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BANK RESTRUCTURING AND FINANCIAL INSTITUTION REFORM IN INDONESIA

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The banking sector underwent drastic reform in post-crisis Indonesia. Bank restructuring, driven by IMF conditionalities, resulted in the exit of insolvent banks and ownership changes of major private banks. Through recapitalization and sales of government-held shares, foreign-owned banks emerged as leading actors in the place of business-group-affiliated banks. As part of the restructuring process, an exit rule was created. The central bank, which up to that time had been given only partial authority under the jurisdiction of the Minister of Finance, now gained a full range of authority over banks. The central bank's supervision system on banks, risk management systems at individual banks, and their efforts to build risk management capacities, began to function. This is totally different from the old financial institution under the Soeharto regime, where banks had no incentive to control risks, as the regime tacitly ensured their survival.

INTRODUCTION

THE banking sector experienced drastic changes in post-crisis and post-Soeharto Indonesia. The changes occurred because the sector was severely hit by the economic crisis, and also because it was placed at the center of the economic reforms carried out under International Monetary Fund (IMF) conditionalities. Some of the major changes in the banking sector were the redeployment of actors and institutions. Following a series of bank reconstruction measures, there were major changes in the roster of owners of leading private banks. This change stands in stark contrast to the situation in Thailand, where the four largest financial conglomerates survived the crisis. Even domestically, the banking sector suffered a different fate from the corporate sector, where the redeployment of actors that should have been associated with corporate debt disposal has taken place only partially, and in a non-transparent manner.

The financial institution, and the bank supervision system in particular, has undergone major changes. Bank Indonesia, the central bank, which was formerly placed under the executive branch of government and given only limited authority, was legally guaranteed independence from the government and obtained broad authority over banks. The risk management systems of individual banks and the deposit

insurance system started to be institutionalized. Though introduced at the initiative of the IMF, these institutional reforms represent a fresh effort to build a financial institution that was never functional under the Soeharto regime.

Indonesia's banking crisis, which "proved to be one of the most serious in any country in the world in the twentieth century" (Enoch et al. 2001, p. 8), has drawn much research interest. There have been two major streams of research: policy research designed to derive policy implications from the Indonesian experiences,[1] and empirical research which analyzes the functions and structure of the Indonesian financial sector from such aspects as monetary policy, financial intermediation, and banks' financial conditions.[2] This paper, however, aims to evaluate the banking reform from a different perspective from these specialized financial analyses. One of the angles is an actor analysis, examining who emerged as new actors after bank restructuring and how these actors reacted to the new institutional environment. The second is a comparative analysis of the financial institution to find out whether post-crisis reform has brought about any fundamental changes in the financial institution built under the pre-crisis Soeharto regime. The task of this paper is to evaluate the bank reform from these two points of view and to consider its significance in Indonesia's economic reorganization. Bank reconstruction has been completed at the cost of imposing enormous costs on state finance, and transferring the task of collecting nonperforming loans to a governmental asset management organization. This paper does not directly address the issues of the fiscal burden or loan collection, however.

Section I of this paper provides a general view of the Indonesian banking sector after the crisis, and Section II is devoted to a review of major actors and the banking institution before the crisis. Section III sheds light on the post-crisis redeployment of actors, while Section IV addresses institutional reforms. Section V examines the features of post-restructuring management reform at major banks. Based on these discussions, the concluding section considers the significance of institutional reform in the banking sector.

I. STRUCTURAL CHANGES IN THE BANKING SECTOR AROUND THE CRISIS

Table I provides an overview of structural changes in the banking sector around the time of the crisis. The total number of commercial banks declined by 37 percent from 239 at the end of 1996 to 151 at the end of 2000, as the closure of banks ran its

[1] Papers from the IMF and World Bank played a leading role. For example, see Enoch (2000), Enoch et al. (2001), and Pangestu and Habir (2002).

[2] For example, see Komatsu (2003) for monetary policy and financial intermediation, and Takeda (2002) and Bank Indonesia, DPNP, BSSK (2003) for an analysis of banks' financial fundamentals. Other references include Ary Suta and Musa (2003).

TABLE I

MAIN INDICATORS FOR THE BANKING SECTOR AROUND THE ECONOMIC CRISIS, 1996–2003

(%)

	1996	1997	1998	1999	2000	2001	2002	2003
No. of commercial banks	239	222	208	164	151	145	142	138
Total assets (ratio to nominal GDP)	72.8	84.3	79.8	71.8	77.8	70.9	65.8	63.9
Total loans (ratio to nominal GDP)	55.0	60.2	51.0	20.5	21.3	21.0	22.7	26.6
Loan to deposit ratio	104.0	105.7	85.0	36.0	37.3	38.0	43.2	54.3
Loans / total assets	75.6	71.5	63.9	28.5	27.3	29.6	34.5	41.6
Claims on government / total assets	0.2	0.2	0.1	34.0	43.6	39.3	35.7	30.2
Capital / total assets	9.6	8.8	–12.9	–2.7	5.1	6.4	8.8	9.7
Nonperforming loan ratio (gross)	9.3	19.8	58.7	32.8	18.8	12.1	8.3	8.1
Nonperforming loan ratio (net)	n.a.	n.a.	n.a.	n.a.	11.1	3.6	2.9	1.8

Sources: Bank Indonesia, *Indonesian Financial Statistics* (various issues); Bank Indonesia, *Annual Report* (various years).

Notes: 1. "Claims on government" of banks on the central government consist mainly of government bonds injected for banks' recapitalization.
2. The nonperforming loan ratios for 1996–98 are figures for the end of each fiscal year (the end of March 1997–the end of March 1999).
3. Nonperforming loan ratio (gross) = nonperforming loans / total outstanding loans × 100.
Nonperforming loan ratio (net) = (nonperforming loans – reserves) / total outstanding loans × 100.

course. While the size of assets in the banking sector (relative to GDP) rose marginally during the same period, the balance of outstanding loans dwindled to 21 from 55 percent of GDP, following the transfer of nonperforming loans to the Indonesian Bank Restructuring Agency (IBRA).[3] The ratio of lending to total assets also declined significantly, while claims on the central government, or government bonds injected by the government into the banking sector, increased to around 40 percent of total assets. As a result of a public capital injection (recapitalization) worth 658 trillion rupiahs (52 percent of GDP in 2000), the ratio of capital to total assets turned positive by 2000. The nonperforming loan ratio declined to a normal level by 2002. The banking sector climbed out of its critical state thanks to the emergency treatment, but the pace of the recovery of financial intermediation has been slow since 2002 in terms of lending activity, due in part to more stringent risk management by banks after the reform.

The ownership structure of the banking sector also changed (Table II). Comparing the situation before the crisis to that after bank restructuring, the weight of

[3] Nonperforming loans transferred from the banking sector to IBRA amounted to 236 trillion rupiahs (as of the end of 1999), or equivalent to 49 percent of outstanding loans. The ratio of claims collected by IBRA from indebted companies was finally just 28 percent when IBRA was dissolved in February 2004.

TABLE II

CHANGES IN OWNERSHIP STRUCTURE IN THE BANKING SECTOR AROUND THE ECONOMIC CRISIS, 1996, 2000, AND 2002

Classification by Ownership	1996 Pre-crisis			2000 Post-restructuring				2002 Post-sale of Government-Held Shares			
	No. of Banks	Total Assets (Trillion Rupiahs)	Asset Composition (%)	Post-crisis Reconstruction Measures	No. of Banks	Total Assets (Trillion Rupiahs)	Asset Composition (%)	Sale of Government-Held Shares	No. of Banks	Total Assets (Trillion Rupiahs)	Asset Composition (%)
State banks	7	141	36.4		5	505	50.3		5	496	45.6
Private banks	164	201	51.7	Private banks total	81	350	34.9	Private banks total	76	423	38.9
				Reconstructed banks subtotal	11	274	27.3	Reconstructed banks subtotal	7	291	26.7
				Nationalization	4	205[a]	20.4[a]	Sale to foreign investors	4	223	20.5
				Recapitalization	7	69	6.9	Yet to be sold/ not for sale	3	67	6.2
				Banks without reconstruction measures	70	76	7.6	Banks without reconstruction measures	69	132	12.2
Foreign bank branches/ joint banks	41	36	9.2		39	123	12.2		31	112	10.3
Regional development banks	27	11	2.8		26	25	2.5		26	57	5.3
Total	239	389	100.0		151	1,004	100.0		138	1,088	100.0

Sources: Bank Indonesia, *Indonesian Financial Statistics* (various issues); *Infobank* no. 289 (June 2003); *Annual Reports* of reconstructed banks.

[a] Including assets of four recapitalized banks that had been consolidated into nationalized Bank Bali.

TABLE III

TEN LARGEST BANKS BEFORE AND AFTER THE ECONOMNIC CRISIS, 1996 AND 2002

Order	1996				2002				
	Name of Bank	Ownership Classification (Business Group)	Total Assets (Trillion Rupiahs)	Asset Composition (%)	Name of Bank	Ownership Classification	Reconstruction Measures	Total Assets (Trillion Rupiahs)	Asset Composition (%)
1	BCA	Private (Salim)	36.1	9.3	Bank Mandiri[a]	State	Consolidation of four state banks, recapitalization	250.4	23.6
2	BNI	State	34.9	9.0	BNI	State	Recapitalization	125.6	11.9
3	BRI	State	34.4	8.9	BCA	Private (→foreign-owned)	Nationalization, consolidation of one bank, sale to foreign investors	117.3	11.1
4	BDN	State	32.4	8.4	BRI	State	Recapitalization	86.3	8.1
5	Exim	State	25.8	6.7	Danamon	Private (→foreign-owned)	Nationalization, consolidation of eight banks, sale to foreign investors	46.9	4.4
6	BBD	State	24.5	6.3	BII	Private (→foreign-owned)	Recapitalization, sale to foreign investors	36.3	3.4
7	Danamon	Private (Danamon)	22.0	5.7	Permata	Private	Nationalization, recapitalization, consolidation of five banks, to be sold to investors	28.0	2.6
8	BII	Private (Sinar Mas)	17.7	4.6	BTN	State	Recapitalization	27.1	2.6
9	BDNI	Private (Gajah Tunggal)	16.7	4.3	Citibank	Foreign bank branch	—	24.6	2.3
10	Bapindo	State	13.7	3.5	Lippo	Private	Recapitalization, to be sold to investors	24.2	2.3
Total for 10 largest banks			258.2	66.6				766.7	72.3
Total for all commercial banks			387.5	100.0				1,059.8	100.0

Sources: Ekofin Konsulindo (2000) for 1996; *Infobank*, no. 289 (June 2003) and other materials for 2002.

[a] Bank Mandiri was established through the consolidation of four state banks in the left column: BDN, Exim, BBD, and Bapindo.

private and state banks was reversed. State banks fell in number from seven to five, but their composition ratio in terms of assets rose from 36 percent in 1996 to 50 percent in 2000. On the other hand, the number of private banks was halved, as 67 banks accounting for 16 percent of assets (as of 1996) closed, and their asset composition declined from 52 to 35 percent in the same period. Some were subject to reconstruction and temporarily became government-owned banks, accounting for 27 percent of total assets (or 78 percent of private bank assets). As the government's shares in those banks were later sold off, in all cases to consortiums of foreign investors, foreign-owned private banks emerged as a new category, accounting for 21 percent of total bank assets in 2002. Combined with foreign bank branches and foreign-joint banks, the composition of foreign-affiliated banks reached 31 percent of bank assets as a whole, up substantially from 9 percent before the crisis.

Table III compares the ten largest commercial banks before and after the crisis. It clearly shows a shift of ownership from state and business groups to state and foreign capital. The share of the ten largest banks in total commercial bank assets, which was already a high 66 percent in 1996, rose further to 72 percent in 2002. In particular, Bank Mandiri, which emerged from a consolidation of four state banks, became a mega bank, accounting for 24 percent of total assets by itself. The top banks with a high concentration of assets, with the exception of Citibank, were all failed banks that have been supported by reconstruction measures.

II. MAJOR ACTORS AND THE BANKING INSTITUTION BEFORE THE CRISIS

A. *State Control and the First Financial Liberalization—Domination of the Banking Sector by State Banks*

Indonesia's banking sector[4] was founded as a state-owned undertaking during the Soekarno era. The Soeharto government inherited and relaunched it, revamping the legal framework.[5] President Soeharto enacted a major shift in basic economic policy from state capital supremacy to private and foreign capital utilization. In the banking sector, new entries were permitted for local private banks in 1966 and for foreign banks in 1968. However, permissions for the establishment of local private

[4] There is an accumulation of literature on the development of the Indonesian banking sector up to the 1997 economic crisis. For the period before the first financial liberalization, see Nasution (1983). For the process of financial liberalization after 1983, see Cole and Slade (1996), McLeod (1994), MacIntyre (1993), Nasution (1996), Hendrobudiyanto (1994), and Komatsu (1994, 1998).

[5] A setup of one central bank and seven state banks was established under the Banking Act of 1967 and the Central Bank Act of 1968. Bank Indonesia, the central bank, has its roots in De Javasche Bank, a commercial bank in the Dutch colonial era, while the seven state banks stemmed from six Dutch and British banks and four state banks created after independence. The overwhelming supremacy of the state banks was established as the state took over all the foreign assets that had formed the core of the colonial economy.

banks were halted in mid-1968 when the number reached 122, while the entry of foreign banks was allowed only for 11 banks[6] in 1968. For the ensuing full two decades, no additional entries were permitted for either local or foreign banks. Contrary to the basic open-door policy, state ownership was maintained intentionally in the banking sector. In fact, state banks consistently accounted for 70–80 percent of the total assets of commercial banks from 1968 to the first financial liberalization in 1983 (Nasution 1996, p. 9; Sato 1992, pp. 226–27).

The Soeharto government transformed the banking sector from a mere state-owned business into a state-controlled business that could play a key role in the developmental regime. To this end, the following institutions were created. The first was the principle of balanced budgets. In 1967, a ban was imposed on government borrowings from banks, and balanced state revenues and expenditures were mandated after 1968. This put a halt to the longstanding malpractice of using the banking sector to cover fiscal deficits, and established a mechanism for directing financial resources from the banking sector to the corporate sector (Cole and Slade 1996, p. 354).

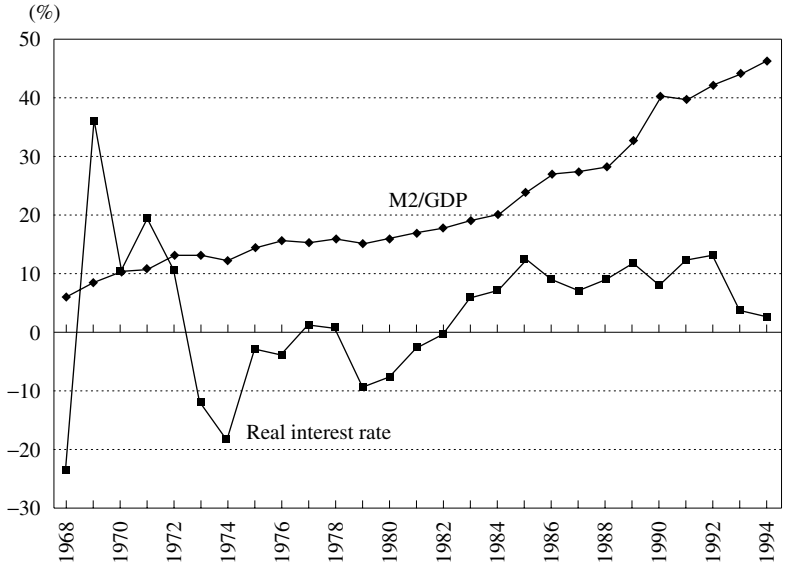
The second was the direct and indirect credit system of the central bank. Bank Indonesia, the central bank, provided financing to the corporate sector through direct credit and indirect credit.[7] Indirect credit, called central bank "liquidity credit," is the system under which the central bank provided state banks with funds for lending to priority sectors. The central bank's direct and indirect credit accounted for 72 percent of all bank lending (including lending by the central bank) in 1968. Despite the subsequent decline, the share still averaged 48 percent during the 21 years until the second financial liberalization (Sato 1992, p. 223; MacIntyre 1993, p. 148). Policy finance provided by the central bank and state banks thus became a channel, along with fiscal investment, for supplying development funds.

Third, the government introduced preferential lending rates and credit ceilings. In 1969, the government established an official interest system under which preferential interest rates were set by sector. Later, the priority sectors were expanded and interest rates were lowered. Real interest rates, which were positive in the period of declining interest rates following the end to hyperinflation, turned negative from 1973 when inflation began to increase (Figure 1). State banks were able to expand lending at an average real interest rate of −5 percent during the 1974–82 oil-boom period, thanks to the central bank's indirect credit underpinned by the government's ample oil revenues, but there was a need to place a ceiling on the lending amount.

[6] Branches of ten foreign banks and a joint-venture bank set up by the Daiwa Bank of Japan.

[7] Major destinations for Bank Indonesia's direct and indirect credits were BULOG (National Food Logistics Agency), the state oil corporation Pertamina, investment credit, agricultural financing called Bimas for rice production increases, and lending to the manufacturing sector (MacIntyre 1993, p. 150). With the exception of credits to Pertamina to finance debt repayments, the central bank credits were primarily intended for the stable supply of food and promotion of industrial development.

Fig. 1. Real Interest Rate and Financial Deepening, 1968–94



	Period (Average)			
	1968–73	1974–82	1983–87	1988–94
Real interest rate (%)	6.7	–5.0	8.2	8.5
M2/GDP (%)	10.3	15.3	23.4	39.0

Source: Compiled by the author based on Cole and Slade (1996, pp. 10, 18).
Note: Real interest rate is the average of one-year deposit interest rates at state banks, deflated by inflation rates.

This is why a ceiling was imposed on the lending of all commercial banks in 1974. With 1973 as the turning point, the state bank financing system thus changed in nature from priority sector lending based on mobilized deposits to subsidized lending associated with full control over interest rates, lending amount, and sectors to be targeted by funds from the central bank.

As the oil boom drew to an end in 1982, the banking sector found itself unable to maintain its role as a conduit for development funds. Indonesia had no choice but to follow the guidance of the World Bank and IMF and implement economic liberalization through a structural adjustment program. In June 1983, the government launched its first financial liberalization, fully liberalizing the deposit and lending rates of state banks and removing credit ceilings on all banks. Consequently, state banks raised both deposit and lending rates, leading to a sharp rise in the average real interest rate from –5.0 to 8.2 percent (Figure 1). In 1983–87, the balance of deposits at all commercial banks rose steeply, by an annual average of 25 percent,

and the balance of outstanding loans also increased by an annual average of 26 percent, with the ratio of M2 to GDP growing to an average of 23 percent from 15 percent in the preceding period. In line with the McKinnon-Shaw model, the removal of control over interest rates and lending was credited with helping eliminate "financial repression," facilitating financial deepening and expanding the banking sector's financial intermediation function.[8]

While the banking system was transformed from state control to market orientation, restrictions on new entries were maintained, leaving the absolute supremacy of state banks intact. Under the restricted competition, banks gained discretion over interest rates and lending, real interest rates turned positive, and inflation remained relatively low. Consequently, the rent, which had previously been distributed to the corporate sector under the preferential lending system, came to remain within the banking sector, giving rise to a situation close to "financial restraint" as described by Hellman, Murdock, and Stiglitz. If so, how did banks use that rent? The differentials between deposit and lending rates at state banks widened after the financial liberalization (Komatsu 1997), indicating that they were securing rent. However, state banks opened fewer new branches and had lower growth rates in lending compared to private banks. While private banks were quick to acquire new customers, state banks apparently failed to make effective use of the emerging rent in improving bank management, due to their antiquated management practices.[9]

B. *The Second Financial Liberalization and Prudential Regulations—Emergence of Business-Group-Affiliated Banks*

In October 1988, the Indonesian government announced a second financial liberalization, removing restrictions on new entries into the banking sector. Specifically, it: (1) liberalized the entry of private banks; (2) liberalized the entry of foreign banks through joint ventures; and (3) eased requirements for the opening of branches by all banks. As a result, many new private banks were established. In the five years up to 1993, the number of private banks rose 2.5 times, from 63 to 158, and the number of branches more than 5 times, from 559 to 2,926. Despite little change in real interest rates, the ratio of M2 to GDP rose sharply from 23 to 39 percent, as a sole result of the quantitative expansion of the banking market through the liberal-

[8] See Komatsu (1994) and Nasution (1994). According to Cole and Slade (1996, pp. 100–104), the IMF recommended a gradual liberalization based on the McKinnon-Shaw model, while the World Bank was cautious about financial liberalization for fear that higher real interest rates would cause a credit crunch. Eventually, the Indonesian government opted for a liberalization more radical than the IMF plan.

[9] The problems besetting state banks may include weakness in developing new customers, an increase in unprofitable projects due to higher lending rates, the emergence of nonperforming loans as a result of decreased indirect credit from the central bank (Komatsu 1998), a maturity mismatch between medium-term investment credits and deposits whose maturities became shorter, and the unchanged patterns of behavior common to state bureaucratic organizations.

ization of entry (Figure 1). New indirect credit by the central bank was halted in 1990, with the exception of agricultural credit, and the previously strong state control over the banking sector was almost completely eliminated.

The second financial liberalization brought about a change in the principal players in the banking sector. The share of the seven state banks in total commercial bank assets declined from 63 percent in 1988 to 38 percent in 1996, while the share of private banks more than doubled from 24 to 52 percent. Since a minimum amount of capital was the only requirement for setting up a bank, many business groups, which until then had been shut out of the lucrative banking industry, established their own banks. Thus, business-group-affiliated banks replaced state banks as the principal players in the banking sector.

This full liberalism policy line was modified with the introduction of prudential regulations in February 1991. The new regulations included: (1) a requirement that all banks meet a capital adequacy ratio (CAR) of 8 percent by the end of 1993;[10] (2) the introduction of new ratio-based standards of soundness and a point-rating system for all banks; and (3) the granting to the central bank of the authority to issue cease-and-desist orders to any bank defying its guidance. The prudential regulations were prepared by the central bank, which was under pressure to design a bank supervision system after the Ministry of Finance took the initiative in liberalizing entry, under a division of roles empowering the Minister of Finance to issue and revoke banking licenses and the central bank to supervise banks.

Beginning in 1991, Indonesia successively introduced institutions designed to ensure the soundness of banks. In 1992, the new Banking Act (Act No. 7 of 1992) was enacted to replace the Banking Act of 1967. It provided for the implementation of prudential regulations, administrative sanctions against noncompliant banks, criminal penalties for bank managers and employees, a "legal lending limit"[11] restricting intra-group lending, and a division of roles between the central bank and the Minister of Finance for supervising unsound banks. The central bank required all banks to issue quarterly financial statements, revamped the loan loss reserve fund system, introduced an early warning system, and established the first domestic credit rating organization, while the Ministry of Finance raised the minimum capital required for the establishment of new banks.

Despite these efforts to develop bank supervision systems, nonperforming loans actually increased and a series of banking scandals occurred. This points to the

[10] Based on the December 1987 Accord of the Basel Committee on Bank Supervision (Cooke Committee) of the Bank for International Settlements (BIS). The capital adequacy ratio (CAR) is the ratio of capital to risk-weighted total assets.

[11] The "legal lending limit: LLL" (Batas Maksimum Pemberian Kredit, BMPK) was the first prudential regulation incorporated into the second financial liberalization measures in 1988. The limit, applicable to a single borrower, group of borrowers, company owned by bank shareholders or bank managers, or business group, was intended to forestall concentrated lending and to restrict lending within business groups.

absence of an institutional environment allowing prudential regulations to be effective. The first conceivable cause is the excessive liberalization of entry, which made it difficult for banks to maintain their financial soundness. Banks were confronted not only with increased costs resulting from intensified competition, but also faced higher market risks, since blue-chip companies had exited after the financial liberalization, leaving only second-rate borrowers behind in the domestic banking market, following a shift in fundraising by reputable companies from the domestic to international money market (Nasution 1994; Komatsu 1997).[12] Borrowers with political and bureaucratic connections swarmed to the state banks, leading to a rise in huge loans to projects run by those well-connected business groups. Despite this, the state banks managed to meet the numerical CAR standards through such means as purchases of central bank money market securities called Sertifikat Bank Indonesia (SBI). The implementation of the restrictions on intra-group lending by group-affiliated banks was practically removed, as the grace period for compliance was extended. Thus the central bank's prudential regulations eventually became stultified.

The second factor was the limitations on bank supervision by the central bank. The foreign exchange loss incident at Bank Duta in 1990 highlighted the rampant dressing of financial statements by banks, and the consequent difficulty for the central bank to evaluate banks on the basis of accurate information. In 1992 Bank Summa was closed due to a financial failure stemming from intra-group real estate finance. The central bank was unable to prevent its failure despite several rounds of direct guidance, exposing the limitations of central bank supervision (Hendrobudiyanto 1994). While the central bank's power was expanded under the Banking Act of 1992, institutionally it remained under the control of the government, and had very limited supervisory authority.

The third potential cause was the lack of exit rules for banks. Even after the banking sector shifted from state control to a market orientation, state banks of course, but private banks as well, tacitly assumed that the government would protect them, and believed that bank closures were unconceivable. The Bank Summa incident sent shock waves through the banking community as the first instance of a bank closure under the Soeharto regime, but failed to mark a first step toward preparing exit rules, with implications that were inconsistent with market principles. While Bank Duta was rescued, Bank Summa was shut down, presumably because of the difference between the two banks in terms of their closeness to the Soeharto

[12] The shift in fundraising by banks and companies to overseas financial market was due to an increase in foreign exchange banks following the liberalization, the central bank's creation of the foreign exchange swap facility, and the removal of the ceiling on banks' overseas borrowings in 1989. But banks were subject to the net open position (NOP) regulation that restricted the net balance of foreign-currency-denominated assets and liabilities to within 25 percent of capital, while companies faced no restrictions regarding overseas borrowings (for state-owned enterprises and state banks, restrictions were introduced in 1991). Consequently Indonesian companies procured funds overseas more aggressively than did banks.

government. Bank Duta was owned by foundations (*yayasan*) affiliated with President Soeharto. Bank Summa, on the other hand, was owned by the eldest son of the founder of Astra Group, the largest Indonesian automaker. In clearing Bank Summa's debts, the founding family of Astra Group was forced to sell off all their shares in the group's holding company as collateral, allowing business groups close to Soeharto to become major shareholders in Astra Group, and effectively leading to the takeover of the top automaker by President Soeharto. The Bank Summa incident left a message for many banks that they would not be crushed as long as they did not fall into disfavor with the Soeharto government. It is likely that the lack of market exit rules and the tacit guarantees by the Soeharto regime were responsible for the banks' pursuit of near-term interests without taking risks into consideration.

III. THE POST-CRISIS REDEPLOYMENT OF ACTORS

A. *The Collapse of Business-Group-Affiliated Banks*

As the Asian currency crisis spread to Indonesia in July 1997, the government officially enlisted the support of the IMF on October 31 in an effort to preempt a further deepening of the crisis. On November 1, it closed 16 private banks as the first measure of bank reconstruction. The Letter of Intent (LoI) signed the previous day listed financial sector reform as one of the three major policy initiatives that Indonesia intended to implement with IMF support. This indicates that both the Indonesian government and the IMF viewed the increasing lack of soundness of the banking sector, despite the booming economy, as a major problem. In fact, in its preliminary consultations with the IMF, the government presented a plan for the resolution of a total of 50 banks (Enoch et al. 2001, p. 124).

The banking crisis in Indonesia, which at first was limited to specific unsound banks, subsequently developed into an overall systemic crisis. The foremost factor behind this development was the financial unrest generated by the political instability and the accelerating currency decline after December 1997. However, bank reconstruction measures, which began with the sudden closure of 16 banks, were in themselves the second factor that helped magnify the unrest. Major problems in the bank reconstruction process included the fact that the criteria for closing or reconstructing banks remained unclear until March 1999,[13] that the introduction of the

[13] It was finally decided that the capital adequacy ratio served as the criteria for bank closure and reconstruction. In principle, banks with a CAR of less than −25% were closed, those with a CAR of −25% to less than 4% and satisfying certain necessary conditions were recapitalized, though those that did not meet the conditions were closed, and those with a CAR of above 4% did not undergo reconstruction measures. The necessary conditions included that directors and commissioners of a bank pass the "fit and proper" test conducted by IBRA, and that bank shareholders raise 20% of the capital necessary to achieve a CAR of 4% (the remaining 80% was injected by the government via government bonds). While all seven state banks had a CAR of less than −25%, they were still

blanket guarantee for bank deposits was delayed until January 1998, and that the authority of IBRA was not legally clarified until 13 months after its establishment. Ultimately, there were five rounds of bank closures and nationalization between November 1997 and March 1999, the recapitalization of reconstructed banks was carried out toward the end of 2000, and government-held shares in nationalized and recapitalized banks were almost sold off by 2004. The bank reconstruction on a scale far larger than initially expected was all but completed in seven years.[14]

The five rounds of bank reconstruction measures resulted in the closure of 67 private banks (accounting for 16% of total commercial bank assets at the end of 1996), the nationalization of 12 private banks (20%), and the recapitalization of all 7 state banks (36%), 7 private banks (8%), and 12 (3%) of a total of 27 regional development banks. The number of nationalized and recapitalized banks reached 38, together accounting for as much as 67% of the banking sector's total assets.

Seen from the angle of bank ownership, no state or regional bank was shut down. The assets of state and regional banks expanded as a result of the recapitalization, with no change in ownership. By contrast, 41% of private banks, accounting for a total of 31% of total private bank assets, were closed. Another 4% of private banks, accounting for 46% of assets, were nationalized or recapitalized, and experienced ownership changes. Changes of ownership took place mainly at banks affiliated with business groups. Of 42 business-group-affiliated banks, which accounted for 38% of all commercial bank assets prior to the crisis, only 7, with a combined ratio of 2% of total bank assets, survived without ownership changes (Table IV). Of the survivors, only Bank Panin was a leading bank, with the rest being small banks operated by business groups as peripheral business. Among banks not affiliated with business groups, there were more survivors than closures. Thus, the collapse of business-group-affiliated banks was the most notable change that occurred in the bank reconstruction process.

A new leading actor in the private banking sector that replaced group-affiliated banks was a new category—foreign-owned private banks. Government-held shares in reconstructed group-affiliated banks were mostly sold off to consortiums of non-bank foreign investors. Unlike in Thailand, there were no cases of single-handed acquisitions by foreign banks. This paper calls the former group-affiliated banks "foreign-owned banks," to make a distinction with existing foreign bank branches and joint ventures with foreign banks, which are termed "foreign banks."

The main owners of foreign-owned banks are Asian capital, mostly from Singapore, Malaysia, and the Republic of Korea (Table V). Bank Central Asia of

reconstructed, instead of being shut down. Of private banks with a CAR of –25% to less than 4%, those that had more than 80,000 deposit accounts were recapitalized after being temporarily placed under state control (in other words, nationalized).

[14] For the course of the five rounds of bank reconstruction, see Enoch (2000), Enoch et al. (2001), Pangestu and Habir (2002), Takeda (2000), Komatsu (2003), and Ary Suta and Musa (2003).

TABLE IV

DECLINE OF BUSINESS-GROUP-AFFILIATED BANKS, 1996 AND 1999

1996			1999		
Affiliation with Business Groups	No. of Banks	Asset Composition (%)	Affiliation with Business Groups	No. of Banks	Asset Composition (%)
Business-group-affiliated[a]	42	37.6	Business-group-affiliated[a]		
Existing after the crisis	7	2.0	Existing	7[b]	2.2
Nationalized	4	16.7			
Recapitalized	3	6.8			
Closed	23	9.9			
Integrated with other banks	5	2.2			
			Formerly business-group-affiliated	7[c]	29.3
Independent	122	13.3	Independent		
Existing after the crisis	78	7.1	Existing	67	6.7
Closed	44	6.1			
Total of private banks	164	50.9	Total of private banks	81	38.1
Total of all commercial banks	239	100.0	Total of all commercial banks	152	100.0

Source: Calculated based on Ekofin Konsulindo (2000).

[a] Includes all banks owned by the top 50 business groups in the 1996 sales ranking, based on *Warta ekonomi* 9, no. 27 (1997).

[b] The number dropped to six after one bank was closed in October 2001.

[c] The number dropped to six after one bank was consolidated in September 2002.

the Salim Group was purchased by a consortium of investors composed of an American investment firm and Djarum Group. The former is believed to be actually owned by Asian capital, while the latter is an Indonesian Chinese business group with a core business interest in clove tobacco. Through this, foreign and domestic investors with no expertise in banking became the new owners of the formerly largest and best-quality bank in Indonesia. Bank Danamon, which was once the core operation of Indonesian Chinese Danamon Group, was sold off to a consortium of investors made up of Singapore's government-affiliated Temasek Group and Deutsche Bank of Germany, while Bank Niaga was sold to a consortium of Malaysian investors. These three banks were former group-affiliated banks that had been nationalized. Of the recapitalized former group-affiliated banks, Bank International Indonesia (BII), the core bank of the Sinar Mas Group—the third largest business group after Salim and Astra—was sold to a consortium of Temasek Group of Singapore and Kookmin Bank, a private Korean bank. The former owners of these banks were totally driven out in all cases except BCA, and the Salim family, which previously controlled BCA, completely relinquished its control rights.

TABLE V

CHANGES IN OWNERSHIP STRUCTURE OF FORMER BUSINESS-GROUP-AFFILIATED BANKS, 1997 AND 2003

Name of Bank [Former Owner Business Group]	Old Ownership Structure (End of 1997)		New Ownership Structure (End of 2003)			
			Foreign Shareholders		Domestic Shareholders	
	Shareholders	Shareholding Ratio (%)	Shareholders	Shareholding Ratio (%)	Shareholders	Shareholding Ratio (%)
1 Bank Central Asia (BCA) [Salim]	Soedono Salim	23.16	Farindo Investments (Mauritius) (Consortium of Farallon Capital Management of the United States and Djarum Group of Indonesia)	52.03	IBRA	8.50
	Second son of Salim	23.15			Second son of Salim	2.09
	Third son of Salim	23.15			Third son of Salim	1.84
	Eldest son of Soeharto	16.00			Soedono Salim	1.11
	Eldest daughter of Soeharto	14.00			Others	0.01
	Others	0.54			Publicly listed shares	34.42
2 Bank Danamon Indonesia [Danamon]	PT Danamon International	48.0	Asia Financial (Indonesia) Pte. Ltd. (Consortium of Temasek Group of Singapore and Deutsche Bank of Germany)	51.0	IBRA	48.1
	Publicly listed shares	52.0			Publicly listed shares	0.9
3 Bank Niaga [Tirtamas]	PT Tunasmas Paduarta	39.5	Commerce Asset-Holding Bhd (Consortium of Malaysian investors)	51.0	IBRA	45.1
	RHB Bena Sdn Bhd	20.0			Others	4.0
	PT Austindo Teguhjaya	10.5				
	AJB Bumiputra 1912	5.4				
	Others	24.6				
4 Bank International Indonesia (BII) [Sinar Mas]	PT Sinar Mas Multiartha	51.0	Sorak Financial Holdings Pte. Ltd. (Consortium of Temasek Group of Singapore and Kookmin Bank of Korea)	51.0	IBRA	42.5
	Publicly listed shares	49.0			Publicly listed shares	6.5

Sources: *Infobank*, no. 294 (October 2003); *Kompas* and various other press reports.

B. *Major Actors in the Post-restructuring Banking Sector*

The major actors in the post-restructuring banking sector can be classified as follows by ownership and reconstruction measures: (a) state banks; (b) former business-group-affiliated banks that became foreign-owned after nationalization; (c) former business-group-affiliated banks that were recapitalized (two of three such banks later became foreign-owned); (d) private banks that avoided reconstruction measures (mostly independent private banks with the exception of Bank Panin); (e) foreign banks; and (f) regional development banks.

Table VI compares the average size of assets per bank and key financial indicators after classifying all commercial banks with total assets above 10 trillion rupiahs into the above-mentioned (a) to (f) (for regional development banks, the top five are included, as even the largest has total assets of only 8 trillion rupiahs). The table shows that, in terms of asset size, state banks dwarf the others, and there is a clear hierarchical structure: the asset size of nationalized former group-affiliated banks is half that of state banks, that of recapitalized former group-affiliated banks half of that, that of independent and foreign-bank-affiliated banks half of that, and that of regional development banks less than half of that.

Looking at financial indicators, state banks and nationalized former group-affiliated banks have similar, medium-range levels of loan-deposit ratios, profit ratios, and efficiency indicators (net interest margins and expense ratios). However, state banks, despite the massive recapitalization, have the lowest CAR and relatively high nonperforming loan ratios, indicating that they have been slow in achieving financial improvement. Conversely, the latter have the highest CAR, but this points to heavy dependence on the government bonds used for recapitalization, and together with the low loan-deposit ratios, indicates an inadequate recovery of financial intermediation functions. The worst performers are recapitalized former business-group-affiliated banks. Despite some recovery in CAR, the nonperforming loan ratios here are high, profit ratios are negative, and expense ratios exceed 100 percent, indicating that these banks, as business entities, are still mired in a crisis situation.

By contrast, the private banks that did not adopt reconstruction measures are leading the functional recovery of the banking sector. They maintain adequate levels of CAR and nonperforming loan ratios, as well as the highest loan-deposit ratios. In particular, Bank Panin and Bank NISP have loan-deposit ratios close to 80 percent, showing that they are leading the recovery of bank lending. Foreign bank branches have the highest profit ratios and efficiency levels, but their nonperforming loan ratios are surprisingly high, ranging from 20 to 30 percent, except for the top-ranking Citibank. Regional development banks, though very small in terms of asset size, excel in efficiency and profit ratios and have the lowest nonperforming loan ratios. Three of these five banks under review were recapitalized, but managed to

TABLE VI

COMPARISON OF SIZE AND FINANCIAL INDICATORS BY BANK OWNERSHIP AND RECONSTRUCTION MEASURES, END OF 2002

Classification by Ownership/Reconstruction Measures	No. of Banks	Average Asset Size per Bank (trillion rupiahs)	Major Financial Indicators (%)					
			Capital Adequacy Ratio (CAR)	Nonperforming Loan Ratio (NPL)	Loan-Deposit Ratio (LDR)	Return on Asset (ROA)	Net Interest Margin (NIM)	Expense Ratio
State banks	4	122	15.8 (5.39)	6.0 (1.28)	45.4 (10.24)	1.8 (0.49)	4.3 (2.61)	88.7 (3.57)
Former business-group-affiliated banks (foreign-owned after nationalization)	3	62	23.4 (9.88)	4.7 (1.36)	44.0 (20.77)	1.9 (1.32)	4.0 (1.84)	88.2 (11.39)
Former business-group-affiliated banks (recapitalized)	3	30	21.6 (11.41)	16.2 (9.67)	27.5 (11.36)	−1.8 (2.67)	2.6 (2.80)	109.2 (25.27)
Independent banks / banks without reconstruction measures	4	13	20.2 (9.56)	4.5 (7.20)	60.8 (21.17)	1.8 (0.95)	4.6 (0.84)	88.2 (5.56)
Foreign banks	4	15	19.6 (4.07)	23.3 (11.35)	52.0 (10.90)	5.3 (2.20)	3.6 (2.61)	66.7 (22.30)
Regional development banks	5	6	17.8 (5.00)	2.8 (3.82)	42.7 (18.62)	3.6 (1.36)	8.6 (1.79)	76.1 (9.65)

Sources: Calculated based on *Infobank*, no. 289 (June 2003); LippoBank, *Annual Report*, *2003* (Jakarta).

Notes: 1. The figure for each financial indicator is the simple mean, with the standard deviation in parentheses. The highest for each indicator is shown in □ and the lowest in ▒.

2. Capital adequacy ratio (CAR) = capital / risk-weighted assets.
Nonperforming loan ratio (NPL, gross) = nonperforming loans (in arrears for 90 days or longer) / total outstanding loans.
Loan-deposit ratio (LDR) = total outstanding loans / total deposits.
Return on assets (ROA) = net profit / total assets.
Net interest margin (NIM) = net interest income / earning assets.
Expense ratio = operating cost / net interest income.

3. The table includes all banks with total assets of 10 trillion rupiahs or more. Regional development banks are the top five banks in terms of assets (West Java, East Java, Jakarta, Central Java, and East Kalimantan).

improve their financial indicators far more than larger-scale banks. While due caution is necessary regarding the recent emphasis on consumer finance, it is deemed that they are likely to play a key role in financial intermediation as locally oriented banks in their respective regional economies.

As seen above, in terms of size, the state banks and nationalized former business-group-affiliated banks can be described as the principal actors in the post-restructuring Indonesian banking sector, and in terms of financial intermediation function, it is the independent private banks that have not implemented reconstruction measures that can be seen as the main actors.

IV. FINANCIAL INSTITUTION REFORM AFTER THE CRISIS

Indonesia's first Letter of Intent to the IMF cited the improvement of "the institutional, legal, and regulatory framework for banking operations to ensure the emergence of a sound and efficient financial system" as one of the reforms of the financial sector. The IMF and central bank found that the prudential regulations introduced before the crisis not only contained loopholes, but that there were also problems with the very legal framework that made these regulations effective. Thus, together with bank reconstruction, financial institution reform was pushed forward in line with the IMF recommendations. This section addresses two key reform issues: bank supervision system and deposit insurance system.

A. *The Shake-Up of the Bank Supervision System*

One of the fundamental reasons behind the lack of effectiveness of the pre-crisis prudential regulations was the limited authority of the central bank in bank supervision. In a narrow sense, this involved the division of powers between the Minister of Finance and the central bank. In a broader context, it involved the central bank's independence from the government and the president.[15]

Under pressure from the IMF's requests and the deconcentration of power after the fall of President Soeharto, moves were carried out to create a legal framework for ensuring the independence of the central bank. First, in the 1998 amendment of the Banking Act, the separation of authority under which the Minister of Finance was empowered to issue banking licenses, while the central bank was limited to bank supervision, was scrapped, and the central bank was given all powers from the issuance and revocation of banking licenses to the imposition of administrative sanctions. In May 1999, the new Central Bank Act (Act No. 23 of 1999) was enacted, replacing the Central Bank Act of 1968. The new act explicitly states that the central bank is "an independent national institution, which is free from intervention

[15] President Soeharto's sudden dismissal of the central bank governor in February 1998, due to his opposition to the planned pegging of the Indonesian currency to the U.S. dollar, left a strong impression that the president would intervene politically in the central bank.

of the Government." It also describes the functions of the central bank as, primarily, currency and monetary policy and, secondarily, bank control and supervision, and prohibits intervention in these areas by any other organization. With regard to the appointment of the governor and other board members, the president proposes candidates to the House of Representatives and makes appointments with parliamentary consent, in an arrangement for common decision making by the executive and legislative bodies. However, neither was given the right of dismissal. These two new laws freed the central bank from the power hierarchy with the president at the apex, allowing it to acquire a status matching that of the president and the House of Representatives (Figures 2.A and 2.B).

This structure evolved further with the 2004 amendment of the Central Bank Act of 1999 (Act No. 3 of 2004) (Figure 2.C). The amendment established a relationship of checks and balances among the president, House of Representatives and central bank out of reflection that the preoccupation with the independence of the central bank led to the disregard of supervision over the central bank. The amendment introduced three major changes. First, the Supervisory Board (Badan Supervisi), comprising experts chosen by the House of Representatives and appointed by the president, supervises the central bank. Second, the central bank is required to make regular reports to the House of Representatives and the president for evaluation by the House of Representatives. Third, the president is empowered to dismiss governors of the central bank when they commit prohibited acts but refuse to resign on their own.

The system of bank supervision by the central bank was also improved in three areas: contents of supervision programs, development of the central bank's supervisory capability, and implementation of supervision. In 1999, with the assistance of the World Bank, the central bank formulated "a master strategy for strengthening Bank Indonesia's regulatory, supervisory, and examination activities." In line with this strategy, its bank supervision was improved drastically, with the frequency of audits increased from once in three years to annually, under a new risk-based supervisory program. In addition, its supervisory function was revamped on the basis of the results of an assessment of nine units related to bank supervision.[16] An important point in implementing supervision was the institutionalization of sanctions against noncompliant banks and exits from the market of financially failed banks. The 1998 amendment of the Banking Act toughened criminal penalties against bankers, made shareholders subject to criminal penalties, and clarified the contents of sanctions. As for failed banks, the experience of the crisis itself was the first step toward the development of exit rules. Banks that failed to satisfy the qualifications were closed or nationalized, even if they were candidates for reconstruction. Even

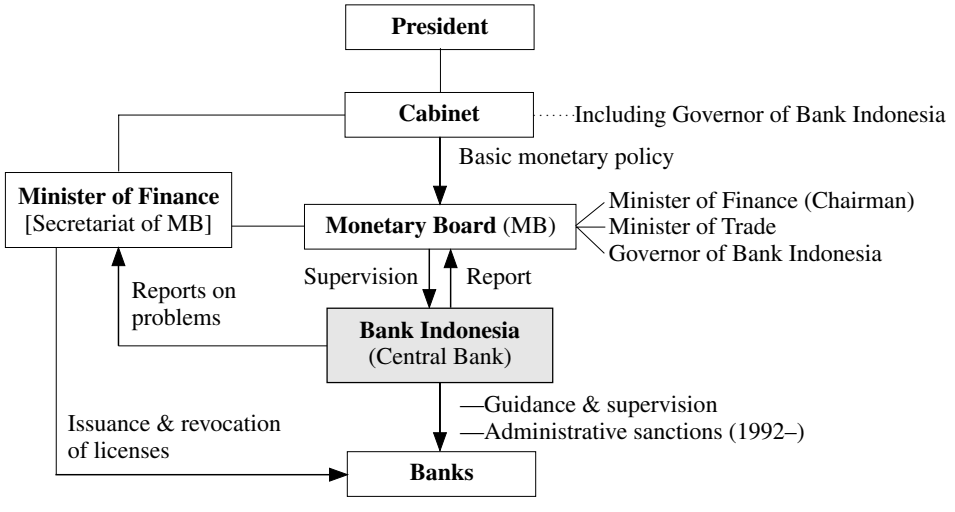
[16] See the Letter of Intent of the Indonesian government to the IMF dated March 16, 1999 and July 22, 1999 (http://www.imf.org/external/np/loi/mempub.asp).

after March 1999, banks that could not achieve the targets of financial improvement indicators set by the central bank were shut down one by one. Moreover, the presence of the IMF ensured the resolute closure of unqualified banks. Indonesia's banking sector experienced an unprecedented disciplining through these developments.

It must be noted that the IMF placed particular importance on the independence of the central bank only for the sake of maintaining an independent currency and monetary policy. It envisioned separating the bank supervision function from the central bank and establishing an integrated supervisory framework for overall financial services. Korea, acting promptly on the IMF's recommendations, established a Financial Supervisory Committee (FSC) as early as in February 1998. For

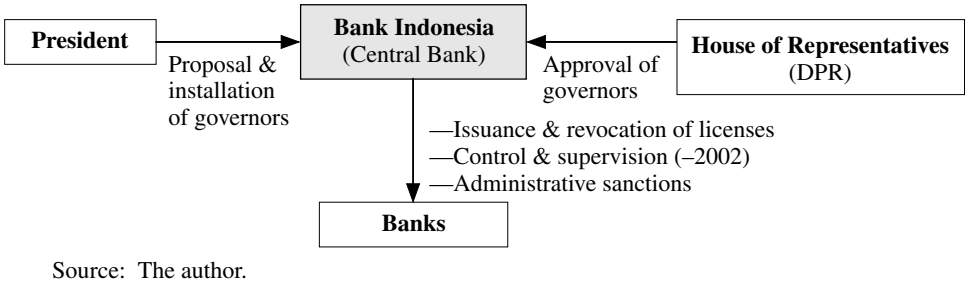
Fig. 2. Position and Functions of the Central Bank

A. Under the Soeharto Regime (1968–98)



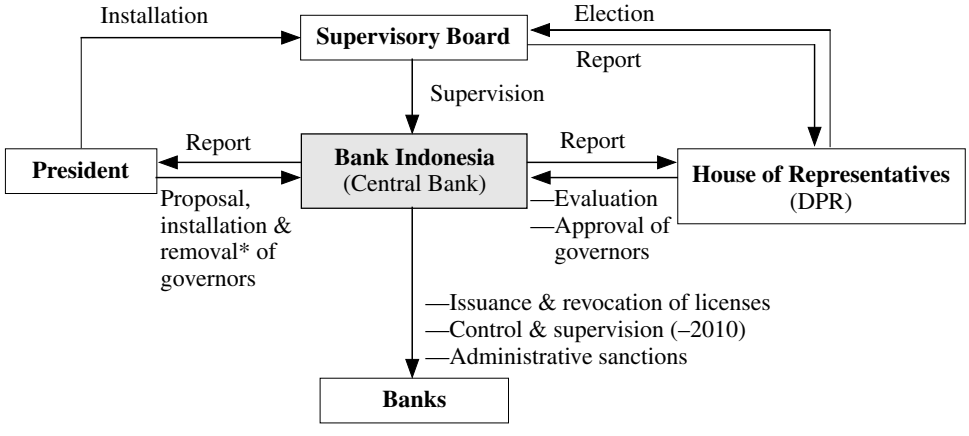
Source: Nasution (1983, p. 64) and the author.

B. Post-Soeharto Reform (1999–2003)



Source: The author.

C. After Amendment of the 1999 Central Bank Act (2004–)



Source: The author.
* Only in cases when governors commit prohibited acts and do not resign, the president can remove them.

Indonesia, the IMF proposed the establishment of the Financial Service Authority (Otorita Jasa Keuangan, OJK), with the task of supervising and regulating four sectors: banks, security markets, insurance firms, and pension funds.[17] However, the establishment of the authority was not realized by 2002 as initially stipulated, and was eventually postponed until 2010.

Behind this delay was strong opposition from the central bank. As discussed earlier, the function of the central bank was divorced from the supervision of bank soundness, as its function during the Soekarno era had been to cover fiscal deficits, and in the early half of the Soeharto administration had been to provide national development funds. While bank supervision became necessary during the latter half of the Soeharto period, the central bank's authority was severely limited. It feared that it would be deprived of supervisory powers just as it finally achieved its independence from the Ministry of Finance and politics in the post-crisis reform. In fact, it is true that the central bank has unparalleled capabilities among government agencies in terms of information, experiences, and human resources regarding the banking industry. There are two camps among financial market experts: one argues that the central bank is the optimal supervisory agency given an accumulation of necessary resources, and the other underscores the need for an integrated financial supervisory system in order to strengthen the international competitiveness of Indonesia's financial service industry and to facilitate the development of major

[17] At present, banks are supervised and regulated by the central bank, security markets by the Capital Market Supervisory Agency (Bapepam) under the Ministry of Finance, and insurance firms and pension funds by the Ministry of Finance's directorate general for financial institutions.

Indonesian banks into universal banks. The idea brought in by the IMF on integrated supervision merits careful consideration in light of Indonesia's conditions.

B. *Introduction of the Deposit Insurance System*

The deposit insurance system is generally a matter of argument, particularly with regard to the scope of insurance coverage and the timing of the system's introduction. The early introduction of a generous insurance system can create moral hazards at banks and increase costs for the government, while the lack of a system can spawn financial unrest. In pre-crisis Indonesia, the only example for reference was the closure of Bank Summa. Based on this experience, the central bank made the judgment that the shutdown of 16 banks in November 1997 would cause little trouble if the same level of protection were provided to small depositors. The measure it announced involved insurance coverage for deposits of 20 million rupiahs or less, which covered 93 percent of all depositors. However, unprotected large depositors, who accounted for 80 percent of the total amount of deposits, put up strong resistance to this measure. Large depositors at other banks also became alarmed, leading to runs on banks. Then, at the end of January 1998, the central bank finally introduced a blanket guarantee system for all deposits, and liquidity support loans provided by the central bank to affected banks during the intervening three months reached as much as 46 trillion rupiahs (equivalent to 4.5 percent of GDP) (Enoch 2000, p. 5).[18]

The Letter of Intent to the IMF described the blanket guarantee as a temporary measure, which would expire by 2004. The government decided to establish a deposit insurance agency in 2004, with the phased introduction of a payoff system. The plan called for the gradual lowering of the ceiling on guaranteed deposits from the full amount at present to 5 billion rupiahs, to 1 billion rupiahs, and then to 100 million rupiahs (about U.S.$12,000) by 2007. The planned introduction of the payoff system has been highly appraised among financial market experts, as it is expected to encourage depositors to choose good banks, and to make positive contributions to competition and soundness of the banking sector. During the Soeharto era, when there was no deposit insurance system, the regime tacitly guaranteed the survival of banks, making depositors oblivious to the need for individual risk management. With the introduction of the deposit insurance system, the guarantee function inherent in the Soeharto regime will be shaped into a formal institution, with depositors given the task of shouldering part of the risk. However, the government should be careful in setting an appropriate level of guaranteed amount and should make efforts to have the public fully understand the new system, in order to avoid a

[18] This became a big issue later when it was found that a portion of the central bank's liquidity support loans had been diverted to purposes other than to boost liquidity, such as debt repayments and capital flight overseas.

repetition of the 1997 mistake that led to bank runs by large depositors contrary to the government's expectations.

V. FEATURES OF THE MANAGEMENT REFORM OF BANKS

The principal actors in the banking sector are implementing management reforms in response to the new institutional environment. This section looks at two particular features of reform commonly found in multiple banks.[19] The first is the establishment of in-house risk management systems, while the second is the expanding foreign presence in Indonesia's bank reform. Both show that a fundamental change is taking place from the pre-crisis standard of bank management.

A. *Establishment of an In-House Risk Management System*

Although many banks had organizations and procedures for credit management even before the crisis, they were generally little conscious of risk management. Changes seen after the crisis include a growing consciousness of risk management, the launching of corporate efforts toward the establishment of risk management systems, and associated organizational reform. Several examples follow.

Before the crisis, at the state-owned PT (Persero) Bank Negara Indonesia Tbk (hereinafter, referred to as BNI), credits were screened by the Credit Control Division (Divisi Pengendalian Kredit). However, as one director admitted, there was no clear sense of risk in the screening operation. After the crisis, as the bank was required by the government and the IMF to carry out management reform as a condition for receiving a massive injection of public capital, it implemented an omni-directional reform covering areas from treasury, organization, and personnel management to business strategies, and embarked on a path of shedding its old practices as a state-owned enterprise. It set up the post of risk control director, and created a Risk Control Division (Divisi Pengendalian Risiko) and Financial Control Division (Divisi Pengendalian Keuangan) under this director, to clarify responsibilities and organizations for risk management. In addition, it created a Credit Risk Analysis Unit (Unit Analisis Risiko Kredit) for both corporate and individual customers under the existing post of director in charge of credit, and increased personnel involved in credit screening. The new president of the bank, who called

[19] The analysis in this section is based on the author's interviews with directors of the surveyed banks, as well as annual reports and other materials provided by the banks. The ten surveyed banks are two state banks (Bank Negara Indonesia, BNI, and Bank Rakyat Indonesia, BRI); two former business-group-affiliated banks that became foreign-owned after nationalization (Bank Central Asia, BCA, and Bank Danamon); two private banks that did not undergo reconstruction measures (Bank Panin and Bank NISP); two recapitalized former business-group-affiliated banks (LippoBank and PermataBank); a foreign bank branch (Citibank); and the central bank, Bank Indonesia. All were surveyed in September 2003. For details about reforms at each of these banks, see Sato (2004). Also see Tim INDEF (2003) for BNI.

the shots during a series of reform measures, had all bank employees sign a Code of Conduct in an effort to facilitate the switchover from a bureaucratic to corporate organization and to boost awareness regarding risk management.[20]

PT Bank NISP Tbk, an independent bank that remained outside of the bank reconstruction measures, expanded the size of its assets 14-fold over the period of seven years spanning the crisis. In the process of this rapid expansion, it proactively pushed the modernization and systematization of management. In 1999 following the crisis, it developed its own credit screening system. Using customer information centralized in the head office, the system automatically evaluates credit applications with nine-stage scores. Then the Credit Committee considers the evaluation results and decides on credit advisability and amounts. The key feature of the bank's reform is the minimization of discretion by individual bank officials through automatic, systematic, and centralized lending decisions.

As shown by the case of Bank NISP, risk management systems share the common feature of centralized information control. LippoBank, a recapitalized group-affiliated bank, established a Central Credit Committee at its head office following the crisis. The committee meets every Monday for an intensive review of all credits above a certain amount extended by Thursday of the previous week. BNI's new growth strategy also focuses on the centralization of customer information. It was promoting the decentralization of information management before the crisis, but switched to a strategy of centralizing customer information after it failed to provide efficient services to a large number of customers, who returned to state banks amid the crisis.

PT Bank Central Asia Tbk (hereinafter, referred to as BCA), a foreign-owned, former business-group-affiliated bank, already had a system for central control of information in place, and took the next step toward the internal development of credit screening capacity and the transfer of that capacity to local branches. BCA, which was once affiliated with Indonesia's largest Salim Group, had always led the banking industry in terms of its branch network, number of automatic teller machines (ATMs), introduction of information technology (IT), and quality of financial services provided, and had the highest-quality human resources and highest degree of management systematization. Although it now has new owners and management, the scope of its business operations has not changed much, as it inherited tangible and intangible assets and good corporate customers from the old BCA.

[20] In late 2003, a risk control director resigned to take responsibility for an LC (letter of credit) forgery incident at one of BNI's branches involving a borrowing company and branch staff. The incident indicates that even though reform efforts have begun at state banks, outsiders' views of state banks have not changed. Some financial sector experts point out that not only depositors but also borrowing companies continue to seek the "security" of doing business with state banks, and that companies tend to think delays in loan repayments and other maneuvers are negotiable with state banks.

However, there have been some notable changes in the following areas. At the former BCA, lending decisions were made in a top-down manner, with Anthony Salim, chief executive officer of Salim Group, being the ultimate risk bearer. Today the bank is managed under a collective leadership of professional bankers, necessitating internal risk control capabilities which were not fully developed under Salim's leadership. The new BCA, while retaining centralized control of credit information, has tried to develop credit screening capacity, and decided to decentralize lending decisions. With Deutsche Bank providing training as a consultant, it trained a dozen credit officers who became capable of screening credit applications of between 10 billion to 20 billion rupiahs from small businesses, conducting market assessments, and making lending decisions. The bank later sent these credit officers to local branches in an effort to develop credit screening capabilities at the branch level.

In the new post-reform situation, many banks have started to make efforts, at their own expense, toward information control for risk management and for the development of credit screening systems and capabilities.[21]

B. *The Foreign Presence in Bank Reform*

Given the closed nature of Indonesia's banking sector historically, the significantly expanded foreign presence as a guide of bank reform is worthy of special mention. Although foreign banks have not become the sole owners of any Indonesian bank,[22] foreign investors and bankers have begun to involve themselves directly in leading banks as major shareholders, managers, and consultants.

The most remarkable example may be PT Bank Danamon Tbk, which was placed under foreign-led management. Temasek Group of Singapore, Bank Danamon's largest shareholder, seized control rights, sent more than half of the directors and commissioners, and appointed to the presidency a British banker of Indian descent who once worked at the London branch of Citibank but had no direct ties with Temasek. The new president adopted a new business strategy that shifted emphasis from assets (credits) to liabilities (deposits) and sought to expand services for de-

[21] However, this phenomenon has not necessarily been seen at all banks. State-owned Bank Rakyat Indonesia (BRI), which adopted a new strategy of focusing on micro credit operations, is confident of the effectiveness of the conventional risk management method, under which specialized Micro Units make on-the-spot inspections and monitoring, and the customers' businesses themselves and the relationship of trust are considered sufficient collateral. Bank Panin, the largest among banks not undergoing reconstruction measures and a typical model of a family-run bank led by a founder, has the strength of family-led conservative yet prompt lending decisions. The bank's approach has not changed much even after the crisis.

[22] In November 2004, a consortium of the British-based Standard Charterd Bank and domestic Astra Group made a successful bid to purchase 51 percent of PermataBank, one of the recapitalized former group-affiliated banks. This is the first case a multinational bank appeared as the principal buyer of Indonesian banks. Yet, it is not a single major owner but shares the ownership half-and-half with Astra Group.

positor customers. At the same time, in a departure from the ordinary way of separating internal organizations into credits and deposits, he introduced an organizational structure that would handle both the credits and deposits of individual and of corporate customers in an integrated manner. The foreign banker, through his boldness, brought a new perspective to the Indonesian banking business. Bank Danamon, which was once part of a family-controlled business group, shifted to a totally different corporate governance structure under which the foreign manager sought to achieve business efficiency as a single banking entity, under the watchful eyes of major foreign shareholders.

The above-mentioned Bank NISP was able to convert itself from a family-run bank into one with open and modern management in its growth process during the time of the crisis. This process was also associated with an expanded foreign presence. After the crisis, IFC and OCBC Bank of Singapore took equity stakes in it. Following two issuances of new shares, the ratio of publicly listed shares to total outstanding shares rose to 39 percent, with 95 percent being owned by foreign investors. The equity share of the founding family, which had been 100 percent until 1994, declined to as low as 23 percent, and the ownership structure was fully opened to foreign capital. In the area of management, three of the seven members of the board became independent commissioners, more than the number required under regulation. For this, two Americans, one from IFC and one who used to work at ABN-Amro, and an Indonesian who had a career at an American bank, were enlisted. The bank also developed its own credit screening system, making use of the advice provided by IFC and a Swiss financial institution.

LippoBank invited a team of 12 advisers from ANG Bering Bank of Holland under a three-year contract, and all of the bank's directors were paired with Dutch advisers to conduct day-to-day business. This thorough pairing method is said to have served well not only in introducing new business know-how but also in reforming the directors' consciousness about banking as well as corporate culture. The pairing idea came from Mochtar Riady, the banker founder of Lippo Group, who serves as a president commissioner of LippoBank.

At BCA, unlike Bank Danamon, the new management lineup is dominated by Indonesian nationals, even after becoming foreign-owned. Importantly, however, three out of eight directors and the president commissioner had careers at foreign banks, including Citibank and ABN-Amro. Furthermore, as the new owners were not specialized bankers, Deutsche Bank was appointed to be a consultant as one of the conditions for their purchase of government-held BCA shares. As discussed earlier, Deutsche Bank is playing a key role in the internal development of the credit screening capacity at the new BCA.

Compared with private banks, state banks in general have limited contacts with foreign interests. In the case of the management reform of BNI, the bank enlisted a foreign bank's assistance for the disposal of nonperforming loans and the design of

the risk management system, and sought a foreign consultancy's advice in reforming the personnel system. Nevertheless, the extent of the foreign presence was only partial and temporary. The IMF's ultimate goal for state bank reform was the public sale of a majority of equity shares within three years. However, the largest-scale sale was that of 15 percent of the outstanding shares of Bank Mandiri in 2003; the sale of a majority of shares in BNI was postponed. The fact that the wheel of state bank reform has begun to roll is a significant development. Yet, it has to be said that a long road lies ahead before the intended reform is achieved.

CONCLUSION: EVALUATING FINANCIAL INSTITUTION REFORM IN INDONESIA

Following the economic crisis, foreign banks made broad inroads into Asian markets. In Thailand, major foreign banks purchased private banks one after another, leaving only the four largest financial conglomerates untouched. In the case of Indonesia, however, foreign banks were not the principal buyers of former business-group-affiliated banks. The new owners of these banks are mostly Asian capital, with foreign banks involved as minority shareholders or consultants, and the management being entrusted in many cases to groups of multinational professional bankers. Though in such a peculiar form, the full-scale entry of foreign investors and bankers into the historically exclusive banking sector of Indonesia and their roles as guides of bank reform are an important change that emerged after the crisis. The best example is Bank Danamon, where a British banker took the helm of management. Also, the significant impact of the foreign presence can be seen at the formerly family-run Bank NISP, which was able to achieve a rapid shift to modern systematized management by making deft use of the input from IFC, a Swiss financial institution, as well as Indonesian bankers with professional careers at foreign banks. In this respect, state banks, in comparison with private banks, are still strongly inward-looking in terms of ownership and management. Though BNI and Bank Mandiri made fresh starts as huge commercial banks, it will be a major challenge for them to attain international competitiveness.

One of the characteristics commonly found among the major new actors in the banking sector is an emerging consciousness of risk in the banking business, backed with the establishment of risk management systems and associated organizational reforms. The major challenge confronting Indonesian banks is how to build up information control capabilities at the head office and credit screening capabilities at the branch level. Changes can be seen in this respect in that most banks are making efforts toward these goals at their own expense. The form of organization where internal risk management capabilities are not required because the government (the Soeharto regime) or business group owners stand ready as ultimate risk bearers, is fast becoming a thing of the past.

These changes in internal bank organizations are closely linked to institutional changes in the banking sector as a whole. In the pre-crisis financial institution, the central bank was positioned at a low rank in the power hierarchy dominated by the president, the executive body and the Minister of Finance in that order, and was unable to have single-handed authority for bank supervision. The survival of banks was guaranteed by the president at the apex of the hierarchy, depositor assets were protected, and indebted companies could avoid bankruptcy by refinancing loans in arrears, as long as they cooperated with Soeharto's developmental regime. This was how the banking system worked under that regime. The central bank, positioned in the middle of the hierarchical structure, functioned well as a conduit for development funds. However, after the shift to a market orientation, the central bank was given the difficult task of supervising a large number of new entries without the effective penalty of forced closure. Considering that the responsibilities of the central bank were not specified at that time, it was only natural that it failed to develop internal supervisory capabilities. Manuals for bank supervision became dead letters.

It can be concluded that the banking system in Indonesia has undergone fundamental change as a result of the collapse of the Soeharto regime, the 1998 amendment of the Banking Act and the 1999 enactment of the new Central Bank Act. The central bank was legally guaranteed of its position as the top authority over the banking sector and obtained powers to regulate the entry and exit of banks into the market. With such a legal framework in place, it became able for the first time to make good use of its internal accumulation of information and human resources. The introduction of the deposit insurance system offered guarantee, initially full but partial from 2005 onward, to depositor assets. Furthermore, in the area of corporate debts in arrears to banks, a bankruptcy and arbitration system was introduced to set out market exit rules for failed companies (However, the bankruptcy system is not adequately functioning, as pointed out by Juwana's paper in this special issue). The full internalized guarantees given to banks, depositors and companies under the Soeharto regime have now been externalized with an explicit legal framework, under which banks, depositors and companies are called upon to take on their respective shares of risks. Amid these changes, the banking sector, which has been at the core of institutional reforms, seems well ahead of other sectors in terms of changes. There is no need for premature conclusions on whether all these institutional mechanisms will function as a single stable system. However, at least in the banking sector, the central bank as well as individual banks have initiated efforts to develop risk management capabilities. This should be properly valued, and the fruits of these efforts should be carefully monitored.

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