middle class) is almost exclusively handled by private banks.[130]

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126 See Habir, *supra* n 60 at 60. In 1994, a consortium of three private banks, Bank Central Asia, Bank Utama, and Bank Danamon, acquired control over an ailing private bank known as Continental Bank.

127 See Habir, *id* stating that Bank Indonesia has indicated that officials are reviewing measures to encourage bank mergers. For a general discussion on why a central bank would encourage healthy banks to acquire sick ones, see Anon, 'Please, Governor, Can you Spare a Billion?', *Economist*, 25 March 1995 at p 79.

128 The largest bank in Indonesia, Bank Negara Indonesia, rates only 452 in the Top 500 World Banks, with assets of $US 11,593M. There is not one Indonesian private bank in the 500: see Anon, 'What a Difference a Decade Makes: Euromoney Five Hundred', *Euromoney*, June 1994, at p 158.

129 See Indonesian Banking Profile.

130 Habir, *supra* n 60 at p 60.

As retail banking promises to be the largest growth area for Indonesian banks over the next several years, the emphasis of the private banks on retail banking should provide them with a strong competitive advantage.[131]

Non-performing loans, however, will remain a problem, as both types of banks are believed to be significantly overexposed to Indonesia's highly volatile property market.[132] During the past several years Indonesia, particularly in and around Jakarta, has been experiencing a building boom, much of which has been financed by bank credit.[133] If property prices suddenly decline, bad loans will dramatically increase for a number of banks,[134] for experience in Australia shows that this will occur.

In the foreseeable future, the primary issue facing regulation should be how to increase the strength of the banking sector without imposing standards that only a few of the strongest institutions can meet. Banks play a special role in a country's economy as in providing credit and as guardians of the economy's payments system. The Indonesian banking authorities, therefore, need to chart a careful course for the future, bringing prudential standards in the banking industry up to international standards, without increasing bank failures, a result that would be disastrous for further Indonesian economic development and growth.

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131 See Indonesian Banking Profile.

132 See L Lopez, 'Indonesian Banking Sector Faces Over-Exposure to Property', *Business Times* (Singapore), 8 December 1994 at p 1.

133 See Lopez, *id*. On the real estate boom in Jakarta, see H Sender, 'Space Race' *Far East Economic Review*, 4 August 1994 at p 46.

134 Some analysts believe that certain private banks' vulnerability to the property market could affect as much as 50% of their total loan portfolios. Lopez, *id*; Praginanto, 'Debt-Strapped Indonesian Banks Brace for Credit Squeeze', *Nikkei Weekly*, 26 December 1994 - 2 January 1995 at p 22.