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Indonesia: Blanket Guarantee, 1998[1]

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Abstract

The Indonesian government closed 16 banks on November 1, 1997. At the time, the government said it would guarantee depositors up to 20 million Indonesian rupiah (IDR; USD 6,000) per account. The lack of immediate full protection for large depositors caused deposit runs throughout the banking sector and undermined foreign confidence in the Indonesian financial system. In response, the Indonesian president on January 26, 1998, announced a blanket guarantee and created the Indonesian Bank Restructuring Agency (IBRA) to administer the guarantee and other bank rehabilitation efforts. The blanket guarantee covered all depositors and nonsubordinated creditors in locally incorporated commercial banks. An official estimate of the total amount of covered liabilities is unavailable; for context, Indonesian banks had USD 209 billion in liabilities in June 1997, of which USD 110 billion were in rupiah deposits and USD 34 billion were in foreign currency deposits. The blanket guarantee lasted until September 22, 2005, when the government replaced it with a limited deposit insurance scheme administered by the Indonesian Deposit Insurance Corporation.

Keywords: Asian Financial Crisis (AFC), blanket guarantee, IBRA, Indonesia

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

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Overview

Key Terms

Purpose: To restore trust in the currency and national banking system as soon as possible

Launch Date(s)	Authorization: January 26, 1998
End Date(s)	Creditors removed August 11, 1998, and limited deposit insurance enacted September 22, 2005
Eligible Institutions	Locally incorporated commercial banks
Eligible Liabilities	All depositors and creditors, excluding subordinated debt and related party claims
Fees	A fee of 0.25% of total deposits, paid semi-annually
Coverage	Unknown; banks had a total of USD 209 billion in liabilities in June 1997
Outcomes	Government issued IDR 649 trillion for IBRA operations
Notable Features	The blanket guarantee paid foreign currency claims in local currency at the exchange rate on the day of payment

The floating of the Thai baht on July 2, 1997, caused speculative pressure on the Indonesian rupiah (IDR), leading to the government's decision to float the currency on August 14, 1997 (BI 1998). The Indonesian government suspended 16 commercial banks on November 1, 1997. The government provided a partial guarantee for depositors in the suspended banks, reimbursing up to IDR 20 million (about USD 6,000)[3] per account. This fully covered 92.5% of depositors in the 16 small banks, but the lack of immediate full protection for large depositors triggered a significant loss of confidence (Enoch 2000; WSJ 1997).

Depositors ran on banks throughout the banking sector, looking to shift their deposits from unsound banks into stable ones. By December 1997, 154 banks experienced runs, representing half of the total banking system. Foreign banks also became reluctant to conduct transactions with Indonesian banks (BI 1998; Enoch et al. 2001).

In response to domestic bank runs and the flight of foreign banks and investors, the president of Indonesia issued a decree enacting a blanket guarantee on January 26, 1998. The blanket guarantee covered all depositors and creditors in locally incorporated commercial banks, including derivative transactions[4] and excluding subordinated debt, related party claims, irregular or unverified liabilities, and liabilities that paid above-market interest rates. Bank Indonesia (BI) required bank owners to agree to a set of regulations. The guarantee covered accounts denominated in both rupiah and foreign currencies (Decree 26 1998; Enoch et al. 2001; IBRA 1999). As of

[3] In November 1997, USD 1 = IDR 3,492, per FRED.

[4] Authorities limited eligible derivative transactions to include only currency swaps in May 1999 (IBRA 1999, A-16).

June 1997, the Indonesian banking sector had USD 209 billion in liabilities,[5] including USD 110 billion in rupiah deposits and USD 34 billion in foreign currency deposits (Frécaut 2004).

Alongside the blanket guarantee, the president issued another decree on the same day that created the Indonesian Bank Restructuring Agency (IBRA). IBRA was tasked with administering the blanket guarantee, as well as handling the rehabilitation of weak financial institutions (Decree 27 1998). The government directly funded IBRA through bond issuance. The government and IBRA issued a total of IDR 649 trillion in bonds, and IMF researchers note that IDR 218 trillion went toward liquidity support and the blanket guarantee and IDR 53 trillion went toward interbank claims. The agency's 1999–2004 strategic plan stated that IBRA used shareholder settlements to recover some of the costs of the blanket guarantee. The Indonesian banking sector ultimately suffered IDR 435 trillion in losses, which became the public's burden because of the blanket guarantee (Frécaut 2004, 40; IBRA 1999; IMF Staff 2003; Kariastanto 2011).

In February 1998, Bank Indonesia announced retroactive compensation for the large depositors in the 16 commercial banks closed on November 1, 1997, that were not immediately covered by the partial guarantee. This represented a shift from the original announcement, which attached the protection of large depositors to the sale of bank assets (Jakarta Post 1998; WSJ 1997). On April 3, 1998, IBRA intervened in seven ailing banks, eventually closing them while protecting all depositors. The successful protection of deposits restored public confidence in the blanket guarantee, stopping bank runs. On August 20, 1998, IBRA closed an additional three banks, with deposits transferred to Bank Negara Indonesia (Enoch 2000; Enoch et al. 2001).

At the time of the original announcement, the blanket guarantee was intended to last until January 2000. BI announced its intention to revise the blanket guarantee to exclude creditors from coverage on August 11, 1998. However, limited deposit insurance legislation did not arrive until 2004 when the government enacted a deposit insurance law (BI 1999; Dow Jones 1998; Kariastanto 2011). This law established the Indonesian Deposit Insurance Corporation (IDIC) and empowered it to administer a deposit insurance scheme. This new deposit insurance law took effect on September 22, 2005, officially ending the existing blanket guarantee. The deposit insurance scheme wound down coverage gradually, eventually decreasing to IDR 100 million (USD 11,000)[6] per account 18 months after the law took effect (Jakarta Post 2004; Law 24 2004).

Summary Evaluation

The announcement of the blanket guarantee did not initially succeed in stopping runs in the banking sector. The successful transfer of deposits by IBRA after bank closures in April 1998 bolstered public confidence among retail depositors in the blanket guarantee. Shalendra D. Sharma, an International Monetary Fund (IMF) and World Bank consultant, highlights controversial political decisions made by the Indonesian president that damaged the public's

[5] This number represents the total liabilities in the banking sector as of June 1997. Includes subordinated loans, which the blanket guarantee did not cover.

[6] On March 25, 2007, USD 1 = IDR 9,081, per Yahoo Finance.

perception of the blanket guarantee's administrative agency, IBRA. Specifically, the president prevented IBRA from disclosing its operations publicly, leading to the view that the organization was nonoperational before the publicity of the April 1998 actions (Enoch et al. 2001; Sharma 2001).

Though the successful April 1998 closures restored confidence among retail depositors, there were continued questions of eligibility among institutional depositors in commercial banks. From the guarantee's outset, there were major delays on the payments of interbank claims, while nonbank deposits were immediately serviced. Interbank claims were not paid until 2000. Charles Enoch, then of the IMF, says that the passing of guarantee administration responsibility between IBRA and BI and the exclusion of related party claims caused this delay in the servicing of institutional deposits. This delay weakened the credibility of the blanket guarantee among the international community (Enoch et al. 2001).

Ross H. Mcleod of the Australian National University alleges instances of moral hazard in which banks extended large loans to affiliates. These affiliates used the loans to speculate against the currency or repay foreign currency debts, both actions being motivated by an expected devaluation of the local currency (Mcleod 2006).

Context: Indonesia 1997–1998		
GDP (SAAR, nominal GDP in LCU converted to USD)		$215.7 billion in 1997
		$95.4 billion in 1998
GDP per capita (SAAR, nominal GDP in LCU converted to USD)		$1,064 in 1997
		$464 in 1998
Sovereign credit rating (five-year senior debt)	1997	Moody's: Data not available
		S&P: BBB+
		Fitch: BBB+
	1998	Moody's: Data not available
		S&P: B-
		Fitch: BB+
Size of banking system		$138.1 billion in 1997
		$53.4 billion in 1998
Size of banking system as a % of GDP		64% in 1997
		55.9% in 1998
Size of banking system as a % of financial system		Data not available in 1997
		Data not available in 1998
Five-bank concentration of banking system		Data not available in 1997
		Data not available in 1998
Foreign involvement in banking system		Data not available in 1997
		Data not available in 1998
Existence of deposit insurance		No in 1997
		No in 1998
Sources: Bloomberg; World Bank Global Financial Development Database; World Bank Deposit Insurance Dataset.		

Key Design Decisions

1. Purpose: The government announced the blanket guarantee to restore confidence in the banking sector and national currency.

Speculative pressure caused by the floating of the Thai baht forced the Indonesian government to abandon the peg of the Indonesian rupiah on August 14, 1997. On November 1, 1997, amid economic distress caused by the depreciation of the currency, the government closed 16 weak banks and compensated their depositors up to IDR 20 million per account (BI 1998; Enoch 2000). The lack of immediate full protection for large depositors and skepticism regarding the health of remaining banks undermined confidence, causing runs throughout the banking sector. The resulting drain on liquidity weakened international confidence in Indonesian banks, restricting their access to foreign credit (Sharma 2001).

On January 26, 1998, the government announced a blanket guarantee through presidential decree (Decree 26 1998, art. 6). The government announced the guarantee to restore confidence in the national currency and banking as soon as possible (Decree 26 1998, art. 1).

2. Part of a Package: Following the announcement of the blanket guarantee, the government announced the creation of IBRA to handle the rehabilitation of ailing financial institutions.

The lack of protection for large depositors triggered runs throughout the banking sector, draining banks' liquidity and weakening international confidence in the Indonesian financial system (Sharma 2001). The government responded by announcing a blanket guarantee and creating IBRA on January 26, 1998. IBRA had three major responsibilities: administering the blanket guarantee, rehabilitating financial institutions that BI deemed unhealthy, and taking any other legal actions required to restructure unhealthy banks (Decree 26 1998; Decree 27 1998).

IBRA had a broad array of powers to intervene in struggling financial institutions. Its methods included closures, open bank interventions, full takeovers, and recapitalizations (Enoch 2000). Figure 1 lists the dates of IBRA actions, and the types of interventions taken.

Figure 1: IBRA Interventions by Date and Type

Date	Type of intervention
February 1998	IBRA intervened in 54 weak banks, inserting IBRA officials into banks' respective leadership bodies.
April 1998	IBRA took full ownership of seven large banks and closed seven small banks.
August 1998	IBRA closed three banks.
March 1999	IBRA recapitalized nine banks and took ownership of seven banks.

Source: Author's analysis.

3. Legal Authority: The Indonesian president established the blanket guarantee through a decree.

The Indonesian government established the blanket guarantee through a presidential decree on January 26, 1998. A second presidential decree issued on the same day created IBRA and gave the newly created body the power to administer the blanket guarantee (Decree 26 1998; Decree 27 1998).

4. Administration: IBRA administered the blanket guarantee and reported directly to the Ministry of Finance.

The government created IBRA to administer the blanket guarantee as well as oversee the rehabilitation of Indonesian banks. IBRA and BI jointly carried out the processing of guarantee payouts. Following the closure of IBRA on February 27, 2004, BI took over the administration of the blanket guarantee (AFX Asia 2004; Decree 27 1998; IBRA 1999).

There were some issues of blanket guarantee responsibility being passed between IBRA and BI. This resulted in a slowdown in payments on interbank claims (see Summary Evaluation) (Enoch et al. 2001).

5. Governance: The president appointed a chairman to head IBRA, while the minister of finance appointed other leadership in consultation with the governor of Bank Indonesia.

The president of Indonesia appointed a chairman to lead IBRA. The minister of finance was responsible for choosing the rest of the leadership board (Decree 27 1998).

The Ministry of Finance oversaw the actions of IBRA leadership, and established implementation procedures and conditions in consultation with the BI governor. Lehman

Brothers and JPMorgan also advised IBRA leadership (BI 1998; Decree 26 1998; Sharma 2001).

6. Communication: The government originally communicated a partial guarantee before announcing a blanket guarantee, damaging its credibility among the public.

In a letter of intent sent to the IMF on October 31, 1997, the Indonesian government stated that it would guarantee deposits only up to IDR 20 million in 16 banks that were closed on November 1, 1997. The decision to attach full protection for larger depositors to the sale of bank assets, preventing immediate coverage, led to runs on domestic commercial banks (Gov't of Indonesia 1997; Sharma 2001; WSJ 1997). The continued runs resulted in the government's decision to announce a blanket guarantee, and create IBRA to administer the guarantee, on January 26, 1998 (Decree 26 1998, art. 5).

A key inconsistency between the decree issued by the minister of finance and the decree issued jointly by IBRA and BI caused otherwise eligible liabilities to be excluded due to their being registered late by debtors. The government and BI introduced a new joint decision to rectify the discrepancy (IBRA 1999).

The government originally prevented IBRA from publicizing its actions, leading to the public perception that the body was nonoperational. Before the successful April 1998 closings, the guarantee did not generate confidence in the public, and runs continued within the banking sector (Enoch et al. 2001).

The communication around the April 1998 closings and exercise of the blanket guarantee was effective in instilling confidence among depositors and creditors, ending bank runs. On April 3, 1998, and throughout the ensuing weekend, the finance minister and IBRA leadership held frequent televised press conferences explaining IBRA measures being taken and emphasizing that all depositors were fully protected (Enoch 2000).

7. Source(s) and Size of Funding: The government fully funded the operations of the IBRA, including the blanket guarantee.

According to the presidential decree, the government fully funded the operations of the IBRA (Decree 27 1998). The government took over banks' losses through bond issuance, ensuring that depositors and creditors did not suffer losses. The government and IBRA issued a total of IDR 649 trillion (USD 65 billion)[7] in bonds for the entire crisis response (Frécaut 2004; IMF Staff 2003).

IBRA also used shareholder settlements with responsible bank shareholders to recover some of the costs of the blanket guarantee (IBRA 1999).

[7] In 1998, USD 1 = IDR 10,013.60, per FRED.

8. Eligible Institutions: The government extended the blanket guarantee to all locally incorporated commercial banks, pending their agreement to a set of macroprudential regulations.

All locally incorporated commercial banks were eligible for protection from the blanket guarantee. Prior to official protection, the government required banks to sign agreements to adhere to a set of macroprudential regulations (See Key Design Decision No. 12, Other Restrictions) (Decree 26 1998; Enoch et al. 2001).

9. Eligible Liabilities: The blanket guarantee covered all depositors and most creditors.

The blanket guarantee covered all depositors and most creditors in eligible institutions, including derivative transactions. The guarantee did not include subordinated debt, related party claims, irregular or unverified liabilities, and liabilities that paid above-market interest rates. All liabilities were subject to a stringent verification process conducted by IBRA and BI. The blanket guarantee covered accounts denominated in both local and foreign currencies. IBRA created an exchange offer to extend the maturity claims of foreign creditors and reduce pressure on the state budget. As of June 2007, Indonesian banks' total liabilities were USD 209 billion. Of these liabilities, USD 110 billion were rupiah deposits and USD 34 billion were deposits denominated in foreign currency (Decree 26 1998; Frécaut 2004; IBRA 1999).

In August 1998, BI announced its intention to limit coverage to solely depositors, removing creditors from blanket guarantee coverage. In 2000, IBRA paid interbank claims, which had been previously delayed due to the exclusion of related party claims (Dow Jones 1998; Enoch et al. 2001).

10. Fees: IBRA required covered institutions to pay a percentage of the total value of their deposits.

IBRA required protected institutions to pay a fee of 0.25% per annum of the total value of their guaranteed liabilities. IBRA required banks to pay the fee in advance semiannually (IBRA 1999).

11. Process for Exercising Guarantee: IBRA closed troubled banks and placed matching accounts in stable state-owned financial institutions.

The government and IBRA issued a joint decision requiring creditors or debtors to register eligible liabilities within 60 days of the joint decision or the booking of the liability. IBRA and BI jointly carried out claim processing. IBRA placed depositors' funds in matching accounts at stable state banks. For accounts denominated in foreign currencies, IBRA provided guarantee payouts in rupiah at the market exchange rate on the day of the payment (Decree 26 1998; Enoch et al. 2001; IBRA 1999).

12. Other Restrictions: The government set weekly maximums on the interest rates banks could pay on deposits and limited loan growth.

IBRA created a set of prudential regulations intended to prevent moral hazard. IBRA set a ceiling on the deposit rates banks were permitted to offer. This ceiling, announced weekly by BI, was 500 basis points above the rates offered by the banks that BI used to calculate the Jakarta Interbank Rupiah Rate (JIBOR), the Indonesian benchmark interest rate. In addition, BI placed restrictions on banks' credit growth. IBRA required banks to sign agreements to adhere to these prudential restrictions before receiving coverage from the blanket guarantee (Enoch et al. 2001; Sharma 2001).

13. Duration: The government originally planned for the blanket guarantee to expire in January 2000; however, it lasted until the government passed a law creating a limited deposit insurance scheme, which came into effect in September 2005.

The announcement of the blanket guarantee established an expected end date of January 2000 (BI 1999, vi). The government did not enact limited deposit insurance legislation until 2004, when it created the Indonesian Deposit Insurance Corporation to administer a new limited protection scheme. The new law came into effect on September 22, 2005, officially ending the blanket guarantee. The new deposit insurance scheme wound down coverage gradually, eventually decreasing to IDR 100 million per account 18 months after becoming operational. The insured deposit amount could be adjusted in the event of runs, significant inflation, or if less than 90% of total depositors in a bank were not fully covered by the limited scheme. Accordingly, the IDIC rehabilitated systemically important banks rather than closing them, potentially creating a blanket guarantee for systemically important banks (Jakarta Post 2004; Kariastanto 2011; Law 24 2004; Mcleod 2006).

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