BANKING POLICIES AND REGULATIONS TO COMBAT CORRUPTIONS: THE CASE OF INDONESIA[1]

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1. Introduction

In terms of asset and branch network, banking system is the core of financial system in Indonesia (Table 1). The combination of the shrunk of the economy, precipitous dropped in the external value of the rupiah and steep rise in interest rates, during the crisis in 1997-1998, has had negative impacts on the financial conditions of the banks and their customers. The economic crisis mainly stem from distortions built into the economy over the years. These distortions partly related to credit allocation processes which provide credit, to some sectors, including large state-owned companies or business conglomerations owned by politically well connected groups, at below market costs, to tax policies which selectively subsidized certain types of capital formation, and to trade and exchange rate policies which protect some activities and give monopoly rights to others. Inadequate bank regulations and supervisions also added to the problems. These in combine with the rapid economic growth in the 1970s and 1980s had encouraged banks and corporate sector to rapidly increase domestic and foreign borrowings. Debt itself was not bad; it is the way debt was used that create problems particularly when the unhedged short-term external debt was used to finance long-term projects in non-traded sector of the economy.

The current economic recovery program in Indonesia recognizes these problems and contains measures to address these distortions. The bank restructuring program, which is a central part of the program, includes measures to remove both quantity and price distortions in credit market and to improve prudential rules and regulations targeting those illegal activities in the system. The laws, however, have not explicitly making money laundering as both a crime and symptom of other criminal activities including insider trading, fraud, drug trafficking, tax evasion, theft and outright corruptions.

2. Bank Reforms

The bank reforms in Indonesia introduce in stages (Table 2). The first stage of the reform was initiated in 1983 to relax the financial suppressions, namely: rigid credit

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ceilings, detailed selective credit policy with subsidized interest rates. Bank Indonesia, under the repressed financial system, provided refinancing of credit programs at subsidized interest rates and assumed parts of the credit risks. The scope and coverage of credit program narrowed in 1992 and totally removed in 1999. The new Law Nr. 23 of 1999 prohibits Bank Indonesia from providing refinancing of government credit programs. The same law also requires Bank Indonesia to divest all of its subsidiary companies, including commercial banks and NBFIs operating both in Indonesia and overseas. In the past, Bank Indonesia's subsidiaries were operating as quasi-fiscal agents to finance sectors and activities that Bank Indonesia could not reach under existing regulations.

The second stage of bank reforms was introduced in October 1988. The reforms allowed new entrance into the banking industry and relaxed entry requirements. There are two types of bank in Indonesia, namely, commercial bank and rural bank (BPR). Both are licensed to conduct deposit-taking and lending activities. Until 1998, the Ministry of Finance granted banking licences. Bank Indonesia prescribes prudential rules and regulations and it is the sole banking supervisory authority in the country. Until 1988 supervision of BPR was delegated to Bank Rakyat Indonesia (state-owned Agriculture Bank). Minimum capital requirement was the most single important entry requirements. There were normative criteria for owners and management of banks, but hardly enforced. At that time there was no requirement prohibiting that a bank's capital or the funds used to purchase banks' shares shall not be originating from illegal activities. Following the reforms, the number of commercial banks grew more than double in eight years, from 111 in 1988 to 239 in 1996. During the same period, the number of BPR grew from 420 to 1,931. Total assets of BPRs was less than 0.5 percent of the total assets of all banking industry. On the other hand, Bank Indonesia was unable to upgrade its supervisory capability in line with the rapid pace of the number of both commercial and rural banks.

The problem become more difficult as there were no explicit deposit insurance as well as exit policy for non-viable banks. The state did not only standby its own banks but also directly and indirectly provided financial assistances to help rescue financially distressed private banks. During the outset of the crisis in November 1997 the government provided deposit guarantee up to Rp10 million per account. As this was not powerful enough to deter bank runs, capital flights and panic buying, the authorities introduced a blanket guarantee scheme in January 1998 covering all banks' liabilities to third parties.

The bank restructuring program, since 1997, consists of many key components. The first key component is to avoided systemic risks by strengthening the capital base of domestic banks. During the onset of the crisis, Bank Indonesia provided the financially troubled banks with liquidity supports facility (BLBI-*Bantuan Liquiditas Bank Indonesia*) which was amounted to Rp144 trillion or roughly equivalent to USD38 billion at the then exchange rate at Rp3,960 per US dollar. The BLBI was replaced by government bond in 1999. As of August 2001, the government has floated government bonds (mainly used to recapitalized the financially distressed banks) amounted to Rp665 trillion or equivalent to 50 percent of Indonesia's annual GDP. Through the massive injections of BLBI and government bonds, all of the existing domestic private banks are completely nationalized.

Law Nr. 10 of 1998 transfers the authorities for granting bank licence from the Ministry of Finance to Bank Indonesia. Since then, licensing power, regulating power, supervisory authority and power to enforce the prudential rules regulations have been concentrated in Bank Indonesia. Meanwhile, the prudential rules and regulations have been improved by adopting the risk-based supervision approach in line with Basel core principles. The CAR, however, was temporarily reduced in December 1988, from 8 percent to 4 percent, and to be raised back to 8 percent in December 2001. The new prudential rules raise the minimum capital requirement, check the source of the capital and funds used to purchase bank's shares and require controlling shareholders and managers of commercial banks to pass fit and proper test at Bank Indonesia. The test will make sure that the individuals concerned are of high integrity and banning person involved in fraudulent transactions or defaulted on significant loans or included in the list of disgraced persons. The prudential rules empowered Bank Indonesia to provide detailed information including from holding companies of the banks, their subsidiary companies, affiliated parties, debtors and related parties. Unitary supervision is important as all private banks belong to business conglomerations. Companies and banks within a business group are interlocking with one another in capital, management and business transactions.

Bank Indonesia has set a detail program and strict time schedule on how and when to implement the internationally recognized prudential rules and regulations. Bank Indonesia supervisory approach includes off-site supervision through bank reporting and on-site examination. Bank Indonesia maintains on-site permanent supervisory presence at banks which are having financial or structural problems. Bank Indonesia upgrades its capability to administer the new prudential rules and regulations by retraining the existing banks supervisors and examiners and by expanding the number of staff in the Banking Department from about 600 at present. The licensing power, the power to regulate and the task for bank supervision and impose sanction are to be shifted from Bank Indonesia to an independent Financial Service Supervisory Agency (FSSA) that would be established in 2002. FSSA will supervise all financial institutions: banks, non-bank financial institutions (NBFIs) and capital markets. The FSSA will give power to grant licenses, to regulate, to supervise financial institutions and to enforce prudential rules and regulations.

Bank Indonesia has recently introduced internationally recognized accounting and reporting systems. This improves the quality of information and shortens the time lag of their reporting. The improvements in record-keeping system and data collection can detect problems and suspicious activities early. Each bank is now required to have a compliance director whose is responsible to improve governance by supervising internal implementation of the prudential rules and regulations. He or she reports to Bank Indonesia if there is any irregularity, breach of prudential rules or criminal transactions. The special Unit for Banking Crimes Investigation of Bank Indonesia is responsible for the investigation of irregularities which cover prudential and criminal activities. The result of investigation is reported to the Police and the Attorney General Office for action. There are 48 criminal cases have been reported until August 2001.

The recapitalized banks are mandated to improve operating mechanism, modernize technology, upgrade human resources and change corporate culture by presenting business plans and by having twinning programs with reputable international institutions. In practice, the state-owned banks operating as arm-length extension of government bureaucracy as they were the principal implementers of credit program of the past. The end of the repressed credit program in conjunction with restructuring and privatisation program will transform state banks into business entities. The controlling shareholders (who own at least 25 percent of voting powers), management and key principal officers of the private banks are subject to fit and proper test done by Bank Indonesia. The recapilatized banks are required to change management and the new management are periodically evaluated base on their performance to achieve the targets of the business plans. New regulation has been introduced prohibiting that a bank capital shall not be generating from unlawful activities.

3. Policies to Combat Money Laundering

(a) Focus

Indonesia has begun to take measures for combating money laundering focusing on nine criminal activities, including corruption. At present, Indonesia has no acts to provide the police with the authorities to investigate suspected drug-derived assets and terrorist-related funds. Draft Law concerning Eradication of Money Laundering, which is being discussed in the Parliament and to be passed in 2001, will make corruptions as predicate crimes. Decree Nr. XI/MPR/1998. Law Nr 28 of 1999 gives special attention to state administrators in all branches of government. For this purpose, the KKPN (*Komisi Pemeriksaan Kekayaan Penyelenggara Negara*) or Commission to Investigate Wealth of State Officials has been established to collect information and verify wealth of state officials.

(b) Know your customers principle

To combat money laundering, Indonesia starts with acquiring simple information from the commercial banking system. Bank Indonesia Regulation Nr. 3/10/PBI/2001 of June 18,2001 adopts the Basle Core Principle Nr. 15 that require banks to know their customers. The regulation, however, acknowledges that it is not bank responsibility to detect money laundering. As discussed earlier, there are also regulations to prohibit that a banks' capital shall not be originated from and for the purpose of money laundering. There are regulations that require banks to monitor and report cross border rupiah-denominated or foreign currency financial transactions including foreign exchange flows of banks and NBFIs. These regulations, however, are not specific to counter money laundering. Nevertheless, at least, they make more difficult for money launderers harder to operate.

At present, the regulation for banks to know their customers only applies to commercial banks. The regulation, however, is not yet applied to walk-in customers with maximum value of transaction up to Rp100 million. The regulation is also not applicable to rural banks and non-bank financial institutions such as travel agencies, money wire services, credit unions, insurance companies, money changers, brokerage houses, car dealers, and all traders and businesses dealing in cash. The old traditional banks are still in operation, a system that is based on trust and mainly dealing in cash. At present there is neither a requirement for banks to report cash transaction to the Directorate General for Taxation in excess of specific amount nor a regulation to deal with phony bank accounts and transactions. Banks are only required to verify the identity of the owners of the accounts, but not for other transactions.

The know your customers policy put the burden to identify customers and to report transactions squarely on the shoulders of bank directors. To implement the rule bank should set procedures for customer identification, obtain information on customers including beneficial owners, verify supporting documents of the applicant's identity, check and monitor the characteristic of customer's transactions and report suspicious transactions to Bank Indonesia. Existing Bank Indonesia rules prohibit banks to carry out financial transactions of unknown beneficial owners. To implement the regulations, the bank should establish a special unit or appoint an officer in charge. The officers and staff of Bank Indonesia need to be trained to allow them recognize and report money laundering activities.

As money laundering is not yet a crime in Indonesia, there is neither mandatory reporting system nor dedicated anti money laundering agency. There is no centralized agency for the collection, analysis and dissemination of suspicious transactions to relevant authorities. The Law Concerning Eradication of Money Laundering Law, to be passed in 2001, and establishment of FSSA, probably in January 2004, will expand the coverage of supervisions of money laundering activities to other financial industries and corporate sector. FSSA will be empowered to issue regulations and standard governing the prevention of financial crime, including money laundering. Anti-money laundering agency will be established following the passage of the Anti Money Laundering Law later this year.

Contains of the draft Anti Money Laundering Law include: (a) making money laundering a serious crime; (b) requiring banks and other financial institutions to report on suspicious transactions and cash transaction over Rp100 million or equivalent in foreign currency; (c) requiring banks and financial institutions to know your customer principle; (d) prohibiting the disclosure of identity of reporting parties; (e) providing a legal framework for Anti-Money Laundering Agency (KPTPPU); (f) empowering KPTPPU to make inquiry, receive and evaluate suspicious reports and reports on cash transactions over Rp100 million, recommend policy, prepare guidelines on prevention of money laundering and to investigate financial institutions; (g) authorizing KPTPPU to make recommendation to Bank Indonesia, Ministry of Finance and relevant authorities on administrative sanction for banks, non-bank financial institutions and companies; and (h) requiring KPTPPU to keep identity of reporting parties secret and to protect witnesses. The power to investigate money laundering offence remains at the hands of police.

4. Limited Capabilities to Combat Money Laundering

A number of structural problems makes anti money laundering activities more difficult to implement in Indonesia. The first major obstacle is because of the presence of a large number of unregulated and unsupervised small-scale financial institutions in Indonesia which operates similar to those of banks. These include savings and loans run by the cooperative sector, *bank pasars*, traditional underground trust based banking systems and others. Total assets of this unregulated sectors, as a percentage of assets of financial sector, is very small. The assets of some of the unregulated institutions, however, are larger than that of branches of banks. Because of limitation in the number of Bank Indonesia's bank supervisors, supervision of BPR is partly entrusted to public accountants.

The second obstacle is the excessive secrecy provision regarding banks. Article 41 of the Banking Act No. 7/92 as amended by Act Nr. 10/98 prohibits banks from disclosing information regarding depositors and their deposits. The Governor of Bank Indonesia can issue permission to police, a prosecutor or a judge to obtain information from a bank concerning deposits of a bank depositor suspected of a crime or facing criminal charge. The requests for information should be made in writing by the Chief of Police, the Attorney General and the Chief Justice. The Minister of Finance should make written request for obtaining information required for investigation of tax related matters. As money laundering is not a crime, the exception to the bank secrecy law does not apply.

The third obstacle is because the lack of analysis of information provided by bank supervisors and limitation of the Special Unit for Banking Crimes Investigation of the BI. At present, the investigations are mainly focused on fictitious transactions and financial exposures, which breach the financial indicators such as CAR, legal lending limits regulations, net open position, fraud and outright theft. As pointed out earlier, money laundering is not yet a concern both bank supervisors and investigators.

The fourth obstacle is because the modern accounting and information systems are only applicable to large banks and companies. The lack of resources has limited their applicability in medium and small-scale companies.

The fifth obstacle is due to inadequate resources both in public and private sector to counter and combat money laundering. Bank compliance directors need rigorous training on how to deal with suspicious transactions.

The sixth obstacle is due to the restraints in other parts of regulatory and legal systems. As Indonesia does not recognize the concept of trust, commercial laws only require registration of owners of business entities but not the beneficial owners.

The seventh obstacle is due to the limited international cooperation at judicial level. At present, Indonesia has signed only four extradition treaties with the Philippines, Malaysia, Thailand and Australia as well as an Agreement for the Surrender of Fugitive Offenders with Hong Kong. Only the treaty with Australia and agreement with Hong Kong include money laundering as extradition offence.

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