

## **Abstract**

The paper assesses the roles played by bank restructuring macroeconomic conditions in fostering economic recovery in Indonesia. An evaluation of the performance of now defunct Indonesia bank restructuring agency is made. The contribution of other factors that influence bank activities beyond the control of even the healthiest of banks encompassing macroeconomic instability, political and social insecurity, central-local government wrangling over territorial, investment, infrastructure, and taxation jurisdictions, and in hampering both bank-restructuring efforts and economic recovery, are assessed. Accelerating the pace of economic recovery requires multi-faceted improvements in bank management and a series of measures to ensure sustainable conducive macroeconomic environment. The foregoing, among others which constitute the recommendations of the paper.

Key words: Economic crisis, non-performing loans, re-capitalization, restructuring

## **1. Introduction**

The state of soundness of the banking system is very vital for the economy, especially in developing countries. This is because, unlike developed economies, the level of financial development in developing economies is thin, fragmented, and comprises of mainly banking institutions, as agents of intermediation. Thus, it isn't far fetched to state that the state of health of the banking industry gauges the state of health of the economy. This is true in developed and developing countries alike. However, as has been mentioned earlier the statement is far truer for developing economies. The banking industry in Indonesia as was the case in other East Asian nations, was severely disrupted by the 1997 financial crises, which was sparked off by pressures of national currencies that eventually forced national banks to adopt flexible exchange rates. This was at a time, when both banks and firms, had borrowed heavily loans denominated in foreign currencies. Increasing pressures on regional currencies led to steep depreciations, that had the effect of more than quadrupling the cost of foreign currency denominated debt in terms of local currency. This is was more so in Indonesia, whose currency suffered a severe depreciation against the US dollar. The impact of depreciated rupiah on balance sheets of banks was profound.

Foreign currency liabilities soared, just at the time assets, mainly loans lost value due to the high probability of default coming on the heels of the crisis. Banks capacity to conduct operations was severely undermined as the public confidence tumbled, which led to bank runs, which left un-handled by the government, would have led to massive bankruptcy and eventual insolvency. The collapse of the banking system would have caused severe systemic risk which would have spelled national economic collapse. The banking industry faces many challenges, among others, managing banking institutions in accordance with prudential stipulations with respect to risk weighted capital adequacy requirements, as well as adopting internal risk based risk management practices in line with international requirements as embodied in Basel I and soon Basel II; identifying and developing banking services basing on core competence as a means to maintain competitiveness in the offering of an increasing variety of financial services in a world

of few if any, barriers across national boundaries, using ever increasingly sophisticated electronic gadgetry; and managing and controlling risk of the increasing variety of business lines comprising the investment portfolio.

The banking crisis that affected Indonesian banking industry, which by most accounts was responsible for compounding the 1997 financial crisis into a full-fledged economic provides ample testament of the worst case scenario if the banking system fails to adhere to prudential principles. The banking industry was characterized virtual non-compliance with prudential banking practices the fallout of which, were high non-performing loans, high exposure to funding, operational, and investment risk, low capital levels and low provisioning, and poor management of banking services especially by conglomerates.

It is not far fetched to say that the economic crisis perhaps helped ‘unravel’ the monstrous scale of mismanagement besetting the Industry, and by so doing, set the stage for efforts to put the banking industry on track once again. Revitalizing the banking industry had to begin with the formidable task of restructuring the industry. It is the cornerstone of this research to assess the drivers of bank restructuring, analysis of opportunities and challenges thereof; and taking Indonesia as a case study, to delve into the performance of such a process in a developing country context, a pre-requisite for identifying feasible solutions.

The foregoing presages the underlying objectives of the article as ; i) to examine performance of bank-restructuring drive, and the extent to which the performance of the restructuring endeavors has affected efforts to achieve economic recovery; ii) evaluate the role played by macroeconomic environment in influencing the performance of bank restructuring drive and national economic recovery. Section two presents the rationale for bank restructuring drives, which is followed by an assessment of the components of bank restructuring programs in section three. Section four presents a scoreboard of bank restructuring efforts in Indonesia; and section five evaluates the performance of the economy in general. Section six attempts to provide some plausible antidotes to

problems identified in the bank restructuring in Indonesia, while section seven draws conclusion to the article.

## **II. The rationale for bank restructuring**

Bank restructuring becomes imperative in conditions of dramatic and fundamental changes in political-economic environment under which banks operate. Changes in a banks' external environment caused by increasing competition, technological advances, globalization, and consumer tastes and preferences, among others, reduce bank effectiveness as financial intermediaries as their operations are no longer commensurate with the demands of their clientele. The change in external environment impinges on the bank effectiveness as long as vision, objectives, strategies, programs, and design do not adjust to such changes in time. Performance measured in terms return on assets, capital invested, and operating profits suffers. The ultimate goal of the bank as a going concern, which is the maximization of the stakeholders' value (creditors, depositors, shareholders) becomes unrealizable. Bank operations become ineffective because internal operations, procedures, mechanisms, networks which are determined by objectives, strategies, operations and bank organizational design can not cope with changes in the external environment either due to the inflexibility inherent in them or utter superfluity an indication that they have outlived their usefulness, or both.

In short , there is an apparent inextricable relationship between external conditions (increase in the number of banks arising from deregulation, changes in laws regulating banking operations manifested in laws on minimum authorized capital, capital adequacy ratio, pre-requisites for management and shareholders; macroeconomic conditions; and social conditions reflected in changes in consumer tastes and perception of the role of banks in society, increasing consumerism and environmental awareness impacting on the bank and internal conditions manifested in bank structure, managerial responsibilities, span of control, operational procedures, tasks, and performance evaluation criteria, and job appraisal and reward mechanisms. Bank restructuring and reforms are adopted in many countries not only to re-establish bank effectiveness as

financial intermediaries but also as an endeavor to prepare the banking industry for adversity of roles demanded by an increasingly sophisticated clientele.

Banks are forced to restructure whenever the change in the external environment is so profound that they cannot continue their operations for long without grossly undermining their performance. While for banks in the United States, the crisis in the Savings and Loans institutions owed much to high ratios of non-performing loans, low liquidity, and insolvency, triggered bank deregulation and restructuring of late 1980s and early 1990s, the collapse of command economies in the former Eastern Bloc caused the spark that lit the fire of bank restructuring far and wide. In some South Eastern Asian countries such as Malaysia, Indonesia, Thailand, and Philippines, bank restructuring became imperative as a reaction to the battering of their economies inflicted by the 1997 financial crisis, which exposed the vulnerabilities of the banking sector to the very edge.

For the Eastern Asian countries the spark that triggered the bank restructuring was the financial crisis that hit the region in the second half of 1997 (Cole and Slade, 1998; Sadli, 1998). Beginning with the collapse of efforts to beef up the Thai bhat, on July 2, 1997, persistent pressure on the currency prevailed forcing the Thai government to allow the bhat to float against the Dollar. This had the effect of increasing pressure on the Philippine Peso, Malaysian Ringgit, the Indonesian Rupiah, Singapore Dollar, and the Korean Won, and the as speculators anticipated eventual depreciation in light of high financial market interdependence among these economies. Philippine Peso was floated on July 11, the Ringgit suffered pressures forcing it to depreciate, though not floated; the Indonesian Rupiah was floated on August 14, and the Korean won depreciated in late December of 1997.

In any case all the economies pursuing basically an export promotion strategy, which relied heavily on the exchange rate between each nation's currency against the Dollar. So depreciation in one currency had the inevitable effect of triggering depreciation in other currencies. The financial crisis was compounded by the woeful state of the banking system in most of these countries, which were ridden with short-term foreign currency denominated debt, as well as having high rates of insufficiently provisioned non-

performing loans. This was in addition to high vulnerability banks were exposed to arising from the lack of transparency and high prevalence of corruption. Aware of the deep-seated problems in banking systems, investors' confidence suddenly deteriorated disposing of their assets in the rush to avoid potentially devastating future losses (Hakimian, 1999).

One of the most prominent characteristics of banking institutions was the high level of non-performing loans, which had accumulated on bank balance sheets. This unenviable state had come as a consequence of banking deregulation policies which had opened the doors to more players, freed the determination of deposit and credit interest rates to market forces, and allowed the opening of new bank branches for existing banks (Indonesia, Malaysia, Thailand, Philippines). Such changes led to unhealthy competition among banks for depositors and credit market share, which without strong, foolproof regulations obliging banks to adhere to prudential banking principles in place, spawned liberal credit policies, poor credit analysis, and negligence of risk management tools.

Though deregulation of banks had gathered pace, it was evident that states still regarded banking institutions as the best source of finance for priority sectors and industries, as well as grandiose projects. Thus, state intervention in the channeling of credit manifested in for example credit program policy in Indonesia, bank credit extension to chaebols in South Korea, banks as buyers of government bonds (Malaysia), and state banks used as conduits for loans to inefficient and inefficient state owned and private enterprises (Indonesia, Malaysia, Korea).

It should also be noted that the adoption of open capital account policy, which allowed unimpeded flow of capital to and from Indonesia opened opportunities for offshore borrowing. This was exacerbated by the prevalence of a higher domestic interest rate regime than in the rest of the World and weak bank control and supervision mechanisms. Thus with banks saddled with un-hedged foreign currency denominated loans, depreciation could not but spark off the worst banking implosion East Asia has ever witnessed. With banks trying to sell off as much local currency as they could to meet their staggering foreign obligations pressures on local currencies intensifying plunging

local currencies into deeper quagmire. Bank confidence nose-dived to the very watermark as depositors scampered to save their savings from unhealthy banks setting off the contagion of bank runs in the process. With the state of banks in convulsion, enterprises suffered from credit crunches, output declined, unemployment rate soared, inflation spiraled upwards as recession strangled the economies hitherto regarded as the New Industrializing Countries.

Pundits point to some fundamental causes of the crisis, which magnified the effect of the July 2, Thai government decision to float the Bhat. This include the lack of decisive government action to timely overcome over-heating of the economy and reduction of persistent current account deficits and plummeting export receipts; improper deregulation of the banking sector to avert deterioration of investor sentiments; under-deregulation of corporate sector; over capacity in real sector which triggered the collapse of property prices; and slow down in economic growth.

It was in an attempt to salvage the banking system from total collapse that governments took steps to carry out reforms in banking institutions, driven by the reality that the banking sector has a profound role in the financial sectors of developing economies. Without revamping the banking system, it was apparent, the much needed halting of economic decline let alone economic recovery was unachievable.

### **III. Principal Forms of Bank Restructuring**

Bank reforms are underway in many countries both developing and developed. However, the importance of such reforms in the developing world are more crucial in light of the key role played by the banking sector in the provision of financial services carry out bank reforms. Bank reforms encompass several aspects, which entail financial restructuring of banks, revitalizing financial sector enabling environment, and bank consolidation.

*a) Bank financial restructuring*

Banks being highly leveraged financial institutions are vulnerable to capital inadequacies. This explains why one of the most vital components of bank restructuring is bank re-capitalization. The Good Bank-Bad bank approach is one of the modes of bank re-capitalization. This involves the setting up of a consolidation bank (bridge bank) entrusted with the task of recovering loan from existing banks as well as winding up the operations of such banks (bad banks) to putting in place banks unsaddled with high volumes of Non performing loans (good banks). The consolidation bank is wound up upon completion of the loan recovery effort. Where this mode of bank re-capitalization is adopted it must be accompanied by fiscal prudence, rapid privatization, and operational restructuring, and management re-orientation if it is to achieve the intended the cherished goal of restoring bank solvency and liquidity (Boris, et al., 1996; Miurin and Sommariva, 1993).

Another mode of bank re-capitalization is the establishment of bank restructuring agency by the government. As is the case with a bridge-bank, the bank restructuring agency becomes the repository of non-performing loans from banks to as one of the measures to improve the balance sheets, before re-capitalization is made. The issue of loan recovery is thus centralized at the agency with the state in full support of such efforts. Restructuring agencies are in addition entrusted with restoring banks to soundness through injection of capital to improve capital adequacy ratios and change in management. Governments issued bonds and sometimes guarantees to replace non-performing loans on bank balance sheets thereby strengthening their capital base.

Governments committed immense sums in the effort to re-capitalize banks (Boris et al., 1996) with US \$ 5 billion in Czech and Slovak republics ,US\$ 750 million in Poland, US\$3 billion in Hungary, US \$1.3 billion in Slovenia, US\$750 million in Croatia, \$4.6 billion in Bulgaria, \$300 million in Romania, US\$72 million in Albania, Rp.440 trillion (US\$44 billion) in Indonesia, US\$45 billion in Turkey. On regaining soundness, health banks are allowed to operate in the wake of the restructuring measures under new management, and in some cases privatized. Restructuring agencies make it possible for a quicker and easier clean-up of bad loans on bank balance sheets quickening the process of

banking system revitalization, which shortens the restoration of public confidence in the banking system.

Since the mode of re-capitalization is bankrolled by the government it is viewed as credible and therefore liable to receive cooperation from the concerned parties. Malaysia, Indonesia, Korea, and Thailand have used bank-restructuring agencies to manage bank restructuring. The cost to the state is phenomenal however, since loan recovery more often not, is achieved through massive write-downs or outright write-offs, which must be met by national budgets. To be successful, bank restructuring agencies must be well staffed with experienced staff, which might be found wanting in many developing countries, leading to the use of foreign consultants at high costs as was the case in Poland, Indonesia. If unaccompanied by privatization, management re-orientation, improvement in macroeconomic fundamentals, restructured banks face the problem of relapsing back into unhealthy states, which requires additional re-capitalization, such as occurred in Hungary and is about to recur in Indonesia in cases of Bank International Indonesia BII and Bank Universal.

Bank restructuring agencies may be vulnerable to motley of vested interests, which may hinder the efficient execution of their responsibilities. As such agencies are established by the state, the effectiveness of bank restructuring undertaken depends on the officials upon whose shoulders bank restructuring is bestowed. Political considerations may compromise economic considerations in making appointments, which increases both the cost and time of bank restructuring. State banks though constitute the largest banking institutions may escape serious restructuring which undermines the effectiveness of the bank restructuring measures for example Indonesia.

One form of bank restructuring that should not go unnoticed in the use of merger to strengthen the banking system. Problems associated with many, but small banks encompass; difficult to monitor and supervise by monetary authority; induce deposit and credit market fragmentation which precludes scale and scope economies in the production of banking services; inability to marshal sufficient equity capital, which makes them vulnerable to excessive risk taking (Shrieves and Dahl, 1992:450-455); create

excessive pressure on the available human resources (experienced and skilled bank managers) breeding such malpractices as poaching, which undermine the total productivity of the industry. Bank merger can be carried out by either healthy banks bidding for assets and liabilities of troubled banks which they acquire on winning the bid or by monetary authority forcing banks to merge as was the case in Bank Danamon merger with other eight bank, the founding of bank Mandiri from the merger of Exim, Bank Dagang Negara, Bapindo, and Bank Bumi Daya in Indonesia. Mergers may lead to problems of organizational incompatibility, high costs of adjustment, retrenchment, worsening capital positions of the some banks in the merger that were hitherto relatively healthy.

The thrust of bank re-capitalization in some countries is not the injection of new capital, which may be lacking, in any case, but is tailored towards resolving the high level of non-performing loans on bank balance sheets, which is the main source of insolvency and lack of liquidity. Since factors that influence debtors differ from one to the other it is deemed pertinent that problem loan restructuring and recovery should be carried out on a case-by-case basis. The case by case approach is generally employed with the hope that high recovery rate is attainable as factors affecting each individual debtor are factored in the loan recovery program, in which the debtor plays a part in putting in place. Incentives are provided for those debtors who cooperate in the form of a reduction of interest rate and discounting on principal, while fines are imposed on those who renege on their commitments.

As factors responsible for loan default are bound to differ from one debtor to the other, the case-by-case approach in debt collection enabled creditors to adopt different loan recovery approaches to different debtors. This task was carried out by revitalized state banks in countries such as Hungary, Check republic, Poland, Croatia, and Romania, and by new private banks in the Russian federation (Boris et al., 1996). The case-by-case loan recovery approach was adopted in Indonesia, Malaysia, Korea, and Thailand undertaken by asset management agencies entrusted with that task. Such agencies were deemed more potent in tracking down debtors. In Indonesia the Jakarta initiative meant

to facilitate negotiations between creditors and debtors was also used to restructure loans on a case-by-case basis. This is one of the most common tools employed in the process of bank restructuring by directly injecting new bank capital by the state. Bank re-capitalization was intended to restore bank solvency so that management have the capacity to carry out internal bank reforms meant to restore bank competitiveness.

*b) Problem-Loans Management*

Dealing with problem-loans on a case-by-case basis underlay different modes of loan recovery employed in a number of countries. Carve-outs constitute the most common mode used in bank re-capitalization in former communist countries where state banks were owned by state owned enterprises. Carve-out according to Woeltel (1994:192) is “...part of a stream of cash to be received from future transactions ... pledged as security for the financing necessary to guarantee the cash flow.” One of the distinguishing feature of carve-outs as employed in former Eastern Bloc countries, was the separation of non performing loans on credit made before a specific date whose burden became the responsibility of the government, from those on credit made later which became the responsibility of banks that made them.

Banks had to collect loans as well as undertake provisioning for any new loans made. In other cases, the monetary authority purchases or guarantees some of the bad loans made by banks to keep it afloat, followed by change in management. This approach reduced the burden in terms of non-performing loans that became the responsibility of the government, which meant that lesser strains on national budgets would ensue. It however, creates the problem of classifying which loans are the responsibilities of the state and which were for the bank. Banks would possibly make use of *creative accounting* so that more non-performing loan fell into the category that was covered by the state. May not help in restoring investors' confidence in the banking system as it allows uninsured creditors and shareholders to lose out. In any case, non-performing loans, which were not covered by the state, were in effect in default for it was the state that was the *de facto* guarantor. Without being accompanied by privatization carve-outs can't restore

sustainable bank soundness as state banks continue to extend loans to loss making state owned enterprises. This is in other words a mere papering over the cracks.

Another mode of accelerating problem-loan recovery in the banking system is executed by the use of workout units. Under this mechanism debtors are given additional time and opportunity to work out their financial difficulties in order to repay their outstanding obligations as set out in the workout program which is arranged by the creditor and consented to by the borrower. Workout units are usually set under the umbrella of the bank-restructuring agency and are used to accelerate problem-loans recovery. In Indonesian the Master Settlement and acquisition agreement worked out between on one hand, Indonesian bank restructuring agency IBRA and bank Indonesia, representing the government as creditor; and bank shareholders as debtors of bank Indonesia liquidity support, on the other, underpins the spirit of work out scheme. Depending on the nature of asset being handled work out arrangements are executed by specialized units such as the asset management credit unit, asset management investment unit, consultant management unit, and bank-restructuring unit in the Indonesia bank restructuring agency. These have been used to great success in many countries to restructure banks as well as foster financial recovery and development.

Nonetheless, this approach of problem loan recovery can only work effectively if supported by an efficient technical staff, and sufficient institutional capacity with the mandate to handle liquidation cases. Work out units are therefore bedeviled by the lack of work-out traditions and experience, paucity of legal framework necessary for loan recovery such as weak bankruptcy laws, few courts as well as experts on commercial law, and frail collateral and property registration, absence of proper valuation, repossession, and liquidation mechanisms, and continued pressure for loan relief from a variety of sources, in many countries where they are used. As is the case with carve-outs, workout units, cannot operate effectively in the absence of determined government efforts toward privatization backed by streamlined laws on bankruptcy, liquidation, and repossession.

The use of debt- equity swaps and loan sales-asset swaps is one of the means employed to accelerate loan recovery. Enterprises exchange their equity for the value of

loans to creditor banks, which in effect turns them into shareholders giving them some leverage over their financing and investment decisions. As an incentive for faster loan recovery banks such loans are written down. With banks as shareholders the pace and intensity of enterprise restructuring is accelerated. In some cases asset management agencies are established by the state to handle bad loans from banks, which are then rehabilitated or restructured before they are sold off. Malaysia and South Korean established such agencies as one of the measures to revitalize their banking systems. The results were impressive, as by 1999 ratio of non-performing loans to total bank credit had considerably declined to 10 per cent and 25 per cent respectively. This is in stark contrast to the situation in Thailand and Indonesia where banking systems were still saddled with an overwhelming 39 per cent and 60 per cent in non performing loans in the same period respectively.

Debt-equity swaps have been used in China in her bid to restructure the banking system. Most non-performing loans on state banks balance sheets originated from state owned enterprises, with a small proportion emanating from joint-ventures between Chinese Companies and foreign companies. Asset Management agencies were set up and entrusted with handling banks' bad debts by swapping them into equity. Such measures were backed by financial beefing up of banks through massive injections of capital to the tune of 270 billion Yuan with the hope of raising Capital adequacy ratios from 4.4 per cent to the International bank for settlements recommended Ratio of 8 per cent by 1998. This mode of re-capitalization was evident in the arrangement between Dengfeng Citroen Automobile Co. which is a joint venture between the Citroen French car maker and a china firm, and China Development Bank. China Orient Asset management, serving as the asset management agency converted the US\$1.45 billion debt owed by Dengfeng Citroen Automobile Co. to China Development Bank into equity held by the latter in the former. (Sender, 2000).

Nonetheless, the mechanism was bedeviled by hurdles especially with regard to deals between state banks and state owned enterprises arising from the lack of stark distinction between government handouts which are not repayable and bank loans;

repayment of state banks loans by state owned enterprises wasn't considered issue; lack of any distinction between enterprises unable to pay from those unwilling to do so; absence of measures to restructure state enterprises in the wake of debt equity swaps since the state still had the final say over everything; and persistent state pressure to banks for more loan extensions to the already debt ridden enterprises meant that enterprise reform was forestalled.

The downside of such a mode of loan recovery however, is that it puts banks into the position of shareholders in ventures they may lack the experience and knowledge, which can adversely delay their own restructuring efforts. Moreover, as owners of enterprises, banks' exposure to risk emanating from operations of enterprises is enhanced. Pressure on bank staff is heightened which inevitably reduces their effectiveness and efficiency. One should not forget that banks as shareholders of enterprises may end up injecting additional funds into debtor-enterprises with the hope of achieving some turn around instead of carrying out much needed restructuring. This may end up enmeshing banks into deeper mire as their liquidity is compromised considerably. The lack of markets in many assets, evaluators, and skilled personnel means that asset sale off is difficult to carry out in many developing economies. Debt-equity swaps are difficult to affect in situations where banks are in a relational contracting arrangement such as is the case in Korean Chaebols, with each enterprise holding shares in other enterprises in a durable trading arrangement (Larkin, 2000). This is not dissimilar to the Indonesian case where banks are in the main one among a list of companies owned by one conglomerate.

Acceleration of loan recovery is sometimes achieved through out-of-court approaches in many countries with the intention of shortening the loan recovery period, which enables quicker bank revitalization and recovery. Out of court settlements are short term measures of keeping the process of bank and enterprise restructuring moving as long term solutions are being worked out, hence reduce costs associated with waiting for the right time by ensuing continuity of operations.

Banks are considered knowledgeable about the enterprises, businesses and less vulnerable to bureaucratic red tape and political intervention than state agencies. Banks

have the onus to settle the issue of non-performing loans with debtor-enterprises, as well as taking the vital role in restructuring finance, structure and operations of enterprises, with the government kept off limits. This entails that banks possession of apt experience in negotiating such deals, conduction of evaluations, stipulating mechanisms and a great sense of candor and honesty by both the bank officials and enterprise representatives. Since legal means take a lot of time and cost, even acrimony between banks and enterprises, out of court settlements are preferred in many countries as the first option, litigation being resorted to if deadlocks emerge between the two parties. The problem, with this mode of bank re-capitalization lies in the assumption that banks have the experience and requisite skills necessary for conducting out of courts settlements which is more often than not, isn't the case.

In any case banks in such conditions require as much restructuring as might be required in overhauling debtor enterprises. Out of courts settlements may end up enmeshing banks into operations of enterprises with the consequence that they lose sight of banking operations. This is hardly the best way to prepare banks for better management of their liabilities and assets to avert similar problems in future. The mode of loan recovery calls for cost in monitoring the adherence of both parties to the pact put in place, which might be more than banks can afford. The measure is less likely to succeed in countries where banks are owed by state enterprises. State enterprises are public property, which cannot be restructured at will or shares there in exchanged without rancor from the public. Collateral being also state property disposal by banks to recover part of their debts may be out of the question. Out of court settlements were adopted in Hungary, Estonia, and Indonesia. Under the master of settlements and acquisition agreement, and master refinancing agreement.

*c) Overhauling the financial enabling environment*

Bank restructuring cannot take root if the financial enabling environment is inadequate, which explains why reforming the financial environment is considered a vital component of bank restructuring. It encompasses the change in the rules of the game from those

encouraging risky investment merely driven by high return, to prudent, risk weighted ones. Reforms in a multitude of regulations encompassing new rules, laws, procedures, and norms are put in place providing a new aura of fundamental change, distinct from the old. Such reforms include reforms that limit or eradicate state involvement in bank operations by doing away with directed credit guidelines to priority sectors; liberalizing credit and deposit interest rates; re-visiting bank prudential laws as a means to strengthen bank capital and soundness; overhauling bank supervision; and the encouragement of alternative financial instruments such as treasury instruments in order to increase the effectiveness of monetary control. Some efforts are put place in some countries to improve the legal framework by enacting laws on bankruptcy proceedings, collateral, and property rights.

It is thus, notable that the role of the state in establishing an enabling environment can hardly be over-emphasized. The success of bank reforms can thus be expected to depend on the extent to which bank restructuring is supported by a well-streamlined, financial enabling environment. Reforms can only be executed if hard budgets imposed on banks and enterprises are hard to violate; settlements can be honored by all parties; justice is assured for all, all of which require conducive legal environment. Bank restructuring must be accompanied by genuine and consistent improvements in the financial enabling environment if it is to achieve dramatic successes in increased bank performance and financial development.

#### **IV. Bank restructuring In Indonesia: What a long and bumpy road it has been?**

##### **a) The Indonesia banking restructuring agency IBRA**

The Indonesian bank restructuring agency IBRA was established in 1998, entrusted with the tasks of fostering economic recovery by contributing to national coffers funds that were to come from its restructuring and credit sales, divestment of banks, running the PKPS program involving the repayment of obligations to the state by former control shareholders of banks. In the conduct of its activities, IBRA was supposed to uphold principles of fairness/justice, accountability, transparency, and prioritizing the Interests

of Indonesia. The legality of IBRA's activities is based on Banking law No 10/1998, Law No. 25/2000, government instruction No. 17/1999/3.4/ and national consultative council MPR resolution No. X/MPR/2001.

The legal foundation of IBRA mandated the agency to serve as an economic development facilitator, which was why the policies adopted transcended merely putting banks back into soundness/health to encompass such long-term tasks as : the revitalization of the banking system to a more sound footing through restructuring the high ratio of non performing loans on banks balance sheets, re-capitalizing banking system in accordance with international standards, overhauling bank management and ownership, manage assets surrendered by debtors as compensation for non performing loans; settle the repayment of Rp.144.5 trillion bank Indonesia liquidity support injected into national banks to avert systemic collapse at the zenith of the 1997 financial crisis, divestment of re-capitalized banks as well as assets in its control; speed up asset recovery at fair rates; revitalize the real sector by restructuring and monitoring the debt obligations, restore banking sector financial intermediation function to normality, accelerate the PKPS program (MSAA, MRJA, and PKPS-PU arrangements), contribute to institutional development for example the formation of financial services authority , and savings guarantee scheme, and foster good corporate governance in Indonesia. Underlying such tasks were several objectives which IBRA had to accomplish in four-year period which entailed; BRA had assets worth Rp. 644 trillion, which meant that IBRA of crucial importance to the Indonesian economy, hence the performance thereof would determine whether or not economic recovery and sustained growth would come sooner than later.

IBRA has been so important to the economy that the very fate of the Indonesian President was linked to the performance of the agency. This was embodied in the national consultative council resolution No. X /MPR/2001, which among other things entrusted the president to:

1. Manage assets with the aim of raising their productivity
2. Speed up the disposal of assets in IBRA and achieve fair recovery rate following transparent and accountable procedures, as well as attempt to exchange assets with bonds
3. Government to implement agreements reached with debtors and take action against those debtors that fail to honor their obligations.

To expedite its operations, IBRA established divisions/ work units which consisted of *Investment asset management (AMI)*, *credit asset management (AMK)*, *bank restructuring unit (RBU)*, *administration and operational support unit*, and the *system procedure and compliance unit (SPK)*. The *investment asset management unit* was responsible for settling obligations owed by shareholders of frozen banks to the state, disposal of any assets that were surrendered by them either through directly or establishment of holding companies (MSAA<sup>1</sup>, MRNIA, and PKPS-PU arrangements), manage equity for credit swaps through the restructuring of debtors' obligations. The tasks of *credit management unit* encompassed managing loans of frozen banks, loan guarantees / securities (non core assets such as land, and other property) for loans on balance sheets of Bank take-overs (BTO), and frozen banks (BBKU), and re-capitalized banks.

The tasks of *bank restructuring unit (BRU)* consisted of restructuring non performing loans on bank take-overs, and frozen banks, as well as re-capitalized banks, restoration of unhealthy banks to soundness through re-capitalization, and merger, and manage the deposit guarantee scheme (account No. 502). The *administration and operational support unit (DKA)* was responsible for administering BBO/BBKU (frozen banks) such

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<sup>1</sup> Under the master settlement and acquisition agreement (MSAA) arrangement, former shareholders of banks were supposed to pay an initial cash payment, surrender assets equivalent to the value of their obligations to the state (large debtors covered by the scheme included Salim group, Syamsul Nursalim, Sudwikatimono, Risjad, and Hasan). Under PKPS Master settlement and note issuance agreement (MRNIA), the large debtor didn't have sufficient assets to surrender to the state to pay the full obligation he owed the state, hence made personal guarantee to repay notes issued by the holding company to IBRA, which represented the state) (Those covered under this arrangement included Usman Admajaja, Kaharudin Ongko, Hokiorto and Hokiorto, and Samadikun Hartato). PKPS PU involved agreements made between IBRA and shareholders who didn't show good compliance with arrangements made. Such shareholders were supposed to agree to the reformulation of their commitments and means of repayment, and accelerated pace of executing the repayment (30 debtors were covered under this arrangement)

as, settling obligations owed to the state by such banks, and eventually liquidating them; handled communication, human resources, operational support system, general affairs, and managing the closure of IBRA (IBRA was given a four-year tenure on its establishment).

The activities of the *system procedures and compliance unit* (SPK) consisted of assisting in the development and application of effective and efficient systems and procedures with the aim of minimizing possible risks that would occur in the course of IBRA operations. The work units in IBRA were assisted by two directorates, directorate for legal affairs, and the directorate in charge of finance and management. While the former (DH) was responsible for providing legal support and advice to work units in their dealings with third parties such as debtors, legal advice on restructuring loans, handled contracts with consultants, handled litigation services, coordinated with the government, and advice on finishing up work frozen banks, and improving reporting standards, the latter (DKM) was responsible for improving financial reporting to internationally acceptable standards, improving efficiency of IBRA operations to ensure the realization of annual financial targets set by the state and increase its asset recovery rate, among others.

It is thus apparent that with 4 368-person strong well remunerated workforce, IBRA served as a bridge bank where all non-performing loans from both state and private national banks that qualified for re-capitalization as well as from liquidated banks were transferred, cleaning up their balance sheets prior to full-fledged re-structuring of their management and operations. IBRA came of age on February 28, 2004, at which date it was officially dissolved leaving an asset transfer body to finish up the unaccomplished tasks and commitments. It is thus high time a scorecard of the agency's performance is made. A glimpse of the performance of IBRA's bank restructuring drive (of course assuming the most unlikely scenario that other agencies didn't play a significant role) can be construed from some indicators of the banking industry between 1998 and 2003 presented in figures 1, 2, 3, and 4.

**b). IBRA' s Achievements, 1999-2004**

The Indonesian bank-restructuring agency has succeeded in attaining some of its objectives. It is because of IBRA operations for instance, backed by Bank Indonesia that the banking system in Indonesia is still operational. Banks considered worth retaining in the system were re-capitalized through the injection of colossal state funds enabling them to have relatively higher capital adequacy ratios than was the case in 1998. Bank management has also been restructured bringing in new blood. Banks considered worth rehabilitating were taken over by the government, a process necessary to facilitate their re-capitalization, while those irrevocably insolvent were liquidated. With the number of banks reduced from 208 in 1998 to just 136 in June, 2004 ([www.bi.go.id](http://www.bi.go.id)), the spread of re-capitalization resources was reduced increasing the effectiveness. In addition fewer banks imply reduced credit market segmentation, which created the opportunity for existing banks to expand and widen both their scale and scope of operations. IBRA states as one of its achievements the restoration of unhealthy banks to soundness, which is evidenced by higher capital adequacy ratios, lower non performing loans ratios, and higher liquidity than at the time it began its operations.

**Figure 1 Selected indicators of Bank take-overs BTOs and all banks , 2003**

<b>Selected ratios</b>	<b>BTOs</b>	<b>All Banks</b>
Capital adequacy ratio (CAR)	15.73	22.86
Loan to deposit ration (LDR)	55.20	40.34
Non –Performing loans(NPL)	7.98	7.05
Net interest margin (NIM)	4.26	4.41
Return on assets (ROA)	1.99	2.24
Return on equity (ROE)	26.80	25.86

Source. Bank Indonesia

The performance of bank takeovers BTO banks, can serve as a measure of the extent to which IBRA has lived to its expectations, especially with regard to its bank restructuring efforts. Figure I presents ample evidence of the relatively superior performance of BTO banks over CAR, NPL, NIM, LDR, ROA, and ROE, which can vindicate IBRA's statements that it managed to perform the work it was entrusted with quite well. As bank takeovers constituted banks that were initially unhealthy, mainly

due to low capital adequacy capacity, their turnaround is clear testimony that IBRA has indeed done its work of strengthening the capital foundation of Indonesian banking system. Since bank takeovers contribute significantly to total market share in the banking industry, improvements in performance of such banks should have a positive effect of the general performance of all banks (figures 2, 3, 4).

**Figure 2. Performance of banks basing on some key indicators Fourth-quarter 2001 –First quarter 2004**

Key Indicators	December 2001	December 2002	December, 2003	December, 2004
Capital Adequacy Ratio(CAR)	19.93	22.44	19.43	21.08
Loan to Deposit ratio (LDR)	33.01	38.24	43.52	50
Non-Performing-loans/ total loans (NPL)/Gross	12.23	7.50	6.78	5.75
Operational cost/ operational income (%)	98.41	94.76	88.10	
Return on Assets (ROA)	1.45	1.96	2.63	NA
Net Interest margin	3.60	4.14	4.64	6.32
Profit (trillion Rp)	12. 2	16. 5	22.9	NA
Non Operational costs (billion IDR)	50 461	51 825	39 7290	17 225
BIC (billion IDR)	74. 296	76 859	101 374	94.1

\*CBI, Bank Indonesia certificates

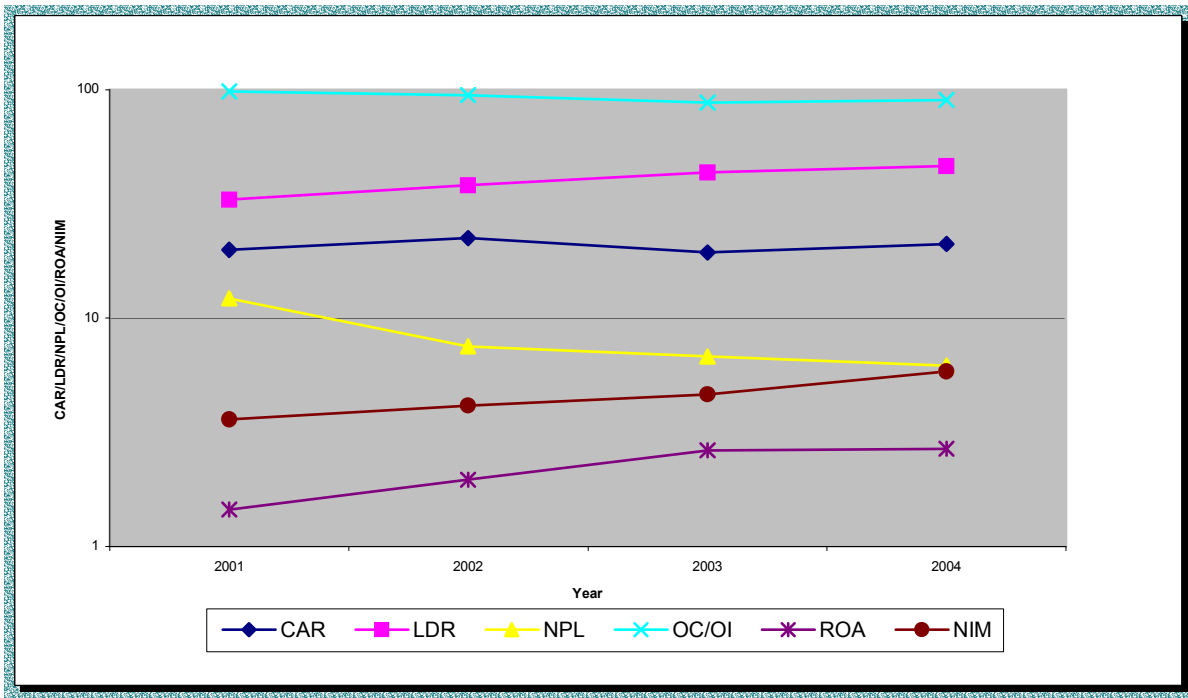
Source, Monthly Commercial banks Report, Bank Indonesia

Commercial Banks are experiencing annual increase in return on assets they hold, standing at 1.45 in 2001, rose to 1.96 in 2002, rose again to 2.63 in 2003, and higher again by June, 2004 (2.67), which is a sign of increasing efficiency (figures 3 and 4). Another indicator of good bank performance is the ratio of doubtful, and default loans to total loans extended NPL. The ratio stood at 6.19 percent in June, 2004, compared to 34.7 per cent in 1998. Banks are better capitalized than they were prior to the advent of IBRA, a fact indicated by an increase of capital (equity) from Rp.–41.2 trillion in 1999 to Rp. 110.9 trillion 2003; while deposits mobilization has experienced a 44 percent increase from Rp.617.6 trillion 1999 to well over Rp.888.5 trillion 2003. Total bank deposits stood at Rp.1, 076.5 trillion by December , 2004, and had already surpassed the Rp. 959.3 trillion level by March 2005.

The upsurge in total deposits has sparked an increase credit channeled to various sectors of the economy. Total credit was Rp. Rp.487.4 trillion in 1998, stood at Rp. 553.5 trillion in December, 2004, an indication that credit extension had slightly surpassed the period prior to the 1997 financial crisis. Increased loan expansion signifies a rebound in financial intermediation role, proof of which is shown by the Loan to deposit ratio. Loan to deposit ratio LDR has experienced an increase of 80 percent from 26.2 percent in 1999 to 47.28 percent 2003. The ratio stood at 50 percent in December, 2004, an indication that the function of financial intermediation is in full gear once again. The expansion of credit channeling has been risk weighted, in line with Bank for international settlements 1988 Capital adequacy stipulations. This is shown by the trend in the capital adequacy ratio which has shown remarkable improvement from an asset 'dissipating' ratio of -8.1 percent in 1999 to a sound 19.43 percent in 2003 (369 percent increase), to financially sound ratio of 21.08 in December, 2004.

It is a testament that sufficient protection against unexpected risk has become mandatory in Indonesian banking today. Credit expansion has enabled banks increase their earnings before tax for banks, a fact shown by a turnaround from a loss of Rp. 178.6 trillion in 1998 to a profit of Rp.21.9 trillion in 2002. Net profits showed modest improvement in 2001 (Rp.19.2 trillion), declined somewhat in 2002 (Rp.16.5 trillion), shot up again to Rp. 22.9 trillion in 2003, but decreased in June, 2004 to Rp.16 trillion Rupiah. However, all in all banks are back in profit territory, once again, which is good for the economy.

Figure 3 Developments in several bank indicators , 2001-2004



Another measure of improved profitability of the banking system is the net interest income. Interest income has improved thanks to lower deposit rates which have fallen in line with falling prime interest rates enabling banks to move from negative interest margin to the tune of Rp. 61.2 trillion in 1998 to a modest Rp. 42.9 trillion in 2002. Net interest margin improves further in 2003 and December , 2004, showing a ratio of 4.64 and 6.32, respectively. Operational costs of running banks are on the decline, as evidenced by the operational cost to operational income ratio (figure 3 and 4).

It is indisputable that with bank management as well as ownership overhauled, it would presuppose that all sources of past malfunctions were uprooted, preparing banks for a new era. Re-capitalized banks were ‘empowered’ to compete in the world without frontiers than was the case prior to restructuring. In essence, the crisis proved a blessing in disguise by providing the thrust to revamp the banking system, something that would not have taken place without strong fiscal pressures. Moreover, thanks to the enactment of the Banking law No. 10, 1998, bank monitoring and supervision mechanisms have been revisited as well as the scope of operations widened. By diversifying bank operations

both in type of lines of business engaged in and sectors or sub sectors invested in, bank vulnerability to high risk arising from credit over concentration in particular sectors or sub sectors has been somewhat alleviated-or so it seems.

**Figure 4. Bank Indicators 1998 – 2005 at a Glance (trillion Rupiah)**

Item	Particulars	1998	1999	2000	2001	2002	2003	2004	2005*
1	Deposits	358.6	617.6	699.1	805.8	835.8	888.5	1,076.5	959.3
2	Total Credit disbursement	487.4	277.3	320.4	358.6	410.3	477.2	553.5	576.4
	Credit to Industry	171.7	84.3	106.8	116.5	1211	123.1	143.6	39.4
	Credit to Agriculture	39.3	23.8	19.5	20.90	22.3	24.3	32.4	14
	Credit to Trade	96.4	43.3	44.1	48.5	66	84.3	111.0	20.5
3	Capital	-129.8	-41.2	53.3	62.3	93.0	118.60	131.6	138.50
4	Credit to SMEs	45.6	37.2	56.6	62.6	62.3	74	85.2	89.0
.									
5	SBI(Bank Indonesia certificates)	-	-	58.70	74.3	76.90	101.40	94.10	107.60**
6	Net interest margin(ratio)	-62.2	-38.6	2.9	3.7	4.01	3.2	6.32	6.0
.									
7	NPL/total credit net (%)	34.7	7.3	5.8	3.6	2.9	3.0	1.7	1.9
.									
8	Total assets	895.5	1006.7	1030.5	1099.7	1112.2	1068.40	1272.0	1280.6
.									

\*March, 2005;\*\*February, 2005

Source: Bank Indonesia Home page: [www.bi.go.id/](http://www.bi.go.id/)

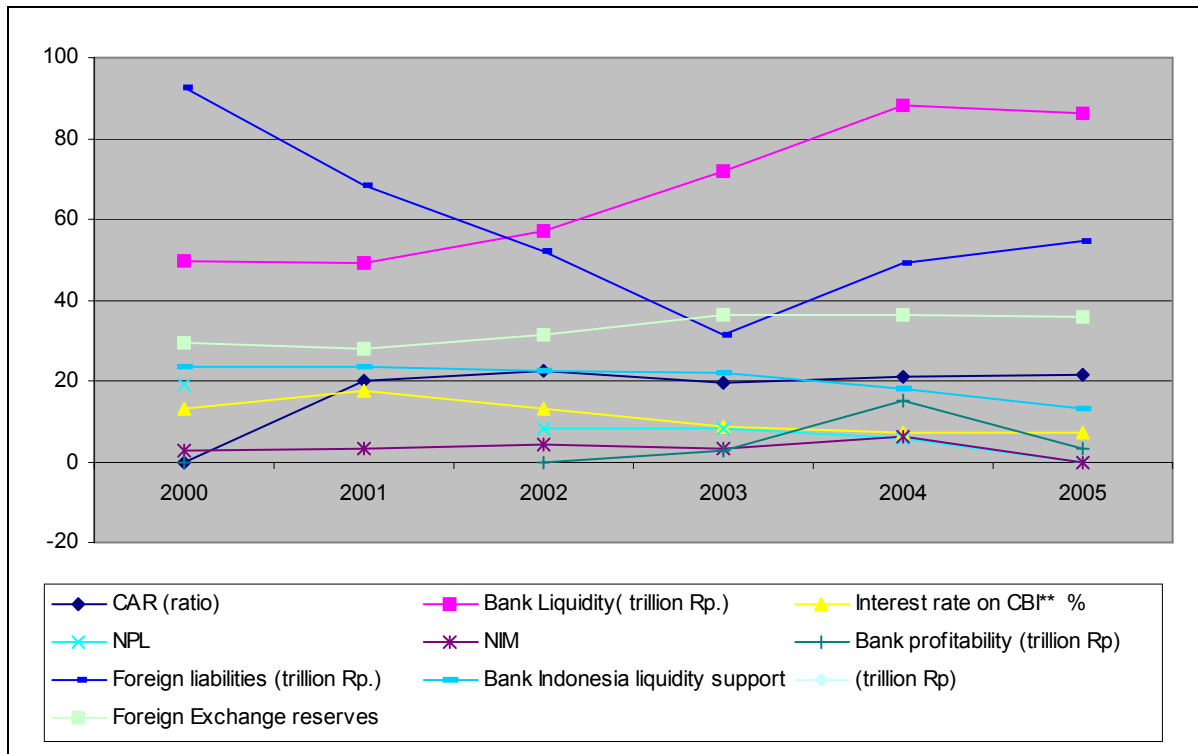
The indulgence in over-the-limit affiliate lending is clearly proscribed with heavy fines awaiting whoever breaks the rules. In essence the banking system collapse has been averted, at least for the time being. It is incontrovertible that people's confidence in banks has been restored to its original level prior to the 1997 economic crisis. This is evidenced by the volume of bank deposits which has reached Rp. 1076.5 trillion in December, 2004, a potent seal of approval from the public for efforts toward strengthening the banking sector in Indonesia

Figure 5. Indicators of Bank Risk Vulnerability

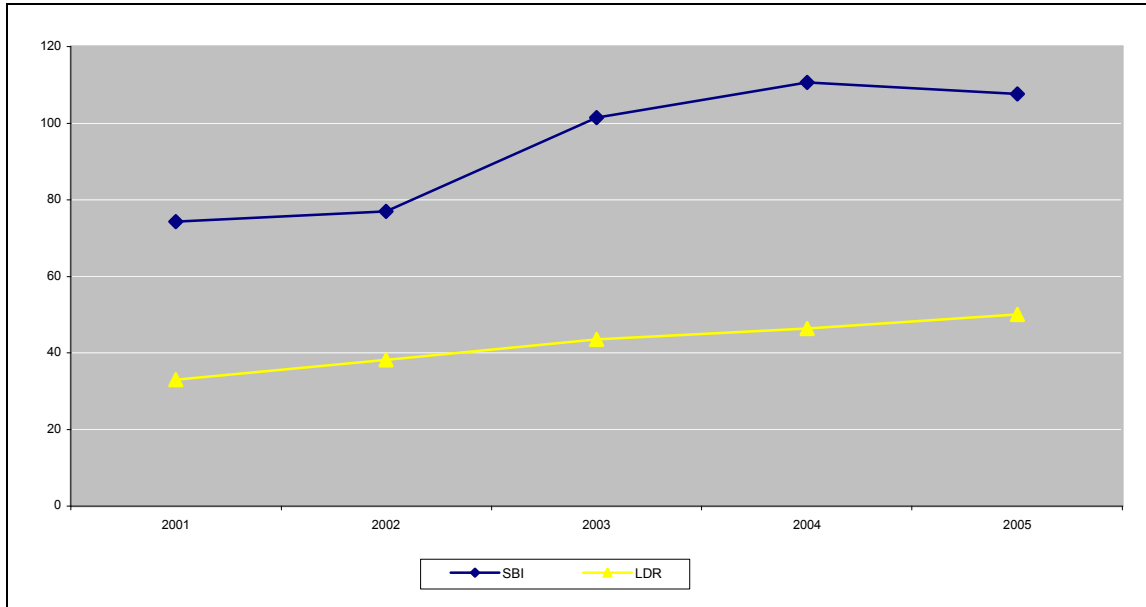
Indicator	2000	2001	2002	2003	2004	2005*
CAR (ratio)		19.93	22.44	19.45	21.08	21.7
Bank Liquidity( trillion Rp.)	49.7	49	57	72	88	86
Interest rate on CBI** %	13.04	17.63	13.11	8.43	7.29	7.31
NPL	18.8		8.09	8.20	5.75	6.0***
NIM	2.90	3.10	4.01	3.20	6.32	5.40***
Bank profitability (trillion Rp)	-20		-10	2.7	14.91	3.10
Foreign liabilities (trillion Rp.)	92.7	68.4	51.9	31.5	49.3	54.6
Bank Indonesia liquidity support (trillion Rp)	23.6	23.3	22.6	21.9	18.1	13.3
Foreign Exchange reserves (US\$ billion)	29.4	28.0	31.6	36.3	36.3	36.0

\*March 2005; \*\*Interest rate on 3 months Bank Indonesia certificates;\*\*\*data for February, 2005

Figure 6. Some bank indicators 2000-2005



**Figure 7. Trend of Bank Indonesia certificates, and loan to deposit ratio, 2001-2005**



IBRA has been lauded for reducing the strain on state finances by contributing a total of Rp. 163.1 trillion from 1999/2000 to December, 2003, to the national revenues arising from asset sales, privatization efforts, payment of coupons on state bonds, among others (Figure 8). The annual contribution made by IBRA to the national treasury can be broken up as Rp.17.1 trillion in 199/2000, Rp..20.7 trillion in 2000, Rp.48.5 trillion in 2001, Rp.48.5 trillion in 2002, and Rp.28.3 trillion in 2003.

**Figure 8. IBRA cash realization to state coffers, 1999/2000-2003**

Year	Cash realized (Trillion Rp)	Realized bonds (Trillion Rp)	Non. National Budget cash (Trillion Rp)	Recycled bonds (Trillion Rp)	Total (Trillion Rp)
1999/2000	12.9	4.3	-	-	17.1
2000	18.9	-	-	-	20.7
2001	28	-	-	20.5	48.5
2002	35.3	7.5	5.7	-	48.5
2003	19.7	6.4	2.2	-	28.3
<b>Total</b>	<b>114.8</b>	<b>18.2</b>	<b>9.8</b>	<b>20.5</b>	<b>163.1</b>

Source: IBRA Monthly Report, December, 2003.

It is also worthy noting that between 1999 and 2003 IBRA accomplished the task of selling assets under its *PPAP* asset disposal program attaining a recovery rate of 151 percent from 5, 910, disposed of another 2, 702 property having face value of Rp. 1.10 trillion in 2003, attaining a recovery rate of 120 percent property. In 2003, another achievement made by IBRA was the sell of loans worth Rp. 105.28 trillion, of which Rp.52.64 trillion constituted non performing loans, the disposal of SME retail loans program covering 41 048 debtors with total loan value of Rp. 2.57 trillion, disposal of commercial loans covering 259 debtors with total loan value of Rp. 3.64 trillion, and disposal of corporate assets covering 312 debtors with total asset value of Rp.46.43 trillion (BPPN, 2003).

Additional revenues contributed by IBRA to state coffers aegis of executing the strategic assets sale program (PPAS) fetched a total value of Rp.2.61 trillion, which covered the sale of Gula Rajawali factory(Rp.95 billion), Chandra Astri and IPIC (Rp.602.5 billion, and Asia pulp and paper (US\$213 million). Such figures are by no means a mean achievement. This apparently served as relief to the fiscal strains on government expenditure, which was no mean achievement.

Another laudable contribution made by IBRA was in the area of resolving Rp.29.2 trillion outstanding credit to small and medium scale enterprises, which covered 239 440 firms by September 2003. This was an astounding 98 percent of SME obligations, which *ceteris paribus*, should have enabled SMEs to resume operations (BPPN, 2003).

IBRA has also made headway in its bank restructuring drive, not only by re-capitalizing bank BCA, bank Danamon, Bank International Indonesia BII, bank Niaga, bank Lippo and bank Permata, but has also succeeded in divesting BCA, BII, bank Niaga, bank Danamon, and bank Permata. IBRA's performance has been proving overtime, which is indicated by the success of its cost cutting measures especially with regard to huge consultancy as well as other operational costs. The ratio of costs to revenues has been falling from 10.8 percent in 1999/2000 to just 5.2 percent (figure 9).

**Figure 9 Trend of IBRA's efficiency over time, 1999/2000/2003**

Description	1999/ 2000	2000	2001	2002	2003	Total
Operational cost to funds collected by IBRA (%)	10.8	7.4	3.7	2.9	3.5	5.2

Source. IBRA Monthly report No 45, December, 2003

**c). The downside of IBRA's performance and continued underperformance of the banking sector**

Heavy cost has been incurred by the government in an endeavor to revitalize the banking industry nonetheless, things haven't been rosy and cozy on all fronts for IBRA as the following arguments will elaborate.

It has been argued that the level of capital on balance sheets of banks has improved significantly, which is indisputable if the capita adequacy ratio and equity figures, are anything to go by. Yet, it is likewise undeniable that the apparent indication of strong capitalization is partially attributable to significant amounts of government funds injected during the course of re-capitalization drive that continue to give a rosy picture of strong soundness, rather than an outcome of improved performance in bank operations. Bank Indonesia liquidity support stood at Rp. 18.1trillion by December, 2005, and falling to Rp. 13.3 trillion by March 2005 (figure 5) is , if nothing else, an indicator that bank soundness in Indonesia as it is today continues to be bolstered by the state. In short, despite efforts by the state to disengage itself from bank operations through privatizing formerly re-capitalized private national banks, through public offerings at the Jakarta stock exchange and selling controlling interest to strategic investors; and instituting public offerings for state banks, it continues to be the main source of bank soundness.

Bank restructuring was accomplished at the expense of an increase in unemployment which was the aftermath of the freezing of 45 banks, and the liquidation of 16 others, bank-restructuring efforts have had other adverse effects as well. One

cannot ignore the immense cost involved in re-capitalizing and restructuring banks the five bank take-overs and four state banks. Bank re-capitalization and re-structuring has contributed to the huge domestic debt of a staggering Rp. 660 trillion through Bank Indonesia re-capitalization amounting to Rp. 152.185 trillion (the state contributing Rp. 141.031 trillion (Kompas, June 1, 2004:14) while former bank shareholders footed Rp.11.153 trillion), and government deposit guarantee scheme amounting to Rp.73.78 trillion.

Such state resources were thus unavailable for investment in social services such as education, health, sanitation, let alone reduce public suffering, critically needed at the time of great adversity in the wake of the 1997 financial crisis. In addition putting colossal sums into bank re-capitalization meant that cutbacks on state investment in infrastructure projects had to be made, which in effect reduced the effect of both private and state consumption expenditure on economic growth.

No doubt the efforts to stimulate the economy out of the mire have been met with little success, if any. Yet the hemorrhage continued in another form which was the cost of Rp. 55 trillion per year in payments of interest on state bonds in the re-capitalized banks as well as the issuing of additional bonds which the government was forced to do in case of re-capitalized banks that continued to under-perform despite immense injections of bailout money. Bank Universal, Bank Prima express, Bank Artamedia, and Bank Patriot continued to under perform despite Rp. 11.233 trillion re-capitalization which compelled the injection of another Rp. 14.727 trillion to facilitate the merger of the four banks with Bank Bali to become Bank Permata, which has just been divested to standard bank – Astra international consortium (Kompas, June 2, 2004:25).

In the frantic effort to prop up state revenues, IBRA was compelled to sell re-capitalized banks to the those with strong banking background, as well as financially sound, local and foreign alike. As the domestic investors were still reeling from the adverse effects of the 1997 financial crisis, many couldn't qualify, leaving IBRA and Bank Indonesia the one and only option at the time, of disposing heavily re-capitalized banks to foreign investors. The result of such a policy has been that all re-capitalized private

national banks are controlled by foreign investors (Danamon, Bank Central Asia, Niaga, Permata, among others).

The issue here is not about ownership per se, rather, the readiness of private national banks under new ownership to implement monetary policy as signaled by the Indonesian central banks through its conventional monetary instruments such as manipulating the basic lending rate, influencing the interbank market, discount window, reserve requirements ratio, cash ratio, moral suasion, and so on. This is because, privately controlled banks, unlike locally owned private national banks, have easier access to funds, securities, derivatives in foreign markets, by virtue of being controlled by a bank incorporated in such markets or conducts operations. This is the more disconcerting considering the thin size of the domestic credit market.

The change of ownership may also impact on the effectiveness of government policy, especially with regard to long term, high risk investment programs. The banking industry is no longer guided in its investment decisions by the state, through central banks, the legacy of financial repression. Various packages of financial deregulation freed credit markets, liberalized deposit rates, opened ownership to foreigners, allowed establishment of foreign banks and branches to virtually regency centers. It should be noted that decried though it is, financial repression enabled the government to fund costly infrastructure projects at low cost, which has become the strong foundation, and often stimulated, various economic activities that have spurred economic growth. It is hard to imagine the state using the same mechanisms to achieve such remarkable feats given the new banking landscape today.

Nonetheless, despite the injection of staggering amounts of funds, the state of health of national banks is far from satisfactory. Banks still rely on incomes arising from the payment of interest income on state bonds, implying many re-capitalized banks can not stand on their own feet. This is evidenced by the dominance of banks' productive assets portfolio by re-capitalization bonds (59 per cent), compared to the proportion of credit (33 per cent). The loan to deposit ratio, a measure of bank's effectiveness and efficiency in financial intermediation, is a mere 45.59 per cent which is below the

optimum 75-80 per cent (Bank Indonesia, 2002). Banks' role as a bridge between savers and investors is far from working effectively evidenced by slackness in credit disbursement despite increase in savings. Investment in risk-free bank Indonesia certificates takes precedence over credit.

This explains why banks are as vulnerable, if not more, to changes in interest and exchange rates, as they were before the crisis (Bank BCA for example is reckoned to have suffered from asset depreciation amounting to Rp.5 trillion due to changes in exchange rates). The relapse into dangerous territory by Bank International Indonesia and Bank Universal, among others, in 2001 is evident enough that things have not fundamentally changed as regards bank operations. The ease with which banks 'relapse' into doldrums signals that some great task is still unsolved.

More alarming is the increasing rate of fraud that time and again, hits re-capitalized banks, which is an eloquent testimony that safety mechanisms put in place to prevent a recurrence of such problems as over-the-limit-lending, loans to affiliates, and adherence to prudential banking are not working. Bank BNI suffered Rp. 1.7 trillion fraud, (Kompas June 11, 2004), bank BRI another Rp. 300 billion, Bank Danamon another Rp. 200 billion, and Bank Permata Semarang Branch Rp. 1 billion, and Bank International Indonesia Rp.13 billion. The mind boggling fraud in Bank Global involving the directors and management, the Rp. 2 trillion loans with high likelihood of default on Bank Mandiri books are cases that are still fresh in the minds of observers of Indonesian banking industry. This is ample evidence that prudential banking principles have hardly taken root in the Indonesian banking system, at least in practice.

The closure of Bank Asiatic and Bank Dagang Bali because owners failed to bolster the equity, improve the quality of productive assets, resolve the problem of doubtful loan transactions, and change management as indications were aloud testaments of the scale of underperformance of the existing management), was another indication that banks are far from sound despite the immense cost incurred by the government in re-capitalizing and merging them (Bank Indonesia, 2004).

As Aditya (2000) opined, the very nature of bank re-capitalization has been criticized for the lack of a standard mode of strengthening bank capital. With the state of economic activity still fraught with high uncertainty, banks to this day, continue to show reluctance to extend credit to the real sector fearing default preferring instead to invest their funds in low yield risk-free bank Indonesia certificates, SBI, State notes SUN, acquisition of IBRA loans (allowed 50 percent of their capital by Bank Indonesia), and investment in exchange foreign currencies. Yet as long as banks continue to receive deposits, interest rate on which changes with the level of bank Indonesia prime rate, they face the potential danger of experiencing negative interest margins.

This is why the type of state bonds a bank has in its portfolio has a lot to project its resilience to deal with changing economic situations. Banks with high percentage of fixed interest rate bonds experienced hardships at times of rising interest rates as they were exposed to declining real interest income. Income on state bonds was stable but banks were obliged to pay rising interest rate on deposits, which poses the danger of negative interest income. On the contrary in times of falling interest income, banks with flexible interest rate bonds enjoy stable earnings since interest income adjusts with the level of the prime rate. Lower interest rates translate into low interest income, and low interest expenditure on interest on deposits which falls with the level of prime rate. Thus, banks such as bank central Asia BCA and bank Mandiri which received the largest proportion of their re-capitalization funds in form of flexible interest rate bonds, have stable earnings, while other banks whose re-capitalization mainly comprised of fixed interest rate bonds such as Bank Niaga, Bank Bali, Bank Rakyat Indonesia, Bank Tabungan Negara, Danamon, and Bank International Indonesia are not that lucky.

As if that was not enough, the amount of capital injected into banks for the purpose of facilitating turnarounds starkly differed from one bank to the other. For instance if for Bank BCA and bank BNI were re-capitalized above 40 percent the former receiving Rp. 57 trillion in floating interest rate bonds out of Rp. 60 trillion, leaving a mere Rp. 3 trillion in fixed interest rate bonds, bank Mandiri above 20 per cent, other banks received a mere 6 percent of funds relative to their risk weighted assets. The

probability of banks with lower re-capitalization to relapse into insolvency is higher in times of high economic uncertainty. This forbearance implies that for a level playing field to be established, some banks have to be allowed to operate at lower than optimal standards compared to others, making them liable to differential measure of performance evaluation (Aditya, 2001).

Yet on the contrary, the evaluation of bank soundness and solvency does not differ from one bank to another, which seems unrealistic. This smacked of indulging in *ad hocism* which was indicative of a sloppy target-focused, improper sufficient background research on the real state health of the national banking system, and over optimism about the economic prospects as well as the state of government finances. Yet as Dewatripont and Tirole (1993) contend, “banks should be... re-capitalized by an amount contingent on the average profitability of banks facing similar opportunities.”

The choice of Rupiah as the denomination for the state bonds issued to re-capitalize banks hardly seemed to have considered the fact that most bank debts were denominated in dollars. Bank capital a significant proportion of which was in form of state bonds, is still vulnerable to exchange rate swings. It is even worse for banks with fixed interest rate bonds, since any depreciation of Rupiah erodes away much of bank capital, reduces bank interest income in real terms, and undermines bank asset position, which weakens bank ability to repay its obligations. In case of currency appreciation banks with flexible rate bonds will have their incomes reduced as interest income falls with decreasing prime interest rate. The fundamental problem that led to the financial crisis in 1997 is apparently still unsolved. As long as re-capitalized banks do not have mechanisms to overcome this problem, the vulnerability of the banking system is still far from resolved.

Bank re-capitalization unaccompanied by enterprise restructuring is bound to achieve little (Isard et al., 1996). This is because the volume of non-performing loans on bank balance sheets is due to the failure of enterprises to repay their obligations. Hence unless efforts are made to overhaul the finances, operations and management of enterprises bank re-capitalization is hardly likely to improve bank soundness. Banks

income mainly arises from financial intermediation, which can only occur if credit is lent out to healthy enterprises. This partially explains why despite a remarkable growth in bank deposits Rp.358.6 trillion 1998 to an a staggering Rp. 701 trillion in 2001, credit disbursement has failed to bounce back to the level of Rp.487.4 trillion in 1998 merely hovering over Rp. 264.9 trillion. One hopes that the measure by bank Indonesia to link the minimum cash ratio  $GWM^2$  to bank liquidity will encourage higher levels of credit disbursement in the economy (Nugroho, 2004:27).

Credit to the agricultural sector (forestry, fishing, animal husbandry, and foodcrops sub sectors), although shows an upward trend, is by no means any closer to the amount that should be channeled to the sector in line with its importance to the economy in terms of employment and being the mainstay of more than 60 percent of the 230 million population. If the agricultural sector received 8.06 percent of total credit disbursement in 1998, the ratio fell to just 5.87 percent in 2004. On contrary, the Industrial sector received 35 percent of total credit disbursement in 1998, which slightly fell to 26 percent in 2004. Trade sector received 19.8 percent of total bank credit in 1998, and 20.1 percent in 2004, an indication that banks have tended to shift funding from the slowly growing real sector for instance manufacturing and agriculture, to trading activities. This is perhaps in line with the fact that national economic growth is driven by mainly by government and private consumption (5.01 percent, and 6.89 percent, in 2003, and 2004, respectively).

Another daunting problem is the relatively low rate on deposits in line with falling Bank Indonesia prime rates<sup>3</sup> (figures 8), which however is not matched by low interest rate on credit, discourages savings on one hand, and lending on the other. Interest on bank credit is still high (interest rate on consumer credit stood at 17.5 percent, working capital was at 14.10, and interest on investment credit stood at 14.64 percent by June, 2004) because banks have to factor in the high risk premium of extending credit to

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<sup>2</sup> Bank Indonesia with effect from the second quarter is adopting an increase in cash ratio  $GWM$  that depends on the volume of deposits a bank has on its balance sheet, the higher the volume of bank deposits the higher the amount of money bank is obliged to maintain in cash form. Deposits under Rp. 1 trillion are subjected to cash ratio of 5 percent; between 1 trillion- Rp. 10 trillion Cash ratio of 6 percent; Rp. 10 trillion-Rp.50 trillion cash ratio of 7 percent; and  $\geq$  Rp.50 trillion cash ratio is 8 percent

<sup>3</sup>Bank Indonesia, has of recent started raising the prime interest rate in line with rising inflation and United states federal reserve rate

the corporate sector which has yet to settle some of the obligations it owes to lenders, still experiencing production, and demand uncertainty. This raises the possibility of a recurrence of negative interest margin regime, which should erode away bank capital (Claessens et al., 1999:2).

Such danger is clearly shown by the movements of the CAR and LDR curves in figure 3 above. Higher credit expansion in 2003 led to the worsening of the CAR ratio, because of the potential danger than under the prevailing economic conditions, improvement in loan extension translate into higher non performing loan ratios in future, and thus banks are obliged to undertake higher loan provisioning, why by implication means that bank Indonesia calls for higher capital levels Revitalizing the banking system cost the government more than Rp. 144.5 trillion in bank Indonesia liquidity support and around US \$44 billion in re-capitalization funds. The government had to increase its domestic debt through the issuing of government bonds and Notes SUN to unprecedented proportions, which is likely to crowd out private investment as funds are sucked into state programs.

State involvement in the affairs of IBRA undermined its operations. There was no better evidence of this than the type of government policy on PKPS (repayment of obligations by shareholders with controlling interests in bank takeovers and frozen banks), which changed with change in government (IBRA, 2002). For instance the controversial December 11, 2001 decision No.2 issued by the Committee on financial sector policy KSKS which in effect among other concessions, gave a go-ahead for the extension of the period in which former shareholders of bank take-overs from four to ten years and the reduction of interest rate on state bonds to 9 per cent. This was in the main an implicit discounting of the obligations such large debtors were supposed to repay. In real terms the amount that reduced the amount that could be recovered for despite the nominal value remaining unchanged, taking account of inflation reduced the real value.

Moreover, bank owners being in the main wealthy individuals, such the decision smacked of outright discrimination by the government against small debtors. Besides, the decision reduced the pressure on IBRA to recover as much debts as possible before its

life span ran out, which would have meant extension of its duration or transferring its responsibilities to some other agency. It is the latter that prevailed as it turned out. Even the commissioners appointed by the government to supervise newly appointed management weren't new men in government business, often Ministers or heads of state owned enterprises with much work up their sleeves already, hardly the type to supervise an overhaul of dysfunctional banking industry.

The high turnover of executives at the bank-restructuring agency reduced the continuity of policies, which delayed bank restructuring and revitalization. It is not only efforts to recover assets from debtors that were considerably undermined by high turnover of IBRA top management, but also the motivation of the employees was affected considerably as they are uncertain of their tenure which increased the probability of indulging in underhand activities. Thus it is not only economic recovery that was deferred to some uncertain future date, but the cost of bank restructuring on the economy soared to astronomical proportions.

The sloppy work of IBRA as reflected in a number of cases didn't augur well for quick bank revitalization. This is evidenced by the paltry sum accepted by IBRA from former owners of five bank take-overs BTO, ten banks whose operations were frozen BBO, 39 banks whose activities were discontinued BBKU, which surrendered a mere Rp. 12.345 trillion as compensation for a colossal Rp.144.5 trillion in liquidity support. This implies the task of loan recovery is not well handled. This is compounded by the indulgence of IBRA officials in other improprieties manifested in the disposal of assets at below market prices, which in effect reduces the recovery rate considerably. This is reflected in a number of cases.

The selling of Bank Umum Nasional plot of land valued at Rp. 135.688 billion at Rp. 40 billion to PT. Perkasa Mandiri which is a loss of Rp.98.688 billion to the state; collateral in form of land plots surrendered by PT. Bank Sewu International to IBRA one of 282 sq. meters of land in Tamansari Jakarta worth 1.124 trillion and another at Basuki Rahmat street worth Rp. 3.491 billion which were sold at Rp. 2.925 billions and Rp.900, respectively; plots of land surrendered by 11 banks (BDNI, BUN, Bank Hokindo, Bank

Bira, Bank Dagang Industri, Bank Danahutama, Bank Dewa Rutji, Bank Lautan Berlian, Bank Pesona Kriyadana, Bank Tata, Bank Uppindo which were valued at Rp.298.828 billions, but were sold off at Rp.184.432 billion. Evidence of underhand deals is indicated by yet another malpractice. This is in form of shares in Bank Dewa Rutji belonging to former bank BDNI, which were relinquished by BDNI to IBRA in compensation for liquidity support, yet the same shares were surrendered by Bank Dewi Rutji to IBRA for the same purpose. Such malpractices help to explain why the debt recovery rate was as low as 26 per cent a far cry from the projected 75 per cent. Indeed the aforementioned deals are more than ample evidence lack of good governance at IBRA. The loss to the state was quite dazzling at a time when the government was /is severely cash strapped (Kompas, 2002).

Divestment of assets under IBRA was fraught with underhand deals, which cost the state dearly. In the case of Indomobil conducted by IBRA which involved the divestment of 73.63 per cent of Indomobil listed shares at Rp. 624.5 each to Trimegah securities, is reckoned to amount to a loss of Rp. 1.357 trillion to the government since the valuation at the time of relinquishing the shares by the Salim group in 1998 the price was Rp.2500 per share (Irwanto, 2002; Kompas, May 31, 2002). Similar cases are cited in Texmaco on its Rp. 17 trillion, Gajah Tunggal group, and Sinar Mas (injection of more funds in Bank International Indonesia instead of allowing it to bust), among others. The possibility of cheap repossession of assets in IBRA by former owners are hard to refute, which undermined not only IBRA's' credibility as the executing agency, Bank Indonesia as the institution that was responsible for conducting due diligence evaluation, and the oversight committee which is supposed to serve as a watch dog on such transactions. Some assets were reckoned to have been sold to relatives of IBRA officials (Kompas, August, 19, 2002).

The dearth of ample domestic resources considered to be critical in the short term cannot therefore be overcome by taking recourse to offshore borrowing. This is so despite the presence of many Indonesian nationals who are categorized as 'high net worth' individuals, with assets amounting to \$257 billion (higher than the estimated total

state and private foreign debt \$74 billions, and \$63.438 billions respectively plus domestic public debt of \$62 billion, 2001 figures) (Gie, 2001). Along the way, vestiges of shareholder 'control' compounded by both overt and covert state intervention over 'relinquished' enterprises hampered efforts by IBRA to carry out restructuring prior to selling them off. Shareholders had the view that their assets were relinquished at very low prices because of the then prevailing distressed conditions, hence expect better prices with time as improvement in economic conditions set in (Kompas, June, 29, 2000).

There was a lot of foot-dragging by former owners as a result. Potential buyers obviously were unlikely to get entangled in enterprises where former owners still held sway! This problem is evidenced by the case of Bank Danamon's Usman Atmadjaja who was able to fire Milan Schuster and Ali Wardhana, Danamon's bank's directors appointed by IBRA, once they fell out of line with his interests (Gie, 2002). The consequence of all this was that IBRA became merely an asset-managing restructuring *per se*, a far cry from its enshrined task of managing such assets with the purpose of disposing them off to recover state funds. Indeed there is no doubt according to Mulyani, a distinguished Indonesian economist (Vatikiotis, 2000) who was in control during the bank privatization phase "...instead of the owners being hostage to IBRA, IBRA is hostage to the owners."

## **V. A Glance at the state of the economy**

The state of the economy significantly impacts on the performance of banks. An economy growing substantially creates the demand for the services offered by the banking system such as credit, securities, among others. A good macro-economy shown by low interest rates, stable exchange rate, buoyant export performance, substantial foreign exchange reserves, low indebtedness level, offer good opportunities to banks. It is also true, however that the state of the banking system profoundly affects state of the economy. A sound banking system provides the services demanded by the economy, by availing the financial intermediation function of linking deficit spending units (investors) with surplus spending units (savers). By reducing the cost of transactions Banks propel faster growth of the economy. Banks also reduce the risk borne by the

non-financial sector through the provision of underwriting services, ensuring liquidity, and as consultants in investment management. A quick glance at the economy from 1997 to 2005 gives a lot of optimism, though some continue to raise cause for concern.

On the positive note, the state of the economy (figures 8, 9, 10, and 11), is showing strong signs of gradual and consistent recovery. This is discernible from the gradual but steadily rising GDP growth (the economy grew by 5.13 percent in 2004, an improvement on 2003 growth of 4.35 percent); stable, though slowly creeping inflation rate (5.05 percent in 2003, and 6.4 percent in 2004), increasing export. Financial markets recovery is also well underway attested by the performance of the bonds market, the value of which grew by 68 percent in the 2002-2003 period, grew by another 29 percent in the 2003-2004 period, and was already up by 4 percent between December 2004 and March 2005). The stocks index, the Jakarta stock composite index CPI, the gauge of the performance of listed companies on Jakarta stock exchange, has shown remarkable performance over the past three years, reaching a breaking the record 1000. The CPI index grew by 8.4 percent in 2002, by another solid 60 percent in 2003, followed by a 47 percent growth in 2004.

Indications of an upsurge in investment have already boosted the stock market index to gain 8 percent by March 2005 over the previous year's figure. This is a solid indication that business performance has taken off once again to consistent growth. Recovery is also visible in the rising government expenditure which is good for pump-priming the economy, and the narrowing savings to investment gap, which has been mainly due to rising domestic savings rather than improvements in year-to-year direct investment.

Improvement in consumer confidence has stimulated higher consumer expenditure, which is indicative of the realization by consumers that it is now time to spend money on transactions rather than stacking it in savings, both financial and otherwise. Private consumption expenditure registered an increase of 4.72 percent and 4.3 percent in 2002 and 2003, respectively. This is crucial to stem the downward trend of the economy, as rising private consumption is likely to improve business confidence,

which is vital for resumption of private investment. This trend has been given a boost by rising government expenditure, which has risen over the past few years, among other factors, being attributed to increasing civil servants wages, resumption of halted infrastructure projects, and over the past few years on the general election and unfortunately, on security in areas prone to civil unrest such as Aceh, Maluku, and Central Sulawesi provinces. The government has been compelled to spend money on disaster assistance to earthquake battered regions in East Nusa Tenggara and Irian Jaya, and Tsunami affected regions of Nias and Aceh regions during the course of the past and current year.

Despite poor performance in the past few years, showing wide year-to-year variation, the level of approved foreign direct investment (FDI) has shown solid recovery in 2005 (Figure 10a), with the value already registered by March 2005, reaching US\$1034.5 billion compared to US\$694 billion during the whole of 2004. This is an increase of 40 percent. The rebound in FDI will reduce the decline in capital stock, which has affected the economy over the years. Capital stock declined by Rp. 53.6 billion in 2001, followed by another Rp. 73.9 billion decrease in 2002, and Rp. 67.3 billion in 2003. Domestic investment also shot up by 130 percent in 2003, from a plummet of 56 percent suffered in 2002 and is likely to grow strongly in 2005 evidenced by the figure in March of Rp 2.4 trillion, which is already 30 percent of 2004 figure of Rp. 3.4 trillion.

Another encouraging sign is the better management of external debt, which though still high US\$135 billion by March 2005, has a higher percentage of the long term component than the short term. Long term debt gives the national treasury some breathing space with respect to repayment than is the case with short term debt (figure 10a, Figure 10b).

**Figure 10 a. Trend in Some macroeconomic Indicators 1997-2004**

Indicator	1997	1998	1999	2000	2001	2002	2003	2004	2005*
Foreign Direct Investment (US \$ million)	1 992.7	399.7	372.2	765	6633.2	681.6	428.1	694	1034.5
Domestic Investment (billion Rp.)	5175.1	1812.5	1585.8	1348.98	2887.9	3325.5	1469.6	3378	2367.8
Inflation rate	11.05	77.63	2.01	9.35	12.55	10.03	5.06	6.4	8.81
Government Bonds (trillion)	-	-	845.5	1 295.4	1 306	419.4	403.4	402.1	410.1
Interest rate on credit *(%)	17.34	23.16	22.93	16.59	17.90	17.82	15.68	13.41	13.31
Jakarta Stock Exchange CPI	401.7	398.03	676.9	416.3	392.0	424.9	679.3	1000.2	1080.2
LQ-45 (Value)	7500	3426	12612.64	9570.97	16732.16	9714.38	8011.73	18951.54	61719.11
Inter-bank money market	-	108023	87473	51899	64353	50453	91524	118524	5844
Bonds market (billion Rp)	18740.5	18890.5	23174.4	28787.4	31662.4	37812.4	63485.5	81805.3	85780
International Reserves (US\$ billion)	17.4	23.5	27.3	29.4	28	32	36	36.3	36.03
External Debt (US \$ billion)	136.1	151	151	144	134	132	135	136.1	135
Debt servicing (US \$ billion)	19.7	18.1	17.3	16.2	13.3	14.3	18.9	22.4	4.2
Debt service as a % of exports	37	37.1	36	26	24	25.1	31	32	5.7
Total long term debt as % of total debt	73.7	80.7	80	76.8	76.9	75.7	NA	NA	NA
Debt as a % of exports	254	309	310	232	238	232	221	192	182
External debt as % of GNI	65	167	116.9	103.7	98.9	80.3	NA	NA	NA
Budgetary surplus/ deficit as % of GDP	0.5	-1.7	-2.5	-1.2	-2.8	-1.7	-1.9	NA	NA
Export value US\$ billion	53.4	48.8	48.7	62.1	56.3	57.0	61.1	71	74
Imports(US\$ billion)	42	27.3	24	34	31	31.2	42.1	59	64

\*March 2005

Source: [www.adb.org/](http://www.adb.org/), [www.bi.go.id](http://www.bi.go.id), Central bureau of statistics

**Figure 10 b. Trend in Some macroeconomic Indicators 1997-2004**

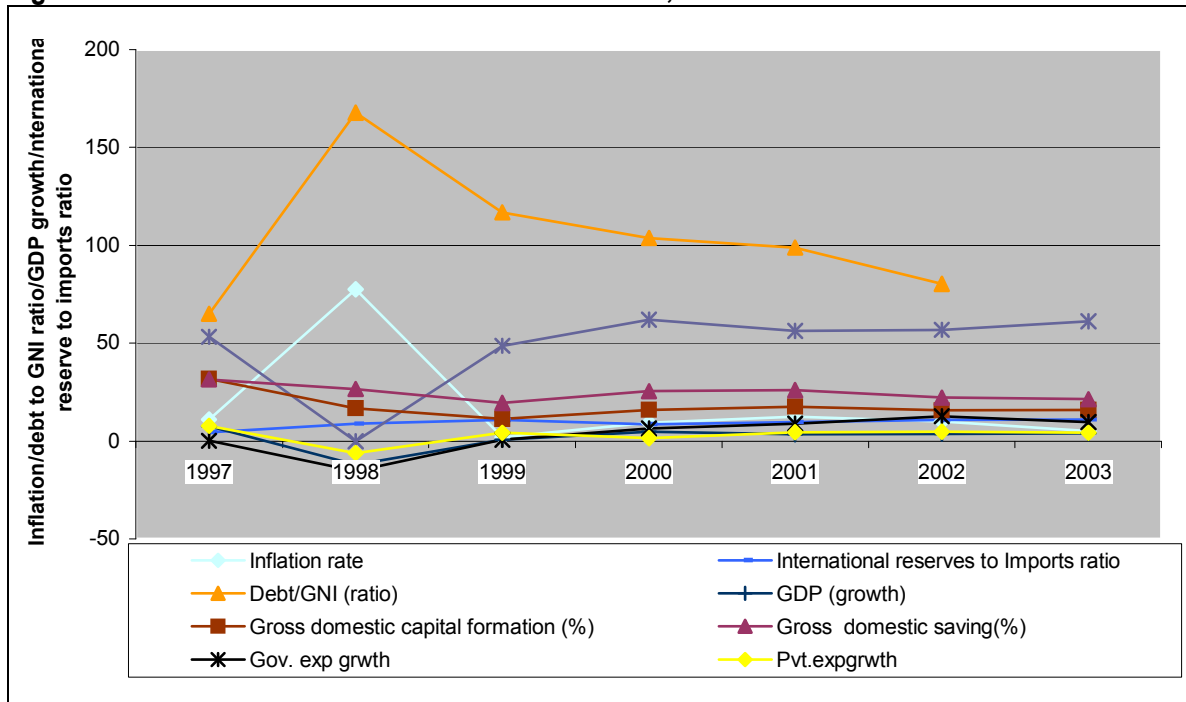
Indicator	1997	1998	1999	2000	2001	2002	2003	2004	2005*
Exchange rate Rp/US\$	2909	10014	7855	8422	10261	9311	8577	9290	9480
GDP (growth)(%)	7.4	-12.1	0.8	4.9	3.4	3.7	4.35	5.13	NA
Unemployment rate (open)(%)	7.5	5.5	6.4	6.1	8.1	9.1	10.1	NA	NA
% change in labor force y-t0-y	-0.6	3.5	2.3	0.8	3.3	1.7	-0.5	NA	NA
Gross domestic capital formation (%)	31.8	16.8	11.4	16.1	17.7	15.7	16	NA	NA
Gross domestic saving(%)	31.5	26.5	19.5	25.6	26.0	22.2	21.5	NA	NA
Increase in stocks (billion Rupiah)	21.6	-82.7	-96.5	-72.2	-53.6	-73.9	-67.3	NA	NA
Government Expenditure growth (%)	0.06	-15.37	0.69	6.49	8.98	12.79	9.84	NA	NA
Private consumption Expenditure growth(%)	7.82	-6.17	4.16	1.58	4.39	4.72	4.3	NA	NA

\*March 2005

Source: [www.adb.org/](http://www.adb.org/), [www.bi.go.id](http://www.bi.go.id), Central bureau of statistics

The exchange rate of the national currency against hard currencies strongly influences the rate of domestic inflation, interest rate, and terms of trade. A stable exchange rate regime should presage favorable terms of trade, stable inflationary rate and interest rate. The exchange rate Figure 10b) is showing good signs of stabilizing, which is due to improving international reserves position, rising export revenues, and favorable country risk rating. The improvements are reflected in rising portfolio investment, which has led to an upsurge in the domestic bonds market, money market, and capital market (figure 12).

Figure 11. Trend in some macroeconomic indicators, 1997-2005



However many hurdles continue to thwart fully-fledged economic recovery. Such problem areas can be construed, among others, from the still high debt to GNI ratio, which means that a large proportion of export revenues is unavailable to stimulate the economy back to normality; the high and rising budgetary deficit, which is indicative of either low tax revenues or high fiscal expenditures.

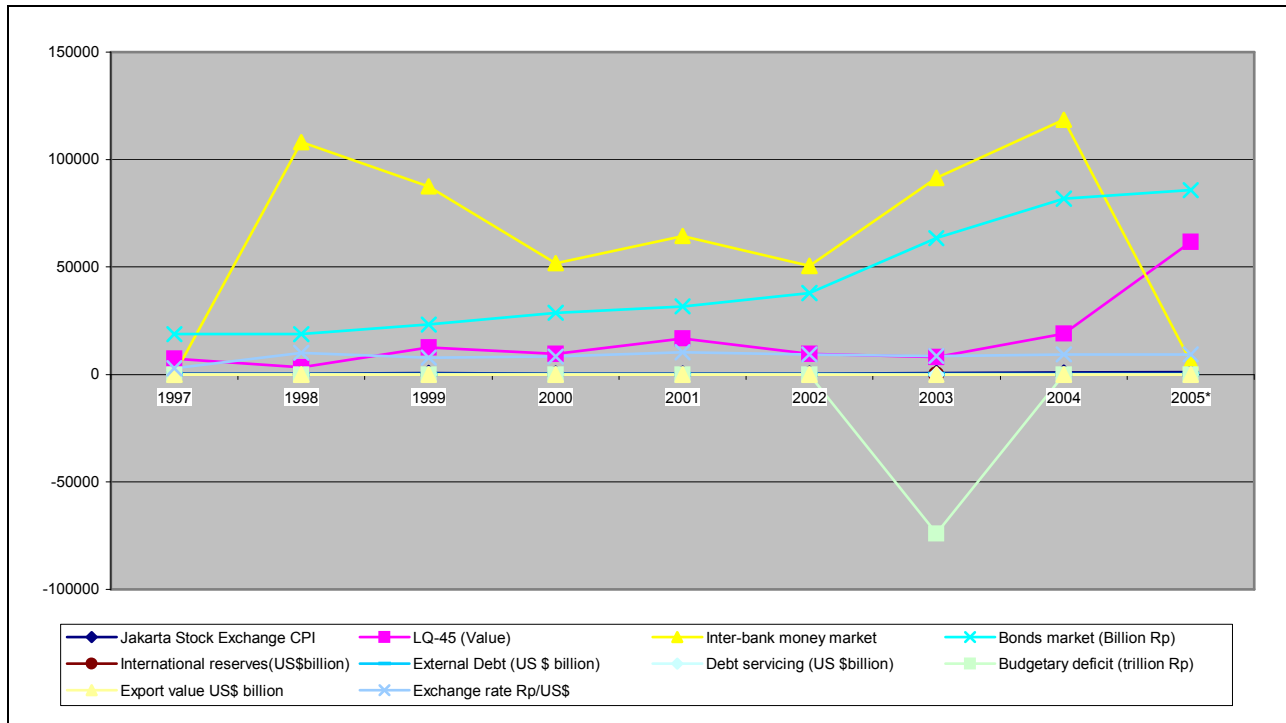
Low tax revenues into state coffers is which is attributed to among other factors, the still low level of business activity reflected in high excess capacities in industries, low taxable capacity, and poor tax administration which results into low tax returns. The government continues to spend not only on directly productive investment, but as indeed it should under the prevailing circumstances, continues to subsidize poor family incomes, payment for the upkeep of internally displaced persons (IDPs), political stabilization efforts in areas still affected by internecine conflicts, and the rapidly rising petroleum subsidy.

High government spending does not augur well for improvements in direct investment flows, because of the crowding effect it has on private investment. Thus, inevitably increase in raising funds from the domestic market by the state to finance its

programs, through rising domestic borrowing, increases the cost of funds to private investors, domestic and foreign alike. Private investment has been declining which has led to decreases in stocks (dis-investment), and rising unemployment rate (10.1 percent in 2003). This is not to mention widespread underemployment of more than 40 million people, which is a stark indicator of not only labor underutilization, but total low factor productivity. Another worrying signal is the steadily declining international reserves to imports ratio, which is mainly attributed to the increase in imports, which is not offset by equally high export revenues to finance them (figures, 8, 9, and 10).

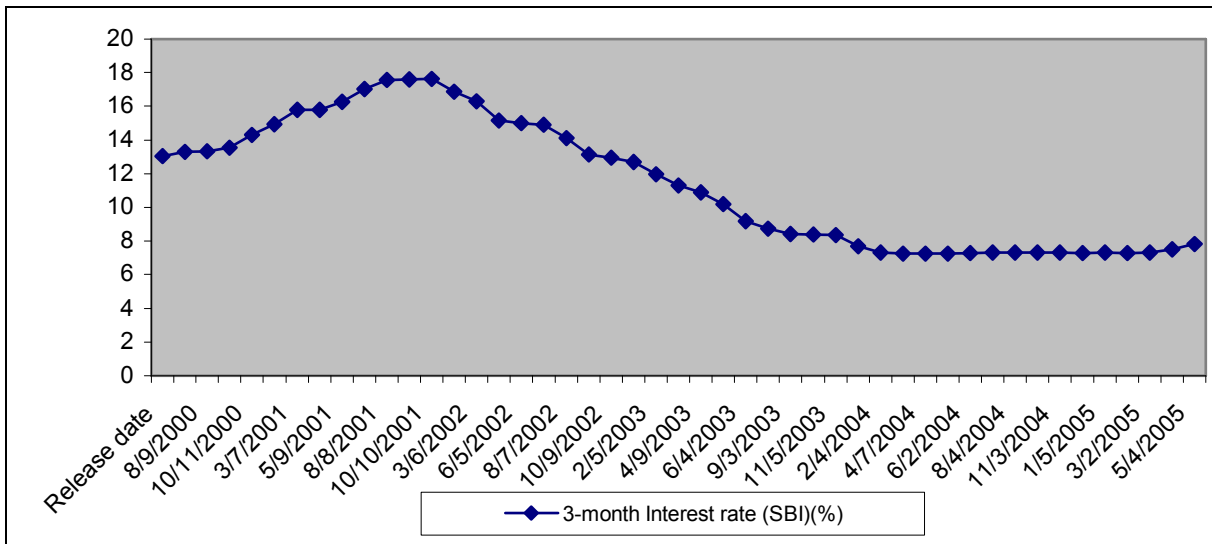
Moreover, few inroads in the field of privatization have undoubtedly lengthened the duration of the economic malaise, and thus contrary to expectations unlikely quicken the pace of bank solvency and liquidity efforts. The social instability moreover undermined government efforts to privatize state owned enterprises and assets acquired by the government from former bank shareholders compensating for the colossal bank liquidity support as well as state owned enterprises to attain growth targets. Incitement of workers to strike against privatizing state firms led to the abandonment of such efforts. The case of Cemex, holding a 25 per cent in Semen Gresik, a state owned cement company, failed to increase its stake to 51 per cent due to pressures emanating from bureaucrats in Sulawesi and Sumatera, as well as employees of Semen Gresik (Business week, 2001). Similar efforts were at work in derailing the privatization of bank Bali to Standard Chartered Bank in 1999, and the Kalimantan Prima Coal saga.

**Figure 12. Trend in macroeconomic Indicators, 1997-2005**



Thus, despite the onset of falling interest rates regime (figure 13) , financial intermediation has not picked up pace, a fact indicated by the still relatively low loan to deposit ratio of below 50 percent. Banks are wary of high likelihood of default, which is still high in the real sector. This lengthens bank dependency on income arising from interest rate payments on state bonds as well as investment in risk-free bank Indonesia certificates. Logically, to avoid incurring risks, banks still prefer to invest their funds into liquid, risk-free, bank Indonesia certificates, depriving real sector of much needed funds for kick-starting economic recovery. Without injections of new credit to the real sector, unlikely due to problem of increased information asymmetry between banks and their corporate clients in the wake of the 1997 financial crisis, firms can hardly embark on utilizing their excess capacity, let alone making new investments. Thus, little headway can be made in the direction of economic recovery if the state of the economy remains edgy, banking sector timid to extend new credit lines, and corporate sector wary of contracting new loans under such hard conditions fearing increasing debt overhang.

**Figure 13. The trend in Interest on 3-months bank Indonesia certificates, Jan,2000-4 April, 2005**



Many commercial banks are still focusing on lending for consumption purposes, which is understandable as the largest percentage of economic growth emanates from private and public consumption spending. However, if the trend remains unchecked it is likely to fuel inflation as it increases demand for imported goods. This is ironical because one would expect high consumption expenditure to stimulate increased production capacity of domestic industries especially those dealing in consumer goods. This isn't the case because of the high percentage of private consumption goods that are imported, which doesn't have substantial multiplier effects to the domestic real sector. Such a situation of Increased consumption expenditure induces higher foreign exchange demand, which compounds the already balance of payments problem.

It should also be noted that domestic industries have high dependency on imports of intermediate goods, and raw materials, which has the implication that despite improvements in some macroeconomic indicators, reflected in falling interest rates, inflation, stable exchange rate, the high external deficit and increasing budgetary deficit are signals of volatile economic performance, which has the potential to change for the worse once international macroeconomic indicators worsen. In short the problem of high dependency of the economy on external factors, which is a direct consequence of

financial and real sector deregulation policies pursued by the government since late 1970s as well as part and parcel of IMF-Indonesian government macroeconomic stabilization programs, 1998-2004.

Private sector foreign debt was the crucial factor that turned currency depreciation in one country into a multinational, multidimensional financial crisis in 1997 since it made debts denominated in hard currency difficult to repay. Small wonder that settling the \$52.08 billion of private debt owed by domestic banks (US\$3.77 billion) and enterprises (US\$44.49 billion) in Indonesia and US\$78.59 billion government debt (July, 2004 position) to foreign agents should be the overriding goal if bank soundness is to be restored. The attempts to resolve private debt through bilateral settlements between creditors and debtors through rolling over or discounting debt, forcing debtors into bankruptcy by creditors, participating in the Indonesian debt restructuring agency program by both debtors and creditors haven't made much dent into the huge private debt (Nuswantoro, 1998).

While some enterprises have been able rollover some of their debts such as Bakrie Brothers, and Astra International, many haven't been able to do so, possibly because debtors still consider the government as willing to foot part of the bill, a case that is indicated by the INDRA debt repayment scheme. Bankruptcy means have been thwarted by debtors filing for bankruptcy before creditors have the chance to force them to do so, which reduces the recovery rate of assets. Some debtors such as Semen Cibinong (\$250 million) and Sinar Mas make claims of millions of dollars of offshore deposits that cannot be withdrawn to settle their obligations (Murphy, 1999). Such factors, among others have increased the perception of high risk by investors which means that some modes of debt repayments such as debt-equity swap and assets sales hasn't attracted creditors and investors' interest.

The country continues to pay a large percentage of its export revenues to service debt as indicated by the percentage of debt service to exports. The country spent 25 percent of the export revenue to service debt that now stands at US\$135 billion (figure

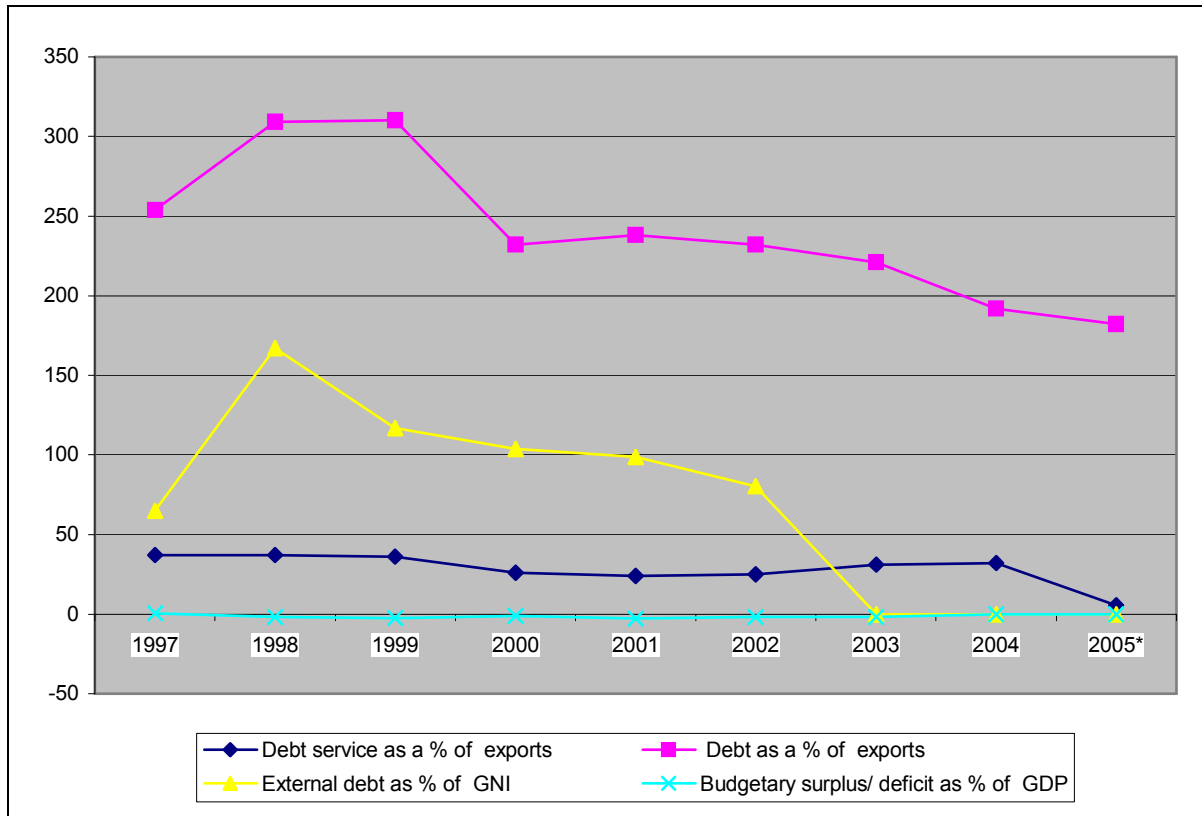
14). This reduces the government leverage to pump[ prime the economy, so much needed in times economic recovery.

The rising budgetary deficit continues to be cause for concern,. This is because poor mishandling of the deficit can spin the economy into inflationary territory, which can fuel high interest rates, undermine the currency exchange rates(depreciation). Investment climate should suffer as a result as indicators of business confidence take a nose dive. The cost of contracting future loans rises as country risk rises, which undermines the flow of foreign direct and portfolio investment.

The rise in imports which stood at US\$64 billion in March 2005 continues to show signs of rising while may indicate that the economy needs more imports to sustain economic growth as many economic activities require high percentage of imports of intermediate goods, machinery, petrochemicals, among others, to carry out their operations. Nonetheless, such steep rise if imports may also harbor rising costs of petroleum products which have gone up significantly in line with spectacular rise in petroleum prices. High import costs may also indicate increasing consumption of imported goods, which apparently undermines domestic economic recovery.

Privatization of restructured enterprises rarely attained its intended targets. Despite the colossal amounts spent on restructuring banks, was never going to succeed to obtain sufficient cash from the sale of assets to either domestic or foreign private sector. It should recalled that under depressed economic conditions (Shleifer and Vishny, 1992) , the most likely buyers of restructured bank assets and enterprises in the domestic market were under hard conditions too, restricted to purchase by the government (prohibition of former owners of re-capitalized banks to purchase them back after re-capitalization, by the government and the regulation that bidders for restructured banks had to have track records in financial institution management), the regulation forbid the purchase of bank and corporate assets by potential buyers from other industries or abroad. Such restrictions obviously reduced the already small sample of potential buyers, which as was the case increased the running costs of such assets to the tax payer.

**Figure 14 . Indicators of national indebtedness (Indonesia)**



Social stability is absolutely crucial for restoring already battered investors' confidence for even if privatization was to be accomplished, social unrest by other stakeholders in such enterprises may prevent the changeover or even curtail the operations of the enterprises. It is incontrovertible that some parts of Indonesia are still characterized by unstable social and political conditions translate into high country risk, which jeopardizes foreign capital and investment inflow. Rescheduling of state and private loan repayments becomes difficult, as will be the contracting of new loans, if any. Creditors' fear of sovereign default increases the higher the country risk since the cost of funds soars due to higher premium demanded on new loan arrangements cover for higher risk as well as the tightening of credit terms by creditors on new loan disbursements.

Sluggish corporate lending for investment activities due to capital stringency requirements increases costs of deposits on bank balance sheets as banks must pay interest on them, but not able to generate interest income because of little lending. Thus,

many banks still rely on investment in safe but low -return bank Indonesia certificates as well as interest on state bonds as income.

The drag on economic growth arising from the soaring petroleum prices can't by any means be underestimated. The price of petroleum oil hovers around the US\$70 mark, which constrains state finances to import petroleum oil, increases the cost of petroleum consumed in the country as most of it is subsidized (estimates of petroleum subsidies are put at about Rp.140 trillion mark if the price trend continues to the end of the year. High government expenditure on petroleum oil reduces funds to other economic activities, especially investments in long term programs such as road, health, and education infrastructure.

Moreover, as is already apparent from the trend in prices, inflation has begun to reverse the downward trend, which it showed towards the end of 2004. High inflation definitely leads to the adoption of tight money policy, which is the reality today, as Bank Indonesia changed tack from encouraging strong liquidity to stemming it through its charge on bank Indonesia certificates sales.

The problem could be compounded if prime interest rate on bank Indonesia certificates raises to double digit levels, which will force banks to stem credit extension as the probability of default increases with high loan cost. The Pandora's box will be open as borrowers will start to feel the pinch of high credit cost, creditors fearing the worst calling up loans or renegotiating loan terms from fixed to flexible or indexed interest rates, bank Indonesia instituting even tighter credit disbursement requirements, and high reserve ratios, all of which will end up creating another crashing credit crunch.

## **VI. Un-finished business and recommendations**

The most apparent testimony that the banking system is yet to serve its function as a financial intermediary effectively can be seen from the loan to deposit ratio which is still around 50 percent, an indication that banks are stashing a lot of deposits in vaults instead of channeling them to investors as well as investing in low return, risk free bank Indonesia certificates. It is hard to imagine sustained economic growth without increased

credit extension. Yet it must be noted that merely opening up the credit tap before fraud proof mechanisms are set up to avert non performing loans problem, which accelerated bank convulsion at the peak of the 1997 economic crisis would be foolhardy as recurrence of the tumultuous events can hardly be ruled out. The slow pace of efforts to restructure bank loans on bank balance sheets (especially state-owned banks) postpones the resumption of effective financial intermediation (Kompas, May 29, 2004:25). The problem of loans on balance sheets of state owned banks from state owned enterprises, must be resolved, not merely by the state taking over the problem loans, but the revamping of corporate management of such companies. Using a big stick to punish private banks and enterprises while providing succulent carrots to state banks and enterprises is the best way to re-invite bank and corporate mismanagement, which is responsible for compounding the short term exchange rate misalignment into long term financial and economic crisis.

Though strenuous efforts have already been made toward reducing the number of banks there is still more room for consolidating the banking system further as by so doing a strong, sound, solvent and competitive banking system is created. Thus, failing banks should be allowed to go under rather than given more new lease of life through costly re-capitalization. A good banking system will project good prospects for investors who will bring in the much-needed capital necessary to enhance effectiveness.

This of course does not mean that bank capital should not be strengthened further, as without such a foundation, survival in the local and foreign market, let alone, compete is out of the question. Compliance with prudential banking principles along the lines of the Basle accord 1988 should not only be the guidelines along which bank managers run their banks, but must become part and parcel of the fit and proper test that a potential banker manager must pass before he is given the green light to embark on his trade. The caveat, is in order here that capital requirement should not be a certain percentage for all banks across the board, as is the norm to day, rather, should depend on the specificity of assets a bank invests in, with the implication that diversification effects

of negatively co-varying asset returns should be taken into account when determining capital requirements (Mullins and Pyle,1994:132).

The privatization of re-capitalized banks, both state and private owned, should be accelerated to release state funds for other economic activities. It is through privatization that an injection of new bank management techniques, strengthening bank competitive edge through the acquisition of state-of-the art information technology, all of which require substantial amounts of money. It is easier for privately run banks to refocus bank operations from loss making ventures to money-spinners in line with the demands of the clientele because of minimal bureaucratic red tape, driven by the profit motive, without which their demise is *fait accompli* (Business week July 2, 2001). Financial institutions with track records in bank management must be given top priority if the aforementioned injections are to be realized. Privatization should not be restricted to re-capitalized private national banks, but also state banks.

It is through privatization that state banks which control a significant proportion of bank credit and savings market share that the entire banking system efficiency will be improved. State owned banks are renowned for the high bureaucratic red tape, which thwarts innovation and creativity making them unable to quickly adjust to changes in the banking environment.

Thus, immense national resources are spent on the bloated bank staff, for the guarantee of deposits, liquidity support, for writing off poorly executed loan disbursements, and for re-capitalizing of state banks to keep them afloat. It is through cautious and well thought out privatization that the drain on the nation's resources will be curbed, and the low rate of innovation and creativity, common to state banks, given a shot in the arm. Yet the sticking point is how to privatize debt-ridden banks without discounting heavily on their values. This is in addition to staggering value of state bonds that still comprises a significant proportion of bank capital, which on privatization automatically goes into the hands of the new owners.

Bank privatization should not be viewed as an end in itself, call it a revenue collection exercise merely intent on maximizing the contribution of the disposed asset to

state budget revenue, rather than a lynchpin towards revitalizing the entire economy. With that in view, therefore, potential buyers should show their commitment to make substantial investment in financial services related human resources development, which should be one way of forestalling the recurrence of banking malpractices, which torpedoed the banking industry to its knees once the economic crisis struck. Revitalized privatized banks should play a key role in re-establishing bank-corporate relationships, though had taken long to establish, many succumbed to the convulsions of the 1997 economic crisis.

It is incontrovertible that without making effort at establishing such bank-corporate relationships, the resumption of substantial credit extension is nothing more than a pipe dream. It is long standing bank-corporate relationships that reduce information asymmetry inherent in lending transaction as banks come to acquire more information about their clients performance and prospects, something arms length bank-corporate relationships can hardly achieve (Greenbaum et al., 1988; Word, 1975; Holland, 1994:369). The internalization of corporate prospects by banks made possible in long standing relationships reduces the perception of risk on credit extended to the firm, which thus breaks the cycle of high credit risk, high default, low credit extension, output contraction, decrease in credit worthiness, and lower credit levels.

In order to foster the emergence of sustainable sound banking system it is an onus of the government to impose hard budget constraints on loss making re-capitalized banks and enterprises. Resort to outright liquidation without incurring additional costs should be the policy towards banks that show indications of persistent underperformance despite improvements in market conditions. This will reduce the cost, which has to be met by virtue of its depositors' guarantee scheme, which in turn will reduce the size of the fiscal deficit. Lower fiscal deficit will reduce inflationary pressures; increase the chances of a strong local currency and the sustainability of a low interest rate regime. Such conditions will be congenial for macroeconomic stability, which provides an enabling environment for both the real and financial sector. Hence allowing inefficiency to blossom with losses being covered by price and rate increases is the hardly the way to enhance the

development of efficient banks since the state of enterprises affect the quality of loan portfolios on banks balance sheets.

The plethora of many small bank branches of national banks impairs bank efficiency. These drain bank resources though may each may add little to consolidated bank earnings (Zardkoohi and Kalori, 1994). Consolidation of many small branches should be made in order to enhance bank efficiency as evidence is abound that supports the view that large size branches are more efficient than small ones. The consolidation of small bank branches should go hand in hand with the consolidation of the banking industry in general. This should be carried out through forced acquisitions, mergers, or forced take-overs. The proviso here is that such a process should not reach the extent of undermining competition by creating large bank monopolies, which in any case, become inefficient beyond the \$100million dollar mark in assets (Houston and Ryngaert, 1994:1167).

The deepening of financial markets is imperative for the emergence of a sound banking institutions. Thus, markets in securities and bonds, should be promoted by the government to reduce bank reliance on credit. Increasing the variety of financial institutions should go hand in hand with enactment of laws on transparency and the adoption of international accounting systems Widening the variety of financial assets will provide additional sources of capital as well as enhance bank liquidity and stability.

Banks are, as good debtors as the real sector, yet it would be simplistic to draw a hard and fast line distinction between the two types of debts since enterprises and banks more often than not, are owned by the same individuals in Indonesia. This explains why government enmeshed itself into rougher waters when it embarked on bank re-capitalization. The entrapment was that since the re-capitalized banks became *de facto* state banks as well as the enterprises surrendered to IBRA as compensation for liquidity support misappropriations, debts owed by such business entities became the responsibility of the government-or so it seems. The state therefore should take bold steps to settle not only its US \$74 million debt but also that of the private sector. The government should not give mixed signals to private debtors on the latter's' responsibility

to repay their obligations by strengthening bankruptcy laws so that creditors are able to force enterprises and banks that fail to repay into bankruptcy and eventual liquidation.

Shareholders of liquidated and bank take-overs should be compelled in need be to settle foreign debt obligations using their assets within and outside the country. This is possible if the government coordinates its policies with international banks, multilateral agencies, and foreign governments. The more than \$80 billion in capital outflow over the past few years, should surely more than repay the entire foreign debt private enterprises owe. Debt settlement is crucial for not only curbing persistent pressures on the domestic currency whenever debt maturity approaches, but should also quicken economic recovery.

Bank corporate governance should be over hauled. It is because of poor corporate governance that led banks to indulge in excessive un-hedged off shore borrowing, which was the main catalyst that compounded the 1997 financial crisis. Poor credit analysis, extending loans to affiliate enterprises beyond the legal maximum, and indulging in investment whose risk is contingent upon 'states of the world' are indications of bank governance gone fundamentally wrong. Though the 1998 bank law obliges banks to seek for approval credit amounts beyond certain sums, this is not enough to reduce the high level of non-performing loans in future. Bank credit policies should be scrutinized by the central bank and the bank supervisory agency, once it is established, to avoid the recurrence of dad loans as well as loans to affiliates. Banks must also be compelled to adopt modern risk management practices such as hedging, interest rate floors and caps, among others, to reduce the adverse effect of exchange rate and interest rate fluctuations on banks ability to meet foreign currency denominated transactions and obligations. Managers of banks should be professionals with track records in asset and liquidity management, and possess sound professional character.

The rules on non-performing loans should be streamlined so that banks undertaking highly risky investments should do it at the cost of not only higher capital requirements but also higher provisioning. This is because by adhering to stringent capital requirements, banks are protected from falling into major crises, improves loan management and by so doing lowers the possibility of high non performing loans.

High loan provisioning serves as a budget constraint to bank management, and should therefore increase the quality of not only financing decisions, but also investment decisions. It in other words makes management more prudent that would be the case without it.

To reduce the problem of risky assets on bank balance sheets, banks should be encouraged to sell assets without recourse in order to reduce potential future risk. Securitization removes such assets from the bank balance sheets, which by so doing increases the bank's cash ratio, and thus its liquidity (Dewatripont and Tirole, 1993: 164). The proviso is that securitization should not be conducted with the aim of hiding management's imprudence in credit allocation and other investment decisions. Laws on good bank supervision and monitoring should thus be part and parcel of securitization.

Since high risk banks pay higher premiums, lenders, individual and corporate alike, charge high interest on funds extended increasing the difficulty for such banks to acquire funds. Besides, depositors' confidence in such banks should plummet the higher the premium the bank pays to the insurance scheme since it is regarded as a measure of the state of its health. Troubled banks should in addition be made to face progressively harsher sanctions the graver their state of dysfunction (Kaufman, 1995), and mandatory closure should be forced by the central bank before bank capital becomes negative to reduce the cost of bank liquidation on the state sponsored depositors' guarantee scheme (Garcia, 1995). . The presidential instruction No. 17, 2004, which restricts state guarantee to deposits and inter-bank obligations is in the right direction. The instruction changed the Presidential instruction No. 26 , 1998 and presidential instruction No. 120, 1998 which authorized bank Indonesia and commercial and regional development banks and peoples banks to issue blanket guarantees under which the state gave a blanket guarantee of all obligations owed by commercial banks(Kompas, September 12, 2003).

Though the strength of official oversight has been shown not to improve bank performance, the expectation is that better loan classification and provisioning and corporate governance and structure of barriers will reduce opportunities for banking malpractices. However, for long term improvement in bank efficiency, reliance on

regulation and state supervision should be reduced while private monitoring encouraged in the long run (Barth et al., 2002). This is why divestiture and measures to encourage banks to list shares on stock exchanges should be laudable policies. Such measures should go hand in hand with strengthening capital stringency requirements as strongly capitalized banks reduce the likelihood of a major banking crisis and reduce bank distress (Barth et al., 2002:20).

To improve the quality of items on bank balance sheets, market value accounting should be adopted. This means that items in bank balance sheets are marked to their market value, which reflects their real value as distinct from their historical value. Moreover, market value accounting reduces the tendency for bank managers to indulge in gains trading, common under historical accounting system. It is well established that in gains trading, managers dispose of assets that appreciate above some cut-off value, because by so doing their improvement in their performance rating occurs; and retain assets that appreciate below the cut off value since any disposal implies reduction on operating profits as charges must be made against reserves. Gains trading foresters short term profitability, to the managers' benefit, at the expense of long-term firm profitability.

Adoption of market value accounting should not be partial either, for instance by requiring the marking bank assets only. This is because, by not marking liabilities to market, leaves the main source of bank failures, bank capital miss-valued (Carey, 1995). Adoption of market value accounting must be made with full knowledge of its problems, which include lack of markets in illiquid assets on bank balance sheets, which may lead to difficulties of marking them to market; possible manipulation of market values by regulators and banks; and under valuation of assets arising from adverse selection.

Commercial banks have been shown to be more stable if allowed to diversify across non-traditional economic activities such as security underwriting and selling, investment management, and so on (Barth et al., 2002). Bank supervisory body should push this forward, definitely without losing sight of strict compliance to prudential principles.

Early warning systems should be put in place by the monetary authority by for example obliging banks to submit regularly reports on their liquidity positions. This is because liquidity positions help supervisors identify possible insolvency problems enabling the arrangement of rescue plans or effect immediate foreclosure to reduce the cost on the government deposit guarantee account, as well as recover some of the re-capitalized funds by disposing bank assets. The state of bank liquidity however, may not predict the timing of bank failure. Thus, the early warning system put in place should not only focus on a banks' current ratios, but also the condition of its capital, assets, net income, which factors presage the timing of bank failure (Cole and Gunther, 1995) .

Bank safety net has to be more selective and efficient if it is to enhance bank solvency. Carrying out blanket deposit guarantee increases the possibility of moral hazard due to conditions of high idiosyncratic and market risk, intensifies adverse selection, and worst still, makes it hard for the government to force failing banks into liquidation fearing the huge cost of repaying depositors. Among the measures in that line, should be the shifting of the entire burden of bank failure from the state to management and shareholders. This can be done by linking premium payments to depositors' insurance schemes to the level of bank capitalization and structure of bank management; enforcing bank management structures that link high risk taking to the payment of higher premiums to the state depositors insurance scheme, and making it obligatory for shareholders of failing banks to pay higher premiums to depositors' guarantee scheme than others.

Better use of forbearing in dealing with problem banks. Forbearing, which is the practice of allowing insolvent banks to continue operations under regulatory supervision enabling the institution to regain solvency before closure (Allen and Saunders, 1993; Nagarajan and Sealay, 1995), can reduce the problem of risk taking as well as risk shifting by making it costly to do so through an incentive compatible mechanism. As many banks in Indonesia still face the likelihood of insolvency not only due to idiosyncratic factors (specific to them) but also factors beyond their control (market risk), forbearance backed by stricter induced closure policy and effective minimum capital requirements by

increasing shareholders' risk in the event of bankruptcy, should reduce shareholders' incentive to shift risk by gambling with insurance funds, and by so doing reduces state liability as the guarantor of peoples' deposits.

Bank operations cannot be improved without re-orientating their operations from corporate to retail business. Commercial banks in Indonesia being set up by owners of other enterprises, had their credit evaluation, collection, and terms geared towards channeling credit to such enterprises making them inexperienced in dealing with small and medium enterprises. Yet one of the consequences of the 1997 economic crisis was the contraction of corporate activity implying that banks have to re-orientate their activities from corporate to retail banking if they are to increase the level of transactions without which sustainable soundness and liquidity cannot be achieved. SMEs contributed 99.8 percent to GDP in 2002 yet banks are not yet ready to deal in SME credit because of their inexperience, inflexible bank standards unsuitable for small scale credit, and the difficulty of dealing with the paucity of collateral among SMEs. There is no more evidence of this state of unpreparedness than the fact that the colossal credit amounting to Rp. 2.1 trillion earmarked by bank Indonesia for small and medium size enterprises in the 2001/2002 fiscal years had hardly been deployed by January 2002. Yet caution in embracing credit extension to SMEs is still necessary if new credit does not end up into bad loans that already amounted to Rp. 44.3 trillion on re-capitalized and liquidated banks.

The emergence of efficient payments systems in the banking sector within the country as well as across national frontiers should go a long way in improving bank transfers, verifications and settlements. This will increase the source of capital, diversify further investment opportunities and open national banks to modern bank management practices, which very vital for developing healthy and competitive banking institutions.

Considering the predominant role of state owned enterprises in the Indonesian economy it is illusory to imagine any fundamental economic overhaul if privatization is merely restricted to re-capitalized banks and restructured enterprises of former shareholders of bank take-overs and liquidated banks, leaving state owned banks and

enterprises intact. Privatization and divestiture drives should be intensified to reduce economic inefficiency and softer budget constraints that state ownership creates (Barth et al., 2002). The role of the state should be replaced gradually by the private corporation ownership of banks, which should foster private sector monitoring, appointment of independent directors on company boards, and enforcing information disclosure by encouraging banks to sell shares on the stock exchange for example, along with more openness for the mass media are predicted to enhance bank performance and stability. Privatization, if well executed will obviate the recurrence of high ratios of non-performing loans, the writing-off of which must be met by tax payers' money; reduce state underwriting of state-owned enterprises losses, which amounted to Rp. 17 trillion losses in 2001; increase competitiveness in the financial as well as the real sector, as the number of players increases, all of which should stimulate growth and development.

Reviewing the blanket depositors insurance scheme to reduce moral hazards as well as the likelihood of a major banking crisis. Liberal depositors guarantee scheme, if not accompanied by effective law enforcement, openness and private monitoring efforts of bank activities are found to beckon banking crisis. However, as fears are still abound about volatile depositors' confidence, the continuation of the depositors' guarantee scheme should be strengthened by improvement in law enforcement and greater political openness to reduce the danger of underhand deals and covert banking practices. Judicial capacity enhanced by increasing the number of courts dealing in bankruptcy and liquidation cases, as is the number of judges and lawyers familiar with commercial law. Institutional capacity building should also be enhanced by providing training to judges and lawyers in market based systems.

Laws on collateral registration and evaluation; property rights, sanctity of contracts and liquidation proceedings should be streamlined. Instill financial discipline in borrowers. It is imperative to enhance courts' enforcement powers in order to increase debt recovery and asset repossession. It is expected that such overhaul will bring in much needed financial discipline among borrowers as well as increasing loan recovery rates for creditors.

The investment climate should be improved by putting in place a well-streamlined investment code, which is nationally applicable to reduce the probability of conflicts between national and local government policies, environmental conservation and economic development, over state and private sector roles.

Important though the aforementioned are, it should be noted that banks are sound and vibrant, well managed, and profitable as the real sector, to which credit they channel their credit (Isard et al., 1996). To this end, enterprise restructuring must go hand in hand with efforts to restore bank soundness, otherwise the vicious cycle of sound banks extending loans to unhealthy enterprises leading to high non-performing loans that in turn send banks into illiquidity and eventual insolvency will continue. This calls for the enactment of laws on managing operations stipulating conditions on the use of debt, transparency of operations as well as adopting international accounting standards, and revisiting laws on off balance sheet items. Management of operational, financial, and technological risk should be well streamlined by corporate managers before operations are given a go ahead.

Yet whatever reforms banks undergo in Indonesia, the undeniable fact is that no bank can face new challenges on its own, which is why alliances among banks with similar niches is vital. Using advantages of knowing well local markets, technological advances such as the internet can be used to form virtual alliances that increases the accessibility to bigger market, provision of more innovative products, and achievement of greater reach at low cost in real time with large size, and at high speed (Ong, 2001).

Considering the immense cost of bank re-capitalization, and the reality on the ground that it has so far failed to induce significant irreversible shifts in bank performance, one wonders whether re-capitalization is not too much of a costly gamble that may never pay off, after all. Resort to bank re-capitalization should be undertaken if and only if; other alternatives such as the pursuit of privatization, bankruptcy and liquidation are more costly. This is because undertaking such a stance instills financial discipline among bank managers who have to ensure that banks under their tutelage are not only profitable but also liquid in order to avert collapse. There shouldn't be a bank

that is too big to fail nor should the adage that ‘ *if you owe a bank \$10,000 you are in trouble, but if you owe the bank \$10 billion the bank is in trouble*’ be denied only in theory but by all indications is by and large !

The last but by no means the least note one fact that shouldn’t be glossed over, is that as banks take on new activities such as dealing in securities, (under the 1998 banking law , commercial banks in Indonesia were allowed to carry out other activities for instance underwriting security offers on the stock exchange, addition to taking deposits and lending to customers. The expectation at the time perhaps was that giving banks the opportunity to diversify their investments would reduce the risk of incurring losses in the conduct of their operations. Nonetheless, the undeniable fact is that new economic activities mean new risks to banks, which call for new measures for the central bank and banking system, alike to control and manage. This is the more so in light of the impending adoption of Basel II capital adequacy standards that call for banks to establish internal risk measures in line with risk exposure emanating from economic activities comprising respective investment portfolio. The importance of individual risk for each business unit comprising the portfolio should assume greater importance in the new Basel arrangements (Turnbull, 2002; Lopez, 2003; BIS, 2005).

## **VII. Conclusion**

Bank restructuring which has taken different forms has emboldened the banking system through reduction of non performing loans, liquidation of inefficient banks, re-capitalization of banking institutions, and change in management. Non-performing loans have declined, capital adequacy ratios have shot up, and deposit collection has accelerated.

Nonetheless, credit extension hasn’t recovered as expected, implying that the real sector is till deprived of much needed credit, without which attaining economic recovery is illusory, at best. More needs to be done in the bank management re-orientation, improvement in the investment climate, more government commitment to privatization, and enterprise restructuring. Increase in the intensity as well as frequency of bank supervision as envisioned by bank Indonesia is long over due for without it transparency

will continue to suffer. The role of supervision has never been greater than today with banks allowed to engage in services related to banking such as underwriting share offering and dealing in securities on stock exchanges. Yet merely focusing on bank restructuring leaving other aspects of the economy intact is a futile game, which can never bear fruits. The interdependence of sectors of the economy calls for a comprehensive master plan that incorporates all the sectors of the economy. Small wonder, full-fledged sustainable economic recovery continues to be an elusive expectation, at least to date in Indonesia.



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