Regulatory Failure in Emerging Markets

Carolyn Currie

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Author and Presenter: Dr Carolyn Currie, University of Technology, Sydney

Systemic failure in Asian markets has been analysed and attempts made to correct future occurrences by changes to the regulatory models governing those markets. However many of those markets still have not initiated necessary public sector reforms to ensure good governance, financial stability and market based accounting systems essential for required privatisations. Reasons for this may lie in the stage of development of the underlying political and social systems. Hence policy makers when choosing rational macroeconomic measures need to recognise the dependencies of different systems. Also questions can be raised as to the necessity of some of the IMF programmes. Indonesia is used as a case study to illustrate the case for a new blueprint for recovery that does not rely on traditional methods that can be at times be totally counterproductive to the original goals.

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1 * Senior Lecturer, Financial Services, School of Finance and Economics, University of Technology Sydney, P.O.Box 123, Broadway, 2007. Mobile: + 61 2 412 261 568; 61-2-95147723(W); 61-2 99693760(H). Fax 61-2-99607342. email: Carolyn.currie@uts.edu.au
Introduction

The 1997 Asian crisis which started in Thailand rebounded on Indonesia within months bringing to an end 30 years of uninterrupted economic growth during which per capita income had grown in comparative terms from ½ of India’s to 3½ times India’s level\(^2\). The banking crisis which resulted is regarded by the IMF as one of the most serious in any country in the world in terms of effect on GDP and on external debt.

By 1999 Indonesia ranked as the eighth most indebted nation with net external debt of US$136 billion after the world of US$2 trillion, the USA with US$862 billion, Brazil of US$258.1 billion, Canada with US$253 billion, Russia with US$164 billion, China with US$159 billion, Australia with US$156 billion, South Korea with US$154 billion, and Mexico also with US$154 billion\(^3\). However this takes no account of factors commonly used by bankers in country risk assessment such as debt per capita, or debt divided by exports less imports\(^4\). By 2002 external debt is anticipated to equal 83\% of GDP\(^5\). Despite this, Indonesia does not qualify for relief under the “Heavily Indebted Poor Country” (HIPC) programme of the IMF for which it must satisfy a set of criteria, namely,

- face an unsustainable debt burden, beyond available debt-relief mechanisms;
- establish a track record of reform and sound policies through IMF- and World Bank-supported programs.

To pull a country out of a systemic crisis, it is necessary for a financial system to control systemic risks which can be achieved by improving systemic efficiency - operationally (in terms of providing low cost finance to aid growth and development), allocatively (in terms of providing it to the right sector) and dynamically (in terms of offering innovative products and services to both the public and private sector)\(^6\). If the causes of a systemic crisis are fully understood then the cure is attainable.

Hence this paper begins by briefly analysing factors precipitating the crisis in order to understand what barriers to recovery have prevented the IMF programme succeeding, as evidenced by the recent downgrading in the credit rating of Indonesia in February 2002 by Standards and Poor from CCC to “Selective Default”.

To understand barriers to recovery it is first essential to understand the radical restructuring programmes prescribed by the IMF, the elements of which resemble proposals espoused by international regulators emanating from the Asian Crisis as a general cure for emerging nations. Some of the performance criteria\(^7\) requested by the IMF derive from the Compendium of Standards put forward by the Financial Stability Forum, designed to enhance Indonesia’s world standing with the banking community

\(^3\) www.geographic.org
\(^5\) “IMF completes Fourth Review of Indonesia Programme, Approves $341 million Disbursement and One-Year Extension of the Program” (IMF News Brief No. 02/7, 29th January, 2002).
and the IMF\textsuperscript{8} by bringing the infrastructure of the financial markets up to best international practice. Other measures are linked to increasing the standards of prudential supervision of the banking system as laid down by the Financial Stability Institute (FSI), a subdivision of the Bank for International Settlements\textsuperscript{9}.

Many of these reforms have been deferred due to the necessity to gain political consensus and difficulties of improving the judicial system given the present constitution. For instance a World Bank report in May 2001, when comparing South East Asian judiciaries highlighted the lack of independence and transparency in recruitment and promotion\textsuperscript{10}, which concerns were also noted in a Brookings Institutions Brief in September 2001\textsuperscript{11} Despite countries such as Australia funding judicial training in Indonesia\textsuperscript{12}, the ability for the Indonesian President to directly appoint judges lacks the checks and balances of the Westminster system.

Indonesia has complied with all but two of the ten reforms deemed necessary by the IMF in their original 1998 blueprint for reform\textsuperscript{13}. These two key elements are interdependent - introducing market based accounting systems in the public sector to prevent corruption, is essential to the programme of privatisation of banks and government owned utility companies, and asset sales. These elements continued to be deferred due to the need to gain acceptance from employees and unions, and a failure of enforcement by the judiciary particularly in the case of bankruptcies. Of 68 proceedings to which Indonesia committed to pursue\textsuperscript{14} only one has been successful.

Some of the conditions of the original 1998 blueprint have actually prolonged the crisis and may not have been necessary given the underlying stage of development of the legal system – such as blanket guarantees for private bank shareholders and inflation and money supply targeting with a resultant flight of capital and a credit crunch\textsuperscript{15}. Other elements of the IMF programme may not have been sufficient as they did not include innovative solutions to problems of,

\begin{itemize}
  \item \textbf{money laundering}, which has permitted flight of capital fostered by the government taking over bank obligations,
  \item \textbf{debt recovery from defaulting bank shareholders},
  \item \textbf{public private partnerships} for infrastructure development and supplies of utility products,
\end{itemize}

\textsuperscript{8} See FSF - Compendium of Standards, initial page, key standards and home page - also refer direct to their website: http://www.fsfollow.org/.
\textsuperscript{9} Refer to the website of the Bank for International Settlements (www.bis.org) which contains a summary of these measures under the heading "Financial Stability Institute". 
\textsuperscript{11} http://www.brook.edu/comn/policybriefs/pb89.htm
\textsuperscript{12} http://www.alri.org.au/pdf/projects_indonesia_062000.pdf
\textsuperscript{15} Agung, J, "Credit Crunch in Indonesia in the Aftermath of the Crisis: Facts, Causes and Policy Implications" (Directorate of Economic Research and Monetary Policy.) Bank of Indonesia, March, 2001
employee objections to privatisations which could have been overcome by spreading ownership and control through the use of employee share ownership schemes,

an excessive government debt burden resulting from an IMF driven bailout of the private sector. With interest and principal repayments equal to US$24.6 billion in 2002 which may equal 25% of GDP\(^6\), there is an urgent need to reconstruct debt through innovative debt equity swaps or buying back debt at a discount, and then reissuing at longer maturities while setting up a swap market, collateralising these issues with securities. Another strategy is debt defeasance by the private sector but only when the loan is due. All or part of private debt, when a loan is due, is repaid to the government, instead of to the bank. The government issues coupons to the original lender, guaranteeing a buy back at a certain date - a secondary market in such debt should be created and such issues could be linked to bank restructurings and asset sales. Such a solution was used by the Philippine Government in 1988.

selling impaired bank assets through an arms length refloat such as the good/bad bank strategy,

This paper will give a background to the present situation in Section I by discussing causes of systemic crises as a precursor to finding the cure, detailing Indonesia’s response to the Asian crisis in view of the changes to the regulatory model governing its financial system in the previous decade. A discussion of the necessary conditions of the IMF programme such as mechanisms to ensure accountability, good governance as well as protect against fraud, and use of the financial system for criminal activities, in Section II precedes an analysis of how the IMF package could be supplemented by innovative solutions.

I UNDERSTANDING THE CAUSES OF SYSTEMIC CRISIS AS PRECURSOR TO FINDING THE CURE

Prior to the Asian crisis in 1997 no studies queried or assessed the role of regulatory models governing the most important layer of the financial system, the banking sector\(^7\). By 2002 here is still a paucity of literature focusing on classifying regulatory models in Asian financial systems. The literature uses a narrow definition of national financial markets for dealing in securities and attempts to explain the Asian crisis using traditional economic theories\(^8\) specifically blaming misallocation of resources\(^9\), or resorts to theories of bank management\(^10\), or proffers explanations in terms of a tendency to political interference via a command or control economy\(^11\). At

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\(^6\) "BI predicts foreign debt repayment $8.9B in Q1", The Jakarta Post, 19\(^{th}\) February, 2002.

\(^7\) For instance the 1993 Asiamoney poll which ranked the regulatory performance of securities markets in Asia (Asiamoney, 1993).


\(^9\) As put forward by Stiglitz, (1997), and extended by Wade and Veneroso, (1998), in terms of lifting of exchange controls causing excessive short-term, unhedged dollar loans which when misallocated led to a liquidity crisis.

\(^10\) As in (Latter), 1997.

\(^11\) As propounded by Honohan, (1997), and said to go hand in hand with 'insider dealing, corruption, and weak corporate governance', (Radelat and Sachs), 1998.
times all three explanations are used\textsuperscript{22}, together with reasons of underregulation or excessive deregulation\textsuperscript{23}.

Later studies\textsuperscript{24} do emphasise regulatory capture but there is a need to explain exactly what was wrong with the regulatory models applied in these countries and how to correct them. The view of the systemic crises in Asian economies as being a currency crises ignores the OECD's analysis of crises developed post 1987 (OECD, 1991). The OECD's four stage eight precondition analysis highlights the role of the banking system in both generating and containing systemic risks. The banking system by both allowing debt accumulation of low risk premia and high concentration portfolios, while undergoing a rapid and radical programme of change such as liberalisation, can convey market shocks of price falls in securities through interdependencies both within the national core economy and through interlinked international financial intermediaries (OECD, 1991, p.14)\textsuperscript{25}. The subsequent flights of capital and currency devaluations is a direct result of the perception of heightened systemic risk with the associated increase in bankruptcies and failures of both financial and corporate entities.

During rapid liberalisation, failure to impose strong prudential measures while liberalising protective measures can lead to an incorrect regulatory model being imposed on the key banking sector, inducing a climate where banks fail in their delegated monitoring role, with concomitant blowout in bad and doubtful debts.

**A. Liberalisation of the Indonesian Financial System**

To understand the current situation, the history of deregulation of the Indonesian banking sector is a necessary input. The best description of this lies in the analyses by the IMF analysis\textsuperscript{26} and by the Bank of Indonesia\textsuperscript{27}.

The comprehensive package of deregulation measures introduced in October 1988\textsuperscript{28} with clearly stated reasons, included measures to promote the export of non-oil and gas products:

1. Establishment of joint venture banks,
2. The opening of foreign bank sub-branch offices,
3. Improvements to swap arrangements,

and various reforms to mobilise funds, including

4. Opening new bank and non bank branch offices,
5. Establishment of new private banks,
6. Expansion of foreign exchange banks and rural credit banks,
7. Issuance of certificates of deposits,

\textsuperscript{22} As in Fischer, (1998).
\textsuperscript{24} Bonjini, Claessens and Ferri (1999).
\textsuperscript{25} The OECD analysis relied on a framework developed by Davis (1989) who studied four periods of financial disorder in the light of various theoretical approaches - the 1974 Herstatt Crisis, the 1982 Debt Crisis, the 1986 Floating Rate Note (FRN) Market Crisis and the 1987 Equity Market Crisis. Davis found no support for any one theory of crisis but did find many common features revealed by the crises.
\textsuperscript{26} See Enoch et. al. (1999), Section III "Banking Sector Developments: 1998-1999", referred to in footnote 6.
\textsuperscript{27} See Agung, op.cit.
\textsuperscript{28} "Indonesian Banking Policy", Client Newsletter, Freehill, Hollingdale and Page, November, 1988.
8. Issuance of unlimited licences for money changers,

Reforms to enhance efficiency, such as
9. Liberalisation of requirements so that state and local non bank enterprises could place deposits with private bank/non bank financial institutions,
10. Expansion of banks and branch offices,
11. Imposition of legal lending limits which were very broad and liberal (20% to any single borrow, 50% of capital to any group and 5% to any members of business connected with the Board who were not shareholders, with loans against equity participation in a financial institution allowed)

Reforms to enhance the implementation of monetary policy,
12. A dramatic lowering of liquidity requirements for banks and non banks from 15% to 2% of liabilities to third parties,
13. Introduction of open market operations (liberalisation of maturities from 7 days to 6 months); introduction of auctions from daily to weekly, efforts to establish a discount market,

Reforms to develop the capital market,
14. Equalization of the tax treatment of income from deposits with that of income from other securities to be set at 15%,
15. Freeing from investigation of the background and origin of funds placed in time and savings deposits (note that this reform now is in direct contradiction to the principles of the Financial Action Task Force).
16. Permission to expand the equity base of financial institutions by new share issues.

The structure of the banking system was largely government owned before liberalisation with 70% of the market share controlled by five State Owned Banks, the rest of the market being dominated by private national foreign exchange banks of which there were ten, branches of foreign banks permitted to work only outside Jakarta in joint ventures, investment finance companies (nine) and co-operative banks.

Given the spectrum of deregulation possibilities (see Table 1) what Indonesia did was to conduct a formal deregulation which could be regarded as a catastrophic ending to a previous regulatory model of strong protective measures which contained risk taking behaviour by banks and corporations.

Table 1 : Spectrum of Deregulation Possibilities

<table>
<thead>
<tr>
<th>Scenarios</th>
<th>I</th>
<th>II</th>
<th>III</th>
<th>IV</th>
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</thead>
<tbody>
<tr>
<td>Formal Deregulation (Planned)</td>
<td>Guided or unguided</td>
<td>Wind down</td>
<td>Disintegration with transfer of programs</td>
<td>Stripping</td>
</tr>
<tr>
<td>Informal Deregulation (Evolutionary)</td>
<td>Non Enforcement or selective enforcement</td>
<td>Life cycle effects</td>
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</table>

To understand this statement we need to understand the range of regulatory models that can govern financial systems. According to a taxonomy developed by the author (Currie, 2000) regulatory models governing financial systems (that is the rules and methods of regulation) consist of two halves – a prudential side and a protective side.

Prudential supervisory systems include three essential elements –

29 The Bank Bumi Daya, the Bank Dagand Negars, the Bank Ekspor Impor Indonesia, the Bank Negara Indonesia (1946) and Bank Rakyat Indonesia.
• the predominant enforcement mode (seven types),
• the type of sanctions (which can be summarised into two categories of strong and weak) and,
• the type of compliance audits (two types of strong and weak).

Prudential supervisory arrangements are thus regulatory measures which are primarily preventive. They are primarily geared to checking on whether banks are acting prudently in order to ensure the stability of the financial system. Protective measures have goals of safety in terms of depositor, investor and consumer protection as well as structural efficiency.

However the separation between protective and prudential measures of regulation is not entirely mutually exclusive. They interrelate in several ways. First the basic idea of protective regulations is the creation of confidence in the banking system, with subsequent beneficial effects on the probability of bank runs and system crises. At the same time, however, protective measures involve the danger of moral hazard and adverse effects on the riskiness of banks.

Prudential measures are designed to check on the state of risk management, performance and adherence to agency relationships. They are also to check on the success of protective measures, and whether additional protective measures are needed or existing should be removed. In reverse, protective measures often call for supplementary prudential measures. That is, there are particular bundles or packages of prudential and protective regulations which go together.

Protective measures are aimed at the entire industry, but can be applied on a discretionary and institutionalised basis. At times some disclosure rules such as reports to central banks are used in a discretionary sense, and hence become part of the compliance audit process, or at times a form of sanction. The main characteristic of a discretionary intervention is that it is not granted without some element of uncertainty, since some amount of private risk remains. This uncertainty creates obvious incentives for lenders to monitor the riskiness of the financial institutions to which they are lending. Nevertheless, over time certain traditions and practices can evolve, and authorities can be more or less generous in determining the thresholds beyond which help is supplied.

Institutionalised protective measures must be applied on an industry basis in order to ensure consistency, so as to promote regulatory goals of safety, stability and structure. Institutional interventions include contractual relationships referred to by Llewellyn (1996), such as deposit insurance systems used in the United States and recently introduced in numerous other countries, but on a risk rated basis.

In 1988 Indonesia effectively removed all discretionary and institutional measures, without introducing a strong prudential system of full compliance audits, sanctions and strong enforcement mode now deemed necessary for an open market system. From theories of bank behaviour and regulation several possible scenarios post deregulation can be isolated –

• return, risk and efficiency measures remain the same;
• return measures increase but so do risk levels but not to a level to threaten systemic stability, while efficiency measures decline but not to a dysfunctional level; or
• return and risk decline, while efficiency measures improve;
• return measures decline, risk levels increase while efficiency deteriorates.

The fourth outcome is suboptimal and could result in efficiency savings being consumed by management in increased compensation packages, so that they are not passed on to the economy in cost savings. Combined with this, if legal and market mechanisms to ensure adequate provision of information to banks were faulty, this could prevent banks performing in their role as delegated monitors. This could lead to poor credit judgements, which eventually erode risk and return levels. A further possible reason for poor profit performance due to bad credit judgement could be that liberalisation of bank entry rules in a previously strictly controlled environment was too rapid and permitted too many new entrants, creating a rush to increase market share, and resulting in what the BIS (1992) called poor crowd like judgements.

If changes in the Indonesian financial architecture post 1988 achieved their stated goals as expressed above one would expect that risk ratios would not be significantly higher, return ratios would not be significantly lower while efficiency ratios should be significantly improved.

In Australia an adverse change in the regulatory model in 1984 took five years to impact. In Indonesia in the year of change in 1988, several smaller banks started to experience liquidity problems. The IMF diagnosed the problem in Indonesia as being a too rapid increase in the number of banks from 111 in 1988 to a peak of 240 in 1994, with a large number of local conglomerates establishing their own bank (Enoch et al, 1999).

By its nature the marketplace for financial institutions should be non contestable – that is with high barriers to entry and exit in order to preserve stability. Efficiency can be achieved by economies of scope and scale. However deregulation in Indonesia reduced barriers to entry to the “wide open” status, while not preserving barriers to exit. The IMF cites Bank Summa in the early nineties as an illustration of this type of problem. State banks also suffered from poor prudential supervision – their financial weaknesses deriving from poor repayment mechanisms (Enoch et al, 1999, p. 24).

The IMF prescribed a three stage/ten step scheme for bank restructuring directed at Indonesia’s response to the Asian crisis (see Enoch et al, 1999, pp. 10-12). Stage I involving four steps comprised management of the acute crisis phase, where measures were utilised to stop the panic and stabilise the system, such as liquidity support to banks affected by runs, then a blanket guarantee for depositors and creditors.

Stage II, (steps 5 – 8) consists of the stabilisation phase, where measures are used to restructure the system. This involves designing the tools needed for a comprehensive restructuring, including the required legal, financial and institutional framework as well as tightening prudential supervision and regulations. Losses should be recognised with a focus shifting from liquidity to solvency support. The authorities should design a financial sector restructuring strategy, based on a vision for the post-crisis structure of the sector. Visible banks should be recapitalised which the Bank of Indonesia did through the injection of fixed interest government bonds, in return for assuming control of bad bank assets.

By 1999 the first eight stages had been completed to some extent. However by 2002, Stage III consisting of two further steps, had not, which appears to bear a direct causal relationship to Indonesia’s current problems. These steps of 9-10 comprised the recovery phase, or measures to normalise the system such as nationalisation of banks by reprivatisation, and privatisation of government owned banks, with restructuring of
corporate debt and sale of bad assets. Hence the blanket guarantee could be revoked, which should be a non event if step 9 has been followed.

Failure to privatisé nationalised banks, restructure corporate debts and sell off bad assets may be considered to be one cause of the continuation of heightened systemic risks and lowered systemic inefficiency in Indonesia, with the possibility of a further systemic crisis.

However in retrospect it appears that the design and timing of Stage I and II may have made Stage III impossible to achieve, and some of the content of the rescue package may have been unnecessary. The whole package of government guarantees, liquidity support and assumption of control over bad bank assets has suffered from inherent weaknesses of moral hazard and failure to realise that laws and judicial standards were not in place to ensure the basic infrastructure to effect asset sales and recover debts was established. That is Stage II should have preceded Stage I, and alternatives to the Bank of Indonesia Liquidity Support Fund, bank closures and guarantees of private bank shareholders canvassed.

The net result of the IMF package is that by 2nd March, 2002 the Republic of Indonesia (RI) has lost more than US$14.3 billion due to manipulation of the Liquidity Support Fund (BLBI), first disclosed by the Supreme Audit Agency (BPK) in May 1999. From August 1997 to early 1999 Rp144.5 trillion was provided to assist 48 commercial banks to cope with bank runs. The audit agency subsequently revealed that 95% of the troubled banks misappropriated the BLBI funds. Slow law enforcement meant that when a fire in the Bank of Indonesia in December 1999 destroyed some of the documents of those banks, that prosecution of 80 suspects was thwarted by lack of data. Only a dozen defendants have been indicted with only one conviction, a minor infringement of a banking law. Corruption charges were overturned and the fine was equal to 0.1% of the total losses caused of Rp583.4 billion in the case of that one bank.

Failure to prosecute and convict for fraud, apart from limited data, is attributed to the lack of knowledge of both judges and prosecutors of the banking system and regulations. Judicial independence and training is thus an essential element of the IMF package which should have preceded all reform attempts. In addition it will be shown that Indonesia still has not reformed the legal system to prevent money laundering and minimise bank fraud, while ensuring accountability and good corporate governance. The very agency — the Indonesian Board for Reconstruction of Assets (IBRA) has now been placed under surveillance by a parliamentary committee during the sale of a key bank (BCA) with the independence of IBRA's chair being questioned.

The next section will illustrate the necessity for measures to counteract these trends which although in the IMF's current contract with Indonesia, need greater emphasis to make existing aid packages effective.

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31 "IBRA questions government plan to set up team on BCA Tender", the Jakarta Post, 6th March, 2002.
II NECESSARY CONDITIONS OF INDONESIA’S CURRENT CONTRACT WITH THE IMF

The Letter of Intent (LOI) dated 27th August, 2001 between Indonesia and the IMF reflects concentration on improving the regulatory structure of Indonesia’s financial system, and of getting rid of poorly performing assets, while improving the efficiency and control mechanisms in the public sector. To understand why such a programme needs supplementation by reinforcing necessary conditions and introducing innovative solutions to first lower debt burdens and second allow new and existing businesses to grow by acquiring the necessary resources, this paper first overviews the principal components of the package.

Performance targets agreed to in the LOI32 only cover the first of six parts of the IMF’s programme to trade Indonesia out of difficulties – “Macroeconomic Framework and Policies”. Such targets are expressed in terms of GDP and inflation and were criticised during negotiations in early 2002 as being too focused on irrelevant and unachievable targets, such as single digit inflation33. The other five parts of the LOI were:

- Fiscal Decentralization, to enhance the new democratic structures, reduce corruption and promote more targeted development.

- Banking System Reforms, of which privatisations of state owned banks is a principal part. To date progress totally lags targeted goals due to failure to incorporate innovative techniques, as will be explained in the third section to this paper. Without privatisations the reform of the supervisory and regulatory framework is difficult to assess as bank assets remain under government control.

- IBRA Asset Recovery and restructuring – the LOI devotes another separate section to the performance of this unit, which is now being totally questioned by the Government34. The LOI does not incorporate innovative techniques that could solve the current dispute over the sale of Bank Central Asia (BCA)35.

- Corporate Restructuring and Legal Reform – the IMF recommendations to improve market mechanisms for accountability and corporate governance focus on amendments to court procedures, legislation, audits and the number of judges36. Although such elements are necessary not only to the IMF’s own programme, they are also an essential base for innovative solutions in order to provide the basic conditions of legal asset recovery necessary to bank lending. However other systems of checks i to prevent corruption need to be put in place, involving not just greater prudential supervision of banks but conforming with the money laundering principles of the Financial Action Task Force.

- Public Sector and Other Structural Reforms need to be supplemented by strict adherence to the Compendium of Standards developed by the Financial Stability Forum (FATF).

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32 See Table 3 attached to the LOI available on the IMF website.
34 “IBRA questions government plan to set up team on BCA Tender”, the Jakarta Post, 6th March, 2002.
35 “Threats to Bank BCA sale”, (Editorial, The Jakarta Post, 4th March)
36 referred to in the LOI, 27th August, 2002, clauses 31 and 32.
If we analyse barriers to achievement of the IMF programme we also isolate the necessary conditions to its success. Stabilising exchange rate and capital flows by the type of country bankruptcy recently proposed by the IMF (discussed in Section III) cannot work while mechanisms to prevent manipulation of government funds, and fraudulent use of the banking system exist. The next subsections discuss the necessity for Indonesia to adopt the standards of the FSF and FATF.

A. The Financial Stability Forum and The Compendium Of Standards
The Financial Stability Forum (FSF)\(^{37}\) was formed in 1999 as a result of the Asian Crisis by key supra mega regulators – the World Bank, the IMF, the OECD, the Bank for International Settlements and representatives of Central Banks and Regional Banks for Reconstruction. Since that date they have developed a Compendium of Standards (see Table 2) which they urged emerging nations to adopt to promote confidence in their financial systems and hence stem the capital outflows, while encouraging the inflows necessary for economic growth. In this respect they urged upgrading of national accounting and auditing standards and corporate governance practices and monitoring of the role of hedge funds. The objective of the *Compendium of Standards* is to provide a common reference for the various economic and financial standards that are internationally accepted as relevant to sound, stable and well-functioning financial systems. The Compendium highlights 12 standards which have been designated as key and deserving of priority implementation by the FSF depending on country circumstances, and includes around 60 more standards considered relevant for sound financial systems.

While the key standards vary in terms of their degree of international endorsement, they are broadly accepted as representing minimum requirements for good practice. Some of the key standards are relevant for more than one policy area, e.g. sections of the Code of Good Practices on Transparency in Monetary and Financial Policies have relevance for aspects of payment and settlement as well as financial regulation and supervision. The standards are described briefly below in Table 2 by subject area, key standard, issuing body.

**Table 2: Compendium of Standards**

<table>
<thead>
<tr>
<th>Macroeconomic Policy and Data Transparency</th>
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<tr>
<td>❚ Monetary and financial policy transparency - IMF</td>
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<tr>
<td>❚ Fiscal policy transparency - IMF</td>
</tr>
<tr>
<td>❚ Data dissemination(^1) - IMF</td>
</tr>
<tr>
<td>Institutional and Market Infrastructure</td>
</tr>
<tr>
<td>❚ Insolvency (2) - World Bank</td>
</tr>
<tr>
<td>❚ Corporate governance - OECD</td>
</tr>
<tr>
<td>❚ Accounting - (^3) - IASC(^4)</td>
</tr>
<tr>
<td>❚ Auditing - FAC(^4)</td>
</tr>
<tr>
<td>❚ Payment and settlement - CPSS</td>
</tr>
<tr>
<td>❚ Market integrity - FATF</td>
</tr>
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\(^{37}\) See FSF - Compendium of Standards, initial page, key standards and home page - also refer direct to their website: http://www.fsforwm.org/.
The next sections relates these standards to the IMF’s views on growth, lessons from past banking crises and attempts to avoid corruption in financial systems that make them vulnerable to illicit uses and hence explains the rationale behind five of the six reform measures in the IMF’s current contract with Indonesia. In doing so it illustrates elements which are necessary but which have not been emphasised in the IMF programme and hence adopted.

B. Money Laundering and Targeting Fraud

During July, 2001 the IMF Institute offered a course on economic growth where three factors were highlighted as being the most important to economic growth –

- factor accumulation of capital, both physical and human (as attained through education);
- market-friendly institutions,
- an economy open to trade, capital, technology, ideas, direct foreign investment and to information.38

However growth can be aborted when a national economy liberalises what the OECD regards as its core element, the banking sector, and does not institute appropriate prudential supervisory systems, which can include market mechanisms and self regulatory devices to promote accountability and good governance as well as externally imposed auditing requirements on every type of entity and institution. These checks in turn act to minimise insider abuse at financial institutions, which has happened in every economy at some stage, can result in “billions of dollars of losses to institutions, their shareholders, and to tax payers”39. Ultimately this can cause not only bankruptcy of the financial institution(s) involved, but through a credit crunch and a rise in systemic risk levels, create total systemic instability, leading to “bankruptcy” of the national economy. Using the OECD analysis, reverberations can spread to the international financial system through the connected tissues of globalised lending and trading.

As Gup (1995) has pointed out there is a thin line between abuse and fraud, that frauds can exist for years without detection, and when finally detected prosecution is extremely difficult, not just because of the complexity but due regulatory fears of the effect on public confidence and systemic stability of the publicity surrounding fraud prosecutions. Of all the frauds, money laundering is considered by the biggest risk by regulators, as evidenced by the establishment of the Financial Action Task Force in 1989 following upon the Bank for International Settlements issuing guidelines for prevention. Although initially a response to the scandal of the collapse of the Bank for Credit and Commerce International (BCCI), which resulted in the loss of US$4 billion (possibly equal to ten times that amount in today’s terms), of which part was from the Treasury funds of more than 30 countries and the funds of more than 1 million depositors around the world, due to the events of 11th September, 2001, the purposes of the FATF have been expanded. In conjunction with the United Nations, the FATF has issued regulations to suppress terrorists and urged all central supervisory authorities to regularly publish list of entities and persons with whom banks are prohibited from doing business, whose property should be frozen and reported to the relevant authorities.

**Money laundering** involves **processing of criminal proceeds** to disguise their illegal origin. So the individual or group that carries out the act can enjoy the profit and use them for other illegal purposes. Money laundering involves three stages – placement, layering and integration. The *placement stage* involves disguising the source, changing the form or moving funds to places where they are less likely to attract attention. This can be done by breaking up large amounts of cash into smaller sums which are deposited directly into a bank account, or by purchasing a series of monetary instruments, such as cheques and money orders, which are collected and deposited into accounts at another location. After the funds have entered the financial system the second *layering stage* of conversions takes place by buying and selling investment instruments or wiring funds through a widely scattered set of accounts.

The third stage of money laundering is *integration* in which the funds re-enter the legitimate economy as investments in real estate, luxury assets or business ventures. The location of money laundering is usually in areas where there is a low risk of detection due to weak or ineffective anti-money laundering programmes, although often stable financial systems are preferred. At each stage funds are located differently:

- at the placement stage close to the underlying activity;
- at the layering stage at an offshore financial centre, a large regional business centre or world banking centre;
- at the final integration stage in any economy other than one which is unstable or offering limited investment opportunities.

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42 See the United Nations suppression of Terrorism Regulations and the List established by the United Nations Security Council committee (AFG/131, SC/7028).
It has been estimated by the IMF that the aggregate size of money laundering could be somewhere between 2% - 5% of the world’s GDP or in terms of 1996 statistics US$1.5 trillion. The principal effect on business is on the reputation for integrity of the banking and financial services marketplace. If it is deemed not to function within a framework of high legal, professional and ethical standards then inexplicable changes in money demand, prudential risk, contamination of legal financial transactions, and increased volatility of international financial flows and exchange rates could result due to unanticipated cross-border asset transfers. In addition development of economies with growing or developing financial centres can be detrimentally affected as these are often targeted due to inadequate controls. In order to combat these trends and effects the FATF in April 1990 issued a report containing a set of Forty Recommendations, providing a complete global framework of counter-measures covering the criminal justice system, law enforcement, the financial system and its regulation, and international co-operation.

Only member countries\(^{43}\) provide information on the status of the Forty Recommendations by responding each year to a questionnaire. A second monitoring element is the mutual evaluation process which the APG also has adopted. Enforcement an occur by application of escalated sanctions such as requirements for a progress report, a letter from the FATF President or a high-level mission to the Non-Complying Member Country. Penultiately recommendation 21 can be applied – involving financial institutions to check on certain business relations and transactions. Finally the FATF membership of the country in question can be suspended.

Of concern here is that certain jurisdictions do not co-operate in anti-money laundering investigations, so transactions for the purchase of goods and services can be legitimised. Due to this aspect the FATF has identified Non-Cooperative Countries and Territories (NCCT) which could engage in this activity\(^{44}\).

Indonesia is only a member of one of the FATF-style Regional bodies, the Asia/Pacific group on Money Laundering (APG), but as at the date of this paper, does not fall under any published compliance checks and through its regional membership of the APG would be only subject to a mutual evaluation, on which there is no information published on the FATF or APG website. It has now been singled out by the EU to be subject to sanctions by EU businesses until it joins the FATF\(^{45}\). Failure to comply with FATF guidelines permitted the manipulation of the Liquidity Support Fund and abuse of guarantees which has left Indonesia with an unserviceable debt burden. The infrastructure of the banking system also suffers from lack of governance mechanisms necessary to minimisation of fraud.

**C. Targeting Fraud**

Since the establishment of the first bank in Italy, Monte de Pashi di Sienna in 1472, banks have been regarded as the safe repository of savings, as well as sources of incredible wealth and power. The English merchant bank Barings Brothers were

\(^{43}\) Currently there are 29 member nations and two regional organisations.

\(^{44}\) The FATF website (www1.oecd.org/fatf) provides a list of compliance status of member nations. As at 7th September, 2001 these include the Cook Islands, Dominica, Egypt, Grenada, Guatemala, Hungary, Indonesia, Israel, Lebanon, Marshall Islands, Myanmar, Nauru, Nigeria, Niue, Philippines, Russia, St. Kitts and Nevis, St. Vincent and the Grenadines, and the Ukraine.

considered to be a power to the rival Russian and Hapsburg empire when they financed the Louisiana purchase in 1890. In the 1960's and 1970's the major US and other international banks took on the task of recycling OPEC countries' wealth to finance the development of the booming economies of Latin America. Consequently, correspondent banking and interbank dealing was considered a virtually riskless venture and the idea of evaluating banks' creditworthiness was not even considered.

With the collapse of Bankhaus Herstatt in 1974 and the foreign exchange losses suffered by a host of foreign banks as a result, together with the experience of too rapid liberalisation in the eighties and globalisation in the nineties, regulators have re-emphasised not only the need to evaluate creditworthiness of financial institutions, their commercial loan portfolios, and country risk exposure, but also the need to prevent and target fraud.

Causes of bank crises range from lack of investor and depositor confidence precipitated by perception of deterioration in asset quality. The latter is most commonly caused by excessive growth into overheated markets with failure to spread risks. Excessive industry or country risk concentration, intergroup lending all result from lack of credit control, sound lending policies and internal control procedures checked upon by external auditors and the central bank supervisors.

Apart from asset quality, large diversifications into new areas of business where the institution lacks expertise are reasons that financial institutions as well as corporates get into difficulties. The risks in overtrading in banks where either the foreign exchange positions are not controlled or the option writing not fully appreciated is enormous, and spectacular losses have been made by banks in these areas. Greater volatility in international foreign exchange, money markets and stock markets will only exacerbate this situation.

Another classic failing of financial institutions is liability mismanagement. The finance house industry in the UK in the seventies and the Savings and Loans industry in the U.S.A. in the eighties experienced appalling losses when funding fixed rate assets with floating rate funds at times when interest rates were rising.

Within this framework of causes of bank crises, fraud is the most difficult for the bank analyst to predict. Gup (1995) advocates establishment of an appropriate framework for clearly structuring a financial institution, by allocation of responsibility to directors in deterring fraud and establishing a system of internal controls, auditing, examinations and security.

The Office of the Comptroller of the Currency (OCC) found that deficiencies within boards of directors contributed to insider abuse and fraud, to bank failures and to problem banks. Prevention devolves around embodying the responsibilities of a bank's Board of Directors in criminal law, company law and common law, the latter requiring actual convictions of negligence and failure to exercise duty of care. It also requires prudential supervisors to prescribe what they consider to be an appropriate committee structure, prudent lending policies, lending authority, how loans should be reviewed, and what practices are deemed unsafe and unsound.

Due to these factors being deemed to be lacking in failed banks and in particular Asian Banks pre the Asian Crisis in 1998, the Bank for International Settlements.

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quickly moved in 1998 to lay down principles of what they consider to be an appropriate structure for internal controls to prevent fraud, and to prevent the development of other factors which can lead to banking crises\textsuperscript{47}. The lack of operation of those principles has been well documented (Gup, 1995) in the case of BCCI, and the Banca Nazionale del Lavoro (BNL), "the largest bank fraud in history". BNL can be explained by virtue of its ownership – it was state owned, as the worst bank failures in many OECD countries can be attributed to lack of private market mechanisms as well as the quandary of how governments can supervise entities they own. All the state owned banks failed in Australia during the late eighties.

The above elements of prevention, although necessary to the achievement of IMF performance targets as well as providing a basis for any alternative solutions, are not specifically spelt out in the IMF programmes embodied in the various memorandum of economic and financial policies issued during 2000-2004\textsuperscript{48}.

III A NEW BLUEPRINT FOR RECOVERY

Traditional solutions of governments taking over banks and companies, or buying assets then selling them off needs to be supplemented by the types of financial innovations that emerged during the eighties to cope with the burden of the $1.2 trillion of Third World debt outstanding at the end of 1987. These innovations included debt-equity swaps described above but also more general techniques of securitisation. What the owners of bank loans (eg IBRA) or overseas lenders to Indonesia can do is follow the type of Mexican solution, described below, or pursue other typical or innovative solutions described below.

A typical plan called for the loans to be repackaged into a combination of bonds and equity. The first step was to repackage loans into senior bonds (which would mature in five years), junior bonds (maturing in 20 years) and equity (which would share in any remaining loan repayments). Such a scheme was described by the infamous Mike Miliken as recapitalising country debt, similar to the method by which companies could be recapitalised. Another of his projects was the creation of a "conversion fund" which would engage in debt-equity swaps. Investors would pool their money to buy Latin American loans at a discount on the open market. Local governments would buy back the loans with their own currencies, which the fund would then use to purchase equity stakes in local businesses. Miliken's ideas were put into practice in Mexico, and applied in principle in restructuring banks.

A. Debt Equity Swaps or The Mexican Solution\textsuperscript{49}

In 1988 part of Mexico's external debt was restructured successfully. This case study is highly relevant to the situation in Indonesia, but requires external support as will be


\textsuperscript{48} "Memorandum of Economic and Financial Policies Medium-Term Strategy and Policies for 1999/2000 and 2000" 20\textsuperscript{th} January, 2000, 17\textsuperscript{th} May, 31\textsuperscript{st} July, 7\textsuperscript{th} September, and "Letter of Intent", 27\textsuperscript{th} August 2001, "IMF Approves US$5 billion Extended Arrangement for Indonesia", 4\textsuperscript{th} February, 2000.

\textsuperscript{49} This section is based on a case study "J.P. Morgan’s Mexican Bank Debt-Bond Swap", from Hayes, S. L and Meerschvam, D.M., "Managing Financial Institutions - Cases within the Financial Services Industry" (The Dryden Press, USA, 1992).
explained. To understand one method to deal with reconstruction of external bank debt, it is necessary to understand the concept of asset swaps, which relates to the recomposition of a security’s cash flows. Typical structuring may include repackaging an issue paying fixed rates into floating rates (or vice versa) or converting cash flows stated in one currency to another, with the purpose of transforming and improving the character of an investor’s assets.  

By the middle of 1987 Mexican international bank debt stood at US$ 78 billion, and accounted for an estimated 33% of total Latin American and Caribbean bank debt. Its debt level had been the focus of publicity since the summer of 1982 when the third-world debt problem was elevated to crisis proportions. One strategy followed by the major banks to reduce exposure was to build up loan loss reserves. The second strategy was debt-equity swaps, which allowed the banks to sell their loans (at some discount so that a write-off did take place) to a foreign direct investor into Mexico. The investor would sell the loans to the Mexican government, receive Mexican pesos and invest them in Mexico. Depending on the prices charged at the various intermediate steps of the transactions such debt-equity transactions could be favourable to all parties. While banks typically kept the Mexican loans on their books at face value, a small but active secondary market valued most Mexican loans at approximately 50% of face value. On average these loans had a weighted average life of 14 years and paid LIBOR +13/16. Most banks in the U.S. had not accumulated enough reserves to write the loans down to secondary market value plus they incurred additional costs associated with their loans to Mexico. This was reflected in requests to provide “new money” plus the risk of regulatory reform forcing a capital adjustment to adjust the value of the Mexican loan portfolio closer to the secondary market value. This would have resulted in banks having to find new capital to reduce the size of their existing loan portfolios.

Up until 1987 the only solution apart from debt-equity swaps, was to reschedule debts by extending maturities and revising interest rates downwards, a process blighted by needing to obtain the agreement of all bank participants.

By the end of 1987 J.P. Morgan had designed and developed an innovative third new method of dealing with a “debt crisis” in an emerging economy. Although initially only for 10% of total external bank debt, the “debt-bond exchange”, whereby new bonds were offered in exchange for existing bank debt, the concept had wide application to the problem of any LDC debt.

The exchange offer, devised by the investment bank working with the Mexican government, asked holders of eligible bank debt to submit bids at which they would be willing to exchange specified amounts of principal of bank debt for specified amounts of principal of a new 20 year fully collateralised bond, to be the obligation of the Mexican government, ranking pari passu with existing senior debt, and bearing a coupon rate of LIBOR +1 5/8%. The collateral would be US Treasury 20 year zero coupon bonds held in a special account at the Federal Reserve Bank of New York, and would only secure the principal at the stated maturity. Non-payment of interest would not be an event of default. Bonds were to be registered, listed on an exchange, which would provide annual information regarding Mexico’s economic performance.

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50 “Product Summary – Asset Swaps – Creating Synthetic Instruments” (Federal Reserve Bank of Chicago, Financial Markets Unit, August, 1996).
Interest was to be strippable and the bonds could not be restructured, or used for future requests for new money. Bids were to be made through a bid ratio and were to be submitted by a certain date, with acceptance at the sole discretion of the Mexican government. Tax and regulatory consequences were more favourable to the new bondholders than retaining existing loans.

Apart from debt-equity and debt-bond swaps, there are additional mechanisms.

B. Other Methods of Reconstructing Debt

Other methods of reconstructing debt that are relevant are:

- **Buying back debt at a discount** and then reissuing at longer maturities while setting up a swap market;

- **Debt Defeasance**, deeming all or part of private debt public debt when a loan is due. Funds are repaid to the government, instead of the bank. The government issues coupons to the original lender, guaranteeing a buy back at a certain date - a secondary market in such debt should be created and such issues could be linked to bank restruction.

The latter approach was first tried by the Philippines. It has now received a partial endorsement in a proposal put to the IMF in December, 2001 by Krueger (2001).

Such a proposal is to be used if a country does find itself confronting a truly unsustainable debt burden. External debt will need restructuring in an orderly manner by the IMF encouraging private creditors to roll over their existing commitments and to limit their demands for repayment.

There is an obvious analogy here with a domestic bankruptcy regime. As Krueger (2001) has stated, for a variety of practical and legal reasons, sovereign debt problems are more complicated to deal with than those of companies or banks in a domestic context. In the 1980s restructuring sovereign debt was a long drawn out, but nonetheless a mostly orderly, process that involved getting maybe 15 commercial banks round a table. In the early 1980s, banks held around 85 percent of outstanding emerging market sovereign debt. The banks had good reasons to cooperate: similar institutional interests; a desire to secure future business from the debtor; a reluctance to offend regulators; and a legal obligation to share any proceeds of litigation with their fellow creditors.

In recent years countries have increasingly turned to bond issues to raise capital. As a result, the international capital market is more diversified and generally functions more effectively. However private creditors have become increasingly numerous, anonymous and difficult to coordinate - a problem exacerbated by the sheer variety of debt instruments and derivatives involved. Individual bondholders have greater incentives to sue delinquent creditors than banks, and are less amenable to arm-twisting by regulators.

In one recent case a holdout creditor in effect held a country to ransom, threatening to push it into default with other bondholders unless the holdout was repaid. Hence countries facing severe liquidity problems often go to extraordinary lengths to avoid restructuring their debts to foreign and domestic creditors. Countries know that even an orderly debt restructuring can deal a heavy blow to their economy and banking system; a disorderly restructuring can sever access to private capital for years to come, transforming an unpleasant drama into an enduring crisis. As a result countries with unsustainable problems wait too long before confronting the
inevitable; too long for their own good, and too long for the good of the international community.

A possible solution is for the IMF to introduce a formal mechanism for a country to request a temporary standstill during which debts would be restructured, only if deemed truly unsustainable. A condition would be implementation of policies to protect against flights of capital and preserve future repayment capacity.

A sovereign workout mechanism operating in the shadow of the law according to this scheme would need four key features (Krueger, 2001) – the ability to prevent creditors from disrupting negotiations on a restructuring by demanding repayment through national courts; to ensure that the debtor behaved itself during the period of the stay, treating creditors properly and adopting appropriate policies; the encouragement of additional private lenders by subordination of existing creditors and a mechanism to bind minority creditors into accepting a restructuring once it was agreed to by a large enough majority.

If these principles were established and enforced, it is clear that they would need the force of law in any country where enforcement might be sought. In practice, this means that they must have the force of law universally. Otherwise creditors could engage in regulatory arbitrage, shopping around for jurisdictions in which they have the best chance of enforcing their claims. Getting every country to amend its domestic bankruptcy law – let alone to enforce it in a uniform way - would be a heroic undertaking. An alternative route might be to establish a treaty obligation by amending the Fund’s Articles of Agreement. This would require the support of three-fifths of our members, holding 85 percent of the Fund’s total voting power. The majority decision would then be binding on all IMF members. In any event, were this route or another taken, any new approach requires very broad support from the international community.

The President of the World Bank has suggested another method of achieving such a workout mechanism.

C. Sale of Third World Debt

The President of the World Bank, James D. Wolfensohn in August 2001 confirmed that it was his idea to include the sale of private sector IFC loans of client countries in a proposal for the Bank to sell its public sector debt to client governments and teach them how to self-manage and self-finance their own development.

Instead of making loans, the World Bank would provide know-how for countries to self-finance their development. The alternative is debt forgiveness, which reduces shareholders equity, hence undermines credit ratings and increases their borrowing and lending rates. The suggestion made by Wolfensohn was for debtor countries to buy their loans from the World Bank. The purchase would be financed by debtor countries setting up an Economic Development Facility (EDF) to issue 20-year local currency bonds to the Bank in exchange for their loans. Bank loans to the private sector of client countries should also be sold back. In some respects this proposal mirrors the Mexican solution, initiated over a decade previously.

51 The IFC (International Finance Corporation) is part of the World Bank.
The arrangements would make the World Bank a genuine partner with developing countries. If self-financing development were successfully established then the balance sheet of the bank would not be affected. However, if the development process did not generate wealth then the 20-year bonds may have to eventually be written off. But the plan provides time for the World Bank to improve non-performance of its loan portfolio.

One method of implementing this proposal includes the following:

"Interest free finance for EDF projects could be provided by the local Central Bank. Repayment of EDF loans would be fully guaranteed outside the banking sector to insure commerciality and avoid inflation. The cost of loan insurance would not only replace the cost of interest but also provide a market mechanism to allocate development finance. The discipline of requiring private sector loan insurance would avoid the EDF funding projects that were not self-financing and so bankable. No private sector foreign borrowing would be required as the Central Bank could provide as much credit as could be insured. Nor would external borrowing be allowed to avoid losing foreign exchange or income by this means to depress local living standards. The EDF would quarantine all the foreign exchange earned by the projects it financed to provide reserves to import key technology for development. This could create a dual domestic currency. The devil is in the details."

The proposals would not eliminate the need for international aid to augment the cost of improving education, health and welfare in less developed countries. However it has been proposed that the management of these transfers and the know-how of self-financing development to provide local income for these services could become the new mission of the Bank.

Of greater urgency is the reconstruction of failed banks, where IBRA holds US$43 billion of loan portfolio in return for recapitalisation. Asset securitisation has been suggested as one solution but the marketability of such issues depends on the recoverability of loans and the ability of IBRA to pay interest. Classification of loans and non payment of defaulting debtors plus the ability of investors to seize collateral inhibit the ability to securitise any loan portfolios so that adoption of a "Good/Bad Bank Strategy" may be a suitable alternative.

D. Methods of Bank Reconstruction

A case study of "Restructuring the Mellon Bank" is used as an example of a bank rescue. With many of Indonesian banks requiring reconstruction this case merits discussion.

In 1988 the Directors of Mellon Bank designed a plan to extract Mellon from ongoing problems – the plan hinged on spinning off a billion dollars worth of problem assets into a new bank. The Mellon Bank started as a privately owned family bank in the 1840s in the U.S. By the mid-1970s it ranked 13th in terms of total assets, but second last out of the US top 25 banks in terms of profitability. During the 1980s it moved aggressively into high growth areas like international lending, real estate and energy lending. It also grew by acquisition, attempting to move into retail banking where management was lacking in experience.

55 op.cit.
53 "Restructuring the Mellon Bank", in Hayes et al, op.cit., pp. 223-244.
Mellon was typical of problem banks described in Section 4 above – its assets doubled in six years from 1980 to 1986, while revenue tripled. However the annual provision for loan losses expanded more than tenfold during that period while operating expenses increased 400%. Obviously controls of all types were lacking, but principally credit control, which resulted in a doubling of provisions.

The restructuring plan that Mellon’s management eventually decided upon centred upon an ambitious good bank/bad bank restructuring plan, calling for Mellon (the “good bank”) to spin off about a billion dollars’ worth of problem assets to a new bank (the “bad bank”) which Mellon would create and capitalize. The new bank – Grant Street - would carry out a plan of liquidation approved by the Comptroller of the Currency. Both Mellon and Grant Street would raise new financing. As Mellon sold the problem assets with a face value of US$975 million to Grant Street for their estimated market value of approximately US$575 million, Grant would finance about US$130 million of the purchase price by issuing common stock, junior preferred and senior preferred stock to Mellon. The rest of the purchase would be financed by issuing bonds. The loss on sale would be written off against both provisions and directly against equity, with new share issues planned to replace capital eroded by the losses on sale.

The sole function of Grant Street would be to liquidate the portfolio of problem assets and it was not to accept deposit, only making new loans if legally or economically necessary for the management of its existing asset portfolio. The life of Grant Street would depend on the time taken to liquidate its problem loans. Grant would oversee but not actually manage the business of liquidation, the portfolio to be managed by a new subsidiary of Mellon, with Grant paying the subsidiary expenses plus 3% of net cash flow defined as the excess of Grant’s receipts over asset related operating expenses. The advantage of this restructuring was that an orderly sale could be effected. Equity was to be primarily issued to Mellon bank, its directors and shareholders. The success of the restructuring lay in the detail of the financing (see Hayes et al (1992) and the time given to trade out.

Mellon Bank was the first application of the good bank/bad bank strategy which in essence constitutes a blueprint for bank reconstruction, and the rationale for Indonesia’s IBRA. However another method of dealing with problem banks is privatisation, a general solution to government owned businesses operating in an industry where private suppliers are considered more efficient and the industry structure permits competition.

E. Public Private Partnerships and Privatisations

Privatisations in Indonesia have been hampered by the lack of political consensus on the need and method of such a process, particularly when privatising natural resource companies and banks. Although companies that have been run by the State for decades are undergoing a five stage transformation process involving restructuring, modernisation, changing the regulatory structure of the industry in which it operates in order to ensure competition, corporatisation, and finally sale of shares to the public, few privatisations are finished. From the beginning of the programme in 1998 and to the end of the fiscal year in March 1999, only two transactions were completed 56. A minority stake in a cement producer Semen Gresik was sold to Cemex of Mexico for

US$121.5 million, and shares in Indofood Sukses Makmur were sold for US$56 million.

For the fiscal year of 1999/2000, the government set a privatisation revenue target of Rp 13 trillion (equal to US$ 1.3 billion at current exchange rates). Although some shares were successfully sold in Pelindo II (Rp 1.9 trillion), Pelindo III (Rp 1.52 trillion), Indofood (Rp 500 billion) and Telkom (Rp 3.27 trillion) this was far short of the target but better than the succeeding year, when no privatisation revenue was received to meet the Rp 6.5 trillion planned from ten transactions. Entrenched interests reportedly oppose privatization of state companies due to the benefits received from government ownership. In February 2002 the first of the most important major bank privatisations – the BCA, is being opposed by the unions and employees, despite this being regarded as an essential element of the IMF reform package.

This paper points out by careful choice of the method of privatisation, the valuation technique, plus considering the use of a national superannuation scheme combined with an insistence on ensuring ownership rights of employees or public users through either an ESOT (employee share ownership trust) together with the method of issuing to the public (loans secured by shares), that political stumbling blocks can be overcome.

This section will examine reasons for privatisation and elements that distinguish a successful from an unsuccessful outcome, while discussing the role that Employee Share Ownership Trusts can play in both overcoming political objections and providing a major incentive to economic growth. Privatisations are particularly relevant to the Indonesian government when it now owns and controls 65% of banking assets. An example of the privatisation process of a state owned bank, namely the State Bank of NSW in Australia, will be used to illustrate how pitfalls in the privatisation process can be avoided. The privatisation of this bank was conducted in a unique manner – not by floating shares, by auction or concessions but by private tender with little public disclosure of the eventual return to government, which finally turned out to be nil. This case bears marked similarity to the problems of the sale of the Bank Central Asia (BCA) which is regarded as the principal component of the IMF’s 2002 programme.

This case sheds light also on the most vital issue of privatisation - how to judge success. Is it the maximisation of returns to the government as vendor, or the removal of an economic burden by the creation of a privately owned entity that allocates resources in a more efficient and productive manner? Did the lack of transparency protect bank managers, and government officials disguise flaws in prudential supervision? Or did the lack of transparency act in the government’s favour or would transparency have exposed the fact that buyback provisions in the sale price were grossly underestimated? Would a transparent process have allowed the free operation of market forces to attain a better price albeit at the expense of delaying the sale?

The eventual sale of the State Bank of NSW branch network to the newly privatised Commonwealth Bank of Australia for $9 billion must raise questions of whether the government should have required a percentage of any future capital gain upon sale of the network in return for the more than generous conditions of the sale. It also raises

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questions of the need to have a proper conceptual model on which to base the transfer of ownership from the public to the private sector.

A Conceptual Model for Privatisations

Such a framework introduced should be based on four principal dimensions: political, legal, economic and financial, and managerial/organisational structure and process (Culpin, 1999, pp. 10-12).

The political dimension reflects a belief that private owners manage scarce resources better than state officials. However political instability, lack of political commitment and a philosophical view of privatisation as revenue generating instead of being part of a fundamental transformation into greater market economy can explain the lack of success of privatisation in an economy. The legal dimension of the model refers to legislation being passed that contains the optimum flexible but clear legal framework consistent with constitutional law necessary to the realisation of privatisation goals. The economic and financial dimension to privatisation is that before privatisation both State and State owned entities should generate added value for the economy by operating efficiently and effectively. The final dimension - managerial/organisational structure and process - refers to the competitiveness of salary packages of government owned entities and the inbuilt structures to prevent frequent changes in leadership within such entities due to changes in government. In the process of privatisation, hasty actions without essential preparations can lead to crucial mistakes and delays. “Moreover, bureaucratic formalities slow down the process while the opposing groups to the bank privatisation use their influence to cancel the whole process or further postpone the process” (Culpin, 1999, p.12).

How then do we judge privatisation - by the original motives, which may be the desire to allow market forces to work in the face of government inefficiencies, thus avoiding political embarrassment? Or by the actual dollar value returned to the State?

Reasons For Privatisation

Some commentators consider that the drive for privatisation is propelled by ideology and economics, that it is a necessary condition for a transition to a market economy, to democracy and accountability, while state ownership is economically inefficient and leads to budget deficits (Abdel-Magid, 1999, p.2, World Bank, 1995; OECD, 2000, 2000a)

The studies by the World Bank (1995) and the OECD (2000, 2000a) provide evidence for viewpoints such as that of Helik (1997, pp. 27-28) who maintains that:

• private ownership is linked to greater efficiency through agency costs by providing managers with adequate incentives to achieve production efficiency;
• privatisation can produce gains due to a shift from monopoly to competitive markets;
• privatisation is considered more efficient by subjecting the firm to the scrutiny of capital markets;
• privatisation leads to the removal of public sector constraints on efficient behaviour.

There are other reasons for privatisation such as the achievement of a stated mission, such as helping the financing certain sectors of the economy. Another reason for privatisation occurs particularly in the case of state owned banks where political
intervention prevents the true commercial operations of those entities (Culpin, 1999, p. 5). Such political interference can extend to the appointment of top managers, financing of government activities, offering higher than market interest rates for deposits in order to engender popularity for the government, over staffing and the extension of loans to those individuals and companies who have close associations with the government in power. This can result often in non-payment of those loans. “It is not accidental to see that non-performing loan amounts of state owned banks are much higher than those of private banks. This means diminishing capital of state owned banks” (Culpin, 1999, p.5).

However Helik (1997) regards the success of privatisation in achieving gains to the State as an open question. Abdel-Magid (1997, p.3) sees three critical factors in the privatisation process from a comparison of the British and Russian experiences - careful planning and gradual implementation, essential open market institutions, the linking of the type of privatisation to the valuation methods used. Over and above these factors, the British programme added other essential inputs, achieving depoliticisation of the process, demonstrated justifiability to the public, ensured that all citizens received a minimum number of shares, used careful pricing, balancing value to the State with post privatisation gains, and engaged available experts and institutions in the legal, financial and accounting arenas.

By contrast the Russian experience was ad hoc and abrupt, failing to anticipate the competition that local goods would face, combined with failure to create new institutions to maintain law and order, prevalence of cronyism, indifference to the advanced technology locked up in the military industrial complex and lack of functioning judicial, financial and accounting institutions, in addition to a shortage of experts with even a minimum understanding of how markets operate. A crucial factor in the Russian case was a lack of accountants - hence accounts were not prepared in accordance with international accounting standards and audited. In addition the ability to produce macroeconomic data was scarce (Radygin, 1997). Appropriate valuations appear to be crucial to a successful outcome.

Valuation Techniques

Privatisation can give rise to two difficult problems - allocation of property rights and valuation. The former involves political value judgements, so only the latter is considered here. The usual method adopted in Australia with the sale of government corporations operating on a commercial basis is to offer shares in a public float where the price is predetermined for retail shareholders within a range of bidding set by institutional shareholders (this was the privatisation of the Commonwealth Bank of Australia, Telstra, Qantas in the nineties). This open bidding system, although backed by a pre-bid valuation phase by the government as vendor, ensures that the final valuation is a true market value depending on the willingness of the market with rival bidders setting the final price.

The case of the State Bank of NSW (SBN) resembles the method by which BCA is being sold, which is generating objection. SBN was put up for private tender with the details of the portfolio only being available after each tenderer went through a discovery process – there was no open market bidding and the selection of the final bidder (who was the only bidder remaining) required the passage of a special bill through parliament giving the purchaser an opt-out clause with agreed compensation costs up to a maximum of $7million (CS First Boston, Coopers and Lybrand, 1994).
In the report to the State Parliament that was required as part of the process only one method of valuation was used. To understand how this may have undervalued the bank (evidenced in retrospect by the sale of the network of branches six years later for $9 billion) we need to understand common valuation techniques.

There are several methods that are used - the Discounted Cash flow (DCF) - which calculates the value of the firm as the present value of after-tax net cash flow. In this case value depends on three variables - an estimate of the net cash flow over the useful life of the firm (as an asset), an estimated discount rate which is normally the weighted average cost of capital, and an estimate of the residual value of the firm at the end of the period. Although the method is ideal theoretically, some commentators consider that its built-in problems limit its usefulness for the purpose of privatisation (Abdel-Magid, 1999, p. 8). These problems are subjectivity inherent in making estimates of future net cash flows and in estimating the weighted average cost of capital, the question of how to account for future inflation and high uncertainty, incorporation of management expectations in the resulting present value which can result in over-pricing and the inability to price individual assets. In the case of the SBN where the valuation used the DCF method, individual assets were priced, namely the impaired assets, but management expectations regarding those assets led to underpricing.

Before discussing this case further, other valuation methods should be noted - such as capitalisation of earnings using rates implicit in the P/E ratios for the industry. This method was difficult to apply to the SBN as all the other State banks were not publicly listed and regional banks were not comparable.

Another approach is to use modern management techniques to forecast future income of the enterprise, and replacement cost and value engineering to value the assets. This approach provides an opportunity for introducing market-oriented, modern management techniques to the privatised enterprise, using modern techniques such as target pricing, value engineering and activity based costing in order to generate information for decisions crucial to the technical problems associated with privatisations. Examples of such crucial decisions are the redesign of products, the evaluation of future service potential of existing assets, retooling of factories, generating information about future capital outlays and rationalising downsizing and retraining of the existing labour force (Haggis, 1997, pp. 14 -15).

An emerging economy such as Indonesia can learn from the experience of other nations undergoing privatisation, which shows privatisations combined with spreading ownership and control through ESOTS, or structured remuneration packages or discounted share issues to customers promotes economic growth and heighten consensus (Kelso and Kelso, 1991; Ashford and Shakespeare, 1999), rather than imposing the types of IMF covenants. This was the subject of three forums reviewed in a recent IMF survey, where it was highlighted as a principal contributing factor behind the recent high comparative growth rates of the Australian

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58 There are plenty of publications in the area of Public Private Partnerships that can be used as a guide - see Montanheiro, L. and Spiering, M.(ed), “Public and Private Sector Partnerships: The Enterprise Governance”(Sheffield Hallam University Prss, 2110 ISBN 0 86339 937 1).

59 This field of literature is known as “Binary Economics”.

60 “Speakers argue that ownership, not the number of conditions, is key to success of an IMF program”, IMF Survey, Volume 30, Number 16, August 13, 2001.
and Chinese economies. In those countries privatisation was accompanied by a dramatic increase in direct investment by shareholders in the stockmarket. This was achieved by the issuing of employee options, but also through the mandatory superannuation in Australia, and ESOTs, as well as issuing shares at a discount to customers of a company being privatised.

Conclusion

This paper has canvassed some of the essential ingredients in the resolution of regulatory failure in emerging economies, such ensuring efficiency on an operational, allocative and dynamic basis. This involves privatising many government owned organisations, (both traditionally owned and rescued) many of which collapsed as a result of the Asian crisis. What is new in this paper is the suggestion of some continued government involvement by requiring a percentage of future profits or gain upon resale when economic and political opinion consider privatisation a fire sale solution, as well as putting forward the idea of ensuring employees (and customers) share in the benefits conferred by a privatised entity. More private involvement in the public sector in emerging economies is now being espoused by both the World Bank and the IMF as a solution to the huge investment resources required for infrastructure expansion and modernisation, as well a cure for prolonged use of IMF resources.

Also new in this paper are unique ways of debt and bank reconstruction in order to alleviate a debt burden that is channelling scarce resources away from productive projects. For any of these solutions to occur there is an urgent need for compliance with standards of the Financial Stability Forum, the Financial Action Task Force and the Bank for International Settlements. This is because a major road to recovery is improving the perception of the integrity of financial markets, which includes not only concepts of good governance, transparency and disclosure, but also openness and market-friendly institutions, and above all an independent judiciary and central bank. Such compliance has not been spelt out in the various IMF memorandum and are necessary elements for any economy to cope with a systemic crisis.

A key conclusion from this paper is that a too rapid liberalisation of the financial system, and application of solutions which do not take account of the history, culture and stage of growth of Indonesia can explain in part the current performance of its economy as detailed in Sections 1 and 2.

Although this analysis could be disputed, what cannot be disputed is the urgent need for decisive choice of action from a vast range of available alternatives.

Bibliography


