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**TREND AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK
MANAGEMENT: THE EXPERIENCE OF INDONESIA**

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Introduction

Following the crisis in 1997/98, Indonesia gains many lessons to be learnt dealing with insolvency resolution in financial industry and in other commercial companies. How to treat the failing companies without creating distortion in the financial system is the art of the crisis management in Indonesia. Do we need to close a systemic financial institution or a large corporate? In theory, the answer is really subject to the information with respect to the minimum cost to economy in the both choices, which is very difficult to explain. Moral hazard is also the main concern for public when the legal and good governance are not well managed.

Rule based insolvency resolution helps the authority to ensure that moral hazard will be minimized. In fact, it would be no guarantee that the rule based resolution will work well in any condition. In some cases, judgment is still necessary in a specific circumstance to achieve the minimum cost in the economy.

Indonesian government has improved insolvency prevention and resolution for the purpose of maintaining financial system stability as stipulated in the amendment of Central Bank Act (Act no. No.3, 2004) and deposits protection law. Two failing banks in the mid of 2004 were good cases in exercising the treatment of insolvency, which work very well without creating instability in the financial system. Does the approach also work in the future and how to deal with a systemic bank failure? It would be very difficult to answer without having experience with the similar case. Additionally, we can draw the lesson to be learnt from the failing banks that bad governance and weak risk management are the sources of insolvency in Indonesia.

This paper will outline the development of insolvency prevention and resolution in Indonesia by focusing on three area, namely: the trend and development in insolvency and creditor rights framework and practice; current risk assessment and management systems and policies; and future agenda in credit risk management and financial safety net.

A. Trends and Developments in Insolvency and Creditor Rights Frameworks and Practices

I. Current legal and institutional developments

There are two important legislative initiatives should be regarded in recent insolvency reform in Indonesia. Firstly, the reform in banking sector which also touches the insolvency aspect of the banking sector. Secondly, the amendment of bankruptcy law.

A lot of critics were addressed to government in bailing bank failures during the crisis. The main issue was whether the decision of recapitalised banks was the best solution for public interest. It would not be the issues if the legislation provides clearer mandate to the authorities. To address the similar issues in the future, government has a set of agenda to improve legal framework for bank insolvency, such as amendment of Central Bank Act, establishment deposit protection scheme, amendment of Banking Act, and establishment Financial Safety Net Act.

Among all legislative initiatives in banking sector, only the bill on Central Bank and bill on the Deposit Protection Agency has been approved by the parliament.¹ The remaining of the bills, including the Financial Service Authority Law failed to be passed during the 1999-2004 parliament term, due to insufficient time for discussing those bills.² This means that the next parliament should start the discussion of the bill from the beginning, since state convention does not recognize the system that the succeeding parliament should be bounds by the interim result of the parliament from previous term. If the succeeding parliament wishes to continue the discussion of

¹ The Law No. 3/2004 on the Central Bank, the law on Deposit Protection Agency had been passed by the parliament and still waiting for Presidential signature.

² Please note that the Law on Deposit Protection Agency will be effectively in force one year after the enactment in 24 September 2004.

outstanding bills from the previous term, they should commence it from the beginning.³ Nevertheless, there is still no guarantee that the succeeding parliament will even discussed the subject, since they might have their own agendas and priorities.

The finalization of the bill on the Financial Service Authority might be further delayed, since the article 34 Law No.3/2004 on the amendment of the Central Bank's Law already stipulated that the Financial Service Authority will be established, at the latest in 2010. While the bill on the Financial Service Authority is still under discussion, the supervision authority shall remains in each supervising institution.

1. Deposit Protection Agency Law

Even though article 37 b of Law No. 10/1998 on Banking Law only stipulates the establishment a deposit protection agency ("LPS") as an agency to provide guarantee to public deposit in national banks, the Deposit Protection Agency law expands the function and authority of LPS to also include restructuring of failing banks by way of formulating, deciding and implement the policy to settle failing banks having no systemic impact to the society, as well as authority to restructure failing banks having systemic impact to the society.

This has made LPS an institution with more or less similar function with the previous Indonesian Bank Restructuring Agency (IBRA) when it comes to bank restructuring.⁴ Compared to IBRA this law provides clearer barrier on how LPS should implement its function in handling failing banks. For example, in handling failing-banks with systemic impact to the economy, the LPS shall only have 3 years (2 years for failing bank with no-systemic impact to the economy) before it should sell all of its participation on that particular bank.

The time frame can only be extended two times, one year for each, to obtain optimal level of return. The optimal level of return required in this law is at least the same amount of the LPS's participation on that particular bank. Nevertheless, the law still allows LPS to waive obligation to achieve the optimal level of return if the restructuring process has been extended two times. The institution can also directly shut down and liquidate failing banks, if LPS predicts that shutting down such failing bank will not create systemic impact to the economy and fulfil certain particular criteria.⁵

The debate surrounding the bill itself is more focused towards the guarantee function of LPS instead of its restructuring function. Regardless public consensus about the needs to have a proper protection scheme for public funds in the banking sector, nevertheless, the question on whether the institution should be in form of government-managed institution or privately-managed institution remains an important question on deliberation of this bill. Some experts said that a government-run deposit protection agency would not provide sufficient incentive for the private sector to take more care in doing their business, since the government, in the end of the day would be the one who bear all the cost. However, considering the authority structure of the LPS, which also involves the authority to restructure and liquidate failing banks, the involvement of government should become imperative.

2. Amendment of the Bankruptcy Law

After being suspended for more than three years, the parliament finally passed the amendment of the 1998 Bankruptcy Law in September 2004, few days before their terms expired. Many alleged that the amendment of Bankruptcy Law was premature since the parliament did not contribute sufficient time in the discussion of the bill, instead suspend its deliberation for years before they suddenly accelerate the discussion process significantly.

One of the chief concerns that drove the amendment of the 1998 bankruptcy law is that the 1998 bankruptcy law regarded by many as being too creditor friendly, as it enable creditors to easily send debtor into bankruptcy, regardless the amount of debt relative to debtor's asset. Many believe that it is necessary to limit creditor's ability to file for bankruptcy, in order to protect solvent companies from easily being sent into bankruptcy, so as to

³ This is an unwritten convention that has been practised in Indonesian parliament. See the Parliament's Chairman Akbar Tanjung speech at the closing ceremony of the third meeting session on 2003-2004, see also explanation from Mr Zein Badjeber, Chair of the Legislative Body in the Parliament.

⁴ IBRA was dissolved in March 2004, and it was succeeded by an Asset Management Corporation named PT PPA.

⁵ See Law on the Deposit Guarantor Agency Chapter Bab V regarding the Settlement and Handling of Failing Bank.

provide legal certainty and recover investor's trust which has been deteriorated by the several infamous bankruptcy cases.⁶

Therefore it is not too surprising that one of the main agenda of the amendment is to limit the capacity of creditor able to file for bankruptcy for certain types of business. According to the amended law, bankruptcy of financial institutions such as Insurance and Reinsurance Companies, Pension Funds, and other state owned enterprises that are fully engaged in providing public services can now only be submitted by the Ministry of Finance.⁷ This measure is lower than expectation from some analysts that the law should impose mechanism to measure solvency level of a company before the court could even entertain a bankruptcy petition.

There is an indication that problem in implementation of bankruptcy law in Indonesia was caused by lack of understanding about the core concept of bankruptcy. This lack of understanding often leads into misperception in understanding the role of bankruptcy in society. The amendment apparently realizes this problem. The amendment argues that it is necessary to draft a new law on bankruptcy and suspension of payment with more domestic oriented value and in accordance with the needs and legal development within the society. In doing so, the law introduced set of principles that must be referred in interpreting the law, namely:

- The principle of balance, this law aims to avoid excessive and abusive use of bankruptcy law by both debtors and/or creditors;
- The principle of going concern, this law contains provisions that enable prospective debtors to continue their business;
- The principle of justice, this law objective is to provides justice to every stakeholders in the bankruptcy, by preventing abusive behaviour by the creditor who demand fulfilment of their debt without considering other creditors;
- The principle of integration, this law contains an understanding that the formal legal system and its material legal system is a complete integration of the private law system and the national's private procedural law.

The spirit of current amendment is to limit the interpretability nature of the bankruptcy law. The 1998 bankruptcy law was alleged of being too summary. Thus, leaves great discretion to judges and practitioners to make interpretation about the provisions of the law, which often lead to uncertainties in practice. The 1998 Bankruptcy Law approach to only regulates main principle and allow practice to relate those provisions to other private law provisions (for example, in the Civil Code, Commercial Code, Company Law and others) has been proven not too successful in building solid bankruptcy practice. Such discretion has generated contradict interpretation on some important provisions of the bankruptcy law, for example the definition of debt and definition of maturity of debt.

In addition to that, the summary nature of the bankruptcy law has made some important measures cannot be implemented effectively, because judges were having difficulties in implementing provisions having no direct explanation in the law. For example, the problems to implement conservatory attachment, detention of uncooperative debtor (*gijzeling*), claw back provision (*actio pauliana*).

Nevertheless, some analysts also allege, that the amendment has only touch the very skin of the problems on bankruptcy law and failed to address the main problem. These peoples argue that the underlying problems on the commercial court are on the insufficient judge's education and supervision rather than solely the provisions of the law, thus amendment might not be the ultimate answer for the problems in implementation of bankruptcy.

Establishment of legal barriers does not guarantee more effective and efficient implementation of bankruptcy law, as many of the content of the amendment was actually had been settled in practice. Issues such as definition of debt, maturity date and arbitration clause were just sample of the amended provisions that have already been settled in practice. By imposing a proper training scheme and increasing the quality of supervision, it is believed

⁶ It is quite obvious that the acceleration of the amendment process was contributed by the bankruptcy of PT Prudential Life, an Indonesia's operation of British's Prudential Life on March 2004. This was the second time that a high profile and solvent company sent into bankruptcy by the court. In 2002 the court sent the Canadian's Manulife into bankruptcy over dispute on dividend with it's ousted former partner. Even though the Supreme Court later overturned these decisions, it is for sure that the court's initial rulings had created negative impact to both company.

⁷ This provision follow the similar policy that had been set by the 1998 Bankruptcy Law for bankruptcy of banks and securities company which each could only be done by the Central Bank and Capital Market Supervisory Agency.

that the knowledge of judges can be improved and a proper supervision could help in building consistency and discipline, which in turn could increase the level of certainty in the commercial court.

It also should be noted an important provision which aimed to promote the use of court-supervised restructuring. Before the amendment, the separatist creditors are excluded from the decision making process during the suspension of payment, therefore, the separatists whose disagree with the composition plan often could interfere the composition process by simply enforce its right. However, under the new law, the separatists are now eligible to vote in the suspension of payment, further, the separatists whose disagree with the composition plan can now be bought out by compensating the separatists with the lowest value between the security or the actual debt value which directly secured by the security right.⁸

However, there are also some down turns in this amended law. The law has extended the time available for court to hear bankruptcy petition from 30 days to 60 days in all court level. This provision is considered by many as unnecessary, as almost all bankruptcy decision (especially in the commercial court) always delivered on time, and the summary nature of the examination process should allow proper hearing to be conducted in 30 days, therefore there was no real demand to provide longer time to hear bankruptcy cases . Further, there is also downturn in sector of the legal professional service which will be discussed later.

II. Institutional Developments

1. Qualifications and Standard Performance of Judges

There are currently 14 active judges in the Commercial Court in the Court of Central Jakarta from out of almost 30 commercial judges all over Indonesia.⁹ The Commercial Court judges were recruited among the judges from court of general jurisdiction, who has been considered as having sufficient experience and has accomplished special education on commercial matters held by Supreme Court. The closed career system of Indonesian court makes it impossible for a non-career judge to be appointed as commercial court judge. However, the law open possibilities for a legal expert to be appointed as *ad-hoc* judge in all level of the court.¹⁰

The requirement to be appointed as commercial court judge is currently more associated with seniority and ranks, instead of a competitive scheme. Article 302 (2) does regulate several requirements to recruit new commercial judges, chiefly the experience and participation on a special training. However, in practice, the selection of judges who will participate in the training is quite problematic, as it is known that during the two roofs system, the court's database on human resources has not been managed very well.

Traditionally the judicial corps has been reported to be independent, relative to executive branch.¹¹ Recent amendment of the Law on Judiciary Power, which put together the authority to manage both organization and administrative aspect of the court in the hands of the Supreme Court (also known as one roof system) has made this notion even stronger.¹² The one roof system has made the government practically lost their influence over judges. Before the one roof system, the government through the Ministry of Justice and Human Rights run the management of human resources of lower court.¹³ After the one roof system all authority to manage the lower court were transferred to the Supreme Court.

⁸ Article 281 Bankruptcy Law

⁹ The Commercial Court in Central Jakarta is noted as the most active commercial court in the land and hear the most cases compared to other commercial court.

¹⁰ See article 302 (3) of the amended Bankruptcy Law. Please also note that there is currently no active ad hoc judge in all court level, the last batch of ad hoc judges were appointed in 2001 and their term has been expired.

¹¹ Survey conducted over judges in the court of first instance in regions, in Policy Papers on Judicial Personnel Management Reform, study conducted by the Institute for the Independence of Judiciary on behalf of the Supreme Court Republic of Indonesia, 2003.

¹² Before the enactment of the Law No. 35/1999 on the Basic Provisions on Judicial Power the management of the court system was separated into two organisation, the Supreme Court managed the organization and technical aspect of judicial corps, while the Ministry of Justice managed the administrative aspects, namely the budget, finance and human resource management.

¹³ During the two roof system the Ministry of Justice and Human Rights run the management of the lower court, for some aspects they run it jointly with the Supreme Court. This is to include recruitment, promotion and transfer, and all supporting systems of lower court.

However, before the one roof system was implemented, observation on the decision making behaviour of the commercial court judges do not give the impression that the court can be easily affected by the government's intervention. In fact the only intervention made by the government against the commercial court by temporary dismissed judges who are suspected to violate their professional oath in deciding the infamous case of Manulife was responded by the judicial corps by establishing their own internal *Committee for the Professional Honor* in the Court of Appeal, which in contrary with the government findings, concluded that these judges were innocent.

The commercial court, the court is currently experienced various institutional development. Starting 2002 the court also hears intellectual property right cases, and several new laws also refer their dispute settlement towards the commercial court.¹⁴ Several constructive programs such as study on the needs assessment of the commercial court, development of the career path of the commercial court judges, development of the court report, court's blue print and publication of the manual of the commercial court administration were conducted under the auspices of the Steering Committee for commercial court to ensure continuous increasing capacity of the commercial court as model of an ideal court for Indonesia.

2. Roles of Professionals

The amended law has also brought some changes into the constellation of professionals involved in bankruptcy process. For advocates, basically there is no special regulation that limits eligibility of an advocate to appear before the commercial court. As long as the advocate has complied with the Law No. 18/2003 on Advocate, he/she is eligible to represent his/her clients before the commercial court. There is also an Association of Bankruptcy Lawyers. However, its membership status does not affect the eligibility to appear before the court.

With regard to the receiver and administrator, some down turn took place. Before the amendment, this registration of receiver and administrator in Ministry of Justice was subject to the membership on the Association of Indonesian Receiver and Administrator (AKPI) as the sole recognized professional association for receiver and administrator. However, the amended law apparently will revoke the exclusivity AKPI of being the sole recognized professional association. Under the amended law everybody can freely establish their own professional association and registration in the Ministry of Justice and Human Rights is subject to the receiver's membership in one of the association.

This is of course raised a great concern from the legal practitioners. It is feared that more than one professional association will bring difficulties to control the professional behaviour of receiver/administrator. Each association might have their own standard, and their own code of ethic. It is also still unclear on how to implement the admission test. Before the amendment, the admission test was conducted by AKPI, and successful candidate will be recommended by AKPI to be registered in the Ministry's registry. However, if a competing organization established, would they also conduct admission test as well? This problem is still unsolved, and the government is planning to draft the Ministerial decree to regulate it.

The amended law also change the mechanism to determine receiver's fee. Before the amendment of the law, the receiver and administrator fee has to be determined up front, with the rate in accordance with the Ministry of Law decree number *M.09-HT.05.10 year 1998 regarding the Guidance on Receiver and Administrator fee*. However, current law stipulates that the receiver and administrator fee should be determined after the receiver/administrator complete his/her task.¹⁵ This provision can also be considered as down turn. It was complained by many receivers, as it could limit the flexibility of the receiver to advance some costs associated with bankruptcy as there is no guarantee that a proper fee payment will be received afterwards.

3. Indonesian Banking Restructuring Agency (IBRA)

Under the Presidential Decree No. 27 of 1998 on The Establishment of IBRA, the government took strategic steps by establishing an ad hoc institution called IBRA, which has the main tasks of restructuring the banks transferred to IBRA, recovering bank assets, both physical assets and loans, and recovering state funds formerly disbursed to the banking sector.

¹⁴ Recent Deposit Guarantor Law stipulates that settlement of dispute in relation with bank liquidation shall be heard by the Commercial Court.

¹⁵ Article 75 Bankruptcy and Suspension of Payment Law.

In fact, IBRA faced several difficulties in meeting the overall objectives due to structural weaknesses in the integrity of assets held by IBRA as it did not have direct ownership of the assets of the previous bank owners, and incomplete and inaccurate documentation of the problem loans moved to IBRA; weaknesses in the legal documentation supporting IBRA's claims to assets which impedes the ability to enforce IBRA's rights; book versus market value of assets held by IBRA; public distrust over IBRA and its operations; decision making process hindered by an unwieldy and inefficient structure; and the economic situation in Indonesia.

IBRA management had identified several initiatives with the support of all IBRA's stakeholders to resolve several of the difficulties facing IBRA while expediting the restructuring and disposal process of assets held by Asset Management Credit/AMC and Asset Management Investment/AMI as well as improving IBRA's efficiency; transparency, and legal and litigation capacity. In the implementation of the initiatives, IBRA required an approval of the Ministry of Finance and/or the Financial Sector Policy Committee/FSPC as necessary. However, the recovery rate of IBRA is still very low. Ultimately, IBRA was closed in February 2004, and the remaining tasks have been transferred to a new working group called Asset Management Company (PPA).

III. Current Practices in Various Areas

1. Efficiency of Secured Lending Procedures

The implementation of secured lending in Indonesia has slowly began to show improvement, especially after the enactment of several new laws on security rights, namely Law No. 4/1996 on Mortgage and Law No. 42 /1999 on Fiduciary Transfer which give business actors with more certainty in securing their transaction and its enforcement process.

One of the most important contributions of both laws is that they eliminate many doubts and inconsistencies in enforcement sector. The new Mortgage Law allows the first level hypothec holder to exercise-the right of instant execution without the obligation to obtain prior court order-to be implemented properly. Something that even though has been regulated under the old Civil Code, but it failed to be implemented properly. Prior to this law, the first level mortgage holder mostly has difficulties in enforcing this privilege, as the auction house usually requires the hypothec holder to firstly obtain a court order prior enforcing his right, something that often resulted to a lengthy and costly litigation proceeding, especially if the process was intervene by third party.

On the other side, the fiduciary transfer law has establish the first fiduciary transfer registry in the land, which provides registration facility of movable assets being encumbered with security right. With this registry, business actors become more confident to encumber movable property with security rights. A central fiduciary transfer registry has been properly set up in the capital city, while other will soon be established in regions.

Unfortunately, these developments were hampered by the fact that the land registry system –an important infrastructure to mortgage law- is still not sufficiently reliable. The manually managed national land registry system often could not provide people with reliable registry and the integrity of the data itself is often questionable. Low integrity in the land registry often caused enforcement of secured lending had become inefficient, as the hypothec holder often faced with legal suits concerning the ownership status of the land encumbered with security right before they could even enforce it.

2. Unsecured Lending

Financial Institutions only offer unsecured lending in a selected environment and under very prudent policy. Financial Institutions aimed unsecured lending only to borrowers in the distress area and to micro and retail lending. This is based on argument that distress area economy need to be developed and small creditors have less morale hazard compared with larger one.

Since it is only aimed to small scheme lending, thus, litigation simply becomes not feasible, particularly since Indonesia does not have small claim court. Bankruptcy law actually try to accommodate all value of debt, however, it is deemed by many as still too expensive and inefficient for retail debtor to use bankruptcy, as the commercial court registration fee is ten times more expensive than the registration fee on ordinary court. Therefore financial institutions rely mostly on out-of court mechanism to recover their unsecured lending. Self help mechanism is reported as primary tool for recovering unsecured debt. A financial institution reported to recover at least 30% out of total defaulting unsecured debtors through self-help mechanism.

3. Out of Court Work-Outs

With the dissolution of the Jakarta Initiative Task Force in December 2003, there is currently no general scheme to facilitate creditor work-outs. The existing court-supervised work-outs-the suspension of payment scheme could not be said as an effective scheme among business actors. Nevertheless, for most banks, out of court settlement is still the primary choice for their restructuring scheme. The main argument on this is that the court settlement is costly and time consuming. Ultimately, net recovery of out of court settlement is higher.

Most banks' current restructuring portfolios were acquired from IBRA before it was dissolved in March 2004.¹⁶ These portfolios consist mostly of loans, which has been failed to be restructured or at least difficult to be restructured. Banks' generally consider that cooperativeness of debtor is the key to restructuring process. Therefore, given its potential difficulties in recollect the claim, most banks buy them at very deep discount. The problem is when the bank tries to restructure the portfolios, as most debtors are naturally uncooperative and they were unfortunately informed about the rate which bank took from IBRA. Later this has proven to be disincentive for the banks, as relatively difficult as it corner the bank in making negotiation to improve the recovery rate of the portfolios.

B. Current Risk Assessment And Management Systems And Policies

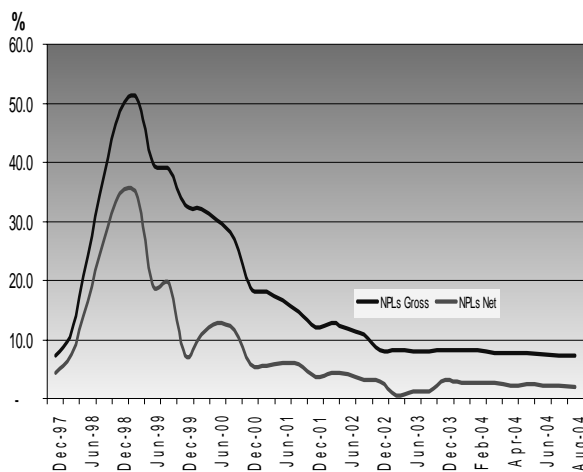
I. Risk Assessment and Management Systems

According to the experiences in the 1997/98, lack of prudential regulation and improper crisis resolution was in place in Indonesia. This condition leads to high cost for government to bring public confidence to banking system. This section will outline the main sources of insolvency in the banking system, role of risk management in the crisis prevention, and re-formulation of financial safety net in the banking system. Those three agendas are the main efforts of banking industry restructuring in Indonesia.

1. Sources of crisis

Risk is associated with estimation of future losses in financial institution. The failure of managing risk may as the main cause in the insolvency in financial and corporate sectors. Therefore, adoption of risk management process is the most important strategy to manage risk properly and, furthermore, to prevent the insolvency and crisis.

Risks in financial institutions may cover credit risk, market risk, operational risk, legal risk, strategic risk and reputational risk. Each financial institution has its own risk characteristic. In general, credit risk was main source of risk in insolvent banks in Indonesia as the traditional loans dominates asset portfolio in banking. That is the main reason why the main discussion in this section will focus more on credit risk management. The main indicator of the existence of credit risk is the level of non-performing loans (NPLs). The following graph shows the level of NPLs before and after crisis.



¹⁶ During the crisis IBRA recapitalized failing banks and take over their non-performed portfolios. These portfolios later restructured by IBRA. Before the dissolution IBRA sold most of its remaining portfolios to Indonesian banks. Unfortunately, most of these portfolios are already portfolios with low level of collectability, not much can be expected from it.

The loan loss classification reached IDR 280 trillion during crisis and these loans have been transferred to Indonesian Bank Restructuring Agency (IBRA) for further work out during crisis.

Macro economy shock (ie. extreme volatility) during crisis was believed as the main sources in the increased of NPLs. Corporate borrowers suffered the most in this distress economy as the demand for goods dropped and the cost of production increased. Corporate companies were struggle to pay their obligation to banks and became non-performing. It would be fair to say that proper credit risk management its self is not enough to prevent a bank from insolvency without stable macro economy in that country.

Potential Reverse of NPLs

NPLs ratio has gradually decreased in the last five years as a large number of them (approximately 60% of loans portfolio) has been removed from banks' to IBRA. The NPLs transfer was a requirement for an insolvent bank to enter government recapitalization scheme. A bank was required to make 100% provision before these loans were transferred to ensure that the losses have been absorbed by capital. Ultimately, the remaining capital would be the true economic capital available for the bank to continue its business. If the capital adequacy requirement (CAR) of the bank was below the minimum requirement (i.e. 4%), the owners were mandatory to inject more capital. Government would allow a bank to enter the recapitalization scheme since the owners failed to increase CAR to a minimum level. The scheme allowed the owners to improve their shares 20% out of the total minimum capital injection for the banks, the rest of 80% would be the government money by issuing Government Debts. The total number of government debts is, approximately, IDR 431 trillion (USD 47.9 billion). This money is considered as crisis cost by tax payers. Finally, the government debts dominate the asset portfolio in banking sectors. The slop of NPLs reduction is very low in post of recapitalization; hence, the NPLs resolution in banking sector is un-successful. It would be possible reversing back of performing to non-performing in the future. Finally, we can conclude that: (1) The deteriorating of NPLs is still on with a lower slope (main reduction of NPLs was just because of transferring NPLs from banks to IBRA); (2) Restructuring process in Indonesia has some problems dealing with legal, bad governance and asymmetry information.

Lack of good governance was also the main sources of credit risk in banking industry. Majority of credits was associated with internal group of companies, which speculated in real estate investment. State banks' management was less independent from government, hence, majority of credits were granted for the borrowers who affiliated with government officials.

2. Financial Safety Net and Crisis Resolution

Insolvency and crisis prevention is not always success in the financial system. The previous section mentions that macro economy has a significant share in the stability and soundness of financial institutions and financial system. One crisis hit in the system, clear role and responsibility for each agency to take action is the main prerequisite to restore stability of the system.

Indonesian experiences show that there was no clear role for both BI and Government to solve the crisis. The case of Indonesia, bailing out of failing banks by BI has made long debate between BI and other related agency, which believe that the process of bailing out banks was illegitimate. The absence of financial safety net and crisis resolution mechanism may provide very clear authorities and responsibility of the related agency to take action in the event of crisis. For that purpose, Government has initiative to establish financial safety net scheme and crisis resolution mechanism.

The first action by government was to amend the 1968 central bank act in 1999. The main focus of this amendment was to provide more independency for BI and focus more on monetary policy. There were three main features of this amendment. First, the governor and deputy governors are proposed by president and appointed by parliament to ensure that central bank is independence from the government; Second, central bank is not allowed to have

credit exposure to public; Third, banking supervision function will be transferred to an independence supervisory agency by end of 2002. The act was amended in January 2004 to improve the governance of BI by setting supervisory board and to explicitly specify BI role in financial stability, in more precisely, role BI in lender last resort for a systemic bank in emergency condition. This role is one of the nets in financial safety net to maintain financial system stability in Indonesia. Additionally, government also extends the time limit of establishment of supervisory agency by 2010 at the latest because this agenda is less priority for the government at that moment.

Deposit protection scheme law has been approved by parliament in the mid of 2004. This scheme limits the protection to small depositors with maximum IDR 100 mio (equivalent roughly around USD 11.000 with current exchange rate). Protection is also applied for public funds namely, demand deposits, time deposits and saving. Government will implement this scheme gradually to ensure there will no deteriorating public confidence to banking industry. This agency also has a role to bail out a systemic insolvent bank based on the recommendation of financial stability committee (a joint committee between Governor of BI and Minister of Finance). Just in case, if the agency has no enough funds to bail a systemic bank then the Government will be responsible to bail out the deposit protection agency.

With the completion of the legal basis, Indonesian financial system has a set of financial safety net, which provides authorization for each related agency to take action in preventing and solving insolvency and crisis. The central bank law and deposit protection law covers the following safety net arrangement:

- The first net is the implementation of risk management in banks to ensure that there will be no liquidity and solvency problem.
- The second net is the short-term liquidity facility from central bank in the event of a bank suffers from liquidity mismatch with liquid collateral and maximum 90 days.
- The third net is emergency liquidity facility from central bank for solvent bank in emergency condition. This facility will be granted since a bank doesn't satisfy to receive the second net. This facility is under fully pledge by Government guarantee.
- The fourth net is the insolvency resolution by deposit protection agency for both systemic and non-systemic bank. A joint committee is authorized to provide recommendation to bail out a systemic bank to prevent systemic crisis. Deposit protection agency will solve the non-systemic insolvent bank using least cost method.
- The fifth net is the government funds' injection to deposit protection agency in the event of short liquidity.

3. Institution Insolvency Prevention: Adoption of Risk Management

Insolvency is the event when the capital of a bank is not enough to absorb losses and to repay its debts. Merton (1973) believes that insolvency occurs when the market value of capital is less than the amount of debts they should repay. This approach has been used widely to estimate the probability of firm failure. How to measure the market value of capital is very complicated especially for the un-traded shares or traded shares in thin capital market such as capital markets in emerging economy. Risk management tools provide information the potential loss in assets and liabilities items for the purposes of economic value of assets and liabilities assessment to come up with economic value of capital or market value of capital.

Illiquid and insolvency prevention policies by regulatory authorities in banking industry are stipulated in risk management and capital adequacy regulation. A series of international standards have been released by Basel Committee on Banking Supervision in Basel to improve the effectiveness of risk management and accuracy of capital adequacy regulation (CAR) in banking industry around the world such as 25 Principles for Effective Banking Supervision (BCP), Basel Accord 1988, Market Risk Amendment 1996, Basel II June 2004, and Risk Management Guidelines.

BI has set up a master plan to improve the compliant to 25 BCP and CAR. Risk management guidelines for banks has been released in July 2003 with transition period until December 2004 to provide more times for banks preparing infrastructure and skills. CAR regulation has been improved by adopting component market risk in the capital regulation in July 2003 with transition period around 2 year. Implementation of New Basel Accord (Basel II) is expected a few years to come. A working group between BI's staff and practitioners has been set up with the main task is to develop implementation time schedule in Indonesia. Implementation of risk management is the prerequisite the implementation of Basel II.

With the implementation of risk management, information of potential loss will be available and banks will be more effective in preventing and managing the potential loss in such way to limits the future loss. Ultimately, probability of banks' insolvency can be minimized.

4. Current status of risk management in banking

Risk management system is a comprehensive process from policy formulation, senior management oversight, risk identification, measurement, mitigation, monitoring of implementation, and independent internal control. The following list contains the typical current risk management practice in Indonesian banks.

- Policy covers only the area of business and target without specifically mention risk management policy
- Implementation is based on the traditional approach where mainly only covers credit and liquidity risk. Other risk such us operational risk, legal, market risk, reputation, strategic are not stated clearly in the policy, further more, these risks are not the main concern of Indonesian banks.
- Judgmental risk assessment methodology is the main weaknesses of traditional approach, hence, fair value of the assessment on asset and liabilities is difficult to achieve.
- Limited data base and information system for risk management analysis and decision support
- Risk management skill is very limited

Improper risk management process and assessment may result in misleading information for stakeholders and create wrong public opinion with respect to bank performance. Financial ratios will fail to reflect true banks condition, hence, transparency to public will be misleading.

General economic down turn was the main sources of credit problems. High interest rates and exchange rates volatility during crisis were good evident to show that macro economy affects significantly to credit quality. NPLs increased sharply during crisis reaching more than 50%. Credit risk management, public disclosure and effective supervision are important to improve good governance, however, stable macro economic is the most important to minimize the NPLs.

Credit risk assessment is mainly based on traditional loan classification. Five grades has been applied, namely, good, special mention, sub-standard, doubtful and loss according to the delinquency and business prospect. This approach is to proxy the potential loss for each grade and imposes provision for that loss. Potential loss for each grade is simply a certain percentage, which has been committed between regulatory authority and banking industry. The provisions for un-expected losses is 1% and for expected losses are, 5%, 15%, 50% and 100% respectively for special mention, substandard, doubtful and loss.

The current credit risk assessment approach is still relevant for the industry since credit information system is not available. However, this approach will be irrelevant for credit derivatives. The role of credit rating agency will be important to anticipate the development of credit risk assessment for credit derivatives instruments in the future.

II. Credit Information System

Good risk management system in banks will be effective to provide accurate information since the external infrastructure such as credit information center (credit bureau), rating agency, legal basis, credit insurance, and regulations and supervision are available.

Availability of information is a key to produce accurate assessment in credit risk management. A comprehensive individual and aggregate debtors' data base are statistical requirement to assess the probability of firm default, credit rating and scoring, which is a proxy for potential loss in credit risk. The database will only available if information sharing among banks and other financial institutions is permitted by jurisdiction in the country. How they share the information is the main issue in credit information system. Is any legal constraint in the country to share individual information of debtors? These issues will affect the quality information sharing among institutions.

Comprehensive credit information center has been developed in Indonesia under BI organization. The information is still limited to raw financial information for debtors with outstanding more than IDR 50 million. No information of credit scoring or variables to assess credit scoring including negative information of debtors. Credit bureau will be established in Indonesia in a few years to come.

Decision making in credit risk management adopts the traditional approach by relying more on judgment based on scatter information with respect to debtors. In some cases, banks find problems to decide the total loans and other credit facilities of the debtors within internal bank and industry as a whole. Information on individual rating and group wide is unavailable in the market because majority of debtors are unrated.

Unit responsible for problem loans work out has been set up. However, recovery rate is still very low due to complicated legal settlement in Indonesia, hence, legal cost is too high compared to private settlement. This condition may create moral hazard for debtors.

III. Credit Risk Transfer and New Financial Instruments

In general, credit risk was main source of risk in insolvent banks in Indonesia as the traditional loan dominates asset portfolio in banking. Therefore, to manage the loan portfolio, banks maintain diversified portfolio of risk assets in line with the capital desired.

Portfolio management is an integral part of the credit process that enables the banks to limit concentrations, reduce volatility, increase liquidity and achieve optimum earnings. A limit concentration is an aggregation of credit with common characteristic or exposures. The concentration may define by one obligor, by business segment, by industry, geography, risk rating, tenor, credit program or other dimensions appropriate to the portfolio.

If the loan exposure is approaching the limit, banks may reduce the portfolio through credit risk transfer as one of risk mitigation techniques recognized in financial sector and this technique has been endorsed by regulatory authority and stipulated on the Basel II document.

1. Credit Risk Transfer (CRT)

Credit risk transfer is an approach to manage credit risk portfolio in such away to match credit risk position, reduce the risk related to single borrower or single industry and obtain capital management benefit through transfer the risk. Additionally, credit risk transfer will also help to optimize the relationship between asset quality and provisioning in the future through loan guarantees, loan sales, loan syndications, credit insurance and through capital market solution (i.e. asset back securities). We will use the term of credit derivative for the instrument of credit risk transfer in this paper.

In Indonesia, generally banks use loan guarantees, sales of loan, syndication and credit insurance as traditional credit transfer instrument rather than use capital market instrument such as asset back securitization.

Asset back securities (ABS) transfer inherent risk in a pool of related asset from the originator to investors. ABS also transfers illiquid assets into a security. The assets include credit card receivables, auto loans, residential mortgage and other risky assets. Practitioners in banking industry use the ABS as the most efficient instrument to transfer credit risks to investors. The growth of this market in developed country is relatively high in the last decade. Basel Committee on Banking Supervision has become increasingly concerned with the use of credit derivatives to maintaining capital commensurate with their risk exposure as stipulated on the Basel II document.

2. Role of Policy and Process.

Credit risk transfer in Indonesia is relatively low due to the absence of credit derivatives market. Inadequate of market infrastructure such as legal basis, fair value accounting system and relatively high credit risk premium are the main reasons for the absence of credit derivative market in the country. Financial market authority and banking supervision authority are the agency responsible to develop the infrastructure of the credit derivative market. Bank Indonesia (BI), Minister of Finance (MoF) and Capital Market Supervisory Board (BAPEPAM) have an initiative to develop this credit derivative market as this instrument will give benefit for financial institutions to mitigate their credit risk.

Credit derivatives transactions require players, code of conducts, regulatory endorsement and supervisory treatment, market transparency, accounting treatment. The following section outlines the mechanism of ABS transaction.

a The originator

The originator has to satisfy the following requirements:

- Corporate commitment.
 - Track record of loan portfolio to be transferred.
 - Internal system (origination, servicing, collection system).
 - Loans must be transferable.
 - Information of history of loans including collateral.
 - Origination capacity.
 - Market position.
- b. Special Purpose Vehicle (SPV).
A new legal entity is created, a special purposed vehicle (SPV) purely for the purpose of holding and financing the assets to be securitized. The originator will sell and assign certain asset portfolio such as credit card receivables to the SPV. Generally, the nature of the transfer and legal status of the SVP is vary subject to several issues and require careful design.
- c. Credit Rating Enhancement.
Asset selection and structure design to obtain high rating from a major credit rating agency.
- d. Cash Flow Allocation.
Originator as a servicer will receive payment from borrower and passes to the SVP less servicing fees. The SVP in turn pays a predefined interest rate to investors plus any principles repayments, according to the terms of ABS.
- e. Transformation of Cash Flow.
When all principle payments have been made and the securities have been matured, the SVP is extinguished and any remaining assets are returned to the originating bank or firm.

3. Are Indonesian Banks ready for ABS?

Some big banks in Indonesia are ready for ABS, but they still have some issues on the ABS policy and process such as: (a) bank regulation and capital constraint have not been treatment yet; (b) lack of statistical data record; (c) critical legal issues for SPV: bankruptcy remote, tax treatment, type of SPV; (d) critical legal issues on transfer must be true sales : off balance sheet treatment, sales and purchase effective, notice of obligor, consent or acknowledgement of obligor; (e) accounting treatment: sales VS financing, accounting for loan servicing, consolidation; (f) monitoring and reporting system have not been ready yet.

4. Credit Risk Transfer Market.

In general, Indonesian major banks expect CRT market to be functioning well in the near future. Currently, the potential for description of the CRT markets was considered to be small, since the supply and demand is small.

CRT supply is small, due to following reasons: (a) in general, the big player banks in Indonesia as originator have high Capital Adequate Ratio ($\pm 21\%$); (b) credit risk is still manageable (NPLs' gross $\pm 7\%$); (c) some issues on the policy and process of ABS (as mentioned above); (d) the technique can be complex and requires significant initial investment of financial and managerial resources.

CRT demand is small because of two folds: (a) the potential buyers or investors are unfamiliar with originator and the product because lack of data information; (b) the potential buyers or investors know that the legal status and regulation are not clearly yet.

5. Market in a few Institutions.

Banks represent the major share of CRT activity. Their involvement can be defined in two categories: First, banks use CRT instrument for portfolio management purposes; Second, banks use CRT instrument for trading purposes as intermediary. In both portfolio management and intermediary activities, banks can engage in the originations of CRT instruments. Generally, the player banks' involvement is for trading purpose rather than for portfolio management purposes because their Capital Adequate Ratio is high and their NPL's are still manageable.

Other than banks, the potential investors involve in CRT market are: Mutual Funds, Insurance Company, Pension Fund, Finance Companies, and individuals.

6. Role of Credit Monitoring and Credit Rating Agencies.

As mentioned above, a good risk management system in banking industry will be effective to provide accurate information since the external infrastructure as Credit Bureau, rating agency, credit insurance, regulation has been integrated.

Currently the credit information centre is under Bank Indonesia management providing limited data of debtors, no information of credit rating, credit insurance and does not accommodate information from capital market transaction. To improve this, BI will establish Credit Bureau in the near future.

Banks will use the company-rating agency especially for complicated CRT transaction. This is because banks do not have adequate risk management system in place. A standardized approach of using external ratings is an adequate guidance for the banks to assess simple transaction.

C. Future Agenda in credit risk management and financial safety net

Formal implementation of risk management in banks is the main priority of Indonesian banks. BI has released risk management guidelines for banks and risk management practice will be effectively enforced in 2005 using risk-based supervisory approach.

To improve accuracy of regulatory insolvency, which is minimum 8% capital adequacy regulation (CAR), BI will adjust the calculation approach of credit risk component by incorporating more accurate proxy for credit risk. Risk weighted asset in current approach contains some deficiencies in estimating credit risk because the approach just employs risk-weighted asset based on owner classification, namely government, state-owned enterprises, and private debtors. This approach assumes that government has no risk, state-owned enterprises have a risk weights ranging between 20 to 50% and private debtors have a 100% risk weight. The best approach to proxy credit risk in regulatory insolvency is rating of debtors. This approach has been recognized in Basel II document.

BI will establish credit Bureau with the main tasks is to support information correspond to credit risk assessment for banks. Raw information will be collected from banks and this bureau will be independent institution.

Government will establish deposit insurance corporation to replace blanket guarantee scheme. Law has been approved by parliament in the third quarter 2004. The gradual implementation of new scheme is stipulated on the law to ensure that there will be no distortion in the implementation.

To prevent crisis, draft of financial safety net law is underway. This law is to ensure that each agency has clear authority and responsibility in the crisis prevention and resolution. Bank Indonesia Law mentions that this draft will be submitted to parliament by end of 2004.

D. Conclusions and Recommendations

Insolvency in financial institution has been the main sources of crisis, particularly in Indonesia. Recovery of insolvent banks was the main agenda in the banks' restructuring program. To speed up the recovery, government rescued systemically important bank and closed small bank during the crisis. Government also issued debts roughly IDR 431 trillion (USD 47.9 billion) or 52% of GDP in year 2000 to bailout the banks. Currently, the financial sector has been fully recovered as key financial indicators improves (see Appendix 1)

Following the crisis, government has employed initiatives both to prevent further crisis and develop crisis resolution mechanism containing roles and responsibilities for each agency to solve the crisis. These initiatives were triggered from the experiences that crisis management must be in place to ensure a clear segregation of authority and responsibility between central bank and government. The recommendations of these initiatives have been stipulated on the amendment of central bank law, deposit protection law, and financial safety net bill.

To prevent insolvency, supervisory authority (Bank Indonesia) adopts 25 Basel Core Principles (BCP) to improve regulatory and supervisory approaches. The ultimate target of this effort is to enhance good governance in banking industry, among others, by imposing bank to adopt risk management. Effective risk management system will be the foundation for management to identify and manage the potential losses and minimize the negative impact to capital and solvency.

The sources of problems in banking industry may come from other financial sector, such insurance, pension funds and other non-bank financial institutions. In some cases, credit risk transfer from banks to other financial institutions is possible through asset securitization. Tight regulation and supervision in banking industry may cause risk transfer from banks to other financial institution through this channel. However, the fear of credit risk transfer is irrelevant for Indonesian financial sector while credit derivatives and asset sales do not exist in Indonesia. Additionally, market share of non-bank financial institutions in the financial intermediary is very small.

Further development of legal and financial market infrastructure is still underway. This infrastructure includes good governance in financial industry, transparency, credit information system (credit bureau), rating agency, supervision and regulation by adopting international standard and minimizing distortion to economy.

Advanced approach in risk management will be relevant for the country with comprehensive infrastructure such as database, market discipline, legal framework. In-adequate infrastructure will create wrong information for management in taking the decision. This condition will lead to instable financial sector.

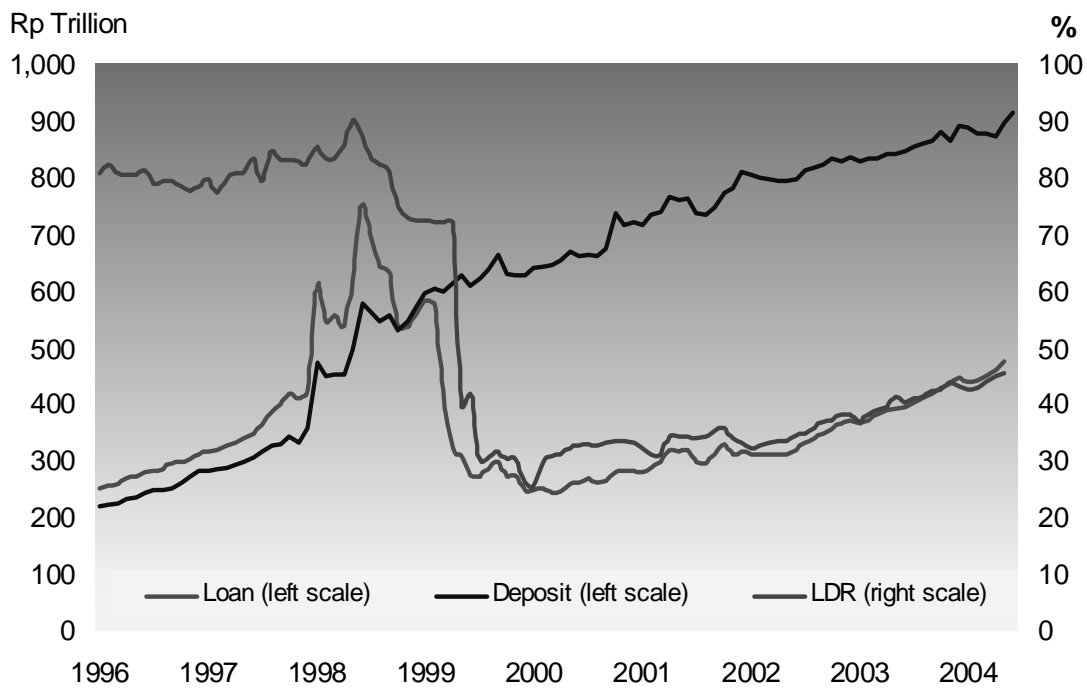
Appendix 1

Banking Financial Indicators

| Financial Indicators | Des-00 | Des-01 | Dec-02 | Dec-03 | Mar-04 | Jun-04 | Jul-04 | Aug-04 |
|---------------------------|--------|---------|---------|---------|---------|---------|---------|---------|
| Total Asset (Rp Trillion) | 1030.5 | 1099.7 | 1,112.2 | 1,196.2 | 1,150.0 | 1,185.7 | 1,182.8 | 1,208.2 |
| Deposits (Rp Trillion) | 699.1 | 797.4 | 835.8 | 888.6 | 875.1 | 912.8 | 909.5 | 919.3 |
| Loans (Rp Trillion) * | 320.5 | 358.6 | 410.29 | 477.19 | 485.91 | 528.68 | 530.18 | 547.5 |
| Earning Assets (Rp T) | 1007.2 | 1048.08 | 1,023.6 | 1,072.4 | 1,080.3 | 1,102.8 | 1,087.7 | 1110.8 |
| NII (Rp Trillion) | 2.9 | 3.1 | 4.01 | 3.2 | 5.7 | 5.4 | 5.4 | 5.3 |
| LDR (%) | 33.2 | 33.0 | 38.2 | 43.2 | 43.7 | 46.4 | 46.8 | 47.9 |
| ROA (%) | 0.9 | 1.5 | 1.9 | 2.5 | 2.7 | 2.7 | 2.7 | 2.8 |
| NPLs Gross (%) | 18.8 | 12.1 | 8.1 | 8.2 | 7.8 | 7.6 | 7.3 | 7.1 |
| NPLs net (%) | 5.8 | 3.6 | 2.1 | 3.0 | 2.7 | 2.1 | 2.2 | 2.0 |
| CAR (%) | 12.7 | 20.5 | 22.5 | 19.4 | 23.5 | 20.9 | 20.6 | 21.0 |

*) including channelling

Growth of Loans, Deposits and LDR



Appendix 2

| STRUCTURE AND GROWTH OF THE FINANCIAL SECTORS, 1988-2002 | | | | | | | | | | | | |
|--|-----------|------|-------|------|----------------|--------|--------|--------|--------------|-----------|-----------|-----------|
| | NUMBER IN | | | | SHARE IN ASSET | | | | ASSET GROWTH | | | |
| | 1988 | 1994 | 1997 | 2002 | 1988 | 1994 | 1997 | 2002 | 1983-1988 | 1989-1991 | 1992-1994 | 1995-1997 |
| BANK INDONESIA | 1 | 1 | 1 | 1 | 36.8% | 15.0% | 10.0% | 33.1% | 18.8% | 9.2% | 6.6% | 50.1% |
| BANK (Deposit Money banks) * | 113 | 243 | 222 | 141 | 56.9% | 76.8% | 78.8% | 58.2% | 22.4% | 32.6% | 37.4% | 72.8% |
| - State Commercial Banks | 7 | 7 | 7 | 5 | 34.5% | 36.9% | 35.8% | 27.0% | 19.7% | 20.7% | 16.7% | 73.6% |
| - Private Banks | 63 | 166 | 144 | 76 | 13.1% | 31.5% | 32.4% | 21.7% | 41.5% | 56.9% | 67.9% | 63.8% |
| - Private forex Banks | 12 | 53 | 78 | 36 | 8.8% | 27.3% | 30.2% | 20.6% | 36.1% | 64.9% | 75.7% | 73.8% |
| - Private non forex banks | 51 | 113 | 66 | 40 | 4.3% | 4.2% | 2.2% | 1.1% | 32.2% | 37.3% | 28.7% | -8.0% |
| - Foreign Banks | 11 | 40 | 44 | 34 | 2.8% | 6.4% | 8.8% | 6.4% | 16.8% | 55.4% | 44.6% | 122.2% |
| - Development Banks | 29 | 27 | 27 | 26 | 4.4% | 2.0% | 1.8% | 3.0% | 22.1% | 42.2% | 21.3% | 45.3% |
| - Savings Banks | 3 | 3 | 0 | 0 | 2.1% | 0.0% | 0.0% | 0.0% | 27.9% | 14.5% | - | - |
| NON BANK FINANCIAL INSTITUTIONS**) | 13 | 100 | 301 | 332 | 2.7% | n/a | 1.8% | 2.1% | 22.3% | 14.9% | n/a | 50.7% |
| INSURANCE COMPANIES**) | 106 | 150 | 177 | 173 | 1.6% | 3.3% | 3.5% | 4.1% | 21.2% | 62.3% | n/a | 86.1% |
| LEASING COMPANIES**) | 83 | 206 | 248 | 259 | 1.9% | 4.4% | 5.6% | 2.1% | 45.4% | 33.6% | n/a | 111.4% |
| OTHER CREDIT INSTITUTIONS*) | 5783 | 9196 | 9338 | 7571 | 0.6% | 0.5% | 0.3% | 0.4% | 33.4% | 15.9% | n/a | 23.8% |
| TOTAL ASSET OF FINANCIAL INSTITUTIONS (TAR) | 6099 | 9896 | 10287 | 8477 | 0.0% | 100% | 100.0% | 100.0% | 0.0% | 0.0% | 0.0% | 71.7% |
| TOTAL (TRILLIONS OF Rp) | | | | | 115.50 | 434.61 | 528.52 | 655.46 | | | | |
| M1 / GDP | | | | | 0.10 | 0.14 | 0.12 | 0.12 | | | | |
| M2 / GDP | | | | | 0.30 | 0.55 | 0.57 | 0.55 | | | | |
| Total Asset of Financial Institution / GDP | | | | | 0.81 | 1.01 | 1.45 | 1.19 | | | | |
| M2 / TAR | | | | | 0.36 | 0.55 | 0.39 | 0.46 | | | | |

Number of Banks and Offices

| Group of Banks | October 1997 | Increase/Decrease | | | October 2004 |
|-------------------------------|--------------|----------------------------|-----------|----------|--------------|
| | | Liquidation/ Suspension | Merger | New Est. | |
| State-Owned Banks | 7 | - | 4 | 2 | 5 |
| National Private Banks | 194 | 77 | 23 | - | 94 |
| - National Banks | | | | | 74 |
| - Ex Joint Banks | | | | | 20 |
| Regional Dept. Banks | 27 | 1 | - | - | 26 |
| Foreign Bank Branches | 10 | - | - | 1 | 11 |
| Total Commercial Banks | 238 | 78 | 27 | 3 | 136 |
| Total Bank Offices | 7,781 | | | | 7,927 |

Appendix 3

| Improvement of Banking Regulation | | | |
|--|---|---|--|
| Regulation | Pre-crisis | Crisis | Post-crisis |
| 1 CAR | 1993: min 8% | 1998: min 4% | 2001: min 8% |
| Capital/RWA x 100 | | | 2003: min 8% including market risk |
| | (Tier 1+ tier 2)/RWA | (Tier 1+ tier 2)/RWA | 2001: ((Tier 1+ tier 2)-equity participation)/RWA |
| | | | 2003: Capital=tier1+tier2+tier3, only for banks meet with one of these criteria (to incorporate market risk); (i) total asset of Rp10 trillion or more, (ii) trading book position of securities and or derivatives transactions of Rp20 billion or more (for forex bank); or (iii) trading book position of securities and or derivatives transactions of Rp25 billion or more (for non-forex bank) |
| Tier 1: | paid in capital, donated capital, after tax profit, provision | paid in capital, donated capital, after tax profit, provision | paid in capital, disclosed reserve (i.e. after tax profit, loss, agio, disagio, etc.) minus goodwill and deferred tax |
| Tier 2: | hybrid/quasi capital, subloan, provision from asset revaluation, and general provision of earning assets max 1,25% of RWA | hybrid/quasi capital, subloan, provision from asset revaluation, and general provision of earning assets max 1,25% of RWA | general provision of earning assets max 1,25%, provision from asset revaluation, hybrid/quasi capital, subloan, incremental value of equity participation available for sale max 45% |
| Tier 3: | - | - | only for calculation of market risk |
| | | | subloan with medium term with criteria (i) not guarantee by banks and fully paid, (ii) agreement period no less than 2 years, (iii) payment based on agreement or BI approval, (iv) lock-in clause, (v) clear loan agreement and repayment schedule, and (vi) approved by BI |
| 2 LLL | 1993: | 1998: | |
| % of capital | placement of funds consists of loans, guarantee, securities, and other placements | placement of funds consists of loans, securities, interbank, equity participation, and off B/S transactions | |
| | - | Separation of lending in excess of LLL and violation of LLL | |
| | | Lending in excess of LLL arising from exchange rate fluctuation and/or reduction in capital (formula= provision of funds at the LLL reporting date/capital at the LLL reporting date) | |
| | | Formula= provision of funds at the date of provision/capital at the date of provision of funds | |