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**Liquidity Support And The Financial Crisis:  
The Indonesian Experience**

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## ABSTRACT

During the Indonesian financial crisis, Bank Indonesia provided liquidity supports to banks facing liquidity problems. This paper argues that this policy became a public controversy because of the magnitude of the possible loss to the government, which ultimately would have to be borne by the taxpayers. Suspicions of corruption amongst bankers (as the receiving parties) and officials of Bank Indonesia (as the party that made the decision and the provisions) also added to the public debate. The public's lack of understanding about the issues, given the non-transparency of operations in the banking sector in general, further complicated the issues.

This paper is an effort to shed some light on the issues and problems as well as the proposed solutions to the problems that arose out of Bank Indonesia's liquidity support policy. While it is hoped that the issues would become clearer, the paper does not promise that the solutions are at hand. Instead, the paper will show that weak governance on the part of the banks, the bankers and owners of banks, as well as the authorities and the government institutions, in combination with weak legal institutions and intense political interests, have made the issue messy and without any clear prospect for a sustainable solution.

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## SUMMARY

Bank Indonesia's liquidity supports to the banking sector in the face of liquidity shortages that occurred during the financial crisis generated public debates after the Supreme Audit Agency (BPK) announced the findings from its general and investigative audits on the bank in November 1999 and August 2000 respectively. Based on the investigative audit, the Agency found that the liquidity supports to the banking sector from 1996 to January 1999 amounted to IDR 144.5 trillion. It was claimed that as a result of deviations in the provision of the funds by the central bank and uses by receiving banks, the government faced a potential loss of IDR 138.4 trillion, or 95.7 percent of the total liquidity supports provided.

Bank Indonesia's liquidity supports became a public debate because of the magnitude of the possible loss to the government budget, which ultimately would have to be borne by the taxpayers. The alleged corruption that had been suspected both on the part of bankers (as the receiving parties) as well as officials of Bank Indonesia (as the party that made the decision and the provision) also added to the debate. With weak legal and judicial institutions and intense political interests the whole issue has become messy without any clear prospect for a quick resolution.

On the possible losses to the government budget from the provision of liquidity supports, several points need to be noted. First, the total amount claimed by the Supreme Audit Agency in its audit report was based on the total supports that were granted by the central bank to the banking sector. Although the recovery rate was low, the estimate completely ignored the amount of funds and other assets recovered. The absence of any reference to the possibility of recovery is incredible. In other words, according to the Agency report, the amount of assets that could be recovered was almost zero. Secondly, the Agency should also have checked whether the receiving banks had acknowledged the amount of funds that they received because such funds were assets of the government or the Indonesian Banking Restructuring Agency (IBRA). Only after this process could an estimate of the possible losses be made, which would roughly be equal to the total amount of funds received by banks minus the expected recovery of assets.

The liquidity support provided by Bank Indonesia, whether to one or two banks in normal circumstances or indiscriminately to all banks during distress and crisis, contrary to some allegations, was not based on any motivation to save bank owners or any particular bank from possible losses. Instead, it was provided on the basis of Bank Indonesia's function as a lender of last resort to assist banks in liquidity shortage so as to prevent the banking sector (as the backbone of the national payment system) and hence, the national economy, from collapsing. After all, the functions of Bank Indonesia prior to the granting of its independent status included "assisting government policies in facilitating production activities, development and employment to enhance the welfare of the people." (Article 7b of Law No. 13/1968 on the Central Bank).

The decision by the board of directors of Bank Indonesia to provide liquidity supports to the banks was also based on the government's policy not to close banks and to assist banks with liquidity shortages during the crisis period. This policy was personally stated by the President on two occasions; in late 1996 and in April 1997 when the board of directors presented proposals to liquidate a number of banks. The government also announced that it would not be making further bank closures just after liquidating 16 banks in November 1997. The President repeated his announcement in January 1998 at the signing of the second letter of intent (LOI) to the International Monetary Fund.

The lack of a consistent banking policy – in not closing banks prior to the coming of the Fund, followed by bank closures in November 1997, and then back to a policy of non-closures, before reverting to liquidating banks in August 1998 – had definitely been confusing to the market to say the least. This was, however, due to the dynamic nature of the crisis. And for better or for worse, this was the policy of the government which Bank Indonesia was part of. In the period prior to its independent status, Bank Indonesia could not act other than implement the Government's policy as stated in the Central Bank Act of 1968. (Article 8 of Law No. 13/1968).

Public perception of the problems of liquidity support has been biased in its blame of Bank Indonesia for providing the support as well as its perceived weakness in the supervision of banks that were accused of misusing the funds that they received. With respect to weak banking supervision, even if public perception had not always been

completely correct, no one would argue against it. However, faulting Bank Indonesia's decision for granting liquidity supports was neither fair nor valid.

And to say that the decision by the central bank was in violation of rules and regulations or that it was a misuse of authority was definitely incorrect. This accusation was based on the investigative audit findings conducted by the Supreme Audit Agency, which strongly holds this opinion. As Bank Indonesia had correctly argued in a recently published book on the issue, the problem with the conclusion drawn in the audit report was its refusal to acknowledge the presence of an emergency situation arising from the crisis. The other problem with the accusation against Bank Indonesia was the categorization of a legally sound and legitimate government policy as a criminal act of corruption.

# LIQUIDITY SUPPORT AND THE FINANCIAL CRISIS: THE INDONESIAN EXPERIENCE

## Introduction

Several steps that were taken during the financial crisis by Bank Indonesia (BI), the Indonesian central bank, have become part of public debate in Indonesia. Some have become controversial. The controversies arose, at least partly, from a lack of understanding among some regarding the objectives behind the policies, or the actual reasons behind some of them. Others have become controversial because of ideological differences or conflicting interests, which are more difficult to resolve. It is indeed unfortunate that to this date, over five years after the financial crisis struck Indonesia, there has not been any clear-cut resolution to some of the issues.

One of the controversies resulted from the step taken by Bank Indonesia to provide liquidity supports to banks in distress and crisis. The policy was to prevent the collapse of the banking industry and the national payment system during the crisis. Following the crisis, this policy together with the bank closures of November 1997 and the granting of independent status to BI policies, have developed into controversial issues in Indonesia.<sup>1</sup>

These controversies arise because of the magnitude of the liquidity supports, the burden of the financing that ultimately had to be borne by the taxpayers, and suspicions on the alleged misuses of the funds by receiving banks, as well as allegations of corruption by Bank Indonesia officials.

The controversies over the provision of liquidity supports to commercial banks that have been lingering on for over five years have to do with several issues. These include disputes on whether the policy was government policy or central bank policy, and what the respective reasoning behind the policy was? How should the burden of cost or loss arising from the implementation of the policy be apportioned between institutions? Who should

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<sup>1</sup> I presented my account of the Indonesian crisis (as viewed from Bank Indonesia's perspective) in a book published in October 2001, *Mengelola Bank Indonesia Dalam Masa Krisis* (Managing Bank Indonesia in Crisis), Jakarta : LP3ES, 2001. An English and updated version of the book, entitled *Bank Indonesia and the Crisis: An Insider's View* is currently in the process of publication.

be held responsible for the policy and its implications? How did the government deal with the alleged corruption associated with the policy?

This paper will discuss some of the above-mentioned issues. In particular, the paper would address issues related to the concept of liquidity supports, the debates over the ownership of the policy, and problems arising from the policy. I will also provide assessments of the policy to provide liquidity support to banks as part of the macroeconomic policy to tackle the financial crisis.

At the outset, it should be noted that the explanation, assessment and analysis presented here are my personal account in my capacity as the former Governor of Bank Indonesia. My tenure as Governor, from March 1993 to February 1998, covered the initial stage of the Indonesian crisis. The provision of liquidity support to the banking sector during the crisis was based on the function of Bank Indonesia as lender of last resort and its status as a central bank, which under the current regulation (Law No. 13, 1968), was legally and politically placed under the government or the President of the Republic. Bank Indonesia was not an autonomous central bank under the current regulation.

As the former Governor of the Indonesian central bank who provided liquidity supports to the banking sector during the crisis, I had spent many hours giving testimonies and answering questions in Parliament, the Attorney-General's Office, and to the police. I also testified in courts as a witness in corruption cases involving the owners and management of banks as recipients of liquidity support, and in cases against some managing directors of Bank Indonesia, who were accused of violating rules for providing liquidity support to banks.

In late May 2002, the Attorney-General's Office issued a statement that cast me as a suspect together with three former Bank Indonesia managing directors on the basis that I had misused my authority in providing banks with liquidity support.<sup>2</sup>

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<sup>2</sup> See *Jakarta Post*, June 1, 2002.

## Controversy over the liquidity support policy

Bank Indonesia's policy to provide liquidity support to banks during the crisis became controversial following the issuance of two reports by the Supreme Audit Agency (BPK) after its audits on the central bank. The first was a report of a *general audit* issued by the Agency in November 1999. Officially, the audit report was issued with a *disclaimer*, which basically meant that the auditor did not have enough information to make conclusive evaluations. However, despite the disclaimer, it gave a detailed evaluation about the central bank's operation, including the claim that the central bank had weak internal controls and faulty accounting.

The second was a report of an *investigative audit* as requested by the Parliament based on alleged suspicions of corruption. The report, issued in July 2000, confirmed the suspicion of possible criminal acts, either in the usage of funds by the receiving banks or the provision of funds by the central bank, or both. This time the report was publicly announced at a press conference held by the Supreme Audit Agency.<sup>3</sup>

How the controversy around the alleged possible corruptions would ultimately be resolved is not clear. But since the end of 2000, many investigations have been conducted by the Attorney-General's Office, both on a number of bank owners and CEOs of banks suspected to be involved. Similarly, investigations have also been conducted on Bank Indonesia's officials – from banking supervision, to accounting, foreign exchange, legal compliance and others, and involving in particular a number of directors and managing directors, including the former governor, who were in charge of the policy for providing the liquidity supports. A number of cases that involved some bankers associated with the receiving banks and three former managing directors of Bank Indonesia have been tried in court.

The liquidity supports have attracted much public attention because of the huge amount of funds involved, the huge losses that could occur, and the sense of public outrage since ultimately it is the tax-payers that would have to bear the burden.

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<sup>3</sup> Press release of the Supreme Audit Agency (BPK) on "Special Audit Report on The Provision and Usage of Bank Indonesia Liquidity Supports", August 4, 2000.

The problem has been perceived to be worse than what it actually is because public perception had not been freed from misunderstandings, misgivings and preconceptions. The public perception about bank owners and bankers in Indonesia had been negative, not without valid reasons, as they symbolized the social ills of Indonesia, i.e., the corruption, collusion and nepotism (KKN) of Soeharto's New Order era. Some would argue that these bankers and bank owners were the benefactors of all the funds. They constituted the group who, in cooperation with government officials, including or in particular Bank Indonesia's officials, had caused the economic bankruptcy. It would be unfair, so the argument continued, that the taxpayers – at times wrongly perceived to comprise solely the poor – had to bear the burden for bailing these conglomerates out. This is a very appealing argument, but it contains serious flaws nonetheless.

In this argument, the role of Bank Indonesia, which was also not well understood by many, had been confused with the real problem of structural weaknesses in the banking sector and supervision. Criticism against the central bank's decision to provide liquidity supports came, at least partly, from a denial that there was a financial crisis in the national economy.

In a situation of non-transparency and weak governance in both the public as well as private sectors, a central bank decision to provide liquidity supports to banks suffering from distress caused by bank-runs, in accordance with its function as lender of last resort and in conformance with the government policy of not closing banks, could turn into a controversy. Political considerations, coupled with individual and group interests, which were facilitated by the less than flawless Supreme Audit Agency's evaluation have made the issues even messier.

The issues associated with the liquidity supports were already raised in news circulating through the Internet, together with protests by two owners of liquidated banks who happened to be relatives of President Soeharto, in November 1997. In some writings, it was alleged that Bank Indonesia had secretly been helping a number of big, and Chinese banks, like BCA, Danamon, BUN, and Lippo with liquidity supports that amounted to trillions of rupiah. In November 1997, these writings were collected and

published in a little book titled *Konspirasi Menggoyang Soeharto: Kumpulan Selebaran Aktual* (“Conspiracy to Shake up Soeharto: Collection of Up-to-Date Papers”).<sup>4</sup>

If only the issues concerning the policy for providing liquidity supports were clearly explained to the public; if only transparency and governance were already embedded within both the government, including Bank Indonesia, and the private sectors, including the banking sector; and if only political interests and group as well as individual interests were minimal, the policy for providing liquidity supports to banks would be acceptable, and no controversy over this would have arisen. Indeed, it seems to be the case that liquidity support to banks became controversial to a large extent because of the deep flaws in Indonesia’s political and corporate governance systems.

### **What is liquidity support?**

It may be instructive, prior to analyzing its implications and how to deal with them, to look at what is actually Bank Indonesia’s liquidity support? What are the justifications for the central bank to provide liquidity support? And why do central banks provide liquidity support?

Bank Indonesia’s liquidity support is a facility that the central bank provides to banks suffering from systemic liquidity mismatch so as to prevent the banking sector, which is very vital in the Indonesian payment system, from collapsing. But the liquidity support that Bank Indonesia provides actually comprises of a number of forms with different maturities and requirements so as to address the different problems confronting the banks that needed the liquidity supports. By the nature of its operation, the banking sector, which for most developing and emerging countries plays a very dominant role in the payment system as providers of financial inter-mediation and sources of financing, could at any time face problems of liquidity mismatch.

What is liquidity mismatch actually? And why is it that any bank could face the problem of liquidity mismatch at any time? A liquidity mismatch in a bank occurs when the short term or liquid liabilities are not equal to its short term assets, in particular when

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<sup>4</sup>*Konspirasi Menggoyang Soeharto: Kumpulan Selebaran Paling Aktual*, November 1997 (mimeo)

the liquid liabilities are larger than its liquid assets. Due to the nature of a bank's operation, it is very possible that on any day a bank could be in the position of having liquid liabilities, which implies obligations to pay, that are larger than its assets or the right to receive payments.

Liquidity mismatch has nothing to do with the condition of a bank's capital. Thus, a healthy bank with sufficient capital adequacy ratio (CAR) could, on a particular day, face a problem of having an immediate obligation to pay that is larger than its immediate right to be paid. A bank in this position is said to face liquidity mismatch. Since the nature of a bank's operation is in mediating between groups in an economy that have surpluses of funds and or otherwise, it is very possible that in the process of mediation, a bank encounters problems of different liquidity profiles. In fact, banks operate to mediate shorter term sources of funds with longer-term usages of funds. Thus, it is possible for a healthy bank operating in a normal situation to encounter liquidity mismatch, and it is even highly probable that this bank encounter an even bigger mismatch in a distress or crisis.<sup>5</sup>

The central bank as lender of last resort and guardian of the payment system had designed different schemes of liquidity support. The general term that was understood better by the public was the discount window or rediscount facility. However, the public in Indonesia was only aware of the liquidity support when, due to the crisis, Bank Indonesia was forced by the call of duty and by government policy, to help many banks that suffered from a liquidity problem because of bank runs. Due to the amount of funds involved, the possibility of loss, and the burden of financing the cost through the government budget and taxpayers money, the issue attracted much public attention. The term 'Bank Indonesia liquidity supports' (*Bantuan Likuiditas Bank Indonesia* or BLBI in Bahasa Indonesia) was only widely known in early 1998, when the public started to debate on the issue that was mentioned in the letter of intent (LOI) to the Fund as 'central bank liquidity support'<sup>6</sup>.

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<sup>5</sup> V. Sundararajan and Balino defined 'banking crisis' or 'financial crisis' as a situation in which a significant group of financial institutions have liabilities exceeding the market value of their assets, leading to runs and other portfolio shifts, collapse of some financial firms, and government intervention, while 'banking in distress' is used to describe a situation in which banks are insolvent but not illiquid. A distress situation has effects that resemble those of a crisis, but in a less acute form (V. Sundararajan and Tomas J.T. Balino, Eds., *Banking Crisis: Cases and Issues*, Washington DC: IMF, 1991, pp. 3-4).

<sup>6</sup> "Indonesia - Memorandum of Economic and Financial Policies", Jakarta, January 15, 1998, point 15.

Some of the public comments on the issue showed a lack of understanding about the real issue. For example, the following comment sounded as if a secret operation had been uncovered: “As it turned out, Bank Indonesia had been giving this liquidity support to banks, even prior to the crisis.”

In spite of such seemingly innocent or naïve comments which reflected widespread public ignorance about the central bank’s operation, the different schemes of liquidity support had been part of Bank Indonesia’s policy instruments since its transformation from the old *de Javasche Bank* in 1953, to become the central bank of the new Republic. Like other central banks in modern economies, Bank Indonesia has been the lender of last resort for the Indonesian banking industry since its birth.

The easiest way to describe the central bank’s facilities that could be included in the definition of liquidity support is to do it by defining what are not included. This will give us a very broad definition of what is meant by Bank Indonesia liquidity support. In this concept, Bank Indonesia liquidity supports constituted all facilities in the form of liquidity support outside BI liquidity credits provided by the central bank.

The Bank Indonesia Liquidity Credits (*Kredit Likuiditas Bank Indonesia* or KLBI) are loans provided by the central bank to commercial banks at subsidized interest rates to support government programmes, like loans to finance small and medium scale enterprises (SMEs), the cooperatives, and loans to the Bureau of Logistics (Bulog) for financing programmes of self-sufficiency in rice. So, the broad definition of Bank Indonesia liquidity support includes all facilities provided by the central bank for the banking sector outside these KLBI schemes.

Using this broad definition, there were altogether fifteen facilities for providing liquidity to banks that Bank Indonesia employed in the past. The fifteen facilities could be grouped into the following five categories:

1. *Liquidity supports to banks suffering from liquidity mismatch*

There were two types of liquidity support to resolve liquidity mismatches faced by banks; one that bore a very short term of 15-30 days, which was termed Discount Facility I, and another one for short term, between 90-150 days, which was termed Discount Facility II. The latter required promissory notes as collateral.

2. *Liquidity supports to banks in the context of Bank Indonesia open market operations*

In this facility, Bank Indonesia rediscounted promissory notes or other debt instruments of commercial banks, either through periodic auction or direct deals with banks in need.

3. *Liquidity supports in the context of bank rescuing or nursing programme that Bank Indonesia conducted*

Bank Indonesia gave support to the restructuring of problem banks through merger and acquisition in the form of emergency or subordinated loans.

4. *Liquidity supports to banks facing runs in the context of stabilizing the banking industry and the payment system*

The facilities were in the form of drawings by banks from their funds with the central bank which were for fulfillment of reserve requirements, and the exemption for banks to participate in daily clearing notwithstanding the presence of negative balances in their accounts with Bank Indonesia.

5. *Liquidity supports to banks in the context of defending market confidence in the banking sector*

These facilities were in the form of advances by the central bank to the government for payment to small deposit holders of liquidated banks, advances for the implementation of blanket guarantees and advances for payments of banks' arrears to their foreign counterparts for trade financing and inter-bank debt exchange offers.

Bank Indonesia's liquidity supports in the first two categories are instruments that most central banks provide in their operation as monetary authorities and lenders of last resort. Prior to the crisis, Bank Indonesia had been using these instruments in its operation. The third one had also been resorted to in its operation to give an incentive to investors that had workable plans to invest in problem banks that were rescued through merger and acquisition. In other words, these were the liquidity supports that Bank Indonesia had used in its operation in normal conditions, prior to the crisis.

When the crisis struck the country, Bank Indonesia resorted to other categories of liquidity supports, i.e., the last two categories. These supports were resorted to in the face of contagion in the banking sector to save the payment system from collapsing altogether. In effect, the supports did save the banking sector from collapsing, due to its strategic role in the payment system.

But, how did Bank Indonesia's liquidity support actually develop? Let me touch on the process of how the facility evolved. The financial turmoil that struck Indonesia in July 1997 started to cause problems for the banking sector when in defence of the currency slide the central bank took steps to limit liquidity. After the currency float in mid-August, the government and the central bank further tightened the liquidity. The policy was executed through a combination of interest rate increase, expenditure reduction by the government as well as administrative intervention. The last one was in the form of an instruction by the Minister of Finance for state enterprises to transfer their bank deposits into Bank Indonesia Certificates (SBIs).

In the meantime, due to their concern for the safety of funds held in banks, people started to withdraw their deposits from banks, especially those perceived to be weak. This process caused a number of banks to feel the brunt from increasing scarcity of liquidity in the inter-bank money market. In effect, by this time the Indonesian banking industry began to suffer distress.

The problem started to become systemic when, as a reaction to bank closures in early November 1997, the banking industry lost its credibility. Depositors reacted negatively to the closures by moving their bank deposits and savings to safety. The process of *flights to safety* ensued and a large amount of funds was moved from banks

perceived to be problem banks to others that were considered safe. The inter-bank money market no longer functioned normally. In fact, it was segmented. The number of banks suffering from liquidity mismatch increased. And the banking industry was confronted with a worsening problem – the distress became a crisis.

Bank Indonesia responded to the problem by providing banks that suffered from liquidity problem with liquidity supports. It was done through different schemes of liquidity facility that were available. Since the problem was systemic, and faced by an increasing number of banks over time, the most dominant form of the support was through the mechanism of daily clearing.

By this, commercial banks were required to participate in daily clearing in their operation. This was a mechanism to check the condition of the banks' liquidity after their daily operations. A bank that experienced a negative balance with the central bank as shown in the clearing process was given a day to settle the obligation.<sup>7</sup> In a normal situation, this bank would settle the liquidity mismatch by borrowing funds from other banks in the inter-bank money market. This was routine in normal situations.

When banks were in distress, many of them suffered liquidity problems due to massive withdrawals of deposits and savings. However, the inter-bank money market ceased to function normally. Even banks that had excess liquidity did not want to lend to other banks. An increasing number of banks was forced to rely on alternatives. They started using their own funds that were put aside with the central bank as reserve requirements. So, banks that failed to get funds from the inter-bank money market started using funds that were held with BI to meet reserve requirements. The number of banks violating the reserve requirement rule started to increase. But since the condition was worsening, the process of massive deposit withdrawals continued, and banks started to run out of their own funds with BI. Eventually, Bank Indonesia liquidity supports were the last resort for these banks to continue in operation.

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<sup>7</sup> There is an internal measure in Bank Indonesia, issued by the Board in 1981, that stated “a bank that failed to solve its liquidity mismatch in a daily clearing *could be* sanctioned by BI to be excluded from the clearing process”. The Supreme Audit Board interpreted this rule as an instruction for BI to sanction banks that failed to solve their liquidity mismatch. In other words in the Supreme Audit Agency's interpretation, the rule said that BI *must* sanction the banks by stopping them from participating in clearing. And not doing this is a crime. This interpretation has become public understanding that fault BI for not sanctioning banks that had a liquidity mismatch, and providing liquidity support to them instead.

What Bank Indonesia actually decided on was that of allowing banks having negative balances to continue participating in the clearing process. By allowing banks that were experiencing liquidity mismatch and carrying negative balances with Bank Indonesia to operate normally, they could exercise their right to claim for repayments from their outstanding loans and other assets. On the other hand, had Bank Indonesia decided to freeze and liquidate these banks, all settlements of both assets and liabilities could have been done only through bankruptcy proceedings.

We do not know what the outcome would have been had this alternative policy been adopted. Argentina in November 2001 and Uruguay in July 2002 elected to limit the withdrawal of deposits from the banks which, in effect, was similar to partially freezing banking operation. We still do not know what the end result of this policy will be. However, it has been reported that the decision had caused social and political turmoil in Argentina at least.<sup>8</sup>

When Bank Indonesia made the decision to help the banks that were having liquidity problems, it was bound by the President's decision not to liquidate banks during the fragile period. Thus, based on its function as lender of last resort, and in defending the banking industry and the payment system from collapsing, Bank Indonesia provided liquidity supports to banks that were in need. This was the main reason why liquidity supports were made available to banks indiscriminately. There was a serious systemic liquidity problem.

Under normal conditions, the liquidity supports usually resorted to were mostly discount facilities and the rediscount of banks' promissory notes. These instruments carried predetermined specifications and better safeguard measures for Bank Indonesia. The receiving banks had to produce collateral in the form of promissory notes and other debt instruments for using these facilities. Even though these instruments carried better safeguard measures for Bank Indonesia, the procedure was more cumbersome in the face

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<sup>8</sup> See Asnar Ashari, "Krisis Argentina dan Refleksi Masalah BLBP" (The Argentine Crisis and Reflection on BI Liquidity Support), *Kompas*, 29/07/2002, and Abdul Mongid, "Menelaah Kebijakan Penjaminan dan BLBP" (Analyzing Guarantee Policy and the BI Liquidity Support), *Media Indonesia*, 24/09/2002. For an analysis on the Argentine problem, see Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy*, Washington DC: Institute for International Economics, July 2002.

of contagious liquidity mismatch of banks. Speed was of the essence for the support to be effective in safeguarding the payment system.

However, in the midst of distress and crisis, the financial sector experienced pressing problems that demanded faster mechanisms to address. A bank confronted with a run could face a worsening condition, i.e., the liquidity problem could turn into a solvency problem within days. In the face of a pressing risk of a collapsing banking sector and based on expectations that the crisis would be short term in nature, Bank Indonesia was forced to act swiftly to provide support to banks through the clearing process.

Indeed, Bank Indonesia was compelled to act swiftly, and the most logical choice of instrument under the circumstances was the clearing mechanism. By letting banks having a liquidity problem that was systemic in nature to continue in operation, it was hoped that the banking industry had breathing time to get back to normalcy with regards to their liquidity position. In this way, the collapse of the payment system could be avoided, and the national economy could continue thriving. In the process, the collapse of the banking sector would also be avoided.

However, the downside of the provision to let banks carrying negative balances with Bank Indonesia to participate in clearing was that it did not have safeguard measures for the facility in use. But the expectation was for the crisis to be over quickly, and that the banks would be able to get back the lost deposits in the longer run, and to operate normally. The banking industry would be saved from collapsing and banks would be able to pay back their obligations to the central bank. In this manner, the payment system would not be disturbed and the banking industry could continue performing its intermediation function to support economic activities.

However, when the crisis did not recede and problems continued to get worse Bank Indonesia on several occasions changed the clearing process facility that was given to banks into more secured ones, i.e., the discount facilities. By the end of 1997, all these provisions were even transformed into a more secured rediscount facility.

As it turned out, the crisis lingered on in spite of further measures like the adoption of a blanket guarantee and the formation of a special institution to deal with problem

banks, i.e., the Indonesian Banking Restructuring Agency (IBRA). In April 1998, the government resorted to an even longer-term facility of bank restructuring through a programme of bank re-capitalization to both state-owned and private banks.

The provision in the programme of bank re-capitalization was for bank owners to provide 20 percent of the capital needed for the banks to have a capital adequacy ratio of 4. In this scheme, the government would provide the 80 percent of capital needed. The private banks had received huge amounts of funds from Bank Indonesia liquidity supports before. Due to the liquidity supports from Bank Indonesia and the capital injection by the government through the re-capitalization programme, government ownership in the banking industry shored up substantially to more than 80 percent of the total after the crisis, or doubled that of the pre-crisis level.

As described above, other liquidity supports were advances made by Bank Indonesia for financing different items owed by problem banks. These included payment for small deposits of the liquidated banks in November 1997, the adoption of blanket guarantee and payment of banks' arrears to their foreign counterparts in accordance with the agreement between national banks and foreign banks, known as the Frankfurt Agreement of June 1998. These obligations were later transferred to the government or IBRA for more transparent resolution in addition to freeing Bank Indonesia from making the repayments.

### **Debate over the origin of the policy**

The saying that 'failure has no father' seems fitting in determining responsibility for the policy of liquidity support. This issue became public debate after the Parliamentary Commission on central bank liquidity support summoned officials and former officials of Bank Indonesia and the Ministry of Finance to testify in February 2000.

These officials and former officials, including the governor and the former governor of Bank Indonesia and former Ministers of Finance, were asked to give their testimony on the issue of whether the decision of providing liquidity support was made by the central bank alone or together with the government. In other words, whether the policy to provide liquidity support was Bank Indonesia policy or Government of Indonesia

policy. It became public debate after a statement by three former ministers of finance claimed that the provision of liquidity support was not a government policy, and that the central bank made the decision out of its misunderstanding of government policy.<sup>9</sup>

However, in November 2000, the Parliamentary Commission in its report on the investigation into the issue of liquidity support, concluded that the decision for Bank Indonesia to provide liquidity supports to banks during the crisis was a government policy to resolve the financial and banking crisis. The Commission recognized that the policy to provide liquidity supports to banks was based on crisis conditions that were different from normal conditions.<sup>10</sup>

To make an assessment on the whole issue, it is important to get a good overview of the matter including the roles played by the President and the Indonesian government as well as Bank Indonesia with regards to the policy to provide liquidity support to commercial banks during the crisis.

It should be noted that based on the 1992 Banking Act, Bank Indonesia had adopted a case-by-case approach to restructure problem banks. In this approach, a variety of steps were taken to restore the health of the ailing banks. These steps ranged from requiring the banks to increase capital, to write-off bad debts or to change the management, to assisting the bank to find interested investors through acquisition or merger. If these efforts failed, and if allowing the bank to continue its operation would endanger the stability of the banking system, then a proceeding for its liquidation would be pursued.

Basically, the above process implied that Bank Indonesia would make a recommendation to the Ministry of Finance for liquidating the bank only after all other avenues had failed. The bad experience arising from a long drawn process of the closure of Bank Summa in 1992 had led the central bank to cling to the ‘too big to fail’ approach in bank restructuring.

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<sup>9</sup> Taken from a report entitled (in Bahasa) “Former Ministers of Finance and Bank Indonesia’s Governor exchanged accusations on who is responsible for Bank Indonesia liquidity supports” in *Suara Pembaruan Daily*, 10/2/2000 (<http://suarapembaruan.com/News/2000/02/10/Ekonomi/ek07.html>).

<sup>10</sup> Bank Indonesia, *Mengurai Benang Kusut BLBI* (“Untying the winding knot of Bank Indonesia liquidity supports”) (Jakarta: Bank Indonesia), 2002, p. 94.

The case-by-case method of bank restructuring was discarded when Bank Indonesia faced an increasing number of problem banks. The number of bank problems increased following the weakening of the national economy towards the end of the 1980s and the beginning of the 1990s. The problem became worse when the financial crisis erupted in July 1997.

The bank restructuring policy in the face of more systemic problems was no longer based on a case-by case approach. In this case, Bank Indonesia was still continuing its efforts to mediate and to provide incentives for investors, who could come up with workable plans to rescue problem banks. However, the method for resolving problem banks was more systemic, taking into consideration all relevant aspects of bank restructuring, including the costs and benefits of each alternative solution.

Confronted with a new phenomenon, Bank Indonesia submitted a proposal for the closure of a number of banks. In December 1996, Bank Indonesia's governor together with two managing directors in charge of bank supervision proposed the closure of seven problem banks that did not have good prospects for a rescue.

It turned out that the President did not approve the proposal. Instead, he instructed Bank Indonesia to finalize a draft of the government decree for bank closure. It was in fact correct that at this time there was no specific regulation on bank liquidation. At this time, should a bank be liquidated, a general liquidation regulation on corporation would be applied. One of the problems was that banks could not treat deposit holders as priority creditors to receive repayments that preceded other creditors. In other words, even if there was deposit insurance, the payment to deposit holders of liquidated banks could only be done together with payment to other creditors. There was no provision to prioritize payments for deposits. Deposit holders and other creditors were competitors.

As a result, there were no bank closures. Instead, the government hastened the process for the enactment of new rules that would allow banks to give priority to deposit holders for repayments in the case of liquidated banks. A government decree on bank liquidation was ultimately issued towards the end of 1996 (Government Decree No. 68, 1996, on Bank Liquidation).

On April 1997, Bank Indonesia again proposed liquidating the seven problem banks since their financial conditions did not get any better. This time, the President gave his approval. However, it was ironic that he instructed Bank Indonesia to postpone the execution until after the general election and the general session of the Peoples' Consultative Assembly. This was due to the President's concern over the implications of bank closures on social and political stability that could disrupt the general election that was scheduled in October 1997 and the general sessions of the People's Consultative Assembly in March 1998. This in effect meant that the closure could only be executed after March 1998.

Unfortunately by July 1997, the financial crisis struck Indonesia, and a lingering crisis ensued. As the crisis deteriorated, and amidst the policy responses and the market reactions, the number of problem banks increased. And based on the Fund-supported programme, bank closures were conducted on sixteen insolvent banks on November 1, 1997. Included in the sixteen were the seven banks Bank Indonesia had earlier proposed to the President for bank liquidation.<sup>11</sup>

Confronted with signals of a further weakening of banking financial conditions and increasing liquidity tightness on the one hand, and the call to maintain the functioning of the payment system on the other, Bank Indonesia decided to provide liquidity support to banks faced with the problem of liquidity mismatch. When this problem started to hit banks in a systemic way, the readily available instrument lay in helping banks suffering from negative balances with the central bank to continue their day-to-day operation. Technically, this took the form of allowing banks to continue participating in daily clearing, irrespective of their negative balances with the central bank.

It turned out that the government's decision to float the rupiah on August 14, 1997, was a shock to Indonesian businesses. The uncertainties of the foreign exchange rate after the float created panic among those in the business community that had high degrees of foreign exchange exposures, in particular, those involved in unhedged loans for financing

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<sup>11</sup> Actually, during the discussions with IMF staff for the first letter of intent concerning the bank closures, I pointed out that Bank Indonesia had fully prepared to close the seven banks, which I had brought to the attention of the President prior to the crisis. I stated that my staff needed more time to prepare for the closure of other banks. This time, I was repeatedly reassured by the IMF staff that I should not worry too much. "After all, the 16 banks only comprised 3 per cent of the total assets of the Indonesian banking industry," they argued.

risky and speculative projects. They started to buy the dollar heavily, the financing of which had caused a liquidity crunch in the banking sector. Bank Indonesia detected the severe scarcity of liquidity from cases of SBI liquidation before maturity by a number of banks and the surge of inter-bank rates of interest. Bank Indonesia also learned from reports of similar developments in Thailand following the collapse of the baht.

Confronted with strong pressures of liquidity shortage in the banking sector and the President's instruction not to liquidate banks, Bank Indonesia did not have much choice except to let banks continue their operation despite their negative balances with the central bank. As mentioned earlier, Bank Indonesia executed this policy by allowing banks in the red with the central bank to keep participating in the daily clearing process.

In a fragile condition like the one Indonesia was then experiencing, even a groundless rumour about a bank suffering a loss in the clearing process could lead to a run on that bank. An announcement by Bank Indonesia sanctioning the exclusion of a bank from bank clearing would definitely be perceived as putting a nail in its coffin. If this involved a number of banks, it would be an invitation to unwarranted bank runs. Letting these banks continue their operation would give them a chance to recoup their liquidity mismatch and to repay their debts to the central bank later on.

Thus the initial decision to let banks with negative balances participate in clearing was based on the government policy of temporarily not liquidating banks. However, after the implementation of the Fund-supported programme that included the stipulation to liquidate banks, the policy was continued because of the prospect of worse bank runs should public confidence in the banking system suffer further loss.

However, both the case-by-case as well as the systemic method of bank restructuring involved costs, which were sometimes substantial. Someone or some group would ultimately have to pay. And problems would usually arise when deciding who should pay the costs or worse still, the losses. The cost of bank restructuring through a variety of facilities to Bank Indonesia (as the provider of these facilities) ultimately constituted what was known as Bank Indonesia liquidity supports, more popularly known as *Bantuan Likuiditas Bank Indonesia* (BLBI) in Bahasa Indonesia.

The bulk of liquidity supports were used to finance the mass withdrawals of funds from a large number of banks in the banking industry. The flight to safety occurred when market confidence in the banking sector was lost partly as a public reaction to the bank closures in November 1997. As a result, the banking sector suffered runs which threatened the payment system with collapse. The negative balances of commercial banks with Bank Indonesia kept increasing as the condition deteriorated from one of distress to one of crisis.

From the table below, the negative balance of commercial banks increased from IDR 1.4 trillion in July 1997 to IDR 15.3 trillion by the end of 1997, and IDR 48.4 trillion by February 1998. The total negative balance of banks was IDR 371 million prior to the crisis. It went up to IDR 1.4 trillion by the end of July 1997 and increased further to IDR 5.2 trillion by the end of September 1997. The amount of banks' negative balances kept increasing despite efforts by Bank Indonesia, with the support of the government, to substitute the facility with a better safeguard liquidity support instrument and to stop allowing banks to run negative balances.

The increasing volume of the negative balance of banks seemed to be induced by government decisions in addressing the problems associated with the crisis. Increases in the facility to allow banks with negative balance to participate in bank clearing seemed to follow government policies to float the rupiah in August 1997, the closing of banks in November 1997, the introduction of the blanket guarantee, the transfer of authority over problem banks to IBRA in February 1998, and the riots that ended up with Soeharto's resignation in May 1998. All these steps were associated with heightening uncertainty in the market which seemed to lead to the flights to safety and bank runs.<sup>12</sup>

Broadly defined, liquidity support should also include other types of facilities. Firstly, advances made by Bank Indonesia for financing the repayment of deposits up to IDR 20 million of the liquidated banks. Later on, based on an instruction from the President, the Minister of Finance decided on the repayment for all deposit holders of the liquidated banks. In the table below, the advances amounted to IDR 5.7 trillion. Secondly, advances for financing related to the adoption of blanket guarantee, and for

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<sup>12</sup> Read also Dradjad Wibowo, *BLBI Sebagai Sebuah Kebijakan* ("BI Liquidity Support as a Policy"), *Kompas*, September 9, 2002.

payment of banks' arrears on trade finance to foreign banks. Bank Indonesia also issued a new discount facility in March 1998.

Bank Indonesia's liquidity supports skyrocketed from IDR 10.9 trillion in July 1997 to IDR 62.9 trillion at the end of 1997, IDR 96 trillion at the end of February 1998, IDR 173.4 trillion in 1998 and to IDR 178.6 trillion in 1999. During the crisis, liquidity support in the different forms described above was used by 164 banks or two-thirds of the Indonesian banking industry.

**Bank Indonesia Liquidity Supports, 1997-1999  
(Billion IDR)**

	1997 (Jul)	1997	1998 (Feb)	1998	1999
<b>Extended Lending</b>					
Subordinated	7,954	9,422	9,383	8,915	7,237
Emergency Bridging (1)	351	475	475	449	421
	-	1,706	5,335	-	-
<b>Discount Facility</b>					
Disfa I	-	678	-	-	-
Disfa II	-	747	747	-	-
New Disfa (2)	-	-	-	30,610	-
<b>Debit Balance</b>					
Overdraft	1,394	15,343	48,385	16,859	1,000
Facility covering Ov (3)	-	-	-	54,573	-
<b>Rediscount Facility</b>					
SBPU	1,167	5,079	5,856	1,018	-
Special SBPU (4)		29,479	29,479	23,903	7,242
<b>Others</b>					
Trade arrears	-	-	-	11,781	-
Government bonds				20,000	162,712
<b>Total</b>	<b>10,866</b>	<b>62,929</b>	<b>96,029</b>	<b>173,443</b>	<b>178,612</b>

Source: Rearrangement of Table 30, IMF, *Indonesia: Statistical Appendix* (Washington: The International Monetary Fund, Oct 2000), p. 33.

- (1) Advances by Bank Indonesia to pay for small depositor holders, ultimately all depositors of liquidated banks.
- (2) New discount facility, introduced in March 1998.
- (3) To cover negative balances of banks with Bank Indonesia in the forms of discount facilities I and II.
- (4) Rediscount facility to replaced liquidity supports previously received by banks, introduced in December 1997.

What was the government's role in the policy to provide liquidity supports to banks during the crisis? It was explained earlier that Bank Indonesia had decided in mid-August to allow banks having a negative balance with Bank Indonesia to participate in clearing. Not to do so would have been tantamount to letting them experience runs and be liquidated. The central bank was compelled to provide these banks with liquidity supports since the President did not approve Bank Indonesia's proposal on bank closures.

In a way, the liquidity shortage, which was intentionally created by the government's policy to defend the rupiah, had forced Bank Indonesia to opt for its lender of last resort function to provide liquidity supports to banks in need of liquidity. Bank Indonesia based its decision on the law that made it a central bank to implement the government policy of not liquidating banks.

In fact, the government issued a discretionary policy that specifically instructed the central bank to provide liquidity support to banks that experienced a liquidity problem. This policy was issued prior to the coming of the Fund on September 3, 1997. The policy was in the form of policy directives by the President to the Cabinet. On the liquidity support, the directives were as follows:

- Healthy national banks that suffered from liquidity problems should temporarily be helped with liquidity.
- Banks that are really unhealthy should be put under a programme of merger and acquisition with healthy banks. If the efforts failed, these banks would be liquidated with a view to protect the interest of deposit holders, especially small depositors.<sup>13</sup>

In the first letter of intent, which itemized the government adjustment programme for addressing the crisis, several references were made that showed the government's involvement in the liquidity support policy. After all, the LOI was a Government of Indonesia (GOI) document showing the programme that the government had planned to

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<sup>13</sup> "President's Instructions and Decisions in the Cabinet Meeting on Economics and Finance, Development Supervision, Production and Distribution" (Jakarta: Bina Graha), September 3, 1997, point 8.

implement during the stand-by arrangement. Several points mentioned in the document were:

- The government did not guarantee repayment of the liabilities of liquidated banks, except to small depositors up to a maximum of IDR 20 million (around USD 5,000). The repayment would be done through a Bank Indonesia advance, but the government would finance it. This would be done until a deposit insurance scheme was adopted (First LOI, point 21).
- The government would phase out in stages quasi-fiscal operations of Bank Indonesia, as in the case of its liquidity credits for government programmes. The government would show all subsidies transparently in the budget (First LOI, point 35).
- Bank Indonesia would streamline its lender of last resort function (First LOI, point 36).

In the second LOI it was stated that:

Since the crisis began, Bank Indonesia's monetary strategy has been to support the rupiah exchange rate, and limit any increase in inflation, by maintaining a firm monetary stance. The execution of this policy, however, has been hampered by problems in the banking system. Following the closure of 16 banks in November last year, customers concerned about the safety of private banks have been shifting sizeable amounts of deposits to state and foreign banks, while some have been withdrawing funds from the banking system entirely. (Second LOI, point 14).

Furthermore, this document that itemized the Fund-supported programme through a stand-by arrangement also explained clearly that the central bank's liquidity supports to the banking sector was an effort to defend the banking system from collapsing. The document stated:

These movements in deposits have greatly complicated the task of monetary policy, because they have led to bifurcation of the banking system. By mid-November, a large number of banks were facing growing liquidity shortages, and were unable to obtain sufficient funds in the inter-bank

market to cover this gap, even after paying interest rates ranging up to 75 percent. At the same time, another smaller group of banks was becoming increasingly liquid, and were trading among themselves at a relatively low JIBOR<sup>14</sup> of about 15 percent. As this segmentation continued to increase, while the stress on the banking system intensified, *Bank Indonesia was compelled to act. It provided banks in distress with liquidity support, while withdrawing funds from banks with excess liquidity*, thereby raising JIBOR to over 30 percent in early December, where it has since remained. (Second LOI, point 15)

These passages from the government documents showed that the policy to provide liquidity to banks during the crisis was a step that the central bank was compelled to take in an effort to prevent the banking sector and payment system from collapsing. The decision was based on the Bank Indonesia Act of 1968 which gave Bank Indonesia the authority as the lender of last resort to provide banks with liquidity they desperately needed in the face of runs (Article 32 (3)). The decision was also based on the policy of the government not to close banks temporarily as well as an explicit instruction from the President to the monetary authorities to help banks with liquidity problems during the crisis.

The policy to liquidate 16 banks in November 1997, which ultimately caused bank runs, was surely part of a government policy for a comprehensive financial restructuring programme. The financial restructuring itself was one of the pillars of the government's Fund-supported adjustment programme to address the crisis. To support the policy of bank closure, the government decided to pay back the owners of bank deposits of up to IDR 20 million. The payment was made using Bank Indonesia advances. However, it was explicitly stipulated in the programme that the financing of the payment would be borne by the government.

In late January 1998, the government made a decision to adopt a blanket guarantee that covered both the assets and the liabilities of national banks, which subscribed to the programme. The payment for the blanket guarantee was also borne by the government budget. In late February 1998, the government decided also to make payment to the rest of the deposits held by the liquidated banks in the same manner as the payment to small depositors.

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<sup>14</sup> Jakarta Inter-Bank Offered Rate.

As a part of the corporate debt restructuring programme in June 1998, an agreement was reached between international banks – as creditors to Indonesian corporations – and the steering committee representing Indonesian corporations to set up a scheme for corporate debt restructuring on a voluntary basis. The agreement was later known as the Frankfurt Agreement. The agreement stipulated the government’s guarantee for Indonesian banks’ exposures to international banks. The GOI had to make payments for past arrears of Indonesian banks as a condition for the resumption of the international banks’ facility on trade financing and inter-bank debt exchange offers. Bank Indonesia made an advance to pay the arrears with the understanding that it would be borne by the GOI.

In August 1998 and thereafter, when the government implemented its programme of bank re-capitalization with a formula of 20 percent of the value of capital to be paid by bank owners and the rest by the GOI, the institution in charge was IBRA. If only Bank Indonesia was in charge, Bank Indonesia would have paid the 80 percent of capital first, but the burden would later be borne by the GOI.

From the sequence of decisions made by the government or the President, and Bank Indonesia (as explained above), the issue of ownership of policy for providing liquidity supports to the banking sector and the burden of financing could easily be deduced. After the granting of autonomy to Bank Indonesia with the enactment of Law No. 23, 1999, on the central bank, and after the worst period of the crisis was over, the issues concerning ownership of the liquidity support policy, and who should be made accountable for payment of the costs and losses as well as other adverse implications of the policy, had become political issues.

As mentioned earlier, contrary to some claims during the Parliament hearing in February 2000, the decision by Bank Indonesia to provide liquidity support to the banking sector was neither a wrong interpretation of government policy nor was it in violation of the Central Bank Act. It was definitely not an action that was based on any misuse of power or authority bestowed to Bank Indonesia and its Board of Directors, including its Governor as chairman and member of the Board.

### **Attempts to resolve the problems**

The problems associated with the liquidity supports are enormous, very complex and easily misunderstood. Conflicting interests have constrained their resolution. In fact, the problems linger on with slim prospects for quick resolution. I would only discuss briefly the government efforts to deal with the problems of liquidity supports based on available documents and information.<sup>15</sup>

In spite of the tendency for some to believe that the policy for providing the liquidity supports was merely a central bank policy from the Board of Directors during my term as Governor, statistics cited in the previous table showed that the policy was continued at least until the end of 1998. The report of an audit on Bank Indonesia by the Supreme Audit Agency also used the liquidity supports position of beginning 1999, which confirmed that the policy was not exclusively that of the Bank Indonesia Board under my leadership.

After the dismissal of four members of the board in late December 1997 and myself in mid-February 1998, and another one a week later, there were two other board members that were dismissed in March 1998. By this time, all the board members that I had appointed were all dismissed before finishing the five-year term. The managing directors who joined the board in late December 1997 participated in the management, and together with the others, had been continuing and expanding the policy of providing liquidity supports to banks for the rest of 1998.

For sure, several measures to safeguard the liquidity support provisions were adopted after I had left Bank Indonesia. The new management designed a more stringent rule in providing liquidity supports to banks. These new measures were put into the provision in accordance with the agreement with the Fund that actually was already stipulated as part of the government intention in both the first and second letters of intent. Point 36 of the first letter of intent stated that, “Bank Indonesia will streamline its lender of last resort function”. And point 25 of the second letter of intent stated that, “The central

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<sup>15</sup> In particular, Bank Indonesia, *Mengurai Benang Kusut BLBI* (“Untying the winding knot of BI liquidity support”), Jakarta: Bank Indonesia 2002, Sukowaluyo Mintorahardjo, *BLBI Simalakama* (“The Dilemma of BLBI”), Jakarta: Riset Ekonomi Sosial Indonesia, 2001, and Charles Enoch, et al, *Indonesia: Anatomy of a Banking Crisis, Two Years of Living Dangerously, 1007-1999, IMF Working Paper*, WP/01/52, Washington DC: IMF, May 2001.

bank will provide liquidity support to banks subject to increasing conditions, while insuring that liquidity support extended to banks will be consistent with the program's monetary growth objectives".<sup>16</sup>

Be that as it may, what had been the national efforts to address the liquidity support problems? I would not go into the details of the issues. Suffice it here to show the contour of the national efforts to address the liquidity support problems. In a book published recently, Bank Indonesia showed that there were two types of solutions; political and legal.<sup>17</sup>

### ***Political Solution***

In terms of a political solution, the Parliament (as mentioned before) had set up a working committee on Bank Indonesia liquidity supports, which conducted hearings with officials from the Ministry of Finance and Bank Indonesia, bankers and other parties to come up with solutions to the problems. The committee came up with a report in March 2000 which included the following conclusions:

- On the issue of responsibility for the policy to provide liquidity supports, it concluded that based on the Central Bank Act of 1968, Bank Indonesia is a central bank that also functions as the government treasurer. The Governor, besides heading the board was also a member of the Cabinet as well as a member of the Monetary Board. This made the Governor a decision-maker as well as the implementer of financial policy. Bank Indonesia's policies derived from government decisions. Bank Indonesia's liquidity support was a government policy and the government should therefore be responsible for it.
- On the possibility of irregularities in the channeling and use of funds, the committee instructed the Supreme Audit Agency to conduct investigative audits on

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<sup>16</sup> See *Indonesia – Memorandum of Economic and Financial Policies*, Jakarta, October 31, 1997, point 36 (mimeo), and *Indonesia – Memorandum of Economic and Financial Policies*, Jakarta, January 15, 1998, point 25 (mimeo).

<sup>17</sup> Bank Indonesia, *Mengurai Benang Kusut BLBI*, Jakarta: Bank Indonesia, 2002.

Bank Indonesia and receiving banks. From the audit, the roles of each official could be identified. The Governor of Bank Indonesia and the Minister of Finance should also take responsibility for the mistakes that Bank Indonesia committed.

- The government should expedite action to get IBRA to optimize its management and sale of the assets of frozen banks, banks taken over or liquidated banks, to maximize the repayments of outstanding liquidity supports.
- Should the audit be suspicious of any criminal act that caused losses to the government, the Attorney General's Office should investigate promptly.

Based on the investigative audit, the Supreme Audit Agency found that the liquidity supports to the banking sector from 1996 to January 1999 amounted to IDR 144.5 trillion. It was claimed that due to deviations in the channeling of funds by the central bank and the uses by receiving banks, the government could suffer losses of IDR 138.4 trillion or 95.7 per cent of the total liquidity supports provided to the banking sector throughout this period.

It is tricky to talk about resolving an issue when the issue itself is not very clear or well understood. To be sure, there is no clear agreement as yet on the findings of the investigative audit on Bank Indonesia by the Supreme Audit Agency. In the book mentioned earlier, Bank Indonesia put up arguments concerning the nature of the audit and the procedure, as well as the findings that raised some questions. The crucial ones are the following:

- The audit was more of a compliance audit which, in general, checked whether the actions by the central bank were in compliance with existing rules and regulations. The rules and regulations were set up for normal conditions, while the facilities were provided in a crisis situation. The policy's deviations from existing rules should not be interpreted as violations as this was not a compliance audit. The prevailing economic and financial conditions as well as the contagion that in fact compelled Bank Indonesia to take the decision to provide the facility were completely ignored in the audit.

- The audit did not take into consideration the function and authority of the central bank in conducting monetary and banking policy. Consideration was also not given in terms of whether the policy to provide liquidity support was outside the jurisdiction of Bank Indonesia, or whether the decision was a misuse of the central bank's authority.
- The policy for not stopping banks with negative balances from participating in clearing during an emergency situation, was in accordance with the Central Bank Act and the government policy at the time to assist banks with liquidity shortages and not to liquidate banks.
- The conduct of the audit was questionable in view of the fact that the auditors did not make any attempt to interview the former and present board members, and that they failed to conduct any review session with Bank Indonesia officials on the findings, which is a normal practice in auditing. Bank Indonesia also criticized the Agency for publicly releasing the report instead of submitting it to the Parliament.

There were other points of disagreement that Bank Indonesia put up in the book. But the most important issue was the different views on the nature of the audit. For example, it was argued by the Agency that Bank Indonesia's advance for repayment of deposits held with the liquidated banks was a deviation from the rule for bank liquidation. In the government regulation for bank closures, payments for deposit holders should be financed through the selling of assets of the liquidated banks.<sup>18</sup> Thus, according to the finding of the audit, Bank Indonesia could not ask the government to bear this burden of financing. The Agency completely ignored the fact that the decision to liquidate banks was a government policy, and that there was a promise by the government to bear the burden of the financing as mentioned in the first LOI to the Fund and in a letter by the Minister of Finance to the Governor.<sup>19</sup>

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<sup>18</sup> *Government Regulation*, Number 25, 1999

<sup>19</sup> See First LOI, point 2. This was also mentioned in a letter from the Minister of Finance to the Governor of Bank Indonesia, February 20, 1998.

In Bank Indonesia's contention, the political resolution to the problem of the liquidity supports had been finalized by the legal solution through the Master Settlement and Acquisition Agreement (MSAA), the Master Refinancing and Note Issuance Agreement (MRNIA) and agreements between IBRA and bank owners on the repayments of what they owed to the government from the facility they received before.

After reviewing the Agency's audit report on Bank Indonesia, the Parliamentary Committee on liquidity support issued a report on November 1, 2000, as a conclusion on this issue. The conclusions were as follows:

- Bank Indonesia's liquidity support was a policy taken by the government in the face of the crisis on September 3, 1997.
- Because the policy on liquidity supports was taken during the crisis, the channeling and settlement were not based on rules that apply for normal conditions.
- The resolution of liquidity support issues should be based on optimizing the real economic sectors' recovery and minimizing government losses. Therefore the solution via MSAA and MRNIA was acceptable
- The resolution of liquidity support problems should minimize the cost to the government budget through redeeming bonds from Bank Indonesia and re-capitalized banks.

The Parliament asked the government and the central bank to work together in finding solutions to the problems, with a view to financial responsibility over the liquidity support and to minimize budgetary costs.

In response to the Parliament's decision, the government formed a working team to resolve Bank Indonesia's liquidity supports. The team comprised of the Chairman of the Supreme Audit Agency, the Minister Coordinator for Economics and Finance, the Minister of Finance, the Governor of Bank Indonesia and the Attorney General. On

November 17, 2000, the team produced a document entitled “Basic Agreements between the Government and Bank Indonesia.”

The agreements encompassed several issues that included:

- An agreement on burden sharing of the costs arising from the liquidity supports between the government and the central bank with a view to minimizing costs to the budget. IBRA would make concerted efforts to maximize asset recovery. Bank Indonesia would bear part of the costs in accordance with its financial condition. However, this should not in any way compromise its solvency or bring its capital below IDR 2 trillion.
- The payment of the central bank share of the cost is to be done by issuing promissory notes to the government.
- The government and Bank Indonesia were in agreement on the issue that the liquidity supports were granted by the central bank during the crisis to save the monetary and banking system, as well as the national economy, from collapsing. The central bank took the action as an implementation of government policy.
- Taking its financial condition into consideration, the cost that has to be borne by Bank Indonesia was agreed to be IDR 24.5 trillion.

It is Bank Indonesia’s contention that the agreement, which was conducted in good faith by officials of the government and Bank Indonesia on November 17, 2000, should be considered a valid agreement, and the political solution to Bank Indonesia’s liquidity support problems.

The last point of the agreement between the government and Bank Indonesia deserves to be noted here. It does not seem to be consistent with Bank Indonesia’s claim and my own analysis that the provision of liquidity support to the banking sector was based on Law No. 13 (1968), and on the government’s policy. In the face of crisis, as the lender of last resort, Bank Indonesia was compelled to act to save the payment system from collapsing by providing liquidity support to the banking sector. The alternative of

letting banks to collapse was closed by the President's policy of not allowing Bank Indonesia to execute bank closures.

However, a question arises here, namely, why Bank Indonesia should pay IDR 24.5 trillion as part of the cost of financing liquidity support. This was what the political solution seemed to imply. The agreement was made in November 2000, during the administration of President Abdurachman Wahid. It was stated in the agreement that to reduce the burden on the government budget, the cost of financing liquidity support should be shared between the government and Bank Indonesia.

When the present government took over in July 2001, a question was raised on the validity of the agreement on burden sharing between the government and the central bank on the cost of liquidity support. An independent team was formed to come up with a recommendation to resolve this question. The recommendation seems to be agreeable to the present government and Bank Indonesia.<sup>20</sup> But, the detail of the recommendation has not been made public yet since the Parliament has yet to discuss it.

### ***Legal Solution***

The legal resolution of the problem has been even more complex than the political solution. There are two issues here: the transfer of the right for repayment from the provision of the liquidity, and the steps taken by IBRA on the settlement of liquidity supports.

On the first issue, the right for repayments of liquidity support was originally with Bank Indonesia as it was the provider of the facility to the banks. With the formation of IBRA in late January 1998 and the transfer of authority for bank restructuring of 54 problem banks to this institution shortly after, the transfer of authority for repayments of all facilities that were received previously by these banks was just a logical consequence. After all, the major justification for putting banks into the IBRA for restructuring was the amount of liquidity supports that these banks received from Bank Indonesia.

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<sup>20</sup> See "Indonesia - Letter of Intent", mimeo, June 11, 2002

On February 6, 1999, the Minister of Finance and the Governor of Bank Indonesia signed an agreement to subrogate the right for repayment on liquidity support from the central bank to the government, i.e., IBRA as the implementing institution. With the agreement, IBRA acquired a cession on the right for repayment of liquidity support owed by receiving banks from Bank Indonesia. The first batch of the cession involved the amount of liquidity supports outstanding as of January 29, 1999, as reported in the Supreme Audit Agency's audit report on Bank Indonesia.

The transfer of cession to IBRA from Bank Indonesia was done on February 22, 1999. The transfer involved ten frozen banks, five taken-over banks and 18 banks under the nursing programme. Included in this transfer were the 16 previously liquidated banks. The total number of banks was 49, but since one of the liquidated banks – Bank Andromeda – did not receive liquidity support, the total number of banks involved in the transfer of cession was 48.

The fact that Bank Andromeda, a well-connected bank, did not received liquidity support might surprise some, in particular since there are some accusations that corruption surrounding Bank Indonesia's liquidity support have often centred on the view that connected banks had received more liquidity support. In this case, the question should also be asked as to why state banks, except Bank Exim and Bapindo, did not receive liquidity support also.

Actually, this just shows that the above accusation was not based on any fact. During the crisis, liquidity support was provided to all banks facing a systemic liquidity problem arising from runs due to the flight to safety. Obviously Bank Andromeda was not suffering from a bank run. It was included in the liquidated banks in November 1997 because of insolvency, but it was not suffering from a run.

State banks, together with foreign banks, were saved from runs because in the peoples' perception, they are secured banks. In fact, they even benefited from the flight to safety since they were the recipients of funds transferred from weakly perceived banks. This is not to say that state banks did not receive any government support. In fact, in the re-capitalization programme, state banks received the biggest portion of government funds to help them fulfill their requirement for capital adequacy ratio. In the government's re-

capitalization programme of banks in 1999, out of the total of IDR 281.8 trillion bonds issued in the programme, IDR 178 trillion (or 63 percent) were for the state banks.<sup>21</sup> The state banks did not suffer from runs during the crisis, so they did not face any liquidity problem. However, the state banks suffered from huge amounts of non-performing loans, with a high percentage arising from well-connected lending. This condition had threatened their solvency, which led to costly re-capitalization.

With the transfer of cession of the collateral, the liquidity supports from receiving banks was also transferred from Bank Indonesia to IBRA. The collateral comprised of banks' assets, bank owners' assets, and assets associated with group lending from the 33 banks that were valued at IDR 132.3 trillion or 99.8 percent of total liquidity supports to these banks (IDR 132.8 trillion).

In Bank Indonesia's contention, the cession also included liquidity supports to the 16 liquidated banks to the amount of IDR 11.9 trillion. However, due to the opinion of the Supreme Audit Agency that considered this support a deviation, IBRA had not been willing to accept the cession from Bank Indonesia. This is another dispute on the status and legality of some liquidity supports that has not been resolved.

In spite of the unresolved issues on the status of some forms of liquidity support, IBRA had been taking steps to deal with the assets legally under its control in accordance with the February 1999 agreement between the Minister of Finance and the Governor of Bank Indonesia.

The government had already channeled liquidity or funds to banks under restructuring programmes that included liquidity supports, advances by IBRA, and payments against claims under the blanket guarantee. The responsibility to claim repayments on all these facilities lies with IBRA.

IBRA had taken four legal steps in its effort to get repayments from banks that had been receiving liquidity supports. The steps are: transfer of assets through the Master Settlement and Acquisition Agreement (MSAA), Master Refinancing and Note Issuance

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<sup>21</sup> See Bank Indonesia, *Annual Report 1999* (Jakarta: Bank Indonesia), Table 6.1, p. 61

Agreement (MRNIA), conversion of liquidity supports into capital participation in banks, and settlement of liabilities of principal bank owners.

MSAA is an agreement to solve the obligation to pay by surrendering assets. This technique is offered by principal bank owners who owned adequate assets for the settlement of their obligation arising from the liquidity supports they had acquired before. IBRA would perform acquisitions to the assets being surrendered.

There are two types of MSAA. First, those offered to principal owners of frozen banks or which were in the process of liquidation. The arrangement included settlement of liquidity supports the banks owed to IBRA, and group lending that violated legal lending limits. Second, those offered to principal owners of banks taken over by IBRA. The arrangement includes only group lending that violated legal lending limits. The liquidity supports that the banks owed to IBRA in these cases were settled via conversion of the liquidity supports into capital participation.

The settlements of liquidity supports through MSAA are out-of-court settlements. The settlements contain a clause of release and discharge, which implies that by signing the agreement the banks and the principal bank owners are released from their obligation to make repayment of liquidity supports owed. According to the record cited by Bank Indonesia, settlements of liquidity supports through MSAA that involved five large banks - BDNI, Bank Surya, Bank Hokindo, Bank Modern and Bank Umum Nasional – constituted liquidity supports to the amount of 53.6 trillion rupiah.<sup>22</sup>

The settlement of liquidity supports through MRNIA is applied to principal bank owners who have surrendered assets to IBRA for the settlement of what they owed but were not enough to cover their total obligation. In the agreement, the bank owners acknowledged their unfulfilled obligations. For that, they surrendered additional assets that were treated as personal guarantees and corporate guarantees for settling the rest of the debts within a stipulated time period. Bank Danamon, a big bank, is an example in which IDR 3.3 trillion in liquidity supports were resolved.<sup>23</sup>

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<sup>22</sup> Bank Indonesia, *Mengurai Benang Kusut BLBI*, ...p. 88.

<sup>23</sup> Bank Indonesia, *Mengurai Benang Kusut BLBI*, ...p. 90

On March 26, 1999, the Minister of Finance and Governor of Bank Indonesia issued a joint decree on the re-capitalization of banks that had been taken over by IBRA. Based on the agreement, IBRA re-capitalized four banks, including large banks, by converting the liquidity supports that these banks owed IBRA into capital participation. The banks were BCA, Bank Tiara, Bank Danamon and Bank PDFCI. The value of liquidity supports that had been converted into capital participation in these banks as of May 29, 1999, was IDR 54.6 trillion.<sup>24</sup>

Altogether, settlements of liquidity supports through MSAA, MRNIA and personal guarantees resolved a total of IDR 111.5 trillion of the liquidity supports outstanding. In the assessment of Bank Indonesia, the resolutions through legal and political steps that had been taken by the government have been encouraging.

Of course, Bank Indonesia has been too optimistic. The problems concerning the liquidity supports linger on, both politically as well as legally with the continuing process of prosecution against Bank Indonesia officials accused of violating or misusing their authority to provide liquidity supports to banks that resulted in losses to the state.<sup>25</sup>

The legal process has been going on for some time now. But it is by no means completed. I would like to note the following points here:

First, aside from the fact that the decision to provide liquidity support to banks was based on a strong legal foundation, it was also clearly done as the implementation of a valid government policy. If the policy to provide liquidity support to banks was considered to be a bad or even wrongful policy, accusing the proponent(s) of the policy of committing a criminal act is definitely problematic to say the least. This does not, of course, absolve officials who were involved in corruption in the process.

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<sup>24</sup> Bank Indonesia, *Mengurai Benang Kusut BLBI*,... p. 89.

<sup>25</sup> Three former Managing Directors of Bank Indonesia have been prosecuted in court. And, on May 31, 2002, it was announced by the Attorney General's office that I became a suspect in the BI liquidity support case on the basis of misusing the authority to provide liquidity supports to banks that caused losses of trillions of rupiah to the government (*Jakarta Post*, June 1, 2002).

Second, aside from the flaws that seemed to happen in the conduct of the audit as well as the estimate of the cost as shown in this paper, there are some disquieting inconsistencies that should be noted, including:

- IBRA had provided liquidity support to banks taken over by it in 1999, which was basically identical to the liquidity supports given to 164 banks during the crisis. In spite of IBRA's status, which is not formally a lender of last resort, the Supreme Audit Agency did not consider this action in violation of any rule.<sup>26</sup>
- The September 1998 solution through the Master of Settlement and Acquisition Agreement (MSAA) included a *release and discharge* clause for bankers that freed them from criminal charges. With a view to fairness, this clause is not consistent with the criminal charge laid on Bank Indonesia officials, especially if the charge is to fault them as the originators of the decision to provide liquidity support.
- As a provision to help the banking sector, the funds (bonds) that the government provided to banks in the re-capitalization programme are identical with liquidity support to banks. Liquidity support is a provision to banks to help them in dealing with liquidity mismatch, while a re-capitalization programme is a provision to banks to help them in dealing with the problem of insufficient capital. It is inconsistent to argue that the former is wrong (and a crime) while the other is a novelty.

Third, the public seems to forget that IBRA was created in February 1998 to manage problem banks through restructuring programmes. These banks became problem banks as the result of different factors. But in general, their problems were related to the size of their non performing loans (NPLs), which were sometimes due to excessive group lending or violations of legal lending limits (LLL). But there was another factor that tended to be forgotten, i.e., their large amount of liability with Bank Indonesia, which arose from the liquidity support received in the crisis. In other words, IBRA was created, at least partly, because of the outstanding Bank Indonesia liquidity supports. This remains a fact, even if some would choose to ignore it.

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<sup>26</sup> See also Dradjad Wibowo, "BLBI Sebagai Sebuah Kebijakan", *Kompas*, September 9, 2002.

## Final Notes

In closing, after assessing the issues and reflecting on the development of the policy of liquidity support to banks (and the responses) in the early part of the Indonesian crisis presented above, I would like to mention these points:

- It is my conjecture that lack of transparency and the serious problem of weak governance, including the banking sector's misunderstandings and misinformation about the operations of banks and the central bank in Indonesia, had constrained the public from getting a proper perspective of complex issues such as liquidity support to commercial banks.
- Since the credibility of government institutions and officials, including the central bank (at least in the past), was generally weak, it was inconceivable to the public that provisions to commercial banks involving trillions of rupiah could be done without involving kickbacks. This is a sad but difficult issue that lingers on without a clear prospect for its resolution. In the meantime, straight and clean officials remain under a cloud; bearing up to the harsh judgement of an unenlightened public. Even the champions of justice in the fight against corruption have overlooked the plight of these innocents, since their focus is on punishing the wrongs, which is laudable but not enough.

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