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THE UNFINISHED STORY OF THE INDONESIAN BANK RESTRUCTURING: IN SEARCH OF A HAPPY ENDING?

(Lessons and implications for other developing economies)[1]

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I. INTRODUCTION

The causes of the Asian crisis have been widely analyzed to date and as the story unfolded, the assessments and consensus with regard to the appropriateness of responses and longer term restructuring issues have also changed. The various IMF programs that the crisis countries such as Indonesia have undergone have also evolved, and the IMF itself has undergone introspection with regard to the appropriateness of IMF conditionalities. It would be true to say that we are all still in the process of understanding and learning. A consensus has yet to emerge on how to balance the dilemma between the conditions set to access IMF and other donor funds, and the implementability of the program from the perspective of the country in question. Assessing the latter involves a range of issues such as appropriateness of the responses, ownership of the program, and the acceptable degree of flexibility given institutional and political constraints. The experience to date, whether it was in the case of Indonesia or in Russia, Turkey and Argentina, indicates clearly that required actions and conditionalities cannot be determined without consideration of the governance problems, pressure from vested interests, political pressures, weaknesses of institutions and legal infrastructure.

The aim of this paper is to take the experience of the Indonesian economic crisis and the management thereof through the various IMF programs, as a case study to demonstrate the complexity of the dilemma, the lessons we have learned to date, and more importantly some potential next steps that could be taken. In order to make the analysis more focused, we will focus in particular on the banking crisis, restructuring and current process of recovery experienced by Indonesia. Given the intertwining of the banking, corporate and macro stories, one must necessarily also discuss these components of the story.

This paper will begin by reviewing the consensus and debate, and changes thereof, that have emerged to date on causes of the crisis, and vulnerabilities of the fundamental structure of these economies which led to a longer and deeper crisis than would otherwise have been the case. The debate has evolved, and as a result thinking on the remedies to be undertaken to respond to the crisis, to restructure, and to initiate recovery and to

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finally introduce elements to prevent future crisis have also evolved. Mistakes were made and lessons learned, with fiscal ramifications, which will be long felt. Indonesia was chosen as the case study due to the author's familiarity with the country and also because it was the worst hit country, and one which continues to struggle with its bank restructuring program.

The second section will focus on the lessons learned in managing banking crisis and the subsequent process of rehabilitation and recapitalization. In particular issues related to how realistic it was to have expected countries like Indonesia with the institutional, legal and political constraints -- as well as struggling with the setting up of democratic institutions in a newly found democracy, to meet second generation Washington Consensus and international standards (including BIS) of transparency, corporate governance. The key question is how much is the ineffectiveness and slow progress of bank restructuring, corporate restructuring and continued dilemmas in macro economic policy management in Indonesia a factor of the wrong program, the wrong sequence or emphasis, and how much due to politics, corruption and incapacity of policy makers?

In the third section we assess the way forward and what are the interim steps that a country like Indonesia needs to take. A number of suggested approaches have emerged and basically there is now a recognition of the need for intermediate steps prior to the longer term goals of bank prudential regulations and standards which approach that of developed countries. The issue of applicability to the Indonesian case will be examined.

The main message of the paper is the importance of sequencing and pacing necessary reforms by bearing in mind the dilemma between what is ideally desirable, and what is doable. It is also important to design interim steps to get more ownership and support domestically for the reform program, institutional and behavioral changes to ensure that the longer-term goals will be upheld.

II. STRUCTURAL VULNERABILITIES IN BANKING SECTOR PRE CRISIS

Build Up of Vulnerabilities Pre Crisis

Three major sets of factors contributed to the build of vulnerabilities in the banking sector pre crisis. First was the rapid expansion of the banking sector after the comprehensive reforms in 1988 that was not accompanied by adequate prudential regulations and central bank supervision. Second weak corporate governance in the banking sector due to high concentration of ownership. Third the effects of the economic boom and international financial integration which amplified the vulnerabilities.

Comprehensive liberalization and inappropriate sequencing

Indonesia's financial sector liberalization was undertaken in two stages, with the lifting of interest rate and credit ceilings, and reduction of liquidity credits to state banks in 1983, followed by comprehensive liberalization in October 1988 whereby most of the entry barriers and various restrictions that favored certain types of banks were removed. There was open entry for new domestic and joint venture banks, relaxation of branching requirements for both domestic and joint venture banks, reduction of the reserve requirement ratios, and state owned companies were allowed to deposit up to 50 percent of their deposits in non state banks.

Within a few years of the reforms there was a dramatic increase in the number of banks and branches, M2 growth, and credit. The number of new banks increased from 61 in 1988 to 119 in 1991 and the number of foreign banks increased from 11 to 29. The number of branches of private domestic banks quadrupled from just 559 in 1988 to 2,639 by the end of 1991. The asset quality problem and low capital levels hindered the growth of state bank, whilst the private banks expanded rapidly and began to overtake the state banks by 1994, in terms of loans, deposits (private banks were already ahead in 1992) and total assets. The government attempted to strengthen the state banks by announcing plans for mergers and privatization, but only Bank Negara Indonesia, the largest of the state banks went public and no meaningful progress on mergers took place prior to the crisis.

Unfortunately the rapid expansion of the banking sector was not matched by prudential regulations and improving the supervision capacity of Bank Indonesia, the Indonesian Central Bank, to deal with the dramatic increase in the number of banks and branches. The rapid increase in liquidity due to the reduction in reserve requirements and growth of M2, led to overheating pressures and rising inflation in the early 1990s. The monetary authorities responded by tightening monetary policy and responding to the growing criticism and caution regarding the rapid expansion of the banking sector by introducing improved prudential regulations of the banking system in February 1991, two years after the comprehensive liberalization of the banking sector.

The prudential regulations introduced included a comprehensive capital, asset, management, equity and liquidity (CAMEL) quantitative rating system. The system included requirements for stricter qualifications of bank owners and managers; a schedule to meet capital adequacy requirements (CAR) according to the Bank of International Settlement (BIS) standards of 8 percent on risk weighted assets by 1993; stricter information and reporting requirements; and stricter legal lending limit regulations to related groups or to one individual group. A new banking law was passed in 1992 with strict sanctions for bank owners, managers and commissioners for violation of laws and regulations related to managing the banks. Foreigners were also now allowed to purchase bank shares in the capital markets and the legal status of the state banks was changed to a limited liability company, to allow them more autonomy and be managed as a private corporation. In October 1992, as part of the desire to limit the number of banks, the capital requirements to set up domestic and joint venture banks were raised by five times for the former and by double for the latter.

Despite these regulations and regular updates and improvements in the prudential regulations, there were still weaknesses in the legal and regulatory framework especially with regard to loan classification. An even more serious problem was the lack of enforcement of these prudential regulations due to a combination of weak capacity and capability of bank supervisors in the Central Bank, corruption and political interference of favored owners close to the center of power. As a result violations of the prudential regulations were not properly sanctioned and non-compliance was widespread as became evident in the audits of the banks undertaken after the crisis.

In comparison Malaysia already experienced a banking crisis in the mid 1980s and a substantial reform program introduced afterwards leading to a recovery in the late 1980s. The experience of the crisis contributed to Malaysia having better institutional and regulatory structure compared with Indonesia or Thailand, and Malaysia also differed from the other two countries as having relatively stronger regulatory structures and legal frameworks for corporate sector problem resolution even prior to the crisis. For instance prior to the crisis it already had a modern bankruptcy laws, regulations and procedures.

Even though, Malaysia did not embark on rapid liberalization of the financial sector like Indonesia and had a better legal and institutional infrastructure, Malaysia remained nevertheless vulnerable to the crisis due to a number of reasons (Thillainathan 2001). In the period 1990-97 there was rapid expansion of credit at around 30 percent p.a., over exposure of the banking system to the volatile share market and property sector (estimated at over 40 percent of the portfolio), weak management caused by continued restrictions on hiring and compensation, weak supervision due to capacity and hiring constraints as well as failure of the government to raise the banking standards closer to international best practices and align incentives of owners, managers, depositors, and regulators to prudent banking.

The failure to meet international standards has to do with not imposing the required rigorous standards on loan classifications and provisioning and financial disclosure. The increasing role of banking groups in underwriting and brokerage business in the 1990s has also been a source of concern as these institutions are exposed to both credit and market risks. The requirement for risk capital for these institutions were also low.

As for Thailand, banks were related to business groups since banks were started by trade financiers who later expanded to becoming industrialists and eventually these bank centered groups became large industrial conglomerates whereby insider lending was a problem just as in the case of Indonesia. The problem of lack of proper evaluation of loans, even to third parties, was a major problem in the Thai banking system. The lack of evaluation and monitoring was substituted by demanding collateral in the form of land or property as well as personal guarantees from limited liability companies. In comparison the foreign commercial banks operating in Thailand had to adhere to international standards and principles advocated by their headquarters and thus their lending decisions were based on proper evaluation. The main vulnerabilities identified by Vichyanond (2001) of the Thai banking system was lack of systemic credit risk assessment; over exposure to credits given to affiliated businesses, shareholders and directors; and speculative lending with rapid growth and concentration in risky sectors such as real estate which was vulnerable to asset price changes. These outcomes came about because of lack of competition and lack of qualified and professional bank personnel. In Thailand the liberalization occurred by allowing entry of financial companies, who were in fact under less stringent rules compared with banks.

Table 1 Comparative Initial Conditions: Indonesia, Malaysia and Thailand

	Indonesia	**Malaysia**	**Thailand**
Foreign Liab. Banks/Total Liab. (1997)	15%	7.4%	27.4%
Capital Adequacy	8% target 87% banks complied	8% target actual 11.4%av	8.5% target actual 9.8%av
NPL/total loans (end 1997)	7.2%	5.9%	22.6%
Corporate Debt (98)	$118 bill	$120 bill	$195.7bill
- external	$67.1bill	$ 40 bill	$ 32.5bill
- domestic	$50.9bill	$80.2 bill	$163.2bill
Debt/Equity (96)	200%	140%	240%
Major Financial Institutions (early 1997)	238 banks incl 10 foreign	48 banks incl 13 foreign,& 39 finance co.	29 banks incl 14 foreign, and 91 finance co.
Desposit Insurance	None (explicitly unlim Aug. 1997)	None (explicitly	None Jan. 98)
Bankruptcy law	Outdated, 1998	Modern	Outdated, 1940

Source: adapted from Table 1, Kawai (2001)

The lesson is clearly that of poor sequencing with controls on bank liabilities being removed, such as interest rates, but with the oversight on the assets side and the skill and experience for assessing the level of risk, lagging behind. The vulnerabilities that this caused was severely underestimated by all -- academic analysts, advisers, policy officials and international financial institutions. Even after the prudential regulations were introduced and capital adequacy standards met, information and data problems, inadequate loan loss provisioning and the quality of loan portfolios were still problematic. In addition to higher risk the newly liberalized financial sector also had to contend with revolution in technology, communications and financial engineering (World Bank 2001:90).

Weak Corporate Governance, Moral Hazard and Incentive Structures

Although prudential requirements and regulations were introduced to address corporate governance issues such as legal lending limits, there was overall weak banking sector governance and little incentive for banks to review their corporate lending carefully or behave in a risk appropriate way. There are several underlying reasons for this outcome.

First is that despite the increase in the number of banks after 1988, the banking sector remained highly concentrated amongst a few private and state banks. The top 10 private banks and the 6 state banks together accounted for 75 percent of total bank assets. The number of private banks doubled to reach 164 after the 1988 bank liberalization, but concentration of the sector remained high with the top 10 private banks in Indonesia accounting for 68 percent of total private bank assets. However, concentration per say was not the issue, rather it was the lack of incentive for appropriate behavior.

Second is concentration in majority ownership hands, both state and private sector, which resulted in asymmetry of information for all stakeholders. Even though, a number of the major private banks also issued shares in the capital market, the majority of shares were still being held by the original owners, and information asymmetries prevailed between the majority shareholders and minority shareholders, investors and creditors. Furthermore, even if information disclosure was required, given weak accounting standards and auditing capability, whatever information was disclosed was not necessarily accurate. There was also information asymmetry problems with bank supervisors, as well as of course weak capacity of bank supervision as the Central Bank, including collusive practices and instances of interference. Despite legal lending limits to affiliated groups or one group, there was gross violation of this requirement as became evident in the post audits being undertaken on banks taken over by the government. The top ten private banks were linked to major business groups (Table 1), as well as politically powerful groups. Both Bank Central Asia (BCA) and Bank Umum Nasional (BUN) have shareholders linked to former President Suharto, and Bank Duta is known to hold the funds of the former President's foundations and of Badan Urusan Logistik Negara (BULOG), the state logistics agency. As for state banks, a number of the large banks, including BNI 1946 the largest state bank, did issue shares to the public. However, the state also still retained a large majority and was thus still able to exert a great deal of control over the bank. Other mechanisms to enforce good governance over owners and managers, such as central bank supervision and rating agencies were not effective due to a combination of lack of implementation, and information asymmetries.

In comparison, the Malaysian banking system is less concentrated and relationship based compared with other East Asian countries. The structure of the banking system is as follows. Twenty percent of the banking system is accounted for by foreign banks. Government owned or controlled banks account for another 30 percent of the market share. The largest bank is government owned and is also publicly listed. The remaining banks are privately owned, often with private family interests. The leading local banks are mostly publicly listed, but still have dominant shareholder in the form of a government institution or private family interest. However, the private commercial banks were mostly not part of a conglomerate. Prohibition of loans to related parties and enforcement by the Central Bank of this rule appeared to have been able to reduce over exposure to large business group lending as had occurred in Indonesia. There was also no overt directed lending imposed by the government on banks.

The weaknesses lay elsewhere (Thillainathan 2001). The promotion and support of a number of mega projects by the government, and lenders' assumption that the government would not let these projects fail, let to lending by banks based on the collateral of the project as well as implicit government guarantees, and not necessarily on the viability and feasibility of the project. Therefore, a situation of over investment, lower returns, poor cash flows and emerging problem loans also came about. Privatization deals which was not purely market driven but also to fulfil non economic objectives of promoting indigenous or indigenous (*bumiputra*) business people have also caused problematic privatization deals and exposing the stock market and banking industry with its over exposure to share financing, to vulnerabilities of the crisis.

Third there was an implicit government guarantee to bail out banks and no exit policy. Only one bank had been allowed to fail in the 1990s and there were cases of government banks and private banks being bailed out as described in Box 2.

Box 1: Examples of Too Big or Too Important to Fail

1. ***Bappindo***, the state owned development bank had been having problems for many years and in the late 1980s was discovered to have a large number of non-performing loans, including a case of serious corruption in order to obtain credit for large projects. Instead of closing down the bank or undertaking drastic restructuring efforts, the bank was allowed to continue to function and the sanctions to the corruption stopped at the officers level and one business man who actually "escaped" from prison.

2. Another case was ***Bank Duta*** which was a private domestic bank that experienced large foreign exchange losses due to currency speculation. At the time the Bank went public, in fact they were already suffering losses due to foreign exchange positioning, but the bank still went public with fraudulent financial statements. The bank held deposits of the State Logistics Agency and the foundations of Suharto, and as such was "rescued" by "persuading" one of the business conglomerates to contribute to a bailout plan. The manager of the Treasury division was jailed and the management of the Bank changed.

3. ***Corporations***: two corporations in cement (i.e. Indocement) and cold rolling mill which is the upstream of steel production (i.e. CRMI) which had a large stake of the Salim group was "rescued" by the government coming in as shareholders.

4. Cases of ***implicit government guarantees*** through providing captive market, special policy and directed lending (often involving state banks and/or central bank liquidity credits). One of the most blatant examples in recent times was the Timor National Car and the clove import monopoly, both linked to the former President Suharto's youngest son. Timor was given special status of being allowed to import their parts and components, and then later fully built up vehicles from Kia in Korea, duty free. The argument was that satisfaction of local content would be met within three years. Not only was it given this special duty free status, captive market was provided through government civil servants being given special preferences to purchase the vehicle and for police cars to Timor. Furthermore, banks including state banks, were asked to give loans to the venture. In the case of the clove monopoly, the private body was given monopoly to purchase the cloves from farmers and resell to cigarette manufacturers, and was provided low interest credit directly from the Central Bank. Later on it ran into many difficulties.

In contrast, in the case of Malaysia the regulatory and incentive system facing Malaysian banks was such that after the 1980s banking crisis, no banks with few exceptions would be rescued. However, depositors were implicitly guaranteed thus still creating the problem of moral hazard. Thillainathan (2001) argues that this led to Malaysian banks having a higher gearing ratio and higher propensity for banks owners and managers to engage in risky lending than would otherwise have been the case without such full guarantee of depositors.

Macro Policy and Financial Integration

The buildup in Indonesia's vulnerability pre crisis was associated with reinforcing dynamics between capital inflows, macro policies, and weak financial and corporate sector institutions. It should be noted at the outset that Indonesia has had an open capital account since the late 1960s.

As a result of reforms undertaken since the mid 1980s, success in restructuring the economy away from oil and high levels of growth, Indonesia saw a surge in private capital inflows and progressive integration with world financial markets in the first half of the 1990s. The private capital inflows exacerbated domestic macroeconomic cycles leading to overheating of the domestic economy in 1990/91. Inflation rose, especially the prices in the non-tradable sector, and the current account deficit widened. The next bout of overheating of the domestic economy occurred in 1994-96, when again, inflows of private capital surged.

In responding to the domestic overheating pressures and capital inflows, Indonesia employed a macroeconomic policy mix that actually encouraged further inflows of capital. The policy mix comprised of a dramatic tightening in the monetary policy stance;[2] fiscal policy which was not used in a counter cyclical way so that the burden of stabilization fell on monetary policy and led to high interest rates; and predictable depreciation of the rupiah of around 5 percent p.a. The high domestic cost of borrowing led to offshore borrowing by corporations which could do so and banks, often unhedged given the predictable depreciation. The monetary authorities attempted to curb expansion of liquidity through the banking system by placing offshore borrowing limits on banks, state related lending, and eventually non bank financial institutions (NBFI). The three shocks, tight monetary stance, prudential regulations and offshore borrowing ceilings imposed in the early 1990s, had a major impact on the banking system. However, private corporations did not experience limits to offshore borrowing, and the tend to borrow abroad without hedging and deposited the funds they obtained abroad in the domestic banking system for activities which were predominantly rupiah based. The high domestic interest rates also led to an increase in deposits of non-residents or Indonesians repatriating their funds domestically.

[2] Including the famous Sumarlin shock whereby Rp. 8 trillion of State Bank Deposits were converted into Bank Indonesia certificates (SBI) and interest rates more than doubled.

Despite monetary easing, interest rates on lending did not come down initially because of the usual lag effect and increased provisioning for problem loans. Problem loans were already emerging and, there were at least two banks known to have problems. The government responded very differently in each case. Bank Duta was effectively bailed out with the entry of a new shareholder injecting capital, given that the Bank held funds of the foundations of Suharto and was closely linked to Bulog. However, in the case of Bank Summa, it was liquidated. The increase in problem loans detected in 1991 and the beginning of some banks experiencing problems were early warning signals of the vulnerabilities that existed. However, the pick up in economic growth and large private capital inflows that ensued subsequently continued to lead to the build up of vulnerabilities.

The monetary authorities continued to try to curb over heating by continuing a relatively tight monetary stance, increasing reserve requirements, moral suasion, and finally imposing limits on property lending which were introduced only in 1996-7. In addition, in late 1995 the Central Bank banned commercial papers issuance by finance companies and this triggered a massive switch of their source of funding from on-shore to off-shore borrowings. Finance companies alone borrowed USD 5.1 billion in 1996, slightly more than 25 per cent of total Indonesian corporations' new debts issuance in the year, jumping from only about USD 819 million of new debts issuance in 1995. In 1996 the Central Bank also required commercial paper traded by banks to be rated, effectively requiring companies issuing commercial paper to be rated, as banks are major traders of commercial paper. Domestic interest rates continued to be high and the differential higher than the expected depreciation.

The fact that the economy is largely dependent on the domestic banking system for financing in Indonesia suggests that the credit channel is likely to be important. Although direct evidence on the credit channel is difficult to obtain, empirical evidence for Indonesia does suggest that economic activity is found to be more sensitive to changes in domestic credit than to changes in the money supply.

The importance of the credit channel reflects the continued reliance by domestic firms on funding from the banking system. While Indonesian firms are increasingly able to borrow abroad directly, either through syndicated loans or through the issuance of international equity, bonds and commercial paper, such access remains limited to the larger firms. Most firms, particularly the small and medium-sized enterprises, continue to rely primarily on the domestic financial system. Furthermore, despite the progress made in the development of the domestic financial sector, most firms rely on domestic *banks* for non-internal sources of finance. Flow of funds data suggests that during 1990-96 banks intermediated around 40 percent of private non-bank investment on average, direct finance from abroad funded 7 percent of investment, the government financed 10 percent and the remaining 43 percent was funded within the domestic non-bank sector. Based on 1996 data, net new bank lending amounted to IDR 58.3 trillion, compared to new IPOs and right issues of IDR 14.6 trillion and new bond issuance of 8.6 trillion. One estimate (Montgomery, 1997) also showed that stock market had contributed only about 15 per cent of total business finance, while the rest had been provided by the banking sector.

The domestic banks were thus flush with liquidity and there was rapid expansion of credit, which were directed at increasingly unproductive and risky sectors, such as property. The expansion of credit has also been directed to consumer lending as banks strategize to compete by entering the domestic retail market as discussed below. Consumer lending was utilized for purchase and speculation in property and stocks. This was especially the case in the early 1990s and in 1994 when interest rates were low. The resulting asset price increases in the real estate and stock markets, in turn progressively skewed investments towards these sectors as banks increased lending especially to the property sector based on inflated collateral prices.

Property lending grew rapidly in the few years prior to the crisis, increasing from 6 percent of GDP in 1993 to 16 percent of GDP in 1996. The rapid credit expansion to the property sector was reflected in the supply and demand for commercial as well as residential properties. During 1991-1997, the occupancy rates of office space in Jakarta were relatively high and relatively stable at about 90 per cent and property expansion was based on this kind of continued scenario. The amount of mortgage loans also almost tripled during the 1993-96 period from Rp. 6 trillion to Rp. 16 trillion reflecting the consumption boom and banks focus on the retail sector. Similar excess capacity and over investment can be found in the infrastructure sector such as power generation, and some of the manufacturing sectors, such as automotive.

Table 2 Non-Performing Property Loans, 1992-April 1997 (NPL/Total Property Loans, per cent)

SUB SECTOR	**1993**	**1994**	**1995**	**1996**	**April 1997**
Construction	13.49	13.25	11.62	9.58	9.62
Real Estate	8.05	5.77	4.48	3.71	4.37
Mortgage	3.20	2.67	2.72	2.99	3.67
Total Property	9.24	7.86	6.53	5.69	6.04
Total Credit	NA	11.63	NA	8.79	9.23

Source: Bank Indonesia, Infobank

Financial integration and the opening up of the banking sector resulting from the 1988 also increased the presence of foreign banks. The presence of foreign banks is intended to facilitate transfer of technology in skill and products, through technical assistance or foreign bank personnel moving to the local banks. However, it is unclear that increased efficiency due to competition was achieved based on two indicators, bank net interest and operating margins, which did not show a definitive declining trend. Part of the reason for this outcome is that competition has increased the risk profile and overhead costs of domestic banks by crowding out of prime borrowers and the higher risk and costs of competing domestically.

Foreign banks have largely focused on the corporate sector and within this segment have naturally focused their attention on home-based or existing multinational company customer base in Indonesia and the top-tier corporations, given their more conservative and strict credit risk profile, resulting in intense bank competition within this market segment. Furthermore, top-tier corporations, also largely with the help of foreign banks (investment and commercial banks) have been active in tapping the capital markets (both foreign and domestic) directly, either through the issuance of equity or debt (short-term CP and long-term bond) instruments. Stocks issued through the capital markets grew from Rp27.6tn as of end-1991 to Rp152.2tn by end-1995. For the same period bonds issued grew from Rp2.2tn to Rp5.3tn. The top tier firms were obtaining lower cost of offshore funding due to high domestic interest, the risk premium charged were also declining due to learning as well as reputation. For instance top tier corporations such as Astra observed their spread on Eurobonds narrowing from an average of 2.5-3.0 per cent in the late 1980s down to around 1.5-2.0 per cent in the 1990s.

Domestic banks trying to avoid competing head on with the foreign banks gradually shifted their strategic business focus on what they often called the middle market made up of second tier corporations and small and medium businesses, and individual consumers. Most of the top-tier private banks began to focus on the retail middle market as their major business in mid 1990s. Given information availability and transparency issues, entry into this relatively new segment meant that banks faced higher risk and inevitably experienced larger non-performing loan levels. Reflecting this higher risk, interest spreads on retail-type loans are normally 2-3 percentage points higher than a corporate loan. Prior to the crisis, average corporate lending rates were 19-20 percent, collaterized consumer loans were 22-23 percent, and security free consumer receivables, such as credit card outstanding were in the 30 percent range.

The nature of retail loans implied that banks were carrying a greater risk in their portfolio. The quality and quantity of individual or sectoral credit information were limited and thus a great deal of effort was needed to make credit-scoring assessment effective. Furthermore, the lending was based mainly on collateral value, whether it was a business property, house or car. The collateral was often specific to ensure quick repossession and sales in the secondary market. Finally, repetition of this process improved the quality until a saturation point was reached, whereby a geographical extension of the market or the launch of a new financial product was then called for. Banks competed by extending their branch networks in terms of numbers and geographical coverage. Although most banks are still focusing on the more commercial cities, many ventured into new locations and smaller towns with little or no previous experience, raising further the risk profile.

The increased risk profile of banks' loan portfolio as they shifted their business to relatively new market segments and locations, and efforts in going public which led to investment in technology, human resources, branch networks, and improving their management, kept net interest margins high and operating margins low.

Despite their higher risk profile, most domestic banks continued to have provision for bad debts less than their non-performing levels. This practice was not uncommon and was reinforced by Bank Indonesia allowing banks to deduct loan collateral value from the provisioning needs. Thus, prior to the crisis most of the Indonesian domestic banks were still in the initial learning phases of entering the retail sector and expanding their network, and thus they were still in this "risky" development phase when the crisis hit.

In sum: Lessons learned

The important lesson here is that financial liberalization should be gradual and done in a step wise sequencing that takes into account the preparedness of the underlying institutions, legal and human capacity.

D-Kunt (1998) found a strong relationship between financial liberalization and financial fragility (53 developed and developing countries during 1980-95 - liberalization observed policy change of deregulation of interest rates) after controlling for other variables such as macroeconomic variables, characteristics of the banking sector, and institutional variables. He found that stronger fragility occurs not immediately after liberalization but a few years after; and lack of institutions such as effective prudential regulation and supervision, well functioning capital markets, legal system. Bank franchise value falls after liberalization and there have been suggestions that increased moral hazard is linked to this lower franchise value and thus making banking crisis more likely (Caprio and Summers, 1994 and Hellman, Murdock and Stiglitz, 1994). That is, financial liberalization benefits to growth is offset by increased vulnerability to banking crisis, if not sufficient attention to the supporting institutional framework to support a well functioning and open financial system. This suggests that institutional development needs to be emphasized early in the liberalization process and since this requires time (training of supervisor and bank managers, setting up institutions etc.), a gradual path to financial liberalization is recommended. Furthermore, more thought is needed on designing appropriate prudential regulations and supervision in developing countries.

Of course not having the requisite institutions should not be an excuse for not beginning liberalization. Prior to the crisis the argument on the so called optimal order of liberalization[3] was that whilst conventional wisdom could dictate a certain sequence of liberalization, the reality is at the time of reform the pro reform policy makers undertook what they could first. Financial sector liberalization happened to have less resistance because more than half of the sector was state owned. There was more resistance to real sector liberalization initially as the vested interests were far greater. In the early 1990s various analysis of Indonesian reform noted the reverse sequencing of Indonesian reforms with respect to financial sector liberalization prior to real sector liberalization, and with an open capital account as an initial starting point (not as the last step in the process of economic opening up). At the time there was already great awareness of institutional weaknesses and the vulnerabilities from weak governance and lack of transparency, but high growth meant that these vulnerabilities whilst recognized were not addressed adequately. In the case of Indonesia the issue lies in a combination of inappropriate sequencing and lack of a governance and political structure which was conducive to a sound financial sector.

[3] See Ronald McKinnon, "The Order of Economic Liberalization: Lessons from Chile and Argenina" Carnegie-Rochester Conferences Series on Public Policy 17:159-86,1982 and popularised by Sebastian Edwards, The Order of Liberalization of the External Sector", Princeton Essays on International Finance, no. 156, 1984.

Thus the first lesson that emerged early on in the crisis was that structural weaknesses precipated/caused the crisis or at least made the crisis worse (longer and larger), so to prevent future crisis needed to correct structural weaknesses financial sector (prudential), bad governance and relationship banking. As such the subsequent recommendations for reforms were related to meeting G7 codes of conduct, with some unrealistic expectations that they would be met in a short span of time.

Under such circumstances, with hindsight, what should have Indonesia done? What can other countries learn from Indonesia? If a country already has an open capital account then one has to be cautious about opening up and managing the foreign exchange risks. There needs to be stricter requirements on who and how foreign exchange transactions can be conducted, and certainly better reporting requirements. Institutions are key. If there is inability for supervision and regulatory capacity, then a step wise liberalization needs to be considered. This could be a combination of real corporatization and eventual privatization of state banks and allowing a limited number of bonafide new entrants. Restructuring of the state banks has been an unsuccessful story on its own and these recommendation pre dates the crisis.[4]

One old argument in Indonesia pre crisis is that rather than allow a limited number of new entrants, whose granting of licenses will then be subjected to rent seeking and intensive lobbying, it was better to allow everyone to enter subject to certain criteria. This argument is probably a good one for countries where such selectivity would be a problem. The key is then to of course set the criteria sufficiently strict and with the end goal in mind, desirability of new entrants in introducing fair competition, technology, best practices and risk appropriate behavior. The criteria should be a combination of sufficiently high capital, proven track record of the entrant (foreign bank or fit and proper managers/directors),

Many of the recommendations for actions and conditionalities in the IMF reform programs predicate on what was thought to be the causes of the crisis and the structural vulnerabilities which at the end of the day led to longer and deeper crisis. Therefore, it is important to have a synthesis of the outcome of this debate three years down the road, with more analysis and hindsight behind us.

III. LESSONS LEARNED IN SYSTEMIC BANK CRISIS MANAGEMENT AND RESTRUCTURING

It is by now evident that mistakes were made in the initial responses to the crisis by the GOI as well as by the IFIs which made the systemic crisis worse and the eventual cost higher than should have been the case. What are the main lessons that should be learned from these mistakes?

[4] As was experienced by the failed World Bank program loan to recapitalize state banks.

Conventional Wisdom on Bank Restructuring

Based on international experience and studies, there are various options for undertaking bank restructuring. All the options entail tradeoffs between speed of restructuring, fiscal costs, incentives for bank performance and confidence in the banking system (Claessens, 1998). For instance bailouts would be the fastest option, but would entail the highest fiscal cost, greatest disincentive for bank performance and financial discipline, and also not increase the confidence of the banking system. In the East Asian crisis as well as in Japan, it is not surprising that this option was not used, and especially in a systemic crisis that faced Indonesia, bailouts just did not make any sense. The other extreme would be to close down unviable banks and pay off creditors and depositors. This would also be speedy, send a strong signal about financial discipline, and involve relatively low fiscal costs (depending on the extent of unviable institutions), but would have a dire effect on the confidence of the banking system.

Therefore, most East Asian governments, including Indonesia have opted for selective closures of the most unviable banks, combined with one of the other options of facilitating mergers of banks o recapitalize distressed banks with the option to sell the banks at a later date. These options involve lower fiscal costs and moderate to better incentives for better bank performance and could restore the confidence in the banking system Mergers would achieve restructuring more rapidly compared with recapitalization.

The experience of other bank crises, including the lessons learned thus far in East Asian bank restructuring[5] suggests that there are some key principles that should be adhered to in the steps taken to correct the banking system in response to the crisis and restructuring the banking system. The main principles are in summary:

- Only viable institutions should remain in operation.
- Costs of restructuring should be allocated in a transparent manner, while minimizing costs to tax payers.
- Restructuring should be done in a way that strengthens good financial sector governance by allocating losses to existing shareholders, creditors and perhaps large depositors.
- Measures introduced and implementation thereof should ensure that the incentives for new private capital are preserved and that there is discipline toward bank borrowers.
- Restructuring needs to occur at a sufficient pace to restore credit while maintaining confidence in the banking system.

These principles should be borne in mind when analyzing the initial responses by the IMF and the GOI, and the subsequent steps taken to stabilize the financial system as well as restructure it.

Based on past experience there is also a sequencing of bank restructuring.

[5] See amongst others, World Bank (1998) chapter 3; IMF (1999); Claessens (et al, 1999); and World Bank (2000),Chapter4;

Box 2
Sequencing of Bank Restructuring

1. Responding to Acute Crisis: to stop panic and bank runs

Crisis: over leveraging, denial of government and bank owners

Bank runs intensify, confidence falters: central bank provides liquidity credit with the intention of sterilizing the liquidity support so as not to loose monetary control.

If Liquidity Credit fails to stem runs: introduce deposit or blanket guarantee scheme.

2. Stabilizing and Restructuring the Banking System

Consolidate, recognize losses, take over, close down, merger
Recap viable banks
Introduce new rules and regulations

3. Recovery to Normal Banking System

Nationalized banks are privatized, corporate debt restructured, bad assets sold
Phase out blanket guarantee and replace with normal deposit insurance scheme

Source: Lindgreen

In applying the conventional wisdom to managing the crisis in Indonesia, what were the lessons learned and could the mistakes have been avoided?

Initial Responses

The initial responses by Indonesian authorities to the early signs of the crisis prior to the IMF program coming in was actually very similar to conventional wisdom of IMF programs: raise interest rates, fiscal austerity, freeing up the exchange rate and begin to address the weaknesses in the banking sector. However, the lack of credibility of the program and the flip flop in interest rate increases at the end, led to loss of confidence.

The float of the Thai Baht on July 2, 1997 precipitated responses in the other economies and Indonesia firstly widened the exchange rate band from 8 to 12 percent, which led to an immediate 7 percent depreciation of the rupiah to Rp. 2600/US$ with the first wave of capital outflow from international mutual funds and hedge funds. As pressure built up and it was obvious that intervention to defend the band would be too costly, the rupiah was floated on August 14 and monetary policy tightened considerably. Overnight call rates increased to a very high level of 81 percent and SBI rates went up from 12 percent to 30 percent. However, the rupiah continued to weaken and depreciated even further corporates with large and unhedged external debt tried to cover their positions. The combination of rupiah depreciation and high interest rates, and the beginning of problems experienced by over leveraged borrowers, led to the first round of effects on the banking system. Bank Indonesia had at the time already begun to provide liquidity support to some banks.

In early September 1997, the government announced steps to be taken such as fiscal austerity, including postponing private power projects related to President Suharto's children, and a plan to restructure the banking sector which would include closures of unsound banks. However, the market did not react too positively as implementation was still an issue. In previous crises, the Indonesian leadership and government had reacted appropriately in the face of the crisis, including sending a signal of the seriousness of its commitments to undertake reforms. However, initial decisive actions was marred by lack of specificity and ambiguity in addressing the needed reforms. Furthermore during September, due to pressure from businesses, the government also undertook measures to loosen monetary stance and reduced interest rates, and SBI rates fell to about 20 percent, sending conflicting signals about monetary policy and led to further capital outflow.

Finally, amidst worsening confidence and weakening rupiah, the government announced that Indonesia would ask the IMF for assistance in October and on November 1, 1997 the first IMF letter of intent (LOI) was announced. The strategy to seek IMF assistance at this stage, supposedly proposed and supported by the technocrats in the cabinet represented a change in their strategy. After the experience of the late 1960s and 1970s the technocrats had preferred a strategy of succeeding in undertaking its own stabilization and crisis response programs, and the top leadership until now had always been able to accept necessary reforms even those which affected closely linked businesses. In fact the technocrats strategy which had worked up to now was to use crisis to push reforms which the top leadership has been reluctant to undertake.

The initial IMF package has been since criticized for several reasons, some of which the IMF itself acknowledged. One criticism is the broadness of the package itself. The "conditionalities" included the usual IMF menu of macroeconomic stabilization measures but also included issues on the environment and the inclusion of structural measures including in banking sector. There were also some severe deadlines imposed on these conditionalities. Was there really an expectation that these conditionalities would be met by GOI in the short time given (three years) because they involved major changes in the law, setting up new institutions or changing existing institutions radically, and the way policy and regulations are to be implemented.

Box 3
Chronology July 1997- December 1998

July 2	Thai Baht floated

July 11	Peso floated, widen band on Rupiah float
August 14	Rupiah floated. Finance Minister ordered Rp. 3.4 trillion deposits (10% base money) of state enterprise deposits to be transferred to Central Bank Certificates. Short term interest rates rose to and SBI doubled; announced plans to merge state banks and reshuffled senior management of state banks.
August 20	Banks beginning to feel stress, shortage of liquidity and high interest rates, corporations scrambled to cover foreign exchange exposures.
September 3	Announce broad government stabilization plan: ease bank liquidity and interest rates, budget revisions (especially cancellation of mega projects) to counter decline in revenues, deregulation in real sector, closure of insolvent banks and 49% limit of foreign purchases on IPO lifted. Lack of specifics, timelines or concrete follow up in the following weeks. Monetary policy eased too quickly, 20% early Sept. to 16% by mid October.
September 16	Review and postponement of private and public mega projects, postponement, short of cancellation.
September 18	Go ahead for 15 well connected projects even though in postponed or reviewed list, as long as had sufficient funding. Undermine credibility and missed opportunity to send signal of commitment to macro stabilization and reforms on own initiative, instead of negotiating with IMF.
October 8	Continued weakening of rupiah, BI had to intervene continuously, and market skepticsm of seriousness of President Suharto/government to undertake reforms. Finally government turned to IMF assistance.
October 31	First IMF stabilization package: strong macroeconomic program, structural reforms especially strengthening financial sector. Amount of assistance large and various mistakes in implementation.

In particular the push on structural reforms that were read as the "signal" for Suharto's commitment to reforms, such as those affecting his childrens' businesses, represented a serious miscalculation on the part of the technocrats and the IMF. The outcome was resistance from the President and reversals of the announced reforms led to a worsening the crisis of confidence. The technocrats and the IMF miscalculated the way the package of reforms worked on "confidence".

The IMF's position was that structural reforms, especially in the financial and corporate sectors were crucial to stabilization. It is unclear whether the GOI negotiating team was pushing for the structural reforms or were hesitant and in the end buckled to IMF pressure. The technocrats were playing the old game again. Use a crisis, and in this case now with external pressure, to get the President to undertake reforms in the controversial and sensitive areas. The argument was more for confidence building to indicate the seriousness of the President's political will to undertake reforms. However this time a serious miscalculation had been made and the push made was too far and too wide, and perhaps because it was being extended by an external body unlike in previous occasions where it was undertaken under willingly and not seemingly forced on the President.

Given the focus of the paper, we would like to now focus more on the bank restructuring component of the reform package. The initial response to what was then perceived to be a limited banking crisis affecting still a small portion of the weakest banks, including the state banks, was in accordance to "conventional wisdom". That is in order to stabilize the financial system by preventing capital flight and a breakdown of the payments system, unviable or unsound banks should be closed down without causing loss of confidence. In order to restore confidence of depositors and creditors a guarantee scheme on deposits needed to be introduced at the same time.

The first LOI comprised of a bank restructuring component which was quite comprehensive, although at the time of the announcement this was not made clear to the public. The first LOI, unlike the subsequent ones, was not made publicly available. The main components of the package included intensifying supervision for a number of the largest private banks, rehabilitation and surveillance plans for a number of smaller private banks, merger of state owned banks, and immediate closure off 16 small and deeply insolvent banks (market share: 2.5 percent) with protection limited to small depositors of up to Rp. 20 million (around US$6000) which accounted for 90 percent of the number of depositors in the banking system. There were also reforms of the state banks, the same recommendations which the World Bank had attempted to impose on state banks under its failed Financial Sector Development Project loan (1992-5) to GOI to recapitalize the State Banks (Kenward (1999)). This comprised of merging or privatization; rationalization; and recovery of bad debts.
Unfortunately, after a brief period of around two weeks whereby there was relatively positive response and the rupiah strengthened back to around Rp. 3000, confidence began to falter for several reasons. The closures of the banks were not planned and executed well. The first IMF Letter of Intent was never made public, and thus, the only information provided was based on the announcement of the Minister of Finance and Governor of the Central Bank. In fact prior to the announcement of the first LOI, it was widely expected that there would be bank closures and that it would include the ones known already to be weak such as Bank Pacific, Bapindo, and a number of banks which were in fact no longer active. However, the arbitrary nature of the choice of banks closed and unclear criteria used, led to speculation that more banks would be closed – especially since the names of the other 34 banks that were to be rehabilitated were not made known. The issue of lack of transparency and unequal treatment was worsened when the son of the President, owner of one of the closed banks, challenged the Minister of Finance regarding the closure. The outcome was that the bank was still closed but allowed to be resurrected by purchasing the license of another bank. This was the first indication and perception that the President was not going to adhere to the IMF reforms and which in turn would seriously affect Indonesia's recovery process.

Furthermore, the deposit guarantee of Rp. 20 million also did not provide the comfort level needed. The response of domestic investors was to withdraw their deposits from private banks to state banks or a flight to "safety" rather than quality. A large number also went to foreign banks or exchanged rupiah for dollars and repatriating the funds. This was the beginning of the domestic capital outflow, which worsened rapidly in December as the crisis of confidence deepened, with rumors of further bank closures, illness of the President and rumors about the death of Sudono Salim, the captain of the largest business conglomerate and owner of the largest bank, Bank Central Asia. The flight to "safety" continued in even greater amounts and not just to state or foreign banks, but taken out of the banking system and kept in cash or repatriated abroad. By mid December 1997, 154 banks (half of the total assets of the banking system) had faced a run on their deposits and during December 1997 Bank Indonesia's liquidity support to banks increased from Rp. 13 trillion to Rp. 31 trillion or 5 percent of GDP. In effect the liquidity support was funneled abroad (Lindgren et al, 1999). There was also inconsistent application of monetary policy, with monetary easing occurring in November, and some tightening in December.

In December, there were attempts to revive the badly shaken confidence by announcing a number of tariff reductions in heavily protected sectors (chemicals and fisheries), setting up of a special task force to assist negotiations with creditors for private sector debt, and announcement of restructuring of the state banks with merger of four of the state banks (Bappindo, BBD, BDN and Bexim) into one, and allowing one to become the subsidiary of another (BTN and BNI 1946).

The major failure to stabilize the financial system with the initial efforts appears to be the lack of the necessary legal, institutional and policy framework to select non viable institutions and mismanagement of the process the closure, compounded by political economy factors, which led to a crisis of confidence and further bank runs. The corporate debt problem was initially also not prioritized as the magnitude of the problem was not known with any precision and the impact of corporate distress due to the macroeconomic shocks and subsequently the effect it has on the banking sector, not well understood by the IMF or the government economic policy makers.

Another set of criticisms relate to the way the policy package was announced and made known to the public and market since as the IMF itself acknowledges, the intention of the IMF coming in is to restore confidence to prevent private capital outflows and/or bring back needed private capital inflows. The initial strategy was to show a rapid IMF response comprising of a comprehensive package, including structural reforms, and a large amount of assistance amounting to $10.1 billion (4 times Indonesia's quota), and shored up in the first few days with intervention to the tune of $4 billion by a concerted action of central banks to strengthen the rupiah. Indeed the rupiah appreciated by some 10 percent in the first few days after the first IMF package was announced, but weakened sharply afterwards.

The macro shocks led to corporate distress and a rise in non performing loans, and a shift of deposits from small and weak banks to larger often foreign banks in all the crisis countries except for Philippines which had a deposit insurance scheme in place, and all had to resort to some sort of government guarantee of deposits. External short term liabilities of banks also turned out to be much higher than envisaged and the need to roll over these liabilities became a major issue.

Dynamics of Crisis: Second Round of Stabilization

The crisis of confidence worsened in January, with the rupiah plummeting to Rp. 15,000 towards the end of January. The crisis of confidence was precipitated due to a number of major developments such as the announcement of an unrealistic budget in early January, clear signs that the President was not committed to the reforms even as the second LOI was signed in mid January, as the President made it be known that his choice of Vice President would be the controversial B.J. Habibie, the firing of four of the Central Bank directors and as it became clear that the economic technocrats became less and less in charge of the economic policy making. This crisis of confidence sealed the fate of the banking sector into a full fledged systemic crisis and liquidity support from Bank Indonesia exceeded Rp. 60 trillion by end of January.

On January 26, 1998 the government established the Indonesian Bank Restructuring Agency (IBRA) to assist the government in its banking sector restructuring and recapitalization program[6]. IBRA was set up at the same time the government announced the provision of deposit guarantee for all deposits to prevent further bank runs like the bank run which took place after the closure of 16 banks in 1997. IBRA is engaged in three main activities. The first is the implementation of the government guarantee program including the registration of bank's liability, premium payments, and the administering of claim verifications. The government guarantee on all bank liabilities covered both on and off -balance sheet obligations, with subsequent automatic extensions every six months, unless an announcement is made by IBRA. Derivative transactions (other than currency swaps), bank liabilities to affiliated parties and shareholders of 10 per cent or more shares in the bank were excluded from this guarantee.

The second involves the bank-restructuring process, including coordination and monitoring of bank performance, improving the value of bank's assets, and overseeing divestments of IBRA's shares that were derived from recapitalization program. IBRA was established for a finite period of five years to restructure troubled banks through closures, mergers, recapitalizations and eventually the sale of its ownership in these troubled banks; to recover the transferred bad loans; and to monitor and sell corporate assets pledged or transferred to IBRA from former bank owners as collateral for emergency BI liquidity credits.

The third activity involves the coordination and supervision of banks that had been frozen or closed, in order to complete the whole process of closing banks. These activities include the execution of operational activities as well as management and administration of settlement processes.

Essentially the objectives of IBRA are: to restructure banks through closures, recapitalization, mergers, and acquisitions; to recover loans through restructuring and sales; and to monitor and to sell corporate assets related to bank restructuring. Under the law[7], IBRA has been granted extraordinary powers, including certain judicial power, to execute agreements in its name, to acquire, manage, transfer and sell banks assets, and to restructure and to rehabilitate the banks under IBRA's supervision, including the ability to conduct mergers, acquisition and mergers. IBRA has a statutory existence of five years from February 1999, but such term could be extended as required.

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[6] Presidential Decree No 27. 1998

[7] Law of No 10, November 10, 1998, amending the Law no. 7 of 1992 on Banking and Government Regulation No. 17, 1997.

While IBRA was formally established in January 1998, the blue print for banking recapitalization program was finally announced and implemented in December 31, 1998, in the form of Government Regulation No. 84/1998. The design is basically picking up the loser, and not the winner. The program is basically designed to select bad banks to be closed, and leave banks that had viable prospect to continue to operate and grow.

The immediate impact on confidence was relatively positive and the rupiah strengthened to around Rp. 10,000-12,000 by early February. By February 1998, 54 banks (36.4 percent of banking sector) which had borrowed heavily from BI (more than 200 percent of their capital and CAR less than 5 percent) were placed under IBRA supervision. This included the four state owned banks (BAPINDO, Bank Bumi Daya, BDNI and Bank Exim) which accounted for one quarter of the liabilities of the banking sector and 50 private and regional banks. However, continued uncertainties regarding the implementation of the IMF reforms, including the President's seeming insistence to introduce the currency board system during February; the replacement of the head of IBRA; and political uncertainties leading up to the Presidential selection in March of that year, undermined the confidence further. There continued to be deposit runs as well as credit lines to domestic banks being withdrawn, and liquidity support continued to increase.

In early March the liquidity support facility was unified into a single liquidity facility with interest rates being just slightly above market rates to replace the many windows with high interest rates. The focus was shifted from using high interest rates to deter irresponsible usage of liquidity support, to non-market sanctions. Banks with borrowings outstanding for more than one week would be inspected by the Central Bank which in turn had one week to report whether the banks activities should be restricted or whether the bank should be put under IBRA. The monetary authorities meanwhile hiked up interest rates with SBI rates doubling to 45 percent, and thus the interest rates on liquidity support remained high.

In early April, IBRA announced its first major action whereby seven of the banks (15.6 percent of liabilities) which has borrowed more than Rp. 2 trillion each and accounted for over 72 percent of total Bank Indonesia liquidity support were taken over (banks taken over). Out of the seven one was a state bank, Bank EXIM and the other six comprised some of the major private banks. IBRA suspended the owners and removed the management of the private banks, twinning them with state banks. Another seven smaller banks (0.4 percent of banking system) which had borrowed more than 500 percent of their capital were closed. Learning from the previous experience of bank closures, great effort was made to ensure smooth transition by ensuring that the deposits of these closed banks were directly transferred to a designated state bank, Bank Negara Indonesia on that weekend itself; announcing and explaining the objective criteria for closure and BTO. As a result the actions were well received by the market and there were only sporadic runs.

However, the banking system was hit by another big shock in the weeks leading up to the May riots and the resignation of President Suharto. The rupiah which had stabilized at around Rp. 10,000 around the February-April period, destabilized again to go above Rp. 10,000. There was a serious loss of confidence by both domestic and foreign investors. In the week of the riots and following the riots, there were massive deposit runs on the biggest bank, Bank Central Asia which accounted for 12 percent of the banking system. The majority owner of BCA is the Salim group, known to be close to President Suharto and in fact 30 percent of the shares of BCA are held by two children of the President. The Central Bank and two state banks injected liquidity support to the tune of Rp. 30 trillion to BCA over the week following May 16. On May 29, BCA was taken over by IBRA and the shareholder's rights suspended and management was changed. This stemmed the runs on BCA.

Table 3
Chronology of Bank Closures

	1/11/97	14/2/98	4/4/98	29/5/98	21/8/98	30/9/98	13/5/99
Private Domestic Banks							
Liquidated	16 (2.5)						
Surveillance (IBRA)		50 (11)	37				
BTO (IBRA)			6	7	4		11
Frozen			7		10		
Closed							38
Merged			4				
Recap							9
State Banks							
Surveillance		4 (25)	3				
BTO			1				
Merged						4	
Regional Banks							
JV and Foreign							

Notes:
4/4/98: six private BTO banks: BUN, BDNI, Modern, Danamon, Tiara Asia, PDFCI and one BTO state bank, EXIM; seven frozen: Surya, Pelita, Subentra, Hokindo, Istismarat, Deka and Centris
29/5/98: BCA was taken over

Following from this, interest rates began its steep ascent with Bank Indonesian Certificates (SBIs) fetching a high 70 per cent p.a. interest rate and deposit rates also reaching 60-70 percent as banks sought to maximize liquidity position to anticipate against potential deposit runs, and given that inflation by then had already reached 50 percent. The negative spread experienced by the banking sector increased substantially during this period, further affecting its capital base. In October 1998, the equity of the private national and the 7 state banks dropped to the negative territory, leaving a major portion of the banking sector technically insolvent. The economy contracted at close to 14 per cent in 1998 and bank NPL reached 75 per cent of total loans.

Rehabilitation and Recapitalization

After the resignation of President Suharto in May 1998, and with the government under the leadership of President Habibie, there followed a few months of uncertainty and the exchange rate remained weak and interest rates remained high. Not much development could be expected under such conditions in banking restructuring, although much was done in terms of auditing all the banks in the banking system in order for the new team at IBRA to move to a broader program of bank restructuring and setting up a strengthened prudential and regulatory framework.

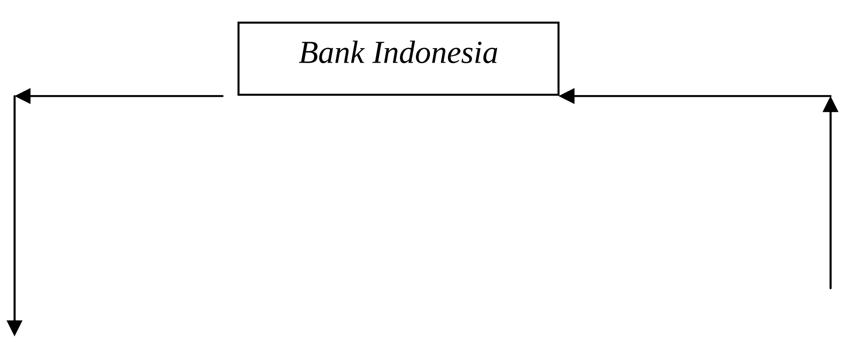
What needed to be done was to complete the selection of viable and non-viable banks, and rehabilitate and recapitalize the remaining viable banks. Clear criteria of viability is necessary and needs to be linked to operational restructuring in terms of imposing a cost to the existing owners (dilution of shareholding, forced consolidation, change in ownership/management) and ensuring proper prudential oversight subsequently. In a systemic bank crisis as Indonesia faced, it was clear that private capital was unlikely to be attracted without government participation. With the blanket guarantee, the cost of recapitalization became the burden of the government and managing the emerging government debt became apparent. The cost of the restructuring was in turn intricately linked to the ability to resolve value impaired assets by restructuring non performing loans (restructuring, rescheduling, sale and swap) and sale of assets and banks taken over. The GOI had opted for a centralized structure to resolve the sale and restructuring of assets, and this in turn led to a lot of political interference.

The audits revealed the complexity and magnitude of the Indonesian banking crisis. In June 1998 the result of the audit of the six private banks which were first taken over in April 1998 was revealed with average NPL of 55 percent of loans (90 percent in one large bank), dominated by affiliated lending and deeply insolvent. On August 21, three of these banks were declared frozen – Bank Umum Nasional, BDNI and Bank Modern, and their deposits transferred to designated state banks. The rehabilitation program for the other three were that Bank Danamon was to be recapitalized by the government and to act as a bridge bank for further mergers with other banks. PDFCI and Bank Tiara were given a final opportunity to be recapitalized by their owners or either be closed or merged with Bank Danamon. In early August the results of the other banks were revealed to show also weak situation of the banks and indicated the deep problems of the banking system.

Each bank was evaluated according to its Capital Adequacy Ratio (CAR), placing it in Category A (CAR above 4 percent), B (CAR between 4 percent to negative 25 percent) or C (CAR below negative 25 percent). Category C Banks that failed to increase their CAR to 4 percent within 30 days would be frozen. Category B Banks were then subject to further classification, either to be closed (BBKU=Bank Beku Kegiatan Usaha, or BBO=Bank Beku Operasi), recapitalized or taken by the government (these are the BTO=Bank Taken Over banks).

IBRA moved to take action against 10 of the former bank owners of the BTO banks which were deemed to have violated their legal requirements. In essence they were asked to pay back the liquidity support obtained from Bank Indonesia and the amount of affiliated lending. By late September some Rp. 200 trillion of assets at the owners valuation had been pledged from several of these owners as well as about Rp. 1 trillion in cash. IBRA's advisors valued the assets at RP. 92. 8 trillion and tentative settlement. A protracted debate ensued as to how much cash up front owners should provide and there was political controversy as suggestions of restructuring of asset ownership emerged, including the possibility of giving some shares to cooperatives. At the end it was agreed that the obligations should be settled within 4 years and that 27 percent be realized in the first year.   This debate continues as some owners have only provided very little cash and the asset value is now far below when it was first assessed for one reason or another (e.g. collapse in pulp prices, worsening rather than improving macro economic conditions etc.).

Figure 1 Bank Recapitalization Scheme



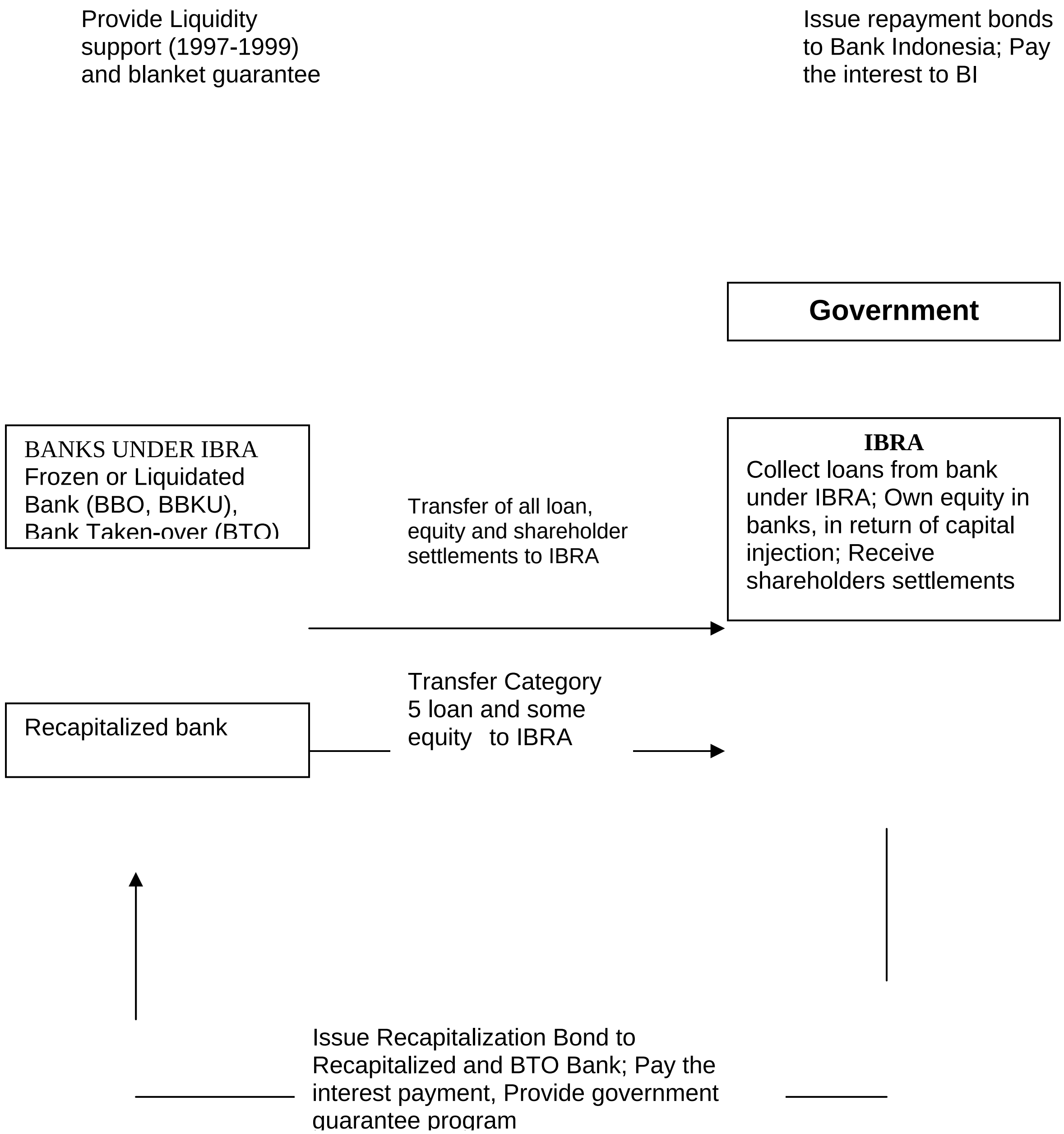


Figure 1 shows Bank recapitalization scheme in Indonesia. The chart shows that the government basically issues bonds to commercial banks as part of the recapitalization program, and to Bank Indonesia as part of the repayment program since Bank Indonesia has provided the liquidity support to the banking system.

Private Banks

With bank equity becoming negative, IBRA moved to launch its re-capitalization program in September 1998. The objective was to recapitalize viable banks and to have burden sharing between the government and the private sector to restructure the banks.

Given the systemic crisis, it was recognized that government injection of capital was necessary to induce private capital. The governments contribution would be in the form of bonds whilst that of owners would be in cash. The owners could reacquire the share in the bank by repaying government contribution and after three years, the government would have an independent valuation of the bank done. The owners had the first option to buy back the government share but after a specified period, the government could sell it to other investors. To encourage owners to inject new capital, the government allowed owners to retain control over the management of the banks. Category 5 loans or those classified as loss, were to be also transferred at zero price to the Asset Management Unit of IBRA. Any resale of these loans would be used to buy back the government preference shares giving the government possibility of earning return on its capital injection and reducing the amount owners have to pay to reacquire the bank.

The program comprises of categorizing banks into three groupings based on an audit by international accounting firms. The first grouping, named category A banks, were those that had CAR above 4 per cent, and were exempt from the program and could resume its operations. The next, category B banks were those whose CAR fell between 4 per cent and negative 25 per cent. These banks were candidates for the program, provided that their respective bank owners could inject 20 per cent of the total new capital injection required to attain a CAR of 4 per cent. For those whose CAR fell below negative 25 per cent, were relegated to the bottom category, namely the C banks. Bank owners of C banks were given time to boost their respective bank's equity position so they could graduate to B category, upon which they would eligible for the program provided they were willing to inject 20 per cent of the new capital required, or to A. Failing this category C banks and B banks, whose owners couldn't meet the additional capital requirements, would be closed. For those in category B, but whose owners couldn't meet the additional capital requirements there was still a chance of being taken over by IBRA (called Bank Take Over or BTO) provided that the bank had sufficient depositor base and branch coverage.

The implementation of the recapitalization program experienced various delays due to political uncertainties and intense lobbying by owners of bank that were in danger of being closed down for not meeting the CAR. The deadline of February 26, 1999 for announcing the categorization of banks experienced delays as this occurred and some banks which should have been closed ended up being taken over by the government. These glitches, affected confidence and the Rupiah weakened again to Rp. 10,000. Finally in mid March the government announced that there were 73 category "A" banks out of the 140 banks which did not need government support; nine banks making up 10 percent of the banking system were categorized as B and eligible for the recapitalization program; 38 banks (5 percent banking sector) were closed; and 7 banks (2 percent of banking system) were taken over by IBRA.

The owners and managers of the "A" category banks also had to be reviewed by the fit and proper test, and one third did not pass the test. The managers and commissioners who did not pass the test had to be replaced, and owners who did not pass the test were given 90 days to divest their shares.

Whereas, the nine category B banks were given five weeks to store up the additional capital and seven met the April 20 deadline. The other two, Bank Bali and Bank Niaga experienced problems. Bank Bali was in the midst of negotiations with Standard Chartered to come in with .. stake when the corruption scandal broke out. Whilst in the case of Bank Niaga the major shareholder did not come through and in the end the bank was taken over by IBRA.

IBRA negotiated performance contracts and MOUs with the owners and management of the eight banks to be recapitalized, taking ordinary stock and allowing management control to the owners of the banks. The estimation of the amount needed for recapitalization had been done in September 1998 and since then, the economic and political situation in fact did not improve much and by May, in the period leading up to the elections, the economy had not recovered, and the rupiah was still weak. Thus, by May 1999, the updated audits indicated that the amounts needed for recapitalization would be almost double than what was originally predicted.

Among the 13 banks taken over by IBRA, 9 was merged with Danamon, while BCA, and Bali remain as they are and were recapped, whilst Bank Niaga was taken over and then recapped. The larger recapped banks are BII (affiliated with the Sinar Mas Group), Lippo (Lippo Group) and Universal (Astra Group). There are 4 smaller sized banks also recapped. These are Bukopin (Cooperative Bank), Prima Ekspress, Arta Media and Patriot. At present there are further plans to merge the four smaller banks with Universal as they could not meet the CAR of 8 percent by end of 2001.

<u>State Banks</u>

As for State Banks, progress on restructuring has been much slower. After Bank EXIM was taken over by IBRA in April 1998, not much happened until the decision to merge the four state banks, Bank EXIM, BDN, BBD and Bapindo into one and call it Bank Mandiri in September 1998. The corporate business segment of BRI was also merged into Bank Mandiri and BRI was to concentrate on small businesses. The non-performing loans of the four banks were transferred to the Asset Management Unit of IBRA. The management of Bank Mandiri was entrusted to professionals with technical assistance from Deutsche Bank, who in turn have done much work to consolidate the bank. Half of the staff have been retrenched and branches have been closed. The bank has received Rp. for recapitalization in … and is being prepared for privatization.

As for the remaining three state banks (BNI, BTN and BRI), after submitting restructuring plans, and the banks have also been recapitalized in … and the management has also been changed. The change of management at BRI invited some controversy as the President's recommended name for the President Director did not pass the proper and fit test of Bank Indonesia. This is part of the ongoing tug of war between the President and the central bank. The person in question is now the Minister of Finance in the revamped cabinet of President Wahid.

There are also plans to recapitalize the 27 regional development banks.

Box 2: Summary of Current Status of Bank Restructuring

No of Banks before Restructuring	Bank Category A	B	C	Restructuring process	No of Banks after Restructuring
State Banks					
7	-	-	7	4 merged into 1 1 new bank (export) All recapped	5
RDBs					
27	13	10	4	**<u>12 recapped</u>**	27
Private National Banks					
142	72	40	30	48 closed 7 recapped 13 BTO	92

Source: Kompas and estimates

Table 5
Summary of Bank Industry Highlights

		<u>State Bank</u>		<u>Prvt Bank</u>		<u>RDevBank</u>		<u>For/JV Bank</u>	
(31 Dec)	<u>97</u>	<u>99</u>	<u>97</u>	<u>99</u>	<u>97</u>	<u>99</u>	<u>97</u>	<u>99</u>	
No of Banks		7	5	144	92	27	27	44	41
Branches/bk		218	316	29	39	20	20	2	2
Assets (IDR tn)	201.9	417.3	248.7	291.6	12.3	18.8	75.2	102.4	
Loans (IDR tn)	153.3	112.3	168.7	56.0	7.5	6.8	48.6	50.0	
Deposits (IDR tn)	133.0	312.2	177.2	252.9	8.8	14.0	38.6	72.3	

Capital	(IDR tn)	13.8	(17.7)	25.2	(10.2)	1.3	2.0	6.1	4.3

Source: Bank Indonesia

All five of the state banks (including newly formed Bank Ekspor Indonesia) fell under category C, while slightly less than half of the 27 Regional Development Banks (RDBs) also were categorized as C. However, due to the perceived importance and political sensitivity, the government opted to maintain the state banks and RDBs. All state banks and RDBs were capitalized. Although the consolidation of the state banks has been termed as a merger, it more aptly resembles the closure of 4 banks and consolidating the remaining performing assets in one single bank (Mandiri). The employees of the merged banks were given generous early retirement payments, which resulted in a significant downsizing, and there was a change in management.

IBRA, Asset Sales and Managing Non Performing Loans

IBRA acts as the centralized agency in bank restructuring. It has to coordinate debt collection from former bank owners for liquidity credits owed during the crisis, it has to dispose of assets taken over in lieu of payment by bank owners and bank borrowers, and it has to also restructure and dispose of non performing loans taken over in the process of bank restructuring. The functioning of IBRA has been heavily politicized with political interference from the very top to protect certain vested interests, lack of transparency and accountability being an ongoing problem. The head of IBRA has been changed six times in the time that it has existed.

(more on this later)

The size of the domestic debt

Table 6 presents the composition and size of domestic public debt. The total domestic public debt basically equals to the total government bonds issued by the government as part of bank restructuring program during the economic crisis. There are two kinds of bonds based on the purpose: recapitalization bond issued to recapitalizd banks, and repayment bonds issued to Bank Indonesia for the guarantees and liquidity supports provided by the central bank. The total government bond in June 2001 is more than US$ 650 trillion, about 50 percent of GDP, and is still increasing. The current negotiation with the IMF involves the possibility to issue additional Rp. 40 trillion bonds to Bank Indonesia to provide larger bank guarantee. Some banks could not meet the required 4 percent CAR at present, and further recapitalization bond is perhaps needed in the end of the year. Therefore we expect to have at least Rp. 700 trillion of government bond by the end of the year, and possibly more depending on the performance of the banking sector for the rest of the year.

The increasing amount of government bonds overtime reflects the problems of banking restructuring. Large amount of repayment bond to Bank Indonesia was caused by massive bank run, something that could have been avoided if the closure of 16 banks in 1997 were credible and sufficient deposit guarantee were provided. The growing amount of recapitalization bonds through out 1998 and 1999 was caused by delays in banking restructuring programs. The move to close bad banks was just too little too late, partly because of various political interference, lack of institutional and legal capacity, and even some high profile scandals like Bank Bali.

There are three types of bank recapitalization bonds. The fixed bond has a fixed interest rate, varies from 12 percent to 14 percent per annum, and the interest is paid every six months. Because the interest rate has increased to more than 17 percent, the government conducted bond-exchange-offer to increase the interest rate of the bond and make it more attractive, even though the weighted average of the coupon rates remains the same. These bonds now carry 10 percent to 16.5 percent coupon rates. These bonds have 5 to 10 years to mature, and the first maturity date would be in September 2004.

The variable rate bond carries flexible exchange rates, which is calculated based on the fluctuation of the three months SBI (Bank Indonesia Certificate) rates. The payment of the interest is done in every three months, and the interest rates of these bonds are around 15 to 17 percent at present. These bonds have 3 to 15 years to mature, and the first maturity date will be in July 2002.

Table 6 Domestic Public Debt (Cumulative, in Trillion Rupiah)

Period	Issued to IBRA *				Issued to Bank Indonesia				Total
	Variable Rate Bonds	Fixed Rate Bonds	Hedge Bonds	Sub total	BLBI **	Bank Guarantee	KLBI ***	Sub Total	
					Inflation Index		Var.Rate		
Dec-98	-	-	-		100	-	-	100	100
Mar-99	-	-	-		164.5	-	-	164.5	164.5
Jun-99	95	9	-	104	164.5	53.8	-	218.3	322.3
Sep-99	95	9	-	104	164.5	53.8	-	218.3	322.3
Dec-99	204	51	27	282	164.5	53.8	10.0	228.3	510.3
Mar-00	204	53	25	282	164.5	53.8	10.0	228.3	510.3
Jun-00	330	59	29	418	164.5	53.8	10.0	228.3	646.3
Dec-00	217	175	35	427	164.5	53.8	10.0	228.3	655.3

Source: Dec-98 to Jun-00: World Bank, March 2000

Dec-00: Anwar Nasution's presentation for IBRA

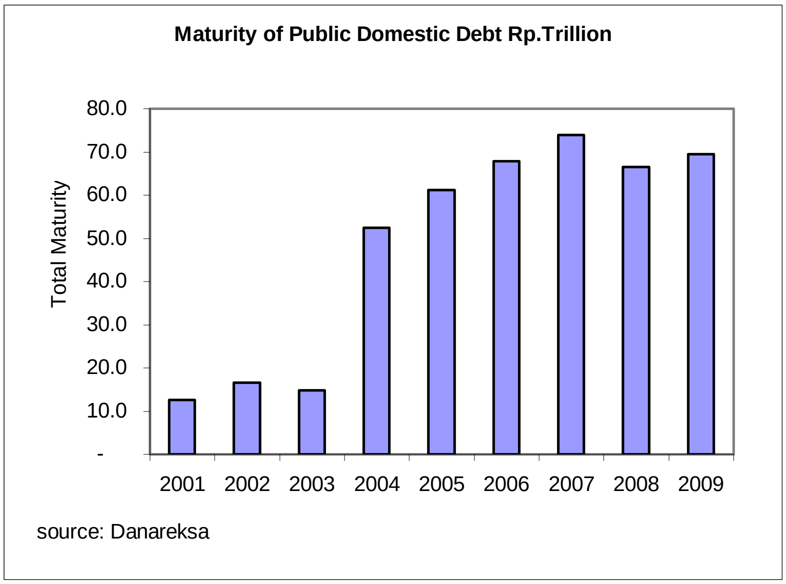
1) *BLBI: Liquidity support given to bank (due to bank run in 1997-98), including Rp 20 trillion to Bank Export Import Indonesia (state bank) which was then merged to Bank Mandiri.*
2) *Bank Guarantee= Blanket guarantee provided by BI*
3) *KLBI: Unpaid subsidized credit given to government by Bank Indonesia*

The hedge bond is hedged to exchange rate (Rp/US$) and is used to cover the exchange rate risk by the bank due to foreign liabilities. Every three months, the interest rate is paid and the nominal value of the hedge bond is reevaluated based on exchange rate fluctuation. If the Rupiah depreciates, the nominal value of the hedge bonds will of course increase. The interest rate is SIBOR plus 3 percent, and currently the hedge bond carries around 6 to 7 percent interest rates. The fixed and variable rate bonds are tradable, while the hedge bond are non-tradable and at maturity the hedge bond will be replaced by other bonds.

The repayment bonds issued to Bank Indonesia is mostly inflation index bond, which carries 20 years maturity. Special for the unpaid subsidized credit of around Rp. 10 trillion, the bond is variable rate with 10 years of maturity.

Figure 2 shows the maturity profile of government bonds up to 2009. The picture basically represents the maturity of the racapitalization bonds given to recapitalized banks since the indexed bonds for Bank Indonesia are 10 to 20 year bonds. It is clear form the picture that a large amount of government debt will be due in 2004 and beyond, and without any development of the secondary bond market by 2004, the payment burden to the government will be massive. The government is clearly facing tremendous pressure coming forward to pay the coupon as well as refinancing its maturing bonds.

Figure 2 The Maturity Profile of Domestic Debt



The real cost of bank restructuring

The net present value of the real cost of banking restructuring is derived from the difference of the bond that is issued by the government and the value of assets that is collected and then sold by the government when the price is right. The balance sheet of IBRA, calculated based on data in April 2001 and December 2000, is presented below. The estimated book value of total assets held by IBRA is round Rp. 541 trillion. The total liability, in the form of bonds issued to Bank Indonesia and recapitalized banks, amounted to about Rp. 655 trillion. The difference between asset and liability at their book values (Rp.207 trillion) consists of IBRA's implicit equity in state banks and the difference between the collections of shareholder settlements and the repayment bonds issued to Bank Indonesia.

Based on the estimated market value, IBRA is expected to recover about Rp. 207 trillion from it's total asset, or about 38 percent recovery rate. The difference between IBRA's asset and liability at their market values represents the estimated net present cost of banking restructuring in Indonesia. This out of pocket expenses that the taxpayer has to pay would be around Rp. 447 trillion at best, or more than 30 percent of the GDP. With around 210 million of population living in Indonesia, the net present value of the cost for banking bailout for each person would be more than Rp. 2 million at best.

Table 7 The real cost of bank restructuring: The net present value

ITEMS	Book Value	Market Value	Recovery Rate % 1)
Asset (April 2001)	**541.8**	**207.9**	38
Corporate equity as sharehorders settlements	131	70.7	54
Core asset from Private and State Banks	270.3	94.6	35
Non-Core Asset from Private and State Banks	8.5	3.0	35
IBRA's investment in Recapitalized and BTO Bank 2)	132	39.6	30
Liability (Dec 2000)	**655.3**	**655.2**	
Government bond to Bank Indonesia	228.3		
Government bond to Recapitalized bank	427		
Asset – Liability	**-170.5**	**-447.28**	

Source: Bank Indonesia and IBRA

Notes:

1) Calculated based on IBRA's strategic plan October 1999

2) Excluding IBRA's investment in state banks

The revenue from asset disposal will automatically finance the cost of banking restructuring as the revenue would go to the asset side of bank's balance sheet and then reduce the amount of government recapitalization bond. IBRA has sold some of its assets, and if the target of the asset sales is more than Rp. 200 trillion, IBRA should raise at least Rp. 40 trillion for the next five years. But the target of cash recovery in 2000, which was met by IBRA, was Rp. 20.7, and the target in 2001 is Rp. 27 trillion, much lower than what is supposed to be. In other words, it is doubtful that IBRA could meet the Rp. 207 trillion cumulative cash recovery target overtime, and therefore the net present value of the banking restructuring is expected to be higher. The issue is how to finance this burden overtime, so that the country could grow-out from its domestic debt without the fear of monetary or fiscal deficit explosions in the future.

Bond market development

The government has issued more than Rp. 650 trillion of government bonds and by looking at the maturity profile, significant amount of the bond will mature in 2004 and beyond. The creation of deep and liquid bond market is needed to reduce the burden of the government in managing the debt repayment in the future and to create another source of long term financing mechanism in the country. In addition, the existence of a liquid bond market would create another monetary instrument for Bank Indonesia to conduct monetary operation. Unfortunately, the bond market is currently underdeveloped, and the government is running against time to set up an effective and efficient market before 2004.

Since February 1, 2000, the fixed and variable rate bonds have been traded, but the volume of transaction remains small. In June 2001, the cumulative total trading of the government bond in the market was around Rp. 56 trillion. The majority of investors remain the banking system itself, accounting for about 75 percent of the total trade bonds.

The market is still shallow and narrow which makes the bond illiquid instrument. Increasing interest rate since the end of 2000 has worsened the situation as the price of the bond declined remarkably. The discount rate ranges from 10 percent to 25 percent because the interest rate has been around 10 to 25 percent higher than the coupon rates. As a result, sellers are suffering from capital losses. Banks are reluctant to sell their bonds to avoid losses, and therefore they still rely on inter-bank money market for liquidity. The fact that the bond is considered a risk free asset held by the banks, the banks are not willing to sell the bond at loss with the risk of declining capital adequacy ratio (CAR). But the banks are not in a position to raise cash or to channel credit to make profit because they can still channel their funds to SBI (Bank Indonesia Certificate) and enjoy the provision of blanket guarantee by the government, both on the asset and liability sides. There has been massive moral hazard problems in the banking system, and with the blanket guarantee in place, the development of the bond market is expected to be slow.

The bond market also suffers from the lack of infrastructure. There is no firm legal basis to protect investors from default risk and lack of information on rules and regulations of government bonds trading. There is no market makers, no benchmark yield curve, and derivative markets. The Ministry of Finance is in the process of establishing debt management unit and it remains to be seen that the effort would be successful.

Fiscal Consequences

Debt service payment will severely constrain public expenditures and the flexibility of overall fiscal and monetary policy. Table 6 presents the amount of debt service payment by the government both for external and domestic debt in the government budget.

Total government debt service obligation amounted to around 30 percent of government domestic revenue compared with only 10 percent before the crisis. Interest payment on the domestic bond alone accounted for 20 percent of domestic revenue in 2001. The principal payment of the domestic bond would increase dramatically for the next several years, as the payment in 2004 is expected at more than Rp. 52 trillion. The peak of the principal payment will take place in 2007 at around Rp. 74 trillion. External debt service payment has been kept relatively low in 2000 and 2001 because of Paris Club debt rescheduling. External debt service decreased from more than 37 percent of domestic revenue in 1999 to less than 16 percent in 2000 and 2001.

Because debt-related expenditure has increased dramatically since the crisis, the government has been forced to reduce the share of development spending and subsidies. As a result, the capacity of the government to be an engine of growth has weakened. Government expenditure for development (excluding subsidies, routine expenditure, and debt service payment), for example, declined from 42 percent of total expenditure in 1996/97 to 18 percent in 2001. At the same time, government interest payment increased from 12 percent of total expenditure in 1996/97 to 24 percent in 2001. The increase is mainly due to sharp increase in domestic interest payment, from zero in1996/97 to 17 percent of total expenditure in 2001.

Table 8. Government Debt Service Payment in Government Budget (Rp. Trillion)

Government Debt Payment	95/96	96/97	97/98	98/99	99/2000	FY2000	FY2001
External	**27.4**	**22.9**	**29.5**	**54.5**	**40.9**	**26.6**	**40.1**
Principal	20.5	13.0	12.8	30.3	20.3	8.1	17.0
Interest	6.9	9.9	16.7	24.2	20.6	18.6	23.1
Domestic	**0.0**	**0.0**	**0.0**	**8.4**	**22.2**	**34.8**	**53.5**
Bond	0	0	0	0	0	0	0
Interest	0.0	0.0	0.0	8.4	22.2	34.8	53.5
Total	**27.4**	**22.9**	**29.5**	**62.9**	**63.1**	**61.4**	**93.5**
Interest payment	**95/96**	**96/97**	**97/98**	**98/99**	**99/2000**	**FY2000**	**FY2001**
As % of domestic revenue	9.7	11.3	15.5	22.2	22.7	27.5	29.1
As % of tax revenue	12.7	15.4	20.5	27.4	34.7	48.0	42.6
As % of expenditure	11.0	12.7	15.0	19.4	20.8	23.8	24.2
As % of GDP	1.5	1.8	2.4	3.1	3.7	5.7	5.4
Total Debt Payment (P+I)							
As % of domestic revenue	38.6	26.1	27.3	42.8	33.5	31.7	35.5
As % of tax revenue	50.4	35.6	36.1	53.0	51.1	55.3	52.0
As % of expenditure	43.9	29.4	26.4	37.4	30.7	27.4	29.6
As % of GDP	5.8	4.1	4.3	6.0	5.5	6.5	6.6
Domestic							
As % of domestic revenue	0.0	0.0	0.0	5.7	11.8	17.9	20.3
As % of GDP	0.0	0.0	0.0	0.8	1.9	3.7	3.8
External							
As % of domestic revenue	38.6	26.1	27.3	37.1	21.7	13.7	15.2
As % of GDP	5.8	4.1	4.3	5.2	3.5	2.8	2.8
As % of export	23.7	8.1	5.9	13.3	7.8	4.8	6.4
As % of Gross For. Reserves	46.7	21.4	12.4	25.2	17.4	10.7	14.2
Primary fiscal surplus/GDP (%)	**3.3**	**3.6**	**1.9**	**1.1**	**2.2**	**2.5**	**1.7**
Gov. surplus or deficit/GDP (%)	**1.8**	**1.8**	**-0.5**	**-2.0**	**-1.5**	**-3.2**	**-3.7**

Despite the large interest payment, government expenditure on subsidies has been maintained during the crisis. A major component of government subsidies is fuel subsidy, and because of higher oil prices, expenditure on subsidies have increased dramatically and reached 26 percent of total expenditure in 2000. Because of budgetary constraints, the subsidies have been substantially reduced leading to higher fuel prices, which are in fact more in line with international prices. However, the share of subsidies in the government expenditure is still high at 17 percent in 2001. The government is expected to cut more subsidies in anticipation of higher interest payment in the years to come.

Hindsight Analysis: Reviewing the Results of the Audit and Restructuring

The results of the audits of the banks and the process and progress of restructuring reveal several important trends.

The dangers of foreign currency lending. It is interesting to note that banks, which survived the crisis, were largely those that had no foreign exchange license or, even if they had, their foreign currency transactions were minor compared to their rupiah activity. This is in spite of weak management and credit processes at some of the surviving banks. It was those large banks (both state and private) that provided foreign currency services and were exposed to considerable foreign exchange risk that were badly hit by the crisis. This is not surprising, given the volatility of the exchange rates during the crisis. The extent of the damage caused by the crisis was often directly correlated with the level of foreign currency loans on the bank's books. Panin was an exception, given their higher CAR level and their quick response to reduce their USD loan oustandings. Another exception are foreign banks which have been able to absorb these losses, given their world wide and diversified earnings.

The first loans to experience problems during the crisis were those in foreign currency. Bank customers had borrowed heavily in foreign currency, given the lower interest rates and the steady 4-5 per cent annual depreciation of the rupiah against the USD for the last few years. But most of these borrowers were rupiah income earners and when the rupiah dropped in value by 70-80 per cent, their rupiah income had to service four times their loan in rupiah terms.

The dangers of affiliated lending. Another trait of banks badly impacted by the crisis is the widespread lending to affiliates beyond the legal lending limit (LLL) allowed. The problem with affiliated loans is that loans are often not adequately scrutinized, collateralized, documented, appropriately priced and monitored. The problem was exasperated by practices to overcome the LLL, such as the practice of loan swaps between banks and to channel the loans through other banks by providing interbank placements to banks that would then on-lend these funds to affiliates of the funding bank. Thus, when the crisis happened and problem loans mounted many funding banks were stuck with inter-bank borrowings that could not be repaid. This is the reason why many inter-bank borrowings, despite guaranteed under the government's guarantee program, they were often categorized as ineligible due to these type of transactions. Group-affiliated banks were the most impacted by this problem.

After the fact, based on data from the international audits of the banks under the Indonesian Banking Restructuring Agency, there is evidence that concentration of ownership is positively correlated with various indicators of unsound banks. There is also evidence of gross violation of legal lending limit. It is estimated that an average of 50 percent of total lending of these banks was to their own group. This can be compared with the legal lending limit rule of 35 percent of equity, and thus assuming CAR of 8 percent, lending to own group was close to 20 times more than legal lending limit.[8]

Present conditions and remaining challenges for the banking sector

Despite the progress in rehabilitation and recapitalization of the banking system, there remain many challenges and problems. The banking sector remains dominated by state banks, all of which have been recapitalized, but which remain weak, or banks taken over by the state. After the restructuring the state has become dominant, either through state banks or because it has taken over or recapped private banks. In fact close to 85 percent of the total banking sector third party liabilities are owned by the government with 13 BTO and 80 percent of the 7 recapitalized banks under IBRA, and the remaining 4 state banks. Whilst the state banks have been recapitalized and the management restructured, the problem with state banks remain numerous due to the political pressures it faces.

The rest of the banking system comprises firstly, of the former large private banks which were taken over, merged and recapitalized and now comprising basically of four banks: BCA, the merged 10 banks under Danamon, Bank Niaga and Bank Bali. Only BCA has undergone divestment, with 22.5 percent of its shares sold to the public at Rp. 0.9 trillioin in May 2000. Plans are under way for divestment of the others, however, the market remains weak and there are many uncertainties surrounding the prospects for further divestment. The purely private banks not under IBRA are made up of 63 small sized Category A banks. There are now 26 regional development banks and 50 joint venture banks. The top four foreign banks are Citibank, Standard Chartered, ABN Amro and Hong Kong Shanghai Bank.

The problems faced by the banking sector at present are three-fold. First, even after the recapitalization, with the exception of a limited number of banks, the CAR level of most banks are still low and remain close or below the 4 percent minimum level. Any material loan growth would easily lower a bank's CAR level as risk-weighted assets rise and capital levels stay more or less level. Furthermore recapitalization has achieved the minimum CAR by increasing the assets side of the balance sheet with government bonds, but there is no real cash to increase loans unless the bonds are sold. Should the economy recover and loan demand increase, banks would still face a problem of liquidating their government bonds in the secondary market to create funding for issuing loans. Government bonds still trade at a discount, which if too large, would in the end hurt the Bank's CAR level. The amount of recapitalization in fact was lower than what was needed at the time due to the fact that the calculations were made to cover losses up to March 1999, but yet the actual bonds issued was some 3-4 months later when the losses had gone up.

Second, earnings are also still low, reflected by very low interest margins. Banks assets still largely contain government bonds with low yields (12-13 per cent), while deposit

[8] Estimates from interviews with IBRA officials.

rates are slowly rising with the weakening of the Rupiah. The corresponding interest margins are often too low to cover operational costs.

Lastly, NPL levels remain high, even after the bad (category 5) loans were transferred to the AMU in IBRA. The slow economic recovery, means that corporations have not yet been able to significantly improve their debt service capabilities and thus there is the likelihood of another round of losses.

Problems and Issues

With the economic recovery projected to remain at its current "muddling" pace with low growth of 3-4 percent, given the political realities, bank earnings are not expected to improve sufficiently to maintain their already low CAR levels. With NPL levels still high, even category A banks are showing earnings fatigue, which if translated into declining CAR levels would imply a need for a second round of recapitalization. The question though is where the source of this recapitalization is going to come from. With the government budget already spread so thin among competing and basic needs, there is limited government resource available.

This points to the market and whether private investors (both foreign and local) would have the appetite to buy into an Indonesian bank. There had been limited response from foreign investors with the first offering of BCA in the aftermath of Standard Chartered Bank's failed acquisition of Bank Bali, and potential strong reactions against foreign investment in the banking sector. However, more recently the divestment of BCA shares appears to have sparked foreign investor, in partnership with domestic investors, interest. Standard Chartered is one of the leading candidates to buy up to 51 percent shares in BCA.

Nevertheless the likelihood of foreign investors coming in to the banking sector is likely to be limited. Thus, unlike the experience of the Latin American banking crises, foreign investors will not be the source of new capital or source of better governance, management and know how.

Financial investors which come in with capital and a new management team to restructure the bank with the hope of reselling at substantial capital gain, are more likely to have appetite for such risky investments as Indonesian banks. However, the major issue remains as to how to restructure the sector to make it attractive for investors and also what specific conditions are needed to make the investment sufficiently attractive for investors to want to come in.

Further consolidation is probably in order for the Indonesian banking sector and this process should not be delayed.

Completing Restructuring: Developing Core Banks. The above discussion point to the facts that the commercial banking sector remains weak and under capitalized, the number of banks still remains above 100 (low franchise value), and the state dominates 85 percent of third party liabilities of the banking sector. The state banks are still experiencing relatively high NPLs, which could increase and remain under capitalized. The situation is not likely to improve given the uncertainties that continue to plague economic recovery and corporate debt restructuring. Therefore, another round of cleaning out NPLs and increasing capital will probably be required, followed by a further consolidation of private and state banks to establish a number of sound core banks which would be in a position to function as financial intermediaries.

The justification for developing a smaller number of core banks is based on the following reasoning. First, given the limited number of qualified and experienced Indonesian human resources in the banking sector, fewer banks would allow surviving banks to get a larger share of this scarce resource. IBRA has resorted to using foreign bank experts to enter the management of the banks under its control, as well as using advisers and consultants. However, resorting to such means to meet the shortfall in scarce human resources is likely to be limited, given the complexities of operating in the Indonesian environment. Second, fewer banks would also ease the burden on the supervisory and monitoring task of the central bank (and the independent supervisory agency in the near future). Third consolidation would allow more economies of scale to take place, given the high fixed cost of developing bank technology. Fourth, better performance and profitability of existing banks and the limit in the number of banks, would add to the franchise value of the bank and attract private investors to inject the needed capital into the banking system.

Consolidation should not be based on deciding the number of “ideal banks” and undertaking an exercise of picking winners with less than objective criteria. Consolidation should be based on incentive based framework and the requirements of core banks should be designed in a way to ensure risk appropriate behavior and good governance by the owners, managers and supervisors of banks. A possible path towards further consolidation could be as follows.

With regard to state banks, it is recommended that further mergers could be undertaken whereby the already merged state bank, Bank Mandiri, could be merged with Bank BNI 1946. The NPL are transferred to AMU in IBRA or a separate subsidiary for NPL of state banks set up. The management of the newly merged state bank should be changed and good Indonesian expertise put in place in the top management. The elements of good governance over a state owned bank should also be introduced such as transparency, disclosure, ensuring independence and proper credit evaluation for providing loans (no political interference) with outside directorship or statutory body overseeing the bank, and so on. In order to raise capital, the government could inject capital which is linked to the change in management, and since BNI 1946 is publicly listed, capital could also be raised in the capital market. Injection of public funds and other steps taken to increase the franchise value of banks, will hopefully attract the interest of private investors.

As for private banks another round of mergers and consolidations should be encouraged out of the remaining bulk of the private sector banking system. The few core private banks which emerge will, along with the 2 or 3 strengthened state banks, form the back bone of the banking system. The remaining 63 smaller private banks which are not under IBRA should also be encouraged to merge and consolidate to perhaps 20-30 and be regarded as second tier or community banks with a different market segment. The consolidation of the private banks should be based on the following incentive based framework.

International experience and lessons indicate that the key elements of an incentive based framework focuses on rules to ensure that core banks are financially strong and behave in risk appropriate way. Important elements would be first to link determination of the minimum amount of capital and capital adequacy requirements (CAR) with increased risk. For instance it can be required that only core banks can have a foreign exchange license with high requirements on capital and CAR (e.g. 15 percent), which will in turn encourage further consolidation. The higher level of capital requirement would imply serious initial commitment of owners and management who want to be in the banking business, and also protect franchise value of banks from unfair and imprudent competitors (Bossone and Promisel, 1998). Additional incentives such as tax relifef for bank mergers can also be provided. The experience of build up of vulnerabilities pre crisis given the open capital account and rapid pace of financial integration, implies that any bank providing foreign currency services and transactions should be well equipped to face volatile exchange rate movements.

Second, to ensure there is pressure for bank management to be subject to good governance, foreign exchange banks should be publicly-listed. Its soundness and health ratings by the Central Bank should be published and made accessible to the public, and to ensure appropriate behavior of the supervisors, the banks should also be rated by both international and local rating agencies. A similar approach was adopted in Chile which other than government or central bank supervision of internal risks ratings and valuations of a bank, two independent private accountancy firms must audit the bank every year and their findings published. The central banks is to publish ratings based on capital requirements and the quality of the assets of the bank

Third, given the governance problems of asymmetrical information due to the concentration of ownership in the banking sector and the problems of excessive affiliate or group lending and having banks act as the owners' business group's treasury function, it would be important to have more diversified ownership. As mentioned already, diversification of ownership through increased foreign bank ownership is likely to be limited. Widely dispersed ownership of banks may also not provide the effective oversight to banks until enforcement of prudential regulations are adequate (World Bank, 2000). Another avenue for diversification of ownership is through divestment of the government shares in the banks through the capital markets or through seeking financial investors. The funds raised can then be used for recapitalization. Given the past problems of excessive violation of the legal lending limit by business groups, a recommendation would be to limit the share of financial institutions that can be owned by business groups and limit the percentage of single ownership to less than majority (e.g. 49 percent or 25 percent).

Fourth, banks with foreign exchange licenses have to have the capacity to manage risk. This implies very strong and proper criteria for evaluating whether bank owners and managers are “fit and proper”. Bank Indonesia is implementing such a process in Indonesia at present.

Fifth whilst it is not expected that foreign banks will play a role in recapitalization of the banks, foreign banks can bring in capacity, know-how and human resources. There is also an expectation that foreign banks can introduce better governance and corporate culture.

Political Economy: State Divestiture of Assets and Banks. The most difficult problem facing a country like Indonesia is the political and social constraints to be able to institute rapid restructuring and reforms that will strengthen the financial sector. As indicated above, the ownership of banks and major corporations rests in state hands. Restructuring has already involved large losses and how the losses should be distributed between the state, tax payers, creditors, bank owners, borrowers and depositors is not yet completed. More importantly restructuring involves redistribution of wealth and control directly through restructuring of assets and liabilities, and indirectly through taxation and wage and employment adjustments (Claessens (1998:2). A clear consensus has not emerged in Indonesia with regard to the role of ownership and control in the banking sector or market between the state and the private sector, between domestic and foreign companies, and between large and small medium sized corporations. This process is likely to still be politicized, given also the ethnic dimension of predominant Chinese ownership of banks and businesses. Until these issues are resolved the progress is likely to be slow and continued to be plagued by problems and interventions.

IV. THE WAY AHEAD: APPROPRIATE SEQUENCING AND INTERIM STEPS

The situation that Indonesia is in right now is an ongoing restructuring process with the majority of the banking sector still in state hands. There are a host of measures on paper which have been taken, and a set of other measures which yet to be taken. Many of them relate to addressing and correcting the vulnerabilities which existed prior to the crisis and which was discussed in detail in the second section of this paper.

A Note on The IMF Rescue Package and Conditionalities

The intention of the first IMF package was to demonstrate decisive government action on dealing with the banking system, which in turn would improve confidence in the remaining banking system. The experience in providing blanket guarantee in Thailand with the closures of the non-bank financial institutions led to the limited guarantee scheme (Enoch, 2000). The strategy of boosting confidence also included concerted interventions to the tune of $4 billion by the central bank, Bank Indonesia, assisted by Central Bank of Japan and Monetary Authority of Singapore, and the amount of the package itself which was large ($10.1 billion or 490 percent of Indonesia's quota).[9] In

[9] There was also a so called second line of funds to come bilaterally from various countries, the Singapore, US, Australia and even China, adding up to another $7 billion.

addition to the World Bank and Japan as the first line assistance the program amounted to US$12 billion.

The main justification for the IMF assistance program was to shore up confidence and to assist the deterioration in foreign exchange reserves due to the massive capital outflows in 1997/8. The IMF rescue loan package is linked to an IMF Letter of Intent (LOI) and the IMF team comes at regular intervals to assess the performance of the LOI and sign new ones. The IMF LOI that Indonesia has agreed to is a very comprehensive one covering macro economic measures such as base money and fiscal deficit targets; structural reforms in the real sector related to trade and investment barriers being removed and financial sector restructuring. There are also a host of laws, regulations and institutional changes mandated including the independence of the central bank, competition law, bankruptcy law, bank-restructuring agency, and debt facilitation agency.

Indonesia has signed 15 IMF LOI in the November 1 1997 – September 2000 period, with each LOI getting more and more detailed in terms of targets, time tables, and guidelines of implementation. This has been due to the deterioration of relations between IMF and the GOI, and the resulting decline in trust, especially during the second half of 2000 until recently. Many deadlines were missed and seriousness of implementation questioned, especially with regard to the transparency of debt restructuring of the major private sector obligors and asset sales, under the Indonesian Bank Restructuring Agency. There have been cases where both President Habibie and Wahid intervened to provide for differential treatment for certain debtors and obligors. The legal and court system has also been found lacking in being able to enforce decisions on corruption and bankruptcy so that even when decisions are made, there has been few actual sanctions and bankruptcies actually happening. The lack of transparency and discretion has led the IMF to increasingly micro manage the LOI, by creating oversight committees, independent committees and so on in an attempt to overcome the lack of authority and independence of IBRA and ineffective court systems. In the last LOI the corporate guiding principles were introduced and all past agreements have to be reviewed against these guidelines.

Other than the issue of lack of transparency and discretion, there were also proposals by the GOI that the IMF could not accept. One of the most controversial being the idea of asset securitization of loans and amendments to the central bank law, which would allow the removal of the current board of governors. A new LOI was supposed to have been signed at the end of 2000 and this was not possible, and as time passed and the macro conditions changed as well, the number of pre requisites that the IMF required before the LOI could be signed increased.

The new government which came in mid 2001 successfully signed the IMF agreement making the way for release of the $400 million from the IMF. The six priors that the IMF imposed as conditions before a meeting to discuss a new LOI could commence have been met. They are the issuance of new bonds to replenish the government blanket guarantee program, approval of the 2002 budget by the Parliament, divestment of BCA and Niaga, guidelines for corporate debt restructuring, review of a number of debt restructuring and agreements of major obligors under IBRA. However, due to the World Trade Center incident, the negotiations for rescheduling under Paris Club II has been delayed from the original planned meeting in the second week of September and it is not clear when the meeting will take place.

The result has been a delay of the signing of the LOI and the disbursement of loans which looks like being resolved recently. One of the conditions however, was greater transparency with regard to extension of debt payment by former bank owners which has caused a lot of controversy domestically as well as with the IMF.

Changing Thinking on IMF Conditionalities

Given that Indonesia's bank restructuring is still an ongoing and problematic area of reforms, there has been much analysis, debate and changes in thinking regarding what should have been done and what should be done moving forward. The IMF itself has undergone introspection and has undergone an evolution in the types of conditionalities it imposes. As is clear from the Indonesian experience, the reforms and required actions has gone from general macro and financial targets, to micro management. Furthermore, the required actions were not increasingly just about what policies to undertake and institutions to be set up, but also how the institutions and policies should be implemented such as what kind of contracts and terms the government has to have with the banks and debtors. The shift to micro management and implementation issues, especially with regard to transparency and governance, had a lot to do with the growing distrust between the IMF and the GOI. However, the approach was becoming increasingly ineffective, and deadlines and targets were being continuously missed.

As is evident from the above analysis of what was done and the results, as well as some alternatives of what could have been done, it is clear as has been pointed out by some that we ought to be more humble in providing detailed policy prescriptions to developing countries, when there is no sure theoretical basis or conclusive empirical evidence to support the optimal policy prescriptions (Rodrik, 1999).

The second justification for the types of conditionalities being introduced, including those to do with transparency and governance, was according to the IMF as well as in the case of Indonesia the GOI negotiating team of technocrats, the need to instill confidence and thus – to bring in private capital flows. The perception was that the signing on with the IMF was not just about the assistance received, because much more funds is needed to rescue the economy. It was about instilling confidence so that private capital (domestic and foreign) flows back in, interest rates come down and the currency strengthens and stabilizes. Given the confidence issue with regard to the political commitment of President Suharto, then the reasoning was that transparency, strengthening financial systems and open markets, and structural reforms were necessary to restore market confidence.

However, as has been pointed out whether the policy prescriptions are the optimal ones for the country or are the ones that the IMF thinks will restore market confidence, are two different considerations. Investors in turn are heavily influenced by what the IMF, the Treasury and academic economists are saying (Rodrik (1999)). In the case of Indonesia, in the absence of transparency and information about companies, and banks, foreign investors and creditors relied on the World Bank country reports. Is sending a signal that Suharto was willing to entertain reforms which will affect his children what was needed to restore confidence? The results were in fact disastrous and a defiant President actually increasingly challenged the IMF as well as the technocrats who were initially in the negotiating team.

Under its new managing director, the IMF has been reviewing its conditionality program and moving away from micro management back to broader macro and financial targets.

Revisiting Financial Restructuring

The essence of the bank restructuring program pursued by Indonesia under the IMF program is to retain and rebuild a viable banking sector, and at the same time introduce a combination of measures, tools, institutions, and incentives not to repeat same vulnerabilities in the banking sector which emerged pre crisis.

Thus, the analysis of what should have been done and what should be done needs to be done at two levels. First is with regard to reviewing whether there were alternative solutions that could have brought about better outcomes in terms of dealing with the crisis and restructuring. Second is with regard to the comprehensive program that is now in place with the intention of addressing the vulnerabilities, which were evident pre crisis (as discussed in the next section).

The end game: appropriateness of second generation Washington consensus reforms -- does one size fit all?

More than half of the required actions which Indonesia has to undertake comprise of compliance to the new rules of the game or what has often been termed second generation Washington consensus reforms. The focus is on reforming what has been perceived as the weaknesses which led to the vulnerabilities of the banking sector pre crisis, and thus the focus is on reforms in the areas of corporate governance, bankruptcy procedures, business and government relations, stricter prudential regulations and implementation.

The reforms are in turn often linked to international best practices and codes such as Basle, Code on Good Corporate Governance, International Accounting Standards and so on. Whilst Indonesia by and large and on paper has complied to many of these requirements, implementation and enforcement are far from being realized and given institutional, legal and political constraints, may not be implemented satisfactorily any time soon. Furthermore, the banking sector remains weak and there is still a huge confidence problem, which makes it extremely difficult to phase out the blanket guarantee scheme in place right now.

In sum the problems amount to distorted incentives; inadequate information (asymmetry of information); inappropriate allocation of responsibilities; and poor market infrastructure. The recommendations to respond to date in the post crisis set of reforms include complying to international arrangements and standards in order to minimize moral hazard, sequence liberalization consistently with the overall pace of market development, and supporting liberalization with appropriate incentives and market discipline.

The risks associated with introducing these second generation of reforms by developing countries such as through the IMF programs should also be realized (Rodrik, 2001). First it reduces national autonomy in development policy and asks the country to embark on an untested model of development, while precluding national experimentation with other development models. The interpretation of this risk is not that the benefits of an open capital account, good corporate governance and strengthened prudential regulations are not realized, but that by a concerted focus on developed country norms means that one ignores the development goals which may be in conflict with those goals (Rodrik…).

Second too much of a focus on internal reforms may still not address issues of systemic risks that banks have to operate in due to specific circumstances of developing countries such as Indonesia are still in (Goodhart et al (1998)) and particular fragilities of financial sector. That is the economy in which the banks operate may still be one which is dependent on a limited set of primary products, financial markets less liquid, and subject to more volatile real economic growth, inflation, nominal and real exchange rate prices, equity prices and for those with an open capital account, capital flows as well as to confidence. As the crisis has demonstrated any shock to these variables will affect the balance sheet of even sound banks, as well as corporates which in turn affect banks. The effect is even worse for banks with undiversified portfolios (exposure to sector, particular business group or region). For instance banks did have an over exposure to real estate developers and during the crisis this was the worst hit sector. Yet pre crisis real estate developers were receiving rents in dollars and thus seemed perfectly hedged for dollar loans. However, during the crisis distressed corporations simply did not pay their rent or could only pay with the pre crisis exchange rates.

Developing countries are also smaller and the concentration and exposure of the economy to certain sectors or business groups high so that they are less able to absorb shocks arising from exchange rate, interest rate or aggregate demand shocks. Banks also dominate the financial sector in developing countries leading to high debt equity ratios and greater fragility of its corporate sector to interest rate shocks as is clear from the experience of the Asian crisis.

Third World Bank (2001), points out that the banking sector is fragile in general because of the intertemporal problem of intermediation, accepting money today for some return in future. There are all the asymmetry of information problems that lead to adverse selection and moral hazard behavior. The banking sector is also open to the possibility of contagious deposit runs which may begin at insolvent banks but can spread quickly to otherwise sound banks. The financial sector is more fragile in developing countries because the problem of availability and accuracy of information is worse leading to inappropriate risky behavior and related lending.

A final and very important aspect of the fragility of developing country financial sector is that the financial liberalization advocated as part of the Washington consensus, with a "regulatory and incentive environment ill prepared for a market-based financial system, and in particular one that encouraged or condoned excessive risk taking (World Bank 2001:89))."

Fourth the practicality of being able to undertake such extensive and comprehensive reforms involving setting up regulatory and legal institutions, and independent institutions, which took developed countries decades to do. The World Bank further points out that

> "Moreover, differences in institutional development and economic volatility, combined with the ability of financial market participants to adjust to regulation, mean that rather than precise forms or rules, authorities need a strategy for approaching financial sector regulation, and the strategy has to go considerably beyond convergence to industrial country norms." World Bank (2001:98)

For the banking system the most important problems are the lack of strong and transparent accounting systems which makes it difficult for bank supervisors to evaluate banks and for banks to evaluate borrowers, often leading to collateral rather than cash flow based lending. At the same time lack of legal protection for creditors makes it difficult to collect collateral from borrowers who default (Goodhart et al (1999:103)).

Fifth is the prevailing issue of concentration of ownership in state or private hands. In most developing countries, banks still dominate the financial system and the problem of concentration of ownership, whether in state hands or business groups prevail. Even after liberalization and deregulation, it is difficult to close down or manage state owned banks which are often over exposed to the non performing loans of state owned enterprises or private companies related to the center of power. In the case of Indonesia, due to the banking crisis it is estimated that 85 percent of ownership is now in government hands and privatization of government ownership to date has occurred at a very slow pace. It is expected that dominant ownership whether in state hands or with business groups is likely to continue during and after restructuring.

Given these differences between developed and developing countries, as well as a wide range of differences in institutional, economic structure and political economy features, in assessing what is best for the country in question, one must go beyond the ideal prescriptions based on the second generation Washington consensus. One size doees not fit all. What is then the minimum and broad set of regulations and rules. Even if one knows what should be done is one thing, but knowing what to do to get there is another thing. Given the analysis in the above sections, it is clear that what will be crucial is the synergy between the shorter term and longer term goals of bank restructuring, and how should one best sequence it? How to ensure that the long term goal is the national consensus so that it will stick? How to design the interim steps so that we move toward the end goal and not away from it? Can this be designed or is it impossible?

Possible Approaches for Developing Countries

The above analysis on higher risks faced by the developing countries due to the dominance of the banking system, the vulnerabilities to shocks and concentration of ownership of banks, often leads to the conclusions that for developing countries, the need for regulation (and with higher standards) is even greater, and that externally imposed rules and ratios to correct moral hazard and lack of incentives are more important since internal mechanisms are weak (Goodhart et al, (1998)).

However Barth et al (1999) point out that while moral hazard problems and lack of incentives for risk appropriate behaviour have been found to lead to banking crises, there is no consensus on how to correct the incentive and moral hazard problems for banks so as to prevent future crises. For instance it is far from sure that requiring higher capital adequacy ratios, stricter definition and provisioning of non performing loans, and strengthening and improving central bank supervision of banks are the most appropriate steps to be taken. This is because of differences in institutional and legal infrastructure and capacities, weak bureaucratic and judicial systems, deficiencies of data making it difficult to make accurate assessment of financial conditions of banks or their borrowers, and weak human capacity which make these reforms not easily or not at all implementable. Structural differences may also not make reform frameworks work. For instance in Latin America, there is evidence that requiring high capital standards will not necessarily work because of high levels of concentration of wealth and thin equity markets to make standards work or effectively controlled.

Therefore, much more thought needs to be put into thinking through an appropriate system for developing countries. Distinction should be made between regulation (establishment of specific rules of behavior), monitoring (observing whether the rules are obeyed) and supervision (the more general observation of the behavior of financial firms). There needs to be a balance between the three for the system to be effective, and there is a recognition that it is best to keep regulations, and thus monitoring, simple and straightforward, and steer away from detailed and prescriptive regulations (Goodhart et al (1998)). One must be clear on the objective of regulation and institutional strucutre designed to maximize meeting the objectives.

Others have recommended an incentive based system rather than tough and non implementable prudential standards and regulations. That is, "authorities in emerging markets should focus on using incentives to harness market forces that favor effective and efficient financial markets, and employ individual standards in so far as they contribute to this purpose" (World Bank (2001:92)). Advocates of an incentive based system point out that the difficulties of monitoring and enforcing international best practices in prudential regulations and supervision because of weak government capacity and lack of institutional and legal support, an incentive based reforms that induce good conduct and self policing behavior should be considered. It is easy to adopt rules and standards, and even pre crisis, Indonesia's prudential regulations and standards were already converging to international best practices. CAR was already introduced and an 8 percent target set according to the 1988 Basel Accord. However, implementation and enforcement by the supervisory authorities and risky behavior of the regulatory authorities, bank owners and corporates continued to be prevalent.

The current situation is still where developing countries, especially those under an IMF program, are meeting international standards of regulations, rules, governance and have set up institutions. However, convergence of developing country to developed country norms is more on paper and implementation in reality is still a far cry from convergence. On paper Indonesia has implemented a host of reforms and institutional changes, but it is evident from the analysis above, that implementation is still a serious problem and there remains a great deal of skepticism whether behavior and norms can change any time in the near future. The information needed to verify the compliance to standards, the lack of an incentive system and institutional and legal capacity, mean that developing country norms are still far from the developed countries.

What is an incentive based system? An incentive based system is defined as "system of rewards and penalties such that market participants perceive (correctly) that it is in their own best interest to behave in efficient and prudent ways (Bossone 1998:15)". It is argued that such an approach is more relevant for developing countries, which have limited public and private institutions, and scarcity of information. Incentives that reward market participants for prudent behavior (efficient capital allocation and risk appropriate behavior) will in turn promote growth and stability. In fact this system is along the same line of thought as the prudential regulations and supervision along market compatible principles, also taking into account capacity issues, that Goodhart et al advocates more generally.

The recommended components of such an incentive based system, including consideration for capacity and developing countries, and drawing on examples, include the following. Also analyze appropriateness.

Prudential and Regulatory Requirements

Developing countries are now being required to meet a host of prudential and regulatory requirements on capital adequacy, loan loss provisioning, and so on.

Simple but straightforward regulations

First on capital requirements. Before discussions on the type of CAR to best introduce, one should be aware of the limitations of CAR. They are intended to measure strength of banks' financial capital and Basle Accord has set minimum capital requirements for active banks determined according to the risk structure of banks portfolios. This implies that one can measure capital, know what should be included, have adequate procedures for evaluating asset quality and proper loan loss provisioning. In turn this will depend on existence of good accounting practices and principles, and capacity of the bank managers

and supervisors (Bossone (1998)). Given these difficulties CAR should only be one important element of the norms set to ensure sound banks.
Developing countries have come a long way to meet the 1988 Basel Accord which recommended a minimum CAR of 8 percent. Since then a case has been put forth that given higher risk, developing countries should have simple but higher standards of CAR. There is evidence that higher levels of capital are needed to compensate for volatility in emerging markets. For instance Argentina, HK, Singapore had CAR 15-17 percent in 1997. The counter argument against this other than the difficulties of measuring capital to begin with as already mentioned, is that there are many loopholes to overcome CAR requirements such as by booking loans offshore (reducing risky assets), and disintermediation. It could also lead to excessive placement of funds in government bonds or instruments with low risk, but also lower private returns which in turn could impair the bank's performance.

However, there is still a case for having the capital base be linked to incentives, that is higher CAR requirements should be linked to wider and often more riskier range of activities such as foreign exchange transactions and quality of internal risk management systems. Many have recommended having capital adequacy requirements being related to bank credit and market risks such as concentration of bank portfolios in particular sectors and foreign exchange exposure.

In any case capital adequacy is only one component of the soundness of a bank, which needs to be complemented by requirements to ensure the quality of the portfolio. The important measure is capital net true provisions for loan losses whose usefulness and accuracy depends on definition used to define non performing, accounting standards and proper information disclosure.

Second introducing portfolio diversification guidelines. For instance restrictions on asset growth especially with regard to limits on risky lending like real estate. This is intended to avoid shocks affecting asset prices leading to an impact on the balance sheet of banks.

One idea to reduce banking risk and fragility is the idea of a narrow bank. The idea of a narrow bank is that it is a depository taking institutions but are not allowed to make loans. The funds would be placed in safe assets such as government bonds or treasury bills. An example would be the postal savings banks. Other banks or financial intermediaries would then take deposits and make loans, and for the intermediation function which entails greater risk, these banks would have to offer higher interest rates. These banks could also have a limited deposit insurance. However, depositors who want guaranteed returns would get the lower interest rates from the narrow bank. Such a system it is argued would avoid the moral hazard of a widely spread safety net and the public have deposits with guaranteed nominal value. The problem with this recommendation is the selection of which banks become narrow banks, and how to avoid the other non narrow banks or non bank financial intermediaries who are allowed to undertake lending, to behave in a risk appropriate way. It would require stricter regulations and supervision of the financial institutions which are allowed to do lending, especially since they will have to give higher interest rates for their deposits compared with the narrow bank. The narrow bank would not solve the financial fragility problem.

However, the narrow bank concept can be a transition solution as part of the crisis and bank restructuring reform program. In the case of Indonesia the idea of a narrow banks has been proposed in relationship to state banks. Given that there is still weak capacity of state banks to undertake proper credit risk evaluation and assessment, and the potential for vested interests and political interference to play a role in influencing credit, ability to evaluate risks appropriately to provide credit, some have suggested that some of the original state banks be made into narrow banks. Post-recapitalization, a large proportion of their assets are already being held in government bonds. Strict CAR, uncertain economic environment and prevailing distressed corporations, have also meant very limited growth in loans and funds are being channeled to safe assets such as Bank Indonesia certificates. The narrow bank could be a temporary or interim solution until such time the state banks can be further consolidated, made efficient and capable again of giving out loans.

Strengthening Prudential Regulation and Supervision in Indonesia

Under the IMF reforms, there is a comprehensive set of changes of prudential regulations. Nevertheless, it will be important to redesign prudential regulations and supervision along market compatible principles (Bossone and Promisel, 1998). Some possible recommendations for an introducing such incentives in the prudential regulations after the process of consolidation and to ensure continued risk appropriate behavior would be as follows. First temporary limits on asset growth in general and growth portfolio of risky assets such as real estate to ensure risk diversification and smooth and reasonable growth.

Second strengthening requirements for minimum capital. The issue is whether capital requirements for banks in developing countries should be higher since they are operating in more risky environments. For instance in the US small community banks have higher capital ratios than money center banks because they have less diversified portfolios (Bossone and Promisel, 1998). This requirement could lead however, to perverse behavior such as disintermediation or booking of loans in offshore subsidiaries as well as investing excessive amounts of assets in government bonds, which bear lower returns. Therefore, this consideration must be incorporated in strengthening capital requirements.

Third, prudential regulations could also be market oriented by rewarding prudent and honest behavior with positive incentives such as lower CAR and less regulations or interventions for institutions deemed to be better managed. Fourth sanctions for misconduct should be implemented and enforced strictly, whether it is towards bank owners/managers and supervisors. For instance in Chile, once the capital requirement of the bank for one reason or another is not met, then the banks must be closed unless the uninsured creditors and supervisors agree to restructure the bank. Fifth, financial regulation and supervision of the sector need to be deepened and expanded. Finally, given the experience pre crisis, there has to be better exit mechanisms for orderly bank closures.

Of course the problem faced by Indonesia and many other developing countries, is whilst one can design incentive based rules, poor enforcement of rules and underdeveloped legal and supervisory infrastructure can thwart their proper implementation. Whilst governments and international institutions have prioritized institutional and capacity building to address this problem, it is likely to take time. Meanwhile much can be done by market participants to establish institutions that reduce risks, ensure risk appropriate behavior and avoiding corruption. This could be through private credit rating agencies, independent corporate governance bodies, representative groups to put pressure from various stakeholders such as consumers, minority shareholders and the like.

Supervisory capacity

Third given the vulnerabilities of not having adequate supervisory capacity pre crisis, obviously the reform of the central bank, introducing transparency requirements, making it accountable and independent, and strengthening capacity has been prioritized. The reality is that legislating the setting up of an independent central bank and having transparency and accountability requirements are not enough. Improving supervision will be a difficult task, which will require time. Lack of skills can be overcome in time with training of supervisors as well as of managers in the banks themselves, or temporarily outsourcing if need be. The incentive structure facing supervisors also be appropriate. Thus, to attain effective supervision and enforcement by the central bank, bank supervisors must be paid well especially as future reward (i.e. generous pension as deferred bonus) since misdeeds are difficult to determine immediately.

However, there are more fundamental problems, which are not so easy to solve. Developing countries face the problem of creating a framework for a sound banking system whilst at the same time trying to create a broader financial system. For instance trying to introduce good corporate governance without there being depth in the capital markets. Lack of liquidity in banks shares and also that not a large portion of the shares are publicly listed means that the role of the capital markets to complement the monitoring job of supervisors and regulators is missing. Lack of equity market means that bank owners can meet capital adequacy through borrowing from own or associated banks.

In the transition one recommendation is to use the market for short term bank liabilities as a source of information and policing device. If the short term liability market is functioning properly then the risk is priced appropriately based on the perception of the soundness of the bank in question, for instance through higher interbank borrowing rates. Therefore, the guarantee on banks' third party liabilities and the implicit or explicit guarantee on banks being bailed out or too big or too important to fail, should also bereduced or removed for the market of short term liabilities to reflect the information about the risk profiles of banks.

For instance some countries have also introduced issuance of uninsured and subordinated debt by banks so that investors will monitor these banks closely.

Another problem is that banks are still controlled by vested interests, including the government itself. The direction of institutional change is towards creation of independent institutions. Given weak supporting legal and political systems, making the concept "independence" meaningful is problematic. The conventional wisdom and direction of other central banks is for independent central bank and separation of monetary policy and supervision. Impact of delegation depends in turn on political polarization and the structure of agenda setting. Checks and balances are very important when there is more polarization. "Policy reformers face frustration if, in the absence of appropriate political institutions, they grant policy making authority to formally independent agencies. .. Political institutions are crucial to the sustainability and effectiveness of independent agencies" (Keever, 2000)

Another approach is to have external monitors of supervisory bodies as well as banks in addition to the supervisory agency. For instance requiring external and private agencies to monitor the regulatory institutions, to ensure that potential lack of independence and weak capacity of regulatory authorities do not undermine the soundness of the banking sector. Mandating external audits is one way such as in Chile where it is required that two independent accountancy firms must audit bank each year and make its findings public and bank supervisors must make also make its findings on bank compliance public three times a year. In addition to central bank supervision and rating of soundness, requiring commercial banks to also be rated by independent credit rating agencies (Chile, Argentina, NZ).

External monitors which directly monitor banks would also be another way to strengthen the supervisory agency's monitoring. Even the best supervisors would still find their job difficult because of information asymmetries (incomplete and imperfect information system) and such information problems affect all stakeholders, creditors, shareholders, senior bank managers and regulators.

Fourth strengthening accounting and greater disclosure requirements (Chile, Argentina, NZ). ; and

Fifth true net worth of capital with adequate loan loss provisioning - accounting standards and avoid under provisioning. IN developing countires it is difficult to prevent non performing loans apparent by preventing ever greening or providing new loans to service old loans.

Sixth external pressure can also come from Role of foreign banks. Claessens et al shows that a larger share of foreign bank ownership and thus more competition, forces domestic banks to operate more efficiently. Foreign bank entry also strengthens domestic financial markets by bringing in experience, technology and diversification of portfolios. In Mexico and Venezuela foreign banks emerged as key players in recapitalization of banks, in Argentina and NZ brought in much needed capital, and in Poland and Hungary needed knowhow and capital.

Seventh functioning and effective legal system, bankruptcy procedures
stricter prudential regulations in accordance with Basle and implementation,

Corporate governance and Moral Hazard

Eighth corporate governance norms and rules, how to implement given ownership problems, business government relationship. how to avoid moral hazard and bad corporate governance in the interim (lack of legal system, majority ownership) and in the longer run

Lack of liquid markets for bank shares and thus the role of capital markets to monitor corporate governance, and concentration of ownership both in the financial sector and in the real sector (i.e. lack of corporate governance and asymmetry of information of borrowers), constrain the effectiveness of implementing developed country regulatory and supervisory framework in developing countries in the short run. In the transition what should be done.

- higher prudential requirements because banks have to be more sound in developing countries to better be able to cope with the more volatile economic environment it faces. Therefore, higher CAR, higher than prudent level of loan loss reserves. But these can be rendered meaningless if accounting systems and auditing procedures lead to mispresrentation of information.
- Loan loss provisions of developed country standards: interest in ninety days past due should be considered NPL, therefore mans that banks need to report loans as NPL appropraitely and that there is legitimate loan classification and documentation procedures in place. Misclassification means NLP not reported accodint to internatinoal standars and capital adequacy overstated

Ninth moving to a deposit insurance scheme (DIS) under normal conditions. How to design it to maximize the benefits and avoid pitfalls, namely moral hazard and adverse selection and agency problems? How to design it so that there are good incentive structures for promoting financial soundness?

To reduce the current and extreme moral hazard situation of full guarantee on deposits and third party liabilities, Indonesia needs to move to a more normal deposit insurance scheme. The prevailing consensus is not to adopt a 100 percent deposit insurance scheme for all categories of deposit. The challenge for a country like Indonesia is firstly, phasing out the full blanket guarantee to a more normal deposit insurance scheme without causing panics or bank runs which would add to an already unsustainable fiscal cost to the government. By regulation the government must provide six months notice of any change in the deposit insurance scheme.

The second challenge is to identify the type of deposit insurance scheme which is most appropriate for the current conditions as well as a more ideal scheme in the longer run, and how to sequence it. A related issue is balancing the explicit and implicit guarantees. What is the appropriate exit mechanisms for insolvent banks? How does one signal that too big to fail or too important to fail implicit guarantees will no longer be carried out, since there is always an implicit insurance by authorities in both developed and developing countries, against a systemic crisis or even against the failure of one big bank

A normal deposit insurance scheme is one which is partial, not full, and aims to protect the smallest depositors such as the $100,000 limit under the US FDIC. Furthermore, along the market oriented or incentive based line of thinking would mean introducing risk weighted deposit insurance premiums whereby riskier banks pay a higher premium.

Incentive Based Safety Nets. Safety Nets for Indonesia

Safety nets are necessary to reduce the risk of a systemic crisis, but their design and implementation needs to be balanced between the need to protect consumers with the well known problem of minimizing moral hazard and making the cost of protection linked to the risk. The blanket guarantee was perhaps the appropriate response given the crisis of confidence in January 1998, however the scheme has to be replaced by one that is suitable for normal conditions and does not create a moral hazard. To make the safety net for investors more credible, the deposit insurance scheme should be more limited than its current government blanket guarantee format and only cover deposits (demand, time and savings) up to a certain maximum amount.

Experience in other countries show that especially in the 1980s, that financial institutions do take risks knowing that they are protected by some kind of deposit insurance (Caprio and Klingebiel (1996a, 1996b). This was the experience in Argentina in 1990 and Chile in the mid 1980s. If the deposit insurance scheme is seen to be full and the government is expected to protect fully depositors, bank managers will be less concerned about the impact of their actions on depositors and depositors will also not be prudent in their choice of banks.

It is not easy to introduce safety nets based on the right incentive structure and minimizing moral hazard. However, in redesigning a more normal deposit insurance scheme for Indonesia, the scheme could be used to provide positive incentive for the better performing banks by linking the annual premium payments to the banks risk profile. The latter could be measured by level and quality of bank capital, and a bank's credit rating. This way the deposit insurance scheme is self-funded by the banking community and becomes less of a burden on the government. The Chilean deposit insurance scheme introduced after the crisis is another good example, since partial coverage means private debt holders have an incentive to monitor banks and punish inappropriate behavior.

V. CONCLUSIONS

The experience of the Indonesian banking crisis offers the following policy lessons on avoiding or minimizing the build up of vulnerabilities as countries integrate with international financial markets. Financial liberalization needs to be preceded or accompanied by strengthening of supporting institutions and prudential regulations, and this must be accompanied by enforcement and sanctions for non compliance. Financial integration in world financial markets implies when exchange rate regimes are not flexible, prudential supervision of foreign currency exposures and risks or at the very minimum monitoring of the exposures so that there is awareness of vulnerabilities become crucial. Furthermore policy makers must be aware and be able to manage financial-macro linkages which can exacerbate macro economic cycles. Concentration of ownership of banks makes it difficult to monitor behavior due to asymmetric information and led to gross violations of the prudential regulations. This implies a need to reduce dominant single ownership and/or improve substantially prudential regulations, the qualifications of owners and managers, and of course corporate governance norms and regulations to strengthen information disclosure. Finally, moral hazard problems are great when there are no clear exit mechanisms and when there are always bail outs due to "too big or too important" to fail arguments.

The responses to a financial and banking crisis as experienced by Indonesia, need to be gauged carefully. The important lessons here are that liquidity support and lender of last resort facilities need to be designed in a way that do not lead to misuse and are accountable. Furthremore, failure to sterilization of liquidity to absorb excess liquidity will lead to increased liquidity which fuels inflation and capital outflows, further weakening the rupiah. Of course in the case of Indonesia, political realities need to be considered. The crisis of confidence implied that the usual relationship between capital flows no longer held, and high interest could not stem capital outflow.

The issue of avoiding a confidence crisis in managing closures of unviable institutions is a difficult one, but the Indonesian experience underlines the importance of ensuring that the closures must be accompanied by a clear explanation to the public regarding the criteria for bank closures, consistency in implementation, and a well defined deposit guarantee scheme. The deposit guarantee scheme must be prepared in advance so that it is clear to depositors that they are able to get their money back or transfer to quality banks (IMF, 1999). Furthermore, once there is a massive crisis of confidence, limited deposit guarantee is not sufficient. Comprehensive deposit guarantee is needed, however it is debatable whether the guarantee should have been extended to all liabilities of banks.

What are the lessons in bank restructuring? Since Indonesia is still undergoing the process, the lessons are preliminary. First recapitalization was necessary, but the selection of viability was questionable, including lack of uniform treatment between state and private banks. Furthermore it would seem that the recapitalization program was not linked to a serious restructuring program, and as such the danger and potential of the need for a second recapitalization has emerged. Thus, recapitalization alone is not sufficient to attract private equity injection without certainty in the direction of restructuring, low franchise value, and uncertainties in implementation of a sound banking system.

Political interference in the process has been and continues to be a major problem leading to delays and inconsistencies in the restructuring process. It is clear that restructuring cannot proceed without full commitment by government to support the agencies undertaking the restructuring in terms of giving IBRA sufficient independence to operate, protection from law suits, and a means to attract the necessary expertise.

Asset valuation of NPL and other value impaired bank assets remain the most difficult and intractable task of bank restructuring in Indonesia due to changing economic conditions. Yet it is key to reducing the fiscal burden of the cost of bank restructuring. The key issues is now to properly value the NPL to avoid bailing out existing shareholders, undermining private sector recap and proper governance of banks. Asset disposal has been centralized in IBRA, but a concensus is not apparent with regard to the strategy of asset sales, especially with regard to the speed of disposition of assets, and how to conduct the divestiture of state ownership in banks taken over or assets taken over. Key is that valuation of the NPL has to be realistic to avoid bailout of existing shareholders, undermining private sector recap and proper governance of banks.

With hindsight, the policy lessons of vulnerabilities pre crisis and the management of the crisis are clear. In moving ahead it is important to be reminded of these policy lessons in order for the same mistakes not to be repeated. It should also inform us how the strengthening of the financial structure should be undertaken in the immediate and longer term. Needless to say the reestablishment of a sound banking sector which is part of a developed financial sector is going to take time, will require substantial public resources, and significant changes in institutions, regulations and behavior of the key participants.

The issues and possible way forward is evident for Indonesia, but given that the magnitude of its banking sector and corporate sector distress is much larger and since its external debt is also much larger, this implies that Indonesia already faces a serious fiscal situation. Furthermore, Indonesia has the weakest institutional framework for resolving its banking and corporate sector problems (Claessens, 1998 p. 4).

Banks are only as good as their customers, the saying goes and if we follow this argument it means that the effective restructuring of Indonesian banks can only occur if the local economy recovers. Focusing on the banks themselves is not enough. However, the country's economy can only recover if there are new investments (both local and foreign) coming into the country. And whenever we talk about attracting investments, the obstacle in Indonesia right now is politics or more aptly political stability, which unfortunately is in short supply at this early phase of our democracy. Political differences among the many ethnic, regional and religious groups, which have been suppressed for so long, have risen to the surface, all at the same time. Given the inadequacies of our political, social and legal institutions to address these divisive issues, the remedies require structural changes, which are all long-term in nature. As a result, economic recovery is most likely to progress at its current slow and "muddling" pace. In this situation, the important issue is perhaps not to be preoccupied with speed, but to keep the restructuring momentum going and ensuring it moves in the right direction.

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