Corporate Governance of Banks in Indonesia

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ACRONYMS

ADB : Asian Development Bank
API : Arsitektur Perbankan Indonesia, *Indonesian Banking Architecture*
Bank EXIM : Bank Expor Impor
BAPEPAM : Badan Pengawas Pasar Modal, *the Capital Market Supervisory Agency*
BAPINDO : Bank Pembangunan Indonesia
BBD : Bank Bumi Daya
BCA : Bank Central Asia
BDNI : Bank Dagang Nasional Indonesia
BI : Bank Indonesia, *The Central Bank of Indonesia*
BII : Bank Internasional Indonesia
BLBI : Bantuan Likuiditas Bank Indonesia, *Bank Indonesia Liquidity Assistance Loan*
BoC : Board of Commissioners
BoD : Board of Directors
BRI : Bank Rakyat Indonesia
BTO : Bank Take Over
BUN : Bank Umum Nasional
CAR : Capital Adequacy Ratio
CEO : Chief Executive Officers
ERM : Enterprise Risk Management
GMoS : General Meeting of Shareholders
GOI : Government of Indonesia
IBRA : Indonesian Bank Restructuring Agency
IDR : Indonesian Rupiah
IMF : International Monetary Fund
JSX : Jakarta Stock Exchange
KLD : Kredit Likuiditas Darurat, *Emergency Liquidity Credit*
LDR : Loan to Deposit Ratio
LLL (3L) : Legal Lending Limit
LPS : Lembaga Penjamin Simpanan, *Deposit Insurance Company*
MOF : Ministry of Finance
MRA : Master of Restructuring Agreement
MSAA : Master of Settlement and Acquisition Agreement
NCCG : National Committee of Corporate Governance
NPL : Non Performing Loan
OECD : Organization for Economic Cooperation and Development
OJK : Otoritas Jasa Keuangan, *Financial Supervisory Authority*
OPT : Operasi Pasar Terbuka, *Open Market Operation*
PT : Perusahaan Terbatas, *Limited Liability Company*
ROA : Return on Assets
ROE : Return on Equity
SBI : Sertifikat Bank Indonesia, *Bank Indonesia Certificate*
SBPU : Surat Berharga Pasar Uang, *Money Market Securities*
SOEs : State Owned Enterprises
SOL : Subordinated Loan
UP3 : Unit Pelaksana Penjaminan Pemerintah

1. Introduction

One of the major factors for the vulnerability of Indonesian companies to the negative impact of the 1997 financial crisis was their weak internal corporate governance mechanism. Like other corporate entities in the region, the failure of Indonesian companies to implement prudent corporate governance practices in their company management was related to a number of factors, including a high concentration of company ownership and the lack of transparency in the procedures for corporate acquisitions and control. In addition to the problem of inefficiency, the Indonesian corporate sector was also vulnerable to the problems of risk exposure associated with its over reliance on external funding, especially when there was ineffective supervision by the Indonesian Board of Commissioner and inadequate monitoring by creditors. [1]

The lessons of the financial crisis made it clear that serious improvements were needed to restore investors' confidence in the Indonesian companies. Two elements of corporate governance were regarded as particularly crucial by regulators: 1) appropriate financial reporting system and 2) the introduction of risk management systems, especially to control large foreign exchange exposures.

Corporate governance practices that were not implemented properly in the banking sector imposed serious constraints on the efficient allocation of resources in the economy. This is particularly so in the Indonesian banking sector which was most seriously hit by the problems of "double mismatch" (currency mismatch and maturity mismatch) of the corporate sector and its high non performing loans. [3] Therefore, the banking sector was placed as the core of the government economic reform and had to accept the most drastic reforms required by the IMF and the World Bank.

Before the financial crisis, many private banks in Indonesia were dominated by conglomerates. In practice, most of these banks' lending went to their own groups, and mostly exceeded the legal lending limits. The ten biggest private national banks owned by conglomerates are shown in Table 1.1.[4] The ownership structures of the conglomerate groups were highly concentrated in the industry with shares accounted for almost 60 percent of the total bank assets. This resulted in imprudent banking practices, increasing risk taking, improper lending decisions due to collusive practices and instances of interference, lack of incentive of the professional bankers for appropriate behavior, and decline in the quality of managerial capabilities, especially on the critical functions of credit analysis and risk management of the bankers who managed the banks.

[1] Asian Development Bank (ADB), "Corporate Governance and Finance in East Asia. *A Study of Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand"* (Edited by Ma Virginita Capulong, David Edwards, David Webb, and Juzhong Zhuang), Vol. 1 and Vol. 2., 1999.

[2] Asian Development Bank (ADB), "Corporate Governance and Finance in East Asia. *A Study of Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand"* (Edited by Ma Virginita Capulong, David Edwards, David Webb, and Juzhong Zhuang), Vol. 1 and Vol. 2., 1999.

[3] This contention which attributes main cause of Asian Currency Crisis to "double mismatch" has been argued in various papers. Among others, see Yoshitomi, M. and Ohno K., "Capital-Account Crisis and Credit Contraction", ADBI Working Paper, May 1999

[4] I Putu Gde Ari Suta and Soebowo Musa, *Membedah Krisis Perbankan, Anatomi Krisis dan Penyehatan Perbankan*, (Jakarta: Yayasan Sad Satria Bhakti, September 2003), 205.

Table 1.1
The 10 Biggest Private Banks
(as of December 1996)

Bank	Total Assets (in trillion Rp)	Owner	Main Business Line
BCA	35.3	Salim group	Cement, automotive, food
Bank Danamon	21.9	Usman Admajaja	Property, banking
BII	16.7	Eka Cipta Wijaya	Paper, food
BDNI	16.5	Sjamsul Nursalim	Property, finance, tires
LippoBank	10.2	Mochtar Riady	Finance, property
Bank Bali	7.6	Bali Financial Group	Finance
Bank Niaga	7.3	Tirtamas Group	Cement, Finance
BUN	7.1	Bob Hasan/Ongko	Agribusiness, property
Panin Bank	5.4	Mu'min Ali Gunawan	Property, finance
Bank Duta	5.2	Bob Hasan/Sigit H.	Agribusiness, wood

Source: Membedah Krisis Perbankan, Anatomi Krisis dan Penyehatan Perbankan.

In addition to the problem mentioned above, in the absence of an efficient risk management system in the banking sector, there were many political interventions to the state-owned banks and private banks to extend more credits to certain business sectors without official and sufficient credit evaluation. Some credits were allocated to less profitable sectors, such as property, capital intensive chemical industry and private power plants. Furthermore, the bureaucracy in the state-owned banks was complicated, which resulted in the inefficiency in the banking operations. Some key positions in these banks were held by government officers appointed from the Ministry of Finance and the Central Bank, which tends to create conflict of interest.

Lastly, the policy in the banking sector was not in line with the government's monetary and fiscal policies. For example, the deregulation package issued to develop the banking sector was not followed by the policy of control and prudential banking.

Significance and Objective of the Study

In Indonesia, although some policies to strengthen corporate governance in banking sector have been issued after the crisis, in-depth investigation of corporate governance practices in banking sector and of their impacts on banking performance is still lacking. Hence, this study aims to examine all the major aspects of corporate governance practices in Indonesian banking sector including roles of financial safety nets and prudential regulation, banks' internal governance mechanism and the role of market disciplines, including the analysis of the relationship between corporate governance practices and banks' performance.

This paper is organized as follows. Section 1 explores the corporate governance problems in the banking sector before the crisis. Section 2 reviews the condition of the banking sector after the crisis and some efforts implemented by the Government of Indonesia to restructure the banks. Section 3 overviews the development of financial safety nets that include a deposit insurance company and the lender of the last resort mechanism of Bank Indonesia and evaluates the effectiveness of financial safety nets in relation to market discipline. Section 4 examines the internal corporate governance practices of banks within the regulatory framework of good corporate governance in Indonesia by using the results of questionnaire survey conducted to 26 listed banks in Jakarta Stock Exchange. Section 5 provides an overview of the performance of the banking sector and address the critical issue

of how monitoring stakeholders as depositors, creditors and investors are disciplining banks. Section 6 evaluates overall issues and makes some policy recommendations.

Findings on Corporate Governance of Banks

In Indonesian banks in general, controlling shareholders have the strong voice in selection or dismissal of the president director and independent commissioners. Members of the board of commissioners and directors are usually nominated by banks' controlling shareholders or management. Less than a half of the surveyed banks have established a nomination committee. In addition, although most of surveyed banks have allowed for minority shareholders to nominate the candidates of BoC at the GMoS, such rights have been rarely executed.

As it is required by Jakarta Stock Exchange Regulation, all surveyed banks have appointed independent commissioners through a relatively fair and transparent process and all of them confirm that there is a high degree of "independence" in the position. In practice, however, independent commissioners do not seem to be really independent from the BoD or controlling shareholders. This gap can be traced to the fact that some of the banks hire former directors, employees or large shareholders as their independent commissioners.

According to the survey, the respondent banks have not fully applied performance-based compensation schemes for commissioners. Almost 60% of the surveyed banks have no formal procedure and criteria for evaluating the performance of commissioners. But 80% of them have a formal system for evaluating the performance of the president director. This reflects the general business perception toward commissioners as honorary position. However, the absence of evaluation criteria may imply that majority of the surveyed banks pay little attention to the commissioners' function of effective oversight of directors.

Most of the surveyed banks confirm that the bank's managements are intensively involved in reviewing the evaluations of internal control with internal and external auditors as well as reviewing the appropriateness of the bank's risk limits. They also confirm full compliance of the regulatory requirement regarding external audit on bank's financial performance. However, the results of the survey suggests that the respondents are still not satisfied with the overall risk management procedures in the banks. 27.3% of the banks reply that they have never reviewed the process at all and 36.4% reply only once during the last three years.

Although all of the surveyed banks comply with the regulatory requirements of annual reports and quarterly financial reports, the adequacy of disclosure and transparency remains a major challenge. Inadequate disclosures include: self dealing or related party transaction; the banks' share transaction by their own commissioners or directors; remuneration of commissioners and directors; background of commissioners and directors; fees to external professionals or other related parties; major contingent liabilities; significant changes in ownership; governance structure and policies; and the extent to which the bank's internal control practice conform to the established standard.

2. Evolution and Restructuring of the Banking Sector

Following the implementation of the extensive bank reforms in October 1988, the banking industry grew rapidly, in terms of both the number of banks and total assets. The "boom" in the number of banks was not followed by the concern of prudence and trust principle of banks. During the economic crisis, the performance of Indonesian banking sector was sharply deteriorated and depositors withdrew their money from banks, which eventually led to the serious problem in banking liquidity. To restructure the banking sector, the government of Indonesia introduced two fundamental policy measures: 1) The reconstruction of sound banking system through recapitalization of troubled banks; 2) Improvement of regulations and enforcement of principles regarding precaution.

2.1 Overview of Banking Sector After the Crisis

As mentioned earlier, the Indonesian banking sector was the most seriously hurt business sector by the crisis. As a result of the crisis, 16 banks were liquidated through revocation of their licenses, 51 banks were frozen, 13 banks were merged, and over 35,000 employees were laid off.[5] The number of banks in the last eight years is shown in the Table 2.1.

Table 2.1
Number of Commercial Banks in Indonesia: 1997-2004

	1997	1998	1999	2000	2001	2002	2003	2004 (Oct)
State Owned Bank	7	7	5	5	5	5	5	5
Regional Government Bank	27	27	27	26	26	26	26	26
Private National Banks	144	130	92	81	80	77	76	74
Foreign & Joint Venture Banks	44	44	40	39	34	34	31	31
Total	222	208	164	151	145	142	138	136

Source: BI Indonesian Financial Statistic (processed).

The liquidity problems and the loss of public confidence in the banking sector resulted in negative balances in the settlement accounts of the banks with Bank Indonesia. Although the government had already taken actions to stabilize the banking sector and to improve public confidence through the deposit guarantee program, the banking sector still suffered from the crisis. The high cost of funds resulting from the liquidity crisis led the banks to experience negative interest margins. The banks' effort to reduce their negative interest margins by increasing their lending interest rates was restricted since it would worsen asset quality. Consequently, the capital adequacy ratio of the banks became quite low or even negative.

Liquidity Assistance Loan (BLBI)

Bank Indonesia had had responsibility to promote recovery from financial crisis by providing liquidity assistance loans (BLBI) to the problem banks. Law 1968 stated that Bank Indonesia was authorized to provide emergency loans to banks facing critical liquidity problems.

One of the significant actions taken by the Government in restructuring the banking sector was a fresh fund injection of government bonds to some banks which is considered as "Too

5 Iswandi MM, "Ratusan Trilliun Sia-Sia", *Kontan*, 48th ed., August 2001.

Big or Too Important to Fail". This action would be taken only after considerations have been made with regard to the impact of the bank's problems on its branch networks, the number of customers and employees, and the commitment of the owner to contribute 20% of the restructuring cost, among others.

The government bonds were issued in an exchange for bad loans that were transferred to the Indonesian Bank Restructuring Agency (IBRA), while the Government in turn received a portion of the ownership shares in those banks. The Government also issued bonds to Bank Indonesia (BI) as replacement of BLBI which was provided by BI.

In total, the Government had issued Rp 643.9 trillion bonds by the end of 2000. Of this total, Rp 430.42 trillion were allocated to the Bank Recapitalization program, RP 203.51 trillion for the replacement of BLBI to BI and Rp 9.97 trillion to the Government loan program.

Further, the banks that received BLBI were not obliged to repay their loans since their responsibility had been converted into equity of the banks owned by the government. It means that the BLBI no longer appears as a debt in the banks balance sheets. Therefore, the BLBI injection is treated as a transfer of ownership, and the Government will recover the cash when the bank is sold to private investors. However, the previous owner of the banks are required to surrender their assets and make a pledge by signing MSAA (master of settlement and acquisition agreement) and MRA (Master of Restructuring Agreement) comprising their liabilities to the Government.

The issuance of trillions of government bonds for BLBI and the recapitalization of the banks was a very expensive lesson for the Government. At the end, the public as the tax payer have to pay more for less service since the annual state budget could pay only the cost of the crisis which was caused by the negligence in implementing good corporate governance in the banking sector.

Indonesian Bank Restructuring Agency (IBRA)

In line with the guarantee program, the Government of Indonesia established the IBRA in January 1998 to implement the recapitalization program for banks that had liquidity problems, especially those banks that received more than 75% of BLBI and had liabilities in excess of 500% of their equity. IBRA was put under the jurisdiction of the Minister of Finance in early 1998 with the IMF prescription. The main task of the IBRA was to restructure the banking sector and restore the banks' financial health by taking over their irrecoverable loans and disposing the corporate debts that were transferred to and under IBRA management. When the troubled banks were transferred to the IBRA, BI also transferred the collection rights of BLBI to IBRA through a transfer mechanism called 'cessie' (fiduciary transfer). Therefore, IBRA had the right to collect the repayment of BLBI from the banks that received BLBI.

IBRA had implemented some strategies in order to accomplish the Restructuring Program, namely:[6]

- Guarantee on commercial banks' obligation: administration of a government guarantee program toward third parties
- Nursing and restructuring of banks: implementation of a restructuring program, including recapitalization of banks through merger and liquidation
- Restructuring of corporate debts and banks assets: rehabilitating banks assets (including credit portfolios of banks) through debt restructuring program.

[6] I Putu Gde Ari Suta and Soebowo Musa, 261.

- Settlement of shareholder obligation: handling the repayment of government loan extended to banks by allocating the obligation to the banks' controlling shareholders
- Asset disposal and repayment of government fund: handling the repayment of government loan extended to banks through divestment and asset disposal program.

To carry out the recapitalization program for commercial banks, IBRA implemented two policies: first, the shareholders were given the opportunity to add their capital; second, the government took over all the rights of the shareholders (bank takeover, BTO) in return for its recapitalization.

As the first step of restructuring, seven banks regarded as insolvent were closed in April 1998, and another seven banks were taken over by the Government.[7] Since there was no progress and their performance became even worse, three of the taken over banks i.e. BDNI, BUN and Bank Modern, were closed. In September 1998, the Government of Indonesia merged four state-owned banks, namely Bank Ekspor Impor (EXIM), Bank Bumi Daya (BBD), Bank Dagang Negara (BDN) and BAPINDO into a new bank called Bank Mandiri.

Later, the government gave the opportunities to 128 private national banks to implement the restructuring program after a due diligence process. Due diligence process was conducted on all Indonesia owned banks in order to determine solvent and insolvent banks. The result of this assessment is shown in Table 2.2. Banks were regrouped into the following three groups: Category A (solvent) for banks with Capital Adequacy Ratio (CAR) of 4% or above, Category B (insolvent) for banks with CAR between -25% and 4%, Category C (highly insolvent) for banks with CAR less than -25%.[8] The "A" banks could operate normally but they had to prepare a business plan in order to improve their performance. While the "B" and "C" banks were required to prepare and submit business plans to Bank Indonesia as part of the recapitalization program. Out of those 128 private national banks, it was decided that:[9]

- 74 banks with CAR 4% or above (category "A" banks) were allowed to continue operation without the obligation to be recapitalized.
- 9 banks with CAR between -25% and 4% were allowed to continue operation with the obligation to conduct recapitalization in order to meet minimum requirement of 4% CAR. In addition, their shareholders were also required to inject a minimum 20% required capital with the rest provided through Government Bonds.
- 7 category "B" banks were taken over by IBRA.
- 38 category "C" banks were closed.

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[7] The closed banks include: Bank Kredit Asia, Bank Centris International, Bank Deka, Bank Subentra, Bank Pelita, Bank Hokindo, and Bank Surya. Banks taken over by the Government include: BDNI, Bank EXIM, Bank Danamon, BUN, Bank Tiara Asia, Bank PDFCI, and Bank Modern.

[8] Djisman Simanjuntak, "Good Corporate Governance in Post Crisis Indonesia: Initial Conditions, Windows of Opportunity and Reform Agenda", 2001, 42.

[9] I Putu Gede Ary Suta and Soebowo Musa, 209.

Table 2.2
Number of Banks Classified by Capital Adequacy (CAR) and Ownership

	A Category **CAR > 4%**	B Category **-25% <CAR < 4%**	C Category **CAR < -25%**	**Total**
State Owned Banks	-	-	7	7
Regional Development Banks	15	8	4	27
National Private Banks	74	16	38	128
Joint Venture Banks	30	-	2	32
Total	119	24	51	194

Source: Bank Indonesia and Indonesia's Banking Crisis, Resolution Lessons & The Way Forward, Sukarela Batunanggar, December 2002.

Table 2.3 shows the financial review of 128 private national banks after implementing due diligence process.

Table 2.3
Financial Review of Banks

Private Banks		**Capital Adequacy Ratio**			**Capital Required for CAR 4% (Rp tln)**	**Total Assets (Rp bn)**	**3rd Party Deposits (Rp tln)**	**No. of Depositors** (1,000)	**No. of Employees**
No.	**Status**	**Average (%)**	**Best (%)**	**Worst (%)**					
74	A Category	15.4	148.0	4.0	-	na	na	na	na
7	Taken Over by IBRA	-21.1	-15.6	-24.6	5.21	21.62	15.45	1,051	10,314
9	Recapitalized	-16.1	-8.2	-23.1	20.12	98.36	76.59	6,115	24,488
38	Liquidated	-40.2	-10.9	-101.8	23.13	49.47	Na	1,147	16,463

Souce: Bank Indonesia and Indonesia's Banking Crisis, Resolution Lessons & The Way Forward, Sukarela Batunanggar, December 2002.

In general, the guarantee policy and the recovery program gradually convinced the public that their money is safe in Indonesian banks. However, as many banks were suffering from capital shortages, the national banks could not play a proper financial intermediary role for some time.

2.2 Ownership Structure of Banks Before and After the Crisis

Before the crisis, there were 240 commercial banks in Indonesia, consisting of 7 state-owned banks, 27 regional government banks, 165 private national banks, and 41 foreign banks and joint venture banks.[10] The state-owned banks were the dominant players, with about 50% of

[10] Bank Indonesia, *Indonesian Financial Statistic*, 1996.

the market share in terms of total assets in the banking system. The state-owned banks were not well managed due to the continuous political intervention by the government to extend credit, either to certain politically-linked enterprises or to certain priority sectors. In 1997, all state-owned banks had a high share of loans that were non-performing. In 1998, the authorities decided to recapitalize all state-owned banks, and one of the results was the establishment of Bank Mandiri from the merger of four state-owned banks.

As mentioned earlier, before 1997, the ten biggest Private Banks were dominated by conglomerate groups, and these banks were vehicles to extend funds to their own groups. Most of Indonesia's big banks were affiliated to other banks and financial institutions through cross shareholding and management. Many of these conglomerates were related to Soeharto's family.

The first outcome of IBRA's restructuring efforts, therefore, was the realignment of the ownership structure of the banking sector. Besides that, IBRA was assigned to conduct an exit strategy for the Government to divest its ownership in those banks. This program was implemented with several methods, such as:[11]

- Initial public offering: applied to unlisted banks (used for divestment of BCA) by offering its shares to the public;
- Secondary public offering: implemented to the public listed banks by offering the majority shareholder's shares to the public; and
- Offering the bank's ownership to strategic investors: implemented by selling the majority shareholder's shares to the strategic investors.

Table 2.4 shows how the ownership structure of the banking sector changed through IBRA's bank restructuring program. The remarkable development shown in the table is the decline of private banks affiliated with business groups. Before the crisis, 58 banks were affiliated with business groups, accounting for as much as 40% of assets held by all commercial banks. In the private banking sector, they accounted for less than 40% in number but 77% of total assets. Of these business group affiliated banks, 28 were closed, 10 were nationalized, and 4 received the capital injection. After the restructuring, most of the business groups have lost their affiliated banks. Private banks are now categorized into non-group independent banks, banks jointly owned by some business groups, and banks sold off to consortium of foreign and local investors.[12] In this way, the ownership of banks and business groups has been separated.

[11] I Putu Gde Ari Suta and Soebowo Musa, 361.

[12] Yuri Sato, "Post Crisis Economic Reform in Indonesia, Policy for Intervening in Ownership in Historical Perspective", Institute of Developing Economies Research Paper No. 4, September 2003.

Table 2.4
Change in Bank Ownership Structure in Indonesia: 1997-2004
Decline of the Business Group Affiliated Banks

Ownership Type		**Before Restructuring** (1997.6)		**After Restructuring** (1999.12)		**Current Structure** (2004.6)	
		No. of Banks	**% of Assets**	**No. of Banks**	**% of Assets**	**No. of Banks**	**% of Assets**
Government	Total	7	36.9	28	78.4	12	69.2
	State-Owned Banks			5	46.7	5	41.5
	Recapitalized Banks			19	12.0	7	27.7
	Nationalized Banks			4	19.8		
Private	Total	155	52.0	70	7.8	67	12.7
	Business Group-Affiliated	58	39.9	16	1.7	9	3.1
	Independent Banks	97	12.1	54	6.1	58	9.6
Foreign	Total	41	8.4	40	12.7	30	12.3
	Foreign Bank Branches	10	3.8	10	8.1	11	8.3
	Foreign Joint Banks	31	4.6	30	4.6	19	4.0
Regional	Regional Development Banks	26	2.7	14	1.1	26	5.8
Total	All Commercial Banks	229	100.0	152	100.0	135	100.0

Source: Post Crisis Economic Reform in Indonesia, Policy for Intervening in Ownership in Historical
Perspective, Yuri Sato, September 2003 and Info Bank, 2004.

By the end of 2003, IBRA and the Government were able to privatize some of BTO (banks taken over) and the state banks to the private investors and the public, with the aim to regain investor confidence and to obtain cash funding to cover the state budget deficit.

Table 2.5
Privatization of Banks

	Bank BCA	**Bank Niaga**	**Bank Mandiri**	**Bank Danamon**	**Bank BRI**	**Bank BII**
Date	Mar 02	Nov 02	July 03	May 03	Nov 03	Dec 2003
Buyer	Farindo Investment	Commerce Asset, Bhd	Public	Asia Financal (Temasek)	Public	Sorak (Kukmin Korea
Shares Sold	51%	51%	20%	51%	41%	51%

Remaining (owned by Gov/IBRA)	8.6%	25.1%	70%	28.1%	59%	42.5%

Source: Infobank, 2004

Privatization in developing and transitional economy has often become an important tool for improving efficiency and implementing good corporate governance. In general, state banks in Indonesia had been marked by less efficient operation, with a large proportion of their loan book consisting of "obligatory" lending to the state-owned enterprises or the conglomerates linked to authority which was often large loss-making enterprises. Lack of proper credit analysis was the main problem for state banks because the government and/or top government officials influenced most of their credit decisions. As a result, connected lending limits were weakly enforced, resulting in the continued deterioration of the loan quality even after the crisis.

Therefore, by selling the SOEs shares to the public through the capital market, the government expects to be able to increase disclosure, transparency and good corporate governance practices in those banks since an effective functional capital market mechanism will serve as a monitor of the banks' performance and prospects through the banks' stock prices.

Besides the importance of privatization, the other major factor to change the ownership structure is the possibility for foreigners to increase ownership in the banking sector. An increase in the foreign ownership of bank shares is expected to enhance competition, to reduce fee and cost of services, which eventually will benefit the bank customers. The other benefits include:

- less connected lending;
- improved quality and availability of financial services;
- new skills and technology;
- faster and cheaper access to international capital markets and liquid funds (via parent banks); and
- additional oversight by foreign supervisors, which may make them sounder.

Since the current regulations allow foreign banks to open branches or representative offices and even take over domestic banks with the maximum permitted ownership up to 99% (only 1% minimum share for domestic partner), Indonesian banking industry has so far been quite open to foreign investors. However, the remaining impediment for the foreign investment is still the perception of low quality of the bank loan assets since IBRA was not very successful to restructure and manage bad loans, especially for the corporate sector loans.

2.3 Policy Efforts for Enhancing Corporate Governance of Banks

The basis of Indonesia's legal framework for corporate governance is the Company Law 1995. Under this Law, a limited liability company (PT) is a separate legal entity in which the Board of Directors is fully responsible for the company's management in accordance with the company's interest and goals, and the Board of Commissioners is responsible for supervising and advising the Board of Directors in running the company.[13] The General Shareholders' Meeting is the corporate component which has the highest decision-making power in the

[13] Company Law 1995, Article 1(4) & 1(5).

company.[14] Board of Directors and Commissioners are responsible to sign and submit the annual report to the shareholders in the General Shareholders' Meeting.[15] The annual financial statement shall be made in accordance with the Financial Accounting Standards.[16]

The legal framework for corporate governance of publicly listed Indonesian banks is Law No. 8 of 1995 regarding capital market and other related regulations issued by BAPEPAM (the capital market supervisory agency). All publicly listed companies are required to meet disclosure requirements. The disclosure principle is a guideline that requires public companies to disclose to the public, within a certain time, material information with respect to their business.[17] Related to this, every publicly listed company is also required to submit the annual report, which contains material information such as management report, special explanation, and financial statement for the last 5 book years.[18] In 1996 the BAPEPAM Chairman enacted Decree No. 63/PM/1996, requiring publicly listed companies to create the position of Corporate Secretary. The decree stipulates that the responsibilities of a Corporate Secretary are to keep informed about capital market regulations, to provide public information on the company's condition, to give advice to the directors in complying with capital market regulations, and to liaise between the company and its stakeholders.[19]

Jakarta Stock Exchange ('JSX') issued Decree No. 315/2000 as amended by JSX Decree No. 339/2001 concerning listing requirements, which requires listing company to have Independent Commissioner, Audit Committee, and Corporate Secretary. In November 2002, the BAPEPAM issued BAPEPAM Decree No. 20/2002 concerning independence of accountant of publicly listed companies in carrying out auditing services. The new BAPEPAM regulations No.VIII.G.11 and No.IX.I.5 define the responsibility of the Board of Directors on financial reporting and the establishment and duties of the Audit Committee, respectively.

Under the Banking Law 1992, banks were required to comply with the Legal Lending Limit (3L) guideline. The Banking Law 1998 amendments introduced a specific provision which prohibits a bank from exceeding the limit set by the 3L.[20] In addition to the 3L rule, the Banking Law 1998 also required banks to examine the intention and capacity of prospective borrowers to repay borrowed funds, in order to minimize bad debts.[21]

Under the Banking Law 1998, the authority of the Central Bank pertaining to bank supervision has been increased. Previously, banking licenses were issued by the Ministry of Finance after consultation with the Central Bank. Now, such licenses are issued by the Central Bank. Bank Indonesia, which used to undertake periodic audits and inspection of banks, is now also permitted to appoint external public accountants to perform bank audits on its behalf.[22]

In order to promote good corporate governance, BI has introduced some rules, such as:[23]

- Submission of the quarterly and annual financial report to Bank Indonesia (circular letter No. 3/30-31/2003)
- Strengthening legal lending limit regulation (BI regulation No. 2/16/2000)

[14] Company Law 1995, Article 1(3).
[15] Company Law 1995, Article 56 & 57.
[16] Company Law 1995, Article 58.
[17] Law No. 8 year 1995 regarding Capital Market.
[18] BAPEPAM Decree No.38/PM/1996
[19] BAPEPAM Decree No. 63/PM/1996
[20] Banking Law 1998, Article 11(4A).
[21] Banking Law 1998, Article 8 (1)
[22] Banking Law 1998, Article 31A.
[23] Burhanuddin Abdullah, "The Indonesian Banking Industry: Competition, Consolidation and Systemic Stability", August 2001.

- Enhancing the competence and integrity of bankers by imposing a Fit and Proper Test on each bank's shareholders and management (BI regulation No. 5/25/2003).
- Requiring banks to appoint Compliance Directors, responsible for ensuring the banks' compliance with existing regulations (BI regulation No. 1/6/1999).
- Strengthening Bank Indonesia's supervisory function and the status of the Bank (BI regulation No. 6/9/2004)
- Maintaining consistent law enforcement by establishing a Banking Investigation Special Unit, to uncover violations against banking rules.
- Implementation of Know Your Customer Principle (BI regulation No 5/21/2003)
- Application of risk management for commercial banks (BI regulation No. 5/8/2003)
- Application of risk management for transaction through Internet (BI regulation No. 6/18/2004).

Based on BI report for the year 2000, the fit and proper test has been applied to bank owners, directors and commissioners, candidate of owners, directors and commissioners as well as establishment of compliance directors in every bank. In 105 banks, the fit and proper test was conducted on 1077 persons, including bank owners, directors and commissioners. Out of this total, 562 candidates were interviewed and 507 persons passed the interview. For compliance directors, 156 of the 216 potential candidates have been approved, 14 were still in the process of being considered for approval, 30 were rejected and 16 resigned from their positions. In addition, Bank Indonesia has formed a coordination network with the offices of the Attorney General and the Chief of National Police to prevent any form of banking crimes.

In March 2001, the National Committee of Corporate Governance (the 'NCCG') issued the National Code for Good Corporate Governance. The Code consists of 13 chapters, i. e.: shareholders; the board of commissioners; the board of directors; audit system; corporate secretary; stakeholders; disclosure; confidentiality; insider information; business ethics and corruption; donations; compliance with health, safety and environmental protection regulations; and equal employment opportunity.[24] In July 2003, the NCCG has completed the Indonesian Banking Sector Code (hereinafter referred to as "the Banking Code") as a complement of the National Code for Good Corporate Governance to create a healthy banking system in Indonesia.

According to the Banking Code, good corporate governance has five essential elements: fairness, transparency, accountability, responsibility, and independence.[25]

<u>Fairness</u>

- Banks should pay attention to the interest of stakeholders based on the principle of equal treatment.
- Bank should give opportunities to all stakeholders to provide their inputs and comments for the banks' purposes and to have access to information based on transparency principle.

<u>Transparency</u>

- Banks should reveal their information punctually, adequately, clearly, accurately and comparably, and it should be easy for the stakeholders to access.

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[24] National Committee on Corporate Governance, "Indonesian Code for Good Corporate Governance", April 2001.

[25] Forum for Corporate Governance in Indonesia, "Pedoman Good Corporate Governance Perbankan Indonesia", July 2003.

- The information revealed should cover everything related to vision, mission, business objectives, company strategy, financial condition, management structure and compensation, shareholders, cross shareholding, executive officer, risk management, system and implementation of good corporate governance, and other important materials which influence bank conditions.
- The transparency principle taken up by the banks will not influence their obligation to meet bank confidentiality regulation, duty of confidentiality, and personal rights.
- Bank policy should be in writing and be communicated to the stakeholders and others who are entitled to have the information about these policies.

Accountability

- Banks should set up clear responsibilities for each division that are in line with the bank's vision, mission, company's objective and strategy.
- Banks should be certain that all their divisions have competencies in line with their respective responsibilities and are aware of their role in implementing Good Corporate Governance.
- Banks should ensure that there is a check and balance system in bank management.
- Banks should have performance parameters for all levels based on corporate values, bank's objective and strategy and have a reward and punishment system.

Responsibility

- Bank should implement prudential banking practices and ascertain the degree of compliance with prevailing regulations.
- Bank should act as good corporate citizen who care about environment and implement social responsibilities.

Independence

- Bank should prevent improper domination by stakeholders and be free from any conflict of interest.
- Bank should make objective decision, free from pressure of other parties.

The Banking Code also sets out provisions on *Governance Structure and Mechanism* which are summarized as follows:

Shareholders

In accordance to general corporate law perspective, shareholders of banks have the same rights and obligations with those of other forms of corporations. However, there are some specific requirements that must be fulfilled by the shareholders of banks: controlling shareholders have to pass the Fit and Proper Test conducted by BI; controlling shareholders have to meet the minimum capital requirements, otherwise they must give their approval for being merged with other banks, etc.

Board of commissioners (BoC) and board of directors (BoD)

Although the appointment of the members of the BoC and BoD is made through and by GMoS (general meeting of shareholders), the candidates must pass the Fit and Proper Test conducted by BI. The candidates are nominated by a *Nomination Committee* for the approval of the GMoS. BoC of the publicly listed banks and banks with big assets have to be supported by *Audit Committee* and *Risk Policy Committee*, while BoD has to be supported by *Risk and Capital Committee* and *Personnel Committee.* BoD is responsible

for prudential banking practices including but not limited to risk management and internal control systems and BoC is responsible to supervise the BoD.

Auditor and audit committee

Internal auditor is appointed by the BoD based on the BoC approval. The appointment of internal auditor has to be reported to BI. Although internal auditor is responsible to BoD, it has functional coordination with BoC and Audit Committee. The audit committee has to facilitate the internal auditor and external auditor on the process of financial reporting, especially on the preparation of the financial reports. As facilitator, audit committee has to ensure the adequacy of internal control system for prudential banking practices, compliance with the auditing standards, while management will follow up the audit result properly.

Compliance officer

The objective of compliance officer assignment within the banks is to ensure that the banks' activities have complied with laws and regulations, commitment with BI as well as internal standard operating procedures set out by the respective banks. As required by BI, each bank must set up *Compliance Director.*

Corporate Secretary

The Corporate Secretary's main duty is to liaise with the bank's stakeholders and assist the BoD in implementing the corporate governance principles in general.

Syariah Supervisory Board (specially for Syariah Bank – a bank based on Islamic Law Principles)

Syariah Supervisory Board is an independent board that has the function of *directing*, *consulting*, *evaluating*, *supervising* the bank operations to ensure that the banks comply with Syariah principles as set out by Islamic Law.

Stakeholders

Stakeholders. as set out in the Banking Code, are the customers, debtors and employees, among others. According to the Banking Code, banks are required to execute stakeholders' rights in getting information and monitoring banks' performance, to protect stakeholders' interest as set out by the Law, etc. This section includes prohibition to the banks to give political donation.

Since the issuance of the Banking Code and the recommendations of the BASEL II Accord, BI has been very active in encouraging banks to adopt the Code, especially for the establishment of the Audit Committee and strengthening risk management.

3. Roles of Safety Nets and Prudential Regulation

To stabilize the financial sector and to strengthen the future of the banking system, the Government of Indonesia has put into place an infrastructure for the development of a Financial Safety Net that includes a Deposit Insurance Company (known as the Lembaga Penjamin Simpanan (LPS)) and the lender of last resort mechanism of Bank Indonesia. Although these financial safety nets effectively protected depositors' money, at the same time, they might have reduced market discipline by weakening the incentives of depositors and bank shareholders to monitor the banks.

3.1 Depositor Protection Before and After the Crisis

A limited deposit guarantee in Indonesia was first applied when the authorities closed down the Bank Summa at the beginning of the 1990.[26] At that time, BI provided a limited deposit guarantee of up to Rp 20 million for depositors and the owner was forced to liquidate other assets to cover depositors' losses. The Bank Summa was owned by the Soeryadjaja family who established the Astra group, one of the largest conglomerates in Indonesia. BI pointed out that since most of the bank's credits were allocated to its own affiliated companies, the bank had violated the legal lending limit. After the license was revoked, it took a long time to complete the liquidation process as there were difficulties in disposing off the assets. The owner of the Bank Summa gave up most of their share of Astra group during the liquidation process to repay the Bank's obligation. In the Summa's case, all the small depositors' money were fully repaid. The fund required for the repayment was provided by a consortium of banks organized by BI. Since then, there had been no bank closure until the government closed down 16 banks in 1997 and introduced a limited guarantee.

In order to maintain public confidence in the banking system, the GOI issued a Blanket Guarantee in January 1998, which covered all commercial banks' liabilities (rupiah and foreign currency), including both depositors and creditors. Initially, the administration of the Blanket Guarantee was a joint task between BI and IBRA, but later in June 2000, it became the responsibility of IBRA alone.

Depositor's protection was also regulated in the Banking Law 1998 amendment, which introduced the concept of deposit insurance. In the future, all banks would be required to insure their deposits to protect the depositors. A blanket guarantee will be replaced with limited deposit insurance once the banking system is stabilized. Formally, the implementation of deposit insurance is carried out by a Deposit Insurance Company (LPS), whose main task is to protect depositors, especially small depositors. In September 2004, the Government of Indonesia issued Law No. 24/2004 to define the functions, duties and authority of the LPS. This law will come into effect in September 2005.

Prior to the establishment of the LPS, the GOI has established UP3 (Unit Pelaksana Penjaminan Pemerintah) as a temporary institution to continue the functions of the IBRA in providing guarantee to depositors (IBRA was dissolved in 27 February 2004). The UP3 has 40 members, all from the Ministry of Finance (MOF) and IBRA. The objective of the UP3 is to maintain public trust in the banking sectors before the LPS is established. According to MOF Decree No. 85/KMK.06/2004, the task of the UP3 is to conduct coordination, administration and implementation of government guarantee program.

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[26] Sukarela Batunanggar, "Indonesia's Banking Crisis Resolution, Lessons and The Way Forward", December 2002, 21.

Phasing out the Blanket Guarantee System

By the year 2004, as the banking system in Indonesia has been considerably recovered, the Government of Indonesia announced a plan to gradually reduce the guaranteed amounts in order to decrease public spending and subject the banking industry to market discipline. The reduction can be summarized as follows:[27]

- Until 17 April 2005, all payment obligations of commercial banks are guaranteed by the Government.
- From 18 April 2005 until 21 September 2005, the guarantee program only covers deposits and inter-bank money market transaction.
- After 22 September 2005, the blanket guarantee system will expire and the deposit guarantee will be provided by Deposit Insurance Agency or known as LPS.

Law No. 24/2004 relating to the Deposit Insurance Company (LPS) stipulates that:[28]

- From 22 September 2005 until 21 March 2006, all deposits will be guaranteed.
- From 22 March 2006 until 21 September 2006, the maximum guaranteed amounts will be Rp 5 billion.
- From 22 September 2006 until 21 March 2007, the maximum guaranteed amounts will be Rp 1 billion.
- From 22 March 2007, the maximum guaranteed amounts will be Rp 100 million.

Table 3.1
Phase of Deposit Guarantee System

Obligation	Blanket Guarantee		Deposit Insurance by LPS			
Deposits	100%		100%	Rp 5 bil.	Rp 1 bil.	Rp 100 mil.
Inter-Bank Money Market	100%					
Other Obligation	100%					
Protection Base	Per account		Per depositor per bank			
Time Phase (until)	April 2005	Sept.2005	Mar.2006	Sept.2006	Mar.2007	Thereafter

Source: UP3, Ministry of Finance

[27] President Decree No. 95/2004 and UP3, Ministry of Finance
[28] Law No. 24/2004 and UP3, Ministry of Finance.

3.2 Other Financial Safety Nets

Lender of the Last Resort (LLR)

Besides the blanket guarantee, BI provided liquidity support (BLBI)[29] to problem banks in order to prevent the collapse of the banking system and to maintain the payment system. It was in line with Law No. 7/1992 which states that in the event banks have liquidity problems which threaten their business performance, BI may take necessary action based on the prevailing regulation. Law No. 13/1968 also stated that Bank Indonesia may extend liquidity credit to banks in order to solve liquidity problems in an emergency situation.

Basically BLBI consists of 5 facilities as follows:[30]

- Discounting facility: this was intended to maintain the stability of payment system which had been disrupted by the mismatch between public fund received and withdrawals.
- Facility of Open Market Operation (OPT), which was in line with the monetary program in the form of money market securities (SBPU) auction or bilateral sales.
- Facility in the event of banking nursing and rescue which was in the form of emergency liquidity credit (KLD) and subordinate loan (SOL).
- Facility to maintain the stability of the banking and payment system in the face of the 'bank rush', in the form of the withdrawal of reserve requirement or when there was a negative balance or debit balance or overdraft of banks' account in BI.
- Facility to maintain public trust in the banking sector by providing credit support to banks to pay their foreign debt and to implement the blanket guarantee.

After the major banks' closures in November 1997, BI continued to provide liquidity to the banking system as a signal to the public that there was no intention to close more banks in the near future. Since then, BI provided support to all banks without taking any collateral (by allowing their current accounts with BI to overdraw). In return, BI got personal guarantees from banks' owners with the condition that the loans were used to meet their liquidity needs, and their banks were in compliance with all prudential regulations. As described in Figure 3.1, the liquidity support increased remarkably.

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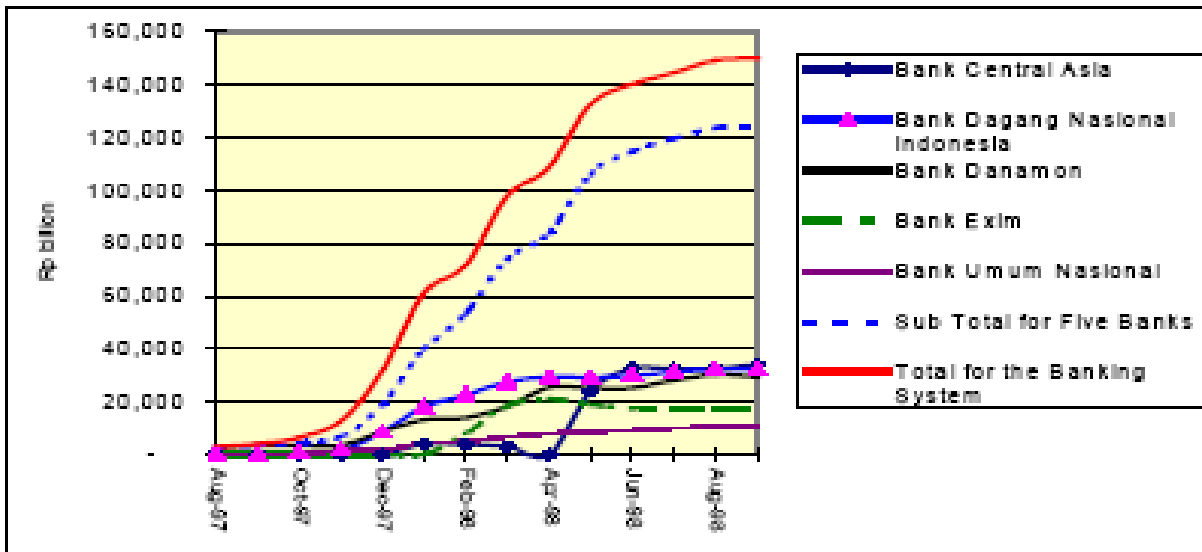
[29] The term "BLBI" has been known since 15 January 1998, when it was mentioned in the Letter of Intent with the International Monetary Fund (IMF). In other words, BLBI was a government liquidity support program that was both acknowledged and required by the IMF.

[30] Soedrajad Djiwandono, "Bank Indonesia, Permasalahan BLBI".

Figure 3.2
Bank Indonesia Liquidity Support



Source: Indonesia's Banking Crisis Resolution, Lessons and The Way Forward, Sukarela Batunanggar, December 2002.

In 1998, the amount of BLBI extended to Banking sector reached Rp 144.54 trillion and consisted of:[31]

- BLBI which was aimed to solve banking liquidity, i.e, debit balance, SBPU, and discounting facility: Rp 129.40 trillion.
- BLBI which was aimed at providing fund for clients' of 16 liquidated and frozen banks: Rp 6.015 trillion.
- BLBI for trade finance payment to foreign creditor: Rp 9.13 trillion.

Table 3.3
Liquidity Assistance Loans

	Type	Period	Interest Rate	Objective
1	Discounting Facility I	2 days		
2	Discounting Facility II	90 days		
3	Emergency Liquidity Credit	6 month	16% per annum	Banking nursing
4	Subordinate Loan	20 years	6%	Banking nursing
5	SBPU Auction	3 month	2% above SBI bilateral	Banking liquidity
6	SBPU without Auction	3 weeks – 3	Weighted	To fulfill

[31] Bank Indonesia, "BLBI, Kebijakan Pemerintah Untuk Menyelamatkan Perekonomian Nasional", September 2000.

		month	average discount rate on the last SBI auction	banking daily liquidity
7	Debit Balance/Negative Current Account Balance	When the debit balance happened	125% of average JIBOR	To maintain banking system stability
8	Discounting Facility I Repo	7 days	28% per annum	To support sound banks who have no SBI but illiquid
9	Special SBPU	3 – 18 months	27% per annum	
10	Discounting Facility	1 month	125% of average JIBOR overnight over the past month	To cope with the negative current account balance or violation on minimum reserve requirement
11	Fund Facility to Liquidated and Frozen banks			Payment to client of liquidate and frozen banks
12	Government Guarantee to Banks' Payment Obligation			Blanket guarantee
13	Government Guarantee to BPR Obligation			Blanket guarantee
14	Credit fund to Banks for Trade Finance and Interbank Debt Arrears	Max. 2 months	Foreign Exchange: LIBOR 1 year+10% 1 year Rp SBI+2%	To improve people's trust in national banking system
15	Guarantee on International Trade Financing			To promote international trade

Source: Bank Indonesia

Based on the current Banking Law No 23/1999, BI is permitted only a very limited role as the lender of last resort. BI may extend credit to a bank for a maximum period of 90 days to overcome bank's short-term financial difficulty. The implementation of this financing should be guaranteed by a high quality and liquid collateral which is equal to at least the amount of the accepted financing. The collateral could be securities or claims issued by the GOI or high-rated legal entities which should be tradable in the market. In practice, government recapitalization bonds and BI's certificate (SBI) are the only eligible assets currently available to Indonesian banks. BI can only provide limited LLR in normal circumstances to banks.[32]

[32] Sukarela Batunanggar, "Indonesia's Banking Crisis Resolution, Lessons and The Way Forward", 25.

Bank Insolvency Procedures

Government Regulation Number 25/1999 on Dissolution and Liquidation of Banks regulates the liquidation of a bank. Under this regulation, if a bank is insolvent and endangers its own operations, BI may revoke its license. Sixty days after revoking the bank's license, BI may request the directors of the bank to convene a general meeting of shareholders (GMoS) to ask them to approve the dissolution of the bank and appointment of a liquidation committee.

If the shareholders fail to adopt such a resolution, BI may request the court to issue an order to dissolve the bank, appoint a liquidation committee, and implement the liquidation procedure set out in the regulation and order the liquidation committee to be directly accountable to BI. The liquidation process must be completed within five years of the appointment of the liquidation committee. If by that time, the liquidation has not been completed, the bank's assets will be sold through public auction.

BI evaluates the capital adequacy ratio (CAR) every three months and if a bank's capital falls below the CAR requirement as determined by BI at that time, BI may require the shareholders to inject sufficient additional capital to achieve the CAR requirement. If the shareholders fail to inject sufficient capital or take other remedial action, BI may close all of the bank's offices and suspend all of its banking operations. Thereafter, the bank's management must convene a GMoS to approve the dissolution of the bank and to establish a liquidation committee. If the directors fail to convene such a meeting or the shareholders fail to approve the resolution and appoint the liquidation committee, BI may request the relevant district court to dissolve the bank based on a court order as discussed above.

BI may also require shareholders to change the management of the bank, or require the bank to write off its bad loans and account for its losses with its capital. BI may also require the merger or consolidation of the bank with another bank, or offer the bank's shares to a third party that is willing to assume the bank's liabilities, or require the bank to transfer the management of its activities to a third party, or to sell the bank's assets to a third party.

Alternatively, if the supervision of the bank is transferred to IBRA, IBRA may take over the authority of the management and the shareholders of the bank including the rights and authority of the GMoS. IBRA may assign the management of the bank and the management of the bank's assets to third parties, and sell or transfer the assets of the bank as well as the assets of certain shareholders of the bank wherever they are located, or require the controlling shareholders to inject additional capital into the bank.

BI's LLR differs according to the circumstances.

1. Lender of last resort in normal circumstances: In normal times, LLR assistance should be based on clearly defined rules. Transparent LLR policies and rules can reduce the probability of self fulfilling crisis, and provide incentives for fostering market discipline. It may also reduce political intervention and prevent any bias toward forbearance. LLR in normal times should only be provided for solvent institutions with sufficient acceptable collateral, while for insolvent banks stricter resolution measures should be applied such as closure. Once a deposit insurance scheme has been established, the Central Bank's role in LLR in normal time can be reduced to a minimum since the deposit insurance company will provide bridging finance in the case where there is a delay in closure process of a failed institution.

2. Lender of last resort in exceptional circumstances: In a systemic crisis, LLR should be an integral part of a well-designed crisis management strategy. There should be a systematic risk exception in providing LLR to the banking system. The regulation on the LLR facility should clearly set the guiding principles and specific criteria of a systematic crisis and or a potential bank failure leading to systematic crisis. BI should be responsible for analyzing the systemic threats to financial stability while the final decision on systematic crisis resolution should be made jointly by BI and Ministry of Finance. To ensure accountability, an appropriate documentation audit trail should be maintained.

3.3 Strength of Prudential Supervision

Since 1991, BI has initiated prudential regulatory and supervisory reforms. However, the progress was very slow. The main weaknesses of banking supervision in Indonesia can be summarized as follows:

- Premature banking liberalization
- Insufficient banking consolidation
- Poor development of organizational capabilities (including human resources)

Based on Law No. 23/1999, BI has the authority to prescribe the banking regulations which contains the prudential principle. In order to create a sound banking system, this prudential principle should meet international standards, particularly the Basel Core Principles for Effective Banking Supervision. Since July 2000, BI has been conducting an intensive supervision to commercial banks by placing on-site supervision team to major banks to ensure that they were well managed and were not involved in high-risk businesses that would threaten the stability of the banking system.

Independency and Accountability of BI

In the past, the failure of Indonesia's monetary policy was caused by the government's interference in the conduct of monetary policy. Before 1999, BI was part of the government and its Governor had the same status as cabinet minister. Under this structure, BI was only a member of the monetary board chaired by MOF. Therefore, the authority of BI to supervise and regulate the banking sector was to some extent limited. However, in practice, Central Bank's independency was observed even if it was not supported by written law.

By the Law No 23/1999 and its amendment Law No. 3/2004, BI has the legal status as an independent state institution and to be free from interference from the government or any other external parties. At present, BI is fully autonomous in formulating and implementing each of its task and authority. Not only external parties are not allowed to interfere with BI in the implementation of its tasks, BI can also refuse any interference by other parties. In the administrative structure of Indonesia, BI has indeed a special position to implement its role and function more effectively and efficiently.
In implementing its tasks, BI is led by the Board of Governors which consists of: Governor, Senior Deputy Governor and Deputy Governors. All of them are nominated and appointed by the President of Indonesia upon the approval of the House of Representatives. The performance of the Board of Governors is evaluated by the House of Representatives. By the amendment law No. 3/2004, the authority of the Governor of BI in nominating the Deputy Governor has been reduced since the Governor may only give recommendation to the President regarding the candidates of Deputy Governor. The Board of Governors and other officials of BI cannot be punished for any decision and policy taken in accordance with their tasks and authorities, as long as it is conducted in good faith.

Capacity and Effectiveness of BI

The above mentioned 1999 law made BI as the primary authority in overseeing Indonesian banking operations. Before the enactment of the Law, both BI and MOF had the authority and responsibility to supervise banks. The authority of MOF is now limited to the monitoring, supervision and regulating finance companies and insurance companies, as well as certain aspects of securities companies.

Under the Law, the main objectives of BI are to stipulate and implement monetary policy, regulate and maintain the soundness of the payment system and regulate and supervise banks. BI has authority to grant licenses for the opening, closure and removal of an

Indonesian bank, including any branch of that bank inside or outside of Indonesia. The Bank can also grant licenses for the opening, closure and removal of an Indonesian branch or office of a foreign bank and approves changes in share ownership and management of a bank as well as granting licenses to banks to operate certain types of business.

BI also has the authority to require banks to submit certain reports and to carry out audits and inspections of banks. In addition, BI can issue regulations concerning the banks' soundness, solvency and liquidity. Since 1998, IBRA has been involved in the supervision and management of certain banks placed under its supervision. These include banks experiencing financial difficulties, such as deteriorating loan portfolios, an increasing number of non-performing loans, or a poor CAR.

Effort for Compatible Supervision and Regulation

To improve governance and to strengthen the regulatory and supervisory frameworks in the financial sectors, Law No. 23 of 1999 Concerning Bank Indonesia mandates the establishment of consolidated supervisory authority for financial services. In line with this mandate, the government will establish the Financial Supervisory Authority (FSA) or Otoritas Jasa Keuangan (OJK) in Indonesian, the planned consolidated regulatory and supervisory authority. The FSA will act as "mega" regulator and supervise all financial institutions (excluding rural banks) and financial markets. This new supervisory agency will not be under the authority of BI. On the new amendment of BI Law No. 23 year 1999, which was approved in December 2003, the establishment of this supervisory entity will not be later than December 31, 2010. However, up to now, the detailed regulations for FSA have not been promulgated and it is still under discussion in the parliament.

With the objective to enhance the sound banking system and the supervision capacity, some new prudential regulations have been issued since 1999 as follows:

- Capital adequacy ratio:
  BI requires Indonesian banks to have a minimum 8% of CAR. Banks that are not able to meet this requirement will be classified as under surveillance by BI.

- Bank's statutory reserves:
  Banks are required to maintain Statutory Reserves (in Rupiah) of at least 5% of third party funds in Rupiahs. In addition to complying with the Statutory Reserves (in Rupiah), foreign exchange banks are required to maintain Statutory Reserves in foreign currencies of at least 3% of third party funds in foreign currencies.

- Non-performing loans:
  BI requires that non-performing loans in banks should not be more than 5% of its total credit.

- Financial transparency:
  BI requires banks to publish monthly financial reports besides quarterly and annual reports on the BI's website in order to fulfill public demand.

Overall Evaluation: Balance between Government's Safeguard Role and Market Discipline

The introduction of the blanket guarantee did not instantly stop the bank runs. There were still some insolvent bank runs which could be traced by the increase in BLBI from Rp 92 trillion in January to Rp 178 trillion in August 1998. The reason for the continuation of these bank runs was due to the public perception of the unclear policies and a lack of trust that the

government would stick to their commitment. This led depositors to transfer their money from the perceived weak banks to the safer banks (state-owned or foreign banks). Depositors also anticipated that there would be more bank closures. Even though their deposits were fully guaranteed by the government, they recognized that their deposits would be transferred to other banks, creating a time lag between the claim and the payment of their deposits.

However, the recent closure of some banks due to the failure to implement prudent banking principles and good corporate governance did not affect public confidence on the banking sector, since the blanket guarantee scheme remained effective and credible. As a result of unethical practices, such as related party lending, and the fabrication of asset records and fictitious credit records in the Bank Dagang Bali, Bank Asiatic and Bank Global in 2004, these banks were closed by the government after the directors and shareholders of the banks failed to heed official warnings to shore up their ailing balance sheets. Following the closure of these banks, depositors could fully recover their money within 180 days.[33]

In summary, it could be said that to some extent the government's financial safety nets have weakened the incentives of market participants to monitor the performance of the Indonesian banks. Since the implementation of the government's blanket guarantee of all deposits, both depositors and shareholders appeared to play a more passive role in monitoring the risk behaviors of the banks. By introducing the Banking Architecture Framework policy, the Indonesian government aims to let the markets take over the disciplining work. As a result of this policy, it can be expected that there will be further rationalization in the banking industry in 2005.

4. Internal Corporate Governance Mechanism

In line with the Indonesian Code of Good Corporate Governance, publicly listed banks have begun to adopt and implement the key principles of good corporate governance. The primary requirements of compliance to the code of good corporate governance include the appointment of independent commissioners, the establishment of the audit committee and the active roles of various management committees. Using the results of extensive questionnaire surveys of banks, this section will address the issue of how the internal corporate governance practices of banks are implemented within this regulatory framework.

4.1 Unique Features of Corporate Governance for Banks

Although corporate governance is essential to the success of firms in any industries, the banking sector deserves special attention. The banking sector is mainly responsible for the allocation of financial resources to all other sectors of an economy, whose efficiency very much determines the performance of the economy. Banks are inherently vulnerable to shocks and loss of public confidence due to their characteristics including high leverage and inter-temporal nature of most financial services. In recent decades, banks and other financial institutions around the world have increasingly been exposed to new and higher risks as a result of financial deregulation and globalization as well as the development of information processing and other technologies.

All these factors give corporate governance of banks some distinct features different from that of other firms. First, it may be wrong for corporate governance of banks to be exclusively, or even mainly, concerned about the interests of shareholders without giving adequate

[33] On April 8, 2004, the operating license of Bank Dagang Bali and Bank Asiatic were revoked. Payments were carried out after document verification was completed. The verification process was conducted gradually and the first phase of payment was started on April 26, 2004 for savings account depositors. By October 2004, about 98% of banks' obligation was paid to their depositors.

attention to other stakeholders like depositors. Second, the incentives of private market participants to monitor the financial institutions have been substantially weakened by the introduction of the government's blanket guarantee after the crisis. Finally, banking institutions probably require much higher standards of corporate governance compared with other firms.

As mentioned in section 2.3, corporate governance in the Indonesian banking sector is determined and characterized by the following main regulations and codes:

- Corporate Law 1995 which deals with the general rights and responsibilities of shareholders and the corporate boards as per their limited liability status.
- Indonesian Banking Law 1998 which deals with the licensing of banks and the capital and finance requirements for the operations of banks. In support of the implementation of this particular law, BI issues some circular letters to elaborate particular provisions such as risk management of banks, requirements and Fit and Proper Test for directors and commissioners of banks, etc.
- Indonesian Banking Sector Code of Corporate Governance (the Banking Code) of July 2003. The Banking Code sets out provisions on governance structure and mechanisms including: shareholders (especially on the controlling shareholders criteria); BoC and BoD criteria and appointment; board' committee such as Audit Committee, Risk Policy Committee, and Risk and Capital Committee and Personnel Committee; and the requirements of new functions or enhanced role of existing functions such as Internal Audit, Compliance Officer, Corporate Secretary, Syariah Supervisory Board, and the banks' stakeholders such as the customers, debtors and employees who are explicitly set within the banks' governance structure.

4.2 The Questionnaire Survey

The survey was conducted through sending a set of questionnaires to be filled by relevant persons at the targeted banks. The target banks were 26 banks listed in Jakarta Stock Exchange in 2003, which consists of 3 State Owned Banks and 23 Private Banks. Table 4.1 shows the general features of these 26 targeted banks including information on their deposit and asset share compared to the total banking industry, which indicates substantial share in both indicators.

Each set of the questionnaire consists of four components addressed to different persons at the bank:

- Questionnaires of General Information of the respondent bank that have to be answered by the corporate secretary.
- Opinion Survey which have to be answered by a board member. Since Indonesia has a two-tier board system, one copy of the questionnaires is given to a commissioner (independent commissioner) and another to an executive director.
- Questionnaires of Risk Management Practices which have to be answered by the Risk Management Officer of the bank or the person in charge. The questions are designed to gather information on the Banks' practices in managing risk.
- Questionnaires of Executive Compensation to be answered by either the corporate secretary or other officer dealing with executive compensation.

Table 4.1
Status of 26 Respondent Banks

Name of Bank	Ownership Status	Deposit Share (%, 2003)	Asset Share (%, 2003)
PT. Bank Mandiri, Tbk.	State-owned	20.12	23.25
PT. Bank Negara Indonesia, Tbk. (BNI)	State-owned	11.85	12.31
PT. Bank Rakyat Indonesia, Tbk (BRI)	State-owned	8.59	8.86
PT. Bank Central Asia, Tbk. (BCA)	Private	13.30	12.47
PT. Bank Danamon, Tbk.	Private	4.48	4.93
PT. Bank Internasional Indonesia, Tbk. (BII)	Private	3.32	3.25
PT. Bank Permata, Tbk.	Private	2.64	2.72
PT. Bank Lippo, Tbk.	Private	2.68	2.48
PT. Bank Niaga, Tbk.	Private	2.18	2.22
PT. Bank NISP, Tbk.	Private	1.40	1.44
PT. Bank Panin, Tbk.	Private	1.31	1.76
PT. Bank Mega, Tbk.	Private	1.29	1.30
PT. Bank Buana, Tbk.	Private	1.38	1.34
PT. Bank Eksekutif, Tbk.	Private	0.18	0.16
PT. Bank Bumi Putera, Tbk.	Private	0.30	0.30
PT. Bank Inter Pacific, Tbk.	Private	0.00	0.04
PT. Bank Victoria, Tbk.	Private	0.16	0.16
PT. Bank Nusantara Parahyangan, Tbk.	Private	0.19	0.18
PT. Bank Global, Tbk.	Private	0.15	0.21
PT. Bank Arta Niaga Kencana, Tbk.	Private	0.10	0.10
PT. Bank Mayapada, Tbk.	Private	0.23	0.22
PT. Bank Kesawan, Tbk.	Private	0.13	0.12
PT. Bank CIC Internasional, Tbk.	Private	0.49	0.62
PT. Bank Pikko, Tbk.	Private	0.13	0.13
PT. Bank Danpac, Tbk.	Private	0.11	0.11
T. Bank Swadesi, Tbk.	Private	0.06	0.06
Total		**76.79**	**80.74**

Source: PT. UFJ Institute Indonesia

Table 4.2
Number of Responses

Questionnaire	Number of Reply	Collection Rate (%)
Factual Information	24	92.3
Board Opinion – Independent Commissioners	22	84.6
Board Opinion – Executive Directors	18	69.2
Executive Compensation	15	57.7
Risk Management	22	84.6
Total	101	77.7

The overall response rate was 77.7% which is higher than the original target of 70%. If we do not take into account the questionnaire for Executive Compensation which was expected to have a low response rate due to the confidential nature of the question, the response rate exceeds 82%.

In addition to the set of questionnaires above, some basic and general corporate information of the bank and their board of director and commissioners were gathered by the country consultant (in order to minimize the burden of answering the questionnaires by the respondents). They also compiled information for the analysis of evidence of market discipline, including time series of annual data on the individual surveyed banks as well as country-specific information.

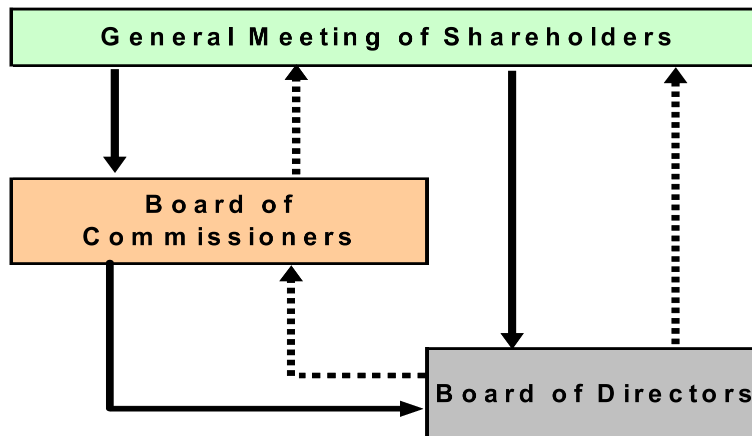
4.3 Description of The Survey Result

A. Effectiveness of the Board

The Appointment of Board Commissioners and Board of Directors

The board structure of a company in Indonesia is based on a two-tier system; where every company (limited liability company) has two separate boards: the Supervisory Board (known as BoC) and the Management Board (known as BoD).

Figure 4.1
Structure of Board in Indonesian Companies



* A solid line represents supervisory direction.
** A broken line represents reporting direction.

As stipulated in the Company Law No. 1/1995 in a limited liability company or Perseroan Terbatas (PT), the GMoS constitutes the highest decision-making authority in the company. Members of BoD and BoC are appointed by this GMoS.

Since all Indonesian publicly listed banks are in the form of limited liability companies (PT), the nomination and replacement of the BoC and BoD are carried out by the GMoS. For some banks (40.9% of respondent banks), the nomination of BoD and BoC is proposed by the nomination and remuneration committees to the GMoS. Nominees to the BoC and BoD should obtain approval from BI before being appointed to their positions.

For state-owned banks, the controlling shareholder, which is the MOF, has the strongest voice in the selection and dismissal of the president director and independent commissioners. Generally, about 63.2% of the banks replied that the controlling owner has the strongest voice for nomination and replacement of the president director and the other banks said that nomination committee and Government's voice can also influence the selection. Only 47.4% of the banks confirmed that the controlling shareholder has the highest authority for selection and dismissal of independent commissioners, while other banks replied that the nomination committee, the Government, and the CEO also play an important role in the process of selection and dismissal.

The period of assignment for independent commissioners varied among banks. About 52.2% of the banks have appointed independent commissioners for 3-5 years period and the remaining 47.8% for 1-2 years period. All banks replied that the independent commissioners can be reappointed after their term is over and the decision to reappoint is based on the formal performance review by the nomination committee (70.8%). Regarding the possible length of service, 56.5% of the banks replied that there is no ceiling for independent commissioners, and 39.1% banks confirmed that it varied from 1-5 years, while the remaining banks said that the ceiling is 10 years. The absence of a ceiling may imply that independent commissioners with an unlimited terms of office would be close to the bank management and would tend to lose their independency. As such, the Indonesian company law should set a ceiling on the terms of office of the independent commissioners. It is recommended that the same ceiling should be applied to members of the audit committee, i.e two times of the commissioner's term of office.

With respect to the selection of independent commissioners, 70.8% of the banks confirmed that there are transparent written rules for this selection and 29.2% banks believed that there are no such rules. Although rarely implemented, 83.3% of the banks surveyed said that their minority shareholders can nominate the candidates of BoC at the GMoS. In contrast, about 20.8% replied that minority shareholders cannot nominate the candidates of BoC. In selecting independent commissioners, cumulative voting is sometimes practiced by 58.3% of the banks. 33% of the banks said that cumulative voting, though recognized, is not practiced; and while the rest said that it is not recognized.

The fact that minority shareholders rarely exercise their rights to nominate the independent commissioners is a serious concern . Awareness and encouragement for minority shareholders to exercise their rights are needed at a larger scale. Perhaps, a regulation to seek officially the candidate name from minority shareholder prior to other processes is worthwhile to consider. At least, it will increase the minority shareholder's awareness and stimulate their activism.

Board Size, Composition and its Independence

Based on the Bank Indonesia Regulation, BoC of a bank shall comprise at least 2 members, while BoD shall comprise at least 3 members. Besides that, the Jakarta Stock Exchange (JSX) regulation requires publicly listed companies to have independent commissioners not less than 30% of the total number of commissioners. Bank commissioners are required to have knowledge and/or experience in banking while bank directors are required to possess at least 5 years in banking operation as an executive officer of a bank. For banks whose shares are owned in part by foreign party may appoint foreign citizens as members of BoC and BoD with the condition that at least one member of the BoC and BoD are Indonesian citizens.

Most of the surveyed banks have 3 to 10 members of BoC with the number of their iIndependent commissioners in compliance with the JSX Regulation, and most of the independent commissioners have background in finance or banking. They seem to be free from the influence of controlling shareholders. About 23% of surveyed banks have foreigners in their BoC and 11.5% have foreign independent commissioners.

Since Indonesia has a two-tier board system and members of BoC and BoD of banks are not allowed to have concurrent position at the BoD and BoC, the chairman of BoC cannot serve as the CEO/President Director of the bank.

In discussing corporate matters, quite high portion of banks (91.7%) hold commissioners' formal and informal meetings without the management several times a year. All banks replied that their independent commissioners are truly independent from the CEO/President Director or controlling shareholders.

Function of the Board

The BoC reports to the shareholders and independently supervises the management policies of the BoD. This includes, among others, ensuring that the bank charts a course in line with the stated goals and business strategy, supervising the risk management implemented by the bank, overseeing external and internal audit works, following up the audit findings, ensuring accurate and timely disclosure of material information, facilitating the implementation of good corporate governance and ensuring proper conduct of business.

Related to the BoC effectiveness in conducting some roles and tasks, the independent commissioners agree that BoC:

- plays an important role in selecting, monitoring and replacing CEO/President Director (71.4%)

- is active in formulating long–term strategies (100%)
- establishes and monitors the risk management and internal control system (100%)
- monitors and assesses the process of business operations discerning poor operating performance (90.9%)
- effectively oversees potential conflicts of interest including related-party transactions and self-dealings (90.9%)
- ensures the integrity of the bank's financial reporting by effectively utilizing the work of internal and external auditors (100%)
- ensures board member of commissioners are qualified and independent and have a clear understanding of their roles (90.9%)
- seriously reviews executive compensation (72.7%)
- seriously reviews directors compensation (81.8%), and
- conducts corporate governance in a transparent manner with adequate public disclosure of relevant information (100%).

In fulfilling the regulation of the Capital Market Supervisory Agency and to implement Good Corporate Governance, all surveyed banks have established an audit committee. The main function of this audit committee is to assist the BoC in carrying out its supervisory duties.

Besides the audit committee, only 40.9% of surveyed banks have established nomination and remuneration committee to assist the BoC. The duties of this committee, among others, are to review and determine:

- size and composition of the BoC and BoD
- criteria for board membership including desirable qualifications and experience for individual new appointees
- potential candidates for appointment to the BoC and BoD
- basis for determining and calculating performance-based bonus payments awarded to directors and commissioners to be proposed to the annual GMoS of the bank, and
- appropriate remuneration system for BoC and BoD members.

In addition to these two committees, most of surveyed banks have established the following executive committees to assist BoD:

- risk management committee
- asset and liability committee
- credit risk and policy committee
- market risk committee
- operational and technology committee
- corporate governance committee

These executive committees are responsible for providing professional opinions and assistance to directors on the efficient and effective implementation of strategies, reviewing operating performance and significant issues confronting banks and managing risks systematically and proactively. Almost all of the surveyed banks replied that they have established risk management committee.

General Support for Independent Commissioners

86.9% of the banks provide mandatory education/training programs for bank commissioners and directors. Of the 91.3% of the banks that provide some other education/training programs beyond what is mandatory for commissioners and directors, 73.9% conducted such training occasionally, 17.4% actively, and the remaining 8.7% never conducted any training program.

As publicly listed company, the surveyed banks have established the position of corporate secretary which represents the banks' BoD in the matter of external communications and especially with investors, capital market community, and shareholders as well as in monitoring the bank's compliance with capital market rules and regulations. The corporate secretary also maintains the bank's image through the exercise of public relation activities and provides support to the BoC and BoD to ensure that the bank's business is conducted in line with the bank's articles of association and other internal regulations. 73.9% of the banks employ a corporate secretary for the support of independent commissioners. Most banks' corporate secretary also support the BoD.

About 50% of the independent commissioners of surveyed banks have meetings with the managers and workers frequently and the other 50% replied that it is sometimes. 77.3% of the independent commissioners acknowledged that they always receive adequate information in time to be digested before every BoC meeting. However, only 50% of the independent commissioners indicated that their banks allow them to obtain the service of outside legal, financial and other professional advisors at the company expense, while 40% only exceptionally. Only 21.7% of the banks provide full personal liability insurance for their Commissioners, while 26.1% of the banks provide it partially, and 52.2% of the banks do not provide it at all.

B. Evaluation and Compensation of Commissioners and Directors

Performance Evaluation of President Director and Commissioners

With regards to the performance evaluation of president director, 58.3% of the banks replied that they use a formal procedure and criteria regularly and 20.8% of the banks sometimes use a formal mechanism and 20.8% do not use it at all.
Meanwhile, 58.3% surveyed banks replied that there is no formal procedure and criteria for evaluating the performance of commissioners and the compensation are invariable (65.2%). The great majority of banks do not offer stock-based compensation to the commissioners (87.5%) so far.

Furthermore, many surveyed banks (69.6%) are not familiar with the compensation in the form of stock option for the president director, but most of them (70.8%) replied that part of the compensation are based on the bank performance**.** Most of the banks surveyed indicated that the performance measures include NPL, target profit, revenue, ROA and ROE. The structure of the compensation is in the form of base salary, annual bonus and other cash compensations.

The independent commissioners agree that:
- they are satisfied with their current financial compensation (68.2%)
- there is an adequate link between their compensation and bank performance (90.9%)
- it is important to link compensation and bank performance (95.5%)

- their compensation gives them adequate financial incentive to maximize shareholders' interests (77.3%)
- the financial incentive of their compensation leads them to maximize the interests of stakeholders as a whole (95.5%),
- they are willing to serve as commissioners even if their compensation is not as much as they can get from other opportunities (85.7%), and
- the financial incentive is important than the social status as a banker (36.4%).

For the services performed, commissioners are entitled to salaries and other benefits which are determined and approved by the GMoS. Total gross annual salaries and benefits for the members of BoC are disclosed in the bank's annual report.

C. Ensuring Internal Control, Disclosure and Transparency

The Strength and Effectiveness of the Internal Control System

Most banks (95.2%) indicated that the top management directly handles the internal control system of the bank. Most banks replied that part of the regular tasks of the BoD are:

- to discuss with the management the effectiveness of internal control systems (100%)
- to review evaluations of internal controls made by management, internal auditors and external auditors (100%)
- to check whether concerns expressed by auditors and supervisory authorities on internal controls are addressed by management (100%), and
- to review the appropriateness of the bank's risk limits (95%).

All surveyed banks have established the internal audit department which is responsible to ensure that the existing policies and procedures remain adequate and comply with the BI regulation. This internal audit department should report to the top management (36.4%), BoD (31.8%), and to audit committee (31.8%).

Concerning the overall risk management, more than 50% of the banks said that the portion of employee assigned for market risk management, credit risk management, operational risk management and risk management in total are below 1% respectively. Most banks replied that the responsibilities for approving the strategy and policies for managing credit risk, market risk and operation risk are on the hand of BoD, and other banks gave various responses, such as it is the responsibility of BoC or management committee or CEO. Also, more than 50% of banks require risk exposure report more than 5-12 times each year.

Most banks answered that information on target market, structure of limits, exception reporting, portfolio mix, approval authorities, price and non-price terms are covered by written credit policies and procedures. In credit appraisal process, most banks (95.5%) consider purpose of credit, source of repayment, reputation of borrower, repayment history of borrower, enforceability of collateral or guarantees, cash flow projections of borrower, adequacy of collateral/guarantees, legal capacity of borrower to assume liability, proposed terms/conditions of credit. Also, 90.9% of the banks responded that they take into account borrower's position within his economic sector, situation of borrower's economic sector, borrower's business expertise. Other factors less frequently considered include current risk profile of borrower (86.4%) and sensitivity of risk profile to market trends (77.3%).

When deciding to enter into new credit relationship, most banks normally consider such factors as the financial condition of borrower or counterparty, references from known parties, how well the borrower is known to the bank, information from Bank Indonesia or individual responsible for managing the borrowing company. All banks also regularly monitor the current financial condition of borrower, compliance with existing covenants, potential problem credits, collateral coverage relative to obligor's current condition, contractual payment delinquencies.

Regarding the significant loans extended to the subsidiaries, affiliates, major shareholders, directors and senior managers, most banks need approval from BoD and Supervisory Authority.

Related to the key risks of banking activities, surveyed banks maintained:

- system of documented approvals and authorizations (100%)
- policies governing segregation of duties to address potential conflicts of interest (100%)
- checks on compliance with management controls (95%)
- system for regular verification and reconciliation of transactions and accounts (95%)
- system for maintaining safeguards for access to (and use of) bank assets and records (95%)
- disaster recovery and/or business continuity plan (90%)
- system for monitoring adherence to assigned risk limits or thresholds (90%)
- policies, processes and procedures concerning the review, treatment and resolution of non-compliance issues (89.5%)
- system to ensure appropriate expertise and training for staff (84.2%), and
- system and policies to identify business lines or products where returns are out of line with reasonable expectations (52.6%).

During the last three years, only 27.3% of the surveyed banks conducted a review about the overall risk management procedures 2 to 3 times; 36.4% only once and about 27.3% never review it at all. This fact is indeed problematic as the New Basel Accord requires a comprehensive risk management procedure to be adopted by banks, while the Banking Code implicitly requires ERM (enterprise risk management) across the enterprise of the banks. In this particular regards, Bank of Indonesia has initiated effort to disseminate the concept and the implementation of ERM in banks as planned in their API (Arsitektur Perbankan Indonesia – Indonesian Banking Architecture, starting in early 2005).

All surveyed banks require regular presentations and performance reports on progress toward strategic goals to the board and/or top management. About 81% of the banks require regular performance and exception reports to department or division level management. 95.5% of the banks undertake periodic inventories of tangible assets, including cash and securities; and 86.4% of the banks have a process for reviewing compliance with limits on risk exposures. All banks require approval and authorization for transactions over certain limits, while 95.2% of the banks undertake periodic reconciliations to compare cash flows to account records and statements.

All banks conducted the accounting and audits in accordance with auditing standards established by the Indonesian Institute of Accountants. This standards comply with the International Accounting Standard.

The Effectiveness of Audit Committee

As mentioned earlier, all banks which are also publicly listed companies, are required to have an audit committee. The members of the audit committee are entirely made up of independent parties and led by an independent commissioner. The role of the audit committee is not to duplicate the duties and responsibilities of the BoD and the internal auditor. The audit committee implements its supervisory function by carrying out reviews of internal audit reports, financial reports, financial information, accountancy policies and compliance to internal and external rules and regulations.

Almost all banks surveyed (95.7%) replied that their audit committee is chaired by an independent commissioner and most of the members have accounting and finance background. 86.4% of the banks replied that minutes are written for each audit committee meeting. All surveyed banks have written rules governing overall audit function. 78.3% of the audit committees select or even recommend an external auditor autonomously or conduct a proper review of his work. The audit committee is somewhat more involved in the approval of the appointment of the internal auditor and supervises him to routinely review risk exposure and accounting procedures, with 56.5% of the audit committees indicate that they are very much involved and 47.8% are involved to at least to some extent.

Disclosure and Transparency

Most surveyed banks have their own website (82.6%), and it is available and very informative both in Indonesian and English language (40.9%), informative in Indonesian language but limited information in English (27.3%), informative only in Indonesian language (13.6%), not very informative in Indonesian language (4.5%). As publicly listed banks, they are required to issue annual reports and quarterly financial statement.

Most banks are more informative in their annual reports than in their website. Some information are available in the annual report and this includes:

- background of commissioners or directors (87%)
- extent to which the banks' corporate governance practices conform to the establish standard (82.6%)
- policies on risk management (81.8%)
- significant changes in ownership (73.9%)
- governance structure and policies (73.9%)
- remuneration of commissioners or directors (65.2%)
- major contingent liabilities (65%)
- self dealing or related party transactions (52.4%)
- fees paid to external auditors, advisors, and other related parties (47.8%), and
- commissioners or directors selling or buying shares in their banks (23.8%).

Beside disclosing the above information in the annual report, most banks report them to BI as well.

4.4 Summary on the Effectiveness of Internal Corporate Governance Mechanism

The effectiveness of internal corporate governance mechanism is characterized mostly by the process and structure of BoD and BoC. Since all surveyed banks are limited liability companies, they have two-tier board system where the BoD and the BoC are appointed by the GMoS. In order to implement Good Corporate Governance of the bank, the challenge is

how to maintain independence, competency and professionalism of the members of BoC as the core body of monitoring and advising corporate governance.

Board Size, Composition and its Independence

The survey result is rather encouraging. Given the two-tier board system, there will be no possibility of CEO duality and hence we can keep the independence of chairman or president commissioner against CEO's or president director. The BoC's size (from 3 to 10) reflects the different needs of the bank depending on the size and complexity of the bank itself. All banks have complied with the regulatory requirements to have at least 30% independent commissioners in their BoC, leading to a more independence of BoC from the controlling shareholders.

However, there are still some challenges that need to cope with in enhancing the effectiveness of Independent Commissioners:

- Weak shareholder activism as reflected in "the rare to almost no" banks whose minority shareholders exercise their rights to nominate independent commissioner. Awareness and encouragement for minority shareholders to exercise their rights are needed at a larger scale. Perhaps, a regulation to officially seek the candidate name from minority shareholders prior to other processes is worthwhile to consider. At least, it will increase the minority shareholder's awareness and stimulate their action.

- Absence of ceiling for independent commissioners' length of service. This may cause unlimited term of office of independent commissioners and let them be attached to the bank management so closely and tend to lose their independence. It is worthwhile to consider a regulation to set such ceiling on length of service for independent commissioners.

- A low level of general support for independent commissioners with such activities as meetings with managers/workers and obtaining the service of outside legal, financial and other professional advisors at company's expenses. The absence of such regular meetings and support to obtain outside advice may impede independent commissioner from taking more active role and actions due to lacking of proper and direct information. To overcome such a potential backlog, an explicit meeting mechanism and outside advice and support need to be spelt out in the related committee charter (such as the Audit Committee Charter) where independent commissioners sit as the chairman or member.

- Inadequate provision of personal liability insurance for the commissioners. This might hinder the active role of independent commissioner due to insecurity about their personal liabilities. Taking into account the benefits and costs, a provision of personal liability insurance for independent commissioner is worthwhile to be considered as mandatory for banks.

Besides all the challenges, the possibility of perception bias exists when the question on "independence" is addressed to independent commissioners and executive directors. In fact, 7 out of 26 banks hire former directors, employees or large shareholders as their independent commissioners, since they are not specifically excluded by the regulation. These facts and perhaps the imperfection of the regulation may erode the effectiveness of independent commissioners.

With respect to compensation, a majority of banks confirms that part of the president director and commissioners' compensation is based on the bank performance, but limited to non-stock based compensation. This practice is commonly observed in Indonesian publicly listed

companies where bonus and related benefits are usually given in a cash basis. There is no evidence whether this condition will cause conflict of interest between shareholders and other parties. However, stock-based remuneration is getting more popular in many developed countries to maximize the corporation's performance in the best interest of shareholders. Certainly, stock-based remuneration will lead to a behavior of president director and commissioners to be more in line with shareholders' interest. This, however, may not necessarily be desirable given the potentially conflicting interests of other stakeholders including taxpayers who will bear the burden of bank failure. Further research might be needed to seek what is the optimal mix between stock-based and non-stock based compensation for president director and commissioners in the context of Indonesian environment.

In spite of increasing information in their annual reports, there are some concerns of insufficient disclosure on self dealing or related party transactions, selling or buying shares of their banks by the banks' commissioners or directors, and the fees paid to external auditors, advisors, and other related parties. This deficiency should be seriously taken care of by the capital market authority (BAPEPAM and JSX) in order to improve the transparency to the public as a key pillar of good corporate governance practices.

Functions of the Board

All the banks confirm that BoC functions independently of the BoD, and a majority of them confirm their full effectiveness in conducting some roles and tasks, except in selecting, monitoring and replacing CEO/President Director (71.4%), review executive compensation (72.7%), and review directors compensation (81.8%). This result is consistent with the subsequent fact where only 40.9% of the banks have established their nomination and remuneration committee as compared with the establishment of audit committee in all banks, and risk management committee in 95.7% of banks. This phenomenon is not a surprise as the requirement of audit committee and risk management committee is mandatory as stipulated by JSX/BAPEPAM and the New Basel Accord, respectively. The setting up of other committees is still considered as voluntary (Banking Code).

Since the nomination process and remuneration setting are crucial elements to provide check and balances against the influence of controlling shareholder, it may be worthwhile for the government to consider the establishment of nomination and remuneration committee to be mandatory in all banks.

5. Roles of the Markets in Disciplining Banks

Before the crisis, not much attention has been given to the disciplinary role of private agents like depositors, creditors, and investors. After the crisis, the government and supervisory agencies have been very heavily involved in restructuring the banking sector and enforcing discipline through an array of new detailed regulations and codes. The scheduled abolishment of blanket guarantee for deposits in banks in 2005 is expected to strengthen market discipline by depositors. In this section, we will provide an overview of the performance of the banking sector and explore the central issue of how monitoring stakeholders as depositors, creditors and investors are disciplining banks by making empirical analysis.

5.1 Overview of Competition in Banking and Operational Performance

Before 1997, the enforcement of the country's banking laws was generally weak, as the priority was put on maximizing the financing of the expansion of the economy. Disciplining the banks based on prudent banking principles, corporate governance and even profitability was not considered as priority policies for regulators. The unavailability or lack of adequate

published bank data has been a hindrance to the proper scrutiny and analysis of banks' financial conditions before 1997. The share prices of banks moved along with the changes in general stock prices, which were mainly driven by the influx of the portfolio investments of domestic and international mutual funds.

When the crisis eventually hit Indonesia, the Indonesian rupiah (IDR) depreciated against US dollar from Rp 2400 to Rp 3700 in September 1997. The government attempted to maintain the exchange rate of IDR by intervening in the foreign exchange market and raising interest rates. The sharp rise in the (overnight lending) interest rates had the immediate impact of causing acute liquidity problems especially in those banks that had funded their long-term investments with short-term capital.

To mitigate the liquidity problems, there was a tight competition among banks in offering high interest rates to attract new depositors and increase the existing depositors' fund. Some private owned banks i.e. Bank Danamon and BCA offered interest rate higher than 50% per annum for rupiah time deposits. Other private banks offered interest rates between 20% and 47%. The state owned banks such as Bank BNI and BRI offered about 40% and 35%, respectively.

As a result of the massive restructuring of the banking sector in 1998, shares of the Indonesian government in the banking sector increased sharply, especially in business group affiliated banks and, to a much lesser extent, in independent banks (see Table 2.4, section 2.2). The number of government-owned banks increased from 7 to 28, and its share in the total banks' assets increased from 36.9% to 78.4%; as the government recapitalized 19 major banks and took over another four banks. The number of private banks, especially the banks that belonged to business groups, declined sharply from 155 to 70, and their share in the total banks' assets declined from 52% to 7.8% since some of them were partly taken over or recapitalized by the government or closed. Foreign-owned and joint venture banks remained almost the same in number but increased their share in the total banks' assets from 8.4 % to 12.7% as they absorbed the deposits that were away from troubled domestic banks.

The banks that had been recapitalized by the government heavily relied on the income from government bonds. Indeed, for many Indonesian banks, the government bonds are still a safe and high-yielding source of income. Therefore, banks were somehow reluctant to increase their lending to the private sector because of the unstable economic conditions, limited availability of corporate financial data, and uncertain repayment capacities of business firms.

Having recovered from the crisis, the Indonesian banking sector shows major improvements in its fundamental financial conditions as reflected in their CAR and NPL ratios (See Table 5.1). Banks are generally well capitalized and have successfully reduced impaired loans by undertaking rigorous loan work out and restructuring program.

Table 5.1

Major Indicators of the Indonesian Banking Sector: 1998-2003

INDICATOR	1998	1999	2000	2001	2002	2003
Total Assets (Rp trillion)	895.5	1,006.7	1,030.5	1,099.7	1,112.2	1,196.2
Deposits (Rp trillion)	625.3	616.7	699.10	797.4	835.8	888.6
Loans (Rp trillion)	545.5	277.3	320.5	358.6	410.3	477.2
Loans/Earning Assets (%)	74.4	33.8	33.0	34.8	40.1	44.5
Loan to Deposit Ratio	72.4	26.2	33.2	33.0	38.2	43.2

(%)						
Gross NPL Ratio (%)	48.6	32.8	18.9	12.1	8.1	8.2
Net NPL Ratio (%)	35.1	7.3	5.8	3.6	2.1	3.0
CAR (%)	(15.7)	(8.1)	12.7	20.5	22.5	19.4

Source: Bank Indonesia

The increase in the aggregate total assets of banks during the last five years has been, driven mainly by the expansion in the extended credit portfolio and BI certificate portfolio. Since 2000, the increase of public confidence in the national banking system has stimulated the rise of third party funds. Third party funds increased by 13.4% in 2000 and 14.1% in 2001; but increased by only 4.8% in 2002. Although the extended loans dropped sharply by 49% in 1999, bank intermediation recovered in 2000. This was indicated by higher outstanding credits and actual channeling of new credits. The increase in new credits has successfully raised the loan to deposit ratio (LDR) in the same years. The improvement in the banking sector is also indicated by the increase of CAR. The overall banks' CAR reached 12.7% in 2000, and continued to increase in the subsequent years.

As shown in Table 5.2, at the end of 2003, Bank Mandiri is the largest bank in terms of the asset size, which is followed by BCA, BNI, BRI and Bank Danamon. These 5 biggest banks hold 76.6% of the total asset of the public listed banks. Bank Mandiri, BNI and BRI are publicly listed state-owned banks. Bank Mandiri was established in 1999 from the merger of four state-owned banks, i.e. Bank Dagang Negara, Bank Bumi Daya, Bank Ekspor Impor Indonesia and Bank Pembangunan Indonesia. Following this merger, Bank Mandiri emerged as the largest bank in Indonesia with 28.9% share of the market. Bank BCA and Bank Danamon were classified as bank take-over (BTO) and were managed by IBRA under the recapitalization and restructuring program in 1998. In 2002, IBRA divested approximately 51% of the total BCA shares through a tender private placement process for strategic partners, which was won by Farindo Investments (Mauritius) Ltd. Meanwhile, Bank Danamon was acquired by the Asia Financial Indonesia Consortium, which took a majority controlling stake in the bank. In terms of third party fund and outstanding loan, the above mentioned five banks hold the largest deposit and loan share, amounting to 76% and 74%, respectively. The increase in public confidence in the banking sector, especially in the state-owned bank and the large private banks was reflected by the success of these banks in extending funds to the public.

Table 5.2

Operational Performance of 26 Listed Banks

Name of Banks	Asset Share (2003, %)	Deposit Share (2003, %)	Loan Share (2003, %)	ROA (2003, %)	ROE (2003, %)	CAR (2003, %)	NPL (2003, %)
BII	4.02	4.32	3.45	0.87	9.76	22.02	6.13
BCA	15.43	17.33	9.78	2.6	23.85	27.95	2.34
NIAGA	2.75	2.83	4.82	1.92	37.53	11.58	3.61
LIPPO	3.06	3.49	1.59	-1.5	-45.8	17.9	8.8
PANIN	2.18	1.7	2.47	2.92	15.34	42.35	9.61
MEGA	1.61	1.68	2.13	2.27	32.51	14.04	1.54
NISP	1.79	1.83	3.19	1.71	22.77	13.78	0.84
PERMATA	3.36	3.44	2.88	1.9	66.1	10.8	2.9
DANAMON	6.10	5.83	7.6	3.3	31.4	26.8	6.8
BUANA	1.66	1.8	1.76	2.31	17.0	22.32	0.86
MANDIRI	28.87	26.21	25.27	2.8	23.6	27.72	8.6
BNI	15.22	15.43	15.54	0.77	11.83	18.16	2.07
BRI	10.96	11.19	15.93	4.02	43.41	20.87	3.12

VICTORIA	0.20	0.20	0.21	0.69	8.77	11.52	4.05
NUSANTARA P.	0.22	0.25	0.23	1.84	19.17	13.53	0.31
PIKKO	0.17	0.18	0.11	-3.15	-75	8.41	2.95
DANPAC	0.13	0.14	0.12	1.54	7.75	25.33	0.76
EKSEKUTIF	0.05	0.002	0.06	3.23	36.18	10.4	4.58
INTERPACIFIC	0.20	0.24	0.42	0.89	5.40	35.86	89.57
GLOBAL	0.26	0.20	0.15	0.51	2.33	42.50	1.40
MAYAPADA	0.27	0.29	0.52	0.94	2.08	13.68	4.68
ARTHA NIAGA	0.12	0.13	0.19	1.70	8.03	21.96	3.54
BUMI PUTERA	0.38	0.38	0.83	1.4	12.37	9.94	2.93
CIC	0.76	0.64	0.49	0.14	3.74	15.95	4.59
KESAWAN	0.14	0.17	0.16	0.36	3.51	16.99	4.04
SWADESI	0.07	0.08	0.1	2.33	10.83	27.07	2.73

Source: PT. UFJ Institute Indonesia based on Banks 2003 Annual Report.

In general, the publicly listed banks have managed to maintain CAR far above the regulatory requirement of 8%. This was mainly due to the progressive completion of recapitalization and the accumulated profits. Some smaller banks, i.e Panin Bank, Bank Inter Pacific, Bank Global were able to maintain their CAR at healthy level and produced higher CAR compared to the five largest banks. These banks were amongst the few banks exempted from being recapitalized by the Government of Indonesia through IBRA.[34]

Amongst the state-owned banks, Bank BRI has the highest ROA, followed by several other private banks. Bank Permata, which was formed from the merger of five private banks under the management of IBRA in 2002, achieved the highest return on equity (ROE) in the banking sector. Bank BNI and BRI and most private banks with some exception such as Bank BII, Panin, Danamon and Interpacific were able to maintain their NPL ratio below 5% as a maximum level required by BI.

5.2 Role of Stakeholders in Disciplining Banks

It has been mentioned in the previous section that corporate governance of banks in Indonesia is mostly disciplined by regulators like Bank Indonesia. However, the actual driving force to make better performance of banks may not come from regulators, but rather from the stakeholders. Therefore, it is critical to analyze how the corporate governance of banks is disciplined by the stakeholders in terms of achieving better performance. In this section, stakeholders are defined as the depositors, the shareholders, and the creditors of the banks.

Discipline by Depositors

As mentioned earlier, a number of deposit holders were heavily affected by the closure of 16 banks in 1997. The government, however, guaranteed all deposits up to Rp 20 million, thereby avoiding widespread panic, social unrest and loss of confidence in the banking sector as a whole.

Despite the government's guarantee, there were massive withdrawals and re-channeling of deposits from Indonesian-owned private banks to state-owned banks and foreign-owned banks; and this has contributed to the serious liquidity problems in many Indonesian-owned banks. The shock to depositors' confidence in 1997 has certainly contributed to banks' awareness of the importance of observing sound banking principles and disclosure of financial information in order to maintain clients' confidence. According to Birchler and Maechler (2001), depositors generally do exert market discipline on their banks by

[34] Later, in the beginning of 2005, the operational license of Bank Global was revoked by the government due to its capital inadequacy as indicated by CAR of -39.11 in 2004.

withdrawing uninsured deposits. It can be assumed that after the experiences of 1997/1998, market discipline has started to function in Indonesia, at least to some extent.

Deposit Growth and Key Iindicators

Despite the assumption mentioned above, the empirical analysis of the time series data (2000-2003) does not indicate that depositors play an effective role in monitoring and disciplining the banks . There is no significant correlation between deposit growth and some key indicators during this period. What was also tried a comparison of deposit growth rate with soundness or other performance indicators across surveyed banks in 2003, when the banking sector performance was best since the crisis. As illustrated in Figure 5.1, there is no correlation between CAR and deposit growth, as depositors might have assumed that all banks should have at least 8% CAR as required by Bank Indonesia. Likewise, the current safety net scheme implemented by government's blanket guarantee system may also have influenced depositors' behavior in believing that the government can fully protect their deposits regardless of the banks' CAR.

On the other hand, there is a positive correlation between the key performance indicators and deposit growth. A bank that performs well usually attracts more depositors. Similarly, a bank with a lower NPL ratio seems be more attractive to depositors. This may imply that more banks will try to perform better to attract more depositors. In turn, the depositors' role in disciplining the banks will become significant.

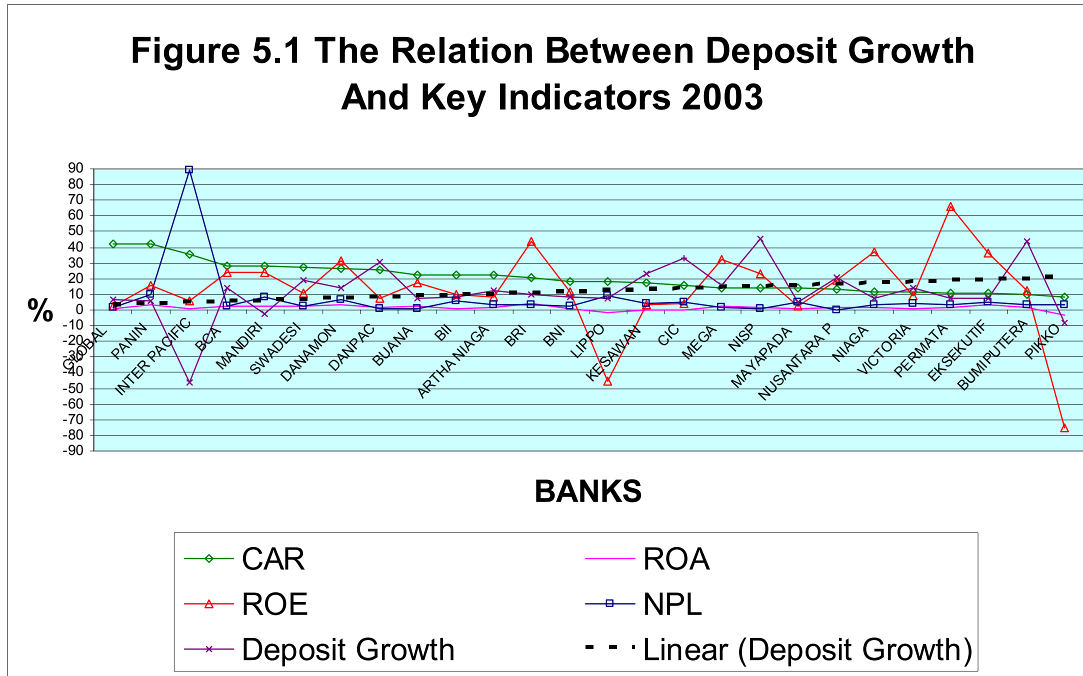
Meanwhile, by using multiple regression models with 'enter' method, it indicates that there is a relationship between some key performance indicators and deposit growth in 2003. On the contrary, in 1998, some key performance indicators give no effect to deposit growth at all. This probably because of the limitation data obtained.

Enter method is used to analyze how much the effect of all independent variables as a whole to dependent variable regardless the effect of each independent variable. Due to the limitation data, some missing values are replaced by the average value (mean). Dummy variables are used for ownership indicators. The results are as follows:

- *The relationship between independent variables (interest rates, ownership and CAR) to dependent variable (deposit growth) in 1998*
  By using 95% of confidence interval, the significant value (P-value) obtained is 0.47. It means that the P-value is much higher than its 5% level of significant. Therefore, the multiple regression model for analyzing the independent variables (interest rates, ownership, CAR) to dependent variable (deposit growth) is not significant. (See appendix 1 for detail result)

- *The relationship between independent variables (interest rates, ownership, ROA, ROE, CAR and NPL) to dependent variable (Deposit Growth) in 2003.*
  By using 95% of confidence interval, the significant value (P-value) obtained is 0.006. It means that the P-value is lower than its 5% level of significant. Therefore, the relationship is quite significant. With coefficient of multiple correlation of 0.790 and coefficient of determination of 0.624, the independent variables (interest rates, ownership, ROA, ROE, CAR, NPL) as a whole has an impact to deposit growth by 62.4%. (See appendix 2 for detail result)

  If we look at the result (see appendix), out of 7 independent variables, only NPL has value lower than the 5% level of significant. It means that NPL is strongly affects the deposit growth. Low NPL tends to increase deposit growth.



Source: PT. UFJ Institute Indonesia

It is expected that the government's plan to abolish its current blanket guarantee for deposits in banks starting from 2005 will enhance a more effective market disciplinary force from deposit holders.

Discipline by Creditors

Correlation Between Liabilities Growth and CAR or NPL in 2003

An analysis of the time series data of 2000 – 2003 does not show any significant correlation between liabilities growth and banks performance, i.e. NPL and CAR. In other words, the analysis does not provide any significant indication that market discipline by creditors indeed exists. In Figure 5.2, we tried to analyze the correlation between liabilities growth and CAR or NPL in 2003. The higher the NPL ratio, the lower liability growth is observed. This means that banks tend to maintain a lower NPL ratio in order to attract creditors, or creditors discipline the banks to maintain lower NPL ratio. Creditors seem to see banks with high rate of NPL as "troubled" banks and are reluctant to provide financing. On the other hand, no significant correlation could be observed between CAR and Liabilities growth.

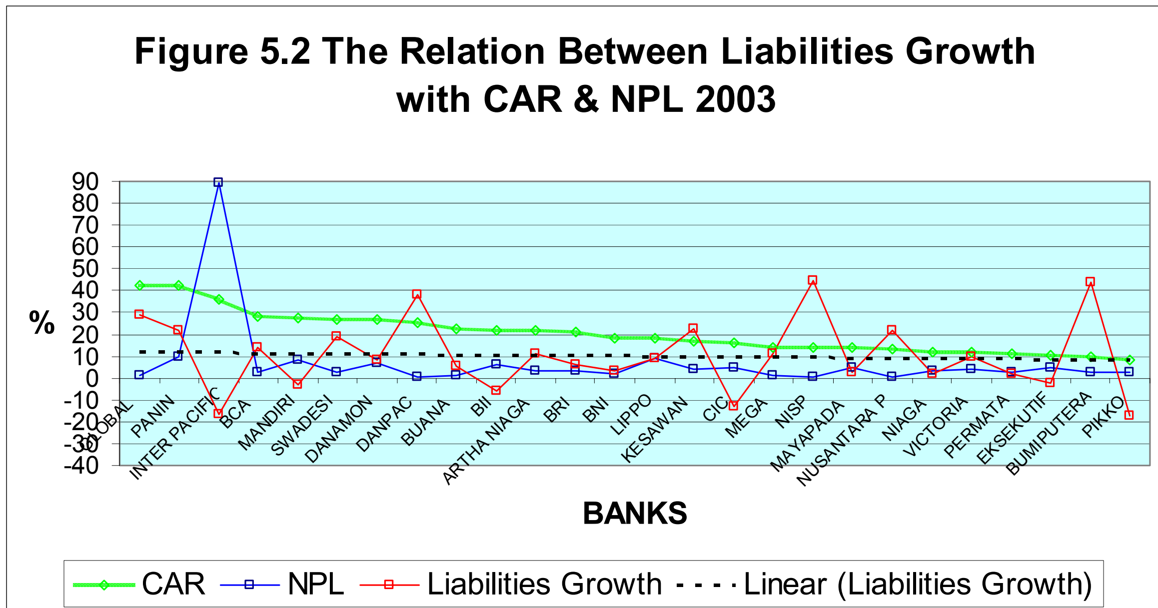


Figure 5.2 The Relation Between Liabilities Growth with CAR & NPL 2003

Source: PT. UFJ Institute Indonesia

From the analysis, the other existing indicators such as ROA and ROE also do not indicate significant correlation with the liabilities growth. Since better performing banks may have little need to borrow and they are more inclined to raise fund in capital market with cheaper cost, the liability growth and bank performance have potentially negative relationship. Therefore, this sort of analysis, i.e. the analysis of the correlation between liability growth and bank performance, has a limitation to identify the creditors' role in disciplining banks.

Correlation Between Liabilities Share and CAR or NPL in 2003

Comparing with the above analysis, there appears to be some correlation between liabilities share and CAR or NPL in 2003 as shown in figure 5.3, as each line in the chart tends to meet at one point. This means that in 2003, the higher CAR and the lower NPL will make creditors more reluctant to put their money although some inconsistencies are found in several banks, such as Bank Inter Pacific, Mandiri and BNI due to bank mortgage/ bond issued to maintain the liquidity of the banks.

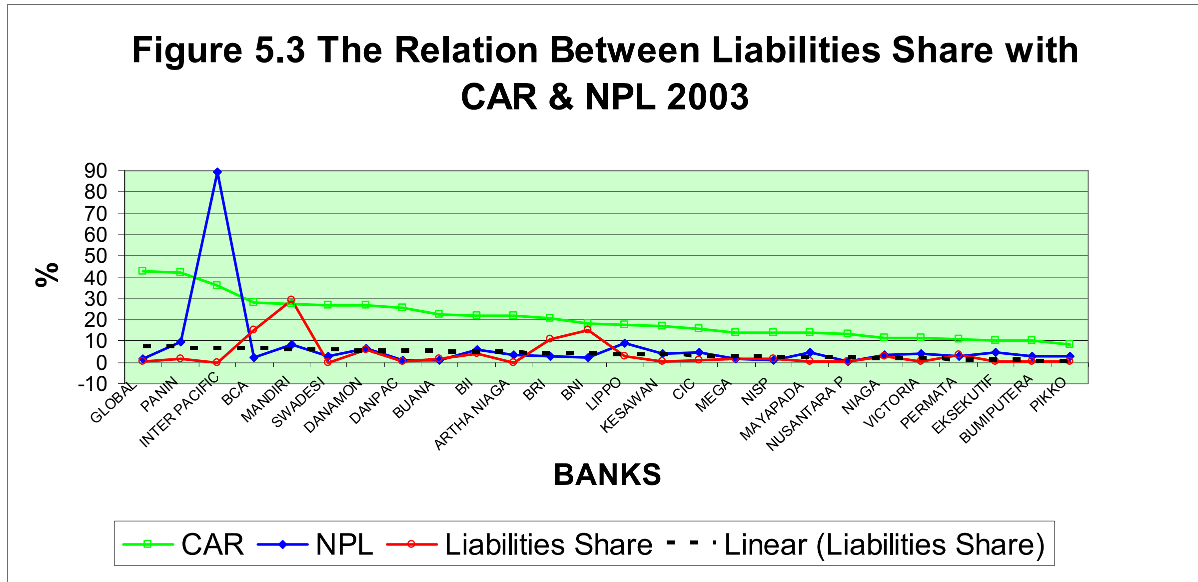


Figure 5.3 The Relation Between Liabilities Share with CAR & NPL 2003

Source: PT. UFJ Institute Indonesia

However, if multiple regression model is applied, the analysis shows that there is no relationship between some performance indicators and liabilities growth. The results are as follows:

- *The relationship between independent variables (CAR, NPL and ownership) to dependent variable (liabilities growth) in 1998.*
  By using 95% of confidence interval, the significant value (P-value) obtained is 0.59. It means that the P-value is much higher than its 5% level of significant. Therefore, the multiple regression model for analyzing the independent variables (CAR, NPL, ownership,) to dependent variable (liabilities growth) is not significant. (See appendix 3 for detail result)

- *The relationship between independent variables (ROA, ROE, CAR, NPL and ownership) to dependent variable (liabilities growth) in 2003.*
  By using 95% of confidence interval, the significant value (P-value) obtained is 0.12. It means that the P-value is higher than its 5% level of significant. Therefore, the multiple regression model for analyzing the independent variables (ROA, ROE, CAR, NPL, ownership,) to dependent variable (liabilities growth) is not significant. (See appendix 4 for detail result)

Judging from the correlation between liabilities growth or share and bank soundness indicators, it can be said that creditors' significant role in disciplining banks cannot be confirmed in Indonesia.

Discipline by Shareholders

To examine the effectiveness of market discipline from shareholders, it is crucial to analyze the correlation between bank stock price and bank performance. Since stock price itself depends on the number of issued shares and publicly offered shares in the market, it is more appropriate to analyze the correlation between stock price increase rate and bank performance, i.e. NPL, CAR, ROA and ROE as important indicators of soundness and profitability of the bank. As Table 5.3 illustrates, except for a few banks, a positive correlation between stock price increase and CAR, ROA and ROE could be observed. Also observed

is an expected negative correlation between NPL and bank stock price increase. . Therefore, it can be said that to some extent bank stock prices are responding to the soundness and profitability indicators of the banks, indicating a corporate governance role of shareholders.

Table 5.3
Correlation between Bank Stock Prices Growth and Performance

Name of Bank	NPL (2001-2003)	CAR (2001-2003)	ROA (2001-2003)	ROE (2001-2003)
BII	-1	0.97	1	0.99
BCA	0.15	-0.15	-0.28	-0.38
NIAGA	-1	-0.94	0.94	0.68
LIPPO	1	0.02	-0.36	-0.37
PANIN	-0.86	0.99	0.94	0.94
MEGA	0.45	0.97	1	0.99
NISP	-0.41	0.41	-0.41	-0.93
PERMATA	-0.42	0.75	0.41	0.37
DANAMON	0.77	0.44	0.37	0.33
BUANA	1	1	0.67	0.8
MANDIRI	N/A	N/A	N/A	N/A
BNI	-0.65	0.91	-0.86	-0.94
BRI	N/A	N/A	N/A	N/A
VICTORIA	N/A	N/A	N/A	N/A
NUSANTARA P.	-1	-1	1	1
PIKKO	-0.73	0.06	-0.48	-0.49
DANPAC	-0.43	-0.95	-0.38	-0.39
EKSEKUTIF	0.26	0.78	-0.35	-0.42
INTER PACIFIC	-1	1	N/A	1
GLOBAL	0	-0.8	-0.55	-0.5
MAYAPADA	-0.62	0.48	0.95	0.99
ARTHA NIAGA	-0.92	-0.94	-0.54	-0.6
BUMI PUTERA	N/A	N/A	N/A	N/A
CIC	0.99	1	0.74	0.91
KESAWAN	N/A	N/A	N/A	N/A
SWADESI	N/A	N/A	N/A	N/A
AVERAGE	-0.22	0.25	0.17	0.20

Source: PT. UFJ Institute Indonesia

Table 5.4 shows the stock market statistics of banking sector compared to total stock market statistic. Market capitalization of banking industry in Indonesia has grown significantly, and its trading volume and trading value also indicate remarkable improvement. This might be due to the decreasing number of troubled commercial banks and recapitalization of many banks.

Table 5.4
Banking Industry Stock Market Statistics

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Market Capitalization (%)	10.5	6.5	7.4	35.3	27.4	20.8	24.0	24.0	28.5
Trading Volume (%)	13.4	22.4	17.3	42.2	21.4	21.0	28.1	30.9	26.3
Trading Value (%)	12.1	16.3	6.7	13.6	4.5	4.9	9.5	19.5	28.9
Number of Listed Banks	24	32	32	34	21	23	24	26	24
Number of Commercial Banks	239	222	208	164	151	145	142	138	135

Source: Jakarta Stock Exchange Annual Statistics and BI, Indonesian Financial Statistics 2004.

5.3 Bank Ownership and Bank Performance

The Indonesian banking sector has gone through some drastic changes in the ownership structure, and major improvements in the financial conditions have been achieved. Supported by improved macroeconomic conditions, the overall performance of the banking sector has improved. This was reflected in a stronger capital structure, improved NPLs, higher profitability and recovery in bank intermediation. All banks are now in compliance with the mandatory capital adequacy ratio of 8%.

Given the improved financial conditions of the banking sector, the Government of Indonesia has privatized some banks. Among the major accomplishments in this area, have been the sales of BCA, Bank Niaga, Bank Danamon, BII, and the initial public offering of 20% stake in the state-owned Bank Mandiri and BRI. Besides that, foreign investors have also increased their presence in Indonesia by holding stakes in some prominent banks including the above banks.

Bank performance is measured by evaluating major performance indicators, such as: return on assets (ROA), return on equity (ROE), capital adequacy ratio (CAR), and non-performing loan (NPL) ratio. In order to explore the relationship between the ownership and bank performance, we classify the publicly listed banks into three categories based on ownership structure in year 2001:

- Government-owned banks: it consists of three publicly listed state-owned banks (Bank Mandiri, BRI and BNI) and six private banks which were taken over by the government of Indonesia (Bank Permata, BII, BCA, Niaga, Lippo and Danamon);
- Foreign-owned banks consisting of private listed banks owned by foreign; and
- Private-owned banks.

BII, Lippo and Danamon, are classified as government-owned banks until 2002, and in 2003 they are classified as foreign-owned banks. BCA and Bank Niaga are classified as government-owned banks until 2001, thereafter classified as foreign-owned banks. Bank NISP is classified as private-owned banks in 2001, but since 2002, it is classified as foreign-owned banks.

As shown in Table 5.5, the ROE and ROA of the government-owned banks tend to be the highest compared with the foreign-owned and privately-owned banks. A remarkable improvement was achieved in 2003, when the three taken-over private banks (BII, Lippo,

Danamon) were released from government control as the government of Indonesia tried to strengthen the accountability of state banks. The ROA of the government-owned banks increased significantly from 0.04% in 2001 to 2.4% in 2003.

Table 5.5
Performance of 26 Surveyed Banks by Ownership Type (%)

	ROA			ROE			CAR			NPL Ratio		
	2001	2002	2003	2001	2002	2003	2001	2002	2003	2001	2002	2003
Government-Owned Banks	0.0	0.4	2.4	29.9	-10.1	36.2	13.8	20.3	19.4	12.7	7.1	4.2
Private-Owned Banks	0.7	0.7	1.6	2.0	-30.8	13.2	20.2	18.2	20.2	7.0	4.2	3.5
Foreign-Owned Banks	2.3	1.4	0.9	20.8	15.7	2.0	20.9	22.5	21.1	31.3	18.3	13.5

Source: PT. UFJ Institute Indonesia

The negative ROE of government-owned banks in 2002 was caused by very poor return for Bank Permata (-153.5%) and Bank Lippo (-36.3%). Meanwhile, the negative ROE of private-owned banks in 2002 was caused by big loss of Bank CIC (-535.4%). The ROE of these banks became positive in 2003.

The Capital Adequacy Ratio (CAR) of all banks was maintained above the 8% required level, an indication that there has been improvement in the management of the banks. Compared to other banks, the NPL ratio of foreign-owned banks was still high; and they were mainly caused by Bank Inter Pacific with its persistence 3L problems. The NPL ratio of this bank declined slightly from 93.6% in 2002 to 89.6% in 2003.

5.4 Summary of Main Finding

Before 1997 when the banking sector was thriving in a rapidly growing Indonesian economy, market participants such as investors and depositors were not monitoring bank performance systematically. It was also a time when Indonesia did not have a tradition in shareholder activism. Since 1997, the government and supervisory agencies have been very heavily involved in restructuring the banking sector and enforcing discipline through an array of new detailed regulations and codes.

At the same time, disciplining forces like investors, depositors, competitors, employees and even commissioners are becoming gradually more active in enforcing discipline on banks. As the economy recovers, these forces can be expected to take over much of the disciplining role of the government, which has put in place the necessary regulations. The government, in its Banking Architecture framework, aims to let the markets undertake the disciplining work starting in 2005. This will probably lead to further rationalizations in the banking industry. There are already clear signs of increased competition in the deposit and lending markets, and banks follow the regulations of government and supervisory agencies with regard to their governance.

Reviewing the role of stakeholders in disciplining banks, it is believed that depositors have performed its role effectively in monitoring and disciplining banks right after the crisis. They were shifting their deposits from the perceived unhealthy banks to the sound banks. They

also placed their deposits in banks which offer higher interest rates. Since the implementation of the blanket guarantee on deposits by the government, depositors have become more passive in performing their role in disciplining banks. When the government abolishes its current blanket guarantee for deposits in 2005, the expectation is that it will enhance the effectiveness of market discipline especially from deposit holders.

Judging from liability growth and liability share, it can be said that creditors have not performed a significant role in disciplining banks in Indonesia. The growth rates of banks' liabilities are mainly dependent on their expansion policies and liquidity conditions, which have no bearing on the role of creditors in disciplining banks. However, the correlation between banks' stock prices and performance suggests that market discipline by shareholders does exist to some extent in Indonesia.

6. Conclusion: Overall Evaluation and Major Policy Issues

The lessons of the crisis demonstrated that improvements were needed to restore investors' confidence in Indonesian companies and banks in particular. Three elements of Corporate Governance were regarded as particularly crucial by regulators: (i) transparency and adequacy of disclosure (ii) effectiveness of the board of commissioners, and (iii) introduction of risk management systems.

Since 2000, the Indonesian Government has issued a number of rules and regulations to strengthen Corporate Governance of publicly listed companies. These rules and regulations include: (i) establishment of audit committee (ii) requirement of independent commissioners (iii) establishment of corporate secretary, and (iv) responsibility of the board of directors on financial reporting.

Furthermore, in 2001, the National Committee of Corporate Governance (the 'NCCG') issued the National Code for Good Corporate Governance. The Code was formulated primarily on the basis of the OECD Principles of Corporate Governance but also covers specific Indonesian issues such as confidentiality, insider information, business ethics and corruption. In addition to those rules and guiding principles for publicly listed companies, the Bank Indonesia has also issued numerous prudential regulations to strengthen corporate governance of banks, which include specific guides on the basis of five essential elements: fairness, transparency, accountability, responsibility, and independence.

While significant institutional development has been achieved by post-crisis regulatory reforms mentioned above, there still remain a number of important issues to be addressed with respect to internal corporate governance scheme and market discipline to strengthen corporate governance of banks in Indonesia.

Rights of Shareholders

In Indonesian banks in general, controlling shareholders have the strong voice in selection or dismissal of the president director and independent commissioners. Members of the board of commissioners and directors are usually nominated by banks' controlling shareholders or management. Only around 40% of the surveyed banks have established a nomination committee. In addition, although most of surveyed banks have allowed for minority shareholders to nominate the candidates of BoC at the GMoS, such rights have been rarely executed. The following recommendation may be considered:

- Require all the listed banks to establish a nomination committee to nominate candidates of president director and members of the BoC; and

- Consider concrete measures to increase minority shareholders' voice in the selection of BoC and BoD members at the GMoS, which include the introduction of mandatory cumulative voting for commissioners and directors.

Effectiveness of the Boards of Commissioners and Directors

Since Indonesia's Corporate Law adopts a two-tier system, the BoC has a critical role for overseeing and supervising the activities of directors. However, Indonesian commissioners in general tend to represent controlling shareholders' interests and have not paid much attention to minority shareholders' interests or corporate social responsibility. Therefore, Indonesian regulators have to establish the new institution of independent commissioners who act independently from the interests of controlling shareholders. The JSX regulation now requires listed companies to fill at least 30% of the BoC with independent commissioners.

Independent commissioners have been appointed by all the surveyed banks and all of them confirm that there is a high degree of "independence" in the position. In practice, however, independent commissioners do not seem to be really independent from the BoD or controlling shareholders. This gap can be traced to the fact that some of the banks hire former directors, employees or large shareholders as their independent commissioners. In this regard, the process of nomination and selection of independent commissioners needs to be strengthened. In addition, in order for independent commissioners to exercise more effective oversight role of BoD, further efforts have to be made to enhance their skills and knowledge by facilitating them with professional services and also by providing personal liability insurance.

- Further define the nature of independence of commissioners and their required qualification under the Code of Good Corporate Governance;
- Require nomination committees to nominate independent commissioners;
- Support independent commissioners to obtain professional legal, financial or accounting services; and
- Provide independent commissioner adequate personal liability insurance.

Evaluation and Compensation of Commissioners and Directors

According to the survey, the respondent banks have not fully applied performance-based compensation schemes for commissioners. Almost 60% of the surveyed banks have no formal procedure and criteria for evaluating the performance of commissioners. But 80% of them have a formal system for evaluating the performance of the president director. This reflects the general business perception toward commissioners as honorary position. However, the absence of evaluation criteria may imply that majority of the surveyed banks pay little attention to the commissioners' function of effective oversight of directors. The commissioners' compensation should be proposed by remuneration committee, which is still not widely introduced in Indonesia.

In addition, majority of the surveyed banks have not applied stock-based compensation system for directors and commissioners although they have introduced some performance-based compensation schemes. Since the stock-based remuneration is getting more popular in many developed countries to better align the interests of board members with those of shareholders, it may not necessarily be desirable in the case of the banking sector.

- Adopt formal evaluation criteria and procedure for commissioners' performance;

- Require all the banks to establish a remuneration committee as an institution for evaluating the performance of directors and commissioners; and
- A further study is needed to search for the optimal compensation scheme for the members of the BoC and BoD.

Internal Control System

Most of the surveyed banks confirm that the bank's managements are intensively involved in reviewing the evaluations of internal control with internal and external auditors as well as reviewing the appropriateness of the bank's risk limits. They also confirm full compliance of the regulatory requirement regarding external audit on bank's financial performance. However, the results of the survey suggests that the respondents are still not satisfied with the overall risk management procedures in the banks. 27.3% of the banks reply that they have never reviewed the process at all and 36.4% reply only once during the last three years. This fact is indeed problematic as the New Basel Accord requires a comprehensive risk management including ERM (enterprise risk management) be adopted by banks. This survey result indicates Indonesian banks' insufficient preparation to the New Basel Accord.

Although all of the surveyed banks comply with the regulatory requirements of annual reports and quarterly financial reports, the adequacy of disclosure and transparency remains a major challenge. Inadequate disclosures include: self dealing or related party transaction; the banks' share transaction by their own commissioners or directors; remuneration of commissioners and directors; background of commissioners and directors; fees to external professionals or other related parties; major contingent liabilities; significant changes in ownership; governance structure and policies; and the extent to which the bank's internal control practice conform to the established standard.

- Socialize and disseminate the risk management requirement under the New Basel Accord and the concept of ERM;
- Require listed banks to disclose their state of internal control; and
- Improve transparency relating listed banks' governance structure.

Market Discipline

In Indonesia, the disciplinary role of private agents has not been paid much attention until the financial crisis probably due to the insufficient and inadequate financial disclosure of listed companies. After the crisis, the government and supervisory agencies have been very heavily involved in restructuring the banking sector and enforcing discipline through an array of new detailed regulations and codes. Depositors seem to have effectively implemented discipline on banks right after the crisis, as they were shifting their deposits from perceived unhealthy banks to sound banks. Since the blanket deposit guarantee was introduced, however, depositors have become more passive in their disciplining role. Our analyses show some evidence that bank shareholders have played a disciplining role in Indonesia, even though creditors do not seem to play such a role.

As the economy fully recovers from the shock of the crisis, market forces can be expected to take over much of the disciplining role of the government, which has put in place necessary regulations after the crisis. There are already clear signs of increased competition in the banking services markets. The government, in its Banking Architecture framework, aims to encourage the markets to enhance its disciplining role starting in 2005, when the current blanket guarantee system is phased out. This will probably lead to further rationalizations in the banking industry.

APPENDIX 1

The Relationship between Independent Variables (interest rates, ownership and CAR) to Dependent Variable (deposit growth) in 1998.

Model Summary

Predictors: (Constant), car, interest, private, Govment	
R	0.458017882
R Square	0.209780381
Adjusted R Square	-0.015996654
Std. Error of the Estimate	114.8598065

ANOVA

Source	Sum of Squares	df	Mean Square	F	Sig.
Regression	49032.18613	4	12258.04653	0.929148447	0.474964575
Residual	184698.852	14	13192.77514		
Total	233731.0381	18			
Predictors: (Constant), car, interest, private, Govment					
Dependent Variable: depositgrw					

Coefficients

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	56.51165874	163.950427		0.344687475	0.735452563
Govment	191.6418593	137.9662861	0.630051428	1.389048475	0.186518565
Private	24.52497823	121.6064909	0.090146581	0.201674911	0.84307186
Interest	0.160710044	2.909500459	0.014918642	0.055236301	0.956730747
Car	0.973992922	0.954306189	0.339303763	1.020629368	0.324744001
Dependent Variable: depositgrw					

Note: The calculation is using Enter Method
Missing value is substituted with mean
Dummy variables of Ownership: Govment and Private
Government: Govment=1 and Private=0
Private: Govment=0 and Private=1
Foreign: Govment=0 and Private=0

APPENDIX 2

The Relationship between Independent Variables (interest rates, ownership, ROA, ROE, CAR and NPL) to Dependent Variable (deposit growth) in 2003.

Model Summary

Predictors: (Constant), npl, interest, roe, car, govment, roa, private	
R	0.78983768
R Square	0.62384356
Adjusted R Square	0.477560501
Std. Error of the Estimate	12.53490584

ANOVA

Source	Sum of Squares	df	Mean Square	F	Sig.
Regression	4690.529288	7	670.0756126	4.264632973	0.006118
Residual	2828.229558	18	157.1238643		
Total	7518.758846	25			
Predictors: (Constant), npl, interest, roe, car, govment, roa, private					
Dependent Variable: depositgrw					

Coefficients

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	6.999471799	19.51227823		0.358721402	0.723977
govment	-10.88702921	13.01798062	-0.31146527	-0.83630707	0.413947
private	-2.96878544	13.68716415	-0.087030945	-0.21690289	0.830723
interest	1.945030815	2.490827938	0.160698277	0.780877228	0.445024
Roa	-1.135052214	3.859732475	-0.098819709	-0.29407536	0.772065
Roe	0.151517903	0.219556035	0.232754217	0.690110397	0.498927
Car	-0.168340273	0.329364872	-0.09228896	-0.51110573	0.615489
Npl	-0.625538927	0.17359694	-0.613778933	-3.60339835	0.002032
Dependent Variable: depositgrw					

Note: The calculation is using Enter Method
Missing value is substituted with mean
Dummy variables of Ownership: Govment and Private
Government: Govment=1 and Private=0
Private: Govment=0 and Private=1
Foreign: Govment=0 and Private=0

APPENDIX 3

The Relationship between Independent Variables (ownership, CAR and NPL) to Dependent Variable (liabilities growth) in 1998.

Model Summary

Predictors: (Constant), npl, private, car, govment	
R	0.413011508
R Square	0.170578506
Adjusted R Square	-0.066399064
Std. Error of the Estimate	63.68954085

ANOVA

Source	Sum of Squares	df	Mean Square	F	Sig.
Regression	11679.20526	4	2919.801315	0.719808654	0.592479639
Residual	56789.00658	14	4056.357613		
Total	68468.21184	18			
Predictors: (Constant), npl, private, car, govment					
Dependent Variable: liabilitiy					

Coefficients

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	25.11239015	72.57637183		0.346013303	0.734477466
govment	-8.333131282	75.61153988	-0.050618299	-0.110209781	0.913807279
private	26.69457247	67.89825186	0.181291441	0.393155519	0.700126387
car	0.404501011	0.588830495	0.26035516	0.686956628	0.503331114
npl	0.871909866	1.039130562	0.254911143	0.839076337	0.415524547
Dependent Variable: liabilitiy					

Note: The calculation is using Enter Method
Missing value is substituted with mean
Dummy variables of Ownership: Govment and Private
Government: Govment=1 and Private=0
Private: Govment=0 and Private=1
Foreign: Govment=0 and Private=0

APPENDIX 4

The Relationship between Independent Variables (ROA, ROE, CAR, NPL and ownership) to Dependent Variable (liabilities growth) in 2003.

Model Summary

Predictors: (Constant), npl, roa, Private, car, roe, Govment	
R	0.617676501
R Square	0.38152426
Adjusted R Square	0.186216131
Std. Error of the Estimate	14.91479192

ANOVA

Source	Sum of Squares	df	Mean Square	F	Sig.
Regression	2607.27889	6	434.5464817	1.953447934	0.123748
Residual	4226.569344	19	222.4510181		
Total	6833.848235	25			
Predictors: (Constant), npl, roa, Private, car, roe, Govment					
Dependent Variable: liabltGrw					

Coefficients

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	9.988792147	12.93107261		0.772464315	0.449342
Govment	-17.43101112	14.02447581	-0.523074119	-1.2428993	0.229025
Private	-3.450620223	12.88135815	-0.106104173	-0.26787705	0.79168
roa	-1.003536241	3.730507488	-0.091643402	-0.26900797	0.790823
roe	0.236019161	0.215664715	0.380295585	1.094380049	0.287469
car	0.498639626	0.367035936	0.286740425	1.358558051	0.190199
npl	-0.402989222	0.214992118	-0.414754858	-1.8744372	0.07633
Dependent Variable: liabltGrw					

Note: The calculation is using Enter Method
Missing value is substituted with mean
Dummy variables of Ownership: Govment and Private
Government: Govment=1 and Private=0
Private: Govment=0 and Private=1
Foreign: Govment=0 and Private=0

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