INDONESIA’S BANKING CRISIS RESOLUTION
Lessons and The Way Forward*

Sukarela Batunanggar**
2 December 2002 (Preliminary)

Abstract

The views expressed in this paper are those of the author and do not necessarily represent those of Bank Indonesia or Bank Indonesia policy. Please do not quote without the author’s permission.

This paper assesses the measures taken to resolve the recent banking crises in Indonesia and draws lessons for the future. Indonesia’s banking crisis was the most severe in East Asia and one of the most costly crises the last quarter of the 20th century. The crisis resolution suffered from two main problems: (i) a lack of understanding from the IMF and on the part of the authorities of the crisis which resulted in inappropriate strategies both at the macro and micro level; and (ii) a lack of government commitment to take consistent and objective measures. Two key steps are suggested to improve the resolution mechanism in Indonesia: (i) a gradual replacement the current blanket guarantee with an explicit and limited deposit insurance scheme; and (ii) a more well-defined lender of last resort which is more transparent both in normal times and during systemic crises.


**Senior Analyst at Bank Indonesia. The author would like to thank Peter Sinclair (CCBS, Bank of England), Glenn Hoggarth (Bank of England), Rasmo Samiun, Romeo Rissal, Wimboh Santoso and Agus E. Siregar (Bank Indonesia) for helpful comments and suggestions; Maman H. Somantri, Nelson Tampubolon, Muliaman Hadad (Bank Indonesia), and CCBS staff for kind support. All errors are those of the author. E-mail address: batunanggar@bi.go.id
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I. Introduction

The East Asian financial crisis stands out as one of the major crisis of the 20th century. After enjoying marked economic growth for three decades, Indonesia, together with Thailand and South Korea, experienced an extraordinarily turbulent “twin crises” – a currency crisis and a banking crisis. The impact of the crisis has been devastating. Indonesia has suffered particularly badly. There has been a deep and prolonged recession and the fiscal costs of crisis resolution are so far over 50% of annual GDP. During the last quarter of the century, only the Argentina crisis in the early 1980s was more costly to the budget. Although the crisis is now over, but Indonesia will experience its effects for years to come.

There is now a large literature on the causes of the Asian crisis1. There are two main polar views of the causes of the crisis. The first view argues that the main cause of the crisis were weak economic fundamentals and policy inconsistencies (Krugman (1998), Mishkin (1999). The second view believes that the root of the crisis was pure contagion and market irrationality ((Radelet and Sachs (1998); Furman and Stiglitz (1998) and Stiglitz (1999, 2002)). While some other commentators such as Corsetti, Pesenti and Roubini (1998) and Djiwandono (1999) took the middle ground arguing that both contagion and poor economic fundamentals caused the Asian crisis. Financial crises do not occur only in the presence of weak fundamentals, but weak fundamentals can trigger bank run psychology and this in turn can have disproportionately bad effects on the real economy.

Safeguarding financial stability is a core function of a modern central bank, no less important than maintaining monetary stability (Sinclair, 2001). Financial stability is built on four main foundations: (i) a stable macro-economic environment; (ii) well-managed financial institutions, within a sound framework of prudential supervision; (iii) efficient and smoothly functioning financial markets; (iv); and (v) a safe and robust payments system (Laker, 1999). Fragility in financial institutions particularly in banks, is one source of instability (Crockett, 1997, 2001). Therefore, banking crises should be either prevented or resolved in order to avoid disrupting the payments system and the flows of credit to the economy. Wherein, crisis prevention involves measures taken to avoid banking problems occurring, crisis management focuses on how the authorities deal with a crisis once it materialises. Facing with a banking crisis, the authorities confronts a trade-off between maintaining financial stability today – through offering protection to failing banks – and increasing financial instability in the future.

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1Note, however, the literature predicting the likelihood of a crisis in Indonesia beforehand is much more parsimonious.
through increasing moral hazard (Hoggarth et al., 2002). In resolving banking crisis, the authorities should try to minimise the fiscal costs and any moral hazard that may be induced. This paper will be focused on banking crisis resolution. In particular, the paper assesses what lessons were learnt on how best to resolve a major systemic crisis in Indonesia in the future. Chapter II analyses the steps taken of resolving the Indonesia’s banking crisis. Chapter III discusses safety nets issues including blanket guarantees and Bank Indonesia’s liquidity support. Chapter IV lists some important policy lessons from resolving banking crisis. Chapter V proposes some actions that should be taken to improve financial stability in Indonesia, particularly in the realm of lender of last resort and deposit insurance. Chapter VI concludes.

II. Banking Crisis Resolution: Process and Issues

1. Banking Policies before the 1997 Crisis

1.1. Banking Policies and Evolution of the Banking System

The Indonesian banking system has experienced large structural developments. Before the 1997 crisis, it evolved in five stages (period): (i) the rehabilitation period (1967-1973) to restore the economy from high inflation; (ii) the ceiling period (1974–1983) where interest rate ceilings were applied; (iii) the growth period (1983–1988) following banking deregulation of June 1983 removed the interest rate ceiling; (iv) the acceleration period (1988–1991) following the impact of extensive bank reforms in October 1988; and (v) the consolidation (1991–1997) in which prudential banking principles were introduced including capital adequacy and bank ratings.2

Following the implementation of extensive bank reforms in October 1988, the banking industry grew rapidly in terms of number of banks as well as total assets. Within two years Bank Indonesia granted licenses for 73 new commercial banks and 301 commercial banks’ branches. However, a lack of effective supervision resulted in imprudent behaviour by the banking industry. In February 1991, prudential banking principles were introduced, and banks were urged to merge or consolidate. Unfortunately, wide-scale banking consolidation never took place prior to the recent crisis. This was due to a lack of commitment by banks’ owners to strengthen their banks and a lack of law enforcement from Bank Indonesia as the supervisory authority. Under its old law of 1967 Bank Indonesia lacked independence and to a

2For a more detailed discussion see Batunanggar (1996) and Djiwandono (1997).
large extent was unable to apply tough measures on well-politically connected banks. Most experts, including the IMF and the World Bank, were overoptimistic about the prospects of Indonesia’s economy. A few observers, such as Cole and Slade (1996), were concerned about the weaknesses of Indonesia’s financial system. They expressed concern over the mounting evidence of corruption and cronyism and its potential effects on the future health of the financial system. A number of fundamental problems were faced by the banking industry prior to the current crisis. These included weak corporate governance, poor risk management, large exposures to foreign currency loans and high non-performing loans caused by imprudent lending particularly to affiliated business groups and to the property sector. In addition, there was also a large amount of unhedged and poorly monitored private sector offshore borrowing.

1.2. Banking Problem Resolutions – Before the 1997 Crisis

Prior to the 1997 crisis, Bank Indonesia adopted an open bank resolution strategy in solving bank problems through providing emergency loans both for liquidity and capital purposes. It was based on a belief that bank closure would reduce confidence in the banking system, cause bank runs and endanger system stability. Due to a lack of law enforcement and bank supervision, this strategy proved ineffective and created moral hazard problems. The relaxed policy on bank entry since 1988 and absence of a bank exit policy combined with weak banking regulation and supervision increased the fragility of the banking system.

Bank Summa was the only unsound commercial bank actually liquidated (1992) in the two decades prior to the 1997 crisis. At the time, Bank Indonesia provided a limited adhoc deposit guarantee of Rp20 million (US$8,000) while the bank’s owners shared the resolution costs. The liquidation process of Bank Summa was protracted. It reflected inadequacies of procedures and powers at the disposal of Bank Indonesia for dealing with a failed bank. This experience reinforced Bank Indonesia’s view that bank closures should be avoided at all costs.

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4 See for example World Bank’s report on Indonesia released in mid-1997.
5 In their words “Increasing politicization of major investment and financial decisions raises the level of risk. Most financial systems do experience crises sooner or later, and Indonesia is not likely to be an exception. If and when such a crisis arises, its handling will provide an important test of how sound a structure has been created”.
6 See Wimboh (2000) for several cases of problem bank resolution in Indonesia during the pre 1997 crisis.
7 Bank Summa – part of the Astra Group, one of the main diversified groups in Indonesia – had accumulated non-performing loans largely to affiliated groups and concentrated mainly in the real estate sector and faced large losses in 1991.
2. Overview of the 1997 Crisis

Following the floating of the Thai baht and the Philippine peso at the beginning of July 1997, the rupiah came under heavy pressure. At the outset, Bank Indonesia tried to defend the rupiah against speculative attacks by intervening in the market and raising the official interest rates on Bank Indonesia Certificate by widening the intervention bands from 8% to 12%. Similar steps were taken five times between 1994 and 1997. Due to intense market pressures, on 14 August 1997 Bank Indonesia abolished the intervention bands and the rupiah was freely floated. To limit depreciation of the rupiah, Bank Indonesia continued to intervene in the market.

One of Indonesia’s fundamental economic problems since 1990 was a large amount of unhedged offshore borrowing by the private sector. Although the government was quite effective in limiting foreign offshore borrowing by commercial banks, accounted for US$12.8 billion in 1997, it was not in the case of the non-bank private sector (NBPS). During five years before the 1997 crisis, foreign currency debts of the NBPS increased from US$28.2 billion in 1992 to US$78.1 billion in 1997, exceeding the government offshore borrowing of US$59.9 billion in 1997. The limited foreign exchange reserves at Bank Indonesia and the proposal to introduce a currency board system led to market expectations that the government may impose capital controls.

Figure 1. Foreign Exchange Rate Volatility (IDR/USD): January - October 1998

This created a one-sided market with a huge demand but no supply for US dollars. Under the free floating exchange rate system and free capital controls, the rupiah was vulnerable to
speculative attacks. This created a financial panic, which in turn caused a further depreciation of the rupiah – a self-fulfilling prophecy.

During the pre-crisis period, besides having poor governance and management, the banking industry also suffered from fundamental liquidity management weaknesses indicated by: (i) large volatile deposits in the composition of banks’ funds (ii) a high loan to deposit ratio and exposure to foreign exchange risk. As the currency crisis spread, this generated other risks. Firstly, there was an increase of liquidity risk due to a huge maturity mismatch of assets and liabilities as short-term foreign currencies borrowings were replaced by medium-term and long-term rupiah loans. Secondly, credit risk increased due to the inability of debtors to repay their foreign currency loans as the rupiah depreciated sharply.

Meanwhile, the adoption of a tight monetary policy by Bank Indonesia to reduce speculative attacks on the rupiah further tightened market liquidity. The banking system soon faced a severe liquidity crisis. Overnight interest rates rose sharply to 300% p.a. The deterioration in confidence in the banking system together with the political uncertainties resulted in a flight of safety within the banking system from private banks to both state-owned banks and branches of foreign banks as well as of capital flight out Indonesia. The corporate sector, with a large unhedged offshore borrowing, suffered from the sharp depreciation of the rupiah against the US dollar. The twin currency and banking crisis was a real test of the resistance of the banking system and the economy which had previously been thought to have strong fundamentals by the authorities and the IMF and World Bank.

On October 3, the government requested IMF assistance and the first Letter of Intent was signed on October 31. The agreement encompassed a programme for economic and financial restructuring complemented by monetary and fiscal programmes including a standby arrangement of $10 billion.

Many observers have shown that contagion from Thailand served as a trigger for the Indonesian crisis. Irina and Sjöholm (2001) suggest that investors’ behaviour, rather than real linkages, seems to have facilitated the contagion. Political factors, such as the

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8 Foreign exchange risk was reflected in the increasing ratio of foreign currency liabilities to assets and the significance of foreign currency loans in banks’ portfolios.

9 Sachs (2000) argued that the adoption of tight money policy in the midst of a banking crisis exacerbates bank’s problems. Higher interest rate will likely decrease the demand for bank loans and also reduce the ability of debtors to pay on their loans.


11 Experimental analysis by Cipriani and Guarino (2002) shows that in a financial market, mechanism of price formation may lead traders to disregards their own private information and herd. When this happens, the price does not aggregates traders
uncertainty surrounding the presidential succession, also amplified investors’ nervousness toward Indonesia. In addition, the closure of insolvent banks in the absence of adequate financial safety nets fuelled a panic and consequently a systemic bank run and large capital flight.

McLeod (1999) and Hill (1999) argued that the main reason for the depth of the 1997 crisis was due to poor crisis management, which, in turn, reflected the fragile political system and escalating social and ethnic tensions. Hill (1999) asserts that once the crisis started, the political system and social texture proved quite unable to respond effectively.

Stiglitz (1999, 2002) argued that the IMF made three major policy mistakes in East Asia: (i) the adoption of contractionary monetary and fiscal policies rather than expansionary ones during the crisis which halted the credit flows; (ii) failure to recognise fully the impact of policies spilling over from one country to another; and (iii) poor financial and corporate restructuring. In particular, the adoption of a high interest rate policy forced many large over-leveraged companies to go bankrupt and reduced spending and output. Most importantly, he argued these policies increased social and political tension, which, in turn, made the crisis more difficult to manage.

3. Banking Crisis Resolution – Post Crisis Period

From November 1997–2000, there were six major rounds of intervention taken by the authorities, including both “open bank” resolutions and bank closures: (i) the closure of 16 small banks in November 1997; (ii) intervention into 54 banks in February 1998; (iii) the take over of 7 banks and closure of another 7 in April 1998; (iv) the closure of four banks previously taken over in April 1998 and August 1998; and (v) the closure of 38 banks together with a take over of 7 banks and joint recapitalisation of 7 banks in March 1999; and (vi) a recapitalisation of six state-owned banks and 12 regional banks during 1999–2000.

3.1. The first round of bank closures – rushed and too few?

The situation at the outset of the crisis was marked by several constraints including: a lack of accurate and comprehensive microeconomic data and information especially on the condition of individual bank and offshore borrowing by the corporate sector, limited institutional

information and does not reflect the fundamental value of the assets. Consequently, a financial crisis may occur even when fundamentals of the economy are sound.
capacities, and a poor legal and regulatory infrastructure. However, a preliminary assessment by Bank Indonesia, assisted by experts from the IMF and the World Bank, revealed that there were a significant number of banks that were insolvent. Many of these violated prudential principles and were already subject to runs.

Based on an IMF recommendation, on 1 November 1997, Bank Indonesia closed down 16 small insolvent banks (3% of the total assets of the banking system) and placed more under intensive supervision. The government provided only a limited and temporary deposit protection of Rp20 million (around USD6,000) per depositor per bank. It covered about 90 percent of depositors, but only 20 percent of the deposit base. Prior to the crisis, Indonesia had no explicit deposit insurance. The Ministry of Finance and the Governor of Bank Indonesia also made public announcements that there would be no more bank liquidations.

The wider impact of the closures was unanticipated. The measures were aimed at restoring confidence in the banking system but, in fact, had the reverse effect. In the absence of clear guidelines on depositor compensation, and opaque liquidation policies coupled with political uncertainties, the decision prompted a market panic and systemic bank runs. Depositors withdrew a large amount of their money and transferred them from presumed unsound banks to the state-owned banks that were perceived more likely supported by the government, and partly to foreign banks both onshore (branches) and off-shore.

Consequently, a number of banks ran into liquidity problems and became overdrawn on their accounts with Bank Indonesia. To prevent contagion Bank Indonesia provided emergency liquidity support to the illiquid banks. Up to December 1997, the liquidity support amounted to Rp62.9 trillion (10.1% of annual GDP).

The ‘flight to safety’ created a large segmentation in the inter-bank money market reflected by a concentration of liquidity in a few banks and a widening range (between the highest and lowest) of overnight rates. The bank run during 1997Q4 caused private national banks’ deposits to fall by Rp34.7 trillion. Meanwhile, deposits in state-owned banks and branches of foreign banks included joint venture banks rose by Rp12.3 trillion and Rp1.5 trillion respectively.
Overall, there was a general currency flight out of rupiah assets, including bank deposits which fell by Rp20 trillion between October and December 1997. Similarly with Thailand, Malaysia, the Philippines and South Korea, Indonesia was estimated to suffer a net-capital outflow of US$12 billion in 1997 after enjoying private net capital inflows of up to US$11.5...
billion before the crisis in 1996. In 1998Q1, there was a further net capital outflow of US$6.2 billion but the remainder of the year there was a net capital inflow of US$7.8 billion.

The initial bank closures, unlike in Korea and Thailand, failed to regain confidence in the government and the banking sector and even prompted a more intensive bank run. Lindgren et al. (1999), from the IMF, argued that the main reason for the failure was a lack of government commitment to implement the key reform measures in its IMF-supported programme. Political intervention at the outset also damaged the effectiveness of the liquidation process. Market confidence deteriorated markedly due to the lack of transparency and commitment from the authorities to execute the programme agreed with the IMF. Some politically well-connected banks known to be insolvent were kept open. Based on BI’s supervisors and recommendations from the IMF staff, there were at least 34 more politically linked insolvent banks that should have also been closed down at the time.

Technically, the bank closure were handled efficiently by Bank Indonesia’s supervisors with cooperation with banks. However, it was not accompanied with a well-devised strategy and supported polices. It reflected a lack of understanding of the problem by the authorities and the IMF and an over optimistic interpretation of the economic fundamentals in the Indonesian economy. Nasution (1999) argued that there were policy inconsistencies in the stabilisation programme. It was indicated by the closure of 16 banks in November 1997, followed by a tight monetary policy. The authorities even squeezed market liquidity by shifting deposits into the central bank rather than injecting more liquidity into the system. Since the banks were inadequately supervised, the public could not distinguish between good and bad banks.

Radelet and Sachs (1999) argued that the IMF’s initial approach in Indonesian of closing down 16 banks in November 1997 was poorly thought out and, thus, failed. They argued that the bank closures were meant to be a signal to foreign investors but should not have been made in the middle of a panic without a detailed plan for restructuring the financial system. The IMF’s initial programme failed to include provisions for deposits insurance, for managing the performing and non-performing assets of these banks, or for securing and strengthening

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12 If the foreign exchange rates effect is included, the private banks’ deposits decreased by Rp14.7 trillion while the state banks’ and foreign & joint venture banks’ deposits rose by Rp21.6 trillion and Rp10.8 trillion respectively from October to December 1997.

13 The owners of two small closed banks (Bank Djakarta owned by Suharto’s half brother and Bank Andromeda owned by Suharto’s son) sued the Minister of Finance and the Governor of Bank Indonesia at the courts and won. Bank Indonesia was subjected to political pressure to grant the purchase of Bank Andromeda. The bank was then allowed to reopen under a new name Bank Artamedia within weeks.
the rest of the banking system. This was apparently admitted later by the IMF in an internal document\textsuperscript{14}.

Similarly, Stiglitz (1999, 2002) argued that the IMF policies towards closing banks in Indonesia failed. The sixteen banks were closed down, and notice was given that other banks might be subsequently shut down later. This news, in conjunction with the apparent very limited deposit guarantee scheme, led to a flight to safety, especially to state-owned banks, because depositors expected to incur further losses.

3.2. The Second Round of Closures (April 1998 to August 1998) – Too Late?

At the end of 1997, the rupiah continued to weaken to Rp4,650 per US. This mainly resulted from the increase in demand from the corporate sector to pay their offshore borrowings and also reflected a speculative attack on the rupiah. The continuing free fall of the rupiah and system-wide bank runs depleted liquidity and equity for most banks. At the beginning of 1998, monetary conditions worsened. The announcement of an unrealistic new state budget on 6 January 1998 and the nomination of Dr. B.J. Habibie as Vice President were also met by a negative market reaction. The erosion of confidence in the banking system and an increase in demand for foreign currency caused a massive withdrawal of money from the domestic banking system. Consequently, rupiah in circulation increased dramatically. Shortages of basic commodities due to a prolonged drought and increasingly expensive prices of imported raw material and panic buying resulted in the monthly inflation rate increasing from 5.7% in 1997Q4 to 25.1% in 1998Q1.

Meanwhile, it seems that Bank Indonesia adopted an inappropriate monetary policy. Bank Indonesia’s significant intervention in the inter-bank market resulted in a liquidity drain with overnight interest rates increasing to 80% (per annum). Bank Indonesia responded to this situation by increasing the supply of liquidity through open market operation and allowing all banks to overdrawn their balances with Bank Indonesia. This gave the wrong signal to the market and was followed by panic buying of US dollars. In January the exchange rate slumped to Rp16,000 per US dollar while the monthly inflation rate rose sharply to 6.9%.

The Government accelerated and broadened the coverage of its stabilisation and economic reform programme. On 15 January 1998 the second agreement with the IMF was signed followed by the creation of the Indonesian Bank Restructuring Agency (IBRA) as an agency

under the Ministry of Finance\textsuperscript{15}. The Government attempted to regain market confidence in the banking system and stabilise the rupiah by adopting a tight monetary policy. On 27 January 1998, the Government announced a blanket guarantee programme covering all depositors and creditors of all locally incorporated banks. IBRA was also made responsible for administering the Government’s blanket guarantee programme for all banks’ liabilities.

This was followed by IBRA intervening in the 14 worst banks and placing them under its surveillance on 4 April 1998. The seven largest of the 14 banks had borrowed more than Rp2 trillion each from Bank Indonesia and accounted for over 75\% of total Bank Indonesia liquidity support to the banking system. IBRA took over these banks and suspended the shareholders’ rights. The operations of another seven small banks that had borrowed more than 500 percent of their equity and 75 percent of their assets from Bank Indonesia were frozen. Their deposits were transferred to designated state banks\textsuperscript{16}. On August 21, 1998 IBRA froze three of the banks it had previously taken over\textsuperscript{17}.

3.3. The Third Round of Closures – March 1999

Following the financial review of all commercial banks during the second half of 1998, IBRA closed down a further 38 insolvent banks on 13 March 1999\textsuperscript{18}. The closure was delayed due to political intervention. Some insolvent but well politically linked banks were not closed down but taken over by IBRA for special surveillance.

There were three major issues with this second and third round of bank closures. \textit{First}, it was not well planned or carried out smoothly due to a lack of operational skills\textsuperscript{19}. The process of this second round of closures was even worse than the previous one due to a lack of operational skill especially of the staff hired from the accounting firms. The process was also delayed for about two weeks due to strikes by the banks’ employees who were demanding for better redundancy terms.

Second, closure was delayed by political intervention and inability of the authorities to make a speedy resolution. Initially, only 7 small banks out of the 14 banks were closed. The other seven bigger banks – which had borrowed about Rp2 trillion each from Bank Indonesia –

\textsuperscript{15}There was no institution formally responsible for financial restructuring in Indonesia until the IBRA was established.

\textsuperscript{16}Known as banks-taken over (BTO) and Bank Beku Operasi (BBO) or banks whose operations are frozen (see Table 2/Appendix.

\textsuperscript{17}Bank Umum Nasional (BUN), Bank Dagang Nasional Indonesia (BDNI) and Bank Modern.

\textsuperscript{18}This time, the authorities used a different (but similar meaning) term so called “Bank Beku Kegiatan Usaha (BBKU)” or Banks Operationally Frozen.

\textsuperscript{19}While the first closure was solely performed by Bank Indonesia, the second round of closures was the responsibility of IBRA. Due to insufficient personnel, IBRA hired accounting firms to carry out the bank closure assisted by Bank Indonesia’s supervisors. There is lack of operational skill especially of the staff hired from the accounting firms.
were initially taken over by IBRA on 4 April and then closed later on 21 August 1998. Since these 14 banks had been deeply insolvent since the beginning of the crisis they should have been closed earlier in November 1997.

Third, the third round of bank closures would have been taken earlier if the authorities had a fuller understanding of the crisis which would have enabled them to develop a clear resolution strategy. The repeated bank closures not only increased the fiscal costs of resolution but more generally damaged public and investors’ confidence which, in turn, worsened the situation.

3.4. The Bank Restructuring Programme

The main objective of the bank restructuring programme was to overhaul the banking system and to enable banks to function as financial intermediation as efficiently and quickly as possible. The sequencing of resolving financial crises usually comprises of three main steps: (i) a diagnostic review; (ii) a resolution of non-viable institutions and recapitalisation of viable ones; and (iii) a resolution of non-performing loans.

Essentially, bank restructuring consists of two elements: (i) financial restructuring including capital injection and loan restructuring; and (ii) operational restructuring comprising of improvement of a bank’s internal organisation such as its operational efficiency, governance, risk management and control. Generally, the approaches adopted in Korea, Thailand, Indonesia and Malaysia were similar. Financial restructuring has focussed on closure of deeply insolvent financial institutions, takeovers, carving out and transferring bad assets to a central agency, and capital injection from private and public sources. Lindgren et al. (1999) identify that techniques to consolidate the financial sectors used in most countries include closures, mergers, purchase and assumption operations, and bridge banks.

Since the creation of IBRA in January 1998, the government initiated a bank restructuring programme as part of a broad resolution programme including takeovers, mergers and recapitalisation.

3.4.1. Banks Takeover

During 1998 IBRA took over 13 insolvent but considered “important” banks (Table 2/Appendix). Besides an inability and/or reluctance of their shareholders to recapitalise the banks, the main consideration to take over insolvent banks was the systemic threat of the banks to the economy.
IBRA lacked a though, clear and objective criteria of what banks should be taken over. The classical reason given for government take over is if a bank is systemically important. In Indonesia’s cases, the criteria were often vague. In most cases there was political intervention in order to exclude some banks from being frozen or closed. There was also lack of a clear strategy and objective in resolving the banking crisis. This was reflected in repeated bank closures and takeovers, which should have been done at the outset of the crisis. The reluctance of the authorities to take tough decisions reduced their credibility.

3.4.2. Merger and Recapitalisation

As part of the bank restructuring programme, on 21 August 1998 the government announced a bank recapitalisation programme (see Box 3/Appendix). There were two types of bank recapitalisation: self-recapitalisation carried out by the bank owners alone or with new strategic investors; and joint recapitalisation between bank owners and investors and the Government. The latter required some criteria that must be met by banks including the obligation to inject some additional capital (minimum of 20% of required capital to meet capital adequacy ratio (CAR) 4%), a viable business plan and fitness and probity of the banks’ controlling shareholders and management (see Box 1).

<table>
<thead>
<tr>
<th>Box 1. The Criteria of Recapitalisation Programme</th>
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<tbody>
<tr>
<td>The eligibility of a bank for joint recapitalisation programme primarily was based on two main aspects: (1) the viability of a bank’s business plan; and (2) the fitness, and probity of bank’s management and controlling shareholders. The assessment was conducted by several committees (Technical Committee, Evaluation Committee, and Policy Committee) representing Bank Indonesia, Ministry of Finance and IBRA. To ensure transparency and objectivity, independent observers representing the IMF, World Bank, and ADB were invited to the meeting but without any rights over the decision making process.</td>
</tr>
<tr>
<td>❏ Business Plan Review ➔ a. Main criteria, included:</td>
</tr>
<tr>
<td>❏ - ability of bank’s shareholders and/or new investors to inject minimum of 20% funds to meet a 4% CAR,</td>
</tr>
<tr>
<td>❏ - compliance with the existing regulations (legal lending limit, net open position, etc.),</td>
</tr>
<tr>
<td>❏ - bank’s viability to meet CAR of 8% at end of 2001, based on a stress test model (developed by international consultant).</td>
</tr>
<tr>
<td>❏ b. Additional criteria, including:</td>
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<tr>
<td>❏ - asset rehabilitation plan, business development plan, franchise values (networks, IT/IS) and significance to the economy, projected ROE 15% at the end of 2001.</td>
</tr>
<tr>
<td>❏ A bank will pass the business plan review if it met at least all these main criteria.</td>
</tr>
<tr>
<td>❏ Fit and Proper Test ➔ a. Fitness Test - the competence and independence of bank’s board of commissioners and directors.</td>
</tr>
<tr>
<td>❏ b. Propriety Test - integrity, fulfillment of commitment to BI, enlistment of bad debts and or other imprudent fraudulence actions of bank’s management and controlling shareholders.</td>
</tr>
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</table>

In addition, if an insolvent bank was considered to have a significant role in the economy (mainly based on the number of deposit accounts) it was taken over by the government (IBRA), and/or merged with another bank. The objectivity of this additional criterion in
practice, however, is debatable. Insolvent banks that failed to meet these criteria were frozen and then later liquidated.

After two weeks, on 13 March 1999 the government announced the result of the due diligence and assessment on the viability of banks to be included in the joint recapitalisation programme. The results were as follows: (i) 74 banks were solvent; (ii) 38 banks were insolvent and would be closed; (iii) 7 insolvent banks were taken over and would be merged and recapitalised; and (iv) 9 banks would be recapitalised. Meanwhile the state banks (all were insolvent) and 12 insolvent regional development banks would be also recapitalised. The delay of the announcement led deposits runs on the perceived weak banks and flight to quality to the perceived good banks. As impact, Bank Indonesia should provide liquidity supports to those banks run by depositors.

State-owned Banks – Too Big to Fail?

Prior to the 1997 crisis, state-owned banks were dominant players, representing about 50% of market share in terms of total assets, in the banking system. Before the 1997 crisis, the state-owned banks were not well managed due to continuous political intervention by the government to extend credit either to certain politically-linked enterprises or to certain priority sectors. Unsurprisingly, in December 1996 state-owned banks had a high share of loans that were non-performing (16.6%). Prior to the crisis, all state-owned banks were under a restructuring programme led by the World Bank. In addition, the supervision of state-owned banks by Bank Indonesia was not intensive and on-site visits were rarely carried out.

The authorities decided to recapitalise all state-owned banks on 21 August 1998. Bank Mandiri was established On 30 September 1998, as an amalgamation of the four state-owned banks. It serves as universal bank and focuses on the corporate market. In line with this strategy, some of the corporate loan portfolio of another state-owned bank, Bank Rakyat Indonesia (BRI), was transferred to Bank Mandiri. The completion of recapitalising Bank Mandiri and other state-owned banks was planned by March 2000 but delayed until October 2000. This significantly increased the recapitalisation costs. Other problems faced by Bank Mandiri at the initial stage of the merger were the difficulty in integrating the different information systems and cultures of the four former banks. A full integration of operations, systems and human resources is still ongoing. All state-banks’ management were subject to the “fit and proper” test by Bank Indonesia. Those failing the test were replaced. However, the

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20 Bank Export Import Indonesia, Bank Bumi Daya, Bank Dagang Negara and Bank Pembangunan Indonesia.
selection of Bank Rakyat Indonesia’s management was subject to political intervention after one of the appointed directors failed the test.

The decision to recapitalise all state-owned banks was based mainly on the ‘too big to fail’ argument that they were all systemically important banks, and therefore recapitalised regardless of their viability. This policy was subject to criticism since all of them were highly insolvent and for some of them recapitalisation may be impossible.

Private Banks – Unselective Recapitalisation?

The first round of the private recapitalisation programme was carried out for 7 banks on 28 May 1999, followed by 12 regional development banks. The second round of recapitalisation of private banks was planned at the end of November 1999 and the legal process was estimated to be completed by 2000Q1. All 7 banks taken over were merged with Bank Danamon followed by two other banks taken over (see Table 2/Appendix). Among major issues of the merger was that the problem loans of each of the taken over banks were very large and needed to be transferred to IBRA. Therefore, the merger combined all the banks’ liabilities but not all their assets.

The recapitalisation of the seven private banks was performed quite objectively and transparently. Conversely, the recapitalisation of the twelve regional development banks was taken without consideration for their viability, but merely on the basis that they were considered to have an important role in the regional economy. Most of the regional banks were not well managed, due to a lack of qualified personnel and intervention by the local government (the shareholders).

The form of banking crisis resolution in Indonesia recommended by the IMF tended to be piecemeal and reactive. It was not an integrated approach. This was due to a lack of understanding of the extent of the crisis. A diagnostic review – a crucial initial step in determining the extent of a banking crisis and in formulating resolution strategies – was taken quite late in the midst of the crisis. The authorities were also reluctant to take hard but effective measures due to group interests or political intervention.

Stiglitz (1999, 2002) argued that the IMF economic models, which more focus on financial variables fail to fully capture the adverse impact of policy on the real economy and associated social consequences. He suggested that the strategy for dealing with financial restructuring has to be designed to mitigate, not exacerbate, the economic crisis. A key goal must be the maintenance of credit flows.
De Luna-Martinez (2000) argued that the political and social constraints faced by policy makers to manage and resolve a crisis are ignored in the recent literature on banking crises. Given the magnitude of systemic banking crises, practically the whole process of crisis resolution, including the design of strategies and policies, the timing and sequence of reforms as well as the final outcomes, can be influenced by social and political constraints faced by policy makers. In contrast to Korea, which adopted a rapid “big bang” approach, Indonesia was more similar to Mexico, which has adopted gradual approach to all stages of crisis resolution (De Luna-Martinez (2000).

To a large extent, Indonesia’s strategy has been hindered by the inability and reluctance of the authorities to acknowledge the extent of banks' problems earlier in the crisis. They preferred to apply temporary policies as a “quick” remedy. This phenomenon was analogous with Kiggundu’s (1996) observation that management in developing countries is frequently characterised by reactive responses to crises and firefighting rather than preventive actions. This reactive stance can be altered if managers and leaders incorporate the concept and techniques of strategic management into their implementation toolkits.

4. Prudential Regulatory and Supervisory Reforms

Lack of supervisory capability is often cited as one of the reasons for financial system weaknesses. As Mishkin (2001) argued, asymmetric information leads to adverse selection and moral hazard problems that have an important impact on financial systems and justifies the need for prudential supervision. Since 1991, Bank Indonesia has initiated a prudential regulatory and supervisory reforms. However, the progress was very slow. The main weaknesses of banking supervision in Indonesia were: (i) premature banking liberalisation; (ii) insufficient banking consolidation; and (iii) poor development of organisational capabilities (including of human resources). A plan to deal with the latter has been initiated since the mid-1990s but was ineffective due to an inappropriate bank supervisory strategy and some policy inconsistencies in the implementation of the improvement plan. Central to this issue was high political intervention and a lack of strong and visionary leadership as well as lack of law enforcement in the banking industry.

As detailed in its “Master Plan” agreed with the IMF on July 1999, Bank Indonesia attempted to enhance the effectiveness of banking regulation and supervision to meet international
standards, particularly the Basel Core Principles for Effective Banking Supervision. This will be achieved by adopting three strategies: (i) a clear responsibility for the supervision and regulatory functions within the Board of Governors; (ii) a uniform supervision standards for all public and private banks; and (iii) risk-based supervision. Essentially, the plan covers bank entry and exit policies, coordination between supervisory authorities, adoption of risk-based supervision and consolidated supervision, incorporation of market risk in the capital adequacy, and improving market discipline by enhancing banks’ transparency. Since July 2000, Bank Indonesia also carried out an intensive supervision by placing an on-site supervision team in each of the systemically important banks to ensure that they were well managed and did not pose a high risk to the stability of the banking system.

Another important issue is the plan to transfer banking supervision into a new established Financial Supervisory Authority (FSA) by end-2002. The FSA will act as “mega” regulator and supervise all financial institutions (excluding rural banks) and financial markets. Two critical issues on the creation of Indonesia’s FSA are: (i) it status may not be fully independent since it is under the President; and (ii) budget constraints since it will be solely funded by supervision levies from the financial industry. Therefore this issue requires careful consideration by the authorities. In addition, the transition process should be well-prepared and managed carefully in order to minimise risks.

5. Fiscal Cost of Crisis

The fiscal costs of resolving the Indonesian banking crisis is the highest among Asian countries amounted to Rp654 trillion or 51% of annual GDP. It is the second highest in the world during the last quarter of the century after Argentina’s of 55.1% of GDP during its 1980–1982 crisis. On the assumption that the recovery rate of banks’ bad assets under IBRA is 25%, the estimated ultimate fiscal cost only be a little lower (45.3%). It was largely bank recapitalisation costs and Bank Indonesia’s liquidity support which accounted for 65% and 22% respectively of the total fiscal cost figure.

Initially, total resolution costs for all banks, including for recapitalisation and payment for deposits of liquidated banks was estimated Rp238.8 trillion (May 1999). However, the real

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22As was stated in BI’s Law article 34. Abram and Taylor (2000) and Goodhart (2001) provide excellent discussions on the issues in the unification of financial sector supervision. Goodhart argues that banking supervision in less developed countries is better to be kept within the central bank because it will be better funded, more independent and more expert and reliable.
cost of bank recapitalisation and repaying depositors of closed banks was Rp425.5 trillion (June 2000) or an increase by 78%. The increasing cost of bank recapitalisation was caused mainly by the increase of banks’ losses.

The main factors that contributed to the high resolution costs were: (i) long delays in resolving the banking crisis, in particular, the bank closures and recapitalisation programme; (ii) a lack of understanding of the causes and the extent of the crisis which lead to the adoption of inappropriate strategies (e.g. a piecemeal approach to banking closures); (iii) a lack of coordination and consensus between the authorities in managing the crisis; (iv) a lack of commitment to take “hard” measures to solve the crisis e.g. to close all insolvent and non-viable banks at the outset of the crisis and to avoid political intervention; and (v) a lack of law enforcement and legal and regulatory weaknesses which fostered moral hazard.

In recent decades, a majority of countries have experienced a systemic banking crisis requiring a major, expensive – and to some extent unavoidable – overhaul of their banking system. The failed bank’s shareholders clearly should be responsible, but the problem is if they were not able to do so. In many countries, the burden has been borne by tax payers24.

Indonesia’s experience of banking restructuring supports the empirical study by Honohan and Klingebiel (2000, 2002) which revealed that unlimited deposit guarantees, open-ended liquidity support, repeated recapitalisation, bail-out of debtors and regulatory forbearance add significantly and sizeably to the fiscal costs of the crisis. Indonesia should have favoured a strict rather than an accommodating approach to crisis resolution. However, in reality this approach was difficult to take in Indonesia’s case because of political intervention.

23This compares with Thailand 32.8%, South Korea 26.5%, Japan 20%, Malaysia 16.4%, and Philippine 0.5% (1998) and 13.2% (1983 – 1987), see Honohan and Klingebiel (2000).
III. Safety Nets for Crisis Resolution

1. The Blanket Guarantee Programme

Before the 1997 crisis, none of the East Asian crisis countries except the Philippines, which was least affected by the crisis, had an explicit deposit insurance scheme. Bank Indonesia provided both liquidity and capital support to problem banks on an ad-hoc basis and in non transparent ways. The support was also not based on any pre-existing formal guarantee mechanism but rather on a belief that some of the banks that needed support were too big to fail or the failure of a bank could cause contagion.

A limited deposit guarantee in Indonesia was first applied when the authorities closed down Bank Summa at the beginning of the 1990s which was considered unsuccessful. After then, there were no bank closures until the authorities closed down 16 banks in November 1997 and introduced a limited guarantee. However, this failed to prevent systemic bank runs.

To restore domestic and international confidence in the economy and the financial system, the government signed the second agreement with the IMF on 15 January 1998. However, market perceptions and reactions to the government commitment and capacity to resolve the crisis were still negative. There was a huge amount of capital flight of around $600 million to $700 million per day. On 22 January, the rupiah plummeted to a record low of Rp16,500.

To prevent a further slide and to maintain public confidence in the banking system on 27 January, the government issued a blanket guarantee. It covered all commercial banks’ liabilities (rupiah and foreign currency), including both depositors and creditors. It was an interim measure pending the establishment of the Deposit Insurance Agency. Initially, the administration of the blanket guarantee was a joint task between Bank Indonesia and IBRA. From June 2000 it has been the responsibility of IBRA alone.

The Indonesian case suggests that a very limited deposit insurance scheme was not effective in preventing bank runs during the 1997 crisis. Deposits denominated of more than Rp20 millions – the uninsured component – accounted for about 80% of total deposits. Therefore, if a blanket guarantee had been introduced earlier at the outset of the crisis, the systemic runs might have been reduced.

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25 However, this was done primarily for domestic rather than foreign banks.
26 The plan for establishing a deposit insurance scheme has been discussed quite intensively since the early 1990s. However, the authorities declined the proposal because they considered that it would create moral hazard.
That said, the introduction of the blanket guarantee did not instantly stop bank runs. Although fewer, there were still bank runs on some insolvent banks (although not on the domestic system as a whole). This was indicated by the increase in Bank Indonesia’s Liquidity Support from Rp92 trillion in January to Rp178 trillion in August 1998. These banks were run by depositors for some reasons. The first possibility is a poor public perception due to unclear policies what was covered and a lack of trust that the government would stick to their commitment. This led depositors to transfer their money from perceived bad banks to safer banks. After three highly insolvent banks were taken over and closed down on 21 August 1998 bank runs, and therefore Bank Indonesia’s liquidity support, decreased markedly.

Secondly, depositors anticipated that there would be more bank closures. Even though their deposits were guaranteed fully by the government, they recognised that they would be transferred to other banks. This would create a time lag between the claim and the payment of their deposit. To avoid this, they withdrew their deposits from perceived weak banks and transferred to those banks thought “safer” (state-owned and foreign banks). There was also a relatively long time lag before the implementation of the blanket guarantee programme. In fact, IBRA, as administrator of the guarantee programme, became operational three months after its creation.

Even though it was introduced after some delay, the implementation of a blanket guarantee appears to have worked. After June 1998 the segmentation in the inter-bank market decreased sharply and liquidity in the banking system increased. This enabled banks to borrow from the

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27Initially it was to be retained for a minimum of two years, with a provision for an automatic six months extension in the absence of an announcement of termination of the scheme.

28BI retains the role of administering the guarantee scheme to trade finance, inter-bank debt exchange and rural banks.
inter-bank market at lower interest rates (see Figure 5). In addition, there were no significant bank runs despite the change in government in 1999 and some other policy reversals.

2. Bank Indonesia Liquidity Support

Central bank could promote recovery from financial crisis by pursuing lender of last resort role in which it stands ready to lend freely during a financial crisis. There are many instances of successful lender of last resort operations in industrialised countries (Mishkin, 1991, 2001).

Under its old Law of 1968, Bank Indonesia was authorised to provide emergency loans to banks facing critical liquidity problems\(^{29}\). However, there were no well-defined rules and procedures on how this function was to be performed. During the 1997 crisis, Bank Indonesia provided liquidity support to problem banks in order to prevent the collapse of the banking system and to maintain the payments system. The continuing deterioration of confidence in the banking system coupled with political uncertainties and social unrest had caused severe bank runs from perceived unsound banks to sound ones.

As the crisis intensified, the amount of overdraft facilities increased from Rp31 trillion in December 1997 to Rp170 trillion in December 1998. Liquidity support, however, was concentrated on only a small number of banks - 80% of the total was provided to five banks and over 60% to four private banks. All these banks faced huge deposit withdrawals, except Bank Exim (state-owned) which faced huge losses on foreign exchange transactions. Bank

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\(^{29}\)The previous BI’s Law (1967) set BI’s status is a “dependent” agency served as assistance of the Government in carrying out monetary, banking and payment system policies. The current BI’s Law (1999) sets its the independence from political intervention.
Central Asia, owned by the Salim group which close links to Suharto, was the largest borrower of Rp31 trillion following riots in May 1998 (see Figure 6).

According to conventional wisdom, liquidity support should be only provided to illiquid but solvent banks. In order to reduce the likely hood of losses the central bank should take adequate collateral. Enoch (2001) argued that there should be restrictions against protracted use of such lending, since this is likely to be an indicator of solvency difficulties. After the bank closures of November 1997, and given there was no intention to close more banks in the near future, Bank Indonesia was locked into providing liquidity. Since then, Bank Indonesia provided support to all banks without taking any collateral (by allowing their current accounts with Bank Indonesia to go overdrawn). Instead, Bank Indonesia took only a personal guarantee from banks’ owners that the borrowings were used to meet liquidity needs, and their banks were in compliance with all prudential regulations. Unsurprisingly, as illustrated in Figure 6, liquidity support increased markedly.

The large budgetary cost that this entailed created tension and distrust between Bank Indonesia and the Government particularly over the accountability and integrity of Bank Indonesia in providing the emergency liquidity support. Enoch (2001) observed that the main criticism of BI’s LLR practices related to the lack of control over such lending, for example, whether lending matched a commensurate loss of deposits. While Bank Indonesia did undertake such matching in the latter part of the crisis – in particular in May 1998 when BCA was subject to severe withdrawals – there seems to have been less control during the earlier period. In fact, BI placed 2 or 3 supervisors in each distressed bank to verify the bank’s transactions. However, it was insufficient to ensure that there was no misuse of the liquidity support by banks’ management and owners.

This case has led to investigations into the operation of the LLR facility and dispute between the Government and Bank Indonesia about the amount of and who should bear the liquidity support. After a prolonged negotiation there is a commitment to finalise and implement a burden-sharing agreement on Bank Indonesia liquidity support between Bank Indonesia and the government. In fact, the decision to provide the liquidity support to distressed banks has been discussed in the Economic and Financial Stabilisation Council and approved by the

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30 Later, bank examination found that there were a strong indication of moral hazard indicated by dubious interbank transactions between the closed banks.
31 An investigation was performed by the Supreme Audit Agency (BPK) reported that there were weaknesses in BI’s internal control and governance in providing liquidity support.
President – ‘that Bank Indonesia could help distressed but good banks to maintain the banking system and the payment system’\textsuperscript{33}. However, as argued by Sinclair (2000) and Goodhart (2002), within the time scale allowed, it is often difficult, if not impossible, for central banks to distinguish between a solvency and a liquidity problem. Therefore, the basic problem was unclear criteria for distinguishing a good from bad banks and the absence of LLR guidelines and procedures to ensure accountability. In addition, there was also a lack of coordination between agencies in managing the crisis.

In addition, with a large amount of foreign-denominated debt it made difficult for Bank Indonesia to promote recovery from a financial crisis by using expansionary monetary policy. This policy is likely to cause domestic currency to depreciate sharply. For similar reasons, as was argued by Mishkin (2001), LLR activities by a central bank in a emerging market countries with substantial foreign-denominated debt, may not be as successful as in an industrialised countries. Bank Indonesia lending to the banking system in the midst of the crisis expands domestic credit. This led to a substantial depreciation of the rupiah which resulted in the deterioration of banks’ balance sheets, which in turn made recovery from the crisis more difficult likely. Therefore, the use of the LLR by a central bank in countries with a large amount of foreign-denominated debt is trickier because central bank lending is now a two-edged sword (Mishkin, 2001).

Based on its current Law of 1999, Bank Indonesia is permitted only a very limited role as lender of last resort. Bank Indonesia can only provide limited LLR in normal times to banks (for a maximum of 90 days) that have high quality and liquid collateral; and not in exceptional circumstances. The collateral could be securities or claims issued by the Government or other high-rated legal entities which can be readily sold to the market. In practice, government recapitalisation bonds and Bank Indonesia Certificate (SBIs) are the only eligible assets currently available to banks. The facility serves like a discount window, which the central bank routinely opens at all times to handle normal day to day operational mismatches which might be experienced by a bank. However, the facility does not constitute a LLR function typically used to provide emergency liquidity support to the financial system during crisis periods (i.e. when banks usually do not have high quality collateral).

\textsuperscript{33}The Council members are the Coordination Minister of the Economy, the Minister of Finance and the Governor of BI.
IV. Lessons Learnt from the Crisis

With regard to crisis prevention and resolution, there at least ten key lessons that could be drawn from Indonesia’s banking crisis.

1. **An open bank resolution** strategy and implicit guarantees were not an effective resolution measure in Indonesia’s case. They resulted in moral hazard and a higher of resolution costs. They were not accompanied by sufficient conditionality on sound management and tighter regulation for example. And this was aggravated by deficiencies in the inadequate legal and judicial system.

2. **Bank closure** should be executed rapidly but with a well-devised strategy including a contingency plan consisting a worst case scenario and risk mitigation strategy required to prevent and or to resolve the problems. The timing of closure is important – the bigger the problem, the more difficult to resolve. Frequent and/or delayed bank closures hurt public confidence and increased the fiscal costs significantly. A big bang closure is more likely to achieve success than a gradual approach, even though it might be difficult to implement, particularly at the beginning. When there is widespread bank insolvency, the key to restore confidence is to ensure that all the bad banks have been closed or resolved, that the rest are sound, and that small retail depositors are, at least, partly protected.

3. **A blanket guarantee** is important but should only be used as temporary measure in crisis resolution. The timing of its introduction is critical. A blanket guarantee is required at the outset of the crisis when bank closures occur, implicit guarantees have been given, and political and social conditions are not stable. In the long run it is quite likely that the blanket guarantee, with inherent moral hazard, could make future banking crises more likely. Therefore, a blanket guarantee should be replaced with a limited deposit insurance scheme once the banking system has been stabilised.

4. **A transparent and clearly-defined lender of last resort (LLR)** policy and procedures is required for crisis management in particular in a systemic crisis environment. It may serve as an important crisis management tool if it is defined clearly and announced to public. The absence of a well-defined LLR policy may create moral hazard and cannot ensure accountability.

5. **Bank restructuring** policies should be transparent, uniform and implemented consistently. Bank recapitalisation should be selective and encourage private sector
participation. If a market-based solution is not possible, resolution strategies should be more focused on the closure of highly insolvent banks and force the banks’ shareholders and, where possible, the large creditors to share the losses.

6. **Combination of micro and macroeconomic policies** is required for an effective crisis management, in particular if currency crisis and banking crisis occurs simultaneously. Failure to stabilise the exchange rate and to rebuild market confidence ca accentuated a banking crisis. With a freely floating exchange rate and free capital movement, Bank Indonesia found it difficult to stabilise the rupiah from speculative attacks. Since adopting restrictions on foreign exchange transactions in January 2001, it appeared to have been quite effective in containing speculative attacks on the rupiah. In addition, adoption of tight monetary policy exacerbates, rather than solves the financial crisis.

7. **Effective cooperation** between related institutions is necessary for effective crisis prevention and resolution. The effectiveness of crisis management depends on the response of senior political authorities and their cohesiveness. Crises are best resolved when political differences and group interests can be put aside in favour of the broader public interest. There should be a clear division of responsibilities and coordination between related institutions.

8. **Institutional capacity** is an important aspect of crisis management. The ability to acknowledge the extent of crisis early and to devise proper resolution strategies is essential. Lack of crisis management skills may be resolved by assigning a dedicated crisis management team with members selected from related institutions to handle the crisis with assistance of international institutions or experts if necessary.

9. **Political intervention and a lack of commitment** to resolve the crisis disrupts the resolution process and aggravates the situation. Inconsistent policies and a reluctance to address the core problems and to take tough decisions hinder the effectiveness of crisis resolution.

10. **Prudential banking regulation and supervision** is a principal element in creating and maintaining financial system stability. Ineffective prudential banking regulation and supervisory capability coupled with a lack of supervisory power and independence amplified the banking system fragility. Two main reasons for ineffectiveness of banking supervision in Indonesia were poor organisational and institutional development and high political interference.
V. The Way Forward

1. Overview of Indonesia’s Banking System

The banking system, particularly the commercial banks, dominate Indonesia’s financial system and play a key role in the financial intermediation process\(^{34}\). Indonesia’s banking system has two main features. First, it is a highly concentrated with the 15 largest commercial banks accounting for 75% of total assets (see Table /Appendix). Second, there is a high degree of government control of over 80% of the banking system’s assets. Domestic private banks and foreign banks account for only 11% and 8% respectively of total assets. The latter was a result of the bank restructuring programme in 1999–2000.

Following the bank restructuring programme, the banking system performance improved as indicated by an increase in profit /and capital as well as deposits. However, the banking system is still vulnerable and its capacity to support economic growth remains constrained by poor capitalisation and continued high credit risk in the economy. The main problems facing the banking industry are: (i) a high credit risk indicated by the continued high level of non performing loans; (ii) slow progress in loan and corporate restructuring, and; (iii) slow credit growth due to unfavourable economic conditions\(^{35}\).

At the heart of the financial crisis in Indonesia in 1997 – 1998 lay a slump in economic growth and investment. Since 1998, the economy has grown slowly. However, the outlook for the Indonesia economy is still uncertain. Nasution (2002) observed that the failure of the

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\(^{34}\)Indonesia’s financial system comprises banks and non-bank financial institutions (security firms, insurance companies, pension funds and pawn brokers). The banking system consist of commercial banks with shares up to 99% in terms of total asset to the banking system and rural banks. Commercial banks are the dominant players consisting of almost 80% of the total assets in the financial system.

\(^{35}\)Empirical study by Agung et al. (2001) found strong evidence of the existence of a credit crunch in Indonesia.
investment to rebound significantly suggest that the crisis is having a long-term adverse effect. Moreover, there are critical issues related to Indonesia’s financial stability including heavy pressures on the government budget deficit, public sector debts with payment of principal and interests US$9 billion per year, and difficulties in settling private sector debts.

| Table 1. Performance of the Indonesian Banking System: 1997 - 2001 (in trillion rupiah) |
|----------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Total Assets                     | 715.2           | 895.5           | 1,006.7         | 1,030.5         | 1,099.7         |
| Credits                          | 378.1           | 487.4           | 225.1           | 269.0           | 307.6           |
| Deposits                         | 357.6           | 573.5           | 625.6           | 699.1           | 797.4           |
| Equity                            | 46.7            | -98.5           | -41.2           | 52.3            | 62.3            |
| Capital Adequacy Ratio (CAR) %   | 9.19            | -15.7           | -8.12           | 12.34           | 19.28           |
| Non Performing Loans (Gross) %   | 32.18           | 48.6            | 32.8            | 18.8            | 12.1            |
| Return on Equity-ROE (%)         | 19.6            | -437.23         | -110.8          | 9.65            | 13.6            |
| Loan to Deposit Ratio-LDR (%)    | 105.7           | 85.0            | 36.0            | 38.5            | 38.6            |
| Number of Commercial Banks       | 222             | 208             | 173             | 164             | 159             |

Source: Bank Indonesia, Annual Report

A number of issues need to be resolved in order to restore the banking system to full health, so that it can perform its vital role as financial intermediary to the economy. Bank loans restructuring and corporate restructuring should be further accelerated in order to foster the internal growth of the banking industry. In addition, the institutional and organisational capabilities should be enhanced toward the international standards including risk management, good governance and banking supervision.

2. Redesigning the Safety Nets

Two strategic issues are proposed as part of a comprehensive crisis management strategy. First, replace the blanket guarantee with an explicit deposit insurance scheme and, second redesign the lender of last resort (LLR) facility.
2.1. Replacing the blanket guarantee with a deposit insurance scheme

There was a controversy over the adoption of a blanket guarantee. Some commentators such as Furman and Stiglitz (1998), Stiglitz (1999,2002), Radelet and Sachs (1998) argue that if the blanket guarantee had been introduced earlier, before some banks had been liquidated, the damage and costs of the crisis would have been much less.

In contrast, others criticised the blanket guarantee for being too broad. Goldstein (2000) argued that had all bad (insolvent) banks been closed at the beginning of the crisis then even with the limited deposit guarantee scheme in place there would not have been widespread deposit withdrawals because the remaining banks would have been ‘good’ ones. He believed that with a blanket guarantee, the government ended-up providing ex-post deposit insurance at a higher fiscal cost and with adverse moral hazard effects increasing the likelihood of future banking crises. Therefore, he suggested that Indonesia should develop an incentive-compatible deposit insurance system – along the lines of FDICIA in the United States – which should be a permanent part of the financial infrastructure.

Honohan and Klingebiel (2000), based on a sample of 40 developed and emerging market crises, found that unlimited deposit guarantees, open-ended liquidity support, repeated recapitalisation, debtors bail-out and regulatory forbearance significantly and sizeably increase the resolution costs. Moreover, based on evidence from 61 countries in 1980-97, Demirgüç-Kunt and Detragiache (1999), find that explicit deposit insurance tends to be detrimental to bank stability, the more so where bank interest rates are deregulated and the institutional environment is weak. Similarly, Cull et al. (1999) based on a sample of 58 countries also find that generous deposit insurance leads to financial instability in the presence of a weak regulatory environment.

However, systemic bank runs in Indonesia at the outset of the 1997 crisis cannot be attributed solely to the absence of a blanket guarantee. The inconsistent and non transparent bank liquidation policies applied by the authorities and some political uncertainties during the end of Suharto’s regime also played their part, as Lindgren et al. (1999) and Scott (2002) document. The introduction of the blanket guarantee programme at the outset of the crisis might be necessary in order to prevent larger potential economic and social costs of the systemic crisis (Lindgren et al. 1999). However, the scheme should be replaced as soon as possible with one that is more appropriate to normal conditions and does not create moral hazard.
Garcia (1999, 2000), based on surveys in 68 countries, identified the best practices of explicit systems of deposit insurance principally should have good infrastructure, avoid moral hazard, avoid adverse selection, reduce agency problems and ensure financial integrity and credibility. Based on a study of deposit insurance systems in Asian countries, Choi (2001) argues that it is reasonable in Asia to establish and maintain an explicit and limited deposit insurance system in order to prevent further possible financial crisis. Pangestu and Habir (2002) suggest that Indonesia’s deposit insurance scheme should be designed on two key aspects. First, it should provide incentive to better performing banks by linking the annual premium payment to their risk profile. Second, it should be self-funded in order to foster market discipline and reduce the fiscal burden.

In order to avoid a disruption to the banking system, Garcia (2000) suggests that a partial guarantee should not be introduced ideally until: (1) the domestic and international crisis has passed; (2) the economy has begun to recover; (3) the macro-economic environment is supportive of bank soundness; (4) the banking system has been restructured successfully; (5) the authorities possess, and are ready to use, strong remedial and exit policies for bank that in the future are perceived by the public to be unsound; (6) appropriate accounting, disclosure, and legal systems are in place; (7) a strong prudential regulatory framework is in operation; and (8) public confidence has been restored. It seems that currently Indonesia does not meet all these requirements.

Demirguc-Kunt and Kane (2001) suggest that countries should first assess and remedy the weaknesses of their international and supervisory environments before adopting an explicit deposit insurance system. In line with this, Wesaratchakit (2002) reported that Thailand decided to adopt a gradual transition from a blanket guarantee to a limited explicit deposit insurance scheme. It was considered that there are some preconditions that should be met – particularly the stability of banking system and the economy as a whole, effectiveness of regulation and supervision as well as public understanding – before shifting to an explicit limited deposit insurance system.

There is an issue of how depositors will react to the introduction of the limited scheme. In January 2001, Korea replaced its blanket guarantee with a limited deposit insurance system with an insurance limit of 50 million won per depositor per institution. There was a noticeable migration of funds from lower rated to sounder banks. Also, large depositors actively split their deposits to several accounts in banks and non-bank financial institutions. But there has been no bank run on the Korean financial system as a whole.
It is important to prepare a contingency plan before removing the blanket guarantee in order to anticipate the worst-case scenarios such as a loss of public confidence. If such conditions occur, the central bank may have to extend liquidity support to illiquid but solvent banks. In addition, there should be a clear legal framework for the deposit insurance scheme. To reduce moral hazard and to induce market discipline, the authorities should set a tough sanctions to the financial institutions and players which are violate the rules and cause problems into banks and ensure that law enforcement are in place.

2.2. Redesigning the Lender of Last Resort (LLR)

Historical experience suggests that successful lender of last resort actions have prevented panics on numerous occasions (Bordo, 2002). Although there may well be good reasons to maintain ambiguity over the criteria for providing liquidity assistance, He (2000) argues that properly designed lending procedures, clearly laid-out authority and accountability, as well as disclosures rules, will promote financial stability, reduce moral hazard, and protect the lender of last resort from undue political pressure. There are important advantages for developing and transitional economies to follow a rule-based approach by setting out ex ante the necessary conditions for support, while maintaining such conditions is not sufficient for receiving support. In the same vein, Nakaso (2001) suggests that Japan’s LLR approach has shifted from “constructive ambiguity” towards increasing policy transparency and accountability.

<table>
<thead>
<tr>
<th>Box 2. Key Considerations of Emergency Lending</th>
<th>Normal Times</th>
<th>Systemic Crisis</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Have in place clearly laid out lending procedures, authority, and accountability.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>2. Maintain close cooperation and exchange of information between the central bank, the supervisory authority (if it is separate from the central bank), the deposit insurance fund (if exist), and the ministry of finance.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>3. Decision to lend to systemically important institutions at the risk of insolvency or without sufficient, acceptable collateral should be made jointly by monetary, supervisory, and the fiscal authority.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>4. Lending to non-systemically institutions, if any, should be only to those institutions that are deemed to be solvent and with sufficient acceptable collateral.</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>5. Lend speedily</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>6. Lend in domestic currency</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>7. Lend at the above average market rates</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>8. Maintain monetary control by engaging effective sterilization</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>9. Subject borrowing banks to enhanced supervisory surveillance and restrictions on activities</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>10. Lend only for short-term, preferably not exceeding three to six months</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>11. Have a clear exit strategy</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>12. Emergency support operations should be disclosed when such disclosure will not be disruptive to financial stability</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>13. Repayment terms may be relaxed to accommodate the implementation of a systemic bank restructuring strategy.</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>14. Emergency support operation should be disclosed when such disclosure will not be disruptive to financial stability.</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

While individual frameworks differ from country to country, there is a broad consensus on the key considerations for emergency lending during normal and crisis periods (see Box 2).

In Indonesia, along the line suggested by He (2000), there should be a more clearly defined role for Bank Indonesia in LLR. In addition, there is also a need for criteria or mechanisms for providing LLR during systemic crises.

2.2.1. Lender of Last Resort in Normal Times

In normal times, LLR assistance should be based on clearly-defined rules. Transparent LLR policies and rules can reduce the probability of self-fulfilling crises, and provide incentives for fostering market discipline. It may also reduce political intervention and prevent any bias towards forbearance. LLR in normal times should only be provided for solvent institutions with sufficient acceptable collateral, while for insolvent banks stricter resolution measures should be applied such as closure. Therefore, there should be a clear and consistent adoption of a bank exit policy. Once a deposit insurance scheme has been established, the central bank role in LLR in normal time can be reduced to a minimum since the deposit insurance company will provide bridging finance in the case where there is a delay in closure process of a failed institution36.

2.2.2. LLR in Exceptional Circumstances

In systemic crises, LLR should be an integral part of a well-designed crisis management strategy. There should be a systemic risk exception in providing LLR to the banking system. Repayment terms may be relaxed to support the implementation of a systemic bank restructuring programme. In systemic crises the disclosure of the operation of LLR may become an important tool of crisis management. The criteria of a systemic crisis will depend on the particular circumstances, thus, it is difficult to clearly state this beforehand in a law. However, the regulations on the LLR facility should clearly set the guiding principles and specific criteria of a systemic crisis and or a potential bank failure leading to systemic crisis. To ensure an effective decision making process and accountability, there should be a clear institutional framework and LLR procedures. Bank Indonesia should be responsible for analysing the systemic threats to financial stability while the final decision on systemic crises resolution should be made jointly by Bank Indonesia and the Ministry of Finance. To ensure accountability, an appropriate documentation audit trail should be maintained.

36See Nakaso (2001) for a discussion on the Japanese LLR model.
VI. Conclusion

Indonesia’s experience shows that resolving banking crises can be costly, painful and complicated. However, it also brings some important lessons for policy. Unlike the other East Asian countries, the twin currency and banking crises in Indonesia resulted in a political crisis, which in turn made the financial crisis more difficult to manage. Social unrest and the volatile political situation limited the policy options available to policy makers. A lack of a comprehensive strategy both at the micro and macro level, a lack of commitment to take tough measures together with high level political intervention make for less effective and costlier resolution of banking crises. To be effective, the resolution process should be carried out objectively, transparently, and consistently in order to restore the health of the financial system and the economy.

Two key steps are suggested to improve the resolution mechanism in Indonesia: (i) a gradual replacement the current blanket guarantee with an explicit and limited deposit insurance scheme; and (ii) a more well-defined and transparent LLR function both in normal times and during systemic crises. Deposit insurance and LLR can be important tools for crisis management, but they are not sufficient to prevent banking crises. They should be used along with other financial stability tools such as market discipline and prudential banking supervision.

In order to strengthen the stability of Indonesia’s financial the current list of programmes – enhancing the effectiveness of bank supervision, bank and corporate restructuring, enhancing market discipline, improving the legal and judicial systems, and reducing the share of government in the banking system – need to be further accelerated. An independent and competent bank supervision is required which is able to take prompt corrective actions and resolve the difficulties created by failed institutions at least cost without damaging financial stability. In order to achieve this, bank supervision should converge on international best practice. It is also important to promote cooperation between Bank Indonesia and the FSA (once it is established) and with foreign supervisors and central banks to reduce the possibility of a future crisis and to better manage one should it occur.

Two other important policy options could be considered. First, limits could be set on holdings of foreign-denominated debt by financial institutions and other companies in order to reduce the vulnerability of the economy to the risk of another currency crisis. Second, policies could be introduced that reduce risk-taking by banks that might think they are too big, or too
important, to fail. This could be done by reducing the government control over banks or via outright privatisation and through intensifying supervision on systemically important banks. Cross-country experiences show that banking crises are difficult to predict and, thus, to avoid. History also tells us that financial crises often reoccur. That said, crisis prevention is vital in order to enhance the resilience of the financial system. It is essential to put in place a well-devised framework and strategy. With a strong commitment and enlightened leadership from senior policy makers, hopefully a healthier financial system will emerge in Indonesia – one that is able to foster higher and more stable economic growth in the future.
Appendix

### Box 3. Indonesia’s Steps Toward Bank Resolution: A Piecemeal Approach?

1. **Open-Bank Resolution and Emergency Liquidity Support**
   Until the crisis occurred, BI adopted an open bank resolution strategy by supporting either illiquid or insolvent banks to avoid closure. BI encouraged banks to consolidate and/or merge. However, these strategies were not effective due to a lack of enforcement and independence of BI in such a “crony capitalism” environment.

   Once the currency crisis spread, systemic bank runs occurred which drained the liquidity of the system caused by the deterioration of confidence and speculative attacks. For systemic stability reasons BI provide emergency liquidity support to all commercial banks, through overdraft facilities. This created tension between BI and the government over the accountability of BI in providing support to the banking system.

2. **1st Round Closures of 16 Small Banks**
   On November 1, 1997, the day after signing the first agreement with the IMF, BI closed down 16 small insolvent banks while “tolerating” 34 other insolvent and politically well-connected banks to operate (despite the recommendation of IMF staff). The closure criteria and process including the right of depositors was not communicated well to the public. The government provided limited deposit guarantees up to Rp20 million accounting for 80% of depositors but only 20% of the total deposits of the closed banks.

3. **Introduction of the Restructuring Agency and the Blanket Guarantee**
   The Indonesian Bank Restructuring Agency (IBRA) was established on 15 January 1998 with objectives to restructure the problem banks and to act as an asset management company to restructure the problem banks’ assets. At the outset, there were marked criticisms of IBRA’s governance and tension between IBRA and BI because the division of responsibilities was unclear.

4. **Special Surveillance of 54 Banks**
   On 14 February 1998, IBRA took over 54 problem banks (4 state banks and 50 private and regional development banks). Their borrowing from Bank Indonesia was more than 200 percent of their capital, and had capital adequacy ratios below 5 percent in December 1997. Hundreds officials from BI and related agencies were placed in the banks’ premises, but this “soft” intervention still had a very limited impact.

5. **1st Take over of 7 Banks and the 2nd Round Closure of 7 banks**
   IBRA adopted tough measures against the 14 worst banks that were taken over. Seven of these banks had borrowed more than 2 trillion rupiah each from Bank Indonesia and accounted for over 75% of Bank Indonesia’s liquidity support to the banking system. IBRA suspended shareholders’ rights and changed their management. The seven other small banks had borrowed from Bank Indonesia more than 500 percent of their equity and 75% of their assets. The operations of these banks were frozen while their deposits transferred to selected state banks.

6. **3rd Round Closure of 3 Banks formerly taken-over.**
   On 21 August 1998, IBRA again frozen three banks taken over on February 1998 (BDNI, BUN and Modern), while their deposit were transferred to state-owned banks.

7. **2nd Round Taken-over of BCA**
   On 29 May 1998, IBRA took over Bank Central Asia (BCA) - the largest domestic private bank (12.0 percent of the liabilities of the banking sector) following large depositor runs. IBRA suspended the bank owners’ rights and replaced the management. At the same time, two private domestic banks (1 forex and 1 nonforex) were merged with other banks.

8. **Due Diligence of 119 private banks**
   Started in August 1998, BI together with the international auditors carried out due diligence (a financial review) on all Indonesian-owned private banks in order to determine their solvency. It was completed by the end of October 1998.

9. **Mega Merger of State-owned banks**
   On 30 September 1998, the authorities announced a plan to merge four state-owned banks (Bank Bumi Daya, Bank Pembangunan Indonesia, and Bank Ekspor Impor Indonesia) into the newly established Bank Mandiri. Bank Mandiri and three other state banks (Bank Negara Indonesia, Bank Rakyat Indonesia, and Bank Tabungan Negara) were then recapitalised. The merger and recapitalisation process was delayed and caused a large additional cost.

10. **Liquidation**
   On 19 October 1998, the authorities announced a plan to liquidate 10 frozen banks. Since then, IBRA had been only responsible for the BTO and frozen banks while other banks were returned to Bank Indonesia.

11. **Recapitalisation Programme**
   On 13 March 1999, the government announced the results of due diligence. Banks were categorised by their capital adequacy ratio (CAR). "A" banks with CARs more that 4%; "B" banks with CARs between 4% and -25%; and "C" banks with CARs less than -25%. The result was as follows. 74 banks were "A" banks (6% of total banking liabilities), 9 "B" banks (12% of banking liabilities) and 7 "C" banks (4% of banking liabilities) were taken over by IBRA to be recapitalised. The other 38 "B" banks (5% of banking liabilities) including 17 "C" banks were closed. The recapitalisation process of the private banks was delayed due to some institutional and technical constraints which increased the recapitalisation costs.
Box 4. Bank Restructuring Process in Indonesia

- **Performing a Diagnostic Review**
  As an initial step, a financial review ("due diligence") was carried out by BI supervisors and international auditors to determine the banks’ solvency and the recapitalisation costs based on stricter criteria of asset classification and loan loss provisioning. Based on the result of this due diligence, banks were categorised into three categories according to their capital adequacy ratio (CAR): "A" banks with CAR of 4% or more, "B" banks with CAR from -25% up to less than 4%, and "C" banks with CAR less than -25%.

  The "A" banks were not required to adopt the recapitalisation programme, however, they had to prepare a business and action plans to improve their performance. While the "B" bank had to increase their capital to meet a CAR of at least 4% either by self-recapitalisation or applying for joint-governmental recapitalisation.

- **Recapitalisation Programme**
  The eligibility of a bank for the joint recapitalisation programme primarily was based mainly on two aspects: (1) the viability of a banks’ business plan; and (2) the fitness, and probity of banks’ management and controlling shareholders. The assessment was conducted by several committees (Technical Committee, Evaluation Committee, and Policy Committee) representing Bank Indonesia, Ministry of Finance and IBRA). To ensure transparency and objectivity, independent observers representing the IMF, World Bank, and ADB were invited to the meeting but without any rights in the decision making process.

- **Business Plan Preparation**
  The viability for the joint-recapitalisation programme was based on two main criteria: (1) the business prospect measured by the viability of the bank’s business plan, and (2) the fitness and propriety of management and owners. Other criteria were the bank’s contribution to the economy measured by networks and number of depositors. In particular, "C" category banks had to increase their capital to the minimum level of "B" banks in 30 days in order to be considered for the recapitalisation programme. The bank’s business plan comprised:
  
  a. **Current condition** - identification of a bank’s core problems and areas for improvement
  b. **Economic assumptions** used for projections
  c. **Asset Rehabilitation Plan** - action plans to reduce non-performing loans (NPLs)
  d. **Compliance Plan** with the regulations - action plans to settle Legal Lending Limit (LLL) and net open position (NOP) violations, and to improve the loan quality to affiliated debtors
  e. **Business Development Plan** - bank strategies to improve performance and soundness comprising risk management, governance, operational efficiency.
  f. **Settlement Plan** Bank Indonesia Liquidity Support (BLBI)
  g. **Divestment Plan** of government shares within three years
  h. **Financial Projections** - detailed financial projections including financial targets: CAR of minimum 8% and RoE minimum 15% by 31 December 2001.

- **Reviewing the Business Plan**
  a. **Main criteria**, included:
     - capability of shareholders and/or new investors to inject min. 20% funds to meet a 4% CAR,
     - compliance with the existing regulations (legal lending limit, net open position, etc.),
     - bank’s viability to meet CAR of 8% by the end of 2001. The bank’s projected CAR in December 2001 was based on a stress test model developed by international consultants.
  b. **Additional criteria**, included:
     - asset rehabilitation plan, business development plan, franchise values (networks, IT/IS) and significance to the economy, projected ROE 15% by the end of 2001.
  A bank would pass the business plan review if it met at least all the main criteria.

- **Performing a Fit and Proper Test**
  The fit and proper test was conducted on a bank’s shareholders (those owning more than 25% shares or the controlling shareholders), board of commissioners, and board of directors. The fit and proper test consisted of:
  
  a. **Fitness Test** - assessment of the competence and independence of bank’s board of commissioners and directors.
  b. **Propriety Test** - assessment of integrity fulfillment of commitment to BI, enlistment of bad debts and or delinquent people in the banking sector, other imprudent and fraudulent actions.

- **Recapitalisation**
  The recapitalisation process involved several key steps including:
  - Transferring a bank’s bad loans to IBRA;
  - Signing the recapitalisation agreement (contract) between the government, BI and the bank’s management.
  - Injecting additional capital by bank owners (fresh fund) and the government (government bonds).
As an initial step in the bank restructuring programme, Bank Indonesia, assisted by the international auditors, performed due diligence (a financial review) on all Indonesian-owned banks in order to determine the solvency and the costs of recapitalisation. It was started in August 1998 and completed in December 1998. An examination of all foreign exchange commercial banks including state-owned banks was performed by international auditors, while the non foreign exchange banks were examined by Bank Indonesia’s supervisors. These assessments focused on banks’ portfolio to determine solvent (good) and insolvent (bad) banks based on a strict loan quality assessment and provisioning. It was followed by a discussion with banks’ directors and commissioners in order to communicate the findings and the banks’ status and follow-up actions that a bank should take in line with the recapitalisation programme.

The due diligence categorised banks into three groups according to their capital adequacy ratio (CAR): (i) solvent “A” banks with CARs of 4% or more; (ii) insolvent “B” banks with CARs from –25% up to less than 4%; and (iii) highly insolvent “C” bank with CAR less than –25%. The B and C banks were required to prepare and submit business plans to Bank Indonesia as part of a joint recapitalisation programme. In addition, their shareholders were also required to inject a minimum of 20% of required capital to meet CARs of 4%. While the “A” banks could operate normally but they had to prepare a business plan in order to improve their performance. The viability of a bank for a joint recapitalisation programme was determined by committees with representative members from Bank Indonesia, IBRA and the Ministry of Finance.

### The Result of Due Diligence on Commercial Banks (13 March 1999)

<table>
<thead>
<tr>
<th>Group of Banks</th>
<th>A Category</th>
<th>B Category</th>
<th>C Category</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CAR &gt; 4%</td>
<td>-25% &lt; CAR</td>
<td>CAR &lt; -25%</td>
<td></td>
</tr>
<tr>
<td>1. State-owned banks</td>
<td></td>
<td></td>
<td></td>
<td>7</td>
</tr>
<tr>
<td>2. Regional Development Banks</td>
<td></td>
<td></td>
<td></td>
<td>7</td>
</tr>
<tr>
<td>3. National Private Banks</td>
<td>74</td>
<td>16</td>
<td>38</td>
<td>128</td>
</tr>
<tr>
<td>4. Joint-venture Banks</td>
<td>30</td>
<td>-</td>
<td>2</td>
<td>32</td>
</tr>
<tr>
<td>Total</td>
<td>119</td>
<td>24</td>
<td>51</td>
<td>194</td>
</tr>
</tbody>
</table>

Source: Bank Indonesia

### Table 2. Financial Review Result

<table>
<thead>
<tr>
<th>No</th>
<th>Status</th>
<th>Capital Adequacy Ratio</th>
<th>Capital Required for CAR 4% (Rp tln)</th>
<th>Total Assets (Rp bn)</th>
<th>3rd Party Deposits (Rp tln)</th>
<th>No. of depositors</th>
<th>No of employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>74</td>
<td>A Category (CAR &gt; 4%)</td>
<td>15.4</td>
<td>N/a</td>
<td>N/a</td>
<td>N/a</td>
<td>N/a</td>
<td>N/a</td>
</tr>
<tr>
<td>7</td>
<td>Taken over by IBRA</td>
<td>-21.1</td>
<td>-15.6</td>
<td>-24.6</td>
<td>21.62</td>
<td>15.45</td>
<td>1,051,084</td>
</tr>
<tr>
<td>9</td>
<td>To be recapitalised</td>
<td>-16.1</td>
<td>-8.2</td>
<td>-23.1</td>
<td>20.12</td>
<td>10.45</td>
<td>6,115,289</td>
</tr>
<tr>
<td>38</td>
<td>Liquidated</td>
<td>-40.2</td>
<td>-10.9</td>
<td>-101.8</td>
<td>23.13</td>
<td>49.47</td>
<td>1,147,495</td>
</tr>
</tbody>
</table>

Source: Bank Indonesia

### Table 3. Financial Condition of 9 Private Banks to be Recapitalised (31 December 1998)

<table>
<thead>
<tr>
<th>No</th>
<th>Bank</th>
<th>Total Liabilities (Rp tln)</th>
<th>Liabilities to BI (Rp tln)</th>
<th>Bad Loans (Rp bln)</th>
<th>CAR (%)</th>
<th>Capital Needs (Rp bln)</th>
<th>Projected CAR 2001 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Bukopin</td>
<td>5.48</td>
<td>1.10</td>
<td>630.5</td>
<td>-17.2</td>
<td>767.2</td>
<td>4.1</td>
</tr>
<tr>
<td>2</td>
<td>Bank Bali</td>
<td>9.99</td>
<td>0.01</td>
<td>1,663.4</td>
<td>-8.2</td>
<td>1,821.8</td>
<td>6.1</td>
</tr>
<tr>
<td>3</td>
<td>Bank Arta Media</td>
<td>N/a</td>
<td>0.01</td>
<td>69.2</td>
<td>-9.3</td>
<td>150.0</td>
<td>4.5</td>
</tr>
<tr>
<td>4</td>
<td>Bank Patriot</td>
<td>0.15</td>
<td>3.9</td>
<td>-23.1</td>
<td>32.1</td>
<td>34.8</td>
<td>6.0</td>
</tr>
<tr>
<td>5</td>
<td>Bank Universal</td>
<td>8.89</td>
<td>0.14</td>
<td>1,097.5</td>
<td>-21.8</td>
<td>2,421.9</td>
<td>4.7</td>
</tr>
<tr>
<td>6</td>
<td>Bank Lippo</td>
<td>20.13</td>
<td>81.1</td>
<td>1,097.5</td>
<td>-16.1</td>
<td>3,356.7</td>
<td>5.4</td>
</tr>
<tr>
<td>7</td>
<td>Bank Internasional Indonesia</td>
<td>40.06</td>
<td>4,922.6</td>
<td>-15.9</td>
<td>7,612.5</td>
<td>5.0</td>
<td>5.2</td>
</tr>
<tr>
<td>8</td>
<td>Bank Prima Express</td>
<td>1.84</td>
<td>16.5</td>
<td>-15.6</td>
<td>252.7</td>
<td>5.2</td>
<td>5.2</td>
</tr>
<tr>
<td>9</td>
<td>Bank Niaga</td>
<td>N/a</td>
<td>0.70</td>
<td>728.2</td>
<td>-17.4</td>
<td>3,700.0</td>
<td>6.4</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>2.05</td>
<td>9,212.9</td>
<td>-</td>
<td>20,114.9</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bank Indonesia
Table 4. List of Liquidated Banks, Banks Taken Over (BTO), Frozen Banks (BBO) and Recapitalised Banks

<table>
<thead>
<tr>
<th>1st Round Closures - Liquidated Banks (16): 1 November 1997</th>
<th>2nd Round Closures - (10) Frozen Banks</th>
<th>1st Round Taken-over (8)</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>3rd Round Closure - Frozen Banks (38): 13 March 1999</th>
<th>2nd and 3rd Round Taken-over (9)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Bank Sewu</td>
<td>2. Bank Danamon, Merged with 7 BTOs</td>
</tr>
<tr>
<td>3. Bank Indonesia Raya</td>
<td></td>
</tr>
<tr>
<td>4. Bank Ficorinvest</td>
<td></td>
</tr>
<tr>
<td>5. Bank Central Dagang</td>
<td></td>
</tr>
<tr>
<td>6. Bank Dharmala</td>
<td></td>
</tr>
<tr>
<td>7. Bank Ciputra</td>
<td></td>
</tr>
<tr>
<td>8. Bank Sembada</td>
<td></td>
</tr>
<tr>
<td>Artanugroho</td>
<td></td>
</tr>
<tr>
<td>9. Bank Aken</td>
<td></td>
</tr>
<tr>
<td>10. Bank Intan</td>
<td></td>
</tr>
<tr>
<td>11. Bank Alfa</td>
<td></td>
</tr>
<tr>
<td>12. Bank Dewa Rutji</td>
<td></td>
</tr>
<tr>
<td>13. Bank Kharisma</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>1st Round (7) 21 April 1999</th>
<th>Recapitalisation of Private Banks</th>
<th>Recapitalisation of Regional Development and State-owned Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Bank Lippo, Tbk.</td>
<td>1. Bank Danamon, Merged with 7 BTOs</td>
<td></td>
</tr>
<tr>
<td>2. Bank Int’l Indonesia</td>
<td>• Bank Duta</td>
<td></td>
</tr>
<tr>
<td>3. Bank Bukopin</td>
<td>• Bank Nusa Nasional</td>
<td></td>
</tr>
<tr>
<td>4. Bank Universal</td>
<td>• Bank Pos Nusantara</td>
<td></td>
</tr>
<tr>
<td>5. Bank Prima Ekspress</td>
<td>• Bank Jaya</td>
<td></td>
</tr>
<tr>
<td>6. Bank Artamedia</td>
<td>• Bank Tama,</td>
<td></td>
</tr>
<tr>
<td>7. Bank Patriot</td>
<td>• Bank Rama</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1. Bank Bali</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. Bank Niaga</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>4th Round (3) March 2000</th>
<th>2nd Round (12) 28 May 1999 Regional development banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Bank Danamon, Merged with 7 BTOs</td>
<td>1. BPD DI Aceh</td>
</tr>
<tr>
<td>• Bank Duta</td>
<td>2. Bengkulu</td>
</tr>
<tr>
<td>• Bank Nusa Nasional</td>
<td>3. BPD Sumatera Utara</td>
</tr>
<tr>
<td>• Bank Pos Nusantara</td>
<td>4. BPD Lampung</td>
</tr>
<tr>
<td>• Bank Jaya</td>
<td>5. BPD DKI Jakarta</td>
</tr>
<tr>
<td>• Bank Tamara,</td>
<td>6. BPD Jawa Tengah</td>
</tr>
<tr>
<td>• Bank Rama</td>
<td>7. BPD Jawa Timur</td>
</tr>
<tr>
<td>• Bank Risya Salim Int’l June 2000</td>
<td>8. BPD NTB</td>
</tr>
<tr>
<td>1. Bank Bali</td>
<td>9. BPD NTT</td>
</tr>
<tr>
<td>2. Bank Niaga</td>
<td>10. BPD Kalimantan Barat</td>
</tr>
<tr>
<td></td>
<td>11. BPD Sulawesi Utara</td>
</tr>
<tr>
<td></td>
<td>12. BPD Maluku</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3rd Round (4) (March - July 2000) State-owned banks</th>
<th>1. Bank Mandiri*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Bank BNI</td>
<td>2. Bank BRI</td>
</tr>
<tr>
<td>3. Bank BTN</td>
<td>*a new established bank, merger of 4 state-owned banks:</td>
</tr>
<tr>
<td></td>
<td>• Bank Ekspos Impor Indonesia</td>
</tr>
<tr>
<td></td>
<td>• Bank Bumi Daya,</td>
</tr>
<tr>
<td></td>
<td>• Bank Dagang Negara</td>
</tr>
<tr>
<td></td>
<td>• Bank Pembangunan Indonesia</td>
</tr>
</tbody>
</table>

Source: Bank Indonesia
Table 5. Indonesia’s Fiscal Cost of Banking Crisis Resolution (in trillion rupiah)

<table>
<thead>
<tr>
<th>Bank</th>
<th>No. of Banks</th>
<th>Total</th>
<th>Liquidity Support*</th>
<th>Credit programme</th>
<th>Govt. Guarantee</th>
<th>Recapitalisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidated banks</td>
<td>16</td>
<td>11.89</td>
<td>11.89</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regional Banks</td>
<td>12</td>
<td>1.23</td>
<td></td>
<td></td>
<td></td>
<td>1.23</td>
</tr>
<tr>
<td>State-owned banks</td>
<td>4</td>
<td>302.32</td>
<td></td>
<td></td>
<td>20</td>
<td>282.32</td>
</tr>
<tr>
<td>Various</td>
<td></td>
<td>63.75</td>
<td></td>
<td></td>
<td>9.97</td>
<td>53.78</td>
</tr>
<tr>
<td>Frozen banks (BBKU)</td>
<td>38</td>
<td>17.32</td>
<td></td>
<td></td>
<td>17.32</td>
<td></td>
</tr>
<tr>
<td>Frozen banks-1 (BBO-1)</td>
<td>7</td>
<td>6.02</td>
<td></td>
<td></td>
<td>6.02</td>
<td></td>
</tr>
<tr>
<td>Frozen banks-2 (BBO-2)</td>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td>51.67</td>
<td>51.67</td>
</tr>
<tr>
<td>Bank taken-over-1 (BTO-1)</td>
<td>4</td>
<td>163.97</td>
<td></td>
<td></td>
<td>54.62</td>
<td>109.35</td>
</tr>
<tr>
<td>Bank taken-over-1 (BTO-2)</td>
<td>2</td>
<td>17.8</td>
<td></td>
<td></td>
<td>3.02</td>
<td>14.78</td>
</tr>
<tr>
<td>Recapitalised private banks</td>
<td>7</td>
<td>17.86</td>
<td></td>
<td></td>
<td>17.86</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>653.83</td>
<td></td>
<td>144.54</td>
<td>9.97</td>
<td>73.78</td>
</tr>
</tbody>
</table>

Source: IBRA, Annual Report 2000

*From Bank Indonesia.

Table 6. Indonesian Banking System as of 31 March 2002 (in trillion rupiah)

<table>
<thead>
<tr>
<th>Rank</th>
<th>Banks</th>
<th>Total Assets</th>
<th>% of the Banking System</th>
<th>Rank</th>
<th>Banks</th>
<th>Total Assets</th>
<th>% of the Banking System</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Bank Mandiri</td>
<td>260.2</td>
<td>24</td>
<td>10</td>
<td>Pan Indonesia Bank</td>
<td>18.0</td>
<td>2</td>
</tr>
<tr>
<td>2</td>
<td>Bank Negara Indonesia</td>
<td>126.5</td>
<td>12</td>
<td>13</td>
<td>Bank Mega</td>
<td>12.3</td>
<td>1</td>
</tr>
<tr>
<td>4</td>
<td>Bank Rakyat Indonesia</td>
<td>83.4</td>
<td>8</td>
<td>14</td>
<td>Bank Buana Indonesia</td>
<td>12.2</td>
<td>1</td>
</tr>
<tr>
<td>7</td>
<td>Bank Tabunging Negara</td>
<td>27.3</td>
<td>3</td>
<td></td>
<td><strong>Sub Total of Top 15</strong></td>
<td>802.9</td>
<td>75</td>
</tr>
<tr>
<td>3</td>
<td>Bank Central Asia</td>
<td>100.0</td>
<td>9</td>
<td></td>
<td>Other Regional &amp; Joint Recapitalised Banks</td>
<td>12.8</td>
<td>1</td>
</tr>
<tr>
<td>5</td>
<td>Bank Danamon Indonesia</td>
<td>48.3</td>
<td>5</td>
<td></td>
<td>Foreign Banks</td>
<td>88.9</td>
<td>8</td>
</tr>
<tr>
<td>8</td>
<td>Bank Niaga</td>
<td>23.6</td>
<td>2</td>
<td></td>
<td>Regional Development Banks</td>
<td>48.5</td>
<td>5</td>
</tr>
<tr>
<td>12</td>
<td>Bank Bali</td>
<td>13.3</td>
<td>1</td>
<td></td>
<td>Other</td>
<td>40.3</td>
<td>4</td>
</tr>
<tr>
<td>6</td>
<td>Bank Internasional Indonesia</td>
<td>31.8</td>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Lippo Bank</td>
<td>23.5</td>
<td>2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Bank Universal</td>
<td>13.5</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Bank Bukopin</td>
<td>9.1</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Total Banking System</strong></td>
<td><strong>1.064.7</strong></td>
<td></td>
<td></td>
<td><strong>Sub Total of Top 15</strong></td>
<td><strong>802.9</strong></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bank Indonesia
**Box 6. Division of Responsibilities in Financial Stability – Current Setting**

<table>
<thead>
<tr>
<th>Authorities</th>
<th>BANK INDONESIA</th>
<th>GOVERNMENT</th>
<th>IBRA**</th>
<th>TREASURY DEPT./BAPEPAM</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Functions</strong></td>
<td>• Maintain monetary (rupiah) stability; incl. provide LLR for liquidity mismatch</td>
<td>• Provide blanket guarantee</td>
<td>• Administer the blanket guarantee (Keppres No. 27/1998)</td>
<td>• License, regulate and supervise non-bank financial institution (Treasury Department)</td>
</tr>
<tr>
<td></td>
<td>• Regulate and oversee the payments system</td>
<td>• Systemic bank resolution (Art. 37A Banking Act, 1998)</td>
<td>• Individual bank resolution (Art. 37A Banking Act, 1998)*</td>
<td>• License, regulate and supervise capital markets (Bapepam)</td>
</tr>
<tr>
<td></td>
<td>• License, regulate and supervise banks</td>
<td>• Individual bank resolution (Art. 37A Banking Act, 1998)*</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Individual bank resolution (Art. 37A Banking Act, 1998)*</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Financial Institutions**

**BANKING SYSTEM** (Commercial banks and rural banks - conventional and Islamic)

**NON-BANK FINANCIAL INSTITUTIONS** (Insurance, securities, pension fund, and capital markets)

*Based on the current Banking Law (1998), there is an overlap in responsibility in dealing with individual bank resolutions between BI and IBRA. Article 37 authorises BI to resolve a problem bank, while Article 37A also grants a wider authority to IBRA to restructure insolvent but viable or systemically important banks and to freeze banks’ operations.

**Based on the current regulation, individual bank resolutions are carried out by IBRA. Bank Indonesia sets the criteria of a “problem bank” which should then be transferred to IBRA. Bank Indonesia and IBRA coordinate with each other in executing the blanked guarantee scheme for individual bank resolutions. As a temporary body, IBRA will last until 2004.

Source: Adapted from Bank Indonesia

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**Box 7. Division of Responsibilities in Financial Stability – Proposed Future Setting**

<table>
<thead>
<tr>
<th>Authorities</th>
<th>BANK INDONESIA</th>
<th>FSA (OJK)**</th>
<th>DIC (LPS)***</th>
<th>GOVERNMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Functions</strong></td>
<td>• Maintain monetary (rupiah) stability; incl. provide LLR for liquidity mismatch</td>
<td>• Licence, regulate and supervise financial institution and capital market (micro-prudential)</td>
<td>• Regulate and an explicit and limited deposit insurance scheme.</td>
<td>• Provide a supporting legal and political infrastructure.</td>
</tr>
<tr>
<td></td>
<td>• Regulate and oversight the payments system.</td>
<td>• Individual bank resolution.</td>
<td>• Individual bank resolution</td>
<td>• Provide fund for systemic resolution (based on joint decision among BI, FSA, and DIC and if necessary after approval from the House of Representative).</td>
</tr>
<tr>
<td></td>
<td>• Promote and surveillance of financial stability (macro prudential).</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Financial Institutions**

**BANKING SYSTEM** (Commercial banks and rural banks - conventional and Islamic)

**NON-BANK FINANCIAL INSTITUTIONS** (Insurance, securities, pension fund, and capital markets)

**CAPITAL MARKET**

Based on the Banking Law (1998), bank supervision function should be transferred to a financial services supervisory agency (now called FSA) by the end of 2002. The future legal and institutional framework in financial stability and banking supervision has been drafted by the government in FSA Law together with the amendments of BI’s Law (1999) and the Banking Law (1998).

* The systemic liquidity support will be made by a joint decision of BI with the Government, DIC and FSA.

**The creation of the FSA supervisory agency is underway. However, it seems that the creation of the FSA will be delayed due to two main constraints: (i) the draft of FSA’s Law and the amendment of BI’s Law (1999) and Banking Law (1998) have not been approved by the House of Representative; and (ii) unresolved operational issues such as budget and resources required for the FSA. FSA responsible to warns BI and the government if a problem of an institution could lead to a systemic crisis.

***The new-established DIC will regulate, supervise and administer the explicit limited deposit insurance scheme which will replace the current blanket guarantee programme. DIC will also responsible for individual bank resolution. A joint team of representing related institutions is preparing the design of the insurance scheme.

Source: Adapted from Bank Indonesia

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Safeguarding financial stability is a core function of a modern central bank, no less important than maintaining monetary stability. Essentially, financial stability as the avoidance of a financial crisis. A proper crisis resolution framework and strategy should be designed not only based on the international best practice but also on specific local conditions. It must be part of a broad framework and strategy of national financial system stability. Financial stability relies on six interrelated elements: (1) a stable macro-economic environment; (2) a stable and sound financial system; (3) a well-managed financial institutions; (4) an efficient financial markets; (5) a sound framework of prudential supervision; and (6) a safe and robust payment system.

In line with its Law of 1999, as the monetary authority, Bank Indonesia’s main objective is to achieve a stable value of the rupiah (price stability). This has been stated as Bank Indonesia vision - to achieve a stable value of rupiah by maintaining monetary stability and promoting financial stability for Indonesia’s long term sustainable development. Responsibility in promoting financial stability needs to be explicitly stated in the Bank Indonesia Law. To achieve the objective of promoting financial stability, Bank Indonesia is required to apply four strategies.

First, is the coordination and cooperation both internally and externally with other related institutions, especially the Ministry of Finance, IBRA, the supervisory authority (once banking supervision function is separated from Bank Indonesia) and the Deposit Insurance Agency which will be established. Since the financial stability is a goal of public policy, it is necessary to define a clear role and responsibilities for each institution and a coordination mechanism between them (see Box 5 and 6 of the institutional framework).

Second, surveillance comprises activities to identify, assess and monitor risks and related aspects of the financial system stability. An early warning system consisting of micro and macro-economic indicators is an important tool that should be developed for this purpose.

Third, regulation including providing a comprehensive formal regulatory framework and setting a proper financial architecture and fostering market discipline, as a solid basis for promoting financial stability.

Fourth, crisis management comprising lender of last resort, deposit insurance and crisis resolution which are closely interrelated. Figure illustrates a general framework of Bank Indonesia financial stability.

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**Box 8. Financial System Stability Strategy for Indonesia**

Safeguarding financial stability is a core function of a modern central bank, no less important than maintaining monetary stability. Essentially, financial stability as the avoidance of a financial crisis. A proper crisis resolution framework and strategy should be designed not only based on the international best practice but also on specific local conditions. It must be part of a broad framework and strategy of national financial system stability. Financial stability relies on six interrelated elements: (1) a stable macro-economic environment; (2) a stable and sound financial system; (3) a well-managed financial institutions; (4) an efficient financial markets; (5) a sound framework of prudential supervision; and (6) a safe and robust payment system.

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Second, surveillance comprises activities to identify, assess and monitor risks and related aspects of the financial system stability. An early warning system consisting of micro and macro-economic indicators is an important tool that should be developed for this purpose.

Third, regulation including providing a comprehensive formal regulatory framework and setting a proper financial architecture and fostering market discipline, as a solid basis for promoting financial stability.

Fourth, crisis management comprising lender of last resort, deposit insurance and crisis resolution which are closely interrelated. Figure illustrates a general framework of Bank Indonesia financial stability.

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**Framework of Financial System Stability (FSS)**

- **Coordination & Cooperation**
  - Internal Coordination
  - External Coordination
  - Joint Committee

- **Surveillance**
  - Early Warning Systems
  - Macroeconomic Indicators
  - Micro-prudential Indicators (agr.)

- **Regulation**
  - Regulatory Framework
  - Financial Architecture
  - Market discipline

- **Crisis Management**
  - Lender of last resort
  - Deposit Insurance
  - Crisis resolution

Source: Adapted from Bank Indonesia
List of Abbreviation

BAPEPAM Capital Market Supervisory Agency (“Badan Pengawas Pasar Modal”)
BI Bank Indonesia
BILS Bank Indonesia Liquidity Support (“Bantuan Likuiditas Bank Indonesia/BLBI”)
BNI Bank Negara Indonesia (State-owned Commercial Bank)
BPD Regional Development Bank
BPK Supreme Audit Agency
BPKP Finance and Development Supervisory Agency
BPRS Sharia (Islamic) Rural Credit Bank
BRI Bank Rakyat Indonesia (State-owned Commercial Bank)
BTO Bank Taken Over
BTN Bank Tabungan Negara (State-owned Commercial Bank)
BBO Bank Beku Operasi (Operationally Frozen Bank)
BBKU Bank Beku Kegiatan Usaha (Operationally Frozen Bank)
CAR Capital Adequacy Ratio
DIC Deposit Insurance Company (“Lembaga Penjamin Simpanan/LPS”)
DPR House of Representatives (“Dewan Perwakilan Rakyat/DPR”)
FSA Financial Services Authority (“Otoritas Jasa Keuangan/OJK”)
GDP Gross Domestic Product
IBRA Indonesian Banking Restructuring Agency (“Badan Penyehatan Perbankan Nasional”)
IMF International Monetary Fund
JIBOR Jakarta Interbank Offered Rate
KLBI Bank Indonesia Liquidity Credit (“Kredit Likuiditas Bank Indonesia”)
LLR Lender of Last Resort
LDR Loan to Deposit Ratio
NIM Net Interest Margin
NPLs Non-Performing Loans
ROE Return on Equity
Rp Rupiah
SBI Bank Indonesia Certificate (“Sertifikat Bank Indonesia”)
US United States
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