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Indonesia Joint Recapitalization of 1999[1]

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Abstract

The Indonesian government implemented a joint recapitalization program in 1999 to aid some of its private banks struggling with the effects of the Asian Economic Crisis. Nine banks were eligible, and seven ultimately participated. The program was voluntary; in order to participate, bank managers had to pass a test proving that they were competent enough to run their bank and create a three-year plan for the bank's operations subject to independent assessment. All of the bank participants were able to return to the 4% minimum capital adequacy ratio by the end of the program.

Keywords: Asian Economic Crisis, Capital injection, Indonesia, liquidity nonperforming loans

[1] This case study is part of the Yale Program on Financial Stability (YPFS) selection of New Bagehot Project modules considering broad-based capital injection programs. Cases are available from the *Journal of Financial Crises* at
https://elischolar.library.yale.edu/journal-of-financial-crises/.

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Indonesia Joint Recapitalization of 1999

At a Glance

In order to deal with the escalating effects of the Asian Economic Crisis on the banking sector, the Indonesian government announced a joint recapitalization plan for some of its surviving private banks in September 1998.

Banks were sorted into three categories based on an independent audit; those that had a capital adequacy ratio (CAR) of between –25% and +4% were categorized as "B" banks and were the only ones eligible for this joint recapitalization scheme. Nine banks were eligible, and of these, seven ultimately participated.

Summary of Key Terms	
Purpose: Help private banks return to the 4% CAR requirement	
Announcement Date	September 26, 1998
Operational Date	March 13, 1999
Sunset Date	Unknown
Program Size	Rp 300 trillion
Usage	Rp 644 trillion by December 2000
Outcomes	All banks achieved the 4% CAR requirement

There were several conditions for a B bank to enter joint recapitalization. The banks' owners were required to create a business plan detailing the bank's viability over a three-year period that would be assessed by independent advisors; if this plan was deemed acceptable, the managers then had to pass a test ensuring that they were technically competent enough to run their bank. After both of these conditions were satisfied, the bank's private shareholders could decide whether to participate in recapitalization with the government. The joint recapitalization scheme was a voluntary program.

If the bank's private shareholders elected to participate in the government recapitalization program, the bank was required to provide 20% of the necessary capital, in cash, required to meet the 4% minimum CAR requirement for all Indonesian banks at the end of 1998. The bank's owners remained in control of day-to-day operations while the government provided the other 80% of capital and became a controlling shareholder. The owners were given the first option to buy back their shareholdings after three years.

Summary Evaluation

The joint recapitalization program appeared to be effective in that it enabled the private banks to reach the CAR requirement of 4%. After a series of communication missteps, the program's implementation was generally well received and the markets reacted positively to its announcement. Evaluations of the program frame it as somewhat successful, but there is not currently a robust evaluation of the program.

Indonesia Context (1998 -1999)	
GDP (SAAR, nominal GDP in LCU converted to USD)	\$98.23 billion in 1998 \$141.47 billion in 1999
GDP per capita (SAAR, nominal GDP in LCU converted to USD)	\$464 in 1998 \$671 in 1999
Sovereign credit rating (five-year senior debt)	Data for 1998: S&P: B- Fitch: BB+ Data for 1999: Fitch: BB-
Size of banking system	\$44.96 billion in 1998 \$56.32 billion in 1999
Size of banking system as a percentage of GDP	45.77% in 1998 39.81% in 1999
Size of banking system as a percentage of financial system	100% in 1998 100% in 1999
5-bank concentration of banking system	60.27% in 1998 73.36% in 1999
Foreign involvement in banking system	Data not available for 1998 Data not available for 1999
Government ownership of banking system	Data not available for 1998 Data not available for 1999
Existence of deposit insurance	No in 1998 No in 1999
Sources: Bloomberg; World Bank Global Financial Development Database; World Bank Deposit Insurance Dataset.	

I. Overview

Background

Banks in Indonesia faced problems prior to the beginning of the financial crisis in 1997. In 1992, Bank Indonesia (BI), Indonesia's central bank, had been forced to resolve Bank Summa, a problem bank; the process was difficult, leading to anti-BI protests and contributing to a BI policy of resisting active intervention. Between 1992 and 1993, the World Bank contributed $300 million to a recapitalization worth $4 billion (4% of GDP) for state-owned banks. However, due to BI's hands-off policies, banks falling into difficulty were left independent until 1997, when the crisis began (Enoch et al. 2001).

Before the crisis, BI had limited authority in bank supervision, due to both the division of powers between the Minister of Finance and the central bank, as well as the appearance of lack of independence from President Soeharto. Following the end of President Soeharto's tenure, amendments were made to increase the independence of BI (Sato 2005).

The financial crisis began in Indonesia with authorities unpegging the rupiah from the Thai baht in July 1997 (Enoch et al. 2001). In the months following, the rupiah had depreciated by close to 40% (Enoch 2000). In October 1997, a policy package "aimed at restoring health to the banking sector" became part of an adjustment program agreed upon with the International Monetary Fund (IMF) (Enoch et al. 2001). At this point, the issues in the banking sector were not considered to be a systemic banking crisis (Enoch et al. 2001). In November 1997, the closing of 16 banks by the government eroded confidence in the banking sector, triggering a run on the banking system by depositors (Reiner 1998).

This erosion of the banks' deposit base meant that Bank Indonesia had to provide massive amounts of liquidity: during December 1997[4] alone, this support increased from Rp 13 trillion to Rp 31 trillion, equivalent to 5% of GDP (Sharma 2001). In addition, the IMF required a series of economic reforms to provide aid: a revision of growth forecasts to 0% from 4%, a revision of inflation forecasts to 20% from 9%, ending the Soeharto family monopolies, and a revision the 1998–1999 budget with the exchange rate calculated with a weaker exchange rate than before (Williams 1998). Contrary to these reforms, business groups receiving liquidity injections funneled public funding exceeding the legal lending limit to the businesses they owned (Reiner 1998).

In January 1998, the rupiah headed into free fall. The exchange rate fell further, and the banking sector's problems deteriorated into a "full-fledged systemic crisis" (Lindgren et al. 1999). In its 1998–1999 annual report, BI notes that multiple factors contributed to the instability in the banking system. Internal difficulties emerged from unprofessional management, where outside interests were able to influence decision-making within banks; banks would lend to certain groups and their own subsidiaries, exceeding the legal lending limit numerous times (BI 1999). Additionally, short-term unhedged foreign loans were used to finance long-term rupiah projects, leading to a currency mismatch exacerbated by the depreciation of the rupiah (BI 1999; Enoch et al. 2001).

In response to the crisis, the government announced a new three-pronged approach to preserve financial stability: (1) the complete protection of all depositors and creditors in

[4] During Q4 1997, the exchange rate of rupiah to USD stood at 4,650 (Federal Reserve Bank of St. Louis, Federal Reserve Economic Data).

domestic banks; (2) the establishment of the Indonesian Bank Restructuring Agency (IBRA) to supervise, guide, and restructure ailing banks and manage their nonperforming assets; and (3) a proposal for the handling of corporate restructuring (Enoch et al. 2001; Indonesian Government 1998a).

In mid-February 1998, IBRA proposed that all banks that had borrowed at least twice their capital base from BI should be managed by the agency, and 54 banks—accounting for 36.7% of the banking sector—were invited to apply to IBRA for management. Each bank applied, and IBRA officials joined the banks' offices the next week. However, President Soeharto decided that the work of IBRA officials should have no publicity, decreasing the credibility of IBRA and making it seem as though the agency was still nonoperational. The first head of IBRA was removed within a month of the agency's operation, under the reasoning that he was doing his job too diligently (Enoch et al. 2001).

At this point, more than 75% of liquidity support to the banking system went to seven banks, holding 16% of the liabilities in the system (Enoch 2000). The banks had each borrowed at least Rp 2 trillion (equivalent to $240 million) (Enoch 2000). In the months following, IBRA performed a series of examinations and bank closures under new directorship, including audits by international auditors or IBRA and BI officials of the 16 strongest private banks in the system under IBRA (Enoch et al. 2001). The results of the audits were leaked to the public, showing 55%–90% of total portfolios comprised nonperforming loans. Many of the portfolios were highly interconnected. Authorities realized that Indonesia needed to develop stability in the financial system, even if the banks were not fully solvent in the event of a financial crisis (Enoch et al. 2001).

In September 1998, the government announced a new set of measures to combat the crisis: resolving the banks already under IBRA; restructuring state-owned banks; and finally providing joint recapitalizations under strict conditions for private and regional development banks (Enoch et al. 2001). The purpose of the plan was to preserve only the best private banks in the banking sector and build burden sharing of the costs of bank resolution between the private sector and the government (Lindgren et al. 1999).

Prior to the execution of the private bank restructuring, the Indonesian government and the IMF came up with a plan to recapitalize all seven of the state banks (Sharma 2001). Four of these (which together comprised half the assets of the Indonesian banking sector) were merged into the new Bank Mandiri, which became Indonesia's largest bank and, as a result, held 30% of all deposits (Fane and McLeod 2002; Sharma 2001).

Program Description

On September 26, 1998, the governor of the BI announced a new government plan to restructure the private banks, most of which were insolvent (Enoch 2000).[5] The recapitalization scheme was announced publicly by joint decree between the Ministry of Finance and Bank Indonesia on December 31, 1998 Indonesian Government 1998b; *Jakarta Post* 1998b). This plan was not implemented until March 1999 (Enoch 2000).

The recapitalization scheme was overseen by IBRA, though there were representatives from BI, the IMF, the World Bank, and the Asian Development Bank through the process. IBRA acted as a representative shareholder for the government, as well as controlling shareholder. Additionally, outside consultants were hired to estimate the amount of

[5] This plan benefited private commercial banks, state banks, and provincial banks; however, information on implementation or outcomes for provincial banks could not be found.

performing assets on bank balance sheets (Suta, Musa, and Slangor 2004). The injected capital appears to have been jointly managed by BI and IBRA. It is unclear how much IBRA handled specifically, but Sharma (2001) mentions that IBRA deposited the 80% of government funds for joint recapitalization, which implies that the organization had oversight over the day-to-day activities. The MOF oversaw IBRA (Sharma 2001).

The large restructuring plan was predicated upon a review of all private banks, audited by a group of international accounting firms that estimated the capital needed to recapitalize each bank and sorted banks into three categories (Fane and McLeod 2002). Banks were sorted into categories based on capitalization status: "A" banks, with capital adequacy ratios (CARs) greater than 4%; "B" banks, with capital adequacy ratios between –25% and +4%; and "C" banks, with capital adequacy ratios lower than –25% (Enoch et al. 2001). The lower threshold of –25% was chosen as many of the "best" banks in the system had capital ratios of –20%, and few banks fell below that value (Enoch et al. 2001).

Banks submitted their financial statements as of December 31, 1998, for committees to determine the state of their balance sheets. Committees evaluated loan portfolios, examining credit by a five-level classification: performing, substandard, doubtful, nonperforming, and default. Uniquely, the government placed the responsibility for resolving group-affiliated nonperforming loans on the controlling shareholders of companies rather than the companies that received the loans. To determine the level of assistance needed, the government considered off-balance-sheet commitments, productive assets, non-earning assets, contingent liabilities needing reassessment, transactions of related parties, transactions of subsidiaries, and events that may have happened after the December 31, 1998 (Suta, Musa, and Slangor 2004).

After estimating the condition of banks and giving owners of "C" banks the opportunity to raise capital, private banks in the Indonesian financial system were separated into three categories:

- Seventy-three banks, representing 5.7% of the banking sector's assets, were "A" banks, and as such, continued to operate without government support (Enoch 2000).

- Of the "B" banks, nine (representing 10% of the banking sector's assets), were eligible for joint recapitalization; seven (representing 2.5% of the banking sector's assets) had failed the tests, but if they had at least 80,000 depositors, were set to be taken over by IBRA;[6] and 19 (representing 2% of the banking sector's assets) were to be closed (Enoch 2000).

- Nineteen banks,[7] representing 3% of the banking sector's assets, were "C" banks and were to be immediately shuttered (Enoch 2000).

Six of the seven major state banks had capital adequacy ratios less than –25%, placing them squarely in the "C" category of banks to be shut down (Reiner 1998). However, the

[6] This joint recapitalization and IBRA takeover of some of the category "B" banks was done instead of enforcing closure to "minimize disruption to the payment system." Additionally, the owners of these banks were barred from assuming future roles as bank managers (Sharma 2001).

[7] Discrepancy: Lindgren et al. (1999) say there were 17 of these banks but that 38 total were to be closed—indicating that these authors believe that 21 category "B" banks were closed, rather than 19.

government announced these banks were too big to fail, with state-owned banks accounting for 70% of banking sector liabilities, and therefore were to be recapitalized instead of closed (Enoch et al. 2001).

"B" banks were the only category eligible for joint recapitalization with the government. There were several conditions for a "B" bank to enter joint recapitalization. First, banks seeking recapitalization were required to submit business plans spanning three years (Indonesian Government 1998b).

In addition to proposing a business plan detailing the bank's viability over a three-year period, bank managers had to pass a test ensuring that they were technically competent enough to run their bank (Fane and McLeod 2002). This technical test was based off of a review of a portfolio, as well as the experience and knowledge of BI officials (Enoch et al. 2001). The fit-and-proper test consisted of several items, including:

(1) A written commitment to Bank Indonesia,

(2) Engagement of delinquent individuals in the banking sector,

(3) Engagement of bad debts in the banking sector,

(4) Integrity,

(5) Any interventions in bank operations,

(6) Any violations of prudential principles by directors or commissioners, and

(7) Competence and independence (BI 1999).

The 20% of capital required to raise the CAR had to be supplied in cash, at which point the government provided the remaining amount in the form of newly issued bonds. Some of these bonds had fixed nominal interest rates and others had variable nominal rates; originally, the government intended to use variable-interest-rate bonds to raise banks' equity to 0% and fixed-interest-rate bonds to raise equity to 4%. However, in practice, some of the fixed-rate bonds were used to bring banks' capital to 0% (Fane and McLeod 2002). However, during performance contract negotiations, the government decided to keep its shares as ordinary stock instead of preference shares, as had been initially planned (Lindgren et al. 1999).

After bank management provided a business plan and passed a fit-and-proper test, the bank's private shareholders could decide whether to participate[8] in recapitalization with the government (Fane and McLeod 2002). If the bank's private shareholders elected to participate in the government recapitalization program, the operation proceeded as follows. The bank provided 20% of the necessary capital, in cash, required to meet the 4% minimum CAR requirement for all Indonesian banks at the end of 1998. The bank's owners remained in control of day-to-day operations while the government provided the other 80% of capital and became a controlling shareholder. The owners were given call options to buy back their shareholdings after three years (Enoch 2000).

[8] If the private shareholders elected not to participate, the banks were nationalized, and they received nothing in return (Fane and McLeod 2002).

The government's equity stake (in preference shares) was convertible into ordinary shares in two situations:

(1) If the bank could not adhere to its business plan (Lindgren et al. 1999).

(2) After three years (Lindgren et al. 1999).

In practice, the government acquired ordinary shares rather than preference shares. The banks remained able to reacquire their shares during the three-year period by paying the government back either for their account or an outside investor. At the end of the three-year period, the bank's value was independently assessed and the owners had the first option to buy back their shareholdings. If the owners did not buy back their shares, the government sold them over the course of the next year (Lindgren et al. 1999).

Private shareholders of banks participating in the capitalization scheme also received call options over the government shares purchased. The government made these call options available to private shareholders who provided the 20% of the capital for injection. The call options provided an opportunity for shareholders weary of participating in the scheme to profit from the recovery of the bank that had been recapitalized, as share prices for the options were set equal to the issue price of the banks shares, plus any accumulated interest (Fane and McLeod 2002). Shareholders were also provided certificates of entitlement (COEs), an instrument tradable on the capital market. These COEs entitled the asset holder to proceeds of collections and sales of assets transferred to IBRA over a specified period, with the idea of increasing the incentive to participate in the recapitalization process (Suta, Musa, and Slangor 2004).

The joint decree establishing the parameters for recapitalization also placed requirements on boards. As required by the decree, each commercial bank participating in the recapitalization program required shareholders to elect a member to each bank's board to serve as a compliance director. The board member's appointment also required Bank Indonesia's approval. Compliance directors were required to submit the ongoing results of the recapitalization to Bank Indonesia quarterly (Indonesian Government 1998b).

The original budget for the joint restructuring allocated Rp 300 trillion of bonds to finance the recapitalization, as well as an additional Rp 34 trillion due to the interest rate paid on the capital injected paid for in both issued bonds and the liquidation of assets (*Jakarta Post* 1999b). However, upon beginning capital injections, the costs expanded. By the end of the capitalizations, the government had spent slightly above Rp 500 trillion, with state banks accounting for Rp 303.4 trillion of the allocations and private banks accounting for Rp 199.2 trillion (Suta, Musa, and Slangor 2004).

IBRA asset recovery moved slower than expected, as seen in Figure 1. While IBRA optimistically estimated its recovery rate at approximately 40% of the book value of the assets, in reality, the agency was only able to recover little more than half of the estimated recovery by 2002.

Figure 1: Cost of Indonesia's Bank Restructuring by August 2002

	Book Value	Expected Recovery	Actual Recovery
Total assets transferred to IBRA (Rp trillion)	**548.3**	**212.2**	**111.3**
Asset Management Credit	275.2	96.3	75.5
Core loan assets from private and state banks	262.4	—	—
Noncore assets	12.8	—	—
Asset Management Investment[1]	141.4	76.4	17.8
Bank Restructuring Unit[2]	131.7	39.5	18
Total liabilities issued (Rp trillion)	**703.6**	**703.6**	**703.6**
Government bonds to Bank Indonesia	268.3	—	—
Government bonds to recapitalized banks	435.3	—	—
Total assets minus liabilities	**–155.3**	**–491.4**	**–592.3**

Notes: (1) Corporate equity as shareholders' settlements; (2) net book value of government investment in recapitalized banks and banks that were taken over.

Source: Feridhanusetyawan and Pangestu 2003.

Outcomes

Initially, seventy banks (49 of which were domestic commercial banks, 15 of which were provincial development banks, and six of which were state banks) were eligible for recapitalization as part of the "B" group (*Jakarta Post* 1998a).

Ultimately, seven private banks were recapitalized in 1999 (Sharma 2001).[9,10] Though just nine "B" banks were later eligible for joint recapitalization, only seven owners provided their share of the cash capital ahead of the April 20, 1999, deadline. The remaining two banks had more complex situations that embroiled IBRA in "intense discussions" leading up to the deadline; one of them was ultimately acquired by a major foreign bank, and the other was unable to provide capital and was subsequently taken over by IBRA (Lindgren et al. 1999).

During the month of May 1999, the government worked with the remaining banks undergoing recapitalizations and established performance contracts and memoranda of understanding. Further audits revealed that the amount of capital these banks needed was double the initial estimation; the banks provided their share of the extra capital by the end of May 1999 (Lindgren et al. 1999).

Overall, composition of assets in the banking sector changed after the capital injection, as shown in Figure 2. Banks during this time continued to accrue losses due to the negative interest rate spread emerging from currency mismatch in short-term-lending-funded projects. Private banks faced the largest drop in gross revenue amongst all banks in the system, dropping by 12.5%. State banks held the largest share of deposits in the system, 48.9% (an increase of 60.1%) due to government measures appointing state banks to pay

[9] Discrepancy: Nasution (2000) accounts that "the recapitalized banks include[d] 49 private banks (including 13 taken over by the government) . . . " (Nasution 2000).
[10] Discrepancy: Sato (2005) writes that the recapitalizations took place toward the end of 2000 (Sato 2005).

cash to depositors of those banks liquidated by the government. Finally, foreign loans at banks dropped by Rp 20.0 trillion (a 16.7% drop); with creditors reluctant to extend loans, new requirements asked debtors to pay all matured loans rather than roll them over (Bank Indonesia 1999).

Figure 2: Total Assets by Bank Grouping

	Outstanding (in trillions of Rp)		Percent Change		Share[1] (in percent)	
	1997/98	1998/99	1997/98	1998/99	1997/98	1998/99
Commercial Banks	737.6	645.8	84.6	−12.5	100	100
State Banks	296.2	258.8	107.6	−12.6	40.2	40.1
Private National Banks	319.2	263	51.2	−17.6	43.2	40.7
Regional Government Banks	11.8	22.4	6.3	89.8	1.6	3.5
Joint Banks	60.1	50.1	204.9	−16.6	8.1	7.8
Foreign Banks	59.9	58.5	254.7	−2.3	8.1	9.1
Rural Credit Banks[2]	2.9	2.8	6.6	−3.4	0.4	0.4

Notes: (1) Share of each group to commercial banks; (2) as of the end of December 1998.

Source: BI 1999.

Public contribution to financial sector restructuring totaled 51% of GDP by mid-1999, and the vast majority of this expenditure was to recapitalize the banks and lend liquidity support (Sharma 2001). The breakdown of the public's contribution to financial sector restructuring can be seen in Figure 4.

By December 2000, the total amount of government bonds issued to recapitalize the banks had reached Rp 644 trillion, equivalent to 58% of GDP in 1999 (Fane and McLeod 2002). The final cost of recapitalization ultimately reached Rp 502.5 trillion, with state banks accounting for Rp 303.4 trillion of the allocations and private banks accounting for Rp 199.2 trillion (Suta, Musa, and Slangor 2004). Figure 3 shows the number of shares purchased by IBRA through the recapitalization.

Figure 3: Government Holdings of Private Bank Shares

Bank	Number of Shares	Value[1]	%
BII	52,691,346,000	6,586,418	56.78%
Bank Lippo	23,203,407,899	6,027,874	59.26%
Universal	30,018,085,856	4,084,201	78.65%
Arta Media	6,460,440,000	130,000	76.91%
Bukopin	6,379,675,501	364,916	74.75%
Patriot	1,059,537	51,500	80.99%
Prima Express	1,772,734	530,911	88.64%

Note: (1) In millions of rupiah, after deduction of returned excess bonds and exercise of share option rights, as of December 31, 2000.

Source: BI 2001.

Ultimately, "government-held shares in nationalized and recapitalized banks were almost sold off by 2004. The bank reconstruction [took place] on a scale far larger than initially expected [and] was all but completed in seven years" (Sato 2005).

Figure 4: Public Cost of Financial Sector Restructuring in Indonesia as of 1999

	Percent of GDP	**In Billions of US dollars[1]**
Central bank liquidity support assumed by the budget	12	20
Recapitalization including outlays for deposit guarantee	23	40
Purchases of nonperforming loans or capital for asset management company	12	20
Interest cost (on budget)	3	5
Total	**51**	**85**

Note: (1) Converted at 7,500 rupiahs per US dollar.

Source: Lindgren et al. 1999.

However, "as a percentage of GDP, the amount of government bonds needed to recapitalize the banks [was] more than four times the proportion initially estimated" (Fane and McLeod 2002).

II. Key Design Decisions

1. The bank recapitalization plan of March 1999 was part of a larger strategy to restore the banking sector to health.

The government pursued a three-pronged strategy: resolving the banks already under IBRA; restructuring state-owned banks; and finally providing joint recapitalization under strict conditions for private and regional development banks (Enoch et al. 2001). The purposes of the plan were to preserve only the best private banks in the banking sector and build burden sharing of the costs of bank resolution between the private sector and the government (Lindgren et al. 1999).

This intervention was accompanied by monetary policy tightening by BI. The increased interest rates were meant to reduce excess liquidity in the system (BI 1999).

Additionally, the capital injections were complemented by a simultaneous debt restructuring plan to deal with the banks' nonperforming loans, the details of which can be seen in another YPFS case (Smith and Nunn 2021).

In May 1999, the government moved to improve supervision and regulation with an amendment to the 1968 Central Bank Act. Under this new act, Bank Indonesia was guaranteed full independence to conduct monetary policy and given priority in supervision and regulation over any other government entity (Sato 2005). With assistance from the World Bank, Bank Indonesia began to formulate "a master strategy for strengthening Bank Indonesia's regulatory, supervisory, and examination activities" (Sato 2005).

2. Bank Indonesia had the legal authority to recapitalize under its designated powers as a central bank, established by the legislature.

In May 1999, a new Central Bank Act (Act No. 23 of 1999) was enacted, replacing the Central Bank Act of 1968. This act provided the bank the ability to issue and revoke bank licenses, as well as supervise banks. It also reinforced the independence of BI, which at the time was being questioned under the regime of President Soeharto. Finally, the act gave BI complete monopoly on bank control and supervision, prohibiting intervention by any other organization in these matters (Sato 2005).

Under the new act, BI had purview to make temporary capital investment in banks (Sato 2005). With this legal backing, the Ministry of Finance and Bank Indonesia issued a joint decree on December 31, 1998, outlining the structure of the recapitalization program (Indonesian Government 1998b).

While the structure of the legal regulations and limitations on the BI changed in response to the financial crisis, this structure did not specifically change in support of the joint recapitalization project.

3. Despite positive reactions to various bank closures and restructuring announcements, public confidence in the banks eligible for joint recapitalization faltered due to some confusion caused by an initial emphasis on forced mergers of these banks.

The announcement of the various bank closures and restructurings on March 13, 1999, received a positive reaction. It had been formulated in conjunction with public relations efforts including specialist consultants, and the markets reacted positively. However, public confidence in the banks eligible for joint recapitalization faltered due to some confusion and negative public comments, leading to runs and a dearth of liquidity (Enoch 2000).

This confusion may have been due to President Habibie's announcement in December 1998 that, rather than the recapitalization plan, there would instead be a strategy of forced mergers. After a brief period of rioting, market uncertainty, and further depreciation of the rupiah, the government reaffirmed the private bank recapitalizations, and the parliament passed a budget for it in February 1999 (Lindgren et al. 1999).

As such, the public expected that bank closures and restructurings would take place before the end of February; however, two days before the expected implementation of the plan (the weekend of February 26, 1999), the government postponed it yet again on the grounds that there was a lack of political consensus surrounding the plan for several of the banks. The public reacted negatively, with some belief that decisions were influenced by outside factors. Over the next two weeks, political consensus was achieved, and "B" banks lacking acceptable business plans were permitted to resubmit their plans (Enoch 2000).

A further interesting aspect to the communication of the joint recapitalization plan was that upon its implementation, on March 13, 1999, the government generally reaffirmed the terms of its original commitment but neglected to "explicitly restate its earlier commitment to leave the day-to-day running of the banks in the hands of the owners" (Lindgren et al. 1999).

During May 1999, when further audits revealed that banks needed more capital than had initially been estimated, the government communicated to the public that it would continue to provide 80% of the necessary capital for joint recapitalization. For the largest private recapitalized bank, this strategy was especially successful in attracting private investment (Lindgren et al. 1999).

4. The injected capital appears to have been jointly managed by BI and IBRA.

Sato (2005) writes that "Bank Indonesia, which was formerly placed under the executive branch of government and given only limited authority, was legally guaranteed independence from the government and obtained broad authority over the banks."

The MOF oversaw IBRA (Indonesian Government 1998a). It is unclear how much IBRA handled specifically, but Sharma (2001) mentions that IBRA deposited the 80% of government funds for joint recapitalization, which implies that the organization had oversight over the day-to-day activities.

5. IBRA injected newly issued interest-bearing government bonds into banks.

The original budget for the joint restructuring allowed for about Rp 300 trillion of bonds to finance the recapitalizations. Of the Rp 300 trillion of bonds, the recapitalizations required an additional Rp 34 trillion due to the interest rate paid on the capital injected paid for in both bonds and through the liquidation of assets from closed banks (*Jakarta Post* 1999b). However, upon beginning capital injections, the costs expanded. By the end of the capitalizations, the government had spent slightly above Rp 500 trillion, with state banks accounting for Rp 303.4 trillion of the allocations and private banks accounting for Rp 199.2 trillion (Suta, Musa, and Slangor 2004). The capital injections were funded by newly issued government bonds (Fane and McLeod 2002).

6. Management of banks seeking recapitalization had to pass a fit-and-proper test; the government also required banks to submit business plans as well as raise 20% of the capital required to meet a 4% capital adequacy ratio.

Banks had to fall into one of three categories (the "B" category) to be eligible for joint recapitalization:

> (1) "A" group—banks with CARs estimated to be more than 4% that did not require government support,
>
> (2) "B" group—banks with CARs between –25% and 4%—at the time, no "B" bank had a positive CAR (Fane and McLeod 2002), [11] or
>
> (3) "C" group—banks with CARs below –25%, which were not eligible to receive government support and were to be liquidated (Fane and McLeod 2002).

[11] Once a recapitalization was agreed upon, the bank's most severely impaired (Category 5) loans were transferred at no price to IBRA's Asset Management Unit (AMU/AMC), which then entered into a contract with the originating bank for the recovery of the loans. Banks could, at their discretion, also transfer loans classified as doubtful to the AMU/AMC for the same treatment. "Any recoveries from such loans would be used immediately to buy back the government's preference shares, thus giving the government the prospect of an early return of its financial infusion, and reducing the amount to be paid by the owners to reacquire full control of their bank" (Fane and McLeod 2002; Lindgren et al. 1999).

Nine of the banks classified as category "B" (with capital ratios of between –25% and 4%) were eventually eligible for recapitalization (Sharma 2001).

First, banks seeking recapitalization were required to submit business plans spanning three years (Indonesian Government 1998b). The work plan for commercial banks eligible for recapitalization under the scheme required that a series of points be addressed:

(1) The current condition of the bank and weaknesses needing attention;

(2) Any assumptions made in creating the plan;

(3) Steps and a schedule for resolution of problem loans and nonperforming property loans;

(4) The bank's strategy to improve performance and health, both short and long term;

(5) Financial projections to achieve a capital adequacy ratio of 8% by 2001;

(6) Plans to settle with BI within three years of injection, with repayment of 20% the first year, 30% in the second and third years, and 50% of the remaining balance per year ongoing;

(7) plan to meet capital shortages;

(8) Plans to resolve violations of legal lending limits no later than a year after signing the recapitalization agreement with BI;

(9) A plan to resolve net open position violations; and

(10) Any planned mergers with other commercial banks (Indonesian Government 1998b).[12]

Banks were encouraged to include mergers in their business plans with two or more banks, with projections based on such a merger (Enoch et al. 2001). Banks placed in category "A"—having a capital ratio above 4%—were also required to submit business plans, though only a subset of the list above (points 1–7) were required (Indonesian Government 1998b).

The recapitalizations required four committees to consider banks' submissions of business plans. The Steering Committee's members consisted of the minister of finance and BI's governor. The Policy Committee, consisting of BI's regulation and development directors, BI's supervision directors, IBRA's chairman, and the directorate general of the Ministry of Finance, examined the validity of the business plan, administered a fit-and-proper test to shareholders, and provided a recommendation on a commercial bank's participation in the recapitalization to the Steering Committee. The Evaluation Committee had representatives from BI, the Ministry of Finance, and IBRA, and existed to assess submitted business plans and provide a recommendation to the Policy Committee on the eligibility of the business plans as well as the results of the fit-and-proper test. This committee also supervised the implementation of business plans and reported to the Policy Committee.

[12] Translation based on Google Translate.

Finally, the Technical Committee, also with representations from BI, IBRA, and the MOF, evaluated business plans as well as assessed the results of the fit-and-proper test. The Technical Committee could employ outside consultants to assess business plans. Additionally, representatives from the World Bank, Asian Development Bank, and IMF attended committee meetings to monitor the decision-making process as nonvoting members in each committee (Suta, Musa, and Slangor 2004).

However, the international consultants hired tended toward a more negative view of banks than the BI did due to low confidence externally in the possibility of loan recovery. To address the mismatch, the above four-stage committee process was created whereby BI, the Ministry of Finance, and IBRA assessed valuations and recommendations by the external consultants and determined a policy decision in tandem. In the event of irreconcilable differences between the external consultants and the bank evaluation committees, the BI evaluation took precedence because the central bank was primarily responsible for the capital injections (Enoch et al. 2001).

Due to bank management being perceived as unprofessional in allowing outside interference and as lacking in competency and integrity, after proposing a business plan, bank managers had to pass a test ensuring that they were technically competent enough to run their bank (BI 1999; Fane and McLeod 2002). This technical test was based off of a review of a portfolio, as well as the experience and knowledge of BI officials. Banks were also required to provide a share of the capital to be injected in the recapitalization (Enoch et al. 2001). The fit-and-proper test consisted of several items, including:

(1) A written commitment to Bank Indonesia,

(2) Engagement of delinquent individuals in the banking sector,

(3) Engagement of bad debts in the banking sector,

(4) Integrity,

(5) Any interventions in bank operations,

(6) Any violations of prudential principles by directors or commissioners, and

(7) Competence and independence (BI 1999).

Once bank owners agreed to joint recapitalization, the bank was required to provide 20% of the capital required to reach a 4% CAR requirement in cash, and the government provided the remaining 80%. The government became a large shareholder of the bank, with owners in daily control. The owners received prioritized call options[13] to buy back their shareholdings at the end of three years (Enoch 2000). The government saw leaving

[13] As Fane and McLeod (2002) state:

> For each bank, the number of options issued was equal to the number of shares acquired by the government. Their exercise date was set three years after recapitalization and their exercise price was set equal to the issue price of the new shares, plus an allowance for accumulated interest during these three years. The total number of new shares was set at 100 times the number of shares already in existence prior to recapitalization, and the issue price of the new shares was calculated to ensure that the value of new equity injected into each bank was enough to raise its CAR to 4 percent, given the auditors' estimate of the value and average risk-weight of its existing assets.

owners in day-to-day control of the bank as a way to encourage them to contribute new capital (Lindgren et al. 1999).

However, state banks were not subject to the same requirements for capital injection. Due to ongoing restructuring of the state banks because of repeated failures of previous recapitalizations, these banks were not required to submit business plans. Additionally, recapitalization funds were tranched to maintain the momentum of operational restructuring (Enoch et al. 2001).

Foreign and joint venture banks were excluded from the recapitalization program (Nasution 2000).

7. Bank Indonesia allocated enough capital for each participating bank to reach a 4% capital adequacy ratio.

Rather than ask each bank to apply for specific capital injection amounts, BI allocated enough capital for each participating bank to reach a 4% capital adequacy ratio (Indonesian Government 1998b).

8. The capital provided had several parameters.

The capital injections were funded by newly issued government bonds. Originally, the government planned to utilize variable-interest-rate bonds to raise capital adequacy ratios to 0% and fixed-interest-rate bonds to cover the additional 4% to reach a 4% capital adequacy ratio. However, in practice, some of the fixed-rate bonds were used to bring banks' capital to 0% (Fane and McLeod 2002).

The variable-rate bonds paid interest between 13% and 15% per year, paid every three months, with a three- to 15-year maturity period, whereas fixed-rate bonds paid interest between 12% and 14% per year with interest paid every sixth months. When the Indonesian government increased interest rates in 2000 to more than 17%, the government offered a bond exchange to increase the rates of the fixed-rate bonds to be more attractive, with new bonds carrying coupon rates of 10%–15% with five- to 10-year maturity periods. In addition, to hedge for exchange rate risk, the government issued hedge bonds linked to the Rp/USD exchange rate. Every three months, the interest rate and nominal value of the hedge bond was reevaluated based on the exchange rate—so the depreciation of the rupiah increased the nominal value of the hedge bond. The interest rate was based on the Singapore Interbank Borrowing Rate (Feridhanusetyawan and Pangestu 2003).

Additionally, while bonds were intended to bring capital adequacy ratio upwards, the banks were injected with cash from a yearly interest payment on bonds (*Jakarta Post* 1999a). Interest payments alone were estimated to amount to Rp 34 trillion (*Jakarta Post* 1999a). The bonds were tradable (Lindgren et al. 1999).

Private shareholders of banks participating in the capitalization scheme also received call options over the government shares purchased. The government made these call options available to private shareholders who provided the 20% of the capital for injection. The price of these options was the share issuance price, plus accumulated interest; the total number of new shares was 100 times the number of shares existing before recapitalization. Issue price was determined such that the value of new equity met the 4% threshold given auditors' estimates of the value of the bank's assets. The call options provided an opportunity for shareholders weary of participating in the scheme to profit from the recovery of the bank that had been recapitalized, as share prices for the options were set equal to the issue price of the bank's shares, plus any accumulated interest (Fane and McLeod 2002).

Shareholders were also provided certificates of entitlement, an instrument tradable on the capital market. These COEs entitled the asset holder to proceeds of collections and sales of assets transferred to IBRA over a specified period, with the idea of increasing the incentive to participate in the recapitalization process. The COEs had no underlying commitment from the government to pay the holder (Suta, Musa, and Slangor 2004).

These agreements with shareholders were met with public controversy as they were perceived as disadvantageous to the government while advantageous to the shareholder. However, the government used the recapitalization terms as an opportunity to encourage controlling shareholders to incur the costs of the recapitalization, as well as provide itself an exit strategy in divestment through the call options on government-owned shares (Suta, Musa, and Slangor 2004).

9. Indonesian capital markets regulation created difficulty in share issuances necessary to raise capital to participate in the recapitalization.

Due to Indonesian capital markets regulation, the process for raising capital was slightly hindered for banks. The government required private banks to issue new shares to increase liquidity available in the recapitalization scheme, but Indonesian regulation required a preemptive rights issue as shareholder protection. The process for rights issues was lengthy, causing delays in the recapitalization process. While the Financial Services Authority of Indonesia issued a regulation allowing direct public offerings, there were protests within the agency over this method as it lacked protection of minority shareholders. To combat this, the Financial Services Authority required all banks undergoing recapitalization to undertake a rights issue, preventing banks from raising capital through direct public offerings and creating delays in the process (Enoch et al. 2001).

10. Oversight and governance of the participating banks was an ongoing issue throughout the program.

These governance issues applied to all of the Indonesian government's efforts to salvage its banking system, not just the joint recapitalization program. The issues were "diverse," and included problems with "each of the principal institutions involved," such as BI and IBRA, leading to public perception of a lack of commitment to reform of the banking sector (Enoch et al. 2001).

Though able to coerce debtors into promises in reworking loans, IBRA struggled to enforce such promises. Not allowed to use existing powers to legally seize court assets, the agency was forced to take debtors to court. There, it lost four of every five cases. Under pressure to sell assets so that revenues could contribute to the budgetary deficit under IMF provisioning, IBRA often sold assets cheaply to foreign buyers ready with cash (Arnold 2003).

11. There were consequences for the owners of the banks undergoing recapitalization.

IBRA replaced the management of the banks; almost all of the banks eligible for joint recapitalization had provided their share of the capital; and the markets reacted well to the news (Enoch 2000).

The owners of the banks that chose to participate in recapitalization were banned from managing other banks in the future (Sharma 2001). While state and regional banks did not face changes in ownership, of the 42 business-group-affiliated private banks involved in recapitalization or restructuring, only seven kept their doors open without ownership changes; of those, only one major bank—Bank Panin, not a participant in the recapitalization scheme—was left untouched (Sato 2005).

The government often sold shares of banks not affiliated with groups; rather than sole acquisitions, groups of investors purchased shares of banks. Of the recapitalized banks, Bank Internasional Indonesia was sold to Temasek Group of Singapore and Kookmin Bank of Korea (Sato 2005).

The joint decree establishing the parameters for recapitalization also placed requirements on boards. Shareholders of each commercial bank participating in the recapitalization program were required to elect a member to each bank's board to serve as a compliance director. The board member's appointment also required Bank Indonesia's approval. Compliance directors were required to submit the ongoing results of the recapitalization to Bank Indonesia quarterly (Indonesian Government 1998b).

12. The joint recapitalization program had a multi-pronged exit strategy.

The banks remained able to reacquire their shares during the three-year period by paying the government back either for their account or an outside investor. At the end of the three-year period, the bank's value was independently assessed and the owners had the first option to buy back their shareholdings. If the owners did not buy back their shares, the government sold them over the course of the next year (Lindgren et al. 1999).

According to an IMF report from 2000, even if banks reached the 4% CAR requirement, BI and IBRA continued to monitor the banks, as the CAR requirement increased to 8% for end-2001 (Giorgianni et al. 2000). The status of the various banks' CARs can be seen in Figure 5.

Figure 5: Banks' Performance as of March 2000

	Capital Adequacy Ratio (%)	
	Business Plan	Reported
Bank Lippo	14.9	17.6
BII	5.5	5.2
Universal	4.0	5.2
Bukopin	4.0	12.4
Prima Express	4.0	5.7
Arta Media	4.0	9.5
Patriot	8.0	16.6

Source: Giorgianni et al. 2000.

III. Evaluation

The announcement of the various bank closures and restructurings on March 13, 1999, formulated in conjunction with public relations efforts, including specialist consultants, received a positive reaction from the markets. "The general feeling was that finally the authorities had a full grip on the banking situation" (Enoch 2000). After the recapitalizations, bank runs subsided (BI 1999). However, providing extended timelines to raise the capital necessary for recapitalizations made space for increased uncertainty in the markets and provided opportunity for depositor withdrawals (Enoch et al. 2001). Public confidence in the banks eligible for joint recapitalization faltered due to some confusion and negative comments by public officials, leading to runs and a dearth of liquidity (Enoch 2000).

Over the next four years of implementation of the recapitalization scheme, the rate of nonperforming loans in the banking sector decreased dramatically, as shown by Sato (2005) in Figure 6.

Figure 6: Main Indicators for the Banking Sector around the Economic Crisis, 1996–2003

								(%)
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
No. of commercial banks	239	222	208	164	151	145	142	138
Total assets (ratio to nominal GDP)	72.8	84.3	79.8	71.8	77.8	70.9	65.8	63.9
Total loans (ratio to nominal GDP)	55	60.2	51	20.5	21.3	21	22.7	26.6
Loan to deposit ratio	104	105.7	85	36	37.3	38	43.2	54.3
Loans/total assets	75.6	71.5	63.9	28.5	27.3	29.6	34.5	41.6
Claims on government/total assets	0.2	0.2	0.1	34	43.6	39.3	35.7	30.2
Capital/total assets	9.6	8.8	-12.9	-2.7	5.1	6.4	8.8	9.7
Nonperforming loan ratio (gross)	9.3	19.8	58.7	32.8	18.8	12.1	8.3	8.1
Nonperforming loan ratio (net)	—	—	—	—	11.1	3.6	2.9	1.8

Notes: (1) "Claims on government" of banks on central government consist mainly of government bonds injected for banks' recapitalization; (2) the nonperforming loan ratios for 1996–1998 are figures for the end of each fiscal year (the end of March 1997 to the end of March 1999); (3) nonperforming loan ratio (gross) = nonperforming loans/total outstanding loans x 100 nonperforming loan ratio (net) = (nonperforming loans – reserves)/total outstanding loans x 100.

Source: Sato 2005.

Experts originally were optimistic about the efficacy of the program. Lindgren et al. (1999) note that "the recapitalization program . . . saved [the] banks, and the government seems likely to get back at least a share of its investment sooner than originally envisaged."

However, optimism waned. In October 2000, the IMF evaluated the performance of the recapitalized banks as "satisfactory," while noting that "return on equity has fallen short of business plans in several banks" (Giorgianni et al. 2000). Khambata (2001) writes that the restructuring program had "produced some insignificant results," noting the increase in total external debt, the high amount of nonperforming loans, and the fact that a 4% CAR requirement was low, even for a developing country (Khambata 2001).

Following the recapitalization program, Bank Universal, Bank Prima Express, Bank Arta Media, and Bank Patriot were merged with Bank Bali to become Bank Permata. Immediately after its recapitalization, Bank Universal's capital adequacy ratio dropped quickly, as a result of overaggressive loan growth, inefficient management of foreclosed assets, high costs in managing liabilities, and general vulnerability in the banking sector affecting the bank's performance. Meanwhile, Bank Internasional Indonesia was placed under bank restructuring status in 2001 after shareholders struggled to resolve problems with the legal lending limit on group-affiliated loans as per terms of the recapitalization agreement (Suta, Musa, and Slangor 2004).

Problems also arose from the lengthy implementation of the recapitalization scheme. Authorities did not follow the plan as outlined when announced. Additionally, the first two banks chosen to receive injections were seen as political choices rather than needs-based selections, affecting the market. Three months later, in December 1998, President Habibie partially retracted his decisions on which banks would receive injections, and preparations for the implementation of the scheme truly began (Enoch et al. 2001).

Both the call options and COEs offered to shareholders were also met with public controversy as they were perceived as disadvantageous to the government while advantageous to the shareholder. However, the government used the recapitalization terms as an opportunity to encourage controlling shareholders to incur the costs of the recapitalization, as well as to provide itself an exit strategy in divestment through the call options on government-owned shares (Suta, Musa, and Slangor 2004).

For state banks, some moral hazard behaviors emerged as a result of the "too big to fail" label on state banks also undergoing recapitalization. As bank managements were indifferent to losses, there was little incentive to recover loans, with nonperforming loans rising during the crisis[14] (Enoch et al. 2001).

The sheer size of the required recapitalizations led to deep cuts in government expenditure on development and subsidies. In 2002, almost 40% of government expenditure was used for debt service payment. The share of subsidies in government expenditure was reduced from 29% in 2000 to 12% by 2002 (Feridhanusetyawan and Pangestu 2003). Total debt expenditure over time can be seen in Figure 7.

[14] Enoch et al. state that it is unclear whether the rise in nonperforming loans was due to "genuine corporate distress or opportunistic nonperformance" (Enoch et al. 2001).

Figure 7: The Indonesian Government's Debt Service Payments

	1996–1997	1997–1998	1998–1999	1999–2000	2000	2001	2002
Total Debt (domestic + external)	22.902	29.485	62.911	63.106	57.691	115.274	136.367
External Debt	22.902	29.485	54.526	40.876	26.453	49.023	72.942
Principal	13	12.75	30.337	20.818	7.623	19.746	43.967
Interest	9.902	16.735	24.189	20.058	18.83	29.277	28.975
Domestic Debt	0	0	8.385	22.23	31.238	66.251	63.425
Bonds	0	0	0	0	0	0	3.9
Interest	0	0	8.385	22.23	31.238	66.251	59.525

Note: In trillions of rupiahs.

Source: Feridhanusetyawan and Pangestu 2003.

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