Indonesian Banks: Survival of the Fittest

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Overview of the Financial Sector

Until late 1997, it seemed that nine years of financial liberalization had paid off for Indonesia. (See Appendix 1.A for a detailed chronology of financial liberalization and regulatory developments.) Seventeen of the country's top banks made the global Top 1,000 in a survey based on Tier-1 capital strength while the largest, Bank Negara Indonesia (BNI), ranked 40th in an Asian Top 200 survey (Appendix 2). Prolonged buoyant economic growth, lowering of entry barriers, loosening of lending restrictions, a stable exchange rate regime, and heavy capital inflow fostered an environment of rapid credit expansion.

The increasing importance of the financial sector is illustrated in the monetization ratio (M2/gross domestic product [GDP]), from 30 percent in 1988 to an estimated 58 percent at end-1997. During this period, total assets of commercial banks increased 10-fold to Rp715.2 trillion, exceeding, for the first time, the size of the country's GDP. Concomitantly, nonbank financial institutions (NBFIs) also flourished, with total assets growing at an annual compound rate of 56 percent in 1991–1996, reaching Rp80 trillion by end-1996. In short, the financial sector was at the heart of the economic boom.

The currency turmoil that swept across the region from Thailand in mid-1997 immediately exposed the cracks in the banking system. A 70 percent plunge in the value of the rupiah against the dollar (hitting a record low of Rp16,500 in January 1998) started a domino effect across the entire economy, resulting in a financial crisis. Banks, having engaged in aggressive lending to the cyclical sectors, and being heavily exposed to foreign currency volatility through substantial offshore borrowing, are going through a survival test.

The Government's defense of the rupiah, partly through domestic interest rate hikes, dealt yet another blow to the banks. Squeezed by tight liquidity, negative interest margins, soaring bad debts, and overseas liabilities (many short-term and unhedged), a great number of banks have become technically insolvent.

To date, 23 commercial banks have been closed, 7 are being nationalized, and 40 more are under intensive supervision by the recently established Indonesian Bank Restructuring Agency (IBRA). In hindsight, had the sector's weaknesses been addressed during the boom years, the problems currently facing both the authorities and sector participants would have been mitigated. This study identifies issues and recommends a policy framework to strengthen the banking system.

Background

Banks

Although efforts at financial deregulation date back to 1983, when interest rate ceilings and direct credit targets were removed, the present banking system is largely shaped by two laws: PAKTO 1988 and the Banking Act of 1992. Earlier reform packages, starting with PAKTO, aimed to encourage competition by lowering the barrier to entry. The Government avidly promoted banks as the key financial intermediaries in mobilizing funds, as prescribed by an orthodox development strategy.

Measures such as drastically cutting the reserve requirement from 15 to 2 percent of third-party funds (defined as all demand, savings, and time deposits, plus certificates of deposit [CDs] from unrelated parties) and easing branch office opening procedures and the conversion to foreign exchange bank status contributed to the banking sector's explosive growth. Even though the minimum paid-in capital was raised from Rp1 billion to Rp10 billion ($5.8 million) for commercial banks, it was offset by the relative ease of obtaining a banking license.

Two months after PAKTO, there were 111 commercial banks and 1,957 bank offices. By end-1992, the numbers had jumped to 208 and 5,495, respectively. Most of the new entrants were small or joint

venture banks, which fragmented the sector and intensified the competition for funds.

In 1983–1988, the seven State banks' share of total outstanding bank credit hovered around 65 percent, but after three years of liberalization their share dropped to 56 percent in 1991 and further to 40 percent by end-1997. State banks have historically played an important role in the allocation of subsidized credit (at preferential interest rates), known as "liquidity credit," to priority social and economic sectors assigned by Bank Indonesia (BI), the central bank. The credit allocation system, often subject to political abuse, curtailed the State banks' ability to compete with private banks. Liquidity credits and access to BI rediscounting facilities were extended to sugar estates and refineries, rubber and palm oil plantations, and construction contractors by 1980. The conglomerates obtained loans at sharply reduced interest rates. Bank Pembangunan Indonesia's (Bapindo's) massive subsidized credit to businessman Edi Tansil's grandiose schemes, for example, which turned sour in the early 1990s, dragged the entire State banking sector into the red in 1994.

Private bank expansion in the four years after PAKTO is best illustrated by the 60 and 39.5 percent annual growth rate in their assets and credits, compared with 22 and 21 percent for State banks. However, private banks' rampant growth was achieved at the expense of sector soundness. The strains within the system finally came to light with the collapse of Bank Duta (due to foreign exchange trading losses) in 1990 and Bank Summa in 1992.

In the wake of the bank failures, BI finally took the lead in financial reform. In February 1991, it introduced prudential regulations, including the capital adequacy ratio (CAR) based on the Basle Accord. It incorporated them into the revised Banking Act the following year, raising the minimum paid-up capital for private national banks to Rp50 billion ($25 million).

In 1993–1996, it phased in more prudential regulations and supervisory tools for ensuring bank soundness—from reporting requirements, to self-regulation, to capital adequacy, asset quality, management, earnings, and liquidity (CAMEL) bank ratings. By end-1996, prudential practices in Indonesia's banking sector were largely in line with those recommended by the Basle Committee and comparable to those adopted in the US and EU (Appendix 1.B.1).[1] In order to ensure bank compliance with the increasingly comprehensive regulations, BI revamped its banking supervision division in 1994. At present, 550 staff members are assigned to the three commercial and one rural supervision departments, and 100 to the regional offices. Another 50 researchers work in the regulation and development department.

However, the authorities' efforts to improve and promote best practice came when the sector was already deeply troubled. Both State and private banks inherited a high level of nonperforming loans (NPLs) from the period of aggressive lending in 1989–1993. The Bapindo loan scandal, for example, led to a substantial deterioration of State bank asset quality. NPLs accounted for 20 percent of total State bank credits in 1993, and State banks' CAR plunged to a mere 2.5 percent in 1993. Consequently, NPLs for all commercial banks were a staggering 12 percent in 1994 (Table A3.1, Appendix 3).

The absence of a developed domestic capital market was the reason behind the Government's offshore funding. Around 95 percent of rupiah deposits (over 70 percent of total deposits) in commercial banks are considered short-term (demand, savings, and time deposits below one year), compared with over a quarter of rupiah loans lent as investment credits (loans over one year), and so it is not surprising that banks have also relied on overseas funding to bridge the maturity mismatch. An additional incentive to borrow offshore was the large differentials between local and international interest rates. For banks with investment-grade credit ratings, going offshore often represented savings of at least 7 percent on local interbank rates and over 10 percent on

rates for time deposits, which constituted about half the rupiah deposit base.

The popularity of tapping foreign money was further enhanced by Indonesia's track record in currency stability, with an annual 3–5 percent nominal exchange rate depreciation. Commercial banks were among the first to take advantage of offshore funding, as evidenced by the 160 percent increase in foreign currency borrowings in 1993. By June 1997, commercial banks' foreign currency liabilities (deposits and borrowing) amounted to about 30 percent of total liabilities.

Meanwhile, strong domestic economic growth, a stable rupiah, and high local interest rates also attracted plenty of foreign investors, who were more than willing to lend to "booming" Indonesian businesses, mostly on a short-term basis. The biggest corporations, with their apparent international creditworthiness, were able to borrow, usually unhedged, or to raise equity offshore directly, bypassing the banks altogether. Consequently, in the past few years, commercial banks' loan portfolios also suffered as the larger, more profitable customers were replaced with smaller and often less creditworthy ones. By March 1997, total private sector external debt amounted to $60.5 billion, about a quarter of the size of GDP.

The ease with which they got foreign funding enabled the banks to sustain brisk domestic credit growth, which showed no sign of slackening. In 1993–1997, bank loans expanded at the annual average rate of 26 percent, much higher than the growth in nominal GDP. Strong loan growth helped the banks disguise deteriorating asset quality, as the sector's reported NPL fell from 14 percent in 1993 to 7.2 percent in 1997. Despite attempts by smaller banks to attract potential customers with competitive rates and new products, the sector remained dominated by a handful of large banks. As of June 1997, the top 14 commercial banks (6 State, 8 private) controlled 68 percent of total sector assets, with the rest (32 percent) split among 197 small banks.

Profitability, as measured by return on assets (ROA) and return on equity (ROE), has improved for the State banks since 1993, but not for the private foreign exchange banks. ROA for the banking sector was 1.37 percent in 1997, higher than the average for medium-sized US commercial banks in the past decade. Joint venture and foreign banks had much higher returns due to more efficient credit and liquidity management, relatively higher-quality loan portfolio, and the difference in the definition of their capital. Net interest margin (NIM) for the top 200 banks was only 2.6 percent in 1997, but has been narrowing, according to annual reports of the two largest banks.

On the surface, most of the commercial banks complied with BI's prudential requirements. In 1993–1996, not only was CAR met across the board, but the industry CAR was much higher than the recommended 8 percent minimum. As for other ratios such as legal lending limit (LLL), loan-deposit ratio (LDR), and net open position (NOP), BI reported general compliance and few violations, except for LLL.[2] Nonetheless, one ratio—cost/income—did hint at trouble ahead. It was very high, showing that, despite years of liberalization, banks in Indonesia remained extremely inefficient. Both State and private banks have ratios above 90 percent, although a separate study on the top 17 banks puts the figure at 59 percent (Table A3.2, Appendix 3).[3]

Nonbank Financial Institutions

NBFIs are categorized into two: those engaged primarily in capital market activities and the rest. The former are regulated and supervised by the Capital Market Supervisory Agency (Bapepam), while the rest—finance companies, venture capital companies, insurance companies, and pension funds—are supervised by the Ministry of Finance (MOF), with assistance from BI in some cases.

This study will focus only on NBFIs under the MOF umbrella. At end-1996, 836 NBFIs (including insurance-supporting companies) were engaged pri-

marily in a broad spectrum of noncapital-market activities. The finance companies had the largest share of assets in the sector (43 percent), but the insurance (and supporting) business had the greatest number of firms (280).

FINANCE COMPANIES

Finance companies in Indonesia are not allowed to draw funds directly from the public. They cannot take deposits nor issue promissory notes nor engage in the securities business. Because of their limited scope of sourcing, they have been subjected to less rigorous regulations and supervision than commercial banks.

Before October 1995, finance companies were permitted to conduct business in leasing, factoring, consumer financing, credit card financing, as well as venture capital activities. However, as venture capital activities were perceived to carry much higher risk than other financing businesses, they were formally placed in a different category in October 1995. At the same time, the minimum paid-in capital for national private finance companies was raised from Rp2 billion in 1988 to Rp10 billion ($4 million). They were given until October 1998 to comply (Appendix 1.B.2).

The sector benefited most from the robust economy in the first half of the 1990s. The ratio of finance companies' assets to bank assets increased from 5 percent in 1991 to 6.6 percent in 1996, indicating the sector's expanding role in financial intermediation. In 1992–1995, the sharpest growth was in factoring, which experienced triple-digit annual average growth. Nonetheless, factoring declined in 1996 and lost its lead to leasing, which had a 46 percent share of total business activities in the sector. Consumer finance continued to expand steadily beginning in 1992, averaging 43 percent annual growth in contract value over four years. In contrast, competition from commercial banks in credit card financing almost wiped out the finance companies. By end-1996, NBFIs' share of credit card financing had plunged to Rp61 billion, from a peak of almost Rp1 trillion in 1994.

The Government has encouraged venture capital to promote small and medium-sized enterprises. Although the number of venture capital companies rose steadily, the volume of their business activity dropped by 64 percent—from Rp118 billion in 1995 to Rp42 billion in 1996—when finance companies separated from venture capital companies. Of the 43 venture capital companies licensed at end-1996, 20 were regional, with investments in 482 companies. Venture capital companies are regulated solely by MOF.

Due to the restriction placed on their funding sources, finance companies rely heavily on both domestic and offshore loans. In 1996, their total funds stood at Rp37 trillion, including outward borrowing (funds raised from unrelated parties), equity, and other sources of capital, of which two thirds were from bank loans (Rp12.9 trillion or 35 percent of the total) and offshore borrowings (32 percent). In December 1995, recognizing the need to limit finance companies' debt financing, MOF issued regulations on the limits for borrowings and equity investment, as well as on reporting requirements. Finance companies were allowed to borrow up to a maximum of 15 times their net worth, with offshore loans limited to only 5 times their net worth. The same month saw another important MOF decision—to stop issuing new licenses for finance companies, of which there were already 254, a number MOF considered adequate.

Since a great number of finance companies are affiliates of commercial banks, BI assists MOF in supervising all finance companies except venture capital companies. However, BI supervision is limited to (i) domestic and offshore borrowing, (ii) issuance of promissory notes (as collateral to banks), (iii) asset qualities, (iv) truthfulness and completeness of reports, and (v) interrelated activities between banks and finance companies. Reported cases of regulatory noncompliance among finance companies were few and

dwindling in 1996, according to BI, while NPLs stood at 3 percent but appeared to be rising.

INSURANCE COMPANIES

The insurance industry and its supporting industries have experienced modestly higher growth than other NBFIs. When the Insurance Law was promulgated in 1992, there were 145 insurance companies, then 171 by August 1997, with assets growing 25 percent annually (to Rp22 trillion at end-1996). The expansion was mainly attributable to joint venture companies, whose number rose from 19 to 40. Under the Insurance Law, the minimum paid-in capital requirement for private national companies by 1998 was Rp2 billion for life insurance, Rp3 billion for nonlife, and Rp10 billion for reinsurance (Appendix 1.B.3).

Life and nonlife insurance accounted for much of the sector's activity. Life insurance enjoyed a 58 percent average yearly growth of assets in 1992–1996. Indemnity (nonlife) insurance and reinsurance accounted for the largest share of gross premium. The rest of the sector—reinsurance and social insurance companies—was lackluster throughout the period. Capital restraint has forced most of the reinsurance business offshore, prompting the Government to reestablish a second State-owned reinsurance company with paid-in capital of Rp250 billion in 1997. By August, there were 120 insurance-supporting companies, made up of insurance and reinsurance brokers, loss adjusters, and actuaries.

In a bid to step up regulation of the insurance industry, MOF issued guidelines on investment, financial soundness (including a solvency rating), and the maximum retention limit on investment. Although insurance companies are allowed to invest in a wide range of domestic financial instruments as well as other assets, the lack of a well-developed capital market and long-term investment instruments has led to a bias toward short-term bank deposits and Bank Indonesia Certificates (SBIs). At end-1996, 55 percent of the Rp18 trillion invested by the industry went into time deposits and 15 percent into SBIs. The maturity mismatch is now a pressing issue, given the insurance sector's large portfolio exposure to the soundness of commercial banks.

In early 1997, MOF warned that 33 insurance companies had failed the solvency test based on a variety of components, including company liquidity, risk management, profitability, and legal aspects. Of the 33, 19 were life insurance companies (i.e., a third of the total number of life insurance companies), of which 14 had solvency ratings below the minimum 101, and the other 5 had inadequate capital.

PENSION FUNDS

The Government promotes pension funds as it believes they will play an important role in mobilizing long-term funds. The Pension Funds Act of 1992 outlines the legal framework for the voluntary establishment, administration, and regulation of employer-managed (private) pension funds. Although the act does not compel private companies to set up pension plans for employees, it does provide clear guidelines for those who elect to do so. Several other MOF decrees followed, defining the eligible instruments for investment of fund assets, as well as disclosure requirements (Appendix 1.B.4).

In December 1996, there were 261 pension funds—239 employer-managed and 22 financial institutional. There were also three sizable Government pension programs: PT Taspen for the civil service, Asabri for the armed forces, and PT Astek for social security, with some benefits for participating private companies. Much of the sector's growth was in the employer-managed funds, which increased at an annual average rate of 26 percent since 1993 to reach Rp13 trillion in 1996. However, the pension participation rate is still low, covering less than 20 percent of the labor force. Total sector assets in 1996, at Rp21 trillion, were equivalent to only 4 percent of GDP (compared with 40 percent in Malaysia and 60 percent in Singapore).

The pension fund industry suffered similar investment constraints as the insurance industry, with a

high concentration of assets in time deposits and CDs (54 percent at end-1996, down from 74 percent the previous year). The rest of the portfolio was spread more or less evenly among listed stocks, bonds, private equity, and real estate. Of particular concern is the fact that financial institution pension funds placed nearly all (97 percent) of the amount in short-term bank deposits. In February 1997, in a bid to encourage portfolio diversification, MOF added mutual funds to the eligible investment instrument list. However, like insurance companies, pension funds are not allowed to invest offshore.

Recent Developments

Prelude to the Crisis

Exchange rate volatility was an important factor in triggering the financial crisis. It is thus ironic that some of the factors contributing to the rupiah's free fall in January 1998 can be traced to BI's then-successful defense of the currency in the wake of the 1995 Mexican crisis. In response to speculative attacks on the rupiah, BI hiked SBI rates in 1995, leading to sharply higher domestic real interest rates. Real interest rates on SBIs of 4 percent or more (8 percent or higher for time deposits) made Indonesia even more attractive to short-term foreign capital as the rupiah's reputation for stability was greatly enhanced after the Tequila effect.

To discourage short-term capital inflow, which had been fueling money supply growth, BI accelerated the widening of the exchange rate intervention band and switched to a more market-determined mechanism for SBI yields. BI widened the band five times from 3 percent in January 1996 to 12 percent in July 1997, in the hope that greater interest rate and exchange rate flexibility would discourage the influx of mainly short-term capital. The measure came too late, as external debt stock (both public and private) had already piled up to an estimated $108 billion by end-1995, just as the current account deficit ballooned. Nonetheless, strong economic growth and high domestic returns continued to draw foreign investors, who were undeterred by BI's more "flexible" exchange rate policies.

Meanwhile, local banks and businesses were raising foreign capital under the steady rupiah-depreciation regime, made possible by the comparatively low funding cost. For instance, most commercial banks with international credit ratings could source foreign funds at rates around the London interbank offered rate plus 70 basis points (bp) (about 6.3 percent) at end-1996—minimal compared with the 16 percent paid on rupiah time deposits. Given the rupiah's stable track record in the past decade, neither foreign creditors nor domestic borrowers associated exchange rate risk with such transactions, even though half of them were short-term (maturity of less than one year).

The proliferation of debt instruments with minimal documentation—such as promissory notes, floating rate notes (FRN), or floating rate certificates of deposit (FRCD), which were all readily accepted by foreign creditors—also facilitated offshore borrowing. It is worth noting that funding through debt proved extremely popular among conservative business groups, as it involved no share dilution. By March 1997, reported foreign borrowings of the private sector had increased to $61 billion from $48 billion at end-1995, more than offsetting the fall in public sector foreign debt.

Foreign capital flooded the banking system with liquidity, as reflected in the gradual decline in SBI and interbank rates from mid-1996 onward. By early 1997, SBI rates had dropped below 10 percent for the first time in four years. A status quo in the exchange rate regime was by then taken for granted, as demonstrated by the fact that most commercial banks held short-dollar NOPs in June 1997, immediately before the currency crisis.

Poor timing notwithstanding, it should be recognized that both BI and MOF had paved the way for consolidations within the banking and NBFI sectors by setting higher capital requirements and prudential regulations since 1995. Non-foreign-exchange banks

were required to raise their minimum paid-in capital to Rp100 billion and CAR to 10 percent by 1999. In hindsight, the requirements were not stringent enough and came after the industry had become fragmented. In December 1996, Regulation No. 68 empowered BI to advise MOF on revoking bank licenses, prescribing remedial measures against problem banks, and liquidating failed banks. To tighten liquidity and to guard against liquidity risk, BI raised the statutory reserve requirement of third-party funds from 3 to 5 percent in April 1997. Furthermore, in order to curb loan growth, all new real-estate-related loans, with the exception of those for low-cost housing, were banned beginning in July 1997.

The Crisis

When the currency crisis spread from Thailand, BI initially tried to defend the rupiah against speculative attacks by intervening in the market and raising SBI rates. Eventually, it decided to float the rupiah and abandon the exchange rate bands on 14 August 1997, precipitating a period of currency volatility, resulting in a 30 percent depreciation of the rupiah by mid-October and the collapse of the stock market. On 8 October, the Government requested assistance from the International Monetary Fund (IMF). A $10-billion standby arrangement was agreed upon on 31 October. The IMF program also generated additional funding commitments of over $40 billion, of which $4.5 billion were from the World Bank and $3.5 billion from the Asian Development Bank. Individual countries formed a second line of defense.

The Government pledged to restructure the financial sector by closing banks under intensified supervision with no rehabilitation plans and by establishing quantitative performance targets for State-owned banks. The very next day, on 1 November, it shut down 16 insolvent banks and placed more banks under intensive supervision. Unfortunately, in the absence of clear guidelines on depositor compensation, the hasty decision triggered serious bank runs. Depositors panicked and transferred money from private national banks to State banks, which they perceived to carry implicit Government guarantees, and to foreign banks both onshore and offshore. The "flight to quality" helped boost liquidity of State and foreign banks, but also drained $2 billion out of the local banking system in November alone.

Worse, capital flight was not confined to depositors. Financial institutions and corporations were all accumulating dollars, partly in anticipation of upcoming debt services, and partly due to an erosion of confidence in the domestic financial system and currency. Commercial banks had reportedly switched to a long-dollar NOP by this time, except for a very few State banks (primarily the Exim Bank), which the Government asked to continue supporting the rupiah. Concurrently, foreign investors were beating a massive retreat, causing further sell-offs of domestic assets and the rupiah. The vast amount of funds withdrawn from the private national banks widened their liquidity gaps, which the banks were barely able to bridge through the interbank market (with rates ranging from an average of 40 to over 100 percent). To finance the liquidity shortfall, many banks turned to the lender of last resort—BI.

The increasing dependence of some banks on BI's liquidity facility hampered BI's attempt to tighten money supply and stabilize the currency. It was only in late November that the central bank was able to intervene in the overnight interbank market to maintain and push up interest rates. On 31 December, the Government unveiled plans to restructure the State banks through mergers and privatization—an IMF requirement. Four State banks were scheduled to merge by March 2000 into one entity, while BNI, Bank Tabungan Negara, and Bank Rakyat Indonesia were to be restructured. A new entity, Bank Mandiri, would be established to handle some of the nonperforming assets of the merged banks.

On 1 January 1998, depositors of the 16 closed banks were finally compensated (up to about $6,000

per person), covering roughly 75 percent of the total value of the banks' deposits. However, by this time, both domestic and foreign market participants had lost faith in the financial system and the currency. Concerns over Indonesia's external debt (estimated to be around $140 billion or two thirds of GDP at end-1997),[4] caused by the rupiah's sharp depreciation, cast doubt on Indonesia's debt service ability relative to its foreign reserve position. Market players and local corporations were ready to sell rupiah at the slightest hint of further uncertainty. Both pre-election political jitters and budget blunders sent the rupiah on a rapid downslide.

In a bid to restore confidence in the economy and the currency, a second IMF agreement was signed on 15 January 1998, which was essentially a stronger version of the first one. Still, questions about Indonesia's commitment to reform and the deterioration of the external debt position continued to fuel capital flight. January saw huge net outflow of allegedly all-domestic capital of around $600 million to $700 million per day. On 22 January, the rupiah nose-dived to a record low of Rp16,500. To stem the slide, on 27 January, the Government issued a blanket guarantee on all 212 commercial banks' domestic and foreign obligations, covering both depositors and creditors.

On the same day, IBRA was established as an independent body under MOF to nurse the banking sector back to health and to hold it to an internationally accepted standard. IBRA also administers the Government's guarantee program. On 14 February, 54 banks, of which 4 were State banks, with liquidity support from BI in excess of 200 percent of equity capital or with CAR below 5 percent based on adjusted December 1997 figures, were placed under IBRA's supervision (Appendix 4). The Asset Management Unit was formed at end-1998 to resolve the supervised banks' bad debts.

After the Government's call for a temporary freeze on foreign debt repayment, the steering committee of foreign bank creditors, the contact group of debtors, and the private external debt team met for the first time on 26 February to discuss the restructuring of Indonesia's external debt. The initial plan was to model the debt solution on the 1983 Mexican Ficorca strategy to enable private companies to service their foreign currency debt through payments in local currency to the Indonesian Debt Restructuring Agency (INDRA), which was launched in August 1998. INDRA could, in turn, pledge equivalent dollar payments to creditors without issuing a formal guarantee on the private debt. However, results of the restructuring remain to be seen. To accurately capture the size of the private sector debt, the Government issued a decree on 8 April, requiring all companies with foreign borrowings to report their debt position to BI by the end of the month.

Until the external debt problems are resolved, Indonesia's commercial banks are not likely to see their creditworthiness improve. On 26 February, the international rating agency Standard & Poor's downgraded credit ratings of Indonesian banks across the board. Even previously investment-grade State bank BNI saw a nine-grade drop to CCC- in its foreign currency debt rating. Overseas creditors' rude awakening to the reality that Indonesian banks carried such high counterparty risk pushed them to cut off most local banks' overseas credit lines, causing a standstill in trade finance and trading. Although several major trading partners such as Japan and Singapore offered to facilitate trade financing, the banking system still suffers a chronic shortage of foreign exchange liquidity.

As part of the IMF program's measures to strengthen the supervisory framework for banking, BI announced the new loan classification and provisioning guidelines on 27 February (Appendix 1.B.1.c). The stricter classification and higher provision are gradually shedding more light on the actual size of NPLs. The general slowdown in economic growth and the tight credit condition are expected to precipitate large-scale defaults, particularly on dollar loans. NPLs for the banking sector under the old

classification were only 7.2 percent of total outstanding credit at end-1997; recent industry estimates for 1998 are drastically higher—from 30 to 70 percent.[5] To put the problem in perspective, at 60 percent of total credit, NPLs would be roughly four times the size of the sector's capital.

The devaluation of the rupiah caused a sharp increase in the rupiah value of banks' foreign assets, expanding the size of banks' asset base and causing most banks' CAR to fall below the 9 percent requirement. (The entire sector's average fell from 11.8 percent at end-1996 to 6.9 percent in January 1998.) The tight liquidity environment also forced many banks to rely on BI's liquidity support as the only means to meet the 5 percent statutory reserve requirement. To preempt an all-out funding competition for deposits among the banks, BI placed a ceiling on deposit interest rates on 27 February. As the burgeoning amount of liquidity support readily extended to the banks had handicapped BI's monetary policy, BI announced on 6 March a series of punitive measures and restrictions on the use of the discount window facility. Banks are now entitled to the facility up to 14 consecutive days; those who fail to comply are put under direct IBRA supervision. The charge for using the facility was also raised substantially to discourage abuse.

Seeing Indonesia's reform efforts waver, IMF suspended the second tranche of the $3-billion standby agreement on 15 March, causing other multilateral and bilateral funds to be suspended as well. The Government reentered into negotiations with IMF, and demonstrated its commitment to the program by tightening liquidity (by raising the SBI one-month rate from 22 to 45 percent) on 23 March and accelerating bank restructuring. On 4 April, IBRA suspended operations of seven commercial banks and took over the management of another seven, all of which have received liquidity support from BI in excess of 500 percent of equity (Appendix 4). The move signaled the authorities' readiness to restructure and consolidate the banking sector. As the owners of the banks are deemed politically well connected, IBRA's action also suggested that the authorities were now taking an evenhanded approach—the past lack of which had impeded reform efforts.

Of the 14 banks, seven are listed banks and one (Exim) is a State bank. The seven banks currently under IBRA management accounted for 75 percent of total BI lending to the banking system. The size of BI liquidity support to all 54 IBRA-supervised banks was subsequently disclosed as Rp80 billion, roughly the same as the stock of credit outstanding of the 54 banks. (By 17 April, the amount had jumped to Rp103 trillion.) IBRA took over the Rp80 billion by repaying BI in indexed bonds from MOF. Additional bonds of Rp75 billion were launched in 1998 for the rehabilitation of the IBRA-supervised banks. IMF estimated the total cost of restructuring and recapitalizing banks to a minimum 8 percent CAR to be around 15 percent of GDP. The final cost could be higher as actual NPLs are likely to be way above the end-January 1998 data on which the estimate is based. (World Bank estimates put the cost at 30 to 40 percent of GDP, although most banks are still doing their 1997/98 audits.)

Given that four out of the seven State banks are under IBRA, the authorities are putting their original merger plan on hold, except for Bank Bumi Daya (BBD) and Bapindo, which were merged with BND and Exim in October 1998. BBD and Bapindo are expected to meet the capital requirement (5 percent CAR) for leaving IBRA. Six private national banks are also proposing merger plans and four were no longer under IBRA supervision by 22 April. As for the banks under IBRA management, five are managed by a State bank and were audited by independent auditors.

After lengthy negotiations, a third IMF program was agreed upon on 8 April and a fourth signed on 26 June. The latest program supplements the previous three but sets precise structural policy commitments and target dates requiring constant monitoring by the executive committee of the Resilience Coun-

cil to preempt slippage (Appendix 5). IMF is now monitoring Indonesia's compliance monthly rather than quarterly.

In accordance with the third program schedule, three important bank-related policy measures were announced on 22 April:

- The minimum paid-in capital requirement, after loan-loss provisions (LLP), for all banks would be raised to Rp250 billion ($31 million) by end-1998.
- LLP would be fully tax-deductible (previously capped at 3 percent).
- Amendments to Indonesia's antiquated bankruptcy law would take effect and a special commercial court be established by August.

On 21 April, BI tightened liquidity again by raising SBI rates (the one-month SBI rate increased to 50 percent). At this level, banks suffered vastly negative interest margins, paying over 52.5 percent for rupiah time deposits and lending at much lower rates (around 30 percent). Most local banks' balance sheets hemorrhaged and expected to break even at best in FY1998. A great number of banks also faced serious maturity mismatch, sourcing one-month time deposits but lending one-year-or-longer working capital. Already undercapitalized due to the currency depreciation, the banks faced possible large write-offs on the increasing amount of NPLs while having to comply with the increase in capital requirement by end-1998. In view of the banks' difficulties in raising capital (two listed banks' attempts in rights issue from April to July 1998 were canceled at the last minute due to lack of investor interest), BI, on IMF's recommendation, relaxed the capital requirement on 19 June. The minimum paid-up capital target of Rp250 billion was made flexible and CAR lowered to 4 percent until end-1998, to rise gradually to 8 percent by end-1999 and to 10 percent by end-2000. Still, commercial banks are looking at even tougher times ahead, and it is inevitable that the sector will be shaken out further and consolidate in the medium term.

Issues and Recommendations

A variety of factors contributed to Indonesia's financial crisis. They include macroeconomic, political, social, structural, regulatory, and supervisory issues. This study concentrates only on the last three.

Sector Fragmentation and Undercapitalization

Many of the banking sector's woes are due to lack of capital, which was partly caused by the sector's fragmented nature—a legacy of PAKTO deregulation in 1988, which lowered barriers to entry. About 180 banks share less than 30 percent of total sector assets. Most of the smaller banks are not listed and thus denied the option of raising equity through the market. Many exist only to cater to a few large customers, mainly related parties. Consequently, their sources of funding are limited and occasionally overlap with their assets. In many cases, LLL was breached. Since the onset of the financial crisis, the smaller banks' deposit (particularly dollar) base has contracted significantly, and their access to the interbank market cut off. As a result, many small banks are undercapitalized and insolvent.

Recommendation. Raise the capital requirement to prompt consolidation, and liquidate insolvent banks. The Government initially planned to impose a minimum paid-in capital of Rp1 trillion ($125 million) by end-1998. Clearly, the figure was set with a view to boost Indonesian banks' standing among their international peers, given that in 1997, the top 1,000 banks all had Tier-1 capital exceeding $150 million. With NIM deep into negative territory, most banks faced a loss in 1998, so the easiest route of recapitalization—via operating profit—was out of the question, while other efforts were rendered difficult by the financial crisis. In view of the drying up of capital sources and in anticipation that vast LLP would cause asset quality to deteriorate, the amount has been reduced to Rp250 billion or below.

There are only five recapitalization options open to banks at the moment: (i) injecting equity by major shareholders and owners, (ii) raising funds through the stock market, (iii) revaluing their assets, (iv) securitizing part of the assets, or (v) undergoing merger and acquisition (M&A). Even at the most conservative estimate of 30 percent NPL, and assuming an average rupiah exchange rate of Rp8,000, NPLs will be roughly $20 billion. If the NPLs are to be written off in one go against the banks' capital, there will be a shortfall of around $10 billion. Hence, the cost of recapitalizing the banking sector, even before meeting the 9 percent CAR requirement, is likely to be in the region of $10 billion upward. BI reduced CAR to 4 percent until end-1999 to allow the banks to go through rehabilitation and restructuring while recapitalizing—a tall order, and few, if any, banks are expected to accomplish all three by end-1999. (See Table A3.3, Appendix 3 for the estimate based on more stringent assumptions of 65 percent NPL and 9 percent CAR.)

With interest rates so high, few of the listed banks will be able to raise capital through the battered equity market. Owners are just as cash-strapped as their banks and heavily indebted. After asset prices collapsed, asset revaluation generated little surplus on Tier-2 capital, and dependence on such account window dressing is not a long-term solution. Similarly, securitization of mortgages or consumer loans, which are becoming more popular among bank treasurers, addresses only the CAR requirement but will not boost underlying bank capital. Understandably, the Government has been actively encouraging M&As, seeing them as the only way most small banks can possibly meet the new capital requirement. In the current rush into mergers, small banks are proposing merger plans but paying little attention to their feasibility, and they do not choose partners on the basis of mutual financial or structural compatibility.

In anticipation of a period of M&A mania, the Government has set up a "one-stop service" in order to reduce the paperwork. IBRA treats failed banks already under its supervision carefully even as it proceeds to nationalize some of the larger problem banks while releasing the smaller ones upon presentation of their merger proposals. The Government's message is clear: avoid too many closures. There are various ways of dealing with failed banks. In the past two decades, the Federal Deposit Insurance Corporation (FDIC) has used any of the following six options to sort out insolvent US banks:

- *Purchase and assumption (P&A).* The most widely used method. A sealed-bid auction is held on a uniform package consisting of the performing assets of the bank with a put-back option. The winning bank bidder assumes the liabilities, and FDIC liquidates NPL and other unwanted assets. Given the struggle of even the largest Indonesian banks to stay afloat and the potential NPL-shock of the failed banks, however, there may not be enough interested parties to warrant this option in the near term.
- *Deposit payoff.* The second most commonly used method. The insolvent bank is liquidated, only insured depositors (all depositors in the case of Indonesia) are paid off fully, and uninsured depositors are partially paid off from residual asset values. The 16 bank closures in November 1997 followed this route, but the banks lost their goodwill.
- *Insured deposit transfer.* IBRA used this method to close down seven banks in April 1998. All bank deposits were transferred to BNI, the most secure State bank. This method avoids deposit compensation.
- *Open bank assistance.* An acquiring bank injects cash into the failed bank to preserve it while FDIC receives notes of preferred stocks of the acquirer. In Indonesia, this method has limited feasibility, as healthy banks will only take on problematic ones if instructed to do so by the Government.
- *Total asset P&A.* A bid (usually negative) is submitted by the acquirer for all the assets (includ-

ing bad debts) of the insolvent bank, with detail restructuring (capital, management, debt collection) filed with FDIC. This method will not prove popular in Indonesia at the moment.

- *Bridge bank*. FDIC operates the bank until a qualified buyer can be found. This option is akin to IBRA's strategy of nationalizing some of the banks under its care and rehabilitating them until they are fit to be privatized.

Much as it is preferable to salvage as many banks as possible, the sector still needs to weed out unhealthy banks that are primarily public financial intermediaries. Since the likelihood of bank-closure panic is now greatly reduced following the Government guarantee in March 1998, IBRA should consider stopping its support for many of the nonviable banks and put them through liquidation. The outstanding loan portfolio of these banks should be transferred to the asset resolution company as previously proposed.

For NBFIs, it is the same sector-consolidation story. From finance to insurance companies, acute capital shortage has been the main problem. Although the companies were expected to fulfill their capital requirement in 1999, MOF hinted that it would raise the minimum paid-in capital across the board. Given that many finance companies are overleveraged through their foreign exchange borrowing, MOF should not hesitate to close the insolvent ones.

Defunct Bankruptcy Law

The former bankruptcy law, a legacy of the Dutch colonial legal system, was seldom invoked due to its long, drawn-out, costly, and sometimes unfair procedures. A case could take up to seven years traveling through three courts, with decisions subject to appeal in the Supreme Court, before creditors were informed of the final ruling. The proceedings were subject to abuse, with politics and corruption frequently influencing the outcome of the lawsuits. Banks or finance companies had no effective means of exercising their rights as creditors to recover their loans in the event that their debtors were unable to repay. In short, financial institutions were entirely at the mercy of their customers when it came to interest and principal payments, with no legal protection.

It defies logic that anyone would want to dabble in such a high-risk business, and all the more amazing that many conglomerates even bothered to set up not just one, but several banks and NBFIs. A fundamental reason is ready access to cheap loans. Anecdotal evidence suggests that no less than 70 percent of Indonesian companies are technically bankrupt, but none filed for bankruptcy under the former bankruptcy law. Commercial banks, their main creditors, were entangled in a myriad of bad debts that could not be resolved in the short term.

Recommendation. The Government announced on 22 April 1998 that amendments to the bankruptcy law would be effective in 120 days. The new commercial law and regulations are largely based on the US Chapter 11 bankruptcy laws and will allow creditors to send debtors into bankruptcy nine months after a claim is filed, as well as to seize assets of the insolvent companies. The commercial court can declare bankruptcy where a debtor has two or more creditors and has not repaid at least one loan by its expiry date. Either the debtor or creditor can apply for the order. The decree also gives BI and Bapepam the right to petition for the liquidation of banks and brokerages.

Hearings of petitions seeking a declaration of bankruptcy are to be held within 20 days after the filing of the petition, with the bankruptcy declaration to be made within 30 days of lodgment of the petition. The right of appeal to the Supreme Court remains. However, dissatisfied parties have only 30 days to lodge their appeals. The amended law also provides for the following: (i) expert advice, (ii) trustees to oversee companies brought before the court, and (iii) a 270-day moratorium on suits by nonsecured creditors. So far, several outstanding issues still need to be clarified, including indemnity for trustees, court deadlines not being met, rights of

nonsecured creditors, and a comprehensive law to prevent the fraudulent transfer of assets.

To prevent unjustifiable delays in the adjudication process and to enforce the new bankruptcy procedures, the Government has created a Special Commercial Court, to be staffed with especially trained judges. Around 50 judges drawn from the country's 27 provinces are being trained in the new commercial law and regulations relating to the administration of bankruptcies. It remains to be seen whether or not the changes herald a new chapter in Indonesia's legal structure and indirectly improve the environment in which commercial banks operate. A demonstration of political will is vital to the independence of the judicial process.

Role of Owner and Management

As Indonesia once lacked even the most basic legal framework within which financial institutions could operate and exercise their rights as creditors, why did banks and NBFIs boom in the early 1990s, creating a crowded and fragmented financial sector? Owning a bank must be especially profitable if businessmen bend over backward to obtain a license. According to MOF, borrowing via affiliated finance companies could often result in about 75 bp savings for some groups. While financial institutions, given their unique role, can obviously raise capital at a lower cost than companies or conglomerates engaged in other industries, there must be additional benefits that make owning a bank attractive.

A closer examination of performance ratios suggests that although Indonesian banks were historically profitable, returns were mediocre compared with their counterparts in other countries. ROAs for all banks hovered just above 1 percent since 1995 (compared with over 4 percent for the world's top 25 banks), while NIM was less than 3 percent in 1997 (Table A3.4, Appendix 3). Profit, therefore, is not likely the main motive behind the scramble for bank licenses. Currency movements and interest rate hikes since mid-1997 have caused a temporary surge in performance ratios. Actual losses and damage to profit will be revealed only after negative margins and bad debt are reflected in the audit of end-1998 results.

The relationship between most private banks and their owners can be summarized in the immortal words of a bank president: "Deposits are part of the bank's assets." Incredibly, his statement represented most owners' business strategy, which guided management decisions. Essentially, many businessmen viewed banks as leveraging tools for their capital. Given that banks are allowed to absorb public funds primarily in the form of deposits, a CAR of 9 percent means that the owners' paid-in capital can be geared up 11 times into bank assets. A large portion of affiliated bank assets are then channeled into the parent group's many investment projects, even though LLL is explicitly set at 20 percent of bank capital for a listed group and 10 percent, at arm's length, for a single borrower or related party.

For the past few years, BI reported compliance by the majority (around 86 percent at end-1995 and in 1996), but the true extent of related-party borrowing is much higher. Some bankers estimated average related-party lending to be around five to seven times the size of bank capital for many small banks. Consequently, many banks had their funds tied up in intergroup or intragroup lending, with their owners or major shareholders incapable of injecting funds in the aftermath of the financial crisis as they were also heavily indebted to the same banks. Regardless of bank size, many shareholders saw banking simply as a convenient source of leveraged capital, as illustrated by the recent audited findings that all six major banks under IBRA (Bank Dagang Nasional Indonesia, Danamon, Modern, Bank Prima Dana Finance Corporation Indonesia (PDFCI), Tiara, Umun Nasional) had extended more than 50 percent of their credit base to affiliated companies.

It is not surprising that the integrity and competence of the senior management, shareholders, and owners of banks have often come under fire. In the

licensing process, BI required that board directors or commissioners of commercial banks possess good character and morals, and that at least half the board members have a minimum of three years' banking experience. There are also restrictions on the appointment of family members into senior management. Those failing the "fit and proper" test are supposed to be banned from holding a bank management position. Yet the measures have deterred few private bank owners or managers from running the bank as a funding source for group projects rather than as a financial intermediary.

Recommendation. The issue is partly structural and partly supervisory. Indonesia's LLL is relatively conservative compared with other countries'.[6] However, the definition of "related party" in the Indonesian context should include listed but affiliated companies. In the long run, bank owners will be dissuaded from exploiting bank resources and assets only in an environment where banks are highly profitable. The owner of a healthy, well-established, and profitable bank is less likely to undermine the franchise of his bank license by engaging in high-risk activities or violating prudential requirements.

Economic and currency volatility notwithstanding, the key to reducing connected lending is the bank supervisors. Strict enforcement of LLL compliance and detection of unreported related loans using dummy accounts or derivatives (e.g., the so-called loan swap, where an implicit agreement between two banks allows the crossing of loans to designated parties, who are apparently unrelated to the creditor banks), will be crucial to preempting asset exploitation by owners. The BI banking supervision division currently divides responsibilities between teams on a group basis, with affiliated banks or NBFIs monitored by the same team. Supervisors are in theory familiar with the financial partners and management style of a group of related banks. Board directors and commissioners should closely monitor managers and strictly separate strategic from day-to-day decision making. The independence, enforcement, and quality of the supervisors are crucial to reform.

Supervision

Although prudential regulations for banks and NBFIs are generally up to the international standard (Appendix 1.B), the financial crisis is partly due to the delay in their implementation, which lagged behind financial liberalization. Specifically, lax supervision and the lack of supervisory independence are to blame. Given that many bank and NBFI owners or major shareholders are politically well placed, neither BI nor MOF supervisors were in a position to enforce swift corrective action in the event of noncompliance. Incidents where senior BI officials were replaced under political pressure due to their decision to penalize some delinquent but well-connected bank owners are particularly damaging to BI's authority and credibility. Anecdotal evidence also suggests that on-site supervisors were often targets of bribery, resulting in weak governance.

Before the crisis, the BI banking supervision division had 28 teams covering the commercial banks and 8 teams dedicated to rural banks. BI has joined forces with MOF in supervising NBFIs, except venture capital companies, and in closely monitoring banks with affiliated NBFIs. Both banks and NBFIs have rigorous and frequent reporting requirements even by international standards. Banks are required to submit weekly, monthly, quarterly, and audited annual financial reports to MOF and BI, while NBFIs must submit monthly, quarterly, and audited annual reports. The amount of paperwork and volume of data supervisors receive periodically is overwhelming, reducing the time that should be spent on information analysis. In BI's CAMEL rating system, the factors of capital adequacy, asset quality, earnings, and liquidity are mostly derived from the submitted weekly and monthly reports.

Management factor assessment is based mostly on on-site examinations. Before the crisis, on-site examinations were conducted on an ad hoc basis,

and about once every two years for the larger banks. The length of each on-site examination depends on whether it is an event-driven or routine assessment. For a major commercial bank, it may take up to a month for a full team of supervisors. With over 200 commercial banks under only 28 teams, the frequency of on-site examinations is limited. The establishment of IBRA has strengthened supervision of undercapitalized and technically insolvent banks, although a little too late. It is recommended that, in addition to a qualitative assessment of management performance, BI adopt an efficiency measurement model. Currently, the measurement of efficiency is a simple cost/income ratio, but some sophisticated quantitative models should be considered in order to reveal both allocative and technical efficiency of the banks.[7]

Historically, most cases of noncompliance were resolved through compromise or negotiation between BI and the bank involved. Such precedents invariably reduced the effectiveness of prudential regulations as banks tend to view them as flexible rather than mandatory. Indeed, Regulation No. 68 empowers BI to close down only failed banks. However, there are still no clearly defined exit policies, as shown by the prolonged liquidity support extended to the 54 banks under IBRA. Bankers also complain that many supervisors' lack of industry experience or product knowledge makes them unable to detect breaches of regulations, evaluate the risk profile, or locate inconsistencies in bank financial statements.

Recommendation. It is imperative that the supervisory bodies—BI, IBRA, and MOF—have sufficient authority, independence, and well-qualified staff. BI has thus adopted the 25 Core Principles for Effective Banking Supervision proposed by the Basle Committee. To avoid delay and political intervention in enforcing corrective measures, noncompliance should be penalized by well-defined laws and regulations such as the FDIC Improvement Act of 1991, which classifies banks into five categories according to their Tier-1 and Tier-2 risk-based capital ratios.

BI does have a list of corrective measures, ranging from temporary suspension of certain bank activities to revocation of bank licenses, but it does not state what violations are to be penalized and by what measures. Ambiguity should be minimized to protect supervisors from forced informal compromise or pressure from politicians. Prompt and orderly bank closures, although unpopular, will be viewed by the banking industry and business world alike as a sign of supervisory efficiency and strength.

Where no public funds are directly at stake, existing regulations governing NBFIs appear to be adequate. Again, emphasis should be on the enforcement of the prudential regulations and prevention of intergroup (bank-NBFI) asset abuse by the parent company. MOF and BI must immediately impose corrective action in case of banks' noncompliance.

To remedy supervisors' oversight and inefficiency arising from their lack of expertise and industry knowledge, BI should provide frequent training and, where appropriate, supervisors should be seconded to commercial banks to gain "real world" experience. Judging from commercial banks' feedback, supervisors particularly need to understand treasury and credit operations. BI should also consider appointing outside consultants or industry experts in areas involving advanced technical knowledge. Human resources are so important that they warrant further discussion.

Human Resource Constraint

The shortage of high-caliber and experienced staff is not confined to the area of supervision but is widespread in the financial industry. Frankly, the lack of managerial and industry expertise, even at the treasurer level, is simply appalling. Few senior managers are well versed in the operational details of banking—a problem rooted in the ownership and management structure of Indonesian banks, and also a reflection of the human resource constraints in the financial sector. As a result, many banks are placed in a precarious position as few officers or managers

are able to gauge the bank's credit, interest rate, liquidity, and capital risk profile—information vital to the management and operation of a healthy commercial bank.

Recommendation. Producing enough qualified industry professionals starts in the education system, which is beyond the scope of this study, which focuses on what the financial industry can do to ensure a high level of expertise. Although Government regulations require banks to spend at least 5 percent of their personnel budget on training, few officers have benefited from the scheme. Foreign and joint venture banks are now the main training grounds for industry professionals; a few treasurers have overseas work experience. Local banks need systematic training schemes for junior professional staff and a well-structured training-testing-promotion path for executives in order to encourage voluntary improvement in technically demanding areas.

One area requiring particular attention is treasury, which is usually in the hands of a few dealers and traders, who may inadvertently commit the bank to a high degree of risk exposure. Derivative products are poorly understood by senior managers at even the world's leading banks, so it is important that bank directors understand off-balance-sheet risk. Since treasury is an area of intensive financial innovation, the treasurer must be up to speed on the use and valuation of the full range of derivative instruments at the bank's disposal. If possible, all senior staff should be sent regularly to professionally run training courses or seminars.

Liquidity Management

The banking sector's heavy exposure to foreign exchange debt can be traced to the banks' need to balance their maturity profiles. Due to the absence of a developed domestic capital market, banks were forced to go offshore in their search for long-term capital. What started as a prudential practice soon degenerated into a pursuit of cheap funding, pushing the sector's total foreign borrowing to around $30 billion by end-1997, about half of which was due within 1998. The rupiah's plunge further augmented foreign liability in rupiah terms. Following the "flight to quality" in January and February 1998, many local private banks suffered from liquidity shortages in both dollar and rupiah assets. Banks relying on BI's liquidity support in excess of twice their equity capital are already under IBRA, while the rest are scrambling for deposits. However, from the reported LDR figures (85 percent for all commercial banks and 93 percent for private foreign exchange banks in January 1998), it is difficult to picture the extent of the liquidity squeeze (Table A3.2, Appendix 3).

Given that most banks have switched to a long-dollar position, coupled with the amplification of dollar assets relative to total assets in rupiah terms, many banks have vastly exceeded the NOP limit (25 percent of capital). To be in excessively long-dollar position is obviously less of a headache for the treasurer if the rupiah continues to depreciate, but few banks want to be caught by a rupiah appreciation. Some banks have been trying to unwind NOP by converting some dollar loans into rupiah loans at a preagreed exchange rate. However, the scheme is not too popular with customers hoping for a rupiah rebound to, say, Rp6,000 to the dollar. Given that trade financing has dwindled, and along with it the forward markets, commercial banks are being deprived of their other option in squaring some dollar exposure: selling dollar forward contracts to customers, primarily importers.

Although it is generally accepted that the bulk of banks' deposits comes from time deposits, not all banks impose a prematurity withdrawal penalty on them. During the capital flight in November 1997–February 1998, many time-deposit holders closed their accounts at the private banks and sent the money abroad or to State and foreign banks. The instability of time deposits and the difficulty in differentiating the maturity profile among demand, savings, and time deposits rendered liquidity management a near impossibility.

Like all central banks during financial crises, BI faced a dilemma: whether or not to stick to its tightening stance, with high interest rates offered on SBI as a main tool to sterilize liquidity from the system. The result, as many distressed bankers have pointed out, is that banks unfortunate enough to be short in liquidity have no way out of their predicament. By end-July 1998, one-month SBI rates were offered at 58 percent while time-deposit rates were 45–50 percent at top-grade commercial banks. What chance did bank deposits have against risk-free domestic instruments offered at much higher rates? Worse, borrowers have requested all banks to cap their lending rate in the wake of Indonesia's social and economic woes. For instance, customers were not satisfied when the housing loan rate was lowered from 50 to 27 percent at Bank Internasional Indonesia in early July, and demanded an even lower range of 19–21 percent. With such interest rate mismatch, it is impossible for banks to sustain massive negative interest margins for long, even if the bank had been in perfect shape to begin with. The only winners at the moment seem to be the foreign banks. Seen as safe and sitting out the crisis because their deposit rate is much lower than private national banks', they are now flushed with fresh liquidity from new customers, which is to be invested in low-risk instruments such as short-term SBIs at lucrative rates (51 percent or above).

Recommendation. The issue hinges upon the development of a domestic capital market and the successful rescheduling of some of the banks' foreign liabilities, both of which are beyond the scope of this study. In an active capital market, investors such as insurance companies and pension funds can reduce their exposure to the banking sector, which still accounts for over half of their total investment portfolio. At this stage, there is little that banks can do to improve their liquidity, aside from injecting capital from shareholders or competing intensely to attract deposits (at a negative margin). Without the overhang of currency devaluation, BI could relax its monetary stance and foster a low interest rate environment that could accelerate the banks' balance sheet rehabilitation process. Sadly, this option is not open to BI now.

From a different angle, BI's definition of LDR, which includes bank capital and short-term borrowing (under three months) in the calculation of deposit base, distorted the true picture of bank liquidity. A simple definition would put LDR at around 114 percent for all commercial banks in January 1998. In fact, LDR has not dipped below 110 percent in the past decade, except in 1996.

It would appear that liquidity management among Indonesian banks has been fairly reactionary. In a properly run bank, treasurers, together with senior management, must factor an asset-liability plan into their annual business projection. Of the usual range of liquidity ratios, BI monitors only net obligations of interbank call money to liquid assets and the statutory reserve requirement, besides LDRs. For internal reference and for their own guidance in liquidity management, treasurers ought to closely monitor the most common liquidity ratios: (i) liquid assets/total assets, (ii) volatile deposits/total deposits, (iii) short-term securities/total deposits, and (iv) total borrowing/equity capital. In addition, it should prohibit or impose a standard penalty on the early withdrawal of time deposits to ease the treasurer's task of managing bank liquidity.

At present, although banks are reporting their contingencies and commitments to BI on a weekly basis, all the positions are at book values. In other words, they fail to capture the market risk profile of the derivative instruments, whose value, being dependent on the prices of underlying assets, can be extremely volatile. Given the increasing importance of derivative products in liquidity management, it is essential that all off-balance-sheet items should be marked to market in order to capture the level of market risk exposure they represent.

Credit Management

A combination of economic boom and lending restrictions has discouraged efficient credit allocation

among Indonesia's commercial banks. In 1993–1997, credit in private national banks grew at 39 percent compound rate each year. To remain selective at this rate is difficult, and the result of aggressive lending is finally showing up in the latest NPLs. The previous looser classification and the common practice of evergreening NPLs, together with the 3 percent tax-deductibility cap on LLP, have caused serious underprovision for bad debts. In the past, commercial banks conveniently limited their LLP to around 3 percent. At end-1997, total bank credit amounted to over 70 percent of GDP. Given the high debt/GDP ratio, the key longer-term question is whether or not Indonesia is capable of generating sufficient cash flow to service the debts. In the near term, the specter of high interest rates and economic contraction will result in more corporate failures and, in turn, further deterioration of bank and NBFI asset quality.

The Government's long history of allocating subsidized credit to "priority" sectors culminated in the State banks' lower-than-sector-average returns and interest margins. Recently, various credit restrictions were placed on private banks: (i) a minimum 20 percent of total credit to be extended to small business credit (Kredit Usaha Kecil [KUK]); (ii) a minimum 50 percent of all foreign bank credit for export credit; and (iii) a ban on new loans for property development, except for low-cost housing. Such rigidities dented banks' ability to allocate credit efficiently. All too often, the creditworthiness of the borrower received less weight than warranted in a normal credit analysis. In some State banks, political influence swung management's decision toward awarding cheap loans to well-connected borrowers, further undermining the banks' credit risk.

As for private banks, years of economic boom enabled them to aggressively expand their balance sheet. Many of the large and smaller banks alike opened new branches in a bid to attract more depositors and borrowers in the mid-1990s. As a result, they placed little emphasis on the quality of assets and did not standardize the lending process. They approved corporate loans almost entirely without paperwork. According to several treasurers, banks competed intensely with each other for large corporate borrowers, who typically would also deposit a portion of the funds with the creditor bank. Anecdotal evidence indicates that in the case of related-party lending, the loan is almost always preapproved regardless of what the funds will be used for.

In contrast, individual customers, particularly those taking out mortgages, are viewed as most creditworthy as they fear losing their property (automatically used as collateral for a housing loan). However, few of the major banks have a credit analysis system allowing credit officers to review a potential customer's credit history, financial standing, income projection, and other relevant information. The situation fostered kickbacks and corruption by both customers and bankers.

Recommendation. As part of the IMF program, the Government plans to scrap all restrictions on bank lending, except to KUK, encouraging banks to exercise independent judgment in the risk-return management of their credit portfolios. As credit analysis is a weak point in commercial banking, banks need to exercise prudence in their credit policies. Treasurers need to monitor credit risk ratios such as (i) risk assets/total assets, (ii) LLP/earning assets, and (iii) interest-rate-sensitive assets/total assets.

A standardized credit approval procedure, incorporating detailed credit analysis, should go hand in hand with staff training in order to safeguard the loan quality of commercial banks. All banks should state explicitly the financial information and documentation required from all potential corporate and individual customers for scrutiny in order to avoid abuse or preferential treatment. Junior officers handling loan approvals should be allowed to report management intervention and all other irregularities in credit decisions directly to BI's supervision department, with the matter kept strictly confidential so as not to endanger the officers' employment prospects. Credit officers who approved loans paid back

in full should be rewarded in order to deter them from accepting kickbacks.

The recent tightening in loan classification and the announcement of full tax deductibility of LLP will pave the way for better bad-debt provision. But at the end of the day, it is the supervisor's duty to ensure that bad loans are properly reported and to weed out evergreening. As the public sector's involvement in banking should be reduced gradually in the long run, the Government should prepare to privatize State banks in order to enhance sector competition.

Deposit Insurance

The bank runs and subsequent capital flight in November 1997 could have been mitigated by a system of explicit deposit insurance. In the past, the Government had intervened in every isolated banking problem; Indonesia thus had an implicit deposit insurance system. However, the closure of the 16 banks sent public confidence spinning downward and the system now requires a more explicit scheme.

In lieu of a formal system, and facing more bank closures in March 1998, the Government issued a blanket guarantee, administered by IBRA, covering all bank deposits and obligations. Now banks pay an annual premium of 0.25 percent of the average monthly amount of guaranteed deposits and obligations. The scheme covers all banks, irrespective of soundness, and is thus viewed as inefficient. It will remain for two years before it is replaced by a new scheme.

Recommendation. The Government should decide whether the new scheme is to be voluntary or compulsory, and run by Government or industry. The recent financial crisis points to the necessity, at least in the initial stage, of a compulsory scheme. In some industrialized countries, the deposit insurance agency also has regulatory and supervisory power over the banking industry, providing additional checks and balances in the sector. It remains to be seen whether or not an industry organization will have enough authority to take on this role. In the US, it is FDIC that has full exit power over the commercial banks. Be it Government- or privately run, the agency must have the legal authority and political independence to resolve bank failures in conjunction with the supervisory authorities, MOF, BI, and IBRA.

A mechanism to prevent owners and borrowers from exploiting the system is necessary to avoid moral hazard. Each bank must pass all the regulatory, capital, and solvency requirements set by BI. Every bank's soundness should be automatically reviewed as part of the restructuring process. The premium should be low and standardized, or risk-based, so that banks engaged in higher-risk lending or with a less-than-spotless track record may be charged a higher premium than those engaged in, say, mortgage lending.

The system may be funded initially by a start-up levy borne entirely by members of the scheme, or partially shared by the commercial banks, central bank, and treasury in a Government-run system.[8] In the US, the cost of premiums is borne by the banks, but insured deposits carry a much lower interest rate. In the event of bank failure, the deposit insurer should automatically act as receiver on behalf of all depositors and creditors, particularly in Indonesia, which had only 16 receivers in August 1998, compared to over 3,000 in the US.

A ceiling on the amount insured is necessary, although it may favor the larger banks in the long run as they will be perceived as "too big to fail." In most cases, insurance schemes protect the small depositors. However, insured depositors must have preferred status over other creditors so that the cost of the insurance system will fall on uninsured depositors and other creditors, which is one way of increasing discipline in the system.

Accounting and Disclosure Standards

Financial Accounting Standard for Banks reporting requirements are fairly comprehensive and roughly in line with international standards (Appendix 1.C). One key exception is that the values of off-balance-sheet items are not marked to market. The external

auditing process is not strictly standardized; some auditing firms are viewed as more lenient and cooperative in disguising potential violations of prudential regulations and are therefore more popular. The Bank Secrecy Code discourages transparency and disclosure in banking. Thus, although a measure of bank soundness—the CAMEL rating compiled by BI—exists, the information is not publicly available.

Recommendation. BI needs its own internal model of the valuation of complex derivative products, which were largely overlooked by supervisors. All off-balance-sheet items should be based on market value in order to correctly reflect their risk profile. The only way to discourage excessive window dressing is to have greater transparency and a tighter external audit process. To this end, the Government should consider watering down the Bank Secrecy Code. Greater public disclosure of bank performance, income, and balance sheet will delegate some of the regulatory responsibilities to the more efficient market. Poorly run and inefficient banks will then automatically be penalized by the general public. Needless to say, to prevent the reporting of misleading or false information, professionalism and integrity of the internal and external auditors also need to be strengthened.

Conclusion

After three attempts to hammer out a feasible reform package, market participants are waiting to see if Indonesia remains committed to the painful but necessary process of consolidating and restructuring its beleaguered financial sector. So far, the Government seems to be sticking to the reform schedule and has announced a broad range of measures. However, a successful rehabilitation of the banking sector requires a consistently tight monetary policy to prevent the rupiah's further slide, and an agreement to resolve the external-debt problem.

Restructuring begins with promoting sector consolidation by raising the capital requirement. Amending the legal framework is equally important, as is changing the way owners and managers view the banking business so that banks will cut down related-party loans. Next, the supervisors need regulatory and supervisory power and independence. Prudent liquidity and credit management of the banks' assets and liabilities can then be promoted. At the same time, a carefully tailored staff training program, together with strengthened accounting and disclosure standards, will ensure better external and internal assessment of banks' performance and risk profile. Finally, a safety net—a deposit insurance system—should be introduced to enhance good governance and to safeguard depositors' interest.

Although there is no quick fix for the country's financial woes, the good news is that the Government is finally addressing the very issues behind the financial sector's chaos and failures. With time and perseverance, the sector will emerge from the crisis on a much firmer footing than before.

Notes

[1]See Lindgren et al. (1996).

[2]See *Bank Indonesia Reports* (1995/96:79), and (1996/97:71).

[3]See *The Banker* (July 1997:140).

[4]See Memorandum of Economic and Financial Policies, IMF (15 January 1998).

[5]Perfindo, the credit-rating agency, estimated in April 1998 that NPLs of commercial banks would rise to 60 percent by end-1998.

[6]See Goldstein and Turner (1996:22).

[7]See Wheelock and Wilson (1995:40).

[8]See Garcia G., *IMF Working Paper 96/83.*

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Appendix 1

Policy and Regulatory Environment

A. Chronology of Regulatory Developments

1953
- Bank Indonesia (BI) is officially set up as the central bank.

1967
- The Banking Act is passed.

7 December 1968
- The Central Bank Act defines the role of the central bank.
- Private local banks consolidate as 24 are ordered to suspend operations temporarily.
- Village banks are to be administered and supervised by Bank Rakyat Indonesia (BRI) with guidelines from BI.

1969–1970
- Multiple exchange rates are unified.
- The Government opens a capital account in line with Article VIII of IMF membership rules.

1974
- 30 percent of foreign private sector borrowings (other than for direct investments) are to be deposited at BI.
- Credit ceilings are imposed and entry of new banks strictly limited.

June 1983
- PAKJUN 1983 comes into effect.
- Credit ceilings are replaced with reserve requirements.
- Interest rates are deregulated.

27 October 1988
- PAKTO 1988 comes into effect.
- Minimum paid-up capital for commercial banks is raised from Rp1 billion to Rp10 billion.
- The requirement for conversion to foreign exchange bank status is eased to Rp100 billion in assets, with Rp80 billion in deposits and Rp75 billion in loans.
- The legal lending limit (LLL) is put in place, although defining it is complicated. It is 20 percent maximum of equity capital to a single borrower and 50 percent of equity capital to groups of affiliated borrowers.
- Opening of existing banks' new branches is facilitated.
- New foreign joint venture banks are encouraged. Minimum paid-in capital is set at Rp50 billion, with foreign ownership allowed up to 85 percent of total.
- State-owned enterprises are allowed to deposit up to half of their excess funds with private banks.
- Reserve requirements are reduced from 15 percent of third-party deposits (effectively 8 percent) to 2 percent.
- Foreign and joint venture banks are required to grant at least 50 percent of total credit as export loans.

20 December 1988
- Minimum paid-up capital for finance companies engaged solely in factoring, consumer finance, or credit cards is set at Rp2 billion for national private companies or cooperatives, and Rp8 billion for joint venture companies.
- Minimum paid-up capital for finance companies engaged exclusively in leasing or venture capital is set at Rp3 billion for national private companies or cooperatives, and Rp10 billion for joint venture companies.
- Minimum paid-up capital for finance companies engaged in more than one business activity is Rp5 billion for private national companies, and Rp15 billion for joint venture companies.

29 January 1990
- PAKJAN 1990 comes into effect.
- Domestic commercial banks are required to extend at least 20 percent of total credit as small-scale business credit (KUK).

28 February 1991
- PAKFEB 1991 comes into effect.
- A prudential regulation package is introduced to cover reporting requirements to BI, treasury activities controls, and new LLL.
- Three years' experience is required for founders, bank directors, and commissioners, and limits are imposed on the number of senior management with close family ties to them.
- Banks are required to spend at least 5 percent of their total personnel budget on training.

November 1991
- Offshore borrowing in the form of foreign commercial borrowings (Pinjaman Komersial Luar Negeri or PKLN) is limited to an aggregate of 30 percent of capital.
- Banks with PKLN are required to allocate 80 percent of such funds for export loans.

25 March 1992
- Banking Act No. 7 replaces the 1968 law.
- Minimum paid-in capital is raised to Rp50 billion for private national banks, and to Rp100 billion for foreign joint venture banks.
- New foreign ownership of joint venture banks is reduced to 49 percent.
- Banks are allowed to issue share capital to the public.
- Banks are required to maintain a capital adequacy ratio (CAR) of 5 percent.

20 April 1992
- Pension Funds Act No. 11 provides for the establishment, administration, and regulation of pension funds.
- The Insurance Law establishes minimum paid-up capital at Rp3 billion for local general insurance companies, Rp2 billion for life insurance companies, Rp10 billion for reinsurance companies, and Rp500 million for insurance or reinsurance brokers. The amount is treble for foreign companies.

29 May 1993
- Banks' CAR is to be raised to 8 percent by end-1993.
- Banks' interbank obligation is not to exceed 100 percent of capital.

August 1994
- BI reorganizes its banking supervision division into five departments: three for commercial bank supervision, one for rural bank supervision, and one for regulation and development.

1995
- The KUK ceiling is raised to Rp350 billion for all banks, including foreign and joint venture banks. Penalties are imposed for noncompliance.
- A self-regulatory banking framework is introduced, under which banks are required to have a written

Continued next page

Appendix 1

Policy and Regulatory Environment (Cont'd)

credit policy covering loan principles, management, and bad-debt settlement.

25 January 1995
- A "fit and proper" test to assess competence, integrity, and qualifications of prospective bank management is introduced.

11 August 1995
- Guidelines on issuance and trading of commercial paper (CP) are established. Commercial banks are prohibited from acting as underwriter of CP, but may act as arranger, issuing agent, or dealer of investment-grade CP with a maximum term of 270 days.

September 1995
- Conditions to convert to foreign exchange banks are tightened as minimum paid-in capital is raised to Rp150 billion and CAR to 9 percent.

3 October 1995
- Financing and venture capital companies are required to be separate.
- Minimum paid-up capital for finance companies is increased to Rp10 billion for national private companies, Rp25 billion for joint ventures, and Rp5 billion for cooperatives, to be fulfilled by October 1998.
- Minimum paid-up capital for venture capital companies is set at Rp3 billion for national private companies, Rp10 billion for joint ventures, and Rp3 billion for cooperatives.

December 1995
- The statutory reserve requirement is raised from 2 to 3 percent.

19 December 1995
- BI is to assist the Ministry of Finance (MOF) in the supervision of finance companies.
- Regulations on finance companies' borrowing limits, guidelines on investment, and reporting requirements are introduced.

21 December 1995
- MOF discontinues issuance of new finance company licenses.

29 December 1995
- Guidelines on derivative transactions are issued. Banks may conduct only derivative transactions on foreign exchange and interest rates.
- Cut-loss is limited to 10 percent of bank capital.
- Banks are required to submit weekly reports on derivative transactions to BI.

3 December 1996
- Government Regulation No. 68 on the revocation of operating licenses, dissolution, and liquidation of banks is promulgated.
- BI is empowered to make recommendations to MOF to revoke the license of problem banks if remedial measures fail. Remedial measures include replacing the management, requesting shareholders to increase capital, writing off bad debts, merging with another bank, selling off the bank to buyers, among others.

28 February 1997
- Pension funds are authorized to invest in mutual funds.

26 March 1997
- PKLN ceiling for all commercial banks is set at $1.5 billion for the year. Commercial banks are required to extend export credit at a minimum of 80 percent of PKLN.
- The CAMEL-rating system is introduced for all banks.

16 April 1997
- The statutory reserve requirement is raised to 5 percent.
- All commercial banks, including foreign and joint venture banks, are required to extend 20 percent of total loans (previously only rupiah loans) to KUK. Fines are to be imposed in case of noncompliance.

2 July 1997
- Commercial banks are no longer allowed to extend new loans for land purchase or property development, except for low-cost housing.
- The value of land is no longer counted as collateral in extending working capital loans to developers.

14 August 1997
- The rupiah exchange rate is allowed to float.
- Public sector enterprises, under instruction from MOF, are to shift deposits from commercial banks to BI.

September 1997
- Commercial banks' CAR is raised from 8 to 9 percent.

1 November 1997
- Sixteen insolvent commercial banks are closed.

31 December 1997
- The Government announces its plan to merge State banks.

1 January 1998
- Small depositors of closed banks are compensated.

27 January 1998
- The Indonesian Bank Restructuring Authority (IBRA) is established as an independent body under MOF to return the banking sector to solvency and to regulate the sector to an internationally accepted standard.
- The Government, through IBRA, guarantees all 212 commercial banks' previous obligations to foreign and domestic depositors/creditors. The guarantee is effective for two years and payment is to be made in rupiah in the event of a claim. Banks will need to pay semiannually to IBRA an annual premium of 0.25 percent of the average monthly amount of guaranteed deposits and obligations.

1 February 1998
- Branch restrictions on foreign banks are lifted.

14 February 1998
- Fifty-four commercial and regional development banks are placed under close supervision of IBRA.

27 February 1998
- New loan classifications are implemented. The overdue period is shortened across the board. Collateral is no longer included in doubtful and loss loans. A new category, "special mention," is introduced.
- Loan-loss provisions (LLP) guidelines are tightened in accordance with the new loan classifications, effective 31 March 1998. General provisions are raised from 0.5 to 1 percent.

- Prudential principles concerning interbank obligations, takeover of claims, and provisions for fund growth are introduced. Banks failing to comply are prohibited from increasing fund growth.
- The ceiling on interest rates for third-party funds is set at 150 percent of Bank Indonesia Certificate (SBI) rates. The value of prizes on deposits is capped at 1 percent of total interest expense.

6 March 1998

- Interest rates on discount facilities are raised to 200 percent of seven-day Jakarta interbank offer rate (JIBOR) for less than seven days, and to 300 percent of seven-day JIBOR for more. Banks are given a maximum 14-day facility limit. Failure to comply results in IBRA supervision.
- The penalty for noncompliance with the minimum reserves is increased to 150 percent of overnight JIBOR rates, and to 200 and 400 percent of overnight JIBOR for noncompliance exceeding 7 and 14 consecutive working days, respectively.
- Negative reserve balance of banks at BI is charged at 500 percent of overnight JIBOR. Unsettled balance results in supervision by IBRA.

23 March 1998

- The one-month SBI interest rate is hiked from 22 to 45 percent.

4 April 1998

- IBRA suspends operations of seven commercial banks and takes over management of seven others.
- BI liquidity support claims are transferred to IBRA.

15 April 1998

- The ceiling on interest rates for third-party funds is reduced to 125 percent of SBI rates.

21 April 1998

- The one-month SBI interest rate is raised to 50 percent.

22 April 1998

- Minimum paid-up capital for banks is to be increased to Rp250 billion, net of LLP, by end-1998.
- LLP are to be fully tax-deductible in FY1998.
- The merger plan of State banks is revised. Only BBD and Bapindo are to merge in June 1998.
- The amendment of the Bankruptcy Law and establishment of a special commercial court is to take effect in 120 days' time.

19 June 1998

- Minimum paid-up capital is reduced to below Rp250 billion.
- Minimum CAR is reduced to 4 percent by end-1998, 8 percent by end-1999, and 10 percent by end-2000.

B. Present Regulatory Requirements

1. Banks

(a) Establishment, licensing, and expansion

- Minimum paid-up capital[a]

State or private national banks	Rp50 billion
Joint venture banks	Rp100 billion
Rural banks	Rp50 billion

- Management
  - – At least 50 percent of the board directors must have operating experience in banking of not less than three years.
  - – Board directors, whether severally or jointly, are prohibited from owning more than 25 percent of another company.
  - – Board commissioners may not hold a similar position in more than three commercial banks.
- For commercial banks to open an additional or subbranch office, a "sound" CAMEL rating must have been achieved for 20 of the previous 24 months and a "fairly sound" rating for the remaining 4 months. The CAR requirement must also have been met for the past two years.
- A non-foreign-exchange bank may convert to foreign exchange status provided it has a minimum paid-up capital of Rp150 billion, a "sound" CAMEL rating for the previous two years, and a CAR of at least 10 percent prior to conversion.
- A non-foreign-exchange bank may obtain a license to trade foreign currencies provided it has a "sound" CAMEL rating for 10 of the previous 12 months and a "fairly sound" rating for the remaining 2 months.

(b) Regulation of business activities

- Statutory reserve requirement. At least 5 percent of a bank's third-party funds are to be deposited at BI.
- KUK. At least 20 percent of total loans are to be allocated to KUK. If not, at least 25 percent of loan growth is to come from KUK. Noncompliance will result in a fine equivalent to 2 percent of the shortfall.
- Foreign banks are required to extend at least half of total loans and at least 80 percent of foreign currency loans as export credits.
- Banks are prohibited from underwriting CP, but may act as arranger, issuing agent, or dealer of investment-grade CP with a maximum term of 270 days.
- Commercial banks are no longer allowed to extend new loans for land purchase or property development, except for low-cost housing.

(c) Prudential requirements

- CAR. 9 percent for all commercial banks, to increase gradually to 10 and 12 percent by end-1999 and end-2001, respectively.
- Legal lending limit (LLL). 20 percent of bank capital for an individual or a group (or listed companies) not affiliated with a bank, and 10 percent for a related party.
- Net open position (NOP). Limited to 25 percent of bank capital for the weekly average net position of both on- and off-balance-sheet positions.
- Loan-deposit ratio (LDR). Maximum of 110 percent.
- Asset quality and LLP

[a] Minimum paid-up capital for all commercial banks has been raised to Rp250 billion, net of loan-loss provisions (LLP) since 22 April 1998. Banks have until end-1998 to fulfill the requirement. This replaces the BI's previous plan to raise the minimum paid-up capital (gross of LLP) to Rp1 trillion and Rp2 trillion by end-1998 and end-2000, respectively.

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Appendix 1

Policy and Regulatory Environment (Cont'd)

Classification	Criteria	Provisioning Requirement (%)
Pass	Interest fully paid	1
Special mention	Interest past due < 90 days	5
Substandard	Interest past due > 90 days	15
Doubtful	Interest past due > 180 days	50
Loss	Interest past due > 270 days	100

- Loans previously classified as "Doubtful" or "Loss," but subsequently rescued, may be categorized as "Substandard" at the highest within six months from the beginning of the rescue program, even though it can fulfill the "Pass" criteria.
- Securities are categorized as "Pass" if in the form of Surat Berharga Pasar Uang or if not yet due. Otherwise, they are classified as "Loss."
- PKLN. Limited to an aggregate of 30 percent of bank capital. Banks with PKLN are to allocate at least 80 percent to export credit.

(d) CAMEL rating

Factor	Weight (%)
Capital	25
Asset quality	30
Management	25
Earnings	10
Liquidity	10

- Capital, asset quality, earnings, and liquidity factors are calculated using the banks' monthly report submitted to BI, while the management factor is derived from on-site examinations and updated by reference to the results of day-to-day supervision and prudential meetings.
- Ratings are classified as "Sound," "Fairly Sound," "Poor," and "Unsound."

(e) Reporting requirements

- All commercial banks are required to report on a weekly, monthly, semiannual, and annual basis to BI.
- Weekly report
  Includes:
  - reserve requirements;
  - consolidated deposits and specific items of balance sheet;
  - profit/loss statement of derivative transactions;
  - foreign exchange NOP.
- Monthly report
  Includes:
  - balance sheet and profit/loss statement by bank offices;
  - credit reports by bank offices;
  - violation of LLL by bank head offices.
- Semiannual report
  Includes:
  - report of the board of commissioners on the bank's work program progress;
  - published financial statement.
- Annual report
  Includes:
  - audited report by registered accounting firms and a management letter.

2. Finance companies

(a) Establishment and licensing

- Minimum paid-up capital
  - Leasing, factoring, consumer financing, credit card

National private companies	Rp10 billion
Joint ventures	Rp25 billion
Cooperatives	Rp5 billion

  - Venture capital

National private companies	Rp3 billion
Joint ventures	Rp10 billion
Cooperatives	Rp3 billion

(b) Regulation of business activities

- Amount of borrowing is not to exceed 15 times equity capital (net worth) minus participation.
- Maximum overseas borrowing is five times net worth.
- Finance companies are not allowed to engage in securities trading.
- They are not allowed to draw funds directly from the public in the form of deposits or promissory notes. They are prohibited from issuing promissory notes except as collateral against bank debt.
- They are allowed to participate only in a company engaged in the financial sector, with participation not exceeding 25 percent of the paid-up capital of the company concerned and the total amount of participation limited to 40 percent of net worth of the finance company.

(c) Reporting requirements

- Finance companies (except venture capital companies) are required to submit to MOF, with a copy to BI, the following:
  - monthly financial report;
  - quarterly business activity report;
  - annual financial report audited by a public accountant.
- Venture capital companies are obliged to submit the following to MOF:
  - semiannual operational and financial reports;
  - annual financial report audited by a public accountant.

3. Insurance companies

(a) Establishment and licensing

- Minimum paid-up capital
  - General insurance

National private companies	Rp3 billion
Foreign companies	Rp15 billion

  - Life insurance

National private companies	Rp2 billion
Foreign companies	Rp4.5 billion

  - Reinsurance

National private companies	Rp10 billion
Foreign companies	Rp30 billion

  - Insurance/reinsurance broker

National private companies	Rp500 million
Foreign companies	Rp3 billion

(b) Regulation of business activities
- Insurance companies are permitted to invest assets in time deposits, promissory notes, SBIs, money market instruments, listed stocks and bonds, direct equity, properties and mortgages, as well as loans to policyholders.
- Their maximum retention limit is set relative to the net worth of each insurance coverage or for the company as a whole.
- Insurance companies are not allowed to participate in insurance-supporting companies or in offshore investment, except in another insurance company.
- They are not allowed to conduct derivatives transactions, including commodities and currency futures.

(c) Reporting requirements
- Insurance and reinsurance companies are required to submit the following to MOF:
  - quarterly financial report,
  - annual financial report audited by a public accountant.

4. Pension funds

(a) Establishment
- Employer-managed pension funds
  - They must be established as a separate entity with assets properly segregated from those of the founder.
  - Those implementing a defined benefit pension plan, in which the benefits to an employee are based upon a pay-out schedule to be met by the employer, must appoint an administrator, a supervisory board, a custodian, an auditor, and an actuary.
  - Pensionable earnings are capped at Rp5 million per annum per employee.
  - The employer's maximum annual contribution on behalf of an employee is 20 percent of annual pensionable earnings.
- Financial institution pension funds (FIPF)
  - They must have a defined contribution plan in which employees' benefits are limited to the return on investments made by the pension fund.
  - Maximum annual contribution is 20 percent of personal earnings.
  - Employees covered by employer-managed funds may join an FIPF, with the maximum annual contribution limited to 10 percent of earnings.

(b) Regulation of fund activities
- Pension funds are permitted to invest assets in time deposits and CDs, money market instruments, mutual funds, listed securities (except options and warrants), unlisted equity, certificates of indebtedness, land, and buildings.
- They are not allowed to place deposits with affiliated banks or to purchase money market instruments of affiliated companies.
- They are prohibited from investing outside Indonesia.
- Contributions are tax-deductible, while benefits paid to members are taxable.
- In the case of a defined benefit pension plan, the supervisory board is to monitor the administrator's management of the pension fund, and to submit written annual reports on the results of their findings to the founder.

(c) Reporting requirements
- Employer-managed pension funds must file an actuarial report with MOF at least once every three years, or in the event of an amendment in the regulations specifying required benefits.
- The actuarial report must state:
  - contributions required for funding the pension plan,
  - asset adequacy for the payment of benefits,
  - additional contributions required to cover any shortfall.

C. Accounting system

1. Standards
- Financial Accounting Standard for Banks (FASB, Statement No. 31), which is based on General Accepted Accounting Principles and the International Accounting Standards, includes a compilation of accounting principles, procedures, methods, and techniques. It covers accounting for assets, liabilities, capital, commitments and contingencies, revenues and expenses, and bank financial statements. Banks are required to apply FASB in all financial reports.
- For derivatives transactions, banks are required to submit weekly reports on gains or losses, either realized or unrealized, and the net position of derivative transactions, in compliance with the Special Standard for Indonesian Banking, drawn up in reference to the Basle / International Organization of Securities Commission's framework.

2. Audit

(a) Internal
- Banks are to adopt the internal audit function stipulated in the Standard Practices for Bank Internal Audit Function, which requires banks to do the following:
  - formulate an Internal Audit Charter,
  - establish an Audit Committee,
  - establish an Internal Audit Unit,
  - formulate Internal Audit Guidelines.
- Compliance with standard practices is monitored by BI.

(b) External
- All banks are subject to external audit by certified public accountants registered with BI. State banks are also subject to additional audit by the Financial and Development Supervisory Board.

3. Disclosure
- Banks are required to publish annual consolidated financial statements that include the following:

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Appendix 1

Policy and Regulatory Environment (Cont'd)

- balance sheet,
- profit and loss,
- off-balance-sheet statement,
- other information, including list of ownership, board of management and commissioners, audit committee, and the disclosure on each item in the published statements.

- The Capital Market Supervisory Agency (Bapepam) administers disclosure requirements with respect to publicly listed banks.
- Finance (including venture capital) companies are obliged to publish the balance sheet and brief profit-and-loss statement annually in at least one widely circulated daily newspaper within three months after the end of each financial year.
- Insurance companies are obliged to publish annual reports in the newspapers.

D. Financial Management System

1. Risk management

- BI has introduced the concept of self-regulation within the banking industry to help ensure the implementation of prudent banking practices. In particular, banks are expected to take into account the following types of risk:
  - liquidity risk,
  - market risk,
  - credit risk,
  - operational risk,
  - legal risk,
  - ownership and management risk.

2. Liquidity management

- Banks' liquidity positions are monitored based on the following:
  - LDR,
  - net obligations of interbank call money/liquid assets,
  - maturity profiles,
  - day-to-day interbank clearing with BI and money market securities dealing,
  - day-to-day bank statutory reserve at BI (minimum of 5 percent).
- Overall bank liquidity positions are consolidated from branches and subsidiaries.

E. Payment, Clearing, and Settlement Systems

- BI is setting forth guidelines for a national payment system, which will focus on three components: large value transfer system, intercity clearing, and retail payment. All transaction settlements originating from them will be processed through an integrated system operated by BI to enable commercial banks to better monitor and control their demand deposits with BI.
- As of 1997, interbank clearing in Indonesia was still paper-based and held in 103 local clearing regions. Processing was undertaken by BI, or, in the absence of a BI regional office, by an appointed regional commercial bank. A same-day settlement schedule was introduced in Jakarta in 1997. Processing is divided into three categories:
  - automatic local clearing: Jakarta, Medan, and Surabaya;
  - semiautomatic local clearing: in 50 cities;
  - manual local clearing: in 50 cities.
- The Jakarta Electronic Clearing System was implemented in 1998. Electronic clearing will be supported by a paper-based system operating with image technology. Settlements among participating banks within Jakarta will be managed by the central clearing computer through an electronic network to provide a fast, accurate, and secure clearing process.
- BI has begun drafting regulations on electronic fund transfer (EFT) to support a system for electronic and non-paper-based payments.
- An on-line accounting system is being developed between BI and commercial banks to facilitate intrabank, interbank, and intercity electronic transfers by banks through BI.

Sources: Bank Indonesia and Ministry of Finance.

Appendix 2

Top 20 Commercial Banks' Global and Regional Ranking

Global Ranking	Asian Ranking	Bank	Tier-1 Capital $ million	Tier-1 Capital % change[a]	Assets $ million	Assets % change[a]	Domestic Rank by Asset	ROA (%)	Cost/Income (%)	BIS CAR (%)
257	40	Bank Negara Indonesia	1,151	81.5	14,856	(6.2)	2	1.34	57.90	11.82
383	65	Bank Central Asia	745	12.2	15,374	35.6	1	0.72	64.22	9.53
377	67	Bank Rakyat Indonesia	698	0.8	14,656	20.5	3	1.00	81.40	8.69
413	71	Bank Dagang Negara	663	15.2	13,781	9.4	4	0.99	69.67	na
454	79	Bank Bumi Daya	604	28.5	10,443	10.2	6	0.42	82.05	11.48
462	80	Bank Ekspor Impor Indonesia	593	22.7	10,988	17.1	5	1.13	61.72	10.74
506	88	Bank Tabungan Indonesia	521	7.1	4,839	18.9	11	1.67	17.20	na
552	107	Bank Internasional Indonesia	470	24.4	7,541	35.9	8	2.08	54.70	8.72
599	127	Bank Dagang Nasional Indonesia	416	(8.6)	7,092	33.9	9	1.63	48.15	8.50
629	136	Lippo Bank	386	79.3	4,337	33.5	12	1.58	62.90	13.20
650	139	Bank Danamon	365	22.5	9,436	58.0	7	1.27	54.00	10.28
686	141	Bapindo	334	4.7	6,361	(6.9)	10	0.06	na	na
828	159	Bank Bali	239	2.1	340	26.3	13	2.24	63.75	10.92
835	161	Bank Niaga	235	107.8	3,353	19.5	14	1.78	52.75	10.75
850	162	Panin Bank	230	10.9	2,289	28.8	16	2.18	36.03	14.87
868	166	Bank Umum Nasional	219	67.4	3,044	19.4	15	1.35	57.40	10.90
958	173	Bank Duta	184	3.7	2,248	60.5	17	1.34	65.05	14.00
na	188	Bank Tiara	115	10.8	924	64.6	20	2.72	44.96	11.51
na	195	Bank Bukopin	94	9.5	1,449	32.9	18	0.94	72.57	13.50
na	198	Tamara Bank	86	59.0	1,232	40.5	19	1.73	88.23	14.71

( ) = negative values are enclosed in parentheses.
na = not available, BIS = Bank for International Settlements, CAR = capital adequacy ratio, ROA = return on assets.
[a] year-on-year.
Source: *The Banker,* July and October 1997, based on December 1996 reported figures, except for Bapindo (December 1994).

Appendix 3: Selected Statistics on Banks and Nonbank Financial Institutions

Table A3.1: Commercial Bank Credit Collectibility, 1994–1998

	1994		1995		1996		1997		Jan 1998	
Bank Type and Loan Classification	Rp trillion	% share	Rp trillion	% share	Rp trillion	% share	Rp trillion	% share	Rp trillion	% share
All Commercial Banks	217.02		267.81		331.29		444.96		645.67	
Current	190.85	87.9	239.92	89.6	302.17	91.2	412.78	92.8	594.73	92.1
NPL	26.17	12.1	27.89	10.4	29.12	8.8	32.18	7.2	50.94	7.9
Substandard	7.30	3.4	7.36	2.7	8.55	2.6	11.72	2.6	20.35	3.2
Doubtful	10.20	4.7	11.73	4.4	11.07	3.3	11.38	2.6	18.36	2.8
Loss	8.66	4.0	8.80	3.3	9.50	2.9	9.09	2.0	12.23	1.9
State Banks	104.13		120.86		138.88		198.06		285.30	
Current	84.73	81.4	100.84	83.4	120.23	86.6	176.06	88.9	251.94	88.3
NPL	19.40	18.6	20.03	16.6	18.65	13.4	22.00	11.1	33.36	11.7
Private National Banks	90.09		116.93		157.46		187.46		254.45	
Current	85.26	94.6	111.22	95.1	149.42	94.9	180.66	96.4	243.33	95.6
NPL	4.82	5.4	5.72	4.9	8.04	5.1	6.80	3.6	11.12	4.4
Regional Development Banks	4.39		5.61		7.19		10.76		13.89	
Current	3.52	80.1	4.71	83.8	6.22	86.5	9.59	89.1	12.60	90.8
NPL	0.88	19.9	0.91	16.2	0.97	13.5	1.17	10.9	1.28	9.2
Joint Venture Banks	10.91		14.44		15.99		29.17		55.67	
Current	10.02	91.9	13.41	92.8	14.85	92.9	27.60	94.6	52.49	94.3
NPL	0.89	8.1	1.03	7.2	1.14	7.1	1.57	5.4	3.18	5.7
Foreign Banks	7.50		9.96		11.76		19.52		36.37	
Current	7.32	97.5	9.76	98.0	11.44	97.2	18.88	96.7	34.37	94.5
NPL	0.19	2.5	0.20	2.0	0.32	2.8	0.64	3.3	2.00	5.5
All Rural Banks	1.56		1.88		2.14		2.21		2.21	
Current	1.20	76.8	1.43	75.7	1.62	75.6	1.66	74.9	1.66	74.9
NPL	0.36	23.2	0.46	24.3	0.52	24.4	0.56	25.1	0.56	25.1

NPL = nonperforming loan.
Source: Bank Indonesia.

Appendix 3

Table A3.2: Commercial Bank Performance Indicators, 1993–1998 (%)

Performance Indicator	1993	1994	1995	1996	1997	Jan 1998
Return on Assets						
All Commercial Banks	1.04	0.62	1.13	1.22	1.37	2.01
State Banks	0.95	(0.30)	0.50	0.90	1.14	1.55
Private FX Banks	1.17	1.47	1.41	1.51	1.02	1.56
Private Non-FX Banks	0.20	0.80	0.39	0.36	1.15	1.27
Regional Development Banks	1.87	1.60	2.23	2.40	1.80	2.52
Joint Venture Banks	2.01	1.53	2.56	2.55	2.67	3.47
Foreign Banks	0.96	3.23	4.62	4.40	5.71	9.08
Return on Equity						
All Commercial Banks		2.95	16.14	16.38	19.06	28.04
State Banks		(4.75)	10.78	15.18	21.80	30.71
Private FX Banks		12.03	17.95	15.04	13.53	21.08
Private Non-FX Banks		3.31	3.15	3.79	11.19	12.03
Regional Development Banks		13.43	25.30	27.89	21.55	30.56
Joint Venture Banks		5.98	20.17	20.19	20.73	30.11
Foreign Banks		20.30	40.08	35.67	53.01	96.92
Efficiency (Cost/Income)						
All Commercial Banks	90	95	92	92	95	96
State Banks	92	104	96	93	94	96
Private FX Banks	91	90	92	94	97	97
Private Non-FX Banks	96	95	98	98	92	96
Regional Development Banks	88	89	85	85	95	85
Joint Venture Banks		85	81	80	84	82
Foreign Banks		80	75	75	86	90
Capital Adequacy Ratio						
All Commercial Banks	9.90	12.50	11.85	11.82	9.19	6.93
State Banks	2.50	10.50	13.72	14.09	7.77	6.08
Private FX Banks	9.40	13.10	9.87	9.38	9.60	7.18
Private Non-FX Banks	9.40	15.50	10.48	11.83	17.55	17.84
Regional Development Banks	12.10	11.40	12.64	13.74	11.45	13.00
Joint Venture Banks	16.50	21.80	15.47	15.93	11.21	6.83
Foreign Banks[a]	10.40	11.90	11.91	13.68	12.76	12.76
Loan Deposit Ratio						
All Commercial Banks	78.50	81.20	81.07	78.31	82.58	85.24
State Banks	81.70	80.20	79.64	75.63	83.38	79.27
Private FX Banks	81.50	82.90	82.11	80.35	83.55	93.31
Private Non-FX Banks	73.60	88.20	88.02	82.94	86.22	87.67
Regional Development Banks	59.50	56.70	54.89	56.22	53.65	44.29
Joint Venture Banks	81.80	81.80	89.85	86.81	107.73	115.79
Foreign Banks	92.60	83.30	84.85	80.54	60.33	63.81

( ) = negative values are enclosed in parentheses, FX = foreign exchange.
[a] Latest data are for August 1997.
Source: Bank Indonesia.

Appendix 3

Table A3.3: Estimation of Recapitalization Cost of Commercial Banks, End-March 1998

Item	Amount (Rp trillion)
Industry Bank Loans	476.8
In Rupiah	286.9
In Dollar	189.9
Total Assets	737.6
Risk-weighted Assets (assumed 90% of total)	663.8
Industry Capital	44.2
Industry CAR (%)	6.7
NPL (assumed 65%)	309.9
Cash Collateral Coverage (assumed 15% of NPL)	46.5
Provisions for NPL[a]	132.5
Current LLP	9.5
Write-off to Capital	123.0
Net Capital Deficit	(78.8)
Required Capital for 9% CAR	59.7
Total Cost of Recapitalization	**138.5**

( ) = negative values are enclosed in parentheses.
CAR = capital adequacy ratio, LLP = loan-loss provision, NPL = nonperforming loan.
[a] NPL provisions in accordance with latest BI regulations (see Appendix 1. B. 1c), current LLP around 3 percent.
Sources: Bank Indonesia; Merill Lynch.

Table A3.4: Performance of 200 Largest Banks, End-June 1997 (%)

Type of Bank	ROA	ROE	NIM	CAR	LDR
Top 200	1.15	10.02	2.55	14.63	97.71
State Banks	0.69	6.84	1.51	10.23	95.02
Private Banks	1.12	7.91	2.56	15.15	96.79
Foreign Banks	2.05	50.6	2.98	7.74	116.35

CAR = capital adequacy ratio, LDR = loan-deposit ratio, NIM = net interest margin, ROA = return on assets, ROE = return on equity.
Source: Infobank.

Appendix 3

Table A3.5: Commercial Bank Credit by Sector, 1990-1997 (Rp trillion)

Sector	1990	1991	1992	1993	1994	1995	1996	1997
Total	**96.98**	**112.83**	**122.92**	**150.27**	**188.88**	**234.61**	**292.92**	**378.13**
Agriculture	**7.18**	**8.47**	**10.28**	**12.06**	**13.86**	**15.53**	**17.63**	**26.00**
(% of total)	7.4	7.5	8.4	8.0	7.3	6.6	6.0	6.9
(% change)	35.8	18.0	21.5	17.3	15.0	12.0	13.6	47.5
Rupiah	6.88	7.98	9.17	10.37	12.03	13.66	15.16	20.34
Foreign Currency	0.29	0.49	1.11	1.69	1.83	1.86	2.47	5.66
Manufacturing	**30.50**	**33.13**	**37.29**	**51.43**	**60.21**	**72.09**	**78.85**	**111.68**
(% of total)	31.5	29.4	30.3	34.2	31.9	30.7	26.9	29.5
(% change)	50.0	8.6	12.6	37.9	17.1	19.7	9.4	41.6
Rupiah	25.00	24.83	26.20	36.33	42.24	48.48	51.98	56.12
Foreign Currency	5.50	8.30	11.09	15.10	17.98	23.61	26.87	55.56
Mining	**0.62**	**0.74**	**0.76**	**0.78**	**0.80**	**0.91**	**1.69**	**5.32**
(% of total)	0.6	0.7	0.6	0.5	0.4	0.4	0.6	1.4
(% change)	4.1	19.4	2.6	2.6	2.6	13.4	85.7	214.8
Rupiah	0.57	0.61	0.61	0.42	0.36	0.43	0.72	2.77
Foreign Currency	0.05	0.13	0.16	0.36	0.44	0.48	0.98	2.55
Trade	**29.74**	**33.05**	**32.94**	**37.79**	**44.37**	**54.22**	**70.59**	**82.26**
(% of total)	30.7	29.3	26.8	25.2	23.5	23.1	24.1	21.8
(% change)	47.9	11.1	(0.3)	14.7	17.4	22.2	30.2	16.5
Rupiah	27.27	28.84	28.10	31.47	36.84	43.61	55.76	57.47
Foreign Currency	2.47	4.21	4.84	6.32	7.53	10.62	14.82	24.79
Services	**17.21**	**20.07**	**25.87**	**35.82**	**50.81**	**66.58**	**91.66**	**113.57**
(% of total)	17.7	17.8	21.0	23.8	26.9	28.4	31.3	30.0
(% change)	65.1	16.6	28.9	38.5	41.8	31.1	37.7	23.9
Rupiah	14.26	16.68	21.98	30.17	42.45	57.43	78.39	85.60
Foreign Currency	2.95	3.38	3.89	5.66	8.35	9.15	13.26	27.97
Others	**11.74**	**17.37**	**15.77**	**12.39**	**18.83**	**25.28**	**32.51**	**39.30**
(% of total)	12.1	15.4	12.8	8.2	10.0	10.8	11.1	10.4
(% change)	71.0	48.0	(9.2)	(21.5)	52.0	34.2	28.6	20.9
Rupiah	11.17	16.33	14.84	12.37	18.82	25.27	32.48	39.23
Foreign Currency	0.57	1.05	0.93	0.01	0.01	0.01	0.03	0.07

( ) = negative values are enclosed in parentheses.
Source: Bank Indonesia.

Appendix 3

Table A3.6: Commercial Bank Assets and Liabilities, 1991–1997[a] (Rp trillion)

Item	1991	1992	1993	1994	1995	1996	1997
Assets	169.54	195.73	291.27	333.71	413.80	506.87	664.21
State Banks	91.75	108.63	152.35	160.35	187.12	211.56	262.71
(% change)		18.4	40.2	5.3	16.7	13.1	24.2
(% of total assets)	54.1	55.5	52.3	48.0	45.2	41.7	39.6
Private National Banks	60.03	65.83	108.02	136.73	179.50	240.20	322.18
(% change)		9.7	64.1	26.6	31.3	33.8	34.1
(% of total assets)	35.4	33.6	37.1	41.0	43.4	47.4	48.5
FX Banks	47.10	53.32	93.39	118.61	157.68	212.91	291.36
Non-FX Banks	12.93	12.51	14.63	18.13	21.82	27.29	30.81
Regional Development Banks	4.83	5.50	6.94	8.74	11.19	13.10	15.40
Joint Venture Banks	6.13	8.25	13.91	16.96	21.62	24.62	35.62
Foreign Banks	6.80	7.53	10.05	10.93	14.37	17.40	28.31
Credit	121.39	130.89	177.47	217.02	267.81	331.29	439.98
(% change)		7.8	35.6	22.3	23.4	23.7	32.8
(% of total assets)	71.6	66.9	60.9	65.0	64.7	65.4	66.2
State Banks	67.85	77.61	94.14	104.13	120.86	138.88	175.15
(% change)		14.4	21.3	10.6	16.1	14.9	26.1
(% of total credit)	55.9	59.3	53.0	48.0	45.1	41.9	39.8
Private National Banks	42.20	40.95	65.02	90.09	116.93	157.46	212.92
(% change)		(3.0)	58.8	38.5	29.8	34.7	35.2
(% of total credit)	34.8	31.3	36.6	41.5	43.7	47.5	48.4
Regional Development Banks	2.68	3.03	3.56	4.39	5.62	7.19	10.17
Joint Venture Banks	3.42	4.13	8.40	10.91	14.44	15.99	23.98
Foreign Banks	5.24	5.18	6.34	7.50	9.96	11.76	17.76
Rupiah	103.52	108.76	133.13	167.22	205.01	252.04	300.60
(% change)		5.1	22.4	25.6	22.6	22.9	19.3
(% of total credit)	85.3	83.1	75.0	77.1	76.6	76.1	68.3
State Banks	60.35	67.50	71.96	82.43	95.14	109.69	125.70
Foreign Currency	17.87	22.13	44.34	49.80	62.79	79.25	139.30
(% change)		23.9	100.4	12.3	26.1	26.2	75.8
(% of total credit)	14.7	16.9	25.0	22.9	23.4	23.9	31.7
State Banks	7.49	10.10	22.18	21.70	25.72	29.20	49.45
Liabilities							
Deposits	95.12	111.43	160.60	187.61	235.50	303.21	373.61
(% change)		17.2	44.1	16.8	25.5	28.8	23.2
(% of total liabilities)	56.1	56.9	55.1	56.2	56.9	59.8	56.2
State Banks	41.81	52.60	73.60	76.74	94.93	109.28	140.04
(% change)		25.8	39.9	4.3	23.7	15.1	28.1
(% of total deposits)	43.96	47.20	45.83	40.91	40.31	36.04	37.48
Private National Banks	43.14	47.67	73.54	93.67	119.18	167.62	197.28
(% change)		10.5	54.3	27.4	27.2	40.6	17.7
(% of total deposits)	45.36	42.78	45.79	49.93	50.61	55.28	52.80
Regional Development Banks	3.23	3.70	4.78	6.18	7.81	8.52	8.54
Joint Venture Banks	1.73	1.64	2.18	3.38	4.30	5.23	7.78
Foreign Banks	5.21	5.83	6.50	7.64	9.28	12.56	19.98
Rupiah	74.10	86.70	114.09	134.81	170.72	225.67	241.02
(% change)		17.0	31.6	18.2	26.6	32.2	6.8
(% of total deposits)	77.90	77.80	71.04	71.86	72.49	74.43	64.51
Foreign Currency	21.02	24.74	46.52	52.80	64.78	77.53	132.53
(% change)		17.7	88.1	13.5	22.7	19.7	70.9
(% of total deposits)	22.10	22.20	28.96	28.14	27.51	25.57	35.47

( ) = negative values are enclosed in parentheses.
FX = foreign exchange.
[a] End of period for 1991–1996; as of October for 1997.
Source: Bank Indonesia.

Table A3.7: Number of Banks and Bank Offices, 1992–1997[a]

Type of Bank	1992			1993			1994			1995			1996			1997		
	No. of Banks	No. of Offices	BRI Unit Offices	No. of Banks	No. of Offices	BRI Unit Offices	No. of Banks	No. of Offices	BRI Unit Offices	No. of Banks	No. of Offices	BRI Unit Offices	No. of Banks	No. of Offices	BRI Unit Offices	No. of Banks	No. of Offices	BRI Unit Offices
Commercial Banks	**208**	**5,495**		**234**	**5,773**		**240**	**6,026**		**240**	**6,590**		**239**	**7,314**		**222**	**7,377**	
State Banks	7	1,434	3,195	7	1,455	3,267	7	1,490	3,267	7	1,635	3,512	7	1,707	3,595	7	1,762	3,647
Private FX Banks	40	2,258		50	2,699		60	2,918		75	3,335		77	3,865		76	4,015	
Private Non-FX Banks	104	1,127		111	902		106	887		90	825		87	903		68	722	
Regional Dev Banks	27	613		27	639		27	645		27	705		27	745		27	779	
Joint Venture Banks	20	31		29	45		30	50		31	52		31	55		34	58	
Foreign Banks	10	32		10	33		10	36		10	38		10	39		10	41	
Rural Credit Banks	**8,835**			**9,032**			**9,196**			**9,271**			**9,310**			**9,348**		
Rural Banks	1,512			1,709			1,873			1,948			1,987			2,116		
Village Finance Entities	7,323			7,323			7,323			7,323			7,323			7,232		

BRI = Bank Rakyat Indonesia, FX = foreign exchange.
[a] End of period.
Source: Bank Indonesia.

Table A3.8: Number of Commercial Bank Offices by Province, June 1997

Type of Office	Sumatra	Java	Kalimantan	Sulawesi	Others	Total
Head Offices	9	202	4	5	9	229
Branch Offices	531	1,662	181	210	229	2,813
Subbranch Offices	290	2,483	65	119	168	3,125
Payment Point	226	991	40	29	94	1,380
Total	**1,056**	**5,338**	**290**	**363**	**500**	**7,547**

Source: Bank Indonesia.

Appendix 3

Table A3.9: NBFI Sector Profile, 1991–1997[a]

Item	1991	1992	1993	1994	1995	1996	1997
Total Assets (Rp trillion)	8.4	19.1	29.7	42.5	58.3	77.1	
(% change)		127.6	55.6	42.8	37.2	32.4	
Finance Companies							
Number of Firms	136	150	176	206	254	252	
Total Business (Rp trillion)	5.8	6.2	9.1	16.8	25.9	26.6	
Leasing	3.9	3.7	4.6	6.0	8.5	12.1	
Factoring	0.3	0.8	2.2	5.3	11.7	8.0	
Consumer Financing	1.6	1.5	2.2	4.5	5.4	6.4	
Credit Card	0.0	0.2	0.1	1.0	0.3	0.1	
Financial Position (Rp trillion)							
Assets	8.4	10.1	11.9	19.1	23.9	33.6	
Equity	1.1	1.6	2.0	3.3	4.2	8.2	
Net Investment	5.2	7.8	9.2	14.8	18.7	26.7	
Outward Borrowing (Rp trillion)	10.6	6.1	7.3	12.6	17.6	23.7	
Domestic	4.1	2.8	3.8	7.2	10.4	12.9	
Foreign	6.5	3.3	3.5	5.4	7.2	10.8	
Venture Capital Companies							
Number of Companies				20	33	43	
Private National				7	10	12	
Joint Venture				7	7	11	
Local				6	16	20	
Number of Investee Companies				47	154	527	
Private National				25	39	44	
Joint Venture				12	7	1	
Local				10	108	482	
Business Activity (Rp billion)				49.6	117.8	41.9	
Private National				27.7	99.0	19.1	
Joint Venture				21.4	14.0	0.1	
Local				0.5	4.8	22.7	
Insurance Companies							
Number of Companies		145	145	150	160	163	171
Life		46	46	49	53	56	58
State-owned		1	1	1	1	1	1
Private National		39	38	40	37	38	38
Joint Venture		6	7	8	15	17	19
Nonlife		90	90	92	98	98	103
State-owned		2	2	2	3	3	3
Private National		75	74	75	78	77	79
Joint Venture		13	14	15	17	18	21
Reinsurance		4	4	4	4	4	5
State-owned		2	2	2	1	1	2
Private National		2	2	2	3	3	3
Social and Jamsostek		2	2	2	2	2	2
Civil Service and Armed Forces		3	3	3	3	3	3
Assets (Rp trillion)		9.0	11.3	14.4	17.3	22.1	
Life		1.2	2.4	4.0	4.9	7.3	
Nonlife		2.2	2.6	3.1	4.3	5.0	
Reinsurance		0.6	0.7	0.8	0.4	0.5	
Social and Jamsostek			2.3	2.9	3.6	4.9	
Civil Service and Armed Forces			3.3	3.6	4.0	4.4	
Investments (Rp trillion)		7.2	8.8	10.7	13.4	18.0	
Life		1.5	1.8	2.6	3.4	5.7	
Nonlife		1.4	1.5	1.9	2.8	3.5	
Reinsurance		0.4	0.5	0.5	0.3	0.3	
Social and Jamsostek			2.0	2.6	3.4	4.6	
Civil Service and Armed forces			3.0	3.1	3.7	4.0	
Pension Funds							
Assets (Rp trillion)			6.6	8.9	17.0	21.4	
Employee Sponsored			6.5	8.8	10.6	13.0	
Financial Institution			0.0	0.1	0.2	0.3	
Civil Service					6.2	7.1	
Armed Forces						1.0	

NBFI = nonbank financial institution.
[a] End of period for 1991–1996; as of August for 1997.
Source: Bank Indonesia.

Appendix 4

Banks Under the Indonesian Bank Restructuring Agency

CATEGORY A

Liquidity support needed in excess of 500 percent of total equity and equal to or in excess of 75 percent of total assets.

Action to be taken
The immediate freezing of the bank's operations, transfer of all liabilities to a healthy bank, suspension of shareholders' rights, and replacement of management. The Indonesian Bank Restructuring Agency (IBRA) will function in place of the former shareholders with full control over the bank.

Banks suspended
- Centris Bank
- Deka Bank
- Hokindo Bank
- Bank Kredit Asia
- Bank Pelita
- Bank Subentra
- Bank Surya

CATEGORY B

Liquidity support needed in excess of Rp2 trillion and in excess of 500 percent of total equity.

Action to be taken
The immediate suspension of shareholders' rights and replacement of management. IBRA will function in place of the former shareholders, and a governance contract is to be drawn up with a State-owned financial institution to provide new management with full control over the bank.

Banks under management[a]
- *Bank Eksim*
- Bank Danamon Indonesia
- Modern Bank
- Bank Dagang Nasional Indonesia (BDNI)
- Bank PDFCI
- Bank Umum Nasional
- Bank Tiara Asia

CATEGORY C

Liquidity support needed in excess of 500 percent of total equity or in excess of 50 percent of total assets.

Action to be taken
Foreign exchange, derivatives, or other important transactions curtailed and strong supervision put in place through on-the-ground presence by IBRA officials.

CATEGORY D

Liquidity support in excess of 200 percent of total equity or a capital adequacy ratio of less than 5 percent.

Action to be taken
Intensive supervision by IBRA staff.

Banks under supervision

3 State banks
- Bank Bumi Daya (BBD)
- Bank Pembangunan Indonesia (Bapindo)
- Bank Dagang Negara (BDN)

11 regional development banks
- BPD NTB
- BPD Sumatera Utara
- BPD Aceh
- BPD Sumatera Selatan
- BPD Lampung
- BPD Kalimantan Barat
- BPD Maluku
- BPD Jawa Timur
- BPD NTT
- BPD Sulut
- BPD Sulteng

26 private national banks
- Bank Aken
- Indomitra Development Bank
- Bank Danahutama
- Bank Baja Internasional
- Bank Intan
- Bank Putra Surya Perkasa
- Bank Sewu
- Bank Tabungan Pensiun Nasional
- Bank Dewa Rutji
- Bank Dagang dan Industri
- Bank Tata
- Bank Indonesia Raya
- Bank Patriot
- Bank Central Dagang
- Bank Ficorinvest
- Bank Lautan Berlian
- Bank Uppindo
- Bank Papan Sejahtera
- Bank Asia Pacific
- Bank Pesona Kriya Dana (Bank Utama)
- *Bank Nasional*
- *Bank Nusa Internasional*
- *Bank Sri Partha*
- *Bank Umum Servitia*
- *Bank Kharisma*
- *Bank Nasional Komersial*

[a] Banks in italics are expected to exit from IBRA management or supervision soon due to merger plans or additional capital injection, enabling them to meet capital adequacy and liquidity facility requirements. Of the State banks, BBD and Bapindo will merge, while Bank Eksim is set to receive additional capital through the Government equity scheme. Of the private national banks, Bank Kharisma, Bank Nasional Komersial, Bank Umum Servitia, and Bank Sri Partha have already met the capital adequacy ratio of over 5 percent and liquidity facility requirements, and were no longer under IBRA care as of 22 April 1998. Bank Nasional and Bank Nusa Internasional proposed to merge with Bank Angkasa and Bank Komersial, which will enable them to leave the IBRA soon.
Source: IBRA, Press Release, 4 April 1998.

Appendix 5

Banking Policy Commitments Under the International Monetary Fund Program

Policy Action to be Implemented	Target Date
1. Continue to take control of or freeze banks that fail to meet liquidity or solvency criteria (see Appendix 1.B.1). Where necessary, any such action will be accompanied by measures to protect depositors or creditors in line with the Government guarantee. This is the job of the Indonesian Bank Restructuring Agency (IBRA).	Over program period
2. Reduce the minimum capital requirements for existing banks.	19 June 1998
3. Issue a presidential decree to provide appropriate legal powers to IBRA, including its Asset Management Unit.	30 June 1998
4. Establish an independent review committee to enhance transparency and credibility of IBRA operators.	30 June 1998
5. Amend the banking law in order to remove the limit on private ownership of banks.	30 June 1998
6. Merge and conduct portfolio reviews of two State banks.	30 June 1998
7. Draft legislation enabling State bank privatization.	30 June 1998
8. Submit to Parliament a draft law to eliminate restrictions on foreign investments in listed banks and amend bank secrecy laws with regard to nonperforming loans.	30 June 1998
9. Update the reporting and monitoring procedures for foreign exchange exposure of banks.	30 June 1998
10. Appoint high-level foreign advisers to Bank Indonesia (BI) to assist in the conduct of monetary policy.	30 June 1998
11. Establish a Financial Sector Advisory Committee to advise on bank restructuring.	30 June 1998
12. Declare the insolvency of six private banks the Government intervened in April and write down shareholder equity.	mid-July 1998
13. Freeze, merge, recapitalize, or liquidate the six banks for which audits have already been completed.	mid-July 1998
14. Announce the restructuring of State banks through mergers, transfer of assets and liabilities, or recapitalization before privatization.	31 July 1998
15. Issue Government bonds to Bank Negara Indonesia at market-related terms to finance transfer of deposits of banks frozen in April.	31 July 1998
16. Conduct portfolio, systems, and financial review of all IBRA banks as well as major non-IBRA banks by internationally recognized audit firms.	30 August 1998
17. Submit to Parliament a draft amendment of the banking law.	31 August 1998
18. Submit to Parliament a draft law to institutionalize BI's autonomy.	30 September 1998
19. Conduct portfolio, systems, and financial review of all other banks by internationally recognized audit firms.	31 October 1998
20. Introduce at least 20 percent private sector ownership in at least one State bank.	1 November 1998
21. Require banks to regularly publish more data on their operations.	31 December 1999
22. Prepare State banks for privatization.	2001
23. Impose limits on and phase out BI credits to public agencies and public sector enterprises.	Ongoing
24. Strengthen BI's bank supervision department. Strengthen enforcement of regulations.	Ongoing
25. Establish a program for divestiture of BI's interest in private banks.	Ongoing
26. Introduce a deposit insurance scheme.	Over program period
27. Eliminate all restrictions on bank lending except for prudential reasons or to support cooperatives or small-scale enterprises.	Over program period

Source: IMF: Second Supplementary Memorandum of Economics and Financial Policies of the Government of Indonesia, 24 June 1998.