FINANCIAL MARKET DEVELOPMENTS IN INDONESIA[1]

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1. Background

The years of 1997 and 1998 witnessed the most onerous pressures on Indonesia's economy over the course of three decades of development. These pressures, precipitated by the exchange rate crisis beginning in the second half of 1997, had adversely affected the economy performance and turned to a prolonged crisis affecting various sectors. The crisis developed rapidly, given the openness of economy and its reliance on the external sector, and was further exacerbated by the existing structural weaknesses in the economy, most notably at the financial sector and banking in particular.[3]

The major factors characterizing the inherent weaknesses prevailing in the banking industry that led to its vulnerability and contributed to the crisis include:

First, the implicit guarantee from the central bank that banks should not be allowed to fail–so as to prevent systemic risk to the banking system-had led to moral hazard on the part of bank owners and management. The implicit guarantee induced banks to leverage and encouraged banks to exercise less caution in extending loans to high risk sectors. As a result, commercial bank risk was shifted to the central bank while systemic risk in the banking system mounted.

Second, supervision by the central bank was less than fully effective as the central bank was unable to keep up with the rapid progress and increasing complexity of bank operation. Consequently, banks were lured to overlook prudential principles governing their operations. Although Indonesia had adopted international standards for

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[3] Financial crises are seldom generated by one or two isolated factors. The Indonesian crisis is no exception. As indicated by Goldstein (1998) at least there are typical sources of the recent Asian crises: the

prudential regulations recommended by the Bank for International Settlements, the existing weaknesses in law enforcement and lack of central bank independence resulted in ineffective supervision and inadequate corrective measures.

Third, sizeable connected lending (either directly or indirectly to individuals or business group), had raised commercial banks' exposure to the risk of non-performing loans. While various disciplinary measures entailing strong sanctions had been introduced to prevent unsound lending practices, violations persisted due mainly to the structure of banks' ownership, which tended to be concentrated on few groups or individuals.

Fourth, the relatively low managerial skills in banking led to the weakening productive asset quality and rising risk exposure. This was aggravated by the existing weaknesses in internal supervision and information, which resulted in the failure to monitor, detect, and solve non performing loans and excessive risk exposure. These weaknesses had further limited banks' ability in anticipating and overcoming the emergence of financial crisis.

Fifth, lack of transparent information on bank condition had undermined not only the accuracy in the analysis of banks' financial position but also inhibited efforts to introduce social control and market discipline. This factor contributed to the erosion of confidence in the banking sector, which raised the systemic risk in the banking industry.

Coupled by the loss of the credibility and confidence of the Indonesian economy among international investors and domestic players as well as uncertainties due to political instability, the crisis in the financial sector became more severe bringing Indonesia to the brink of insolvency. At this point, the banking condition worsened following massive banking rushes owing to the weakening confidence in the banking system. Consequently, banks should operate under abnormal condition and could not operate normally. Violations of the prudential principles were widespread, liquidity and

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weaknesses of financial sector; the pressure of external shocks due to currency depreciation; and contagion effect.

capital adequacy dropped drastically, and reliance on liquidity support from Bank of Indonesia rose sharply. These accumulated problem disrupted intermediation process and accordingly brought about unfavorable impact on the entire economy.

2. Impact on local financial market

The pressure on the Rupiah resulted in a severe liquidity problem, which gave a sharp rise in the need for funds both to service external obligations falling due and to meet massive withdrawals by depositors. At the same time, the tightening of liquidity, which propelled the interbank interest rate to its peak of 350% in January 1998, further hampered commercial banks' efforts to raise funds from domestic sources, which rendered banks' greater reliance on the central bank's liquidity support. The depressed Rupiah raised the risk of non performing loans (NPL), which worsened the productive asset quality. NPL grew very rapidly to a level where the viability of banks and the whole banking system was threatened.[4] Furthermore, the high interest rate and tight liquidity in the banking industry virtually led the banking operations to a halt. Against this backdrop, substantial losses and worsened solvability of the banking industry were unavoidable.

The banking crisis was further compounded by the various rumors and the downgraded rating for Indonesia and pessimistic outlook for the banking industry given by international rating agencies.[5] Public panic led to a massive withdrawal of funds and a transfer of funds from apparently unsound banks to presumably sound ones. Consequently, several banks that once belonged to the category of sound banks and functioned as lenders of funds in the money market were adversely affected by the crisis and converted their position from lenders to borrowers in the money market. Meanwhile, the credibility of domestic banks also depreciated internationally as evidenced by an increasing number of international banks declined to deal with domestic banks in foreign currency and letter of credits. As a result, not only did liquidity worsen, but also

[4] See graph in the appendix 1.

[5] Moody's and Standard and Poor's indicated negative outlook for overall banking industry and some other major banks in January and February 1998.

profitability and solvency of the banks were aggravated as reflected in the increase in non performing loans and in the decrease in return in assets.

Overall, the ongoing crisis has worsened banks and the industry performance. As a result, the industry witnessed violations covering the statutory reserve requirement, loan to deposit ratio, net open position, capital adequacy ratio (CAR) and legal lending limits. Small and big banks faced severe liquidity problems. Solvency of the industry, as indicated by CAR, declined sharply. Meanwhile, there has been persistent violation in legal lending limits. Deterioration in the banking performance was also reflected in increased losses. Majority of banks, accordingly, became illiquid and insolvent.

Due to liquidity problems, an increasing number of banks carried negative balance in their accounts with Bank of Indonesia. Such problem necessitated the government to resort liquidity support to the banking system to avoid systemic implications to the financial sector. The large magnitude of liquidity support prompted public controversy. Some viewed the supports as merely a means subsidizing the banks and the conglomerates.

3. Specific Government Program

The worsening crisis has increased the banking system's financial troubles to the point where the viability of the rest of the economy is threatened. Hence, reforms to establish credit flows and deal with problems of troubled banks is more pressing than ever. Many banks, particularly domestic banks, need urgent action to resolve their bad debts and restructure their portfolios.

In response to this development, with technical assistance from IMF, the World Bank and the ADB, the government has put in place a comprehensive policy package to restore confidence and arrest the decline of Rupiah. This initiative provided the supportive framework for restructuring the financial sector and putting in place wide-range structural reforms. There are 4 (four) elements of this initiative which can be described as follows:

The **first** element of the initiative is to isolate the unviable banks from the rest of the financial system. Along this line, government closed 16 unviable banks on November 1997. These banks have already ceased all operations, and their licenses were revoked. Consistent with the law, shareholders' losses will not be compensated. The government paid of the liabilities of these banks for up to IDR 20 million per depositor per bank. Payment to depositors was administered by Bank Indonesia and funded by the government. The rest obligation to other depositors and creditors were settled after the selling of assets of the liquidated banks.

The **second** element is to establish proper procedure and policies to deal promptly with weak but viable banks, so they can be placed quickly on the road to recovery. In this line, some institutions are placed under conservatorship or intensive supervision of Bank Indonesia. Each bank should submit rehabilitation program which clearly specify the sources of any new funds, the proposed changes in ownership structure and the future focus of activities and procedures.

The **third** element is to resolve specific problems of the state and regional development banks. The government's goal is to ensure that these banks are safe and sound while at the same time reducing the risk of incurring fiscal costs to maintain their capital adequacy. For these reasons, on November 1997, government announced the intention to merge state banks, to improve corporate governance and to assure that the banks benefit from increased private ownership and participation in the governance of the banks.

The **fourth** element of the initiative is to improve the institutional, legal and regulatory framework for banking operation to ensure the emergence of a sound and efficient financial system. To this end, the laws and decrees governing central bank and banking operations, bank liquidation, as well as legislation, judicial and administrative agencies for title registration, collateral perfection, foreclosure and bankruptcy, were revised to incorporate international best practices. Regulation concerning foreign ownership of banks were modified to facilitate entry of international banks and investors. Prudential regulations and enforcement procedures will be strengthened in line with the Basle Committee's Core Principles of Banking Supervision. With the assistance of the IMF, reporting requirement for foreign exchange exposure was modified to capture the true risk inherent in foreign exchange positions.

However, as the economic slowdown and uncertainties continued partly due to unconducive political situation, the implementation of these elements was considered inadequate. To further address the crisis and avoid systemic implications, in late January 1998, a new strategy was adopted. This is to include three elements:

1. The government is providing guarantees to all depositors and creditors of locally incorporated banks. This is designed to stabilize the situation so that an orderly work-out of the banking system problems can be carried out. In exchange for the guarantee, Bank Indonesia is exercising enhanced supervisory oversight, involving additional prudential requirements to prevent abuse of the guarantee;

2. A new government agency, the Indonesian Bank Restructuring Agency (IBRA) has been created to take over the claims deriving from the Bank Indonesia emergency support to the banks, as well as the cost of the guarantees for depositors and creditors, and to undertake close surveillance, monitoring, and assessment of the weak banks with a view to planning and carrying out the work-out of the banking system IBRA is financed by the government through the issue of bonds, with the interest on the bonds borne by the budget;

3. There is to be an enhancement and increase in transparency in the supervision and operation of the banking and monetary systems.

These strategies had an immediate impact. Supported by exchange rate intervention on the first week of February 1998, the Rupiah appreciated by 40 percent from its trough level of around IDR 17,000 per US dollar in January. For the first time since September 1997, Rupiah began to flow back into the banking system.

To accelerate the implementation of these strategies, Bank Indonesia developed criteria for selecting which banks would come under IBRA for assessment and possible restructuring. The resulting list included those banks that had borrowed more than 200 percent of capital from Bank Indonesia, had capital adequacy ratios below 5 percent. With the additional of four state banks which were subject to a restructuring plan under the World Bank, in total this came to 54 banks, comprising around 40 percent of total assets of the banking sector.

Around 200 seconded staffs-largely from Bank Indonesia's Supervision Department-entered the banks that have been transferred to IBRA. Examination staffs monitored closely management's compliance with the instruction given by IBRA. The objective to cut the links between owners and managers in the conduct of unsound business seemed to be successful. In this line, Bank Indonesia invited representatives of Big Six international accounting firms to perform portfolio reviews of the 54 banks under IBRA.[6] These reviews were completed in July 1998 and formed the basis for IBRA's analysis of each bank as to whether the bank is sound, can be made sound, or will need to be restructured under its auspices.

Despite the fact that these measures show that the authorities are on their way to carry out their commitment to rehabilitate the banking system, the authorities have been reluctant to give them any publicity. In part this appears to derive from fear that public misunderstanding of the measures – especially if any announcement were also to identify the banks being subject to close supervision – could undermine confidence in the safety of the banks and prompt runs on them. Unfortunately, the news of the close surveillance of 54 banks became public in a distorted form. This led to growing rumors on the condition of the concerned banks and thus further decline of public confidence.

In addition, as a result of the social and political upheavals in May 1998, the economic situation and outlook have worsened considerably, and the economy faces a very serious crisis. The distribution network has been badly damaged, economic activity, including exports, generally disrupted, and business confidence severely shaken. The exchange rate has substantially weakened and inflation increased very rapidly. In

[6] This include KPMG, Ernst&Young, Price Waterhouse, Deloitte Touche Tohmatsu, Coopers&Lybrand and Arthur Andersen.

addition, large scale liquidity support has had been provided to meet runs on a major private bank, which has since been placed under the control of the IBRA.

To bring about the initiative back on track, government introduced a ‘revised’ strategy in order to put the solution for the banking system on the highest priority. The objective is to resolve the financial difficulties of the weak banks and establish a sound functioning banking system as quickly as possible. A key element of the revised strategy involves measures to strengthen relatively sound banks partly through the infusion of new capital. The approach to the weak banks will involve moving swiftly to recapitalize, merge or effectively close them, while maintaining the commitment to guarantee all depositors and creditors. Decisions regarding individual banks will be based on uniform and transparent criteria, drawing from the results of portfolio reviews by international accounting firms. Along this line, to isolate further some troubled banks, government suspended 7 (seven) banks in April and further taken over additional 7 (seven) banks. In addition, a presidential decree was issued to provide appropriate legal powers to IBRA, including its Asset Management Unit (AMU). Moreover, a high level Financial Sector Advisory Committee is being established to advise on the coordination of all the necessary actions for bank restructuring.

As a result of these ‘revised’ strategies, and the increasing pressure to accelerate the resolution program, on August 21, 1998, the government announced a major bank restructuring package that now covered all banks in the industry (IBRA and Non IBRA banks). This package comprised of two main categories:

1. Policies aimed at preparing the economic recovery by rebuilding a strong banking system through (i) a recapitalization program, (ii) improvement of banking regulations and laws, and (iii) improvement and enforcement of prudential regulations.

2. Policies aimed at resolving the problem banks by accelerating the efforts of bank restructuring.

Banking recapitalization program is undertaken by involving viable banks. All banks (both IBRA and non IBRA banks) were reviewed to identify the magnitude of problems faced by each individual bank.[7] This activity was performed in stages. The results of the reviews were used by Bank of Indonesia to determine banks, which need to participate in the recapitalization program. Banks which were deemed to need recapitalization should submit a business plan. Banks, whose business plan was considered feasible, can obtain investment from the government, with prerequisite requirements that banks must:

(1) absorb the losses arisen from loans extended to affiliated parties;

(2) inject new capital;

(3) transfer all obligation which were obtained from Bank of Indonesia liquidity support to IBRA.

In the regulatory front, government submitted an amendment of the Banking Act of 1992 to parliament which comprised major changes. Bank licensing is transferred to Bank of Indonesia (previously vested with Minister of Finance). Foreign investors are given greater opportunities to become shareholder. Bank secrecy, which previously covered all asset and liability information, is changed to be merely covering information related to depositors and their deposits. In addition, as part of the refinement of banking regulations, several improvements have been done, particularly in the extension of the leverage of earning assets quality and required loan loss provisions and guidance on problem loans restructuring.

The refinement of the regulation was intended to achieve more realistic banking performance, and give opportunities and flexibility toward banks and debtors in order to ensure they may emerge from the facing crisis. In line with this objective, banks were obliged to fulfill the capital adequacy ratio of 4 per cent, 8 per cent and 10 per cent by the end of 1998, 1999 and 2000 respectively. To build up legal certainty, government

[7] These reviews were also conducted by the big six international accounting firms.

conducted stricter legal action toward bank owners and management who were proven to violate existing regulation.

Within the framework of banking restructuring, government announced merger of four sate banks[8] and the corporate business of Bank Rakyat Indonesia. All non performing loans of these banks are transferred to the Asset Management Unit (AMU) of IBRA. In addition, 3 of 7 taken-over banks were suspended[9] and other seven banks which were suspended in April 1998[10] were liquidated. The liquidation process of these banks was carried out after all the assets were transferred to the AMU. In this case, the government took actions to litigate and prosecute relating to those banks, either civil or criminal.

3. Other measures

Based on consultation with the IMF, World Bank and ADB, a revised economic program was signed in August 1998. Despite of promising start, this program has been improved to accommodate the government commitments to a rapid stabilization of the economy and far reaching structural reform. Significant changes to the macroeconomic framework and to monetary and fiscal policy-including to allow for a strengthened social safety net to cushion the escalating effects of the crisis on the poor- are taken. In the financial sector, government continued with more focus on its restructuring policies. The reform strategy on the banking restructuring was focused on:

1. the implementation of the government-assisted recapitalization program for potentially viable private banks;
2. the merger, reform and recapitalization of the state banks;
3. the solution of non-viable banks;

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[8] Bank Ekspor Impor Indonesia, Bapindo, Bank Bumi Daya and Bank Dagang Negara.
[9] BDNI, Bank Umum Nasional and Bank Modern
[10] Bank Surya, Bank Subentra, Bank Istismarat, Bank Pelita, Bank Hokindo, Bank Deka and Bank Centris.

4. the introduction of measures to recover liquidity support previously extended to troubled banks by Bank of Indonesia; and

5. the improvement of banking supervision system.

Inline with this direction, government announced the key elements of the bank recapitalization program on September 1998. It was clearly indicated that to participate in the recapitalization a bank must:

1) presently have a capital adequacy ratio, after full provisioning for all impaired loans of better than minus 25 per cent but less than 4 per cent,

2) inject new capital with the government also injecting funds and taking a commensurate equity position,

3) make current all non performing loans to related parties and reduce their level to within new prudential requirements' and

4) prepare an acceptable business plan showing how it can achieve medium-term viability, and compliance with all Bank of Indonesia prudential regulations.

In addition, the priority to address deficiency in infrastructure – in particular the legal and organizational underpinnings of the institutions central to the banking resolution strategy – was set up in line with the renewed commitments of the authorities to carry out their strategies and initiatives.

As regards the legal infrastructure, problems in the legal framework specifying IBRA's power were highlighted by IBRA's inability to achieve declaration of insolvency in the several private banks taken over in April 1998. This deficiency could lead to future reversals and serious loss of credibility for IBRA. Therefore, the authorities have proceeded with the details of amendment of the banking act of 1992 which specifically indicated the power of IBRA and its AMU.

As regards the organizational infrastructure, government introduced policies to overcome some problems such as delays in approval of IBRA's budget, rapid turnover of IBRA's management and staffs as well as uncertainties over respective institutional responsibilities. It was noticed that IBRA will have difficulties carrying out its mandate unless it has the full support of the various public institutions which it interact – particularly Bank of Indonesia, Ministry of Finance, and the Attorney General's Office. Therefore, government has provided IBRA, and its AMU in particular, its fullest support to ensure the success of the rehabilitation program.

Accordingly, to activate the operation of AMU of IBRA, government has look very closely any assistance available locally and overseas, both through the international financial institutions and bilateral supporters. Therefore, at the early stage of the operation, government set a coordinating group that will seek to match the various possible sources and needs for assistance. In line with the power provided by the amendment of the banking act of 1992, the AMU of IBRA is now operating with professional management hired from the private sector.

To cope with the needs to improve some prudential regulations, the consultation with the IMF mission has continued to bring the existing key prudential regulations close to international best practices. This consultation encouraged the adoption of the "improved" prudential standards to ensure that any recapitalization of the banking sector is implemented in line with sound accounting practices and full transparency. In addition, the improvement of the existing prudential regulation framework was undertaken, particularly on the regulations of asset quality and off balance sheet transactions, allowances for asset quality and off balance sheet transactions and regulations for troubled debt restructuring, legal lending limits, liquidity reporting, net open position, transparency of annual and published financial statements.

5. Outstanding problems

There are 3 (three) other areas outside the financial sector are now becoming more crucial for economic recovery and hence banking rehabilitation program. That is

(i) the corporate debt restructuring, (ii) monetary and macroeconomic stability, and (iii) improvement of public and private governance.

financial restructuring of the corporate sector is crucial for economic recovery and essential counterpart to bank restructuring program – a sound corporate sector is necessary for a sound banking sector. Large sections of Indonesia's corporate sector are in severe financial difficulty. Indonesia's external debt stands at US$138 billion. Of this, private corporates owe US$64.5 billion, the bulk of which is owed by commercial banks. Indonesian banks owed another US$13.6 billion, of which US$12.8 billion was from interbank lines. Total amortization payments falling due for calendar year 1998, according to the World Bank, is estimated at US$32 billion (before any restructuring). Of this, 80 per cent is private debt, most of it corporates.[11] Apart from those that were naturally hedged, the depreciation of the Rupiah meant that all corporates are finding it almost impossible to meet their external debt-service obligations and are consequently also defaulting on their domestic loans. Central to a resolution of this crisis will be a mechanism to reduce this debt burden and restore Indonesia's corporate capital stock to productive use. It is in this context that the Frankfurt debt agreement is of such critical importance.[12] The agreement comprise 3 (three) components: a framework for restructuring the external debt of corporates; a scheme to repay interbank debts; and an arrangement to maintain trade finance facilities. A government guarantee of foreign exchange risk will form the core in the framework for corporate debt restructuring. Participation in the scheme is voluntary and decided jointly by debtors and creditors. The agreement also includes other concession from lenders on existing debt, and efforts by the borrower to repay debts, including through the sale of some assets.

The restructuring of external corporate debts takes place in the context of wider financial restructuring of corporates that include debt renegotiations with domestic banks. If one of the domestic creditors include banks under the supervision or management of IBRA, IBRA then became an active participant in these negotiations and be elected to the creditors' committee to represent the interest of its banks. The aim of

[11] See World Bank (1998).

corporate debt restructuring is to improve the liquidity position of corporates, avoid disruption in production, and restore the capacity of corporates to repay their financial obligations. This is the very heart of the stabilization program, for without solvent and creditworthy corporates, a restored banking system would have no corporate clients. Therefore, to be successful, corporate debt restructuring will also need to be accompanied corporate reorganization, including bankruptcy, liquidation, downsizing, mergers, and acquisitions.

Meanwhile, the task of improving governance is equally critical for the short-term as it is for the next several decades. In short term, bank and corporate restructuring need to be done honestly and transparently, according to the law and well established rules. This is essential for the credibility of the reforms. According to the World Bank, there are 3 (three) urgent governance issues confronting the government: the bankruptcy law; competition policy and the privatization program. These three factors are building block for a competitive corporate sector and are important signals for how Indonesia's business culture will move toward being more fair and transparent.

The task of restructuring banks and corporates and improving crucial aspects of governance will be made much easier in a stable macroeconomic environment. So managing aggregate demand is a crucial task for the government. Therefore, to ensure that inflation is reduced quickly and that Rupiah continues to strengthen, government has commitment to implement a firm monetary policy consistent with the monetary targets already established as part of the economic rehabilitation program. It is believed that as inflation declines, and provided the Rupiah remains stable, the interest rates will decline gradually, easing the pressure on the corporate and banking sectors. However, as the results of government's tight monetary policy during 1998, there has been a big concern about the impact of high interest rates on the banking system and the corporate sector. This is including the effects of negative spreads between deposit and lending rates, which are adding to the banks' insolvency and the eventual costs of bank restructuring.

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[12] The agreement reached on June 4, 1998.

Taking into account the concerns involved, government has been consistent with the program agreed with the IMF, the World Bank and the ADB. Some progresses and proceeds are visible. All these efforts are reflected by almost all commitments done timely with a wide range of issues: bank restructuring, bank rehabilitation, monetary and fiscal policies and other policies related to the real sectors.[13] It has been very visibly acknowledged that the government has worked very hard to reduce the inflation rates. Fortunately, as the results of this long effort, the rate of inflation declined substantially, partly due to the strengthening Rupiah and the stabilization of food prices. This development led to further decline in interest rates. The rate of one-month central bank certificates (SBIs) has declined by about 10 per cent in a single month of September. Provided the Rupiah remains strong and inflation falls, there will be a scope for further gradual reductions in interest rates. However, in order not to jeopardize the stability that is being achieved, government clearly stated that monetary policy remained flexible and would be tightened if there are signs that inflation is not declining, or exchange rate weakens.[14]

6. Future Issues

The crisis, after all, is the crisis of confidence, particularly confidence in the Rupiah. The restoration of confidence is more than necessary condition to rebuild the economy. However, given the existing condition, there is little alternative to restoring confidence except the old fashioned way – earning it. In order to earn it, there will be at least 5 (five) important issues still to be addressed and managed in the future. The proceeds of this efforts will determine the sustainability of the rehabilitation and restructuring program. These major future issues will include (1) the cost of restructuring; (2) reducing moral hazard; (3) making bank recapitalization more orderly; (4) further strengthening prudential standard; and (5) improving transparency and disclosure.

[13] All commitments in accordance with the IMF program are attached.
[14] The development of exchange rates, inflation and interest rate are separately described in the appendix 2,3 and 4.

The official estimates of the cost for bank restructuring is totaling up to IDR 300 trillion, that is equivalent to USD 38 billion or one-third of the GDP. This will be financed by the issuance of government bonds. The interest costs on the public funds for the budget year of 1999/2000 is up to IDR 34 trillion. However, the current budget provides only IDR 18 trillion. The remaining IDR 16 trillion is expected to come from the sale of assets recovered from the banks. The total costs could be higher if inflation does not come off as projected, and funding costs remain closer to current short term rates of 30 per cent rather than the 20 per cent average assumed. This issue is important to be specified as some controversies, particularly in the parliament and general public, are unavoidable. It is clear that the message from the budget is given the reality of the resource constraints. Some analysts even said that stabilizing the banking system has been relegated to a lower priority as limited resources should be allocated to other sectors. Managing this issue is paramount for the continuation of the restructuring program.

Furthermore, reducing moral hazard is also the important future issue. Because this moral hazard has been the case prior to the crisis, the restructuring package (some cynically called: bail out) introduced by the government during and after the crisis would turn out to be worsened the moral hazard in the future. In addition, blanket guarantee announcement has placed the government in a bind, and thus, the case history of official bail-out will get another entry. Along this line, as it is also suggested in the amendment of the banking act of 1992, the intention to establish a deposit protection scheme through a deposit insurance program should be handled carefully.

Some general lessons from successful restructuring elsewhere underline the importance of a political consensus for effectively dealing with banking crisis. The solutions chosen should ideally not run the risk of legal challenge which might delay necessary adjustment measures. It has been acknowledged that a series of piecemeal steps may not have a credible effect on expectations and thus may prolong the difficulties. Moreover, it should be transparent. Thus, an orderly taken and transparent restructuring process will minimize the risk of delay and lack of positive expectations.

Prudential requirements center on banks holding adequate capital and avoiding it being eroded by poor credit practices such as connected or concentrated lending. Adequate and comprehensive risk management and control systems are needed within the banking sector. In this regards, the publication of a set of 25 Core Principles for effective banking supervision by Basle Committee becomes important. It is the objective of the future improvement on the area of supervision and prudential regulations. There should be clear commitment from the authorities to equip the supervisory and regulatory body with the principles.

The prudential rules discussed above need to be enforced, requiring checks on data reported by banks. This is done by on-site examinations and use of external auditors. Increasingly, more information on banks' performance is being publicly released. A balance needs to be struck between active supervision and reliance on market forces to discipline banks' performance. Recent crisis, on one hand, creates heavy bank losses, borne by tax payers, have prompted the authority to strengthened disclosure requirements. On the other hand, the authority, while supporting greater disclosure, fears that full public knowledge of the true financial state of banks could undermine confidence and that genuine towards better disclosure cannot be made when banks are weak. Given the existing condition, it is not easy to draw the line for the balance of both sides. However, the bottom line is that both the authority and market discipline depend on transparent, timely, comprehensive and accurate information on the wide array of risks taken by banks and should be able to monitor the quality of banks' internal systems for managing, evaluating and controlling risk exposures.

Jakarta, 15 January 1999.

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