



Chapter 9

Banks and Other Financial Institutions

Chapter 9: Banks and Other Financial Institutions

One noteworthy aspect from Indonesian banking performance in 2007 is the vastly improved banking system stability in post-crisis. This is evident from banking performance and conditions in 2007, reflected both in the intermediary function and the resilience of the system itself. This achievement is hand in hand with the stable condition of the economy and also owes much to policies designed to promote the intermediary function and strengthen banking resilience. Regarding intermediation, progress was reflected in credit expansion well ahead of the target set at the beginning of 2007. Also attesting to the improved resilience is the continued stability of the banking system reflected in high levels of capital and declining non-performing loans (NPLs). The subprime mortgage crisis that has struck the banking system in various countries has so far had minimal impact in Indonesia. Sharia banking also made heartening progress, reflected in expansion of service coverage, funding growth and higher levels of financing compared to past years. In other financial institution sector, the capital market charted significant performance gains as indicated by the soaring Indonesian Composite Index (IDX Index). The bond market, mutual funds, multifinance companies, insurance companies and pension funds also demonstrated improving trends.

Bank performance recorded significant gains in 2007, buoyed by more conducive economic conditions. This improvement was reflected in above-target credit expansion, improved credit quality and capital adequacy ratios far above the regulatory minimum. Bank lending to micro, small and medium enterprises (MSMEs) remained strong, as demonstrated by the expansion in MSME credit during the year under review. Concerning capital, the banking system achieved compliance with the Rp80 billion minimum capital requirement established by Bank Indonesia. Consistent with the positive trends for commercial banks, sharia banks and rural banks also reported steady improvement in performance.

Performance of the capital market and other financial institutions also showed buoyant trends. Surging performance on the capital market was reflected in the Composite Index, which reached an all-time high in Indonesia's stock market history. The upbeat trend on the bond market was reflected in both government and corporate bond trading. Companies tapped the opportunity presented by soaring activity on the capital

market to raise investment funds, as demonstrated by the escalating number of share and bond issues. On the mutual funds market, net asset value climbed significantly, tracking upward movement on the stock and bond markets. Performance gains were also recorded by multifinance companies, insurance companies and pension funds, with increases in total assets, extended financing and managed investment funds.

The improved performance of banks, the capital market and other financial institutions is closely correlated to the policy packages released by Bank Indonesia and the Government. In the banking sector, credit expansion received a boost from the policy decisions to lower the BI Rate and amendments in various regulations, most importantly the changes in quality rating of earning assets announced in March 2007. On the capital market, policy focused on improvements in infrastructure, efficiency, competitiveness and quality of supervision. One landmark action was the merger of the Jakarta Stock Exchange (JSX) with the Surabaya Stock Exchange (SSX) to form the Indonesian Stock

Table 9.1
Number of Banks and Bank Offices¹

Category of Bank	2000	2001	2002	2003	2004	2005	2006	2007
Commercial Banks								
Number of Banks	151	145	141	138	133	131	130	130
Number of Offices	6,510	6,765	7,001	7,730	7,939	8,236	9,110	9,680
State Owned Banks								
Number of Banks	5	5	5	5	5	5	5	5
Number of Offices	1,736	1,807	1,885	2,072	2,112	2,171	2,548	2,765
Regional Development Banks								
Number of Banks	26	26	26	26	26	26	26	26
Number of Offices	826	857	909	1,003	1,064	1,107	1,217	1,205
Private Foreign Exchange Banks								
Number of Banks	38	38	36	36	34	34	35	35
Number of Offices	3,302	3,432	3,565	3,829	3,947	4,113	4,395	4,694
Private Non-Foreign Exchange Banks								
Number of Banks	43	42	40	40	38	37	36	36
Number of Offices	535	556	528	700	688	709	759	778
Joint Venture Banks								
Number of Banks	29	24	24	20	19	18	17	17
Number of Offices	58	53	53	57	59	64	77	96
Foreign Banks								
Number of Banks	10	10	10	11	11	11	11	11
Number of Offices	53	60	61	69	69	72	114	142

1 Excluding village units operated by BRI

Exchange (IDX). In further action to support financial market deepening, the Government issued a policy to promote the development of sharia financial products, municipal bonds and other products.

Commercial Banks

Growth in number of bank offices has brought banking services even closer to the public. Economic advancement in some regions and keen competition for customers has prompted banks to do more to improve and expand their service offering to the public. As part of this, banks have increased the number of outlets in their office networks to make services accessible to all levels of society. During the year under review, banks added 570 offices to their networks, bringing the total number of bank offices to 9,680 (Table 9.1).

This improvement in banking services led to gains in bank performance (Table 9.2). One indicator of stronger bank performance was credit expansion that reached 25.5%, ahead of the targeted 22%. Accompanying this was improvement in bank credit quality reflected in lower NPLs ratios, both gross and net. Increased lending alongside lower deposit rates helped to boost bank profitability, as indicated by rising net interest

income (NII). Banks also successfully kept their capital adequacy ratios (CAR) at a high level well above the Bank Indonesia-prescribed minimum. These positive developments also point to improved resilience in the banking system in 2007 compared to past years, which places banks on a strong footing for confronting challenges and strengthening bank intermediation in 2008.

Credit expanded at a faster rate than bank funds mobilisation. Total bank lending at end-2007 stood at Rp1,045.7 trillion, with credit expansion at 25.5%. At the same time, bank depositor funds were up 17.4% at Rp1,510.7 trillion. The significant growth in bank lending also widened the share of credit in bank earning assets from 53.6% to 57.3% (Chart 9.1) and boosted the loan to deposit ratio (LDR) to 69.2%, the highest level since the crisis (Chart 9.2). As a result of this lending performance, banks expanded their role in financing economic activity.

Banking credit, like before, was dominated by working capital and consumption credit of short term nature. During the year, the share commanded by working capital credit widened to 53.2% while consumption credit and investment credit narrowed to 28.2% and 18.6% of the total (Table 9.3). Analysed by growth, investment credit recorded 23.2% expansion, behind 28.6% and 24.9% for working capital credit and consumption credit. Nevertheless, the expansion in investment credit was well ahead of that of the

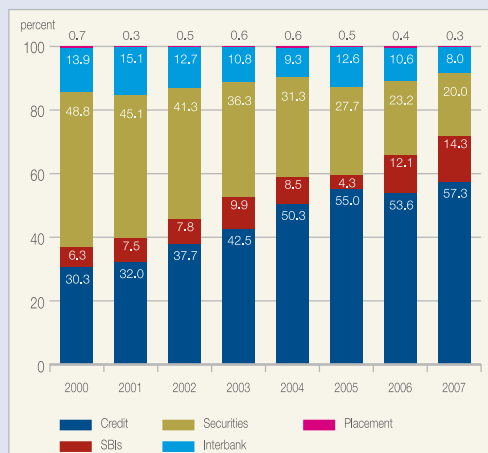


Chart 9.1
Composition of Earning Assets

Table 9.2
Commercial Bank Performance Indicators

Key Indicators	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total Assets (Trillions Rp)	1,006.7	1,030.5	1,099.7	1,112.2	1,196.2	1,272.3	1,469.8	1,693.5	1,986.5
Depositor Funds (Trillions Rp)	617.6	699.1	797.4	835.8	888.6	963.1	1,127.9	1,287.0	1,510.7
Credit (Trillions Rp) ¹	277.3	320.5	358.6	410.3	477.2	595.1	730.2	832.9	1,045.7
LDR (Credit/Deposits, %)	44.9	45.8	45.0	49.1	53.7	61.8	64.7	64.7	69.2
NII (Trillions Rp)	1.1	2.9	3.1	4.0	3.2	6.3	6.2	7.7	8.9
ROA (%)	(6.1)	0.9	1.4	1.9	2.5	3.5	2.6	2.6	2.8
Gross NPLs (%)	32.8	18.8	12.1	8.1	8.2	5.8	8.3	7.0	4.6
Net NPLs (%)	7.3	5.8	3.6	2.1	3.0	1.7	4.8	3.6	1.9
CAR (%)	(8.1)	12.7	20.5	22.5	19.4	19.4	19.5	20.5	19.2

¹ including channeling loan.

preceding year. One key factor preventing accelerated investment credit growth was slow disbursements of infrastructure loans, reflected in the 26.7% disbursement ratio on approved infrastructure lines of credit. This low portion of investment credit demonstrates that banks have not achieved an optimum level of credit expansion in support of long-term financing.

Consumption credit¹ was the product of choice for banks, offering greater diversification and ability to measure risk with loans spread out among many debtors with low individual ceilings. At 20 banks, consumption credit accounted for more than 75% of the lending portfolio and the share at a further 13 banks ranged from 50%-75%. Consumption credit was dominated by home mortgages at 33.4%, or 9.0% of total bank lending. Home mortgages were also the fastest growing segment of the credit market at 29.6%, followed by credit cards at 19.7% (Chart 9.3). Private foreign exchange banks and state-owned banks held sway on the mortgage market with 45.8% and 40.8% of these loans. On the other hand, credit cards operations were dominated by foreign banks at 49.7%, followed by private foreign exchange banks at 26.5% and state-owned banks at 15.9%. Leading in other forms of consumption credit were the state-owned banks with 31.8%, followed by private foreign exchange banks and regional development banks at 29.5% and 25.4%.

Overall quality of consumption credit was fair except for credit cards. Nominal NPLs from credit cards mounted significantly (65.0%) over the previous year, with gross NPLs in this segment up from 9.1% to

12.2%. In contrast, gross NPLs for home mortgages and other consumption credit was quite low at 3.0% and 1.9%. Despite the slight increase in gross NPLs for home mortgages and other consumption credit from the previous year, the trend is low and stable. However, the gross NPLs trend for credit cards mounted sharply in 2006 (Chart 9.4). The credit card marketing strategy, which offers many conveniences, encourages the public to indulge in more consumptive spending, resulting in increased card use. On the other hand, economic conditions and public purchasing power have not fully recovered from the previous fuel price hike. For this reason, banks must be more selective in issuing credit cards to avoid further build-up of NPLs.

The largest share of credit expansion during the year under review was channelled into the trade and business services sectors, which are regarded as

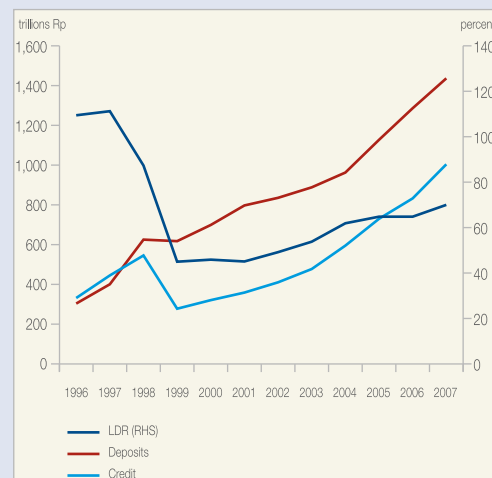
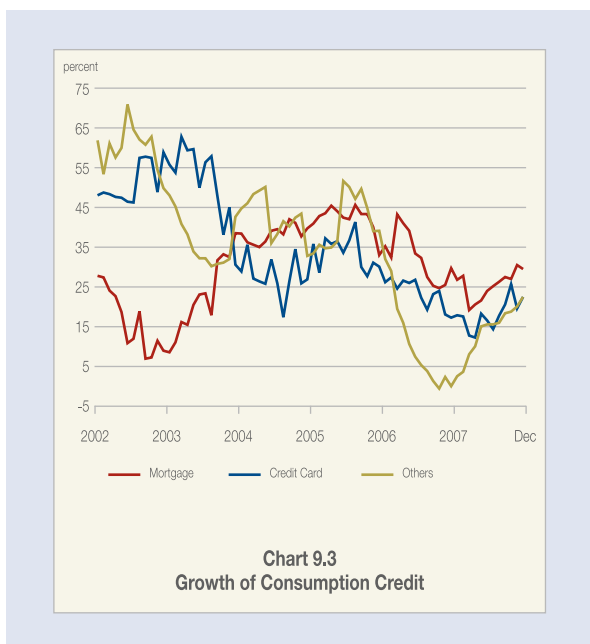


Chart 9.2
Bank Deposits, Credits, and LDR

¹ Consumption credit offered by banks include home mortgages, credit cards, car loans, credit for household or electronic purchases, home renovation loans, educational loans, holiday loans, unsecured loans and multipurpose loans.



having manageable risks. The two sectors received Rp53.5 trillion and Rp31.3 trillion in additional lending, representing a contribution of 25.5% and 14.3% to overall bank credit expansion in 2007. Trailing was the manufacturing sector with a contribution of 10.3%. However, measured by growth, the most robust credit expansion took place in the mining sector at 85.9%. This surge was prompted by soaring prices for mining commodities, including oil, gas, coal and nickel, which

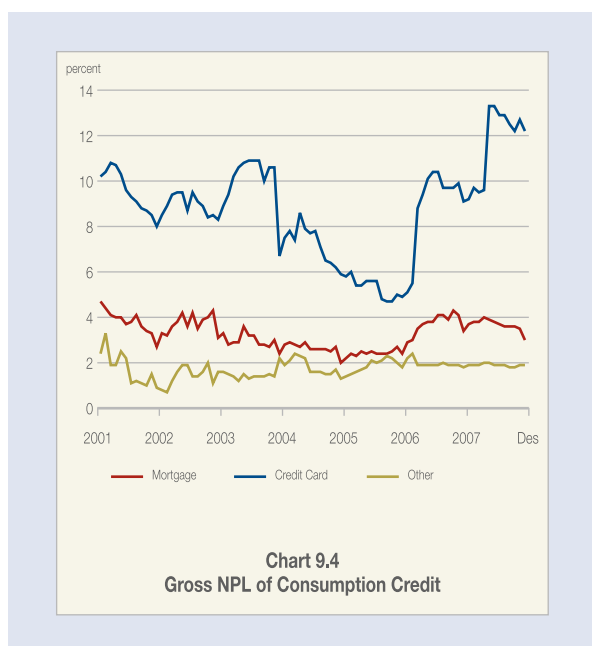
encouraged business to forge ahead with expansion in order to profit from the price momentum.

Foreign currency lending climbed significantly, buoyed by growth in international trade. Expansion in foreign currency-denominated loans reached 36.8% in 2007, up considerably from only 18.5% in the previous year, while rupiah credit expansion during the year under review reached 24.0%. These developments indicate that the external shocks that reared their head midway through the year have not impacted business demand for credit.

Credit quality underwent significant improvement. Gross NPLs fell from 7.0% to 4.6%, the first drop below the indicative 5% limit since the financial crisis, while net NPLs eased from 3.6% to 2.3%. The improvement in credit quality came mainly in response to the corporate debt restructuring programme at state owned banks. Most of the restructured corporate debt was in the manufacturing sector, a traditional customer for working capital credit, investment credit and foreign currency credit facilities. As a result of the debt restructuring, gross NPLs for the manufacturing sector fell from 10.5% to 7.1%, with similar decline in gross NPLs for working capital credit from 6.3% to 3.7%, gross NPLs for investment credit from 10.3% to 6.6% and gross NPLs for foreign currency credit from 9.9% to 5.1%.

Table 9.3
Bank Credits

Notes	Position (Trillions Rp)					Growth (%)					Share (%)				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
Economic Sector															
– Agriculture	24.4	33.1	37.2	45.2	56.9	7.7	35.6	12.2	21.6	25.9	5.6	5.9	5.3	5.7	5.7
– Mining	5.1	7.8	8.1	14.1	26.2	31.1	52.7	4.0	73.6	85.9	1.2	1.4	1.2	1.8	2.6
– Industry	122.4	144.9	171.3	184.0	205.6	(0.2)	18.3	18.2	7.4	11.7	28.1	25.9	24.6	23.2	20.5
– Electricity, Gas and Water	4.5	6.0	5.4	7.2	7.9	2.9	33.7	(10.2)	34.1	10.0	1.0	1.1	0.8	0.9	0.8
– Construction	12.5	20.0	27.0	33.1	44.1	32.8	60.2	35.2	22.6	33.2	2.9	3.6	3.9	4.2	4.4
– Trade	84.0	113.1	135.8	163.4	216.9	26.8	34.6	20.1	20.3	32.7	19.3	20.2	19.5	20.6	21.6
– Transportation	16.3	17.7	19.8	27.1	36.8	29.7	8.2	12.3	36.6	35.8	3.8	3.2	2.9	3.4	3.7
– Business Services	44.3	56.4	72.6	78.4	109.7	39.3	27.2	28.9	8.0	40.0	10.2	10.1	10.4	9.9	11.0
– Social Services	10.8	8.1	10.0	12.0	13.9	135.7	(25.3)	24.5	19.8	15.7	2.5	1.4	1.4	1.5	1.4
– Others	110.8	152.5	208.4	227.7	284.0	19.3	37.6	36.7	9.3	24.7	25.5	27.3	30.0	28.7	28.3
Category of Use															
– Working Capital	231.2	289.6	354.5	414.7	533.2	11.9	25.3	22.4	17.0	28.6	53.1	51.8	51.0	52.3	53.2
– Investment	94.5	118.7	134.4	151.2	186.2	12.0	25.6	13.2	12.5	23.2	21.7	21.2	19.3	19.1	18.6
– Consumption	109.4	151.1	206.7	226.3	282.6	36.8	38.1	36.8	9.5	24.9	25.1	27.0	29.7	28.6	28.2
Currency															
– Rupiah	330.6	431.6	565.8	638.4	791.6	23.1	30.6	31.1	12.8	24.0	76.0	77.2	81.3	80.6	79.0
– Foreign Currency	104.5	127.8	129.8	153.8	210.4	1.9	22.3	1.6	18.5	36.8	24.0	22.8	18.7	19.4	21.0
TOTAL	435.1	559.4	695.6	792.2	1,002.0	17.2	28.6	24.4	13.9	26.5	100.0	100.0	100.0	100.0	100.0
Channeling	42.1	35.7	34.5	40.7	43.7	7.4	(15.3)	(3.2)	18.0	7.2					



On the funding side, downward movement in deposit rates did not diminish public interest in holding funds in the banking system. Bank funds mobilisation mounted again in 2007 by Rp223.8 trillion to Rp1,510.7 trillion. The highest growth was recorded in savings deposits (31.4%), which accounted for 46.8% of expansion in depositor funds. Next were demand deposits with 20.0% growth, contributing 30.1% of additional funding. The steep rise in savings deposits came in response to a range of marketing campaigns offering prizes to depositors. On the other hand, time deposits narrowed slightly as a share of total depositor funds due to the effect of falling interest rates (Table 9.4). The shift in the deposit structure lowered the cost of funds, enabling banks to cut lending rates despite also constraining flexibility for extending long-term credit.

Foreign currency deposits gained wider popularity following the revocation of the Bank Indonesia ruling prohibiting banks from accepting savings deposits in foreign currencies, a move that led to increased volume of foreign currency savings at banks. Total foreign currency deposits mounted Rp32.4 trillion, representing growth of 16.7% over the previous year's position. In addition, some customers took pre-emptive action with the weakening trend in the rupiah, particularly in the second half of 2007, by transferring funds placements from rupiahs to foreign currency.

The more modest downward trend in lending rates compared to deposit rates has strengthened bank revenues. Also contributing to accelerated revenue growth was credit expansion and reduction in NPLs reflected in the rise in bank net interest income (NII) from Rp7.7 trillion to Rp8.9 trillion. With the improved profitability, return on assets (ROA) similarly climbed from 2.6% to 2.8%, the highest ROA reported in Asia.

Bank capital remained stable even with the credit expansion. Higher lending brought with it the consequence of increases in risk-weighted assets that would have to be backed by bank capital. Even so, the credit expansion produced only a slight reduction in the bank capital ratio from 20.6% to 19.2%, which remained the highest in Asia. At this level, capital provides a robust buffer for even greater credit expansion and in anticipation of future risks.

MSME Credit

During 2007, bank lending to micro, small and medium enterprises (MSMEs) exceeded target. MSME lending growth reached 22.5%, up considerably from the 15.7% recorded in the previous year. This growth was

Table 9.4
Bank Deposits

Notes	Position (Trillions Rp)					Growth (%)					Share (%)				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
Demand Deposits	219.1	245.9	281.3	338.0	405.5	11.2	12.2	14.4	20.2	20.0	24.7	25.5	24.9	26.3	26.8
– Rupiah	150.1	171.0	193.8	249.5	309.3	15.3	13.9	13.3	28.8	23.9	68.5	69.5	68.9	73.8	76.3
– Foreign Currency	69.0	74.9	87.5	88.4	96.2	3.3	8.6	16.8	1.1	8.8	31.5	30.5	31.1	26.2	23.7
Savings Deposits	240.7	296.8	281.5	333.9	438.5	25.0	23.3	(5.2)	18.6	31.4	27.1	30.8	25.0	25.9	29.0
– Rupiah	240.7	296.8	281.5	333.9	434.5	25.0	23.3	(5.2)	18.6	30.1	100.0	100.0	100.0	100.0	99.1
– Foreign Currency	–	–	–	–	4.1	–	–	–	–	–	–	–	–	–	0.9
Time Deposits	428.8	421.5	565.0	615.1	666.7	(3.9)	(1.7)	34.0	8.9	8.4	48.3	43.7	50.1	47.8	44.1
– Rupiah	351.8	351.9	455.0	509.9	541.0	(3.5)	0.0	29.3	12.1	6.1	82.0	83.5	80.5	82.9	81.1
– Foreign Currency	77.0	69.6	110.0	105.2	125.7	(5.6)	(9.6)	58.0	(4.4)	19.5	18.0	16.5	19.5	17.1	18.9
Total	888.6	964.2	1,127.8	1,286.9	1,510.7	6.3	8.5	17.0	14.1	17.4	100.0	100.0	100.0	100.0	100.0
– Rupiah	742.6	819.7	930.3	1,093.3	1,284.7	8.1	10.4	13.5	17.5	17.5	83.6	85.0	82.5	85.0	85.0
– Foreign Currency	146.0	144.5	197.5	193.6	226.0	(1.6)	(1.0)	36.7	(2.0)	16.7	16.4	15.0	17.5	15.0	15.0

ahead of the 20% target, but still below non-MSME credit expansion, causing the share of MSME lending to narrow to 50.2% (Table 9.5). Accompanying this was improved quality in MSME loans, with the NPLs ratio down from 4.2% in 2006 to 3.5%. This was attributable, among others, to a series of policies launched in 2007 including amended rules for micro, small and medium enterprises (MSMEs) in Bank Indonesia Regulation No. 9/6/PBI/2007 concerning the Second Amendment to Bank Indonesia Regulation No. 7/2/PBI/2005 concerning Asset Quality Rating for Commercial Banks, the loan guarantee scheme, the linkage program for commercial bank and rural bank cooperation in MSME financing and the provision of technical assistance to banks and Business Development Services Providers (BDSPs) for improved MSME access to financing.

MSME credit growth was dominated by consumption credit. During 2007, consumption credit mounted by Rp51.3 trillion (25.4%), ahead of expansion in working capital credit and investment credit at only Rp33.6 trillion (19.7%) and Rp7.4 trillion (20.0%). The expansion in consumption credit accounted for 55.5% of total MSME credit increase during 2007, consistent with the rise in domestic demand and especially in household consumption. Analysed by sector, additional lending to MSMEs during 2007 was dominated by trade, followed

by business services and construction (Table 9.5). Analysed by category of bank, private domestic banks again led the way in lending to MSMEs at Rp217.6 trillion, with state owned banks next at Rp176.7 trillion and regional development banks trailing with Rp67.8 trillion.

Rural Banks

The downward trend in numbers of rural banks continued with further progress in mergers. During 2007, Bank Indonesia issued approvals in principle for 27 rural banks and operating licences for 25 rural banks, while 105 rural banks were approved for merger/consolidation into 19 entities. In addition, Bank Indonesia revoked the operating licences for 5 rural banks beyond rescue due to structural problems. Through these actions, the total number of rural banks eased to 1,817 at end-2007, down 63 from the end of the preceding year (Table 9.6).

Rural banks, like before, are concentrated in Java and found mainly in regencies. Java accounted for 75.6% of Indonesia's rural banks, with the remainder dispersed among other regions. In addition, 79.3% of rural banks were operating in regencies or rural areas. Under the master plan for rural banks, Bank Indonesia is pursuing actions to reduce this disparity and encourage the

Table 9.5
MSMEs Credits¹

Notes	Position (Trillions Rp)			Growth (%)		Share (%)	
	2005	2006	2007	2006	2007	2006	2007
Category of Use							
Working Capital	142.6	171.1	204.8	20.0	19.7	41.7	40.7
Investment	33.0	37.1	44.6	12.5	20.0	9.0	8.9
Consumption	179.2	202.2	253.5	12.8	25.4	49.3	50.4
Total	354.8	410.4	502.8	15.7	22.5	100.0	100.0
Economic Sector							
Agriculture	12.6	13.9	16.1	10.5	15.7	3.4	3.2
Mining	1.0	1.3	1.5	31.0	14.5	0.3	0.3
Industry	32.5	36.7	37.8	12.8	3.1	8.9	7.5
Electricity, Gas and Water	0.2	1.5	0.3	640.0	(79.7)	0.4	0.1
Construction	7.7	10.1	13.2	31.4	30.4	2.5	2.6
Trade	87.5	107.3	134.6	22.6	25.5	26.1	26.8
Transportation	6.5	6.6	7.2	1.5	9.1	1.6	1.4
Business Services	20.6	23.5	30.5	14.1	29.7	5.7	6.1
Social Services	5.3	6.0	6.7	13.6	11.3	1.5	1.3
Others	180.9	203.5	254.9	12.5	25.2	49.6	50.7
Total	354.8	410.4	502.8	15.7	22.5	100.0	100.0
MSMEs Loan Ratio/Total Bank Loan	51.0	51.8	50.2				

¹ excluding loan of Rural Banks

Table 9.6
Rural Bank Performance Indicators

Indicators	2003	2004	2005	2006	2007
Number of Rural Banks	2,141	2,158	2,009	1,880	1,817
Total Asset (Billions Rp)	12,635	16,707	20,393	23,045	27,741
Depositor Funds (Billions Rp)	8,868	11,161	13,178	15,771	18,719
Credit (Billions Rp)	8,985	12,149	14,654	16,948	20,540
LDR (Loan/Deposits, %)	101.32	108.85	111.20	107.46	109.73
Gross NPL (%)	7.96	7.59	7.97	9.73	7.98
CAR (%)	-	-	19.34	19.50	23.38

spread of these institutions throughout Indonesia. The objective of this policy is to ensure that all members of society and especially MSMEs have access to and benefit from the presence of rural banks.

The rural bank industry reported positive performance gains (Table 9.6). Total rural bank assets in 2007 were up Rp4.7 trillion (20.4%) over the previous year's position to Rp27.7 trillion. This asset growth resulted mainly from Rp3.6 trillion in credit expansion (21.2%) to Rp20.5 trillion, in line with the Rp2.9 trillion (18.7%) growth in depositor funds. In response, the LDR for rural banks widened from 107.5% to 109.7%, well ahead of the LDR for commercial banks.

Demand for credit continued to rise, despite relatively high rates on offer. At the end of the year under review, rates for savings deposits at rural banks were 7.6% and for time deposits 11.6%. Although down from the previous year, these rates remained well above the levels offered by commercial banks. The relatively high cost of funds borne by rural banks was also passed on to their customers in high loan interest rates at 22.7% per annum. However, the most important considerations for rural banks customers when applying for loans were speed and service, and these customers were therefore not deterred by the relatively high loan rates.

Rural bank lending again focused on consumption credit. Although the majority of rural banks are located right within rural communities, funds channelling was still dominated by the trade sector (37.6%) and the miscellaneous sector (44.1%). In contrast, the agricultural sector, the primary source of livelihood for the rural population, received only 6.5% of financing. Lending for industry was even smaller at just 1.6%.

Credit quality at rural banks has improved. The gross NPLs ratio at rural banks fell from 9.7% to 8.0%, although at this level, NPLs were above those of commercial banks. The main contributor to high NPLs was micro enterprises (78.0%), which also accounted for the largest share of rural bank lending. Micro enterprises are simply another expression for the informal sector, which is highly susceptible to business failure because of the nature of business not supported by technology or qualified human resources. In addition, the majority of micro enterprises operate without formal business licences, and it is therefore difficult to monitor business survival. Analysed by category of use and economic sector, the most important contribution to rural bank NPLs came from working capital credit and credit to the trade sector.

The high capital levels at rural banks function as a buffer to risk while also supporting more vigorous credit expansion. Reflecting this was the rural bank CAR at 22.3%. The majority of rural banks (52.5%) operate with Tier 1 capital in the Rp1-10 billion range, while only 16.4% have Tier 1 capital below Rp500 million. On an individual level, 66 rural banks were unable to meet the minimum 40% minimum paid up capital requirement within the December 2006 deadline.

Policy for Conventional Banking

Banking policy in the year under review focused again on promotion of the intermediary function and strengthening of the condition or resilience of the banking system. These policy objectives were interrelated, given the essential importance of a structurally robust banking system to maximizing the banking role of lending in support of economic activity. To achieve these objectives, policy implementation in 2007 gave emphasis to short to medium-term and long-term programmes.

Short to Medium Term Programme Implementation

The following are some short to medium term policies pursued by Bank Indonesia during 2007:

- a. Provision of business data and information to facilitate the bank intermediary function for the real sector. To this end, Bank Indonesia launched the National Economic Database and the Economic Research Information Centre in July 2007.

- b. Facilitation of mergers in support of the bank consolidation programme, focusing on compliance with the minimum capital requirement.
- c. Amendment to regulatory content and clarified interpretation of some previously issued regulations. This policy emphasizes the risk management capability in the banking system in extending and evaluating credit rather than fulfilment of requirements. It is now possible for various requirements for assessment of loan collectibility, now regarded as burdensome, to be waived insofar as banks have a proper understanding of their risk exposures and are ready with the necessary mitigation measures.
- d. Regulation of bank employment of expatriates in order to build competence and ensure greater opportunity for Indonesian employees. Employment of expatriates in middle management positions is restricted to two levels below the board of directors, unless it can be proved that a position cannot be filled by local staff. In such a case, expatriate contracts are restricted to a maximum of 3 years.
- e. Active development of the domestic financial market and expansion of available instruments, such as: (i) new regulations released to support Treasury Note issues; (ii) creation of larger market for longer-term SBIs; (iii) provision of effective regulatory environment for development of broader range of products and markets encompassing medium term notes, corporate bonds and commercial papers; and (iv) greater opportunity for activities related to asset securitization, universal banking and development of sharia-compliant instruments.
- f. Rural bank industry development targeting improved competitiveness, expanded service coverage and increased rural bank financing for the MSME sector. Specific actions in support of this policy include: (i) improvements to rural bank regulatory framework; (ii) more effective supervision with launching of the Rural Bank Supervision Information System and online reporting by rural banks; (iii) institution building for rural banks through continuation of the rural bank industry restructuring policy; (iv) capacity building for rural banks through promotion of the Professional Certification (CERTIF) Programme for rural bank directors, provision of

technical assistance for rural bank managerial level staff to build technical competence and hosting of workshops for rural bank financing for productive sectors; (v) continuation of the Apex programme² with monitoring of Apex institutions already in operation at the regional level and preparations for establishment of national-level Apex institution; (vi) research on the causes of NPLs at rural banks; (vii) study of rural bank efficiency levels to identify ways of building rural bank efficiency to enable reductions in loan interest rates; and (viii) research on unsecured rural bank loans for productive businesses.

Long-Term Programme Implementation

The long-term programme for the banking sector is set out in the Indonesian Banking Architecture (API). During the year under review, implementation of API Pillar 1 reached the final preparation stage. The following is the progress achieved on Pillar 1 during 2007: (i) successful compliance with the Rp80 billion minimum Tier 1 capital requirement; (ii) upscaling of the linkage program between commercial banks and rural banks to more than 1,000 rural banks with total credit lines of Rp3.3 trillion and piloting of cooperation between commercial banks and cooperatives with credit lines totalling Rp576 billion; and (iii) improvements to the loan guarantee scheme aimed at improving access to credit for MSMEs unable to provide loan collateral, i.e. feasible but not bankable.

To improve the quality of banking regulation (Pillar 2), banking research institutions were established at the regional level. During 2007, four regional banking research institutions were set up in collaboration with four higher educational institutions: Brawijaya University, North Sumatera University, Hasanudin University and Andalas University. Research findings from the individual institutions will be incorporated into the policy making for strengthened intermediation at the regional level.

Improvement in the oversight function (Pillar 3) was achieved through reorganisation of the banking sector at Bank Indonesia and improvements to the system for risk-based supervision. Internal consolidation in the bank supervision units included the setting up of specialist supervisor groups, liaison officers

² Umbrella institutions for providing bridging funds for rural banks experiencing liquidity difficulties due to mismatch.

and transfer of licensing for bank office networks. To support the risk-based supervision system, draft guidelines were prepared for loan sampling and improvements were made to the judgement mechanism in the Supervision System (SIMWAS) application. In addition, work was completed on the study for the Bank Supervision System Blue Print, which identifies issues in the bank supervision system and contains recommendations for improvements to the regulatory framework, supervision framework and management of supervision resources.

Further progress took place in risk management certification and good corporate governance (GCG) to strengthen the quality of bank management and operations (Pillar 4). During 2007, risk management certification examinations were held for 12,865 level 1, 4,267 level 2 and 829 level 3 participants, with 9,024, 1,874 and 416 participants awarded passing grades. To pave the way for GCG, discussions were held on how best to implement GCG in the banking system with participation from banks, associations, institutions and non-government organizations involved in GCG.

Development of banking infrastructure (Pillar 5) focused on development of the Credit Bureau. In 2007, discussions were held on the final draft road map for the development of Credit Bureau. In addition, Bapepam-LK, the capital market and financial institutions supervisor, and Bank Indonesia signed a memorandum of understanding on collaboration in the operation of the Debtor Information System (SID) for financing institutions.

The programme for enhanced consumer protection (Pillar 6) focused on improvements in the complaints mechanism, mediation and public education. During the year under review, Bank Indonesia developed a program for automated online reporting of customer complaints to Bank Indonesia, slated for use in early 2008. In addition, the banking mediation function performed by Bank Indonesia will end on 31 December 2007 and will be taken forward by a banking mediation agency established by banking associations. However, because banking associations are not currently in a position to take over the mediation tasks, Bank Indonesia will retain this function until the banking associations have achieved the required readiness. In the area of public education, Bank Indonesia

cooperated with the Banking Education Working Group in the launching of the national public education campaign on banking in November 2007.

MSME Credit Policy

Bank Indonesia has worked consistently to support the development of micro, small and medium enterprises (MSMEs). MSME development activities during the year under review include technical assistance, provision of information and research. Technical assistance was provided in the form of training sessions for bankers and Business Development Service Provider (BDSP) and the MSME Development Pilot Project programme. The pilot project involves a cluster approach as a key strategy in upstream-downstream linkages in commodity-based industries, with this approach applied to leading products in 6 regions³. At the same time, provision of information involves mainly the organisation of intermediation bazaars, seminars, talk shows and public awareness campaigns and uploading of the Small-Scale Business Information System (SIPUK) in the Indonesian Business Information Database (DIBI). Research activities in support of MSME development to date includes: (i) identification of regional and central government regulations related to MSME development; (ii) identification and development of mainstay products in the MSME sector; (iii) identification of lending models with potential for development; and (iv) database on MSMEs with potential for bank financing, disseminated on a website. The results of this research can be used as a baseline for MSME development policy and strategy and provision of recommendations to the government and particularly regional governments.

Sharia Banking

Sharia banking has taken on an expanding role within the national economy. Despite a second quarter downturn in the growth of sharia banking from the knock-on effects of higher fuel prices among some sections of society, the sharia banking industry reported improved growth for the year overall. The sharia banking industry reported stronger performance in both funds mobilisation and financing, in so doing widening its share of national economic activity.

³ Serdang Badagai Regency (cassava), Pandeglang Regency (melinjo crackers), Bandung Regency (paprika), Sukoharjo Regency (rattan furniture), Mojokerto Regency (footwear) and Central Lombok Regency (seaweed).

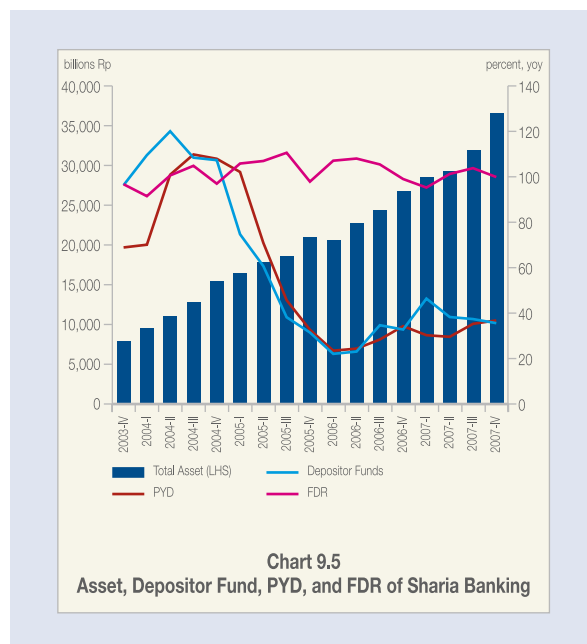
Table 9.7
Sharia Banking Offices

	2003	2004	2005	2006	2007
Sharia Commercial Bank (SCB)	2	3	3	3	3
Sharia Business Unit (SBU)	8	15	19	20	26
Sharia Rural Bank	84	88	92	105	114
Number of SCB & SBU	253	355	458	531	597
Number of Sharia Service Unit	–	–	–	456	1,195

Performance of Sharia Banks

During 2007, sharia banking office networks underwent significant expansion. Key milestones were the establishment of 9 sharia rural banks, opening of 6 sharia Divisions at conventional banks and network expansion totalling 66 offices (including cash offices, sub-branch offices and sharia service units) (Table 9.7). In addition, the decision to allow office channelling provided a significant boost to business volume in the sharia banking industry. This is indicated by the almost tripling of sharia service outlets from 456 offices to 1,195 offices at end-2007. Sharia bank office networks also expanded their outreach to over 70 regencies and municipalities in 31 provinces. The office network expansion is an indication of the strong need or demand in society for sharia financial services.

Sharia banks made considerable strides in 2007, as indicated by key performance indicators. The improved performance was closely related to network expansion by sharia banks during the year under review that paved the way for funds mobilisation and financing. Growth in depositor funds reached 35.5%, while disbursed financing mounted by 36.7% (Chart 9.5). With disbursed financing expanding more rapidly than depositor funds, the sharia bank financing to deposit ratio (FDR) widened from 98.9% to 99.8%. With these achievements, business volume in the sharia banking industry climbed Rp9.8 trillion or 36.7% over



the preceding year to Rp36.5 trillion. The increased business volume saw the share of sharia banking assets to total banking assets in Indonesia improve from 1.6% at end-2006 to 1.8% at end-2007.

Growth in depositor funds held at sharia banks in 2007 was driven by rising numbers of customers. Office network expansion proved successful in attracting significant numbers of new customers. During 2007, customer accounts increased by 853,777, of which 97.7% were held by individuals and 2.3% by corporate customers. Funding growth was also bolstered by competitive profit sharing returns, which stimulated public interest in placing funds in sharia banks. Depositor funds held at sharia banks increased by Rp7.3 trillion (35.3%) over the preceding year to Rp28.0 trillion. As a result, the share of sharia bank depositor funds in the national banking system improved from 1.6% at end-2006 to 1.9% at end-2007.

Table 9.8
Composition of Sharia Banking Depositor Funds

Descriptions	Total (Billions Rp)			Growth (%)		Share (%)	
	2005	2006	2007	2006	2007	2006	2007
Wadiah Deposits	2,045	3,416	3,750	67.00	9.80	16.52	13.39
Mudharabah Savings	4,371	6,430	9,454	47.13	47.02	31.11	33.75
Mudharabah Deposits	9,166	10,826	14,807	18.11	36.77	52.37	52.86
Total	15,582	20,672	28,012	32.66	35.50	100.00	100.00

Table 9.9
Sharia Financing

Descriptions	Total (Billions Rp)			Growth (%)		Share (%)	
	2005	2006	2007	2006	2007	2006	2007
Musyarakah	1,898	2,335	4,406	23.0	88.7	11.4	15.8
Mudharabah	3,124	4,062	5,578	30.0	37.3	19.9	20.0
Murabahah Receivable	9,487	12,624	16,553	33.1	31.1	61.7	59.2
Istishna Receivable	282	337	351	19.6	4.2	1.6	1.3
Qardh Receivable	125	250	540	100.6	115.6	1.2	1.9
Ijarah	316	836	516	164.7	(38.3)	4.1	1.8
Total	15,232	20,445	27,944	34.2	36.7	100.0	100.0

The funding structure in sharia banks was again dominated by mudharabah (investment) deposits. Unlike in past years, funding growth saw a shift towards mudharabah-based deposits. Growth in wadiah demand deposits plunged from 67% in 2006 to 9.7% in 2007 while expansion in mudharabah deposits mounted dramatically from 18.1% to 36.4%. The sharply reduced wadiah growth narrowed the share of these deposits from 16.5% of total funds to 13.4%, in contrast to the expanding share of mudharabah deposits (Table 9.8). Analysed by tenor, the mudharabah deposit structure also shifted in favour of longer-term funds.

The predominant share of investment funds in the funding composition may mitigate liquidity risks in sharia-compliant banking. Potential for liquidity risks

is related primarily to fluctuation in funds held by corporate depositors, most of which are sensitive to the competitiveness of offered profit sharing. Corporate depositors account for a very large share of deposits (44.4% of total depositor funds) even though representing a very small number of customer accounts (2.3%).

Healthy progress was achieved in the financing channelled by sharia banks. In 2007, sharia bank disbursed financing grew by Rp7.5 trillion or 36.7% to Rp27.9 trillion, bringing the share of sharia bank financing within overall national bank lending to 2.7%. This rate of disbursed financing growth was well ahead of credit expansion in the conventional banking system, underscoring the growing sharia banking contribution to financing in the real sector. This positive contribution

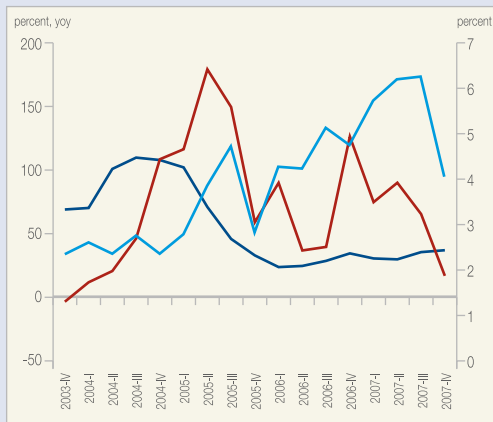


Chart 9.6
NPF of Sharia Banks

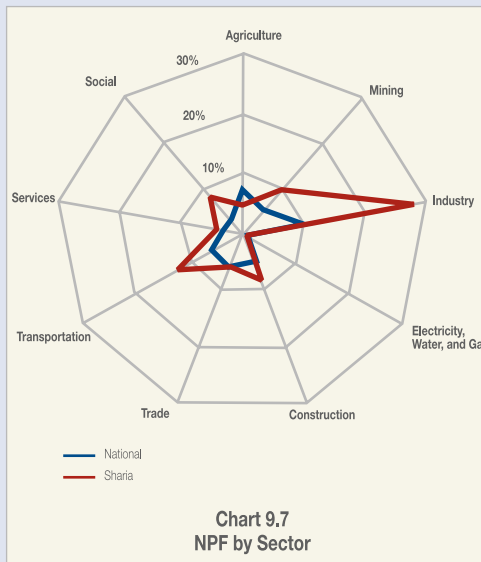


Chart 9.7
NPF by Sector

Table 9.10
Sharia Rural Bank Performance Indicators

Key Indicators	2005	2006	2007	Δ 2007
Total Asset (Billions Rp)	605.0	906.3	1.207.2	33.2%
Depositor Funds (Billions Rp)	353.6	530.2	711.3	34.2%
PYD (Billions Rp)	435.9	636.3	879.7	38.3%
Ratio:				
FDR (%)	123.3	120.0	123.7	3.67
NPF Gross (%)	10.6	8.3	8.0	-0.31
NPF Net (%)	9.5	7.1	6.6	-0.47

is also supported by the considerable portion of MSME financing at Rp19.6 trillion or 70.0% of total financing extended by sharia banks. Analysed by sector, financing growth is dominated by business services, trade and construction.

The murabahah contractual arrangement retains its lead in sharia-compliant financing, despite some decline in overall share. Murabahah financing underwent 31.1% expansion in 2007, slightly less than the 33.1% recorded in the previous year, with the share in overall financing narrowing to 59.2%. On the other hand, musyarakah and mudharabah financing expanded by a robust 88.7% and 37.3% (Table 9.9), bringing the share of musyarakah and mudharabah to 15.8% and 20.0% respectively. Key to growth in the musyarakah profit-share financing was the sharia bank financing operated in cooperation with micro and small-scale financial institutions such as sharia rural banks, cooperatives and sharia financial cooperative trusts (baitul maal wa tamwil or BMT). This growth is indicative of the preference in sharia banking for profit-sharing based financing, which carries higher risk than other forms.

Non performing financing at sharia banks eased mainly as a result of restructuring. From early 2006, the non-performing financing (NPF) ratio mounted to a high of 6.3% in Q3/2007 (Chart 9.6) due to sluggish economic conditions. This downturn in financing quality took place in the manufacturing, transportation and construction sectors (Chart 9.7). Despite this, the various actions pursued by sharia banks to reduce non-performing financing through restructuring succeeded in lowering the ratio to 4.1% in 2007, down from 4.8% one year earlier.

Increased risks in funds mobilisation and channelling were adequately offset by anticipatory measures.

Table 9.11
Sharia Rural Bank Financing

Category	2005	2006	2007	Δ 2007
Category of Financing (Billions Rp)				
a. Murabahah Receivable	355.9	524.0	717.30	36.9%
b. Mudharabah Financing	24.5	26.8	42.17	57.1%
c. Musyarakah Financing	40.1	65.3	96.48	47.8%
d. Others	15.4	19.6	38.49	96.8%
Financing Classifications (Billions Rp)				
a. Micro (Rp0-Rp50 million)	297.6	418.0	583.80	39.7%
b. Small (Rp50 million-Rp500 million)	121.7	178.8	263.10	47.1%
c. Others	16.4	39.5	47.53	20.4%
Category of Use (Billions Rp)				
a. Working Capital	252.6	378.8	506.49	33.7%
b. Investment	50.2	78.6	126.80	61.4%
c. Consumption	132.9	178.8	261.14	46.1%
Economic Sector (Billions Rp)				
a. Agriculture	12.1	41.0	26.45	-35.5%
b. Mining	0.1	0.5	1.18	142.7%
c. Manufacturing	9.4	12.5	13.61	9.2%
d. Electricity, Gas and Water	0.1	0.7	0.56	-25.5%
e. Construction	3.5	6.6	18.59	182.9%
f. Trade, Restaurants and Hotels	195.8	254.2	322.63	26.9%
g. Transportation and Communication	3.6	8.7	8.71	0.0%
h. Business Services	49.5	72.2	114.14	58.2%
i. Social Services/Public	5.2	5.6	10.81	91.9%
j. Others	156.2	233.7	377.77	61.6%

Despite some levelling in earnings growth, return on assets (ROA) remained strong at 1.78%, above the 1.55% recorded in the preceding year. The reduced earnings growth is explained by the expanded proportion of operating revenues allocated to depositors to improve profit sharing and sustain competitiveness. Added to this, sharia banks increased their loss provisioning in anticipation of financing risk in order to maintain capital levels above the minimum capital adequacy requirement.

Sharia Rural Banks

Sharia rural banks, which as financial institutions offer services to low-income groups, have also seen rapid growth. The network coverage of these banks expanded further with the addition of 9 new sharia rural banks, bringing the total to 114. Strengthened by this network expansion, business volume mounted Rp300.9 billion (33.2%) to Rp1,207.2 billion, with sharia rural banks widening their share within the national rural

bank industry to 4.2%. Funds mobilisation was also up at Rp711.3 trillion, while financing disbursements increased to Rp879.7 billion (Table 9.10), bringing the Financing to Deposit Ratio (FDR) to 123.7%. Financing quality also improved, as indicated by the drop in the NPFs ratio, gross and net, to 8.0% and 6.6%, respectively.

The preferred financing arrangements for these banks are sale and purchase under the murabahah agreement and musyarakah profit-sharing. Both types of financing are used primarily to meet the customer needs for working capital. Murabahah was again the dominant financing arrangement with an 80.2% share, followed by musyarakah and mudharabah-based financing at 10.8% and 4.7%, respectively (Table 9.11). Murabahah financing generally involves amounts smaller than Rp50 million used for purchases of consumer goods, such as motor vehicles and homes, by micro and small-scale entrepreneurs.

Sharia Banking Development Policy

Bank Indonesia has formulated a plan for building capacity in the sharia banking industry through accelerated development of sharia-compliant banking under the guidelines of the Blue Print for Development of Indonesian Sharia Banking (Box: Grand Strategy for Sharia Banking Development under the Accelerated Sharia Bank Development Programme). The objectives of building service capacity are aligned to the target for accelerated growth in sharia banking to achieve a 5% share of total national banking volume at end-2008. In essence, the accelerated sharia banking development programme simultaneously targets both supply side and demand side.

Supply Side Reinforcement Programme

To build expertise in sharia compliance and other technical areas, technical assistance is provided in the form of a certification programme for sharia rural bank directors, upgrading of sharia bank management and preparation of a textbook on Sharia Economics. During 2007, the certification programme was held for 2 intakes of a total of 53 sharia rural bank directors, in addition to the sharia bank management upgrading programme to meet the personnel needs for office channelling. In a further effort to improve the quality of university-level graduates joining sharia banks, a textbook on Sharia Economics was developed to

support teaching processes for sharia-compliant economics, finance and banking.

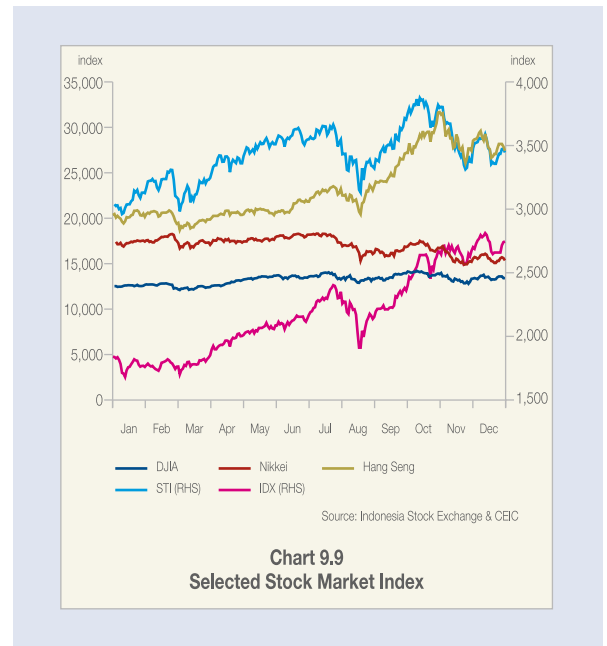
Bank Indonesia has encouraged the opening of office channelling as a means of expanding network coverage for sharia-compliant banking services. In 2007, office channelling services were expanded beyond deposit taking for customers to include financing.

Part of the effort to broaden the range of financial services offered by sharia banks involves the compilation of a book codifying sharia-compliant banking products. In 2007, a codified book was prepared with information on various sharia banking products available on the domestic market as reference material for sharia banks in expanding their range of financial products.

Demand Side Reinforcement Programme

This programme involves the following actions.

- a. Public awareness of sharia banking. The public awareness programme takes place in various forums with involvement of many different stakeholders, including bankers, academics and the general public. In 2007, a public awareness campaign was launched for the sharia banking industry, using information media such as television, radio, newspapers and other promotional media.
- b. Operation of the linkage program as part of the development of the sharia banking industry. The objective of the linkage program is to strengthen the interaction between sharia banks and the business sector. In 2007, the linkage program was replicated in the form of training for trainers of MSME for sharia bank managers, local government officials and relevant NGOs in Cilegon and Yogyakarta.
- c. Appeal to Government for active involvement in the development of the national sharia banking industry. One message conveyed to the Government calls for greater engagement with sharia banks in financing Government projects and managing Government sources of funds in the sharia banking system.
- d. Improvements to laws and regulations to promote the development of sharia banking. During the year under review, consultations were held on amendments to taxation regulations, including the



imposition of value added tax on products based on the sale-and-purchase principle. Work also progressed on the draft Sharia Banking Law and draft Sharia Treasury Note Law, both of which are strategic to the future development of the national sharia banking industry.

- e. Promotion of the voluntary sector programme. This programme has been launched to boost the potential role of the sharia banking industry in the social sector, with the Sharia Banking Social Care programme (Perbankan Syariah Peduli Umat or PSPU) working in cooperation with existing charitable institutions managing ZISWaf (Zakat, Infaq, Sadaqah and Waqaf) funds. This programme is envisaged as a means of building public recognition of the benefits of the sharia banking industry for the public and lower income groups in particular. In 2007, management of social aid funds widened by Rp12.6 billion to Rp40.1 billion, with ZIS-based social assistance at Rp33.3 billion and qardh (loan) based social aid funds at Rp6.8 billion.

Capital Market and Other Financial Institutions

The Capital Market

The capital market recorded significant gains in 2007, building on the achievements of the preceding year. At end-2007, the IDX Composite Index stood at 2,745.8 points, up 940.3 points (52.1%) from the preceding year

(Chart 9.8). This achievement placed the Indonesian Stock Exchange (IDX)⁴ as the third best performing stockmarket in Asia Pacific, after Shenzhen (164%) and Shanghai (98.4%). In fact, the IDX Composite Index touched a level of 2,811 points in the second week of December 2007, representing an all-time high in the history of the Indonesian capital market, before sustaining correction. Analysed by sector, the most important contribution to IDX index gains came from the mining, agriculture and property sectors. Total value of share transactions also climbed significantly from Rp445.7 trillion to Rp1,050.1 trillion (135.6%). The index gains and vibrant trade resulted in a 59.2% increase in market capitalization to Rp1,988.3 trillion, with the share of the capital market to GDP rising from 37.4% to 57.0% at end-2007.

The buoyant performance of the capital market was supported by improvement in domestic and external factors. Domestic factors behind the steep index growth include the cumulative 175 bps cut in the BI Rate during 2007 and progressive improvement in macroeconomic indicators. Inflation was subdued and in decline, international reserves were strong and economic growth on the rise. At the micro level, stock exchange-listed companies reported stronger performance with substantially improved earnings, especially in Q3/2007. Expectations of earnings growth

⁴ Formed from the merger of the Jakarta Stock Exchange (JSX) and Surabaya Stock Exchange (SSX), officially commencing operation on 1 November 2007.

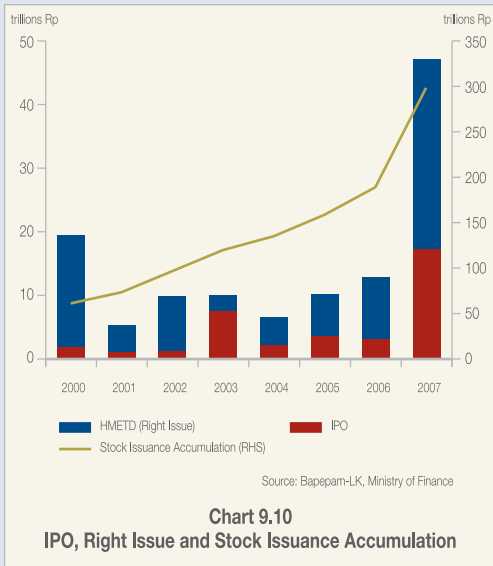


Chart 9.10
IPO, Right Issue and Stock Issuance Accumulation

for mining and agricultural companies in particular soared due to escalating commodity prices on the international market. The improvement in macro and micro factors boosted market optimism, with capital market liquidity climbing from Rp1.8 trillion to Rp4.3 trillion per day.

Analyzed by external factors, gains on Indonesia's capital market were driven by renewed positive sentiment on international and regional stock exchanges. Although global markets in 2007 were

rocked by the US subprime mortgage crisis, the bursting of the asset bubble in China and soaring international oil prices, response by global authorities to the crisis restored market optimism, paving the way for renewed stock index growth. The Indonesian Stock Exchange bounced back on index gains in the United States and China, which bolstered the Hangseng, Straits Times and other regional indices, with the IDX index mounting to an all-time high (Chart 9.9). Also fuelling index performance were the attractive levels of the price earnings ratio (PER) in Indonesia compared to other emerging markets in Asia.

During 2007, the capital market recorded fresh rounds of heavy buying by foreign investors. The net foreign purchase on the stock market reached Rp32.6 trillion, a rise of 88.8% over Rp17.3 trillion in the previous year. At the same time, share ownership by foreign investors mounted from Rp522.3 trillion at end-2006 to Rp790.8 trillion at end-2007. Heavy foreigner buying, while encouraged by improving macroeconomic indicators and corporate performance, was also fuelled by global excess liquidity in search of outlets for investments on emerging markets. On the IDX, foreigner buying spree was hardly dented by the subprime mortgage crisis. Foreigner net purchase continued unabated amid downward pressure on the index from the subprime mortgage crisis, with activity spurred by relatively low stock prices (Chart 9.8). Domestic investors also followed suit, pushing the IDX composite index to even higher levels.

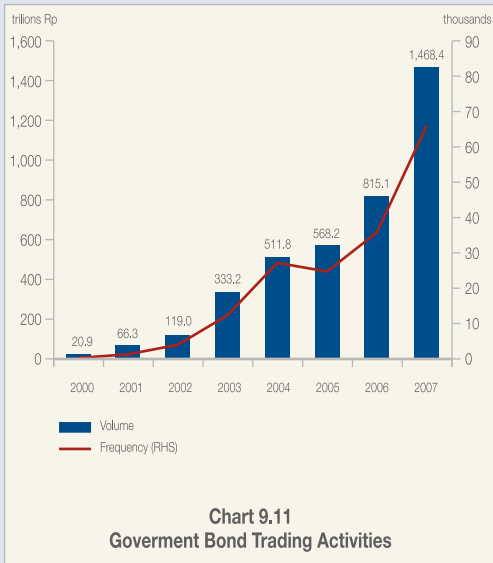


Chart 9.11
Government Bond Trading Activities

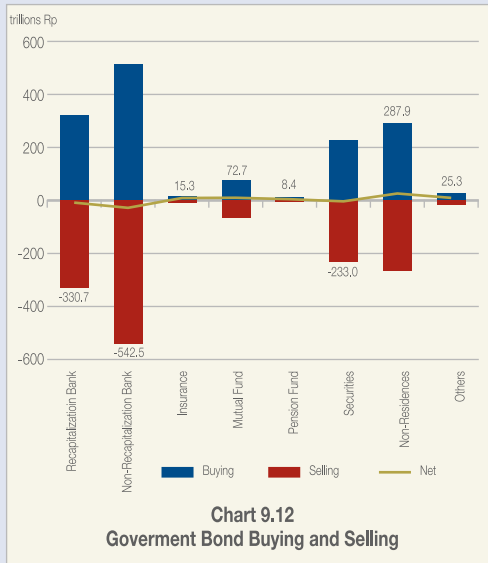


Chart 9.12
Government Bond Buying and Selling

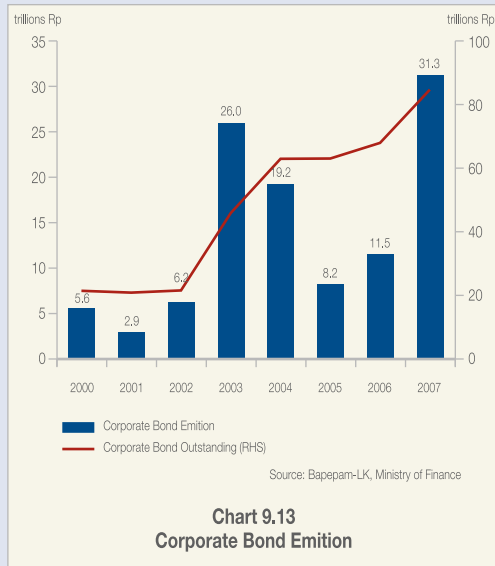


Chart 9.13
Corporate Bond Emission

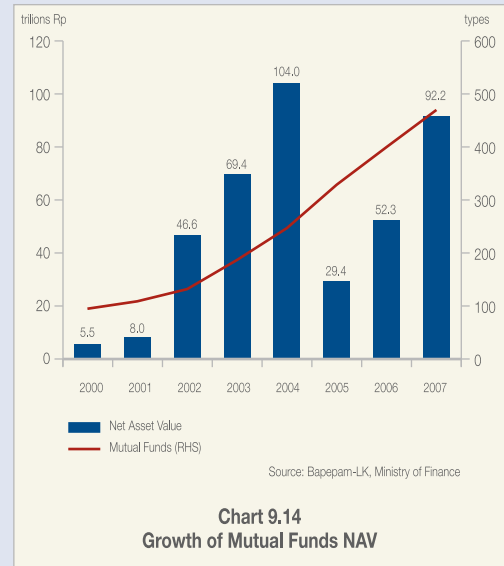


Chart 9.14
Growth of Mutual Funds NAV

Companies moved quickly to take advantage of the surging stock market performance and keen demand to raise funds for investment and business expansion. During 2007, the number of IPOs mounted 100% from 12 to 24 companies with the value of IPO shares soaring from Rp3.0 trillion to Rp17.2 trillion (471%). In addition to IPOs, 25 companies held right issues with a total issue value of Rp29.8 trillion. This represents a significant increase over the preceding year, when 16 companies floated rights for Rp9.8 trillion. Accordingly, the total value of shares issued during 2007 reached Rp47 trillion (Chart 9.10).

The Bond Market

Like the capital market, the government bond market gained in volume and frequency of transactions. Trading volume in government bond climbed 80.1% to Rp1,468.4 trillion in 2007 from Rp815.1 trillion in the preceding year (Chart 9.11), driven in part by additional issues of government securities. During 2007, the Government held 24 government bond auctions, including initial offerings and reopenings, besides 3 auctions of treasury notes, netting a total of Rp70.7 trillion. Added to this, the government held 3 auctions of Indonesia Retail Bonds (ORI), raising a total of Rp15.6 trillion. One successful innovation by the Government was the issuance of zero coupon (ZC) bonds in 3 auctions. An added factor in the higher trading volume was escalating frequency of transactions, reflecting

high demand for government bond. Government bond transactions mounted in frequency by 84.7% from 35.7 thousand transactions in 2006 to 66 thousand in 2007.

Non-residents were again the largest net buyers of government bond, followed by mutual funds and insurance companies (Chart 9.12). The high rate of capital inflows during 2007 resulted in a net foreign purchase of Rp23.7 trillion. At the same time, net purchases by mutual funds and insurance companies reached Rp7.6 trillion and Rp6.7 trillion. Recovery of investor confidence in mutual fund products strengthened demand for government bond, with mutual funds ranking second as net buyer. Following from the trend the year before, non-recapitalized banks, recapitalized banks and securities houses recorded net sales on the government bond market at Rp30.5 trillion, Rp10.8 trillion and Rp6.0 trillion.

Despite volume trailing that of government bonds, the corporate bonds market also recorded significant gains. Increased trading activity in corporate bonds, as on the capital market and government bond market, was fuelled by growing investor confidence on the strength of improved macroeconomic indicators and keen demand driven by excess liquidity. Some companies took good advantage of these conditions to launch public offerings of corporate bonds. During 2007, 39 companies issued bonds worth a total of Rp31.3 trillion

Table 9.12
Performance of Finance Companies

Descriptions	Position (Trillions Rp)			Growth (%)	
	2005	2006	2007	2006	2007
Number of Companies ¹⁾	236	214	205	(9.32)	(4.21)
Total Assets	96.5	108.9	127.3	12.81	16.87
Business Turnover	67.6	93.1	107.7	37.67	15.64
Leasing	19.1	32.6	36.5	71.05	11.76
Factoring	1.4	1.3	2.2	(7.80)	69.10
Credit Cards	1.8	1.5	1.4	(16.22)	(2.37)
Consumer Finance	45.4	57.7	67.6	27.14	17.09
Source of Funds:					
Bank Loans	49.2	55.0	66.4	11.66	20.73
– Domestic	25.0	29.8	36.7	19.09	23.06
– Foreign	24.2	25.2	29.7	3.96	17.96
Other Loans	11.6	10.2	10.5	(12.01)	3.05
– Domestic	4.5	3.4	3.8	(24.41)	13.86
– Foreign	7.1	6.8	6.7	(4.22)	(2.32)
Bonds Issuance	10.2	10.1	12.8	(0.83)	27.33
Capital ²⁾	15.2	19.0	24.5	25.22	28.90
Current Year Profit (Loss)	3.5	3.1	4.4	(10.04)	39.79

1) Number of companies submitting reports.

2) Consists of paid in capital, premium, reserves, holding profit, and current year profit.

Source: Ministry of Finance

(Chart 9.13), significantly more than in the previous year, when only 14 companies issued bonds for a total value of Rp11.5 trillion.

Of the total bond issue, Rp1.03 trillion or 3.3% consisted of sharia bonds issued by 4 companies. At this level, sharia bond issues were up 413% over Rp0.2 trillion in 2006, when only one company issued these bonds. Since coming on the market in 2002, sharia bonds have been issued 21 times for a total of Rp3.2 trillion, or 2.5% of total bonds issued on the market.

Mutual Funds

The mutual funds market gathered renewed momentum as the stock and bond markets forged gains. Net Asset Value (NAV) at the end of 2007 reached Rp92.2 trillion, a rise of 76.4% over Rp52.3 trillion in 2006 (Chart 9.14). The rise in NAV was related to the increased prices of underlying securities, most importantly shares, and expanded net subscription. The year 2007 saw the launching of 70 new mutual funds, with the total climbing from 399 to 469 mutual funds (17.5%). Fixed income funds again predominated with a market share of 35.3%, followed by protected funds at 24.1%, mixed funds at 21.8% and equity funds at 11.6%. Other factors supporting the rise in NAV included redoubled efforts to educate potential investors and more

balanced perceptions of risk between mutual funds and bank deposits, following the scaling back of guarantees by the Indonesian Deposit Insurance Corporation (LPS).

In 2007, four sharia mutual funds received statements of effective registration, bringing the overall number of sharia mutual funds to 25, or 5.7% of the total mutual funds on the market. NAV held by sharia mutual funds soared 206.5% to Rp2.1 trillion from the previous Rp0.7 trillion. As a result of this expansion, the share of NAV held by sharia mutual funds widened from 1.3% to 2.4% at the end of 2007.

Multifinance Companies

Multifinance companies charted renewed gains in 2007 on the strength of private consumption. Despite some reduction in the overall number of multifinance companies, total assets and turnover improved significantly (Table 9.12). Total assets during the year under review reached Rp127.3 trillion, a rise of 16.9% over the previous year. At the same time, business turnover mounted 15.6% to Rp107.7 trillion. Like before, business conducted by multifinance companies was dominated by consumer financing at Rp67.6 trillion, or 62.7% of total turnover, and leasing at Rp36.5 trillion (33.9%).

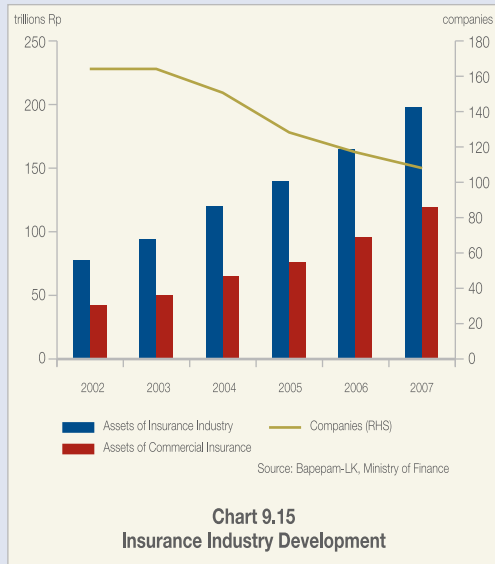


Chart 9.15
Insurance Industry Development

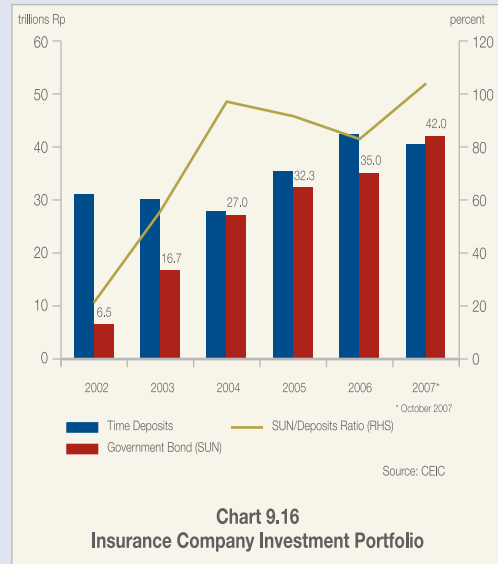


Chart 9.16
Insurance Company Investment Portfolio

In terms of funding structure, the primary source of funding for multifinance companies is bank loans. Bank loans in 2007 totalled Rp66.4 trillion, representing 58.1% of total funding. Of this total, Rp36.7 trillion (55.3%) consisted of borrowings from domestic banks and the remainder from overseas banks. At the same time, the proportion of funding from issuance of securities, other borrowings and additional capital reached 41.9%. With domestic and foreign interest rates in decline, multifinance companies expanded their bank borrowings by 20.7% from Rp55 trillion to Rp66.4 trillion.

Insurance Companies

Insurance companies reported significant performance gains in 2007 alongside a general improvement in efficiency. The overall number of insurance companies has steadily declined since 2003 (Chart 9.15). Over a period of 4 years, the number of companies fell 14.5% from 173 to 148, divided into 46 life insurance, 93 general insurance, 4 reinsurance companies and a further 5 companies operating in social insurance and insurance for workers, military personnel and police. However, the reduction in number of companies did not adversely impact insurance industry performance. As of

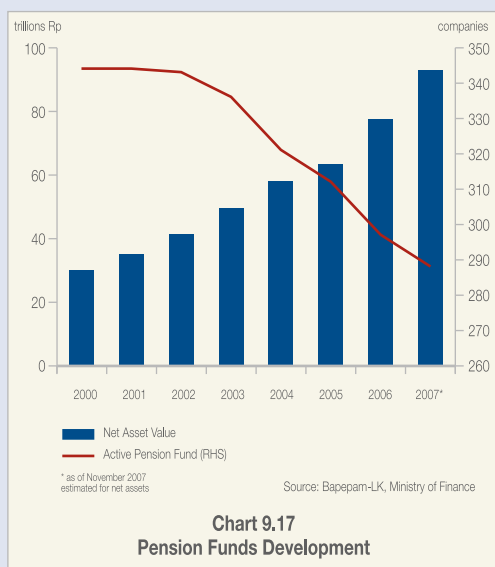


Chart 9.17
Pension Funds Development

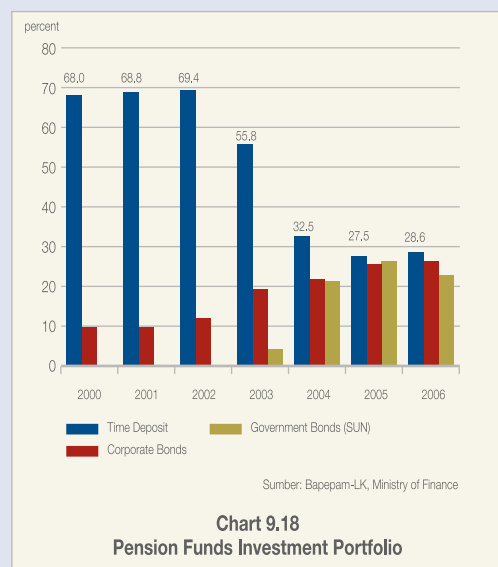


Chart 9.18
Pension Funds Investment Portfolio

September 2007, total insurance industry assets were up significantly at Rp198 trillion compared to the 2003 position of Rp94.1 trillion, a rise of 110.4%. Similarly, total assets held by commercial insurance companies (life insurance, general insurance and reinsurance) mounted 137.6% from Rp50.1 trillion in 2003 to Rp119.1 trillion.

As part of the overall growth in sharia financial institutions, more sharia insurance companies have come on the market. At the end of 2007, Indonesia reported 3 sharia insurance companies, 32 sharia insurance branch offices and 3 sharia reinsurance branch offices. Total assets managed by sharia-compliant insurance companies in September 2007 reached Rp1.4 trillion, a 46.5% increase over Rp1.0 trillion in the preceding year. Through this, the share of sharia-compliant insurance assets in total insurance industry assets widened to 1.2%.

Insurance company investments were dominated by government bond portfolios and time deposits. A noteworthy development in insurance industry investment behavior is the growing interest in investment in government securities. During the past five years, government securities portfolios expanded by Rp35.5 trillion from Rp6.5 trillion at end-2002 to Rp42.0 trillion in October 2007, while time deposits were up only Rp9.5 trillion from Rp31.0 trillion to Rp40.5 trillion. The predominance of time deposits in investment portfolios has thus given way to government securities, as reflected in the 103.8% ratio of government securities to time deposits (Chart 9.16). This change in the investment behavior of insurance companies has fuelled growth in the government securities market and indirectly contributed to reduction of excess liquidity in the banking system.

Pension Funds

Pension funds have also made impressive strides. Total net assets in the pension funds industry have maintained a consistent upward trend, despite the fall in numbers of pension fund operators since 2002. As of November 2007, pension fund operators totalled 288 companies, down 16% from 343 companies in 2002. At the same time, total net assets held by pension funds grew by an estimated 20% to about Rp93.0 trillion. At this level, net assets value was up 125.6% over the Rp41.2 trillion position recorded in 2002 (Chart 9.17).

Pension fund investment portfolios, like before, were dominated by time deposits and bonds, comprising both government and corporate bonds. Pension funds have followed an almost identical pattern of behaviour as insurance companies, starting out by relying heavily on time deposits, which accounted for 70% of fund placements. However, from 2003 the proportion of time deposits progressively declined to the end-2006 level of 28.6% (Chart 9.18). During this time, bond portfolios, consisting mainly of government securities, expanded significantly bringing government securities portfolios almost on par with time deposits. This is a heartening development, given the enormous potential for bond market investments by pension fund as managers of long-term funds for the public. As such, pension funds are expected to become major players on the government securities market.

Policy for Capital Market and Other Financial Institutions

Following the guidance in the Indonesian Capital Market Master Plan, capital market policy will continue to emphasise improvements in infrastructure, efficiency, competitiveness and oversight. In 2007, the Jakarta Stock Exchange (JSX) merged with the Surabaya Stock Exchange (SSX) to form the Indonesian Stock Exchange (IDX). The merger has not only strengthened synergy and efficiency in capital market activities, but is also expected to boost the capacity and competitiveness of the Indonesian capital market. In a parallel move, further revisions were made to the draft law on Amendment to the Capital Market Law to bring it into line with the draft law on the Financial Services Authority. In the area of oversight, further improvements were made to examination and compliance testing for securities houses.

To strengthen investor confidence, policy also seeks to improve transparency and good corporate governance. During the year under review, a regulation was issued on deadlines for periodical financial statements issued by listed companies⁵ in a move designed to ensure access to information and disclosure. To strengthen good governance in the mutual funds industry, changes were made to regulations related to management of

⁵ Regulation of the Capital Market and Financial Institutions Supervisory Agency (Bapepam-LK) Number X.K7 concerning Deadlines for Release of Period Financial statements and Annual Reports by Public Companies Listed on Stock Exchanges in Indonesia and on Stock Exchanges in Other Countries, Appendix to Decree of the Chairman of Bapepam-LK Number Kep-40/BL/2007 dated 30 March 2007.

mutual funds set up as collective investment contracts. At the same time, to improve the quality of pension fund financial statements⁶, a regulation was issued on Pension Fund Technical Reports. This regulation focuses on disclosure of pension fund technical data and information and strengthening the effectiveness and efficiency of supervision.

New instruments were developed for the deepening of the financial market. During 2007, two regulatory packages were issued as a legal foundation for issuance of new instruments. The first package was for issuance of municipal bonds. Besides enriching the diversity of financial market instruments, the issuance of municipal bonds will also provide a financing alternative for regional development. The second regulatory package deals with the issuance of Real Estate Investment Funds set up as Collective Investment Contracts (DIRE KIK).

Further progress took place in the development of the sharia financial market. Since the year under review, Bapepam-LK, the capital market and financial institutions supervisor, began regularly issuing the Sharia Securities List⁷ as a guide for fund management by sharia mutual funds. New policies were also issued to encourage the establishment of sharia multifinance companies. Two regulations were issued to set out the legal basis for sharia multifinance activities and the standardized sharia contractual arrangements (akad) to be used in these activities⁸. At the same time, to support the issuance of sharia bonds (sukuk), Bapepam-LK completed a study on accounting treatment for the sukuk ijarah and sukuk mudharabah instruments.

Insurance industry policy was focused on improvements in quality of corporate management. In one action to strengthen the integrity and quality of board of directors and board of commissioners of insurance companies, improvements were made to the regulation on the fit and proper test⁹. Other activities aimed at expanding business volume in the insurance industry include: (i) public education and awareness raising; (ii) development of insurance products; and (iii) improvement in marketing strategy for bancassurance.

6 Minister of Finance Regulation Number 100/PMK.010/2007 dated 5 September 2007 concerning Pension Fund Technical Reports.

7 Bapepam-LK Regulation Number II.K.1 concerning Criteria and Publication of the Sharia-Compliant Securities List, Appendix to Decree of the Chairman of Bapepam-LK Number: Kep-314/BL/2007 dated 31 August 2007.

8 Bapepam-LK Regulation Number II.K.1 concerning Activities of Multifinance Companies Based on Sharia Principles and Regulation Number Per-04/BL/2007 concerning Sharia Contractual Arrangements (Akad) for Use in Activities of Multifinance Companies Based on Sharia Principles.

9 Minister of Finance Regulation Number 78/PMK.05/2007 dated 24 July 2007 concerning the Fit and Proper Test for Directors and Supervisory Directors of Insurance Companies.

Grand Strategy for Islamic Banking Development under the Accelerated Islamic Banking Development Programme

The sharia banking market has enormous potential for expansion. Reflecting this are the more than 80 million accounts held by public users of banking services at conventional banks. In response, Bank Indonesia launched the initiative of the Sharia Banking Acceleration Programme, subsequently followed by the “iB Campaign 2008” programme. In this programme, Bank Indonesia invites all actors in the sharia banking industry to synergise their public education and information campaigns in order to build greater public awareness of the existence of sharia banks and stimulate public interest in the use of sharia banking products and services. Ultimately, a successful public information programme will contribute enormously to the achievement of the acceleration targets.

This expansion calls for judicious market positioning of the sharia banking industry for penetrating a broader market segment in order to expand the customer base from the current level of 3 million accounts.

Within the context of competitive strategy, the entrenched position of the conventional banking system with its massive economy of scale calls for more innovative response from the Islamic banking sector. A market driven strategy imitating conventional banking products will generate only a similar range of sharia banking products without clear differentiation, preventing the public from visualizing their added value. The consequence of this will be lukewarm appeal to members of the public to try out the use of sharia banking products. Faced with two similar products, public users of banking services, which make up the target market¹, will tend to react indifferently and lean in favour of well-established products. In the long run,

1 “Nielsen Consumer Insight,” the Nielsen Company and Bank Indonesia. November 2007. Data from The Nielsen indicates that the profile of the target market for banking products and services in Indonesia lies in the more optimistic sections of the population with material comforts and modern lifestyles.

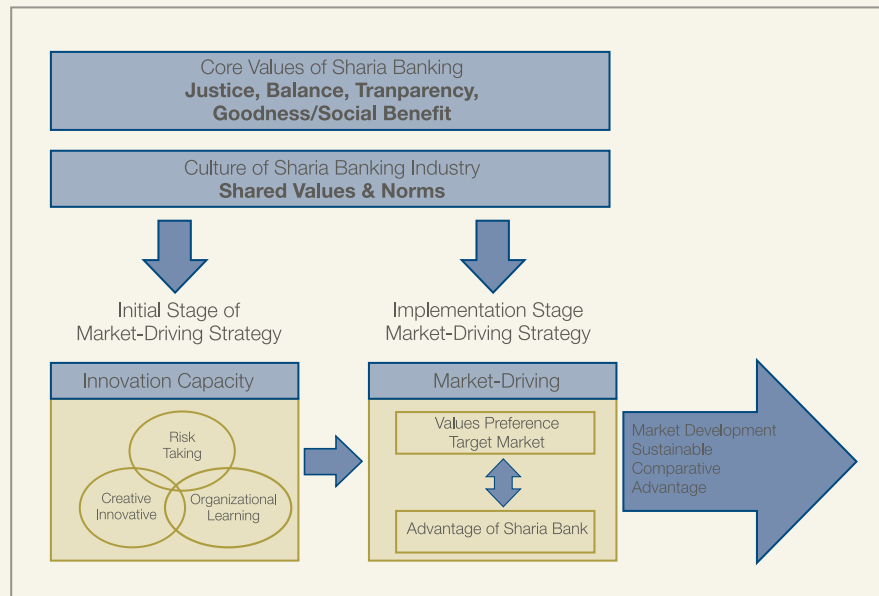
market-driven strategy will likewise not yield any lasting comparative advantage for the sharia banking system².

Given the specific nature of the system that sets it apart from conventional banking, sharia banking is in fact able to position itself as a market driving industry shaping the market in its own right according to the unique advantages inherent in the system³. Development of the market driving strategy involves two major phases, capacity building for innovation in the initial strategy development and value proposition to the target market in the subsequent phase of strategy implementation. Capacity building for innovation is closely intertwined with the development of personnel competencies and an organizational culture that supports and rewards creative processes and encourages experimentation and out-of-the-box thinking in the product innovation process. The ability to anticipate market needs and capture unspoken needs in the target market must be given leading priority in product development⁴ in order to develop products that do not merely satisfy needs, but can also guide target market behaviour and form a market structure appropriate to the advantages of sharia banking.

2 Johnston, Lean L., Ruby Pui-Wan Lee, Amit Sani and Bianca Grohmann, 2003. “Market-focused Strategic Flexibility: Conceptual Advances and an Integrative Model.” *Journal of the Academy of Marketing Science* 31 (1): 74-89: “If every actor in the market follows a market-driven strategy and every firm adapts to competitors’ strategic moves and stays aligned with consumers requirements, then no actor will be able to offer a value proposition superior to the competition.”

3 Carrillat, François A., Fernando Jaramillo, William B. Locander, “Market-Driving Organizations: A Framework.” *Academy of Marketing Science Review* 2004, <http://www.amsreview.org/articles/carrillat05-2004.pdf>: “Market-driving organizations may achieve greater performance than market-driven organizations by reshaping the structure of the market according to their own competencies and by exploiting the competitors’ weaknesses.”

4 Focus Group Discussion, “Profile of Islamic Banking Market Penetration Strategy in Indonesia: Obstacles and Challenges, 2008,” Bank Indonesia and Islamic banking industry, Jakarta, 6 November 2007.



The increased value proposition stage can be interpreted as the way in which Islamic banks offer a higher level of values to target markets compared to that offered by others. The offered values may lie in the products, services, business processes, human resources, communications or physical facilities. Within this framework, the core values of sharia banking, namely fairness, equity, transparency and social responsibility, are in fact a rich source of values applicable to all aspects of sharia banking operations that can be used to spearhead marketing.

A communication and promotion strategy that emphasizes the distinctive values of sharia banking in language understandable by all will instill an awareness of the differentiation of sharia banking products from others. Furthermore, this strategy will also work indirectly over time to shape the market and build new preferences among the public for products with a broader dimension than merely the financial. For example, the principles of fairness and social responsibility found in sharia banking

can be used to build public preferences for socially responsible investment and ethical banking, as well as community development banking. These three characteristics are in fact specific to sharia banks, and represent their comparative advantage. Having considered all these angles, Bank Indonesia has developed the Sharia Banking Development Grand Strategy as primary guidance for public education and dissemination activities and sharia bank expansion. The grand strategy, which encompasses public awareness/communication, branding strategy, product development strategy and improved service quality, has been prepared with the involvement of sharia banking actors to ensure common ownership of the design and a common drive to accelerate the growth of the sharia banking industry in Indonesia. Since 2007, public service advertising was launched in various media in a public awareness campaign for sharia banking. While continuing the public service advertising in 2008, programmes held at the Sharia Economic Festival (FES) in Jakarta and several other major cities presented growth achieved in the real sector and industry with the use of sharia-compliant financial and banking services. The FES is envisaged as an annual programme.

