BANKING DEREGULATION IN INDONESIA

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1. INTRODUCTION

In late 1988, the Indonesian government adopted a number of reforms aimed at deregulating the country's banking sector.¹ Since the reforms, Indonesia's banking system has been undergoing a transformation from an inefficient system dominated by a relatively small number of state-owned banks, to a more volatile system, in which competition among state and privately owned banks is encouraged.²

This transformation has been very difficult for the Indonesian banking sector. One example of the difficulties caused by banking deregulation is the number of scandals involving Indonesian banks and banking officials reported by the international financial press over the past few years. In 1992, for example, Bank Summa, a private institution

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¹ The Indonesian government's policies regarding banking deregulation were part of a general economic deregulation process pursued throughout the 1980s. The deregulation policy, which has been supported by the Asian Development Bank and the World Bank, began in 1983, when the sharp decline in crude oil prices caused Indonesia's economic planners to re-evaluate the structure of the country's economy, which was largely dependent upon oil. William Keeling, Jakarta Struggles to Control Its Deregulation, FIN. TIMES, June 9, 1992, at 4. At that time, oil and gas accounted for roughly 80% of Indonesia's export revenue. Id. The banking deregulation package, known as PAKTO '88, relaxed the restrictions on the establishment of private and foreign-owned banks, as well as those on existing banks opening new branches. See Paving the Way for Growth, INSTITUTIONAL INVESTOR, Nov. 29, 1992, at 172 [hereinafter Paving the Way].

² This transformation is discussed generally in Manggi Habir, Private Treatment, FAR E. ECON. REV., Apr. 28, 1994, at 54.
owned by one of Indonesia's wealthiest families, was liquidated by the government after the bank amassed more than $700 million in nonperforming loans. At the time of its liquidation, Bank Summa was one of Indonesia's ten largest banks and it was estimated that over 70% of the bank's loans were nonperforming. A large proportion of those loans were made to other members of the Summa Group on an unsecured basis.

More recently, a scandal involving the state-owned Development Bank of Indonesia ("Bapindo") has focused additional attention on the problems facing the Indonesian banking sector. Bapindo's principal problem revolves around a $430 million letter of credit issued to a little-known Indonesian conglomerate named Golden Key. Golden Key was supposed to use the letter of credit to equip

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3 Bank Summa, a member of the Summa Group, was controlled by the Soeryadjaya family. The Soeryadjaya family also formerly controlled Indonesia's second largest listed company, Astra International. See Suhaini Aznam, Father Knows Best, FAR E. ECON. REV., June 25, 1992, at 62 [hereinafter Father Knows Best]. The sale by the Soeryadjaya family of its controlling interest in Astra International was directly related to the collapse of Bank Summa. See Suhaini Aznam, Sold, at Last, FAR E. ECON. REV., Jan. 28, 1993, at 54 [hereinafter Sold, at Last].

4 All monetary figures in this Article will be in U.S. dollars unless otherwise stated.

5 See id. Bank Summa's disastrous loan portfolio generally is blamed on mismanagement by the Chairman of the bank, Edward Soeryadjaya, the eldest son of the head of the family's business empire, as well as on the policy of using loans from the bank to finance the Summa Group's property speculation. See Father Knows Best, supra note 3, at 62. No criminal charges were filed in the Bank Summa matter, but Indonesian authorities did allege publicly that the bank violated rules restricting the amount of loans a bank could make to its owners and to single customers. See Richard Borsuk, Indonesia Bolsters Its Commitment to Tight Rein on Credit, ASIAN WALL ST. J. WKLY., Jan. 24, 1994, at 17.

6 The bank's name in Bahasa Indonesia is Bank Pembangunan Indonesia, and it is generally known by the acronym "Bapindo." See Paul Jacob & Simon Sinaga, Trader's Trial a Show of Jakarta's Intentions, STRAITS TIMES, May 10, 1994, at 14.

a petrochemical plant in West Java, but Golden Key drew on the letter before any of the equipment for the plant was delivered, and it was never repaid. The incident led to allegations of corrupt dealings by Golden Key and the arrest of the head of the company, as well as the detention of several high Bapindo officials.

Bapindo also is involved in at least two other separate incidents involving allegations of fraud. One incident stems from loans made to PT Kanindo Prima Perkasa ("Kanindo"), an Indonesian textile company. Kanindo owes an aggregate of more than $200 million to Bapindo and another state-owned bank, Bank Bumi Daya. Kanindo allegedly diverted the proceeds from the loans away from the

9 The Indonesian authorities have alleged that the letter of credit was altered improperly so that payment was made to the head of Golden Key, Eddy Tansil, rather than to the equipment suppliers, and that Tansil then diverted the money to Hong Kong rather than using it to purchase the equipment for the proposed petrochemical plant. See Borsuk, supra note 8, at 24; Mallet, supra note 8, at 4; see also, Jacob & Sinaga, supra note 7, at 14.

10 See Indonesian Is Arrested in Case of Big Loan at State-Owned Bank, WALL ST. J., Feb. 18, 1994, at A-5; John McBeth, The Year of Doing Business, FAR E. ECON. REV., Sept. 1, 1994, at 70, 71 (discussing the impact on the Indonesian economy of the arrest and conviction of the owner of Golden Key). Several high-ranking officials in the Indonesian government also have been implicated in the Golden Key case, including the former Minister for Political and Security Affairs, Admiral Sudomo, and the former Minister of Finance, Johannes Sumarlin, who at the time was also a member of Bapindo's Board of Commissioners. Although neither man has been charged formally in the case, the letter of credit apparently was issued by Bapindo partly on the strength of an informal reference provided by Sudomo and was approved by Sumarlin. See Economy: Bapindo Scandal Highlights Crisis in Banking Industry, ECONOMIST INTELLIGENCE UNIT - COUNTRY REP., Aug. 5, 1994, available in LEXIS, Asiapc Library, ALLASI File; Suharto Aide Testifies in Indonesia Scam Trial, June 27, 1994, available in LEXIS, Asiapc Library, ALLASI File.

11 PT Kanindo Prima Perkasa is part of the Kanindo Group, which is owned and operated by controversial businessman Robby Tjahjadi. See Manuela Saragosa, Indonesian Whispers Turn to Shouts, FIN. TIMES, Sept. 13, 1994, at 7. Mr. Tjahjadi spent time in jail in the 1970s on charges of smuggling luxury cars, and is often referred to as a "former convict" by the Indonesian press. See Simon Sinaga, Banks Set to Move on Group Linked to Bapindo, STRAITS TIMES, Sept. 3, 1994, at 19.

company's textile business, and instead used the funds for real estate speculation. In addition, the company's owner is believed to have used political connections to influence officials.

Bapindo also has been investigated by the Indonesian government for loans made to a businessman named Kim Johannes Mulia. Mr. Mulia allegedly obtained export credits from Bapindo by using forged documents stating that his company, PT Detta Marina, had exported garments to Singapore. The extension of credit by Bapindo to Mr. Mulia, together with the Golden Key and Kanindo incidents, suggests a serious pattern of mismanagement by the bank and a lack of supervision by banking regulators.

Incidents such as the collapse of Bank Summa and the Bapindo scandals do not appear to be isolated examples of mismanagement in an otherwise sound banking system. Rather, these incidents point to fundamental problems with Indonesia's banking sector following deregulation. Domestic bank credit increased by 158% between the end of 1988, when the deregulation package was adopted, and the end of 1991. This dramatic increase in bank credit was largely fueled by indiscriminate lending by state-owned and privately owned banks and has left both types of banks with a heavy nonperforming debt burden. For example, Indonesia's Ministry of Finance has admitted that at the end of 1993, 21% of the loans held by the largest of the state banks were nonperforming.

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14 See Yates, supra note 12.
15 See Bapindo Target of Another Government Probe into Fraudulent Loans, STRAITS TIMES, Oct. 9, 1994, at 15.
16 See id.; see also Paul Jacob, Jakarta Ministry Probes Export-Credit Scandal, STRAITS TIMES, Oct. 15, 1994, at 16.
17 See Keeling, supra note 1, at 4.
18 See Graham Field, Banks Refocus on Making Profits, EUROMONEY, Sept. 1993, at 253 (describing the indiscriminate lending policies of Indonesian banks during the period immediately following deregulation); see also Hendro Suwito, Indonesian Banks Trapped by Bad Debts, REUTER ASIA-PAC. BUS. REP., June 28, 1993, available in LEXIS, Asiapc Library, ALLASI File.
19 See Habir, supra note 2, at 54. This figure can be compared to an estimated 17.4% at the end of 1992 and an estimated 6% at the end of 1990. See Mallet, supra note 8, at 4.
The kinds of imprudent lending policies followed by many of Indonesia's banks include: (1) conducting little or no investigation into prospective borrowers; (2) lending on an unsecured basis without requiring adequate evidence of the borrower's ability to repay the loan; (3) failing to restrict or monitor the borrower's use of loan proceeds; and (4) "memo lending," or lending on the basis of a recommendation from a prominent or politically well-connected person. Although such practices are not unique to Indonesian banks, they are unusually pervasive throughout the Indonesian banking sector. Memo lending in particular is endemic to the state-owned banks. Directors and other high-ranking bank officials, who are appointed by senior politicians, often believe that their jobs depend more on loyalty to their political patrons than on the quality of their loan portfolios.

The problems faced by Indonesia's banking sector since 1988 raise significant questions about the wisdom of the government's deregulation efforts. The deregulation package was intended to stimulate economic development in the country by injecting competition into a banking system that had been controlled by a small number of poorly managed and highly inefficient state-owned banks. Although the government succeeded in creating a more competitive banking environment, it appears that the government did not take adequate measures to ensure

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20 The expression "memo lending" refers to the fact that loans are often prompted by a memo from a powerful person to a bank official recommending that a certain company or individual receive a loan. See Tony Shale, Indonesia: Marie's Lone War Against Corruption, EUROMONEY, Aug. 1994, at 20.

21 See id. (describing the problems resulting from Indonesia's imprudent lending policies); see also John McBeth, Banking on Friends: Business and Politics Mix in Bapindo Case, FAR E. ECON. REV., June 23, 1994, at 25. For a general discussion about the problem of corruption in the Indonesian economy, see Manuela Saragosa, 'Favours' Blamed for Putting Indonesia in Second Division, FIN. TIMES, Sept. 29, 1994, at 6.

22 See McBeth, supra note 21, at 25; see also Henny Sender, Nor a Lender Be, FAR E. ECON. REV., Sept. 1, 1994, at 73, 74 (discussing the "culture of deference" in Indonesia, where bank officials defer to the politically powerful who often disregard their obligations to repay their loans).

23 See Shale, supra note 5, at 56.
the economic strength of the banking system. For example, the minimum capitalization requirements for private banks were set so low that many of the new banks were badly undercapitalized from their creation. In addition, bank lending practices were largely unrestricted. Many of the new banks were established by Indonesia's largest industrial groups, which then used the banks as a source of inexpensive intragroup funding. Moreover, a significant portion of the lending that occurred during the first two years after deregulation was invested in speculative real estate projects at the peak of Indonesia's property boom. Thus, one result of deregulation is that many state-owned and privately owned banks hold large portfolios of nonperforming loans and have a limited capital base.

This Article examines the Indonesian government's efforts to deregulate the country's banking system. Although a number of Asian countries recently have opened government-dominated banking sectors to private competition, Indonesia has attempted to deregulate at a particularly accelerated pace. In so doing, the country has experienced more problems, such as the Bank Summa and Bapindo scandals, than countries such as Taiwan, which have deregulated their banking industries in a more

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24 See id. The minimum paid-in capital requirement for the new private banks was only $5 million. Id. By comparison, when Taiwan deregulated its banking industry in 1989 to permit the establishment of private banks, the minimum paid-in capital requirement set by the Taiwanese government was approximately $370 million. See Lawrence S. Liu, Financial Developments and Foreign Investment Strategies in Taiwan - A Legal and Policy Perspective, 25 INT'L LAW. 69, 83 (1991). For reference purposes, Indonesian rupiah amounts have been converted into U.S. dollars using the exchange rate of $1 to 2,000 Rp.

25 See Shale, supra note 5, at 56.


27 See Habir, supra note 2, at 54.

28 Taiwan, for example, amended its banking law in 1989 to permit the establishment of new private commercial banks. See C.Y. Huang & Marc H. Sterling, New Amendment Liberalizes Taiwan's Banking Sector, E. ASIAN EXECUTIVE REP., Aug. 1989, at 8. Additionally, South Korea also has begun to liberalize its banking sector. See Robin Bulman & Lee Young-Ho, Opening Up Korean Finance, GLOBAL FIN., May 1993, at 85.
cautious manner.\textsuperscript{29} As a result, Indonesia's experience with banking liberalization may hold important lessons for other rapidly developing countries which are considering deregulating their banking industries.

This Article first summarizes the regulatory framework of the banking industry in Indonesia, focusing on the principal banking laws and regulators. It then briefly reviews the history of the Indonesian banking industry and examines the deregulation efforts made by the Indonesian government since 1983. This Article also discusses the general impact that deregulation has had on the financial strength of banks in Indonesia, and the Indonesian government's response to the more detrimental effects of deregulation. Finally, this Article compares the deregulation of the Indonesian banking industry with banking liberalization programs in other Southeast Asian countries.

2. THE REGULATORY FRAMEWORK OF THE BANKING INDUSTRY

The Indonesian government exercises control over the country's banking industry through the direct ownership of the state-owned banks and through the regulation of the entire banking sector. The principal statute governing banks in Indonesia is the Banking Law.\textsuperscript{30} The Banking Law regulates all aspects of Indonesian banking, including the classification and listing of permitted activities,\textsuperscript{31} licensing,\textsuperscript{32} ownership,\textsuperscript{33} supervision,\textsuperscript{34} and manage-

\textsuperscript{29} For example, in 1992, when private banks were first established in Taiwan, they were required to retain 30\% of their earnings as legal reserves and were prohibited from paying dividends in excess of 15\% of earnings until their accumulated reserves equaled their total paid-in capital. See Jane K. Winn, \textit{Banking and Finance in Taiwan: The Prospects for Internationalization in the 1990s}, 25 INT'L LAW. 907, 935 (1991).

\textsuperscript{30} Law No. 7 of Mar. 25, 1992.


\textsuperscript{32} Chapter IV of the Banking Law of 1992 authorizes the Minister of Finance to grant banking licenses, subject to certain requirements with respect to the organizational composition, capital, ownership, and business plan of the applicant, as well as other matters. \textit{Id.}
The 1992 enactment of the Banking Law was a response to the perception that the Basic Banking Law of 1967 provided an insufficient legal framework for the banking industry in light of the accelerating pace of financial developments in Indonesia. Specifically, the government enacted the Banking Law to restructure the banking industry and correct its problems by: (1) decreasing the number of types of banks, thus reducing the confusion over the scope of activities of each type of bank; (2) stipulating and clarifying the licensing and ownership requirements for banks; (3) improving governmental control over bank lending and capital adequacy policies and procedures; and (4) emphasizing training and professionalism among bank officers and directors.

The Banking Law permits the establishment of only two kinds of banks, general commercial banks and rural credit banks. The rural credit banks are confined to a more limited range of activities than the general commercial banks, as they are restricted to receiving deposits and extending loans. In addition to those basic banking

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33 Chapter IV of the Banking Law of 1992 regulates the ownership of banks, including the level of foreign control. Id.
34 Chapter V of the Banking Law of 1992 delegates primary authority for the supervision of banks to Bank Indonesia. Id.
35 Chapter VI of the Banking Law of 1992 provides requirements for the composition of the Board of Commissioners and Board of Directors of banks. Id.
38 See PDD Dermawan, Banking System to Be Restructured, INT'L FIN. L. REV., Sept. 1991, at 44.
40 See Sullivan, supra note 31, at 21-22. The rural credit banks also may engage in financial transactions involving profit sharing. Id. See Osama Mohamed Ali, Making Sense of Islamic Banking, INT'L FIN. L. REV., June 1992, at 30, 31 (discussing profit-sharing schemes in Islamic financing). In the past few years, the Indonesian government has approved the establishment of an Islamic bank called Bank Muamalet Indonesia and has been increasingly supportive of Islamic banking. See Kenneth L. Whiting, No Interest on Deposits, Loans: Instead, New Indonesian Bank Makes Political Profits, CHI. TRIB., Sept. 20, 1992, at 9.
services, the general commercial banks are authorized to engage in certain types of securities transactions; custodial, receiving agent, paying agent, and trust services; and credit cards issuance.

In order to standardize the banking sector further, the Banking Law requires that each commercial bank be organized as either a state-owned limited liability company, a privately owned limited liability company, a provincial government company, or a cooperative. Prior to the enactment of the Banking Law, each of the seven state-owned banks was established by, and operated in accordance with, its own unique legislation. To comply with the Banking Law, each state-owned bank reorganized as a state-owned limited liability company in June 1992.

The Banking Law also imposed stricter standards on banks with respect to licensing, ownership, and lending policies than its predecessor, the Basic Banking Law. These new standards, and the degree to which they have improved the strength and integrity of the Indonesian banking industry, will be discussed below.

41 See Sullivan, supra note 31, at 21. The types of instruments that general commercial banks may buy, sell, and underwrite include: (1) bank bills with a bank acceptance and a term not exceeding one year; (2) short term commercial paper not exceeding one year; (3) Bank Indonesia Certificates; (4) Indonesian treasury paper and government guaranteed certificates; and (5) bonds. Id.

42 Id.


44 Id. Each state-owned bank was a unique legal entity that was not subject to the general commercial laws of Indonesia. Id. Therefore, the general commercial laws could not mandate that the state-owned banks take actions, such as increasing their capital requirements. Rather, such actions could be accomplished only through acts of the legislature. Id.

45 Id. The seven banks converted to state-owned limited liability companies pursuant to special regulations promulgated on April 29, 1992, under Article 54(1) of the Banking Law. See PDD Dermawan, Banking Law Regulations Issued, INT'L FIN. L. REV., June 1992, at 41. Under these regulations, a new state-owned limited liability company was established to correspond to each bank. Id. Simultaneously, the corresponding bank dissolved and all of the rights, obligations, assets, and employees of such bank at the time of dissolution were transferred to the relevant state-owned limited liability company. Id. The Minister of Finance appointed the members of the initial Boards of Directors and Boards of Commissioners of the new state-owned limited liability companies. Id.
In addition to the Banking Law, banks are subject to periodic decrees, decisions, and circulars issued by the Minister of Finance and Bank Indonesia. These administrative regulations are the source of many specific operating requirements for the banks. Bank lending limits, minimum capital requirements, and asset quality evaluations, for example, are all described in circulars issued by Bank Indonesia. The banks, indirectly through the decrees of Bank Indonesia, are also subject to the capital adequacy requirements adopted by the Bank for International Settlements and, in certain areas, to supervision by the World Bank. Finally, the business activities of banks are also subject to the Indonesian Commercial and Civil Codes.

The Indonesian banking industry's primary regulators are the Ministry of Finance and Bank Indonesia. The Ministry of Finance is vested with plenary regulatory power over the entire Indonesian financial system, including the banking sector. Bank Indonesia is the country's central bank and is principally responsible for implementing the government's monetary policies by controlling the money supply, credit and foreign exchange policy, and interest

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47 Id.
49 Following the conversion of the state-owned banks into limited liability companies in 1992, the state-owned banks were recapitalized partly with funds supplied by the World Bank. See STANDARD & POOR'S RATINGS GROUP, ASEAN BANKING PROFILES: INDONESIA, Apr. 12, 1994 [hereinafter ASEAN BANKING PROFILES]. In addition to recapitalizing, each Bank adopted an “Action Plan” in cooperation with the World Bank that set out limitations on credit growth. Id.
50 The Indonesian Commercial Code of 1847, as amended, and the Indonesian Civil Code of 1847, as amended, are modeled on Dutch law as it existed in the nineteenth century. See DOING BUSINESS IN INDONESIA, supra note 48, at 88. Both the Commercial Code and the Civil Code contain provisions applicable to banks. The Civil Code, for example, provides for the creation of mortgage-type security interests in, and foreclosure on, collateral pledged to secure the payment of a debt. Id. at 69. In addition, Art. 1365 of the Civil Code, which imposes liability for the loss of the property or person of another, could be the basis of a lender liability claim, although this has not yet been used as a basis for such a claim. See Sullivan, supra note 31, at 26.
51 See DOING BUSINESS IN INDONESIA, supra note 48, at 73.
In addition, Bank Indonesia is responsible for the supervision of the banks and the daily regulation and administration of the banking system. The government recently established a third regulatory body in response to the high percentage of nonperforming loans held by Indonesian banks. In 1993, government officials formed a credit supervision committee, composed of senior officials from both the Ministry of Finance and Bank Indonesia, to monitor the status of problem loans. This committee works in conjunction with the Indonesian Attorney General's office to identify significant nonperforming loans and to investigate allegations of fraud and negligence on the part of bank officers and regulators.

Finally, to the extent that banks are participants in the Indonesian securities markets as issuers, buyers, sellers, or underwriters of securities, they are regulated partly by BAPEPAM, Indonesia's central securities regulatory agency. Banks that are listed on the Indonesian Stock Exchange periodically are required to submit audited financial statements to BAPEPAM.

See id. at 60. There is also a group of senior government economic advisers, called the “Monetary Council,” which is responsible for advising the President and other government officials on monetary policy. The Monetary Council can request reports from Bank Indonesia on monetary policy issues.

Bank Indonesia evaluates banks on the basis of the CAMEL system. CAMEL is an acronym for the following factors: capital, asset quality, management competence, earnings, and liquidity. The relative weight that Bank Indonesia assigns to each factor is changed periodically. On the basis of its evaluation, Bank Indonesia assigns each bank a rating of either sound, fairly sound, poor, or unsound.

Banks generally are required to prepare audited financial statements in accordance with an accounting standard known as the Special Standard for Application of Bank Accounting in Indonesia (“SKAPI”). SKAPI, which was developed by Bank Indonesia and the Indonesian Accounting Association in 1993, increased the level of financial disclosure required by banks and, in certain areas, standardized the accounting methodology used by state-owned banks and private banks. In general, the degree of financial disclosure and level of accounting practices required of publicly listed banks regulated by BAPEPAM is higher than that of...
3. DEREGULATION OF THE INDONESIAN BANKING SECTOR

3.1. Historical Background

The development of a modern banking system in Indonesia can be traced to the mid-1800s, when Indonesia was a Dutch colony known as the Dutch East Indies. Banks were established to assist Dutch companies with the financing of their trading activities. Dutch colonial rule over Indonesia continued until 1942, when the Indonesian islands were occupied by the Japanese military. After the withdrawal of the Japanese at the end of World War II, the Dutch attempted to reassert sovereignty over Indonesia, but were opposed by an indigenous independence movement. The Dutch ultimately recognized Indonesian independence in 1949.

In 1946, the revolutionary government established Indonesia's first state-owned bank, Bank Negara, as part of the independence movement. Bank Negara was the country's central bank as well as its principal commercial bank. Over the following two decades, the Indonesian government nationalized a number of Dutch-owned banks in the country and incorporated them into Bank Negara.

Development of the banking system during this period was very limited, however, because of the severe economic and political instability that the country was experiencing at that time. In 1957, President Sukarno declared martial law, which lasted until 1964. An unsuccessful coup attempt by the army in 1965 led to a period of bloody strife in which hundreds of thousands of Indonesians were killed. Given the unstable political environment, it is not surprising that the development of the banking system was

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other banks. Id. For a general discussion on Indonesian accounting practices, see DOING BUSINESS IN INDONESIA, supra note 48, at 117.

57 See ASEAN BANKING PROFILES, supra note 49.
58 For a brief review of Indonesian history, see DOING BUSINESS IN INDONESIA, supra note 48, at 3-4.
59 See ASEAN BANKING PROFILES, supra note 49.
60 Id.
61 Id.
62 See DOING BUSINESS IN INDONESIA, supra note 48, at 4.
not a priority for the government. 64

Following the establishment of the Suharto government in 1967, Indonesia entered a period of increased economic growth and political stability. 65 This period of relative stability led to the introduction of a number of structural economic reforms, including those in the banking system. The most important early banking reform was the promulgation of the Basic Banking Law in 1967. 66 This law and the additional regulations and decrees required for its implementation created the regulatory framework for the banking industry. This framework lasted until the enactment of the Banking Law in 1992. 67

In connection with the enactment of the Basic Banking Law, the Indonesian government replaced Bank Negara as the country's central bank with the newly established Bank Indonesia in 1968. 68 Bank Indonesia was set up strictly as a central bank and, unlike Bank Negara when it held that position, was not permitted to perform commercial banking functions. 69 In addition to being charged with the general development and supervision of the banking industry, Bank Indonesia set interest rates for both loans and deposits and controlled the lending activities of state-owned banks by setting credit ceilings for each institution. 70

The Indonesian government also enacted a series of laws that reversed the earlier integration of the nationalized banks into Bank Negara. 71 This resulted in the creation of seven separate state-owned banks, including Bank

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64 By the end of President Sukarno's rule in 1967, the Indonesian economy was in shambles, with an annual per capita GNP that was half the size of India's. Id. at 3.

65 The Indonesian economy during President Suharto's regime has averaged annual GNP growth of approximately 7%. See id. at 3.


68 See ASEAN BANKING PROFILES, supra note 49.

69 See Indonesia: Finance, ECONOMIST INTELLIGENCE UNIT COUNTRY PROFILE, Dec. 1, 1993, available in LEXIS, Asiapc Library, ALLASI File [hereinafter INDONESIA COUNTRY PROFILE] (noting that the integration of the nationalized banks and the central bank, namely Bank Negara, "into a single administrative unit meant that the banking system became little more than a conduit for channelling freshly printed currency into the economy").

70 See ASEAN BANKING PROFILES, supra note 49.

71 See INDONESIA COUNTRY PROFILE, supra note 69.
Each of the seven state-owned banks was established and governed by its own separate law and was responsible for the development of a specific sector of the national economy.

The Basic Banking Law also provided foreign banks with limited access to the Indonesian banking market. Prior to the enactment of the Basic Banking Law, there were no foreign banks operating in the country, the last such bank having ceased operations in 1964. Although foreign ownership of domestically incorporated banks was prohibited, the Basic Banking Law permitted foreign banks to establish branch or representative offices in Indonesia, subject to the approval of the Ministry of Finance. After the enactment of the Basic Banking Law, however, only ten foreign banks established branch offices in Indonesia.

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72 See ASEAN BANKING PROFILES, supra note 49.
73 See id. Each of the seven banks was involved with developing a specific sector of the national economy: 1) Bank Negara Indonesia - industry; 2) Bank Dagang Negara - mining; 3) Bank Bumi Daya - agriculture and forestry; 4) Bank Rakyat Indonesia - agriculture and fishing; 5) Bank Ekspor Impor - foreign trade; 6) Bank Tabungan Negara - national savings bank; and 7) Bapindo - national development bank. Id. The specialization of the banks has since been reduced by time and deregulation. See INDONESIA: BANKING, U.S. DEPT OF THE TREASURY, NATIONAL TREATMENT STUDY 317 (1994) [hereinafter NATIONAL TREATMENT STUDY].
74 See INDONESIA COUNTRY PROFILE, supra note 69.
75 Article 8 of the Basic Banking Law required shares of a domestically-incorporated bank to be wholly owned by either Indonesian individuals or corporate bodies. See Mitchell, supra note 37, at 3.
76 Law No. 14 of 1967, arts. 19 & 20. See Robert Hornick, Foreign Banking in Indonesia, 6 NW. J. INT'L L. & BUS. 760, 774 (1984) (discussing the regulation of foreign banks under the Basic Banking Law). Under the Basic Banking Law and the regulations and decrees promulgated in connection therewith, foreign bank branches could be licensed to engage in any activity in which a domestic general bank could engage, subject to the restriction that foreign bank branches could only be established and do business in Jakarta. Id. at 765-66. In contrast, representative offices were only permitted to engage in a limited set of activities, and were expressly prohibited from taking deposits or making loans. Id. at 776.
77 See Hornick, supra note 76, at 762 n.3. Among the ten foreign banks that established branch offices in Indonesia were four from the United States: Chase Manhattan, Citibank, American Express Bank, and Bank of America. Id. The other foreign banks that established branch offices in Indonesia prior to 1972 were Bank of Tokyo, Hong Kong & Shanghai Bank, Bangkok Bank, The Chartered Bank, Algemene Bank Nederland (now ABN-AMRO Bank), and the European-
1970, the Indonesian government imposed a ban on new foreign bank branches which remained in effect for the next eighteen years.\textsuperscript{78}

The Basic Banking Law also permitted the establishment of a number of private commercial banks in the country.\textsuperscript{79} The majority of the private banks, however, were small in comparison with their state-owned counterparts. For example, although the total number of private commercial banks had grown to approximately seventy by 1984, collectively they controlled less than one-fourth the amount of the financial assets of the seven state-owned banks.\textsuperscript{80}

The system created by the banking reforms during the late 1960s, therefore, was highly regulated, with interest rates, credit ceilings, and strict market entry barriers imposed by Bank Indonesia. The system was also dominated by a small number of state-owned institutions. These factors made the banking system an inefficient allocator of funds for the rapidly expanding Indonesian economy.

During the late 1970s and early 1980s, Bank Indonesia set interest rates on deposits at an artificially low level to keep the cost of capital low for the state-owned banks.\textsuperscript{81} As a result, a great deal of private capital remained outside of the banking system, and the state-owned banks were funded principally by liquidity credits from the government.\textsuperscript{82} In addition, the Indonesian government used state-owned banks primarily as vehicles to finance the government's economic development objectives.\textsuperscript{83} Thus, government directives, rather than market principles, allocated credit from the state-owned banks.

\begin{thebibliography}{99}
\bibitem{Asian Bank} Id.
\bibitem{Mitchell} Mitchell, \textit{supra} note 37, at 3. The "ban" was in the form of a decision by the Indonesian government to temporarily discontinue the implementation of Article 20 of the Basic Banking Law, which permitted foreign bank branches. \textit{See id.}
\bibitem{See INDONESIA COUNTRY PROFILE} \textit{supra} note 69.
\bibitem{See Kieran Cooke, Indonesia: Moves to Mobilise Domestic Funds, FIN. TIMES, May 29, 1984, at 27.}
\bibitem{Telephone Interview} Telephone Interview with Fahmila Imam, Financial Economist, Export-Import Bank of the United States (Apr. 2, 1995) [hereinafter Imam Interview].
\bibitem{Id.} \textit{Id.}
\bibitem{See, e.g., ASEAN BANKING PROFILES, \textit{supra} note 49.}
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Furthermore, the government's use of state-owned banks to fund its development goals resulted in the growth of a number of practices that had negative effects upon the state-owned banking sector. Such practices included state-owned banks extending credit on the recommendation of powerful officials rather than on a thorough credit analysis of the borrower, and borrowers from state-owned banks viewing loans as forms of development assistance from the government rather than as obligations to be repaid.

3.2. Deregulation Efforts

By 1983, the Indonesian government began to recognize that the over-regulation and lack of maturity of the banking system was impeding the development and modernization of the economy. Official recognition of these impediments was spurred partly by the sharp decline of the international price of oil, Indonesia's principal export commodity, in 1982 and 1983. As oil prices fell and the Indonesian economy weakened, the government realized that the lack of an efficient domestic banking system was hampering the country's economic development and making it overly dependent on foreign borrowing.

In an effort to address the perceived weaknesses of its banking system, the Indonesian government introduced three major banking reforms in 1983. The reforms enacted by Bank Indonesia included: (1) abolishing Bank Indonesia's control over interest rates on deposits and loans; (2) eliminating credit ceilings for state-owned banks; and (3)

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84 See McBeth, supra note 21, at 25; Saragosa, supra note 21, at 6; Shale, supra note 20, at 20.
85 See Shale, supra note 20, at 20. The confusion over the repayment obligation appeared to be particularly acute when the borrower was also a state-controlled enterprise. Imam Interview, supra note 81.
86 See ASEAN BANKING PROFILES, supra note 49.
87 In 1982-83, Indonesia's earnings from oil exports fell by 24%, which at that time represented 70% of the country's total export earnings. See Indonesia: Gaining from the Oil Glut, ECONOMIST, Sept. 24, 1983, at 90; Indonesia Aborts Its Push for Heavy Industry, BUS. WK., June 20, 1983, at 48; Richard Cowper, Indonesian Borrowing Status Cast in a Gloomier Light, FIN. TIMES, Feb. 24, 1983, at 23 (discussing the fall of international oil prices and its effect on the Indonesian economy in the early 1980s).
88 ASEAN BANKING PROFILES, supra note 49.
phasing out the practice of funding state-owned banks by means of government liquidity credits.99 The reforms were intended to create a more market-oriented banking system that would attract a larger amount of domestic funds.90

The 1983 reforms had a number of positive effects on the development of the banking sector. Freeing interest rates on deposits, for example, succeeded in drawing more funds into the banking system. After the reforms were enacted in June 1983, interest rates offered by the state-owned banks rose over 20%.91 By the end of the year, the total amount of money held in time deposits at state-owned banks was almost 90% greater than the amount held at the end of 1982.92

In addition, phasing out liquidity credits forced the state-owned banks to compete directly with privately owned banks for alternate sources of funding.93 Faced with a more competitive banking environment, the state-owned banks began to modernize their operations and improve the quality and types of services that they provided.94

The Indonesian government enacted additional sweeping reforms that further liberalized the banking industry in October 1988. As was the case in 1983, the 1988 reforms came at a time when the international price of oil was falling.95 Through the reforms, the Indonesian government sought to create a more efficient financial system that would be better able to mobilize domestic funds and that would bolster the development of the non-oil sectors of the economy.96

99 Id.
90 See, e.g., Cooke, supra note 80, at 27.
91 See DOING BUSINESS IN INDONESIA, supra note 48, at 72.
92 See Cooke, supra note 80, at 27.
93 See ASEAN BANKING PROFILES, supra note 49.
94 See Cooke, supra note 80, at 27; see also ASEAN BANKING PROFILES, supra note 49.
96 See Brown, supra note 95, at 6; see also Jonathan Thatcher, Indonesia Unveils Sweeping Bank Reforms, Oct. 27, 1988, available in LEXIS, Asiapc Library, REUWLDP File. The Indonesian economy has become steadily less dependent on the oil industry since the early
The banking reforms were part of a deregulation package known as PAKTO '88, which made numerous specific changes to the regulatory structure of the banking industry. The central aims of the reforms were to inject a greater level of competition into the banking sector and to increase credit availability throughout the country.

One key element of PAKTO '88 was the easing of restrictions on foreign banks. For example, foreign banks already operating branch offices in Jakarta were permitted to open subbranches in each of the country’s seven other major cities: Surabaya, Semarang, Bandung, Medan, Ujung Pandang, Denpasar, and Batam Island. Previously, foreign banks that were licensed to operate a branch office in Indonesia were restricted to operating only in Jakarta.

In addition, PAKTO '88 permitted foreign and Indonesian banks to establish joint ventures together, subject to a number of conditions. Among the more significant of these conditions was the requirement that each joint venture bank have a minimum paid-in capital of 50 billion Indonesian rupiah ($25 million), with the Indonesian partner supplying at least 15% of that amount. Also, export credits had to constitute at least 50% of a joint venture bank's total loan portfolio within one year of the bank’s establishment.

At that time, oil and gas accounted for roughly 80% of the country’s export earnings. By 1994, that figure had fallen to 26%. See McBeth, supra note 10, at 71.

PAKTO '88 is the name given to the policy package released by Bank Indonesia on October 27, 1988. See ASEAN BANKING PROFILES, supra note 49. For a general description of PAKTO '88, see Deregulating Indonesia: It’s the Banks’ Turn, E. ASIAN EXECUTIVE REP., Nov. 15, 1988, at 9 [hereinafter Deregulating Indonesia].

Subbranches are permitted to accept deposits and cash checks, but are not allowed to engage in other banking businesses, such as lending funds. See NATIONAL TREATMENT STUDY supra note 73, at 322.

The minimum paid-in capital requirement for new foreign joint venture banks was later raised to 100 billion rupiah. See NATIONAL TREATMENT STUDY, supra note 73, at 321.

The foreign partner was required to be classified as a “major” bank in its home country and the foreign bank’s home country.
PAKTO '88 also eased the restrictions on opening new private banks. New private commercial and development banks could be established, subject to a minimum paid-in capital requirement of 10 billion Indonesian rupiah (approximately $6 million).\(^\text{105}\) Moreover, existing domestic banks, both private and state-owned, were permitted to establish additional full-service branches throughout the country provided that they were able to meet certain criteria for financial soundness.\(^\text{105}\) Existing banks were permitted to open support branches simply by notifying Bank Indonesia.\(^\text{107}\) Another change enacted by PAKTO '88 was that state-owned, nonbanking business enterprises were permitted to place up to 50% of their funds with both foreign and domestic private banks, with a maximum of 20% placed with any one such bank.\(^\text{108}\) Previously, state-owned enterprises had been required to deposit their funds solely with state-owned banks. The reforms also reduced the minimum Bank Indonesia liquidity reserve requirement for banks from 15% to only 2%,\(^\text{109}\) and lowered the previously existing barriers to banks becoming licensed as foreign exchange banks.\(^\text{110}\) Finally, the reforms imposed maximums on the percentage of a bank's capital that could be

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\(^{105}\) PAKTO '88 extended the validity of licenses for foreign exchange dealers indefinitely, whereas previous licenses were available for only one year periods. \textit{Id.} at 9.

\(^{106}\) \textit{Id.} at 18. On the adequacy of this minimum paid-in capital requirement, see Shale, \textit{supra} note 5, at 56. The minimum paid-in capital requirement has since been raised to 50 billion Indonesian rupiah for non-foreign exchange commercial banks and 100 billion rupiah for commercial banks that are licensed to engage in the foreign exchange business. \textit{ASEAN BANKING PROFILES, supra} note 49.

\(^{107}\) \textit{See Deregulating Indonesia, supra} note 97, at 18. To open additional branches, banks needed to be categorized as "sound" for at least 20 of the preceding 24 months and no worse than "sufficiently sound" for the remaining months. \textit{Id.}

\(^{108}\) \textit{Id.} at 18. It was estimated at the time of this change that 5 trillion Indonesian rupiah were available for deposit by state-owned enterprises in foreign and/or domestic private banks. \textit{See} Jonathan Friedland, \textit{No More Coddling: Indonesia Opens Up Banking Sector to Competition}, FAR \textit{E. ECON. REV.}, Nov. 10, 1988, at 68, 70.

\(^{109}\) \textit{See Deregulating Indonesia, supra} note 97, at 19.

\(^{110}\) \textit{Id.} at 17. PAKTO '88 extended the validity of licenses for foreign exchange dealers indefinitely, whereas previous licenses were available for only one year periods. \textit{Id.}
lent to any single borrower or affiliated group of borrowers and permitted the establishment of credit banks in districts outside of Jakarta in order to increase the availability of credit in rural areas.

Continuing the banking sector reforms which began with PAKTO '88, Bank Indonesia introduced ancillary banking reform packages in each of the following two years. In March 1989, the central bank enacted a reform package known as PAKMAR which eliminated the ceilings previously imposed on the amount of offshore borrowing by foreign exchange banks. Subsequently, in January 1990, Bank Indonesia enacted an additional banking reform package known as PAKJAN. The main element of PAKJAN was an instruction to banks to allocate at least 20% of their credit portfolios to small-scale business lending.

PAKTO '88, together with PAKMAR and PAKJAN, resulted in explosive growth in the Indonesian banking sector with respect to both the number of banks operating in the country and the amount of credit extended by the banking industry. For example, the opening of the privately owned banking market to new entrants, combined with the expansion of existing banks' branch networks, led to a

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111 See id. at 18. The lending limits were as follows: to an individual borrower, 20% of the bank's capital; to an affiliated group of companies, 50% of the bank's capital; to a member of the bank's Board of Directors or supervisory board who is not a shareholder of the bank (or to a company owned by such a board member), 5% of the bank's capital; to a member of the bank's Board of Directors or supervisory board who is not a shareholder of the bank and to an affiliated group of companies owned by such a board member, 15% of the bank's capital; to a shareholder of the bank or a company owned by a shareholder, 10% of such shareholder's equity holding in the bank; to a shareholder of an affiliated group of companies owned by a shareholder, 25% of such shareholder's equity holding in the bank; to directors or employees of the bank, various percentages based on the individual's remuneration from the bank and the individual's ability to repay. Id.

112 See id. The rural credit banks were put under the direct supervision of Bank Rakyat Indonesia, which was under the guidance of ASEAN BANKING PROFILES, supra note 49.

113 See ASEAN BANKING PROFILES, supra note 49. In place of offshore borrowing ceilings, PAKMAR required foreign exchange banks to "maintain a net open foreign exchange position of no more than 25% of shareholder's equity." Id.

114 See id.

115 See id.
rapid growth in the number of private banks.\textsuperscript{116} Between 1988 and 1992, the number of private banks more than doubled, growing from 63 to 134.\textsuperscript{117} Many of the new private banks were established by Indonesian conglomerates, which in many cases viewed establishing a bank as a cost-effective way to fund the conglomerate's own business activities.\textsuperscript{118}

The amount of outstanding credit extended by the banking sector also grew at a high rate. Credit grew by 53.8\% in 1989-90, and by 40.3\% in 1990-91.\textsuperscript{119} The credit expansion was fueled by the rapidly increasing number of banks and bank branches, the corresponding increase in competition in the banking industry, and the reduction of the liquid reserve requirement to only 2\% of bank capital. The lower liquid reserve requirement meant that each bank had more capital available for lending.\textsuperscript{120} Credit growth in the years immediately following PAKTO '88 was mainly attributable to the domestic private banks. Between 1988 and 1993, for example, the private banks' relative market share of outstanding credit increased from 23.1\% to 41.7\%, while the relative market share of the state-owned banks decreased from over 71\% to 52.7\%.\textsuperscript{121}

Moreover, although PAKTO '88 increased the presence of foreign institutions in the Indonesian banking market,\textsuperscript{122} foreign banks continued to play a relatively minor

\textsuperscript{116} See Julia Leung, Indonesia's Banks Taste Sour Side of Deregulation, \textit{Asian Wall St. J. Wkly.}, Dec. 21, 1992, at 1, 5; see also ASEAN BANKING PROFILES, \textit{supra} note 49.

\textsuperscript{117} See Leung, \textit{supra} note 116, at 5. Private banks also account for approximately 90\% of the new bank branches that have been established in Indonesia since 1988. \textit{See NATIONAL TREATMENT STUDY, supra} note 73, at 318.

\textsuperscript{118} See Shale, \textit{supra} note 5, at 55. Two of the largest private banks in Indonesia, Bank Central Asia and Bank Internasional Indonesia, were established by large Indonesian industrial conglomerates. \textit{See ASEAN BANKING PROFILES, supra} note 49. Bank Central Asia was created by the Salim Group and Bank Internasional Indonesia by the Sinar Mas Group. \textit{Id.}

\textsuperscript{119} See ASEAN BANKING PROFILES, \textit{supra} note 49.

\textsuperscript{120} See Leung, \textit{supra} note 116, at 5.

\textsuperscript{121} See \textit{NATIONAL TREATMENT STUDY, supra} note 73, at 323.

\textsuperscript{122} Although the number of foreign banks operating an independent branch in the country has remained constant at 10, the number of joint venture banks rose from one before the enactment of PAKTO '88 to 29
role in the banking sector. Branches of foreign banks as well as foreign joint venture banks in Indonesia have tended to concentrate on "wholesale corporate business and serving the needs of their global clients" in the country, rather than on domestic retail business.\textsuperscript{123} As a consequence, foreign banks represent a very small segment of the Indonesian banking market. In 1993, for example, lending by foreign and joint venture banks only accounted for 3.6% of all outstanding bank credit.\textsuperscript{124} The assets held by the largest foreign bank in Indonesia, Citibank, only accounted for roughly 1% of total commercial bank assets.\textsuperscript{125}

### 3.3. Effect of Deregulation on the Financial Strength of Indonesian Banks and the Government's Response

The rapid growth of the banking industry following the deregulation of the late 1980s left many Indonesian banks in a weak financial position. For many banks, credit expansion was achieved at the expense of credit quality.\textsuperscript{126} As a result, the aggressive credit growth between 1988 and 1990 caused the overall loan quality of the Indonesian banking system to deteriorate substantially.\textsuperscript{127} In 1991, for example, the percentage of loans classified as "bad" or as of July 1994. This information was based on statistics supplied to the author by the law firm of Makarim & Taira S., Jakarta, Indonesia. The only foreign joint venture bank existing prior to PAKTO '88 was Bank Perdania, a Japanese - Indonesian joint venture. See Hornick, \textit{supra} note 76, at 771 n.41. There has also been an increase in the number of representative offices of foreign banks in Indonesia since 1988, including the opening of representative offices by seven banks based in the United States: Chemical Bank, J.P. Morgan, Bank of Boston, Bank of California, Philadelphia National Bank, Republic National Bank, and Bankers Trust. See \textit{NATIONAL TREATMENT STUDY}, \textit{supra} note 73, at 321.

\textsuperscript{123} \textit{ASEAN BANKING PROFILES}, \textit{supra} note 49. In some limited areas, however, the foreign banks have become market leaders. For example, in 1994 foreign banks were the leading providers in Indonesia of security custodial services for local and foreign fund managers. See Habir, \textit{supra} note 54, at 60. Foreign banks are also active in offshore commercial loans and as issuers of debt and equity instruments for Indonesian companies. \textit{Id.}

\textsuperscript{124} \textit{See NATIONAL TREATMENT STUDY}, \textit{supra} note 73, at 323.

\textsuperscript{125} \textit{See ASEAN BANKING PROFILES}, \textit{supra} note 49.

\textsuperscript{126} Imam Interview, \textit{supra} note 81.

\textsuperscript{127} \textit{See ASEAN BANKING PROFILES}, \textit{supra} note 49; Leung, \textit{supra} note 116, at 5.
“doubtful” made by all Indonesian banks increased by more than 50% from the year before to 5.9% of total loan portfolios.\(^{128}\)

Deteriorating loan quality was a problem that affected both state-owned banks and private banks. Both types of banks lacked sufficient staff experienced in credit analysis.\(^{129}\) Despite this similarity, however, the root of the bad debt problems for the two types of banks differed greatly. The bad loans accumulated by the state-owned banks were primarily the result of making loans based on political, rather than financial grounds,\(^{130}\) and the fact that customers of state-owned banks felt little or no pressure to repay their obligations.\(^{131}\)

For private banks, many bad debt problems stemmed from excessive lending to the bank’s controlling shareholders. Conglomerates and business groups that established banks in response to the PAKTO ’88 reforms often used their “in-house” banks as a source of inexpensive capital.\(^{132}\) As captive lenders to their corporate groups, many private banks made loans to affiliated companies without proper credit analysis.\(^{133}\) Although PAKTO ’88 limited the proportion of a bank’s capital that could be lent to a single borrower or affiliated group of borrowers, these limits were often exceeded.\(^{134}\) At the time of the collapse of Bank Summa in 1992, for example, government regulators alleged that an extremely high percentage of the bank’s

\(^{128}\) See William Keeling, Indonesian Banks Face Pressures, FIN. TIMES, June 3, 1992, at 4. Bank Indonesia classifies loans for which repayment is uncertain as “sub-standard,” “doubtful,” or “bad”. See ASEAN BANKING PROFILES, supra note 49. One analyst believed that Bank Indonesia underreported the extent of the problems with their non-performing debts and that the actual percentage of bad or doubtful loans was much higher than reported. See Suwito, supra note 18.

\(^{129}\) See Leung, supra note 116, at 5.

\(^{130}\) See Keeling, supra note 128, at 4.

\(^{131}\) See Field, supra note 18, at 253.

\(^{132}\) Id.

\(^{133}\) See ASEAN BANKING PROFILES, supra note 49.

\(^{134}\) See Field, supra note 18, at 254. The problem of excessive loan concentration also affected the state-owned banks. For example, in 1993, it was reported that the aggregate amount of credit extended to one Indonesian conglomerate, the Barito Pacific Group, by three state-owned banks, Bank Dagang Negara, Bank Bumi Daya, and Bapindo, was over four times the maximum permissible amount. Id.
nonperforming loans were to affiliated companies in the Summa Group.\textsuperscript{135}

In response to the deteriorating financial position of many Indonesian banks, the Indonesian government began to take action in 1991 to bolster the stability and loan quality of the country's banking system. In its initial effort to limit further credit growth and reduce bank liquidity, the government tightened monetary policy and succeeded in pushing interest rates above 25\% by the beginning of 1991.\textsuperscript{136}

Interest rate increases alone, however, did not prove to be sufficient to slow down credit expansion, primarily because Indonesian banks reacted to higher domestic interest rates by increasing offshore borrowing.\textsuperscript{137} The Indonesian government, therefore, took a number of additional steps to curb credit growth. The government directly reduced liquidity from the banking system in February 1991 by requiring state-owned banks to purchase large amounts of Bank Indonesia certificates.\textsuperscript{138} Additionally, the government instructed state-owned enterprises to withdraw a certain portion of their funds from the state-owned banks.\textsuperscript{139}

The government also introduced new controls on offshore borrowing. These controls included the establishment of a new governmental body known as the Foreign Commercial Debt Management Coordinating Team ("FCDMCT"), which set a ceiling on the aggregate amount of funds that could be raised by offshore commercial loans within any particular

\textsuperscript{135} See Shale, \textit{supra} note 5, at 55.
\textsuperscript{136} See id. The tightening of monetary policy became known as the "Sumarlin Shock," named after then Finance Minister Johannes Sumarlin. \textit{Id.}
\textsuperscript{137} See ASEAN BANKING PROFILES, \textit{supra} note 49. Each year between 1988 and 1991, offshore borrowing constituted a larger source of all commercial bank funding than the year before, growing from 0.4\% in 1988 to 4.5\% in 1991. \textit{Id.}
\textsuperscript{138} See Paving the Way, \textit{supra} note 1, at 6. This policy was reported to have succeeded in withdrawing approximately 8 trillion Indonesian rupiah from general circulation. \textit{Id.} Bank Indonesia certificates are known as "SBIs", and they were first introduced in 1984. See INDONESIA COUNTRY PROFILE, \textit{supra} note 69. The SBIs are discount instruments with varying maturities and different denominations which can be traded among banks. \textit{Id.}
\textsuperscript{139} See ASEAN BANKING PROFILES, \textit{supra} note 49.
borrowing. These controls included the establishment of a new governmental body known as the Foreign Commercial Debt Management Coordinating Team ("FCDMCT"), which set a ceiling on the aggregate amount of funds that could be raised by offshore commercial loans within any particular year. The prior approval of the FCDMCT was also required before certain types of institutions could borrow from offshore lenders.

In addition, the government imposed stricter prudential standards on banks in a number of areas. The new prudential standards enacted by Bank Indonesia in February 1991, known as PAKFEB, were aimed at controlling credit growth and strengthening the central bank's supervisory role over banks in order to better ensure the soundness of the banking system. The standards covered many different areas, including capital adequacy, reserve requirements, and loan loss provisioning. For the most part, the standards were drafted for banks as targets to be met by certain prescribed dates. For example, banks were required to attain a minimum risk weighted capital ratio of 7% by March 1993 and 8% by December 1993.

The establishment of the FCDMCT and the enactment


141 See Cornwell & Huber, supra note 140, at 45. The government required all borrowers, even those not subject to the prior approval requirement, to submit periodic reports to the FCDMCT describing their offshore borrowing. Id.

142 See ASEAN BANKING PROFILES, supra note 49.

143 See id.

144 See id. The following six points have been identified as the principal objectives of PAKFEB: (1) "to establish operational rules and regulations" for banks; (2) "to improve the supervisory system so that it efficiently acts as an early warning system;" (3) "to develop a method by which a bank's financial condition can be determined objectively;" (4) "to establish an effective guidance mechanism for banks;" (5) "to sanction implementation and a problem-solving alternative for banks experiencing difficulties;" and (6) "to improve the support systems to achieve increased efficiency in the banking system." Id.

145 See id.
work that was too lax. The government's admission should not be seen, however, as evidence that the entire deregulation effort was a mistake. The economic logic behind the government's decision in the 1980s to expand the banking system and expose the inefficient state-owned banks to a greater degree of competition is undeniable.

The Indonesian government did not have sufficient regulatory safeguards in place, however, when it exposed the banking sector to explosive growth with the enactment of PAKTO '88 and the other liberalization packages. For example, the minimum paid-up capital requirement of only $5 million to establish a new private bank resulted in many of the new private banks being badly undercapitalized from their creation. Similarly, the reduction of the liquidity reserve requirement from 15% to only 2% of a bank's capital meant that the accumulation of any meaningful amount of bad loans significantly increased the risk that the bank would become insolvent.

In 1991, bank regulators began to respond by attempting to impose the types of controls and prudential standards necessary to ensure a sound banking system. The precarious financial positions of many banks, particularly the state-owned ones, have forced Indonesian regulators to perform a difficult balancing act. If the government imposed standards were too strict, a number of banks might have been forced to close, thereby seriously undermining public confidence in the banking system. The banking authorities, therefore, have had to proceed cautiously with the goal of increasing banking soundness in order to avoid widespread bank failures.

See Shale, supra note 5, at 56 (arguing that PAKTO '88 and the other liberalizing reforms left the Indonesian banking industry with a regulatory structure that was "worryingly loose").

See id.

See id.

The very weak financial condition of the state-owned banks is demonstrated by the fact that in 1993 the Ministry of Finance acknowledged that over 20% of the loans held by the state-owned banks were non-performing, while in 1990 this figure was approximately 6%. See Habir, supra note 2, at 54. Out of the seven state-owned banks, Bank Negara and Bank Ekspor Impor are believed to control the strongest loan portfolios. Id.

Imam Interview, supra note 81.
Recognizing the need to strike a balance, in 1993, Bank Indonesia relaxed certain standards imposed by PAKFEB when it became clear that many banks would not be able to meet its mandated targets.\textsuperscript{151} The standards were relaxed in various ways, with Bank Indonesia extending target dates in some cases and lowering targets in others.\textsuperscript{152} For example, in order to ensure that banks would be able to meet the risk-weighted capital ratio requirements, Bank Indonesia amended its risk weighting guidelines in May 1993.\textsuperscript{153} The central bank also reduced the risk weighting of loans to state enterprises and to undisbursed assets from 100\% to 50\%.\textsuperscript{154} Bank Indonesia’s decision to relax certain standards in 1993 illustrates the extent of the problems facing the Indonesian banking sector in the wake of deregulation. The financial strength of state-owned banks in particular has continued to be weakened by high levels of nonperforming loans, low capitalization, and declining earnings.\textsuperscript{155}

Not all of the banking sector’s problems can be blamed on the deregulation efforts of the late 1980s. Two of the principal reasons for the weak loan portfolios of the state-owned banks are the politically motivated lending practices and the lack of adequate credit analysis.\textsuperscript{156} Both of these causes of weak portfolios, as well as other problems, are the direct result of the years prior to deregulation when state-owned banks were protected from private competition and were used to fund the government’s economic development objectives.

Deregulation, however, exacerbated the deterioration of the general asset quality of the banking system. The banking environment in Indonesia in the years immediately

\textsuperscript{151} See ASEA\textsc{N} BANKING PROFILES, supra note 49; see also Suhaini Aznam, \textit{Punch Drunk: Indonesian Reforms Unlikely to Spur Lending}, FAR E. ECON. REV., June 17, 1993, at 65.

\textsuperscript{152} See ASEA\textsc{N} BANKING PROFILES, supra note 49.

\textsuperscript{153} See id.

\textsuperscript{154} See Aznam, supra note 151, at 65.

\textsuperscript{155} See ASEA\textsc{N} BANKING PROFILES, supra note 49. Although these problems are well-known, the inadequate level of financial disclosure provided by the state-owned banks makes it difficult to determine the true extent of the problems. Imam Interview, supra note 81.

\textsuperscript{156} Imam Interview, supra note 81.
following the deregulation package of PAKTO ’88 had five dominant characteristics: (1) rapid credit growth; (2) a sudden influx of a large number of poorly capitalized banks; (3) a significant increase in competition among banks for customers; (4) significant overexposure of banks to single customers; and (5) a lack of adequate regulatory safeguards. Based upon these characteristics, it is not surprising that bad loans proliferated rapidly in the Indonesian banking system.

As awareness of the bad debt problem increased, the Indonesian government recognized that the deteriorating asset quality of the banking sector could become a threat to the soundness of the country’s entire financial system. Thus, while deregulation was the main goal of the banking authorities in the late 1980s, controlling credit growth and bolstering bank stability became their primary concern in the early 1990s.

3.4. Comparison with Other Southeast Asian Countries

Indonesia’s efforts to deregulate its banking sector are part of a general movement in Southeast Asia toward banking liberalization. As in Indonesia, governments throughout the region traditionally viewed banks as an instrument they could use to intervene in, and maintain control over, their economies. Either by owning banks directly or by exercising leverage over the lending decisions of private banks, many Southeast Asian governments have used their country’s banks to channel the high domestic savings of their citizens to certain favored borrowers,

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157 See ASECAN BANKING PROFILES, supra note 49.
158 See id.
158 See The Luck of the Bankers, supra note 159, at 5.
160 Domestic savings rates are on average much higher in Southeast Asia than in developed Western countries. Expressed as a percentage of GDP, the domestic savings rate as of late 1994 was 48% in Singapore, 38% in Indonesia, 37% in Thailand, and 31% in Malaysia, as compared with 28% in Germany, 19% in Canada, and 15% in both Great Britain and the United States. See BUSINESS: The 1994 Bottom Line,
often at below-market interest rates. This emphasis on government-directed lending, combined with protectionist policies that limited, and in some cases prevented, foreign and domestic competition, resulted in the proliferation of highly inefficient banking sectors throughout the region.

In recent years, many of the countries in the region have undertaken banking deregulation similar to Indonesia's program. The extent of such deregulation efforts differs from country to country. In countries that already had relatively liberal banking sectors, such as Hong Kong and Singapore, the recent reforms have been comparatively limited. In 1994, for example, Hong Kong began to deregulate the interest rates payable on time deposits, and Singapore permitted designated commercial banks to begin selling shares in privatized companies through their automated teller machines.

On the other end of the reform spectrum is Vietnam, which until the early 1990s had a completely closed and monolithic banking system. The Vietnamese banking sector is not being deregulated so much as it is being rebuilt from its foundations, so it can re-emerge as a market based system. Prior to 1990, Vietnamese banks serviced only the needs of state enterprises. Vietnam is still in the process of creating a banking system that will be widely

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162 See The Luck of the Bankers, supra note 159, at 5.
163 See Ed Paisley, Hong Kong: A Car Park with a View, FAR E. ECON. REV., Oct. 6, 1994, at 52; Hong Kong Banks: Consuming Interest, ECONOMIST, Mar. 5, 1994, at 87 (discussing the cartel-like practices of Hong Kong banks in setting interest rates). Not all the recent reforms of the Hong Kong banking system involve deregulation. The establishment of the Hong Kong Monetary Authority in 1993 actually increased the level of government supervision of banks in Hong Kong over the past few years. See, e.g., Henny Sender, Bank on Us, FAR E. ECON. REV., Nov. 17, 1994, at 66, 67. Government regulation of banking in Hong Kong, however, is still relatively lax. Id.
used by Vietnamese individuals and small businesses.\textsuperscript{167}

In the middle of this spectrum are countries such as Indonesia, Taiwan, Thailand, and Malaysia, which all have begun, to varying degrees, to dismantle restrictive banking regulations. In Taiwan, for example, a closed system of state-controlled banks was opened to private competition in 1989.\textsuperscript{168} Prior to the 1989 amendments to Taiwan’s Banking Law, every commercial bank in Taiwan was owned by either a governmental unit or by entities with close ties to the ruling Kuomintang Party.\textsuperscript{169} The government’s extremely conservative fiscal policies effectively restricted bank financing to priority sectors, such as the largest industrial borrowers.\textsuperscript{170} As a result of the government’s tight credit policies, a large-scale underground financial sector developed in Taiwan, which catered to the needs of individuals and small and medium-sized businesses that had not been able to obtain financing from regulated

\textsuperscript{167} Vietnamese banks traditionally charged high fees, paid rates of interest on deposits that were exceeded by the rate of inflation, and were highly inefficient. \textit{See} Pham, \textit{supra} note 165, at 16. As a result, many Vietnamese have preferred to use their savings to buy gold, real estate, and to the extent possible, foreign currencies, rather than deposit money with banks. \textit{Id.} In order to create a more efficient and better capitalized banking system, Vietnam is trying to channel savings into the system by restricting the use of foreign currencies in domestic transactions. \textit{Id.} The government also has permitted the establishment of joint-stock banks with up to 30% foreign ownership in hopes that foreign partners will inject capital as well as management skills into the Vietnamese banking system. \textit{See} Gene Epstein, \textit{Open for Business: Vietnam Wooing Investment from West}, \textit{BARRONS}, Apr. 11, 1994, at 34, 35; Larimer, \textit{supra} note 166, at A21; Michael Vatikiotis, \textit{Vietnam: Foreign Help Wanted}, FAR E. ECON. REV., Oct. 6, 1994, at 55; Barry Wain, \textit{North-South Rivalry, Archaic Financial Sector Hinder Emergence of Vietnam Stock Exchange}, \textit{ASIAN WALL ST. J. WKLY.}, July 19, 1993, at 1, 22.

\textsuperscript{168} \textit{See} Winn, \textit{supra} note 29, at 933.


sources.\textsuperscript{171} The underground sector includes loan sharks, underground investment houses, post-dated check discounters, and rotating credit clubs. Taiwan’s government has made reducing the size and importance of the underground financial sector one of the goals of its liberalization program.\textsuperscript{172}

The entry of private banks increased the level of competition in the banking sector, with improved access to financing for small businesses in Taiwan, and better service for all customers throughout the industry.\textsuperscript{173} The new private banks have displaced many of the underground sources of capital, which should end the era of “pawnshop banking” and increase the overall stability of Taiwan’s financial system.\textsuperscript{174}

Thailand also has begun to deregulate its banking sector and to expose the country’s domestic commercial banks to a greater degree of foreign and domestic competition.\textsuperscript{175} In 1993, for example, the government established Bangkok International Banking Facility (“BIBF”) licenses for offshore and onshore lending, with hopes of developing Bangkok as

\textsuperscript{171} See, e.g., Jonathan Friedland & Lincoln Kaye, Pennies from Heaven, FAR E. ECON. REV., Jan. 25, 1990, at 54 (reporting that as of 1990, Taiwan’s businesses obtained an estimated 40% of their financing from the underground sector).

\textsuperscript{172} Id.

\textsuperscript{173} Prior to being faced with competition from private banks, the state-run banks in Taiwan were known to offer an unsatisfactory level of customer services. See Jonathan Friedland, Customers Come First, FAR E. ECON. REV., May 7, 1992, at 72; Julia Leung, Taiwan Liberalization Sparks Influx of Banks but Some Analysts Worry about Potential Glut, ASIAN WALL ST. J. WKLY., Mar. 30, 1992, at 1, 18 (reporting that one of the state-run banks began conducting twice-weekly courtesy classes for its employees after the establishment of the private banks). The increased level of domestic banking competition in Taiwan has also led a number of commercial banks to establish foreign operations. See Shu-Ching Jean Chen, Follow the Clients, FAR E. ECON. REV., Oct. 6, 1994, at 50.


\textsuperscript{175} See, e.g., Gordon Fairclough, Spread the Wealth, FAR E. ECON. REV., Mar. 9, 1995, at 62. The combination of Thailand’s rapidly growing economy and protection from foreign competition has made Thai commercial banks some of the most profitable banks in Southeast Asia. See, e.g., Thailand’s Banks: Rising Son, ECONOMIST, Feb. 5, 1994, at 81, 82.
an international offshore banking center that could compete with Malaysia and Singapore.\textsuperscript{176} BIBF licenses, which permit foreign banks to arrange offshore loans from Bangkok in foreign currencies and, subject to certain significant restrictions, in Thai baht, were initially granted to over thirty foreign banks.\textsuperscript{177} In early 1994, Thailand’s cabinet expanded the BIBF system to permit foreign banks with offshore licenses to open a maximum of two branches outside of Bangkok.\textsuperscript{178} More significantly, Thailand’s banking regulators intend to permit several of the foreign banks, now operating under the BIBF system, to establish full-service branches that would compete directly with domestic banks in the Thai market.\textsuperscript{179}

Thailand further increased competition in the banking industry in 1994 by permitting domestic finance companies to establish provincial loan offices.\textsuperscript{180} The government has promised that after two years, demonstrably sound finance company loan offices will be permitted to take deposits from customers.\textsuperscript{181} Several of the largest finance companies may also be granted full banking licenses.\textsuperscript{182}

Malaysia also has begun to liberalize its banking sector. The government’s efforts thus far have been focused on creating a regional offshore banking center on the island of Labuan, which is located just off the coast of the Malaysian state of Sabah.\textsuperscript{183} In 1990, Malaysia established a special

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\textsuperscript{177} See, e.g., Bowman, supra note 176, at 86.
\textsuperscript{179} See Gordon Fairclough, Spreading the Wealth, FAR E. ECON. REV., Aug. 17, 1995, at 48.
\textsuperscript{180} See Mallet, supra note 178, at 4; Owens, supra note 178, at 17.
\textsuperscript{181} See Mallet, supra note 178, at 4.
\textsuperscript{182} See Adam Schwarz, Warnings Irrelevant, FAR E. ECON. REV., Oct. 6, 1994, at 60, 61.
\textsuperscript{183} The center is known as the Labuan International Offshore Financial Center. See, e.g., Lee Siew Lian, Malaysia: Foreign Banks Keen to Do Business with Local Firms, BUS. TIMES (Malaysia), Jan. 9, 1995, at 1; Stephen Duthie, Labuan’s Development as Offshore Center Takes Root, But Its Appeal to U.S. Firms is Limited, ASIAN WALL ST. J. WKLY., Sept. 21, 1992, at 18. Labuan has yet to attract significant numbers of foreign financial institutions, partly because of the island’s
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low-tax and relaxed regulatory regime for Labuan that is intended to make the island an attractive base of operations for multinational banks and other financial institutions. Malaysia is also gradually liberalizing its domestic banking market. Malaysia deregulated interest rates in 1991 by granting banks "individual discretion to set their own base lending rates." More recently, the government has loosened its restrictions on the number of branches that a bank may open in the country.

Additionally, in late 1994, Malaysia liberalized its foreign exchange regime in part by creating what is often referred to as a "two-tier" banking system with respect to foreign exchange. Under this new system, only banks that have been designated as "first-tier banks" are permitted to open foreign currency accounts for Malaysian residents. Seven banks were initially designated as first-tier banks based on factors such as their capital strength, asset quality, and liquidity condition. Overall, the recent reforms strongly suggest that the Malaysian government is committed to internationalizing its banking


See S. Jayasankaran, Working at Home, FAR E. ECON. REV., Oct. 6, 1994, at 62, 64 (reporting that the Malaysian central bank in 1994 gave permission to Hong Leong Bank (formerly the MUI Bank) to open 25 new branches in the country).


Id.

Id. The seven banks designated as first-tier banks are Bank Bumiputra Malaysia, Bank of Commerce (Malaysia), Development and Commercial Bank, Hongkong Bank Malaysia, Malayan Banking, OCBC Bank (Malaysia), and Public Bank. Id. at 41.
Although Taiwan, Thailand, and Malaysia are each liberalizing their banking sectors, at least two factors combine to make Indonesia's experience unique. First, Indonesia has proceeded with banking deregulation at a much faster pace than the other three countries. Evidence of the accelerated rate at which Indonesia has liberalized its banking industry can be found in the large number of banks recently established in the country. During the first five years following the enactment of Indonesia's 1988 banking deregulation package, the number of private banks in the country grew by almost 100. In comparison, neither Malaysia nor Thailand has granted a new domestic banking license in many years, and Taiwan issued only fifteen private banking licenses when it deregulated its banking sector in 1989.

Second, deregulation has left Indonesian banks on average with lower profitability and generally worse financial condition than banks in Taiwan, Thailand, and Malaysia. One important measure of bank profitability is interest margin, which represents the difference between the rate of interest that banks pay to obtain funds and the rate of interest at which they lend funds. While banking liberalization in other Southeast Asian countries generally has not substantially reduced the high interest margins maintained by banks in those countries, interest mar-

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190 On the general efforts of the Malaysian government to internationalize the country's financial system, see S. Jayasankaran & G. Silverman, At Your Service, FAR E. ECON. REV., Aug. 31, 1995, at 56.
191 See Habir, supra note 54, at 58.
192 For the Malaysian case, see Lian, supra note 183, at 1. Malaysia is said to be considering granting its first new banking licenses in many years to the Bank of China and the Development Bank of Singapore. See Shale, supra note 159, at 111. For a discussion of the Thai case, see Handley, supra note 176, at 25 (reporting that the Thai government has promised the newly formed World Trade Organization that it will increase the number of foreign banks permitted to operate full branches in Bangkok from 14 to 19 by 1997).
193 See Baum, supra note 174, at 35.
194 See Handley, supra note 176 (arguing the Thai case); Paul Sherer, Thai Bank Stocks Bring Out the Bulls, ASIAN WALL ST. J., Sept. 21, 1994, at 13 (reporting that interest margins in the Thai banking sector rose to 4.4% in the first half of 1994 from 4.0% in 1993). For a description of the Malaysian case, see Jayasankaran, supra note 186,
gins in Indonesia have steadily narrowed since the 1988 deregulation. This decline in interest margins can be partly attributed to the high levels of nonperforming loans held by Indonesian banks.

The presumed relationship between the speed at which Indonesia has proceeded with banking deregulation and the weak financial condition of many Indonesian banks has provided financial officials in other Southeast Asian countries with a warning about the effects of an overly rapid deregulation. Financial officials in the region have taken the banking scandals and collapses that followed rapid deregulation in Indonesia as a lesson that they should proceed gradually and cautiously with banking liberalization.

Although the problems experienced by Indonesian banks following the 1988 deregulation suggest that Indonesia proceeded with reform too hastily, the long-term effects of Indonesia's banking liberalization efforts should be positive. Liberalization, for example, has led to the growth of a number of successful private banks, which has lessened the traditional dominance of the state-owned banks and created a more competitive banking environment.

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195 ASEAN BANKING PROFILES, supra note 49. Relative to banks in many developed countries, the interest margins of Indonesian banks are quite high. For example, the average net interest margin of Indonesian banks is approximately two percentage points higher than the average net interest margin of banks in Singapore. See Asian Banks Enjoy the Fat Times, EUROMONEY, Dec. 1994, at 111. However, Indonesian banks rely much more on interest income for their profitability than banks in developed countries, where fee income makes up an increasingly large percentage of total bank income. See, e.g., For Our Next Trick . . ., ECONOMIST, Apr. 30, 1994, at 25.

196 See ASEAN BANKING PROFILES, supra note 49. In general, interest margins are larger for the private banks than the state banks. Id.


198 Since the enactment of PAKTO '88, the private banks have risen to challenge the long-standing dominance of the state-owned banks. See Habir, supra note 2, at 54. In terms of both outstanding loans and deposits, private banks maintain a similar share to state-owned banks, and in terms of profitability, private banks have already overtaken their state-owned counterparts. Id.
In addition, the competitive banking environment created by deregulation has resulted in improved banking services for customers. Nationwide automatic teller networks, increased access to credit cards, and telephone banking are all benefits resulting from the greater degree of competition in the banking sector. Finally, by exposing the mismanagement and politically motivated lending practices of the state-owned banks, liberalization has prompted the Indonesian government to conform more to international standards by reforming the state-owned banking sector and by increasing the level of prudential oversight of banks.

4. CONCLUSION

The Indonesian government's deregulation efforts in the late 1980s put the country's banking system under a great deal of pressure. The collapse of Bank Summa in 1992 and the more recent scandals involving Bapindo are the most obvious examples of this stress. The various deregulation packages succeeded in creating a more competitive banking environment and in increasing credit availability throughout the country. The lack of effective regulatory safeguards, however, left much of the banking sector, particularly the state-owned banks, burdened by nonperforming loans after the deregulation.

Although the long term effects of banking liberalization should prove to be positive, the immediate future of the banking sector is unclear. After the large influx of domestic private and joint venture banks between 1988 and 1992, the number of banks appears to be stabilizing. Some analysts predict that the total number of banks may soon decline, as smaller, undercapitalized banks either fail or are acquired by stronger institutions. Bank Indonesia would prefer

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199 See Habir, supra note 54, at 60.
201 See Habir, supra note 54, at 60. In 1994, a consortium of three private banks, Bank Central Asia, Bank Utama, and Bank Danamon, acquired control over an ailing private bank known as Continental Bank. Id. at 58. This rescue of Continental Bank may become a precedent for future bank acquisitions. See Three Indon Banks Plan to
the latter alternative and is actively encouraging healthier private banks to acquire ailing banks in hopes of avoiding further collapses. Such acquisitions, however, could pose other risks for the banking system. Even the strongest private banks in Indonesia are not well capitalized by international standards, and the financial health of any private bank could be seriously threatened by absorbing a bank with a weak loan portfolio.

Assuming that they are not overburdened with the task of rescuing ailing banks, the leading private banks are poised to become the new leaders of the banking sector. Generally, the larger private banks have been more aggressive and innovative than the state-owned banks in modernizing their operations and introducing new banking products and services. The private banks have been particularly active in the retail sector, an area that has generally been ignored by the state-owned banks. As retail

Take Over Continental Bank, BUS. TIMES (Singapore), Aug. 9, 1994, at 12.

See Habir, supra note 54, at 60 (stating that “Bank Indonesia has indicated that officials are reviewing measures to encourage bank mergers”). For a general discussion of why a central bank would encourage healthy banks to acquire sick ones, see Please, Governor, Can You Spare a Billion?, ECONOMIST, Mar. 25, 1995, at 79 [hereinafter Please, Governor].

Even the largest private bank, PT Bank Central Asia, had assets as of the beginning of 1994 of only $7.8 billion. The Top 500 Banks in the World, AM. BANKER, July 29, 1994, at 7A, 11A. This level of capitalization made PT Bank Central Asia only the 485th largest bank in the world when compared by the amount of assets. Id.

In general, the private banks have already overtaken the state-owned banks in terms of profitability. Habir, supra note 2, at 54. According to Perbanas, an association of Indonesian private banks, the return on assets in 1993 for the private banks was 1.2% (compared to 0.7% for the state-owned banks) and the capital-to-total assets ratio was 8% for the private banks (compared to 4% for the state-owned banks). Id.; Shoeb Kagda, Indon Private Banks Set to Play More Dominant Role, BUS. TIMES (Singapore) Sept. 1, 1992, at 2.

See ASEAN BANKING PROFILES, supra note 49.

The state-owned banks traditionally have relied on government entities, such as state-owned enterprises and government pension funds, for their deposit base. Id. Although their near monopoly over deposits from the government sector has been one of the strengths of the state-owned banks, it has also forced the private banks to look to corporations and individuals as their source of deposits. Id. At present, for example, middle-market banking (encompassing second-tier and
banking promises to be the largest growth area for Indonesian banks over the next several years, the emphasis of the private banks on retail banking should provide them with a strong competitive advantage.\footnote{207}

Both private and state-owned banks will continue to struggle, however, with the problem of nonperforming loans. For example, both types of banks are believed to be significantly overexposed to Indonesia's highly volatile property market.\footnote{208} During the past several years, Indonesia, particularly in and around Jakarta, has been experiencing a building boom, much of which has been financed by bank credit.\footnote{209} If property prices suddenly decline, bad loans will dramatically increase for a number of banks.\footnote{210}

Another challenge facing both private and state-owned banks is that the growth of the Indonesian domestic bond market is beginning to threaten the banks' primary role as financial intermediaries.\footnote{211} As Indonesian corporations raise steadily more money through debt issuances, their need for bank financing is declining.\footnote{212} If this process

\begin{footnotes}
\footnote{207} See ASEAN BANKING PROFILES, supra note 49.
\footnote{208} See Leslie Lopez, Indon Banking Sector Faces Over-Exposure to Property, BUS. TIMES (Singapore), Dec. 8, 1994, at 1; see also Borsuk, supra note 26, at 4.
\footnote{209} See Lopez, supra note 208, at 1. On the real estate boom in Jakarta, see Henny Sender, Space Race, FAR E. ECON. REV., Aug. 4, 1994, at 56.
\footnote{210} Some analysts believe that certain private bank's vulnerability to the property market could affect as much as 50% of their total loan portfolios. Lopez, supra note 208, at 1; Praginanto, Debt-Strapped Indonesian Banks Brace for Credit Squeeze, NIKKEI WKLY., Dec. 26, 1994 - Jan. 2, 1995, at 22.
\footnote{212} See Peter Montagnon, Intermediaries Find Role Under Threat in Asia, FIN. TIMES, Dec. 6, 1994, at 21. For a general discussion of the process of disintermediation in international finance, see Exit the Middleman, ECONOMIST, Apr. 30, 1994, at 6, 6-7 (noting that banks' traditional role as intermediaries between suppliers of capital (depositors) and users of capital (borrowers) is breaking down, as both parties increasingly have direct contact through the capital markets).
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continues, Indonesian banks increasingly will need to find alternate sources of income, such as providing more fee-based services.

In the foreseeable future, the primary issue facing Indonesian bank regulators should be how to bolster the soundness of the banking sector without imposing standards that only a few of the strongest institutions can meet. Banks play a special role in a country's economy as "providers of credit and as guardians of [the] economy's payments system."213 The economic cost of bank failures is correspondingly higher than that of bankruptcies in other business sectors. The Indonesian banking authorities, therefore, need to chart a careful course for the future, bringing prudential standards in the banking industry up to international standards, without increasing the number of costly bank failures, a result that would be disastrous for further Indonesian economic development and growth.

213 Please, Governor, supra note 202, at 79.