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# RESTRUCTURING STATE-OWNED FINANCIAL INSTITUTIONS

## LESSONS FROM BANK RAKYAT INDONESIA

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# Abbreviations and Acronyms

| | | |
|---|---|---|
| AVB | – | Algemeene Volkscredietbank |
| Bimas | – | Bimbingan Masal (mass guidance) |
| BKD | – | Badan Kredit Dasa |
| BRI | – | Bank Rakyat Indonesia |
| BPR | – | Bank Perkreditan Rakyat (people's credit bank) |
| BOC | – | board of commissioners |
| BOD | – | board of directors |
| BKTN | – | Bank Koperasi Tani dan Nelayan (cooperative farmers' and fishermen's bank) |
| CAR | – | capital adequacy ratio |
| CEO | – | chief executive officer |
| GDP | – | gross domestic product |
| GTZ | – | Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH (German Agency for Technical Cooperation) |
| IMF | – | International Monetary Fund |
| IPO | – | initial public offering |
| Kupedes | – | Kredit Umum Pedesaan (general rural credit) |
| NPL | – | nonperforming loan |
| ORP | – | operational restructuring plan |
| PAKTO27 | – | Paket 27 Oktober 1988 |
| Simpedes | – | Simpanan Pedesaan (rural savings) |
| SME | – | small and medium-sized enterprise |
| SOFI | – | state-owned financial institution |

## Currency Equivalents

(As of 23 December 2008)

| Currency Unit | – | Rupiah (Rp) |
|---|---|---|
| $1.00 | = | Rp10,893 |
| Rp1.00 | = | $0.0001 |

(Previous Years)

| Year End | |
|---|---|
| 1984 | 1,074 |
| 1985 | 1,125 |
| 1986 | 1,641 |
| 1987 | 1,650 |
| 1988 | 1,731 |
| 1989 | 1,793 |
| 1990 | 1,877 |
| 1991 | 1,992 |
| 1992 | 2,062 |
| 1993 | 2,110 |
| 1994 | 2,200 |
| 1995 | 2,308 |
| 1996 | 2,383 |
| 1997 | 4,650 |
| 1998 | 8,025 |
| 1999 | 7,100 |
| 2000 | 9,595 |
| 2001 | 10,400 |
| 2002 | 8,940 |
| 2003 | 8,425 |
| 2004 | 9,285 |
| 2005 | 9,830 |
| 2006 | 9,393 |
| 2007 | 9,419 |

## Notes

(i) Until 1999, the fiscal year (FY) of the Government of Indonesia ended on 31 March; for 2000, FY was 1 April 2000 to 31 December 2000; and from 2001 on, FY coincides with the calendar year, 1 January to 31 December.

(ii) In this report, $ refers to US dollars.

(iii) Currency amounts in this report are generally stated in $. Rupiah amounts are converted into $ using official end-of-year exchange rates. In some cases, corresponding rupiah amounts are added, e.g., to demonstrate the wide fluctuations in the value of the rupiah during 1997 and 1998.

# Foreword

Despite the trend toward finance sector liberalization in recent years, state ownership of financial institutions is still widespread in the developing world. In general, the establishment of state-owned financial institutions, particularly banks, was advocated to correct market failures and provide resources to underserved or high-priority sectors of the economy, thus facilitating equitable economic growth. However, on the whole, government ownership of financial institutions has not necessarily been conducive to achieving those objectives. Weak governance and susceptibility to political influences have reduced the incentives for these institutions to focus on long-term viability. The implicit government guarantee limited these institutions' effort to achieve sustainability. Faced with the massive budgetary burden to sustain state-owned financial institutions, governments have been forced to decide to either close or restructure them.

A number of state-owned financial institutions have been restructured, yet important questions remain, such as:

- What are the factors that will lead to successful restructuring of state-owned financial institutions?
- How can poorly performing state-owned financial institutions become sustainable organizations?

This study examines Bank Rakyat Indonesia (BRI), the oldest and largest commercial bank in the country, which was successfully restructured twice—one after the interest rate deregulation of the finance sector in Indonesia in the early 1980s, and the other after the Asian financial crisis in the late 1990s. We hope that this study will provide some insights into how state-owned financial institutions can be transformed into viable financial institutions that are instrumental in achieving greater financial intermediation and economic development in developing countries.

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# Introduction

From the 1960s to the 1980s, developing countries—with the assistance of international development agencies—encouraged the establishment of state-owned financial institutions (SOFIs), including banks. The rationale for operating an SOFI was (i) to correct for market failures so that the poor could obtain financial services, and (ii) to ensure a flow of investment to specific sectors of the economy to which the government attached high priority.

However, over the years, and in many countries, SOFIs have generally underperformed compared with their private sector counterparts. Faced with the economic instability to which these failed financial institutions have contributed, governments were often forced to restructure them. Various efforts have been made, sometimes tied to budget support by international development agencies, to restructure SOFIs into sound financial institutions through such actions as privatization, divestiture, or external management contracts. This restructuring often required substantial capital injections, either from the government budget or through external borrowing. However, the outcomes of these efforts have varied, and there have been very few systematic studies analyzing the results and drawing conclusions.

This case study reviews Bank Rakyat Indonesia (BRI) and its transformation from a loss-producing, overstaffed state-owned bank to the most profitable bank with the largest microbanking network in Indonesia. The study is based on historical documents; previous studies of BRI units by Hans Dieter Seibel since 1987; BRI annual reports; and information generously provided by BRI in March 2008. The evolution of BRI from 1895 to 1983 is presented in Appendix 1, and the development of the institutional environment from 1983 to 2008 is presented in Appendix 2. The success of BRI was achieved in two separate restructuring phases. The first was the reform of the BRI microbanking units—*unit desa* (village units)—in 1984.[1] The second was the restructuring of BRI as a whole, from 1999 to 2003, immediately after the 1997/1998 Asian financial crisis. This study aims to extract, from these two phases, decisive lessons for the successful transformation of other SOFIs.

The experience of BRI suggests that an unprofitable SOFI can be transformed into a profitable organization with significantly expanded outreach. In 1983, BRI began the transformation of unit desa from dispensers of subsidized agricultural credit to a self-financed microbanking network with ever-growing deposits, loan portfolios, profits, and outreach to the lower market segment. This transformation established BRI as the world's most successful large-scale commercial microfinance provider, even though microfinance represented just a fraction of its loan portfolio. In 1997–1998, the fallout from the Asian financial crisis destroyed much of the commercial sector in Indonesia and almost wiped out the country's banking industry.[2] However, BRI was one of the state-owned

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1 The unit desa network was established by BRI in 1969 to implement a government-subsidized microcredit program in rural areas. After the restructuring of the unit desa, BRI eventually changed their name to BRI units, also referred to as microbanking units. In this study, the term unit desa refers to the BRI village unit network for the bank's subsidized microcredit programs until 1983; thereafter, they are called BRI units or simply units.

2 Also referred to in Indonesia as the monetary crisis, or *krisis moneter (Krismon).*

banks that were exempted from closure. It was restructured through a massive recapitalization effort in 2000, and it made its initial public offering on the stock market in Indonesia in 2003. In 2007, BRI became the most profitable bank in Indonesia. Since April 2008, it has been the largest bank in terms of loan portfolio size.

The key driver of the BRI reforms was the political will and commitment of the Government of Indonesia to allow BRI the autonomy to restructure itself. An evolving policy framework conducive to such autonomy, starting with the deregulation of SOFI interest rates in June 1983, was an important contributing factor to the bank's successful transformation. Neither expatriate management nor a contract with an external management group was a decisive factor in that transformation, although Harvard University's Center for International Development did play a crucial role in the reform and restructuring of unit desa through long-term technical assistance. Since the start of the reforms, the government's interference in banking has been replaced by an emphasis on good corporate governance. This emphasis, supported by appropriate regulations and effective supervision by the country's central bank, was a crucial element in the banking sector's restructuring.

# Restructuring of Bank Rakyat Indonesia Microbanking Units

## Origin of Bank Rakyat Indonesia Microbanking Units

Although Bank Rakyat Indonesia (BRI) dates back to the 1890s, its present form only emerged after Indonesia's officially acknowledged independence in 1950. In 1951, BRI was declared a government-owned bank, and its broad mandates were to (i) conduct banking business in general, including savings, credit, and other services; (ii) guide and supervise cooperatives and village banks; (iii) handle government programs; and (iv) act as a special bank for groups that were beyond the jurisdiction of other financial institutions. Credit was made available to any sector, e.g., agriculture, industry, trade, and salaried individuals.

During the 1960s, BRI underwent several structural changes to promote the government's social agenda. In 1960, the government merged BRI with the state-owned Bank Tani Nelayan (a farmers' and fishermen's bank) and a nationalized Dutch bank to form Bank Koperasi Tani dan Nelayan, supporting cooperatives of farmers and fishermen with subsidized lending. In 1968, the government separated BRI from Bank Koperasi Tani dan Nelayan, reestablishing it as a commercial bank with a broader mandate. The government tasked BRI with financing the production of improved crop varieties promoted by the "green revolution" and integrated rural development through the Bimbingan Masal (Bimas) (mass guidance) program of subsidized credit to farmers' groups.[1] The government also made BRI responsible for serving agricultural estates and rural small enterprises and microenterprises, as well as supervising close to 6,000 local financial institutions.[2]

To manage the Bimas program, BRI established a network of unit desa in rice-growing areas, mostly one per subdistrict. The number of BRI unit desa, supported by a government subsidy, grew rapidly from 18 in 1969 to 537 in 1970 and to 3,600 in 1983. To strengthen their own resource base, the units were authorized in 1974 to mobilize savings; but government funds remained the main source of financing. In 1974, too, the government initiated additional subsidized lending programs through BRI: Mini Credit for small rural businesses and Midi Credit for medium-sized ones.

The portfolio quality of these subsidized lending programs deteriorated rapidly. In 1971, one-third of Bimas clients were in arrears, resulting in a loss ratio of 17.5% of the Bimas portfolio. With the government's implicit guarantee of these loans, farmers lacked incentives to repay, and BRI staff was unable to enforce credit discipline. The default rates of Bimas borrowers surged to above 50% as of 1982, resulting in heavy losses. Like most subsidized programs at the time, the

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1 The "green revolution" encompasses "the application of science to increasing agricultural productivity, including the breeding of high-yield varieties of grains, the effective use of pesticides, and improved fertilization, irrigation, mechanization, and soil conservation techniques," according to the American Heritage Science Dictionary. The Bimas program was initially intended for intensification of rice production.

2 There are different types of small financial institutions, including village-owned credit organizations and village savings and loan institutions, broadly referred to as bank perkreditan rakyat (BPR), or people's credit bank. Their history goes back to the early 1900s. Since the 1988 financial reforms, the term BPR, is reserved for those that are supervised by Bank Indonesia.

Bimas program was burdened with illegal extra charges, onerous procedures, frequent delays beyond the time of planting, when farmers need credit most, and restrictions of allowable loan purposes to production-oriented agricultural targets; thus, negating its purpose of improving farm productivity and increasing food self-sufficiency.

The oil price decline in 1982 sharply reduced Indonesia's oil-related revenue and forced the government to withdraw from the expensive subsidized lending program. At that point, the government became unable to continue subsidizing such a poorly performing credit program. In 1983, rather than abolish subsidized credit altogether, the government discontinued three major subsidized programs—Bimas, Mini, and Midi. This action was part of the government's broader banking sector liberalization, in which interest rate ceilings were removed and the government reduced its control over the management of state-owned banks. In another reform initiative, the government installed a new reform-oriented management at BRI to take immediate actions to restructure the loss-making unit desa network. In 1983, BRI had 3,617 of these units, with a total of 14,300 staff members within the units—the largest loan delivery network in Indonesia. The new BRI management revamped the unit desa system with long-term technical assistance from Harvard University's Center for International Development, supported by the United States Agency for International Development and the Center for Policy and Implementation Studies in Jakarta. A new unit desa system designed by the technical assistance team was introduced in February 1984.

## New System of Bank Rakyat Indonesia Microbanking Units

Under the new system, at the organizational level, the units were placed under their own administrative structure, supervised by branches, and audited by regional offices. All units were reorganized as self-sustaining profit centers with substantial profit-sharing incentives for the management and staff. These incentives were matched by penalties for managers of poorly performing units. If loan arrears exceeded 5% for a certain period (this benchmark was later lowered to 3%), unit managers would lose their lending authority, which would in turn reduce their chances for promotion. Units were moved from rice planting areas to business centers; unprofitable units were downgraded to village service posts or closed. During 1987 and 1988, a new operating system called the "one-stop service method" was introduced, in which a teller at a unit handled various transactions such as money transfers, check clearing, bill payment, and other noncash transactions in one stop. Training and retraining of unit staff were strengthened and organized in regional BRI education and training centers to equip them with comprehensive banking skills. To maintain the financial health and credit discipline at the units, subsidized programs were not implemented at the units but were confined to the branches.

At the customer or market segment level, the units moved away from the previous commodity approach, which emphasized farmers, crop agriculture, and seasonal loans. Instead, the units adopted a so-called income approach, providing credit to any creditworthy person for any income-generating activity such as petty trading, agriculture, and agriculture input trade, industry, services, horticulture, operation of small plantations and livestock-related activity, as well as consumer credit. Anyone who was able to save and repay a loan was a potential unit customer.

At the product level, innovations in savings and loan products were emphasized, and two new savings and loan products were introduced at the units. One, called Simpanan Pedesaan (Simpedes), was a savings product for those living or doing business in rural areas. This product provided for unlimited withdrawals at any time, and had a lottery component, with prizes awarded at well-publicized public events. Simpedes has become BRI's most attractive savings product, outperforming time deposits and other savings products by a wide margin. The other innovation was a general rural credit product, Kredit Umum Pedesaan (Kupedes), which provided for monthly installment payments and was open to all borrowers for any purpose. Kupedes enabled the units to diversify their portfolio away from mainly agricultural loans and toward various business and consumer loans, rural as well as urban. BRI also introduced an incentive system for timely repayment of the loans, with two components: (i) a refund of 25% of the amount of interest due, and (ii) the expectation of repeat loans of increasing size if all installments were paid on time. This turned out to be a powerful instrument for arrears prevention, as approximately 95.0% of the borrowers repaid their loans on time, a proportion which increased to 98.8% in 2007.

The BRI units have been financially self-sufficient since 1989. BRI initially received funds for the unit desa reform from two major sources: (i) an injection of Rp210 billion of seed capital in 1984 from the government as start-up liquidity for loans and initial administrative costs; and (ii) a World Bank loan of $102 million, distributed as follows: $5 million in 1987 for technical assistance and $97 million in 1989 for liquidity support. However, given the success of the Simpedes savings product, which provided positive real returns to depositors, the units soon became independent of external funding, and by December 1989, they generated excess liquidity of $63 million.[3] Since that time, BRI units have been completely financially self-reliant in mobilizing their own resources, covering their costs, and earning a profit (Table 1).

## Bank Rakyat Indonesia Microbanking Units and the 1997/1998 Asian Financial Crisis

Indonesia was hit hard by the 1997/1998 Asian financial crisis. This crisis resulted in inflation and currency devaluation, which led to a monetary crisis in Indonesia. Virtually all banks in Indonesia were affected, and many were merged or closed. However, the BRI units showed strong resilience and continued to generate profits even during the monetary crisis. During 1998–1999, the



[3] At the time the $97 million was released by the World Bank, the units were already self-reliant, and the liquidity was injected into the branches.

number of deposit accounts at the units grew by 3.6%.[4] In contrast to the general expectation that since the poor were short of funds and would need to increase their borrowing, the number of borrowers stood at an almost constant level during 1997–1999.[5] This implies that the poor were reluctant to borrow because of uncertainty over the future and behaved cautiously. The monetary crisis had little effect on loan repayment at the units. Although there was a moderate increase in loan delinquency, the loan loss ratio remained below 2.2% throughout 1997–1999.[6] Microborrower psychology showed an interesting development during this period. In August 1998, right after the monetary crisis peaked, the units experienced the opposite of a run on the bank to withdraw savings; rather, microborrowers rushed to repay their loans early, resulting in an unprecedented negative 1-month loan–loss ratio of –0.21%.

If not for the resilience of the units, BRI would have closed or merged with other banks. In a more technical sense, the units cross-subsidized BRI in two ways: (i) through the continual transfer of profits from the units to BRI as a bank, and (ii) through the transfer of savings mobilized at the village level to the branches and into corporate lending. Thus, it was these units that ultimately saved BRI in 1998 (Table 1).

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4 The monetary crisis had a strongly positive impact on the units, which showed extraordinary resilience. Growth in the number of deposit accounts continued, from 16.1 million accounts in 1996 to 18.1 million in 1997, 21.7 million in 1998, and 24.2 million in 1999. The figures show a 33.6% increase in the number of accounts from January 1998 to December 1999. During the 3-month peak crisis period, June 1998 to August 1998, when Indonesia had been most badly hit by both a drought and the financial crisis, 1.3 million new deposit accounts were opened in the units; and an additional Rp2.84 trillion ($354 million) was deposited. In nominal terms, during the initial 12-month crisis period, from September 1997 to August 1998, total savings deposits in BRI almost doubled. Deposits in the BRI units increased from Rp7.98 trillion in August 1997 to Rp15.13 trillion in August 1998, an increase of 89.6%. For the same period, in all of BRI, deposits rose from Rp17.86 trillion to Rp35.17 trillion, a growth rate of 96.9%, and an increase well above the 56% inflation rate for the period. On a year-to-year basis, deposits in the units surged by 83.8% in nominal terms, from Rp8.8 trillion in 1997 to Rp16.2 trillion in 1998. In US dollar terms, due to the devaluation of the rupiah, the picture was quite different; deposits in the units fell from $3.0 billion in 1996 to $1.9 billion in 1997. It took until 2003 to reach, and surpass the pre-crisis level.

5 In contrast to the expectations of many donors that were willing to provide extra funds for the poor, the number of borrowers, which had stood at 2.6 million in 1997, fell to 2.5 million in 1998 and 1999. This was not due to a shortage of funds, as was the case elsewhere in the banking system, but to a lack of demand, related to a cautious attitude among the poor concerning an uncertain future. The amount of loans outstanding remained almost constant in nominal terms, increasing slightly from Rp4.41 trillion in August 1997 to Rp4.75 trillion in January 1998, and declining to Rp4.55 trillion in May 1998. In US dollar terms, due to the collapse of the rupiah, there was a substantial decline in loans outstanding: from $1.7 billion in 1996 to $1.0 billion in 1997, falling to a low of $0.6 billion in 1998. The recovery to the pre-crisis level was only reached at the turn of 2003–2004.

6 The crisis had only a moderate effect on loan repayment, testifying to the resilience of both the BRI units and the credit culture of the microenterprises and farmer customers. There were some delays in repayment, indicated by an increase of the arrears ratio (1 day or more) from 3.7% in 1996 to 4.7% in 1997 and to 5.7% in 1998, declining steadily thereafter. But the 12-month loan–loss ratio remained low, increasing from 1.6% in 1996 to 2.2% in 1997, but declining thereafter to an all-time low of 0.5% as of 2001.

**Table 1: Financial Performance of BRI Microbanking Units, 1984–2007**

| Year | Savings Accounts (Number) | Savings ($ million) | Loan Accounts (Number) | Loans ($ million) | Savings-to-Loans Ratio (%) | Surplus Liquidity ($ million) | 12-Month Loan–Loss Ratio (%) | Arrears Ratio[a] (%) | Return on Assets (%) | $ Exchange Rate (Rp)[b] |
|---|---|---|---|---|---|---|---|---|---|---|
| 1984 | 2,655 | 39.3 | 640,746 | 103.4 | 38 | (64.1) | 1.0 | 5.4 | n.a. | 1,074 |
| 1985 | 36,563 | 75.5 | 1,034,532 | 203.6 | 37 | (128.1) | 1.8 | 2.1 | n.a. | 1,125 |
| 1986 | 418,945 | 107.1 | 1,231,723 | 203.7 | 53 | (96.6) | 2.7 | 4.5 | n.a. | 1,641 |
| 1987 | 4,183,983 | 174.2 | 1,314,780 | 260.4 | 67 | (86.2) | 3.0 | 5.8 | n.a. | 1,650 |
| 1988 | 4,998,038 | 284.8 | 1,386,035 | 313.3 | 91 | (28.5) | 4.6 | 7.4 | n.a. | 1,731 |
| 1989 | 6,261,988 | 534.9 | 1,643,980 | 472.1 | 113 | 62.8 | 2.3 | 5.4 | n.a. | 1,793 |
| 1990 | 7,262,509 | 902.9 | 1,893,138 | 736.2 | 123 | 166.7 | 2.0 | 4.1 | 3.0 | 1,877 |
| 1991 | 8,587,872 | 1,275.4 | 1,837,549 | 730.8 | 174 | 544.6 | 4.9 | 8.6 | 2.7 | 1,992 |
| 1992 | 9,953,294 | 1,648.4 | 1,831,732 | 799.5 | 206 | 848.9 | 3.4 | 9.1 | 2.6 | 2,062 |
| 1993 | 11,431,078 | 2,049.9 | 1,895,965 | 927.7 | 221 | 1,122.2 | 2.2 | 6.5 | 3.3 | 2,110 |
| 1994 | 13,066,854 | 2,378.2 | 2,053,919 | 1,117.3 | 213 | 1,260.9 | 0.7 | 4.5 | 5.1 | 2,200 |
| 1995 | 14,482,763 | 2,606.4 | 2,263,767 | 1,382.7 | 188 | 1,223.7 | 1.1 | 3.5 | 6.5 | 2,308 |
| 1996 | 16,147,260 | 2,975.9 | 2,488,135 | 1,710.5 | 174 | 1,265.4 | 1.6 | 3.7 | 5.7 | 2,383 |
| 1997 | 18,143,316 | 1,900.4 | 2,615,679 | 1,007.6 | 189 | 892.8 | 2.2 | 4.7 | 4.7 | 4,650 |
| 1998 | 21,698,594 | 2,011.9 | 2,457,652 | 585.3 | 344 | 1,426.6 | 1.9 | 5.7 | 4.9 | 8,025 |
| 1999 | 24,235,889 | 2,403.1 | 2,473,923 | 839.0 | 286 | 1,564.1 | 1.7 | 3.1 | 6.1 | 7,100 |
| 2000 | 25,823,228 | 1,992.2 | 2,715,609 | 815.7 | 244 | 1,176.5 | 1.1 | 2.5 | 5.7 | 9,595 |
| 2001 | 27,045,184 | 2,114.5 | 2,790,192 | 949.4 | 223 | 1,165.1 | 0.5 | 2.2 | 5.8 | 10,400 |
| 2002 | 28,262,073 | 2,626.4 | 3,056,103 | 1,343.4 | 195 | 1,283.0 | 1.7 | 1.6 | 6.4 | 8,940 |
| 2003 | 29,869,197 | 3,538.2 | 3,100,358 | 1,683.4 | 210 | 1,854.8 | 1.9 | 2.5 | 5.7 | 8,425 |
| 2004 | 31,271,553 | 3,541.4 | 3,210,678 | 2,067.0 | 171 | 1,474.4 | 1.3 | 1.9 | 6.8 | 9,285 |
| 2005 | 32,252,741 | 3,742.7 | 3,313,532 | 2,317.9 | 161 | 1,424.8 | 1.3 | 1.4 | 7.0 | 9,830 |
| 2006 | 30,907,566 | 4,659.7 | 3,455,528 | 2,904.8 | 160 | 1,754.9 | 1.2 | 1.3 | 8.5 | 9,393 |
| 2007 | 21,229,085 | 5,646.4 | 3,515,812 | 3,461.3 | 163 | 2,185.1 | 0.9 | 1.2 | 9.4 | 9,419 |

n.a. = not available; ( ) = negative number.

Note: 1997–1998: Asian financial crisis (hyperinflation); 2006–2007: Cleaning of inactive savings accounts.

[a] Total payments overdue one day or more in % of total loans outstanding, excluding loans written off.

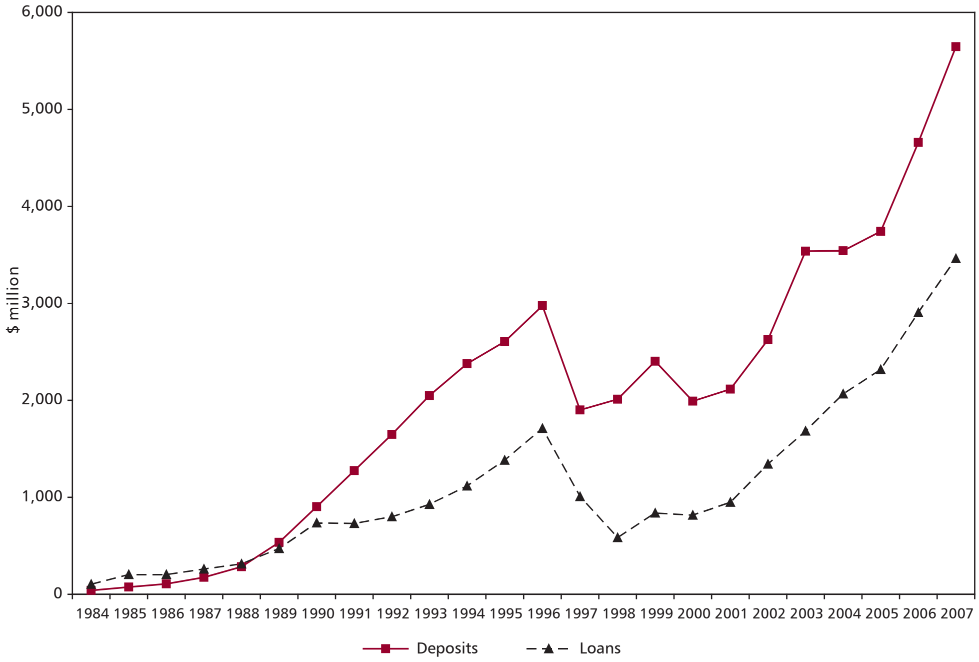
[b] End-of-year exchange rates.

Source: Bank Rakyat Indonesia (BRI), Laporan Statistik BRI Unit.

## Challenges and Decisive Factors in Restructuring

The restructured BRI units are, at the end of 2008, in their 25th year, comprising 4,228 units and 117 village services posts, or a total of 4,345 outlets. The growth of the units' outreach has been unabated; on average, 225,000 loans were disbursed by the units monthly in 2007, a steady increase from 196,200 in 2003 (Figure 1). Geographically, 37.7% of the units' borrowers and 49.1% of the units' loan portfolio are outside of Java. With a return on assets of 9.4% in 2007, the BRI units are highly profitable, more than any other business segment of BRI, and a major contributor to BRI's profitability. The units' success presumably played a key role in the decision to recapitalize BRI at the time of the 1997/1998 Asian financial crisis. Decisive aspects of this success included: (i) the units' continually excellent performance since 1984; (ii) their vast outreach; (iii) the large number of well-trained staff members; and (iv) their international reputation, lauded as "the most advanced example of the microfinance revolution" (Robinson 2001) and "a flagship of rural microfinance" (Seibel 2005).

**Figure 1: Savings Deposits and Loans Outstanding of Bank Rakyat Indonesia Microbanking Units, 1984–2007**
($ million)




Source: Bank Rakyat Indonesia.

The restructuring of the units, in which subsidized agricultural credit was replaced by commercial microbanking, does not mean that agricultural credit was reduced; on the contrary, agricultural credit increased in absolute terms. It has been estimated that about 20% of the nonsubsidized, all-purpose Kupedes loans are directly invested in agriculture. Using this percentage, the amount of agricultural credit extended by the units increased from $21 million in 1984 to $692 million in 2007.[7] In contrast to the Bimas portfolio, which had been declining over time, the portfolio of the restructured units continued to increase.[8] In addition, there is anecdotal evidence that with unrestricted use of credit and the opportunity of safely depositing savings, farm households prefer to invest scarce financial resources borrowed at relatively high interest rates

[7] Over the 24-year period, the annual amount of agricultural loans outstanding averaged $224 million, or approximately $252 million in terms of disbursements.

[8] Under the subsidized Bimas program, handled by the units until 1983, an average of $101 million per year was disbursed over a 14-year period. Given the fungibility of money, it must be assumed that part of that amount flowed into nonagricultural activities.

in activities with high returns, such as petty trading and other microenterprise activities, and to finance agriculture from their own resources. This implies that the discontinuation of subsidized agricultural credit promoted more efficient resource allocation and investments among the farm households.

The units' success in savings mobilization has created a new challenge: recycling the savings within the village economy. Since 1989, the units have produced surplus liquidity. The space between the deposit and loan curve in Figure 1 represents the amount of surplus liquidity, which was negative during 1984–1988 and has been strongly positive since 1990. The units are required to place the surplus within the BRI branch system.[9] With its individual unit-based lending technology and no special outreach mechanism to villages beyond the subdistrict towns and their vicinity, the units have not been able to recycle the savings mobilized locally, despite an unmet demand for credit by an estimated 50% of the rural population. Should the units leave the more remote villages with their savings potential and their demand for smaller loans to smaller financial institutions? Or has the time come to develop more-inclusive outreach strategies? One theory is that "taking the bank to the people" by bringing down the lending operations to community-level institutions increases overall efficiency in extending services to unserved or underserved populations. According to the theory, such arrangements would reduce transaction costs of borrowers and depositors, and the cost savings would be larger than the cost required for the new institutional arrangements. At present, BRI is taking steps in that direction by linking with other microfinance institutions.

Overall, the restructuring of the BRI units demonstrated that microfinance can be commercially viable if financial institutions (i) are given proper incentives to focus on sustainability and outreach, (ii) are adequately supervised, and (iii) are allowed to mobilize resources locally. Several lessons concerning decisive factors of restructuring can be drawn from the experience of the reform of BRI's microbanking business:[10]

(i) With attractive savings and credit products, appropriate staff incentives, and an effective system of internal regulation and supervision, rural microfinance can be highly profitable.
(ii) The poor and near-poor can save, and rural financial institutions can mobilize their savings cost-effectively.
(iii) The poor need savings products more than credit. If both savings and credit services are offered, the demand for savings deposit services effectively exceeds the demand for credit by a wide margin.

[9] Since 1993, surplus liquidity has been consistently above $1 billion except in 1997. During the monetary crisis year 1998 and the following year, surplus liquidity was $1.43 billion and $1.56 billion, respectively—at a time when banks ran out of loanable funds and donors rushed in to provide fresh credit lines. In 2007, surplus liquidity amounted to $2.19 billion. Over the last 10 years, the units have succeeded in lowering their savings-to-loans ratio from 344% in 1998 (mobilizing 3.4 times as much savings as loans outstanding), to 163%–171% between 2004 and 2007 (mobilizing 1.6–1.7 times as much savings as loans outstanding).

[10] BRI is prepared to share this experience with others through an institutionalized exposure visit and training program. For more information, please contact the International Visitor Program, SBU Micro Banking, at fax number +62 21 2511 644, +62 21 2513 013 or through e-mail at ivp@bri.co.id, or ivpbri@cbn.net.id

(iv) Rigorous monitoring, promotion of good credit culture, and incentives for timely repayment are the key to successful microfinance.

(v) In microfinance, outreach to vast numbers of poor people is the way to viability, self-reliance, and financial self-sufficiency.

(vi) Catering to both the poor and nonpoor enables financial institutions to lower average transaction costs as well as interest rates on loans, while at the same time increasing profitability with the increased volume of transactions.

(vii) Finance sector policies that are free of distortive political interference are conducive to financial innovations.

# Restructuring of Bank Rakyat Indonesia

## Pre-Restructuring Period

The decline in oil prices in 1982, and the resulting loss of income from oil exports, initiated an era of liberalization and gradual withdrawal of subsidies by the Government of Indonesia. In June 1983, the government deregulated the interest rate regime of state-owned banks, and withdrew its liquidity supply from the BRI village units. This led to their transformation into highly profitable commercial microbanking units, but had little effect on the main business of BRI and the other state-owned banks. By 1989, the units accounted for a mere 8.1% of the bank's total loan portfolio and 14.6% of its total deposit balance (Tables 1 and 2). At that time, BRI still handled more than 300 government programs, placing a heavy burden on its branches; it was only in 1990 that 32 of the 36 largest remaining subsidized credit programs were phased out and replaced by a 20% small and medium-sized enterprise (SME) lending quota. The deregulation policy of 1983 was continued in 1988 by a law (PAKTO27) designed to ease the establishment of new commercial banks and bank branches. The law also provided a legal framework for the establishment of regulated rural banks—Bank Perkreditan Rakyat (BPR)[11]—under the supervision of Bank Indonesia, the central bank. This led to a rapid expansion of the private banking sector and a concomitant loss of market share by the state-owned banks.

However, the expansion of the finance sector was not accompanied by effective regulation and supervision by Bank Indonesia, which lacked independence and enforcement power.[12] Many of the new private commercial banks were owned by big business conglomerates. These banks borrowed cheaply on international markets and competed vigorously for domestic deposits to finance the expansion of their parent conglomerate companies. Lending decisions of state banks were under political influence. Until 1999, the government controlled Bank Indonesia, which was thus unable to enforce prudent banking supervision, and the banking sector was practically out of control.

The process of expansionary growth of the banking sector was interrupted by the monetary crisis in 1997–1998, which led to a standstill of the economy, the collapse of the banking sector, and the downfall of the political regime.[13]

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[11] The term "BPR" was used before the passage of PAKTO27 as a generic term for nonbank financial institutions (most of them under provincial law), which were also referred to as *Lembaga Dana Kredit Pedesaan*. Since PAKTO27, the term "BPR" refers only to BPRs licensed and supervised by Bank Indonesia. All *Lembaga Dana Kredit Pedesaan* were supposed to be transformed into regulated BPRs; but Bank Indonesia was unable to enforce this transformation process because of strong opposition in the provinces. As a result, rural financial institutions licensed under provincial law continue to coexist with BPRs licensed by Bank Indonesia.

[12] Following the establishment of a timetable for the introduction of prudential standards of capital adequacy (capital adequacy ratios or CARs), legal lending limits and foreign exchange net open positions, a number of measures were instituted from 1991 to 1996, but were slow to take effect: (i) a tight money policy in 1991 taking Rp8.1 trillion from state-owned banks, (ii) raising the CAR to 8% and setting deadlines for banks to meet legal lending limits, (iii) tax incentives for bank mergers in 1995, and (iv) an increase of minimum reserve requirements from 3% to 5%.

[13] In its annual report 1996–1997 (p. 62), Bank Indonesia reported that, "against the backdrop of favorable economic developments in the reporting years, banks maintained their efforts to promote soundness so as to create an efficient, solidly established banking system." Even by the end of 1997, many, including the World Bank, continued to believe in the robustness of the economy of Indonesia.

**Table 2: Bank Rakyat Indonesia Financial Highlights, Pre-Restructuring Period, 1989–1996**

| Item | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|---|
| Total assets ($ million) | 7,758.5 | 10,565.3 | 10,648.6 | 12,130.5 | 11,863.0 | 11,682.7 | 12,376.9 | 14,440.2 |
| Loans (gross) ($ million) | 5,834.4 | 7,841.8 | 7,945.3 | 8,886.0 | 9,070.6 | 8,757.3 | 9,775.1 | 11,225.3 |
| Deposits ($ million) | 3,674.3 | 5,150.2 | 5,836.3 | 6,807.0 | 6,970.1 | 6,802.7 | 6,970.1 | 8,101.1 |
| Equity ($ million) | 160.6 | 185.4 | 200.3 | 453.9 | 535.5 | 621.4 | 711.0 | 759.5 |
| **Profit/Loss** | | | | | | | | |
| Net interest income ($ million) | 355.3 | 505.1 | 437.8 | 468.5 | 487.7 | 618.2 | 681.1 | 672.3 |
| Income after tax ($ million) | 42.9 | 57.5 | 26.6 | 27.6 | 34.6 | 38.2 | 76.3 | 101.1 |
| **Financial Ratios** | | | | | | | | |
| Return on assets (%) | 0.55 | 0.54 | 0.25 | 3.74 | 4.51 | 0.33 | 0.62 | 0.70 |
| Return on equity (%) | 26.6 | 31.0 | 13.39 | 6.12 | 6.44 | 5.28 | 5.74 | 5.26 |
| Loans-to-deposits ratio (%) | 158.8 | 152.3 | 136.1 | 130.5 | 130.1 | 128.7 | 140.2 | 138.6 |

Note: Year-end figures.
Source: Bank Rakyat Indonesia.

In October 1997, the government signed a letter of intent with the International Monetary Fund (IMF) describing its 3-year economic reform program. Finance sector reform was one of three major reform initiatives that the government committed to implement under the IMF's support. In November 1997, the IMF approved a 3-year standby agreement under which the government was to borrow $10 billion.

The monetary crisis most severely affected commercial banks, but BPRs, without foreign exchange and corporate exposure, were less affected. The fragility of the commercial banking sector had been largely due to (i) poor governance, including insider lending and political interference; (ii) currency and maturity mismatches; and (iii) a lack of market discipline after years of rapid economic expansion. All of these factors were exacerbated by weak regulation and a lack of adequate supervision. As the crisis unfolded, the banking sector was unable to cope with the surge in the exchange and inflation rates, capital flight, and depositor and creditor runs on the banks.

By 1998, due to high inflation and devaluation, BRI's assets in US dollar terms fell by 0.6% compared with 1996; the gross nonperforming loans (NPLs) ratio surged to 52.98%, and the net loss amounted to $3.3 billion (Tables 2 and 5). BRI became technically bankrupt, but it took the government until 1999 to decide whether to restructure BRI, or to separate the units in a new microfinance bank and to merge the remainder of the bank with the new Bank Mandiri, an amalgamation of several failed state banks. The performance and international renown of BRI's microbanking units played an important role in that decision; but at 15.2% of the bank's total portfolio and 36.7% of its deposit balance in 1996 (slightly lower in 1997), the units' share of the bank's total business was still too small (and the performance of the other business segments too poor) to keep the bank from insolvency.

## Crisis-Driven Restructuring

Under the Forward Steps for Bank Improvement and Restructuring Program, launched by the government in August 1998, the government decided to restructure insolvent but politically important banks. It kept BRI alive, with a focus on SMEs including those in rural areas, while decreasing the relative weight of the bank's loss-generating corporate sector. Subsequently, the BRI restructuring during 1999–2003 encompassed three phases: (i) the implementation of an operational restructuring plan (ORP), (ii) recapitalization, and (iii) partial privatization.

In February 1999, the Ministry of State-Owned Enterprises established a committee for preparing ORPs for three state-owned banks including BRI. ORPs were mainly focused on (i) resolution of NPLs and restructuring of portfolios, (ii) enhancing risk management, (iii) business strategy, (iv) reduction of operating costs and efficiency improvement, (v) reorganization of the accounting system, and (vi) management information system (MIS) enhancement. Immediately after the formulation of the ORP, BRI took short-term measures to overcome the crisis along the lines listed in Box 1.

For several years before the crisis, BRI's units were highly profitable businesses and operated without government subsidies. Under the new strategy, BRI expanded its micro and consumer lending, which had the lowest NPL ratios among the bank's business segments (Table 4). Furthermore, BRI initiated product diversification and innovation, and introduced an online savings product (Britama) with automated teller machine access. BRI also improved its investment banking services for individual clients.

BRI restructured its problem loans and transferred a total of Rp15.66 trillion ($2.2 billion) of NPLs involving 190 major, mostly corporate, bad loans to the Indonesian Bank Restructuring Agency, which was created by the government in January 1998 to take over insolvent banks and absorb nonperforming assets. The restructuring of nonperforming assets was accompanied by a restructuring of the portfolio composition. BRI drastically reduced its lending to the corporate sector, which was the most problematic portfolio during the monetary crisis, and reconfirmed its commitment to micro and SME lending, with a target of 80% of its portfolio. In support of the micro and SME lending focus, BRI subsequently participated in the establishment of 18 SME business development centers and in a program of land certification, which enables small and micro borrowers to have their housing plots registered and to offer them as collateral.

**Box 1: First Phase of Bank Rakyat Indonesia Operational Restructuring Program, Completed as of 30 September 1999**

1. Loan Recovery Efforts
   - Setting loan restructuring policy
   - Adding loan restructuring staff
   - Training in loan restructuring
   - Setting portfolio analysis concept
   - Improving management information systems to provide more accurate and timely information
   - Strengthening loan restructuring department in regional offices
   - Restructuring 42 debtors amounting to Rp3.0 trillion
   - Restructuring 20 largest obligors amounting to Rp8.9 trillion
2. Risk Management Initiatives
   - Consumer loan data collection to monitor loan quality
   - Early warning system
   - Loan application form simplification
   - Risk rating system for small businesses
   - Analysis and risk ratio standardization for medium-sized businesses
   - Dynamic monitoring system and portfolio management capability improvement
   - Establishment of a loan administration division
   - Asset liability management improvement
   - Computerized asset liability management planning model
3. Business Strategy Redefinition
   - Redefining business concept
   - Reconstruction of business strategy
4. Operational Efficiency and Cost Reduction
   - Reviewing purchasing policy
   - Minimizing expedition cost
   - Reviewing maintenance and repair policy
   - Reviewing third party service, travel, education, insurance, cash in transit and other costs
   - Reviewing relationship with subsidiary company and pension funds
   - Office automation
   - Control improvement
5. Organizational Effectiveness and Efficiency
   - Implementing a hub-spoke branch office concept
   - Closing or merging some regional offices and regional audit offices
   - Voluntary staff retirement
6. Management Information System and Accounting System Improvement
   - Management information system and accounting restructuring
   - Information technology restructuring

Sources: Bank Rakyat Indonesia.

Various enhancements were made in risk management and prudential banking. Aligned with the new operational strategy, the rating of small businesses was introduced as part of the due diligence process. In March 2002, BRI established a risk management committee at the bank's highest level, consisting of the board of directors and senior management. Following the implementation of new regulations by Bank Indonesia, BRI subsequently consolidated its risk management organization in a single unit, the Division for Compliance and Risk Management, which was responsible for integrated risk management covering all eight risks: operational, market, credit, liquidity, compliance, legal, strategy, and reputational (*BRI Annual Report* 2003:25). Since 2001, BRI has also implemented a work ethics program for about 35,000 employees by appointing 1,000 of them who have exceptional performance records to serve as role models, change agents, and motivators.

A key aspect of BRI's restructuring was the installation of new board of directors and commissioners in July 2000. The new BRI management was asked to enter into an investment management performance agreement with the government, requiring management to develop and implement a business plan with specific performance targets and timeframes up to 31 December 2003. The investment management performance agreement stipulated further restructuring steps for BRI including (i) establishment of a loan restructuring division and the introduction of the principle of separating credit risk management from relationship management; (ii) improvements to the information technology platform, including system redefinition, separation of front and back office, and establishment of integrated settlement and treasury operation guidelines and procedures; (iii) an organizational diagnosis for credit risk management, human relations liability, due diligence, and compensation program improvement; (iv) a redefinition of the accounting, supervision, financial reporting, and auditing structures; and (v) the introduction or improvement, respectively, of online services, real-time online information access, automated teller machine sharing, operational risk mitigation, operational efficiency, and information technology investment effectiveness.

The installation of the new board of directors and commissioners was immediately followed by recapitalization of the bank by the government. A total of Rp29.06 trillion ($3.0 billion) in government bonds was injected into the bank, to be repaid in due course; and Rp20.4 trillion was transferred in July 2000 and Rp8.7 trillion in October 2000, to achieve a stipulated capital adequacy ratio (CAR) of 4%. An excess of Rp0.9 trillion, plus interest earned, was returned to the government in November 2001.

The results of these restructuring activities became visible by the end of 2000. The NPL ratio was at a historically low level. After 2 years of massive losses, BRI started yielding a profit. All other financial indicators met the regulatory requirements of Bank Indonesia (Table 5).

In November 2003, BRI became a partially privatized public company and was listed on the Indonesian Stock Exchanges. At the initial public offering (IPO), shares were oversubscribed by 15.4 times. After the partial privatization, the government kept 59.5% of the share capital and the public took 40.5%.[14] Public ownership at the time of the IPO was 44.7% domestic and 55.3% foreign; by



[14] The public share was 43.17% in September 2008. At this stage, there is no indication that the government may give up its majority ownership.

31 December 2003, most of the domestic owners had sold their shares, which changed the public ownership composition to 20.9% domestic and 79.1% foreign. Going public has required a paradigm shift for BRI. It has become crucial for BRI to comply with capital market regulations and gain the trust of shareholders. The bank's new attitude toward public relations is demonstrated in the organization's annual reports, which since 2003 have been published in two volumes, one in English and one in Bahasa Indonesia, at more than twice the length of the previous reports.

## Post-Restructuring Period

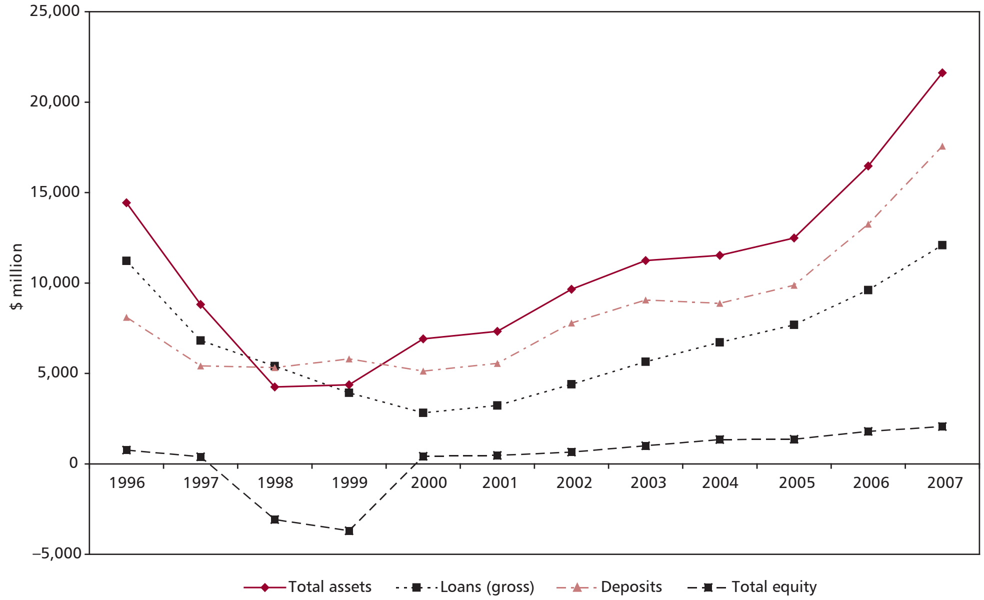
During the slightly more than 4 years after the IPO, until December 2007, BRI showed impressive growth. From 2003–2007, total assets in US dollar terms grew by 92.3% from $11.2 billion to $21.6 billion. Gross loans outstanding grew by 113.9% from $5.6 billion to $12.1 billion. Portfolio quality improved markedly, from a gross NPL ratio of 6.0% in 2003, above Bank Indonesia's 5% limit, to 3.4% in 2007, better than the banking industry at 4.1% (Figures 2 and 3).

With the cost of funds lowered from 7.9% in 2003 to 4.5% in 2007, operational expenditure as a percentage of operational income decreased from 79.8% to 69.8%, better than the banking industry ratio of 84.1%; the net interest margin increased from an already remarkably high 9.5% to 10.9%, far above the industry's net interest margin of 5.7%; profit before tax more than doubled, increasing by 87.5% from $440.6 million to $826.0 million, yielding an after-tax net profit of $513.6 million. During the 7 years since 2001, the year after the recapitalization, BRI paid $1.03 billion in taxes, making the restructuring of BRI a good business decision for the treasury of Indonesia. In terms of the level and variance over time of the NPL ratio, the segments of micro and small consumer loans up to $20,000 have performed best. The risks of the small and medium range of loans up to $5 million are not yet managed well; a more detailed analysis of risks by loan size in the small commercial loan segment would be useful. Corporate loans are by far the riskiest, but at a declining rate.

As of April 2008, BRI had the most extensive delivery network in Indonesia, was the third largest bank in terms of total assets and deposits, the second largest in terms of loans outstanding, and the best in terms of profitability.

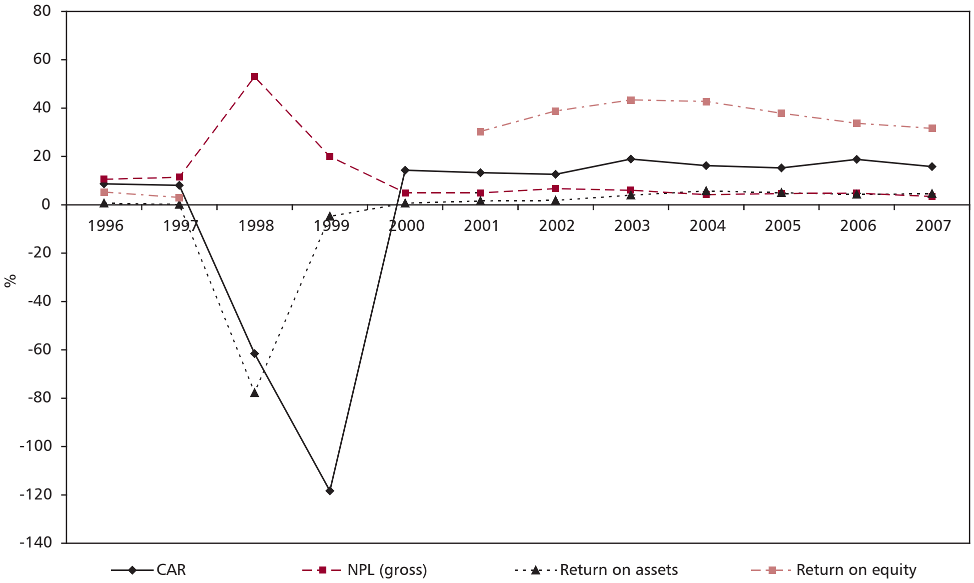
BRI owes its success after the crisis to its emphasis on the urban and micro and SME sectors, the latter including agriculture. The reform during 1999–2003 substantially changed BRI's portfolio composition. Lending to the corporate sector was cut in half from 34.5% in 1998 to 17.4% in 2007, while micro and SME lending grew from 65.5% to 82.6% (Table 3). Due to more effective incentive and risk management structures in micro and consumer lending, BRI's portfolio of small loans has performed much better than its bigger loans. In 2007, the NPL ratio of micro loans (up to $5,000) was 1.2% and consumer loans, 1.7%, while the NPL ratios for small commercial loans (up to $500,000) and medium loans (up to $5 million) were 5.7% (Table 4). In terms of rural and urban portfolios, 30.0% of BRI's loan portfolio reportedly is in rural and

**Figure 2: Bank Rakyat Indonesia Total Assets, Loans Outstanding, Deposits, and Equity, 1996–2007**
($ million)




Source: Bank Rakyat Indonesia.

**Figure 3: Bank Rakyat Indonesia Capital Adequacy Ratio, Nonperforming Loan Ratio, Return on Assets, and Return on Equity, 1996–2007**
(%)




CAR = capital adequacy ratio, NPL = nonperforming loan.
Source: Bank Rakyat Indonesia.

70% in urban areas. BRI's agricultural lending amounts to about $3.5 billion and accounts for almost 30% of the total portfolio. This makes BRI the largest agricultural loan provider in Indonesia. The ratio of nonperforming agricultural loans is higher than the ratio for the overall portfolio—a challenge for BRI to further improve its risk management in agricultural lending.

### Table 3: Bank Rakyat Indonesia Loans Outstanding by Business Segment, 1998–2007[a]

| Business Segment | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|---|---|
| Micro (%) | 11.1 | 18.2 | 30.3 | 30.8 | 30.7 | 30.6 | 31.0 | 30.4 | 30.2 | 28.6 |
| Small Consumer[b] (%) | 7.3 | 11.0 | 21.8 | 24.3 | 24.4 | 23.8 | 23.2 | 22.1 | 21.2 | 19.4 |
| Small Commercial[c] (%) | 42.9 | 46.8 | 17.5 | 19.2 | 24.1 | 26.6 | 27.6 | 27.9 | 27.0 | 27.3 |
| Medium-Scale (%) | 4.2 | 5.4 | 6.7 | 4.9 | 3.9 | 4.4 | 4.7 | 6.3 | 8.3 | 7.3 |
| Corporate (%) | 34.5 | 18.6 | 23.7 | 20.8 | 16.9 | 14.6 | 13.5 | 13.3 | 13.3 | 17.4 |
| **Total (%)** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** |
| **Total (Rp trillion)** | **42.16** | **32.45** | **25.79** | **31.98** | **39.03** | **47.53** | **61.98** | **74.90** | **90.28** | **113.85** |
| **Total ($ billion)** | **5.25** | **4.57** | **2.69** | **3.07** | **4.37** | **5.64** | **6.68** | **7.62** | **9.61** | **12.09** |
| Exchange rate (Rp) | 8,025 | 7,100 | 9,595 | 10,400 | 8,940 | 8,425 | 9,285 | 9,830 | 9,393 | 9,419 |

[a] Totals in rupiah and dollars for 1998–2005 differ slightly from those reported in Financial Highlights.
[b] Small consumer loans include salary-based, car, mortgage, and credit card loans.
[c] Small commercial loans include program loans and Sharia loans.
Source: Bank Rakyat Indonesia.

### Table 4: Bank Rakyat Indonesia Nonperforming Loan Ratios by Business Segment

| Business segment | Loan Size | | Portfolio 31 December 2007 | | |
|---|---|---|---|---|---|
| | **Rupiah** | **$** | **$ million** | **%** | **NPL Ratio (%)** |
| Micro | Up to 50 million | 5,000 | 3,457.05 | 28.6 | 1.19 |
| Small Consumer | Up to 200 million | 20,000 | 2,332.90 | 19.3 | 1.67 |
| Small commercial | Up to 5 billion | 500,000 | 3,299.91 | 27.3 | 5.71 |
| Medium–Scale | 5 billion–50 billion | 500,000–5 million | 882.39 | 7.3 | 5.67 |
| Corporate | >50 billion | >5 million | 2,103.24 | 17.4 | 4.62 |
| **Total** | | | **12,087.59** | **100.0** | **3.44** |

Nonperforming loan (NPL) ratio = ratio of dollar value of nonperforming loans to value of total loans outstanding.
Source: Bank Rakyat Indonesia.

**Table 5: Bank Rakyat Indonesia Financial Highlights, 1996–2007**
(Year-End, $ million)

| Item | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total assets ($ million) | 14,440.2 | 8,809.5 | 4,252.3 | 4,368.3 | 6,913.4 | 7,326.4 | 9,658.3 | 11,241.5 | 11,528.3 | 12,489.9 | 16,472.4 | 21,616.3 |
| Loans (gross) ($ million) | 11,225.3 | 6,817.6 | 5,410.1 | 3,929.7 | 2,817.1 | 3,223.9 | 4,404.1 | 5,649.7 | 6,717.1 | 7,683.9 | 9,611.7 | 12,087.6 |
| Government recapitalization bonds ($ million) | 0.0 | 0.0 | 0.0 | 0.0 | 3,020.5 | 2,734.2 | 3,176.1 | 3,275.6 | 2,443.3 | 1,802.8 | 1,963.7 | 1,934.7 |
| Deposits ($ million) | 8,101.1 | 5,417.8 | 5,324.2 | 5,801.0 | 5,129.4 | 5,553.7 | 7,788.3 | 9,058.3 | 8,874.5 | 9,872.4 | 13,251.3 | 17,568.2 |
| Total equity ($ million) | 759.5 | 395.1 | (3,083.7) | (3,702.4) | 422.4 | 462.9 | 648.1 | 1,003.4 | 1,340.9 | 1,358.4 | 1,797.0 | 2,063.7 |
| **Profit/Loss** | | | | | | | | | | | | |
| Net interest income[a] ($ million) | 672.3 | 422.8 | (203.6) | (149.0) | 291.1 | 477.1 | 680.1 | 952.8 | 1,212.5 | 1,267.2 | 1,466.0 | 1,772.7 |
| Income before tax ($ million) | 144.8 | 29.9 | (3,308.5) | (235.4) | 35.0 | 109.7 | 164.4 | 440.6 | 617.2 | 570.5 | 628.9 | 826.0 |
| Income after tax ($ million) | 101.1 | 12.0 | (3,308.5) | (235.4) | 35.3 | 102.3 | 170.6 | 306.1 | 391.3 | 387.5 | 453.3 | 513.6 |
| **Financial Ratios** | | | | | | | | | | | | |
| Total Capital Adequacy Ratio (%) | 8.69 | 8.10 | (61.54) | (118.35) | 14.35 | 13.32 | 12.62 | 18.94 | 16.19 | 15.29 | 18.82 | 15.84 |
| Nonperforming Loan Ratio (Gross) (%) | 10.60 | 11.40 | 52.98 | 19.94 | 4.96 | 4.93 | 6.74 | 6.03 | 4.19 | 4.68 | 4.81 | 3.44 |
| Return on assets (%) | 0.70 | 0.14 | (77.80) | (4.77) | 0.68 | 1.62 | 1.83 | 4.02 | 5.77 | 5.04 | 4.36 | 4.61 |
| Return on equity (%) | 5.26 | 3.04 | n.a.[b] | n.a.[b] | n.a.[b] | 30.36 | 38.81 | 43.41 | 42.76 | 37.92 | 33.75 | 31.64 |

| Item | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cost of funds (%) | n.a. | n.a. | n.a. | n.a. | n.a. | 9.14 | 10.04 | 7.86 | 4.60 | 4.73 | 6.27 | 4.52 |
| Net interest margin (%) | n.a. | n.a. | (3.18) | (3.41) | 6.60 | 7.60 | 8.12 | 9.54 | 12.16 | 12.17 | 11.16 | 10.86 |
| Operating expenses/ operating income (%) | 93.46 | 97.33 | 361.98 | 118.37 | 96.05 | 90.81 | 89.92 | 79.82 | 68.86 | 70.45 | 74.38 | 69.80 |
| Loans-to-deposits ratio (%) | 138.57 | 125.84 | 99.85 | 62.28 | 53.61 | 56.08 | 56.55 | 62.37 | 75.69 | 77.83 | 72.53 | 68.80 |
| Inflation rates, year-end (%) | 6.47 | 11.05 | 77.54 | 2.01 | 9.35 | 12.55 | 10.03 | 5.06 | 6.40 | 17.11 | 6.60 | 6.59 |
| Rp/$ exchange, year-end (Rp) | 2,383 | 4,650 | 8,025 | 7,100 | 9,595 | 10,400 | 8,940 | 8,425 | 9,285 | 9,830 | 9,393 | 9,419 |

0.00 = less than 0.01; ( ) = negative number; n.a. = not available.
Note: In cases of discrepancies between different sources, this table contains the latest figures available.
[a] With government recapitalization bonds interest.
[b] Not calculated because of negative capital, including the year of recapitalization. The recapitalization was in October 2000.
Source: Bank Rakyat Indonesia (BRI) annual reports; BRI *Financial Updates Full Year 2007*.

## Decisive Factors in Restructuring

The BRI reforms comprised a new management team, better control of management, reformulated targets, effective risk management, and adherence to the principles of good corporate governance under effectively enforced prudential regulation. It was during the 3 years immediately following the restructuring that the new management convincingly demonstrated a sustainable turnaround and steadily improving performance. But what were the decisive factors in BRI's turnaround toward good governance and continual growth?

The restructuring of BRI was a response to an unprecedented systemic crisis. One might have expected that the government would award a management contract to an international consulting firm and redefine BRI's mission. The government did the opposite. All directors, commissioners, and senior officers were selected from the state apparatus, having served in senior positions in state banks or other state institutions. At the same time, BRI's historic focus on micro and SME finance since its inception in 1895 was reconfirmed, and its corporate lending was reduced and restructured. This strategy turned out to be immensely successful. Partial privatization helped to clarify BRI's commitment to profit making, i.e., to better fulfill its mission, but not at the expense of mission drift.

Until 10 November 2003, BRI was wholly owned by the Government of Indonesia, with the Ministry of Finance as the only shareholder. The Minister for State-Owned Enterprises acted as administrative supervisor. The government employed BRI's management and defined its general business policy. Bank Indonesia is the financial supervisor; but until 1999, Bank Indonesia's powers were restricted by its lack of autonomy. In July 2000, a new BRI management took over. Its special task was to prepare BRI for its IPO. All members of the new board of directors (BOD) had a state banking background; there was no private sector experience on the board. The president director had been a director at BRI and had previously worked for 30 years at Bank Dagang Negara, a trade financing state bank. Of the six directors, four had worked at BRI for 20–25 years. In its new strengthened position, Bank Indonesia was able to exercise its influence when the new chief executive officer (CEO) of BRI was to be appointed. Two candidates proposed by the President of Indonesia at that time were turned down by Bank Indonesia; only the third was accepted.

The board of commissioners (BOC), which has four members, is at the apex of a three-tiered system of external audit, internal audit, and internal control. The candidate for the board presidency proposed by the President of Indonesia failed to pass Bank Indonesia's fit and proper test. The president commissioner, appointed by the Ministry of Finance, was a former university president; he resigned after 1 year. Of the three other commissioners, one came from Bank Indonesia, one from the state development bank, and the third from a state tourism enterprise. All three had studied in the United States and attended various professional development programs abroad. The Act on BRI of 1968 reserves BOD and BOC positions for nationals of Indonesia. The commissioners, who do not serve full time, are supported by a newly established audit committee that reports to the BOC. The BOC evaluates internal control, compliance with BRI's good corporate governance policies, the code of ethics, and the work of the external auditors. The internal audit department, which reports to the president director, meets regularly with the audit committee. BRI's supervision and audit structure comprises 11 inspection offices for internal audits and management supervision, 12 regional offices for the branches, and a multilayer system for the units.

BRI is determined to apply good corporate governance principles to all of its operations. Guidelines for their implementation are spelled out in a board manual, which defines the duties and responsibilities of the BOD and BOC. Attendance at board and audit committee meetings is under public inspection, being published in the annual report. BRI has developed a work ethics program and code of conduct, stipulating the principal dimensions of its corporate culture, namely, integrity, professionalism, customer satisfaction, setting a good example, and human resource appreciation.

During BRI's restructuring, ambitious targets were at the core of the bank's business plan. The new CEO set the targets for capital adequacy and profits over and above those required by the government. And these higher targets were exceeded by a considerable margin.[15] Ever-increasing dividends and tax payment far above targets acted as incentives for the government to keep from interfering, giving management the needed independence.

Implementation of the new corporate plan involved a change in corporate culture toward an open style of management and emphasis on greater communication and incentives. Like all state banks, BRI tended to be bureaucratic in its planning, decision making, and communication. Coming from outside, the new CEO conveyed an emphasis on direct communication as his first message. In practical terms, he made his mobile phone number and e-mail address available to all staff members and announced a "walk-and-talk" strategy for the board and management to communicate freely with staff at the head office and in the branches. To reach 35,000 employees scattered throughout the country, he used public media, with almost weekly appearances in national and local newspapers and on television.

At the time of the restructuring, BRI had the lowest salaries among state-owned banks. To motivate BRI's employees, salaries were increased by 20%–30% as of October 2000. Until 2000, a performance-based incentive scheme existed only in the units. In 2000, a new compensation program was introduced for the branches; the staff in profitable branches would receive the equivalent of an extra 1 month salary per year. In 2002–2003, a new formula was introduced, combining corporate and individual incentives; excellent performance would be rewarded with the equivalent of up to four extra monthly salary payments or more. In addition, BRI introduced a management stock option program and an

[15] The government required a CAR of 8% and set the profit target for 2000 at Rp11 billion. The CEO increased the target CAR to 12.5% and announced profit maximization as a target. Within 6 months, the CAR rose to 14.4% and profits reached Rp336 billion, i.e., 30 times the target. The CEO then increased profit targets to Rp500 billion in 2001, Rp1 trillion in 2002, and Rp2 trillion in 2003; actual profits before taxes were Rp1.14 trillion in 2001, Rp1.47 trillion in 2002, and Rp2.58 trillion in 2003.

employee stock ownership program.[16] The new culture of communication and performance rewards made the staff feel recognized and motivated them. With the listing of new shares from BRI's management stock option program, the government's ownership declined to 57% while the public's ownership increased to 43% as of 2006. The public ownership share was 43.2% as of September 2008. Foreign institutions owned 22.4% of the share capital at the time of the IPO, 28.4% by the end of 2003, and 38.3% at the end of 2006; correspondingly, domestic private ownership fell from 18.1% to 12.1% and 4.7%.

Risk management has moved to the center of attention of good governance at BRI. As required by Bank Indonesia since 2003, BRI manages eight risks, comprising credit, market, operational, strategic, compliance, legal, reputation, and liquidity risks. Since 2002, operational and integrated risks were managed by the division of compliance and risk management; credit risk by the division for credit administration; and market risk by the treasury division. These were in turn supervised by a risk management committee, comprising the BOD and senior management members. As of 1 January 2004, following adoption of new regulations by Bank Indonesia, risk management at BRI has been integrated in a single division for compliance and risk management, which implements BRI's written risk management policy. Since 2002, BRI has implemented a credit risk rating system, which provides information to its early warning system and has been basic to the calculation of allowances for possible loan losses, capital at risk, pricing, capital allocation, and portfolio management. To promote a risk awareness culture, BRI has also developed a risk self-assessment mechanism, measuring the performance of every employee and organizational unit and evaluating their respective risks.

Driven by the crisis, a decisive factor has been a firm, new commitment by both the government and bank management, to good corporate governance and performance excellence. Open communication and staff incentives, together with effective risk management, played crucial roles in developing this commitment. In addition, the prudential regulations enforced by the central bank have reinforced this commitment. The main emphasis of the new plan was on profit maximization in preparation for partial privatization. However, profit maximization at BRI is not unlimited. For example, the bank continues to serve remote areas, requiring branch and unit profitability, but not profit maximization. BRI intends to further expand its outreach beyond the 4,300 subdistricts presently served of the approximately 10,000 total subdistricts. In addition, BRI splits units in two once they reach a business volume requiring more than eight employees; profit maximization would require scaling-up and integration rather than division.



[16] Before going public, the staff were to receive Rp4 million in cash and Rp2 million in stocks to be held for at least 1 year; the stock option was increased to Rp4 million in 2002 and Rp6 million in 2003.

# Conclusions and Lessons Learned

Restructuring may encompass part or all of an institution and lead, accordingly, to partial or comprehensive transformation. At BRI, the restructuring of the units in 1984, preceded by interest rate deregulation and the withdrawal of liquidity, enabled the bank to build a rapidly expanding and increasingly profitable microbanking business, free of government interference. The strength of this business segment was an important factor in the survival of BRI when the monetary crisis hit in 1997–1998. Yet, during the 13 years preceding the crisis, the microbanking units remained isolated within the bank, and there was no spillover (or trickle-up) from sound microbanking principles to small and medium lending and corporate finance. These remained weak—with corporate lending being politically dominated—and were unable to withstand the crisis. It was only the total transformation of the bank in all its spheres, under conditions of prudential regulation enforced by an independent central bank, which has created what is now the most profitable bank with the widest outreach in Indonesia, resilient against the current global financial crisis.

Crisis is inevitable, and can result in positive changes when properly acknowledged and responded to. Governments often need a major external crisis to overcome vested interests that stand in the way of restructuring and reform. In the case of BRI, the government, responding to both an economic crisis in 1982 and a severe financial as well as political crisis in 1997–1998, generated the political will to reform BRI, first in microbanking and then in the context of an overall banking sector restructuring process. Both sets of reforms were implemented by management teams from Indonesia, with professional backgrounds mainly in state institutions rather than in the private sector. The driving force has been firm commitments, from the government and bank management, to good corporate governance and performance excellence. The first set of reforms was limited to the microbanking business segment, where a highly effective system of internal control was put in place. The second group of reforms covered all segments of the bank. Additional positive factors moving the reforms forward have included a corporate culture of open management, a strong emphasis on communication, and ambitious targets and performance incentives, together with effective risk management.

Effective methodologies of financial institution restructuring differ, depending on the country context. However, there are some fundamental principles that should be applied in the restructuring of SOFIs:

## Policy Framework

A finance sector environment conducive to change is a prerequisite for the restructuring of a financial institution. On the whole, repressive finance sector policies with heavy state interventions in financial institutions negatively affect the performance of institutions; such policies and interventions could ultimately lead to insolvency and costly bailouts of institutions. Eliminating interest rate ceilings (as Indonesia did in 1983), phasing out subsidized directed credit programs (as in 1983 and 1990), and the granting of operational autonomy to bank management are necessary, along with institutional restructuring.

However, finance sector liberalization must be accompanied by appropriate supervision and the enforcement of prudential regulation; deregulation must be followed by prudential re-regulation. Without it, the possible consequence is a rapid, but uncontrolled expansion of financial services and institutions with poor portfolio quality, as experienced in Indonesia during the 1980s. Effective supervision requires an autonomous financial authority which can enforce prudential standards. At BRI, in the first reform, the bank itself, with the assistance of the Harvard Institute for International Development, set up a system of appropriate regulation and effective internal control over its microbanking system. In the second reform, following the monetary crisis, the central bank was instrumental in establishing good corporate culture and risk management by enforcing prudential regulations and fit and proper tests for senior management. Both reform processes were preceded by adjustments in the policy framework.

## Ownership and Governance

An independent board of directors free of government interference as well as a code of conduct are indispensable for the successful transformation of a state-owned bank. However, the autonomy of the board of directors is difficult to assure under state ownership. Whenever the government owns a financial institution, it may be tempted to use the financial institution to implement its own agenda, often for gaining constituency support. In Indonesia, the budgetary constraint, caused first by the oil crisis of 1982, and then by the monetary crisis of 1997–1998, made it impossible for the government to provide budgetary support to SOFIs for politically motivated lending, concessionary loans, and loan waivers. The implicit guarantee of no interference by the government, driven in the second reform also by partial privatization, enabled BRI's management to concentrate on viability and profitability. The experience of BRI shows that majority private ownership and expatriate management, or a management contract with a foreign consulting firm, are not necessarily decisive for successful transformation.

## Strategy

Successfully transformed state-owned financial institutions may improve their viability through more-inclusive outreach. Many SOFIs were mandated to target specific groups or sectors. In the course of restructuring, institutions need to expand their outreach to other segments of society. BRI has expanded its focus both in rural and urban sectors with diversified products. Savings are the foundation of financial institution self-reliance. At BRI, surplus liquidity has been generated by the microbanking units since 1989, and in the bank as a whole since 2002. Especially for poor and other low-income clients, savings could be more important than credit. With appropriate products and marketing strategies, savings can be extended to the rural poor, which in turn can be a source of funds for further credit outreach and expansion. Attention to profitability is important. Outreach of a financial institution to vast numbers of low-income people is compatible with, and in fact contingent upon, viability and financial self-reliance. Average transaction costs can be lowered, and both the profitability of a financial institution and the volume of loanable funds, can be increased by catering to both the poor and the nonpoor, given their widely differing demands for deposit and loan sizes. The riskiest sector is neither the poor nor agriculture, but the corporate sector, in which BRI has substantially reduced its investment and which the bank has submitted to stringent risk management strategies.

## Institutional Change

The restructuring of an institution requires changes in the corporate culture and mindset of both management and staff. The restructuring of a state-owned financial institution needs to incorporate measures to install good corporate governance. For BRI, management's efforts toward open communication, ambitious targets, and performance incentives, together with effective risk and compliance management, have motivated staff and management to maximize their effort. The new corporate culture at BRI has led to performance far beyond any planned targets.

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# Appendix 1: The Evolution of Bank Rakyat Indonesia: In Search of the Most Effective Inclusion[1]

## Prehistory, 1895–1945

The development of the precursor to Bank Rakyat Indonesia (BRI) began with Raden Bei Aria Wiryaatmadja, vice regent of Banyumas. In 1894, he gave a low-interest loan from his own pocket to a teacher to pay back a usurious loan from a money lender; the teacher had taken the loan to finance a family ceremony. Raden Bei Aria Wiryaatmadja was then entrusted with the management of the local mosque's treasury, which he used to extend loans to civil servants and others. In response to the critique that he was diverting the mosque's funds, and with the approval of his Dutch colonial superiors, he founded the Hulp en Spaarbank der Inlandsche Bestuurs Ambtenaren in December 1895, for the civil service gentry, or *priyayi,* in Indonesia. In 1897, under a new manager, de Wolff van Westerrode, the bank experienced its first reorganization. Based on the Ordinance of 11 August 1897, the bank was given legal status and renamed Poerwokertoesche Hulp, Spaar en Landbouw Credietbank, popularly known as Volksbank (the people's bank). At the same time, it was structured as a member-owned institution, with outreach to creditworthy Indonesians of any occupation, as well as European civil servants in the regency in Indonesia. Its products were expanded to include savings and credit in kind as well as cash.

The bank comprised elements of both self-reliance through savings mobilization and protection provided by the government or state. It became the model for two types of institutions: banks for the priyayi, and cooperative banking institutions with a more diversified clientele. This was paralleled by the establishment of a rapidly growing number of decentralized village credit institutions under community control (today's Badan Kredit Desa, or BKD). State supervision through supervisors who were nationals of Indonesia was organized by the Ministry of Interior Affairs. In 1906, the growth of these village credit institutions, which combined social and commercial banking elements, was declared a priority. These two elements clashed frequently, which led to many closures—the latter being an indication that supervision was being taken seriously. By 1913, the decentralized finance sector of Indonesia—the so-called popular credit system—comprised 75 district banks, 12,424 paddy banks (*lumbung desa*), and 1,336 money banks (*bank desa*). The system was highly liquid, relying almost entirely on mobilization of local resources and self-financing, with interest rates between 25% and 45% annually.

Historically, the popular credit system in Indonesia owes its origins to a combination of crisis and poverty, including (i) the impoverishment of the rural population due to the coercive recruitment of plantation labor until 1870; (ii) the opening up of the rural sector to the capitals of Europe and the People's Republic of China after enactment of the Agrarian Law of 1870, exposing the sector to the fluctuations of global markets; (iii) an increasing land shortage; (iv) the global commodity crisis of 1884, which led to the demise of the agricultural investment banks; and (v) a growing indebtedness to money lenders. As in various European countries, usury and the resulting indebtedness were a major cause of impoverishment. In Indonesia, this was believed to threaten the stability of the colonial system. The establishment of a popular credit system ("inclusive

[1] This chapter is largely based on Schmit (1991) and Bank Rakyat Indonesia (1995).

finance," in today's terminology) appeared as a possible panacea and became the linchpin of the ethical policy ("social banking," in today's terminology) after 1904.

At the same time, central state intervention was deemed necessary, leading to a dual policy formalized in 1913 by two ordinances dealing with (i) the decentralized people's credit system, *Volkscredietwezen*, which lives on in various networks of local financial institutions in private, local government, community or cooperative ownership, such as BKD, Bank Perkreditan Rakyat (people's credit bank), Lembaga Dana Kredit Perdesaan (institution for rural funding and finance), and Koperasi Simpan Pinjam (saving lending cooperative); and (ii) the establishment of a central fund, *Centrale Kas voor het Volkscredietwezen,* a predecessor of BRI*.* By 1925, the Volkscredietwe*zen* flourished—serving one in six rural households—after having resisted efforts to turn the village banks into cooperatives. By contrast, the Centrale Kas struggled, suffering from losses on wartime investments, low interest rates, and an overall lack of functional effectiveness either as a supervisor or as an apex bank. [2]

Efforts to centralize the Volkscredietwezen persisted, against strong opposition. The Great Depression was the next crisis presenting an opportunity for restructuring. The depression hit the district banks hard, while the village banks remained astonishingly resilient. Despite that resilience, in a paternalistic attempt to strengthen central control, the *Algemeene Volkscredietbank* (AVB) was established in 1934. The AVB was a nonprofit multifunctional welfare organization ("Credit-Plus," in today's terminology), regulated and managed as a private company. Among its objectives were (i) the conversion of the 90 district banks into AVB branches, (ii) transformation of the boards of the district banks into local welfare committees, (iii) the consolidation of the village banking system, and (iv) the channeling of debt relief through cooperatives.

After the Japanese occupation in 1942, the AVB was broken up into two parts. The AVB head office and branches were integrated into the Yokohama Species Bank, with greatly restricted lending operations. The village banks were converted into the Syomin Ginko (people's banking) corporation. With a request by the authority of being one of its functions, loan funds were soon depleted, villages were impoverished, and, toward the end of World War II, the village banks came to a complete standstill; many did not recover.

## Postwar History, 1945–1983

On 17 August 1945, then President of Indonesia Sukarno declared independence, which was internationally recognized only after 4 years of fighting, in 1949. This was followed by a period of political instability, economic uncertainty, and state intervention, comprising the following: (i) the demise of liberalism; (ii) concepts of "guided democracy" and "guided economy" (introduced in 1957); (iii) a clash of collectivist, cooperativist, and Keynesian ideas (i.e., new ideological forms of "inclusive finance"); (iv) political agitation and corruption; (v) the nationalization

[2] An apex bank refers to a single bank serving a group of financial institutions.

of former Dutch companies, plantations, and banks; (vi) an ongoing threat of a communist takeover; (vii) a military coup in 1965 led by General Suharto; and (viii) finally, the collapse of the economy and currency. In 1966, General Suharto became president (until 1998). His "New Order" policy created a climate of growth and development. Investments in social and economic development, financed from the proceeds of oil and natural gas sales as well as plantation commodity and textile exports, paid off; annual economic growth rates until the 1997/1998 Asian financial crisis hovered around 6%; the poverty rate fell from 60% in 1970 to 11.5% in 1996. This is the context in which BRI gained its new shape.

After independence, an agreement was reached with Japan to replace Syomin Ginko with BRI; but the smooth transition was interrupted by the arrival of the Allied forces, together with the Dutch army, in September 1945. On 22 February 1946, BRI was formally established as a successor to AVB and Syomin Ginko, financed by a national loan. Yet the war for independence led to the partition of the country as well as of BRI into two parts: the re-establishment of AVB in the Dutch part, and a confusing flux in organizational structure between the two entities. Similarly confusing was BRI's mandate: (i) lending to the government; (ii) lending to small enterprises in the informal sector; and (iii) lending to enterprises of the emerging middle class (the small and medium-sized enterprise sector in today's terminology)—an agenda that surpassed its capacity by a wide margin.

Finally, Indonesia became independent as a unitary nation on 15 August 1950, which also led to the reunification of BRI and the legal abolishment of AVB. On 20 April 1951, BRI was declared a government-owned bank for the middle class as well as a supervisor of rural banks and cooperatives, with an extremely broad mandate: (i) conducting banking business in general, (ii) collecting savings from the public, (iii) restoring the village banks, (iv) providing guidance and supervision to cooperatives and village banks, (v) managing funds of communities and other institutions, (vi) handling government programs, (vii) extending commercial credit to the middle class, and (viii) acting as a special bank for groups that were beyond the reach of other agencies. Credit was made available to any sector—e.g., agriculture, industry, trade, and salaried individuals. Business expanded during the 1950s, but with many ups and downs, due to a continual struggle with nonperforming loans. For example, in 1954, disbursements of BRI's 112 branches amounted to Rp364 million. Of that total, 19% represented rural loans, 14% fixed-income loans, and 67% business loans. Of the total of 455,600 loans outstanding, 63% were village microloans, 20% fixed-income loans, and 17% small and medium-sized enterprise (SME) business loans. Arrears stood at 15%. In 1956, BRI became a foreign exchange bank.

In 1958, the farmers' and fishermen's bank, Bank Tani Nelayan (BTN), was created, as the government's instrument of microcredit to the rural poor, a market segment that did not seem to be adequately served by BRI. In the same year, a new cooperative law was passed, giving the state a decisive role in the formation, guidance, and control of cooperatives; thus, perverting the self-help character of cooperatives from the onset. In 1959, a currency reform and the freezing of deposits led BRI to a money-losing year; but the following year, 1960, the bank recovered. In 1960, too, BRI and BTN together with a nationalized

Dutch bank, were merged to form the Cooperative Farmers' and Fishermen's Bank, Bank Koperasi Tani dan Nelayan (BKTN), comprising 165 branches and some 500 mobile units. The new bank was given the mandate of (i) supporting cooperatives, farmers, and fishermen; (ii) supervising 8,000 village banks; and (iii) contributing to building a socialist Indonesian society. Fishermen and their cooperatives were to be served by a special targeted credit program, based on a model of "supervised credit" originally designed by experts of the Food and Agriculture Organization of the United Nations.

In 1965, further experimentation by the state ensued. BKTN, like other state banks, was integrated into Bank Indonesia, the central bank, and a month later into a new single state bank, Bank Negara Indonesia. Political upheaval, soaring inflation rates, and a drastic decline in incomes led to the collapse of the economy and the currency, also affecting the newly established Bank Negara Indonesia, and finally to the downfall of the "Old Order".

After the beginning of the New Order under Suharto in 1966, Bank Law No. 14 of 1967 reestablished the state banks as "primary banks" according to their former division of labor; the decentralized credit institutions were given the status of "secondary banks," referred to as Bank Perkreditan Rakyat (BPR). Bank Indonesia was given a dual function of central and development banking. The consolidation of the banking sector benefited from successful stabilization and rehabilitation policies; the inflation rate fell from 650% in 1966 to 9.8% in 1969.

Law No. 21 of 1968 reestablished BRI as a commercial bank and the government's main policy instrument in the rural sector, with the task of financing the green revolution and integrated rural development. In addition to serving agricultural estates, cooperatives, and rural SMEs, and supervising close to 6,000 BPRs, the former BKTN was maintained as a division of BRI, handling the Bimas program of subsidized credit to farmers' groups in its early phase, with the objective of rice self-sufficiency.[3] In the tradition of the "dual economy" of the colonial period, BRI was thus again given a dual function: (i) commercial general lending according to banking criteria, and (ii) concessional special loan programs for small farmers and SMEs.

Subsidized targeted credit programs designed by government and donor agencies increasingly dominated BRI's agenda. In 1969, BRI was appointed as the only bank for the Bimas credit program. That same year, Kredit Investasi Kecil/ Kredit Modal Kerja Permanen, a national small enterprise development program mainly for industry, trade and services, was introduced, with BRI as the main disbursement agency through its branches. Numerous other programs followed; Bank Indonesia supplied the required funds. To handle the Bimas program, BRI



3 The involvement of BRI/BKTN in the disbursement of Bimas credit started during the first phase of Bimas, in 1964–1968.

established a network of so-called village units (unit desa), set up mostly at the subdistrict (*kecamatan*) level. As Kuiper (2004:139) noted:

> ….the Village Units were *not* an attempt to introduce micro-finance in Indonesia. There was already more than 75 years experience with micro-finance… BRI was in 1968 already fully engaged in micro-finance activities through its district offices, Mobile Units and its involvement in 5,000 Badan Kredit Dasa (BKDs) (village credit institutions).

A surge in the oil price in 1973 (and again in 1979) enabled Indonesia to invest substantial amounts in development programs. Following a presidential instruction in 1973, the number of units increased to 2,131, with 6,079 employees (out of a total of 14,564); at the same time, the BRI units were reduced to disbursement agencies, without the authority to select clients or enforce repayment. Credit was insured by Ascrindo, a state insurance agency, with the exception of cooperative credit, which was insured by a Cooperative Guarantee Agency, Lembaga Jaminan Kredit Koperasi. The oil price boom also led to a surge of local and rural development grants, injecting liquidity into the rural economy, but undermining the credit culture.

Since 1975, BRI has handled an increasing number of donor projects, particularly in the agriculture sector, either as a handling bank compensated by a fee, or as an executing bank with a stronger operational role.

Starting in the early 1970s, with assistance from various agencies including Asian Development Bank (ADB), BRI modernized its operations in a variety of areas, including (i) organizational structure, (ii) performance rating, (iii) accounting, (iv) reporting, (v) internal control, and (vi) customer relations. Savings mobilization through various products became increasingly important as a source of funds for BRI's commercial operations.

The year 1983 marked the end of the disbursement of program credit by the BRI units, putting the future of the whole network into jeopardy. Program credit, including liquidity supplied by Bank Indonesia and interest rate subsidies, continued to be provided by the BRI branches. In 1983, BRI comprised 292 branches and 3,617 village units, with a total of 31,777 employees, 45% of them in the units—the largest delivery network of any bank in Indonesia. When given the option of either closing or reforming the units, BRI opted for reform and became the largest and most successful provider of commercial microfinance in Indonesia.

# Appendix 2: Finance Sector In Indonesia

## Policy Framework

Following the oil price increases of 1973–1979, Indonesia, as an oil-exporting country, invested substantial amounts in development, using directed credit as one of its tools. In a policy environment of state control, or financial repression, interest rates were regulated and the finance sector was dominated by state banks including Bank Rakyat Indonesia (BRI). BRI was the main provider of directed credit. In contrast to the abundance of financial resources in the early 1970s, the decline of the oil price in 1982 and the resulting loss of income from oil exports initiated an era of liberalization and deregulation, shifting from a supply-driven to a demand-driven financial system approach. In the process, market forces replaced the government as the prime mover of development.

The macroeconomic environment developed as follows: inflation fell from 20% in fiscal year (FY) 1973–1974 to 5.7% in FY1985–1986. Low inflation rates are an important prerequisite for financial market liberalization. In commercial banking and rural finance, the policy environment evolved rapidly toward conduciveness, with an emphasis during the 1980s on deregulation and an increasing concern with prudential regulation during the 1990s. From 1982 to 1990, M2 as a percentage of gross domestic product (GDP), a standard indicator of financial deepening, rose from 16% to 43%; the economy seemed ready for take off into rapid growth.[1] GDP growth rates averaged 7% per annum during 1979–1996. At the same time, Indonesia was hailed as one of the most successful countries in poverty reduction, with a decline in the percentage of poor people from 60% in 1970 to 11.5% in 1996 (The World Bank, 1999).

In October 1988, the government further liberalized the finance sector by passing a law (PAKTO27) that eased the establishment of new commercial banks and bank branches. It also provided a legal framework for the establishment of Bank Perkreditan Rakyat (BPR) (people's credit bank) as part of the regulated banking sector, with a minimum capital requirement of $29,000.[2] This led to great optimism and a rapid expansion of the banking sector, comprising commercial and rural banks. Under such circumstances, it proved impossible for Bank Indonesia to enforce prudential regulation against the vested interests of corporate Indonesia and the political class as well as the advocates of rapid equitable growth and development.[3] Bank Indonesia generally lacked

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1 M2 is a broader category of money supply that includes cash, demand deposits, savings deposits, and non-institutional money market funds. The ratio M2/GDP is a measure of the money supply relative to the size of the economy. It is strongly correlated with the level and the rate of change of the gross domestic product per capita. A higher ratio indicates greater financial sector depth.

2 Bank Perkreditan Rakyat (BPR) was used as a generic term before the passage of the PAKTO27 law in 1988, referring to nonbank financial institutions. Most of them are under provincial law, referred to as Lembaga Dana Kredit Pedesaan. Since PAKTO27, the term BPR, strictly speaking, refers only to BPRs licensed and supervised by Bank Indonesia. All old-type BPRs were supposed to be transformed into regulated BPRs; but Bank Indonesia was unable to enforce this against strong opposition in the provinces. As a result, old- and new-type BPRs coexist.

3 Bank Indonesia had a dual mandate: monetary policy maker and regulator on the one hand, and development banker on the other hand. These two objectives conflicted at times. After 1998, the development banking function was drastically reduced.

independence and enforcement power, and could not adequately regulate the rapidly growing banking industry, especially in the late 1980s. Powerful conglomerates established banks of their own, which borrowed cheaply on international markets and competed vigorously for the mobilization of domestic deposits to finance their expansion. Lending decisions of state banks were under political influence. Strong links between the political and the economic class further exacerbated the conflict of interest between prudent banking and adventurous corporate expansion. The government fully controlled Bank Indonesia, which was thus unable to enforce prudent banking in terms of supervision, and the banking sector was practically out of control.

The process of steady growth was unexpectedly interrupted by the monetary crisis in 1997–1998, which led to a standstill in the economy, the collapse of the banking sector, and the downfall of the political regime. June 1997 marked the beginning of the Asian financial crisis, initially affecting the baht in Thailand, the peso in the Philippines, and the ringgit in Malaysia, and then hitting the Indonesian rupiah more than any other currency. As the crisis reached Indonesia, the government officially enlisted the support of the International Monetary Fund (IMF) to preempt a further deepening crisis. In October 1997, the government signed a letter of intent with the IMF concerning a 3-year economic reform program. Finance sector reform was one of three major reform initiatives that the government committed to implement under the IMF's support. In November 1997, the IMF approved a 3-year standby agreement under which the government was to borrow $10 billion.

The worst year for Indonesia's economy was 1998, when GDP plunged 13.7%; inflation soared to a rate of 77%; and a widely fluctuating rupiah reached its lowest value ever in June, at Rp16,725 to the US dollar. While interest rates skyrocketed, the net interest margin of the banking sector turned negative, resulting in heavy losses for most of the banks. In the midst of rioting and looting, President Suharto was forced to step down.

The crisis revealed the dangers of financial deregulation without effective supervision, and the risks of excessive short-term hard-currency borrowings. It also revealed the fragility of the banking sector as well as the weaknesses of programs for alleviating poverty, leading to a doubling of the number of poor.

However, the crisis opened a window of opportunity for the enforcement of prudential standards, together with the restructuring of the banking sector. Indonesia's economic policy performance over 6 years from 1998 to 2003, under the supervision of the IMF, was successful in implementing macroeconomic policies. Finance sector crisis management was geared to (i) bank rehabilitation by the government, at an estimated cost of $70 billion (at the time, the most expensive bailout in global banking history); and (ii) the enforcement of prudential regulation through effective supervision. Bank Indonesia upgraded the regulatory framework of the banking sector for internal controls, internal audit, and regulatory compliance. In 2000, it issued new regulations concerning capital adequacy (at least an 8% capital adequacy ratio [CAR] was required) and nonperforming loans (NPLs) (a ratio below 5% was required). Since 2000, both the economy and the banking sector have shown steady progress.

The following highlights summarize the chronology of events related to the policy framework since 1983:

- **1983:** Full interest rate deregulation, elimination of credit ceilings and a reduction of Bank Indonesia liquidity credit led to the reform of the BRI unit *desa* (village units) system.
- **1987:** External trade liberalization and conversion of state enterprise deposits in state banks into Bank Indonesia certificates were undertaken to prevent hard currency speculation.[4]
- **1988:** A new finance sector deregulation package, PAKTO27 law for the opening of new private banks and bank branches, and the establishment of local rural banks as part of the regulated banking sector led to (i) rapid expansion of the banking sector, though without simultaneously strengthening bank supervision; and (ii) reduction of reserve requirements for commercial banks from 15% to 2%.
- **1990:** Phasing out of 32 of the 36 major subsidized credit programs; and introduction of a 20% small and medium-sized enterprise (SME) lending quota for commercial banks were implemented.
- **1990–1991:** Timetable announced for the introduction of prudential standards on CARs, legal lending limits, and foreign exchange net open positions.
- **1991:** A tight monetary policy was implemented, withdrawing Rp8.1 trillion ($4.1 billion) from the government and state banks.
- **1992:** A new banking law was passed, recognizing two types of banks: commercial banks and rural banks.
- **1993:** The CAR was raised to 8% and deadlines were set for banks to meet legal lending limits.
- **1995:** Tax incentives for bank consolidation and mergers implemented.
- **1996:** New regulations providing for bank liquidation procedures were introduced; and the minimum reserve requirements were increased from 3% to 5%.
- **1997:** Unfolding of the financial crisis beginning in July; closure of the first group of 16 banks without deposit protection; bailout by the government of depositors for up to Rp20 million ($4,300.00) each occured.
- **1998:** The rupiah was devalued, from Rp2,383 = $1.00 US dollar in 1996 to Rp4,650 = $1.00 in 1997 and Rp8,025 = $1.00 in 1998 (end-of-year rates), after a dip to above Rp16,000 = $1.00 in mid-1998; and Bank Indonesia announced a blanket guarantee for the deposit liabilities of national banks.
- **1999:** 38 private domestic banks were closed; first recapitalization bond issue of $19.4 billion was sold; 4 state banks were merged to become Bank Mandiri; a new law made the central bank, Bank Indonesia, independent; the government declared its intention to establish a separate bank supervision agency; rules on prudent banking were enunciated; and "fit- and-proper" tests for bank directors and commissioners were established.
- **2000:** The bank CAR was set at a 4% minimum while the acceptable NPL ratio was set at below 5%.

[4] Bank Indonesia certificates are commonly known as *Sertifikat Bank Indonesia*.

- **2001:** A Master Plan for Bank Supervision announced following the Basel Core Principles; the CAR was increased to a minimum of 8%; a draft law on *Lembaga Keuangan Mikro*–microfinance institutions was announced (the law is still pending).
- **2002:** The minimum acceptable CAR was increased to 12%; and the blanket guarantee for third-party deposits was extended.
- **2003:** Preparatory measures for the establishment of deposit insurance and a financial safety net were announced.
- **2004:** Lembaga Penjamin Simpanan—the Indonesia Deposit Insurance Corporation—was established, and became operative as of 2005; the Indonesian Banking Architecture plan was presented, with only so-called anchor banks that fulfill criteria set by Bank Indonesia allowed to operate outside their respective province, to engage in foreign exchange trade, and to acquire other banks; the Indonesian Bank Restructuring Agency was wound up, transferring some functions to other institutions.[5]
- **2005:** Restrictions were placed on lending to business sectors with above-average NPL ratios.
- **2006:** An incentives package to promote bank consolidation was implemented; new regulations on earning-asset quality, legal lending limits, merger incentives, and good governance were implemented.
- **2007:** The deposit guarantee threshold was slashed by 90% to $10,600; and macroeconomic policy was prudently managed in the face of escalating world oil prices and the subprime mortgage crisis in the United States.
- **2008:** Minimum capital requirements of anchor banks were imposed at Rp80 billion ($8.7 million).

## Financial Institutions

The institutional liberalization of 1988 had led to a rapid and practically unfettered expansion of the commercial banking sector, particularly of private banks. The number of banks more than doubled, from 111 in 1988 to 240 in 1994. The number of bank offices almost tripled, from 1,728 in 1988 to 4,888 in 1994, excluding BRI's unit desa. This was accompanied by a shift from state to private banks as the dominant subsector, including many banks established by private companies for the expansion of their business. The share of public banks in loans outstanding declined from approximately 90% before 1988 to 30% before the outbreak of the financial crisis. Since February 1991, after the introduction of a tight money policy, the taking back of Rp8.1 trillion ($4.1 billion) from the government and private banks, and a resulting increase in interest rates, banks competed ever-more-vigorously in both the deposit and credit markets. Commercial banks also benefited from the reduction of minimum reserve requirements from 15% to 2%. On the eve of the financial crisis, this action had lowered the quality of the banks' loan portfolios and had weakened their capital base.

[5] Bank Indonesia defines anchor banks as those which have: (i) capital of at least Rp100 billion for the last 3 years; (ii) a capital adequacy ratio (CAR) of at least 12%; (iii) a minimum return on assets of 1.5%; and (iv) a minimum loan–to–deposits ratio of 50%.

The monetary crisis affected the commercial banks most severely. BPRs, without foreign exchange and corporate exposure, were less affected.[6] The fragility of the commercial banking sector had been largely due to poor governance i.e., insider lending and political interference; currency and maturity mismatches; and a lack of market discipline after years of rapid economic expansion, which was exacerbated by weak regulation and a lack of adequate supervision. As the crisis unfolded, the banking sector found itself unable to cope with the surge in exchange and inflation rates, capital flight, and depositor and creditor runs. All state-owned commercial banks and all major private banks were affected.

From 1999 to 2000, the banking sector continued to decline total assets declined from \$142.1 billion to \$107.5 billion; loans outstanding fell from \$39.1 billion to \$33.4 billion; and deposits dropped from \$87.2 billion to \$72.9 billion. The turnaround began during the latter part of 2000, when the government recapitalized BRI. In 2001, the banking sector had stabilized at approximately those levels. The performance indicators demonstrated the turnaround from 1999 to 2000: capital went from –\$5.8 billion to +\$5.5 billion; net interest margin rose from –5.4% to +2.4%; profits before taxes rose from –\$12.9 billion to +\$1.1 billion; and the gross NPL ratio fell sharply from 21.8% to 5.8%. All of these indicators showed further improvement in 2001. After recapitalization, only 8 of the 144 remaining banks missed the target 8% CAR in 2001. As a result of the huge recapitalization costs, especially for the state banks, the government's outstanding domestic debt surged from 0% of GDP in 1996 to 39% in 2002 (ADB 2005b).

By 2001, the number of commercial banks that had existed in mid-1997 had been reduced by about 40%, from 238 to 144: 68 had been closed, 14 had been merged, and 12 had been taken over by the state. By 2004, the remaining number had further shrunk to 138, and by 2006 to 130, including 5 state-owned commercial banks and 26 regional development banks. By 2007, most of the banks that had been nationalized under the government's restructuring and divestment program had been sold back to the private sector. As of 2008, the government had full stakes in Bank Mandiri and Bank Negara Indonesia, and controlling stakes in BRI and Bank Tabungan Negara, the national savings bank.

From 1999 to 2007, the performance of the banking sector improved substantially, from a CAR of –8.1% in 1999 to +19.3%; and return on assets improved from 1.9% in 2002 to 2.8% in 2007. Total assets grew by 16.9% from \$180.3 billion in 2006 to \$210.9 billion in 2007; and loans outstanding grew by 19.9%, from \$88.7 billion in 2006 to \$106.4 billion in 2007. Banks are still over-liquid, with a preference for low-risk investments in central bank papers,

6 At the time when commercial banks were decimated, the number of BPRs continued to grow throughout the crisis, from 1,987 banks in 1996 to 2,427 as of 1999. Until 2000, Bank Indonesia monitored their activities, but did little to enforce prudential standards. It was only in 2001 that Bank Indonesia began to intervene, bringing the number of BPRs down to 2,141 as of 2002. A second wave of intervention began in 2005. In 2006, 134 rural banks were merged into 14, while 6 were liquidated, bringing their number down to 1,880. Despite the reduction in their numbers, their total assets in rupiah terms almost doubled from Rp12.6 trillion in 2003 to Rp23.0 trillion in 2006, while loans outstanding grew from Rp8.9 trillion to Rp16.9 trillion.

but have improved their loans-to-deposits ratio from 26.2% in 1999 to 64.7% in 2006. With regard to the gross NPL ratio, which declined from 32.8% in 1999 to 7.0% in 2006 and to 4.1% in 2007, there is still room for improvement. The favorable macroeconomic trend also helped the improvements in the finance sector. The GDP growth rate rose from 3.5% in 2001 to 5.0% in 2004 and reached 6.3% in 2007; inflation rates were mostly single-digit, with an exceptionally high 17.1% in 2005 falling to 6.6% in 2006 and in 2007.

**Table A2: Performance Ratios of Commercial Banks, 1999–2007** (%)

| Year | CAR | ROA | NPL (gross) | LDR |
|---|---|---|---|---|
| 1999 | (8.1) | n.a. | 32.8 | 26.2 |
| 2000 | 12.5 | n.a. | 18.8 | 33.2 |
| 2001 | 20.5 | n.a. | 12.1 | 33.9 |
| 2002 | 22.5 | 1.9 | 8.1 | 49.1 |
| 2003 | 19.4 | 2.5 | 8.2 | 53.7 |
| 2004 | 19.4 | 3.5 | 5.8 | 61.8 |
| 2005 | 19.5 | 2.6 | 8.3 | 64.7 |
| 2006 | 20.5 | 2.6 | 7.0 | 64.7 |
| 2007 | 19.3 | 2.8 | 4.1 | 66.3 |

( ) = negative number, n.a. = data not available, CAR = capital adequacy ratio, LDR = loans-to-deposits ratio, NPL = nonperforming loan ratio, ROA = return on assets.
Source: Bank Indonesia.

The impact of the crisis on commercial microfinance has not been uniform, bringing out both the strengths and weaknesses of the different subsectors. Overall, while the commercial banking sector virtually collapsed, commercial microfinance institutions weathered the crisis relatively well, foremost among them the BRI units.[7] On one hand, this testifies to the strength of the legal and institutional foundations of the microfinance sector, its self-reliance, and the public's trust in the sector; and on the other hand, it also testifies to the absence of the two fundamental problems experienced by the commercial banks: (i) outside interference in lending decisions, and (ii) excessive foreign exchange risk exposure of the banks and their corporate sector clients. In contrast, microfinance institutions mobilized their resources domestically, and most of them applied sound lending practices.

[7] Mainly comprising BRI units, BPRs licensed by Bank Indonesia, and BPRs licensed under provincial laws. The number of BPRs actually continued to grow, from 1,987 BPRs in 1996 to 2,427 BPRs in 1999. It was only in 2000 that Bank Indonesia began to enforce its regulation of BPRs more rigidly. As a result, the number of BPRs declined to 2,419 in 2000 and continued to fall to 2,010 BPRs in 2005. But this reflected more a long-overdue overhaul of the BPR sector than the immediate results of the monetary crisis.