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**THE DIRECTION OF INDONESIA'S BANKING POLICY
IN FACING ASEAN ECONOMIC COMMUNITY¹**

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Abstract

Indonesia, together with the other member states, has agreed to establish 2020 ASEAN Community on October 2003. One of its fundamental components includes the enactment of ASEAN Economic Community. Specifically for the banking sectors, on April 2011 the member states have adopted ASEAN Banking Integration Framework, which is mainly designed so as to develop regulatory and policy harmonization as well as to accelerate banking business integration throughout the region. Needless to say, this paper primarily aims to address what efforts should be taken by Indonesia vis-à-vis the banking policy and regulatory regime in the interest of preparing them to enter into the era of effective enforcement of the ASEAN Economic Community. Case in point, Indonesia is required (i) to strengthen their national banking performance in facing the regional integration, (ii) to review and adjust their banking regulations to resolve national interest in facing ASEAN Economic Community, and (iii) to harmonize their banking regulations to be in line with the provisions of ASEAN Banking Integration Framework. As for Indonesian state-owned banks in particular, they also must fortify themselves against the coming tough competition from other member states' banks. It is also significant for the regulators to set out a clear distinction of the foreign banks' business in Indonesia. The key ideas are that the foreign banks must also contribute to the development of national financial services industry and be prevented in causing systemic financial risks in the event financial catastrophes occurs.

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1. ASEAN Economic Community Initiative

Integration could be articulated as an action of incorporating several different groups into one. And this happens in ASEAN region. As a result of the Declaration of ASEAN Concord II in Bali in October 2003, the Heads of State of Brunei Darussalam, the Kingdom of Cambodia, the Republic of Indonesia, the Laos People's Democratic Republic, Malaysia, the Union of Myanmar, the Republic of Philippines, the Republic of Singapore, the Kingdom of Thailand and the Socialist Republic of Vietnam have agreed to establish 2020 ASEAN Community, including the ASEAN Economic Community ("AEC").³ Further, the ASEAN member countries have agreed to adopt the AEC Blueprint, which was executed on November 20, 2007, stipulating that each of them shall abide by the AEC by 2015.⁴ Pursuant to AEC Blueprint, the objectives and purposes of AEC are as follows:⁵

- 1) to establish economic integration at 2020 in accordance with the principles of an open, outward-looking, inclusive, and market-driven economy consistent with multilateral rules as well as adherence to rules-based system for effective compliance and implementation of economic commitments;
- 2) to create a more dynamic and competitive ASEAN's single market and production base with new mechanisms and measures; to accelerate regional integration in the priority sectors; to facilitate movement of business persons; to create skilled labor and talents; to strengthen ASEAN's institutional mechanism;
- 3) to address the development divide and accelerate integration of Cambodia, Lao PDR, Myanmar, and Vietnam; and
- 4) to incorporate cooperation in the sector of human resources development and capacity building, recognition of professional qualifications, closer consultation on macroeconomic and financial policies, trade financing measures, enhanced infrastructure and communications connectivity, development of electronic transaction through e-ASEAN, integrating industries across the region to

³ ASEAN, *ASEAN Economic Community Blueprint*, (Jakarta: ASEAN Secretariat, January 2008), page 2.

⁴ Ibid.

⁵ Ibid., page 5-6.

promote regional sourcing, and enhancing private sector involvement for the building of the AEC.

In short, the key characteristics of AEC, among others, are intended to create: (a) a single market and production base, (b) a highly competitive economic region, (c) a region of equitable development, and (d) a region fully integrated into the global economy.⁶

The creators of AEC Blueprint have conducted consultations with relevant bodies/stakeholders in collecting inputs and coordinated joint conference in reviewing the Blueprint in order to ensure consistency of the measures, programs and milestones across sectors and to promote greater sense of belonging of the Blueprint among the member countries.⁷ Further, on the one hand, the relevant ASEAN divisional bodies will coordinate the implementation of the programs and measures, while on the other hand, relevant government agencies will responsibly oversee the implementation and preparation the action plans in more detail at national level.⁸ Participation by all stakeholders for integration process must be assured by actively involving private sector, industry associations and community at regional and national levels.⁹

2. Integration Framework on Banking Industry

So as to provide a general framework for the liberalization and integration initiatives under AEC in the banking sector, ASEAN Central Bank Governors in April 2011 adopted the ASEAN Banking Integration Framework (“ABIF”), in which the target was to achieve significant progress by 2020.¹⁰ ABIF is designed for the following objectives: to enable ASEAN banks to enter and operate in the banking sector of other ASEAN member states, to eliminate discrimination against foreign banks, and to create a more consistent banking environment throughout the region.¹¹ To achieve the target in

⁶ Ibid., page 6.

⁷ Ibid., page 26.

⁸ Ibid.

⁹ Ibid.

¹⁰ Almekinders, Geert et al, *IMF Working Paper, ASEAN Financial Integration* (February 2015), page 7.

¹¹ Asian Development Bank, *The Road to ASEAN Financial Integration: A Combined Study on Assessing the Financial Landscape and Formulating Milestones for Monetary and Financial Integration in ASEAN*, (Philippines: Asian Development Bank, 2013), page 10.

2020, several actions needed to be made, such as that only a small number of high quality banks that meet specific qualifications may gain access to all member states (which is further described as Qualified ASEAN Banks or “QAB”).¹² To obtain a status as QAB, a bank must meet the minimum capital adequacy requirements, consolidation requirements and authority for consolidated supervision, restrictions on large exposure, and minimum accounting and transparency requirements.¹³ The member states must agree to facilitate QAB access to their respective domestic banking markets. Such qualifications would serve as benchmark for regulatory harmonization in the banking industry to accelerate the integration throughout the region and also as operating targets for financial strength and operating efficiency, and thus accelerate capacity building of each region’s banking markets.¹⁴

Note that the integration includes liberalization of market access, which should be implemented for market entry and cross-border bank activities.¹⁵ This means QABs must be allowed to provide cross-border banking activities, which will subject to the relevant types of banking licensing category granted by the host country.¹⁶ Also, the regulators must take into consideration that the process of granting equal treatment to all banks, especially in the matter of regulatory supervision, should be based on their risk profile.¹⁷

In addition to QAB, the regional integration also demands a consistent environment of regulatory, which initially can be originated from the QAB qualifications with key areas of concerns: bank accounting standards and disclosure requirements, minimum capital requirements, risk management, Prompt Corrective Action (“PGA”) and resolution methods for failed banks, restrictions on large exposure, and anti-money-laundering and consumer protection regulations.¹⁸ Moreover, to prevent potential conflict among national supervisors the prudential requirements for banks must also be harmonized using the following requirements, including but not limited to, minimum PGA triggers, accounting practices and disclosure requirements to ensure adequate transparency, asset and liability

¹² *Ibid.* page 11.

¹³ Almekinders, Geert et al, *IMF Working Paper, ASEAN Financial Integration* (February 2015), page 15.

¹⁴ Asian Development Bank, *Opcit*, page 11.

¹⁵ *Ibid.*

¹⁶ *Ibid.*

¹⁷ *Ibid.*

¹⁸ *Ibid.*, page 12

management restrictions to prevent regulatory arbitrage, and risk management regulations.¹⁹

In a few member countries that have less developed banking markets, priority should be given for capacity building by way of, among others, establishing national credit rating agencies, credit guarantee facilities, and interbank lending and borrowing market before a country can begin to entry barriers.²⁰ ADB highlights the importance of joint effort among the member countries as to create a consistent banking environment within the region.²¹ Such less developed member states may find it difficult to establish critical infrastructure in time for the prompt integration of the regional banking market.²² Therefore, assistance and cooperation from other member states would significantly affect the improvement for timely integration.²³

3. Indonesia's Banking Industry at a Glance

To view from a bigger picture, Asia-Pacific became one of the largest sources of global banking profits and will likely to continue expanding.²⁴ Between 2005-2015, the share of global after-tax profits increased significantly from 28% to 46%.²⁵ The global profit for Asia-Pacific regions reached pool above \$ 1 trillion.²⁶ However, in 2015 the profits went lower fell from \$ 548 billion to \$ 538 billion from 2014 to 2015, the first decline since 2009 aftermath of global economic crisis.²⁷ A closer look points out China as the powerhouse in the region while Australia shows its market is more mature than other region, and its competition is more intense.²⁸ Japan had its unique domestic plagued during the period while in other developed markets such as Hong Kong, New Zealand, Singapore,

¹⁹ *Ibid.*

²⁰ *Ibid.*

²¹ *Ibid.*

²² *Ibid.*

²³ *Ibid.*

²⁴ HV, Vinayak, et.al., *Weathering the storm Asia-Pacific Banking Review 2016*. McKinsey & Company, Global Banking June 2016. page 7.

²⁵ Calculations of profit pools were based on a propriety methodology used by McKinsey Panorama team. The analysis excludes a bank's treasury and non-banking activities to account for in-country banking pools, which results in differences with reported financial figures from the banking industry. See *Ibid.*

²⁶ *Ibid.*

²⁷ *Ibid.*

²⁸ *Ibid.*

South Korea and Taiwan, the profits grew 4 percent a year on average.²⁹ For other emerging countries, including Indonesia, Malaysia, Thailand and Vietnam, they averagely grew by 15 percent a year.³⁰

Speaking of Indonesia in particular, the Indonesian banking sector in 2016 is expected to bounce back because of the lower primary reserve requirement ratio for rupiah deposits (6.5 percent), lower cost of funds as well as operational costs, rising credit volume (due to lower interest rate environment) and improving purchasing power.³¹ The banking sector is also expected to taste the stimulus given by the government in order to strengthen domestic business and improve investment climate.³² The banks also will benefit from infrastructure development, one of the cores of government's program.³³ Below is the overall performance of Indonesian banks:³⁴

Variables	2012	2013	2014	2015
Net Profits (in IDR trillion)	92.8	106.7	112.2	104.6
Net Interest Income (in IDR trillion)	391.3	458.2	568.0	646.6
Total Assets (in IDR trillion)	4,262.6	4,954.5	5,615.2	6,132.6
Credit (in IDR trillion)	2,707.9	3,292.9	3,674.3	4,057.9
Third-Party Funds (in IDR trillion)	3,225.2	3,664.0	4,114.4	4,413.1
Loan-Deposit Ratio (LDR) (%)	83.6	89.7	89.4	92.1
Capital Adequacy Ratio (CAR) (%)	17.4	18.1	19.6	21.4
Net Interest Margin (NIM) (%)	5.5	4.9	4.2	5.4
Return on Assets (ROA) (%)	3.1	3.1	2.9	2.3

²⁹ *Ibid.*

³⁰ *Ibid.*

³¹ Bank Indonesia Positive about Banking Sector in 2016, Fitch Doubts. <http://www.indonesia-investments.com/news/todays-headlines/bank-indonesia-positive-about-banking-sector-in-2016-fitch-doubts/item6628>.

³² *Ibid.*

³³ *Ibid.*

³⁴ *Ibid.*

4. What To Do

Descriptions and rationales have been described above. Indonesia would likely be facing some consequences that might arise towards its commitment to AEC and ABIF. A few points that promptly need to be taken into account:

- 1) Indonesia would need to strengthen their national banking sector in facing the regional integration;
- 2) Indonesia needs to review and revise their banking regulations to empower national interest in facing AEC; and
- 3) Indonesia needs to harmonize their banking regulations to be in line with the provisions under AEC and ABIF.

To show Indonesia's commitment towards AEC and ABIF results, among other things, the Indonesian state-owned banks must strengthen its capability and competitiveness in order to become and compete with QAB. One of the effective solutions is to increase a bank's capital. Such capital increase may instantly be realized by consolidating several strong banks into one to meet QAB's requirements. In line with the aforementioned, Indonesian Financial Services Authority (*Otoritas Jasa Keuangan*) has agenda in implementing the Indonesian Banking Architecture by way of creating a strong and efficient banking system as well as consolidating banks through M&A.³⁵ Approximately there are 118 commercial banks in Indonesia and OJK intends to consolidate those 60-70 banks within the next 10 to 15 years, that will comprise of the following categories: international, national and specialized or rural banks.³⁶ This approach also can be seen conducted by Malaysia in light of the AEC in the 2010-2020 period. Case in point, the Central Bank of Malaysia has agreed to the merger between three major Malaysian banks, namely, the CIMB Group, RHB Capital and Malaysia Building Society.

³⁵ Ernst & Young, *Indonesian banking industry: challenging yet promising*. September 2015. page 3.

³⁶ *Ibid*.

³⁷ However, such may not readily result in significant capital increase if compared to, for instance, a Singaporean bank's capital.³⁸ Hence, a strategic intervention from the Indonesian government to inject capital to local banks may be necessary. The government, on the other hand, should also take into account other required actions in preparing the Indonesian banks to meet QAB's criteria.

Concurrent with the aforesaid, it is also important to strictly regulate the business of foreign banks in Indonesia so as to provide latitude for local banks to prepare for QAB. In addition, foreign banks must be regulated for the specific reason of financial inclusion since it must participate in developing national financial services' access and banking products. Foreign banks must also maintain its risk management so as to prevent the Indonesian government from bearing the systematic financial risks caused by foreign banks. Such an arrangement is moreover important to implement reciprocal principles³⁹ and to adjust the existing banking law to the current conditions of the Indonesian economy.⁴⁰ Such plans can be accordingly implemented by reforming the substance of the banking law. With respect to that, the House of Representative of the Republic of Indonesia apparently has formed a task force to prepare the new banking law and as such is listed in number 34 priority of 2016 legislation for the bill to be passed.⁴¹

The new banking law should firstly be adjusted with terms as set out in ABIF. Moreover, the law must differentiate between the definitions of national and foreign banks. The existing banking law does not stipulate the definition of a foreign bank. The proposed

³⁷ See more at <http://www.republika.co.id/berita/koran/pareto/14/10/08/nd40kh35-konsolidasi-menuju-mea-2020>

³⁸ If national bank's capital of IDR 800 trillion consolidated with a local bank with capital of IDR 400 trillion will resulting IDR 1,200 trillion. If compared with DBS that already has IDR 3,500 trillion, then such consolidation will not be significantly impactful. See more details at <http://www.gresnews.com/berita/ekonomi/10202-merger-antar-bank-bukan-solusi-tepat-hadapi-mea/0/>

³⁹ The implementation of reciprocal commitment means the treatment towards foreign banks in Indonesia must be adjusted with the treatment towards Indonesian banks in the originated countries of such foreign banks. The implementation should cover, including but not limited, to the opening of branch office's policy, the opening of ATM network, capital and ownership, and deposit taking limitations.

⁴⁰ The existing banking law was enacted in 1998 with the spirit as to adjust the banking regulations with the economic crises 1998's treatment program. At that time, the banking law was deemed necessary to adopt the liberalization concept as to reduce the state's role and release the financial institutions from "financial repression". Further, the law was also focused on restructuring the bank and its system. The focus of the law must be increased as the Indonesian economic goes to stability, not only focus in restructuring but also in increasing competitiveness of national banks.

⁴¹ <http://www.dpr.go.id/uu/prolegnas>.

definition of a foreign bank shall be a bank incorporated under Indonesian law but which is controlled by a foreign entity/government.⁴² Further, we may stipulate the derivative provisions:

1) The policy of opening of a branch office

Foreign banks have 7,982 branch offices, or 43% of the total of all banks' branch offices in Indonesia.⁴³ As such, the new banking law needs to stipulate restrictions on foreign banks opening new branch offices. For instance, the concept of zoning could be implemented. Zoning is created based on the density level of a branch's amount and the economic growth of certain regions. If a foreign bank intends to open a branch office in a region that has the highest level of density, then it also must open branch offices in two regions that have the lowest density level.⁴⁴

2) The policy of opening Automatic Teller Machine ("ATM") networks

To increase the level of financial inclusivity and national banking competitiveness, the new law may restrict ATM locations only to the location of a foreign bank's branch offices. Also, the owners of the ATM network should be authorized to apply different tariffs. It is similar to banking regulations in Malaysia,⁴⁵ while in Singapore the sole discretion belongs to the Monetary Authority of Singapore.⁴⁶

3) Capital and ownership

The new law must regulate that a foreign bank's capital should be higher than that of a national bank to prevent the country from bearing the financial systemic risk

⁴² In Singapore, pursuant to Article 2 (1) Banking Act, there are two definitions of foreign banks: "bank incorporated outside Singapore" means a bank incorporated, formed or established outside Singapore; and "foreign-owned bank incorporated in Singapore" means a bank incorporated in Singapore, the parent bank of which is incorporated outside Singapore. In Malaysia, pursuant to Part 1 Financial Services Act, there is only definition of "foreign institution" which means a foreign company, not being an authorized person or a registered person, which carries on any business outside Malaysia which corresponds, or is similar, to the business of any authorized person or registered person, whether or not such person has an approved representative office.

⁴³ McKinsey and Company, Indonesian Banking Statistic 2013.

⁴⁴ In Malaysia, the opening of bank's branch offices is limited up to 8 branches. If more, such banks must obtain approval from Malaysian Central Bank and must comply with the ratio 1:2:1 based on the zoning system, which also relies on the density level.

⁴⁵ In Malaysia, the tariff on the opening of ATM network to foreign banks is four times higher than to the local banks.

⁴⁶ In Singapore, the access of foreign bank towards the opening of ATM network is limited compared to local banks.

caused by foreign banks. Also, because of the dynamic Indonesian economy, the new regulation may grant authority to the Indonesian Financial Services Authority (OJK) to change the bank's ownership limitations as OJK regulations are lower than the country's laws, which will insert flexibility for any future changes.

4) Deposit limits

The new law must limit deposits taken from a third party for better risk management and financial stability as well as fair competition between national and foreign banks but still putting forward national interest in banking.

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