Financial Sector Recovery in Indonesia:

A Review and Discussion of the Bank Recapitalization Program

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Recent Developments in the Indonesian Banking Crisis

Background

It is well documented that the Indonesian banks are in a state of total collapse that has both led and compounded the depth and severity of the country's overall economic crisis. The banking sector and indeed the entire financial sector will require of a complete overhaul if there is to be any hope of a sustainable economic recovery. However, any restructuring of the country's financial sector must include genuine reform of its entire spectrum—including the capital markets—not just a paper recapitalization of the banking industry. It will also require a shift in thinking among some of the international macroeconomists who are leading this reform program, regarding their dependency on the type of statistical 'fundamentals' they use to measure the 'soundness' of a financial sector.

Capital adequacy ratios and politically manipulated economic data are not good measurements for understanding the real weaknesses inherent in the Indonesian economy or its banking system. Reform leaders must develop a better understanding the real weaknesses inherent in the cultural and political base upon which the economy and its financial system has been built before thay can implement effective reforms measures. Consequently, any meaningful and sustainable restructuring will require the complete overhaul of all aspects of the financial sector; including changes in the corporate culture and past management practices, which drive the sector.

'Quick and easy' fixes to the balance sheets of banks and companies operating in the financial sector will prove to be overly expensive in the long run and are doomed to ultimate failure. The very way of doing business will have to be inexorably changed and future financial transactions divorced from the pervasive corruption and political intrigue, which document the past. For Indonesia, financial sector reform will require a fundamental and very difficult shift from the ingrained system of crony capitalism, the unsafe linkages between bank management and ownership--often one in the same, insider lending relationships between the commercial banks and their affiliated conglomerates and the ease in which prudential regulations are circumvented.

Sustainable financial sector reform must also include the internal restructuring of the various government agencies involved in the supervision and regulation of the sector and its participants. The most visible of these regulatory agencies is of course bank supervision, and the consequences of its failure to properly supervise the commercial banks or enforce established regulations is well documented. However, there are a number of other areas within the financial sector that require government supervision and regulation; not the least of which are the insurance and pension fund industries as well as the capital markets.

The final—and by far the most important—aspect of financial sector reform is the creation and implementation of a transparent, incorruptible and equitable legal system. That a sound and enforceable legal system with rational corporate laws must be created and implemented is irrefutable. The financial sector must be required to operate within such a legal system in a transparent manner and under the real threat of financial loss and even criminal charges. Recent rulings by the local bankruptcy court have only reinforced the belief by defaulting debtors and foreign investors alike, that the system does not work and there are no negative consequences for malfeasance.

The Indonesian Banking System

Over the past ten to twelve years the Indonesian banking system has expanded rapidly under a series of liberal financial reform packages designed to stimulate rapid asset growth as well as develop a nationwide payment system. The number of licensed private commercial banks rose from 62 in 1988[1] to over 130 by late 1997. At least 117 new banks have been opened in the 10 years since the deregulation package of October 1988 (Pakto 88). With a few notable exceptions, the majority of these new banks were established by major corporate groups, which used them as their primary source of self-financing. The result was the creation of an undercapitalized, inefficient, and fundamentally

[1] Of the 62 private commercial banks registered in 1988, only 15 had foreign exchange licenses. There were 74 private (non-foreign owned) FX banks in operation as of June 1998.

corrupt commercial banking sector. Contributing to the eventual collapse of this system was the notoriously lax regulatory environment in which improper bank licenses were granted, minimal levels of bank supervision conducted and virtually non-existent consequences imposed for violations of prudential regulations.

The fragile foundations of the banking system began to crumble with the contagion of the Asian financial crisis as non-performing loans began to mount and a massive currency depreciation caused major losses for both the banks and their corporate customers. By the end of 1998, Bank Indonesia reported that collectively, the Indonesian banking system had a negative net worth in excess of $11 billion. The level of non-performing loans has skyrocketed and is currently calculated to exceed 85% of total credit extended. New bank lending has virtually ceased since early 1998 and banks are losing money daily. Efforts to decrease the impact negative interest spreads through the forced reductions in interest rates for Bank Indonesia deposit certificates as well as public deposit rates in commercial banks, have been a case of 'too little too late'. While deposit interest rates-and theoretically lending rates-have been forced down, the impact of excessive levels of non-performing loans and high administrative costs are still represent a debilitating drag on bank earnings. International audits conducted in 1998 concluded that over 90% of all Indonesian banks were bankrupt and none of them met international—or even previously established Indonesian standards for capital adequacy.

The fallacies of insider lending, driven by the concentrated ownership structure of the commercial banks; tolerated by the almost total lack of enforcement of established prudential regulations; abetted by inadequate and compromised accounting systems, and then all wrapped in a non-existent or corrupt legal system where abuses go unpunished: have all contributed to the high level of losses suffered in the collapse of the Indonesian financial sector. There can no longer be any doubt that these losses have already occurred—they must now be recognized as such by all parties.

Bank Restructuring Program

In late 1997, the Government of Indonesia began a program to restructure and recapitalize the banking sector. This plan has evolved and been modified over the past two years but essentially its primary goal continues to be the saving of the state banking system and the effective nationalization of those private sector banks deemed salvageable. Over the past 18 months a number of hopelessly defunct banks have been closed and are in the process of being liquidated, while selected banks, which are expected by the program designers to return to profitability, have received assistance in the form of government issued recapitalization bonds.

Only when there is fundamental meltdown of what is usually a chronically weak and corrupt financial system should a country's banking sector need to be restructured in its entirety. In the case of Indonesia, the failure of the private sector commercial banking system can be directly linked to its particular ownership structures and their incestuous lending relationship with affiliated conglomerates. The state-owned banks have an even longer history of losses through mismanagement, inadequate credit analysis and corrupt lending practices. The inordinately high level of non-performing loans in the entire sector actually stems from the combination of extreme related party lending practices, mismanagement of funding risks with an excessive level of un-hedged borrowings in foreign currencies, and outright corruption.

Similar to the proper reformation of the financial sector itself, any restructuring of the Indonesian banks must go beyond merely repairing their balance sheets. Recapitalization in and of itself is not restructuring and without concurrent changes in a bank's management structure, lending practices, and operational systems; such a program is ultimately a waste of money and doomed to failure. In this regard, the current program of bank recapitalization through the issuance of government bonds and without the necessary internal and operational reforms, should be seen for what it is—a patchwork attempt to delay the current recognition of losses and extend the ultimate day of reckoning into the future.

The current IMF sponsored plan for restructuring the Indonesian banking sector does not adequately address many of the fundamental issues which are at the heart of the bank failures—i.e. the systemic weaknesses exhibited in their ownership structures, their excessive lending to affiliated companies,

poor credit risk assessment and ineffective management, and high operational costs. The program also fails to resolve the dominance of the state-owned financial institutions in the system; in fact the net effect of this program has been the nationalization of over 90% of the country's financial sector through the use of government bonds as recapitalization equity.

To date the bank restructuring program has meant the closure and liquidation of a number of bankrupt and unsalvageable commercial banks. These should be considered as positive steps. However, the actual liquidation of the 48[2] financial institutions recently closed has not been properly executed and continues to be subject to delays. The mismanagement of the liquidation process has contributed significantly to the costs of the restructuring program while the inclusion of third-party liabilities in the government guarantee scheme beyond the customer deposit base, has significantly increased the cost of this program and given rise to further rent seeking opportunities.

The state-owned banking system has yet to be effectively downsized or properly recapitalized. The creation of Bank Manderi through the forced merger of 4 large state banks has been a step in the right direction, but this new 'phoenix' bank is still an illiquid shell with very poor prospects for sustained recovery as currently structured. After several months of delay, the first tranche of the recapitalization bonds required by Bank Mandiri were issued in early October. Plans for the internal restructuring and future privatization of the remaining 3major state-owned commercial banks have been subject to continued postponements.

The non-performing loans from the state banks as well as certain private institutions were transferred to the Indonesian Bank Restructuring Agency (IBRA) in late March for collection and the government has issued bonds to fill the balance sheet gap created by such write-offs. These bonds have been counted as new equity in these 'recapitalized' banks and the government has assumed a majority ownership position. This 'nationalization' of the system is scheduled to phase out over the next 5-7 years as the bonds are retired and/or new equity injections from third-party investors are made.

This paper presents a review, analysis, and update of the recent actions taken by the government in implementing this recovery program and discusses the following related questions:

- What is the state of the Indonesian banking sector now?
- Will the recapitalization program lead to a recovery in the sector?
- What will be the future structure of the Indonesian banking sector?
- Is the cost for the program as designed justified?, and;
- Will the restructured banking sector be able to extend new credit, and effectively contribute to the overall economic recovery of the country?

Bank Recapitalization

An essential component of the government's program for economic recovery is the recapitalization of the shattered banking sector. The overall economic recovery plan has been strongly influenced by input from IMF macroeconomists and in many respects reflects this institution's traditional concepts and approach to such problems. Over the past two years, the IMF financial recovery program has been criticized as only offering 'old solutions to new problems' and for not being effective. There is ample evidence that the resolutions offered, to what can only be described as a total financial sector meltdown, are in fact primarily based upon past theoretical macroeconomic remedies and a lack the 'real world' practicality necessary for the Indonesian situation. The recapitalization plan has been structured to allow the participation of as many banks as possible but is inflexible and does not appear

[2] An additional 16 banks were closed and placed into liquidation proceedings and management by the central bank in late 1997. The final disposition of these banks remains a mystery as no disclosure or final accounting has been published by Bank Indonesia.

to have a clearly defined goal as to what the composition of the Indonesian banking sector should be for the future.

The recovery program for the Indonesian banking sector, as set forth by the IMF and Bank Indonesia, is heavily biased towards the state sector as it includes the recapitalization of all state-owned banks but only those private sector banks that qualify under a broad set of quantitative and qualitative criteria. These criteria in turn have been skewed towards the quantitative rather than qualitative and are based primarily on the degree of negative capital suffered by the institution. Independent auditors were hired to conduct a series of due diligence examinations and determine the true quality of the loan assets. Banks were ranked into capital adequacy ratio (CAR) categories[3] in which 'A' banks pass, 'B' banks were eligible to participate in the recapitalization program (provided they passed further tests) and 'C' banks failed and were to be closed. All of the state-owned banks were classified as 'C', but are to be 100% recapitalized under this program.

The range of CAR agreed upon by the IMF and Bank Indonesia is far too liberal, allowing participation of hopelessly bankrupt institutions, and yet only requiring new capital injections sufficient to return the CAR to 4%. This was obviously a politically driven compromise figure and is well below accepted international standards. The initial review and classification of banks passed some 54 banks with a CAR over the 4% minimum. However, over 60% of these banks were still below the 8% international standard. Because of this and the fact that on average over 90% of the recapitalization is to be accomplished without any actual cash investment; it is practically assured that this exercise will not accomplish its goal and at best will need to be repeated in the near future.

While the importance of a banks' capital adequacy ratio (CAR) should not be under-estimated, as it can be a primary indicator of a banks' solvency, it is not a complete measure of a bank's true efficiency or long-term sustainability. In contrast to most commercial businesses, bank capital serves a greater purpose than simply providing a cushion against failure or extraordinary losses. The function of bank capital is also to maintain operating solvency and to control the growth rate of risk exposures. Under normal prudential regulations that require the maintenance of a proper capital adequacy ratio, banks are limited from expanding their risk assets too rapidly without a concurrent increase in their capital account, either through retained earnings or new investment.

However, past lending practices in Indonesia have rendered the dependence on an established CAR limit as basically meaningless. With excessive insider loan transactions the banks did not practice proper risk management, adjust the value of their risk assets, nor create the required level of reserves or provisions (charges against income/capital) against actual and future loan losses. In the case of state-owned banks the CAR is an all but useless measurement tool or control factor in analyzing bank solvency, risk management procedures, or asset quality.

Management competency remains the single most important element of a sound bank and it is in this area that the Indonesian banking sector is weakest. As stated earlier, most private sector commercial banks were formed for the primary purpose of acting as the internal financing arm of shareholder related corporate conglomerates. Insider and related lending was ingrained in the system and often violated established regulatory limits. Loan underwriting, financial analysis, and risk management skills were almost non-existent; and the number of cases of collusion and credit fraud by bank owners and senior managers are legendary.

The Bank Indonesia/IMF led bank recapitalization program emphasizes the quantitative approach and addresses these issues only marginally through a cursory and very subjective 'fit and proper' test on bank management. There are also recent indications that strongly suggest that even this component of the process has been compromised by political considerations as well as influenced by personal relationships among the participants.

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[3] CAR 'A' = >4%; CAR 'B' = <4% to >(25%), CAR 'C' = >(25%)

There is a fundamental flaw in the attempt to recapitalize virtually the entire banking sector without the injection of real equity[4]. Without significant amounts of new cash for lending or a growth in low-cost liquid earning assets, the banks will remain unable to actively participate in the recovery of the economy through new credit extensions. The long-term government bonds placed onto the balance sheets of the 'recapitalized' banks only provide a minimum of liquidity through interest earnings. Additionally, the interest rate on these bonds has been artificially fixed by the government (issuer) itself and is not determined by the market. There are fundamental differences in the theory and market forces which set the rate of interest paid on short-term government money market instruments and the interest rate paid by commercial banks on customer deposits.

It should be noted that, as currently structured, these bonds do not really represent tier 1 capital; they only fill an accounting gap caused by the charge to provisions for the non-performing loans. Since these bonds represent such a high percentage (the average is in excess of 85%) of total assets of the recapitalized banks, the banks actually remain grossly undercapitalized and very limited in their ability to grow and remain within established capital adequacy limits. If the banks are allowed to sell these bonds to the investor public openly, as is currently planned for the year 2000, they will be in direct competition with the central bank and based on tenor alone, will surly trade at a significant discount.

The Indonesian Bank Restructuring Agency (IBRA) was formed in early 1998 to be the vehicle for implementing the bank reform program. However, the majority of the policy decisions regarding the bank recapitalization program and particularly the classification of the banks' themselves, have been led by Bank Indonesia. In many respects IBRA has been marginalized in this process and now must be the responsible party for the implementation of policies they do not control nor necessarily agree with. IBRA is still going through the normal problems associated with any start-up operation and its abilities to collect on loan assets, liquidate closed institutions, and restructure banks placed under its management remain significant unknown factors in the process.

The results of the initial due diligence examinations were devastating as they revealed for the first time the true extent of the troubled and non-performing loans as well as a number of fundamental weaknesses in the structure of the banks.

The following table outlines the initial classification results as published in March, 1999:

Table 1.
Due Diligence Results

Bank Type	**Category**			**Total**
	A	**B**	**C**	
State Banks	--	---	7	7
Regional Development Banks	12	11	4	27
Private Banks:				
--Taken over by IBRA	--	--	4	4
--Under IBRA supervision	1	1	18	20
--Other non-IBRA banks	49	48	11	108
Foreign & Joint Venture Banks*				42
Total	**62**	**60**	**44**	**208**

* To be audited by their own external audit companies

All 7 of the state banks, which represented almost 40% of the bank assets in the system at the time, are in category C-and technically bankrupt. Of the 49 private banks which have been classified as A, and theoretically do not require additional capitalization, only three had total assets greater than Rp. 500bn (US$ 64 million) and many are non-foreign exchange institutions. Most banks received an initial classification of B which under the program required their shareholders to raise cash for at least 20%

[4] In terms of restoring a banking operation to sustainable levels of solvency and liquidity; there is no substitute for a capital infusion in cash.

of the necessary recapitalization amount—just to bring the CAR back up to a positive 4%. The audits revealed the high level of non-performing loan assets in these banks as well the almost total lack of loan loss reserves held against all bank credits. The most damaging revelation of these audits was the gross violations of the legal lending limit regulations with connected lending to shareholder held companies; exceeding 85% of capital in some cases.

Bank Indonesia statistics indicate that the deterioration of asset quality and immense loss of earnings in the industry continued during the 2nd half of 1998, and now into the first half of 1999. With the exception of the regional development banks, the entire banking industry was reported to be technically bankrupt at year-end 1998 with a total negative equity position in excess of Rp. 98 trillion.

The following table illustrates the trend in de-capitalization of the Indonesian banking sector during 1998:

Table 2.
Bank Assets and Equity 1997-1998

In Rp. Billions

Bank	Total Assets		Total Equity	
	Dec-97	**Dec-98**	**Dec-97**	**Dec-98**
State-owned Banks	201,941	304,815	13,803	(50,722)
Private Commercial Banks	248,731	351,913	25,521	(47,765)
Regional Development Banks	12,270	14,548	1,299	1,515
Foreign & Joint Venture Banks	75,224	98,737	6,090	(1,569)
Total	**538,166**	**770,013**	**46,713**	**(98,535)**

It should be noted that the apparent expansion in bank lending implied by the dramatic increase in total bank assets during 1998 is mainly the result of increased Rupiah values in the conversion of foreign currency loans and the capitalization of accrued but uncollected interest. New bank lending has been virtually non-existent since mid-1997 and corporate borrowers who obligated to the banks in foreign currencies now owe increased amounts in Rupiah terms. Likewise, there has been little or no significant repayment of loan outstandings to most of the banks during this period.

The continuing crisis and overall insolvency of the Indonesian banking sector has been primarily driven by the poor quality of the loan assets of the banks[5]. The due diligence reviews completed in early 1999, determined that an average of 67% of the total loans in the system should be classified as *Loss*—requiring a 100% charge for loss provisions against the capital account. Over 95% of the total loan portfolios of all banks are now classified as substandard or worse. It is this classification and subsequent loss of capitalization that has caused the banks to report a negative Capital Adequacy Ration (CAR). The fact that the entire system now reports such a highly negative position can be attributed to the fact that the industry has been undercapitalized for years and has never created the proper level of loan loss provisions.

The following table illustrates that pre-crisis the Indonesian banking system was able to manipulate its accounting figures in such a way as to simultaneously indicate fairly standard levels of return on average assets while reporting a high return on equity (ROE); even while their net interest margins (NIM) were declining. This particular combination of performance figures should have raised many questions among regional financial analysts as they strongly implied that the banks were undercapitalized for their rate of asset growth, had a high level of non-interest expenses, and were quite possibly under-reporting their loan loss provisions.

[5] Strong arguments have been made that the primary cause for the deterioration of the banks' loan portfolio was the massive devaluation of the Rupiah which increased the cost of the bank's foreign denominated liabilities and made the repayment of bank credits extended in foreign currency more problematic. The Rupiah devaluation is a factor (exacerbated by the banks' un-hedged positions) but analysis has shown that most of the loan losses are in fact the result of poor credit underwriting at inception, related and insider lending, and entrenched corrupt practices.

Table 3.
Average Profitably Measurements

Private Banks		1994 (%)	1995 (%)	1996 (%)	1997 (%)
	ROAA	1.18	1.19	1.18	.98
	ROE	14.74	15.18	15.88	14.78
	NIM	4.11	3.82	3.62	3.10
State Banks					
	ROAA	.43	.60	.72	.63
	ROE	8.40	10.50	11.85	11.22
	NIM	3.11	3.23	2.91	2.13

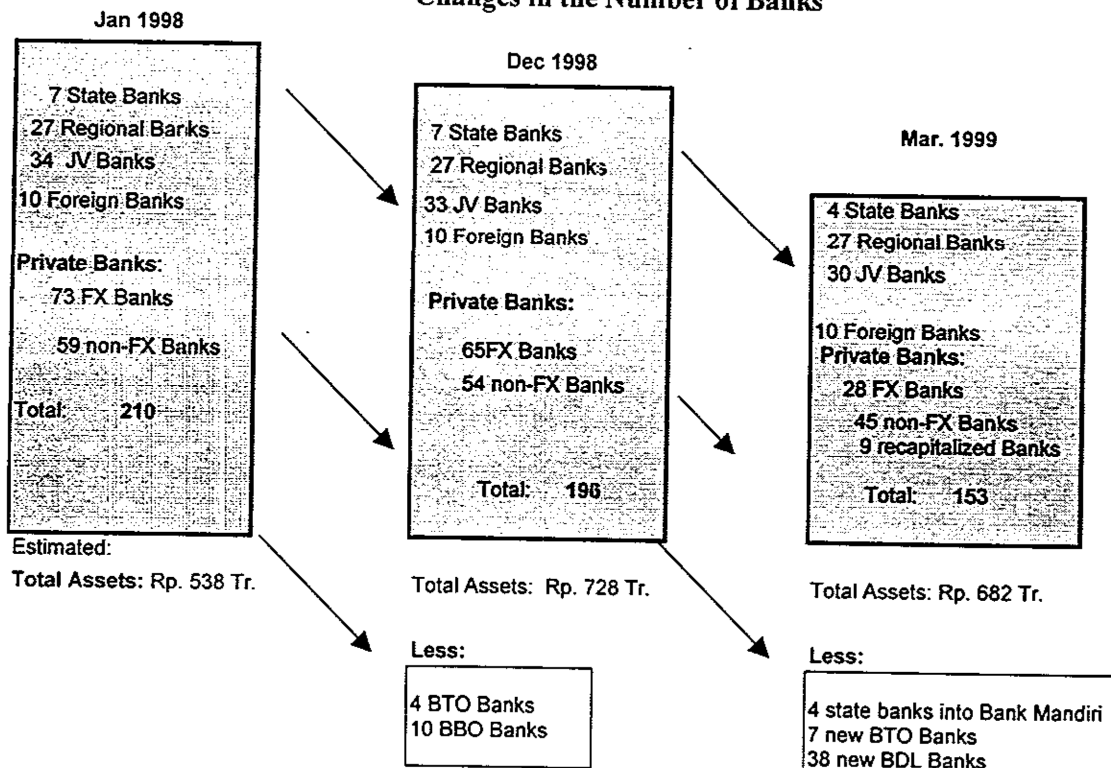
Source: Annual Reports

Many analysts for the local capital markets overly relied on these performance ratios as indicators that the banks were sound and profitable; and therefore good investments. In reality the Indonesian banking sector has been weak for years and the difficulty of continually hiding the negative impact of high overhead costs and understating the true level of non-performing loans was becoming an almost impossible task for most banks even before mid-1997. There had been several major bank failures prior to the Asian Crisis and it seems certain that the Indonesian banking sector would have all but collapsed under its own weight within a very short timeframe—even without the contagion effect of the Asian crisis

The long overdue 'shakeout' of the banking sector was initiated on March 13, 1999 when, after considerable delay and only after consensus agreement was achieved on a number of politically driven issues; the government announced its final position on the classification of the banking system. This vital step is considered by many to be the most significant to date as it sets the profile for the future of the country's banking sector. Effectively, the entire banking system of the country will become *nationalized* with the government holding at least an 80% majority share of all but a few minor commercial banks. The latest decision included the closure of another 38 banks and the take over of ownership control for an additional 7 institutions, which further reduced the size of the banking sector.

The following flow chart illustrates the 'shrinking' of the banking system under this program:

Chart 1.
Changes in the Number of Banks



This chart indicates that the government's program for restructuring the banking sector has led to both a significant downsizing of the sector and a shift towards increased government ownership based on a recapitalization with state bond instruments. The total number of operating banks has decreased 31% in less than 18 months and government equity participation in the entire system has increased from approximately 15% to at least 60%. When the government's ownership in the 13 BTO institutions is included; although this position may be temporary, the direct involvement of the government in the sector is even greater.

The chart also shows that the total number of state-owned institutions has decreased from the traditional 7 to 4 with the merger of Bank Dagang Negara (BDN), Bank Bumi Daya (BDN), Bapindo, and EximBank into a new wholly-owned government bank—Bank Mandiri. A total of 64 private sector banks have now been be closed[6] and are in the first stages of liquidation. The ownership of an additional 13 institutions has been transferred into IBRA for either rehabilitation in preparation for their sale to new investors or eventual liquidation as well. The number of regional development banks are scheduled to remain at 27 while the foreign and joint-venture banks are shown to stay at 40–even though four have already been forced to close as they were unable to raise new equity capital. It is anticipated that at least 10 more joint venture institutions will either merge or cease operations within the next six months. The future recovery of the Indonesian economy therefore will be largely dependent on a smaller, government controlled, and greatly weakened banking sector.

The reported total assets in the system do not appear to decrease in proportion to the downsizing of the number of banks mainly because of the increased Rupiah value of foreign currency assets as a result of the massive devaluation of the Indonesian currency over this period.

A more detailed profile of the remaining banking sector is seen in the following table:

[6] Including 16 banks closed by Bank Indonesia in November 1997

Table 4.
Profile of Indonesian Banking Sector as of 9/30/99

Bank Type	Total Loan Assets*	% of total	Govt. Bonds Req'd.	Ownership Profile	Notes
45 non-FX Private banks	7.6	2.3	0	100%Private investors	Banks classified as 'A' banks Very small institutions with a combined capital base of less than Rp. 500 Billion. Several of these banks are expected to merge in the near future as they must increase their capital base to survive.
36 Foreign & JV Banks	105.5	32.1	0	Foreign financial institutions; Joint Venture banks with local bank partners	4 JV banks have closed and several more are expected to merge; slow to moderate growth seen for foreign banks
27 Regional Development Banks	7.8	2.4	1.30	100% Government-owned	Primarily agricultural lending; traditionally unprofitable
28 FX Private Banks	13.6	4.8	0	100% private and foreign investors	Small banks classified as 'A' Panin Bank and Bank Buana are only 'large' banks
7 FX Private Banks	53.1	16.2	22.2	Now 62% to 90% Government-owned	Recapitalized banks with new CAR = 4%; majority of assets consist of Govt. bond
4 State-owned Banks	148.2**	42.2	233.4	100% Government +owned--except BNI which is 26% publicly traded	Heavy loan losses; majority of asset base is now Govt. bond; traditionally weak management and poor lending practices
147 Total	335.8	100.0	256.9		
Also: 13 private sector banks*** taken-over by Govt. (BTO)	Total Assets: 119,410 Total Deposits: 21,380 # of employees: approx. 65,000 # of branches: 2,450			Now under IBRA control and supervision 100% Government-owned; Senior management teams have been replaced and most mid-level employees remain	Banks not extending new credit, but continue to accept deposits. Plans call for forced merger of 8 BTO banks into Bank Danamon with the further restructuring and recapitalization this 'platform' bank in preparation for future sale. Partial recovery of the recapitalization costs for BCA are anticipated through an IPO for the bank in early 2000

* Total loan assets estimated at 55% of total assets after adjustment for government recapitalization bonds
** As per Bank Mandiri projections for 9/30/99
*** Includes Bank Niaga and Bank Bali—originally included in a group of 9 banks to be recapitalized.

A brief analysis of the figures presented above; further illustrates the structural weakness of the newly 'reformed' Indonesian banking sector:

- Of a total of 147 commercial banks that remaining the system, the government now holds a 100% ownership position in 33 (22%), and an average 80% ownership in 7 (5%). However, these 40 banks control 67% of the remaining credit extended.

- The amount of credit outstanding in the market has been reduced significantly and replaced by government bonds in the state banks and the 7 recapitalized institutions. While providing some level of income above the loss loans, the true impact on earnings and the degree of liquidity provided by these instruments, remains to be seen.

- Of the 73 privately owned banks remaining, only Panin Bank and Bank Buana are of a size to extend meaningful levels of new credit. 70% of these institutions can not conduct foreign exchange transactions. Collectively, they represent only 7% of the total banking assets (loans) remaining in the system.

- All of the state-owned banks (including a number of the regional development banks) now report the majority of their total assets as new government bonds held in replacement for a *written off* loan portfolio. Due to massive write-offs, the state banking sector has a significantly reduced its loan exposure in the market. To date the recapitalization has had minimal impact on the management structure or lending procedures of these institutions.[7]

- The 9 private banks originally scheduled to participate in the recapitalization program has now been reduced to 7[8]. They will be among the weakest in the system as they will emerge in an illiquid state with a technical CAR of only 4%. A high percentage of their earning assets will be dependent on the yield from the recapitalization bonds and it appears that they will continue to suffer a negative spread on their operations, at least for the near term.

- It is unlikely that the foreign and joint venture banks will strive to increase their market share significantly in the near future as the quality of their loan portfolios has also deteriorated, requiring greater charges to reserves and increased losses. Most report a 'cautious, go slow' attitude. Additionally, a number of joint-venture operations, particularly those from Japan or affiliated with the recently closed local banks, are likely to close over the next six months.

- The 256.9 trillion in recapitalization bonds required does not include bonds of approximately Rp. 199.4 trillion recently created for the repayment of Bank Indonesia liquidity advances and payments under the government guarantee scheme, nor the total of Rp. 80.47 in bonds that have been issued for restructure of the 4 original BTO banks.

- Additional recapitalization bond requirements for Bank Bali and Bank Niaga, originally estimated to total Rp. 11.3 trillion, have subsequently increased to Rp. 12.25 trillion.

Bank Indonesia Liquidity Advances

Beginning in late 1997, Bank Indonesia was effectively forced to extend over Rp. 150 trillion in liquidity credits to a number of banks that experienced heavy runs on their deposit base. Considerable controversy surrounds the actions taken by both Bank Indonesia and certain bank owners regarding these liquidity advances, which in several cases exceeded the level of actual deposit withdrawals experienced by the bank[9]. There were also reports of significant international transfers of funds by bank owners and well-connected businessmen during this time. Bank Indonesia's actions (strongly advocated by the IMF) to stem this deposit run and its futile attempts to support the Rupiah exchange rate at that time, can now be calculated to have increased the cost of the bank recovery program by at least 40%.

As the banking crisis expanded and most public deposit funds did not return to the system quickly, those banks with the heaviest indebtedness proved incapable of repaying these liquidity advances. In May 1999 Bank Indonesia and the Ministry of Finance concluded negotiations for *monetizing* this debt through the issuance of a Ministry of Finance bond payable to Bank Indonesia. The balance sheet of the central bank now reflects a large 'due from government' position (as opposed to due from a number of individual commercial banks); while the MoF debt is now a budget item. The MoF has further passed on the ultimate repayment on the original debt through direct debt recovery and asset recovery schemes that involve IBRA.

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[7] A notable exception may be found in the newly created Bank Mandiri, which has conducted a thorough personnel review and has begun an in-depth re-training program for selected key bank staff.

[8] Both Bank Bali and Bank Niaga have been taken over by IBRA and are to be recapitalized through a combination of new rights issues on the local stock exchange and direct sale to foreign investors.

[9] A new law governing Bank Indonesia operations places limits on any future liquidity advances to a maximum tenor of 90 days. This is a positive step that should help to prevent similar abuses in the future.

A major component in the series of decisions to close or place financial institution under IBRA management was grounded on the government's desire to receive a quick repayment of this debt. The records indicate that approximately 60% of the Bank Indonesia liquidity advances went to just 3 of Indonesia's largest private banks[10]. It was announced that these new bonds placed with the central bank, initially totaling Rp. 145 trillion, will pay a 3% coupon rate which is indexed to the annual inflation rate; on a quarterly basis. IBRA is now the agency considered to be the primary source for these payments and is expected to raise the required amounts through its' asset recovery programs. The actual cash flow costs to the government will in fact be fixed at 3% p.a. as the portion of total interest which is calculated to be derived from the annual inflation rate is to be capitalized each year; thus raising the principal balance of the bonds annually. These bonds should be considered separately from the recapitalization bonds that will be placed directly in selected banks.

The structured repayment of these liquidity advances under a shareholder settlement scheme[11] is primarily based on the legal theory (and social pressures) that is would be unacceptable for the shareholders of the failed banks not to lose their entire equity and be made to pay back the loans they made to themselves. The actual implementation of this settlement program has proven to be controversial due to its lack of transparency, asset valuations conducted by investment bankers with a vested interest in the outcome, and charges of favorable treatment on specific assets. The repayment scheme, as devised by an international investment bank advisory team for IBRA, has placed this agency into the unique role of being a stakeholder, a major creditor, and an oversight manager for over 200 non-bank related companies.

Further discussion of this program is provided below in the section on the Asset Management Unit-Investment (AMI) of IBRA.

Recent Program Actions

Over the past 18 months the government has struggled to implement the initial phases of its bank recapitalization reform policies. The program, with considerable input and pressure from the IMF and the World Bank, has experienced a bewildering series starts and stops. Virtually all decisions carried a political component and positive action steps were often followed by delays and political maneuvering, which have only succeeded in increasing the final cost of the program.

Highlights of program activities to date include:

- the closing and liquidation by Bank Indonesia of 16 banks in November 1997;
- IBRA created in January 1998;
- the establishment of a full government guarantee for all deposits and liabilities in January 1998;
- the closing of 7 banks and the take over of 4 banks by IBRA in April 1998;
- the closing of 3 additional banks in August 1998;
- the passage of a revised banking law in November 1998;
- the completion of due diligence examinations on most banks by January 1999;
- the signing of Implementation Regulations for IBRA authorities in February 1999;

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[10] Bank Central Asia, Bank Danamon, and Bank Dagang Nasional Indonesia

[11] Bank Indonesia secured these liquidity advances with the personal guarantees of the majority shareholders of the borrowing banks, thereby gaining access to their personal non-bank assets as a secondary source of debt repayment. Six new holding companies to control assets pledged in settlement of the liquidity credits to the first group of closed and BTO banks have been created. Negotiations are still underway for settlement with certain bank owners of the 7 new BTO banks and the 38 banks closed in March, 1999.

- the second set of audits completed on banks approved for recapitalization in April 1999;
- the closing of 38 additional banks, the take over of 7 banks by IBRA, and the approval of 9 banks to be recapitalized by government bonds in March 1999;
- the transfer of all class 5 (Loss) loans from the 7 state-owned banks as well as most of the banks scheduled for recapitalization in April/May 1999;
- acquisition of 20% of Bank Bali by Standard Charted Bank announced in April, 1999;
- the issuance of Rp. 157 trillion in new government bonds to fund the bank recapitalization program and settle the liquidity credit debt with Bank Indonesia on May 28, 1999;
- the Bank Bali scandal revealed resulting in IBRA takeover of Bank Bali with a management contract awarded to Standard Chartered Bank;
- the first tranche of recapitalization bonds, originally scheduled for June, totaling Rp.103 trillion issued to Bank Manderi. Recapitalization plans for 3 remaining state-owned banks further delayed until early 2000.

Government Decisions of March 13, 1999

The most significant action taken under the government sector recovery plan this year, has been the closure of 38 banks which had failed to qualify under the recapitalization program. Another 7 institutions, which were thought to be too "important" to the system to close at this time; were placed into a 'conservatorship' mode as BTO banks. Most significantly, the government announced the names of 9 private banking institutions that would be recapitalized with a mixture of government bonds and new shareholder equity.

The final negotiations and decisions regarding which banks should be closed and which ones 'saved' through recapitalization; proved to be quite difficult. Although the analytical aspects were completed professionally, the selection procedures were not conducted with the degree of transparency expected. The process experienced considerable delay and was marred by a flurry of rather blatant last minute lobbying from both bank owners and influential parties who are heavily indebted to the system. It appears that only last minute pressure from the IMF and World Bank forced the final decisions to close as many institutions as they have.

The announcement brought to the forefront a number of controversial issues, particularly in the selection of the 7 banks that have been 'taken over' by the government but not immediately closed for liquidation. On a purely analytical basis, there does not appear to be any justification for not closing these banks. They are all highly insolvent and nowhere near as important to the future of banking in Indonesia as rationalized. There was also concern and criticism that the creation of these additional BTO banks was a sign that the government lacked the necessary political will to confront certain owners. It seems that the government, with IMF concurrence, is again employing old methodologies that have proven to be costly and unworkable in other countries under similar circumstances.

There is a strong perception in the market that the status of *BTO* is a sort of a positive 'limbo' state from which the owners can buy back their bank in the future. Depositors have been lured back to these institutions primarily because of the blanket government guarantee on all deposit accounts. The plan to adjust this government guarantee into a formal deposit insurance scheme by the year 2000 is fraught with potential problems and raises such important questions as:

a) who is going to be responsible for and manage the insurance fund?
b) how is the fund to be initially established and at what cost?
c) what sort of balance limits will be placed on customer deposits eligible for insurance?
d) will the public accept an insurance scheme that offers less coverage than the current unlimited guarantee?

e) what will be the cost impact of an insurance scheme on the banks and how will they pass this expense on to the customer?

The following section provides some analysis and discussion of the most recent decisions as they relate to each component of the banking sector and the impact they will have on the future of the Indonesian banking sector:

A. Surviving Banks (Classification A)

The government declared a total of 74 small and medium sized private sector banks to be sound and eligible to remain in operation without further recapitalization at this time. On a technical basis all these banks report a CAR of +4% or better but this is not a complete measure of their viability or future contribution to the Indonesian economy. On an efficient operational basis it appears that only Panin Bank, Bank NISP and Bank Buana among this total group of banks could be in the position to make any meaningful contribution to the economy through new credit extensions. Given their past conservative lending practices it is doubtful that they will now expand their activities too rapidly. For most banks in this group, their actual level of capitalization and corresponding legal lending limit is so low that they should be considered more as private credit unions than commercial banks. 70% of these institutions can not conduct foreign exchange transactions and collectively they represent only 7% of the total loans outstanding today.

Although these banks have passed the ADDP reviews and satisfy the 4% CAR requirements for this phase of the banking reform program, they were still required to submit updated business plans to Bank Indonesia, while management was subjected to a 'fit and proper' test. This process dragged on through the summer as many revisions in business plans were required, while there were only a few changes in management structure imposed by the central bank. Additionally, these banks must raise their CAR to a minimum of 8% by March 2001. Their ability to achieve this level of growth from retained earnings is highly doubtful because of the limiting factors inherent in profit growth through asset expansion from a small capital base.

Despite a significant decrease in interest rates over the past six months, these banks continue to suffer heavily from a negative interest spread; their relatively small size making them more interest rate sensitive than larger, more diversified institutions. June 30, 1999 financial statements indicate that virtually every one of these banks continue to loose money in 1999 and as a group they have been further decapitalized. There have been several announced mergers of some of the smaller institutions and it is anticipated that a number of these banks will be forced to either merge or self-liquidate over the coming months.

In any case, their overall impact on the recovery of the Indonesian economy and their ability to act as the source of new loan funds to the corporate sector in the near future, must be considered as negligible.

B. Recapitalized Banks (Classification B)

Nine private commercial banks initially survived the entire selection process and were declared 'winners' in the contest to receive government recapitalization support. 21additional banks, which had originally been classified as 'B', failed to qualify under the final selection process. The most common rationale for their failure was their inability to present a realistic business plan or to raise 20% of the required new capital. Several shareholder groups also failed the 'fit and proper' test imposed on bank management. Despite the small number of banks selected for recapitalization, they are among the largest in the system in terms of non-performing and the cost to the government in bonds for their recapitalization to the 4% CAR level, will exceed Rp. 34 trillion; or US$ 4 billion at current exchange rates..

The following table provides further detail regarding the status of the 9 banks that were selected for recapitalization in March 1999:

Table 5.
Private Banks to be Recapitalized—as of May 1999
(Govt. Order of 3/13/99)

In Rp. Trillions

Bank	Total Loan Assets*	CAR+	Loss Loans for transfer to AMU	Total Govt. bond required (as of 4/99)		20% equity required from shareholders (as of 4/99)	Recap Bond as % of total earning assets++	Total Deposits	Total Earning Assets
				fixed	variable				
Lippo Bank Tbk.	4.24	(44.4)	5.0	.240	4.785	1.256	36.2	18.45	75.2
BII Tbk.	10.97	(27.6)	6.5	.821	8.250	2.268	25.1	26.92	135.0
Bank Bali Tbk.	3.80	(45.2)	1.9	.134	2.810	.736	36.2	10.38	78.5
Bank Niaga Tbk.	6.39	(55.7)	3.3	.314	5.279	1.398	42.5	10.51	125.2
Bukopin	2.30	(21.0)	.8	.051	.537	.147	15.5	4.12	91.9
Bank Universal Tbk.	3.35	(57.8)	2.4	.172	3.698	.968	52.2	7.49	99.2
Bank Patriot	.03	(52.9)	.03	.008	.037	.011	35.9	.15	75.9
Arta Media	.317	(24.1)	.16	.020	.095	.028	25.3	66	68.9
Prima Express	.498	(50.6)	.19	.019	.479	.124	46.8	1.68	67.4
Totals	31.895		20.28	1.779	25.97	6.936	Ave. 35.1	80.36	Ave. 90.8

Tbk. = publicly listed

- As of revised audit through 12/31/98 with adjustments and required provisions to LLR through 3/31/99

\+ CAR calculated on gross basis as per Bank Indonesia regulations.

++ Total Earning Assets = Σ [bonds + loans (net) + placements (net) + (securities investments net)]

- As this table indicates, the total recapitalization requirement for these 9 banks is calculated to be Rp. 34.7 trillion ($4.5 billion), which represents a 63% increase over the Rp. 21.3 trillion figure originally announced. The government is to place a total of Rp. 27.75 trillion ($3.6 billion) in bonds onto the balance sheets of these banks., while shareholders are expected to raise a total of Rp. 6.9 trillion in new equity.

- Total net loan assets of recapitalized banks will be reduced to Rp. 31.9 trillion with the transfer of a reported Rp. 20.3 trillion in category 5 (Loss) loans to IBRA. The remaining loans are weak as well with the majority classified as substandard or doubtful. Income from remaining loan portfolio continues to be below the contracted loan terms.

- Recapitalization bonds will make up an average of 87.1% of net loans and 35.1% of all earning assets. In fact total recapitalization bonds will exceed the level of performing loans in several banks. Consequently, future bank earnings will be highly dependent on the bond yield, interest earnings from securities and inter-bank placements; all of which are lower than normal loan rates It can be seen that the 4% CAR ratio is heavily supported by zero-risk weighted government bonds and SBIs and that this ratio will necessarily slip below the 4% level as new loans are extended[12].

- The average ratio of total earnings assets to total deposits is high at 90.8%; indicating both the high degree of sensitivity that the banks will have to interest earnings from the recapitalization bonds and the need to close the negative spread gap through a lowering of deposit interest rates.

- Bank Bukopin, although it is a small operation, presents a particular problem as this government institution has traditionally been the primary source for financing cooperatives in the country. The quality of this bank's loan portfolio is particularly dismal and the future sustainability of such a specialized bank with such a financially weak client base is questionable.

In exchange for this asset support the government has assumed a majority ownership position (primarily structured at 80%) in these institutions while the existing shareholders are diluted to a 20% position. The original shareholders were required to pay for their 20% equity position in cash, which

[12] This deterioration in the CAR ratio will occur as all new credit will carry a positive risk-weighting which will in turn increase the denominator of the ration equation and require the bank to increase its general loan loss provisions. Such is the growth limiting factor of the capital account in banks. An expansion in credit requires a corresponding increase in capital.

represents the only true new equity investment into these institutions. The government, through IBRA, created a complicated new structure of share groupings with three separate classes: Existing shareholders prior to recapitalization (holding A shares) will be given the rights to subscribe to the new class B shares (new shares issued to cover at least 20% of the recapitalization requirements). The government will inject the balance in the form of recapitalization bonds in exchange for class C shares. Class B shareholders will be issued 'Certificates of Entitlement' (COE) or warrants, which will entitle holders (primarily the original shareholders) to receive proceeds from bad-debts collected by IBRA (after deduction for IBRA's pro-rata calculation of its internal costs) in a proportion to the total number of class B shareholders in the form of class C shares. Class C shares will then be convertible into class B shares at issue price plus a carrying cost. Effectively then, the original shareholders could reap the benefit of all debt recoveries conducted by IBRA and purchase their banks back at a discount. However, given the very low estimated recovery value of the NPLs transferred to IBRA and the high overhead costs associated with this agency; it is highly unlikely that the COEs will ever have much value.

The five banks that are listed on the Jakarta Stock Exchange are required by current rules to offer a share rights issue when raising this equity in order to protect the minority shareholders. This was primarily a pro-forma exercise as there has been very little interest from the investor public to purchase new shares in these institutions[13] and virtually all of the new equity was in fact contributed by the current majority shareholders.

The total amount of cash that must be raised by the original shareholders is significant. Questions have been raised concerning the source of these funds, which is rumored to consist mainly of the repatriation of personal flight capital. Because of the longstanding incestuous manner in which Indonesian business has developed over the years, there is an additional controversy created by the fact that many of these same shareholders and the corporate groups they control are also heavily indebted to international financial institutions with whom they are currently trying to negotiate settlements. The question now being raised is simply: *Why should a particular lender be requested to accept a substantial discount on debts owed while the responsible parties are allowed to invest new cash into their related banking operations?*

Since the decision to recapitalize 9 private sector commercial banks last March, both Bank Niaga and Bank Bali have been removed from this program and taken over by IBRA. They are now effectively BTO banks, but are being treated as special cases. Both institutions remain open to the public and continue to suffer operating losses on a daily basis.

Bank Niaga was dropped from the program because its shareholder structure came under question and they were unable to raise the Rp.1.4 trillion in required new equity. It was reported that an off-shore subsidiary of Lippo Bank holds 30% of the shares of Bank Niaga, having foreclosed on collateral for a defaulted loan to the current majority shareholder. IBRA announced that it would recapitalize Bank Niaga through a rights issue totaling Rp. 8.85 trillion ($ 1.2 billion), or effectively 100% of the recapitalization costs. This rights issue was held in August with minimally positive results. The public purchased only 3% of the new issue, with IBRA obligated to purchase the balance—to be paid for with new recapitalization bonds. To date the issuance of these bonds has been postponed indefinitely and there has been minimal public disclosure regarding the status and future plans for Bank Niaga except that the institution reported an operating loss for the first six months of 1999 of almost Rp. 5 trillion.

In late April it was announced that Standard Chartered Bank would purchase Bank Bali, initially through the funding of the 20% equity requirement. This cost, originally projected to total $53 million increased significantly as new losses were discovered in the bank. As a result of an audit conducted by Standard Chartered a suspicious payment of approximately $80 million was discovered, leading to the revelations which erupted in to the 'Bank Bali Scandal'. As a result of the increased costs associated with the purchase and recapitalization of the bank, as well as the turmoil caused by the fraudulent

[13] Bank Internasional Indonesia was successful is raising new equity in this manner as they held two new rights issues between May and August. It is rumored however, that most of this new investment came from companies related to the Widjaja family who are the majority shareholders.

payments made by the majority shareholders, Bank Bali was taken over by IBRA in June. Standard Chartered was awarded a full management contract over the bank and the eventual recapitalization was restructured to be done through a rights issue led by IBRA; currently scheduled for year-end 1999. It is now estimated that the total cost to recapitalize Bank Bali to a 4% CAR will exceed Rp. 4.3 trillion due to increased loan losses and a reported operating loss of Rp 1.6 trillion for the first 6 months of the year. A discussion of the Bank Bali scandal and its impact on IBRA's operations is presented in a latter section of this report.

There remain a number of unanswered questions regarding the effectiveness of the recapitalization of these banks and their future solvency. At least five of these banks have been considered to be the seeds of a revitalized private banking sector will be needed to drive any economic recovery of the country. Half measures to restore these commercial banks to solvency but only leaves them technically *'alive; but still requiring life-support'*, will undoubtedly prove more costly in the long run and ensure further delays the banking reform and recovery program.

A brief listing of potential problems and unresolved issues inherent in the recapitalization program as designed, includes the following:

- Poor liquidity levels after recapitalization[14];
- The limited ability of the bank to resume lending to productive enterprises;
- The true yield and liquidity of the government bonds;
- The impact of continued negative spread on the bank's capital account;
- The unresolved settlement of inter-bank claims against banks closed by IBRA;
- Unrealized losses in investment portfolios due to closure of related banks[15];
- The ongoing profitability of the bank under its current balance sheet structure, and;
- The ability of the bank to raise its capital adequacy ratio from 4% to 8% by March 2001;

These are not minor issues and the fact that their outcome remains questionable at this stage of the recapitalization program raises further questions about the concept and structure of the plan itself. The continued economic crisis in Indonesia which offers few creditworthy borrowers, a high interest rate environment-despite recent rate reductions, and a bank recapitalization program which is based primarily on a non-cash accounting adjustment; are all harbingers for a continued deterioration of the banking sector.

It is almost certain that these newly 'recapitalized' banks will continue to suffer operational losses in the near term and will require further equity injections within a year. In late September these newly 'recapitalized' banks reported their financial position as of 6/30/99. Despite a forced decrease in interest rates over the previous months, five out of the seven institutions reported negative interest margins and operating losses for the period.

The following table outlines the profit and loss position of these 7 banks as of June 30th.

Table 6.
Profile of 7 Recapitalized Banks—June 30, 1999

Rp. billions

Bank	Interest Income	Interest expense	Interest Margin	Operational Expenses	Profit (Loss) for period
Bukopin	648.3	503.2	145.1	665.5	7.6
BII	3,079.6	3,913.1	(833.5)	4.433.2	(1,018.7)
Bank Lippo	1,103.2	2,281.6	(1,178.5)	2,793.4	(1,770.9)
Bank Media	62.4	100.3	(37.9)	15.9	(19.6)
Bank Patriot	20.8	20.6	.2	24.1	.5
Prima Express	137.1	184.7	(47.6)	43.6	(79.4)
Bank Universal	470.4	1,394.9	(924.5)	1,882.4	(1,266.5)
Average			(410.9)		(586.7)

Source: published financial statements

[14] It should be noted that the government bonds to be placed as assets in these nine banks will equal an average 77% of the earning assets of the group..

[15] For example: Lippo and BII each own 25% of Bank Dagang dan Industri which is now in liquidation.

A brief review of these performance figures highlights the following operational weaknesses in these banks:

a) All are highly sensitive to the negative spread caused between interest expenses on deposits and actual interest earnings on their very weak loan portfolios;
b) Non-interest operational expenses continue to be very high indicating continued high overheads and inefficiencies
c) The net loss position indicates that these banks have earned very little non-interest income to offset non-interest expenses;
d) All banks, except for two small institutions lost money on operations during the first six months of the year;

The severe illiquidity of these recapitalized banks was recently revealed when IBRA announced that Bank Indonesia would make a cash advance against pending inter-bank claims under the government guarantee program. Several of these banks are owed significant amounts of money from the 48 banks under liquidation; repayment of which would only come from the guarantee program. As a result of delays in the claim payment process, Bank Indonesia will advance a total of Rp. 4.9 trillion ($700 million) to Bank Lippo. Bank Bali, Bank Bukopin, Bank Prima Express, and Bank Universal in order for them to "lower operational losses during the claim verification period."

How this transaction is to be accounted for on the banks' books is important as they could end up with an equal liability for this asset; thereby merely inflating the balance sheet totals. They should be able to convert a portion of their existing *Due from Banks* account to cash and then extend new credit. The actual value of this exercise for banking purposes is questionable however, as the banks will only be allowed to utilize these new funds for investment in Bank Indonesia SBI certificates or government bonds. If they are required to pay any interest for this cash advance, the real benefit of receiving these funds could be totally negated. In addition to assisting the banks with their liquidity shortfalls, this program is seen as an attempt to avoid another Bank Bali type payment scandal.

Banks Taken Over (Classification B and C)

The most controversial aspect of the March 13th announcement was the decision to place 7 more banks into a form of conservatorship as 'Bank Taken Over' (BTO). As a BTO entity, the bank is not closed to the public, however, the ownership rights of the shareholders are effectively seized by the government. The basic plan is for bank management to be replaced and the bank is restructured in preparation for sale to new investors. The government placed 4 banks into this category in 1998 and is still in the process of working out a final solution for them, some eighteen months after the action.

Exactly why these particular banks were selected for this unique status, as opposed to immediate liquidation, remains wrapped in a political enigma. Because these banks are as insolvent as many that were in fact ordered closed, there are charges of collusion and cronyism surrounding this choice; particularly in the case of Bank Nusa Nasional (BNN). The past political connections and ownership structure of Bank Duta also raised problems in the classification process.

The government initially rationalized its decision with a statement that these particular banks were "important to the country's payment system" and that they serve a large segment of the population with a total of 80,000 accounts. The actual financial condition and known market share of these banks do not corroborate this position in the least. Their total deposit base of Rp. 15.5 trillion represents less than 3% of third party funds in the system[16]. With the exception of Bank Duta, these banks are little known outside of the greater Jakarta market.

By placing these banks in this 'limbo' state, the government has set the stage for continued losses and consequently increased costs before any resolution is achieved, be it in the form of new capital or their final liquidation. Past experience has shown that the majority of financial institutions that are placed into this type of conservatorship are subsequently closed and liquidated. Only a very few have been

[16] Per Bank Indonesia statistics, third party funds (deposits) in the Indonesian banking system totaled Rp. 573.5 trillion as of 12/98.

successfully restructured and sold to new investors; and then only at a substantial loss. these banks through this process. The primary problem with placing banks into this poorly defined category of BTO, is that none of the parties involved, from the IMF, through Bank Indonesia, to IBRA; have any well defined program for what to do next. While each bank must be considered a unique case there should nonetheless be an established set of procedures for dealing with banks that have been taken over. Such a plan must include a degree of flexibility to seriously study various alternatives and restructuring scenarios and not be entirely wedded to the believe that these banks will be saved by some 'white knight' investor. The government, through IBRA, should announce their concepts and plans for either the rehabilitation of these banks or their imminent liquidation. Political considerations must take second place to the acceptance of financial realities and in favor of the limitation of excessive additional costs.

Placing these institutions under the control of IBRA to work out a future solution by no means assures a rapid resolution to each case. IBRA's ability to effectively manage the restructuring, resolution, or liquidation the commercial banks placed into the BTO category is questionable. With the exception of Bank Bali, now managed by Standard Chartered Bank, and the new senior management team placed into Bank Danamon in late April; operational management of the BTO banks remains one of the major shortfalls in IBRA's overall control and implementation of the bank restructuring process.

The addition of 7 new BTO institutions to the 4 already under IBRA care greatly increased the burden on this agency well beyond its organizational capacity or ability. The failure of Bank Niaga to conclude the recapitalization program and the forced takeover of Bank Bali have placed two more very complex restructuring problems under IBRA's management—totaling overtaxing the agencies abilities to resolve these issues in-house. Over the past six months it has been seen that bank restructuring is the weakest area of the IBRA administration. The agency simply does not have an understanding of the problem and lacks the cadre of qualified bankers necessary to restructure, manage operationally, or effectively market these distressed institutions.

Table 7. below; presents a review of the ownership of these particular institutions and their stated plans for recapitalization as submitted to Bank Indonesia, and may provide possible clues to the rationale for the government's decision to 'treat them differently' than the others:

Table 7.

Banks Taken Over-Review
(Govt. Order of 3/13/99)

Bank	Majority Ownership Group	Recapitalization Plan
1) Bank Duta Tbk	80% by 3 'charitable' foundations formerly controlled by President Soeharto. Exact ownership at present is unclear and ability of shareholders to raise new capital doubtful.	Unknown. Bank has been 90-95% dependent on Bulog operations for its business. Bulog now disbanded. Bank has good branch network outside Jakarta. The future for this franchise is very unclear.
2) Bank Nusa Nasional	A. Bakrie family and PT. Bakrie Finance Corp. Total related shareholding 89% Bakrie & Bros. Is the largest 'pribumi' business group with strong ties to current administration officials	Plan to merge with Bank Pos Nusantara accepted. Overall business plan rejected as unrealistic. Bank owes Rp. 4 trillion in liquidity credits. Ability to raise required capital doubtful due to high level of debt owed by the Bakrie Group.
3) Bank Risjad Salim Internasional	Bank Central Asia (BCA) holds 26.7%, 51.4% held by Salim family and 22.1% by Risjad family. Bank is a second bank operated by the Salim family and BCA is now owned by IBRA under previous takeover.	Bank is totally dependent of BCA for IT support and has gross violation of legal lending limits to Salim family. Bank recapitalization plan rejected on all fronts. The most probable plan will require bank to be collapsed into the BCA workout, which will add at least Rp. 700 billion in costs to the BCA restructuring.
4) Bank Tamara Tbk	3 local business companies (64.9%) which are controlled by A. Latief, former Minister of Manpower and prominent businessman connected with several large conglomerates. Mr. Latief also has controlling interests in Bank Bira-closed 3/99. China Development Corporation (CDC) has a 10% position and the bank is 25.1% publicly held. Strong political connection to current government	CDC has expressed interest in investing required capital to meet 4% CAR level. Bank in violation of 2 Bank Indonesia compliance criteria in limits on related lending and open FX position. Business plan rejected for failure to correct these issues and unrealistic projections. Bank management has argued for more time to comply and qualify for recap program.
5) Bank Pos Nusantara	PT Telekomindo Capital (67.8%) and PT Pos Indonesia (15%) Telekomindo is related to the army pension fund investment in the mobile telephone industry (through the Artha Graha Group) and PT Pos is the national post office.	Bank was scheduled to merge with BNN; future plans unknown. Business plan was rejected and bank is in gross violation of the legal lending limits. However, equity requirement is minimal. Army affiliation should drive a solution in the future.
6) Jaya Bank	PT Pembangunan Jaya (55%) and PT Ciputra Int. (21%) Pembangunan is a construction business of the DKI, the administration Jakarta city, and Ciputra is a major construction operation.	Bank with major business focus on mortgage lending related to government and Jakarta-based property development. Business plan did not include sufficient new capital to cover continued losses. Bank violates all BI compliance criteria and projections indicate future loses With its political base in DKI, a modified recapitalization program is anticipated.
7) Bank Rama Tbk	J. Gondobintoro and PT Gondobintoro hold 31% majority position. 35.9% publicly traded Ownership group includes members of the local Indian community of traders.	35% of loans in property development and hotel sector with balance to Indian trading companies. Recapitalization plan rejected due to failure to invest 20% cash required. Bank has received interest for investment by the Golden Harvest Group of HK

The following table provides further basic financial information on the 7 banks that were 'taken over' by the government pursuant to its orders of March 13, 1999:

Table 8.
Banks Taken Over by Government (BTO)
(Govt. Order of 3/13/99)

In Rp. Trillions

Bank	Total Assets 3/31	Total Assets 7/31	Total Deposits 3/31	Total Deposits 7/31	Total Recap Required	CAR	Monthly Overheads* 3/31	Monthly Overheads* 7/31	Due BI	Total Loans 7/31	NPL (cat. 5) 7/31
1. Bank Duta Tbk	5.7	2.8	4.4	5.4	1.2	(15.6)	14	12	-	4.3	2.7
2. Bank Nusa Nasional	6.3	3.3	2.9	5.7	4.2	(24.6)+	107	93	3.9	3.5	2.0
3. Bank Rasjid Salim Internasional (RSI)	2.7	3.1	2.6	3.5	352 billion	(20.7)	2.4	2.3	-	.360	.141
4. Bank Tamara Tbk	3.8	1.8	3.4	4.0	672 billion	(23.9)	6.7	6.6	-	2.1	1.6
5. Bank Pos Nusantara	.3	.4	.6	.7	130 billion	(20.9)	4.5	3.8	.97	.465	.398
6. Jaya Bank	1.1	.79	.43	1.4	471 billion	(17.2)	2.3	2.6	.87	.639	.303
7. Bank Rama Tbk	1.2	.79	1.3	1.3	338 billion	(24.6)	2.4	2.7	-	.785	.546
Totals	**21.1**	**12.9**	**15.6**	**22.0**	**7.36**		**139.3**	**123.0**	**5.74**	**12.38**	**7.69**

Source: IBRA data
Tbk = Publicly listed
+ As adjusted by BI Selection Committee in March '99: Previously CAR was (210)
* in Rupiah billions

As can be seen in the table above, these 7 banks are all insolvent. As a group they report Rp. 7.69 trillion in category 5 (loss) non-performing loans, an increase over the original levels determined at take over in March. These banks will require a at least Rp. 7.4 trillion in new capital to achieve a minimum 4% CAR. Total new government recapitalization bonds required, which to date have not been included in any official projections, would be at least Rp. 5.9 trillion. This figure assumes that these banks would be recapitalized under the established 80/20 program and (unrealistically) that no additional losses will be incurred during the interim period before the actual recapitalization process is completed.

It is interesting to note that while total assets have decreased over the past four months, most likely due to provisioning for NPLs; total deposits have increased by almost 41%. This has to be as a result of the government guarantee on deposits combined with the high interest rates these institutions continued to pay. The banks continue to report monthly losses and negative spreads even though their average cost of funds have declined by approximately 31% over the past four months. In summary, deposit interest rates have not declined sufficiently to offset the negative impact of non-payment of interest due on loans combined with an increase in the deposit base itself. None of these banks has received any recapitalization bond support to date so their only source of revenue is their extremely weak loan portfolio.

Over the same four month period these banks have been successful in lowering their overhead costs only marginally. As of the end of March, these banks had some 447 branches and over 10,000 employees. There is little indication that they have initiated any cost savings through branch closings or layoffs. Similarly, the status of their repayment of loans due to Bank Indonesia or to their other liabilities to Indonesian banks through inter-bank transactions in unknown. With the exception of bank Duta and BNN, these banks are very small and their ultimate closing and liquidation seems to be the most rational and cost efficient solution to what has been allowed to become an ongoing problem.

To date the approach to dealing with BTO banks has been too narrowly focused on 'saving' these banks based on the misguided beliefs that they are too important to the system to loose and that liquidation would be many times more expensive than recapitalization. For the two years IBRA staff, as advised by an international investment bank, has concentrated its efforts with the first 4 BTO institutions under its control solely towards the goal of restructuring each of these banks, so they could be sold to a new investors. This single-mindedness has been strongly influenced by the fact that this was the decision as made by government officials in early 1998 and no one has dared to raise possible alternatives. There is also a profit motive influencing the advice being offered as the investment banks stand to receive substantial fee income from any sale transaction they assist in structuring.

In late May recapitalization bonds totaling Rp. 80.5 trillion were issued for the original 4 BTO banks. Bank Danamon and BCA together absorbed approximately 90% of this issue. Repeated attempts to sell Bank Tiara to foreign investors failed and by late September Bank PDFCI was merged into Bank Danamon. With the addition of Bank Niaga and Bank Bali to the BTO category, the IMF forced IBRA to develop a new set of plans for the restructuring and recapitalization of all 13 BTO institutions. In summary, IBRA now plans to take the following actions:

- Merge (absorb) the operations of Bank RSI into Bank Central Asia;
- Make an initial public offering (IPO) for 25 to 30% of Bank Central Asia through the Jakarta Stock Exchange in early 2000[17];
- Conduct a rights issue for Rp. 8.85 trillion for the recapitalization of Bank Niaga and recapitalize it on a stand-alone basis for future sale. The rights issue was held in August with the public purchasing approximately 3% (Rp. 266 billion) and IBRA committed to 'purchase' the balance through the issuance of new recapitalization bonds. Completion of this process has been delayed pending perceived improvement in market conditions, the resolution of the Bank Bali scandal and permission from the government actually issue the bonds;
- Hold a rights issue and complete sale of Bank Bali to Standard Chartered Bank. Amount of issue not yet finalized and date postponed pending final resolution of payment scandal;
- Develop Bank Danamon as a 'platform' bank and force the merger of each of the 8 remaining BTO banks into this entity over the next six months;

The continued plans to save Bank Niaga and BCA on a stand-alone basis must be recognized for what they really are: a very weak attempt to cover the financial problems of these institutions with minimal internal restructuring and a further delaying of recognition or a transference of losses. Despite IBRA's continued instance that these banks will be sold to foreign strategic investors, it must be recognized that the touted franchise value of these bankrupt institutions is severely damaged and they are not readily marketable as a whole institution to any direct foreign investor; at any price. In the case of BCA the IPO should be seen as an attempt to defer recognition of the bank's losses onto the public through the stock market as IBRA intends to use the proceeds of the sale to pay other obligations it has to the government.

Since mid-1998 IBRA has been working on restructuring Bank Danamon and BCA while finalizing settlements with their majority shareholders. Both banks were in gross violation of legal lending limits to related corporations and both borrowed heavily from Bank Indonesia for liquidity purposes. In the case of BCA, the related group credits were far greater than the Bank Indonesia borrowings and emphasis was placed on concluding a settlement agreement with the Salim family as part of the restructuring of the bank. In the case of Bank Danamon, there were very few non-bank assets controlled by the principal owners which could be obtained and IBRA entered into a straight debt for equity swap to repay the amounts due to Bank Indonesia.

The latest plan to 'merge' 8 defunct financial institutions into Bank Danamon, which itself is the largest bankrupt commercial bank remaining in the system, has not been well thought-out and should be totally redesigned by outside advisors. When weak or bankrupt financial institutions are merged into a larger bank, which is just as financially stressed; the result is never positive. It appears that the real purpose behind this proposal is to repeat the Bank Manderi exercise where 4 state-owned banks were 'merged' but effectively liquidated, into one new bank. In this case, IBRA should closely study

[17] Technically BCA does not qualify under the current rules of the Jakarta Stock Exchange to list its shares as it has not been profitable for at least two years, is technically bankrupt, and has yet to fully disclose its actual financial structure or the extend of its contingent liabilities. There is also controversy surrounding the use of any proceeds raised by an IPO as IBRA has announced its intention that they will use most of the funds to cover other obligations of the Salim Group. The investor public will also question the value of their share purchase if the funds raised from such an IPO do not directly benefit the financial structure and future profitability of the company

the legal and operational benefits and compare the financial costs of actually closing and liquidating each of the banks separately and only transferring selected assets and liabilities into Danamon from the receivership estates. At the very least, putting each of these banks into liquidation should significantly slow the rate of loss which is now growing on a daily basis. It should also be recognized that such a merger and/or liquidation plan will not be completed quickly and that several thousand employees will have to be laid off.

A final flaw in the outcome of restructuring these banks in this manner is the totally illiquid and non-productive balance sheet structure of the 'surviving' institutions. At the end of this exercise, none of these entities could possibly be considered a sustainable or functioning commercial bank. The restructured BCA and Bank Danamon can most easily be described as large, and very illiquid, mutual funds with a multitude of investors (depositors) and but a single asset (government bonds). They will be illiquid and may not even receive enough interest income to service deposit interest expenses, much less have the liquidity necessary to extend new credit. Depending on the pricing of the government bond held they will suffer continued losses from a negative interest rate margins.

Similar to the 7 banks that were recapitalized in May, the 13 BTO banks have all reported negative net interest margins and operational losses for the first six months of 1999. The following table highlights the operational performances of these 13 banks as of 6/30/99:

Table 9.
Profile of 13 BTO Banks—June 30, 1999

Rp. billions

Bank	Interest Income	Interest expense	Interest Margin	Total Operational Expenses	Profit (Loss) for period
Bank Duta	244.5	754.1	(509.6)	874.3	(581.1)
Bank Danamon	1,817.9	5,252.8	(3,434.9)	7,583.1	(4,973.8)
Bank Bali	779.7	1,080.9	(301.2)	2,292.9	(1,557.8)
Bank Jaya	57.2	175.5	(118.3)	302.2	(241.9)
Bank Niaga	673.6	1,730.4	(1,056.8)	5,790.1	(4,997.9)
BNN	103.2	1,358.6	(1,255.4)	2,553.6	(3,811.8)
PDFCI	92.2	334.6	(242.4)	362.7	12.2
Bank Pos	45.9	97.5	(51.6)	206.5	(156.1)
Bank Rama	87.9	176.3	(88.4)	43.5	(127.1)
Bank RSI	254.5	420.9	(166.5)	529.3	(275.9)
Bank Tamara	173.6	651.5	(477.9)	1,130.8	(627.9)
Bank Tiara	285.9	675.1	(389.2)	739.2	(364.5)
BCA	7,667.8	13,250.7	(5,582.9)	582.6	(579.5)

Source: published financial statements

The key issues to note in these latest financial statements are:

1) All 13 banks report a negative interest spread as the interest revenues received on their essentially non-performing loan portfolio was significantly below interest paid on deposits and borrowings;

2) Except in the case of the 4 original BTO banks, the class 5 (loss) loans have not been transferred to IBRA, interest accruals on these credits were only reversed from income in at the closing of the 6/30/99 statements;

3) Operational expenses are extremely high in the larger BTO banks, indicating that the inefficiencies of these operations may not be resolvable;

4) The actual impact of increasing their deposit base while suffering from weak to non-existent interest earnings has been an increase in losses through negative spreads.

5) The two largest banks, BCA and Danamon have not rationalized their branch networks for efficiency and to reduce very high operational and administrative expenses. To date there have been only minimal employee layoffs and all 13 of these banks remain grossly overstaffed.

There is every indication that a majority of the operating losses reported by these BTO banks is a result of negative interest spreads, as they continue to attract returning and new customer deposits[18]. The bank is paying market rate interest on these deposits, while receiving minimal interest income from its significant non-performing loan portfolio. Because of the government guarantee on all deposits the bank has seen a number of depositors return. However, any liquidity received from these new deposits has been quickly absorbed by interest payments back to these same customers, payments on some bank debt, and continued high overheads. The banks are in a continuing downward spiral; which must manifest itself in the daily increase to the costs of the government-sponsored bailout package.

C. Closed Banks—In Liquidation

The most dramatic component of the March 13th announcement was the closing of an additional 38 commercial banks with the express decision that their operations should be liquidated. There can be no doubt that all of these institutions are insolvent or that a number of them would have been closed long ago, if proper bank supervision and regulatory principles had been enforced. Owners of several of the banks which were originally classified as 'B' protested the final decision stating that they could raise the necessary capital if given more time or that their business plan projections were rejected wrongly. Under current conditions, there can little doubt that there was some degree of political influence and subjective selection involved in this process, but these owners do not have a strong argument on the facts.

Delays in closing these banks earlier has greatly increased the financial losses to the government, due to the impact of both an increasing negative spread situation and the establishment of a blanket government guarantee in January of 1998. This guarantee scheme, which covers 100% of all customer deposits *and* most all bank liabilities, has cost the government some Rp. 43 trillion to date with new claims being filed almost daily. While the need to reassure depositor confidence in midst of a panic run with a government guarantee is understandable, granting the same level of government support for all other bank liabilities is completely unprecedented and must be considered as a major flaw in the IMF program. This action has created a major moral hazard issue by relieving all bank creditors, including international lenders, of any credit risk. It has also greatly prejudiced the government's outlook and approach to bank closings and liquidations as they are now convinced that the cost of liquidation must be higher than recapitalization. The guarantee has eliminated most possibilities for negotiating reductions in bank liabilities through debt/equity or debt/loan swaps and has created the believe within IBRA that their only option is to pay out all creditors through increased borrowing from the state budget.

There are a number of indications that the government is not truly prepared to liquidate these banks as their procedures are structured to allow for considerable time to lapse before any assets are actually sold or for efforts to collect on non-performing loans be increased. To date the handling of banks that have been closed and the disposition of their assets has not been a transparent process. Bank Indonesia closed 16 banks in November 1997 and virtually nothing has been disclosed on the results of these liquidations. The internal structure and operational procedures of IBRA are not conducive to an orderly liquidation of these banks as one division is only concerned with controlling the management and recovery of loan assets while another is marginally dealing with liabilities. The only step in the liquidation process which has been completed so far has been the transfer of customer deposits to other commercial banks. This procedure was accomplished fairly smoothly considering the number of

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[18] IBRA and Bank Indonesia have stated that one of the successes in the recapitalization program has been the return of deposit funds to these banks. It must be recognized that much of this money is actually represented by the transfer of the deposit base from the 48 closed banks and that any renewed trust in the system by depositors is primarily based on the 100% government deposit guarantee.

individual accounts involved and a distinct lack of cooperation form certain employees of the closed banks.

In 1998, the government closed 10 banks and called them *Bank Beku Operasi (BBO);* or frozen banks. This title is indicative of their aversion to the concept, much less the procedures, of an effective liquidation process. Despite IBRA's lack of authority to effect certain transactions over these BBOs until early this year, little work was initiated towards a true liquidation process with them. Neither the government nor IBRA have as yet demonstrated their ability or willingness to adopt a 'liquidation state of mind' over these institutions. They did not properly plan for these bank closings nor develop the required set of personnel skills in the proven methodologies for bank liquidations. Nor have they developed the IT systems necessary to deal with the complex issues and practical problems that are present in such a massive bank liquidation program.

A review of the financial condition of the 38 banks new banks at the time of their closing, indicates that IBRA is now responsible for the management of approximately Rp. 30 trillion in loan assets from these institutions, with at least Rp. 8 trillion of these classified by the auditors as *Loss.* To date IBRA has not transferred any of the loans to its books nor been able to reach debt restructuring agreements on the major class 5 credits. Due primarily to the lack of a centralized accounting system within IBRA, the agency is struggling to properly credit the periodic payments received from those customers who have performing loans; as well as settling other liabilities of these institutions. Most employees have been laid-off but IBRA has rehired approximately 5,000 former bank staff to continue work in these bank during the liquidation process. Positive steps have been taken in closing a number of branches altogether

Customer deposits of Rp. 23 trillion were transferred to four receiving banks with customer access as of March 19th. It has been reported that this amount was reduced during mid-March to approximately Rp. 15 trillion as a result of last minute customer withdrawals during the 2 weeks leading up to the closings. Due to the extreme illiquidity of these banks, these withdrawals had to be funded by increased liquidity borrowings from Bank Indonesia. Consequently, while the level of asset support, in the form of cash and bonds, to the deposit receiving banks has been reduced; the total amount of MoF bonds payable to Bank Indonesia was increased proportionally.

An interesting, but disturbing, feature of balance sheet structure of these institutions is the amount of funds that these 38 banks owe directly to Bank Indonesia—Rp. 23.6 trillion. Some of these liabilities actually represent the funding for several government-subsidized credit programs to small enterprises and cooperatives, but also some are direct liquidity borrowings. To the extent that these debts represent 'pass-though' loans, both the liabilities and the corresponding loan assets should have been transferred out of the liquidating bank and back to Bank Indonesia—at least temporarily. This did not happen. On the other hand, Bank Indonesia should not have been allowed to receive preferential payment nor offset any of these debts against reserve balances or SBI investments held by the banks ahead of other creditors. The record remains unclear as to whether of not this type of preferential transaction was done as the accounting records passed to IBRA by Bank Indonesia were incomplete.. Any initial liquidity remaining in these banks should have been dedicated to the amount of funds necessary to settle the employee's severance payment issue; but this did not occur either.

The publicity surrounding the payment of interbank liabilities, due from closed banks to one of the banks being recapitalized, has highlighted another major problem in the liquidation process. Recent reports have shown that the 48 banks now under liquidation have a significant level of debt for direct borrowings, guarantees, and off balance sheet transactions covering FX derivative and/or letter of credit, due to other local banks. The total for all these liabilities is currently estimated at Rp. 10.5 trillion, a figure which is to be confirmed when an audit now being conducted by an international firm, is completed. In addition to these liabilities, several of these banks have guaranteed bonds issued by subsidiary companies and individual bondholder/investors are also presenting claims against IBRA for payment. The primary question to be resolved is whether or not these liabilities are eligible for payment under the government blanket guarantee of bank liabilities. If these claims are ruled as payable, it is estimated that the cost to government, and therefore the Indonesian taxpayers, of liquidating these institutions will increase by an additional 3 to 5 billion dollars.

With the closing of 38 banks at one time, a number of operational weaknesses in the process have surfaced. Neither Bank Indonesia nor IBRA were properly prepared for the complicated logistical and implementation procedures surrounding the actual liquidation process. Last minute arguments concerning the separation of powers and responsibilities between Bank Indonesia and IBRA led to a continuing breakdown in communications and coordination. The mechanics of transferring the thousands of affected depositor accounts into selected operating banks, and thereby assuring prompt access to funds, proved more difficult than planned because of poor preparation on a number of basic accounting issues.

The most visible indication of the poor execution and planning in relation to these bank closings was in the area of employee relations. The closings have put approximately 18,000 bank employees out of work and there have already been public protests and mini-strikes. Bank employees have begun to organize and are now demanding severance packages and unemployment compensation up to ten times the legal minimums. IBRA bore the brunt of this problem as Bank Indonesia stepped away from any responsibility in this area. Bank Indonesia and IBRA had previously been warned about the impact of causing such a significant increase in unemployment under the current economic environment and have now been strongly criticized for their lack of preparation. The total amount of money required to satisfy employee demands was significant but actually only be a small fraction of the overall costs of the recapitalization program.

As stated above, neither Bank Indonesia nor IBRA seem capable or prepared at this time to undertake the difficult task of actually liquidating these banks. The liquidation of failed financial institutions and the restoration of financial sector discipline must be considered as fundamental elements of the overall restructuring and recovery of the Indonesian financial sector. The best possible outcome requires extensive and careful planning to ensure activities are carried out in an effective manner that is totally transparent to all parties, and in this case satisfies the political dynamics of the country as well. The required experience and skills sets that are needed to complete this work are lacking in Indonesia and it is apparent that the government will require additional assistance from foreign consultants in this area.

Liquidation procedures must be specifically designed to address the closure of branch networks, massive employee termination, critical asset and data security arrangements, and the development of a communications plan which deals effectively with public uncertainty.

IBRA must develop a liquidation program that is able to successfully complete the following goals and tasks:

1. To liquidate the banks in an efficient, orderly, and consistent manner;

2. To conduct a cost efficient liquidation with a goal to maximize the recovery of available assets in a timely manner;

3. To prioritize asset disposition and pricing in proper proportion to manpower requirements and to conduct a cost/benefit analysis of the various alternatives available;

4. Ensure an equitable and proper division of all recoveries to all stakeholders on a basis which is proportional to their claims against the liquidating institution[19];

5. To conduct the liquidation in an environment of transparency with public disclosure of transactions;

[19] Currently, IBRA is operating under the principle that it has rights to receive and utilize 100% of all revenues received from the liquidating banks, whether from loan payments received or asset sale conducted by IBRA. IBRA has the largest stake in these institutions as it replaced the depositors claims and becomes the creditor in the case of any payment under the government guarantee; however, it is not entitled to 100% of all proceeds in any case.

6. To conduct the liquidation while considering the political, economic and social environment in which the process is taking place.

All 48 of these banks have been placed under the management and control of the IBRA Asset Management Unit-Credit (AMC), which has concentrated its efforts to date on gaining control over the different accounting systems, developing internal procedures, and servicing a small number of performing loans. They are still in the process of analyzing the loan portfolios and identifying those credits which should be transferred to them for future debt restructuring. IBRA has been somewhat successful in closing branches and converting selected offices into 11 IBRA controlled, regional centers for loan processing, There has been limited effort and negligible result in collecting payment on the larger non-performing loans and/or foreclosing on collateral assets. The AMU has held eight public auctions to sell non-core assets, mainly bank vehicles previously owned by these banks.

As with any liquidation program, costs have far exceeded revenues to date. IBRA reports that overall expenditures that can be attributed directly to the liquidation costs of these banks, totals Rp. 3.8 trillion as of 7/31/99. These expenses include severance payments, costs associated with the transfer of deposit liabilities, and ongoing operating expenses. Loan recoveries and all funds received from the asset sales are placed in deposit accounts under the individual bank name. These funds are used to make future payments for expenses and will be periodically debited for transfer to the Ministry of Finance to repay related obligations. IBRA declined to reveal the total balance accumulated in these accounts to date.

IBRA's experience to date, coupled with the addition of 38 new banks to be liquidated as well, strengthens the argument that the agency needs to increase its staff and engage the services of experienced bank liquidation experts. The ability of IBRA to succeed in its role as the agency responsible for efficiency in bank liquidations with minimum cost and maximum recoveries is highly dependent on the competence of its staff and degree of external expertise and guidance that it utilizes.

D. State Banks

The state-owned banking sector represents the greatest loss exposure and cost component of the bank recapitalization program as designed. The government's decision to include all of the state-owned financial institutions, including the 27 regional development banks, in the current recapitalization program means that an estimated total of Rp. 235 trillion (US$33.5 billion) must be extended in new bonds. As the government is already the only shareholder in these institutions, 100% of the recapitalization cost for these institutions will directly impact the national budget. The overall cost of saving these institutions will be increased by a number of factors, not the least of which is interest payments on the recapitalization bonds themselves. This is very much a case of 'robbing Peter to pay Paul' where government funds are expended to bail out failed government operations. Future generations of Indonesian taxpayers will bear the full burden of this component of the recapitalization program; both directly with through future tax increases and indirectly, through opportunity loss as limited government budget allocations will not be readily available for other economic support programs.

The government is joint owner with the provincial administration of 27 regional development banks that have traditionally been the vehicle for government subsidized lending programs into the provinces. These banks, only 5 of which hold foreign exchange licenses, represent less than 3% of the loan assets of the system. All of these banks are windows for the various government credit programs to small and medium enterprises and cooperatives, with the majority concentrating on agricultural lending. However, an analysis of their market dynamics reveals that over 80% of the loan outstandings are concentrated in the larger Java, Sumatra, and Bali based operations. Likewise the highest level of loan losses are found in these same banks which have lent heavily to urban based property development projects. Total loan outstandings for these 27 banks are reported to be Rp. 7.8 trillion and a total 14 (52% of the total), will require government assistance to return their capitalization to a 4% CAR level. In May the government issued new recapitalization bonds for these banks totaling Rp. 1.3 trillion. A second series of audits, currently underway, is expected to reveal that these banks will require additional recapitalization funds to cover ongoing losses on operations.

The largest impact on the government budget will be the recapitalization of the 7 large state-owned commercial banks. Four of these banks, which were primarily commercial banks, have now been collapsed and merged into a new entity—Bank Mandiri, while the remaining 3 are to be recapitalized and allowed to operate on a stand alone basis.

The following table outlines the current status and recapitalization bond requirements for these 7 banks:

Table 10.
Government Banks—Status

Bank	Total Loans as of 12/98+	Of which NPL	Total Equity as of 12/98++	Recap Bond Req.
Bank Bumi Daya*	36.9	72%	(36.6)	*
Bank Dagang Negara*	45.2	49%	(28.5)	*
Bapindo*	20.3	73%	(14.2)	*
Eximbank*	34.2	52%	(27.5)	*
Bank Mandiri	as of 6/98		As of 6/98	137.8**
Bank Rakyat Indonesia	48.7	45%	(10.1)	52.8
Bank Tabungan Negara	13.9	48%	(7.8)	11.2
Bank Negara Indonesia	65.7	66%	(24.9)	31.6
			Total	233.4

* Merged into Bank Mandiri as of 10/1/99 ** as per Bank Mandiri projections
++ Negative equity after ADDP adjustment
+ Loan balances before write-offs and adjustments under ADDP

As can be seen, all 7 of these banks are bankrupt and suffer under the burden of extremely high levels of non-performing loans. Despite years of external assistance programs and previous recapitalization attempts[20], the recent international audits represent the first time that the government has been forced to admit the true extent of the losses inherent in these banks. Collectively, their entire portfolio of non-performing loans is estimated to exceed Rp. 193 trillion, at least 60% of which have been classified as *doubtful* or *loss*. As it is well known that the majority of the large project loans and credits extended to companies affiliated to Soeharto family members are included in the portfolios of these banks, IBRA will be tasked with a very difficult collection and recovery problem indeed[21].

Earlier this year some 1,200 class 5 (loss) non-performing corporate loans, totaling Rp. 106.4 trillion were transferred from the 7 state banks to IBRA[22]. As a result, the newly established Bank Mandiri was left with a gross loan portfolio of approximately Rp. 58 trillion, against deposit liabilities in excess of 174 trillion. To date IBRA has been able to categorize these loans into industry groups and has begun a new series of due diligence examinations of the debtor companies in order to initiate debt restructuring programs. Analysis of the transferred credits shows that 72% of the book value of these loans are with large corporate borrowers while over 85% of the credits, by number of accounts, are smaller retail loans. Retail credits of less than Rp. 1 billion in book value as well as small and medium enterprise loans were not transferred to IBRA. Because of the sheer volume of credits and IBRA's limited resources for loan work outs, commercial credits with a book value between Rp 5 and 25 billion were transferred back to originating bank for management.

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[20] Since the mid-1980s, all of the state banks have received technical assistance from international consultant firms for various credit, bank management, and organizational programs. In 1994 the World Bank funded a US$300 million program to recapitalize selected state banks. This program failed to achieve its perceived goals due to design flaws as well as corrupt lending practices that led to further losses and de-capitalization of the banks.

[21] The media has released a list of the 50 largest debtors of the 4 state banks being merged in to Bank Manderi. This list, which indicates gross violations of the legal lending limit regulations, shows total outstandings to these borrowers of approximately US$ 2.3 billion.

[22] Rp. 66 trillion of this total was transferred from the four state banks which now make up Bank Manderi

The collapse of four state banks into one new institution is considered a positive step in the resolution of the banking crisis and can be considered as a key driver in the long-term reform of the system. The rationalization of the branch network and the downsizing of the redundant staff and the integration of international accounting and loan underwriting systems, are all positive and cost beneficial results of this merger. Bank Manderi was officially opened on August 1st and is still in the process of converting selected branches and consolidating customer operations.

The opening balance sheet of Bank Manderi highlights a number of structural weaknesses created by this forced merger of four bankrupt institutions:

Table 11.
Bank Manderi Opening Balance Sheet 10/1/99

In Rupiah billion

Account	Total	Account	Total
Assets		**Liabilities**	
Cash and Due from BI	8,540	Demand Deposits	18,383
Due from Banks	10,861	Savings & Time Deposits	149,539
Marketable Securities (net)	145,953*	Other Current Liabilities	4,795
Loans (net)	41,204	Certificates of Deposit	3,122
Investments	157	Issued Securities	2,709
Fixed Assets (net)	876	Borrowings	14,471
Accrued Income and Prepaids	1,347	Payables	2,255
Other Assets	5,965	Other Liabilities	7,726
		Subordinated Loans	4,956
		Loan Capital	2,690
		Paid up Capital and Reserves	4,257
Total Assets	214,903	**Total Liabilities**	214,903

- Includes Rp. 137.8 trillion in 'Due from Government' which is the projected recapitalization bond requirement.

The opening balance sheet of Bank Manderi clearly indicates the bank's vulnerable position as government recapitalization bonds exceed the remaining loan portfolio by almost Rp. 80 trillion. Recapitalization bonds, the majority of which will pay a rate equal to the 3-mointh SBI rate equal 64% of total assets and over 50% of total earning assets. The bank's earnings are overly dependent on a non-negotiable government instrument which is paying well below the market rate for new loans. While interest rates on deposits have been forced down of late, the costs associated with total volume of deposits assumed from the four merged banks still exceed the earning potential on these bonds.

An additional weakness is the bank's a very large short position in foreign exchange with only Rp. 36 trillion in foreign currency denominated assets versus Rp. 45 trillion in foreign currency liabilities. This position is well in excess of the open position allowed under current Bank Indonesia regulations. The bank must obtain more non-Rupiah based earning assets or continue to be extremely vulnerable to the impact of foreign exchange fluctuations on its earnings.

Lastly it should be noted that although the balance sheet reports a total of Rp. 137.8 trillion in recapitalization bonds as *Marketable Securities* at August 1st, the actual placement of the first tranche

of these bonds was not made until mid-October.[23] As of October 14th the government placed Rp.103 trillion in recapitalization bonds into Bank Manderi and committed to a final tranche in December; pending the results of a due diligence audit to determine the actual amount that will be required. The management of bank Manderi was also required to sign a performance agreement containing various (undisclosed) conditions which must be fulfilled before further recapitalization bonds will be issued.

The recapitalization programs for the remaining 3 state-owned banks; Bank Negara Indonesia, (BNI), Bank Rakyat (BRI) and Bank Tabungan Negara (BTN) have been delayed several times in the past months as their business plans and financial projections have been subjected to a series of reviews and revisions by the World Bank. The future viability of BRI and BTN is very much as they are to revert back to their original market specializations of rural credit and low cost housing finance. Both of these institutions were unable to maintain profitability in these areas in the past and began to expand into commercial credits; with disastrous results. With the commercial loan portfolios removed, major structural changes in internal lending practices and loan pricing is still required before these banks can be expected to become profitable. A study conducted by the World Bank concluded that BTN should be closed and its housing portfolio distributed to several smaller private banks which have the capacity to service mortgage related credits. The bank long ago ceased lending directly to low and middle class individuals directly, structuring the majority of its credits through real estate development companies.

Bank Negara Indonesia (BNI) has the highest level of NPLs among these three banks at 66% of total loans. As 26% of the bank's shares are owned by non-government investors, it is expected that its restructuring and recapitalization will be similar to the five publicly traded private commercial banks and that it will also go through a rights issue exercise. The recapitalization cost for BNI alone is projected to exceed Rp. 52.8 trillion and its future ability to extend significant new credit into the economy has to be questioned as well. Among the four remaining state banks BNI is the one most greatly in need of an internal reorganization and upgrade in operational procedures.

All three of these banks have reported continued negative spreads and operational losses for the first six months of 1999 as highlighted in the following table:

Table 12.
Financial Condition of 3 State-owned Banks—6/30/99

In Rupiah billions

Bank	Interest income	Interest Expense	Interest Margin	Loss for the Period	Total negative Position*	Recapitalization Costs
BNI	4,113	8.885	(4,772)	(2,848	(10,235)	52.8 trillion
BRI	4,520	5,746	(1,226)	(355.3)	(26,860)	31.6 trillion
BTN	690.0	1,913	(1,223)	(937.4)	(11,480)	11.2 trillion

* it is unclear if this figure includes operating losses for 6 months of 1999 or not.

Delays in the recapitalization program combined with ongoing operational losses have increased the overall costs of 'saving' these state-owned banks. Combined with Bank Manderi, the recapitalization costs for the state-owned commercial banks seems certain to exceed the current estimate of Rp. 234 trillion; perhaps by as much as an additional 15%. This saving of the state banking sector represents over 65% of the costs for the entire bank recapitalization program and as such is of questionable value. By far the majority of the loan losses will be realized from this sector and the future ability of any state-owned bank to efficiently compete in a reformed banking sector and restructured economy is highly questionable. These banks should be forced into privatization as soon as possible, if for no other reason, then to remove the temptation of further abuse by government authorities and politically connected businessmen.

Negative Spread

One of the most difficult issues compounding the difficulty of structuring a sustainable bank recovery program in Indonesia is the problem of negative interest margins, or negative spread, plaguing the

[23] It is hoped that despite wrongly 'padding' the opening balance sheet that Manderi has not begun to accrue interest earnings on these bonds until actually received.

banking sector today. This negative spread situation developed primarily because the banks continued to pay high interest rates to attract and maintain customer deposits while concurrently suffering from an extreme lack of interest income due to non-performing credits. There is also a factor attributable to past pricing practices of the banks and government monetary policies, but the main driver is total non-receipt of interest revenue.

Traditionally, banks will price their loan extensions at a margin over their cost of funds. As long as this margin is sufficient to cover overheads and the loans perform as written, the bank should report a profit. The collapse of the Indonesian economy with the devaluation of the Rupiah, as well as years of poor underwriting practices have now manifested themselves with a vengeance, dragging almost the entire banking sector into bankruptcy. The bank recapitalization program, as currently designed, does little to resolve this problem as the recapitalized banks will now be highly dependent on the coupon rate for the government bonds they will receive for the income to pay ongoing interest expenses on deposits.

As a result of the recapitalization process, control over the negative spread conundrum will shift away from the banks and create a complete mismatch between the pricing mechanisms affecting their deposit base (interest expense) and their earning assets in government bonds (interest income). Market forces such as inflation and the public's faith in the stability of the local currency dictate the pricing of customer deposits, while government money market and fiscal policies drive the interest rates on government issued debt paper. These two factors are often in conflict as the public demands real returns in line with their perceived risks and government strives to keep its interest expenses down and inflation in check. The case for Indonesia is further complicated by the current government policy of intervening in the market to keep the Rupiah from depreciating further. The result is a very volatile pricing scenario for the banks seem to be caught in a trap that only a change in government policy can remove.

Over the past seven months Bank Indonesia has forced interest rates downward; first through the weekly auctions of the SBIs and secondly by advising the commercial banks (now majority owned by the government) that deposit insurance will only be granted on those deposits which pay no more than a maximum of 300 basis points above the one-month SBI rate. As the first tranche of recapitalization bonds was not issued until the end of May, the positive impact of accruing interest on these bonds is not a major factor in the June 30th in the earnings figures for the first six months. On the other hand, the government will have to further reduce deposit interest rates below the SBI rate and drop the spread on deposit guarantees as this actively encourages negative interest spreads and artificially maintains an inverted yield curve.

The government has practically assured that negative spreads will remain an issue by the fact that have priced the majority of the recapitalization bonds at the 3 month SBI rate. At the end of the proposed recapitalization program, it appears that the remaining banking system will be dependent on government bonds for at least 75% of its interest income, on average. As the bank's ability to improve their earnings through new loan extensions is limited; there is therefore a strong need to seek alternative pricing mechanisms to resolve the negative spread problem. The international financial markets have developed a number of derivative instruments that could be adapted to assist the Indonesian authorities with this particular problem.

Recapitalization Costs

The resolution of the Indonesian banking crisis, as currently structured, is almost entirely predicated on the issuance of various types of government debt instruments to fund expenditures and for the recapitalization of the banking system. The Ministry of Finance; the only government body authorized to issue official government debt, has now developed and issued several different bond instruments to cover the costs of the liquidity credit advances from Bank Indonesia, provide support to banks receiving deposits from closed banks, and replacing NPLs removed from the balance sheet of the commercial banks—the so called recapitalization bonds.

The following table provides a summation of the bonds issued to date and their announced cost structures:

Table 13.
Profile of Bonds Issued
(May 28th—October 15th , 1999)

In Rupiah trillions

Bond Type	Amount Issued	Tenor	Coupon Rate
Floating rate bonds to recapitalize commercial bank up to zero CAR	95.15	16 series of bonds with from 3 to 10 years maturity	Interest rate tied to 3 month Bank Indonesia SBI rate. Interest payable quarterly
Fixed rate bond to recapitalize banks up to 4% CAR*	8.68	2 series of bonds with 5 year and 10 year maturity	12% fixed for 5-year bonds and 14% fixed for 10-year bonds. Interest payable semi-annually
Index bonds issued to Bank Indonesia for repayment of BLBI advances and payments made under government guarantee scheme	145.0 53.78	Various, with a maximum maturity of 20 years	Interest rate set at 3% above inflation rate, payable semi-annually. Interest portion due to inflation scheduled to be capitalized annually.
Sub-Total	302.6		
Floating rate bonds as 1st tranche in the recapitalization of Bank Manderi. Issued October 14,1999	103.0	A series of bonds with maturities from 3 to 10 years.	Interest rate tied to 3 month Bank Indonesia SBI rate. Interest payable quarterly
Total Bonds issued to date	405.6		

- Regional development banks are scheduled to be further recapitalized to an 8% CAR with an increased level of fixed rate bonds

The remaining balance of recapitalization bonds which are scheduled to be issued to the state-owned banks in December or early in the new year are projected as follows:.

1. BNI	Rp. 52.8 trillion
2. BRI	Rp. 31.6 trillion
3. BTN	Rp. 11.2 trillion
4. Bank Mandiri	Rp. 34.8 trillion (balance)
Subtotal:	95.6 trillion

Additionally, Bank Niaga and Bank Bali are projected to require an approximately Rp. 12 trillion in new bonds. If any of the 7 new BTO banks are if fact recapitalized through this mechanism, the total could rise again by as much as an additional Rp. 8 trillion. Lastly, it is reasonable to assume that Bank Indonesia will require further bond coverage from the Ministry of Finance as it makes additional payments under the government's guarantee scheme. A total of Rp. 10.4 trillion in new bonds may be required to cover this component of the bank recapitalization program. In summary, the total of all bonds issued to date and projected as required in the near future could be as high as Rp. 531 trillion , approximately $ 76 billion at current exchange rates. Recently the government admitted that the total costs could be in the Rp. 550 trillion range and Moody's Investor Service projected the total cost for the Indonesian bank restructuring program to be $82 billion, or almost 150 % of the 1998 inflation-adjusted GDP of the country.

One of the fundamental flaws in the structure of this bank recapitalization program can be clearly seen in the level of annual interest expenses that must now be paid to the banks. The Government of Indonesia is

constitutionally required to operate within a balanced annual budget. However, even by offering a rate equal to the government's benchmark SBI rate on the majority of the bonds, the annual interest expenses will be far above the current approved budget figure of Rp. 17 trillion for fiscal year 1999/2000.There simply isn't enough money available for the government to finance the bank recapitalization program in this manner and future rescheduling of interest payments seems assured. The government is caught in a balancing act between minimizing its costs to within reasonable budgetary levels, and paying a high enough rate on their bonds to assist the recapitalized banks return to profitability.

The following table provides more detail on the bonds issued and subsequent government ownership position to each of the commercial banks to date:

Table 14.
Bonds Issued by Bank—May 1999

In Rupiah trillions

Bank	Total Bonds Issued*	Shareholder's equity contribution+	Percentage government equity+
Bank Indonesia Intl.	8.71	2.47	77.8%
Lippo Bank	7.73	950 billion	90%
Bank Universal	4.59	477 billion	90%
Bank Arta Media	130 billion	45.7 billion	74%
Bank Bukopin	381 billion	95.3 billion	80%
Bank Prima Express	615 billion	153.8 billion	80%
Bank Patriot	52 billion	13 billion	80%
subtotal	22.2	4.20	
12 Regional Development Banks	1.23	270 billion	82%
4 BTO banks:		A minimal portion of	
Bank Danamon	Total for all	publicly held shares	99.9%
Bank Central Asia	4 banks:	(diluted by rights issue)	99.9%
Bank Tiara	80.47	remain listed on the	99.9%
PDFCI		stock exchange	99.9%
subtotal	103.9	4.47	
Bank Mandiri	103.0	State-owned bank	100%
Total	206.9		

- Complete breakdown between floating rate and fixed rate bonds issued not provided by IBRA
+ Figures extrapolated from known data

The projected annual debt service requirement for these bonds is many times the Rp. 34 trillion (with only Rp. 17 trillion included in the budget), assumed for the 1999/2000 fiscal year. The actual interest bill on the liquidity support bonds and fixed rate bonds is a known factor, and the annualized costs of the floating rate bonds can be calculated on a quarterly basis. Assuming that the 3 month SBI rate averages 13% through March 31, 2000; a *rough* calculation of the interest bill for this fiscal year would amount to approximately Rp. 23 trillion. This is below the Rp. 34 trillion originally projected because of delays in the issuance of these bonds. It is however, above the Rp, 17 trillion allocated in the current budget. The shortfall is assumed to be received from IBRA through its programs for debt recovery and asset sales. For the next fiscal year, which begins in April, 2000, it is projected that the annual debt service burden on some Rp. 500 trillion in bonds will exceed Rp. 75 trillion, or 35% of the current budget.

The recapitalization bonds as currently structured are not negotiable instruments, meaning that at present, the banks can not sell them on a secondary market. This is an impediment to a banks' ability to expand credit. It would be a desirable feature to have these bonds tradable on a secondary market as the banks would then have the ability to raise cash to fund new loans. This source of liquidity would work in an ideal market, or when only one or two financial institutions in the system hold such instruments. In the case of Indonesia, there are several problems with this scenario:

- The capital base of virtually the entire banking system is being supported with these bonds, which currently hold a zero risk weight for capital adequacy ratio calculations;

- Once the bonds are salable on a secondary market, they will be priced by the market—in this case at a significant discount because of their pricing structure, long-term final maturity, and perceived purpose;

- When a market discount price is set, the value of the bonds remaining on a bank's books will have to be 'marked to market', i.e. similarly discounted. This will cause a proportional deterioration in the CAR;

- The local market for Rupiah denominated bonds is heavily saturated with a number of issues in local corporate bonds. The market prices and turnover have been very weak over the recent past due to currency fluctuations and political risk. These factors seem to be improving but probably not enough to absorb a major new inflow of government debt instruments;

- The central bank would not readily want to be in competition with itself on money market policy issues. Bank Indonesia controls liquidity in the market through its weekly auction of treasury certificates (SBIs) and these bonds are really an extension of this program as their coupon rate is directly tied to the 3-month SBI rate;

- Bank Indonesia would want to restrict the sale of these bonds by any one bank to a certain limit in order to better control credit expansion (possibly inflationary) in the system and to better monitor the credit underwriting procedures of the banks.

Neither the government nor the IMF seem to have adequately addressed the issues raised above and it appears that both parties are more interested in piecing together a program that appears to work but actually passes the problems into the future. Given the overriding importance of the recent elections and the need for political stability with the current change in government; such actions are understandable. However, it should be well recognized that the recapitalization bonds represent a number of financial problems that will not disappear simply through denial.

An alternative pricing mechanism for the recapitalization bonds, as currently structured, must be developed. Since the government is willing to capitalize all but 3% its own interest payments on the Ministry of Finance liquidity bonds now due to Bank Indonesia, perhaps it should consider the same accounting slight of hand for the recapitalization bonds as well. The recapitalization bonds could pay a positive margin over the SBI rate with the majority of the coupon payment due quarterly capitalized back into the principal of the bond for payment at final maturity. In this manner the banks would show positive interest earnings through accruals while the majority of the government's actual interest costs are deferred into the future. The actual cash flow in income received by the banks would be lower, and this would have a negative impact on the accumulation of loanable funds, but a program to phase more liquidity into the system could be devised as the economy and the banking sector stabilize. Again, there are alternative methods and structures available to the Indonesian authorities if only more flexible approaches are allowed to be explored and vetted.

Debt Recovery/ Corporate Restructuring

Indonesia is caught in a vicious circle as it tries to extricate itself from continued economic meltdown and it can be seen that the ultimate recovery of the financial sector is inextricably linked to a simultaneous recovery in the corporate sector. Recovery in the corporate sector is in turn dependent on the restructuring of its massive debt burden to the banking sector. The government has expanded its domestic debt burden exponentially in order to save the banking sector; massive debt recovery appears to be its only source of repayment. As discussed above, the entire banking system is technically bankrupt, with non-performing loans in excess of 70% of GDP, and the debt burden of the corporate sector that will require a major organizational restructuring effort within virtually every marginally viable company.

The conundrum is that the government needs to recover payment on past due loans sufficient to offset the cost of bank recapitalization, while most corporations (debtors) need new funds in order to continue in business and meet past debt servicing obligations—even after any significant debt

restructuring program has been agreed to. The recapitalization bond do not provide the banks with sufficient liquidity to extend new credits of any size. Simultaneously, and absent a return to past lending practices, most corporations do not exhibit the levels of creditworthiness nor cash flow ability to obtain new credit.

From the efforts made to date (by both IBRA and The Jakarta Initiative), it is apparent that there are a number of Indonesian debtors who are truly bankrupt and significant losses will have to be recognized and accepted as fact. Among those corporations that are struggling to stay afloat it appears that their financial structure is so weak and their debt burdens so extensive; that they will have to undergo a major restructuring of their internal operations and management in order to survive long enough to service their restructured or rescheduled debt. Some forced mergers may be required and the current foreign shareholders some of the joint-venture corporations are likely to be required to increase their investment or suffer a significant dilution in their ownership position.

Two years after the collapse of the Rupiah, and despite some notable debt rescheduling agreements being reached, it is calculated that the Indonesian corporate sector still has over $70 billion in unpaid foreign debt. This is in addition to an almost equal amount in non-performing Rupiah denominated loans. There has been only minimal progress in restructuring, or even rescheduling, this enormous millstone as many debtors continue to delay and even stonewall attempts to collect monies owed. At the heart of this problem is the need to reform the legal system which overly protects the debtors. That a sound and enforceable legal system with rational corporate laws must be created and implemented is irrefutable. The corporate sector must be required to operate within such a legal system in a transparent manner and under the real threat of financial loss and even criminal charges. Recent rulings by the local bankruptcy court have only reinforced the belief by defaulting debtors and foreign investors alike, that the system does not work and there are no negative consequences for malfeasance.

The prompt and equitable resolution of the outstanding corporate debt issues is a fundamental component for the recovery of the country's financial sector as well. The banking system failed primarily because of non-performing loans to large, and in many cases related, corporations. As the loans went into default, many local banks failed. Foreign banks which have been forced to absorb large write-offs are now rightly reluctant to extend new credit into the Indonesian corporate sector. As the domestic banks are still insolvent and illiquid, they will not be able to actively participate in new corporate lending activities for some time. The keys to encouraging new loan growth include massive debt and corporate restructuring programs and sweeping legal reforms.

There is a real and growing dichotomy between debt restructuring requirements of the corporate sector and the goals and abilities of IBRA; now the primary creditor in the country. There is mounting pressure for the agency to report progress in debt restructurings and to consummate asset dispositions (sales). However, IBRA to date has adopted an inflexible, and in the long run unworkable, approach to debt restructuring. The stated government policy of 'no haircuts' is completely unrealistic and will have to be adjusted before IBRA can negotiate in good faith with the debtors and consummate any sustainable deals. In a growing number of cases, present policies have made IBRA more of an advisory than a cooperative participant on various creditor committees. In actuality a significant haircut in terms of NPV is already occurring because of delays in settlement.

Additionally, IBRA has fallen into a real trap as they consider the NPLs transferred to them as 'assets', when in fact they are still non-performing loans whose net recoverable value probably averages less than 25%. IBRA does **not** have or 'own' Rp. 600 trillion in 'assets'—they actually have management and collection rights on some Rp. 260 trillion in bad loans, several trillion in non-financial assets (fixed assets) from the banks which have been closed, and the right to sell shares in a number of non-bank companies received in settlement from certain bank owners against Bank Indonesia liquidity credits. The actual recoverable or realizable value of these 'assets' is highly speculative given the political and economic uncertainties of the country. Most analysts have projected that a realistic estimate of final net recovery from the NPLs transferred to IBRA at 20 to 30 cents on the dollar—over a period of 5 to 6 years.

Indonesian Bank Restructuring Agency (IBRA)—its role in the recovery of the financial sector

There can be no doubt of the importance of the Indonesian Bank Restructuring Agency (IBRA) as this recently created government agency is nothing short of the keystone to the recovery of the corporate and banking sectors of Indonesia. The agency has been established with unprecedented powers to intervene and manage resolution and recovery programs for almost the entire spectrum of the Indonesian economy. Currently IBRA is responsible for, or strongly involved in the following aspects of bank restructuring and financial recovery programs in progress in Indonesia:

- Loan workout and debt recovery of bank credits transferred from distressed banks;
- Restructuring and sale of banks taken over by the government;
- Management oversight of banks which have been recapitalized with government bonds;
- Joint-management with Ministry of State Owned Enterprises for the recapitalization of the state-owned banks;
- Liquidation of closed financial institutions;
- Sale of non-core (non-financial) assets from closed banks;
- Management and sale of corporate assets received in settlement from former bank owners;
- Reconciliation and repayment to the government all funds received in recovery of government advances and expenditures related to the restructuring of the banking sector.

With the passage of the revised banking law and its implementing regulations late last year, IBRA achieved the necessary legal framework and authorities to move forward. Because of delays which can be partially attributed to the lobbying efforts of a number of influential parties, the government only began the serious implementation phase of the bank recapitalization program in mid-March, 1999. As a result IBRA was charged with several daunting new tasks, including:

- The liquidation of an additional 38 commercial banks, bringing the total of banks to be liquidated to 48;

- The management and restructuring of 7 additional banks, which increased the total number of institutions under the BTO program to 11[24];

- The transfer of some 1,200 separate non-performing loans from the state-owned banks totaling approximately Rp. 107 trillion (US$15 billion)

Despite the lack of an efficient organizational structure and an often counterproductive and decentralized management style; the IBRA staff has worked diligently on an increasing number of complex financial issues assigned to it and has achieved notable progress in certain areas over the recent past. Through the second and third quarters of 1999, IBRA staff continued to concentrate its efforts in the following areas:

1. The completion of the ADDP reviews and subsequent due diligence audits on selected commercial banks;

2. Review of the audit results for classification and acceptance into the recapitalization program;

3. Implementation of the bank recapitalization program in cooperation with Bank Indonesia;

4. The liquidation of the 10 'frozen' banks placed under IBRA control in 1998 and the 38 banks closed in March 1999;

5. The recapitalization and merger of 4 'taken over' banks under IBRA control in 1998 and the study for restructuring of 7 new banks 'taken over' last March;

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[24] The number of BTO banks was increased to 13 as both Bank Bali and Bank Niaga subsequently failed to meet the necessary criteria for normal participation in the bank recapitalization program.

6. Finalization of financial settlements with selected corporate groups for non-bank assets and investments owned by bank shareholders against outstanding Bank Indonesia liquidity advances and inter-group credits. This work now continues with the shareholders of several of the banks closed or taken over last March.

7. Mapping and classification of non-performing loans transferred to the Asset Management Unit from the closed and recapitalized banks and initiation of due diligence studies of majors debtors for the purpose of negotiating debt restructuring and recovery programs;

8. Continued efforts to expand and upgrade the internal organization of the accounting and administrative support departments.

With the IMF-designed bank recapitalization and recovery program now underway in earnest, IBRA has entered into a new phase in its mandate. While it was always known that IBRA would be the main vehicle for collecting the non-performing loans transferred from the banks, the sheer volume and variety of problem loans that have been transferred to the agency (to date in excess of Rp. 230 trillion) for recovery, as well as the number of banks that it must liquidate (48), or restructure (13); has severely taxed the limits of the agency's abilities. IBRA's performance to date with the 10 banks that were closed in 1998 and the first 4 banks taken over for recapitalization and sale has not been impressive.

The lack of staff and mid-level management with applicable experience in loan workouts and bank liquidations has been a very critical shortfall. Many of the professional staff hired in recent months are bright and enthusiastic people, but they sorely lack the perquisite level of experience to efficiently complete their task. Slowly, the IBRA staff is gaining experience with these complex issues and some improvement on an individual basis has been noted in the last few months. The agency continues add people at a very rapid pace with the number of direct hire staff now exceeding 500 The recently reformed risk management group is now belatedly catching up with the two main asset management groups and adding the staff necessary to handle its complex tasks. Additionally, IBRA has hired some 4,420-contract employees to work in the 48 closed banks and senior management teams for the 13 BTO institutions.

However, despite significant increases in overall staff levels and ongoing advice from its financial advisor/ investment bank consultant team; IBRA is still not adequately prepared to properly manage, resolve, or account for: a) the myriad of bank liquidation issues if faces, b) the complex nature of the non-performing loan workouts it is responsible for, c) the sale of a complex set of non-financial assets which must be sold, or d) the disposition of a wide range of investment assets that have been placed under its administration. The future performance of IBRA and its ability to complete its mandate is currently being compromised by the nature of its internal organizational structure with its the low level of inter-departmental cooperation, duplication of effort in critical areas, and lack of a comprehensive strategic plan.

The following section describes the current state of the IBRA organization and a summary of its status and progress through September 1999:

The IBRA organization is currently divided into 4 main divisions:

1. **Asset Management-Credit**, in charge of recovery on non-performing loans, bank liquidations and sale of bank related assets;
2. **Asset Management-Investment**; in charge of recovery from all non-bank assets received or controlled by IBRA and the restructuring of the BTO banks;
3. **Risk Management & Legal**, in charge of determining the agency's risks, payment liabilities and legal functions;
4. **Finance & Administration**, in charge of centralized accounting and agency administration functions.

Asset Management-Credit (AMC)

The AMC group is now responsible for the recovery and collection of approximately 108,000 separate loan accounts totaling Rp. 230 trillion, the majority of which are classified as category 5 (loss) loans; which have been transferred from both the private sector commercial banks and the 7 state-owned banks. To date, category 5 loans have not been transferred from Bank Bali, Bank Niaga nor the 38 banks closed last March. The current breakdown of these loans in the AMC shows that 76% of the loan values are to large corporate accounts while 94% of the number of accounts are smaller retail clients.

This is the lead unit within IBRA responsible for loan workouts and debt restructuring. The AMC as expanded noticeably in the past year as its 'portfolio' has grown. Unfortunately, AMC management and staff seem to have developed a belief over this period that they have the ability (internally) to recover 100% of the book value of the loans they now control--despite the fact that many of them were fraudulent in nature at inception. They are also under a delusion regarding the perceived value of the collateral or security held against these loans. Much of the documentation for this 'collateral' is legally flawed and it will be difficult for IBRA to actually gain overall control of some of these 'assets' in a manner which will allow them to be sold free of unresolved third-party claims. IBRA has been granted certain extra-legal powers on foreclosure and seizure of corporate assets designed to give the agency more leverage and to 'assist' it in gaining repayment on these non-performing loans. To date, IBRA has threatened to use its powers but has not done so, primarily it is believed because of the political uncertainties in the country at the moment.

As of the end of September, there has been no final debt restructuring, credit workouts, loan restructuring, or recovery from any of the large corporate borrowers or loans classified as 'loss'. So far IBRA has only been able to classify the major loans under its control into 4 broad categories of potential recovery and has been successful in getting some 150 of the 200 largest debtors to sign a broadly worded 'Letter of Cooperation'. The threat of preemptive asset seizure or litigation if the borrower fails to cooperate, remains IBRA's primary weapon of intimidation at this stage. However, IBRA management needs to adopt a more realistic approach to the concept of 'time value of money' and realize that the loans and other non-financial assets controlled by IBRA are in fact depreciating in value over time. There is no guarantee, and certainly no precedent from other financial crisis experiences, that IBRA will be able to achieve greater returns in the future.

It is noted that a significant percentage of the large credits held within the AMU-Credit group are to property-related business—either hotel/resort developments or commercial buildings. The fact that the commercial property market in Indonesia is overbuilt and extremely weak, strongly implies that IBRA's ultimate source of recovery on these credits will have to be from the ultimate foreclosure and sale of the underlying real assets. To date IBRA has not taken actual title to any of these properties and there are a number of questions surrounding the legality of some of the collateral documentation involved, land title documentation, and the ability to legally sell this type of real estate to foreigner investors.

The AMC has received revenue on a voluntary basis through periodic loan payments from a small group of debtors. These repayments have been primarily from the smaller commercial or retail-credits extended by the closed banks where the borrowers are still making at least partial payments. IBRA reports gross income from this source of approximately Rp. 1.5 trillion through the end of September.

The AMC also controls the disposition of non-core bank assets in the 48 closed banks currently under liquidation. In this regard, they have held eight public auctions of bank owned art and vehicles. To date IBRA has recovered some Rp. 140 billion (approximately US$ 18 million) from the sale of these non-banking assets through a public auction process.

The AMC successfully completed the sale of the credit card receivable portfolio of one of the closed banks to a local joint-venture financial institution. This sale was reportedly done at a discount from the recorded book value of these receivables and brought receipts of Rp. 29.6 billion into IBRA. The actual amount remains uncertain as the agency has so far refused to release the full details of this

transaction—possibly for fear that it would reveal the fact that a discount (or 'haircut') was accepted by IBRA.

Appendix 1. of this paper presents the current organization chart of the AMC and several pages from an internal IBRA publication discussing the debt restructuring strategies of the AMC

Asset Management-Investment (AMI)

The AMI division of IBRA now has control of non-bank shares, securities, and corporate assets of some 230 separate companies, valued by the investment bank advisors at Rp. 175 trillion, and which they intend to dispose of over a 4 year timeframe. Most of these assets are from settlements with the major shareholder groups of banks which have been closed or taken over by IBRA. These assets are now controlled, but not owned; by IBRA through its relationship with 6 newly established holding companies.

Since first structuring this form of settlement, there has been little progress in actual asset disposition or public marketing of the companies. To date the AMI unit of IBRA has been able to realize actual cash proceeds from the sale of some publicly traded shares, the outright sale of 3 corporate jets, and the purchase of the local shareholding in a chemical processing plant by the foreign joint-venture partner. IBRA also received the proceeds from the sale of minority position in a ceramics company to American Standard. Approximately $47 million has been received from such asset dispositions, but again the agency has been less than transparent in providing details on these sales.

It should be well understood that IBRA does not have direct ownership of the shares of these companies and can not dispose of them without giving the existing shareholders the right and opportunity to pay back the related debt themselves. The corporate shares have merely been placed into the holding company and then further pledged to IBRA by virtue of a promissory note issued by the holding company in favor of IBRA. There is no direct linkage, such as a sinking fund, which places any cash flow burden on the operating companies to repay the debt of the holding company (of which they should now be considered a subsidiary of) to IBRA.

IBRA's control over the disposition of assets received through these settlements is supposed to derive from the fact that the agency will hold a majority position on the Board of Directors of these 'paper companies' and therefore will be able to control all decisions related to recovery of monies due. Disturbingly, for the future management and collection against these assets, IBRA's staff can not be considered as sufficiently qualified to properly control the actions of these companies or their original shareholders. To date IBRA has not seconded qualified outside managers to sit on the boards of these holding companies nor dedicated the internal resources sufficient to properly value and manage these assets.

The future sale of these companies or their shares is planned to be the eventual source of repayment for the liquidity advances that are now owed to IBRA by the holding companies. In fact the government has committed that Rp. 17 trillion will be collected from this source during the 1999/2000 fiscal year. The holding company structure devised is overly complicated and appears to leave too much control in the hands of the original owners who are no longer as directly liable for the debt repayment as before. The AMI has developed a philosophy of not imposing management control on the operating companies themselves, but a more universal system of oversight through periodic financial reports to be presented to the directors of the holding company. Given the severe illiquidity in the local investment market and despite the heavy discount in asset value imposed by IBRA, the future sale of these companies and therefore any meaningful level of recovery on these liquidity advances must be considered as problematical.

As regards asset disposition, IBRA must realize that it is in competition with the rest of Asia for limited investor funds. With local businessmen nominally bankrupt, IBRA must realize that the only market with any depth is dominated by foreign investors who will not pay more than a realistic market price; these foreign investors must be considered the primary client base for the AMI. Traditionally, foreign investors are looking for full or majority ownership positions, long-term profitability and political security. Alternative investments completed in recent months in other Asian countries, as well

as political uncertainties in Indonesia, have put IBRA and the AMI significantly behind schedule. In order to complete actual sales of non-bank assets (i.e. operating companies), IBRA needs to get on with it and be more aggressive in contacting and negotiating with prospective buyers.. While the political climate has improved considerably with the election of a new President, there is still a high degree of uncertainty. The unresolved Bank Bali scandal and the perceived continuation of corrupt practices are also having a negative influence on current investor interest and will be reflected in any final sales price.

Appendix 2. of this report presents a set of internal IBRA papers which discuss the asset disposition program as envisioned by the AMI and a listing of the companies currently held in the holding companies.

The AMI is also responsible for the restructuring and resolution of the 13 commercial banks which have been 'taken over' by the government. In this respect, they 'control' a number of financial and non-financial assets of these institutions. Although all of these banks are technically bankrupt they remain in operation and are continuing to accrue operational losses on a daily basis. The problems associated with the planned restructuring of these banks, their operating losses, ongoing financial costs and recapitalization requirements are presented in detail earlier in this report.

As discussed above, IBRA is responsible for the liquidation of 48 commercial banks; 10 closed in 1998 and an additional 38 closed in March 1999. It must be reported that the liquidation of these institutions is not proceeding at a proper pace and additional losses have been incurred because of delays and inefficiencies in the IBRA's efforts in this area. Legitimate third-party claims against the assets of the closed banks are not being properly addressed and several lawsuits against IBRA have now been filed or are in process. The prompt, complete, and equitable liquidation of these banks must be considered a priority and since IBRA is ill-prepared in the methodologies of bank liquidation, the work should be out-sourced to an experienced international firm.

Risk Management-Legal

IBRA recently formalized the creation of a risk management division which will be responsible for assessing and monitoring the risks inherent in the completion of IBRA's mandate. The risk management group is to provide a new level of 'checks and balances' to the overall process and ensure that established policies and procedures are followed in the three main work area of loan workout and debt restructuring, asset sales, and liability management. In many respects the risk management group shall act as an internal auditor—on an operational level. All asset sales and debt restructuring agreements above a certain value will be reviewed by the risk management team for compliance with established procedures. Because of the mixed nature of the innumerable non-performing loans controlled by IBRA and the complex nature of the non-bank assets that are to be valued and sold; the risk management group will have to employ industry specialists as well as experienced loan officers to review these transactions.

As a direct result of the Bank Bali problem, this group will also be responsible for monitoring all liabilities of the closed banks and claims filed with IBRA under the government guarantee program. This in itself will be demanding and important task for the group. The legal department, which has staff placed into each of the divisions will also report directly through the risk management group.

Finance and Administration

The Finance and Administration group is responsible for the accounting, human resources, IT, and Treasury functions of IBRA. This group is well staffed but suffers from a lack of centralized authority in several key areas, primarily accounting. One of the major operational and organizational problems in IBRA is the multiple accounting systems for both revenue and expense transactions that are currently utilized thorough each division independently. This is particularly true with the AMU-C which does its own operational accounting for loan payments, debt restructuring, and asset sales. These transactions are rarely reported to the Financial Controller of IBRA and the result is a complete inability of the agency to produce a consolidated financial position report. The lack of a well established, centralized accounting system which can properly monitor, control, and consolidate the

myriad of transactions which pass through IBRA is an important issues which must be resolved soon if the agency is ever to be able to produce an accurate consolidated financial report or cash flow statement.

Review of IBRA Organization

Concurrent with the recent criticisms arising from the handling of the Bank Bali payment, IBRA is now under increased pressure to improve the overall transparency of its transactions and provide more public disclosure of its current operations. This has led in turn to a number of questions regarding the agency's slow pace with any meaningful debt restructuring and asset disposition. Considerable criticism has been leveled about the delayed bank liquidation program and the deteriorating financial condition of the 13 commercial banks taken over by IBRA over the past 18 months. There have been numerous complaints from international creditors, prospective investors, and major debtors regarding their inability to deal effectively with IBRA or to conclude any negotiations. The agency's public image has been severely damaged by its lack of transparency and lack of performance.

IBRA management is also having to respond to the renewed realization of the increasing costs of the bank recapitalization bond program and the possibility that they may not be able to meet its goal of raising Rp.17 trillion in revenue towards the debt service requirements of the government by next March. Although IBRA management has publicly stated that they have raised some RP. 8 trillion towards this goal to date, actual gross revenues to agency are far below this figure. The cash value of IBRA's net liquid assets that could be readily applied as real contributions to the government's debt servicing requirements has been estimated to be less than Rp. 3 trillion as of the end of September.

Revelations of the internal operational weaknesses which allowed the Bank Bali transaction to occur through the agency, have greatly assisted the World Bank staff in their quest to convince IBRA management of the need for changes in the agency's organizational structure and operational procedures. Consequently, the World Bank is currently finalizing a new technical assistance agenda for IBRA with an Operational Governance Review and Reform Program which is designed to address many of the organizational and operational issues which have been raised over in recent months. The object of the World Bank corporate governance review is to: *'strengthen the enabling operating environment-internal and external-that IBRA functions in, to ensure that the agency has the capacity, and appropriate policies, procedures and practices in place to carry out its responsibilities'*.

This program promises to be an extensive undertaking which will go beyond the initial phase of an internal assessment of the organization's operational policies and procedures and into the implementation of recommended structural changes necessary to achieve future performance. It should be noted however, that like all technical assistance projects, the success of this project will very much depend on the 'political will' of the government as well as the recipient to accept and implement the organizational changes recommended. The scope of work requires the consultant firm to extend their review to cover governance procedures, including the decision-making powers and procedures of various external governing bodies which influence IBRA's operations. The likely outcome of this aspect of the study will be recommendations concerning IBRA's reporting relationship to the Ministry of Finance vs. the MPR and a clearer division of authorities and responsibilities between IBRA and Bank Indonesia as regards management and oversight of the recapitalized banks.

The program is designed to emphasize a thorough review of IBRA's internal policies and practices on financial reporting, covering its adequacy and consistency with international standards for bank liquidations, asset sales, and bank restructuring. In addition there will be a long overdue assessment of IBRA's internal financial reports: their level of quality, accuracy, transparency, format and frequency. Improvements in this area will come as a result of substantial changes in current operating procedure, including the consolidation of the separate accounting groups now operating in the two asset management units.

The Bank Bali Affair—Impact on IBRA and Financial Sector Recovery

There can be little doubt that the payment transaction involving Bank Bali has had a negative impact on the bank recapitalization and financial sector recovery programs. Superficially, this whole affair appears to be a simple case of misappropriation of government funds[25]. However, upon closer scrutiny this scandal, which is now commonly referred to as *"Baligate'*, is much more complex with its roots entangled in the very psyche of long established patterns of Indonesian power politics and corrupt business practices. In many respects, the fact that this scandal has now come to light is an indication of just how ingrained such practices are and how little has actually changed in matters of moral hazard or corporate governance over the last two years. On the other hand, the fact that it has become such a *cause celebe* at all is a positive statement on the progress openness in the country since the change in government in mid-1998.

The payment to Bank Bali for a portion of its inter-bank claims against closed financial institutions was made under the terms of the government's announced guarantee of all bank liabilities. This blanket guarantee scheme, put in place by Presidential Decree in January 1998, has effectively created new opportunities for this type of rent seeking and abuse as it is overly vague and defective in its design. While the guarantee was instrumental in partially reversing the public run on deposits, it has also negated all semblance of credit risk against the banking system and seems ripe to reward many of the parties responsible for the financial losses in the first place.

The guarantee scheme has significantly increased the cost of the banking reform program, placing an additional estimated loss for third party liabilities (both local and foreign) in excess of US$ 6 billion directly to the government. The belated realization by the government of this potential loss prompted one audit into the flow of funds related to this transaction and a second review of the structure of the guarantee scheme by two international accounting firms. The IMF and World Bank have publicly stated that they want a "full and transparent investigation and a 'satisfactory" solution to the Bank Bali issue. A political stand-off has developed and the multinational agencies have suspended future disbursements under their various economic recovery programs until a resolution is achieved. This in turn has placed an additional impediment in the path towards economic recovery.

Public outcry over this scam was sufficient to cause the perpetrators to return the money[26], with several officials declaring that that should be the end of it. The fact that most of the funds were transferred back into the country from third party foreign accounts, totally different from where the funds were disbursed; is not considered relevant by some government officials.

An independent audit of the fund flows resulting from this payment, as well as an internal audit of IBRA's procedures and involvement in this affair, has been conducted by an international audit firm. For a period of three and a half months there were a series of delaying tactics and attempts to severely compromise the scope of these audits as well as limit the disclosures of their findings. This past week, following completion of the presidential elections, the full audit report was finally released to the parliament. It now seems apparent that a complete public disclosure of the actual use of this money and possibly a clear placing of culpability on the main parties involved will occur. Market perception has been that this audit was merely a pro-forma exercise to be used by the government to rationalize and 'legitimize' its forthcoming explanation that there were no real criminal acts committed and that the issue is 'resolved' since the funds have been 'paid back'.

[25] The basic outline of this transaction is the fraudulent transfer of approximately $80 million in government funds that were paid to Bank Bali under the government's guarantee scheme covering inter-bank debt, to a private company controlled by senior official's in Golkar (the government party). This 'fee' was paid out for assistance in collecting this recovery from IBRA. Such a payment was totally unnecessary, the fee was 'unearned', and the bank incurred a direct loss for an equivalent amount. Current evidence strongly points to collusion among various government officials, IBRA management, and private businessmen to further use these funds to influence the electoral process in favor of the re-election of President B.J. Habibie.

[26] The funds were repaid over a four-day period in late August and have been placed in a special escrow account at Bank Indonesia, pending the finalization of their investigations. Bank Bali continues to be 'out-of funds' and in a loss position at this time.

Published documentation strongly indicates that the senior management of IBRA was involved in this transaction well beyond the agency's normal role as paying agent under the government guarantee scheme. There have been strong allegations involving two of IBRA's deputy chairmen for their involvement in advocating and expediting this payment to Bank Bali. Both deputy chairman have been named as official suspects in this case; one has been suspended from his position while the other appears to be continuing in his daily duties. Whether these charges prove true or not, the image and reputation of IBRA as well as its ability to lead the restructuring of the banking sector, has been severely, possibly irretrievably, damaged. The type of payment problems highlighted by this scandal has also brought to light many of the internal operational weaknesses of IBRA.

The Bank Bali scandal has impacted IBRA negatively as it has brought a number of the agency's managerial, operational and risk management inefficiencies under increased public scrutiny. IBRA's shortcomings in this sequence of events range from a failure to recognize the extent of Bank Bali's exposure to other local banks under IBRA control, through a general mishandling of procedures related to the government guarantee program, to possible collusion with third parties to expedite payment to Bank Bali with prior knowledge of the planned payment of unjustified fees. It appears certain therefore that repercussions from the Bank Bali affair, coupled with the recent change in the government administration, will precipitate changes in IBRA's management team. The level of public criticism aimed at IBRA, its internal structure and operational methodologies, as well as the honesty of its senior management has caused a morale problem among a number of the more junior staff who now express concern about their future as well. Any mass defection of staff would mean a significant setback in achieving the goals set for IBRA as such an action would create a manpower and experience gap that would be most difficult to overcome.

To date Bank Bali has received the only cash payment out of approximately US$1.8 billion in pending local inter-bank claims which may fall under the guarantee scheme. The government has little liquidity to effect these payments in cash and may ultimately be forced to resort to issuing more recapitalization bonds to the creditors banks to cover their losses in this area. In order to prevent any further misuse of the guarantee fund and to expedite pending claims, the government has now appointed an independent auditing firm to review all outstanding inter-bank claims and determine their eligibility for repayment under the guarantee scheme.

Conclusions

It should be well understood that the figures presented in this paper can not denote the total or final cost of the bank recapitalization program for Indonesia They are however, an accurate presentation of the costs incurred to date combined with projections based on publicly disclosed plans. As with any recovery process, the cash flows for this program are very difficult to predict, except to the extent that outflows will far exceed any inflows at the beginning. The overall costs of this program will be greatly dependent on the ability of IBRA to achieve substantial recoveries from the multitude of bad loans it is charged to collect. The costs associated with these collections in such areas as legal fees, appraisals, fees to investment banks, and sales commissions which will be paid for the disposition of real assets, will be substantial. There can be no doubt that the overall costs of asset collection and bank liquidation combined with the debt servicing requirements of the recapitalization bond program will far exceed funds received from actual loan recoveries. Overall the Indonesian economy will suffer economic losses of several tens of billions of dollars.

The banking sector's ability to renew its lending activities into the economy depends on the identification of creditworthy borrowers as well as sufficient liquidity for new credit. The fall out from this economic crisis has left very few healthy corporations remaining and strong underwriting skills will be necessary if banks are to avoid repeating past mistakes. The future liquidity of the banks will be the determining factor in their ability to reenter the market and provide the new credits required to revive a crippled economy. Without a resolution to the negative spread problem, the banking sector will continue to 'de-capitalize'.

It will be years before sufficient retained earnings can be generated by the banks to allow further reinvestment in their capital, or for them to be able to buy out the government's new equity position. Although this recapitalization program buys some time and brings a modest amount of fresh capital to

the system, the overall recovery of the banking sector will be very slow in materializing and the banks will still be rated as extremely weak well into the future. It is difficult to be optimistic about the probability of attracting new foreign investment into the financial sector while the banks remain technically bankrupt, only surviving on the placement of government debt paper onto their balance sheets; or while considerable debt overhang in the corporate sector continues to exist.

This report has brought together the myriad of issues and problems that constitute the current crisis in the Indonesian banking sector. A review of the extent of the loan losses as well as the structural problems encountered leads to the conclusion that strong and innovative measures must be taken if the banking sector is to ever return to its proper role in the economy. The Indonesian bank recapitalization program as currently designed and implemented by the IMF and Bank Indonesia, provides but minimal movement towards this goal. While positive action steps have been taken in the closing of a number of banks, overall this plan has been plagued by half measures, poor planning, and an outdated overly-structured approach. The greatest flaw in the program is the attempt to achieve massive recapitalization with a minimum of new funds, thereby ensuring continued illiquidity in the system and practically guaranteeing that further recapitalization will be required by the surviving banks in the near future.

Attached as Appendix 3 to this report is a re-print of a speech recently presented to an economic forum in Jakarta by Dr. Gary Hufbauer of the Institute for International Economics in Washington, DC. In his speech, Dr. Hufbauer touches on many of the same points raised in this paper and presents an interesting eight-point program designed to clean up the current financial problems while setting Indonesia on "a new course of modern finance". The author agrees with many of the points and recommendations presented by Dr. Hufbauer and notes that leading Indonesian economists are prescribing much of the same medicine..

Table 15 on the following page presents a matrix of recommended action steps to be taken in the areas of Macroeconomic Policy, Banking Sector Reform and Recapitalization, Debt and Corporate Restructuring Requirements and Corporate Governance and Operations Issues in IBRA. There are obviously additional policies, follow-up measures to be addressed, and actions, which need to be taken by the new administration; however, this matrix does present many of the problems and issues discussed in this paper.

Matrix of Recommended Action Steps for Financial Sector Recovery

Macroeconomic Issues & Policy

ontinue IMF-led program for country's acroeconomic framework through policies hich promote:

- Maintenance of programs which encourage stability in prices and low inflation rates;
- Steady monetary policies with lower interest rates and prudent management of fiscal policy;
- Rationalization of customs and taxation procedures with increased transparency in policy implementation;
- Revision and consolidation of all direct and contingent liabilities and off-balance sheet activities of the government;
- New reform programs and lower costs for government sponsored pension schemes;
- Review of structure of current bank recapitalization bond program for impact on state budget;
- Development of a rational and sustainable program for revenue sharing with local governments through fiscal decentralization;
- Continuance of due diligence audits and preparation of state-owned enterprises for privatization;
- Continuation and expansion where justified of established social safety net programs led by the World Bank.

. Honor contracts and accept international arbitration rulings on state enterprise debts.

Banking Sector Recapitalization & Reform

1. Review structure and long-term impact on banking sector of the current recapitalization program for commercial banks.
2. Re-study the overall cost impacts to the government budget vs. the future solvency and operational sustainability of the recapitalized banks;
3. Expedite the complete liquidation of the 48 closed banks with assistance from international experts;
4. Give immediate priority to the 13 banks currently under BTO status and employ international firms to assist in process of merging, closing or selling these banks
5. Revise structure of current government guarantee scheme for all bank deposits and liabilities. Lower coverage on deposits and remove guarantee on inter-bank and other funding sources;
6. Design and establish a rational and affordable deposit insurance scheme to be implemented within 1 year;
7. Continue program to establish a new independent bank supervision agency;
8. Reassess current policy for recapitalizing the 4 state-owned banks and develop time-bound programs for privatizing state-owned banks;

Debt and Corporate Restructuring

1. Continue programs for legal reform with emphasis on review and revision of bankruptcy laws. Strengthen current enforcement procedures. Consider the establishment of an international panel of judges to provide oversight and advice to bankruptcy court on an interim basis;
2. Promulgate a more flexible government policy towards debt restructuring and instruct IBRA that it can negotiate more flexibly with debtors. Adjust current perception that the government will not accept discounts or haircuts on any credits now owed to IBRA;
3. Finalize establishment of interagency debt restructuring committee. Expand role into a joint government- private sector commission with powers to formulate official policies and guide the debt restructuring process,
4. Eliminate impediments and develop rational incentives to encourage the foreign participation in corporate restructurings and a return of direct foreign investment
5. Develop more proactive government programs for strengthening the programs of the Jakarta Initiative and integrate IBRA into the debt restructuring process;
6. Review and revise as necessary the applicable commercial codes, stock market regulations and laws business which currently provide loopholes in international standards and financial practices.

IBRA Corporate Governance & Operations

1. Expedite the scheduled World Bank sponsored *Corporate Governance Review* of IBRA operations and internal procedures. Be prepared to engage the international expertise necessary to implement the changes that will be recommended in the review.
2. Strengthen IBRA management team through regular strategic planning sessions to be held jointly with other government agencies and selected private sector participants.
3. Improve the corporate governance structure of IBRA through the continued enhancement of the role of the International Review Committee and its in-house Secretariat team.
4. Revise overall priorities for IBRA mandate to recognizes immediate need the to stop losses in BTO and closed banks as well as to expedite a program of asset sales in a transparent manner.
5. Develop a more realistic and flexible approach to loan workout and debt restructuring policies and methodologies. Adjust current policies on 'no haircuts' and the single obligor concept.
6. Review non-performing loan portfolio and begin immediate legal proceedings on chronic defaulters.
7. Employ time value of money concepts to accept 100% write-off on loss loans where obvious and sell performing loan groupings at NPV.
8. Reset asset sales priorities for AMC and AMI units of IBRA. Initiate aggressive sales program of traded shares held. Package corporate assets and invite potential investors to conduct due diligence of corporate assets for sale.
9. Require the immediate consolidation and control over all accounting related functions into the Finance and Administration Group.
10. Purchase and install previously approved upgrade to existing loan servicing IT system.

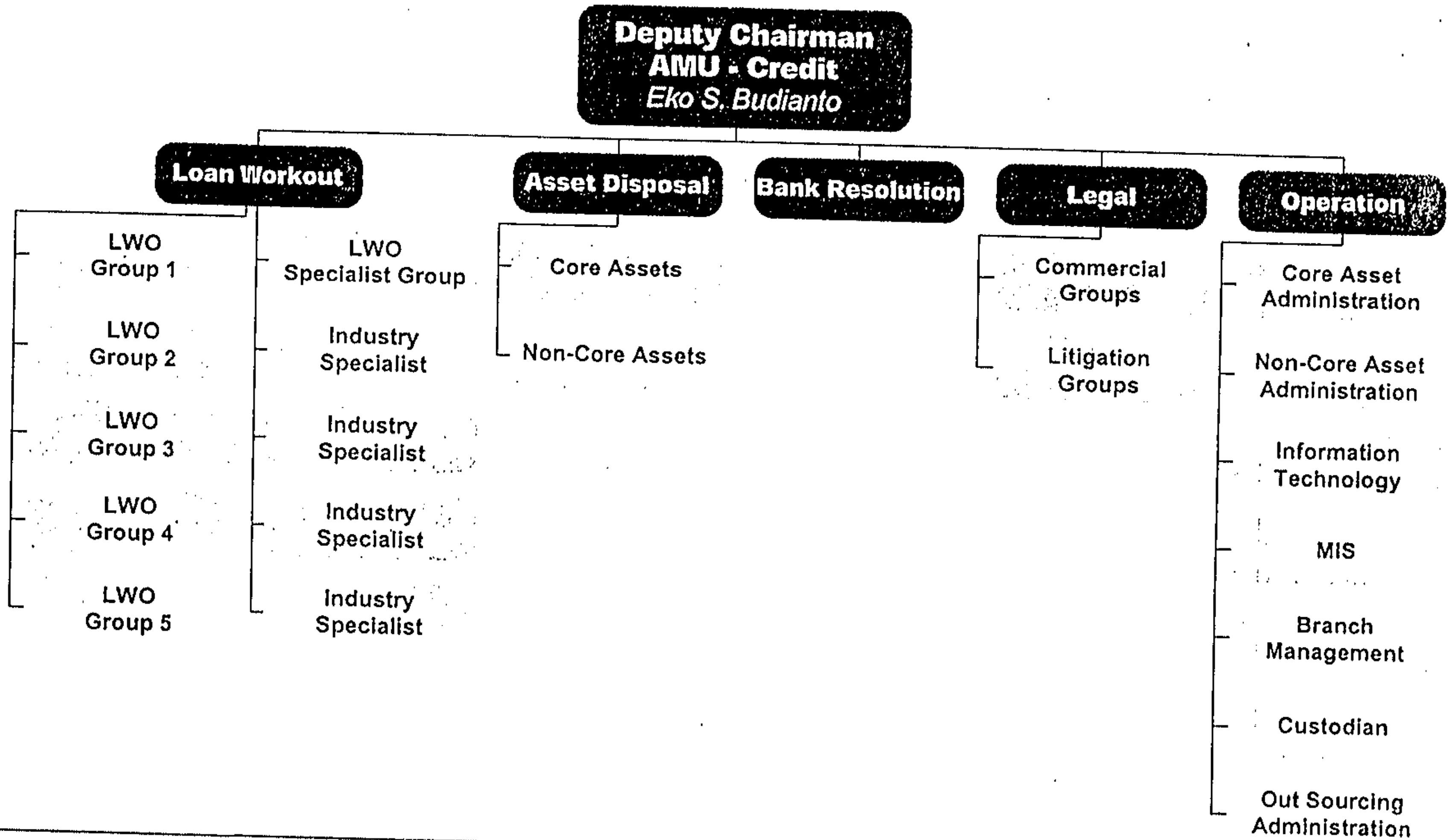
Appendix 1.

IBRA—Asset Management Unit Credit

Organization Chart
and
Debt Restructuring Presentation

Asset Management Credit

Organization Structure



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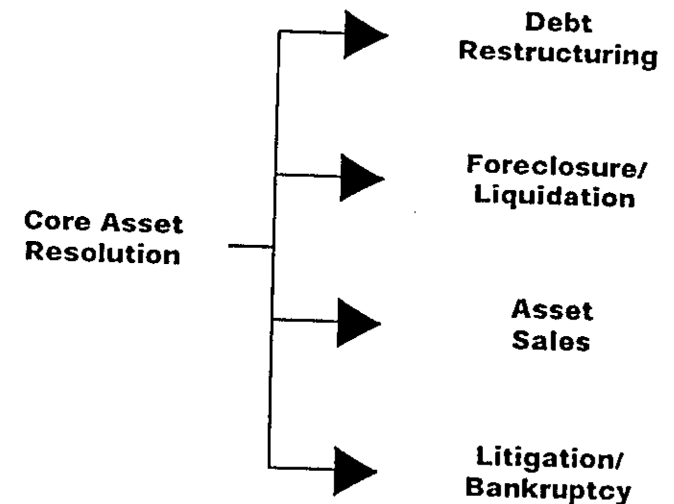
Corporate Debt Restructuring

Corporate Debt Restructuring

Debt Recovery Framework

- Collection through repayment, restructuring, or asset foreclosure/liquidation
- Restructuring of loans to viable borrowers with good business prospect, good asset value, high integrity and willingness to negotiate in good faith
- In the restructuring process, IBRA will use independent third party consultants/advisors for fairness, transparency and best practice procedures
- IBRA will facilitate debt restructuring done through Jakarta Initiative and INDRA



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Corporate Debt Restructuring

Restructuring Principle

Maximize Recovery

- Utilize multiple workout approach
- Encourage transparency and good corporate governance
- Capitalize on "One Obligor" Concept
- Employ international best practices
- Put IBRA special powers into action
- Work with third party creditors
- Publicize bad debtors

Minimize Social Cost

- Furnish working capital and trade finance facilities when appropriate
- Support labor intensive and export-oriented industries
- Utilize government programs to support small and medium businesses

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Corporate Debt Restructuring

Debtor Classification

Class	Classification	Actions
A	Good business prospect with good intention	• Debt restructuring • Asset sale by debtor • Debt to equity conversion
B	Poor business prospect with good intention	• New capital injection • Asset swap • Debt to equity conversion
C	Good business prospect with poor intention	• Litigation • Foreclosure
D	Poor business prospect with poor intention	• Bankruptcy • Liquidation

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Corporate Debt Restructuring

Debtor Classification

Business Prospect

- Potential to generate positive cash flow
- Multiplier effect to other industries
- Employment
- Prospect of product or service
- Potential to increase efficiency and competitiveness

Intention

- Initiate and actively negotiate with creditor
- Full disclosure
- Share the loss
- Preparing or in the process of preparing restructuring plan

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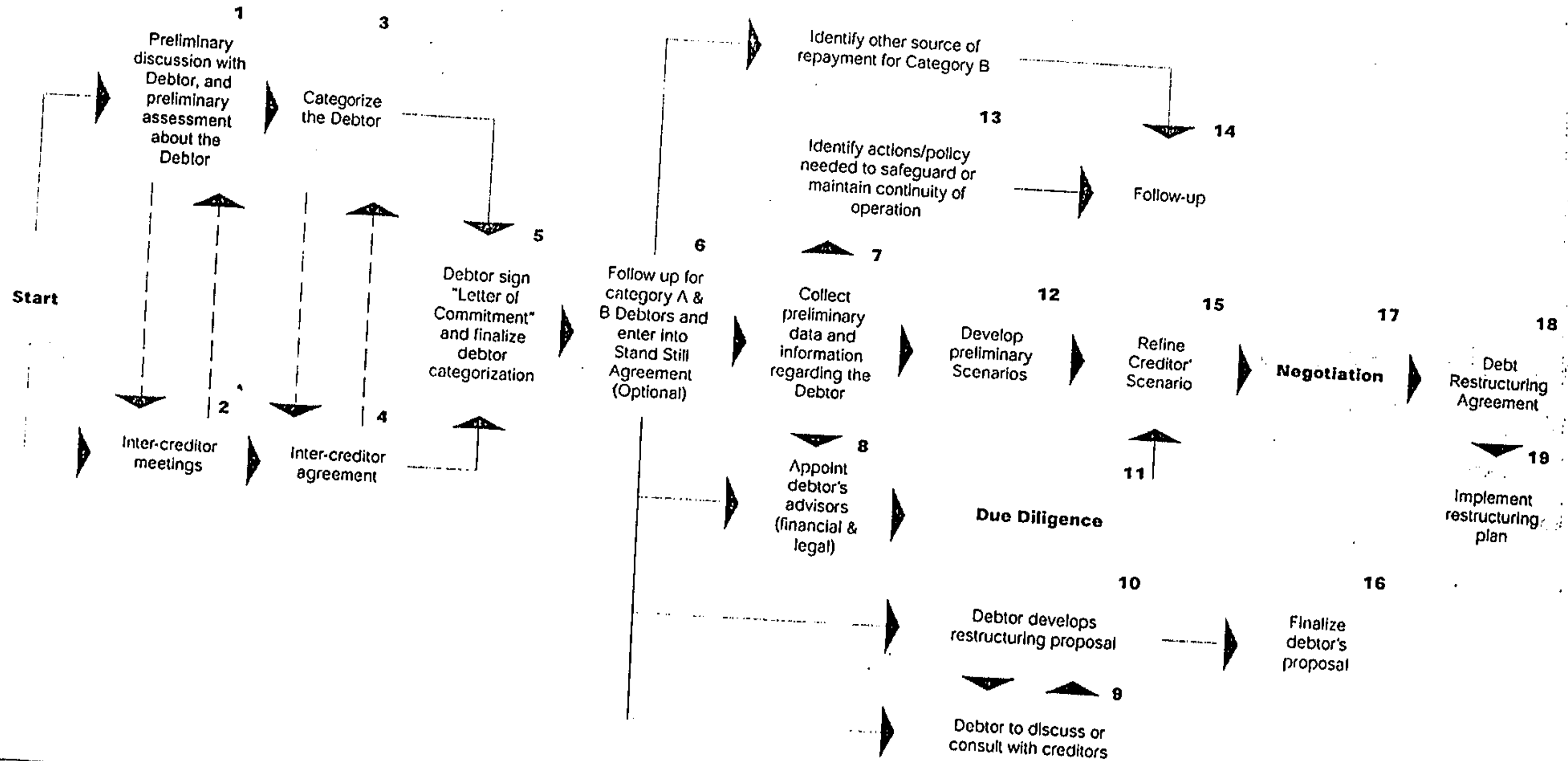
Corporate Debt Restructuring

Debt Restructuring Process



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Corporate Debt Restructuring

Current Restructuring Alternatives

- Payment rescheduling
- Extension of loan tenor
- New capital injection through shareholder or new investor
- Repayment of part of the principal to reduce the outstanding debt
- Asset sales by debtor
- Debt to equity swap
- Issuance of convertible bond

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Core Asset Sales

Divestment Strategy

- Performing retail loans will be sold immediately through refinancing scheme
- Consumer loans will be repackaged to enhance the value for the purpose of sales or asset securitization
- Small business loans (SME) and commercial loans will be restructured prior to sales
- Corporate loans will be restructured prior to sales or refinancing, which will take sometime
- Equity ownership from the conversion of loans will be divested during or after the restructuring process

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Non-Core Asset Sales

- **27 open auctions conducted from December 1998**
  - 2,349 automobiles, 808 motorcycles and 863 artworks were sold, resulting in Rp 139 billion in proceeds.
  - Public open outcry auctions
- **Additional assets for sale will include**
  - Artworks
  - Office equipment
  - Furniture
  - Real estate
  - Automobiles
  - Motorcycles

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Appendix 2.

IBRA—Asset Management Unit Investment

Asset Disposition Program
and
List of companies placed in holding companies

Holdcos – Portfolio

- The Holdco Portfolio is dominated by the Salim Group's Holdiko Perkasa with 55.8% of the asset sale transfer value. Gajah Tunggal's Tunas Setandan Investama is next with 31.6% of transfer value.

(All data in trillions of Rupiah)

Holdco	Shareholder	Amount	Companies	IBRA Transfer Value	Cash Transferred	Companies Transferred to Date	Requires IBRA Oversight
Settlement							
Holdiko Perkasa	Salim	Rp. 47.75	104	Rp. 48.65	Rp. 0.10	32 (83)[a]	Yes
Tunas Setandan Investama	Gajah Tunggal	28.41	12	27.50	1.00	0	Yes
Kiani Wirudha	Hasan	6.16	32	5.44	0.66	0	Yes
Bank Surya	Sudwikatmono	1.85	5	1.88	-	0	Yes
subtotal		Rp. 84.17	149	Rp. 83.47	Rp. 1.76		
Non-Settlement							
Bentala Kartika Abadi	Admadjaya	Rp. 12.50	24	3.66	NM	24	No
Arya Mustika Mulia Abadi	Ongko	7.84	45	NA	NM	0	No
Cakrawala Gita Pratama	Hartono	2.32	15	NA	NM	0	No
subtotal		Rp. 22.66	84	Rp. 3.66	Rp. -		
Total		**Rp. 106.82**	**232 (b)**	**Rp. 87.13**	**Rp. 1.76**	**56**	**NM**

NM = Not Meaningful

(a) 83 is total number of subsidiaries

(b) Less than the sum of the companies transferred by the 5 banks because multiple banks transferred portions of the same company (e.g. both Danamon and BCA transferred shares of PT Astra International)

Holdco Assets – Background

Unique Solution

- Assets transferred to IBRA-controlled Holding Companies
- Shareholders incentivized to maximize value of assets by providing opportunity to re-acquire companies

Massive Recovery

- Greater than US$10.6 billion recovered from 7 shareholder groups in the form of cash and equity in more than 200 companies
- Processing new settlements with the shareholders of 38 recently closed banks

Largest Corporate Groups

- Salim, Gajah Tunggal, Danamon and Hasan

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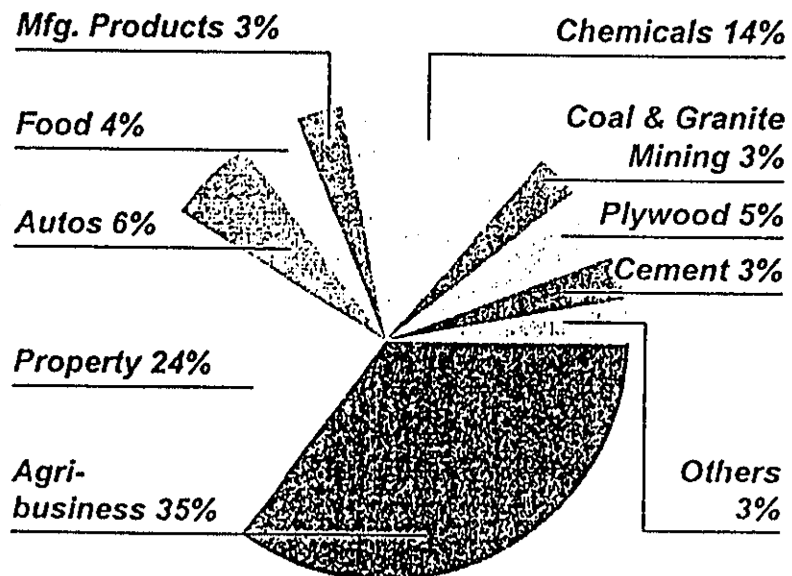
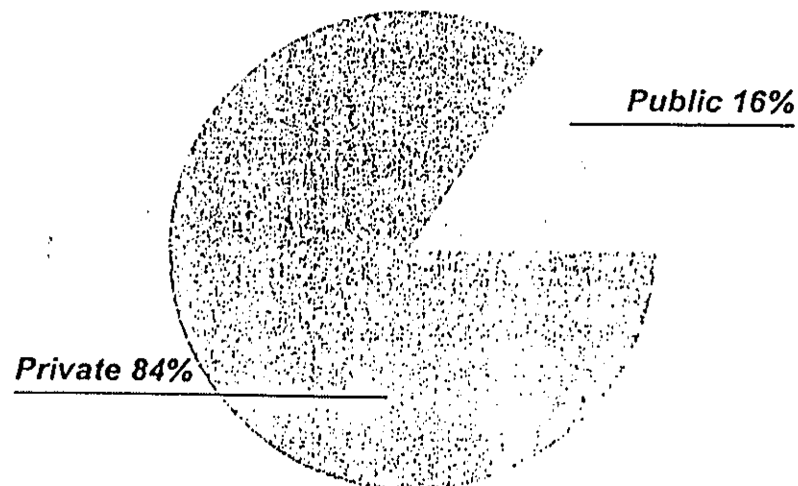
Holdco Assets – Inventory



By Industry



Private / Public

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Holdco Assets – Disposal Strategy

Timing

- Flexible 4-years disposal target executed in line with the government budgetary parameters and IMF's guidelines
- Coordination of sales to avoid cannibalization

Principles

- Hands-off management, hands-on monitoring
- Balance value maximization and timeliness
- Fairness, accountability and transparency

Structure

- Full universe: strategic/financial placements, public market
- Mostly open strategic sales with some exclusive, targeted processes
- As much as possible, divestiture through the capital markets to create liquidity of the asset holdings

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The List of 5 Holdcos in IBRA

PT Bentala Kartika Abadi (Danamon Group)

Company	Industry
Kota Anggana (PT Bentala Lestari, PT Danalaru Jaya, PT Bentala Anggana Madura, PT Bukit Nirmala, PT Alfindo Mercu Estate)	Property
Kota Bentala (PT Kuningan Persada, PT Supra Estetika, PT Wimukti Artamas)	Property
Kota Kasablanka (PT Bentala Mahaya)	Property
Bumi Gunung Salak Permai (PT Bahana Sukmasejahtera)	Property
Hotel Nikko Bali (PT Caterison Sukses)	Property
PT Balibuana Perkasa	Property
PT Grahaprima Citralestari	Property
PT Aetna Life Indonesia	Life Insurance
PT Danamon Asuransi	General Insurance
PT Danamon Multi Investindo	Investment
PT Danamon Finance	Multi Finance
PT Danamon Usaha Pembiayaan	Multi Finance
PT Danamon Sentra Pembiayaan	Multi Finance
PT Danamon GT Management	Mutual Fund
PT Primasindo Insurance Broker	Broker Insurance
PT Dinamika Reinsurance Broker	Broker Reinsurance

Company	Industry
PT Danain Securities	Securities
PT Danamon Sanatel	VSAT Service
PT Danamon Usaha Gedung	Property
PT Danamon Usaha Lestari	Computer Leasing
PT Danamon Usaha Mobil	Vehicle Leasing
PT Gentala Sanggrahan	Investment

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The List of 5 Holdcos in IBRA

PT Tunas Sepadan Investama (BDNI - Gajah Tunggal Group)

Company	*Industry*
• PT Bestari Indoprima	Agribusiness
• PT Birulaut Khatulistiwa	Agribusiness
• PT Dipasena Citra Darmaja	Agribusiness
• PT Mesuji Pratama Lines	Agribusiness
• PT Triwindu Grahamanunggal	Agribusiness
• PT Wachyuni Mandira	Agribusiness
• PT Gajah Tunggal Tbk.	Automotive
• PT Langgeng Bajapratama	Automotive
• PT Meshindo Alloy Wheel Corp.	Automotive
• PT Filamendo Sakti	Chemical
• PT GT Petrochem Industries	Chemical
• PT Sentra Sintetikajaya	Chemical

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The List of 5 Holdcos in IBRA

PT Holdiko Perkasa (BCA Group)

Company	Industry
PT Astra Intenasional Tbk.	Automotive
PT Indomobil Sukses International Tbk.	Automotive
PT Indocement Tunggal Prakarsa Tbk.	Cement
PT Batamas Megah	Chemical
PT Dunia Mustika	Chemical
PT Excell Project Group Limited	Chemical
PT Gumindo Perkasa Industri	Chemical
PT Poli Contindo Nusa	Chemical
PT Worldwide Link Ltd.	Chemical
PT Ganda Upayatama	Coal Mining
PT Indo Tambangraya Megah	Coal Mining
PT Indosiar Visual Mandiri	Communication
PT Chandra Mulia Permai	Consumer
PT Griyamas Sejahtera	Consumer
PT Menara Kaloka	Consumer
PT Perkasa Mostindo Utama	Consumer
PT Sinar Plataco	Consumer
PT Walet Kencana Perkasa	Consumer
PT Berdikari Sari Utama Flour Mills	Consumer
PT Indofood Sukser Makmur	Consumer
PT Indolakto	Consumer
PT Jati Purna Prayasa	Consumer
PT Perkasa Simpati Persada	Consumer
QAF Limited	Consumer
PT Satwika Sinar Mas	Consumer
PT Sembada Widya Cita	Consumer
PT Tatawahana Duta Persada	Granite Mining
First Pacific Co. Limited	Holding Company
Bali Fortune Ltd.	Multi Industry
Crystal Blue Assets Ltd.	Multi Industry
PT Indogift Chuenher Indah	Multi Industry
PT Indopoly Swakarsa Industry	Multi Industry
PT Kerismas Witikco Makmur	Multi Industry
PT Bitung Manado Oil	Oil and Fats
PT Gentala Arta Mas	Oil and Fats
PT Intiboga Sejahtera	Oil and Fats
PT Pratiwimba Utama	Oil and Fats
PT Salim Oil Grains	Oil and Fats
PT Anugerah Sumbermakmur	Palm Plantation
PT Bhaskaramulti Permata	Palm Plantation
PT Minamas Gemilang	Palm Plantation
PT Salim Sawitindo	Palm Plantation
PT Duta Rendra Mulya	Plywood
PT Intl Usaha Kayulama	Plywood

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The List of 5 Holdcos in IBRA

PT Holdiko Perkasa (BCA Group) - cont'd

Company	Industry
PT Kayu Lapis Asli Murni	Plywood
PT Unitama Adiusaha Shipping	Plywood
PT Alam Indah Bintan	Property
PT Ariobimo Estate Perkasa	Property
PT Bahana Dharma Ulama	Property
PT Bali Antaboga Canning	Property
PT Ultramos Jaya	Trading
PT Besland Pertiwi	Property
PT Bintan Inti Industrial Estate	Property
PT Bintan Servicatama Perkasa	Property
PT Buana Megawisatama	Property
PT Bumi Serpong Damai	Property
Cibinong Center Industrial Estate	Property
PT Citra Karimun Perkasa	Property
Great Contribution Investment Ltd.	Property
Great Divinie Group Limited	Property
PT Herwido Rintis	Property
Hotel Istana Bukit Indah	Property
PT Mandara Permai	Property
PT Metropolitan Kencana	Property
PT Indomarco Prismatama	Trading
PT Pertiwi Lestari	Property

Company	Industry
PT Primabahtera Indoshipyard	Property
PT Serasi Niaga Sakti	Property
PT Suakajaya Indowahana	Property
PT Surya Bangun Pertiwi	Property
PT Eka Primaguna Perkasa	Sugar
PT Indolampung Distillery	Sugar
PT Indolampung Perkasa	Sugar
PT Inti Petala Bumi	Sugar
PT Sweet Indolampung	Sugar
Dharma Citra Setia	Textile & Garment
PT Sibatex Abadi	Textile & Garment
PT Indomarco Adi Prima	Trading

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The List of 5 Holdcos in IBRA

PT Cakrawala Gita Pratama (Bank Modern Group)

Company	*Industry*
• PT Awani Modern Indonesia	Property
• Citicon	Property
• PT Era Bangun	Property
• Global Hotel Development	Property
• PT Modern Griyareksa	Property
• PT Modern Menaramas	Property
• PT Modern Putratama	Property
• PT New Asia	Property
• PT Sinar Karya Konstrindo	Property

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The List of 5 Holdcos in IBRA

PT Kiani Wirudha (BUN Group)

Company	Industry
• PT Kiani Kertas	Pulp & Paper Mill
• PT Tanung Redeb Hutani	Logging
• PT Kiani Hutani Lestari	Logging
• PT Belantara Pusaka	Logging
• PT Tugu Pratama Indonesia	Finance
• PT Tugu Bunas Asuransi	Finance
• PT Tugu Jasatama Reasuransi	Finance
• PT Bank Umum Tugu	Finance
• PT Jati Dharma Indah Plywood Industries	Plywood & Logging
• PT Kalhold Utama	Plywood
• PT Santi Murni Plywood	Plywood
• PT Kalimanis Plywood	Plywood
• PT Alas Helau	Logging
• PT Kiani Lestari	Logging
• PT Prima Maluku Timber	Logging
• PT Wenang Sakti	Logging
• PT Essam Timber	Logging
• PT Wana Galang Utama	Logging
• PT Jati Maluku Timber	Logging
• PT Gunung Gajah Abadi	Logging
• PT Pangansari Utama	Catering Service

Company	Industry
• PT Lakosta Indah	Glue & Chemical
• Gatari Plane	Plane (Sold)
• PT Wasesa Lines	Shipping
• PT Batu Penggal Chemicals Industry	Glue & Chemical
• PT KCI Glass	Glass Manufacturing
• PT Kabelindo Murni	Cable Manufacturing
• Babcock & Wilcox Indonesia	Multi Industry
• PT Kertas Kraft Aceh	Paper Mill

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Appendix 3.

Presentation by Dr. G. Hufbauer

<u>Cleaning up the Financial Wreckage:</u>
<u>An Eight-point Program for Indonesia</u>

Conference on
The Economic Issues Facing Indonesia
Sponsored by LPEM FEUI, USAID, PEG
Jakarta, Indonesia
August 18-19, 1999

Cleaning up the Financial Wreckage:
An Eight-Point Program for Indonesia

Gary Hufbauer[1]
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Washington, DC

Background

Indonesia's financial system collapsed in the aftermath of the crisis.. Non-performing loans now exceed 50 percent of bank assets. As Arnold Harberger emphasized at this Conference, the majority of borrowers have gone on a debtor's strike. Those that are truly distressed refuse to pay interest and principal; those that are only wounded, refuse to pay interest. Most Indonesian corporations have also defaulted on bonds issued to domestic and foreign creditors.

The government's response was to create a restructuring agency aimed at preventing a total collapse of the banking system, the Indonesian Banking Restructuring Agency (IBRA). IBRA is financed by a mix of medium and long-term government-guaranteed bonds, some inflation-indexed, others not. These bonds pay high rates of interest, approximately 14 percent annually. IBRA has exchanged these bonds for the worst non-performing loans in the banking system (so-called category 5 loans). In the process, IBRA has acquired some Rp. 500 trillion of assets ($85 billion, measured at face value, not market value). IBRA essentially owns the Indonesian banking system (apart from a few foreign banks, which have a small share of the financial market). As a consequence, IBRA has become the dominant creditor to most the large Indonesian corporations and property developers.

Meanwhile, Indonesian banks are struggling with their remaining bad (but not hopeless) category 2, 3 and 4 assets, and making very few new loans. Even after unloading their category 5 loans to IBRA, most banks have negative net worth and are far from meeting capital adequacy standards. Indonesia non-bank financial markets are relatively small (share, bond, commercial paper, etc.) and accessible to very few borrowers. The result, as Harberger stressed, is a general credit freeze, and government ownership of vast swaths of the economy, indirectly through IBRA and directly through state-owned enterprises (airlines, cement, petroleum, etc.).

In the run-up to the crisis, many Indonesian corporations incurred dollar-denominated and yen-denominated loans from foreign creditors. In many cases, the loans carried an explicit or implicit government guarantee. The amount of "private" external debt (including state bank debt), guaranteed or not, roughly totals $74 billion. Few if any debt service payments are now being made. As a consequence, fresh external credit is virtually unavailable to Indonesian firms.

On top of the "private" external debt, government and state enterprise external debt totals an additional $72 billion. Thus, Indonesia's total external debt (as of March 1999) was $146 billion. In addition, non-residents hold about $3 billion of Indonesian equity securities.[2]

The road to financial ruin was paved, of course, with mismanagement – ranging from weak regulation and poor supervision by Bank Indonesia, to non-disclosure of external borrowing and non-performing loans, to connected lending by state-owned and private banks, to outright fraud.

Indonesia's legal system is weak. The rights of secured creditors exist on paper, not in practice. While a new bankruptcy law has been enacted, its implementation remains to be tested. One should not be hopeful Court-ordered liquidation and foreclosure proceedings are practically unknown in Indonesia. Defaulting corporations and other debtors can defy their creditors almost indefinitely.

But even if Indonesia's laws on secured debt and bankruptcy were as severe as those in Australia, and its court system as efficient and honest, financial wreckage of the present scale would overwhelm the legal system. The tribulations of a case-by-case approach in the weaker legal environment of Thailand are sorrowfully explained by Pakorn Vichyanond.[3]

If Indonesia pursues a case-by-case cleanup of the financial wreckage, relying on the existing legal system, certain outcomes seem foreordained:

- Proceedings will drag on for a decade or longer, as they get tangled in a weak legal system with high political overtones;

- Meanwhile, much of the non-agricultural economy will remain under government control (IBRA plus state-owned enterprises), practically ensuring widespread inefficiency and corruption;

- The recovery process will stagger along, as it has in Japan over the past decade. Years of sub-par performance will ensue, and the era of 7 percent GDP growth will become a distant memory.

To prevent this gloomy prognosis, I propose a bold eight-point program. The program is designed not only to clean up the wreckage in a speedy fashion, but also to set Indonesia on a new course of modern finance. It is designed, as Gus Papanek emphasized at the Conference, to restore the confidence of Indonesians and foreigners alike in the "Indonesian miracle".

Point One: Financial Rectitude. The era has passed when financial misdeeds are punished by public whippings or severed hands. But the public officials and private financial managers who set the stage for collapse prior to 1997 must be called to account. The worst offenders, those who committed fraud, should be sent to jail. Those who were

merely negligent should be fired. Offenders should be barred from holding positions in regulated financial institutions for a period of years, even for life.

Bank Indonesia should post on its public website a running account, bank-by-bank, quarter-by-quarter, showing the number of senior bank managers who have been replaced. At the moment, the same bad managers who ran the banks prior to the collapse continue to hold their jobs. This is no way to establish public confidence in the financial system.

Point Two: Transparency. All banks and major corporations indebted to IBRA, together with all state-owned enterprises, should be required to report key financial magnitudes on a quarterly basis with a lag of no more than 90 days. The president and directors of firms that fail to comply should be subject to personal fines, say in the amount of Rp.100 million per offense. The key financial magnitudes should be reported electronically in a standard format prescribed by Bank Indonesia. The data should be immediately posted on Bank Indonesia's website. Among other figures, banks and corporations should report:

- Foreign exchange assets and liabilities
- Domestic liabilities at face value (including accrued but unpaid interest)
- Non-performing loans (in the case of banks)
- Overdue debt owed (in the case of corporations)
- Delinquent accounts receivable (in the case of corporations)
- Cash and current accounts receivable (in the case of corporations)
- Inventory at cost (in the case of corporations)
- Revenues, expenses and operating profits or losses, on a cash basis

Point Three: Blue Ribbon Commission. Indonesian corporations (including the state banks, but excluding the state-owned enterprises) now owe about $72 billion of foreign exchange debt. Some of the loans and bonds were guaranteed by the government, implicitly (via the government's responsibility for the state banks) or explicitly. And

some of the guarantees were improperly or corruptly procured. Many political figures now argue that the Indonesian government should not be responsible for these debts.

This is an explosive issue. If the government simply walks away from financial guarantees extended in the Suharto era, Indonesia will have difficulty obtaining new external credits for several years. And its diplomatic relations with creditor countries, such as Japan and the United States, will be strained. On the other hand, impoverished Indonesian taxpayers should not be stuck when foreign creditors colluded in the misdeeds of the Suharto regime.

My proposal is that the new government should form a Blue Ribbon Commission, headed by a financial figure of world stature – a person such as Ross Garnaut, or Domingo Cavallo, or Paul Volcker, or Karl Otto Poehl, or Raymond Barre. The Commission should apply two tests to determine whether government guarantees were improperly or corruptly obtained:

- Was the guarantee properly disclosed, at the time it was extended, to responsible officials in the Ministry of Finance, Bank Indonesia, the International Monetary Fund, *and* the public? If there was a failure of disclosure, a rebuttable presumption of impropriety should attach to the guarantee. In other words, in these cases, the burden of proof would fall on the holder of guaranteed debt to establish that the guarantee was proper.

- Was the guarantee extended to benefit a project sponsored by a firm controlled by a member of the First Family or its long-time political allies? If so, then a rebuttable presumption of corruption should attach to the guarantee. The burden of proof would fall on the holder to establish that the guarantee was free of corruption.

Quick resolution of external guaranteed debt is an essential step before Indonesia can reestablish access to foreign credits. Accordingly, the Commission should wind up its

determinations by December 31, 2000. The manner of holding hearings and the evidence taken should be tailored to meet this timetable.

As a working proposal, the face value of improper guarantees should be cut by up to 25 percent, while the face value of corrupt guarantees should be cut by up to 100 percent. Reducing the face value of the guarantee would not, of course, exonerate the debtor. It would, however, reduce the government's obligation to pay if the debtor failed.

Point Four: Extraordinary Powers for IBRA. IBRA should be granted extraordinary powers to liquidate defaulting corporations and foreclose on collateral. A new Special Court with simple and swift procedures should be established. The Special Court judges should be men and women of impeccable reputation.

The Special Court should hear only cases brought by IBRA and its judgments should be final. Decisions should be rendered in accordance with the new bankruptcy law. The claims of creditors, other than IBRA, against the same debtor should be simultaneously heard by the Special Court, *if and only if* those other creditors authorize IBRA to act as their trustee (with normal fiduciary obligations) in resolving their claims.

IBRA and the Special Court should operate on a strict timetable. Final decisions should be rendered within two years from the date IBRA acquires an asset (shares, bonds, mortgages). Special Court decisions should authorize IBRA to liquidate the firm, foreclose the real estate or personal property, sell the asset, and convey a clear legal title (subject to the claims of creditors who do not authorize IBRA to act as their trustee) to a new buyer.

The creation of these extraordinary powers and the Special Court will prompt many debtors to reach a voluntary resolution with IBRA before the Special Court rules on an IBRA petition. Debtors will know that they can no longer string out the day of reckoning by tying up the legal system.

Point Five: Extension of IBRA Mandate to Corporate Debt. IBRA's current mandate extends only to bank restructuring and loan made by banks. However, most large corporations have borrowed from foreign or domestic creditors other than Indonesian banks. These loans and bonds are not being serviced, and most of them have no prospect of being paid in full.

IBRA should be authorized (but not required) to purchase these non-bank loans and bonds at whatever discount it can negotiate with the current holders. IBRA may choose to acquire these loans and bonds in the secondary market, buying anonymously through one of the large international banks. Once IBRA has acquired a loan or bond, it can then use its extraordinary powers and the Special Court to liquidate the firm, foreclose the collateral and sell the assets to a new buyer. This prospect will, of course, speed up resolution of all corporate debt, not just bank loans.

Foreign and domestic creditors, including bondholders, who do not choose to sell their loans to IBRA (directly or through the secondary market), and who do not elect to name IBRA as their trustee in Special Court proceedings, can of course resort to the normal tedious and inefficient Indonesian court system. These creditors would not have the right to bring cases to the Special Court. That right would be unique to IBRA.

Point Six: Create a Modern Financial Market. In many instances, IBRA will be unable to reach a speedy and just resolution with the debtor. Instead, it will need to liquidate the firm and foreclose on collateral. In selling these vast foreclosed assets to new buyers and restoring a private economy to Indonesia, IBRA has been charged with twin goals, goals that are in tension with one another: obtain the best price and sell the assets swiftly.[4]

In addition to these goals (which are the subject of Point Six), Indonesia should seize this unique opportunity to create a modern financial market. In Indonesia's new financial market, the role of banks should be drastically curtailed, and the role of shares, bonds, mutual funds, and insurance companies should be dramatically enlarged. In this way,

Indonesian financial markets in the 21st century will become far more efficient at increasing shareholder value and ensuring high returns on Indonesian savings.

To create a new financial market, IBRA should attach these conditions when it works out a settlement with existing debtors at a discount or sells foreclosed assets to new buyers:

- Payment should be in cash. The existing debtor or new buyer should *not* be permitted to borrow from Indonesian banks to finance its settlement or purchase. Instead, the existing debtor or new buyer must obtain funding from a non-bank financial institution (such as an insurance company), from external sources, or by floating shares or bonds in the Indonesian market.

- In the case of corporations of significant size, for a period of ten years after the existing debtor has settled or a new buyer has acquired, the corporation should be required to obtain any new capital by floating shares or bonds in the Indonesian market. Moreover, it should be required to maintain a conservative equity-to-debt ratio on fresh capital raised, say 2-to-1.

Point Seven: Act Fast but Keep Options and Acquire Equity. There is tension in IBRA's mandate to obtain the best price for foreclosed assets (or to reach the best settlement with existing debtors), but to act swiftly. The great danger is that government-appointed managers will become too comfortable and cautious, and that debt settlements or asset sales will be long delayed in the search for the best price. The result will be prolonged stagnation, as vast stretches of the Indonesian economy remain wards of the state, year after year.

To avoid this outcome, a tight deadline should be imposed on IBRA. It should have no more than one year to reach a settlement with existing debtors. If IBRA cannot reach a settlement, it should foreclose and sell each asset to a new buyer within two years of the date of its acquisition. The target date for winding up IBRA operations, shutting down the agency, and winding up the Special Court should be December 31, 2002. To achieve

this target, many debts will be settled at steep discounts, and many assets will necessarily be sold at bargain prices to new buyers. That will happen even with the best-qualified debt workout negotiators and the best-organized auction procedures.

My suggestion to balance the mandate of swift action with the mandate to obtain the best price involves the use of options and equity. Let me start with the case of a foreclosed asset that is sold to a new buyer. Every time IBRA sells a major asset (such as shares in a big corporation, or a large office building) to a new buyer, IBRA should retain an option to repurchase one-half the shares, or one-half the property, at an "adjusted price". The option would have a duration of 15 years (roughly the term of government bonds issued to finance IBRA). The "adjusted price" would be calculated as follows:

- One-half the initial price received by IBRA; with the principal increased annually by the 15-year government bond rate at the date of sale; and with the principal decreased by the amount of any dividends or other distributions made in respect of the asset.

Under this arrangement, the new buyer knows that, if the option is exercised, it will receive at much as it would have earned by purchasing government bonds. Meanwhile, the public knows that if the price turned out to be a great bargain simply because there were few bidders at the auction, or if super private management subsequently improves the value of the asset, the government will receive approximately one-half of the benefit. Obviously, if the asset turns out to be a loser, the government will not exercise the option.

In the same spirit, IBRA should obtain an equity stake whenever it works out a debt settlement at a discount with an existing debtor corporation. IBRA should receive equity in the corporation equal to half the difference between the face value of the debt and the cash settlement. For this purpose, a recognized independent appraiser, nominated by IBRA, should value the equity.

The combination of fast sales and settlements with retained options and equity stakes will front-load the government's cash recovery from IBRA operations. This will help reduce

the public debt more quickly than would happen if sales and settlements were spaced out over a long period of time.

Some of the assets that IBRA sells, and some of the firms that resolve their debt, will turn out to be winners and others will turn out to be losers. As options are exercised and shares are sold in winning corporations, more of the government bonds used to finance IBRA can be paid off.

Point Eight: Don't be Afraid of Foreign Buyers. Indonesia's problem today is not too many foreign firms, but too few. Available evidence indicates that foreign firms operate more efficiently, bring new technology, and pay better wages. They should be welcomed, not rejected. On the other hand, every country harbors some resentment when foreign buyers appear to be acquiring assets at a fire sale. These are days of distress in Indonesia, and if IBRA acts quickly, it will sell some assets cheap.

To resolve this tension, IBRA is instructed to give a preference to Indonesian parties, either by settling their debts or by according a preference to Indonesian buyers of foreclosed assets. Debts should not, however, be settled at an excessive discount, and the terms of all settlements should be publicly disclosed. In the case of asset sales to new buyers, the Indonesian preference should be expressed in a transparent form. For example, foreign-controlled bidders might be required to pay a premium of 10 percent over Indonesian-controlled bidders.

Endnotes

[1] The views expressed are those of the author, and do not reflect the views of the Director, Trustees, Advisers or staff of the Institute for International Economics. Work on this essay was supported by a grant from the Smith Richardson Foundation.

[2] For data on Indonesian financial magnitudes, including external debt, see, The World Bank, *Indonesia: From Crisis to Opportunity*, July 21, 1999.

[3] Pakorn Vichyanond, "Financial Reforms in Thailand", Conference on The Economic Issues Facing the New Government, Jakarta, Indonesia, 18-19 August, 1999.

[4] The same goals apply to settlements reached with existing debtors.