“Managing the Banking Industry Within the New Dynamics of the Indonesian Economy”

Speech by Governor of Bank Indonesia Burhanuddin Abdullah
at the Annual Bankers’ Dinner 2006

January 13, 2006

Fellow Bankers in Indonesia,

Senior colleagues at Bank Indonesia, distinguished guests, ladies and gentlemen

Assalamu‘alaikum wr.wb,
Good evening, and greetings to you all,

I. Introduction

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

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

3. At this opportunity, on behalf of the other members of the Board of Governors of Bank Indonesia, I wish you all a very Happy New Year. May the New Year of 2006 bring blessing in all that we do.

4. In departure from our tradition of hosting this dinner only for bankers, tonight we are privileged to have with us members of the Indonesian Parliament, the Chair of the Indonesian Chamber of Commerce and Industry, economic analysts, and leading media figures. Your presence here this evening clearly signifies that monetary and banking issues are of concern to us all.

5. Monetary and banking issues are indeed too important that the decisions involving these issues should be the concerns of all of us. For Bank Indonesia, it is essential to have input and opinions from various stakeholder groups before policies are implemented. Bank Indonesia has a moral responsibility to ensure that its tasks in maintaining macroeconomic stability are always performed to the best of its ability. Bank Indonesia, nonetheless, is not the only agency vested with the task. Macroeconomic stability is also a task for the Government. For this reason, coordination between Bank Indonesia and the Government, the spirit of cooperation, and mutual correction are keys to maintaining macroeconomic stability as a framework and foundation for successful economic development.

Distinguished guests, ladies and gentlemen,

6. When I began speaking this evening, the thought came to mind was the same occasion in early 2005, when I stood here before you all. However, one thing is different. At that time, there was a massive cloud hanging over my head, and indeed over all who were there. By end of 2004, almost all of us had planned to ring in the coming 2005 with great joy and celebration. We had worked hard and were very optimistic with the realization of our plans and projections. Quite understandably so, as 2004 had indeed marked a string of successes. That was the year of political transition in which Indonesia successfully managed a peaceful, fair, and highly democratic election. That year also witnessed an accelerated rebuilding of the social fabric that brought peace and contentment to most of the society. We were also convinced that 2004 was the year of macroeconomic stability that put into place a sound basis for stronger growth. Exports and investments gathered pace, providing a basis to support more equitable growth. Optimism was flowing from one end of our nation to the other, as well as from analysts and observers at home and abroad.

7. At the end of 2004, however, we received a dramatic reminder that times of trials, and disasters have not yet ended. The massive tsunami hit Aceh and North Sumatra left us aghast. Suddenly, our lives were torn apart by forces akin to divine wrath. We all felt sadness and grief. Tens of thousands of our fellow countrymen lost lives and everything they had. Infrastructure vital to agriculture and the local economy was devastated, uprooted by the quake and swallowed by the towering waves of the tsunami.

8. We were touched by a sense of shared loss. Indonesians and indeed the rest of the world rushed in with aid and support. The banking industry also dug generously into their pockets. Donations began pouring into Indonesia like never before. At that time, we could sense a renewed wave of optimism that we would be able to make further improvement in the Indonesian economy in 2005.

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

10. This vulnerability became apparent in the second half of 2005, when we began facing a more complex array of problems. Global financial imbalances and soaring international oil prices put upward pressure on domestic prices, adding to the hardship faced by ordinary Indonesians. Moreover, as we approaching the end of of 2005, the anguish and grief that suffered in the beginning of the year in Aceh, also struck the people of Yahukimo Papua, in the easternmost corner of the nation. Then we were made more saddened by other disasters that came to the people in Jember and Banjarnegara.

11. Aside from the natural disaters, the economic and internal bureaucratic problems besetting Indonesia are too many for Indonesia to manage an adequate improvement in external dealings. The last year's World Economic Forum noted that Indonesia's competitiveness had fallen from rank 69 in 2004 to 74 in 2005. Deterioration was recorded in all the three areas of assessment: the technology index, public institutions index, and macroeconomic environment index.

12. With this plethora of problems, the joy and excitement and our carefully crafted plans were quickly dashed. The economic equilibrium that we had so earnestly worked on during the past year was upset and thrown off earlier forecasts. We were then compelled to make adjustments and realignments in response to these changes. That we were attacked by frequent bouts of pessimism was only to be expected, we felt a lack of confidence in our own abilities to resolve these problems.

13. Even so, we could not allow our optimism to be completely swept away. Our nation is still blessed with considerable potential and resources. This was also reflected in the still high level of confidence over Indonesia being expressed by

investors and international observers during my conversations with them. Their predominant view was that in the longer term, Indonesian economy offered good prospects and promised numerous opportunities for success. We also took into account the many actions taken by the Government to improve law enforcement and security and to build a more conducive investment climate. With renewed drive and spirit of coordination, we were confident that our efforts to build new dynamics into the economy would be accomplished.

14. And tonight, I will present some of the policies that are being made to expand the role of both Bank Indonesia and the banking industry in promoting Indonesian economic recovery. These efforts, we believe, are consistent with and represent an integral part of Government economic policy. At the end of the day, we all share the same goal, that of building a just and prosperous society in Indonesia.

II. Reflection of the Economy and Banking Conditions in 2005

Distinguished guests, ladies and gentlemen,

15. Before setting out economic projections and banking sector policies, I would like to invite you to take a brief look back at the developments occurring in 2005, in order to observe, understand and draw several lessons from them.

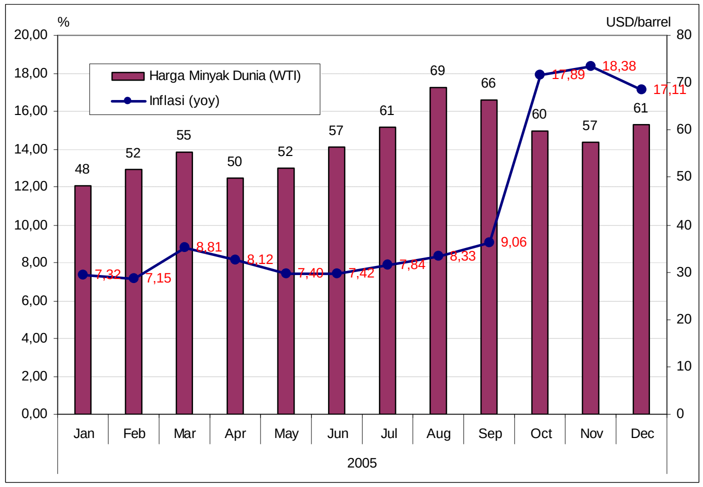
16. **The year 2005 was a year full of challenges. One of them was the slowing of the momentum in economic growth achieved in the previous several years.** Since the crisis of 1997, the growth of our economy has begun to recover, particularly due to the support of strong household consumption. As we entered 2005, we were optimistic that the economic growth would consistently strengthen as the source of growth shifted to investment supported by infrastructure projects. This optimism was proven to be well founded in the first quarter of 2005. Economic growth reached 6.12%, primarily driven by increased investment. These developments provided a ray of hope that 2005 would be the beginning of higher growth period that would bring our economy back to the pre-crisis growth levels of 6-7% per year.

17. Going into the second quarter of 2005, the economic situation shifted suddenly. An uncertain investment climate triggered by various external and internal factors resulted in the weakening of investment. Increased production costs as a result of increased oil prices and reduced investor confidence had holded back private

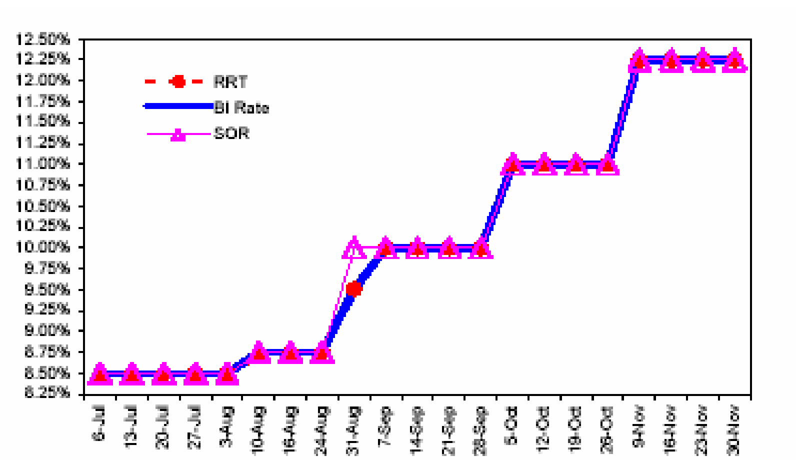
sector investment. Meanwhile, consumption, which usually supports economic growth during difficult times, could not be relied on because of the increasing interest rates and weakening consumer purchasing power in the wake of elevated fuel price. Such developments had limited our expectation to the overall economic growth for 2005 to reach around 5.3-5.6%.

18. **From the point of view of macroeconomic stability, 2005 was a very difficult year.** The external fluctuation in terms of increasing world oil prices and global financial imbalances had strongly affected our macroeconomic stability through several channels. **First,** the long delayed adjustment to the domestic oil price within the highly escalating global oil price had forced the government to make major adjustments to the fuel prices twice during the year 2005. These fuel price adjustments, as we witnessed, have resulted in the increase of inflation to 17.11% in 2005, doubled than what had been intially projected.

19. The steep rise in inflation required immediate and appropriate policy response. As the monetary authority, Bank Indonesia did not want to see this supply side prices fluctuations linger on and drive the inflation rates up even further. Our observation tells that, higher fuel prices had caused a major rise in core inflation, particularly through the second round effect of increased transportation costs and wage increases that had generated a higher expectations of inflation within the public. The 127% rise in oil prices in October 2005 was followed by increased transportation costs, as well as increased in salaries and wages, pushing the core inflation up to 8.7% from the 6.7% recorded in the previous month. As the policy response to this situation, we imposed a tight monetary policy by raising the BI rate to the adequately substantial rates. By end of year 2005, the BI rate reached the level of 12.75%.

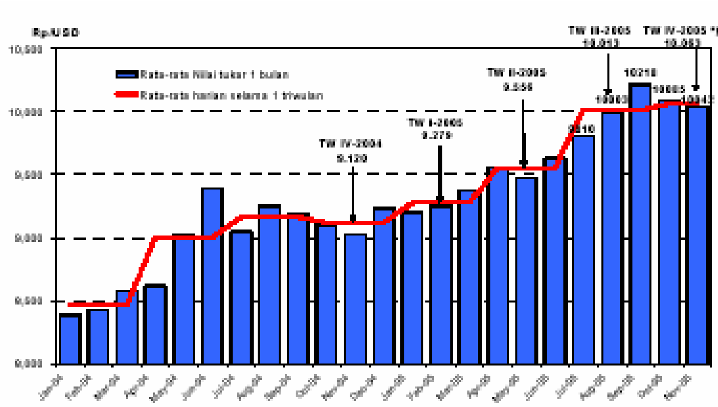


International Oil Prices and Level of Inflation



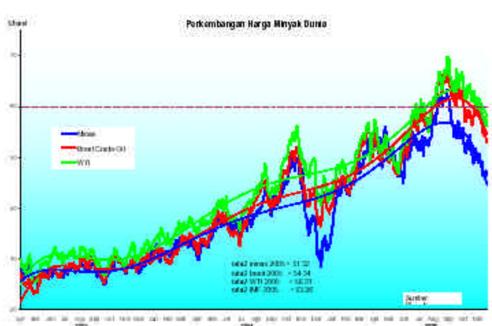
BI Rate Developments

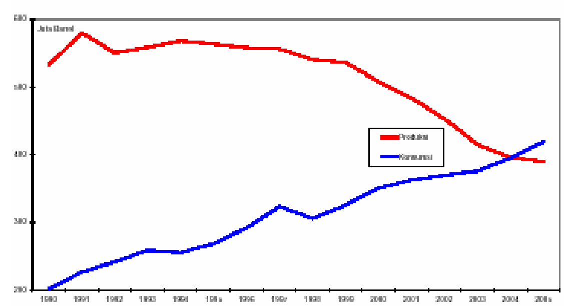
20. **Secondly,** the sharp rise in oil prices had also been increasing the volatility in the foreign exchange market due to the higher demand for the US dollar needed to import oil. The already difficult situation was further exaccerbated by portfolio adjustments made by foreign investors in response to changes in international interest rates and increased volatility in the foreign exchange rates. Within our relatively thin forex market, these two types of fluctuations had caused major increased in the volatility of the Rupiah exchange rate. In 2005, the Rupiah experienced three periods of significant pressures, those were being experienced in April, July and August. Overall, in 2005, the Rupiah exchange rate depreciated by 8.5% for an average rate of Rp. 9700/USD.



Average Rupiah Exchange Rates

21. **Third**, the increase in oil prices had negatively affected the balance of payments position. The 2005 balance of payments shows how the external structural balance had not yet been providing advantage to the efforts in strengthening macroeconomic stability. The sharp increase in oil and gas imports, in the midst of a relatively sluggish export along with the weakening terms of trade had generated a USD778 million deficit in our balance of payments, as compared to a surplus of USD309 million in year 2004.





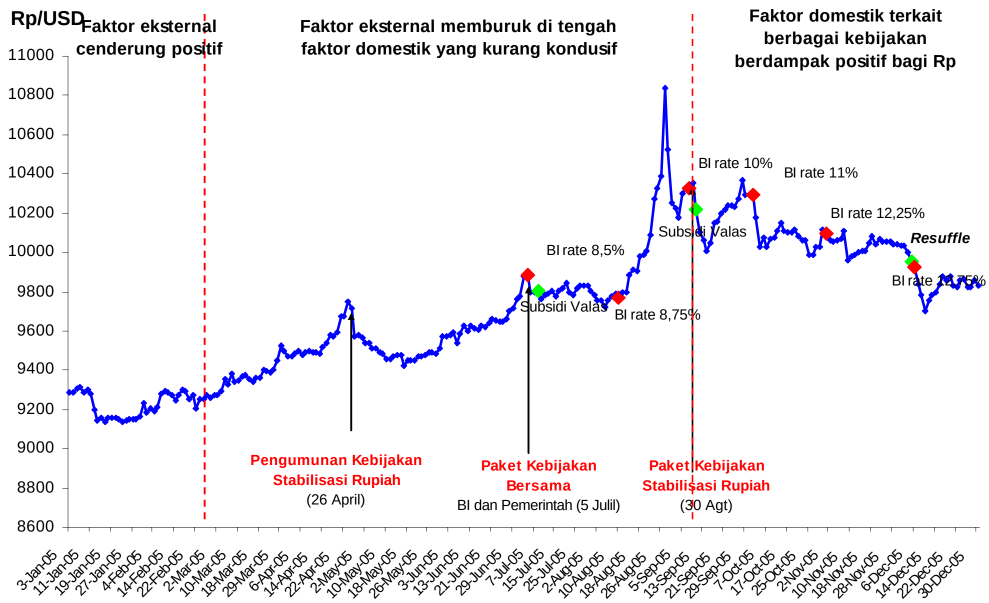
Development of Oil Price

Oil Production and Consumption

Consumption

22. **In facing the threats of macroeconomic instability, Bank Indonesia took several steps aiming at avoiding high inflation and exchange rates volatility to lead to fear and pessimism that might further worsen the economy.** In

overcoming the exchange rate fluctuations occurred in April, July and August 2005, Bank Indonesia set out several policies. **First**, imposed tight monetary policy by raising the BI rate and managing domestic liquidity through increasing the **Banks statutory Reserves Requirement** and activating various instruments of Open Market Operations. **Second**, imposed policies that reduce speculative pressures through limiting the flow of short-term capital, increasing the Net Foreign Exchange Open Position, and forbidding margin trading activities in the foreign exchange market. **Third**, managing the supply and demand of foreign exchanges by state-owned enterprises (SOE), including stipulations for the repatriation of SOE's foreign exchange to the domestic market. **Fourth**, intensifying the commitment to increase the provision of the facility of foreign exchange liqudity in order to secure the situation through the mechanism of the Bilateral Swap Agreement with Japan, Korea and China. These various actions appeared to be effective in controlling the volatile movements of the exchange rates, to make the exhcange rates stabilized at the level around Rp.9800 per USD by end of year 2005.

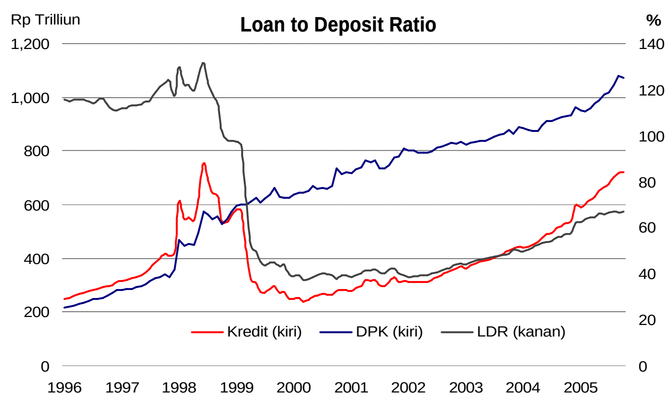


Policy Packages for Rupiah Stabilization and Exchange Rate Event Analysis

Distinguished guests, ladies and gentlemen,

23. **In the midst of these difficult trials and challenges in 2005, we had to be grateful that the banking industry continued to consistently functioning well in its service to the public.** The various efforts undertaken over time to strengthen key points in the institutional, financial and operational structures of the banking system appear to have yielded results. The resilience of the banking industry in absorbing the risk of instability has been improved adequately. Efforts to improve banks capital, apply risk management and be consistent in the application of the prudential banking principles which have long been the focus in strengthening the industry, were apparently effective in preventing the industry from a more drastic weakening. In fact, several indicators showed that the growth of the banking sector was adequately satisfactory.

24. **The intermediary function of the banking industry throughout 2005 went smoothly as planned.** Step by step, the banks' credit expanded in line with the set target to reach the level around 22%. On the other hand, the capability of the banking sector to collect Third Party Funds also experienced moderate growth at around 11%. With the more rapid growth of credit against the Third Party Funds, the bank **Loan to Deposit Ratio**, up to the end of 2005, rose significantly to reach around 68%. Total banking industry assets even experienced growth of around the same level of growth in Third Party Funds, at 12%.



Banking Indicator Developments

Rp Trillions

25. With economic conditions besieged by various constraints as in 2005, the well functioning financing role of the banking industry could at least hold back the declining rate in the economic growth. Banks financing to the economic sectors are deemed to still prospective, especially financing of the consumer sector and

the Smal and Medium Enterprises (SME's) which grew quite significantly, reaching the level of more than 30%.

26. **However, we also comprehend that the recents dynamics of the domestic economy carry implications that must be carefully monitored and responded to with caution by the banking industry.** Various recent banking indicators showed a condition in which the majority of banks are tending to move toward a less favorable directions, making us increasingly aware that the road ahead will not be an easy one. Risisng interest rates and production costs in the real sector have put on pressure toward the emergence of credit risks. The Non-Performing Loan (NPL) of the industry kept rising throughout 2005. Nonetheles, we consider that this phenomenon of rising NPL are unavoidable in the short-term. We understand that efforts to improve conditions in the real sector would require some time. Because of that, the phenomena of rising NPL that reflects problems in the real sector, would hold our attention for some time forward. Meanwhile, the level of current gross NPL that is around 8-9% is still relatively smaller and can be considered safe as compared to the figure during the crisis period. Nonetheless, the movement is always closely monitored. We also took immediate steps aiming at reducing pressures to the NPL, so that in 2006 the NPL will at least remain at the current level, and even be reduced to under 5% over the longer term.

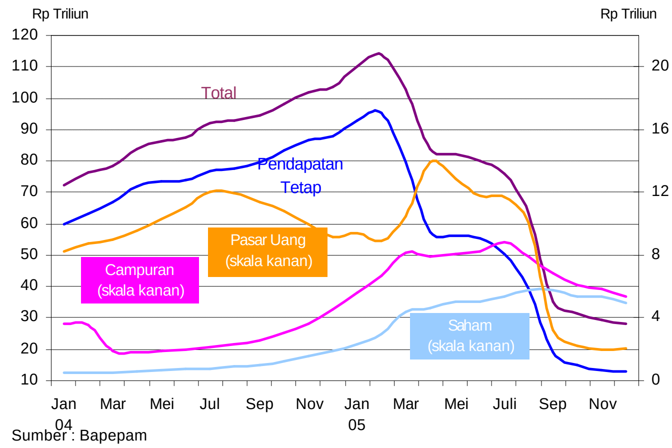
27. **From the financing side,** we in the banking community can be proud that various kinds of banks saving products, in the past two decades, have been serving as important sources of financing in our economic development process. On the other hand, trying to put ourselves in the depositors' mindset, it would not be exaggerating to say that banks are also considered as the safe haven for investors. In our opinion, whateever the reasons people have for establishing relationship with banks, such as simply meeting the need for transactions, or as a precautionary measure, or even for investment, the majority of Indonesians have perceived banking their basic needs.

28. For the past several years, investors have also been provided with the opportunity to allocate their funds in the financial market instruments, such as: SBI, shares, bonds, and mutual funds. Up until the beginning of 2005, these financial market instruments have been capable of generating a relatively high level of profits, that had been increasing the value of these financial market instruments at a quite high level. .

29. In further observing the investors behavior in the Indonesian financial market, which had made the market boom over the past three years, there at least two factors are needed to be underlined. **First**, the excessive liquidity in the banking sector has motivated banks to take an active role in the development of financial instruments, as we had seen in mutual funds, by taking ownership in security and investment firms. **Second,** the low inflation and interest rates during that period had provided better leeway for the issuance varieties of financial market instruments, particularly the ones that are in related to the Govenrment Bonds (**Surat Utang Negara - SUN**) which offer a higher yield than banks' deposits.

30. These factors had proven to have major influence on investor preference over the past three years. However, entering into the second quarter of 2005, along with the weakening of the macro economy as a result of high levels of inflation, investors behavior in the fanacial market began to change. These behavioral changes were not surprising. **First**, the mutual fund portfolios, which are now developing in Indonesia, were primarily dominated by Government Bonds - based mutual funds. The expectation that inflation and interest rates could increase significantly was enough to press the prices on the long term Bonds down. **Second**, the changed in behavior also confirmed that Indonesia's financial market is still dominated by short term investors who are more sensitive to short term profit expectations.

31. Increasing interest rates in the second semester of 2005 had triggered withdrawals of funds from the previously mentioned financial instruments. In fact, the mutual fund industry that had experienced a boom throughout 2004 up to the first quarter of 2005 had to face the bitterness of massive redemptions. The mutual fund Net Assets Value dropped drastically in 2005, from the highest position of more than Rp. 108 trilion to stand at only Rp. 29 trilion at the end of the year.



Developments in Mutual Funds

Rp Trillions

Source: Bapepam

Honored Guests, Ladies and Gentlemen,

32. **From our reflections on the economic and banking sectors perfonances in 2005, we can draw several lessons that will be beneficial in preparing us to face challenges and opportunities in the years ahead.**

- **First**, in the midst of a highly dynamic global economic, we must be able to recognize problems immediately and make adequate decisions quickly. Our inability to make a timely policy responds to external developments, such as the rising world oil prices and global imbalances, had often caused us to lose momentum, which brings a higher costs consequences to be borne by the economy. This is particularly important lesson as external fluctuation would likely to reoccure at anytime in the future.

- Second, tDeveloping alternative energy and means of public transportation with efficient energy consumption will be a necessity. Lower reliance on oil would definitely reduce the impact of oil price fluctuations to the economy, thus guarding our balance of payments and Indonesia's competiveness within the global market and increase the resilience and trength in the entire economy.

- **Third**, the collapse of the mutual funds after such rapid growth has taught us many valuable lessons. First, low interest rates environment has been a fertile ground for over-optimism among portfolio investors. Short term investors, include foreign investors, are usually not very sensitive to the potential change in macroecoomic conditions in the longer term. In this context, the financial sector authorities must be able to convey an early warning system that would avoid sudden and drastic portfolio adjustments that might cause instability in the financial system. Second, close coordination between the capital market authority (Bappepam) and Bank Indonesia is imperative, in terms of both rules of conduct, particularly when involving banks, and in relation to the timing when mutual fund redemptions is considered to start threatening the financial system stability.

? **Fourth**, our relatively thin foreign exchange market that is dominated by large players like Pertamina, is frequently colored by excessive volatility. This relatively high volatility would negatively affect market confidence to the prospects of our macroeconomic stability. This problem would be continued if we don't make structural improvements in foreign exchanges liquidity, by improving exports performance and capital inflows.

III. The Dynamics of the Indonesian Economy in 2006

Honored Guests, Ladies and gentlemen,

33. **Stepping into the year 2006, it is common that in enteringthe new year, we would define the expectations that we want to achieve as well as identify the challenges that we hope to overcome within the coming year. In my view,** the major challenge we will face in 2006 will be to bring the economy to a new equilibrium. As we know, the rise in oil prices has pushed inflation higher and pressed the growth down. It is therefore our tasks, the monetary and fiscal authority and real sectors, as well as the general public, to make sure that the new equilibrium would provide a more stable macroeconomic conditions that would generate a high level of growth.

34. **From the external point of view, several international institutions have projected that the growth prospects for the world economy will not change much. It will remain at around 4.3%, with America and China still functioning as the main engine in the global economic growth.** Global inflationary pressure is expected to be at a controllable level, while pressure from high oil price is still expected to be high, at the level of around 57 USD per barrel in 2006. Global interest rates are also expected to rise, in the midst of

efforts by nations like the United States and the European Union to maintain their macroeconomic balances. However, by the second quarter of 2006, the cycle of tight monetary policy can be expected to end.

35. **From the internal side,** the weakening in the people's purchasing power and the rising cost of production would continue to determine the prospects of domestic demand, so that consumption and private sector invesment would remain constrained up to the first semester of 2006. Within such conditions, the dynamics within the economy in 2006 will be very much depended upon our ability to generate harmony between monetary and fiscal policy. Economic policies must be carried out optimally in order to strike the balance between maintaining macroeconomic stability while at the same time providing adequate stimuli to economic growth.

    - **In the monetary side**, Bank Indonesia will consistently make efforts to reduce the rate of inflation to a single digit in 2006 to allow interest rates to be gradually lowered in order to boost consumption and private sector investment.
    - **In the fiscal side**, fiscal stimuli through government consumption and investment would provide a strong jump start toward economic recovery, especially if the government could make use the unrealized 2005 budgeted spending to be carried forward in 2006 and immediately realized within the first quarter of this year.
    - **In the real sector,** economic prospects will be more dynamic if the previously planned infrastructure projects can be realized. Moreover, if the government investment is channeled effectively into the infrastructure and oil and gas sectors, along with the activation of regulations that provide effective tax and investment incentives for the private sector, then after the first half of 2006, we can expect that the economic growth will start to be more supported by investment.

    With the coherent conduct of these policy coordination, by the second semester of 2006, we expect the economic growth to be improving, supported by both investment and consumption. Overall, Bank Indonesia projects that **the GDP for 2006 to grow within the range of 5.0-5.7%**.

36. **This growth rate is expected to be achieved given domestic and foreign funding for investments can be secured.** Aside from stimuli provided by government's capital expenditures, I expect the banking industry to continue its

role in funding long-term investment projects. An optimistic level of economic growth may be achieved if the banking industry at least maintains last year's level of credit extentions. Foreign sources are also assumed to play a significant role as well. In order to achieve the designated growth level, **it was also noted that foreign fundings are expected to contribute up to approximately 40%. These foreign sources comprised of Foreign Direct Investment (FDI), portfolio investments, and foreign corporate loans.** Therefore, it is apparent that the steps we must take in improving investment climate becomes the keys of success in achieving the level of growth we strive for.

37. **From the sectoral side, this growth will be supported in particular by the trade, processing industry and agricultural sectors.** An optimistic scenario estimates that growth can be achieved if several plans are implemented well. The growth in the agricultural sector is expected to reach around 4% if facilities for rice production, such as adequate supplies of seeds, fertilizer and other chemical preparations can be guaranteed so that prices do not rise sharply at farming community level. Besides that, the ricefield is expected to increase by 0.37% with productivity rising by 0.48%. In the plantation subsector, optimistic growth projections for the agricultural sector are expected to be supported by expansion of palm oil planting areas by three million hectares (ha) in the next three years. In the industrial sector,optimism of growth would be achievable if opportunities in the **TPT** (Textile and textile products) industry for exports to the US, in connection with the quotas on China, can be exploited. Meanwhile, in the construction sector, there is optimism that growth can be achieved if budget funds are disbursed as planned.

38. The economic recovery cycle from the third quarter of 2006 is also supported by the projected decline in the rate of inflation that **will reach a level of around 8% by end of 2006**. This optimism is supported by the expected improvements in various inflation determinants , such as: a stable exhcange rate, a growth rate that is still below the economic capacity, and minimal increases in administered prices. Nonetheless, in the midst of all these positive projections, there are several risk factors that must be anticipated and managed carefully, especially in our efforts to provide macro economic stability.

? **First**, despite the expectation of declining oil prices in 2006, there still exists the potential for volatility in oil prices. Especially if there is an increase in the volume of world trade that would trigger a higher global demand for oil.

? **Second,** the continuous worsening of global imbalance, particularly when the US tightening cycle would once again stimulates volatility in the global foreign exchange market. Moreover, it should be expected that the America's huge balance of payments deficit could lead to a lower demand for imports in the US, which in turn would affect our exports negatively.

? **Third**, the impact of rising fuel prices and its second round effect, which is expected to continue, as well as any possibility of raising administered prices beyond the ones that had been planned for 2006, are expected to increase the risk of inflationary pressure going forward.

IV. Future Banking Dynamics: Opportunities and Challenges

Honored Guests and Ladies and Gentlemen,

39. **The ecomonimc dynamics toward the macro economic equilibrium will certainly affect the dynamics in the banking industry.**

40. **In the credit market:** high interest rate and the still many unresolved problems in the real sector, as well as the declining purchasing power of the public are expected to reduce the demand for credit. From the supply side, rising credit risks in the real sector will cause the banking sector to become incrasing cautious in considering the repayment capacity of its potential debtors. The channeling of funds into the still prospective sectors, including consumer credit, is predicted to decrease. The real sector, which are considered productive and that continues to have good prospects, will become a penetration target that will be fought over by many banks. The sectors considered to be still productive with good prospects for spurring on the economy toward greater growth will provide a specific challenge for the banking industry that must continuously seek for and dig into its potential. Meanwhile, funding to the SMEsi sector is expected to remain high at about the same level as in 2005, that being around 35% of the total overall credit expansion.

41. From the various discussions we held with the banking industry, we could recognize that there are unfavorable perceptions over the decline in the real sector's business spirit and the fact that there is a more basic issue, of declining competetiveness in our economy that has become almost chronic in nature. The limited information about the real sector, lack of understanding on the industrial sector development and development priorities are believed to be the major contributors to these not so positive perception in the banking industry. Especially as those information have been serving as the navigational tools for the banking sector to make decisions on fund allocation. In reality, there also indications that, <u>First</u>, strategic industries are facing a decline competitiveness in the global market, mainly because the resurgent of the Chinese economy that has been successful in providing the world with highly competitive products.; <u>Second</u>, perception in the banking industry that there are still major unresolved problems faced by the real sectors, such as unclear policies and uncertainty in both national and regional government regulations; and <u>Third</u>, unresolved problems that are related to the declining in financial and operational ability of th ereal sector..

42. These constraints, along with the relatively limited growth in the business sector, have caused a significant decrease in the banking sector's enthusiasm for channeling syndicated credit to large projects in the past several years. In order to be able to drive economic growth, Indonesia must be able to overcome these problems immediately. Lack of investment fundings at the time when our banking industry has been experiencing excess liquidity,reflect occurrence of disorientatation in the function and role of the banking industry. These disorientation requires serious handling and rectification by all related parties.

Honored Guests and Ladies and Gentlemen,

43. **In the fund market,** the opposite has occurred. The amount of funds collected by the banking sector has been continuously increasing. In general, the public continues to be confident on banks ability to provide convenience and benefit within all aspects of their economic activities. Understanding this background, we predict that the banks **Third Party Fund** would continue to grow in 2006, at almost the same level as in 2005.

44. Nevertheless, the increasing banks **Third Party Fund** requires a prudence and caution in managing certain aspects of liquidity risks. **First**, as we have stated before, banks third party funds continues to be dominated by short-term funds, such as in terms of checking and savings accounts as well as in one-month time deposits. On the other hand, banks third party funds in longer-term time deposits are tended to decrease. Such a composition of banks third party fund exposes the banking industry to a higher funding volatility, which requires a close attention.

45. For the larger banks, funding structure that are dominated by the short-term funds is one factor that limits their ability in funding large and long-term projects. In dealing with the situation, most banks have selected to focus their placements on shorter-term credits such as consumer and working capital credits. This strategy not only helping banks in avoiding financing mismatch but also useful in mitigating the credit risks that are still perceived high especially as some sectors have not been able to grow optimally. A different situation faces small and medium-sclae banks, which customers are mostly corporates. The management of liqudity in this group of banks is even more difficult. Especially as small banks also face increased competitition in the midst of high interest rates.

46. **Second**, with the operation of Deposits Insurance Institutions (LPS), competition within the banking industry in gaining public funds becoming more sensitive to

the perceived risk of individual bank.. Starting in 2006, LPS coverage of guarantee are expected to decrease in phases from Rp. 5 billion in March 2006, to a maximum of Rp. 1 billion in September 2006 and then to the final level of Rp.100 million in March 2007. Within this environment, competition among banks in collecting funds, should be focused the quality of bank managements and services as well as on and the level of banks' health. Concerns on changes in depositors' behavior because of the gradually decreasing in the coverage of LPS guarantee scheme, should be responded to by efforts that would increase customer confidence. As the LPS coverage of guarantee decreasing, public will certainly become more and more critical and sensitive toward the quality of the banks that manage their funds. Going forward, the public is expected to become more sophisticated in making risk – benefit analysis.

47. **At the end of the adjustment process, the aforementioned developments have caused increasing pressures over banks' profitability and capital.** The current high interest rates environment would narrow the Net Interest Margin (NIM) in the banking industry. Additionally, the increasing NPL would also force banks to create adequate **loan loss provision (PPAP)**, which will also negatively affect banks' income. Besides, efforts to recover or making restructuring of the bad loans would increase bank operational costs. In this context, Bank Indonesia perceives that embracing a strategy of short term pain, long term gain as the best choice. As the authority in this sector, our priority is in the longer term context of maintaining financial system. I am well aware that in implementing this conservative approach there will be trade off that might lead to a temporary decline in banks profitability. Certainly, this is not an easy nor it is a pleasant decision for the management. In this respect, it is possible for the shareholders to have different views and concerns.

V. Future direction of banking policy

Distinguished guests, ladies and gentlemen

48. Within the micro-context of the banking industry, it is fitting for us at the beginning of this year to make a reflection on how far we have gone in the process of strengthening the banking industry. There is no denying that the banking industry is and always has been central to our economy. The history of our economy shows that the state of the economy is closely tied to the development in the banking industry. Our economy is a bank-based economy that continues to rely on the banking system as a source of financing. For this reason, building a strong, sound, and efficient banking industry that would be beneficial to the economy is the key to success in sustaining the national economic development.

49. **Within this context, two years ago we outlined a policy direction that we call the Indonesian Banking Architecture (API).** As a design for the future structure of the banking industry, the API sets forth a number of programs focused on efforts to reshape the banking industry by strengthening the industry's fundamentals. The key measures of strengthening banks institutional aspects, preparation of supporting infrastructures, improvement in banks services to the public, improvement in banks institutional capacity and resources, improvement in the quality of banking supervision and regulation, and increasing public involvement in maintaining the resilience and competitiveness of the banking system are outlined in this design as pillars that must be built into the banking industry of the future.

50. **To a certain level, the API programs involving regulatory provisions and implementation in the fundamentals of banking operations have been working satisfactorily.** Overall banking industry has become more resilient over the past few years, particularly in regard to capital. The CAR of the industry now is in the range of around 20%, a level we regard as adequate to absorb the various risks that may arise. Within the context of improving the bank intermediary function, we have successfully implemented various API programs such as the linkage program between commercial and rural banks and the Askrindo loan guarantee scheme operated in cooperation with regional governments. Meanwhile, as part of our efforts in improving the quality human resources in the industry, we have also been gradually implementing the risk management certification program for bank managers and supervisors.

51. Another achievement that I consider worth mention is the improvements in the conduct of banks supervision through by increasing the quality, depth, and scope of bank supervision. Recent evaluation conducted our technical advisor from the Financial System Authority of the UK, there has been significant improvement in Bank Indonesia's compliance with the 25 Basel Core Principles. Eleven items of the core principles previously categorized as non-compliant or materially non-compliant are now improved to be rated largely compliant, and a good number

have also been categorized fully compliant. Accordingly, out of the standards of the 25 Basel Core Principles, 22 items of these principles applied in Bank Indonesia's supervision are now rated compliant. The remaining problems and weaknesses, which will become the focus of our future improvements, are related to efforts to implement consolidated risk assessment and to improve the accuracy of the supervisory data.

52. I believe it is no exaggeration to claim that these achievements, which represent the direction in banking policy, will be more beneficial to the Indonesia's banking system in the future. A close watch must be kept on the implications of recent dynamics in the national economy, which demand a cautious response from the banking system. Some banking indicators that have shown unfavorable trends, should have reminded us that the road ahead will not be easy. We must ensure that each policy is directed to be precisely and effectively resolve each weakness and problem that we face. To this end, the timeliness in policymaking is crucial. We must always aware of the long term visions and goals. Shorter terms strategies and program should be derived out of this visions and goals, as an integral part of the complete and systematically arranged road map to the future.

5.1. Measures to Provide Leeway in the Operation of the Banking Industry

Distinguished guests, ladies and gentlemen

53. Bank Indonesia fully understands that in the short-term, the heavy burdens faced by the industry call for some adjustments in our policy to strengthen the banking industry. For this reason, this year Bank Indonesia will introduce various policies aimed at providing banks with bigger room to maneuver in performing intermediary function.

First, Bank Indonesia will implement temporary adjustment to the regulation regarding the quality of productive assets, while still maintaining the pricíples of prudentiality.

54. Over the time, policies in managing credit quality have been serving as the critical supports to the banks prudential principles within the banking regulatory framework. The procedure in assessing credit quality, the requirement to form provision for earning assets losses, and the mechanisms and functions that dealing with problem loans have long been serving as important safeguards to the banks business activities. Nevertheless, we must realize that the strategic environment at the domestic and global level is in constant change. In turn, this

will obviously carry implications that will require adjustments in the focus as well as the orientation in managing various aspects of banking operations, especially in managing problem loans.

55. It was in this context that Bank Indonesia issued Bank Indonesia Regulation No. 7/2/PBI/2005 in early 2005, that in essence outlines a uniform classification system for provision of funds by several banks to any one debtor or project. The regulation was designed with a forward-looking principle in anticipating credit risk in the future. Meaning that when there is bank that downgrade the credit quality to one debtor, the other banks must immediately follow suit by setting aside adequate loan loss provision in the most secure amount, that based on the lowest credit quality rating.

56. This regulation has been successful in bringing about positive changes in the debtor behavior in dealing with banks. Following the introduction of uniform classification, they have formed the perception that their exposure and performance will be constantly subject to strict, integrated monitoring by the banks from which they have obtained financing. This will obviously force the debtor to be more prudent , especially especially when a debtor is holding large exposures in the banking system. It is also expected that this regulation would reduce misconducts and other unhealthy business practices in dealings with banks.

57. On the other hand, we also realize that the implementation of these regulations during the currently challenging times will not be easy. **First**, mounting production costs from higher oil prices and cost of capital following increases in interest rates could potentially weaken corporate balance sheets. The uniform classification approach places further restriction on the operations of banks, making the reoccurrence of credit crunch, such as happened in the wake of the economic crisis, cannot be ruled out. **Second**, uniform classification requires improvements in the operation of the credit bureau, the key part within the banking industry's infrastructure that provides debtor information on a symmetric basis to all banks. At this point, the credit bureau is still on the development process, with full operation expected to begin in the next one or two years.

58. Considering the abovementioned aspects, this year, we will be making adjustments to Bank Indonesia Regulation No. 7/2/PBI/2005. This policy is a temporary measure that in essence is a simplification and phasing in of the regulatory provisions. We understand that the type of credit and the condition of

each individual debtor differs from that of other debtors, and thus the phased application of the uniform classification system becomes vital.

59. For this reason, the phasing in of these provisions will begin with syndicated loans, which already supported by adequate means of communication. This will be followed by major debtors that have significant bearing on bank performance, and later by debtors with certain levels of borrowings. In the longer-term perspective, these interim provisions will be progressively brought back to its best practices, inkeeping up with the dynamics in the economy and readiness of supporting infrastructure, expectedly to take place in the next one or two years.

Second, Bank Indonesia will consider a downward revision in the statutory reserves requirement when the condition of macroeconomic stability permits.

60. As we all know, the statutory reserves requirement as a monetary instrument has been exercised by Bank Indonesia to resolve the structural problem of excess liquidity in the banking system. As a monetary authority, we do believe that the tightening of bank liquidity through a well-timed increase in statutory reserves is a very effective instrument to prevent currency switching, particularly during times of pressure on the Rupiah. In this sense, a downward adjustment in this statutory reserves requirement would be considered, when the macroeconomic conditions in 2006 would have been brought to a relatively stable level for relaxing bank liquidity.

Third, Bank Indonesia will work steadily to improve public access to sharia banking services.

61. A recent Bank Indonesia study indicates a growing level of public understanding of sharia banking. On the other hand, however, interest in conducting shariabanking transactions remains low. This is explained, among others, by the limited coverage of sharia banking services. For this reason, it is necessary to foster public interest in conducting sharia transactions by greater access to sharia banking services. In this way, the public will no longer have to go to considerably greater efforts to conduct transactions through the sharia banking system, because access to sharia banking services will on par with conventional banking.

62. From the findings of this study, Bank Indonesia has also begun thinking of various alternatives that could become a breakthrough of the banking system in providing services and easy access of sharia transactions. We have now prepared a regulation that permits branches of conventional banks with a Sharia

Unit to also provide sharia transactions through office channeling. By providing office channeling at conventional branches, banks will no longer need to open Sharia Unit branches in numerous locations to offer sharia banking services. Office channeling will obviously need to be supported by IT networks and installation of sharia banking software at the branch offices to provide office channeling for sharia banking services.

Fourth, Bank Indonesia will pursue efforts to expand the coverage of banking services with focus on the Micro, Small, and Medium Enterprises (MSME) sector for more equitable outreach extending to all remote areas.

63. To put these policies into effect, we will mainly be pursuing the empowerment of the role and function of rural banks. In 2006, Bank Indonesia will begin encouraging rural banks, which have so far been concentrated in Java and Bali, to expand to other more remote areas that have so far not benefited from proper coverage of banking services. The expectation is for rural banks to spearhead financing for the MSME sector, particularly in agriculture and for the rural population. We are currently conducting an indepth study of various incentives that could be put into place in support of this policy.

64. On an operational level, Bank Indonesia has been working for some time to promote commercial bank and rural bank cooperation for channeling credit in an effort known as the linkage program. Overall, this program has produced good results in overcoming the limitations of rural bank capital on one hand and the difficulties faced by commercial banks in channeling credit to MSMEs on the other. To promote further effectiveness and usefulness of the program, in the near future we plan to present a special award to all those participating in the commercial bank and rural bank linkage program.

65. I believe the greater role commercial banks play will be critical in the advancement of this sector. A mapping-survey of MSME shows that the sector lacks confidence when interacting with the banking industry. This is by no means advantagous. It is neither advantagous for the MSME, which makes up for more than 90% of Indonesia’s productive business units, nor for the banking industry itself. The survey results clearly reveal that the MSME sector is full of potential in terms of credits and business management. Profits of the sector reach relatively high levels of 10%-50% per year. These high level of profits are still accompanied by other advantages associated with the sector, i.e. the ability to

withstand the ups and downs of an economy, low levels of NPLs and risk exposure due to the relatively small credits. This is why I believe this sector deserves our attention and also the banking industry's proportional business.

66. However, it is found that the MSME sector, with its informal industry background, usually faces difficulties in providing collateral and meeting other formal requirements demanded by the banks. This is particularly true for the Micro Enterprises. These difficulties obstruct Micro Enterprises from proposing for credit loans from the bank. The current situation calls for a new initiative, which can break through these barriers. The banking community needs to rethink its policies in extending credits to this sector. The MSMEs do not need our pitty nor do they ask for below market price rates. What they need is to be trusted as banks business partners which business will bring benefits to the bank.

V.2. Measures for Further Reinforcement of the Foundations of the Banking Industry

Distinguished guests, ladies and gentlemen,

67. For the medium and long term targets, the API seems have to be able to deliver gradual but consistent benefits in the overall reinforcement of the banking industry. It simultaneously encompasses the process of reinforcing the individual bank as well as the structures and infrastructure of the banking industry. In our planning, 2006 will be a crucial year that will influence our journeys to the future. This is the year in which the API concepts will be fully taken into effect. Over the next five years, all regulations and regulatory provisions will be aimed at the strengthening of operational foundation and prudential principles application. Thus in our vision, in the year 2010 we can expect to see the Indonesian banking industry taking on a new, fully-developed form. This will be a more resilient, more globally competitive and more auspicious banking industry for our national economic development process.

68. For this reason, under the recent adverse economic conditions, it is our opportune moment to reinforce the foundations of the banking industry. In an increasingly competitive climate and less favorable macroeconomic environment, the actions taken by the banking system towards greater reinforcement, therefore, is inevitable.

69. Bank Indonesia's policy direction for the medium and long term will be focused on 5 (five) areas elaborated in the API: **first,** to reinforce capital structures in order to

accelerate the consolidation process; **second,** to expand the role of foreign banks in the economy, **third**, to build the readiness of the banking system in anticipation of future developments in banking business; **fourth,** to strengthen bank internal management; and **fifth,** to improve the banking system infrastructure.

First, reinforce capital structures in order to accelerate the consolidation process

70. In 2005, we outlined an easily understood policy direction for the strengthening of the banking industry through the consolidation process over the next several years. As part of this, we have developed and published a range of strategic concepts and regulatory provisions. However, at this point, we can see that the bank consolidation policy has met with only limited response from the banking system. Action of several banks has generally proceeded only as far as plans for additional capital from the shareholders and expectations of organic growth supported by business earnings. On one hand, this optimism is indicative of the intention of banks to work hard to meet the established capital targets. On the other hand, however, banks need to weigh carefully the likelihood of achieving these targets.

71. Although in 2005 some banks began responding to this policy by seeking merger partners, yet the number of these banks fell far short of Bank Indonesia's expectations. These banks have not taken more concrete actions in preparation for mergers. However, according to Bank Indonesia's records, at least 27 banks face an uphill struggle to reach the Rp 80 billion tier-one capital requirement by the end of 2007. Various reasons for delay, such as lack of incentives for merger, differences in culture between one bank and another, and difficulties in determining the fair value of a bank should not hold up the consolidation process. We all comprehend that this process would bring the tremendous benefits to the future growth of Indonesia's banking industry.

72. Commencing in 2006, we see a need for greater emphasis on the supervision process to accelerate and reinforce bank consolidation. As set out in Bank Indonesia Regulation No. 7/15/PBI/2005 concerning Minimum Tier One Capital for Commercial Banks, the indication of this policy's effectiveness will become evident in the first quarter of 2006, when we have received the action plans from banks with less than Rp 100 billion tier-one capital.

73. This year we will conduct an in-depth evaluation of bank business plans through 2008. Following this, the supervision of these banks will be aimed more at efforts to identify alternatives for bank owners and management in determining the future of their banks. If it is possible to choose merger or acquisition, Bank Indonesia will do its utmost to ensure that the process moves forward properly and expeditiously, is fair, and delivers benefits to all parties.

74. I should emphasize that Bank Indonesia will not hesitate to take necessary actions as prescribed in existing regulations. The successful implemetation of the consolidation policy is a real test that we must pass in order to maintain the current momentum for strengthening the banking industry. For this reason, the restrictions on business activity of banks which unable to comply with the regulation are a measure that must be upheld to ensure that the banking industry develops in the desired direction for the future.

75. We also understand that the process must execute in fairness to both sides. In this sense, Bank Indonesia will conduct intensive studies on various options for the policy measures that must be taken. Our activities in 2006 will focus on various supportive actions to expedite and facilitate the merger and acquisition processes. These actions will also be followed by intensified cooperation and coordination among government agencies to ensure that this policy becomes part of an integrated process.

Second, expand the role of foreign banks in the economy

76. In the last three years, we have seen steady expansion in foreign ownership due to the success of government program in the bank restructuring and divesting program. Foreigners now hold 48.51% ownership of the Indonesian banking industry, comparing to the government's decreasing stake of the 37.45%. Amongst Indonesia's 131 banks, 41 are under the ownership control of foreign investors. In this manner, foreign ownership banks can be classified into branch offices of foreign banks, joint venture banks, and private domestic banks in which foreign ownership dominates.

77. Bank Indonesia's policy regarding foreign ownership in banking has been very clear. We have been very open. We realize that with their various strengths, foreign ownership banks have been able to bring added value to the Indonesian banking industry. Their role in channelling capital flows, supporting bonds secondary market activity, supporting international trade, creating product

innovations, and transfering knowledge, are decipherable. Foreign banks and foreign ownership of domestic banks has created a positive circumstance for the strengthening of the national banking industry.

78. Within a broader scope, we strongly expect that foreign banks will play a greater role in achieving our mission in banking, that of financing sustainable national development. This is consistent with their position as part of the national banking industry. The support of all banks in Indonesia is crucial to achieving this mission, regardless of whether a bank is foreign or locally owned. Moreover in the future, the drive to promote national economic growth that hinges on increased investment and exports will require even greater support from the banking system.

79. Given that we face a period full of economic challenges, we have prepared various policy directions for expanding the contribution of the national banking system, including that of foreign-owned banks, for accelerating economic development. One of the economic problems that we now face and which we believe can be overcome during the coming period is unemployment, now running at 12 million. I call on foreign banks to join side by side in resolving this problem. Looking ahead, Bank Indonesia will consider whether regulations are needed to restrict the use of expatriate staff in middle management positions, i.e., two levels below the Board of Directors of the bank, other than in areas that cannot be filled from the domestic labor market because of scarcity of expertise.

80. One of our studies indicates that foreign banks, both foreign bank branches and joint venture banks, have a relatively small role in the intermediation process. In the post-crisis period, foreign and joint venture banks moved relatively slowly in restoring their levels of lending. When other banks embarked on credit expansion in mid-2001, lending by foreign banks showed a declining trend, followed by negative credit expansion during the 2002-2003 period. Since 2004 there has been gradual expansion in loan disbursements by foreign banks, although mostly for consumption. The third group of banks, i.e., private banks under foreign control, showed only slightly different performance. Loan disbursements, credit quality, CAR, and other indicators do not vary widely from overall industry figures.

81. Twelve of Indonesia's private banks are now under foreign control, and some of these are owned by the same ultimate shareholder. From the point of view of bank supervision, this is obviously neither effective nor efficient. The same should also hold true for the owners themselves. It is not easy to harmonize the

business strategy of several banks under their control and avoid unnecessary competition. For this reason, we are looking at the possibility of adopting a single presence policy for banks, including banks under foreign ownership control. Under the single presence policy, ultimate shareholders controlling more than one bank in Indonesia will be asked to consolidate their ownership. This is also a key policy that we will study comprehensively in support of the work under way by Bank Indonesia in improving the bank supervision system by moving towards use of the consolidated risk-based supervision approach. This supervisory approach will be explained further on in my speech.

82. On the other hand, we will also make use of the current global trend in the single presence policy to accelerate the ongoing process of bank consolidation. Consolidated bank ownership will directly encourage consolidation in business strategy and foster realignment in the competition within the banking industry itself. This will naturally have a positive influence through improvement in the overall efficiency of the banking industry.

Third, Bank Indonesia will build the readiness of the banking system in anticipation of future developments in banking business

83. It is no easy task to find a new equilibrium within an evolving industry. Our envisaged process of building new structures for the national banking industry is indeed a massive task. The issues faced are multidimensional, bringing structural influences to bear on the banking system overall and on individual banks. This is compounded by the rapid acceleration in the dynamics of the banking industry itself and in the condition of the economy, which represents the strategic environment within which the industry operates. Within the domestic scope, we all understand that almost any change or issue within the banking industry has a magnitude that frequently exerts significant influence on the national economy. From a global perspective, the banking industry is an extremely dynamic industry that is constantly putting forward new operational concepts. As soon as a concept is developed, it spreads extremely quickly, reflecting the integrated nature of global financial markets.

84. Regarding this global trend in the banking industry, it can be said that consolidation is under way between almost all ownership of major banking institutions and other financial industry corporations. These institutions have developed a wide range of innovations that integrate various financial products into a single package offered as a banking product. Over time, this has rapidly

become widespread practice, producing a change in the nature of bank business from conventional operations to the more complex business of universal banking. In simple terms, this concept means that a bank as an entity can become involved in almost all financial sector business, such as insurance, money market, securitization, mutual funds, and other related derivative activities.

85. We clearly cannot avoid the fact that the national banking industry is on the verge of this phenomenon. We all know that during the past three years, almost all large banks in Indonesia have offered services to customers investing in mutual funds. Some of these banks even own subsidiaries operating as investment managers and securities houses. Likewise there has been an upsurge in bancassurance, the marketing of insurance-related banking products. Insurance companies themselves are now actively offering products that combine insurance and investments in securities known as unit links. This is not to mention the massive exposure of banks on the government securities and bonds markets, the management of which demands special attention.

86. All of these activities have brought us to the conclusion that universal banking is a development that we must soon anticipate as part of the future of the national banking industry. Looking ahead, we plan to provide further clarification of our position and policy direction in the restructuring of linkages between banks and financial markets. We are fully aware that universal banking is a phenomenon that offers opportunity for the banking industry to growth through increased assets and revenues. In the long term, with banks given opportunity to operate on a universal scale, Indonesia's financial markets will undoubtedly operate at much more liquid levels.

87. Nevertheless, each step taken in product development and business expansion will not only offer opportunities for increased revenues, but will bring on consequences of increased business risk. Opportunity for Indonesia's banking industry to expand into universal banking will also bring about a higher level of integration of Indonesia's financial markets. This also means greater risk of systemic problems.

88. For this reason, the policy for opening the door to universal banking in Indonesia will be introduced selectively. Needless to say, we will ensure that the operating licenses for these activities will be tied to strict requirements reflecting the readiness of the bank in anticipating the risks that may arise. We cannot rule out the possibility that the future structure of the industry, which we have begun to guide towards on capital requirements, will be linked to the eligibility of banks to

operate in universal banking. Banks that are categorized as high performing banks, classified as international or national banks, and that have strong management capabilities will have ample opportunity for product diversification in the direction of universal banking.

89. Consistent with the process described above, our part is to strengthen the bank supervision process that comes under our responsibility. In our journey to the future, the Bank Indonesia policy direction in supervision will be to attempt assessment of the risk exposure of a bank on a consolidated basis. We will adopt this form of supervision, which currently represents best practice, in the oversight of the national banking industry that is predicted to move towards universal banking. In many countries, the expansion of banking business into universal banking has taken place through establishment of bank/financial holding companies with subsidiaries operating in the various types of financial services.

90. In broad terms, we will begin this task by conducting a downstream consolidation assessment of risk that covers risk assessment of the bank and of the financial subsidiaries of the bank, such as for securities companies. Eventually, this will be followed by full consolidated risk assessment with the scope of assessment expanded to include upstream and downstream and the overall conglomerate related to the bank. Within this context, the single presence policy concept becomes highly relevant for application, particularly upon the launching of consolidated assessment.

91. So far, Bank Indonesia has in essence completed several parts of the consolidated risk assessment framework, particularly in regard to transparency of the financial statements issued by banks, holding companies, and subsidiaries, and has conducted a qualitative assessment for the purposes of risk-based supervision and the CAMELS rating system. In the future, the qualitative assessment will also be reinforced by quantitative assessment. This system for consolidated risk assessment is also one of the requirements that must be met for application of Basel II.

92. In regard to the dynamics explained earlier, Bank Indonesia has joined forces with the Indonesian Accountants Association (IAI) and also the national banking industry to initiate a joint study on the to bring Indonesian accounting standards more into line with International Accounting Standards (IAS) in order to support the application of the medium and long term policies described above. I now call on the banking system to start preparing themselves for implementation of IAS 39, which is now in the drafting stage. This has a crucial bearing on the

implementation of all policies that we will be launching. Without the support of a common application and understanding of internationally prevailing accounting standards, international banking business practices will not be suitable for application in Indonesia. It is essential that we all understand and accept that the preparation of supporting infrastructure is a consequence that we must face if we are to bring ourselves up to par with advancements already made elsewhere in the world.

Fourth, strengthen bank internal management

Distinguished guests, ladies and gentlemen,

93. As we understand it, the anticipated future structure of the national banking industry should clearly obtain major attention in the current process of the Banking Act amendment. As set out in the plans for the API, we expect that in 2010, we will see the Indonesian banking industry existing within a new, more robust structure. To this end, we will proceed carefully with formulation of concepts that by nature will change the industry structure, including regulation of the role of foreign banks, universal banking, single presence policy, and consolidated risk assessment. Discussions with industry players will be an essential part of this process.

94. These policies will obviously not be applied all at once, but will be phased in over a fairly long transition period to enable the entire process to be completed smoothly and deliver the desired results. The provision of supporting infrastructure is one task that must categorically be completed before other tasks can proceed.

95. In this regard, bank as a corporate entity also faces business challenges that demand careful calculation to ensure that functions and roles can operate in equilibrium. The banking system for the most part is now faced with mounting competition that knows no borders. For Indonesia, this penetration by the forces of globalization has become more intensive of late, with neighboring countries also racing to become front-runners in banking in this region.

96. Under these conditions, the ability to use information technology and apply best practices is one of the strongest advantages that they possess. The rising implication of this phenomenon is that current global banking dynamics demand a level playing field to ensure accessibility to the far corners of the global market. This in turn will compel us all to conduct a re-alignment in our operational

standards so that we will be able to survive and not be pushed aside in the international business of banking.

97. Aware of this need, Bank Indonesia has adopted the API policy and programs as an umbrella for all programs for preparation of supporting infrastructure for the national banking industry. One of the important dimensions of this policy concerns efforts to build the resilience and competitiveness of each individual bank to enable them to operate soundly and profitability within their individual peer groups.

98. The focus of implementing best practices, which refer to the efficiency and effectiveness of business management of banks as corporate entities in future years, is the application of good governance and Basel II. Thus when the strengthening momentum shifts to growth momentum, we will have the effective operational capabilities to operate within a more dynamic and sustainable spirit of recovery and growth.

Good Corporate Governance (GCG)

99. When we think about catching up in the areas of our shortcomings, at the same time we must also look at the groundwork in place for remedying the various weaknesses and obstacles that persist. One important factor that is fundamental to banking operations in anticipating the complexity of business and magnitude of future risk exposures is the application of good corporate governance (GCG). These measures, if applied effectively, can accelerate the restructuring process and build the overall resilience of the national banking system within a relatively short time. With good governance in place, we will in fact have responded to several issues in one fell swoop.

100. We are fully confident of improvement in bank performance, protection of stakeholder interests, better compliance with laws, regulations, and the code of conduct, and alongside this, reduction in the level of risk in banking business. Aware of the importance of good corporate governance, Bank Indonesia will take steps in 2006 to require the banking industry to embark on more integrated, comprehensive, and complete actions to put the principles of good corporate governance into effect.

101. In this regard, the best practices in good corporate governance in banking are based on five principles of governance. <u>First</u> is transparency in presentation of material and relevant information and disclosure in decision making processes.

Second is accountability, i.e., clarity of the functions and discharge of responsibilities of the various organs of the bank so that management can operate effectively. Third is independence, i.e., the bank is professionally managed without influence or pressure brought to bear from any party. Fourth is responsibility, i.e., compliance in the management of the bank with the applicable laws and regulations and sound bank management principles. Fifth is fairness in fulfilling the rights of stakeholders arising from agreements made and applicable laws and regulations.

102. To ensure that these five basic principles are adequately upheld, the minimum requirements and guidelines that we will put together will cover various dimensions of governance. Of these various dimensions, the regulation of composition and strengthening of the tasks and responsibilities of bank boards of commissioners and boards of directors are fundamentals that will be given considerable attention. This is because of their very important role in a bank, and through this significant improvement is expected in good corporate governance in the short term that will also be sustained over the longer term. Within this context, the bankers associations will play a strategic role in upholding governance. These associations must be capable of applying social pressure on their members so that they consistently uphold professional standards and ethics as basic values of governance for each individual banker.

Basel II

103. We all obviously share the hope that the full range of policies, commitments and actions that have and will be taken to prepare the infrastructure for the banking system will place our banking industry in a condition that will offer encouragement and assurance for us all. With adequate infrastructure in place, in the not too distant future the national banking industry should be able to operate on a level playing field at least with the banking industry in the region, most importantly in the application of best practices.

104. With this established as an objective, Bank Indonesia following intensive discussions with banks sees that the application of the Basel II working framework is a medium-term program with a three to five year time frame that requires us all to contribute our effort. As I explained last year, the Basel II framework will be applied by all banks beginning in 2008. The application of this working framework will be phased in, commencing from the simplest approach.

Following this, as the various necessary supporting infrastructure is put into place, in 2010 the national banking industry is expected to move on to full application of Basel II.

105. This policy is also expected to influence bank behavior in risk management. One underlying consideration is that the Indonesian banking system, and especially the big banks, have become part of the international banking community and thus the application of Basel II cannot be put off any longer. We are fully confident that the application of the Basel II working framework will place the banking system on more resilient, stable foundations and encourage better risk management practices. Furthermore, the application of Basel II must also be directed towards improving the quality of banking services in keeping with the present business focus and orientation of banks. Given that Indonesia is a country whose economy continues to rely on the strength of Micro, Small and Medium Enterprises (MSME), Basel II should clearly not make banks turn their attention away from this sector.

106. This concern has also been heard at the global level. Recognizing that banks worldwide have considerable exposure to the MSME sector, BIS made some adjustments to the Basel II concept some time ago to accommodate the need for channeling credit to MSMEs. One of the important changes in the Basel II regime concerns special treatment for retail portfolios. Not only are retail loans assigned a lower credit risk weighting, but debtors within this group are not assessed individually, but on a portfolio basis using a number of general criteria customarily applied in banking practice, such as orientation on lending, the types of loans that may be extended, and the maximum limits per individual whether stated as percentage or in amount.

107. Furthermore, Basel II also includes the retail portfolio category within the national discretion area, a condition in which the local supervisory authority has powers to establish specific limits adjusted to local conditions. According, the criteria used will be more flexible and more easily adapted to developments in the local economy, as well as accommodating small business financing issues. This will provide incentive to expand lending to the MSME sector while simultaneously providing opportunity to banks to lower their cost of capital by increasing their financing exposures to regulatory retail portfolios.

Fifth, improve banking industry infrastructure

Distinguished guests, ladies and gentlemen,

108. As an institution whose business is based on public trust, the banking industry is required to maintain this trust at all times. In the present era of free markets, securing this public confidence is no easy task. The intense competition among banks has made the public increasingly sensitive in selecting the bank for their needs. Any slight shift in the quality of service or soundness of a bank that could erode public confidence will trigger a rush to move funds from one bank to another. It is in this area that the industry infrastructure will be of great importance. Robust financial system stability, an industry operating on a sound and efficient basis, and customers with proper understanding of their rights and obligations will only come into being if the supporting infrastructure is able to facilitate the emerging dynamics of the industry.

109. To this end, we are fully aware that improvements to banking industry infrastructure represent a strategic policy that must receive priority in the drive to strengthen the banking industry. In 2006, Bank Indonesia's efforts to reinforce the infrastructure will be focused on five main areas: improvement to the Financial Sector Safety Net (JPSK), establishment for the Apex Agency for rural banks, the Banking Mediation Agency, structuring of activities in Card-Based Payment Instruments, and Banking Research Institutions in various regions in Indonesia. These five aspects of infrastructure building are collectively a concrete endeavor that will represent a threshold in the progress of the national banking industry in its journey to the future.

110. In a move to upgrade the Financial Sector Safety Net, the Ministry of Finance, BI, and the Deposit Insurance Agency (LPS) signed a memorandum of understanding on December 30, 2005, that prescribes the roles and functions of the three financial agencies in maintaining financial system stability. In addition, the MoU also sets for a cooperation mechanism among the three agencies in a forum for coordination and exchange of information. At the same time, Bank Indonesia and the Ministry of Finance issued Bank Indonesia Regulation No. 7/53/2005 and Regulation of the Minister of Finance No. 136/PMK.05 on agreement for establishment of the Emergency Financing Facility (EFF). This facility will be extended to problem banks in trouble with liquidity but nevertheless still solvent and deemed systemically important. Taken together, these measures represent an embryo for the future drafting of the Financial System Safety Net Law that will provide a legal umbrella for the regulations needed to safeguard and maintain financial sector stability.

111. At the micro finance level, the Apex Agency is expected to provide a forum and oversight for liquidity management at rural banks both in regard to over mismatch and under mismatch. This is consistent with the Bank Indonesia policy that constantly seeks to build the competitiveness of rural banks and their supporting infrastructure. In addition, the Apex Agency is also expected to provide various forms of technical assistance: HR training, information technology applications, and management consultancy, to build the service quality and resilience of rural banks within the scope of their operations. To this end and to prepare for future development, in 2006 we will facilitate the implementation of apex agency pilot projects in seven provinces using three models: the Apex Agency model operated by a coordinating rural bank, the Apex Agency model operated by a commercial bank, and the Apex Agency model operated by a coordinating rural bank with assistance from PT PNM. The pilot projects are expected to help determine the most suitable Apex Agency model to be used as supporting infrastructure for a sound, strong rural bank industry delivering benefits to customers and society.

112. In customer financing, in 2006 Bank Indonesia will begin to provide facilitation for resolution of customer disputes with banks through mediation in a move aimed at protecting the rights of small-scale customers and protecting the reputation of the banking industry. Bank Indonesia will provide the mediation function only on a temporary basis. Within the not too distant future, it is expected that the mediation function can be handed over to an independent bank mediation agency formed by banking associations.

113. In addition to customer mediation, Bank Indonesia views financial literacy campaigns as a vital task to be undertaken jointly by Bank Indonesia and the banking system. This is because financial literacy does not merely raise public awareness of the financial products offered by banks, but can also deepen public understanding of the proper financial planning needed to improve their standard of living. For this reason, Bank Indonesia could well establish a Financial Literacy Forum in 2006 to promote effective coordination between Bank Indonesia, the banking system, and relevant government agencies.

114. In keeping with the drive for consumer protection, Bank Indonesia will monitor the application of Bank Indonesia Regulation No. 7/52/2005 concerning Operation of Card-Based Payment Instruments, released only at the end of December 2005. With this regulation in place, it is hoped that banks will refrain from excessive exposure in issuance of credit cards and thus avoid endangering

overall financial system stability. The application of this regulation is expected to foster greater prudence among banks and improve the quality of bank services for customers. Banks will also know the financial limits of their customers in taking on reasonable levels of debt and thus the NPLs ratio can be kept to a minimum. On the other hand, customers will clearly exercise greater caution in accepting offers of new credit cards because excessive credit card ownership could tempt them into spending beyond their means.

115. In the long-term policy perspective, Bank Indonesia is now laying the groundwork for banking industry infrastructure that could bring together the specific needs of the public in a particular region with bank strategy and business focus that could respond to these needs. In 2006, Bank Indonesia intends to pioneer and facilitate the establishment of regional banking research institutes. These will be independent research institutes that conduct research aiming at results that can be concretely applied in keeping with the facts on the ground in each region. These research institutes, it is expected, will enable banks to respond to the phenomena and dynamics of social life in the regions as pertaining to the need for bank financing and will provide for mutual beneficial relations that will bring economic benefits to the nation as a whole.

VI. Conclusion: Long-Term Perspective

Honored Guests, and my respected banking colleagues,

116. This is all that I have to convey to you this evening. However, before closing my speech, I would like to remind you of the ancient Greek phrase "*Panta Rei*" that mean that life is like the flow of a river. Everything moves and changes, and the only certainty is change itself. The river seems to remain the same, although the water continues to flow without end – this being the essence of a river. The water that we take today is not the same water that we dipped up yesterday, or that we will fetch tomorrow. Thus, the essence of life and the experience of life is this constant flux. The same thing is true of our economy that constantly shifts and moves within new dynamics.

117. In the midst of all this flux and flow, it is certainly not difficult for us to see the massiveness of the problems that will confront us if we fail to act quickly and effectively. Our economic growth prospects are not yet optimal, the world oil prices still have the potential to fluctuate, the global imbalance can be expected to expand, and the risk of inflation remains high. Besides that, there is not much time available for action before these problems creep up on the banking and financial industries, then, in turn, on the overall economy itself.

118. Because of that we cannot put off taking the steps we need to take. And, of course, we will do that. We will move quickly and effectively, and in a measured manner. We expect that a number of the policy steps that I have set out for you will overcome the various problems still affecting the national banking industry. Certainly, in the next few years, we will be perceived as having undertaken banking consolidation because we were faced with critical issues that needed immediate resolution. It is now that we must focus our attention on the matters that are most urgent. And now, I feel, is the time for us to think within a larger, longer-term frame of time in our efforts to strengthen our institutions so that we can continue, in a sustainable manner, to confront the challenges facing us far into the future.

119. The steps I have set out, will certainly require a lot of sacrifice. However, if we all work together, we can make 2006 as the year that we bring the banking industry toward a new economic equilibrium, I am optimistic that we will all be ready and able to face the possibilities that the future holds. In the future, only those with exceptional ability, capability, and resilience will be able to survive global competition.

120. Because of that, we must all continue to work hard. We cannot rest until our goals are achieved. The banking community will continue to improve and organize itself, and Bank Indonesia will consistently, and in a disciplined manner, lead these steps toward advancement/improvement. And we will continue to work hard until the banking industry is as healthy, strong, and competitive as we hope for together.

121. Once again, Happy New Year 2006, and in this coming year may the Almighty God bestow blessings upon us and lighten our steps as we move toward a better future. Thank you.

Jakarta, January 13, 2006

GOVERNOR OF BANK INDONESIA

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